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Primer on Domestic Asset Protection Trusts

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Asset Protection Statutes in progressive trust law states date back to 1997. Alaska was the first US jurisdiction to enact laws allowing protection for self-settled trusts and was shortly followed by Delaware, Nevada, and South Dakota. In September 2008, Governor Lynch signed into law New Hampshire's "Qualified Dispositions in Trust Act" (the "Act"). The Act became effective on January 2, 2009.

A family need not reside in a state with asset protection statutes in order to avail themselves of their estate planning benefits. Residents of other states and countries may use certain features of the Asset Protection Trusts (APTs) to save taxes, to protect assets, and to achieve other purposes described below. This letter highlights key features and uses of an APT.

I. **Background.**

Traditionally, an individual could not create a "self-settled trust" (i.e., an irrevocable trust from which he or she could benefit) and protect the trust assets from the claims of his creditors. For example, under the laws of virtually all states, your creditor can attach all of the assets of a trust you created that gave the trustee discretion to use the income and principal for you and your children without any limits on the amounts you might receive. This is true even if the trust is irrevocable, the trustee is independent, and you as the trust creator cannot legally compel the trustee to distribute trust property to you or prevent a distribution to your children. This is sometimes referred to as the "self-settled trust rule".

As American society became increasingly litigious, interest developed in certain "offshore" jurisdictions, then in states such as Alaska and Delaware, to provide some limited opportunities to avoid the sometimes harsh consequences of the self-settled trust rule. The early-adopting states enacted and gradually enhanced APT legislation upon which other states' statutes are modeled.

If you meet certain requirements, you can use an APT to retain these benefits in a trust, the assets of which cannot be reached by your creditors. But be aware: the APT is not for everyone. It should be viewed as an option to consider along with other available asset protection and tax planning techniques. Generally, the APT works best for clients interested in protecting against an uncertain future, not for people facing significant existing or impending claims. Certain iterations of APTs can also be used by non-residents of APT states to protect their wealth from erosion from their resident state's state income and death taxes, without requiring them to change their residency.

II. <u>Overview of APTs Uses.</u> Some uses of APTs include:

A. Saving Taxes.

- You might be reluctant to give away assets to use your federal gift tax exemption or your exemption from the federal estate tax generation-skipping transfer tax (currently both $5.34million) for fear that you might need the funds later in life. Although the tax treatment is less certain, you might consider retaining these tax benefits through an APT because you might be able to get assets back in an emergency. Often this feature of using a "completed gift APT" (discussed in more detail later), while remaining eligible to receive future distribution from the trust, is enough to overcome the financial insecurity many clients have that prevents them from making gift transfers to save future taxes.

- If you are a non-resident of a state with an APT statute, and your state has an estate or inheritance tax but not a gift tax (i.e., Maine, Connecticut, Vermont, New York or Massachusetts), you might be able to reduce that tax by making a gift before death. If you make the gift to an APT, you might be able to get funds back in the event of need.
- If you live in certain high tax states (Massachusetts and New York, for example), and are willing to subject distributions to yourself to the control of a committee of "adverse parties" you designate, you might be able to avoid your home state's undistributed ordinary income or capital gains of an APT designed as a "non grantor trust" for federal and state income tax purposes. The IRS has ruled several times that APTs structured in this way may be non grantor trusts. You might be able to receive tax-free distributions on the untaxed accumulated income and capital gains in later years (but should not view it as anything other than a rainy day fund).
- If you are a nonresident alien of the United States ("NRA"), you should consider an APT for two reasons. First, for tax and non-tax purposes, an APT now is a viable planning option for an NRA, whether or not you have family members in this country. Second, if you are considering immigrating to the United States, you might want to create an APT to take advantage of the favorable tax

treatment afforded lifetime gifts and to keep the ability to get funds back if you have a need for them.

B. Obtain Asset Protection.

- If you own substantial assets outright, you might want to fund an APT with some of them to get protection from future creditor claims and business reversals.
- To shield assets from future spouses, creditors and spendthrift risks, you might want to encourage your children to put into an APT assets that they receive (or may withdraw from a trust) at majority, such as assets in a terminating Uniform Transfers to Minors Act Account ("UTMA").
- You may be a corporate officer or director whose activities are receiving increased scrutiny under Sarbanes/Oxley and similar laws. An APT may give you some measure of peace of mind. Medical specialists, architects, CPA firm partners and others facing potentially catastrophic malpractice risks have also used the strategy.
- Several common estate planning vehicles are self-settled trusts and therefore are vulnerable to creditor claims in states without APT laws. These include charitable-remainder trusts ("CRTs"), grantor-retained annuity trusts ("GRATs"), and qualified personal residence trusts ("QPRTs"). An APT can extend protection to these arrangements created in the future, and possibly existing irrevocable trusts modified or otherwise reformed to incorporate APT statutue requirements. Recent changes to trust laws also make irrevocable trust modification much more

simple, expeditious and inexpensive; in many circumstances, an existing irrevocable GRAT, CRT or QPRT can be "retrofitted" into an APT without going to court.

