Wyoming Trusts for California Residents: Reduced Income Tax, Asset Protection, and Other Advantages

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INTRODUCTION

Consider an investment adviser who provides services to a middle-aged professional couple that resides in California and has California heirs. The clients have amassed a meaningful amount of wealth. They not only want to invest their assets, but seek to reduce the burden of state taxes and to provide long-term protection from potential future creditors. The couple may own a family business, which could subject the family to several different kinds of liability, whether from contracts, torts, or government regulations.

The couple's advisor faces a large number of domestic options when deciding where to locate a trust to protect his or her clients' wealth.[1] Settlors of new trusts and revocable trusts have

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[1] While some commentators pejoratively characterize interstate competition for trust business as a "race to the bottom," such competition may simply be the inevitable result of a federalist system in which different states experiment with policy preferences. *See* John V. Orth, *"The Race to the Bottom": Competition in the Law of Property*, 9 GREEN BAG 2d 47, 54 (2005).

a great degree of choice regarding a trust's governing law.[2] Settlors can carefully draft trust instruments, employ fiduciaries, and relocate movable assets to ensure application of their choice of governing law. Settlors and beneficiaries of preexisting trusts, even if irrevocable, also typically have means of changing governing law,[3] often by employing professional to administer the trust in a new state. Such a change often becomes desirable when state laws' application results in unfavorable consequences. A jurisdiction may adopt problematic substantive laws, impose new taxes on trust income, or simply fail to keep pace with recent developments in modern trust law.

Advisers should consider moving trusts with settlors, beneficiaries, or fiduciaries who reside in California to Wyoming Qualified Spendthrift Trusts (WQSTs). In order for a WQST's non-California source income to not be subject to California income tax, (1) the trust must avoid grantor trust status, (2) the trust must have no fiduciaries who reside in California, (3) the trust must have no non-contingent beneficiaries who reside in California, or some combination of the above. To avoid grantor status, a distribution committee composed of individuals with substantial, adverse interests in the trust, none of whom are the settlor or California residents, must approve any distributions from the WQST to the settlor. To ensure that the WQST has no California fiduciaries, California trustees should resign and a Wyoming trust company should be appointed trustee of the trust. Finally, in order for the WQST to have no non-contingent beneficiaries who reside in California, all distributions to California residents must be made at the trustee's discretion, unfettered by the direction of the trust's California beneficiaries. A trust that adheres to these requirements should enable the creation of a domestic asset protection trust that will not have its income subject to California income tax, regardless of where the trust's settlors or beneficiaries reside.

A preexisting California trust—even a pre-existing California irrevocable trust—can also take advantage of Wyoming's trust-friendly laws. By exercising a special power of appointment or appointing a Wyoming trust company to administer the trust, interested persons may change the law governing the trust's administration to that of Wyoming. Interested persons can then use statutory procedures, including nonjudicial settlement agreements and judicial modification, to modify any terms in a trust's governing instrument that must be changed to attain non-grantor status, convert the trust to a WQST, and to ensure that California residents have only contingent interests in the trust.

First, this article discusses reasons that advisers should consider creating Wyoming trusts or moving preexisting California trusts to Wyoming. Second, it considers how to ensure such trusts are not grantor trusts. Third, it discusses how to ensure that California will not impose income tax on the trust's non-California source income. Fourth, it then explains the steps for creating a new WQST for California residents. Next, it examines how to migrate a preexisting California trust to Wyoming. Lastly, the article looks at community property considerations that advisers should take into account before creating Wyoming trusts for California residents.

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[2] *See* RESTATEMENT (SECOND) OF CONFLICT OF LAWS §§ 270, 272 (1971).

[3] *See id.* § 272.

I. WHY MIGRATE A CALIFORNIA TRUST TO WYOMING?

California trusts pose significant disadvantages to clients seeking to protect their family wealth. Commentators do not typically identify the state as an advantageous situs for trusts.[4] One of the foremost problems with California trusts is the fact that California taxes trust income.[5] California will subject any trust with California resident trustees or noncontingent beneficiaries to at least some income tax.[6] The 2010 Census ranked California number one among U.S. states in terms of total state taxes collected.[7] Families can achieve significant savings by moving trusts to jurisdictions that do not tax trust income.[8] A hypothetical California trust with $1,000,000 in long-term capital gains may be able to reduce its tax burden by $91,000 by relocating to a jurisdiction that does not tax trust income.[9]

Additionally, California does not offer favorable substantive laws. The state has adopted the Uniform Statutory Rule Against Perpetuities (USRAP), which voids a nonvested property interest (with some exceptions) unless it must vest either (i) within twenty-one years of an individual alive at the interest's creation or (ii) within ninety years of the interest's creation.[10] The application of USRAP substantially limits families' ability to create long-term dynasty trusts.

California also lags in the asset protection arena. First, California law offers spendthrift protection to third party beneficiaries, but not to settlors who create trusts for themselves.[11] This prevents the creation of self-settled spendthrift trusts (also known as asset protection trusts).[12] Second, even a valid spendthrift trust is partially penetrable. Regardless of whether a trust is subject to a spendthrift restraint, a court may order a trustee to satisfy a judgment against a

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[4] Edward J. McCaffery, Alan T. Yoshitake & Keith A. Davidson, *The Advantages of Creating Out-of-State Trusts*, L.A. LAW., Sept. 2005, at 19 (discussing the tax, perpetuities, total return trust, and asset protection advantages of non-California trusts); *see also* Daniel G. Worthington & Mark Merric, *Which Situs is Best?*, TR. & EST., Jan. 1, 2010 (comparing the top twenty-seven trust situses, a list that does not include California).

[5] CAL. REV. & TAX. CODE §§ 17731–17779 (West 2010).

[6] *See id.* §§ 17734, 17742–17745.

[7] U.S. Census Bureau, *States Ranked by Total State Taxes: 2010* (Mar. 15, 2011), http://www.census.gov/govs/statetax/10staxrank.html.

[8] *See* McCaffery, *supra* note 4, at 19–20.

[9] Richard W. Nenno, *Choosing and Rechoosing the Jurisdiction for a Trust*, 40 HECKERLING INST. ON EST. PLAN. § 404.5[A][2] (2006).

[10] CAL. PROB. CODE § 21205.

[11] *Id.* §§ 15300–15301 (authorizing spendthrift protection for third party beneficiaries), 15304 (voiding such protection for settlors of self-settled trusts); *In re* Moses, 167 F.3d 470, 473 (9th Cir. 1999); McCaffery, *supra* note 4, at 23.

