

# strategies

## DOMESTIC ASSET PROTECTION TRUSTS

**A** sset protection trusts have long been associated with the use of offshore trusts in countries that have laws more favorable and protective than those of the United States. The number of states which have enacted domestic asset protection laws continues to grow and many who desire some form of asset protection can now look domestically to the laws of eight states for their onshore asset protection planning and avoid having to leave the United States to find asset protection statutes.

The states with the two earliest statutory enactments are Alaska and Delaware and coincidentally these are the same two states that are best known for their asset protection legislation. Some of the other states which have recently enacted domestic asset protection include Missouri, Nevada, Oklahoma, Rhode Island, South Dakota and Utah.

DAPT legislation in these eight states have attempted to provide the same anti-creditor features as an Offshore Asset Protection Trust or "OAPT" in that their legislation now permits a US citizen or resident to create a Self-Settled Spendthrift Trust. A Self-Settled Spendthrift Trust is simply an irrevocable trust that permits the trustee to make discretionary distributions to you or your other trust beneficiaries. Since you do not have a "right" to demand a distribution, neither does a creditor who essentially stands in your shoes and only has the same rights that you do. Prior to the enactment of the DAPT legislation, a person was not able to create a Self-Settled Spendthrift Trust anywhere in the United States if they were a beneficiary. If they retained any beneficial interest in the trust, the entire trust would be void as concerns any of their future creditors. From an estate planning point of view, this also meant that transfers made to the trust would not be completed gifts, because they retained an interest in the transferred property even though the trust was irrevocable and the trust assets would all be included in the taxable estate at death. These result with the DAPT legislation may now be changing.

For the purposes of this article, we will examine some common components of the Alaskan, Delaware and Nevada DAPT legislation which, fortunately, have a great deal in common with each other. This summary is intended only as an overview and anyone serious about pursuing any DAPT or OAPT planning is cautioned to seek competent legal and tax advisors and to thoroughly review the applicable statutes as they may apply to your specific assets and situation.

Once you undertake to analyze the various DAPT legislation, you find that the enacted legislation includes four important aspects for creditor protection:

**Self-Settled Spendthrift Trusts.** Each state permits the formation of a trust for your own benefit which is intended to protect you from your own creditors. As previously noted, this is a major departure

from the laws of all fifty states and is, furthermore, against public policy and not permitted in the remainder of the United States.

**Favorable Statute of Limitations.** The applicable statute of limitations has been shortened to limit the time period that a creditor can challenge a transfer into a DAPT.

**Favorable Fraudulent Transfer Standards.** The burden of proving a fraudulent transfer has been statutorily shifted to the creditor, making it far more difficult for the creditor to prove that a transfer or conveyance to the DAPT was improper or fraudulent.

**Prohibition on Assignment of Beneficial Interests.** The statutes also provided that a grantor who holds a beneficial interest in the trust was prohibited from assigning, either voluntarily or involuntarily, their interest in the trust prior to the distribution to the grantor. This statutory prohibition was also applicable to the grantor's current creditors, provided that the transfer into the trust was not a fraudulent conveyance.

Up until then, the highest degree of domestic creditor protection could only be obtained by transferring assets and not retaining any rights to income, to the trust assets, or the right to designate or control who could receive the benefits of the trust assets. This conflicted with most affluent individuals who weren't comfortable with the concept of literally giving away their wealth in trust or outside of a trust with no control over the gifted assets. The only viable solution was to utilize offshore trusts, which is why foreign asset protection trusts became so popular when these individuals realized that the offshore legislation statutorily provided that self-settled spendthrift trusts could be created with yourself as a permitted trust beneficiary, even if you retained certain rights that, in the US, would have subjected the trust assets to creditor claims.

### THE DOMESTIC SOLUTION

Many states watched rather helplessly while their business owners, physicians, attorneys, accountants and other professionals and affluent residents were creating FAPTs to protect their hard-earned wealth from litigation claims. They realized that asset protection trusts were both an essential and legitimate planning tool to preserve their wealth. In 1997, the various state legislatures began passing DAPT statutes which copied the offshore legislation in large part to permit a person to create a self-settled trust which would be protected from future creditors, even though the right to receive discretionary distributions of income or principal was retained. The intent was to permit a US citizen to create a domestic trust in a state with more favorable legislation than their home state and transfer some of their accumulated wealth to the trust created under the laws of Alaska, Delaware or Nevada, for example. The trustee would have full discretion to make distributions from the

irrevocable trust to the settlor and upon the settlor's death, the trust assets would pass to the settlor's children. Under the prior laws of all fifty states, a creditor could reach the trust assets to satisfy a judgment against the settlor and the entire amount of the trust would therefore be included in the settlor's estate for estate tax purposes. With the new legislation created in Alaska, Delaware and Nevada, the trust assets are, by statute, not available to the grantor's creditors and thereby escape taxation in the grantor's estate since they would be completed gifts.

