

Primer on the Oklahoma Family Wealth Preservation Trust

by David W. Wulfers

I. The Oklahoma Family Wealth Preservation Trust Act.

The requirements of the Oklahoma Family Wealth Preservation Trust Act, *Okla. Stat. tit. 31, §§ 10-18* ("Act"), were revised by the Oklahoma legislature in 2014. The revisions generally make this type of trust much more useful, 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 grantor's creditors.¹

In April 2014, the Oklahoma legislature enacted certain amendments to the Act. Those amendments were effective November 1, 2014. One of the amendments removed the \$1,000,000 cap for contributions to a preservation trust which will be shielded from creditors' claims.² The other amendment clarifies 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 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:

- 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

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

²*Id.*

³*Okla. Stat. tit. 31, § 11(2)(a)* (2013 Bill Text OK S.B. 1904, § 1, effective November 1, 2014).

⁴*Okla. Stat. tit. 31, § 17.*

⁵*Okla. Stat. tit. 31, § 12.*

⁶*Id.*

⁷*Okla. Stat. tit. 31, § 11(3)(a)-(b).*

⁸*Okla. Stat. tit. 31, § 11(6).*

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

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 revest 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

⁹*Okla. Stat. tit. 31, § 11(2)(a)-(g); Okla. Stat. tit. 31, § 11(4).*

¹⁰*Okla. Stat. tit. 31, § 11(5)(a)-(e).*

¹¹*Okla. Stat. tit. 31, § 11(1).*

¹²6A *Vernon's Oklahoma Forms 2d Estate Planning*, 2013-2014 Supplement, § 7.8(1) at p. 64.

¹³26 *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.

to the trust by the grantor. This provision is now allowed because the \$1,000,000 cap on the amount that can be shielded from creditors under the Act was removed from the law this year.

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.

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

¹⁵*Okla. Stat. tit. 31, §(5)(d).*

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.*

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 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 in order 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.

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

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