

Asset Protection Planning With Trusts

A Practical Overview

by

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The typical client’s objectives: *“I want to be able to enjoy what I (we) have accumulated, and I want my spouse and children to enjoy it. I want to pay the least amount in taxes - none, if possible. I want to be sure that no creditors can reach any of these assets, and of course, I don’t want to give up control while I’m alive - but keep it simple.”*

Is asset protection the subject or just part of the big picture? And is it a global picture? It wasn’t that long ago that a “Typical” family estate plan consisted of two wills, occasionally including a testamentary trust for minor children. Only a very few plans went beyond this. Today’s estate plan almost always includes one or more living trusts, and a significant percentage of clients not only direct us to the objectives noted above, but actually have estates and circumstances which may warrant such objectives.

As can be quickly seen, these objectives encompass many different considerations and areas of law. To single out “asset protection” as a sole objective is like building only part of a vehicle in the hopes that it will get us where we want to go. Nonetheless, it is often a driving force in many plans and places new demands on attorneys and financial advisors. That is, not only must we be familiar with estate and gift taxation, trust law, property law, partnerships, limited liability companies, corporations, family law, conflicts of laws, and ERISA, but we must now be conversant in debtor-creditor law, and, if we go

“offshore”, we must be aware of the laws of foreign jurisdictions, among other things, as they relate to the client’s plan.

While this discussion will not assume knowledge of every one of these areas, it will assume a reasonable familiarity with estate and gift taxes, property law, and trust law, for the purpose of presenting the available options using trusts and other entities in satisfying a significant portion of the typical client’s objectives. But in order to even begin to consider an asset protection plan, one must have a basic understanding of the fraudulent transfer.

Creditor’s Rights and Fraudulent Transfers. Based on the rules of “fair play”, the cases and development of statutes around the never-ending battle between creditors and debtors have engendered certain fundamental principals, codified by the Uniform Fraudulent Conveyance Act and the Uniform Fraudulent Transfer Act. They are:

- creditors can reach benefits that the debtor can reach
- creditors can receive what the debtor can receive
- creditors can reverse an “unfair” (fraudulent) conveyance
- creditors can have a debtor’s assets placed in the hands of a receiver
- creditors can attach, freeze, and/or force a sale of a debtors’ assets, and
- creditors can force a debtor into bankruptcy.

Generally, a creditor will only resort to use of the fraudulent transfer rules when the transferred assets of the debtor are not legally reachable by a direct attack. For instance, if a debtor makes a transfer to a revocable trust of which he is a beneficiary, or even to an irrevocable trust of which he is a discretionary principle beneficiary, generally, the trust assets in both cases are directly reachable by creditors without the need to argue that a fraudulent transfer has been made. Determining whether the transfer was fraudulent is seldom easy or clear. Furthermore, the issues arises as to whether the conveyance was fraudulent only as to existing creditors, or as to future creditors as well.

Since “intent” is often difficult to prove, there are a number in indicia of actions which may be considered by the court which may indicate the debtor’s intent., such as concealment of the transfer, transfer to close relatives or “insiders”, transfer for less than full consideration, transfers rendering the debtor insolvent, transfers after threat or service of a law suit, and others. See Uniform Fraudulent Transfer Act sec. 4(a)(2).

Note that even though a lawsuit has not been filed or an actual threat made, if the debtor knows of the claim or potential claim a transfer at that point could be a fraudulent transfer.

Another important point is that actions by creditors to attack a debtor’s transfer as fraudulent generally must be brought within a certain period of time after the transfer, otherwise the transfer will be protected, even though it may have been fraudulent. The period of limitations varies from state to state, but as a general rule is four years, or one year if the transfer is to an insider. To make matters a little more complicated, in many states the four year rule is extended to one year after the creditor could not reasonably have discovered the transfer.

Trusts and Asset Protection - In General.

Typical estate-planning trusts for a married couple generally take the form of revocable, reciprocal inter-vivos trusts designed to take advantage of the federal estate tax marital deduction and the credit-shelter by-pass trust. Generally, there is no lifetime asset protection offered by this plan, with very limited exceptions in certain states and where certain offshore jurisdictions are employed (see discussions below). On the other hand, asset protection can be achieved through a trust if the “spendthrift trust” rules apply. A spendthrift trust is one containing a provision stating that the assets of the trust shall not be reachable by the creditors of any beneficiary.

