Effective Domestic Asset Protection Trusts: Self-Settled Assets, State Differences, Forming and Funding

TUESDAY, JANUARY 18, 2022, 1:00-2:50 pm Eastern

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Domestic Asset Protection Trusts

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Traditional Rule: What is a Spendthrift Trust?

Black's Law Dictionary (11th ed. 2019):

"A trust that prohibits the beneficiary's interest from being assigned and also prevents a creditor from attaching that interest; a trust by the terms of which a valid restraint is imposed on the voluntary or involuntary transfer of the beneficiary's interest."

Restatement (Third) of Trusts § 58:

"A trust that restrains voluntary and involuntary alienation of all or any of the beneficiaries' interests."

Traditional Rule: What is a Self-Settled Trust?

Black's Law Dictionary (11th ed. 2019):

"A trust in which the settlor is also the person who is to receive the benefits of the trust, usu. set up in an attempt to protect the trust assets from creditors."

As a result of these definitions, a **self-settled spendthrift trust** is a trust: (a) that restrains voluntary and involuntary alienation of all or any of the beneficiaries' interests; **and** (b) in which the settlor is named as a beneficiary.

Traditional Rule Against Self-Settled Spendthrift Trusts

Restatement (Third) of Trusts § 58:

"(1) Except as stated in Subsection (2), and subject to the rules in Comment *b* (ownership equivalence) and § 59, if the terms of a trust provide that a beneficial interest shall not be transferable by the beneficiary or subject to claims of the beneficiary's creditors, the restraint on voluntary and involuntary alienation of the interest is valid.

(2) **A restraint on the voluntary and involuntary alienation of a beneficial interest retained by the settlor of a trust is invalid**."

Traditional Rule Against Self-Settled Spendthrift Trusts

Uniform Trust Code § 505(a)(2):

"Whether or not the terms of a trust contain a spendthrift provision…with respect to an irrevocable trust, **a creditor or assignee of the settlor may reach the maximum amount that can be distributed to or for the settlor's benefit.** If a trust has more than one settlor, the amount the creditor or assignee of a particular settlor may reach may not exceed the settlor's interest in the portion of the trust attributable to that settlor's contribution."

Identification of Self-Settled Trusts: Definition of Settlor

Black's Law Dictionary (11th ed. 2019):

"Someone who makes a settlement of property; esp., one who sets up a trust. — Also termed *creator*; *donor*; *trustor*; *grantor*; *founder.*"

Uniform Trust Code § 103(15):

"A person, including a testator, who creates, or contributes property to, a trust. If more than one person creates or contributes property to a trust, each person is a settlor of the portion of the trust property attributable to that person's contribution except to the extent another person has the power to revoke or withdraw that portion."

Identification of Self-Settled Trusts: Determining the Settlor

- The comments to §103 of the UTC state that "determining the identity of the 'settlor' is usually not an issue. The same person will both sign the trust instrument and fund the trust. Ascertaining the identity of the settlor becomes more difficult when more than one person signs the trust instrument or funds the trust."

- §401 of the UTC states: "a trust may be created by: (1) transfer of property to another person as trustee during the settlor's lifetime or by will or other disposition taking effect upon the settlor's death; (2) declaration by the owner of property that the owner holds identifiable property as trustee; or (3) exercise of a power of appointment in favor of a trustee."

Identification of Self-Settled Trusts: Determining the Settlor

Restatement (Third) of Trusts §10:

"A trust may be created by:

(a) a transfer by the will of a property owner to another person as trustee for one or more persons; or

(b) a transfer inter vivos by a property owner to another person as trustee for one or more persons; or

(c) a declaration by an owner of property that he or she holds that property as trustee for one or more persons; or

(d) an exercise of a power of appointment by appointing property to a person as trustee for one or more persons who are objects of the power; or

(e) a promise or beneficiary designation that creates enforceable rights in a person who immediately or later holds those rights as trustee, or who pursuant to those rights later receives property as trustee, for one or more persons."

Identification of Self-Settled Trusts: When is a Trust Self-Settled?

Restatement (Third) of Trusts §58 outlines "circumstances in which beneficiary is settlor."

