

SELF-SETTLING TRUSTS – UNSETTLING PROSPECTS

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In a culture where our clients consider creditors as predators, asset protection planning has come to the forefront of over-all planning. However, the objective of minimizing death taxes must be reconciled with our client's desire to retain control of assets during lifetime. Sections 2036 and 2038 of the Internal Revenue Code ("IRC") provide a significant obstacle in meeting these dual goals. Basically, IRC §2036 and 2038 restrict the ability to give away property and still retain either the right to control it or use it.

One of the tools of asset protection planning, asset protection trusts, have taken on increased popularity over the years. For purposes of this article, an asset protection trust is a trust which a Settlor creates for himself as the beneficiary (known as "self-settling") with the beneficial interest protected from his creditors by spendthrift provisions. Self-settled spendthrift trusts can be in the form of foreign asset protection trusts (if it is created outside of the United States), or domestic asset protection trusts (if it is created within the United States). The revocable grantor trust, commonly referred to as the "living trust" is basically a self-settled trust. There is therefore nothing improper about including spendthrift provisions in a trust *per se*, nor with self-settled trusts. Traditionally, however, trust laws provide that the trust assets will be available to the Settlor's creditors if that trust is self-settling.

Beginning in the 1980's, certain off-shore jurisdictions enacted specially drafted trust laws overriding long-standing trust laws. Foreign assets protection trusts quickly became popular. In 1986, the Cook Islands, in an effort to attract trust work, adopted legislation that specifically allowed self-settled spendthrift trusts and also created very strong anti-creditor provisions. However, the rush to form these off-shore trusts slowed after some settlors of the trusts were jailed for their refusal to return funds from off-shore trusts. There have been other challenges to off-shore trusts. In the United States, cases have generally focused on the conflict between the law of the domestic forum (following the general spendthrift trust rule) and the law of the off-shore jurisdiction designated under the trust agreement (which will generally have repealed the self-settled spendthrift trust rules). For example, in *In re Brown*, the debtors argued that their assets were not subject to a judgment creditor's claims by reason of the debtor's self-settled spendthrift trust under the law of Belize. The Bankruptcy Court refused to apply the law of Belize and instead applied the law of the forum jurisdiction in Alaska and included the trust assets in the bankruptcy asset (see also, *In re Portnoy*, 260 B.R. 685 (Bankr. S.D.N.Y. 1996)). Other cases with egregious fact patterns will likely have comparable results including the denial of a discharge of bankruptcy, attachment of the assets in the trust, or similar adverse outcome.

Nevertheless, protecting assets from claims of a creditor has continued to be an increasingly important objective for many individuals and a legitimate planning technique (e.g., the popularity of limited liability companies). While off-shore or foreign trusts still may provide the highest level of protection for assets in many situations, they also have disadvantages including adverse income tax consequences, stringent reporting requirements, costs and the fact that they are required to be set up in foreign (often exotic) locations.

In the past, for a domestic trust to protect a person's assets from creditors, the person had to relinquish all control over the assets with no right to any income or principal. Further, most domestic trusts contain spendthrift provisions which preclude a beneficiary from selling or assigning their trust interest and thereby protect the trust assets from the beneficiary's creditors.

However, as noted, if the Settlor retained a beneficial interest in the trust, the assets would not be protected from his or her creditors.

In the late 1990's, Alaska led the charge of bringing self-settled spendthrift trusts to the United States by its enactment of the Alaska Trust Act. There are now a number of other states that have passed legislation which allow domestic asset protection trusts ("DAPT's"), including Alaska, Delaware and Nevada. DAPT's are basically irrevocable trusts that allow an individual to retain the right to receive discretionary distributions from the trust, while providing protection of the trust assets from that individual's creditors. There is generally no limit to the amount that may be contributed to the trust. As with any other asset protection vehicle, a DAPT protects against the possibility of future liability and not against past claims. Transfers made to defraud known creditors are prohibited under the Fraudulent Conveyance Laws.

Essentially, the DAPT Statutes or trust laws allow the following:

- Self-settled Spendthrift Trusts – The Settlor can form a trust for his or her own benefit that protects the Settlor against creditors.
- Reduced to Statute of Limitations – There is generally a shortened time period that creditors have to challenge the transfer to one of these trusts.
- Higher fraudulent transfer standards – It is generally more difficult for a creditor to prove that a transfer to one of these trusts was fraudulent.

