representation principle is included.

**Alaska 2003 Trust Act (House Bill 212) Dramatically Improved Creditor Protection**

The following is taken from an article authored by Stephen E. Greer that was published in the August 2003 issue of Trusts & Estates Magazine.

On July 10, 2003, Alaska's Governor Murkowski signed a new Alaska Trust Act into law. The provisions of this bill greatly enhance creditor protection for third-party beneficiary trusts and self-settled spendthrift trusts, further enhancing Alaska's desirability as a place to create and maintain trusts. The following is a short discussion of some of the more important provisions found in the act. A more complete discussion can be found in the August 2003 issue of Trusts & Estates.

**Provisions Affecting both Dynasty Trusts and Self-Setiled Spendthrift Trusts**

- *Courts cannot compel distributions or attach beneficial interest.* Creditor protection is dependent on the protection that a spendthrift clause gives and the law of the state where the trust administration occurs. The protection that an Alaska spendthrift clause provides is extremely powerful because all creditors are barred from attaching trust assets before payment or delivery of the assets to the beneficiary. An Alaskan spendthrift clause will protect the trust assets from claims brought by spouses for support, ex-spouses for alimony, providers of necessity, tort creditors and claims for child support. Moreover, there is a provision in the act which states an attachment or other judicial order may not be made against the trustee with respect to a beneficiary's interest held in trust. Nowhere else in the country can a settlor find such protection.
- *Dynasty trusts can name a beneficiary as the co-trustee with the authority to make distributions and there will be no loss in creditor protection.* In many circumstances a settlor would like to give a beneficiary as much control as possible, provided there is no loss in creditor protection. It is now possible to name an Alaska trustee as the administrative co-trustee and name the beneficiary as the co-trustee in charge of distributions, which for tax purposes would usually be limited to the ascertainable standard defined in the Internal Revenue Code, without compromising creditor protection. What beneficiary would not like this right?
- *A beneficiary can be given a general power of appointment and the trust asset will still be protected from creditor claims.* In every large estate there exists the possibility that distributions will be made to subtrusts that are not exempt from generations skipping transfer taxes. Because the estate tax is progressive in nature, federal taxes payable at death often will be less if the assets in a non-exempt trust are exposed to estate tax at the beneficiary's death (rather than having the assets exposed to generation skimping transfer tax when the assets are distributed to skip beneficiaries). To accomplish this, a beneficiary in a non-exempt trust can be given a testamentary general power of appointment that will result in the trust assets being included in the beneficiary's estate tax base. One of the most important provisions of Alaska's new law states a beneficiary can be given a general power of appointment and the assets subject to this power can not be attached by the beneficiary's creditors. This protection exists, regardless of whether there is a testamentary general power of appointment or a presently exercisable general power of appointment. Thus a settlor could conceivably give the beneficiary the power to appoint trust assets to himself and until such time that the beneficiary actually does so the trust assets will continue to be

protected from creditor claims. Thus if the settlor wanted to give the beneficiary unlimited control of the trust assets, the settlor could do so but nonetheless have the assets protected from the beneficiary's creditors until such time that the beneficiary actually distributed the assets to himself. This is an attractive alternative when the settlor wants to make an outright distribution to the beneficiary.

This provision is also important in any trust where a beneficiary has been given a Crummey Withdrawal right. The Restatement of Law the Third, considers a beneficiary with a Crummey right to be the owner of the property over which the rights could be exercised, thus exposing the trust to the claims of a beneficiary's creditors. However, in Alaska a beneficiary can have a Crummey Withdrawal right and the trust assets can not be subjected to the creditor claims of a beneficiary.

- *Use provisions respected.* A use provision allows a trustee to make trust assets available for the use of a beneficiary. The new Alaska law states that real property or tangible personal property may be made available for the use of a beneficiary without the beneficiary's use being considered a distribution, thus insulating the trust assets from the claims of a beneficiary's creditors. This provision also allows an Alaska resident to create a self-settled spendthrift trust and protect a home from creditors where the homestead exemption is inadequate and through the use of a grantor trust provisions the settlor can be treated as the owner under federal income law and thus take advantage of all the favorable income tax laws pertaining to homes.
- *Trust protectors and trust advisors are not considered fiduciaries.* In any long term trust it is often advisable to appoint a trust protector who is given the power to remove and replace the trustee, the power to modify or amend the trust instrument to achieve favorable tax status and the power to increase or decrease the interests of any beneficiary to the trust. In the absence of state law to the contrary, a court could consider the trust protector a fiduciary, thus decreasing the possibility of finding someone who would want to take on the trust protector role. The new Alaska law states a trust protector may have all of these powers and the trust protector will not be held accountable as a fiduciary.

Additionally, a settlor might appoint a trust advisor that is personally knowledgeable of the beneficiary's circumstances to assist a corporate trustee in carrying out its functions. The appointment of an advisor greatly improves the chances the purpose of the trust as envisioned by the settlor will be fulfilled. The new Alaska law states that an advisor will not be held accountable as a fiduciary.

**Provisions Affecting Only Self-Settled Spendthrift Trusts**

Needless to say, many of the provisions applicable to third-party beneficiary trusts also apply to self-settled spendthrift trusts. But some very important changes were made that apply exclusively to self-settled spendthrift trusts.

- *A major defect in self-settled spendthrift legislation is corrected.* In all domestic self-settled spendthrift jurisdictions, other than Alaska, a "pre-existing creditor" has the benefit of what is essentially an unlimited statute of limitations to set aside a transfer of assets as being a fraudulent conveyance. This is because a creditor might not reasonably discover the transfer of assets to a trust until such time that the creditor has first reduced the underlying action to judgment and then had the opportunity to conduct a judgment debtor examination to discover the settlor's assets. Even though a creditor must still prove the conveyance to the trust was fraudulent to have the transfer set aside, the creditor will have an unlimited period of time in which to do so.

Consider this example: A doctor, unaware of any patient complaints, transfers property to a self-settled spendthrift trust. Subsequent to the transfer, a patient who was seen prior to the transfer complains that he was misdiagnosed and the doctor was

negligent. Should this patient be considered a "pre-existing creditor" even though the patient's claim was unknown to the doctor at the time the doctor transferred assets to the trust? If so, the patient would be allowed an unlimited period of time in which to assert a claim that the settlor's transfer in trust was fraudulent and to have the transfer in trust set aside. As a result, no doctor, no contractor, or for that matter, no individual who had ever been engaged in business for any length of time could ever completely discount the possibility of a "pre-existing creditor" from successfully attacking the trust.

The new Alaska law defines a "pre-existing creditor" as one who either:

- Demonstrates, by a preponderance of the evidence, that he asserted a specific claim against the settlor before the settlor transferred assets to the trust; or
- Within four years after the settlor transferred assets to the trust, files an action in court against the settlor asserting a specific cause of action based on an act or omission of the settlor (for instance a negligent surgery) that occurred before the transfer of assets to the trust.

As a result of this change, a settlor will now know that after a certain point in time, a pre-existing creditor cannot suddenly appear and be able to maintain a successful fraudulent conveyance action against the settlor.

- *Threats from future creditors has been substantially reduced, if not eliminated.* Threats from future creditors are now practically eliminated. For creditors that arise subsequent to the transfer of assets in trust, a creditor has 4 years to bring a fraudulent conveyance action to set aside the trust or the statute of limitations will run out. Realistically the statute of limitations is much shorter. First, a creditor will have to reduce the underlying claim to a judgment which in itself can take more than 4 years, before the creditor will be able to conduct a judgment debtor examination in which the transfer of assets to the trust can be discovered. Thus the typical scenario facing a future creditor is this: within a 4 year period all the following must occur; an act giving rise to a claim against the settlor, a lawsuit filed, litigated and reduced to a judgment, a judgment debtor examination conducted and another fraudulent conveyance action filed in which the creditor is able to prove that the transfer of assets in trust was fraudulent as to that creditor, whose existence in all likelihood was unknown to the settlor at the time the lawsuit was filed. Thus, it is highly unlikely that a future creditor will be able to prevail against the settlor.
- *The definition of a fraudulent conveyance is tightened.* Delaware, Nevada, Rhode Island and Utah have adopted the Uniform Fraudulent Transfer Act. Under the provisions of that act, a creditor can have a transfer to a self-settled spendthrift trust set aside of the creditor can prove the transfer in trust was "intended to hinder or delay" a creditor. This gives creditors a huge arsenal with which to attach a trust. Alaska, on the other hand, eliminated the words "hinder or delay" from its statute. In Alaska, a settlor's transfer of property in trust can be set aside only if a creditor can prove the transfer was made with an "intent to defraud that creditor."
- *New affidavit requirement.* It is common practice for an attorney to require an affidavit from a settlor of a self-settled spendthrift trust that states the conveyance is not fraudulent as to any creditor. Alaska now requires the settlor to sign a sworn affidavit containing specific provisions before the settlor transfers assets to the trust. As a result, the chance of a fraudulent conveyance has been reduced and the affidavit also provides additional protection to the attorney who drafts the trust.
- *CRT's, including unitrusts with non-charitable reminder beneficiaries protected.* Alaska law now allows a settlor to protect an annuity or unitrust interest that has been

retained in a charitable remainder trust. In addition, a settlor may create a self-settled spendthrift trust and protect the retention of a unitrust interest despite the existence of non-charitable remainder beneficiaries.

- *An important distinction in Alaska law not changed.* What was not changed is a very important distinction contained in Alaska law. In Alaska, no creditor of the settlor (not a child support agency, a spouse or an ex-spouse) is able to reach any of the trust assets. Completed gift treatment is dependent upon a determination that no creditor is able to satisfy its claim out of the trust assets. Herein lies the ability of a settlor in an Alaska self-settled spendthrift trust to make a completed gift that is not theoretically possible in other self-settled spendthrift trust jurisdictions. In each of those other states, there are specified creditors who can come into existence after the trust is established and have their claims satisfied out of the trust. Because a transfer of assets in a self-settled spendthrift trust in those states must be viewed as an incomplete gift, the trust assets are still part of, and thus must be included in the settlor's gross estate. In Alaska, a settlor can make a completed gift and with proper drafting be able to exclude the assets from the settlor's estate.

## Overview of Senate Bill 344

**Virtual Representation Amendment.**

Expands both the types of proceeding in which notice to one person who may represent another person may bind another person and the circumstances under which substitute notice may be given. Expanding the scope of the proceedings to include non-judicial settlements and informal proceedings under this chapter will streamline the process for resolving issues relating to trusts and estates and minimize the cost associated with formal court proceedings. The amendments incorporate the doctrine of "virtual representation" in which representation by one person having a substantially identical interest with respect to a particular issue may bind another person. Representation is not permitted, however, if there is a conflict of interest.

**Change of Trust Situs to Alaska.**

If the requirements of AS 13.36.035 (c) (1)-(4) are met, then the trust can be moved to the state of Alaska. At that time, if the trust instrument allows or is modified, then a governing law provision may be added which states that Alaska's laws will apply to the trust.

**Limitations on Proceedings Against Trustees.**

AS 13.36.100 expands the reach of the limitations period for claims of breach of trust against a trustee. Under current law, a claim against a trustee for breach of trust is barred as to any beneficiary who receives a final account that terminates the trust relationship if a proceeding to assert the claim is not commenced within six months after receipt of the final account. In addition, if the trustee gives the beneficiary a periodic statement, which the beneficiary does not object, the trustee is resolved of liability after 24 months.

**Intention Regarding Spendthrift Restriction.**

AS 34.40.110 (a) (3) This new provision clarifies the legislature's intent that the spendthrift provisions provided by AS 34.40.110 are intended to come under the exception for spendthrift trusts contained in § 541 (c) (2) (bankruptcy code).

**Protection for Interest and Qualified Personal Residence Trusts, Grantor-Retained Annuity Trusts and Grantor-Retained Uni-Trusts**

AS 34.40.110 (b) Clarifies procedures for asserting claims. Language has been added to make it clear that a beneficiary's interest in such distributions is protected until the distributions occur. Adds spendthrift protections for three commonly used types of estate planning approaches, personal resident's trusts, GRATs and GRUTs.

**Protection for Persons Assisting with Creation of Trusts**

AS 34.40.110 (e) Subsection (e) was intended to protect professionals who assist in the planning and formation of self-settled discretionary spendthrift trusts. Subsequent experience with the formation of these trusts indicate that frequently assets are first placed into a limited partnership or limited liability company, and then interests in such companies are transferred to the trust. The purpose of the additional language is to protect professionals with respect to the formation of these entities as well as the formation of the trusts.

**Procedure for Asserting Fraudulent Transfer Claim**

AS 34.40.110 (b) (1) This provision clarifies that if a cause of action or a claim is asserted that a transfer to a trust is a fraudulent transfer, then the claim must be made under and processed pursuant to Alaska law.

## Conclusion

If you have the need for trust services, the Alaska Trust Company is the place to be. It was formed specifically to concentrate on investment management and trust services. It is the first independent trust company in our state. We also have the most knowledge and hands-on experience regarding trusts that can be setup under Alaska's special trust legislation. Our services extend beyond those traditionally associated with bank trust departments.

Alaska has always been the place for a new way to look at things. Let Alaska Trust Company show you how our state's new trust laws can help assure the most precious wealth of all – a solid and secure future for you and your loved ones. Visit our website for copies of the legislation, sample trust forms, and other information.

**Offering a Full Range of Trust and Investment Management Services for Individuals, Families, and Institutions.**

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- Estate Planning-including Asset Protection, Perpetual Trust Arrangements and Life Insurance Trusts
- Securities Safekeeping/Custodial Services
- Wealth Management utilizing Limited Partnerships and Limited Liability Companies
- Retirement Plans, IRA, Profit Sharing, ESOP, etc

## See How Easy It Is To Open an Account With Alaska Trust Company

- **Attorney Submits**
  - Draft document to Alaska Trust Company for review (Please see section 12 of website for required provisions)
  - Completed Data Information Questionnaire
  - Signed Affidavit of Solvency
  - Additional information required for asset protection trusts

- **Alaska Trust Company Will**
  - Review document
  - Consult with drafting attorney and reviewing Alaska attorney, if any
  - Communicate any changes or concerns
  - Upon approval, sign finalized document and return duplicate to drafting attorney

- **Due Upon Account Set-Up**

If Alaska Trust Company will have custody of individual assets:
- Information on institution currently holding assets; including name of firm, contact, and phone number
- List of assets to be set-up with cost values and Cusip numbers, etc.
- Alaska attorney review fee, if applicable

If Alaska Trust Company will not have custody of individual assets:
- Appropriate set-up fee
- Appropriate annual fee
- $10,000 or other appropriate amount to be deposited in a Certificate of Deposit account at an Alaska bank

- Alaska attorney review fee, if applicable

Alaska Trust Company will set-up an account on its Trust System, and assets as required. Alaska Trust Company will send out statements according to frequency indicated in the New Account Form.

**Remember, Alaska Trust Company's fees are very competitive**

**Selected Articles on Alaska's Unique Trust Laws**

- "Does the New Alaska Trust Act Provide an Alternative to the Foreign Trust?" Journal of Asset Protection, July/August 1997.
- "A New Direction in Estate Planning: North to Alaska " Trusts & Estates, September 1997.
- "New Alaska Trust Act Provides Many Estate Planning Opportunities." Estate Planning, October 1997.
- Estate Planning on America's Last Frontier: Alaska Trusts, Limited Partnerships, and LLCs." ACTEC Notes, 1997.
- "Alaska Consensual Community Property Law and Property Trust." Estate Planning, November 1998.
- "Practice Alert: Alas Community Property Law and Property Trust." Estate Planner's Ale July 1988.
- "Tax Planning with Consensual Community Property: Alaska's New Community Property Law." Real Property, Probate & Trustee Journal. Winter 1999.
- "Self-Settled Spendthrift Trust: Should a Few Bad Apples Spoil the Bunch?" Vanderbilt Journal of Transnational Law, May 1999.
- "Domestic Asset Protection Trusts: More Might Than First Appears." Asset Protection Journal, Summer 1999.
- "Alaska Enacts Additional Estate Planning Legislation." Estate Planning, October 2000.
- "Creditor Protection Vastly Improved with Enactment of 2003 Alaska Trust Bill" Trusts & Estates, August 2003.

***Why Perpetual/Dynasty Trusts***

- "The Megatrust: An Ideal Family Wealth Preservation Tool." Trusts & Estates, November 1991.

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# A New Direction In Estate Planning: North To Alaska

*Alaska recently has enacted legislation* similar to laws in certain foreign asset protection jurisdictions. As a consequence, an American in any state can create a trust for his or her own benefit which is protected from creditors provided, among other things, it is not a transfer intended to defraud known creditors. Perhaps of greater importance, Alaska trusts open a new dimension in estate planning. One of this article's co-authors, Jonathan Blattmachr, was the principle draftsman of this new Alaska legislation.

Two goals that often are sought to be achieved in estate planning are estate tax reduction and protection of assets from claims of creditors. Reducing taxes significantly may be a "sum zero" game if the assets are attached by creditors. Similarly, protecting assets from creditors' claims may not accomplish all goals sought unless taxes also are reduced. Fortunately, these two goals are not only compatible, they usually are complementary. That is, the steps to protect assets from claims of creditors may allow tax reduction to occur, as well. On the other hand, a transfer that fails to protect property from claims of the transferor's creditors is likely to fail to reduce taxes because, almost always, if a creditor of the transferor can attach the asset the transfer is regarded as incomplete for gift and estate tax purposes.[1] The Alaska Trust Act (Chapter No. 6, SLA 1997, effective April 2, 1997) offers a new tool in the United States to accomplish the dual goals of asset protection and tax reduction. The Act also effectively repeals the rule against perpetuities for a trust created under Alaska law. This article discusses the dual goals of asset protection and estate tax reduction and how the Alaska Trust Act can be used in the context of estate planning. It also compares some aspects of Alaska trusts with certain offshore trusts.

## Steps To Reduce Estate Taxation

It seems well accepted that an effective, if not the most effective, estate tax reduction planning step is to make lifetime transfers. Lifetime transfers can avoid gift tax (and, by removing an asset from an estate, can avoid estate tax, as well) in ways that cannot be used at death to avoid estate taxation. However, lifetime transfers are effective for these purposes only if they are "complete" under the federal estate and gift tax rules.[2] The law appears well established that a transfer is complete for such tax purposes only if it is not (or when it no longer is) subject to the claims of the transferor's creditors.[3]

## Fraudulent Transfers, Etc.

IN GENERAL, "fraudulent conveyances" with respect to creditors whose claims arise either before or after the transfer are transfers (a) that the debtor made with actual intent to hinder, delay or defraud his or her creditors or (b) (i) for which the debtor received less than "a reasonably equivalent value" and (ii) after which the debtor had insufficient assets to meet future business needs or to pay debts. A transfer made by a debtor is fraudulent as to a creditor whose claim arose before the transfer if the debtor made the transfer without receiving "reasonably equivalent value" and the debtor was insolvent at the time of or as a result of the transfer.[4] Proof of actual intent to defraud is not required. Most states have adopted these rules in the form of the Uniform Fraudulent Transfer Act. However, some states (including New York) still have in effect the Uniform Fraudulent Conveyance Act. (See N.Y. Debtor and Creditor Law Secs. 273-281.) Alaska has adopted neither the Uniform Fraudulent Transfers Act nor the Uniform Fraudulent Conveyance Act. [See *Summers v. Hasen*, 852 P.2d 1165, 1169 n.5 (Alask. 1993).] Its fraudulent transfer rules are contained in Alaska Statutes (AS) 34.40.010 et seq.

Similar rules are contained under the Bankruptcy Code, and in the case of bankruptcy, fraudulent conveyances may be defined with reference to the Bankruptcy Code or under applicable state law. The Bankruptcy Code permits such transfers to be set aside

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only if made within one year before filing of the petition, but many states permit reference to a much longer period, especially, in the case of transfers to family members. [See, e.g., *FDIC v. Pappadio*, 606 F. Supp. 631, 632 (S.D.N.Y. 1985) (under New York law a claim to set aside a fraudulent conveyance is governed by a six year statute of limitations).] Avoided fraudulent conveyances are "brought back" into the debtor's estate, usually for distribution to the debtor's creditors. In addition, some fraudulent conveyances may deprive a debtor of (1) homestead or other property exemptions[5] and (2) a bankruptcy discharge.[6]

As a general rule, a transfer is found to have been made with an actual intent to hinder, delay or defraud creditors only if it was intended to remove assets from claims of specifically known or anticipated creditors. "If the debtor has particular creditors in mind and is trying to remove his assets from their reach, this would be grounds to deny the [bankruptcy] discharge [on the ground of a fraudulent conveyance]. If the debtor is merely looking to his future well-being, [the conveyance would not be fraudulent and as such] the discharge will be granted."[7]

An example will help illustrate this principle. A property owner makes a gift to a family member (whether outright or in trust) which does not result in the property owner being insolvent or unable to pay her debts as they mature. She has no known or specifically identifiable creditors. Nonetheless, she realizes that a claim against her could arise on account of unforeseen circumstances, such as being involved in a car accident, occurring in the future. This gift should not be regarded as a fraudulent conveyance, despite the fact that she is making it with the general intention to protect the property from claims that could arise against her in the future.

Although the fraudulent conveyance rules apply to creditors in bankruptcy, obviously they also have a broader application. For example, in a number of states a tort claimant is permitted to attack as fraudulent a transfer made after the time of the tort but prior to any judgment.[8]

## Interests in Trusts

TWO SETS OF CONTRASTING rules must be considered to determine whether interests in trusts are subject to claims of creditors. First, as a general rule, a beneficial interest in trust that is subject to a restriction on transfer (called a "spendthrift provision") is not subject to the claims of a beneficiary's creditors.[9] Thus, if the debtor is a beneficiary of a trust established for his or her benefit by another person (such as by a parent) which interest by its terms and/or applicable state law is not assignable, the trust assets should be protected.[10] However, property transferred in trust for the beneficiary may be attached by the creditors of the grantor if the transfer to the trust was a fraudulent conveyance.[11]

In virtually all states, property may be placed in trust for another and thereby be protected from the claims of most creditors of the beneficiaries (and of the grantor). The degree of "creditor proofing" usually varies depending on whether the trust gives the beneficiary the right to receive all of the income, is for the "support" of the beneficiary and/or restricts alienation of the beneficiary's interests.[12] It appears the maximum protection of trust property from the claims of the beneficiary's creditors may be achieved by placing property in a trust that gives the trustee complete discretion as to whether and when to distribute income and/or principal to the beneficiary or beneficiaries of the trust, and which also imposes spendthrift restrictions. The trustee, having control over distributions, probably should not be one of the beneficiaries, both to secure the creditor protection and to avoid inclusion of the property in the estate of a beneficiary for tax purposes (which may be viewed as an additional form of credit protection). The beneficiary, however, may participate as a trustee in investment decisions and may have a non-general power of appointment over all or part of the trust corpus.[13]

Such a trust offers major advantages to the beneficiaries. First, the trust assets should be entirely protected from the claims of most creditors of the beneficiaries, including creditors in bankruptcy and spousal property, and in some cases, even support claims, in the event of divorce or upon death of the beneficiary.[14] In order to maximize the creditor protection, the trustee may be given broad authority not only to distribute or accumulate income and principal, but also to purchase assets for the use of trust beneficiaries. For example, the trustee may be authorized to purchase a home for the use of the beneficiary, thereby preserving that asset in the trust protected from the claims of the beneficiary's creditors. (It seems that this use by a beneficiary should not cause any income to be imputed to the beneficiary.) The purchase of assets "inside" the trust as opposed to distributions also preserves the wealth transfer tax savings that may be achieved through the use of such a trust. Thus, the property owner can confer a substantial benefit on the chosen objects of his or her bounty by transferring during lifetime or bequeathing at death assets to such a "discretionary" trust.[15]

As noted above, however, a transfer for less than fair value[16], including a gratuitous transfer in trust for the benefit of another, may be set aside if it constitutes a fraudulent conveyance. For example, a person could not defeat an outstanding liability by transferring while insolvent all of his or her assets into a trust for the benefit of his or her spouse. Thus, in the case of lifetime planning, it is best to have created trusts and make the transfers in advance of any financial difficulties in order to successfully avoid the challenge that such transfers were fraudulent conveyances.[17]

The second general rule relates to whether and to the extent of which the grantor of the trust has a beneficial interest in it. As to a trust created for one's own benefit, the "black letter" law is that a transfer in trust for the benefit of the transferor is void as against his or her creditors, whether their claims arise before or after the transfer.[18] In other words, the general rule that has

prevailed throughout the United States, at least until the enactment of the Alaska Trust Act[19], has been that the assets in the trust may be claimed by the creditors of the grantor to the extent the grantor is entitled or eligible to receive assets from the trust, even if the transfer to it was not in default of creditors and even though the statute of limitations for a person to make a claim that the transfer to the trust was fraudulent has expired.[20] For example, an individual creates a trust in 1970 from which the individual is eligible, but not entitled, in the exercise of discretion of a third party as trustee, to receive distributions. A judgment is rendered against the grantor in 1997 on account of a car accident that occurred in 1996. To the extent the trustee has the capacity to make distributions of trust property to the grantor, the judgment against the grantor could be enforced according to the Restatement (2d) Trusts against the trust assets even though the grantor had no intention of defrauding that creditor, or any other creditor, when the trust was created in 1970. On the other hand, a judgment creditor of the grantor generally may not attach the assets in a trust of which the grantor is neither eligible nor entitled to receive distributions unless the transfer was in defraud of creditors.

## The Tax Rule

THE TREATMENT OF self-settled domestic trusts has been explored in a series of federal tax cases that follow from the creditors' rights analysis. Specifically, if the grantor's creditors can reach the entire corpus of such a trust, the transfer to the trust is regarded as wholly incomplete and no gift tax is due upon creation of the trust. As a corollary, however, the entire trust is included in the creator's estate under Code Sec. 2036(a)(1).

Thus, in *Paolozzi v. Commissioner*[21], the settlor transferred property to a trust under which the trustees had discretion to pay over the income to her during her lifetime. The Tax Court determined that under Massachusetts law, the settlor's creditors could reach the maximum amount that, under the trust terms, could be paid to the settlor — that is, the entire income interest. Accordingly, the gift was incomplete to the extent of that interest. In *Outwin v. Commissioner*[22], also considering Massachusetts law, the Tax Court reached the same result where the trustee could distribute income and principal to the settlor in the trustee's discretion but only with the consent of the settlor's spouse. The spouse had an income interest following the settlor's death, could receive principal in the discretion of the trustee at that time, and had a limited testamentary power of appointment. However, the Tax Court concluded that the spouse's veto power was not sufficient to distinguish the situation from Paolozzi, regardless of the fact that the spouse might be an adverse party for gift-tax purposes.[23]

More recently, in *Paxton v. Commissioner*[24], the Tax Court held that a trust was included in the settlor's estate where the trustee had discretion to apply income and principal among a class of persons including the settlor; the trustee was the settlor's son, who also had a beneficial interest in the trust. The Tax Court looked to Washington state law, but relied primarily on the Restatement rule, discussed earlier, to support its holding.[25]

## Offshore Trusts

IN THE PAST FEW YEARS, there has been considerable use of trusts created in those foreign jurisdictions that provide greater protection against claims of creditors than is available under American law. A so-called "asset protection trust" allows a grantor to protect assets from his or her creditors without requiring the settlor to relinquish all interest in the assets in the trust. In general, asset protection trusts are trusts established in foreign jurisdictions that have limited the recourse of creditors to trust assets.

The selection of the foreign jurisdiction in which the asset protection trust will be established requires great care because of the existence of the English "Statute of Elizabeth" (precursor to U.S. fraudulent conveyance law, discussed above), which makes it possible to set aside a transfer that is intended to defeat future, but currently unknown, creditors. Some offshore sites have enacted "Statute of Elizabeth override" statutes to circumvent any questions concerning the applicability of the Statute of Elizabeth. Some of the offshore sites that have passed such legislation are the Bahamas, Bermuda, the Cayman Islands, the Cook Islands (which appears to offer particularly strong protection against creditors) and Gibraltar[26]. Other concerns are political stability and the availability of adequate banking and other financial services in the chosen jurisdiction.

Asset protection trusts usually are designed so that the settlor, upon creation of the trust, will experience no tax consequences. In almost all cases, an asset protection trust will be a so-called "grantor trust" for federal income tax purposes, with the result that the creator will continue to be taxed on all the trust income in the same manner as if he or she continued to own the trust property outright.[27] In addition, the settlor typically retains certain powers or interests sufficient to render the transfer to the trust an incomplete gift, thereby avoiding gift tax and keeping the trust property within the settlor's gross estate for estate tax purposes. For example, in Private Letter Ruling 9536002 (May 12, 1995) (not precedent), the IRS ruled that a transfer to an offshore trust was incomplete because the grantors retained a limited power of appointment over the trust property.

## The New Alaska Trust Law

***Elimination of the Rule Against Perpetuities.*** Under the Alaska Trust Law, an interest in a trust will not fail to be valid because it is non-vested if all or part of the income or principal of the trust may be distributed, in the discretion of the trustee, to a person who is living when a trust is created.[28] As a practical matter, this means a trust can be of perpetual duration provided the Trustee has discretion to distribute trust income and principal to the beneficiaries, at least one of whom is living when the trust is created. (This might be contrasted with South Dakota law, which provides that a trust may be perpetual if the trustee is authorized

to sell the trust assets and with Delaware law which has abolished the rule against perpetuities in its entirety, except with respect to real estate.) Thus, a perpetual trust now can be created under the law of Alaska which imposes no income tax. And if the trust is not a grantor trust (causing the income to be attributed directly to the grantor), state (and local) income tax can be avoided to the extent trust income is not currently distributed to beneficiaries who are tax residents of states (or localities) that impose income tax.