- A transfer of part of the property, or supply of part of the consideration, to fund a trust.
- Renunciations where a beneficiary disclaims property into trust when the beneficiary otherwise would have been entitled to the property.
- Establishment by a personal representative, guardian, or conservator of the beneficiary.
- Establishment by a court, or by settlement, of funds otherwise payable to the beneficiary (special needs trusts or settlement of Will contests).
- Holder of a presently exercisable general power of appointment.
- Reciprocal trusts.

Identification of Self-Settled Trusts: When is a Trust Self-Settled?

Common situations where a trust could be unintentionally self-settled:

- Withdrawal rights while exercisable and after lapse;
- Marital trusts after the death of the initial beneficiary-spouse;
- Property held for a beneficiary following exercise of a power of appointment granted to another (by the beneficiary);
- Beneficiary with power to make distributions to self (as a fiduciary or otherwise; subject to distribution standard or unlimited); and
- Beneficiary holding power of appointment (exercised or unexercised; limited or general).

Note that many states have resolved some of these and other situations by statute.

Identification of Self-Settled Trusts: When is a Trust Self-Settled? MS and TN Approach

- Miss. Code Ann. § 91-8-504 and Tenn. Code Ann. 35-15-505.
- Crummey withdrawal rights up to greater of annual exclusion or 5/5, whether outstanding, lapsed, or released, does not cause powerholder to be considered settlor (MS allows double annual exclusion amount for married grantor).
- The power to reimburse the settlor for income tax attributable to the trust does not cause a trust to be self-settled; MS also covers any other IRC § 675 power.
- Inter vivos marital trusts will not be considered self-settled if the original settlor is a beneficiary after the death of the settlor's spouse. In TN, this exclusion is for marital deduction trusts (QTIP and general power of appointment). In MS, marital deduction trusts and trusts of which the spouse is a beneficiary are included.

Identification of Self-Settled Trusts: When is a Trust Self-Settled? MS and TN Approach

- In MS, any trust subject to another person's power of appointment, whether the settlor's interest was created by lapse or exercise. In TN, the interest must have been created by exercise by the powerholder.
- In MS, a presently exercisable power to invade the trust exercisable by an adverse party or subject to an ascertainable standard will not cause a beneficiary to be considered the settlor.
- In MS, the grant of a testamentary power of appointment in a beneficiary, whether general or limited, will not cause the trust to be self-settled.
- In MS and TN, any person who becomes a beneficiary of a trust due to the exercise of a power of appointment by another will not be considered a settlor.

What is a Domestic Asset Protection Trust?

- A domestic asset protection trust ("DAPT") is nothing more than a self-settled spendthrift trust established pursuant to state statutes allowing a settlor to obtain protection from creditors by compliance with certain statutory formalities.
- DAPTs primarily are a reaction to offshore asset protection trusts which protect assets in self-settled spendthrift trusts. Offshore trusts caused significant wealth to leave the U.S., but some estimates over $300 million by the year 2000.
- The first DAPT state was Alaska, passing legislation in 1997. Delaware passed DAPT legislation within a few months thereafter.
- Many prefer a DAPT to an offshore trust – familiar politics, stability of legal systems, currency, language, etc. Also, use of a DAPT avoids offshore IRS reporting requirements.

What is a Domestic Asset Protection Trust? Arguments Against DAPTs

- Paying One's Debts is a Moral Duty: Many argue that the ability to incur large debts while protecting assets from creditors impairs the moral obligation of paying one's debts.
- Exceeds the Limits of Exemption Statutes: State and federal governments have developed exemption statutes based on public policy. DAPTs allow settlors to exceed public policy limitations in those statutes.
- Encourages Risky Behavior: If a settlor knows he can act recklessly while still being shielded by the financial risks of that behavior, then risky behavior may be encouraged.
- Only for the Wealthy: We should not put those who can afford sophisticated trust planning at an advantage over others.

What is a Domestic Asset Protection Trust? Arguments For DAPTs

- Other Asset Protection Structures Already Exist: If we can protect assets in LLC's, corporations, etc., then why not provide other alternatives?
- Puts Earned Wealth on the Same Status as Inherited Wealth: If we can inherit wealth in protected spendthrift trusts, then why should earned wealth not benefit from the same protection?
- Protection from Meritless Claims: We live in a litigious society that encourages meritless claims which prefers creditors' rights to debtors. Similarly, lenders engage in predatory lending practices; debtors need a way to defend against those practices. DAPTs level the playing field.
- Valid Estate Planning: There can be valid estate planning uses to a DAPT.
- Keeps Money in the US Economy: By allowing DAPTs, more money stays in the US economy rather than offshore.

