

Memorandum

Re: The Oklahoma Family Wealth Preservation Trust Act

By: David W. Wulfers

When first enacted in 2004, the requirements of the Oklahoma Family Wealth Preservation Trust Act, *Okla. Stat. tit. 31, §§ 10-18* ("Act") made use of the Act difficult. However, when the Act was revised by the Oklahoma legislature, effective November 1, 2014,¹ this type of trust became much more useful, and appealed to a broader number of individuals.

If a trust qualifies as a "preservation trust" under the Act, its principal and income (including appreciation in value of the principal and reinvested income) is protected from claims of the creditors of the person who creates the trust, referred to as a grantor. One of the revisions effective November 1, 2014 removed the \$1,000,000 cap for contributions to a preservation trust which will be shielded from creditors' claims.² Another revision clarified that equity of an Oklahoma-based entity is a state asset for purposes of the Act, notwithstanding the entity owns assets located outside the state of Oklahoma.³

Notwithstanding the creditor protection afforded under the Act, certain limitations still remain: (1) contributions to a preservation trust remain subject to the Oklahoma Uniform Fraudulent Transfer Act;⁴ (2) child support judgments are exempt from the Act;⁵ and (3) the lien on any property transferred to the trust is not affected.⁶ To qualify as a preservation trust, the trust must:

¹*Okla. Stat. tit. 31, § 12* (2013 Bill Text OK S.B. 1904, § 2, effective November 1, 2014).

²*Id.* ("Notwithstanding Section 3 of this title and Section 299.15 of Title 60 of the Oklahoma Statutes, the corpus and income of a preservation trust shall be exempt from attachment or execution and every other species of forced sale and no judgment, decree, or execution can be a lien on the trust for the payment of debts of a grantor, except a child support judgment, ~~except for any additional property contributed to the preservation trust by the grantor having an aggregate fair market value, determined as of the date of each contribution, minus liabilities to which the property is subject, in excess of One Million Dollars (\$ 1,000,000.00).~~ Any incremental growth derived from income or an increase in value of the corpus of a preservation trust shall also be considered protected by this section. Transfer of an asset to a preservation trust does not affect any mortgage, security interest or lien to which that asset is subject.")

³*Okla. Stat. tit. 31, § 11(2)(a)* (2013 Bill Text OK S.B. 1904, § 1, effective November 1, 2014) ("Oklahoma assets' includes: a stock, bond, debenture, membership interest, partnership interest, or other equity or debt interest issued by an Oklahoma-based company, WITHOUT REFERENCE TO ASSETS OWNED BY THE OKLAHOMA-BASED COMPANY," Prior to elimination of the cap, there was a fairly complicated process in which the \$1,000,000 cap could be increased or decreased, depending on the values of assets in the trust, and what assets the grantor removed from the trust.

⁴*Okla. Stat. tit. 31, § 17.*

⁵*Okla. Stat. tit. 31, § 12.*

⁶*Id.*

- a. [be] established by a grantor under Oklahoma law,
- b. hav[e] at all times as a trustee or cotrustee an Oklahoma-based bank that maintains a trust department or an Oklahoma-based trust company,⁷
- c. hav[e] as beneficiaries only qualified beneficiaries or a qualified beneficiary,⁸
- d. hav[e] a majority in value of its assets comprised of Oklahoma assets,⁹ except that if any asset which qualifies, or is intended to qualify, as an Oklahoma asset ceases or fails to qualify as an Oklahoma asset, the trustee shall have a reasonable period of time following discovery thereof to convert such nonqualifying asset into an Oklahoma asset, and
- e. recit[e] in its terms that the income generated from the corpus of the trust is subject to the income tax laws of this state;¹⁰

⁷"a. 'Oklahoma-based bank' means a bank, saving association or credit union which both: (1) takes deposits insured by the Federal Deposit Insurance Corporation or the National Credit Union Administration, and (2) has a place of business in Oklahoma, which shall be a physical location, and b. 'Oklahoma-based trust company' means a trust company chartered under the laws of this state or nationally chartered and having a place of business in Oklahoma, which shall be a physical location;" *Okla. Stat. tit. 31, § 11(3)(a)-(b)*.