***Spendthrift Provisions.*** Alaska law also was amended expressly to provide that a person who transfers property in trust may direct that the interest of a beneficiary of the trust may not be either voluntarily or involuntarily transferred before payment or delivery of the property to the beneficiary by the trustee. It further provides that if the trust contains such a transfer restriction, the restriction prevents a creditor existing when the trust is created, a subsequent creditor or any other person from seeking to satisfy a claim out of the beneficiary's interest in the trust, subject to four exceptions.

First, if the settlor retains the power to revoke or terminate the trust, his or her creditors may attach the trust property to the extent of the power of revocation or termination. However, a power to revoke or terminate does not include a power to veto distributions from the trust to another beneficiary, the retention of a special testamentary power of appointment, or the right to receive a distribution of income, corpus or both in the discretion of another person, including a trustee, other than the settlor of the trust. The veto power and power of appointment may be retained by the grantor to prevent the transfer to the trust from being complete for federal gift-tax purposes.[29] By the same token, retention of such powers will cause the assets to be includable in the gross estate of the grantor at death.[30]

Second, creditors of the settlor may also attach property in the trust to the extent that the trust income and principal must be distributed to the grantor.

Third, the transfer is void with respect to creditors if at the time of the transfer to the trust the settlor was in default by 30 or more days in making a payment due under a child support judgment or order.[31]

Fourth, the transfer is subject to attachment by the settlor's creditors if the transfer was intended, in whole or in part, to hinder, delay or defraud creditors under the Alaska fraudulent transfer law. (AS 34.40.010.) However, an action to claim the transfer was fraudulent may not be commenced unless (1) if the claimant was a creditor when the trust was created, the action is brought within the later of four years after the transfer to the trust was made or one year after the trust is or could have been reasonably discovered, or (2) if the claimant becomes a creditor after the transfer, the action is commenced within four years after the transfer to the trust.[32]

The foregoing means that if the settlor is not in default by 30 or more days of making a child support payment, the transfer was not intended to defraud creditors and the grantor retains no power to revoke or terminate the trust or the mandatory right to receive income or principal but only retains the right to receive a distribution in the discretion of a trustee, creditors of the grantor cannot reach the assets contained in the Alaska trust. If the grantor retains the power to veto a distribution to other beneficiaries and a special testamentary power of appointment or similar right, the transfer to the trust will not be complete for gift and estate tax purposes even though it is not subject to the claims of the grantor's creditors. On the other hand, if the grantor retains no such power to veto or power of appointment or similar right, the transfer to the trust will be complete for estate and gift tax purposes. Thus, the Act offers flexibility to integrate creditor protection with the grantor's tax and other estate planning objectives.

## The Rule for Making the Trust Alaskan

ALTHOUGH FOUR OTHER jurisdictions (Delaware, South Dakota, Idaho and Wisconsin) allow trusts to last perpetually in their jurisdictions, no statutory guidance is provided by their laws as to what connection or nexus is sufficient to cause their state's law to apply to the trust. The Alaska statute, however, provides an explicit rule as to what makes a trust an Alaskan trust for both the purpose of avoiding the rule against perpetuities and the purpose of creating a trust that will not be subject to claims of the settlor's creditors. First, some of the trust assets must be deposited in the state and be administered by a "qualified person." Deposited in Alaska means held in a checking account, time deposit, certificate of deposit, brokerage account, trust company fiduciary account or other similar account located in Alaska. A "qualified person" is an Alaskan domiciliary or an Alaskan trust company or bank. Second, the Alaskan trustee's duties must at least include an obligation to maintain records for the trust (on an exclusive or nonexclusive basis with other trustees) and the obligation to prepare or arrange for the preparation of income tax returns that must be filed by the trust (again on an exclusive basis or on a nonexclusive basis with other trustees). Third, part of the administration must occur in the state.

## Some Contrasts to Foreign Asset Protection Trusts

ALTHOUGH AN AMERICAN now is able to create an Alaskan trust of which he or she is a discretionary beneficiary which will be protected from the claims of his or her creditors, an Alaska trust will not provide the same level of practical protection from claims of creditors which may be afforded to a trust created in one of the offshore jurisdictions, such as the Cook Islands or the Bahamas. The laws of such offshore jurisdictions typically have extremely short statutes of limitations before the period to commence an action claiming the transfer to the trust was fraudulent runs which, as a practical matter, cannot be met by a creditor especially if the trust is created and funded sufficiently in advance of the entry of a final judgment against the debtor in an American court.[33] Second, the

jurisdiction may prohibit the enforcement of American judgments. That means the action must be retried in the offshore jurisdiction. As a practical matter, that may well be impossible. Because Alaska is one of the American states, its courts will be required to give full faith and credit to any judgment of a sister state although, as indicated, a judgment against the debtor will not be enforceable against the Alaska trust unless there is a finding that the transfer to the trust was a fraudulent transfer or some other reason for voiding the trust, such as the grantor having been in default by 30 or more days in child support payments at the time the trust was created. Third, at least some of these offshore jurisdictions explicitly exclude some claimants from contending a transfer was fraudulent. For instance, in some cases, a claim founded on a domestic right (such as an equitable distribution claim to property in the event of a divorce) cannot be brought against a trust situated in that jurisdiction.

In some ways, however, a foreign asset protection trust may be less desirable than an Alaska trust. Obviously, there is greater political risk in these offshore jurisdictions than there is in the United States. In addition, new "anti-foreign trust" provisions added to the Internal Revenue Code (see, e.g., Code Sec. 6048) will not apply to an Alaska trust. Also, it may be that a court would be more prone to view the creation of a foreign asset protection trust as an attempt to remove or secrete assets than it would the creation of an Alaska trust. In a recent bankruptcy court case, the court expressed considerable hostility to the creation of an offshore trust and ultimately applied New York law to determine whether the debtor had retained a property interest in the trust (which was established under Jersey law) for purposes of determining whether he should be denied a discharge in bankruptcy.[34] It appears, however, that this case may have turned on the rather extraordinary facts, which the court apparently perceived as involving a course of deception and concealment of assets by the debtor.

## Options Under the Alaska Trust Act

A SIGNIFICANT OBSTACLE to the making of lifetime transfers is that the property owner is then cut off from the property. For example, some persons are willing to make a gift, and anticipate that they will be comfortable without the gifted asset and/or the income therefrom under the most likely scenarios, but are concerned about a "disaster" situation in which they might need access to the funds. They may not be at all concerned about protecting assets from creditors. In such a case, an offshore trust may be appropriate to consider. Precisely because the normal U.S. rule permitting creditors to reach the trust does not apply, the fact that the grantor is a permissible beneficiary of trust income and/or principal in the discretion of an independent trustee should not render the gift incomplete and includable in the estate under Code Sec. 2036 or 2038. Thus, the trust can be structured so that the transfer is a completed gift upon creation.[35] Gift tax would be paid (or unified credit applied). In that way, the "normal" estate planning benefits of removing gifted assets and the appreciation thereon from the estate are achieved. However, the Trustee can give the settlor access to the trust assets.

These same opportunities are now available to Americans using Alaska trusts. For example, an individual could create a so-called "Crummey trust"[36] in Alaska for the benefit of himself or herself as well as members of his or her family and protect transfers to the trust from gift tax using annual exclusions with respect to the other family members. For instance, a woman who is married and has two children could transfer up to $50,000 under the protection of the annual exclusion under Code Sec. 2503(c) granting her husband and each child the right, respectively, to withdraw $10,000 and $20,000 from the trust. The transfers to such a trust created under Alaska law would be complete and should be excludable from the grantor's estate at death even though the grantor is eligible, although not entitled, to receive distributions from the trust in the discretion of a trustee other than himself or herself. Of course, the beneficiaries may exercise the powers of withdrawal so that there is no property left in the trust from which the grantor could benefit. In addition, to the extent that the powers of withdrawal have not lapsed tax-free pursuant to Code Sec. 2514(e) and 2041(b)(2), the property subject to the powers of withdrawal will be includable under Code Sec. 2041(a) in the gross estates of the powerholders.

An individual also could create an Alaska trust and transfer the amount of his or her remaining gift tax exemption equivalent (which can be as great as $600,000) and remain a beneficiary eligible to receive distributions in the discretion of a trustee other than himself or herself and avoid having the property includable in his or her estate. This provides an opportunity to remove the income and appreciation earned on the property during the balance of his or her lifetime from his or her gross estate even though the grantor has retained the possibility of receiving assets back in the discretion of the trustee if appropriate circumstances arise. Similarly, an individual could make a transfer, which is complete for estate and gift tax purposes, to an Alaska trust, of which he or she is eligible to receive distributions, equal to his or her remaining GST exemption under Code Sec. 2631(a) which can be as great $1 million. This would allow the amount protected from generation-skipping transfer tax to increase by post-transfer income and appreciation during the balance of the transferor's lifetime even though the grantor is an eligible beneficiary of the trust.

The entitlement to payments from a grantor retained annuity trust (GRAT) described in Code Sec. 2702(b)(1) or grantor retained unitrust (GRUT) described in Code Sec. 2702(b)(2) must terminate prior to the death of the grantor or the trust assets will be includable, in whole or in part, in the grantor's estate.[37] However, if the GRAT or GRUT is created under Alaska law, the property may continue in trust after the grantor's annuity or uni-

trust term ends, and the grantor thereafter could be eligible to receive distributions from the trust without causing the trust to be includable in his or her estate, provided the grantor survives the annuity or unitrust term.

## Conclusions

THE DUAL GOALS OF asset protection and reduction in taxation are often compatible and complementary. The new Alaska Trust Act provides an opportunity for Americans in all states to create trusts in Alaska which may help achieve both goals. Although not providing all of the practical protection that may be available through similar trusts created in offshore jurisdictions, many Americans will prefer for their assets to remain in the United States. For them, Alaska trusts may be considered. Although not discussed in detail in this article, making the trust perpetual in ? offer additional financial, tax and estate planning benefits. ◆

### End Notes

1. See, e.g., *Paolozzi v. Commissioner*, 22 T.C. 182 (1954).
2. Compare Reg. Sec. 25.2511-2(c) with Code Sec. 2038(a).
3. "If and when the grantor's dominion and control of the trust assets ceases, such as by the trustee's decision to move the situs of the trust to a state where the grantor's creditors cannot reach the trust assets, then the gift is complete for Federal gift tax purposes...." Rev. Rul. 76-103, 1976-1 CB 293. See generally, Kartiganer, Rollins & Piontnica, "Completed Gifts to Offshore Trusts and the Three-Year Rule," Journal of Asset Protection (March/April 1996).
4. See generally, P. Alces, The Law of Fraudulent Conveyance, Sec. 504 (1989) (1991 Cum. Supp. No. 2).
5. See, e.g., Tex. Prop. Code Sec. 42.004(a); (under Texas law, a debtor who acquires otherwise exempt personal property with intent to hinder, delay or defraud creditors loses the personal property exemption--however, that is not the case with the Texas homestead exemption, although a bankruptcy discharge may be denied); *Anderson Mill & Lumber Co. v. Clements*, 134 So. 588, 592 (Fla. 1931); (under Florida law, debtor who acquires otherwise exempt homestead property with intent to hinder, delay or defraud creditors loses homestead exemption).
6. See, e.g., Bankruptcy Code Sec. 727(a)(2); *In re Reed*, 700 F.2d 986, 988 (5th Cir. 1983) ("a debtor who converts nonexempt assets to an exempt homestead immediately before bankruptcy, with intent to defraud his creditors, must be denied a discharge in bankruptcy because of the provisions of Section 727 of the Bankruptcy Code"); *In re Myerson & Kuhn*, 121 B.R. 145, 158-159 & n.15 (Bkrcty. S.D.N.Y. 1990).
7. *Oberst v. Oberst*, 91 B.R. 97, 101 (Bkrcty. C.D. California 1988). *See, also, Klein v. Klein* et al., 122 NYS 2d 546 (1952) (similar).
8. See *Myers v. Redmill*, 266 Ala. 270, 96 So. 2d 4 0 (1957) (conveyance to wife two days after automobile accident), and cases cited in annot., 73 A.L.R.2d 749. See, also, annot., 38 A.L.R.3d 597.
9. Such an interest would normally be excluded from a beneficiary's bankruptcy estate as well. See Bankruptcy Code Sec. 541(c)(1) and (2). *In re Remington*, 14 BR 496 (Bankr. DNJ 1981) (in bankruptcy proceeding of New Jersey resident, both income and principal of trust created for his benefit by relative who resided in Pennsylvania protected under Bankruptcy Code because under Pennsylvania law spendthrift provision was effective to provide that protection).
10. In some states, trusts are "spendthrift" only to the extent so provided in the governing instrument. In other states, they are "automatically" spendthrift unless the governing instrument provides otherwise. In still others, they may not be "spendthrift" at all (*i.e.* they are subject to creditor claims regardless of spendthrift provisions in the instruments). See, e.g., *Industrial Nat'l Bank v. Budlong*, 106 RI 780, 264 A2d 18 (1970).
11. *See e.g.*, N.Y. Debtor and Creditor Law, Secs. 278 and 279.
12. *See, e.g.*, Scott, 11A The Law of Trusts, Secs. 152, 155-157.1 (4th ed. 1987); Restatement (2d) Trusts, Secs. 155 and 157; Cal. Prob. Code Ann. Secs. 15400-15307.
13. See Code Sec. 2041.
14. *See Converstan v. Kellogg*, 136 Mich. App. 504, 357 N.W. 2d 705 (Mich. App. 1984); Scott, *supra*, Sec. 157.1.
15. *See* Oshins & Blattmachr, "The Megatrust: An Ideal Family Wealth Preservation Tool", Trusts & Estates 20 (November 1991).
16. It is not always clear whether a transfer is for fair value for this purpose. The analysis will depend on applicable law and the facts of the case.
17. See *Oberst v. Oberst*, 91 B.R. 97 (Bkrtcy. C.D. Cal. 1988).
18. *See, e.g.*, Restatement (2d) Trusts, Sec. 156.2.
19. Although apparently not widely known, a rule somewhat similar to that in Alaska is contained in Missouri Revised Statute Sec. 456.080.
20. However, it seems that not every retained interest will trigger the application of this rule. For example, a power to direct investments probably is not attachable by the grantor's creditors. A related issue is whether creditors can reach the assets of a trust over which the settlor retained a power of revocation (or a general power of appointment), and whether creditors can reach the assets of such a trust to satisfy the debts of the settlor/decedent. It appears that the trend is to allow assets in such a trust to be used to satisfy the debts of the settlor/decedent and toward extending the recourse of creditors (including creditors of a decedent) against such trusts, in some cases by statute. *See*, e.g., Cal. Prob. Code. Ann Secs. 18200 and 18201; *State Street Bank & Trust Co. v. Reiser*, 389 N.E.2d 768 (Mass. App. 1979).
21. 22 T.C. 182 (1954). *See, also*, Rev. Rul. 77-378, 1972-2 CB 347; Rev. Rul. 76-103, 1976-1 CB 294.
22. 76 T.C. 153 (1981), acq. 1981-2 C.B. 1.
23. See *Comm'r v. Vander Wheele*, 254 F2d 895 (6th Cir. 1958), *acq.* 1962-1 CB 5 (same result under Michigan law); PLR 8350004 (same result under California law). Neither a private letter ruling (PLR) nor a national office technical advice memorandum may be cited or used as precedent. Code Sec. 6110(j).
24. 86 T.C. 785 (1986).
25. *See*, however, *Estate of German v. United States*, 85-1 TC ¶ 13,610 (Ct. Cl. 1985) and *Herzog v. Comm'r*, 116 F.2d 591 (2d Cir. 1941), finding that creditors could not reach assets of a trust of which the settlor was one of several discretionary beneficiaries (or found that the Internal Revenue Service had failed to meet its burden to show that settlor's creditors could reach the asset held in the trust). However, the conclusion reached by the Federal courts in these cases may not be the same as those reached by state courts. Compare *Vanderbilt Credit Corp. v. Chase Manhattan Bank, N.A.*, 100 AD2d 544, 473 NYS 2d 242 (2d Dep't 1984) with *Herzog v. Comm'r*, supra.
26. In general, it appears that asset protection trusts will be effective only against future, but currently unknown, creditors. The settlor, generally, cannot be insolvent at the time the trust is created or become insolvent as a result of the creation of the trust.
27. *See* Code Sec. 677(a) (a trust is a grantor trust if, among other situations, the trustee, without the consent of an "adverse party", can distribute the trust assets to the grantor.) There will be no Code Sec. 1491 excise tax consequences since no tax will apply to the transfer of appreciated assets to a foreign trust so long as that trust is a "grantor trust" and the settlor is a U.S. person. Rev. Rul. 87-61, 1987-1 CB 219.
28. AS 34.27.050(a)
29. Reg. Sec. 25.2511-1(c).
30. Code Sec. 2036(a)(2), 2038(a).
31. An Alaska trust could not be used to avoid child support or alimony payments because neither a judgment for child support nor one for alimony is dischargeable in bankruptcy. Bankruptcy Code Sec. 523(a)(5).
32. It is possible that a court would determine that the statute of limitations of the grantor's domicile state (or another state) should be applied rather than the one provided under the new Alaska law. This could mean a shorter, longer or "different"statute of limitations. However, the determination that the trust is "spendthrift" under Alaska law should apply even if the grantor is domiciled elsewhere. *See 4 Collier on Bankruptcy*, 544.02 at 544-13 to 544-14 and fn. 17 (15th ed. 1989) ("The

tendency of the courts is to treat the law of the site of property at the commencement of the case as governing to the extent that Sec. 544(a) refers to non-bankruptcy law"); *4A Collier on Bankruptcy*, ¶ 70.26 at 304-365 (14th ed.) ("Whether the bankrupt's interest as a *cestui que trust* was, at the time of bankruptcy, assignable or transferable, or subject to attachment, seizure or judicial sale, is a matter generally to be determined by the law of the state where the trust has its situs" [footnote omitted]); *Ferrari v. Barclays Business Credit, Inc.*, 108 B.R. 384, 387 (D. Mass. 1989) ("The authorities ... have shown a preference for applying the law of the site of the conveyed property); *In re Remington*, *supra* (applying Pennsylvania law to determine interest of New Jersey debtor in trust established under Pennsylvania law). But cf. In re Portnoy, infra (alleged concealment of assets of offshore trust as grounds for denial of discharge in bankruptcy).

33. But, see 515 S. *Orange Grove Owners Ass'n v. Orange Grove Partners*, Plaint No. 208/94 (High Ct. Raratonga, Civil Div., Nov. 6, 1995)

34. *In re Larry Portnoy*, 201 B.R. 685, 695 (S.D.N.Y. 1996).

35. *See, e.g.*, PLR 9332006 (not precedent) (transfer to offshore trust of which grantor and members of grantor's family are eligible beneficiaries a completed gift and will not be in grantor's estate because under the law governing the trust creditors of the grantor cannot attach the trust assets).

36. *See*, generally, Blattmachr & Slade, "Building an Effective Life Insurance Trust"

*continued on page 94*

Trusts & Estates 29 (May 1990) explaining how to structure such a trust to hold insurance policies on the grantor's life. Crummey trusts can hold other assets as well. It seems that the life insurance proceeds should not be includable in the grantor's estate under Code Sec. 2042 if the grantor is merely an eligible beneficiary of the trust which is not subject to the claims of his or her creditors, because the incidents of ownership (which is the "touchstone" for application of Code Sec. 2042) held by a trust are not automatically attributed to the beneficiary whose life is insured. *See, e.g.*, PLR 9434028 (not precedent).

37. The Internal Revenue Service has contended that a GRAT is includable in its entirety under Code Sec. 2039(a) if the grantor dies during the term for which he or she is entitled to annuity payments. *See* PLR 9345035 (not precedent).

# Estate Planning on America's Last Frontier: Alaska Trusts, Limited Partnerships, and LLCs

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Two 1997 statutory changes to Alaska law provide new estate planning opportunities for clients throughout the country, as well as for some outside the United States. The Alaska Trust Act, Chapter No. 6, SLA 1997, which became effective in April, 1997, allows individuals to create "self-settled" trusts under Alaska law that are immunized under that state's laws from claims of the individual's creditors. Another act amended Alaska law relating to limited partnerships and limited liability companies formed in that state. Chapter No. 78, SLA 1997. This second change was designed to simplify the formation and operation of these entities as permitted under the new Treasury Department "check the box" regulations. These two statutory changes provide enhanced opportunities in the United States for asset protection. Perhaps of greater interest to Fellows, the two acts provide new opportunities in estate planning. Although using either act alone may be effective, estate planning may be more enhanced in many cases by using a combination of Alaska trusts and Alaska limited partnerships or limited liability companies.

## Alaska Trusts

The principal changes made by the Alaska Trust Act are (1) effectively to repeal the rule against perpetuities for Alaska trusts, and (2) to permit an individual to create an Alaska trust of which he or she is an eligible beneficiary yet (unlike the law that prevails in virtually all other American states) which will not be subject to the claims of his or her creditors. This latter change not only provides asset protection, but also allows lifetime transfers to be complete for federal gift and estate tax purposes in ways not previously available under American law.[1]

As a general matter, to the extent that a creditor can reach assets transferred by an individual to a trust, those transfers will not constitute completed gifts and will be includable in the gross estate of the transferor. However, it seems certain that if the trust is formed in "a state where the grantor's creditors cannot reach the trust assets, then the gift is complete for federal gift tax purposes...." Rev. Rul. 76-103, 1976-1 C.B. 293. See also Rev. Rul. 77-378, 1977-2 C.B. 347; *Estate of German v. U.S.*, 7 Ct. Cl. 641 (1985); *Estate of Uhl v. Commissioner*, 241 F.2d 367 (7th Cir. 1957); *Estate of Wells v. Commissioner*, T.C. Memo 1951-574. Both Rev. Rul. 76-103 and Rev. Rul. 77-378 specifically deal with completed gifts, and not with estate exclusion. These rulings make clear that if, under the law where the trust is created, creditors cannot reach the property transferred, the transfer is *entirely* complete for gift tax purposes.[2] If the grantor has retained an interest, as noted above, creditors can reach that interest and presumably the transfer would not be entirely complete. Although it is theoretically possible for a transfer to be entirely subject to gift tax (even though partially an incomplete gift) and still be included in the gross estate of the transferor, such circumstances are rare. However, the rulings state that the transfer is entirely complete for gift tax purposes, not just that it is entirely subject to gift tax. It is thus reasonable to conclude that the Internal Revenue Service has determined that no interest was retained by the transferor because if the grantor had retained an interest, the transfer would be partly incomplete.[3]

In contrast to the law of most American states, many jurisdictions outside the United States provide that the interest of a grantor in a trust he or she created is not subject to the claims of his or her creditors unless the transfer to the trust was a fraudulent transfer under that jurisdiction's rules. As a consequence, under U.S. law transfers to such a foreign trust can be complete for U.S. estate and gift tax purposes, even though the grantor is a beneficiary of the trust. Indeed, the *German*, *Uhl*, and *Wells* cases cited above so hold. In addition, the IRS has explicitly so ruled in private letter rulings. For instance, in PLR 9332006,[4] the Service held that a transfer to an offshore trust of which the grantor and members of the grantor's family were eligible as beneficiaries in the discretion of a trustee (who was a person other than the grantor) was a completed gift and would not be in the grantor's gross estate for federal estate tax purposes because, under the law governing the trust, creditors of the grantor could not attach the trust assets. See also PLR 8037116. With the Alaska Trust Act, such a tax-advantaged trust can now be created under the law of Alaska.

**Self-Settled Estate Planning Trusts**

The Alaska Act opens a new dimension in estate planning for Americans. They can now make lifetime transfers, which are complete for federal gift and estate tax purposes, to an Alaska trust of which the grantor is eligible, but not entitled, to receive distributions in the discretion of a trustee (other than himself or herself).[1] Such self-settled Alaska trusts could be used for virtually all lifetime estate planning transfers.

For instance, an individual may make transfers under the protection of the Internal Revenue Code §2503(b) gift tax annual exclusion by transferring property to an annual exclusion or so-called "Crummey" trust, which provides that certain individuals (such as a transferor's spouse, descendants, and perhaps others, but not the grantor) can withdraw property transferred to the trust up to the amount of annual exclusions not used elsewhere. With an Alaska trust, the grantor may remain eligible to receive distributions of trust property in the discretion of a trustee other than the grantor without causing the trust assets to be includable in his or her estate. From an estate planning perspective, the grantor will want distributions to him or her to be minimized, because such distributions diminish the estate tax planning benefits of having made completed transfers to the trust that otherwise would be excludable from his or her estate.

If an agreement that the grantor would receive the income from or the use of the assets held by the trust may be inferred from the circumstances, the assets almost certainly will be includable in the grantor's estate, under Code §2036(a)(1), even when coupled with the finding that the grantor had no legal entitlement to such income or use. See, e.g., *Estate of Skinner v. U.S.*, 197 F. Supp. 726 (E.D. Pa. 1961), *aff'd*, 316 F. 2d 517 (3rd Cir. 1963). On the other hand, only occasional use of trust assets or occasional receipt of trust income should avoid any such inference. See, *e.g., Estate of Wells v. Commissioner, supra.* Actual retention of the property or the income (that is, the failure actually to transfer the property or the income to another) may also result in estate tax inclusion. See, *e.g., Lee v. United States*, 86-1 U.S.T.C. ¶ 13,649 (CCH)(W.D. Ky. 1986).

**Annual Exclusion Trusts**

Not infrequently, a Crummey trust will acquire one or more life insurance contracts on the life of the grantor or on the lives of the grantor and the grantor's spouse. Ownership of the policies by the trust is an attempt to keep the proceeds paid at death from inclusion in the estate(s) of the insured(s). If the insured holds no "incident of ownership" in the policy at or within three years of death, and if the proceeds are not paid to the estate of the insured, the proceeds should not be included in the insured's gross estate. Code §2035, 2042.

If the terms of an annual exclusion (or another type) Alaska trust that acquires a cash value life insurance contract provide merely that the trustee may, in the exercise of its discretion, distribute trust assets to the grantor, the incidents of ownership in the contract should not be attributed to the insured grantor so as to cause the proceeds to be includable in his or her estate. See, *e.g., PLR* 9434028 (incidents of ownership held by a trust are not automatically attributed to the beneficiary whose life is insured if the beneficiary is not a trustee).

This provides an opportunity for the grantor, through the exercise of discretion of a trustee other than himself or herself, to be eligible to receive cash value in the policy without causing the proceeds paid at death to be includable in his or her estate.

**Unified Credit, GST Exemption, and Other Trusts**

One of the most effective lifetime planning techniques is to transfer as early as possible in life the amount protected from gift tax by reason of the unified credit allowable under Code Sec. 2010 or by reason of the amount of GST exemption under Code Sec. 2631. Use of the unified credit (which under the Taxpayer Relief Act of 1997 will increase commencing in 1998 and continuing through 2006) early in life can result in a very large amount being excludable from the transferor's estate. The early use of the $1 million GST exemption (which under the Taxpayer Relief Act of 1997 is indexed for inflation) can be even more effective from an estate planning perspective. In the long run, because the GST exemption can be used to avoid wealth transfer tax on property as it passes from one generation to the next without limit, the use of the GST exemption to avoid tax may be even more important than use of the unified credit. (As noted earlier, an Alaska trust can be structured so it can last perpetually. Also, Alaska has no income tax.)

The remainder following the grantor's retained interest term in a grantor retained annuity trust (GRAT), grantor retained unitrust (GRUT), or grantor retained income trust (GRIT), including a qualified personal residence trust, can pass outright to others or remain in trust. In most jurisdictions in the United States, the property will continue to be includable in the grantor's estate if the grantor is eligible to receive continuing distributions in the discretion of a trustee after the grantor's entitlement to payments ceases, because the grantor's creditors will be able to attach the trust assets. See Rev. Rul. 77-378, *supra.* However, if the GRAT, GRUT, or GRIT is an Alaska trust, the property should not be includable in the grantor's estate after the annuity, unitrust, income, or use term

ends, even if the grantor remains eligible to receive distribution from the continuing trust for the balance of his or her lifetime in the discretion of the trustee other than the grantor.

If the Alaska trust holds real property outside of that state, it is possible that a court would apply the spendthrift trust rule of the state where the property is situated rather than the spendthrift trust rule of Alaska. If the real estate is located in a state where spendthrift trust provisions are not effective in protecting the grantor's interest in the trust from claims of his or her creditors, it may be appropriate to permit the trustee to distribute trust property to the grantor only if the real property outside of the state of Alaska is no longer held in the trust (*e.g.*, the non-Alaska real estate has been sold by the trustee or distributed to other beneficiaries).