DAPT States: 20 States with DAPT Legislation

- Alabama
- Alaska
- Connecticut
- Delaware
- Hawaii
- Indiana
- Michigan
- Mississippi
- Missouri
- Montana
- New Hampshire
- Nevada
- Ohio
- Oklahoma
- Rhode Island
- South Dakota
- Tennessee
- Utah
- Virginia
- West Virginia

DAPT States: Common Provisions

- Settlor's interest in the trust must be discretionary, meaning the settlor has no automatic right to income or principal.
- Distribution decisions are made by the trustee, at least one of which must be located in the DAPT state and be someone other than the settlor.
- Specific list of powers which may be retained by the settlor.
- The trust agreement contains a spendthrift provision which is enforceable by the settlor.
- The grantor may not be insolvent and transfers to the trust must not render the settlor insolvent.
- Limitations period during which preexisting or future creditors may reach trust assets to satisfy the settlor's debts.
- Heightened burden of proof to establish fraudulent transfer for transfers to the trust.
- Settlor must not fund DAPT with an intent to hinder, delay, or defraud the settlor's creditors.

DAPT States: Primary Differences

- The statute of limitations during which preexisting and future creditors may access trust assets varies from 1.5 years (OH) to 4 years (DE, MO, NH, OK, RI, and WY).
- Some states exempt preexisting tort claims from DAPT protections (DE, HI, MS, and RI).
- Most states exempt claims for divorcing spouses, alimony, and child support from DAPT protections. States vary on which of those protections are available and to what extent. Only Nevada contains no exception creditors.
- Some states require an affidavit of solvency to be required for each transfer to the trust, others do not.
- Other law differences such as income tax, rule against perpetuities, etc.

Considerations in Forming and Funding: Amount of Assets

- A significant consideration in planning is to determine the amount of a client's assets to fund into the DAPT.
- On the one hand, why not protect as much as possible?
- On the other hand, a nest egg approach may have benefits:
  - Less likely to cause the settlor to become insolvent;
  - Less likely to be seen as though the settlor has retained too much control;
  - More likely to prevail against UFTA/UVTA claims ("substantially all of the debtor's assets" as a badge of fraud).
- In any event, the attorney should evaluate the client's personal financial situation to know the value of the client's assets and liabilities. The attorney should keep a record of solvency for use in substantiating the trust.

Considerations in Forming and Funding: Full Faith and Credit

- For taxpayers residing in non-DAPT states (or in DAPT states with exception creditors), consideration must be given as to whether a court will apply the law of the settlor's domicile or the DAPT state (i.e. choice of law in the trust instrument).
- Will the state of the settlor's domicile be required to afford full faith and credit to the DAPT state's protections under Article IV, Section 1 of the U.S. Constitution?
- Even if not, will the DAPT state be required to afford full faith and credit to the judgment of the non-DAPT state for assets sitused in the DAPT state? See *In re Cleopatra Cameron Gift Trust, dated May 26, 1998,* 931 N.W. 2d 144 (S.D. 2019).

Considerations in Forming and Funding: Location of Assets and Applicable State Law

- What state will have in rem jurisdiction over DAPT assets? What type of assets are relevant, real property, personal property, intangibles? Who is the trustee and what ability does a non-DAPT state have to obtain personal jurisdiction over a trustee to compel distributions or otherwise?
- Absent jurisdiction over the trust assets (in rem) or jurisdiction over a trust (in personam), the only way a creditor should be able to recover trust assets is to enforce a foreign judgment in the DAPT state arguing for application of the Full Faith and Credit Clause to the U.S. Constitution.
- Will a transfer of assets to the trust move the situs of the asset to the DAPT jurisdiction? If not, can the property be placed in an LLC to obtain a different result?