#### **THE CRITICAL QUESTION: CAN A CREDITOR REACH THE ASSETS?**

The success of this type of planning depends on a very critical point, which is whether the trust assets are really outside the reach of the grantor's creditors. No doubt exists that the DAPT legislation as drafted offers greater creditor protection than is available in the other states which have not enacted similar legislation. The concern is that creditors may be able to reach these assets and if they succeed, the creditor protection will be lost, as well as the tax benefits of making a completed gift. The DAPT's benefits are far from certain and at the present time, no significant court cases have addressed the validity of the DAPT as an effective asset protection planning tool. Whenever the legal challenge is made, the individual creating the DAPT will have some significant hurdles to cross, some of which include:

#### **The Full Faith and Credit Clause of the US Constitution.**

Unlike an FAPT created in a jurisdiction which, by statute, could not recognize foreign judgments, a DAPT must be created in the United States and all fifty states are governed by the US Constitution which requires all of the sister states to recognize judgments of the other states. Many attorneys are reluctant to rely on this untested DAPT solution since a creditor may simply be able to register their existing judgment and be able to attach all of the trust assets. Until the US Supreme Court rules on this issue, no legal guidance exists when a non-resident of Alaska, Delaware or Nevada attempts to use the more favorable legislation to protect their wealth with a self-settled spendthrift domestic asset protection trust which is prohibited in their own home state as being against public policy.

#### **Choice of Law Favors Local Law and Not the Law of a DAPT Jurisdiction.**

Assuming that the litigation is filed in a home state which does not recognize domestic asset protection trusts and that both litigants reside in that home state, what is the chance that this home state judge will ignore the law he is sworn to uphold and apply the inconsistent law of another state? Whether the claim is based on an automobile accident, a malpractice or business claim, a contract or any other local type of claim, the judge will apply the law of the state in which he is sitting and which he has taken an oath to uphold. This means that the grantor, and not the creditor, will have the burden of arguing the case on appeal that the law of another state should apply and not the law of the state where the claim arose when both parties are, in fact, residing there. This situation could even be worse than described if you are required to post an appeal bond in order to try to retain the assets during the long drawn out litigation, while interest is accruing on the unpaid judgment, or your creditor will have seized the assets and even if you eventually prevail, the assets may not later be available or returned to you. This type of choice of law analysis happens daily where a judge must determine which law will govern the case or a particular aspect of the case. This is no different than an automobile accident that happens in Florida with two tourists being from New York and Georgia. Which law applies? The law of Florida, New York or Georgia? The choice of law frequently decides the outcome of the litigation.

**The DAPT Trustee is Subject to US Jurisdiction.** Unlike the situation with a foreign trustee that is outside the reach of a US court and not required to comply with the orders of a US Court,

the domestic trustee is, in fact, located in the US and the domestic trustee can be compelled to abide by a court order by being held in contempt of court for ignoring a court order and possibly incarcerated for contempt of court. If the threat of jail time for the trustee isn't enough to persuade the US Trustee to cooperate, the US Trustee is also subject to a civil claim that could jeopardize not just your trust assets, but the assets of the US Trustee as well, and it would be anticipated that the US Trustee would be more inclined to satisfy the judgment with your trust assets than to give up his or her personal assets. Additional problems could also arise as claims can be foreseen involving money laundering, wire fraud, mail fraud and/or fraudulent transfers, all intended to help secure the cooperation of the US Trustee. When and if the US Trustee stops fighting, the case is over as the assets have been paid to the creditor.

**Supremacy Clause of the US Constitution.** The Supremacy Clause provides that the law of the federal government is the supreme law of the land and that federal law will prevail over conflicting state law. The federal courts are not necessarily bound by state law; however, bankruptcy courts are federal courts that must apply the law of the state in which they are sitting, and since the majority of the states don't recognize self-settled spendthrift trusts, it is not believed that the bankruptcy court would find that the laws of Alaska, Delaware or Nevada would protect the assets of a bankrupt settlor from the claims of their creditors which claims are valid under state law and which state law does not recognize DAPTs.

**Discovery Orders and Secrecy.** Because the DAPT must have a US Trustee, that Trustee will always be subject to the creditor's subpoenas and discovery orders. Even though the law of the state where the DAPT was created may try to protect this information, each state has its own laws and procedures, as do the federal courts, and it is not anticipated that the DAPT Trustee will be able to successfully ignore the requests for information or the court orders directing the turnover of the debtor's funds.

**Fraudulent Transfers and Child Support.** The laws of the DAPT states provide that certain creditors can reach the trust assets primarily if the transfer into the trust was intended to defraud creditors or to avoid a judgment order for child support.

#### **THE BEST PROTECTION IS STILL WITH FOREIGN ASSET PROTECTION TRUSTS**

In times of uncertainty, it is never wise to select a method of protecting one's wealth which has not been proven to be able to withstand legal challenges. A trust created in a foreign country with debtor-friendly laws still offers the best possible and most predictable creditor protection. All domestic trusts suffer from the same flaw which is the trust is located in the United States and the trust assets and trustee are subject to the jurisdiction of the US courts. The only real protection comes from having the trust, trust assets and trustees outside the reach of the US courts.

#### **For Further Information on Estate Planning or Asset Protection Strategies, Please Contact:**

Law Offices of Robert D. Gillen, Ltd. in Arizona at 480.513.3300 or in Illinois at 630.955.9400.

© 2003-2006 Law Offices of Robert D. Gillen, Ltd.

*Articles and materials presented are for informational purposes only and are not intended to constitute legal advice, to be a legal opinion or to create an attorney-client relationship for the reader or any specific person. Estate and tax planning is fact specific and requires consultation with a tax or legal advisor before undertaking any course of action.*