In most states, the grantor could not become a beneficiary to whom the trustee could distribute assets from any continuing trust after the charitable term of a charitable lead trust without causing the property to be includable in the grantor's estate due to the right of the grantor's creditors to attach the trust assets. See Rev. Rul. 77-378. If the charitable lead trust is created under Alaska law, however, the grantor may remain eligible to receive distributions from the continuing trust after the charitable term ends without causing the property to be includable in his or her estate. *Estate of German v. U.S., supra, Estate of Wells v. Commissioner, supra, Estate of Uhl v. Commissioner, supra.*

**Use of Alaska Trusts by Non-U.S. Persons**

Alaska trusts may also be effective vehicles for use by non-U.S. persons. For example, many individuals who are neither U.S. citizens nor U.S. domiciliaries ("foreigners") have American relatives or friends whom they wish to benefit. Except for U.S. real estate and tangible personal property, a foreigner may make lifetime gifts to or in trust for Americans without the imposition of U.S. gift tax. Similarly, a foreigner may make transfers at death to or in trust for Americans without the imposition of U.S. estate tax, except to the extent the transfer consists of U.S. real estate or tangibles, stock in U.S. corporations, and certain indebtedness of U.S. obligors. In addition to avoiding U.S. gift and estate tax, these transfers may be made free of generation-skipping transfer tax. Treas. Reg. §26.2663-2(b). A foreigner can thus transfer to or place in trust for Americans unlimited amounts of non-U.S. assets which will never be subject to U.S. wealth transfer tax. Such an opportunity suggests consideration of the creation of a very long-term or perpetual trust by a foreigner for American relatives or friends whom the foreigner wishes to benefit.

Six American states allow trusts to last perpetually: Alaska, Delaware, Idaho, South Dakota, and Wisconsin. Alaska may be the most preferable of all for several reasons. First, if the foreigner wishes, he or she could remain a beneficiary of an Alaska trust to whom the trustee could make distributions without causing the trust to be includible in his or her estate for federal estate tax purposes. This could be very important due to the major distinction in the taxation of foreigners for gift tax purposes on the one hand, and estate tax purposes on the other. Lifetime gifts by foreigners of U.S. securities are not subject to U.S. gift tax but those same securities, as a general rule, are subject to U.S. estate tax if includible in the foreigner's estate at death. Hence, a foreigner could transfer U.S. stock to an Alaska Trust free of U.S. tax, remain an eligible beneficiary for life and yet avoid U.S. estate tax on the trust assets at death. Also, only Alaska has a statutory rule of what makes a trust be treated as sited there: (i) there must be an Alaska trustee whose duties consist at least of maintaining a set of trust records and of preparing or arranging for the preparation of any trust tax returns, (ii) part of the trust assets must be maintained in Alaska, such as by maintenance of a bank or brokerage account there, and (iii) some part of the administration must occur in Alaska, such as holding some trustee meetings there or effecting some "trades" there.

In fact, even if a foreigner does not wish to benefit Americans but simply wants to create a trust for his or her own benefit that is protected from claims of his or her creditors, an Alaska trust may be preferable to one created in an "offshore" jurisdiction even if that jurisdiction provides for the trust assets to be protected from claims of the grantor's creditors. For several reasons, many foreigners acquire or maintain assets in the United States. Holding those assets through an Alaska trust may well provide an additional level of protection for them.

**Alaska Limited Partnerships and Limited Liability Companies**

Limited partnerships and limited liability companies have become a mainstay in business and personal planning. The adoption by the Treasury Department of the so-called "check the box" regulations effective January 1, 1997, vastly simplified the formation and administration of such entities. See Treas. Reg. §301.7701-1, 2, 3. Prior to the adoption of those regulations, four complex factors (known as "corporate characteristics factors") had to be analyzed to determine whether an entity other than a corporation would be taxed as a corporation or as a partnership. It is generally preferable for an entity to be taxed as a partnership rather than a corporation because profits are taxed once, losses are passed through to the owners of the entity, and adjustments to basis are usually more favorable. See, e.g.,

IRC § 754. Moreover, entities treated as partnerships for income tax purposes can be much more flexible in formation, operation and ownership than so-called S corporations. Subject to certain exceptions (such as for domestic (U.S.) corporations), an entity may elect on its first tax return filed after 1997 to be treated as a partnership (or, alternatively, as a corporation) for federal income tax purposes.

Entities treated as partnerships, in certain circumstances, can be used to enhance the protection of assets from claims of creditors. First, "buy-out" provisions contained in a partnership agreement (or other document) sometimes provide other owners or the entity itself the right to buy partnership interests (or comparable interests in a LLC) from a partner who becomes bankrupt. Although these "triggered by bankruptcy" provisions sometimes are not enforceable, they may be enforceable in certain other cases. In any event, their mere existence may chill a creditor from attempting to attach a partnership interest. Second, as a general matter, any creditor who does succeed to the economic interest of the bankrupt partner but does not become a partner (because, for example, state law or the partnership agreement so provides) nonetheless may be taxed apparently on a pro rata portion of the income, even if no distributions are made. See Rev. Rul. 77-137, 1977-1 C.B. 178. This may make the attached interest in the partnership a liability in the hands of the creditor (because it may generate an income tax liability without a concomitant distribution of cash or other assets,) which may cause the creditor to agree to disgorge the asset at a lower price or possibly to abandon it. Under the law of virtually all jurisdictions, however, a court having jurisdiction over the partnership may order its liquidation for any "equitable" reason. See, *e.g.*, 8A N.Y. Cons. Law §121-802. In addition, under those state laws that otherwise permit a partner to demand to be bought out upon six month's notice (which is the default rule contained in the Revised Uniform Limited Partnership Act), a creditor might convince a court that a creditor should be able to exercise that power to be liquidated out.

Under the new Alaska law, a court will be able to order the dissolution of a partnership or limited liability company only if it determines that it is impossible for the enterprise to continue to operate. Therefore, the court will be unable to order a liquidation merely for an "equitable" reason. In addition, unlike the default rules under most state laws, an Alaska limited partnership or limited liability company does not go out of existence upon the death of a general partner of a limited partnership or of a member of an LLC.

Limited partnerships and LLCs are widely used for estate planning. They can accomplish many goals, including providing a family unit with an opportunity to shift income more efficiently, share in lower brokerage and investment advisory fees, and centralize and harmonize the management of assets and investment decisions. Use of these entities changes the nature of what is owned. In other words, family members no longer own an interest in the assets owned by the partnership or LLC, but rather own interests in the partnership or LLC. Because the nature of the family's interest changes, so does it value. Often, the value is reduced. Lower value may mean lower gift, estate, or generation-skipping transfer tax when an interest is transferred. It can also mean a smaller "step-up" in income tax basis at death. See IRC §1014.

The Internal Revenue Service has shown a strong and growing inclination to disregard the existence of the partnership (or LLC) when disregarding its existence would result in a larger value for estate, gift, or generation-skipping transfer tax purposes, and thus, higher taxes. The Service's attack, to date, has revolved around four primary arguments. See, generally, Aucutt, "More on Deathbed FLPs," 9 *Probate Practice Report* 1 (August 1997), for a discussion of some of these arguments.

First, the IRS has contended that the taxpayer may be making a gift upon formation of the entity to other equity owners (*e.g.*, partners) if the taxpayer receives back an interest worth less than what he or she contributed. The argument may not be sound. For example, upon termination any such "gift" to the other partners may be offset by a "gift" back from the others. If so, any transfer upon formation must be for full consideration and cannot be a gift. At least in some cases, the courts have not completely dismissed the argument that a gift can be made upon formation, thus this argument should not be disregarded in forming a limited partnership or LLC. Cf. *Estate of Trenchard v. Commissioner*, T.C. Memo 1995-232. See, also, Horn, "Limited Partnerships: Some Thoughts and Theories about Key Issues." 23 *ACTEC Notes* 37 (Summer 1997).

Second, the IRS has contended that the existence of the partnership should not be respected in those cases where the partnership was formed only for tax reduction reasons, at least if its existence has no other substantial economic impact. It appears more likely that there will have been a smaller non-tax impact if a transfer of partnership units occurs immediately after the formation of the entity. See, *e.g.*, National Office Technical Advice Memorandum (NOTAM) 9719006 (formation of partnership by individual who was terminally ill and died two days after partnership was formed). See, also, NOTAM 9723009 (formation 54 days before death), and NOTAM 9725002 (formation two months before death).

Third, the Internal Revenue Service also has recently contended that the existence of the partner-

ship should be ignored because it constitutes a restriction on the use of the assets of the partnership. See, *e.g.*, NOTAM 9719006. IRC §2703 provides that, in certain circumstances, an option, agreement, or other right to acquire or use property at a price less than fair market value or any restriction on the right to sell or use the property is ignored for estate, gift, and generation-skipping transfer tax valuation purposes unless it is established by the taxpayer that the option, etc., is comparable to similar ones found in arms' length transactions.

Fourth, the IRS has attempted to attack partnership discounts under IRC §2704(b), on the basis that the partnership agreement (or LLC operating agreement) imposes one or more applicable restrictions. See, e.g., NOTAM 9724703 (provision of partnership agreement that eliminates the right under Massachusetts law of a limited partner to withdraw on six months' notice is disregarded). A restriction is disregarded for valuation purposes under Code Sec. 2704(b) only if the restriction will expire or if the family acting together without non-family members can remove it. It is understood that the Internal Revenue Service may contend that any applicable restriction in a partnership that contains a fixed term (such as terminating in the year 2039) means that the applicable restriction will expire by the terms of the partnership when the term of the partnership ends, and, therefore, any such restriction should be disregarded for valuation purposes. The Internal Revenue Service may also contend that the family can remove any applicable restriction (which under Treas. Reg. §25.2704-2(b) is to be determined under default state law, and not as limited by the terms of the partnership agreement) even in a circumstance where a non-family member (such as a niece or nephew) is also a partner. Under the partnership laws of many states, certain actions may not require unanimous consent of all the partners (unless the partnership agreement expressly so provides).

Alaska law was amended not only to permit simpler formation of limited partnerships and LLCs pursuant to the check-the-box regulations and to use them more effectively for asset protection and other non-tax reasons, but also to assist a taxpayer in resisting such IRS attacks on valuation of interests in partnerships and LLCs. First, Alaska law is now clear that a single member (one owner) LLC may be formed. Forming a limited partnership with only one real owner of equity (*e.g.*, the same person owns all limited partnership interests and all of the stock of a corporation which owns a relatively small general partnership interest) or a single member LLC should avoid any argument by the Internal Revenue Service that a gift is made upon formation from one owner to another. (If a husband and wife, both of whom are United States residents, are the only partners or members, there also is no taxable gift because any gift from one to the other should qualify for the gift tax marital deduction under IRC §2523, barring some provision that would make it a so-called "terminable interest.") The Internal Revenue Service has essentially conceded that a subsequent gift of an interest even in a wholly owned enterprise is to be valued by looking at the interest transferred in isolation. Rev. Rul. 93-12, 1993-1 C.B. 202. Hence, the "depletion of the value of the estate" argument, which is essentially what the gift upon formation contention is, should not arise if the entity is formed by a single owner who thereafter makes gifts to others of interests in the entity.

One of the most effective ways to avoid the IRS contention that the partnership was formed only for tax reduction reasons and without any other substantial economic or other impact is to operate the partnership or LLC for substantial period of time prior to making gifts or sales of the units (and forming it as long before death as practicable if the interests in it will be held until then). As mentioned above, limited partnerships and limited liability companies often provide significant non-tax benefits, such as providing for asset protection and lower brokerage or investment advisory fees through the aggregation of wealth. By making gifts of relatively small interests in the enterprise, the others who receive these transfers can participate in such non-tax benefits attributable to the structure of the enterprise.

The IRS argument that the existence of the partnership should be ignored under IRC §2703 appears flawed. It is based on the Code section, regulations promulgated thereunder, and its legislative history, which indicate that the section applies only with respect to the property which is the subject of the gift or transfer at death. In the case of gifts or transfers at death of partnership interests, it is those interests (not the underlying partnerships assets) that must be restricted for the section to apply. As mentioned, the section does not apply where the taxpayer establishes that unrelated third parties have entered into similar arrangements. Presumably hundreds of such entities will be created under Alaska law, a majority of which probably will be created by unrelated third parties. In many cases, these agreements will contain no provisions other than those provided under default state law. This may help establish that any family partnership agreement or limited liability company, at least to the extent that the governing agreement does not provide additional restrictions, is the same as that entered into by unrelated third parties.

The new Alaska law should go far in combatting the IRS arguments under §2704(b). First, as a matter of default state law, Alaska limited partnerships and

limited liability companies last indefinitely (just as corporations do). In addition, as a matter of default Alaska law, the terms of a partnership agreement (or governing documents of a limited liability company) can only be changed with the unanimous of all partners (or members of an LLC). Hence, if there is any partner who is not a family member (such as a niece or nephew), the family will not be able to remove the restriction and, accordingly, it should not constitute an applicable restriction the existence of which may be disregarded under IRC §2704(b).

Alaska has also eliminated any right of a limited partner or LLC member to demand to be bought out on six months' notice. In fact, under default state law, a partner or member is entitled to distributions only as provided in the governing documents. Moreover, unlike the default rules under the law of virtually all the other states, neither a limited partnership nor a limited liability company is dissolved under Alaska law upon the death of any general partner or member. Rather, a limited liability company continues for as long as there is one member. A limited partnership continues in existence as long as there is another general partner, or if there is none, it dissolves only if a majority-in-interest of the remaining partners fail to elect a new general partner within 90 days.

### New Delaware Asset Protection Trust Legislation

Effective July 1, 1997, Delaware enacted a new law similar to and intended to produce the same estate planning and asset protection benefits that the Alaska Trust Act provides. The official synopsis of the new Delaware law states that the purpose of the Act is to facilitate the establishment of trusts in Delaware and is intended to be like the Alaska Trust Act. In fact, much of the language in the Delaware law is identical to the Alaska law.[6]

Unfortunately, it appears that the Delaware law will provide less asset protection than the Alaska law will. Perhaps of much greater significance, it may not be possible for a gift to a self-settled trust formed under Delaware law, as enacted, to be complete for federal tax purposes. See Dela. Stat. Ann. §3573. Subsection §3573(a) appears to provide that the trust is permanently available to discharge the grantor's obligation to pay alimony, child support, and property settlement awards even if the obligation arises after the transfer to the trust occurs. As indicated above, a transfer is incomplete for Federal estate and gift tax purposes to the extent the grantor can relegate the grantor's creditors to the trust. Here, because the potential use of trust assets is limited and probably ascertainable, it seems the transfer might be only partly incomplete (i.e., to the extent potential use of trust assets for child support, etc. is ascertainable). See Treas. Reg. §20.2036-1(a)(ii).

Probably most troublesome is §3573(b), under which the grantor can certify in writing to any creditor (including apparently someone who becomes a creditor after the trust has been created) that the trust assets are available to satisfy the creditor's claim. That certification seems to make the trust assets available to that creditor. This virtually assures that the gift to the trust is incomplete, because the grantor can relegate his or her future creditors to the trust assets. This power of relegation is sufficient to render the gift incomplete. Rev. Rul. 77-378, *supra*.

Third, under §3573(c) the trust assets are permanently available to claimants who have suffered personal injury, death, or property damage that occurs prior to the transfer to the trust. It appears quite certain that these claimants continue for all time to have access to the property in the Delaware trust to satisfy their claims, even if the transfer to the trust was not a fraudulent conveyance. It seems that transfers to the Delaware trust are incomplete to the extent of any such pre-transfer claims, under Dela. Stat. Ann. §3573(c).

Nonetheless, supporters of the new Delaware trust act are likely to seek to have these potential problems with the legislation cured early in that state's 1998 legislative session. With certain changes, Delaware law will provide the same estate planning benefits currently available under Alaska law.

## Notes

[4] The extent of asset protection is discussed in more detail in Hompesch, Rothschild and Blattmachr, "Does the New Alaska Trusts Act Provide an Alternative to the Foreign Trust?" *The Journal of Asset Protection*, 9 (July-August, 1997).

[5] For example, Rev. Rul. 77-378 states, in part:

> There would be no doubt of his nonliability for gift tax upon the value of the income if he had reserved to himself the absolute right to the income for his life. But he made no such reservation. *He transferred the entire property. Whether he would enjoy any of its income depended entirely on the trustee, who, in his uncontrolled discretion, could deprive him of it completely.* It was only by virtue of the trustee's direction, which on this record must be regarded as entirely voluntary, that the donor received any of the income; and this direction might be terminated whenever the trustee deemed it proper that the wife should receive the income. *Such a hope of passive expectancy is not a right. It is not enough to lessen the value of the property transferred.... 'Whether the grantor enjoy any of the trust's assets is dependent entirely on the uncontrolled discretion of the trustee. Such a hope or passive expectancy does not lessen the value of the property transferred....'* Rev. Rul. 62-13 is hereby clarified to remove any implication

that an entirely voluntary power held by a trustee to distribute all of the trust's assets to the grantor is sufficient to render a gift incomplete either in whole or in part (emphasis added).

[5] Section 2036(a)(1) requires that the decedent retain either 'possession or enjoyment' or 'the right to the income.' If he has a legal right to income, the 'income' phrase would not support inclusion under Section 2036. Perhaps it may be said he has retained 'enjoyment.' However, if some meaning is to be accorded the word 'retained,' some showing of an arrangement, more than the fact that income was paid to the decedent, should be required.... Since such transfers are treated as complete when made for gift tax purposes there is even less reason for the imposition of estate tax liability under Section 2036."

Stephens et al., *Federal Estate and Gift Taxation*, ¶8[4][c] (footnote numbers and footnotes, other than a portion of the text from n. 42, omitted).

[6] Neither a private letter ruling nor a national office technical advice memorandum may be cited or used as precedent. IRC § 6110(j)(3). However, they often are indicative of the Internal Revenue Service's position.

[7] There are four exceptions (or limitations) to the new Alaska spendthrift rule: (i) to the extent the transfer is a fraudulent conveyance, (ii) to the extent that the grantor is in default by 30 or more days in child support, (iii) to the extent that the grantor retains the right to distributions, or (iv) to the extent that the grantor retains a power to revoke. A power to revoke does not include a power to veto distributions to others or to exercise a testamentary special power of appointment. These two powers (i.e., to veto or exercise a testamentary special power) can be used to prevent the transfer to the trust from being a completed gift, but the retention of either power will cause inclusion in the grantor's estate for federal estate tax purposes.

[8] See, generally, Hompesch, "Alaska v. Delaware: Comparison of Recent Trust Legislation," to be published in *Probate & Property* (Jan./Feb. 1998). Mr. Hompesch was the principal drafter of the Alaska LLC/Limited Partnership Amendment Act.

# Alaska Consensual Community Property Law And Property Trust

**THE STATE OF ALASKA has adopted a new community property law by which a married couple may elect to treat all of their assets or specific assets as community property. This article discusses the estate planning uses and implications of converting one's separate property to community property, and how non-Alaskans may use an Alaska Community Property Trust to obtain the tax and non-tax benefits of community property status for select assets.**

In most community property states, many forms of property acquired by a married couple are automatically held as community property, unless the couple enter into a binding agreement to treat their assets as separate property. The Alaska Community Property Act (the Act) gives Alaska residents the option of conducting their marital finances within a community system, making it the first wholly consensual community property statute in nearly 60 years.[1] Of even greater importance to estate planners in other states, however, the Act allows both residents and non-residents to establish Alaska Community Property Trusts, by which specific assets can be held as community property under Alaska law.

## Alaska Community Property

The Act, which became law on May 22, 1998, allows a husband and wife who are both domiciled in Alaska to enter into an agreement that converts any or all of their property into community property.[2] The Act draws many of its key provisions from the Uniform Marital Property Act, which has previously been adopted only in Wisconsin.[3] The key elements of the Alaska community property rules for residents are that:

1. The couple may select which assets are to be community property and which are to be held in some other form of separate or joint ownership;[4]

2. Community property may be owned with rights of survivorship;[5]

3. Each spouse owns and may control a one-half interest in the community property,[6] but the spouses may choose to grant management authority to one of them;[7]

4. Each spouse is required to act in good faith toward the other with respect to their community property.[8]

5. A spouse may "reclaim" community property given to a third party by one of them unless the non-transferring spouse consents, except for gifts that do not exceed $1,000 in any calendar year or larger gifts which are reasonable, in light of the economic position of both spouses;[9]

6. An Alaska court may equitably divide community property along with marital property in the event of divorce, except to the extent, if any, the spouses have provided otherwise in a community property agreement or trust;[10]

7. Community property is not subject to a claim by a surviving spouse to any minimum or elective share when the first spouse dies;[11]

8. An Alaska Community Property Agreement may be set aside if it is found that it was unconscionable when made, was not voluntarily executed, or that he or she was not given and did not have fair and reasonable disclosure of the property and financial obligations of the other spouse and did not voluntarily waive such disclosure.[12]

## The Alaska Community Property Trust

Both resident and nonresident married couples may classify property as community property by transferring it to a community property

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trust and by providing in the trust agreement that the property is community property.[13] The Act requires for a valid Alaska Community Property Trust that:

1. One or both spouses transfer property to a trust;

2. The trust expressly declares that some or all the property transferred is community property under Chapter 75 of Title 34 of the Laws of the State of Alaska;

3. At least one trustee of the trust is a "qualified person" whose powers include or are limited to a. maintaining records of the trust and b. preparing or arranging for the preparation of any income tax returns that must be filed by the trust. A "qualified person" is an individual Alaska domiciliary, Alaska trust company or Alaska bank as described in AS 34.75.100(a) (Michie 1998). The powers to maintain trust records and prepare or arrange for the preparation of trust income tax returns may be given either to the Alaska trustee alone or to the Alaska trustee and one or more other trustees;

4. The Trust must contain the following language (in capital letters) at the beginning of the trust agreement:

THE CONSEQUENCES OF THIS TRUST MAY BE VERY EXTENSIVE, INCLUDING, BUT NOT LIMITED TO, YOUR RIGHTS WITH RESPECT TO CREDITORS AND OTHER THIRD PARTIES, AND YOUR RIGHTS WITH YOUR SPOUSE BOTH DURING THE COURSE OF YOUR MARRIAGE AND AT THE TIME OF A DIVORCE. ACCORDINGLY, THIS AGREEMENT SHOULD ONLY BE SIGNED AFTER CAREFUL CONSIDERATION. IF YOU HAVE ANY QUESTIONS ABOUT THIS AGREEMENT, YOU SHOULD SEEK COMPETENT ADVICE.[14]

5. Both spouses must sign the trust, even if only one transfers property to the trust;

6. The trustees must maintain records that identify which property held by the trust is community property and which property held by the trust is not community property.

An Alaska Community Property Trust that meets these requirements will allow the conversion of the trust assets from separate or joint property into community property. Furthermore, it allows the spouses to enter into enforceable agreements regarding:

1. Their rights and obligations in the property transferred to the trust;

2. The management and control of the property transferred to the trust;

3. The disposition of the property transferred to the trust in the event of the dissolution of the marriage or of the trust, death of either or both spouses or the occurrence or nonoccurrence of another event;

4. The choice of law governing the interpretation of the trust; and

5. Any other matter that affects the property transferred to the trust and does not violate public policy or a statute imposing a criminal penalty.

An Alaska Community Property Trust may not be amended or revoked unless the agreement itself provides for revocation on a particular date or on the occurrence of a particular event or unless the agreement is amended or revoked by a later community property trust. To amend or revoke the trust, the later community property trust is not required to declare any property held by the trustee as community property. This means that the spouses may amend the trust to transmute property back from community property to separate property. Both an Alaska Community Property Trust and a later (amending) Community Property Trust are enforceable without consideration,

although no such agreement is enforceable if unconscionable when made or the spouse against whom enforcement is sought was not given a fair and reasonable disclosure of the property and financial obligations of the other spouse, did not voluntarily sign a written consent expressly waiving the right to disclosure of the property and financial obligations of the other spouse beyond any disclosure made and did not have notice of the property or financial obligations of the other spouse.

## Efficacy Of Alaska Community Property Trusts

An Alaska Community Property Trust for nonresidents of the State of Alaska should be valid for tax purposes if the trust can create enforceable property rights with respect to property contributed by persons who are not resident or domiciled within the State of Alaska. The law on point supports the use of a trust in one state to create beneficial and property rights for nonresident beneficiaries, but even in jurisdictions in which the law may be less supportive, good planning can help assure the desired result.

The rules by which the state that should assume jurisdiction over various aspects of trust administration, construction and the rights of beneficiaries, depend upon whether the trust corpus is real or personal property. Generally, the intent of the settlor determines the jurisdiction for a trust holding personal property, while the sites of the real property are determinative with respect to a trust on real property.

Issues of the administration of a trust holding personal property (whether tangible or intangible) are determined under the jurisdiction in which the trust is otherwise administered, which itself is determined on the basis of the intent of the settlor, as disclosed in the governing instrument. Absent an express declaration in the instrument as to the place of administration, the settlor's intent is usually assumed to be that the trustee shall administer the trust at the trustee's principal place of business or domicile. A settlor who names two or more trustees who are domiciled in different states may manifest an intention that the trust should be administered at the domicile or place of business of one of them. Therefore, if the settlor names one or more trustees situated in Alaska, as is required of an Alaska Community Property Trust, it may be assumed that the trust should be administered in Alaska and that it should be supervised by the courts of that state.

The requirements for an Alaska Community Property Trust include the designation of at least one Alaska trustee and refer repeatedly to the construction of the rights of the parties in the property under Alaska law. Under the general rule, therefore, Alaska courts should have jurisdiction over matters involving the administration of an Alaska Community Property Trust even though they might lack jurisdiction over some or all of the beneficiaries.[15]

Questions relating to the construction of an inter vivos trust holding personal property and the rights of the various beneficiaries will be based on the law of the state designated in the instrument, or in the absence of such a designation, the law of the place of administration if the issue relates to trust administration, or otherwise the jurisdiction that the settlor would probably have desired to apply.[16] A state need have no connection with the trust in order to use its law in construing the trust instrument, if the settlor has selected that particular state's law.[17]

A similar rule applies in determining the overall validity of a trust of personal property. The validity of the trust is determined under the law of the state designated by the settlor, as long as the state has a substantial relation to the trust and that the application of its law does not violate a strong public policy of the state with which the trust has its most significant relationship.[18] A state

has a substantial relation to a trust if the settlor designates that the trust is to be administered there, if any trustee has its principal place of business or domicile in that state when the trust is created, if the trust is administered in that state or if it is the domicile of the beneficiaries.

As to trusts of interests in land, however, the law of the situs of the land becomes more important. The administration and validity of a trust in land is determined according to the law of the state in which the land is situated, even if the trustees are situated elsewhere.[19] A court of a state other than that in which the property is situated may still exercise jurisdiction over the administration of the trust, if this does not unduly interfere with the control by the courts of the situs.[20]

Issues of construction of the trust instrument, however, have not always been construed according to the situs. Some courts apply the law of the situs,[21] but a few others have applied the law designated by the settlor in construing a trust on real estate.[22] The law of the situs almost certainly controls issues of construction only in the absence of a designation in the instrument of the governing law.

Therefore, it appears very likely that an Alaska Community Property Trust holding personal property will be respected in matters of administration, construction and trust validity, as long as it meets the basic rules set forth by Alaska law. On the other hand, it is quite possible that a court would view an Alaska Community Property Trust as not creating community property interests in real estate, the title to which is held by the trust but the location of which is in another state that has no community property rules, or that has significantly different rules from those adopted in Alaska. A practitioner who wishes to create an Alaska Community Property Trust to hold out-of-state real estate should, therefore, arrange for the transfer of the real estate to an Alaska corporation or partnership or limited liability company if that is otherwise compatible with the client's wishes, since stock, partnership interests and LLC interests are themselves personal property, even if the underlying assets are real property. The stock or partnership or LLC interests may then be transferred to an Alaska Community Property Trust, the terms of which would be governed more clearly by Alaska law.

The administration and validity of a trust in land is determined according to the law of the state in which the land is situated, even if the trustees are situated elsewhere.

## Gift Tax Consequences Of Creating An Alaska Community Property Trust

Although an Alaska Community Property Trust could be irrevocable, the grantor or grantors should ensure that neither spouse will be deemed to make a completed gift for Federal gift tax purposes to any third party upon the transfer of property to the trust or thereafter unless that is what he, she or they wish. Because both spouses must sign the trust, even if only one of them transfers assets to it, one spouse cannot create the trust, make the assets community property and unilaterally control what the disposition of those assets will be. If the other spouse does not agree to the proposed disposition, he or she presumably will not sign the trust.

The gift tax marital deduction would appear to be a simple protection against adverse gift tax consequences on the creation of an Alaska Community Property Trust, but the law does not clearly establish that granting one's spouse the immediate, unilateral and continuing right until death to withdraw one-half of any property transferred to and which becomes a community property asset should qualify such one-half interest for the gift marital deduction. In other words, the fact that the donee-spouse's interest in the community property under the Alaska Community Property Trust will terminate at his or her death (if the right to withdraw that interest from the trust is not exercised) may mean it is a terminable interest.[23]

With reasonable planning and drafting, a transfer to an Alaska Community Property Trust should be capable of qualifying for the marital deduction.[24] One way is to create an interest which constitutes an "estate trust," that terminates in favor of the donee-spouse's own probate estate, making it thereby disposable by that spouse's Will.[25] Alternatively, the transfer may be made to qualify by falling under the life estate general power of appointment exception.[26] The donee-spouse must be entitled to all of the income for life payable at least annually and be granted a lifetime and/or testamentary general power of appointment exercisable by the donee-spouse alone and in all events in favor of that spouse and/or his or her estate. These are known as general powers of appointment marital deduction trusts.