Considerations in Forming and Funding: Location of Assets and Applicable State Law

- Restatement (Second) Conflicts of Laws § 270: a trust is valid if valid ‘‘under the local law of the state designated by the settlor to govern the validity of the trust, provided that this state has a substantial relation to the trust and that the application of its laws does not violate a strong public policy of the state with which, as to the matter of the issue, the trust has the most significant relationship . . . .’’ See *In re Huber,* 493 B.R. 798 (Bankr. W.D. Wash. 2013).
- Restatement (Second) Conflicts of Laws § 273(b): “in the case of an inter vivos trust, by the local law of the state, if any, in which the settlor has manifested an intention that the trust is to be administered, and otherwise by the local law of the state to which the administration of the trust is most substantially related.”

Considerations in Forming and Funding: Location of Assets and Applicable State Law/UVTA

- Traditionally, the UFTA has distinguished between: (a) current creditors; (b) reasonably foreseeable future creditors; and (c) unknown future creditors. The UVTA threatens to merge categories (b) and (c) (comment 2 to §4).
- § 10 of the UVTA establishes choice of law rules. § 10(b) states that claims are governed by the local law of the jurisdiction in which the debtor is located when the transfer is made or obligation is incurred.
- Before the UVTA, these questions were resolved under the common law, as cited in the Restatement sections above as well as others.
- The UVTA has been enacted in 22 states.

Considerations in Forming and Funding: Location of Assets and Applicable State Law/UVTA

- Of particular concern is comment 8 to § 4 of the UVTA implies that a transfer of assets from a non-DAPT state into a DAPT is a per se voidable transfer.

  " ... Section 4(a)(1) would render voidable an attempt by the owners of a corporation to convert it to different legal form (e.g. limited liability company or partnership) with intent to hinder the owner's creditors, as may be the case if an owner's interest in the alternative organization would be subject only to charging order, and not to execution...”

  " ... if Debtor's principal residence is in jurisdiction Y ... but has no legislation validating [self-settled spendthrift] trusts, and if Debtor establishes such a trust in jurisdiction under the law of jurisdiction X and transfers assets to it ... the voidable transfer law of Y would apply to the transfer."

Considerations in Forming and Funding: Location of Assets and Applicable State Law/UVTA

- Certain states adopting the UVTA have affirmatively refused to adopt these comments out of a concern for issues raised. See, e.g., AL, AR, IN, and NY.
- There are at least six DAPT states which have adopted the UVTA – WV, RI, AR, IN, UT, and MI. Question how the two can be reconciled.
- In anticipation of concerns raised by the UVTA, some DAPT states provide that DAPT their statute takes precedence over the UVTA. See, e.g., SD, DE, and NV. This provides guidance to their courts in adjudicating these issues.

Considerations in Forming and Funding: UVTA States

- Alabama
- Arkansas
- California
- Idaho
- Indiana
- Iowa
- Kentucky
- Michigan
- Minnesota
- Nebraska
- New Mexico
- New York
- North Carolina
- North Dakota
- Pennsylvania
- Rhode Island
- Utah
- Vermont
- Washington
- West Virginia

Considerations in Forming and Funding: Bankruptcy Laws

Section 541(c)(2):

"a restriction on the transfer of a beneficial interest of the debtor in a trust that is enforceable under applicable nonbankruptcy law is enforceable under this title." This provides spendthrift protection in bankruptcy generally to the same extent as under general state law.

Section 548(e)(1):

"the trustee may avoid any transfer of the debtor in property that was made on or within 10 years before the date of the filing of the petition if: (A) such transfer was made to a self-settled trust or similar device; (B) such transfer was by the debtor; (C) the debtor is a beneficiary of such trust or similar device; and (D) the debtor made such transfer with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date such transfer was made, indebted." Added as part of the 2005 Bankruptcy Abuse Prevention and Consumer Protection Act.

Considerations in Forming and Funding: Completed Gift?

- Treas. Reg. §25.2511-2(b): a gift is complete when "the donor has so parted with dominion and control as to leave him in no power to change its disposition whether for his own benefit or for the benefit of another."
- IRC § 2036(a)(1) will cause estate tax inclusion of transferred property when "the transferor has retained the right to possession or enjoyment, or the right to income, for a period not ascertainable without reference to his or her death."
- Rev. Rul. 76-103: "if and when the grantor's dominion and control of 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." See also Rev. Rul. 77-378; PLR 9332006 (offshore APT), PLR 9837007 (gift tax), and PLR 200944002 (estate tax).

Considerations in Forming and Funding: Completed Gift?