As a general rule in the great majority of domestic jurisdictions, a spendthrift provision in a trust established by a party other than the beneficiary will operate to

protect the trust assets from the creditors of a beneficiary, with only certain exceptions in the case of necessities provided to a beneficiary in good faith by a creditor. *Bogert, Trusts and Trustees*, 1992, sec. 221 at 405-406. However, if the beneficiary is also the Settlor of the trust (a self-settled trust), the Restatement of Trusts, 2d, sec. 156, sets forth the basic and critical guidelines essential to the use of most domestic trusts in asset protection. The general rule is, a creditor of the Settlor can reach whatever benefits the Settlor/beneficiary has the right to reach, as well as whatever benefits the Settlor/beneficiary could enjoy, assuming the trustee exercised its maximum discretion under the terms of the trust. See also Outwin v. Commissioner, 76 Tax Court 153 (1981), for an excellent review of creditors' rights to self-settled trusts.

In other words, if Jack creates and funds an irrevocable trust under which an independent trustee has the absolute discretion to make or not to make payments of any part or all of the trust income and principal to or among a group of beneficiaries which includes Jack, then in almost all states, Jack's creditors could reach the entire amount in the trust.

[Note that Georgia and Louisiana make exceptions to the spendthrift protection rule in the case of tort creditors of a trust beneficiary who is not the Settlor, while Alaska, Delaware, and Nevada (and to an extent, Colorado and Missouri) **allow** spendthrift protection even for self-settled spendthrift trusts, as discussed below.]

Classes of Creditors. It is important to note that not all creditors are alike. There are creditors, and then there are "supercreditors." Supercreditors are sometimes able to leap tall asset protection trusts in a single bound, even where fraudulent conveyance is not an issue. They are - the federal government, spouses, and sometimes, dependents.

The federal government. It is generally accepted that an enforceable interest in a spendthrift trust constitutes the taxpayer's property for purposes of a federal tax lien. U.S. v. Rye, 550 F. 2d 682 (1st Cir. 1977). But see also First Northwest Trust Co. v. IRS, 622 F.2d 387 (8th Cir. 1980) holding just the opposite. The question is not quite as clear

where the beneficiary's interest is discretionary and there are other beneficiaries. On the other hand, it was only the beneficiary's income interest that could be reached in such cases, the corpus of the trust was protected.

Even this exposure can be protected by in non-self-settled trusts including a forfeiture provision, terminating the beneficiary's interest under the trust in the event of an attack by any creditor. In re Fitzsimmons, 896 F.2d 373 (9th Cir. 1990).

Spouses and dependents. In many cases, it has been made clear that spouses and dependents, but particularly spouses, are even more preferred creditors than the federal government. State courts have been known to readily step over proven and basic principals of trust and property law in order to grant a spouse his or her rights to "marital property" or to enforce a grantor's obligation to support a dependent. *Scott & Fratcher*, *The Law of Trusts* (id.) sec. 157.1, and e.g., Gilbert v. Gilbert, 447 So.2d 299 (Fla. Dist. Ct. App. 1984), In re Chusid's estate, 301 NYS 2d 766 (1969).

Recent Developments in Domestic Trust Legislation -- North to Alaska? . . . or What?

In 1997 people began to be told that taking a cruise would no longer be the only reason they should go to Alaska¹. We were (and are still) told that as a result of new legislation effective April 1997 we could create and transfer our assets to a trust that could provide us benefits for life, offer protection against creditors, and be tax free in our estate. (See e.g., "New Alaska Trust Act Provides Many Estate Planning Opportunities", Blattmachr, Zaritsky and Thwaite's, Estate Planning, October 1997.) Perhaps they should stick to offering cruises.

The new legislation (Alaska Statute 34.40.110) provides that a creditor of a Settlor beneficiary will not be able to reach assets of the self-settled trust so long as:

¹ For the most part, the comments on this section relating to Alaskan trusts will apply as well to Delaware, and Nevada trusts except as noted.

- The trust is not revocable by the Settlor;
- The Settlor was not in default of a child support payment by 30 days or more;
- Distributions to the Settlor are discretionary; and
- The transfers to the trust were not fraudulent.

Similar asset protection trust statutes were subsequently enacted in Delaware, Nevada, and Rhode Island, though in all cases, there are, of course, fraudulent transfer rules to contend with. Existing creditors (at the time of the transfer to or creation of the trust) may attack the transfer up to the later of four years from the transfer, or one year from the time the transfer was or could reasonably have been discovered by the creditor. Future creditors must make a claim within the initial 4 year period. (In the case of Nevada law, the corresponding open periods are two years and six months, respectively).