[12] *In re* Cutter, 398 B.R. 6, 20 (B.A.P. 9th Cir. 2008).

beneficiary from up to 25% of a beneficiary's interest in a trust.[13] Third, there is some question as to whether California law enables effective asset protection through the creation of discretionary trusts. Generally, if a trust instrument gives a trustee discretion to distribute income or principal to beneficiaries, creditors cannot compel the trustee to make distributions.[14] But if a California trust does not have a valid spendthrift provision and the trustee has been served by a judgment creditor seeking to reach the beneficiary's interest under California Code of Civil Procedure section 709.010, then the trustee will be liable to the creditor for transfers to the beneficiary that are subject to the trustee's discretion to the extent that such transfers impair the creditor's rights.[15] In some cases, courts have held that trustees exercised their discretion to withhold trust distributions in bad faith and compelled trustees to pay beneficiaries' support obligations.[16]

Interstate competition for trust business has led a number of states, including Wyoming, to adopt innovative statutes that provide trust settlors, advisors, and beneficiaries with more favorable and flexible trust laws. While each client has different needs, advisers should consider selected factors when deciding where to locate assets in trust, including a jurisdiction's tax burden, retention of the common law rule against perpetuities, limited liability company (LLC) and partnership statutes, substantive trust laws, and asset protection opportunities.

Investment advisers seeking a favorable means of protecting clients' assets should consider the advantages offered by Wyoming trusts. Wyoming offers a range of benefits, including asset protection trusts that can protect family wealth for up to 1,000 years, and other favorable trust innovations.[17] A California couple may protect some of their assets from possible liability by transferring such assets to a Wyoming Qualified Spendthrift Trust (WQST), which is

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[13] CAL. PROB. CODE § 15306.5(a), (b), (f) & cmt; *see also In re* Neuton, 922 F.2d 1379, 1383 (9th Cir. 1990) (holding 25% of a beneficiary's interest in a spendthrift trust could be included in the bankruptcy estate); *In re* Kim, 257 B.R. 680, 688 (B.A.P. 9th Cir. 2000) (holding a retirement plan's anti-alienation clause made it a valid spendthrift trust and that the chapter seven trustee could include only 25% of its value in the bankruptcy estate). Such payments may not exceed the amount the trustee determines is necessary for the support of the beneficiary and the beneficiary's dependents. CAL. PROB. CODE § 15306.5(c).

[14] CAL. PROB. CODE § 15303(a). Unlike the Second Restatement of Trusts, this is true even if the trustee's discretion is subject to an ascertainable standard. *Id.* § 15303 cmt.

[15] *Id.* § 15303(b).

[16] *See* Ventura Cty. Dep't of Child Support Servs. v. Brown, 117 Cal. App. 4th 144, 155 (2004) ("[U]nder section 15305, subdivision (c), a court may overcome the trustee's discretion under the narrow circumstances present here: when there is an enforceable child support judgment that the trustee refuses to satisfy. Under these circumstances, the trial court may order the trustee to satisfy past due and ongoing support obligations directly from the trust."); *cf.* De Mille v. Ramsey, 207 Cal. App. 3d 116, 125 (1989) (holding that a trial court could determine that, despite boilerplate language, a trust was not a spendthrift trust based on intrinsic and extrinsic evidence and could permit a daughter to alienate her interest to her sister). *But see* Young v. McCoy, 147 Cal. App. 4th 1078, 1087–88 (2007) (holding that a trustee did not exercise bad faith in not making distributions because the trustee adhered to the settlor's intent); *In re* Marriage of Pallanck, 2d Civil No. B221580, 2011 WL 1459964, at *3–4 (Cal. Ct. App. 2011) (distinguishing *Ventura County* because the trustee did not refuse to satisfy delinquent orders).

[17] See generally Christopher M. Reimer, *The Undiscovered Country: Wyoming's Emergence as a Leading Trust Situs Jurisdiction*, 11 WYO. L. REV. 165 (2011) for a more detailed discussion of all of the advantages offered by Wyoming trusts.

a type of self-settled spendthrift trust (also known as a domestic asset protection trust). Other than certain child support, fraudulent transfer, and secured claims, the family's assets held in such a trust will likely be protected from attachment by future creditors.[18] By appointing a Wyoming trust company, such as Jackson Hole Trust Company, as trustee and making the trust irrevocable, the clients and their heirs may benefit from the trust's assets without placing them at risk of attachment by the clients' or their heirs' creditors. Unlike in California, this is true even if the client who settles such a trust is its primary beneficiary. Additionally, income derived from assets held by such a trust can avoid California tax if the trust attains non-grantor status and ensures that any beneficiaries who are California residents only have contingent interests in the trust.

A settlor of a Wyoming trust can satisfy the requirements necessary to create a trust that will not be subject to California income tax by creating a new WQST administered by a Wyoming trust company. To create an effective WQST, the settlor must execute a trust instrument that (i) appoints a trustee that is a Wyoming resident (other than the settlor) or a person authorized to act as a trustee to act as a trustee by Wyoming law; (ii) states that it is a "qualified spendthrift trust" under Wyoming Statutes section 4-10-510; (iii) expressly provides that Wyoming law governs questions of the trust's validity, construction, and administration; (iv) provides that the settlor's interest in income or principal is held subject to a spendthrift provision that restricts transfer of the settlor's beneficial interest in the trust enforceable under applicable nonbankruptcy law; and (v) is irrevocable.[19] In addition, an affidavit negating the possibility of a fraudulent transfer must accompany a transfer to a WQST.[20]

Settlors of Wyoming trusts can use them in combination with Wyoming LLCs, which also function as effective asset protection tools.[21] The Wyoming LLC Act provides the charging order as the sole remedy of a creditor against a member's interest in an LLC's assets.[22] This is true even if an LLC has a single member.[23] Creditors who have obtained charging orders cannot foreclose on a debtor's membership interest.[24] Additionally, the Act provides that the charging order is a creditor's sole means of satisfying a judgment from the LLC's assets,[25] which should

[18] *See* WYO. STAT. ANN. §§ 4-10-510(a), 4-10-520 (2010).

[19] *Id.* § 4-10-510(a). Wyoming Statutes section 4-10-103(a)(xxxv) defines a "qualified trustee." Certain powers and rights retained by the settlor will not endanger a WQST's irrevocable status, such as veto power over distributions, receipt of income, an inter vivos or testamentary general or limited power of appointment, the right to receive 5% of the trust's value per year, the right to add or remove fiduciaries, etc. *Id.* § 4-10-510(a)(iv).

[20] *See id.* §§ 4-10-512(b), 4-10-523.

[21] WYO. STAT. ANN. §§ 17-29-101 to -1105 (2010). See generally Dale W. Cottam et al., *The 2010 Wyoming Limited Liability Company Act: A Uniform Recipe with Wyoming "Home Cooking,"* 11 WYO. L. REV. 49 (2011) for a detailed discussion of the Act.

[22] WYO. STAT. ANN. § 17-29-503(g).