- This planning effectively allows gift planning with an escape hatch which may be especially important with the prospect of reduced transfer tax exemptions or for unmarried clients.
- Typical considerations are relevant as with any taxable gift such as the potential for appreciation/depreciation in value of gifted asset, loss of cost basis adjustment at death, etc.
- Particular to completed gift DAPT's is the need to be sure the settlor's creditors cannot reach trust assets (see authority cited above) which raises questions for settlors in non-DAPT states or for DAPT states with exception creditors. Otherwise, there will be estate inclusion under IRC §§ 2036 and/or 2038 unless "act independent significance" rule applies. See, e.g., *Kurz v. Comm'r*, 101 T.C. 44 (1993); *Estate of Tully*, 528 F.2d 1401 (1976); Rev. Rul. 80-255; and PLR 9141027.

Considerations in Forming and Funding: Income Tax Planning

- The IRS has somewhat recently issued a number of private letter rulings (too numerous to cite here) authorizing non-grantor trusts of which the settlor remains a beneficiary. Typically, these trusts are established as incomplete gift trusts and referred to as a NING (Nevada), DING (Delaware), WING (Wyoming), etc.
- These trusts are established in states without state income tax.
- The benefit is that the settlor can establish a DAPT while also allowing tax attributable to trust assets to be exempt from state income tax.

Considerations in Forming and Funding: Ethical Issues

Model Rule 1.2(d):

"A lawyer shall not counsel a client to engage, or assist a client, in conduct that the lawyer knows is criminal or fraudulent, but a lawyer may discuss the legal consequences of any proposed course of conduct with a client and may counsel or assist a client to make a good faith effort to determine the validity, scope, meaning or application of the law." Note that a "fraudulent transfer" is not fraud, rather fraud would refer to a purposeful behavior to deceive. See *Elie v. Smith,* 2011 WL 9349985 (Cal.App.Supp. Oct. 13, 2011) for the proposition that assisting a client in defrauding known or foreseeable creditors would be fraudulent.

Model Rule 4.4(a):

"In representing a client, a lawyer shall not use means that have no substantial purpose other than to embarrass, delay, or burden a third person, or use methods of obtaining evidence that violate the legal rights of such a person."

Considerations in Forming and Funding: Advisor Liability

- Beyond the rules of professional conduct, attorneys and other advisors may have other exposures.
- At least one current case is exposing third parties, including the debtor's attorney, to potential civil RICO liability for conspiring to assist in a fraudulent transfer of assets out of the reach of creditors. See *Kruse v. Repp*, No. 4:19-cv-00106-SMR-SBJ, S.D. Iowa.
- Under the laws of some states, fraudulent transfers can be criminal. See OH, CA, NY, and ILL.

Considerations in Forming and Funding: Advisor Liability

- California ethics rules also provide that advising a client to violate a law has committed breach of ethical duties. See. CA Rule 3-210 and Cal.Pen.Code 154 and 155. Even those receiving assets may be criminally liable. Cal.Pen.Code 531.
- Further, it is a violation of California law to assist with a crime which would make attorney participation in any fraudulent transfer potentially facing liability. That said, the last reported case in this area is *People v. Waller*, 222 P. 171 (1923).
- Other states, including AK, DE, MS, SD, TN, and UT, protect advisors who participate in the drafting, preparation, execution, or funding of a DAPT.
- Under federal statutes, participating in a fraudulent conveyance can trigger criminal liability. See 18 U.S.C. §§ 2 and 1961. Bankruptcy fraud can also be implicated when there is a bankruptcy filing. See 18 U.S.C. § 152.

Considerations in Forming and Funding: Model Clients

- High net worth or high income earning such that readily sizable, liquid net worth likely available to creditors
- High risk profession or lifestyle
- No known or foreseeable future creditors
- Concerned about future claims by creditors
- Has sufficient assets that will not be needed to fund current or foreseeable lifestyle expenses
- Will not want to regularly access DAPT assets

Considerations in Forming and Funding: Best Practices

- Obtain complete financial statement of client, document solvency, and document that transfers to trust will not cause insolvency.
- Fund the trust with intangible assets rather than real or personal property located in a non-DAPT state.
- Name only trustees located in DAPT state.
- Take care not to unintentionally create a self-settled trust.
- Do not fund a self-settled trust through a fraudulent/voidable transfer.
- Do not file bankruptcy during the 10 year statute.
- Limit the settlor’s retained rights.