In the opinion of many of us who practice in this area, the extension of the time period pursuant to the “reasonable discovery” exception opens the door to an almost unlimited exposure to claims of creditors who existed at the creation of the trust. In this regard, some practitioners recommend notifying existing (known) creditors one year (or six months for Nevada) before the expiration of the basic period to establish a definite termination of the period.

Under the “creditor protection theory” put forth by promoters of Alaskan trusts, if creditors of the grantor cannot reach the grantor’s interest under the trust, then the transfer constitutes a completed gift for gift and estate tax purposes. Accordingly, the promoters suggest that, assuming there are no other retained interests which would cause the assets to be included in the grantor’s estate, the assets in the Alaskan Trust will be excluded from the grantor’s estate. As authority for this conclusion they cite PLR 9332006 (not a precedent) where the IRS ruled that a transfer by a U.S. grantor to an offshore creditor protection trust was a completed gift and would not be in the grantor’s estate for federal estate tax purposes. To date, however, the IRS has refused to rule directly on whether assets in a domestic asset protection trust will be excluded from the Settlor’s estate for estate tax purposes.

To qualify as an Alaskan Trust at least some of the trust assets must be deposited and administered in Alaska, either in a checking, brokerage, or similar account, and at least one trustee must be a “Qualified Person”. A qualified person is a resident of Alaska or a bank or trust company with a principal place of business in Alaska (Surprise!)

Another potential problem with the creditor protection is the constitutional law problem. Many commentators have expressed real concern over proponents’ suggestions, if not assertions, that a creditor’s judgment from another state will not be enforceable against an Alaskan trust holding assets of the defendant Settlor/ beneficiary, but this remains a serious question. See, “*Will Alaska Trusts Work?*”, Leslie Giordani and Duncan Osborne, Journal of Asset Protection, Sept/Oct 1997, raising both public policy and constitutional law questions on the issue. Proponents cite, among other sources, Hanson v. Denkla, 357 U.S. 235 (1958) where the U.S. Supreme Court upheld the Delaware Supreme Court’s refusal to recognize the Florida Supreme Court’s judgment over a Delaware Trust.

One point, however, is very clear, and that is that until these issues are resolved by case law (likely the U.S. Supreme Court - who wants to wait?), and the IRS rules on the estate tax issue, it is not only risky but it simply may not be necessary to go to Alaska, or Delaware, or Nevada, or Rhode Island to create an asset protection trust. Instead, there are proven techniques that in certain circumstances allow such a vehicle in virtually every state.

For instance, an income-only trust can offer protection of principle. To illustrate, say that Eric creates and funds an irrevocable trust under which the trustee has discretion to pay him income but no principal. After the applicable fraudulent transfer period, Eric’s creditors may not reach the principal of the trust². See Restatement of Trusts 2d, sec. 156, and *Scott & Fratcher*, *The Law of Trusts*, sec. 156 (4th edition 1987), but this leaves the principle “frozen”, unless there is a “power” to distribute the principal.

² Note that in all cases the fraudulent transfer rules must be considered.

If Eric had also given the trustee the authority to distribute principal to other parties, say his spouse and/or children, then the principal could be removed in case of a creditor's attack. One issue in this case is the trustee's fiduciary duty when considering such distributions and whether a creditor could claim the distribution was improper. (The creditor may have standing since the distribution of principal would reduce Eric's income which would of course reduce the amount available to a judgment creditor. This issue is easily dealt with by giving the power instead to an outside party. Such a power is called a power of appointment.

Powers of appointment can be special or general. A special, sometimes referred to as a "non-general", power of appointment, is one that cannot be exercised in favor of the holder of the power, his creditors, his estate, or the creditors of his estate. Restatement Second Property, sec. 11.4. A typical special power, for instance, might provide that the holder of the power can appoint the subject property to any one or more of his lineal descendants. But the power may be much broader than that and still be a special power. That is, the holder may have the power to appoint to anyone in the world, on such terms and conditions as he may dictate, except to or for the benefit of himself, his creditors, his estate, or the creditors of his estate.

Despite the extent of this power, it is still considered a special power, and, absent a fraudulent transfer, the transferred property is unreachable by creditors of the holder, even though the powerholder may be the Settlor of the trust. Restatement Second Property, sec. 13.1. Furthermore, a court cannot compel a powerholder to exercise the special power. In Re Hicks 22 B.R. 243, D. Ga. 1982.

[A very notable exception to the rule regarding retained special powers may be the Alaskan Trust. Alaska statute provides that if the Grantor reserves a special lifetime power of appointment exercisable without the consent of an adverse party, he will be deemed to have the power to revoke the trust and his creditor protection may be lost.]