Although the statute relating to such general power of appointment marital deduction trusts states that the income must be payable to the spouse at least annually, the regulations promulgated under the gift tax regulations relating to such trusts clarify that the income does not, in fact, have to be paid to the donee-spouse but merely be subject to withdraw by that spouse.[27]

The interest created for the donee spouse in the Alaska Community Property Trust could be made to qualify alternatively for QTIP treatment under Code Sec. 2523(f) by structuring the donee-spouse's interest that way and by election on a timely filed United

States Gift Tax Return. However, it nonetheless seems appropriate to grant the donee-spouse the immediate, unilateral and continuing right to withdraw his or her half of the assets transferred to the Alaska Community Property The nature of community property is that each spouse owns and may control his or her one-half of the assets. Of course, the trust could provide that either or both spouses could relinquish his or her unilateral right to withdraw although, presumably, care should be taken to ensure that any such relinquishment is not a taxable gift, unless that result is intended.[28]

## Income Tax Treatment Of Alaska Community Property Trusts

If one spouse transfers property to the Alaska Community Trust, the trust presumably will be treated as a grantor trust in its entirety with respect to that spouse so that all the trust property, whether all or only part of it becomes community property under Alaska law, is treated as owned for income tax purposes by the grantor-spouse as long as the income and corpus may be distributed, without the consent of an adverse party, to or for the benefit of either or both spouses.[29] Even if the other spouse has the unilateral right to withdraw his or her half of the community property from the trust, powers held by the grantor's spouse are attributed under Code Sec. 672(e) to the grantor. As a result, the grantor-spouse will be treated as though he or she held that power to withdraw, presumably negating any possible application of Code Sec. 678, under which a beneficiary, who is not the trust's grantor but has a unilateral right to withdraw trust property, is treated as the owner of that property for income tax purposes. Moreover, the Internal Revenue Service has consistently held that the provisions of the grantor trust rules (Code Secs. 671-679) which cause the actual grantor to be treated as the owner of the trust assets supercede Code Sec. 678.[30]

When the grantor spouse dies, the trust property will no longer be treated as owned by that spouse for income tax purposes. To the extent that the surviving spouse has a unilateral power to withdraw such property from the trust that spouse will be treated as the owner under Code Sec. 678. Often, a joint revocable community property trust (that is, one created by both spouses with their community property, as well as, perhaps, separate property) provides, when the first spouse dies, that the survivor's half of the assets which had been community property as well as the survivor's separate property, if any, remains subject to that spouse's power of withdrawal. If that pattern is followed in an Alaska Community Property Trust, the surviving spouse will be considered the owner of such property for income tax purposes under the grantor trust rules. However, to the extent the surviving spouse's power unilaterally to withdraw one-half of the community property contributed by the other spouse expires at or before the death of the grantor spouse, the surviving spouse will not be treated as the owner of such property under the grantor trust rules.[31]

When the grantor spouse dies, the trust property will no longer be treated as owned by that spouse for income tax purposes.

To the extent a spouse makes a contribution to the Alaska Community Property Trust that spouse presumably will continue to be treated as the owner of the property, as discussed above, for income tax purposes under the grantor trust rules even if the noncontributing spouse has a unilater-

al right to withdraw none, some (e.g., half) or all of property so contributed if the income from the property contributed or the property itself may be distributed, without the consent of an adverse party, to either or both spouse.[32] As a result, during the spouses' joint lifetimes, each spouse will be treated as owning for income tax purposes the assets he or she contributed. That probably will be the case even if the spouses are treated as exchanging interests in assets contributed. For example, the wife contributes Asset X worth $2 million to the trust which became community property (and, therefore, treated as owned under Alaska law as one-half by the husband) and the husband contributes Asset Y worth $1 million which became community property (and, therefore, treated as owned under Alaska law as one-half by the wife). Even if the wife is treated as exchanging a 25 percent interest of Asset X for a 50 percent interest in Asset Y and the husband is treated as exchanging a 50 percent interest in Asset Y for a 25 percent interest in Asset X, the wife probably will be treated as owning all of Asset X and the husband probably will be treated as owning all of Asset Y for Federal income tax purposes. The reason is that for income tax purposes (of which the grantor trust rules are a part), that exchange normally would be treated as a gift rather than as an exchange.[33] Hence, the spouse who contributed the property presumably will be treated as the sole grantor of that asset for income tax purposes.

To the extent of the property contributed by him or her, the surviving spouse will continue to be treated as the property owner for income tax purposes under the grantor trust rules to the extent the property or its income may be distributed to that spouse, without the consent of any adverse party.[34] After (or as well as before) the other spouse dies. In addition, the surviving spouse may become to be treated as the owner under Code Sec. 678 of property contributed by the first spouse to die upon that spouse's death to the extent the survivor has a unilateral right to withdraw the property after the death of the first spouse to die.

## Basis Adjustment At Death

One major tax advantage of creating an Alaska Community Property Trust is that it enables residents of non-community property states to take advantage of Sec. 1014(b)(6), which states that, upon the death of either spouse, the basis of the entire community property asset (and not just one-half of the asset) becomes equal to the value of the asset at the death of that spouse (or, if applicable, on the alternate valuation date determined under Code Sec. 2032). Sec. 1014(b)(6) does not distinguish between property that is held as community property under automatic (opt out) state laws or under elective (opt in) state laws. Furthermore, significant authority strongly suggests that community property under an opt in law, such as that adopted in Alaska, would be eligible for the basis adjustment at death under Sec. 1014(b)(6).[35]

However, it is appropriate to note that Code Sec. 1014(b)(6) only requires that the property be community property under the laws of any State (or possession or foreign country). Thus, if a non-Alaska married person or persons transfers property to an Alaska Community Property Trust, the property will be community property under the law of Alaska. Therefore, it seems literally to fall under the section.

Although it seems the asset which is community property under Alaska law is "community property ... under the community property laws of [a] State," it is possible the courts will hold otherwise.[36] Accordingly, married couples should elect into the Alaska community property system only if that form of ownership reflects their wishes regardless of whether the basis of the surviving spouse's interest in the property

will be determined on the death of the first spouse to die under Code Sec. 1014(b)(6). Moreover, because the Alaska Community Property law's treatment under that section is untested, it may be preferable for the couple, if it is seeking a step-up in basis for all of their wealth when the first spouse dies, to place all of the assets in the name of the spouse who will die first. Unfortunately, that is not always predictable well before that death occurs. Under Code Sec. 1014(e), no change in basis occurs under Code Sec. 1014(a) for property which was given to the decedent within a year of his or her death and is reacquired, directly or indirectly, by the donor.[37]

## Conclusions

Under the Alaska Community Property Act, both married Alaskans and non-Alaskans may elect for some or all of their assets to be community property under Alaska law. To the extent the value of what one spouse converts to community property exceeds the value of what the other so converts, a gift will be made. That gift should usually qualify for the gift tax marital deduction unless the donee spouse is not a U.S. citizen and the gift, along with other gifts to the spouse, exceeds $100,000 in a calendar year.[38]

Although converting assets to community property that may provide the surviving spouse a significant income tax benefit when the first spouse dies, the change in the nature of assets may have other far-reaching effects.[39] Each spouse, in fact, will have a 50 percent ownership interest in the community property. That means, for example, that the community assets will be subject to a 50 percent division in the event of divorce (except to the extent the court having jurisdiction over the divorce may and does order a different division under applicable equitable distribution or similar laws) and each spouse will be permitted to dispose of his or her one-half of the assets when he or she dies except to the extent agreed otherwise. As with other community property systems, spouses hold other rights with respect to their community property which do not exist with respect to other property they own. As a consequence, it is likely that only couples in long-term stable marriages, and perhaps only those who have descendants only of their common union, will elect to have their assets treated as community property under Alaska law.

Even if neither the Internal Revenue Service nor the courts rule that Alaska community property is community property under Code Sec. 1014(b)(6), it seems likely it will be treated as a "50-50" tenancy in common between the spouses or, if elected under the Alaska Act to be "survivorship" community property as the Act permits,[40] as a joint tenancy with rights of survivorship between the spouses. If so, that probably means one-half of the asset will be included in the estate of the first spouse to die.[41]

Thus, the Alaska Community Property Act and the Alaska Community Property Trust offer a rare opportunity for clients whose marriages are extremely sound, to convert those assets that they wish into community property, with possibly significant income tax advantages upon the first spouse's death. Furthermore, these new laws present this opportunity with remarkably few downside risks. ◆

## End Notes

1. In other community property states, marital property agreements frequently convert some or all of the parties' non-community property assets into community property, filling the gaps left by state law. However, those agreements differ materially from the Alaska Community Property Agreements because the former add some assets to an extant stack of community property, while the latter starts from a situation in which no assets are community property prior to the agreement. On the non-Alaska form of agreement, see, e.g, Rasmussen, "Divorce Provisions in Opt-In Marital Property Agreements," 67 *Wisc. Lawyer* 15 (Apr. 1994).
2. Alaska Stat. 34.75.060(a) (Michie 1998).
3. The Uniform Marital Property Act was approved by the National Conference of Commissioners on Uniform State Laws in 1983. It is adopted in Wisconsin at Wisc. Stat. Ann. Sec. 766.001-766.97.

4. Alaska Stat. 34.75.030 (Michie 1998).
5. *See, e.g.*, Alaska Stat. 34.75.1101(e) (Michie 1998).
6. *See, e.g.*, Alaska Stat. 34.75.30(c) (Michie 1998).
7. *See, e.g.*, Alaska Stat. 34.75.040 and 34.75.909(d) (Michie 1998).
8. Alaska Stat. 34.75.010 (Michie 1998).
9. Alaska Stat. 34.75.050 (Michie 1998).
10. Alaska Stat. 25.24.160(d) (Michie 1998).
11. Alaska Stat. 13.12.208(d) (Michie 1998).
12. Alaska Stat. 34.75.090(g) and (h) (Michie 1998).
13. Alaska Stat. 34.75.060(b) (Michie 1998).
14. A similar requirement exists for an Alaska Community Property Agreement. *See*, Alaska Stat. 34.75.090(b) (Michie 1998).
15. See *Mullane v. Central Hanover Bank & Trust Co.*, 339 U.S. 306 (1950).
16. Restatement (2d) Conflicts of Law, Sec. 268.
17. *Hughes v. Commissioner of Internal Revenue*, 104 F.2d 144 (9th Cir. 1939); *Noble v. Rogan*, 49 F.Supp. 370 (S.D.Cal.1943); *Application of Eyre*, 133 N.Y.S.2d 511 (1954); *Matter of Grant-Suttie*, 205 Misc. 940, 129 N.Y.S.2d 572 (1954); *Matter of Carter*, 13 Misc.2d 1040, 178 N.Y.S.2d 569 (1958).
18. Restatement (2d) Conflicts of Law, Sec. 270.
19. Restatement (2d) Conflicts of Law, Sec. 276.
20. *Fuller v. McKim*, 187 Mich. 667, 154 N.W. 55 (1915); *Knox v. Jones*, 47 N.Y. 389 (1872); *Matter of Osborn*, 151 Misc. 52,270 N.Y.S. 616 (1934); *In re Sandford's Will*, 81 N.Y.S.2d 377 (1948); *In re Fagan's Estate*, 84 N.Y.S.2d 558 (1948); *In re Piazza's Estate*, 130 N.Y.L.2d 244 (1954); *In re Master's Will*, 136 N.Y.S.2d 907 (1954); *In re Warburg's Estate*, 237 N.Y.S.2d 557 (1963).
21. *Bowen v. Frank*, 179 Ark. 1004, 18 S.W.2d 1037 (1929); *Veach v. Veach*, 205 Ga. 185, 53 S.E.2d 98 (1949); *Peet v. Peet*, 229 Ill. 341, 82 N.E. 376 (1907); *Scofield v. Hadden*, 206 Iowa 597, 220 N.W. 1 (1928); *Thompson v. Penn*, 149 Ky. 158, 148 S.W. 33 (1912); *In re Estate of Henche*, 220 Minn. 414, 19 N.W.2d 718 (1945); *Minot v. Minot*, 17 App.Div. 521, 45 N.Y.S. 554 (1st Dep't 1897); *Matter of Good*, 304 N.Y. 110, 106 N.E.2d 36 (1952), *aff'g* 278 App.Div. 806, 927, 104 N.Y.S.2d 804 (1st Dep't 1951), *aff'g* 278 App.Div. 806, 927, 104 N.Y.S.2d 804 (1st Dep't 1951), *aff'g* 96 N.Y.S.2d 798 (1950).
22. *Greenwood v. Page*, 138 F.2d 921 (D.C.Cir.1943); *Guerard v. Guerard*, 73 Ga. 506 (1884); *Brown v. Ramsey*, 74 Ga. 210 (1884) (*inter vivos trust*); *Keith v. Eaton*, 58 Kan. 732, 51 P. 271 (1897); *Houghton v. Hughes*, 108 Me. 233, 79 A. 909 (1911); *Martin v. Eslick*, 229 Miss. 234, 90 So.2d 635 (1956); *Zombro v. Moffett*, 329 Mo. 137, 44 S.W.2d 149 (1931); *Applegate v. Brown*, 344 S.W.2d 13 (Mo. 1961); *Gary v. Carman*, 116 Misc. 463, 190 N.Y.S. 193 (1921).
23. As a general rule, a terminable interest does not qualify for the marital deduction. Code Sec. 2523(b)(1). Certain terminable interests may so qualify. *See, e.g.*, Code Sec. 2523(e), 2523(f).
24. As a general rule, no marital deduction is allowed if the transferor's spouse is not a citizen of the United States. Code Sec. 2523(i).
25. *See, e.g.*, Reg. Sec. 20.2056(c)-2(b)(1)(i). Cf. Rev. Rul. 72-33, 1972-2 C.B. 530.
26. Code Sec. 2523(e).
27. Reg. Sec. 25.2523(e)-1(f)(8). See, also, Reg. Sec. 25.2523(f)-1(f), *Example 2* and *Example 3*.
28. *See, generally*, Reg. Sec. 25.2511-2.
29. Code Secs. 672(e), 673, 676 and 677. The trust may be a grantor trust for income tax purposes for other reasons as well. *See*, Code Sec. 674 (control of beneficial interests in the trust) and 675 (administrative powers).
30. *See, generally*, Blattmachr & Sembler, "Crummey Powers and Income Taxation", *The Chase Review* (July 1995).
31. *See* PLR 9321050, essentially reversing PLR 9026036.
32. As mentioned above, the trust may be a grantor trust for other or additional reasons.
33. Code Sec. 1041.
34. As mentioned above, it may be a grantor trust for other or additional reasons.
35. On the validity of a consensual community property law for this purpose, see *Comm'r v. Harmon*, 323 US 44 (1944); and *McCollum v. United States*, 58-2 USTC ¶ 9957 (USDC ND Ok. 1958); and also see Rev. Rul. 77-359, 1977-2 C.B. 24.
36. The IRS seems to accept that separate property converted to community property by agreement is community property for Federal income tax purposes, at least under an opt-out system. *See* Rev. Rul. 77-359, *supra*.
37. If, as suggested by Rev. Rul. 77-359, *supra*, the transmutation of separate to community property is a gift, Code Sec. 1014(e) may control notwithstanding Code Sec. 1014(b)(6).
38. *See*, Code Sec. 2523(i)(2).
39. Caution should be exercised in converting certain assets to community property, for instance, if one spouse owns a policy of insurance on the life of the other, the conversion presumably will cause the insured spouse to hold an incident of ownership in the policy potentially causing proceeds paid at death to be included in his or her estate. *Cf. Estate of Cervin v. Commissioner*, 111 F.3d 1252 (5th Cir. 1997). It may be inappropriate also for one spouse to convert qualified plan and similar interests into community property. Generally, such interests represent income in respect of a decedent under Code Sec. 691(a) which, under Code Sec. 1014(c), do not receive the income tax free step-up in basis under Code Sec. 1014(a), but complications of such ownership can arise in the non-participant spouse dies first.
40. *See*, Alaska Stat. 34.75.110(e) (Michie 1998).
41. *See, e.g., Harvey v. United States*, 185 F.2d 463 (7th Cir. 1950).

SB

300

# HOUSE COMMITTEE REPC T

(7)
**Date Referred to Committee: April 26, 2006** **FURTHER REFERRALS:**

**Date of Committee Action:** April 26, 2006

**The LABOR AND COMMERCE Committee considered:** **CSSB 300(L&C)**

**CS FOR SENATE BILL NO. 300(L&C)** **MOTOR VEHICLE NEGATIVE EQUITY/CONTRACTS**

**"An Act relating to the handling of negative equity in motor vehicle transactions; and relating to the contents of retail installment contracts."**

**Recommends it be replaced with [ ] HCS *or* [ ] CS *for* _____(_____)**
***For Senate Bills with new title: [ ] Technical Title [ ] New Title: HCR_____*** **[ ] Same Title [ ] New Title**

[ ] attach amendments
[ ] add new referral to _____Committee
[ ] Letter of Intent_____Committee

*List of Abbrev for Depts.:*
ADM
CED
COR
CRT
EED
DEC
DFG
GOV
HSS
LEG
LAW
LWF
MVA
DNR
DPS
REV
DOT
UA

| ***NEW*** FISCAL NOTES *Assigned by Chief Clerk's Office | | | | |
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| List by Dept(s): | *FN# | Fiscal | Indet. | Zero |
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| Signing with recommendations | Printed Last Name | DP | DNP | NR | AM |
|---|---|---|---|---|---|
| Harold T. Crawford Jr. | CRAWFORD | X | | | |
| | LYNN | X | | | |
| | Hart | X | | | |
| | LANDRY | X | | | |
| | Robertson | X | | | |
| | Gallego | | | X | |
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| | | | | | |
| | | | | | |
| Chair: Tom Craddick | ANDERSON | X | | | |
| Chair: | | | | | |

# ALASKA STATE SENATE

Session:
State Capitol
Juneau, Alaska 99801-1182
(907) 465-2327
(907) 465-5241 Fax

Interim:
119 N. Cushman, Suite 201
Fairbanks, Alaska 99701
(907) 456-8161
Senator_Ralph_Seekins@legis.state.ak.us

**Senator Ralph Seekins**
District D

## Senate Bill 300 Sponsor Statement

**"An Act relating to the handling of negative equity in motor vehicle transactions"**

Senate Bill 300 updates the definition of "principal balance" found in the Alaska Retail Installment Sales Act to accommodate the proper disclosure of negative equity. Furthermore, the bill clarifies how, within a lease arrangement, an incidence of negative equity is handled.

There was a time when lending institutions required borrowers to monetarily participate in purchase transactions. In fact, down payments of 25% were quite common. Furthermore, term loans were held to a maximum of 36 months. But, over the last several years these guidelines have gone by the wayside. The strength and stability of the national economy have spurred consumers to demand lower-payment loans along with greater value.

Banks, credit unions and acceptance companies have accommodated the marketplace by offering low, or no, down payment options as well as lengthening the allowable repayment period for many types of lending products. This phenomenon is particularly evident in retail auto sale where qualified buyers often broaden their budget by opting for 100% financing over the longest possible term.

The mathematical effect of this financing strategy is simple – the point in time at which the vehicle's market value exceeds the outstanding balance on the underlying loan occurs much later than it otherwise would. Until this point is reached, the owner's equity position is commonly known as "upside down" or "negative". In other words, the value of the vehicle is not yet sufficient to completely repay the outstanding balance on the loan.

As a result, when the owner wants to trade for a different vehicle, the dealer has to figure out some way to accommodate the loan payoff in the trade-in. At one time it was common practice in some states to simply inflate the price of the car to be purchased enough to permit an allowance for the trade-in that would cover the amount owed. The negative equity disappears.

This method solved the equity problem but failed to adequately describe the transaction mathematically. So, over time, this practice fell into disfavor and, today, it is more common that new vehicles are sold at non-negotiable prices, i.e., through factory incentive programs. Furthermore, the Federal Reserve Board provided guidance on this issue through revisions made to Regulations M and Z. These Regs control the manner in which lease and credit transactions (respectively) are disclosed.

Reg M was revised to provide a dedicated disclosure line on the lease agreement in cases where a *prior* loan or lease balance (negative equity) is rolled in to the new lease transaction. Revisions made to Reg Z altered the definition of "down payment" thereby solving the negative equity issue as it may pertain to a loan transaction.

So what does all this have to do with Senate Bill 300? The vast majority of banks and credit unions are federally regulated. Therefore, they follow federal disclosure laws (state laws do not come into play). However, acceptance companies, like GMAC, Ford Motor Credit, and others, are required to follow federal *and* state laws. The dual adherence requirement has effectively created a disparity in the manner in which loan and lease transactions are disclosed in cases involving negative equity here in Alaska.

So the bottom line is that while Federal law has been revised to accommodate this situation, our state law has not. SB 300 resolves this disparity by updating the definition of "principal balance" as it pertains to the state's disclosure requirements for retail sales contracts found in Chapter 10, Title 45. Furthermore, the Bill adds corresponding language to Chapter 25 pertaining to the handling of negative equity with respect to lease agreements. These modifications bring state and federal law back into alignment.

# FISCAL NOTE

**STATE OF ALASKA**
**2006 LEGISLATIVE SESSION**

Fiscal Note Number: 1
Bill Version: SB 300
(S) Publish Date: 3/10/06

Revision Date/Time (Note if correction):
Dept. Affected: Commerce
Title: Motor Vehicle Negative Equity
RDU: Banking & Securities (536)
Component: Banking & Securities
Sponsor: Seekins
Requester: Transportation
Component No.: 2808

**Expenditures/Revenues** (Thousands of Dollars)

Note: Amounts do not include inflation unless otherwise noted below.

| OPERATING EXPENDITURES | FY 2007 | FY 2008 | FY 2009 | FY 2010 | FY 2011 | FY 2012 |
|---|---|---|---|---|---|---|
| Personal Services | | | | | | |
| Travel | | | | | | |
| Contractual | | | | | | |
| Supplies | | | | | | |
| Equipment | | | | | | |
| Land & Structures | | | | | | |
| Grants & Claims | | | | | | |
| Miscellaneous | | | | | | |
| TOTAL OPERATING | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| CAPITAL EXPENDITURES | | | | | | |
| CHANGE IN REVENUES ( ) | | | | | | |

**FUND SOURCE** (Thousands of Dollars)

| | | | | | | |
|---|---|---|---|---|---|---|
| 1002 Federal Receipts | | | | | | |
| 1003 GF Match | | | | | | |
| 1004 GF | | | | | | |
| 1005 GF/Program Receipts | | | | | | |
| 1037 GF/Mental Health | | | | | | |
| Other (Specify Type--Do not abbreviate) | | | | | | |
| TOTAL | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |

**Estimate of any current year (FY2006) cost:** 0.0
**Mark this box (X) if funding for this bill is included in the Governor's FY 2007 budget proposal:**

**POSITIONS**

| | | | | | | |
|---|---|---|---|---|---|---|
| Full-time | | | | | | |
| Part-time | | | | | | |
| Temporary | | | | | | |

**ANALYSIS:** *(Attach a separate page if necessary)*

This legislation addresses the handling of negative equity in motor vehicle transactions. It does not impact the operations of the division.

Prepared by: Mark Davis, Director
Phone 907.269.8159
Division: Banking & Securities
Date/Time 2/28/06 10:53 AM
Approved by: William C. Noll, Commissioner
Date 2/28/2006
Agency: Commerce, Community, and Economic Development

(Revised 9/7/2005 OMB)

**Alaska Auto Dealers Association**
**5001 Old Seward Highway**
**Anchorage, AK 99503**

March 24, 2006

RE: SB 300

Dear Senator Seekins:

The Alaska Auto Dealers Association Board of Directors met on March 23, 2006 and passed a resolution in support of SB 300.

SB 300 will benefit dealers and consumers by allowing captive financing sources such as GMAC and FMC to lease vehicles under the same requirements and terms as federally chartered banks with regard to disclosure and treatment of negative equity. More financing sources will economically benefit dealers and consumers and we urge the Legislature to support SB 300.

Sincerely,

Jon Cook
Legislative Director

**Seekins Ford**
**Lincoln-Mercury, Inc.**
**1625 Seekins Ford Drive**
**Fairbanks, Alaska 99701**

Finance Department

| | |
|---|---|
| Steve Spencer | (907) 459-4032 |
| Mark Browning | (907) 459-4034 |
| Jaclyn Glynn | (907) 459-4022 |
| Finance Fax | (907) 459-4057 |
| Toll Free | (800) 478-1991 |


# Fax

**TO:** Linda Sackville **From:** Steve Spencer

**Fax:** 465-5241 **Pages:**

**Phone:** **Date:**

**Re:** **CC:**

☐ **Urgent** ☐ **For Review** ☐ **Please Comment** ☐ **Please Reply** ☐ **Please Recycle**

1-800-727-7001 Alaska 12:43:28 p.m. 03-02-2006 11/17/2006 279

9074694067 Seekins Ford

Red Carpet Lease

**Lessee (and Co-Lessee) - Name and Address (including County):**

UPSIDE DOWN JOE
-555 DOWNSIDE DRIVE FAIRBANKS AK

**Lessor - Name and Address:**

SEEKINS FORD-LINC-MERC., INC.
1625 SEEKINS FORD DRIVE FAIRBANKS AK 99701

Ford Credit

"Ford Credit" is Ford Motor Credit Company. The "Holder" is HTD LEASING LLC and its assigns. By signing "You" (Lessee and Co-Lessee) agree to lease this Vehicle according to the terms on the front and back of this lease.

| New/Used/Demo | Mileage at Delivery | Year/Make/Model | GVW if Truck (lbs.) | Vehicle ID# | Vehicle Use |
|---|---|---|---|---|---|
| NEW | | 2006 FORD TRUCK F-150 SERIES | 5324 | 1FTPW14586FA27882 | PERSONAL |

**1. Amount Due At Lease Signing or Delivery** (Itemized Below) *

$ 2000.00

**2. Monthly Payments**

Your first monthly payment of $ 1063.67 is due on 02/28/06 followed by 23 payments of $ 1063.67 due on the 30th day of each month. The total of Your monthly payments is $ 25528.08

**3. Other Charges** (not part of Your monthly payment)

| | |
|---|---|
| Disposition fee (If You do not purchase the Vehicle) | N/A |
| N/A | N/A |
| N/A | N/A |
| Total | $ N/A |

**4. Total of Payments** (The amount You will have paid by the end of the lease)

$ 26464.41

*** Itemization of Amount Due at Lease Signing or Delivery**

**5. Amounts Due At Lease Signing or Delivery:**

| | |
|---|---|
| a. Capitalized cost reduction | $ 343.33 |
| b. First monthly payment | 1063.67 |
| c. Refundable security deposit | N/A |
| d. Title fees | N/A |
| e. Registration fees | 298.00 |
| f. N/A | N/A |
| g. N/A | N/A |
| h. N/A | N/A |
| i. DOC | 295.00 |
| Total | $ 2000.00 |

**6. How the Amount Due At Lease Signing or Delivery will be paid:**

| | |
|---|---|
| a. Net trade-in allowance | $ 0.00 |
| b. Rebates and noncash credits | 2000.00 |
| c. Amount to be paid in cash | N/A |
| d. N/A | N/A |
| Total | $ 2000.00 |

**7. Your monthly payment is determined as shown below:**

| | | |
|---|---|---|
| a. **Gross capitalized cost.** The agreed upon value of the Vehicle ($ 35980.00) and any items You pay over the lease term (such as service contracts, insurance, and any outstanding prior credit or lease balance) (Itemized below)** | | $ 40971.00 |
| b. **Capitalized cost reduction.** The amount of any net trade-in allowance, rebate, noncash credit, or cash that You pay that reduces the gross capitalized cost | − | 343.33 |
| c. **Adjusted capitalized cost.** The amount used in calculating Your base monthly payment | = | 40627.67 |
| d. **Residual value.** The value of the Vehicle at the end of the lease used in calculating Your base monthly payment | − | 17990.00 |
| e. **Depreciation and any amortized amounts.** The amounts charged for the Vehicle's decline in value through normal use and for other items paid over the lease term | = | 22637.67 |
| f. **Rent charge.** The amount charged in addition to the depreciation and any amortized amounts | + | 2890.41 |
| g. **Total of base monthly payments.** The depreciation and any amortized amounts plus the rent charge | = | 25528.08 |
| h. **Lease payments.** The number of payments in Your lease | ÷ | 24 |
| i. **Base monthly payment** | = | 1063.67 |
| j. Monthly sales / use tax | + | N/A |
| k. N/A | + | N/A |
| l. N/A | + | N/A |
| m. **Total monthly payment** | | $ 1063.67 |
| n. **Lease term in months** | | 24 |

$ $ **Early Termination. You may have to pay a substantial charge if You end this lease early. The charge may be up to several thousand dollars. The actual charge will depend on when the lease is terminated. The earlier You end the lease, the greater this charge is likely to be.**

DODGE

**8. Excess Wear and Use.** You may be charged for excessive wear based on our standards for normal use. At the scheduled end of this lease, unless You purchase the Vehicle, **You must pay** to Lessor 20 **cents** per mile for each mile in excess of 36000 miles shown on the odometer. See Items 19 and 23 on back for additional excess wear and use terms.

**9. Extra Mileage Option Credit.** At the scheduled end of this lease, You will receive a credit of N/A cents per unused mile for the number of unused miles between N/A and N/A miles, less any amounts You owe under this lease. You will not receive any credit if the Vehicle is destroyed, if You terminate Your lease early, exercise any purchase option, are in default or the credit is less than $1.00.