Current DAPT Litigation: *Wacker*

- While judgments were being entered against them, the DAPT settlor conveyed MT real estate to an AK DAPT. The creditor filed a fraudulent transfer action in MT to recover property from the DAPT which resulted in default judgments.
- Around the same time, the settlor filed Chapter 7 in AK. The trustee filed a fraudulent conveyance complaint and the settlor argued only AK state court has jurisdiction over the issue, citing to AK statutes. After a default judgment against him in bankruptcy court, the settlor sought declaratory judgment in AK state court.
- Ultimately, the matter ended up in the AK Supreme Court which decided that AK cannot limit the independent jurisdiction of other states. As such, the MT judgments were valid and enforceable. The Full Faith and Credit Clause to the U.S. Constitution did not limit MT to respecting AK's assertion of exclusive jurisdiction. Also, the AK statute cannot limit the scope of the bankruptcy court's authority to enter judgment against the trust's property.
- Some believe this is the end of DAPTs for residents of non-DAPT states. It really is not that clear. Fraudulent transfer laws apply to transfers to DAPTs. All states have fraudulent transfer laws. If the DAPT was not funded through a fraudulent transfer, the DAPT should have worked even for a MT resident. The settlor made another mistake by filing Ch. 7 subjecting himself to bankruptcy's fraudulent transfer laws and 10-year statute of limitations.

Current DAPT Litigation: *Campbell*

- Campbell formed a Nevis APT in 2004. He was not, and did not become, insolvent as a result. In 2010, the Tax Court found Campbell liable for $1.3 million of income tax and penalties.
- Afterwards, Campbell has significant loss of net worth. He sought an offer in compromise, offering to pay $12,603 in satisfaction of his tax liabilities.
- The critical question was whether assets in the APT should be considered as available to Campbell. A taxpayer's OIC must reflect the IRS' reasonable collection potential to be accepted by the IRS. If the $12,603 offer reflected all the IRS could collect against Campbell, then his OIC should be accepted.
- The Tax Court determined that the APT assets do not constitute dissipated assets, would not be collectible by the IRS, and are not available to Campbell. The Tax Court noted that funding of the trust did not make Campbell insolvent, the APT was formed and funded well before IRS debts were final, and Campbell did not retain control over trust assets or distributions. The result is that the Tax Court recognized the APT assets as being unavailable to Campbell and not to be included in calculation of Campbell's OIC.

Current DAPT Litigation: *Cyr*

- After formation of the trust by Cyr's parents, Cyr purchased properties transferred to the trust, Cyr directed that payments payable to him be made to the trust, and Cyr's wife transferred LLC interests to the trust.
- Cyr filed Ch. 7 and the trustee filed sought to have the court access trust assets for Cyr's creditors. The court's ultimate opinion is difficult to read, but the most important results of the case are fairly clear.
- While the court found the trust not to be a sham, it found that Cyr was a settlor of the trust. After that determination, the court disregarded the spendthrift provision. However, the court did not find the entire trust to be self-settled but rather required a tracing of assets contributed by Cyr.
- The court addressed situations that may be covered by the bankruptcy self-settled trust and fraudulent transfer statute. One issue was the term "similar device." The court indicated the term is to be given "broad application."
- This case shows how one can be deemed settlor even without forming or initially fund the trust. Without compliance with DAPT requirements, assets of any such trust may be subject to creditors. Bankruptcy courts may liberally look not only strictly at state law classification but also at what is a "similar device."

Current DAPT Litigation: *Citations*

- *Toni 1 Trust v. Wacker,* 413 P.3d 1199 (Alaska 2018)
- *Campbell v. Commissioner,* T.C. Memo 2019-14
- *In re Cyr*, 602 B.R. 315 (Bankr. W.D. Tex. April 1, 2019)
- Other Cases of Note:
  - *In re Huber,* 493 B.R. 198 (Bankr. W.D. Wash. 2013)
  - *Rush University Medical Center v. Sessions*, 980 N.E.2d 45 (Ill. 2012)
  - *In re Mortensen,* 2011 WL 5025249
- None of these cases involve a DAPT funded through the "best practices" above. Rather, each involved bad facts, especially fraudulent/voidable conveyances and the filing of bankruptcy. As such, the best practices cited above are intended to mitigate against problems which are illustrated in the litigated cases.