[23] *Id.*

[24] *Id.*

[25] *Id.*

effectively prevent the risk of a creditor using reverse veil piercing to satisfy a member's debts from LLC assets. While the charging order entitles the creditor to distributions that the debtor–member would have received, it can allow an LLC to withhold distributions to the debtor–member until the parties have reached a favorable settlement. The Act clarifies that the charging order is against the member's "transferable interest" only,[26] which is defined as the right to receive distributions according to the terms of the LLC's operating agreement.[27] This definition ensures that the creditor cannot use the charging order to obtain management rights with respect to the LLC and cannot compel distributions. California also provides judgment creditors with a charging order remedy against a member's LLC interest,[28] which entitles the creditor to a lien upon the member's interest.[29]

California law provides that the charging order is a creditor's sole remedy against a member's interest in a California LLC, but says nothing about single-member LLCs.[30] This creates the risk that a court will hold that a creditor has non-charging order remedies against single-member LLCs.[31] California law also gives a creditor broad rights with respect to a charging order, including foreclosure on the membership interest[32] and appointment of a receiver that may make the same orders and inquiries that the debtor could make.[33]

II. AVOIDING GRANTOR STATUS

Twelve states currently permit settlors to create spendthrift trusts for their own benefit.[34] Wyoming's modified version of the Uniform Trust Code offers settlors a competitive form of domestic asset protection trust: the WQST.[35] In addition to providing creditor protection, effectively drafted WQSTs can allow settlors living in states that impose tax on trust income to create trusts that will not be subject to such tax. In order for a WQST to effectively avoid income tax, a trust cannot be a grantor trust. Grantor status requires the settlor to report trust income on

[26] *Id.* § 17-29-503(a).

[27] *Id.* § 17-29-102(a)(xxii).

[28] CAL. CIV. CODE § 708.310 (West 2010).

[29] *Id.* § 708.320.

[30] *See* CAL. CORP. CODE § 17302.

[31] *See In re* Modanlo, 412 B.R. 715, 731 (holding that the sole charging order remedy served no purpose in the context of a single-member LLC); *In re* Albright, 291 B.R. 538, 541 (Bankr. D. Colo. 2003) (same).

[32] CAL. CORP. CODE § 17302(b).

[33] *Id.* § 17302(a).

[34] *See* ALASKA STAT. § 34.40.110 (2010); DEL. CODE ANN. tit. 12, § 3570(11)(a) & (b) (2010); HAW. REV. STAT. § 554G (2010); MO. REV. STAT. § 456.5-505(3)(2) (2010); NEV. REV. STAT. § 166.040(1)(b) (2010); N.H. REV. STAT. ANN. § 564-D:1–18 (2010); OKLA. STAT. tit. 31, §§ 10–18 (2010); R.I. GEN. LAWS § 18-9.2-2(10) (2010); S.D. CODIFIED LAWS §§ 55-16-1 to 55-16-17 (2010); TENN. CODE ANN. §§ 35-16-101 to 35-16-112 (2010); UTAH CODE ANN. § 25-6-14(1)(a) (LexisNexis 2010); WYO. STAT. ANN. §§ 4-10-510.

[35] *See* WYO. STAT. ANN. § 4-10-510(a).

his or her personal state income tax returns, preventing a WQST from serving state income tax minimization goals.

The Internal Revenue Code treats settlors who contribute property to certain kinds of trusts as the owners of some or all of such trusts. If a trust is classified as a grantor trust, any income attributable to the part of the trust to which the settlor is treated as the owner will be included in the settlor's taxable income.[36] If income is included in a California resident's federally taxable income, it will also be subject to California income tax.[37] Generally, the settlor of a WQST must avoid five pitfalls that will trigger grantor trust status: (1) the settlor cannot retain a reversionary interest exceeding 5% of the trust's initial value;[38] (2) the settlor cannot have the power to control beneficial enjoyment of the trust's assets,[39] (3) the settlor cannot have the power to revoke the trust,[40] (4) the settlor cannot be able to receive impermissible distributions from the trust,[41] and (5) trust assets must not be subject to claims by the settlor's creditors.[42] Requiring a distribution committee composed exclusively of beneficiaries with substantial adverse interests in the trust to authorize distributions to the settlor should solve these problems and ensure that a WQST avoids grantor status as summarized below.[43]

A. Reversionary Interests (I.R.C. § 673)

A WQST will receive grantor trust treatment if, at the trust's inception, the settlor has a reversionary interest in part of the trust exceeding 5% of that part's value.[44] This raises the question of whether a settlor's ability to receive distributions at a trustee's discretion constitutes a reversionary interest. Code § 672 does not define the term "reversionary interest."[45] However, § 673 likely uses the term in its traditional sense, in which a reversionary interest is created when a person who owns a vested estate transfers a lesser vested estate to another person.[46] The part of

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[36] I.R.C. § 671 (2006).

[37] 38 CAL. JUR. 3D *Income Taxes* § 69 (2011 Supp.); *see also* CAL. REV. & TAX. CODE §§ 17731(a) (West 2010) (incorporating federal income tax laws as applied to trusts and estates unless an exception applies).

[38] I.R.C. § 673(a).

[39] *Id.* § 674(a).

[40] *Id.* § 676(a).

[41] Treas. Reg. § 1.677(a)-1(d) (1971).

[42] Other trust features can trigger grantor status, including impermissible administrative powers, I.R.C. § 675, and foreign trusts with U.S. beneficiaries, *id.* § 679.

[43] *See* I.R.S. Priv. Ltr. Rul. 200612002 (Mar. 24, 2006); I.R.S. Priv. Ltr. Rul. 200502014 (Jan. 14, 2005); I.R.S. Priv. Ltr. Rul. 200247013 (Aug. 14, 2002); Priv. Ltr. Rul. 200148028 (Nov. 30, 2001).

[44] I.R.C. § 673(a).

[45] *See id.* § 672.

[46] *E.g.*, 1 JOHN A. BARRON, JR. & LEWIS MALLALIEU SIMES, THE LAW OF FUTURE INTERESTS § 82 (3d ed. 2004); 2 HERBERT T. TIFFANY & BASIL JONES, TIFFANY ON REAL PROPERTY § 311(a) (2010).

the estate retained by the transferor constitutes the reversionary interest. From this perspective, the settlor of a properly drafted WQST has no reversionary interest because he or she has transferred all of his or her legal interest to a third party trustee. The settlor's ability to receive distributions at the trustee's discretion is not a reversionary interest, but a beneficial interest. Support for the argument that § 673 is using the term in this traditional sense—and thus does not describe a settlor's beneficial interest in a WQST—can be found in I.R.S. guidance, case law, and the statute's legislative history.