KUL (CON'T)

**Other Important Terms.** See Your lease documents for additional information on early termination, purchase option and maintenance responsibilities, warranties, late and default charges, insurance, and any security interests, if applicable.

**11. WARRANTY** The Vehicle is covered by any warranty, extended warranty or service contract indicated below:

[XX] Standard new Vehicle warranty provided by the manufacturer or distributor of the Vehicle.

[XX] FORD ESP

If the Vehicle is of a type normally used for personal use and the Lessor, or the Vehicle's manufacturer, extends a written warranty or service contract covering the Vehicle within 90 days from the date of this lease, You get implied warranties of merchantability and fitness for a particular purpose covering the Vehicle. Otherwise, You understand and agree that there are no such implied warranties except as otherwise required by state law.

**12. OFFICIAL FEES AND TAXES** $ 313.00
The estimated total amount You will pay for official and license fees, registration, title and taxes over the term of Your lease, whether included with Your monthly payments or assessed otherwise. The actual total of fees and taxes may be higher or lower depending on the tax rates in effect or the value of the leased property at the time a fee or tax is assessed.

**13. LESSOR SERVICES** N/A
(See Item 18 on back)

**14. LATE PAYMENTS** You will pay a late charge on each payment that is not received within **10 days** after it is due. The charge is **7.5%** of the full amount of the scheduled payment or **$50.00** whichever is less.

**15. LIFE, DISABILITY AND OTHER INSURANCE** These coverages are **not required** to enter into this lease and will not be provided **unless** You sign below. If insurance is to be obtained by Lessor, the coverages are shown in a notice given to You this date and are for the term of this lease.

**Life Insurance**
Insurer: N/A
Initial Coverage Amount: $ N/A
Insured(s):
Premium: $ N/A
Insured's Signature(s):

**Disability Insurance**
Insurer: N/A
Monthly Coverage: $ N/A
Insured:
Premium: $ N/A
Insured's Signature:

**Other Insurance**
Type: N/A
Insurer: N/A
Monthly Coverage: $ N/A
Insured(s):
Premium: $ N/A
Insured's Signature(s):

**Total Premiums** $ N/A

****16. Itemization of Gross Capitalized Cost**

| Agreed Upon Value of the Vehicle | Sales/Use Tax & Other Applicable Taxes | Title Fees | License & Registration Fees | Extended Warranty & Service Contract | Lessor Services | Acquisition Fee |
|---|---|---|---|---|---|---|
| $ 35980.00 | + $ N/A | + $ N/A | + $ 15.00 | + $ 295.00 | + $ N/A | + $ 595.00 |

| Documentation Fee | Life Insurance Premium | Disability Insurance Premium | | | | Total Gross Capitalized Cost |
|---|---|---|---|---|---|---|
| + $ N/A | + $ N/A | + $ N/A | + $ WEAR CARE 500.00 | + $ N/A N/A | + $ OUTSTANDING PRIOR BALANCE 3536.00 | = $ 40971.00 |

## SIGNATURES AND IMPORTANT NOTICES

**Modification:** This lease sets forth all of the agreements of Lessor and You for the lease of the Vehicle. There is no other agreement. Any change in this lease must be in writing and signed by You and Ford Credit.

Lessee: UPSIDE DOWN JOE By: X Title:

Co-Lessee: By: X Title:

**YOU ACKNOWLEDGE THAT YOU HAVE READ AND AGREE TO BE BOUND BY THE ARBITRATION PROVISION ON THE REVERSE SIDE OF THIS CONTRACT.**

**NOTICE:** (1) Do not sign this lease before You read it or if it has any blank space to be filled in. (2) You have the right to get a filled-in copy of this lease. You state that You have been given a filled-in copy of this lease at the time You sign it and notice of an assignment of this lease by the Lessor to Holder.

Lessee: UPSIDE DOWN JOE By: X Title:

Co-Lessee: By: X Title:

Lessor is hereby notified that Holder has assigned to "Intermediary," as defined in the Red Carpet Lease Assignment, its rights (but not its obligations) with respect to the purchase of this Vehicle and the sale of this Vehicle at lease termination.

Lessor accepts this lease and assigns it to Holder under the terms of the Red Carpet Lease - WOR Plan Agreement between Lessor and Holder unless otherwise indicated here: Program No.

[ ] LEV GUARANTY

Lessor: SEEKINS FORD-LINC-MERC., INC. By: X Title:

# ALASKA SIMPLE INTEREST VEHICLE RETAIL INSTALLMENT CONTRACT

DATE 02/28/2006 12:44:23 p.m. 03-02-2006

9074694067 Seekins Ford

Ford Credit

www.fordcreditcom

Zip Code)

UPSIDE DOWN JOE
-555 DOWNSIDE DRIVE
FAIRBANKS AK

SEEKINS FORD-LINC-MERC., INC.
1625 SEEKINS FORD DRIVE
FAIRBANKS AK 99701

You, the Buyer (and Co-Buyer, if any), may buy the vehicle described below for cash or on credit. The cash price is shown below as "Cash Price." The credit price is shown below as "Total Sale Price." By signing this contract, you choose to buy the vehicle on credit under the agreements on the front and back of this contract.

| New/Used | Mileage | Year and Make | Model | Vehicle Identification Number | Use For Which Purchased |
|---|---|---|---|---|---|
| NEW | N/A | 2006 FORD TRUCK | F-150 SER | 1FTPW14586FA27882 | XX Personal ☐ Agricultural ☐ Commercial |

Trade-in 2005 FORD TRUCK (Year and Make) $ 14000.00 (Gross Allowance) $ 17586.00 (Amount Owing)

## ITEMIZATION OF AMOUNT FINANCED

| | | |
|---|---|---|
| 1. Cash Price | | $ 36479.00 (1) |
| 2. Down Payment | | |
| Third Party Rebate Assigned to Creditor | | $ N/A |
| Cash Down Payment | | $ N/A |
| N/A | | $ N/A |
| Trade-in (description above) | | $ 0.00 |
| Total Down Payment | | $ 0.00 (2) |
| 3. Unpaid Balance of Cash Price (1 minus 2) | | $ 36479.00 (3) |
| 4. Amounts paid on your behalf (Seller may be retaining a portion of these amounts) | | |
| To Public Officials | | |
| (i) for license, title & registration fees | $ 115.00 ; | |
| (ii) for official fees | $ 15.00 ; | |
| (iii) for taxes (not in Cash Price) | $ N/A | $ 130.00 |
| To Insurance Companies for: | | |
| Credit Life Insurance | | $ N/A |
| Credit Disability Insurance | | $ N/A |
| N/A | | $ N/A |
| N/A | | $ N/A |
| To N/A | for N/A | $ N/A |
| To SEEKINS FORD-LINC- | for DOC FEE | $ 295.00 |
| To FORD MOTOR CREDIT | for NEGATIVE EQUITY | $ 3586.00 |
| To N/A | for N/A | $ N/A |
| To N/A | for N/A | $ N/A |
| To N/A | for N/A | $ N/A |
| Total | | $ 4011.00 (4) |
| 5. Amount Financed (3 plus 4) | | $ 40490.00 (5) |

## FEDERAL TRUTH-IN-LENDING DISCLOSURES

| ANNUAL PERCENTAGE RATE | FINANCE CHARGE | Amount Financed | Total of Payments | Total Sale Price |
|---|---|---|---|---|
| * The cost of your credit as a yearly rate | The dollar amount the credit will cost you | The amount of credit provided to you or on your behalf | The amount you will have paid when you have made all scheduled payments | The total cost of your purchase on credit, including your downpayment of $ 0.00 |
| 11.00 % | $ 12569.20 | 40490.00 | $ 53059.20 | $ 53059.20 |

Your Payment Schedule will be:

| Number of Payments | Amount of Payments | When Payments are Due XX Monthly ☐ Semi-Annually ☐ Annually |
|---|---|---|
| 60 | 884.32 | APRIL 14,2006 |
| N/A | N/A | N/A |
| N/A | N/A | N/A |

## INSURANCE

YOU ARE REQUIRED TO INSURE THE VEHICLE. YOU MAY OBTAIN VEHICLE INSURANCE FROM A PERSON OF YOUR CHOICE.
LIABILITY INSURANCE COVERAGE FOR BODILY INJURY AND PROPERTY DAMAGE CAUSED TO OTHERS IS NOT INCLUDED.
CREDIT LIFE, CREDIT DISABILITY AND OTHER OPTIONAL INSURANCE ARE NOT REQUIRED TO OBTAIN CREDIT AND WILL NOT BE PROVIDED UNLESS YOU SIGN AND AGREE TO PAY THE PREMIUM.

Credit
☐ Life N/A
Insurance Company
$ N/A (Premium) N/A (Insured(s))
You/We want Credit Life Insurance.

Buyer Signs

Co-Buyer Signs

Credit
☐ Disability N/A
Insurance Company
$ N/A (Premium) N/A (Insured(s))
You/We want Credit Disability Insurance.

Buyer Signs

Co-Buyer Signs

OTHER OPTIONAL INSURANCE

| Coverage and Insurance Company | Premium and Term in Months |
|---|---|
| N/A | $ N/A |
| By N/A | N/A |
| N/A | $ N/A |

| Number of Payments | Amount of Payments | When Payments are Due ☒ Monthly ☐ Semi-Annually ☐ Annually |
|---|---|---|
| 60 | 884.22 | starting APRIL 14, 2006 |
| N/A | N/A | N/A |
| N/A | N/A | N/A |

FORD CREDIT RETAIL (CONT)

**Prepayment:** If you pay off your debt early, you will not have to pay a penalty.
**Late Payment:** You must pay a late charge on the portion of each payment received more than 10 days late. The charge is 7.5 percent of the late amount or $50.00, whichever is less.
**Security Interest:** You are giving a security interest in the vehicle being purchased.
**Contract:** Please see this contract for additional information on security interest, nonpayment, default, the right to require repayment of your debt in full before the scheduled date, and prepayment penalty.

Insurance Company | Term in Months

N/A | $ N/A

By N/A | N/A

N/A | $ N/A

By N/A | N/A

You/We want the optional insurance for which premiums are included above.*

Buyer Signs

Co-Buyer Signs

**Credit Life and Credit Disability insurance are for the term of the contract. The amount and coverages are shown in a notice or agreement given to you today.**

## BALLOON CONTRACT PROVISIONS

☐ Your last installment payment under this contract is a balloon payment.

**EXCESS WEAR, USE AND MILEAGE CHARGES**

If the box directly above is checked, this section, Paragraph B, and Paragraph C of this contract apply. You may be charged for excessive wear based upon our standards for normal use. If you exercise the option to sell the vehicle back to Creditor under Paragraph B, you must pay the Creditor $0. N/A per mile for each mile in excess of N/A miles shown on the odometer.

☐ **Debt Cancellation Waiver Addendum (Optional)** If this box is checked you have purchased a debt cancellation waiver. Purchase of this coverage is optional and is not required to obtain credit. The terms and conditions of the debt cancellation waiver are set forth in the attached Addendum which is incorporated into this contract. The price for the debt cancellation waiver is set forth on this contract in the Itemization of Amount Financed under section 4.

Buyer Signs

Any change in this contract must be in writing and signed by you and the Creditor.

Buyer Signs X

Co-Buyer Signs X

**YOU ACKNOWLEDGE THAT YOU HAVE READ AND AGREE TO BE BOUND BY THE ARBITRATION PROVISION ON THE REVERSE SIDE OF THIS CONTRACT.**

**The Annual Percentage Rate may be negotiated with the Seller. The Seller may assign this contract and may retain its right to receive a portion of the Finance Charge.**

**Do not sign this contract before you read it or if it contains any blank spaces. You are entitled to an exact copy of the contract you sign.**

**Buyer (and Co-Buyer) acknowledge that (i) before signing this contract, Buyer (and Co-Buyer) received and reviewed a true and completely filled in copy of this contract and (ii) at the time of signing this contract, Buyer (and Co-Buyer) received a true and completely filled in copy of this contract.**

**CONSUMER PAPER**

Buyer Signs X

Co-Buyer Signs X

Seller SEEKINS FORD-LINC-MERC., INC X Title F&I MNGR.

**THIS CONTRACT IS NOT VALID UNTIL YOU AND SELLER SIGN IT.**

## ASSIGNMENT

Seller may transfer this contract to another person. That person will then have all Seller's rights, privileges, and remedies. By signing below, the Seller assigns this contract to FORD MOTOR CREDIT COMPANY ("Assignee").

To contact Assignee about this contract, call 1-800-727-7000, or visit their website at www.fordcredit.com

Seller SEEKINS FORD-LINC-MERC., INC X Title F&I MNGR

PC 17650-SI (OC1 05) (Previous editions may NOT be used.) SEE OTHER SIDE FOR ADDITIONAL AGREEMENTS
FO 17650-8-SI

ORIGINAL

# CONSUMER PAPER — ALASKA CONDITIONAL SALES

The Undersigned Seller (Creditor) SEEKINS FORD-LINC MERC , INC. Seller
and the Undersigned Buyer UPSIDE DOWN JOE Buyer
the following described property and promises to pay on the terms set forth below and on the reverse side of this agreement. Buyer acknowledges and represents that the property is being purchased primarily for: (a) Personal or Family use [ ] (X) Commercial or Business use ☐ (check one)

| YEAR | TRADE NAME | MODEL | BODY TYPE | IDENTIFICATION NUMBER | NEW/USED |
|---|---|---|---|---|---|
| 2006 | FORD TRUCK | F-150 SERIES | SUPERCREW 4X4 | 1FTPW14586FA27882 | NEW |
| | | | | | |
| | | | | | |
| | | | | | |

**COMPREHENSIVE AND COLLISION INSURANCE REQUIRED:** Buyer must immediately procure Comprehensive and Collision insurance coverage. This insurance must contain a Loss Payable Clause Endorsement naming Wells Fargo Bank, N.A. ("WFB") as Lienholder. This insurance may be procured through and placed with Buyers choice of broker and company, subject to WFB's right to refuse to accept an insurer for reasonable cause. If proof of this insurance is not provided to WFB within fifteen (15) days of the date of this Contract, WFB may, at its option, order a policy to protect its interest in the collateral and Buyer must pay for such policy or, at WFB's option, such costs shall be added to the balance of Buyer's loan. This insurance will not include "bodily injury", "public liability" and "property damage liability," and will not comply with any state financial responsibility law. **MAXIMUM DEDUCTIBLE IS $500.**

**ITEMIZATION OF AMOUNT FINANCED**

| | | | |
|---|---|---|---|
| Sales Price | $ 35980.00 | Amounts Paid on Consumer's behalf (Seller may be retaining a portion of these amounts) | |
| Document Fee | 295.00 | Extended Service | $ N/A To N/A |
| | | Rust Proofing | N/A To N/A |
| Total Cash Price | $ 36275.00 (1) | GAP Coverage | 499.00 To CLASSIC GAP |
| Down Payment | | Credit Life | N/A To Insurance Companies |
| Cash | $ N/A | Credit Disability | N/A To Insurance Companies |
| Positive Trade In Value | $ 0.00 | Tax/License/Recording Fees | 130.00 To Public Officials |
| FORD TRUCK EXPEDITION 2005 | | Excess of Lien Over Trade value | 3586.00 Total $ 4215.00 (4) |
| MAKE MODEL YEAR | | Amount Financed (3 + 4) | $ 40490.00 (5) |
| Total Down Payment | $ 0.00 (2) | Finance Charge | $ 12560.80 (6) |
| Net Cash Price (1 minus 2) | $ 36275.00 (3) | Total of Payments (5 + 6) | $ 53050.80 (7) |
| | | Total Sale Price (1 + 4 + 6) | $ 53050.80 (8) |

| Amount Financed | FINANCE CHARGE | ANNUAL PERCENTAGE RATE | Total of Payments | Total Sale Price |
|---|---|---|---|---|
| $ 40490.00 | $ 12560.80 | 11.00 % | $ 53050.80 | $ 53050.80 |
| The amount of credit provided to you or on your behalf. | The dollar amount the credit will cost you. | The cost of your credit as a yearly rate. | The amount you will have paid after you have made all payments as scheduled. | The total cost of your credit purchase, including your down payment of $ 0.00 |

Your payment schedule will be:

| Number of Payments | Amount of Payments | When Payments Are Due |
|---|---|---|
| 59 | $ 884.18 | MONTHLY BEGINNING 04/14/2006 |
| 1 | $ 884.18 | FINAL PAYMENT DUE ON 03/14/2011 |

In any event, the final payment will be the sum of the outstanding principal balance, accrued interest to the date of payment, late charges, and any accrued costs including insurance and attorneys' fees.

CREDIT LIFE INSURANCE AND CREDIT DISABILITY INSURANCE ARE NOT REQUIRED TO OBTAIN CREDIT, and will not be provided unless you sign and agree to pay the additional cost.

| Type | Premium | Signature |
|---|---|---|
| Single Credit Life | $ N/A | I want single credit life insurance. X Signature |
| Single Credit Disability | $ N/A | I want single credit disability insurance. X Signature |
| Joint Credit Life | $ N/A | We want joint credit life insurance. X Signature X Signature |
| Joint Credit Disability | $ N/A | We want joint credit disability insurance. X Signature X Signature |

**SECURITY:** Buyer grants Seller a security interest in the goods or property being purchased and (brief description of other property, if applicable):

**PREPAYMENT:** If you pay off early, you will not have to pay a penalty.

**LATE CHARGE:** If a payment is 15 or more days late, you will be charged the lesser of 10% of the delinquent payment or $25.00. This charge shall not be imposed more than once for each delinquent payment. In the event that part of a payment is 15 or more days late, the late charge shall be assessed only against the delinquent portion of the payment.

**Arbitration Clause:** The terms and conditions on the reverse side of this document are part of the contract. Read these terms and conditions in their entirety.

**The Annual Percentage Rate may be negotiated with the Seller. The Seller may assign this contract and retain its right to receive a part of the finance charge.**

Before removing the vehicle described below from the State of Alaska, I must obtain written permission from the lienholder named on the vehicle title and/or registration as required by Section 28.10.491 of the Alaska Motor Vehicle Act. Wells Fargo Bank, N.A. will not authorize removal from U.S.A.

See your contract documents for additional information about nonpayment, default, right to accelerate, security interests, and any required repayment in full before the scheduled date.

**NOTICE TO BUYER**

THE TERMS AND CONDITIONS APPEARING ON THE BACK HEREOF ARE PART OF THIS SECURITY AGREEMENT

Document Fee (WELLS FARGO (CONT)) 295.00

Total Cash Price $ 36275.00 (1)

Down Payment

Cash $ N/A

Positive Trade In Value $ 0.00

FORD TRUCK EXPEDITION 2005
MAKE MODEL YEAR

Total Down Payment $ 0.00 (2)

Net Cash Price (1 minus 2) $ 36275.00 (3)

Extended Service $ N/A To N/A

Rust Proofing N/A To N/A

GAP Coverage 499.00 To CLASSIC GAP

Credit Life N/A To Insurance Companies

Credit Disability N/A To Insurance Companies

Tax/License/Recording Fees 130.00 To Public Officials

Excess of Lien Over Trade Value 3586.00 Total $ 4215.00 (4)

Amount Financed (3 + 4) $ 40490.00 (5)

Finance Charge $ 12560.80 (6)

Total of Payments (5 + 6) $ 53050.80 (7)

Total Sale Price (1 + 4 + 6) $ 53050.80 (8)

| Amount Financed | FINANCE CHARGE | ANNUAL PERCENTAGE RATE | Total of Payments | Total Sale Price |
|---|---|---|---|---|
| $ 40490.00 | $ 12560.80 | 11.00 % | $ 53050.80 | $ 53050.80 |
| The amount of credit provided to you or on your behalf. | The dollar amount the credit will cost you. | The cost of your credit as a yearly rate. | The amount you will have paid after you have made all payments as scheduled. | The total cost of your credit purchase, including your down payment of $ 0.00 |

Your payment schedule will be:

| Number of Payments | Amount of Payments | When Payments Are Due |
|---|---|---|
| 59 | $ 884.18 | MONTHLY BEGINNING 04/14/2006 |
| 1 | $ 884.18 | FINAL PAYMENT DUE ON 03/14/2011 |

In any event, the final payment will be the sum of the outstanding principal balance, accrued interest to the date of payment, late charges, and any accrued costs including insurance and attorneys' fees.

CREDIT LIFE INSURANCE AND CREDIT DISABILITY INSURANCE ARE NOT REQUIRED TO OBTAIN CREDIT, and will not be provided unless you sign and agree to pay the additional cost.

| Type | Premium | Signature |
|---|---|---|
| Single Credit Life | $ N/A | I want single credit life insurance. X Signature |
| Single Credit Disability | $ N/A | I want single credit disability insurance. X Signature |
| Joint Credit Life | $ N/A | We want joint credit life insurance. X Signature X Signature |
| Joint Credit Disability | $ N/A | We want joint credit disability insurance. X Signature X Signature |

SECURITY: Buyer grants Seller a security interest in the goods or property being purchased and (brief description of other property, if applicable):

PREPAYMENT: If you pay off early, you will not have to pay a penalty.

LATE CHARGE: If a payment is 15 or more days late, you will be charged the lesser of 18% of the delinquent payment or $25.00. This charge shall not be imposed more than once for each delinquent payment. In the event that part of a payment is 15 or more days late, the late charge shall be assessed only against the delinquent portion of the payment.

**Arbitration Clause: The terms and conditions on the reverse side of this document are part of the contract. Read these terms and conditions in their entirety.**

**The Annual Percentage Rate may be negotiated with the Seller. The Seller may assign this contract and retain its right to receive a part of the finance charge.**

Before removing the vehicle described below from the State of Alaska, I must obtain written permission from the lienholder named on the vehicle title and/or registration as required by Section 28.10.491 of the Alaska Motor Vehicle Act. Wells Fargo Bank, N.A. will not authorize removal from U.S.A.

See your contract or lease for additional information about nonpayment, default, right to accelerate, security interests, and any required repayment in full before the scheduled date.

## NOTICE TO BUYER

THE TERMS AND CONDITIONS APPEARING ON THE BACK HEREOF ARE PART OF THIS SECURITY AGREEMENT.

(a) Do not sign this Contract before you read it or if any space intended for the agreed terms, except as to unavailable information, are blank. (b) You are entitled to a copy of this Contract at the time you sign it. (c) You may at any time pay off the full unpaid balance due under this Contract.

**NOTICE: Any holder of this consumer credit contract is subject to all claims and defenses which the debtor could assert against the seller of goods or services obtained pursuant hereto or with the proceeds hereof. Recovery hereunder by the debtor shall not exceed amounts paid by the debtor hereunder.**

**Co-Buyers and Other Owners** - A co-buyer is a person who is responsible for paying the entire debt. An other owner is a person whose name is on the title to the vehicle but does not have to pay the debt. The other owner knows that the Creditor has a security interest in the vehicle and consents to the security interest. The Buyer(s) hereby consent to release of information concerning the debt to all owners of the vehicle.

**Other owner signs here:** _____

THIS CONTRACT CONSTITUTES THE ENTIRE AGREEMENT BETWEEN THE PARTIES HERETO and shall apply to, inure to the benefit of and bind the heirs, executors, administrators, successors and assigns of the Buyer and Seller. The Buyer hereby acknowledges receipt of a true copy hereof prior to consummation and all Buyers are jointly and severally liable.

**Seller intends to Assign this Agreement to Wells Fargo Bank, N.A.**

Seller SEEKINS FORD-LINC-MERC., INC.

By _____ AUTHORIZED SIGNATURE TITLE

Street Address 1625 SEEKINS FORD DRIVE

City, State, Zip FAIRBANKS AK 99701

Date FEBRUARY 28th, 2006

Buyer's Signature(s) UPSIDE DOWN JOE Date 02/28/2006

Mailing Address -555 DOWNSIDE DRIVE

City, State, Zip FAIRBANKS AK

LND 12645 (11/05) White · Customer · Canary · Dealer's Blue

# RETAIL INSTALLMENT SALES CONTRACT

9074594067 Seekins Ford 12:46:49 p.m. 03-02-2006 8/9

**Buyer (and Co-Buyer) Name and Address**

UPSIDE DOWN JOE
-555 DOWNSIDE DRIVE
FAIRBANKS AK

AK USA FCLL

**CREDITOR-SELLER (Name and Address)**

SEEKINS FORD-LINC-MERC., INC.
1625 SEEKINS FORD DRIVE
FAIRBANKS AK 99701

"You" and "your" refer to the Buyer (and Co-Buyer, if any) of the Property Being Purchased. "Creditor" or "Seller" refers to the seller of the Property Being Purchased. "Creditor" includes the party to whom this contract is assigned, if any. You may buy the goods or property described below for cash or on credit. The cash price is shown below as "Cash Sale Price." The credit price is shown below as "Total Sale Price." By signing this contract, you agree to buy the goods or property on credit under the agreements on the front and back of this contract. You agree to pay the Creditor the Amount Financed and Finance Charge according to the payment schedule shown below. Creditor will figure the Finance Charge on a daily basis.

## PROPERTY BEING PURCHASED (COLLATERAL)

| New/Used | Year and Make | Model | GVW if Truck (lbs.) | Identification Number | Use For Which Purchased |
|---|---|---|---|---|---|
| NEW | 2006 FORD TRUCK | F-150 SERIE 5324 | | 1FTPW14586FA27882 | XX Personal, Family or Household; ☐ Agricultural; ☐ Commercial |

Trade-In 2005 FORD TRUCK (Year and Make) $ 14000.00 (Gross Allowance) $ 17586.00 (Amount Owing)

## ITEMIZATION OF AMOUNT FINANCED

| | | |
|---|---|---|
| 1. **Cash Sale Price** PRICE INCLUDES $ 295.00 DOC FEE | | $ 36275.00 (1) |
| 2. **Down Payment** | | |
| **Rebates Assigned to Creditor** | $ N/A | |
| **Cash Down Payment** | $ N/A | |
| **Other** N/A | $ N/A | |
| **Trade-In** (description above) | $ N/A | |
| **Total Down Payment** | | $ 0.00 (2) |
| 3. **Unpaid Balance of Cash Sale Price** (1 minus 2) | | $ 36275.00 (3) |
| 4. **Amounts paid on your behalf (Seller may be retaining a portion of these amounts.)** | | |
| **To Public Officials for** | | |
| (i) license, title & registration fees $ 130.00 ; | | |
| (ii) U.C.C. fees $ N/A ; | | |
| (iii) taxes (not in Cash Sale Price) $ N/A | | $ 130.00 |
| **To Insurance Companies for:** | | |
| **Credit Life Insurance** | | $ N/A |
| **Credit Disability Insurance** | | $ N/A |
| **Other Insurance** N/A | | $ N/A |
| **Other Charges** | | |
| To N/A for N/A | | $ N/A |
| To CLASSIC GAP for GAP | | $ 499.00 |
| To FORD MOTOR CREDI for TRADE-IN PAYOFF | | $ 3586.00 |
| **Total** | | $ 4215.00 (4) |
| 5. **Amount Financed** (3 plus 4) | | $ 40490.00 (5) |

## FEDERAL TRUTH-IN-LENDING DISCLOSURES

| ANNUAL PERCENTAGE RATE | FINANCE CHARGE | Amount Financed | Total of Payments | Total Sale Price |
|---|---|---|---|---|
| The cost of your credit as a yearly rate. | The dollar amount the credit will cost you. | The amount of credit provided to you or on your behalf. | The amount you will have paid when you have made all scheduled payments. | The total cost of your purchase on credit, including your down payment of $ 0.00 |
| 11.00 % | $ 12573.40 | $ 40490.00 | $ 53063.40 | $ 53063.40 |

**Payment Schedule:**

| Number of Payments | Amount of Each Payment | When Payments Are Due |
|---|---|---|
| 59 | $ 884.39 | Monthly starting 04/14/2006 |
| 1 final | $ 884.39 | DUE ON: 03/14/2011 |

**Prepayment:** If you pay off your debt early, you will not have to pay a penalty.

**Late Payment:** If your payment is late seven days or more, you will be charged the greater of 20% of the

## INSURANCE

INSURANCE ON THE GOODS OR PROPERTY BEING PURCHASED MAY BE OBTAINED FROM A PERSON OF YOUR CHOICE.

THE INSURANCE COVERAGE ORDERED UNDER THE TERMS OF THIS CONTRACT DOES NOT INCLUDE 'BODILY INJURY LIABILITY,' 'PUBLIC LIABILITY,' AND 'PROPERTY DAMAGE LIABILITY' COVERAGE.

CREDIT LIFE, CREDIT DISABILITY AND OTHER OPTIONAL INSURANCE ARE NOT REQUIRED TO OBTAIN CREDIT AND WILL NOT BE PROVIDED UNLESS YOU SIGN AND AGREE TO PAY THE PREMIUM.

Credit Life _____ Insurer
$ N/A Premium _____ Insured(s)
_____ Signature(s)

Credit Disability _____ Insurer
$ N/A Premium _____ Insured
_____ Signature

N/A Type of Insurance N/A Term
N/A Insurer $ N/A Premium
_____ Signature

Credit Life and Credit Disability insurance are for the term of the contract. The amount and coverages are shown in a notice or agreement given to you on this date.