⁸"Qualified beneficiary' or 'qualified beneficiaries' means: a. the lineal ancestors and lineal descendants of the grantor or the grantor's spouse, including adopted lineal descendants if they were under the age of eighteen (18) at the time of adoption, b. the spouse of the grantor, c. a nonprofit organization qualified under the provisions of the Internal Revenue Code of 1986, 26 U.S.C. Section 501(c)(3), or d. a trust settled for the sole benefit of one or more qualified beneficiaries." *Okla. Stat. tit. 31, § 11(6)*.

⁹"Oklahoma assets' includes: a. stock, bond, debenture, membership interest, partnership interest, or other equity or debt interest issued by an Oklahoma-based company, WITHOUT REFERENCE TO ASSETS OWNED BY THE OKLAHOMA-BASED COMPANY, b. a bond or other obligation issued by this state or an Oklahoma governmental agency, c. a bond or other obligation issued by a county of this state, by a municipal government located in this state, by a school district located in this state or by any public trust for the benefit of either this state or one or more political subdivisions of this state, d. an account in an Oklahoma-based bank. As used in this subparagraph, 'account' means a demand, time, savings or passbook type of account or a certificate of deposit type of account, e. real or tangible personal property, or any interest therein, having a situs in this state, which shall include, but not be limited to: (1) mineral interests, or (2) promissory notes secured primarily by real or tangible personal property or both, f. any security backed exclusively by promissory notes, if at least a majority in value of such promissory notes are secured by real or tangible personal property having a situs in this state or both, and g. mutual funds, as defined pursuant to The Investment Company Act of 1940, 15 U.S.C., Section 80a-1 et seq. and The Securities Act of 1933, 15 U.S.C., Section 77a et seq., and common trust funds, as defined pursuant to Section 1010 of Title 6 of the Oklahoma Statutes, to the extent the assets within such funds meet one or more of the requirements listed in subparagraphs a through f of this paragraph;" *Okla. Stat. tit. 31, § 11(2)(a)-(g)*.
 "'Oklahoma-based company' means a corporation, limited liability company, limited partnership, limited liability partnership or other legal entity formed or qualified to do business in this state and having its principle place of business in this state, which principle place of business shall be a physical location." *Okla. Stat. tit. 31, § 11(4)*.

¹⁰*Okla. Stat. tit. 31, § 11(5)(e)*.

Other areas of the Act which may be applicable to particular terms of a trust which satisfies the Act are discussed below.

If a married couple decides to create a trust which satisfies the Act, each spouse must create his/her own trust, since under the Act only a "grantor" can create a preservation trust.¹¹ In such circumstances, we recommend the two trusts mirror each other. For example, in the trust created by the husband, he is the grantor and his spouse and the bank or trust company are trustees; under the wife's trust she is the grantor and her spouse and the bank or trust company are trustees. Although the Act is silent on the matter, one commentator has stated the Act permits a grantor's spouse to serve as one of the co-trustees.¹²

The trust document must contain provisions stating the trust is established under Oklahoma law and is subject to Oklahoma income tax. In reality, income from each trust will be reported on each grantor's individual federal and state income tax returns, because the trusts are "grantor trusts" for federal income tax purposes. A revocable trust is a grantor trust for federal income tax because the grantor retains the power to re-vest title to the trust assets in the grantor.¹³ For such trusts, all income and deductions of the grantor trust are included in the grantor's income tax return as though the trust did not exist.¹⁴

In the provisions regarding the trustee's covenants, the trust document should provide that the trustee shall accept any contribution from the grantor regardless of the value of the property being contributed, and without regard to the aggregate value of all property previously contributed to the trust by the grantor. This provision is allowed because the \$1,000,000 cap on the amount that can be shielded from creditors under the Act was removed by the 2014 revisions.

The trust document should also contain a provision regarding when and how assets are to be valued on transfer into the trust, which we recommend be based on fair market value as of the date contributed. If you decide to utilize these trusts, you should consider how and when the trust assets are to be periodically valued by the trustee for purposes of the "majority in value" requirement in the Act, and the trust should include such a provision.¹⁵ The Act is silent on whether this is a periodic test, or the valuation must at all times satisfy the test.