In 1981, the I.R.S. issued a Technical Advice Memorandum considering whether the full amount of a taxpayer's recovery following termination of a trust should be included in the taxpayer's gross income.[47] As part of the memorandum, the I.R.S. determined whether the taxpayer's reasonable expectation of enjoyment of the trust property within ten years of the initial transfer created a reversionary interest. The I.R.S stated that it would not: "a reversionary interest is the interest a transferor has when less than his entire interest and property is transferred to a trust and which will become possessory at some future date."[48] The I.R.S. defined a reversionary interest in a similar fashion in a General Counsel Memorandum.[49] The memorandum concluded that a trust that contained a provision deeming the trust void and returning assets to the grantors upon the I.R.S.'s disallowal of a deduction conflicted with § 676(a). Yet the memorandum defined reversionary interests in the traditional fashion, which would allow a properly drafted WQST to avoid a grantor trust status. The memorandum distinguished a reversionary interest from a possibility of reverter and stated, "the reversionary interest arises only when the transferor transfers an estate of lesser quantum than he owns."[50]

In *Crane v. Commissioner*, the United States Court of Appeals for the First Circuit addressed an unusual trust arrangement in which the settlor transferred stock to a trust.[51] Upon termination of the trust, the settlor would receive either the proceeds from the sale of the stock to the beneficiaries or a return of the stock.[52] The court considered whether the arrangement gave the settlor a reversionary interest in the trust. It applied the traditional definition of a reversionary interest and held that the settlor did have such an interest: "when we look at the obvious purpose of section 673(a), it must be to prevent a grantor from making a temporary transfer of assets in order to diminish, for a limited period, the receipt of taxable income therefrom."[53] By characterizing a reversionary interest as a temporary transfer, the court appears to have applied the traditional definition of a reversionary interest to § 673. The settlor's transfer of a lesser vested estate (the temporary transfer) left the settlor with a reversionary interest. A properly executed transfer to a WQST is distinguishable from *Crane* because it is not a temporary

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[47] I.R.S. Tech. Adv. Mem. 8127004 (Feb. 25, 1981).

[48] *Id.*

[49] I.R.S. Gen. Couns. Mem. 36,410, at 5–6 (Sept. 11, 1975).

[50] *Id.* (citing Helvering v. Wood, 309 U.S. 344 (1940)).

[51] 368 F.2d 800, 803 (1st Cir. 1966).

[52] *Id.*

[53] *Id.*

transfer. While the settlor retains a beneficial interest in the property, full legal title to the property is transferred to the trustee.

The legislative history of § 673 also suggests that the statute applies the traditional definition of a reversionary interest. Congress enacted § 673 in 1954 with the intent of codifying § 39.22(a)-121(c) of Treasury Regulation 118.[54] According to that regulation, "[i]ncome of a trust is taxable to the grantor where the grantor has a reversionary interest in the corpus or income."[55] The regulation noted instances in which a reversionary interest arises, all of which use the traditional definition of a reversion. While the list is not exhaustive, it suggests legislative contemplation of the traditional definition.

Finally, several Private Letter Rulings from the I.R.S. appear to confirm that the ability to receive distributions from a WQST will not cause a trust to be deemed a grantor trust. In 2002, the I.R.S. stated that it would not apply grantor treatment to a trust in which the settlor could receive distributions from the trust subject to the sole discretion of a distribution committee composed of potential recipients of trust distributions.[56] Taxpayers cannot rely upon or cite Private Letter Rulings as precedent. However, they indicate that the I.R.S. has accepted this interpretation in the past and may apply a similar analysis to a WQST.

Drafters of WQSTs seeking to avoid grantor trust status should be careful to ensure that a settlor's spouse not be entitled to a reversionary interest in the trust. This can complicate attempts to create marital trusts because the Internal Revenue Code treats a settlor as possessing any power or interest held by his or her spouse.[57] Yet the settlor may retain a testamentary limited power of appointment in favor of the spouse or a QTIP trust without retaining an impermissible interest.[58]

B. Power to Control Beneficial Enjoyment (I.R.C. § 674)

According to § 674,

> The grantor shall be treated as the owner of any portion of a trust in respect of which the beneficial enjoyment of the corpus or the income therefrom is subject to a power of disposition, exercisable by the grantor or a nonadverse party, or both, without the approval or consent of any adverse party.[59]

[54] H.R. Rep. No. 83-1337 (1954), *reprinted in* 1954 U.S.C.C.A.N. 4025, 4353. The two changes are unrelated to the definition of a reversionary interest.

[55] Treas. Reg. § 39.22(a)-121(c) (1953).

[56] I.R.S. Priv. Ltr. Rul. 200247013 (Aug. 14, 2002).

[57] I.R.C. § 672(e) (2006).

[58] *See id.* § 654(b)(3).

[59] *Id.* § 674(a).

A WQST can retain non-grantor status consistent with this provision even if it gives a trustee discretion to make distributions to the settlor, the settlor's spouse, or other beneficiaries. The trust agreement should specify that one or more members of a distribution committee must consent to distributions. All members of the distribution committee should be adverse parties. An "adverse party" is "any person having a substantial beneficial interest in the trust which would be adversely affected by the exercise or nonexercise of the power which he possesses respecting the trust."[60] Such persons must have a substantial beneficial interest in the trust that will be adversely affected by the exercise or nonexercise of the power to make distributions.

In 2002, the I.R.S. stated in a Private Letter Ruling that it would not treat a settlor as the owner of a trust because a distribution committee of a non-grantor trust consisting of members with substantial, adverse interests in the trust retained discretion over distributions and accumulations.[61] Each member of the distribution committee was eligible to receive distributions from the trust estate and had the nonfiduciary power to participate in deliberations and vote in favor of distributions. The ruling involved a distribution committee that exercised its powers by unanimous consent, although any member acting alone could direct a trustee to make a distribution after receiving the settlor's prior written consent. A planner may structure the distribution committee's decisionmaking process differently, so long as approval by one or more members with substantial adverse interests in the trust is required before making distributions. Again, these rulings are not binding and taxpayers cannot cite them as precedent. But it is likely that the I.R.S. would apply the same analysis to a WQST.

For a California trust redomiciled to Wyoming, none of the beneficiaries on the distribution committee should be California residents. Such residents' power to authorize distributions could make them noncontingent beneficiaries or even fiduciaries, risking application of California income tax.[62]

C. Power to Revoke (I.R.C. § 676)

Section 676 triggers grantor status if the settlor or a non-adverse party has the power at any time to revest property in the settlor.[63] As with § 674, requiring consent by a distribution committee before any distribution to the settlor or settlor's spouse occurs should prevent grantor status under this section.

D. Impermissible Income (I.R.C. § 677)

Section 677 triggers grantor status if trust income, without approval or consent of an adverse party or at the discretion the settlor or a nonadverse party, may be distributed to the settlor or the settlor's spouse, held or accumulated for future distribution to the settlor or the

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[60] *Id.* § 672(a).