III. The Logistics.

A. Creation. To create an APT you must establish an irrevocable trust that contains certain special "spendthrift" language, provides that law of an APT state such as New Hampshire or South Dakota governs the trust, and appoints at least one resident "qualified trustee". A qualified trustee is an individual (other than you) who lives in an APT state, or a trust company that performs certain "ministerial" trustee functions in an APT state. The trust may have non-APT state co-trustees or advisors. The APT state trustee should arrange for the custody of some APT property in their state, prepare or arrange for the preparation of the trust's tax returns, maintain or help to maintain trust records, or otherwise "materially participate" in the APT's administration.

B. Powers/Interests You Should and Should Not Retain. APT statutes specifically permit you to have the power to (i) consent to or direct investment changes, and (ii) veto distributions, and/or replace trustees or advisors, as long as the replacement is not a close family member or business associate.

An APT can also expressly authorize you to have one or more of the following interests in and powers over your APT: (i) the ability to receive income or principal in the APTs trustee's broad discretion or standard (such as for your health, maintenance and support); (ii) the right to receive current income distributions; (ii) an interest in a CRT or a QPRT; (iv) up to a 5% annual principal "total-return unitrust" or a "GRAT" interest; (v) a power, which you may exercise by your will to direct the transfer of the remaining APT property at your death to or for anyone except yourself, your estate, your creditors or the creditors of your estate; (vi) the ability to (a) be reimbursed during your life for the APTs available cash for income taxes attributable to the APTs income and gains on a mandatory or discretionary basis, or to have those taxes paid directly from the APT, and (b) pay death taxes, debts and expenses after your death out of the APT's assets.

There are several provisions which should not be in your APT:

- You should not have the power to serve as a trustee, trust advisor or trust protector, or remove any such APT participant and substitute a family member or business associate (but you can give this power to someone trustworthy that is not an immediate family member);
- The APT should not provide that you will get trust assets back at a certain age or after a certain amount of time;
- The document should not authorize the trustee, advisor, protector, or committee to terminate the trust;
- The APT should not be allowed to reimburse you for gift taxes, and

- Although it is permitted by APT statutes, as a matter of best practice your APT should not appoint a co-trustee in the state where you live or work if you reside outside of an APT state.

C. Funding. You should fund your APT with assets that you never expect to need. Generally, this means that you should transfer to your APT no more than one-third to one-half of your surplus assets that are not already exempt from creditor claims after you perform an analysis of your existing and foreseeable assets and liabilities (see discussion of "Fraudulent Transfers" below). The best assets to put in your APT are "intangibles": cash, stocks and bonds. Interests in a family limited partnership ("FLP") or a family limited liability company ("LLC") may be good candidates to put in your APT.

You should think twice about putting real estate outside of an APT state in your APT. An APT owning real estate located in another state could give a court in the foreign state a basis for applying its self-settled trust rule to that real estate (and perhaps other APT assets). Putting the non-APT state located real estate in a FLP or LLC might help, but this strategy has not been tested.

D. Choice of Trustee. To prevent a foreign court from having jurisdiction over your APT, if you use an institutional trustee the safest course is to arrange for an exclusively APT state based institution to have custody of all assets of your APT. Beware of using as your APT trustee a large bank or trust company with multi-state activities which could subject the APTs assets to the "long arm" jurisdiction of a foreign court in a state where the institution or its affiliates have a presence, or even where its personnel visit frequently to conduct marketing activities. Your best bet is to find an APT based community bank or non-depository trust company with an understanding of the APT strategy and a heightened awareness of the types of out-of-state activities which might subject them to personal jurisdiction in a foreign court.

E. APT Distributions. For the APT strategy to work, you must give up control over the assets you transfer to the APT. You should request discretionary distributions of income or principal rarely, if ever – particularly for the first 3-5 years after you create the APT when the risk of a successful fraudulent transfer claim is most acute (see below). Do not expect to use the trust as a checking account or to get money whenever you ask. If you like, you may keep the right to get regular income or unitrust distributions along with the ability to get principal on a discretionary basis, but this makes those mandatory distributions vulnerable to attachment.

IV. Tax Issues.

A. Federal (and State) Income Taxes. If your APT is a grantor trust, you will have to pay income taxes on the trust's income and capital gains even though you don't receive them.[1] You should keep enough money to pay those taxes and should not ask the trustee for money every April to pay them. Alternatively, your APT may direct the trustee to pay (or reimburse you for) those taxes. A provision in New Hampshire and South Dakota law expressly provides that such a provision will not alone make the APT's assets vulnerable to your creditors.

B. Wealth Transfer and Inheritance Taxes. If you retain a power of appointment by your will and a power to veto distributions ("retained powers"), you will not make a taxable gift when you create your APT. As indicated earlier, we refer to these types of APTs with retained powers as "incomplete gift APTs". Any distribution of the APT's net income and principal to anyone other than you or your spouse will be a gift from you, but your gift tax annual exclusion ($14,000 in 2014) will be available to offset it in whole or in part. If you do not retain those powers, you probably will make a taxable gift when you create your APT (a "completed gift APT"). The APT assets will likely not be subject to federal estate taxation on your death.[2] If you go the completed gift APT route, and the

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[1] As explained above, the use of a non-grantor APT by a resident of certain states outside New Hampshire can possibly avoid income taxation of the APT's accumulated income and capital gains by the state of the trust creator's residence. Ask us to tell you more about this "DING-style" trust option if you are interested.