**Required Insurance**

Creditor requires buyer to acquire and maintain comprehensive and collision insurance for the term of this contract in an amount equal to the cash value of the

| | | |
|---|---|---|
| Trade-In (description above) | $ N/A | |
| Total Down Payment | $ N/A | $ 0.00 (2) |
| 3. Unpaid Balance of Cash Sale Price (1 minus 2) | | $ 36275.00 (3) |
| 4. Amounts paid on your behalf (Seller may be retaining a portion of these amounts.) | | |
| To Public Officials for | | |
| (i) license, title & registration fees $ 130.00 | | |
| (ii) U.C.C. fees $ N/A | | |
| (iii) taxes (not in Cash Sale Price) $ N/A | | $ 130.00 |
| To Insurance Companies for: | | |
| Credit Life Insurance | | $ N/A |
| Credit Disability Insurance | | $ N/A |
| Other Incurance N/A | | $ N/A |
| Other Charges | | |
| To N/A for N/A | | $ N/A |
| To CLASSIC GAP for GAP | | $ 499.00 |
| To FORD MOTOR CREDI for TRADE-IN PAYOFF | | $ 3586.00 |
| Total | | $ 4215.00 (4) |
| 5. Amount Financed (3 plus 4) | | $ 40490.00 (5) |

## FEDERAL TRUTH-IN-LENDING DISCLOSURES

| ANNUAL PERCENTAGE RATE | FINANCE CHARGE | Amount Financed | Total of Payments | Total Sale Price |
|---|---|---|---|---|
| The cost of your credit as a yearly rate. | The dollar amount the credit will cost you. | The amount of credit provided to you or on your behalf. | The amount you will have paid when you have made all scheduled payments. | The total cost of your purchase on credit, including your down payment of $ 0.00 |
| 11.00 % | $ 12573.40 | $ 40490.00 | $ 53063.40 | $ 53063.40 |

| Payment Schedule: | Number of Payments | Amount of Each Payment | When Payments Are Due |
|---|---|---|---|
| | 59 | $ 884.39 | Monthly starting: 04/14/2006 |
| | 1 final | $ 884.39 | DUE ON: 03/14/2011 |

**Prepayment:** If you pay off your debt early, you will not have to pay a penalty.

**Late Payment:** If your payment is late seven days or more, you will be charged the greater of 20% of the interest due or [illegible] cents, to a maximum of $25.00. If you are delinquent two payments, or 32 days in the case of a single payment contract, the late fee is not limited.

**Security Interest:** You are giving a security interest in the goods or Property Being Purchased, as described above. The goods or Property Being Purchased secures other obligations now or hereafter owed by you to the Creditor and other collateral held by the Creditor, including funds on deposit with the Creditor, secures this contract (see reverse side under Security).

**Additional Information:** See the contract (reverse side) for additional information about nonpayment, default and any required repayment in full before the scheduled date.

### NOTICE TO THE BUYER

- Do not sign this contract before you read it or if it contains any blank spaces. You are entitled to an exact copy of the contract you sign.
- The Seller intends to assign this contract to Alaska USA Federal Credit Union.
- Any change in this contract must be in writing and signed by you and the Creditor.

**NOTICE: ANY HOLDER OF THIS CONSUMER CREDIT CONTRACT IS SUBJECT TO ALL CLAIMS AND DEFENSES WHICH THE DEBTOR COULD ASSERT AGAINST THE SELLER OF GOODS OR SERVICES OBTAINED PURSUANT HERETO OR WITH THE PROCEEDS HEREOF. RECOVERY HEREUNDER BY THE DEBTOR SHALL NOT EXCEED AMOUNTS PAID BY THE DEBTOR HEREUNDER.** [Does not apply if purchased for commercial or agricultural use. In that case, you (debtor) will not assert against any assignee or subsequent holder of this contract any claims, defenses or setoffs which you may have against the Seller or manufacturer of the goods purchased.]

- Buyer acknowledges receipt of a true and completely filled in copy of this contract at the time of signing.

02/28/2006

Buyer's Signature Date Co-Buyer's Signature Date

PERTY DAMAGE LIABILITY COVERAGE.

CREDIT LIFE, CREDIT DISABILITY AND OTHER OPTIONAL INSURANCE ARE NOT REQUIRED TO OBTAIN CREDIT AND WILL NOT BE PROVIDED UNLESS YOU SIGN AND AGREE TO PAY THE PREMIUM.

Credit Life ____ Insurer
$ N/A Premium ____ Insured(s)
Signature(s)

Credit Disability ____ Insurer
$ N/A Premium ____ Insured
Signature

N/A Type of Insurance ____ N/A Term
N/A Insurer ____ $ N/A Premium
Signature

Credit Life and Credit Disability Insurance are for the term of the contract. The amount and coverages are shown in a notice or agreement given to you on this date.

**Required Insurance**

Creditor requires buyer to acquire and maintain comprehensive and collision insurance for the term of this contract in an amount equal to the cash value of the goods or property, with a loss payable clause in the name of the Creditor, and providing 10 days notice of cancellation to Creditor.

### ASSIGNMENT

By signing below, the Seller accepts this contract. If no other Assignee is named in a separate assignment attached to this contract, the Seller assigns it to Alaska USA Federal Credit Union.

Seller: SEEKINS FORD-LINC-MERC.

By ____ Date 02/28/06

**QUESTIONS?**

AlaskaUSA Federal Credit Union®

PLEASE CALL US AT
563-4567
1-800-525-9094 (Outside Anchorage)

AKUSA 02163 R 4/29/04

**SEE REVERSE SIDE FOR ADDITIONAL TERMS AND CONDITIONS OF THIS CONTRACT**

WHITE - Creditor YELLOW - Seller PINK - Buyer

SB

310

# HOUSE COMMITTEE REPORT

(7)
**Date Referred to Committee: April 19, 2006** **FURTHER REFERRALS: Finance**

**Date of Committee Action:** 4/24/06

**The LABOR AND COMMERCE Committee considered:** **SB 310**

**SENATE BILL NO. 310** **EMPLOYMENT OF PRISONERS**

**"An Act relating to the employment of prisoners; and providing for an effective date."**

**Recommends it be replaced with [ ] HCS *or* [ ] CS *for* _____ (_____)**
***For Senate Bills with new title: [ ] Technical Title [ ] New Title: HCR_____*** **[ ] Same Title [ ] New Title**

[ ] attach amendments
[ ] add new referral to _____Committee
[ ] Letter of Intent_____Committee

*List of Abbrev for Depts.:*
ADM
CED
COR
CRT
EED
DEC
DFG
GOV
HSS
LEG
LAW
LWF
MVA
DNR
DPS
REV
DOT
UA

***NEW* FISCAL NOTES**
*Assigned by Chief Clerk's Office

| List by Dept(s): | *FN# | Fiscal | Indet. | Zero |
|---|---|---|---|---|
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***PREVIOUS* FISCAL NOTES**

| List by Dept(s): | FN# | Fiscal | Indet. | Zero |
|---|---|---|---|---|
| LWF | 1 | | | X |
| COR | 2 | X | | |
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| Signing with recommendations | Printed Last Name | DP | DNP | NR | AM |
|---|---|---|---|---|---|
| | CRAWFORD | | | X | |
| | LYNN | | | X | |
| | GUTTENBERG | | | X | |
| | [illegible] | | | ✓ | |
| | KOTT | | | — | |
| | ROKEBERG | | | — | |
| | | | | | |
| | | | | | |
| | | | | | |
| Chair: | ANDERSON | X | | | |
| Chair: | | | | | |

# FISCAL NOTE

**STATE OF ALASKA**
**2006 LEGISLATIVE SESSION**

Fiscal Note Number:
Bill Version: **SB310HCS-DOLWD-WIB-04-21-06**
() Publish Date:

Revision Date/Time (Note if correction):
Title: **Employment of Prisoners**

Department: **Labor and Workforce Development**
RDU: **Business Partnerships**
Component: **Workforce Investment Board**

Sponsor: **Senate Finance**
Requester: **House L&C**

Component Number: **2659**

**Expenditures/Revenues** (Thousands of Dollars)

Note: Amounts do not include inflation unless otherwise noted below.

| OPERATING EXPENDITURES | FY 2007 | FY 2008 | FY 2009 | FY 2010 | FY 2011 | FY 2012 |
|---|---|---|---|---|---|---|
| Personal Services | | | | | | |
| Travel | | | | | | |
| Contractual | | | | | | |
| Supplies | | | | | | |
| Equipment | | | | | | |
| Land & Structures | | | | | | |
| Grants & Claims | | | | | | |
| Miscellaneous | | | | | | |
| **TOTAL OPERATING** | **0.0** | **0.0** | **0.0** | **0.0** | **0.0** | **0.0** |
| **CAPITAL EXPENDITURES** | | | | | | |
| **CHANGE IN REVENUES ( )** | | | | | | |

**FUND SOURCE** (Thousands of Dollars)

| | | | | | | |
|---|---|---|---|---|---|---|
| 1002 Federal Receipts | | | | | | |
| 1003 GF Match | | | | | | |
| 1004 GF | | | | | | |
| 1005 GF/Program Receipts | | | | | | |
| 1037 GF/Mental Health | | | | | | |
| Other (Specify Type--Do not abbreviate) | | | | | | |
| **TOTAL** | **0.0** | **0.0** | **0.0** | **0.0** | **0.0** | **0.0** |

**Estimate of any current year (FY2006) cost:** None
**Mark this box (X) if funding for this bill is included in the Governor's FY 2007 budget proposal:**

**POSITIONS**

| | | | | | | |
|---|---|---|---|---|---|---|
| Full-time | | | | | | |
| Part-time | | | | | | |
| Temporary | | | | | | |

**ANALYSIS:** *(Attach a separate page if necessary)*

There is no anticipated financial impact to the department as a result of this legislation.

Prepared by: **John Pratt, Executive Director** Phone: **(907)269-7487**
Division: **Alaska Workforce Investment Board** Date/Time: **4/21/06 1:05 PM**
Approved by: **Greg O'Claray, Commissioner** Date: **4/21/2006**
Agency: **Department of Labor and Workforce Development**

(Revised 9/7/2005 OMB)

# Alaska State Senate
## Senate Finance Committee

Official Business

Mail Stop 3100
State Capitol
Juneau, Alaska 99801-1182

**SPONSOR STATEMENT**

**Senate Bill 310**

**"An Act relating to the employment of prisoners; and providing for an effective date."**

The legislation that created the Alaska Correctional Industries program and commission was repealed on July 1, 2005. The primary purpose of SB 310 is to provide the necessary statutory authority so the Department of Corrections can continue providing inmate work and training programs without interruption.

SB 310 is needed to provide for employment of prison inmates under AS 33.30. This employment program will be funded from Receipt Support Service funds. The bill provides the necessary statutory authority to participate in critical federal Prison Industry Enhancement (PIE) programs. It also grants the authority to actively participate and partner with private enterprise. These partnerships will provide realistic work experience and vocational training for prisoners under conditions similar to those that prevail in the private sector. SB 310 will allow the department to make a deduction from the offenders' wages to apply to the cost of confinement. These receipts will support the prison employment program.

In addition, the prison employment program will allow inmates to work toward financial responsibility by taking deductions from wages to pay for child support, victim restitution, criminal fines, civil judgments, fees for utilities, as well as other obligations.

SB 310 is a vital piece of legislation if we are to continue inmate work and vocational training programs in our correctional facilities.

24-LS1764\G.1
Luckhaupt
4/13/06

**AMENDMENT** #2 adopted

OFFERED IN THE HOUSE

TO: SB 310

Page 3, lines 6 - 17:

Delete all material and insert:

"* **Sec. 2.** AS 33.30.191(b) is amended to read:

(b) The commissioner may enter into contracts or cooperative agreements with any public agency for the performance of conservation projects. **After the effective date of this Act, the** [THE] commissioner may enter into a contract with an individual or **private organization** [AGENCY] for the employment of prisoners if the **commissioner consults with local union organizations before contracting and ensures that the contract will not result in the displacement of employed workers, be applied in skills, crafts, or trades in which there is a surplus of available gainful labor in the locality, or impair existing contracts for services** [WORK TO BE PERFORMED WILL HAVE MINIMAL NEGATIVE IMPACT ON AN EXISTING PRIVATE INDUSTRY OR LABOR FORCE IN THE STATE AS DETERMINED BY THE CORRECTIONAL INDUSTRIES COMMISSION UNDER AS 33.32.015]."

Conceptual Amendment to SB310\G H/ Adopted
By Elkins
4/11/06

Page 5 line 20
Move (6) to line 16 and renumber it (4)
Move (4) to line 18 and renumber it (5)
Move (5) to line 20 and renumber it (6)

# Alaska State Senate
## Senate Finance Committee

Official Business

Mail Stop 3100
State Capitol
Juneau, Alaska 99801-1182

## Sectional Analysis

## Senate Bill 310

**"An Act relating to the employment of prisoners; and providing for an effective date."**

**Section 1.** Deletes the "Correctional Industries Program" from AS 23.15.580(g) and focuses on employment of prison inmates while incarcerated. The Correctional Industries Program sunset on July 1, 2005.

**Section 2.** Replaces "agency" with "private organization" and specifies that a contract for prison labor must include at least minimum wage required by AS 23.10.065 and paid in a timely manner according to contract. Removes reference to Correctional Industries Commission.

**Section 3.** Removes reference to Correctional Industries Commission oversight.

**Section 4.** Removes the reference to AS 33.32 Correctional Industries and renumbers provisions.

**Section 6.** Allows the Commissioner to establish inmate compensation based on minimum wage for partnerships with private vendors and based on prevailing wage to participate in federal Prison Industry Enhancement (PIE) programs (partnerships with private vendors that sell products across state lines). Past legislation did not have provisions to pay prevailing wage as required by federal PIE programs.

**Section 8.** Removes the reference to Correctional Industries.

**Section 9.** Is amended by adding a new paragraph that allows the cost of confinement to be deducted from prisoner wages.

**Section 10.** Removes the reference to purchases of livestock. Removes the reference to the Correctional Industries Fund and Commission.

**Section 11.** Adds a new section to provide for transition from the former Correctional Industries Fund to program receipts and provides an effective date matching the sunset date of July 1, 2005.

**Section 12.** Adds a new section to provide for transition from previous legislation for the non-coverage of AS 23.30 (Alaska Workers' Compensation Act) for the period July 1, 2005 through the day before the effective date of this act.

**Section 13.** Adds a new section to provide for a retroactive date matching the sunset date of July 1, 2005, for the non-coverage of AS 23.30 (Alaska Workers' Compensation Act).

**Section 14.** Provides for an immediate effective date.

# FISCAL NOTE

**STATE OF ALASKA**
**2006 LEGISLATIVE SESSION**

Fiscal Note Number: 1
Bill Version: SB 310
(S) Publish Date: 3/27/06

Revision Date/Time (Note if correction):
Title: Employment of Prisoners

Department: Labor and Workforce Development
RDU: Business Partnerships
Component: Workforce Investment Board

Sponsor: Senate Finance
Requester: Senate Finance

Component Number: 2859

**Expenditures/Revenues** (Thousands of Dollars)

Note: Amounts do not include inflation unless otherwise noted below

| OPERATING EXPENDITURES | FY 2007 | FY 2008 | FY 2009 | FY 2010 | FY 2011 | FY 2012 |
|---|---|---|---|---|---|---|
| Personal Services | | | | | | |
| Travel | | | | | | |
| Contractual | | | | | | |
| Supplies | | | | | | |
| Equipment | | | | | | |
| Land & Structures | | | | | | |
| Grants & Claims | | | | | | |
| Miscellaneous | | | | | | |
| **TOTAL OPERATING** | **0.0** | **0.0** | **0.0** | **0.0** | **0.0** | **0.0** |
| **CAPITAL EXPENDITURES** | | | | | | |
| **CHANGE IN REVENUES ( )** | | | | | | |

**FUND SOURCE** (Thousands of Dollars)

| | | | | | | |
|---|---|---|---|---|---|---|
| 1002 Federal Receipts | | | | | | |
| 1003 GF Match | | | | | | |
| 1004 GF | | | | | | |
| 1005 GF/Program Receipts | | | | | | |
| 1037 GF/Mental Health | | | | | | |
| Other (Specify Type--Do not abbreviate) | | | | | | |
| **TOTAL** | **0.0** | **0.0** | **0.0** | **0.0** | **0.0** | **0.0** |

**Estimate of any current year (FY2006) cost:** None
**Mark this box (X) if funding for this bill is included in the Governor's FY 2007 budget proposal:**

**POSITIONS**

| | | | | | | |
|---|---|---|---|---|---|---|
| Full-time | | | | | | |
| Part-time | | | | | | |
| Temporary | | | | | | |

**ANALYSIS:** *(Attach a separate page if necessary)*

There is no anticipated financial impact to the department as a result of this legislation.

Prepared by: John Pratt, Executive Director
Phone: (907)269-7487
Division: Alaska Workforce Investment Board
Date/Time: 3/24/06 1:24 PM
Approved by: Greg O'Claray, Commissioner
Date: 3/24/2006
Agency: Department of Labor and Workforce Development

# FISCAL NOTE

**STATE OF ALASKA**
**2006 LEGISLATIVE SESSION**

Fiscal Note Number: 2
Bill Version: SB 310
(S) Publish Date: 3/27/06

Revision Date/Time (Note if correction):
Dept. Affected: Corrections
Title: An Act relating to the employment of prisoners; and providing for an effective date.
RDU: Institutional Facilities
Component: Correctional Industries Product Costs
Sponsor: Senate Finance Committee
Requester: Finance
Component No. 702

**Expenditures/Revenues** (Thousands of Dollars)

Note: Amounts do not include inflation unless otherwise noted below.

| OPERATING EXPENDITURES | FY 2007 | FY 2008 | FY 2009 | FY 2010 | FY 2011 | FY 2012 |
|---|---|---|---|---|---|---|
| Personal Services | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Travel | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Contractual | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Supplies | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Equipment | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Land & Structures | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Grants & Claims | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Miscellaneous | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| **TOTAL OPERATING** | **0.0** | **0.0** | **0.0** | **0.0** | **0.0** | **0.0** |
| **CAPITAL EXPENDITURES** | | | | | | |
| **CHANGE IN REVENUES ( )** | | | | | | |

**FUND SOURCE** (Thousands of Dollars)

| | | | | | | |
|---|---|---|---|---|---|---|
| 1002 Federal Receipts | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| 1003 GF Match | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| 1004 GF | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| 1005 GF/Program Receipts | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| 1156 Receipt Supported Services | 3,181.8 | 3,181.8 | 3,181.8 | 3,181.8 | 3,181.8 | 3,181.8 |
| Other (Alaska Correctional Industries Fund) | (3,181.8) | (3,181.8) | (3,181.8) | (3,181.8) | (3,181.8) | (3,181.8) |
| **TOTAL** | **0.0** | **0.0** | **0.0** | **0.0** | **0.0** | **0.0** |

**Estimate of any current year (FY2006) cost:** 0.0
**Mark this box (X) if funding for this bill is included in the Governor's FY 2007 budget proposal:**

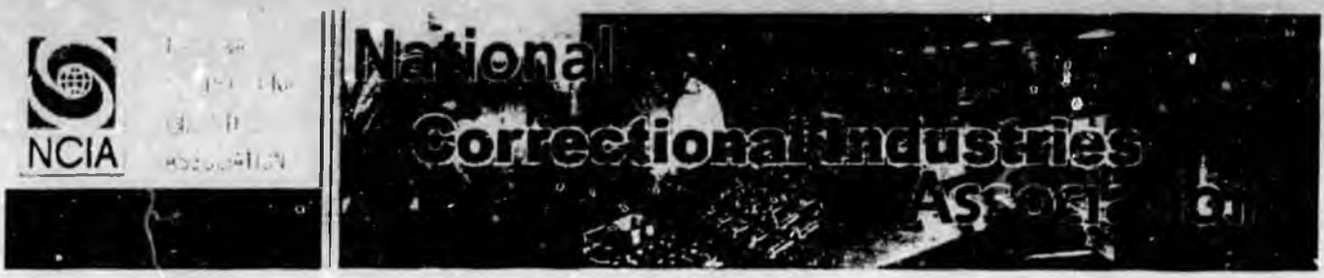
**POSITIONS**

| | | | | | | |
|---|---|---|---|---|---|---|
| Full-time | | | | | | |
| Part-time | | | | | | |
| Temporary | | | | | | |

**ANALYSIS:** *(Attach a separate page if necessary)*

Passage of this legislation provides the statutory authority to the Department of Corrections to continue providing inmate work and training programs without interruption. Legislation that created the Alaska Correctional Industries program and commission sunset on July 1, 2005. This bill provides retroactive clauses for the non-coverage of AS 23.30 (Alaska Workers' Compensation Act) and for transition of the Alaska Correctional Industries Fund to program receipts under AS 37.05.146(c)(81). It also provides the program the statutory authority to participate in federal Prison Industry Enhancement (PIE) programs and to actively participate and partner with private enterprise. This legislation will allow the department to make a deduction from the offenders' wages to apply to the cost of confinement. These receipts will support the prison employment program.

Prepared by: Sharleen Griffin, Director — Phone (907) 465-3339
Division: Administrative Services — Date/Time 3/24/06 8:00 AM
Approved by: Portia Parker, Deputy Commissioner — Date 3/24/2006
Agency: Department of Corrections




About NCIA (Home)
Enterprise Conferences
PIE Certification Program
Membership
Policy & Standards
NCIA Awards
NCIA Communication Tools & Publications
NCIA Links
Upcoming Events
Exclusive Merchandise

*Working on the inside - succeeding on the outside*

## PIE Certification Program

**PIE Final Guideline**

[Federal Register: April 7, 1999 (Volume 64, Number 66)] [Notices] [Page 17000-17014] From the Federal Register Online via GPO Access [wais.access.gpo.gov] [DOCID:fr07ap99-112]

[[Page 17000]]

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**DEPARTMENT OF JUSTICE**

Office of Justice Programs [OJP(BJA)-1213] RIN 1121-AA36

Prison Industry Enhancement Certification Program Guideline

AGENCY: Office of Justice Programs, Bureau of Justice Assistance (BJA), Justice.

ACTION: Issuance of final guideline.

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**SUMMARY:**

The Office of Justice Programs, Bureau of Justice Assistance (BJA), is issuing this final revision to its Prison Industry Enhancement Certification Program (PIECP) Guideline proposed for public comment on July 7, 1998, 63 FR 36710-36719. Under Title 18 U.S.C. 1761(c), BJA PIECP certification excepts participating agencies from certain Federal restraints placed on the marketability of prison-made goods by permitting the transport of such goods in interstate commerce and the sale of such goods to the Federal government. This Guideline addresses statutory amendments and reflects administrative experience gained by BJA since the last final PIECP Guideline published on March 29,1985 (50 FR 12661-64). The publication of this Final Guideline is considered to be a Federal action that will not significantly affect the quality of the human environment. Therefore, preparation of an environmental impact statement is not necessary.

U.S.C. 35). Since its inception in 1979, the PIECP program has certified 38 work pilot projects throughout the country. Prison administrators find PIECP participation an effective way to address idleness among ever- increasing prison populations and as a cost-efficient method for providing inmates with marketable job skills. Taxpayers benefit because PIECP wage deductions result in reductions in incarceration costs. Inmate wages benefit society, generally, in that deducted amounts are authorized to address victim compensation, inmate family support needs and taxes. Lastly, PIECP industries obtain broad market access for their products because they are excepted from the Ashurst-Sumners Act prohibition against the interstate transport of prisoner-made goods and from the Walsh-Healey Act prohibition against certain contract sales of prisoner-made goods to the Federal government. BJA first issued a Final Guideline to implement this program on March 29, 1985, 50 FR 12661-64. After providing an opportunity for public comment on the revised Guideline on July 7, 1998 (63 FR 36710- 19), the agency now publishes this Final Guideline to offer updated program clarification. In so doing, the legislative underpinnings of relevant laws are examined and the scope of their applicability is defined. Compliance expectations are explained as program guidance. Refined administrative practices reflect experience gained by BJA over the past 14 years. The background history, guidance definitions and administrative requirements described in this Guideline are specific only to the PIECP and have no bearing on or relationship to the development, goals or administrative practices of any other prison industry program.

**II. Background of the Prison Industry Enhancement Certification Program (PIECP)**

a. Legislative History

1. Unregulated Prison Labor The 19th Century evolution of industrial capitalism and private sector use of prisoner labor spawned a number of conditions that adversely affected several major segments of society. By the turn of the 20th Century, these segments joined in an organized appeal to Congress and state legislatures nationwide. They collectively asserted that the production and distribution of unregulated prisoner-made goods in interstate commerce needed to be

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# CORRECTION

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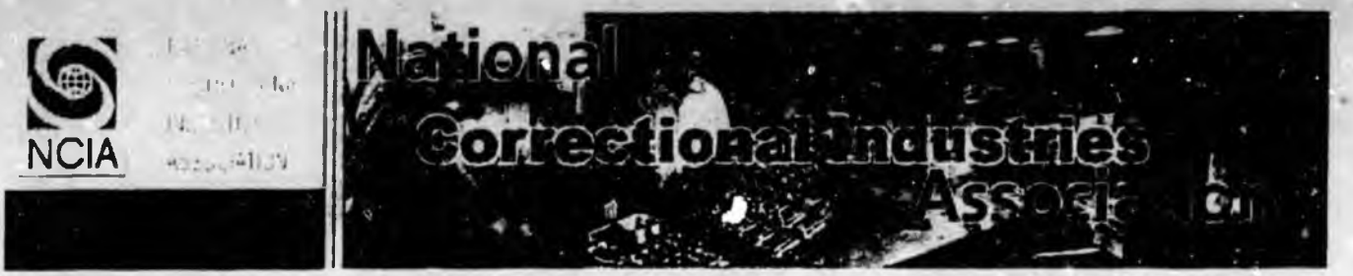


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## PIE Certification Program

**PIE Final Guideline**

[Federal Register: April 7, 1999 (Volume 64, Number 66)] [Notices] [Page 17000-17014] From the Federal Register Online via GPO Access [wais.access.gpo.gov] [DOCID:fr07ap99-112]

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**DEPARTMENT OF JUSTICE**

Office of Justice Programs [OJP(BJA)-1213] RIN 1121-AA36

Prison Industry Enhancement Certification Program Guideline

AGENCY: Office of Justice Programs, Bureau of Justice Assistance (BJA), Justice.

ACTION: Issuance of final guideline.

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**SUMMARY:**

The Office of Justice Programs, Bureau of Justice Assistance (BJA), is issuing this final revision to its Prison Industry Enhancement Certification Program (PIECP) Guideline proposed for public comment on July 7, 1998, 63 FR 36710-36719. Under Title 18 U.S.C. 1761(c), BJA PIECP certification excepts participating agencies from certain Federal restraints placed on the marketability of prison-made goods by permitting the transport of such goods in interstate commerce and the sale of such goods to the Federal government. This Guideline addresses statutory amendments and reflects administrative experience gained by BJA since the last final PIECP Guideline published on March 29,1985 (50 FR 12661-64). The publication of this Final Guideline is considered to be a Federal action that will not significantly affect the quality of the human environment. Therefore, preparation of an environmental impact statement is not necessary.

**EFFECTIVE DATE:** This Guideline is effective April 7, 1999; existing participants will have until April 7, 2000 to achieve compliance with all of the new requirements set forth in this Guideline except for those relating to the National Environmental Policy Act (NEPA). The new requirements implementing NEPA are effective immediately.

**FOR FURTHER INFORMATION CONTACT:** Jeffrey R. Hall, Law Enforcement Program Manager, Bureau of Justice Assistance, 810 Seventh Street, NW, Washington, DC 20531. Telephone: (202) 616 3255.

**SUPPLEMENTARY INFORMATION:**

**Scope of Program Announcement**

I. Introduction: Program Purposes and Objectives II. Background of the Prison Industry Enhancement Certification Program (PIECP) a. The Legislative History 1. Unregulated Prison Labor 2. Prisoner Idleness and Prisoners' Need for Job Skills Training b. The PIECP Program 1. Current State of the Program 2. Future Challenges c. Discussion of Comments c. 1-11 (see Nos. pp 821-847) III. Program Guidance a. PIECP Purposes b. Definitions c. BJA's Initial Considerations for Determining Propriety of Work Pilot Project Certification 1. BJA's Exercise of Discretionary Authority To Define and Certify 50 Work Pilot Projects 2. Threshold Inquiry for Determining Applicability of PIECP Exception Status d. Mandatory Program Criteria for PIECP Participation 1. Eligibility 2. Inmate Wages 3. Non-Inmate Worker Displacement 4. Benefits 5. Deductions 6. Voluntary PIECP Inmate Worker Participation 7. Consultation With Organized Labor 8. Consultation With Local Private Industry 9. Compliance With the National Environmental Policy Act (NEPA) IV. PIECP Administration a. Certificate Holders 1. Project Structure 2. Application Content 3. BJA Review 4. Standard or Provisional Certification 5. Certificate Holder Designation Authority 6. Certificate Holder Monitoring Responsibilities b. Cost Accounting Centers' PIECP Exception Status c. Compliance Reviews 1. Performance Reports 2. On-Site Monitoring Reviews d. BJA's PIECP Administration e. Exception Status Suspension/Termination 1. Notice of Possible Compliance Violation 2. Voluntary Compliance Agreements 3. Failure To Achieve Compliance and Effect of Non-Compliance 4. PIECP Exception Status Suspension and Termination

**I. Introduction: Program Purposes and Objectives**

The Prison Industry Enhancement Certification Program (PIECP), codified at 18 U.S.C. 1761(c), was first authorized by the Justice System Improvement Act of 1979, Pub. L. No. 96-157, 93 Stat. 1215. The PIECP was expanded from 7 to 20 pilot projects under the Justice Assistance Act of 1984, Pub. L. 98-473 Sec. 609k(a)(1), 98 Stat. 2077, 2107. In 1990, The Crime Control Act of 1990, Public Law 101-647 Sec. 2906, 104 Stat. 4789,4914, raised to 50 the number of PIECP projects that may be excepted by the Bureau of Justice Assistance (BJA) from certain Federal restrictions on the marketability of prisoner-made goods, including the Ashurst-Sumners Act (18 U.S.C. 1761(a)) and the Walsh-Healey Act (41

U.S.C. 35). Since its inception in 1979, the PIECP program has certified 38 work pilot projects throughout the country. Prison administrators find PIECP participation an effective way to address idleness among ever- increasing prison populations and as a cost-efficient method for providing inmates with marketable job skills. Taxpayers benefit because PIECP wage deductions result in reductions in incarceration costs. Inmate wages benefit society, generally, in that deducted amounts are authorized to address victim compensation, inmate family support needs and taxes. Lastly, PIECP industries obtain broad market access for their products because they are excepted from the Ashurst-Sumners Act prohibition against the interstate transport of prisoner-made goods and from the Walsh-Healey Act prohibition against certain contract sales of prisoner-made goods to the Federal government. BJA first issued a Final Guideline to implement this program on March 29, 1985, 50 FR 12661-64. After providing an opportunity for public comment on the revised Guideline on July 7, 1998 (63 FR 36710- 19), the agency now publishes this Final Guideline to offer updated program clarification. In so doing, the legislative underpinnings of relevant laws are examined and the scope of their applicability is defined. Compliance expectations are explained as program guidance. Refined administrative practices reflect experience gained by BJA over the past 14 years. The background history, guidance definitions and administrative requirements described in this Guideline are specific only to the PIECP and have no bearing on or relationship to the development, goals or administrative practices of any other prison industry program.