[61] I.R.S. Priv. Ltr. Rul. 200247013 (Aug. 14, 2002); *see also* I.R.S. Priv. Ltr. Rul. 200612002 (Mar. 24, 2006); I.R.S. Priv. Ltr. Rul. 200502014 (Jan. 14, 2005); Priv. Ltr. Rul. 200148028 (Nov. 30, 2001).

[62] *See infra* Section III.

[63] I.R.C. § 676(a).

settlor's spouse, or applied to pay life insurance premiums on the life of the settlor or the settlor's spouse.[64] As with §§ 674 and 676, distribution committee consent should prevent this section from causing grantor status.

E. Creditor Claims (Treas. Reg. § 1.677(a)-1(d))

A trust will receive grantor trust status if, under state law, the grantor's creditors may satisfy claims against the settlor out of the trust's assets.[65] This will ensure grantor status of self-settled trusts in the vast majority of states that adhere to the traditional rule against self-settled spendthrift trusts. However, Wyoming permits such trusts in the form of WQSTs, which should prevent trust assets from being subject to creditor claims.[66] Accordingly, such trusts can avoid grantor trust status.

III. LIMITING CALIFORNIA TAXATION OF TRUST INCOME

A California trust will be subject to income tax in four situations:

(1) A trustee resides in California,
(2) A noncontingent beneficiary resides in California,
(3) The trust has California source income;
(4) Or any combination of the foregoing.[67]

The State of California taxes trust income based on the residence of fiduciaries and noncontingent beneficiaries, regardless of where the settlor resides.[68] In order to avoid California tax, a trust must have no trustees or noncontingent beneficiaries that reside in California and no California source income.

The first step in preventing California tax from applying to WQST income consists of ensuring that no fiduciaries of a WQST reside in California. California income tax will apply to any trust administered in the state by a California trustee, regardless of the location of the trust's assets, beneficiaries, or income source.[69] If a trust's taxability depends on the residence of fiduciaries and a trust has more than one fiduciary, Section 17742 apportions taxable income based on the number of fiduciaries residing in California.[70] The trust will be taxable, subject to deductions, on its net California source income and the proportion of its net non-California

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[64] *Id.* § 677(a).

[65] Treas. Reg. § 1.677(a)-1(d) (1971).

[66] *See* WYO. STAT. ANN. § 4-10-510(a) (2010).

[67] *See* CAL. REV. & TAX. CODE §§ 17742–17744, 17951 (West 2010).

[68] *Id.* § 17742(a). A "resident" is someone who is (1) in the state for anything other than a temporary or transitory purpose or (2) domiciled in the state but outside of it for a temporary or transitory purpose. *Id.* § 17014(a). A temporary absence will not end residency. *Id.* § 17014(c).

[69] CAL. CODE REGS. tit. 18, § 17744 (2011).

[70] CAL. REV. & TAX. CODE § 17743.

source income equal to the percentage of fiduciaries that are California residents.[71] If the WQST has a Wyoming trust company as trustee, the trustee's place of business will be the place where it "transacts the major portion of its administration of the trust." [72] A Wyoming trust company would transact all of its administration in Wyoming, preventing this section from applying California tax.

The next step consists of ensuring that the WQST has no noncontingent beneficiaries who reside in California. If all of the trust's noncontingent beneficiaries reside in California, all of the trust's income will be subject to California income tax.[73] If the trust has multiple noncontingent beneficiaries, California law apportions income tax based on how many noncontingent beneficiaries reside in the state and the size of their interests, as determined by regulations.[74] To eliminate California income tax, one needs to ensure that, in addition to having no California trustees, none of the WQST's beneficiaries residing in California are noncontingent beneficiaries.

California's estate tax regulations provide that "[a] noncontingent beneficiary is one whose interest is not subject to a condition precedent."[75] At common law, a beneficiary's interest in a trust is subject to a condition precedent if the "beneficiary is to take an interest in income or principal only on the happening of a designated event . . . ."[76] California courts follow the common law of trusts unless modified by statute.[77] Thus, a California trust administered by a non-California trust company will only be subject to California tax on its non-California source income if the trust has beneficiaries who are California residents who are entitled to receive distributions not conditioned on any designated event.

The simplest means of ensuring that a WQST has no non-contingent California beneficiaries is to provide non-California trustees with discretion to make any distributions to such beneficiaries. California beneficiaries should be unable to control such discretionary distributions. The exercise of discretion by a third party trustee constitutes a condition precedent to the beneficiaries' ability to receive trust assets. As a result, a California resident's ability to

[71] CAL. CODE REGS. tit. 18, § 17743. Thus, if a trust has no California beneficiaries, one California trustee, and two non-California trustees, one-third of its net non-California course income will be subject to California income tax. *Id.* tit. 18, § 17743 ex. 2.

[72] CAL. REV. & TAX. CODE § 17742(b).

[73] *Id.* § 17742(a).

[74] *Id.* § 17744; CAL. CODE REGS. tit. 18, § 17744.

[75] CAL. REV. & TAX. CODE § 17742(b).

[76] RESTATEMENT (SECOND) OF PROP. § 128 cmt. k (1959). California courts apply a similar definition in the context of contract law: "a condition precedent is either an act of a party that must be performed or an uncertain event that must happen before the contractual right accrues or the contractual duty arises." *E.g.*, Platt Pacific, Inc. v. Andelson, 862 P.2d 158, 601 (Cal. 1993).

[77] CAL. PROBATE CODE § 15002.

receive current distributions would be contingent and would not subject the trust's income to California tax.[78] The California Franchise Tax Board confirmed this conclusion:

> A resident beneficiary whose interest in a trust is subject to the sole and absolute discretion of the trustee holds a contingent interest in the trust. The exercise of the trustee's discretionary power is a condition precedent that must occur before the beneficiary obtains a vested interest in the trust. Once the trustee decides to distribute income in a specified amount, the beneficiary has a noncontingent, vested interest in the trust, but only for that amount. At that time, the trust is taxable on the distributable income pursuant to Rev. & Tax. Code section 17742. The beneficiary continues to have a contingent interest in the remaining current and/or accumulated income of the trust.[79]

If the trust instrument provides the trustee with absolute, unfettered discretion to make distributions to California beneficiaries, the beneficiaries' residence will not subject the trust to California income tax until they receive distributions. It is important to draft the instrument ensure that beneficiaries do not retain excessive control over how the trustees exercise their discretion.[80]

IV. CREATING A NEW WQST FOR CALIFORNIA RESIDENTS

Let us return to our hypothetical California couple seeking to preserve their family wealth. It may be a good idea for them to hold part of their assets in WQSTs. Other than fraudulent transfer, secured, and child support claims, the WQSTs' spendthrift provisions should protect such assets from the claims of future creditors. Using a Wyoming trust company to administer the trusts should create the requisite contacts to allow the trusts to be governed according to Wyoming law.[81]

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[78] Richard W. Nenno, *Planning to Minimize or Avoid State Income Taxes on Trusts*, 352 PLI/EST 132, 164 (2009).