[2] We are reasonably certain that the completed gift APT strategy will work, based on a fair reading of the applicable law and some non-binding IRS private rulings. This is why we use the words "probably" and "likely" in describing the wealth transfer tax consequences. We often consult with our clients' gift and estate tax preparers (or

APT’s assets are not includable in your taxable estate, you may allocate GST exemption at the creation of your APT.

New Hampshire and South Dakota has no gift, estate or inheritance taxes. With respect to New Hampshire, all of our neighboring states in the northeast have one or more of those “death” taxes. Using an incomplete gift APT will not reduce a non-APT state resident creator’s state death taxes, where they apply. A completed gift APT, however, may avoid state estate taxation of the APT assets, mainly in those states such as Massachusetts without state gift taxes or “contemplation of death” transfer look-back rules.

V. “Creditors’ Rights” Issues.

A. Fraudulent Transfers. If you make a gift transfer (whether you give money directly to your children or transfer it to an APT), but do not keep enough assets to pay your existing and foreseeable creditors, you have made a “fraudulent transfer”. The transfer may be undone at the behest of an aggrieved creditor or claimant. To ensure that you don’t make a fraudulent transfer when you establish your APT, your attorney (and probably your chosen qualified trustee) will likely require you to provide background information to complete a “solvency letter” so that the professional participants cannot be accused of aiding and abetting a fraudulent transfer.

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prepare the returns ourselves) to explain these issues and help them to properly report and defend them in the event of an audit.

B. Statutes of Limitations and "Exception Creditors". The following four categories of creditors may reach the assets of your APT, if they act in a timely fashion:

- **Pre-Transfer Claims:** If a creditor claim arises before you create your APT, that creditor must bring suit to have your APT transfer declared fraudulent within a defined time frame after you transferred assets to the APT (South Dakota's statute of limitations for fraudulent transfers is two years, New Hampshire's is four years).
- **Post-Transfer Claims:** If a creditor claim arises after you create the APT, that creditor must bring the fraudulent transfer action within the statute of limitations period after you funded the trust and must prove that it was a fraudulent transfer.
- **"Tort" Claims:** There is no limitations period for any fraudulent transfer claim by a person who suffers death, personal injury or property damage for which you are civilly liable if the claim arises out of an event (i.e., an act of medical malpractice or an auto accident) that occurred before you establish your APT. However, any such claimant may be time-barred under the underlying tort statute of limitations.[3]
- **Family Claims:** Your spouse, former spouse, or minor child who has a claim resulting from a prenuptial agreement or court order for alimony, child support, or property division may reach the assets of your APT, but a spouse

[3] The existence of pending or threatened claims is therefore not necessarily an insuperable obstacle to the prudent use of an APT, but it does add an extra layer of diligence in the pre-transfer fraudulent transfer analysis.

whom you marry after you create your trust may not take advantage of this "exception creditor" status. This is why an APT can be an effective substitute for, or supplement to, a prenuptial agreement (i.e., an APT created before -- optimally comfortably before -- the wedding day to which is transferred family business assets).

VI. **Defending APTs from Creditor and Court Challenges.**

If you live in an APT state or if you are an NRA, your creditors should not be able to reach the assets of your APT except in the four situations mentioned above. If you do not live in an APT state but are a resident of the United States, your APT should afford the same protection. But this cannot be guaranteed because technical federal constitutional "full faith and credit" and interstate conflicts of laws issues might come into play. The danger is that a court outside the APT state rendering a civil judgment against you might apply its law – not the APT law which overrides the self-settled trust rule – and order your APT trustee to pay a creditor, even if the claim is not one that is recognized under the Act.

There are several technical legal reasons why your trust might withstand these challenges -- assuming that you are careful in choosing your APT trustee, and that trustee is equally careful to avoid submitting to the foreign court's personal jurisdiction, as described in Section III. D. above. Although there are no reported cases, there is ample anecdotal evidence from states with longstanding APT laws that creditors threatening attacks on these technical grounds have settled their claims with APT creators on a basis much more favorable to the creators than if the APT were not utilized. Thus, at the very least, a carefully structured and administered APT will stand a good chance of leveling the otherwise plaintiff-skewed litigation playing field more in the APT creator's favor.

VIII. Conclusion.

As mentioned at the start of this article, APT statutes have existed since 1997. In states which have enacted APT laws, no court has yet considered how effectively an APT protects assets. Maybe this is because plaintiffs and their lawyers preferred to settle with the APT creator rather than run for luck by asking a court to effectively ignore clear and well drafted state law.

Still, the APT should not yet be considered as a fail-safe asset protector. But a properly designed and implemented APT will raise formidable obstacles for creditors. The APT also offers other estate and income tax planning options unrelated to creditor protection that might be of great benefit to you and your family.