The power can be exercisable during the holder's lifetime (by a deed), or at the holder's death (through his last will), or both. Note that, although it can be irrevocably exercised only once, it can be exercised on any terms and conditions conceived by the holder, even on a revocable basis.

Federal gift tax laws provide that a transfer of property where the transferor retains a special power of appointment is not a completed transfer. Treas. Reg., sec. 25.2511-2(c). It is interesting and important to note that a transfer with retained lifetime and testamentary special powers effectively allows the transferor to have legally given the property away, but to have "kept" the property for tax purposes, because he has retained virtual complete control over the disposition of the property. Therefore, even though the transferor has legally disposed of the property, because he has retained virtually unlimited dominion and control over the property, the transferred property will be treated in every respect as if it still belonged to the transferor (the holder of the retained power) for income, gift, and estate tax purposes. In addition to the clear confirmation of this concept in basic principles of taxation, it has been repeatedly confirmed by the courts in a respectable list of cases. See, e.g. for income tax purposes, Corliss v. Bowers, 50 S. Ct. 336 (1930), Helvering v. Clifford, 309 U.S. 331 (1940), Bierne v. Commissioner, 52 TC 210 (1969), Anderson v. Commissioner, 164 F. 2d 870, CA-7 (1948) and cases cited therein. This opens the door to asset protection planning without adverse tax consequences.

Interestingly, in most of these reported tax cases the taxpayer/transferor sought to shift the tax burden to the transferee while retaining certain powers or retaining enjoyment over the transferred property. In the asset protection context, however, we often seek to do just the opposite where income-producing property is concerned. The two reasons for seeking to retain the tax ownership are retention of actual benefits over the income and realization of the step-up in basis at death. That is, we seek an arrangement where we can have the best of all worlds: We want a completed transfer for asset protection purposes that starts the fraudulent conveyance period running, but an incomplete transfer for tax purposes. Remember, a transfer by a donor with a retained

special power, or one where the special power is granted to another, constitutes a transfer at the time the original transfer is made by the donor and not when the power is subsequently exercised by the holder. The exercise of the power is considered to complete the terms of a disposition previously made by the donor at the time of the original transfer that contained the grant of the power. Restatement Second Property, sec. 11.1 comment f.

General Power of Appointment. As seen above, property subject to a special power of appointment is not reachable by the powerholder's creditors, regardless of whether the power was created by the powerholder himself or by a third party. What about a general power?

It is well-settled law that if the holder of a general power of appointment is also the grantor of that power, the property subject to the power will be reachable by the grantor/powerholder's creditors. Restatement Second Property, sec. 13.3. However, if the general power was granted by another, then the rule is quite different. As a general rule, except in Bankruptcy cases, creditors of the holder a general power of appointment granted by another cannot reach property subject to the power unless and until the power is exercised. *Id.* at sec. 13.2. A number of states, however, provide by statute that such property will be reachable if other assets of the powerholder are insufficient to pay his debts. (New York, California, Michigan, Minnesota, Oklahoma and Wisconsin), and still other states provide that such property is reachable by creditors of the powerholder in any event (Alaska, District of Columbia, North Dakota, South Dakota and Tennessee). See Restatement Second Property, sec. 13.2, statutory notes 1-3.

Planning with powers of appointment offer the potential for flexibility unavailable with any other trust arrangement. For instance, a person not holding a power could be the authority to grant powers of appointment; powers of appointment could "pass" from one person to another such as in the case of death or disability; powers could be joint or subject to another's consent; powers could be granted to entities such as corporations or

partnerships; and powers could be in the form of a power to amend a trust, that is otherwise irrevocable and non-amendable by the Settlor.

A power to amend held by the Settlor or by someone other than the Settlor of the trust is also a power of appointment. Restatement Second Property, sec. 11.1, Comment C. Therefore, a person who is not a beneficiary of the trust may be given a “limited” power of amendment generally with no adverse tax consequences and with no exposure to creditors. That is, as with a power of appointment, the holder of a power of amendment cannot be forced to exercise it.

The terms governing the amendment will dictate the requirements and extent to which the trust may be amended. For instance, the trust may state: *“This trust may be amended by a trustee other than the Settlor and other than a vested or contingent beneficiary hereunder, by a writing signed and acknowledged by the trustee, provided that any such amendment shall in no way operate to make the trustee a beneficiary of the trust. The foregoing power may be exercised by the trustee in his individual capacity and no fiduciary duty shall be implied or imposed in its exercise.”* [See discussion of tax issues below.]