¹¹*Okla. Stat. tit. 31, § 11(1).*

¹²*6A Vernon's Oklahoma Forms 2d Estate Planning, 2018-2019 Supplement, § 7.8(1) at p. 79.*

¹³*26 U.S.C. § 676.*

¹⁴"Grantors and third parties treated as owners of trusts under §§ 671-679 include all items of trust income, deduction, and credit in computing their taxable income, to the extent they are taxed as the owners of the trust, as if they had received the items of income or incurred the expenses directly." Danforth and Zaritsky, 819 T.M., *Grantor Trusts: Income Taxation Under Subpart E* at A-9.

¹⁵*Okla. Stat. tit. 31, § 11(5)(d).*

There should be a provision in the trust that a majority of the assets in the trust be Oklahoma assets.¹⁶ This requirement and the definition of Oklahoma assets in the Act is much broader than may first appear.

Oklahoma assets include "stock, bond, debenture, membership interest, partnership interest, or other equity or debt interest issued by an Oklahoma-based company, WITHOUT REFERENCE TO THE ASSETS OWNED BY THE OKLAHOMA-BASED COMPANY."¹⁷ If a grantor has foreign assets, the grantor can transform them into Oklahoma based assets by transferring them to an Oklahoma-based company, like a single member limited liability company. The ownership units in the limited liability company could then be transferred to and owned by the preservation trust.

A grantor can only have one preservation trust at a time.¹⁸ If that trust is revoked, the grantor can create a new preservation trust under the Act.

Each trust should contain a provision that the individual trustee is authorized to act independently of the bank or trust company, and the bank or trust company in essence has no authority to act. If the bank or trust company becomes sole trustee, the trust should provide that it is authorized to act.

The trust should contain a provision that so long as the grantor is living and not disabled, the trustee shall consult with the grantor and obtain the grantor's approval before the trustee exercises any of the trustee's powers. If the grantor can no longer exercise that control, the trust should provide the grantor's spouse can do so.

The trust should provide that during the grantor's life, the trustee is restricted to making distributions to beneficiaries for care, support, maintenance and medical attention. If the grantor wishes, the trustee could be allowed complete discretion in making distributions. As an additional or alternative approach, the grantor could direct the trustee to make distributions to specific beneficiaries.

The distributions to beneficiaries will be gifts for federal tax purposes. Distributions to the grantor's spouse will be exempt from tax because of the unlimited federal gift tax marital deduction, with a certain exception which may not be applicable. If distributions to issue are within the federal annual gift tax exclusion amount, they will be exempt; if in excess of that amount, either the grantor will pay federal gift tax or the grantor's lifetime federal transfer tax exemption amount will be reduced by the value of the gift. Gift splitting with the grantor's spouse may also be an alternative.

As mentioned above, the preservation trust is a grantor trust for federal and state income

¹⁶*Okla. Stat. tit. 31, § 11(5)(d).*

¹⁷*Okla. Stat. tit. 31, § 11(2)(a)* (capitalized language effective November 1, 2014).

¹⁸*Okla. Stat. tit. 31, § 18.*

tax purposes, with all income and deductions reported on the grantor's income tax returns, without regard to distributions made to beneficiaries. However, unlike in a Subchapter S corporation where the corporation may distribute cash to shareholders for the latter to pay income taxes, the trustee cannot provide "tax payment" distributions to the grantor to pay income tax, since the grantor cannot be a beneficiary. The grantor must use personal resources to pay the income tax liability or withdraw trust assets by partial revocation to pay the taxes.

In addition to the tax issue, there is another downside to the preservation trust. Under a typical will or trust, if the testator/testatrix or grantor is not survived by his/her spouse or by issue, his/her residuary estate or trust is left to specified family members, friends or heirs at law. If "qualified beneficiaries" in the Act¹⁹ means any beneficiaries, whether those currently vested and contingent beneficiaries, then naming family members other than the surviving spouse and issue, such as friends and heirs at law, will violate the Act and the shield against creditors lost.²⁰ There is no case law interpreting the meaning of "qualified beneficiaries" in the Act. Thus at present, if the grantor is not survived by the spouse and issue, the only remaining "qualified beneficiary" recognized in the Act is a charity.

Since the purpose of the preservation trust is asset protection, the trust should contain language stating that assets in the preservation trust should not be used to pay a deceased grantor's debts except to the extent enforceable against the trust estate, and to the extent there are no other resources to pay debts and taxes.

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¹⁹Okla. Stat. tit. 31, § 11(5)(c) and (6).

²⁰Okla. Stat. tit. 31, § 11(5)(c) and (6).