Alternatives to DAPTs: Legal Entity Planning

- Other than asset protection planning with a DAPT, clients can simply engage in traditional asset protection planning with legal entities such as LLC's, corporations, partnerships, etc.
- Generally, creditors of the entity owner may not reach assets held by the entity.
- For LLC membership interests and limited partnership interests, most states allow a creditor only to receive a "charging order" against the interest which only allow the creditor a pro rata share of distributions in respect to the "charged" interest but no other rights.
- Many planners combine this planning with a DAPT as a "belt and suspenders" plan. If the DAPT doesn't work for any reason, there is an additional layer of protection.

Alternatives to DAPTs: Hybrid DAPT

- A hybrid DAPT is a spendthrift trust where the settlor is not named as a beneficiary. As such, the trust should not be considered self-settled.
- The trust names a third party, typically a Trust Protector, with the power to add beneficiaries. The class of permissible beneficiaries would include the settlor.
- If there ever is a desire to have the settlor become a beneficiary, the Trust Protector exercises the power to add the settlor. For this reason, it is advisable to structure the trust in compliance with DAPT requirements in order to obtain DAPT benefits should the settlor be added as a beneficiary.

Alternatives to DAPTs: Offshore APT's

- Before Alaska was the first state in 1997 to adopt DAPT legislation, offshore jurisdictions offered protections for self-settled spendthrift trusts.
- Commonly used jurisdictions include: Belize, the Cook Islands, and Nevis.
- A primary benefit of offshore trusts is the ability to have the trustee outside the reach U.S. courts, including bankruptcy courts which have nationwide jurisdiction.
- An offshore APT is not subject to open questions regarding application of the Full Faith and Credit Clause to the U.S. Constitution.
- Going offshore requires IRS reporting, opens up uncertainties regarding foreign customs and politics, requires foreign trustees, etc.

Alternatives to DAPTs: Beneficiary Defective Trusts

- A beneficiary defective trust ("BDIT") is one established under IRC § 678 which treats the beneficiary as the income tax grantor of the trust as a result of a lapsed withdrawal right.
- The BDIT is funded by a third party. The only assets of the beneficiary funding the BDIT are sold to the trust for fair market value to avoid the trust becoming self-settled. Since the trust is a "grantor trust," that sale results in no income tax recognition.
- Due to this structure, the trust should not be self-settled resulting in respect for spendthrift protection notwithstanding DAPT considerations.
- In some states, there is a possibility that a lapsed withdrawal right can cause the trust to be self-settled.
- The only way for assets to fund a BDIT by the beneficiary is by sale, meaning that only appreciation is outside of the reach of creditors (although creditors likely do not want a long-term installment note in satisfaction of debts).

Alternatives to DAPTs: Special Power of Appointment Trust

- A special power of appointment trust ("SPAT") is a spendthrift trust established by a settlor for beneficiaries other than the settlor. It is not self-settled.
- One or more individuals are given a lifetime power of appointment held in a nonfiduciary capacity allowing the powerholder to appoint assets to a class of individuals which includes the settlor.
- Should not be self-settled since the settlor is not a beneficiary.
- Can be an income tax grantor or non-grantor trust (either may require special planning regarding identity of the powerholder). The SPAT can be a completed gift or incomplete gift trust.
- Some planners advocate establishing in a DAPT jurisdiction and complying with DAPT statutes "just in case."

Alternatives to DAPTs: Spousal Trusts

- A spousal lifetime access trust ("SLAT") is a spendthrift trust funded for a settlor's spouse (and usually descendants). Since the settlor is not a named beneficiary, the SLAT is not self-settled.
- The SLAT can use a "floating spouse" provision such that the beneficiary is the person to whom the settlor is married at any time.
- As long as the settlor is married (not divorced and spouse not predeceased), the settlor enjoys indirect benefit. What benefits the settlor's spouse, indirectly benefits the settlor.
- The spouse can be given a testamentary power of appointment to appoint assets into a trust for the settlor (but note some states have not clarified that this new trust will not be considered self-settled).

Domestic Asset Protection Trusts

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