**II. Background of the Prison Industry Enhancement Certification Program (PIECP)**

a. Legislative History

1. Unregulated Prison Labor The 19th Century evolution of industrial capitalism and private sector use of prisoner labor spawned a number of conditions that adversely affected several major segments of society. By the turn of the 20th Century, these segments joined in an organized appeal to Congress and state legislatures nationwide. They collectively asserted that the production and distribution of unregulated prisoner-made goods in interstate commerce needed to be

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Herbert Hoover held a conference on the subject of the ``ruinous and unfair competition between prison-made products and free industry and labor.'' 70 Cong. Rec. S656 (1928). Then-Secretary Hoover authorized an advisory committee to study the problem. This committee issued a report to Congress in 1928 wherein Chairman of the Advisory Committee on Prison Industries, Arthur Davenport, submitted the following conclusions:

(1) Certain major factors in the normal cost of production which must be met by all manufacturers are entirely absent in the case of prison industries. If anything approaching normal efficiencies of operation can be attained with the use of prison facilities and labor, the total costs of production are . . . below those of the manufacturer who must meet large overhead expenses as well as employ free labor. (2) It is the universal belief that prisoners should be usefully occupied whether as a part of their punishment or as a means of rehabilitation by teaching them the habits of industry. To this end nearly every State . . . provid[es] productive work for their prisoners . . . (3) The volume of goods produced by prison labor is already very large in some lines, but as more prisoners are put to work, and the industries become more efficient, the output of our prisons will be greatly increased. (4) The effect of placing on the open market a volume of goods which have been produced below normal costs, is to lower prices and disorganize the market * * * The increase in prison production which is predicted will exaggerate this evil and make it difficult if not impossible for manufacturers employing free labor to exist in trade where the prison output becomes heavy. (5) The solution of this problem, if prison production is to continue * * * would seem to be the elimination, in one way or another, of the direct price competition of the prison products with so called ``free products''* * *. 70 Cong. Rec. S656 (1928). In closing, Chairman Davenport urged that solutions be found, ``[o]therwise either prison industries must cease and prisoners kept in idleness or the manufacture of products competing with prison output will become impossible. Either of these developments would be disastrous * * *.'' See S. Rep. No. 344, 70th Cong., 1st Sess., reprinted, Cong. Rec. S656 (Dec. 15, 1928), ``Statement of Prison Labor Problems as Shown by Report of Senate Committee.'' Even if a state prohibited its own correctional institutions from producing and marketing prisoner-made goods, that same state had no jurisdiction to control such goods produced in other states, transported in interstate commerce and sold within its boundaries. As an initial solution to this problem, Congress enacted the Hawes-Cooper Act in 1929, Pub. L. 70-669, 45 Stat. 1084, recodified by Pub. L. 95- 473, 92 Stat. 1449 (1978) [formerly codified at 49 U.S.C. 11507, omitted in the revision of Title 49 by Pub. L. 104-88, Title I Sec. 102(a), 109 Stat. 804 (effective January 1, 1996); See S. Rep. No. 104-176]. This law divested prisoner-made products of their interstate character upon their arrival in the state of their destination and permitted the laws of that state to become operative with respect to the sale and distribution of such products. It was described, at the time of enactment, as an enabling act because it did not prohibit the transportation of prisoner-made goods or force the enactment of state legislation. In 1935, Congress enacted the Ashurst-Sumners

Act, Pub. L. 74-215, 49 Stat. 494 (1935), which authorized Federal criminal prosecutions of violations of state laws enacted pursuant to the Hawes-Cooper Act. Subsequent amendments to this law, including Pub. L. 76-851, 54 Stat. 1134 (1940), strengthened Federal enforcement authority by making any transport of prisoner-made goods in interstate commerce a Federal criminal offense. As amended, 18 U.S.C. 1761(a) now provides:

Whoever knowingly transports in interstate commerce or from any foreign country into the United States any goods, wares, or merchandise manufactured, produced, or mined, wholly or in part by convicts or prisoners, except convicts or prisoners on parole, supervised release, or probation, or in any penal or reformatory institution, shall be fined under this title or imprisoned not more than two years, or both [herein referred to as the Ashurst-Sumners Act].

Certain prisoner-made products were excepted, by statute, from the Ashurst-Sumners Act prohibition, including ``agricultural commodities or parts for the repair of farm machinery'' as well as ``commodities manufactured in a Federal, District of Columbia or State institution for use by the Federal Government, or by the District of Columbia, or by any State or Political subdivision of a State or not-for-profit organizations.'' Title 18 U.S.C. 1761(b). The Walsh-Healey Act, 49 Stat. 2036 (1936), as amended in 1979 by Pub. L. No. 90-351, Sec. 827(b) and codified at 41 U.S.C. 35, also controls the production of prisoner-made goods. This statute prohibits the use of prisoner labor to fulfill general government contracts which exceed $10,000. BJA certification pursuant to Sec. 1761(c) excepts prisoner-made goods produced at PIECP work pilot projects from the Walsh-Healey Act contracting restrictions, as well as the Ashurst- Sumners Act interstate transportation restrictions. 2. Prisoner Idleness and Prisoners' Need for Job Skills Training The PIECP exception to the Ashurst-Sumners and the Walsh-Healey Act restrictions was introduced into the Senate in 1979 after the 1978 Pontiac, Illinois prison riot. In the wake of that uprising, Senator Charles Percy (R-Ill.) stated:

[L]ast summer in Pontiac, Illinois, our worst fears about the conditions in the Nation's prisons erupted into a nightmarish reality. The Pontiac prison riot of 1978 ended with three guards dead, three others seriously wounded, and $4 million in property damage * * *. The shopping list of problems and deficiencies in our prison system is long and well known. Overcrowding, old and obsolete facilities, lack of training or educational programs, crime within prison walls, frustration on the part of guards and inmates are all a part of the dreary picture * * *. Recidivism is now a substantial element in our overall crime rate, and prisons are often accurately characterized as a ``school for crime,'' rather than a deterrent to crime * * *. 125 Cong. Rec. S11834 (1979).

These concerns caused Congress to take measures to encourage prison industries, provided that they not engage in unfair competition with private sector business and labor. Senator Percy's bill, now referred to as the Prison Industries Enhancement Act, Section 827 of

the Justice System Improvement Act of 1979, Pub. L. 96-157, Sec. 827(a), 93 Stat. 1215, was enacted on December 27, 1979. As amended, it now offers 50 certified projects an opportunity to participate in the

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interstate market, provided certain safeguards to free-world labor and industry, and to prisoner-workers themselves, are met. See The Crime Control Act of 1990, Pub. L. 101-647, Sec. 2906, 104 Stat. at 4914. In describing the purpose of his introduced legislation, Senator Percy explained (125 Cong. Rec. S11834 (1979)):

My amendment would do two basic things: First, it would authorize the [BJA] to encourage development of pilot demonstration projects for prison industry at the State level, involving private sector industry * * *. Under this approach, prison programs benefit from the private business, develop access to new markets, and attract needed capital. The goal of these pilot projects would be to create as realistic a working environment as possible within the prison walls, while enabling an inmate to become more self- sufficient to the benefit of himself, the prison system, and the taxpayer. Secondly, my amendment creates a partial exemption to two Federal laws which severely restrict the ability of State prison industries to market their goods * * *. When these laws were enacted decades ago, they represented significant reforms against exploitation of prison labor. Over the years, however, they have developed into heavy-handed roadblocks to growth among * * * prison industry programs * * *. My amendment would provide limited exemptions to these restrictions where inmates have been paid a wage comparable to that paid for similar work in the private sector in the locality * * *. The statutory exception that was enacted to establish PIECP is codified at 18 U.S.C. 1761(c):

* * * [the Federal marketability prohibitions] shall also not apply to goods, wares, or merchandise manufactured, produced, or mined by convicts or prisoners who-- (1) Are participating in one of not more than 50 non-Federal prison work pilot projects designated by the Director of the Bureau of Justice Assistance; * * *

To become eligible for Bureau of Justice Assistance (BJA) certification, an applicant department of corrections must comply with specified statutory requirements. It must pay participating prisoners ``wages not less than that paid for work of a similar nature in the locality in which the work was performed'' and cannot take more than 80 percent in deductions from gross wages for specified purposes including taxes, reasonable charges for room and board, family support and victims' compensation. 18 U.S.C. 1761(c)(2). Certain other conditions of employment must also be met. An eligible applicant cannot deprive participating offenders, solely because of their status as offenders, of the right to participate in benefits made available by the Federal or state government to other individuals on the basis of their employment, such as workmen's compensation. Title 18 U.S.C. 1761(c)(3). PIECP inmates must also

participate on a voluntary basis and must have agreed to the specific deductions made from gross wages pursuant to 18 U.S.C. 1761(c)(2), and all other financial arrangements resulting from participation in such employment. Title 18 U.S.C. 1761(c)(4). The note following 18 U.S.C. 1761, although not codified, is public law and adds two additional PIECP requirements on certified prison industries. The note requires participating prison industries to consult with local union organizations prior to initiating any project qualifying for a 1761(c) exemption. Also, the qualifying applicant must ensure that paid PIECP inmate employment will not result in the ``displacement of employed workers, or be applied in skills, crafts, or trades in which there is a surplus of available gainful labor in the locality, or impair existing contracts for services.'' The Justice System Improvement Act of 1979 added these provisions which became Sec. 827(c) of the Omnibus Crime Control and Safe Streets Act of 1968. See Pub. L. 96-157, 93 Stat. 1215, reprinted in 1979 U.S.C.C.A.N. 2471. In 1984, Sec. 827(c) was redesignated Sec. 819 of the Omnibus Crime Control and Safe Streets Act of 1968, as amended. See Pub. L. 98-473, 98 Stat. 2093. If all eligibility requirements are met and an applicant acquires BJA certification, the agency is thereafter authorized to operate irrespective of Federal prohibitions on the marketing of state prisoner-made goods. Conversely, non-compliance with these statutory eligibility requirements could expose an industry to criminal prosecution under the Ashurst-Sumners Act. Title 18 U.S.C. 1761(a).

b. The PIECP Program

1. Current State of the Program Currently, 38 departments of correction or umbrella authorities are PIECP Certificate Holders. Under the Justice System Improvement Act of 1979, Arizona, California, Idaho, Kansas, Minnesota, Nevada and Utah were certified. In 1984, under the Justice Assistance Act of 1984, 13 prisons work pilot projects were certified in: Alaska, Belnap County (NH), Connecticut, Iowa, Maine, Missouri, Nebraska, New Mexico, Oklahoma, Oregon, South Carolina, Strafford County (NH) and Washington State. Under the Crime Control Act of 1990, the following additional departments of correction were certified: Colorado, Delaware, Florida, Hawaii, Indiana, Louisiana, Maryland, Montana, North Carolina, Ohio, Red River County (TX), South Dakota, Tennessee, Texas, the Texas Youth Commission, Vermont, Virginia, Washington State Jail Industries Board and Wisconsin. About 145 private sector businesses now work in partnership with PIECP certified projects to employ about 2,800 inmates. Either the department of corrections or the private sector enterprise retains project authority to direct and control inmate labor, depending on the management model used. Project implementation has resulted in the production of myriad products including such items as furniture, sheet metal, video equipment, clothing, food products, office products, mattresses, draperies, crutches and road signs. In addition, although service industries were not a threat to the private sector in 1935 and thus, were not included within the scope of the Ashurst-Sumners prohibition, a number of service industries have elected to comply with the PIECP requirements. Between January

1979 and September 1998, PIECP projects generated approximately $113.7 million in gross inmate wages. Nearly half of this amount was diverted to non-inmate recipients: $8.9 million was deducted for victims of crime, $25.7 million was deducted for room and board payments, $5.8 million was deducted for family support and about $13.7 million was withheld in local, State and Federal taxes. BJA monitors the performance of PIECP work pilot projects to ensure that they operate in full compliance with all legislative and administrative program requirements. Under a grant to the Correctional Industries Association (NCIA), prison industry and other professionals conduct regular, on-site reviews of all PIECP projects. BJA responds to matters involving possible non-compliance by taking appropriate remedial action such as providing technical assistance or proposing a corrective action plan. 2. Future Challenges PIECP is used nationwide as a cost-efficient way to provide inmates with work experience and training in marketable job skills, as well as to reduce idleness among growing prison populations. Over time, the limit on the authorized number of pilot projects has been raised to meet the demands of interested applicants. When Congress last increased the project ceiling to 50, the House took into consideration a waiting

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list of states and counties that had wanted to participate and noted that ``the demand for certification by state and local governments indicates a need for this amendment which will enable the program to expand and other jurisdictions to apply.'' H.R. (I), 101st Cong. 202 (1990). BJA administers PIECP with the objective of making participation available to as many qualified applicants as possible, within limits imposed by the statutory ceiling. This Guideline provides projects with clarity as to Federal participation requirements, as well as programmatic flexibility to allow for PIECP Project growth in ways that respond to local needs. The Federal requirements are intended to ensure that the interests of local business and organized labor are protected. In this way, BJA's administrative practices address concerns reflected in the legislative history pre-dating the onset of Federal regulation of prisoner-made goods. Finally, this revised Guideline addresses novel issues presented by new PIECP participants, the private sector prisons. These entities are unique in that they render an essential service traditionally undertaken by public agencies and they do so for profit. Thus, BJA has altered some PIECP program requirements to insure program implementation remains consistent with Congressional intent. Congress enacted PIECP to introduce public departments of correction to private sector profit-making enterprises. Therefore, private prisons are invited to participate in PIECP only as Cost Accounting Centers (CACs) designated under the authority of departments of correction.

c. Discussion of Comments

BJA published a proposed Guideline in the Federal Register on July 7, 1998 for public comment. Written comments from public and private organizations were received. All comments have been considered by the BJA in this publication. This Guideline is final. The following is a

summary of substantive comments and BJA's response. 1. Background on PIECP Comment: BJA should retain the legislative history and background section. It is informative and useful. BJA should explain that the background section does not accurately describe present day political, social or economic concerns regarding the implementation of prison industry programs. Response: BJA provides the background and legislative history section to illustrate social, political and economic concerns that were predominant prior to 1940, before the Federal government first began regulating, as a criminal matter, the interstate transport of prisoner- made goods, as well as such concerns as they existed prior to the 1979 enactment of the PIECP exception to 18 U.S.C. 1761(a). BJA provides this background to inform PIECP Cost Accounting Centers about Congress' intent when developing the program's statutory requirements and exception authority. Accordingly, no substantive change was made in the background section of the Guideline. 2. Program Purposes Comment: BJA should modify its program purposes to add, as a purpose, introducing government to private sector profit-making enterprises. More specifically, BJA should endorse private sector prison options as a specific way to introduce state and local government agencies to private sector profit-making enterprises. Response: Consistent with the legislative history of the PIECP, BJA exercises its administrative authority only to endorse PIECP as a cost- efficient means to address inmate idleness and to provide inmates with work experience and training in marketable job skills. Whether private sector partnerships or private prison contracts are suitable prison industry options for any given jurisdiction, is a state and or local matter for determination. State and local interests are uniquely poised to identify appropriate private sector profit-making enterprises, if any, to partner with prison industries. Thus, as a Federal agency, BJA is not prepared to adopt such a program purpose. Accordingly, no change was made in the program purposes provision of the Guideline. 3. Definitions Comment: BJA should modify the definitions so that references to departments of corrections include public or not-for-profit agencies sanctioned under state law to administer the Prison Industry Enhancement Certification Program. BJA should add a definition of ``chief state correctional officer,'' as the term is used in reference to the room and board deduction, so that it encompasses umbrella authorities where such models have been certified by BJA as prison work pilot projects. With respect to the minimum wage definition, BJA should state that this PIECP program wage threshold is in no way intended, in and of itself, to ascribe to inmate workers ``employee'' status for purposes of other state and Federal laws. BJA should re-define the locality definition. The proposed definition, which defers to state agencies for the making of such determinations, is too vague and subjective. Response: BJA concurs with a number of recommendations to enhance the clarity of terms used in the Guideline. A definition for the term ``departments of correction'' is incorporated to clarify that state and local government agencies and the instrumentalities thereof, including not-for-profit entities sanctioned under state law to administer PIECP, are eligible as potential PIECP Certificate Holders. A definition of the term ``chief state correctional officer'' is added to enhance guidance with respect to model specific implementation of the room and board deduction. Also, the scope of the minimum wage

definition is more specifically defined in relation to PIECP purposes and the operation of other laws. The locality definition has implications both with respect to the inmate wage requirement and the prohibition against private sector employee displacement. BJA directs all Cost Accounting Centers to obtain non-displacement projections and prevailing wage determinations from their appropriate state agencies and, in so doing, extends to the states an opportunity to locally influence implementation of the Federally authorized PIECP Project. BJA expects that by extending this opportunity, the states will exercise their authority so as to protect the interests of local labor groups and private sector competition. This approach was adopted to vest state agencies with authority and flexibility to respond to uniquely local economic trends and conditions. Accordingly, no change to the locality definition was made. 4. Eligibility Comment: BJA should allow private prisons to independently qualify as Certificate Holders. Alternatively, restrictions affecting the designation of private prison industries as Cost Accounting Centers (CAC), should be eased. Umbrella authorities should not be allowed to qualify as eligible Certificate Holders. The certification of umbrella authorities circumvents the 50 project limit imposed on the program by Congress. Response: Title 18 U.S.C. 1761(c)(1) authorizes BJA to exercise broad discretion in certifying PIECP prison work pilot projects. Two significant

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considerations, however, weigh in favor of limiting Certificate Holder eligibility only to departments of correction and not private prisons. First, the legislative history of the PIECP reflects Congress' desire to craft an inmate work vehicle to advance state and local government interests, and specifically their need to gainfully occupy growing prison populations in marketable job skills. Second, as PIECP implementation could impact state and local private sector interests, BJA believes that the protection of those interests would be best served by reserving certification for those agencies which, by their very nature, are accountable to the public. BJA will not authorize any PIECP certified project to designate CACs outside of its jurisdictional boundaries because the Bureau defers to individual state legislatures for determinations as to whether PIECP should be authorized within their jurisdictions. If a state legislature decides not to authorize PIECP implementation in public facilities, private facilities ought not be authorized to implement PIECP, in that same state, through a designation authorized by a Certificate Holder located in another state. BJA, however, incorporates amendments to the Final Guideline to allow any given state Certificate Holder to designate CACs within private prisons operating within that same state, even in the absence of a contract for incarceration services between that state and the private prison seeking to participate in PIECP. The BJA form used to accomplish the designation of a CAC within a private prison must reflect express approval of the designation by the Chief State Correctional Officer for the state in which the private prison CAC is located. See Section IV.(a)(5), infra. CACs designated within private prisons must also retain on-file documentation reflecting approval of PIECP inmate worker participation by the state and local jurisdictions

in which the PIECP inmate workers were convicted. In order to issue such approvals, the remaining state and local jurisdictions must also hold PIECP certificates. This requirement insures continuity of the necessary PIECP project authorization vis-a-vis the PIECP inmate workers, and is responsive to the statutory project ceiling number. If inmate workers could not participate in PIECP within the boundaries of the state and local jurisdictions in which they were convicted, they should not be allowed to participate in PIECP in another state or local jurisdiction through an agreement for private prison incarceration services. Alternatively stated, state and local jurisdictions cannot be allowed to participate in PIECP indirectly through a contract with a private prison that has a PIECP-designated CAC, if they choose not to participate in PIECP directly, i.e., had they incarcerated their inmates within their own state and local jurisdictional boundaries. Title 18 U.S.C. 1761(c) offers ' A broad discretion with respect to defining a prison work pilot proje for PIECP eligibility purposes. Umbrella authorities may represent a mix of agency members such as state and local departments of correction, and youth authorities. Any of these agency members may, through their respective umbrella authorities, designate CACs within themselves or private prisons located in their jurisdictional areas. In order to qualify for PIECP certification, umbrella authorities must be able to assure BJA that a central administration of the CACs can be accomplished to insure project-wide compliance with the guideline and the statute as well as responsible exercises of designation/undesignation authority. Since the inception of PIECP in 1980, BJA has certified several umbrella authorities. During that same period of time, Congress was advised of such projects and consistently increased the project ceiling. BJA interprets such action as tacit approval of BJA's certification of umbrella authority models. Accordingly, changes are made in the eligibility provisions to ease restrictions on Certificate Holder designation of CACs within private prisons located within the Certificate Holder's jurisdiction. Private prisons are ineligible as independent PIECP Certificate Holders. 5. Inmate Wages Comment: Authors of two comments claim that PIECP wage rates do not equal labor costs: BJA should allow Cost Accounting Centers (CACs) to make adjustments in prevailing wage rates to address the hidden, unusual costs of doing business in a prison environment such as the cost of transportation to rural areas, reduced production levels due to rapid turnover, and added expenses of worker training and start-up. Because these cost variables are significant and inherent in doing business within prisons, the PIECP wage requirement is not necessary to ``level the playing field'' with private sector competition. From the perspective of one organized labor group, the proposed Guideline is an improvement over the 1985 PIECP guideline. BJA, however, is urged not only to encourage, but to require CACs to implement salary wage plans based on worker competency and seniority. Regarding the wage self-determination option, in the proposed guideline, the following diverse comments were received: this option is an improvement in that it allows for CAC implementation in instances where state agencies are non-responsive to requests for prevailing wage determinations; this option imposes too great of an administrative burden on CACs; this option provides participants with an opportunity to avoid obtaining state agency wage determinations. In instances where a private

sector partner has both a non-inmate operation and a PIECP CAC in the same locality, the partner should be permitted to bypass a state agency's wage determination and use relevant non-inmate wage scales with respect to PIECP inmate workers performing the same job function. BJA should clarify the meaning of the term of ``notable tasks,'' as it is used in the Guideline with respect to identifying which inmate workers should be paid a PIECP wage. Response: Title 18 U.S.C. 1761(c)(1) expressly states that PIECP wages must be paid at a rate which ``is not less than that paid for work of a similar nature in the locality in which the work is performed.'' PIECP wage determinations must be based only on comparable non-inmate worker wages for performing work of a similar nature. Gross wages earned by PIECP inmate workers may be reduced only through an application of the four authorized wage deductions specified in 18 U.S.C. 1761(c)(2). Thus, the plain language of the PIECP exception statute provides BJA with no authority to allow wage deductions in addition to those set forth in 18 U.S.C. 1761(c)(2) and for the purpose of addressing the unusual costs of doing business in a prison environment, however meritorious such proposed adjustments might be. The language of 18 U.S.C. 1761(c)(3) requires PIECP projects to pay wages based only on private sector wage amounts for performing similar work and it does not, as a matter of law, require the implementation of salary plans. BJA added this policy-based encouragement to advance program objectives. The self-determination option, as reflected in the proposed guideline, was presented to address a recurring challenge confronting many PIECP Cost Accounting Centers (CACs). On occasion and through no fault of their own, CACs are unable to obtain timely, state agency responses to requests for wage determinations. The self-

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determination option, which is available only when state non-responsiveness occurs, assists CACs to achieve compliance without relying on a determination by a third party. The method presented requires only the minimum amount of data collection and analysis necessary to yield a defensible, rationally-based wage determination. Availability of the self-determination option prevents CACs from paying a Federal minimum wage--the lowest possible PIECP wage, indefinitely, when payment of such a wage rate is unwarranted and the state remains non-responsive to wage determinations requests. To ease the impact of PIECP implementation on any given locality's economy and labor force, BJA reserves two opportunities for states to affect the implementation of the Federal PIECP program within state boundaries. The requirement that proposed CACs must obtain wage rates from the relevant state agencies, is one of those opportunities. BJA reserves this opportunity for state participation in the program, without exception, to insure CACs respond to relevant, locally-based input from an objective source. BJA introduces the Guideline concept of ``notable tasks'' as a way to assist CACs in identifying inmate workers to whom a PIECP prevailing wage should be paid. Questions arise as to whether inmates performing support functions, such as janitorial and maintenance services, necessary to CAC operations must be paid a PIECP wage. A more specific

definition, in this regard, is not possible without compromising flexibility in the application. The Guideline offers specific administrative direction by identifying relevant considerations for determining whether a given task is ``notable.'' Accordingly, no change was made in the wage payment provisions of the Guideline. 6. Non-Inmate Worker Displacement Comment: One representative from organized labor claimed that prisoner labor should never be allowed to compete with free-world labor because it undermines the private sector labor force and inmate rehabilitation. Another representative of organized labor generally endorsed the Guideline and the revised non-inmate worker displacement requirement, stating that it is an improvement over that which was issued in 1985. The presumption of non-compliance, applicable when a private sector partner employs non-inmate and inmate workers in the same locality, is too vague and too restrictive on private sector partners. The general language of this requirement makes it difficult to measure displacement in instances where other non-employee, non-inmate workers perform similar jobs or skills in the same locality. Any PIECP operation is likely to affect the private sector marketplace and, consequently, private sector jobs. The requirement ought not be construed in such a way so as to prohibit PIECP companies from engaging in normal business operations such as bidding for contracts on the open market after they have been designated as participating in a PIECP project. Also, BJA should not impede or discourage successful PIECP operations, already designated, from continuing operations even when there is a subsequent general downturn in the economy and, arguably, de facto displacement of non-inmate workers performing similar work in the locality. This requirement is too restrictive in that it prohibits PIECP partners from outsourcing entry level jobs and redirecting their current private sector workforce toward higher skill level jobs. The Guideline encourages potential Cost Accounting Centers to develop new jobs in a locality; this should not be implemented so as to adversely affect a CAC which decides not to follow the encouragement. Response: Congress directs BJA to implement the PIECP program, a prison industry program that places prison made goods in competition with the private sector. BJA has no discretion to exercise in determining whether or not to implement this program. One BJA purpose in revising the Guideline is to improve the program's responsiveness to organized labor's concerns. The agency is pleased that a segment of the labor community views its interests as better served through the re-issuance of the PIECP Guideline. BJA acknowledges that implementing the non-inmate worker displacement prohibition may appear to work at cross purposes with encouraging the commercial success of PIECP Cost Accounting Centers (CACs). The agency must respond to a broad statutory mandate to insure that PIECP does not impair or displace private sector workers and is not applied in skills in which there is a surplus of available gainful labor. However, BJA cannot accomplish PIECP implementation if CAC's are prevented from attaining commercial success by engaging in typical competitive market practices. To address this concern, the guidance language is modified to reflect BJA's expectation that PIECP CACs will engage in typical business operations, such as bidding for contracts on the open market after project initiation. While compliance is a continuing CAC responsibility, a violation of the non-displacement requirement is

more likely to occur and is more discernable just prior to and immediately following CAC implementation than thereafter. For this reason, BJA will scrutinize CAC compliance with this provision just prior to and within one year following CAC implementation. The agency devised a presumption of displacement which may be applicable in instances where a private sector partner retains non-inmate workers in the same locality. This presumption is modified in this Final Guideline to provide partners with a degree of flexibility to reallocate resources to their optimum use. Specifically, the presumption may be overcome if the private sector partner can demonstrate that non-inmate workers have been retained by the private sector partner in jobs at pay rates equal to or greater than that received in the previous position, that non-inmate employees have been provided an adequate opportunity for effective training in any new job skills and that the subject non-inmate employees are being retained by the private sector partner under reasonably similar or improved employment conditions. BJA policy encouragement regarding the creation of new PIECP jobs is not a mandate. CACs which do not bring new jobs to their localities will not be penalized. For obvious reasons, however, CACs generating new jobs are easier for BJA to evaluate and are less likely to be the subject of local criticism. Accordingly, changes are made in the non-inmate worker displacement provision to clarify the scope of the prohibition and to not unduly impede business decisions that lend themselves to effective commercial management and success of PIECP Cost Accounting Centers. 7. Benefits Requirement Comment: A resolution of inconsistent Social Security requirements imposed on PIECP models should be accomplished at the Federal level between BJA, the Social Security Administration and the Internal Revenue Service. The disparate treatment of customer and employer models is arbitrary. Both models should be treated the same way for purposes of requiring projects to provide inmates with Social Security coverage. BJA should clarify its position with respect to imposing the Federal