[79] Cal. Franchise Tax Bd. Tech. Adv. Mem. 2006-0002 (Feb. 17, 2006) (citing e.g., SCOTT ON TRUSTS § 128.3 (2d ed. 1956); Thomas v. Gregg, 24 A. 418 (Md. 1982)).

[80] *Id.*; *In re* Appeal of Yolanda King Family Trust & Mary L. Tunney Junior Trust, Case Nos. 357825 & 357829, 2007 WL 3275358, at *8–9 (Cal. St. Bd. Eq. Oct. 2, 2007) (discussing arguments regarding whether a beneficiary became noncontingent by retaining excessive control over the trustee).

[81] Such protection may not be absolute for California residents. Unresolved full faith and credit issues remain with regard to domestic asset protection trusts. *See, e.g.*, Lynn Foster, *Fifty-One Flowers: Post-Perpetuities War Law and Arkansas's Adoption of USRAP*, 29 U. ARK. LITTLE ROCK L. REV. 411, 432–33 (2007); RICHARD W. NENNO, PLANNING WITH DOMESTIC ASSET-PROTECTION TRUSTS 63–73 (2005). While these issues have inspired significant scholarly debate, no court has had an opportunity to resolve whether a court in a state that allows self-settled spendthrift trusts must give full faith and credit to a judgment obtained in a state that does not.

Assets held in non-grantor discretionary WQSTs should not be subject to California income tax (other than on their California source income) until the trustees make distributions to California residents if they adhere to the following:

First, steps should be taken to avoid grantor status. An attorney should draft the WQST instruments to ensure that the settlors do not retain impermissible interests in their trusts. Distribution committees composed of individuals other than the settlors and who have substantial, adverse interests in the trusts' assets must authorize distributions to the settlors. This will allow non-grantor status even if the distribution committees may authorize distributions to the California settlors. (Any members of the distribution committee of a non-grantor trust should not be California residents so as to avoid creating California beneficiaries with noncontingent interests in the trust.) Proper spendthrift protection should prevent the couple from relegating trust assets to their creditors. If the trusts are deemed to be non-grantor trusts, the California couple will not need to report assets held by the trusts on their federal or California income tax returns.

Second, the trust cannot be administered by any fiduciaries that reside in California. If the WQSTs are administered by a Wyoming trust company that maintains its primary place of business in the State of Wyoming, the residency of the fiduciary will not trigger application of California income tax.

Third, the trust must have no noncontingent beneficiaries who reside in California. If the trust instruments provide that distributions from the WQSTs to California beneficiaries must be made at the sole and unfettered discretion of a Wyoming trust company, such beneficiaries will be considered contingent beneficiaries. Any interest they have in the trusts will be subject to the condition precedent of the trustee's discretionary decision to make a distribution. As a result, there should be no noncontingent beneficiaries who are residents of California.

Of course, California income tax will apply to the trusts' California source income, regardless of where the trustees or beneficiaries reside.[82] California income tax will also apply to any distributions once they are made to California beneficiaries. Until then, however, such assets will be able to appreciate in value and generate income without being subject to California tax.

V. MIGRATING A PREEXISTING CALIFORNIA TRUST TO WYOMING

A. Four Migration Methods

What if the California couple already has a California trust and they want to take advantage of Wyoming laws and remove the burden of California tax on the trust's income? They have four primary options for moving the trust to Wyoming.

[82] CAL. REV. & TAX. CODE §§ 17743, 17744, 17951.

1. Outright Distributions

The current trustees could distribute all of the trust's income and principal to the beneficiaries and have the beneficiaries transfer the assets to new Wyoming trusts. If the trustee has discretion to distribute income and principal, the trustee could use that authority to make outright distributions. California law also allows settlors and beneficiaries to give consent to compel a trust's termination.[83] Trustees or beneficiaries may petition a California court to terminate a trust if continuation of a trust defeats or substantially impairs its material purposes because of circumstances not anticipated by the settlor.[84] Of course, if the trust remains revocable, the settlor may also use procedures provided by the trust instrument to revoke or amend the trust.[85]

This solution is somewhat cumbersome and contains inherent risks. If the trust was GST exempt or had a zero inclusion ratio, the new trusts will not retain that status. Such a procedure may also interfere with the goals of maintaining control over a family's wealth and business holdings. This method also requires that the trustees have absolute discretion to invade a trust's principal, which some trust instruments may not permit.

2. Decanting

In a more favorable option, California trustees would exercise a special power of appointment to appoint the trust's assets to Wyoming trusts (often known as decanting). Some trust instruments may give the trustees such a power. If the instrument does not provide such a power, a trustee will have to rely on statutory or common law decanting. While California may not have a statute permitting trust decanting, one may argue that such statutes merely codify a trustee's common law power to appoint assets in further trust.[86] This argument derives from two principles. First, a trustee who has a discretionary power to invade a trust's corpus possesses a limited power of appointment.[87] Second, the donee of a limited power of appointment may use that power to create a lesser estate in favor of the power's objects (the beneficiaries) if the instrument does not reflect a contrary intent on the part of the donor.[88] Scholars typically cite

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[83] *See id.* §§ 15404(a) (allowing the settlor and all beneficiaries to compel modification or termination), 15403(a) (allowing all beneficiaries of an irrevocable trust to consent to modification or termination).

[84] *Id.* § 15409(a). The court may order trustees to do acts forbidden to them by the trust instrument if necessary to carry out the trust's purposes. *Id.* While a court must take a spendthrift provision into consideration when deciding whether to terminate a trust, such a provision does not preclude termination. *Id.* § 15409(b).

[85] *Id.* § 15401(a)(1).

[86] *See, e.g.*, Rashad Wareh, *Trust Remodeling*, TRUSTS & ESTATES, Aug. 2007, at 20; Joel E. Smith, Annotation, *Power to Appoint Realty in Fee or Personalty Absolutely as Including Power to Appoint Lesser Estate or Interest*, 94 A.L.R.3D 895, § 3[a] (1994); SCOTT ON TRUSTS § 17.2 (4th ed. 2001).

[87] *See* RESTATEMENT (SECOND) OF PROP.: DONATIVE TRANSFERS § 11.1 cmt. d (1986).

[88] *See id.* § 19.3; *In re* Hart's Will, 262 A.D. 190, 194 (N.Y. Sup. Ct. 1941) (holding that, in the absence of words to the contrary, a party with the power to appoint a fee may appoint a lesser estate).

three cases in support of this argument.[89] Common law decanting remains uncertain in most states[90] and individuals should conduct more research and seek court approval before attempting to decant in the absence of a statute or authorization by the trust instrument.

3. Appointing a Wyoming Trustee

A more widely available option for migrating a preexisting trust to Wyoming is to have the California trustee resign and appoint a Wyoming trust company, as trustee. This may require that the trust instrument provide some method of removing and appointing trustees. Under California law, the currently serving trustee may resign (i) as provided by the trust instrument, (ii) with consent of a person who holds the power to revoke the trust, (iii) with the consent of all adult beneficiaries who meet certain requirements (if the trust is irrevocable), or (iv) pursuant to a court order.[91] The settlor, cotrustees, or beneficiaries may also petition a court to have a trustee removed.[92] If the trust instrument provides a method for appointing a new trustee following a vacancy, that method should be followed.[93] If the trust instrument provides no such method, all adult beneficiaries entitled to either current income distributions or principal distributions upon termination may appoint a trust company as trustee.[94] If neither of those methods is possible, an interested person may petition a court to appoint a new trustee to fill the vacancy.[95] Once a Wyoming trust company is appointed as trustee, the trust's assets will be administered in Wyoming. Consequently, California will not tax the trust's income by virtue of the residency of a fiduciary.[96]

4. Petitioning a California Court

California provides a statutory means of migrating a trust to another state.[97] Upon petition, a court may order that a trust's place of administration be transferred to a different jurisdiction[98] if the petitioner demonstrates certain facts.[99] Trustees, beneficiaries, and other

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[89] *See* Phipps v. Palm Beach Trust Company, 196 So. 299 (Fla. 1940); *In re* Spencer's Estate, 232 N.W.2d 491 (Iowa 1975); Wiedenmayer v. Johnson, 254 A.2d 534 (N.J. Super. Ct. App. Div. 1969).

[90] Richard B. Covey & Dan T. Hastings, *Recent Developments in Transfer and Income Taxation of Trusts and Estates and State Trust and Estate Law*, 43 HECKERLING INST. ON EST. PLAN. ¶ 101.3[B] (2009).

[91] CAL. PROBATE CODE § 15640 (West 2010).

[92] *Id.* § 15642(a). While many of the grounds for trustee removal depend on trustee misconduct, the statute provides that a court may remove a trustee "for other good cause." *Id.* § 15642(b)(9).

[93] *Id.* § 15660(b).

[94] *Id.* § 15660(c).

[95] *Id.* § 15660(d).

[96] CAL. REV. & TAX. CODE § 17743.

[97] CAL. PROBATE CODE §§ 17400–17405.

[98] *Id.* § 17401(a).

[99] *Id.* § 17404.

interested persons may appear and file written objections to the petition.[100] While this procedure may provide certainty as to the validity of migration, the statute notes that it "does not prevent the transfer of the place of administration of a trust or of trust property to another jurisdiction by any other available means."[101] As such, the above three migration methods remain available.

B. Applying Wyoming Substantive Law to a Preexisting California Trust

Wyoming's substantive law will apply to the trust once its administration has been moved to Wyoming. At common law,[102] in the absence of a contrary designation in a trust's governing instrument, questions of the administration of a living trust holding movables are typically governed by the law of the state with the most substantial relationship to the trust.[103] Without a contrary designation, questions of the administration of a testamentary trust will typically be governed by the law of the state where the settlor was domiciled at death or the local law of another state where the trust is to be administered.[104] Such common law conflict of law rules often allow the law governing trust administration to be changed by having the trust be administered in a more favorable state.

Wyoming's modified version of the Uniform Trust Code also significantly eases the process of changing governing law. If a Wyoming trust company accepts trusteeship of the trust and administration occurs in Wyoming, the trust's new situs will be in Wyoming.[105] Wyoming law will then govern questions of administration and construction, provided that the governing instrument does not provide otherwise.[106] The law of administration will be the state with the most significant relationship to the trust, a consideration in which the trust's place of administration is the most important factor.[107] The location of the trust's assets is a secondary factor and the location of the settlor and beneficiaries is the least important factor.[108]

Preexisting trusts that designate a governing law often pose problems for migrating trusts, particularly if the trusts have become irrevocable. Wyoming law addresses this problem by allowing courts to "modify the administrative terms of a trust if continuation of the trust on its

[100] *Id.* § 17403(b).

[101] *Id.* § 17400(b).

[102] As noted above, California courts apply the common law of trusts if the legislature has not modified it by statute. CAL. PROBATE CODE § 15002.

[103] RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 272(b) (1971). The Restatements are not binding, but are persuasive and can be considered in the absence of contrary statutes or case law. *See* Canfield v. Security-First Nat'l Bank of Los Angeles, 87 P.2d 830, 844–45 (Cal. 1939) (applying Restatement of the Law of Trusts § 155).

[104] RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 271(b).

[105] WYO. STAT. ANN. §§ 4-10-108, -202 (2010).

[106] *Id.* § 4-10-107(a).

[107] *Id.* § 4-10-107(a)(ii).

[108] *Id.*

existing terms would be impracticable or wasteful or impair the trust's administration."[109] Additionally, "the law of the jurisdiction designated in the terms of the trust may be changed to the principal place of administration by a court with subject matter jurisdiction."[110] This latter provision is unique to Wyoming and unavailable in other Uniform Trust Code jurisdictions.

Consequently, even the settlors and beneficiaries of irrevocable trusts with instruments that designate California as the place of administration can take advantage of Wyoming law. First, the trustee of the California trust should resign and a Wyoming trust company should be appointed to administer the trust in Wyoming. If possible, the beneficiaries, settlor, trustees, and trust protectors should enter into a binding nonjudicial settlement agreement confirming the transfer of the trust's principal place of administration.[111] Moving the trust's place of administration to Wyoming will provide Wyoming courts with personal and subject matter jurisdiction over the trust.[112] A Wyoming trust company can then petition a Wyoming court to modify any problematic terms and change the trust's place of administration to Wyoming if doing so is necessary. If the parties to the trust wish to convert the trust to a WQST, they may do so by nonjudicial settlement agreement without the involvement of a court.[113]

C. Ending Application of California Income Tax to a Preexisting California Trust

To end California taxation of the trust's non-California source income, one must ensure that no fiduciaries or non-contingent beneficiaries reside in the state.[114] Replacing the California trustee with a Wyoming trust company solves the fiduciary problem by ensuring that the trust's fiduciaries do not reside in California.

Ensuring that all California beneficiaries are contingent beneficiaries will depend on the trust's terms. The trust may need to be modified to provide that distributions to California beneficiaries must be made at the discretion of a Wyoming trust company. Trust terms may also need to be modified to obtain non-grantor status by removing impermissible powers or interests held by the trust's settlor, converting the trust to a WQST, and requiring that a distribution committee approve distributions.

One means of changing problematic trust terms to avoid application of California tax is to petition a Wyoming court. According to the Wyoming Uniform Trust Code, "To achieve the

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[109] *Id.* § 4-10-413. This provision exists in the uniform version of the Uniform Trust Code. UNIF. TRUST CODE § 412(b) cmt.

[110] WYO. STAT. ANN. § 4-10-107(b).

[111] *See id.* § 4-10-111(d)(v).

[112] *See id.* §§ 4-10-202(a) (providing that fiduciaries of trusts moving their principal place of administration submit to the jurisdiction of Wyoming courts), 4-10-202(b) (providing that beneficiaries of trusts principally administered in Wyoming are subject to Wyoming jurisdiction regarding trust matters), 4-10-203(a) (providing that district courts have jurisdiction over Wyoming proceedings brought by a trustee or beneficiary regarding trust administration).

[113] *Id.* § 4-10-111(c)(vii).

[114] *See* CAL. REV. & TAX. CODE §§ 17742–17744 (West 2010).

settlor's tax objectives, the court may modify the terms of a trust in a manner that is not contrary to the settlor's probable intention as proved by a preponderance of the evidence."[115] Such modification can be retroactive if the court so provides.[116] It is often likely that the settlor intended to preserve the trust's income and minimize the application of state income tax. Modifying terms to achieve non-grantor status and make beneficiaries' interests contingent on the discretion of a settlor would likely not be contrary to that intention and would achieve the settlor's objective of lowering the trust's tax liability.

Wyoming's statute also provides that interested persons may enter into binding nonjudicial settlement agreements regarding any trust matter.[117] This should include modification of a trust's terms to eliminate the application of California income tax. However, the parties may not enter into agreements that violate a trust's material purpose or include terms that a court could not provide.[118] Whether such changes conflict with a trust's material purpose requires a fact-intensive inquiry that will depend on the specific trust. If there is a question about whether a modification violates a trust's material purpose, the settlor and all qualified beneficiaries may petition the court to modify the trust.[119] If petitioners experience difficulty obtaining the consent of all qualified beneficiaries (as is often the case with dynastic trusts that have large numbers of beneficiaries), a court may still approve the modification if modification would have been possible upon the consent of all beneficiaries and the interests of non-consenting beneficiaries are adequately protected.[120] In appropriate situations, Wyoming also allows beneficiaries who have not consented to be represented by fiduciaries, parents, or persons with substantially identical interests, removing the need for every qualified beneficiary to consent to the modification.[121]

VI. CALIFORNIA MARITAL PROPERTY ISSUES

Trusts with California beneficiaries raise special marital property and asset protection issues because California considers all property acquired by married persons domiciled in California during their marriage to be community property.[122] Courts presume property acquired by either spouse during marriage is community property unless a party rebuts that presumption by a preponderance of the evidence.[123] Certain property held by trusts that are revocable during

[115] WYO. STAT. ANN. § 4-10-417.

[116] *Id.*

[117] *Id.* § 4-10-111(b).

[118] *Id.* § 4-10-111(c).

[119] *Id.* § 4-10-412(a).

[120] *Id.* § 4-10-412(f).

[121] *Id.* §§ 4-10-301 to -305.

[122] CAL. FAMILY CODE § 760 (West 2010). Under California law, a person's domicile is the place where he or she maintains a permanent residence, intends to remain, and intends to return during temporary absences. *E.g.*, Aldabe v. Aldabe, 209 Cal. App. 2d 453, 466 (1962).

[123] *In re* Marriage of Valli, 195 Cal. App. 4th 776, 782 (2011).

marriage or require the consent of both spouses to be modified will also be considered community property if the trust instrument does not provide otherwise.[124] But property owned by a person before marriage or acquired during marriage by gift, bequest, devise, or descent (as well as the profits from such separate property) will be considered separate property.[125] Married persons may also agree to convert community property to separate property and vice versa.[126]

Community property poses special problems for an asset protection strategy because, with some exceptions, creditors may attach such property to satisfy the debts of either spouse incurred during marriage, regardless of who manages or controls the property or which spouse is directly liable for a debt or judgment.[127] If a spouse files for bankruptcy, all community property will be included in the bankruptcy estate.[128] If both spouses file for bankruptcy and the bankruptcy court discharges only one spouse's debts, community property acquired after the petition will remain liable for non-discharged debt.[129]

Thus, it is likely advisable that California spouses transfer their separate and community property to separate WQSTs and LLCs. Additionally, one spouse's transfer of community property to a trust for less than adequate consideration will require the written consent of the other spouse.[130] While spouses may convert community property to separate property,[131] doing so can bring about unintended consequences.[132]

CONCLUSION

Despite its many attractions, California may not provide the ideal place to locate a trust for the preservation of family wealth.[133] In addition to taxing trust income, California law applies the Uniform Statutory Rule Against Perpetuities to trusts and offers inadequate trust laws. California trusts cannot take advantage of a number of modern trust innovations, such as robust third party spendthrift trusts, asset protection trusts, and LLCs with sole charging order remedy protection. A California couple seeking to preserve wealth from the steady drain of state income taxes and the ever present threat of creditor liability should consider moving their assets to a

[124] CAL. FAMILY CODE § 761(a).

[125] *Id.* § 770(a).

[126] *Id.* §§ 850–853.

[127] *Id.* § 910(a). *But see id.* § 911(a) (providing that a married person's earnings during marriage are not liable for debts incurred by that person's spouse before the marriage).

[128] *See* 11 U.S.C. § 541(a)(2)(A) (2006); *In re* Mantle, 153 F.3d 1082, 1085 (9th Cir. 1998).

[129] *In re* Hibbs, 161 B.R. 259, 269 (Bankr. C.D. Cal. 1993).

[130] CAL. FAMILY CODE § 1100(b).

[131] *Id.* § 850(a).

[132] Duncan E. Osborne, *Asset Protection: Trust Planning*, SS039 ALI-ABA 1 (2011) (noting the effect of conversion upon divorce and the amount of property eligible for a step up in basis upon the first spouse's death).

[133] McCaffery, *supra* note 4, at 19.

WQST. If the couple already has assets in a California trust, such a trust may be migrated to Wyoming using one of four techniques: outright distributions, decanting, replacing the trustee with a Wyoming trust company, or petitioning a California court for a change of governing law. If the couple follows proper procedures, such trusts will receive strong creditor protection for the couple and their descendants. Additionally, if the trust drafter takes steps to avoid grantor status and provide that the trust has no fiduciaries or non-contingent beneficiaries who reside in California, the trust's non-California source income will not be subject to California income tax. Taking such steps may provide types of asset protection and dynastic wealth preservation that may have once seemed unavailable to California residents.