Each state's DAPT Statutes contain exceptions to the insulation of the assets in the self-settled trust. For example, in Alaska, the exceptions include (i) a transfer to the trust with the intent to defraud a creditor, (ii) where the trust provides that the Settlor may revoke or terminate all or part of the trust without the consent of a person who has a substantial beneficial interest and which would be adversely effected by the exercise of the power by the Settlor, (iii) where the trust mandates distribution of all or part of the trust income or principal to the Settlor, or (iv) where the transfer to the trust was made when the Settlor was in default 30 days or more in making child support payments. In Alaska, in the event one of these exceptions applies, the amount set aside is only to the extent necessary to satisfy the creditor (plus costs and attorney's fees) rather than the entire trust.

Recently, Oklahoma enacted asset protection trust legislation known as the Family Wealth Preservation Trust Act (Oklahoma Statutes Ann. Title 31 §§10-18 (2004)). Under the Oklahoma Act, the principal and income of a "Preservation Trust" is exempt from judgment creditors of a Settlor up to \$1 million in value. The key distinctive characteristic of the Oklahoma Preservation Trust is that it may be established as either an irrevocable or revocable trust, and no court has the authority to compel the Settlor to exercise the power of revocation. There are a number of open concerns regarding the operation of the Oklahoma Act and interpretation of various terms which are included in the Act. Until these issues are more fully clarified, advisors will likely be reluctant to locate a DAPT in Oklahoma.

In addition, there are those who believe that the DAPT statutes overall have some significant weaknesses as an asset protection method, including:

- A United States trustee may be compelled (e.g. through contempt) to comply with the judge's order and will obviously be unwilling to subject themselves or itself to any civil or criminal penalties to protect the Settlor's assets.

- A major advantage of the off-shore trust was the foreign jurisdiction's ability not to recognize a United States judgment thus requiring the creditor to start the litigation process over in each jurisdiction. On the other hand, under the "full faith in credit" clause of the United States Constitution, a creditor receiving a judgment in one state needs only to register the judgment in the trust state without having to restart their case. This therefore puts the debtor back on the defensive given the ease a creditor has versus having to start over again in a foreign jurisdiction.
- The attempt to apply a DAPT state statute in a different state is questionable. What is the likelihood that a Pennsylvania resident asking a Pennsylvania judge to apply Nevada law in favor of a Nevada non-resident against a Pennsylvania judgment held by a Pennsylvania creditor on Pennsylvania property?
- Application to Federal Courts - The United States Constitution, including the supremacy clause and the full faith in credit clause, give the Federal Courts the ability to possibly ignore state law.

With the heavy marketing of DAPT's over the recent past, these self-settling trusts now have hit the radar scope and attracted the attention of legislatures. As a result, the Bankruptcy Code changes in 2005 include in its target, DAPT's. Section 548(e) of the Bankruptcy Code reads as follows:

"(e)(1) In addition to any transfer that the trustee may otherwise avoid, the trustee may avoid any transfer of an interest of the debtor in property that is made on or within ten (10) years before the date of the filing of the Petition if, -- (A) such transfer was made into 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 that such transfer was made, indebted."

The 10 year period is measured from the filing of the Bankruptcy Petition and there is no grandfather provision for existing trusts. This is a significant change from prior law where the ordinary bankruptcy limitation period was generally 2 years and States have varying limitation periods for challenging fraudulent transfers. This effectively means that all transfers to DAPT's will be vulnerable if a Bankruptcy Petition is filed within the ensuing 10 years. Because of this, DAPT's may no longer be considered effective planning devices.

Even if a debtor professes innocence and points to substantial non-asset protection reasons for making transfers, the Court may still find that the debtor had the "actual intent to hinder, delay or defraud" if the circumstances seem to indicate that to the Judge. As a subjective standard, it becomes very difficult for professional advisors to recommend the DAPT and even worse, the advisor who does recommend it where there is a subsequent bankruptcy, hopefully has his or her own asset protection plan in place.

Asset protection trusts, while a viable option in certain situations, may not be as bullet-proof as the clients perceive. Further, they have enough potential weaknesses as a planning tool that professional advisors will want to make sure they have done their own asset protection planning before making widespread use of them.

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