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Unemployment Tax Act on PIECP models as a benefits requirement. Response: The benefits requirement, as outlined in the proposed Guideline, elicited the greatest number of comments. Several Federal laws apply to wages earned by inmates in penal institutions. BJA, therefore, sought a Guideline review from both the Social Security Administration (SSA) and the Internal Revenue Service (IRS) to ascertain whether the PIECP benefits requirement, as proposed, was consistent with comparable laws administered by those Federal agencies. Both the IRS and the SSA concluded that BJA's benefits requirement is consistent with comparable laws set forth in the Social Security Act, 42 U.S.C. 410(a)(7) and 418(c)(6)(B), and the Internal Revenue Code. Services performed in an institution by an inmate in the employ of a State, a political subdivision, or a wholly-owned instrumentality are excepted from Social Security employment by 26 U.S.C. 3121(b)(7). Section 3121(u)(2)(B)(ii)(II) also provides that such services are not subject to the Medicare tax. In contrast to those inmate services performed in the employ of a state or governmental entity, there is no IRS or SSA exception for

services of inmates performing services in the employ of a non-governmental entity (for example, a private corporation operating a prison or a private corporation operating under the PIECP employer model). PIECP Employer models must generally provide inmates with Social Security coverage. BJA retains the customer and employer models to implement the PIECP benefits provision, 18 U.S.C. 1761(c)(3), in a manner consistent with other Federal laws addressing inmate wages. Specifically, the models are necessary in order to accord states and other governmental entities the Social Security employment or coverage exception status, as recognized by the IRS and the SSA. BJA will monitor and evaluate Cost Accounting Centers (CACs) in accordance with the guidance set forth in this Guideline, but will defer to the expertise of both the IRS and SSA should either of those agencies reach another conclusion with respect to the appropriate benefits treatment of inmate wages earned at any given CAC. In the case of services performed by PIECP inmates, regardless of whether services are being performed under the customer or employer model, Federal Unemployment Tax Act taxes do not apply to such services. See Section 26 U.S.C. 3306(c)(21) which excepts from employment ``service performed by a person committed to a penal institution.'' Accordingly, no changes are made in the benefits requirement of the Guideline. 8. Deductions Comment: BJA ought to expressly authorize the use of room and board deduction funds for the purpose of lowering costs otherwise incurred to maintain and operate a PIECP program. The term ``Chief State Correction Officer'' should be amended to also include ``responsible umbrella authorities.'' Private prisons managing PIECP Cost Accounting Centers (CACs) should be required to demonstrate that any benefit derived through the taking of room and board deductions is passed on to states which provide public funds to cover such costs. The authorized deduction for victims compensation ought to be made available to address a PIECP inmate's legal obligations to pay victim restitution. Response: Consistent with the statutory mandate addressing the room and board deduction, BJA defers to state determinations--as reflected in regulations issued by Chief State Correctional Officers--with respect to determining the amounts of such deductions as well as identifying the specific needs to which such deducted amounts may be directed. BJA has authority to review room and board deductions to insure the amounts deducted are reasonable and are used to defray the costs of inmate incarceration. Specific amount determinations and budget line item uses are issues more appropriately determined at the state and local level. In instances where the Certificate Holder is an umbrella authority, possibly composed of diverse state as well as local agencies, the umbrella authority may itself issue policy on this matter to guide its multijurisdictional membership. A definition of ``Chief State Correctional Officer'' is added to accommodate the administration of this deduction by such models. The room and board deduction was authorized by Congress to lower incarceration costs otherwise borne by the public. Since private prison PIECP inmates' room and board expenses might otherwise be addressed in contracts for incarceration services between private prisons and public agencies, BJA requires private prison CACs to obtain written approval from their respective public agency clients before taking the room and board deduction. In devising this requirement, BJA insures notice of this possible revenue

source is received by appropriate public agencies without unduly burdening contractual relations to which it is not a party. BJA broadens its interpretation of the victims compensation authorized deduction to also include deductions deposited in funds established by law to facilitate victim restitution. Compensation and restitution serve substantially the same purpose in providing victims with financial redress for expenses incurred as a result of crime. Although the statutory PIECP authorization, 18 U.S.C. 1761(c), does not require CACs to make tax deductions, the Internal Revenue Code requires federal income tax withholding if payments of wages are made to employees. BJA encourages all CACs to take whatever deductions, which may be necessary to comply with all Federal laws, including the Internal Revenue Code. As with the PIECP benefits provision, BJA defers to the IRS as the final authority with respect to making CAC tax withholding determinations. Accordingly, changes are made in the deductions provision to clarify that the victims deduction may, in some instances, be used to address a PIECP worker's restitution obligations. Guidance regarding room and board deduction is simplified because of the inclusion of a definition for the term ``Chief State Correctional Officer.'' Clarification is also provided with respect to tax deductions which may be necessary to facilitate CAC compliance with the Internal Revenue Code. 9. Voluntary Inmate Participation Comment: BJA should accept inmate signatures on deduction notices as evidence of voluntary inmate participation. BJA should not require the execution of new inmate voluntary participation agreements each time the deductions affecting inmate wages are changed. Response: The 18 U.S.C. 1761(c) expressly requires not only voluntary inmate employment, but also inmate agreement, in advance, of all deductions and financial arrangements affecting gross wages. While an inmate's signature on a notice form may signify receipt of notice, it does not necessarily reflect inmate agreement. Thus, the proposal is inadequate to insure compliance with the statutory requirement. Accordingly, no change is made to the voluntary participation provision.

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10. Consultation With Local Labor and Business Comment: The consulation requirements reflected in the guideline exceed BJA's statutory authority. The requirements are overly burdensome and should not be implemented so as to compromise the competitive capablity of the Cost Accounting Centers (CACs). BJA should accept as compliance with the labor consultation requirement, the presence of an organized labor representative on the board of an umbrella authority PIECP project. With respect to consulation with organized labor, BJA should routinely require CAC consultation with both state and local union representatives. CACs should also be required to maintain documentation of such consultation, on file. Response: BJA's labor consultation requirement is consistent with the mandate reflected in the statutory note to 18 U.S.C. 1761(c). The provision requiring notice to local business, is consistent with a provision reflected in the 1985 guideline as well as the legislative history of the program exception. In this revised Guideline, BJA provides specific guidance on the minimum amount of information necessary to insure

provision of adequate consultation; it includes general information on the scope and nature of the proposed Cost Accounting Center, the proposed initiatio i date as well as notice of the requirement and an invitation to comment. Implementation of the consultation requirements is not intended to compromise the market competitiveness of a CAC, but to advise local economic interests which may be impacted by the project. Labor consultation cannot automatically be achieved through labor participation on the board of a PIECP project. Such representation does not necessarily insure notice of the proposed CAC activities to the relevant local union representative in the locality to be affected. While BJA issues this guidance to insure provision of consultation to a labor organization (i.e., notice to a state labor organization, in the event a local organization cannot be identified or does not exist), BJA has no statutory authority to require notice to both state and local labor organizations on a routine basis. Accordingly, no change is made to the consultation provisions. 11. Compliance With the National Environmental Policy Act (NEPA) BJA should allow PIECP projects to defer to state environmental requirements and not impose a new national requirement. BJA should provide Cost Accounting Centers (CACs) with technical assistance to facilitate compliance with this program requirement. Response: BJA has no authority to allow CAC applicants to defer to state environmental requirements as a substitute for implementing the provisions of the National Environmental Policy Act (NEPA), 42 U.S.C. 4321-4347 (NEPA). BJA decisions on proposed PIECP certifications and designations consitute ``Federal actions'' as defined by 40 C.F.R. 1508.18 of the Council on Environmental Quality's (CEQ) regulations for implementing NEPA. As such, BJA has a federal obligation to insure that prior to decisions being made on requested certifications and designations, BJA implements the appropriate provisions of the CEQ regulations. These Federal implementation responsibilities, which can be shared with but cannot be delegated to Federal program applicants, have existed since the enactment of NEPA. The technical assistance needs of CACs will be addressed through BJA, itself, as well as its contractor, the National Correctional Industries Association. Accordingly, no change was made to the proposed PIECP provision implementing the NEPA. As a result of public review and comment, the final ``Prison Industry Enhancement Certification Program'' Guideline is revised to read as follows:

**III. Program Guidance**

a. PIECP Purposes

<bullet> To provide a cost-efficient means to address inmate idleness and to provide inmates with work experience and training in marketable job skills. BJA encourages private sector PIECP partners to consider post-incarceration employment to PIECP inmate workers. <bullet> Through inmate wage deductions, to increase advantages to the public by providing departments of correction with a means for collecting taxes and partially recovering inmate room and board costs, by providing crime victims with a greater opportunity to obtain compensation, as well as by promoting inmate family support.

<bullet> Through PIECP participation conditions, to prevent unfair competition between prisoner-made goods and private sector goods.
<bullet> To prevent the exploitation of prisoner labor.

b. Definitions

Benefits refers to inmate benefit coverage required by 18 U.S.C. 1761(c)(3). PIECP projects must provide inmate workers appropriate benefits comparable to those made available by the Federal or state government to private sector employees. The scope of appropriate benefits coverage is impacted by whether the Cost Accounting Center is structured as an employer or customer model and whether the inmate labor work force is controlled by a public agency or the private sector. BJA refers to the Bureau of Justice Assistance within the Office of Justice Programs, U.S. Department of Justice. Certificate Holder refers to a department of corrections, or an alternate umbrella authority, which is approved by BJA for PIECP Project certification. Certificate Holders assume monitoring and designation responsibilities with respect to their designated Cost Accounting Centers. All PIECP prisoner-made goods are produced within Cost Accounting Centers that a Certificate Holder designates within itself, private prisons located in the same state or jurisdiction or, in the case or an umbrella authority, within its membership agencies. Certification refers to an exercise of BJA's discretionary authority to designate a Prison Work Pilot Project pursuant to Title 18 U.S.C. 1761(c). BJA may issue either standard or provisional certifications to applicant projects. BJA certified projects are excepted from certain Federal marketability restraints on the transport of prisoner-made goods in interstate commerce, as provided in 18 U.S.C. 1761(a), and sales to the Federal government in excess of $10,000, 41 U.S.C. 35. Chief State Correctional Officer refers either to the highest correctional officer for the jurisdiction in which the certified work pilot project is located or, with respect to umbrella authorities that control PIECP CACs within a mix of state and local jurisdictions, the authorities themselves. Cost Accounting Center (CAC) refers to a distinct PIECP goods production unit of the industries system that is managed as a separate accounting entity under the authority of a Certificate Holder. All PIECP production activities are conducted within the context of a designated CAC which, generally, is structured either as a customer or employer model for purposes of determining PIECP inmate benefits. All CACs must operate in compliance with the provisions set forth in 18 U.S.C. Sec. 1761(c) and this Guideline.

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Customer Model is a form of a PIECP Cost Accounting Center management structure. In this model, the private sector is engaged in a CAC enterprise only to the extent that it purchases all or a significant portion of the output of a prison-based business owned and operated by a governmental entity, political subdivision or an instrumentality thereof. A customer model private sector partner assumes no major role in industry operations, does not direct production and has no control over inmate labor. These functions are

performed, rather, by a department of corrections. Deductions. CACs may elect to take deductions from a PIECP inmate worker's wages for certain authorized items. Deductions from PIECP inmate gross wages, if taken, may be made only for those items specified in 18 U.S.C. 1761(c)(2), including: payment of taxes, reasonable charges for room and board, allocations for family support and contributions to any funds established by law to compensate victims of crime (no less than 5 percent and no more than 20 percent). In no event may a PIECP inmate worker's total deductions exceed 80 percent of gross wages and each and every PIECP inmate worker must agree, in advance, to all deductions from gross wages. Department of Corrections refers to state or local governmental entity or a political subdivision or instrumentality thereof, including not-for-profit entities, that are legally sanctioned by state legislatures to administer prison industries. Designation is an exercise of a Certificate Holder's discretionary authority to bring a CAC within its certified PIECP Project. This exercise of authority results in an extension of PIECP exception status and an imposition of compliance requirements on an identified CAC operating within the certified PIECP Project. Employer Model is a form of a PIECP management structure. In this model, the private sector owns and operates the CAC by controlling the hiring, firing, training, supervision, and payment of the inmate work force. The department of corrections assumes no major role in industry operations, does not direct production, and exercises minimum control over inmate labor performance. These functions are performed, rather, by the private sector. Goods include tangible items, wares, and merchandise. Locality means the geographic area impacted by the presence of a PIECP CAC operation. For PIECP CACs, it is relevant with regard to: determining inmate wages, providing consultation to appropriate labor and private sector organizations, and determining whether a PIECP CAC operation will displace the private sector labor force. All locality determinations must be documented as part of a Notice of Designation. As used in the calculation of CAC wage rates, locality is usually a matter for definition by the appropriate state agency which normally determines wage rates (i.e., the State Department of Economic Security). Minimum wage refers to the Federal minimum wage which is the lowest possible wage that can be paid to private sector employees under the Fair Labor Standards Act, 29 U.S.C. 206. Any special wage program, excepted by law from the minimum wage requirement in the private sector, may be used by a PIECP CAC as long as the CAC meets the same program participation conditions as private sector participants. The requisite payment of at least a minimum wage, by a CAC, is in no way intended by BJA to imply that PIECP inmate workers are employees for purposes of the PIECP statute or any other Federal law. Monitoring refers to the process of examining Prison Work Pilot Project activities to ensure continuing compliance with 18 U.S.C. 1761(c) and this Guideline. It includes, at a minimum, BJA's receipt and analysis of performance reports and on-site CAC monitoring visits by BJA, BJA contractors and Certificate Holders. NEPA means the National Environmental Policy Act, Pub. L. 91-190, 83 Stat. 852 (1970) (codified as amended at 42 U.S.C. 4321-4347; implemented under 40 C.F.R. pt. 1500). Participation means engaging in the activities and operations of an 18 U.S.C. 1761 (c) excepted PIECP Project. PIECP means the Prison Industry

Enhancement Certification Program as authorized by 18 U.S.C. 1761 (c). PIECP Exception Status. Any PIECP Project which produces prisoner- made goods pursuant to 18 U.S.C. 1761(c) is excepted from certain Federal restraints imposed on the marketability of prisoner-made goods, including 18 U.S.C. 1761(a) and 41 U.S.C. 35. PIECP Inmate Worker is a convict or prisoner who performs notable tasks necessary to produce or transport goods in interstate commerce and for a Prison Work Pilot Project certified under 18 U.S.C. 1761(c). The PIECP Inmate Worker benefits from PIECP by receiving training and work experience. Prevailing wage is a wage rate which is not less than that paid for work of a similar nature in the locality in which the work is to be performed, 18 U.S.C. 1761(c) (2). Prison Industry means an organized utilization of inmate labor to produce goods or render services. Prison Work Pilot Project (PIECP Project) refers to one of 50 non- Federal prison work pilot projects which may be designated by the Director of BJA under 18 U.S.C. 1761(c). This term encompasses the operations of the Certificate Holder's designated Cost Accounting Centers (CACs). Any Prison Work Pilot Project may consist of one or more CACs. Prisoner includes prison and jail inmates, convicts and incarcerated juvenile offenders, and does not include prisoners on parole, probation, or supervised release. Title 18 U.S.C. 1761(a) does not regulate the transport of goods produced by prisoners on parole, supervised release, or probation. Prisoner-made goods include all goods, wares, and merchandise manufactured, produced, or mined, wholly or in part, by convicts or prisoners (except convicts or prisoners on parole or probation). Production is the forming anew or transforming of marketable goods. The term includes mining and manufacture and excludes services. Provisional Certification is issued by BJA in instances where an applicant has not yet come into full compliance with all PIECP requirements, but such compliance appears imminent. It entitles the holder to PIECP exception status for an identified period of time, may be made contingent upon the occurrence of identified conditions, and may or may not be renewed by BJA. Statutory Exception Status refers to a prison industry which meets the statutory requirements set forth in 18 U.S.C. 1761(b), and is thereby entitled to an exception from the prohibition set forth in 18 U.S.C. 1761(a). Supervised Release. 18 U.S.C. 1761(a) states that the Ashurst- Sumners Act prohibition does not apply to ``convicts on parole, supervised release, or probation.'' The reference to ``supervised release'' was added to 1761(a) in 1984, Pub. L. 98-473, 223, and is responsive to changes made at that same time in state and Federal Sentencing Guidelines. Policy statements issued by the U.S. Sentencing Commission explain that supervised release is a ``new form of post- imprisonment supervision created by the Sentencing Reform Act.'' See Federal Sentencing Guidelines, 18 U.S.C.A. ch. 7, pt. A (1997). Umbrella Authority refers to a type of Certificate Holder which is authorized by law to administer a PIECP Project and which consists of state and/or local departments of correction located

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within the same state. A certified umbrella authority may designate

CACs within its membership agencies, as well as within members' private prisons, and assumes responsibility for monitoring CAC compliance.

c. BJA's Initial Considerations for Determining Propriety of Work Pilot Project Certification

1. BJA's Exercise of Discretionary Authority To Define and Certify 50 Work Pilot Projects (A) BJA may exercise discretionary authority to designate up to 50 non- Federal work pilot projects, 18 U.S.C. 1761 (c). (B) BJA may define PIECP eligibility qualifications and, in accordance with its own definitions, may exercise agency discretion to extend or withdraw certification privileges, as it deems appropriate. 2. Threshold Inquiry for Determining Applicability of PIECP Exception Status Appropriate PIECP participants include prison industries whose activities would likely violate the 18 U.S.C. 176 (a) prohibition and would likely not fit within an 18 U.S.C. 1761(b) exception. BJA has devised an administrative approach for identifying such industries. This approach incorporates relevant sections 1761 (a) and (b) considerations, including whether a given prisoner-made item qualifies as an excepted agricultural product, whether a given prison industry activity qualifies as an unregulated service, and whether a product distribution activity qualifies as an intrastate distribution of goods. These considerations are reflected in the following threshold inquiry, which BJA will use to determine whether a prison industry should be encouraged to apply for PIECP exception status:

(A) Is a statutory exception applicable under 18 U.S.C. 1761(b)? The following prisoner-made items are excepted from the prohibition set forth in section 1761(a):

<bullet> Parts for the repair of farm machinery; or <bullet> Commodities manufactured in a Federal, District of Columbia, or state institution for use by the Federal Government, or by the District of Columbia or by any state or political subdivision of a state or not-for-profit organizations. This exception is intended to inure to the benefit of the public; or <bullet> Agricultural commodities grown or cultivated on a farm which retain continuing substantial identity through processing stages, if any. In making the determination as to whether a processing stage changes a product from an agricultural commodity to a manufactured commodity, a relevant consideration is whether the processing is incidental or ancillary to agricultural commodity growth and or cultivation. If the processing is incidental or ancillary in nature and is commonly undertaken by agricultural enterprises, then it would likely fall within the scope of the statutory exception.

(B) Could the contemplated activity trigger 18 U.S.C. 1761(a) by resulting in a production of goods by inmates in any penal or reformatory institution? The production of goods, which is regulated by 18 U.S.C. 1761(a), must be distinguished from inmate services which are not regulated by the criminal prohibition. The following factors are relevant in determining whether a given activity results in

that paid for work of a similar nature in the locality in which the work is to be performed. This requirement benefits society by allowing for the development of prison industries while protecting the private sector labor force and business from unfair competition that could otherwise stem from the flow of low-cost, prisoner-made goods into the marketplace. PIECP participants must, therefore, implement the prevailing wage requirements under like conditions experienced by private sector competition. Toward this end, the following requirements are applicable:

(A) Section 1761(c) requires that the PIECP wage amount be set exclusively in relation to the amount of pay received by similarly

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situated non-inmate workers. In deriving the appropriate PIECP wage, 18 U.S.C. 1761(c)(2) does not allow other cost variables to be taken into consideration, such as unique expenses incurred as a result of undertaking production within the prison environment. (B) Prevailing wage verification must be obtained by the appropriate state agency which determines wage rates (usually the Department of Economic Security). (C) When making PIECP prevailing wage verifications and annual re- verifications, the responsible state agency should recommend the utilization of a non-inmate wage scale which will not result in the displacement of non-inmate workers performing similar work in the relevant locality. (D) The PIECP prevailing wage must be received by those inmate workers performing notable tasks necessary to produce and/or transport goods in interstate commerce. If a similarly situated, private sector company is paying wages to obtain services that are necessary to production, e.g. refuse pickup, then the PIECP CAC must also pay such wages to the inmate provider of like services. In determining which tasks are covered, the following considerations are relevant: the amount of inmate time involved, effort and skill necessary to accomplish the task, the regularity of task performance, and whether the task would have been performed by the inmate absent PIECP production. (E) The prevailing wage must be verified prior to the initiation of PIECP participation. Annually, thereafter, the PIECP participant must re-verify the adopted wage to ensure that it continues to be comparable to wages paid for work of a similar nature in the locality in which the project is located. (F) If no such verification can be obtained from the State Department of Economic Security, or other similar department, the PIECP participant is responsible for establishing a reasonable prevailing wage. In such instances, the participant should retain on file, for BJA's review: (1) relevant wage data from a sufficient number of competitors in the locality; (2) data analyses for determining a reasonable prevailing wage result; and (3) if possible, a written assessment of the reasonableness of the resulting prevailing wage determination by an appropriate state agency which normally determines wage rates. (G) The PIECP prevailing wage can not be set below the Federal minimum wage, as defined in the Fair Labor Standards Act (FLSA), 29 U.S.C. 201 et seq. Payment of the Federal minimum wage, however, does not automatically achieve compliance with the

prevailing wage requirement unless the prevailing wage for the comparable private sector industries is, in fact, the Federal minimum wage. (H) Overtime, at one and a half times the rate of regular or prevailing wage, must be paid for prisoner hours worked in excess of 40 hours per week. See 29 U.S.C. 207(a) (a payment standard imposed on private sector competition). (I) If a CAC pays a wage based on piece work, the project must apply a calculation to convert regular wages paid into a comparable hourly wage. The calculation should be used as a routine check to ensure that inmate workers, paid according to piece rate work, do not receive less than the Federal minimum wage. In instances where the CAC is paying Federal minimum wage and such a wage is less than the industry standard for the prevailing wage, the CAC must be able to identify inmate worker performance variances as justification for the wage rate. (J) BJA strongly encourages the use of wage plans that take into consideration a PIECP worker's experience, seniority, and performance. 3. Non-Inmate Worker Displacement. PIECP CAC operations must not result in displacement of employed workers; be applied in skills, crafts, or trades in which there is a surplus of available gainful labor in the locality; or significantly impair existing contracts. The term ``displacement,'' as used in this provision, includes all such prohibited activities, as well as the inappropriate transfer of private sector job functions to PIECP inmates. This prohibition is intended to protect the private sector partner's non-inmate employees, as well as all other non-inmate workers who perform work of a similar nature in the same locality in which the CAC is located. This prohibition is not, however, intended to prohibit PIECP CACs from engaging in typical business operations, such as competing for business or bidding on contracts on the open market after their designation as Cost Accounting Centers.

(A) Regarding the possibility of displacement among non-inmate employees of private sector partners in the same locality as the CAC: (1) BJA will presume non-compliance where there is a non-inmate worker's job function replacement by a PIECP inmate worker or where a non-inmate worker's job function is eliminated or adversely impacted, to a significant degree, and there is a concomitant assumption of a similar job function by a PIECP inmate worker. This presumption may be overcome if it can be demonstrated that the non-inmate workers have been retained by the private sector partner in jobs at pay rates equal to or greater than that received in previous positions, that non-inmate employees have been provided an adequate opportunity for effective training in any new job skills and that the subject non-inmate employees are being retained by the private sector partner under reasonably similar or improved employment conditions. When making this compliance evaluation, BJA will not consider the private sector partner's intent or economic viability. (2) Prior to CAC initiation, the CAC applicant must provide BJA with written documentation reflecting the private sector partner's agreement not to displace its non-inmate employees with PIECP inmate labor in violation of the 18 U.S.C. 1761(c) statutory note. (B) Prior to project initiation, all CAC applicants must show through written verification by the State Department of Economic Security (or other appropriate state agency) that the PIECP project will not result

in displacement of non-inmate workers performing the same work, regardless of wage rate. In cases where an appropriate state agency cannot provide this service, the applicant CAC should propose to and confer with BJA as to alternative measures to address this requirement. (C) While compliance is a continuing CAC obligation, BJA will scrutinize CAC compliance with the non-displacement requirement just prior to and within one year after the initiation date of CAC operations. (D) In instances where BJA finds that CAC implementation results in private sector worker displacement, the CAC must either cease its operations or comply with a BJA-approved corrective action plan, if BJA proposes such a plan under Section IV. f. of this Guideline, infra.

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(E) BJA strongly recommends that CAC job development be oriented toward the creation of new jobs within the locality. 4. Benefits. PIECP projects must provide inmate workers appropriate benefits comparable to those made available by the Federal or State Government to private sector employees, including workers' compensation and, under certain circumstances, Social Security.

(A) By statute, in some states, inmates are not eligible to participate in workers' compensation programs. Provision of comparable workers' compensation benefits is acceptable as long as the CAC can demonstrate comparability of such benefits with those secured by the Federal or state Government for private sector employees. (B) The PIECP CAC management model impacts whether the CAC must provide Social Security benefits to PIECP inmate workers. Where the employer model is utilized and the private sector directs and controls the PIECP inmate worker, the PIECP participant must provide PIECP inmate workers with Social Security benefits. Where a customer model is utilized and a governmental, or instrumentality thereof, directs or controls the PIECP inmate worker, BJA recognizes the applicability of other provisions of Federal law which may operate to preclude the provision of PIECP inmates with certain benefits, including Social Security. 5. Deductions. Participating CACs are not required under 18 U.S.C. 1761(c) to take deductions from PIECP inmate wages. Deductions, however, may be required under other Federal statutes, such as the Internal Revenue Code. If a CAC elects to take deductions from a PIECP inmates' gross wages, such deductions can be taken only under the following conditions:

(A) Deductions from gross wages, if made, may be withheld only for the following authorized purposes: (1) taxes (Federal, state, local); (2) in the case of a state prisoner, reasonable charges for room and board as determined by regulations issued by the Chief State Correctional Officer; (3) allocations for support of family pursuant to state statute, court order, or agreement by the offender; and (4) contributions of not more than 20 percent, but not less than 5 percent of gross wages to any fund established by law to compensate the victims of crime.

Such deductions, in aggregate, cannot exceed [illegible] percent of gross

wages.

(B) PIECP inmate workers must be paid, credited with, or otherwise benefit legally from, the 20 percent gross remainder. In this regard, the CAC may direct the 20 percent gross remainder to a PIECP inmate worker's expense accounts, savings accounts, or toward the settling of the worker's legal obligations, including the payment of fines and restitution. (C) Each Certificate Holder, through its respective Chief State Correctional Officer, retains flexibility in determining appropriate room and board charges that may be deducted from PIECP inmate workers' gross wages. Except as to CACs within private prisons, the applicable regulations for determining this deduction are those issued by the Chief State Correctional Officer of the state in which the PIECP inmate is incarcerated. (D) The legislative history of 18 U.S.C. 1761(c) reflects a Congressional intent to permit the use of the room and board deduction to lower costs otherwise incurred by the public for inmate incarceration. Thus, prior to making room and board deductions, private prison CACs must obtain written approval of any such proposed deductions from the Chief State Correctional Officers for those states from which the PIECP inmate workers were remanded. (E) A PIECP inmate's gross wages may be subjected to a deduction for the purpose compensating crime victims if the deducted amount is deposited into a fund established by law for the purpose of providing crime victim compensation. State crime victim compensation funds typically qualify as authorized recipients of such deducted amounts. The victims compensation deduction may also be used to address victim restitution as long as the deducted amounts are deposited into a fund established by law to address such victim interests. Amounts deducted by private prison CACs should be deposited in those crime victim compensation or restitution funds in states from which the PIECP inmates were remanded. 6. Voluntary PIECP Inmate Worker Participation The Inmate Worker must indicate, in writing, that he or she: (A) agrees voluntarily to participate in the PIECP project, and (B) agrees voluntarily, and in advance, to specific deductions made from gross wages, as well as all other financial arrangements made as to earned PIECP wages. 7. Consultation With Organized Labor PIECP CACs must:

(A) consult with representatives of local union central bodies or similar labor union organizations prior to the initiation of any certified or designated CAC project. CACs should consult with as many of such organizations as may have an interest in the trade or skill to be performed by the PIECP inmates. If there are no local union bodies or labor organizations, consultation must be made with the state union bodies or similar state-wide labor organizations. (B) provide adequate information about the contemplated PIECP participation such as, at a minimum, an identification of the scope of the intended CAC and projected initiation date, as well as an explanation of the fact that statutory consultation is required and comments are invited. CACs should retain documentation reflecting provision of adequate consultation. 8. Consultation With Local Private Industry PIECP CACs must: