Self-Settled Trusts and Domestic Asset Protection Trusts

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Definition of Settlor

- Black's Law Dictionary defines settlor as "someone who makes a settlement of property; esp., one who sets up a trust.
- §103(15) of the Uniform Trust Code ("UTC") defines settlor as:
  - 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.
- Treas. Reg. §1.671-2(e)(1) defines a trust grantor as "any person to the extent such person either creates a trust, or directly or indirectly makes a gratuitous transfer (within the meaning of paragraph (e)(2)of this section) of property to a trust."

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Relevance

- Knowing when someone will be considered the settlor of a trust can have important implications, primary of which include the rights of the settlor's creditors to access trust assets.
- The accessibility of trust assets to a beneficiary's creditors can have income tax, estate tax, and bankruptcy implications as well.
- While many states have now adopted self-settled spendthrift trust ("DAPT") statutes, many have not.
- Even in DAPT states, not all trusts will be formed following the requirements of DAPT statutes.

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Trust Creation; Determination of 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."

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Trust Creation; Determination of Settlor

- §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."
- Is the "exercise" of a power of appointment required in order to create a new trust?
- What about when a beneficiary dies holding an unexercised power (general or limited)?

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Beneficiary Treated as Settlor

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.

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Beneficiary Treated as Settlor

- Disclaimer: Qualified versus nonqualified disclaimers
- Failure to exercise withdrawal rights
- Equivalence of Ownership
  - Beneficiaries entitled to have trust principal presently titled to themselves cannot benefit from spendthrift protection
  - Beneficiary holds general power of appointment
  - Does it matter whether the power has lapsed or if third party consent is required?

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Beneficiary Treated as Settlor

- *Irwin Union Bank & Trust Co. v. Long*, 312 N.E.2d 908 (Ind. Ct. App.1974).
  - Beneficiary held an annual power to withdraw 4% of the trust assets.
  - After the beneficiary allowed that power to lapse, Victoria Long obtained a judgment against the beneficiary and sought to satisfy the judgment with trust assets.
  - The trial court allowed the creditor to access 4% of the trust corpus.
  - Indiana Court of Appeals overturned the trial court, holding that the creditor could not reach trust property subject to the lapsed power.

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Beneficiary Treated as Settlor

- *University National Bank v. Rhoadarmer, 827 P.2d 561 (Colo. App. 1991).*
  - Bank held a judgment against a beneficiary who had a 5&5 withdrawal right.
  - The trial court allowed the creditor to reach $10,000, the amount which could have been withdrawn during the two years of court proceedings.
  - The Colorado Court of Appeals noted that powers of appointment are a:
    - "personal privilege or authority;"
    - "when a donor gives to another the power of appointment over property, the donee of the power does not thereby become the owner of the property."
  - Court held that until the beneficiary exercises her power, her creditors should have no access to trust assets to satisfy the beneficiary's debts.

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Beneficiary Treated as Settlor

- Restatements are more generous with trusts for spouses.

  Failing to elect under forced heirship laws generally should not cause the surviving spouse to be considered the settlor of the trust.
- Other situations cited in the comments to the Restatements where the beneficiary could be deemed the settlor include:
  - reciprocal trusts;
  - trusts created by courts, such as from proceeds from personal injury actions;
  - beneficiary paying trust expenses, such as improvements on land held by the trust;
  - certain will contests that create trusts;
  - certain Medicaid planning trusts; and
  - when the beneficiary provides consideration in exchange for creation of the trust.

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Common Self-Settled Trust Situations

- Lapse of Presently Exercisable General Power of Appointment
  - Holder generally treated as settlor over assets subject to power.
- Withdrawal Rights
  - Is a current power protected?
  - Is a lapsed power protected?
  - If either are protected, to what extent – 5/5, annual exclusion, double the annual exclusion for split gifts, etc.?
  - Does it matter whether the power is only exercisable with the consent of a third party?
- See Edwin Morrow's 50-state chart outlining state statutes.
  - Available at SSRN: https://ssrn.com/abstract=3165592.

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Common Self-Settled Trust Situations

- Tax Sensitive Powers
  - Settlor's power to substitute assets?
  - Can a creditor require illiquid assets to be substituted for cash in a trust?
    - Is this an unenforceable executory right in bankruptcy?
  - Power to reimburse the settlor's income tax liabilities caused by the trust?
- Marital Trusts (esp. relation back doctrine)
  - These trusts could include inter vivos QTIP trusts, general power of appointment marital trusts, and spousal lifetime access trusts.
  - If original settlor is the beneficiary after the death of the original beneficiary-spouse, who is settlor after the death of the original beneficiary-spouse?

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Common Self-Settled Trust Situations

- Property Subject to Power of Appointment Held by Another
  - Settlor grants the beneficiary a testamentary power of appointment, including to the settlor, and the beneficiary exercises in trust for settlor.
  - Is the trust created through the power of appointment a self-settled trust as to the original settlor or is the original beneficiary the new settlor?
  - What if the default provisions following an unexercised power result in the assets being held in further trust for the original settlor?
  - Does it matter if the power is a general power or limited power?

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Common Self-Settled Trust Situations

- Reciprocal Trusts
  - Settlor determined based on federal tax law?
  - Does it matter whether the reciprocal trusts are between spouses or other parties?
- Beneficiary with Power to Distribute to Self
  - Can a beneficiary be forced to exercise a power of appointment to satisfy creditors' claims?
  - Is the beneficiary holding the power deemed to be the settlor?
  - Does it matter if the power of appointment can only be exercised with the consent of another?

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What is a Spendthrift Trust?

- Black's Law Dictionary defines a spendthrift trust as:
  - "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 defines it as:
  - "A trust that restrains voluntary and involuntary alienation of all or any of the beneficiaries' interests."

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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**."

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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."

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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.

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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.

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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.

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DAPT States: States with DAPT Legislation

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

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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.

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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.

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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.

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Considerations in Forming and Funding: Full Faith and Credit

- For individuals 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).

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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?

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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."

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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.

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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."

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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.

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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

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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.

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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).

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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.

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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.

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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."

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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.

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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.

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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

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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.

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Cases - *Wacker*

- *Toni 1 Trust v. Wacker,* 413 P.3d 1199 (Alaska 2018).
- 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.

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Cases - *Wacker*

- 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.

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Cases - *Mortensen*

- *In re Mortensen, 2011 WL 5025249.*
- In 2005 an Alaska resident created an Alaska DAPT and transferred land worth approximately $60,000 to the Trust. The debtor's credit card debt ranged from $50,000 to $85,000 in 2005.
- The debtor's mother sent him checks totaling $100,000 following the transfer of the land, which purportedly were in payment for his transferring the land to the Trust to be preserved for his children. The debtor claimed he used some of the funds his mother paid him to pay existing debts and transferred approximately $80,000 to a brokerage account in the name of the Trust as "seed money" for operating expenses related to the land. According to the debtor he lent the $80,000 to the Trust, however, no promissory note was ever entered into evidence.

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Cases - *Mortensen*

- The debtor filed for bankruptcy in 2009 when his credit card debt was $250,000. The bankruptcy trustee alleged that the debtor failed to create a valid asset protection trust because he was not solvent when the Trust was established and funded.
- The Court concluded that the debtor was solvent when he established and funded the Trust and therefore recognized the validity of the Trust. However, the Court held that the debtor's transfer to the Trust violated the extended 10-year fraudulent transfer rule under Section 548(e) of the Bankruptcy Code.
- This case illustrates how Section 548(e) of the Bankruptcy Code interacts with DAPTs which had never been previously addressed.

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Cases - *Campbell*

- *Campbell v. Commissioner,* T.C. Memo 2019-14
- Taxpayer formed a foreign APT in 2004. He was not, and did not become, insolvent as a result. In 2010, the Tax Court found the Taxpayer liable for $1.3 million of income tax and penalties.
- Afterwards, the Taxpayer had significant loss of net worth. He sought an offer in compromise, offering to pay $12,603 in satisfaction of his tax liabilities.

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Cases - *Campbell*

- The critical question was whether assets in the APT should be considered as available to the Taxpayer. 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 the Taxpayer, 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 the Taxpayer.

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Cases - *Campbell*

- The Tax Court noted that funding of the trust did not make the Taxpayer insolvent, the APT was formed and funded well before IRS debts were final, and the Taxpayer did not retain control over trust assets or distributions. The result is that the Tax Court recognized the APT assets as being unavailable to the Taxpayer and not to be included in calculation of the Taxpayer's OIC.
- This case illustrates how an APT formed other than through a fraudulent transfer can be enforceable.

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Cases - *Cyr*

- *In re Cyr*, 602 B.R. 315 (Bankr. W.D. Tex. April 1, 2019).
- After formation of the trust by the debtor's parents, the debtor purchased properties transferred to the trust, Cyr directed that payments payable to him be made to the trust, and the debtor's wife transferred LLC interests to the trust.
- The Taxpayer filed Ch. 7 and the trustee filed sought to have the court access trust assets for the debtor's creditors. While the court found the trust not to be a sham, it found that the debtor 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 the debtor.

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Cases - *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.
- This case allows illustrates that bankruptcy courts may liberally look not only strictly at state law classification but also at what is a "similar device."

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Cases - *Huber*

- *In re Huber, 793 B.R. 198 (Bankr. W.D. Wash. 2013).*
- A Washington real estate developer who had guaranteed several large real estate projects was unable to cover debts during the 2008 housing crisis.
- Since Washington did not recognize DAPTs, the debtor created an Alaska DAPT in late 2008 and transferred over 70% of his assets into the trust. Debtor did not retain the right to direct trust distributions but received $14,500 per month for his personal expenses, and most of his requests for additional funds were granted.
- Debtor filed for Chapter 7 bankruptcy in 2011.

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Cases - *Huber*

- The court moved for summary judgment to (1) void the transfers made into the trust as fraudulent; and (2) invalidate the transfers into the self-settled trust under Washington law voiding transfers into self-settled trusts.
- The court found that the only connections the trust had to Alaska was the designation of administration and the location of one of the trustees and that all of the property transferred to the trust, except for a $10,000 CD, was located in Washington.
- The Court noted Washington's strong public policy against self-settled APTs before concluding that Washington law would govern despite the debtor's designation to the contrary.

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Cases - *Huber*

- The court relied upon Restatement (Second) Conflict of Laws § 270 to find the trust invalid rather than § 272.
- The distinction is that § 270 deals with the validity of the trust, rather than necessarily a particular provision of the trust (i.e. the spendthrift provision). Since the debtor selected Alaska as the law to apply to t he trust, this section requires a finding that Alaska have a substantial relation to the trust, that application of Alaska law violates a strong public policy of Washington, and that Washington has the most significant relationship to the trust.
- Some commentators believe the court should have looked at § 272 which would respect the state designated in the trust document as controlling without looking into the factors referenced in § 270.

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Cases - *Rush University*

- *Rush University Medical Center v. Sessions, 980 N.E.2d 45 (Ill. 2012).*
- An Illinois resident made a pledge to Rush University Medical Center for $1.5 million and confirmed in writing that such pledge was to be fulfilled by his estate, living trust, or other estate planning documents to the extent it was unfilled at his death.
- The settlor later blamed the University for not properly diagnosing him with cancer, and modify his estate plan to remove the University.
- The settlor's estate had less than $100,000 in assets. However, the settlor had transferred certain limited partnership interests worth more than $16 million to a foreign APT.

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Cases - *Rush University*

- Illinois had established common law providing that transfers to APTs were per se fraudulent prior to adopting the Uniform Fraudulent Transfer Act in 2006.
- The University sued the trust alleging three things: Fraudulent transfer, breach of contract of a promise that was binding on the Trust, and that the settlor's transfers of assets to the APT amounted to per se fraudulent and thus the Trust should be voided.
- The Illinois Supreme Court rejected the Trust's argument that the per se fraudulent common law and the Fraudulent Transfer Act were in conflict and ruled in the University's favor, finding that the transfers violated the common law.

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Cases - *Cleopatra Cameron*

- *In re Cleopatra Cameron Gift Trust, 931 N.W.2d 244 (S.D. 2019).*
- As part of a trust beneficiary's divorce, the Court ordered her to pay child support. Under California statutes trustees can be compelled to make distributions to fund a beneficiary's child support and spousal support obligations.
- Trusts established by the debtor's father were ordered to make the debtor's child support and spousal support payments directly to her ex-husband.
- The debtor exercised her right to move the trusts' situs to South Dakota. Several years later, the debtor, relying on South Dakota statutes which specifically disavow any "exception creditors" to spendthrift trusts, prevailed in a South Dakota Circuit Court and obtained an order prohibiting the Trusts from making payments directly to her ex-husband.

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Cases - *Cleopatra Cameron*

- The court, referencing the Full Faith and Credit Clause, held that South Dakota law specifically prevents enforcement of judgments against spendthrift trusts. the California order was held not enforceable against the trusts, even though it would have been enforceable against the debtor, because remedies are specific to the state where they are enforced rather than the judgment state.
- Over the years, attorneys have argued whether the Full Faith and Credit Clause would require enforcement of a judgment against out-of-state trusts. This is especially important for DAPTs established by residents of states without DAPT statutes. The argument is that the DAPT state may be compelled to enforce non-DAPT state court order under the Full Faith and Credit Clause.

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Cases - *Klabacka*

- *Klabacka v. Nelson, 133 Nev. Adv. Op. 24 (May 25, 2017).*
- Two debtors were involved in divorce proceedings. Each had their own individual Nevada DAPT. As part of the divorce, the Nevada district court ordered the husband's Trust to satisfy the husband's personal obligations, specifically, child and spousal-support arrears.
- Nevada is well-known as a debtor's haven that has laws that go beyond the protections offered in other states, including the fact that it has no statutory exception for creditors of DAPTS (meaning classes of creditors that can bust through a DAPT despite the DAPT's protection from creditors).
- The cased ended up before the Supreme Court of Nevada, which analyzed the issues by noting the public policy that many DAPT jurisdictions have against protecting assets from spousal and child support creditors.
- The Court concluded that the order made by the district court directing support payments to be made from the DAPT runs contrary to Nevada law.

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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.

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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.

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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.

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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).

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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."

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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).

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Self-Settled Trusts and Domestic Asset Protection Trusts

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