NOTE: If the power to amend is given to a trustee as opposed to a beneficiary or some outside party or parties, a broad exoneration clause should be included exculpating the trustee from liability to any beneficiary. (See *“Building Flexibility in Estate Planning Documents,”* McBryde and Keydel, Trusts and Estates Magazine, January 1996)

An advantage of the limited power of amendment over the limited power of appointment is that the trust property may be rearranged to suit the circumstances without transferring the property/assets out of the trust, as would be the case if a power of appointment were exercised.

If the Settlor prefers not to grant someone the power to amend the trust, still another possibility exists by giving the trustee other than the Settlor the power to grant the power to amend.

NOTE: As with the power of appointment, in those jurisdictions which still recognize the rule against perpetuities, care must be taken to prohibit the exercise of the power in a manner which would cause the rule to be violated.

Authority supporting the power to amend. The use of such a power for asset protection purposes as proposed by the author may be somewhat innovative, as the author has found no cases directly on point. However, since it is clear that the power to amend is the legal equivalent of the power of appointment (authority cited above), there should be no question that the extensive legal precedents supporting the power of appointment will apply as well to the power of amendment.

There can be numerous and complex tax consequences to the granting of a power to amend the trust, and a thorough discussion of these is beyond the scope of this discussion. Accordingly, no power to amend as contemplated here should be added without a thorough consideration of all attendant income, gift and estate tax ramifications. In this regard, following are a few primary tax concerns worthy of note.

The granting of an amendment which is treated as a special power is usually more desirable. If the person holding the power to amend can amend in favor of himself, then the power will likely be regarded as a general power of appointment under IRC section 2041(a)(2), and all of the property subject to the power will be includable in the powerholder's estate. Further, under IRC section 678 (a)(1) all of the trust income will be taxed to the powerholder. Any amendment decreasing the powerholder's share will be deemed a taxable gift from the powerholder, and the grantor will have made a complete gift when the power is granted, whether or not the power is exercised.

To avoid a taxable gift by the grantor when giving another a special power or the equivalent, the grantor would normally reserve for himself a special testamentary power of appointment to render the gift incomplete. Of course, if the power given to another is exercised in a manner that removes the property beyond the grantor's control, the grantor will be deemed to have made a completed gift at the time of the exercise by the powerholder. [For a more thorough review of the tax consequences of powers of appointment see Bove, "Powers of Appointment: More (Taxwise) Than Meets The Eye," Estate Planning, October 2001, Vol. 28 No. 10.]

Protectors. A protector is (typically) an individual named in a trust who has certain overriding authority or power granted him under the terms of the trust. The concept of the protector originated in Europe with family trusts and foundations and was conceived to give a person, trusted by the family, the authority to oversee the administration and distributions of the trust but without conferring any fiduciary duty or ongoing administrative responsibility on the protector. Modern professional opinion and some cases, however, strongly suggest that the office of protector is almost always a fiduciary office and the duty to act sensibly and in a manner consistent with the purpose of the position is not dispensable. Von Knierem v. Bermuda Trust, 1 BOCM 116 (Bermuda High Court, 1994), and Steel v. Paz, Ltd., Manx Court of Appeal October 10, 1995.

For instance, the protector may be given any or all of a variety of powers, including an absolute veto power over trust distributions, the power to remove and appoint trustees, and the power to delete or add beneficiaries other than himself or his interested parties. As with the granting of a power to amend, very careful consideration must be given to any tax consequences that may result if the protector is an interested party or a potential beneficiary.

Furthermore, in the case of an offshore trust, it is very important to avoid having a domestic protector in the case of attack, since a US court would have jurisdiction over a domestic protector and would thus be able to order the protector to perform certain acts to

make trust assets available to a judgment creditor of a Settlor/beneficiary. See FTC v. Affordable Media, LLC, 179 F.3d 1228 (9th Cir. 1999)

The attraction of offshore trusts. A number of offshore jurisdictions have adopted trust legislation specifically providing that the assets of a self-settled discretionary trust will not be reachable by creditors of the Settlor/beneficiary in the absence of a fraudulent conveyance. See e.g., Cook Islands International Trusts Act of 1984, as amended. And in the case of a claimed fraudulent conveyance, the burden of proof is on the creditor, who must prove beyond a reasonable doubt that the conveyance was fraudulent (a much harsher standard than that employed in the US). *Id.* Furthermore, the claim, or suit against the trust, must be made in the Cook Islands, as judgments rendered by the United States (or other “foreign” jurisdictions) are not recognized, and the action must be commenced within the first to occur of two years of the establishment of the trust or one year from accrual of the cause of action. *Id.*

Some jurisdictions, e.g., Gibraltar, and the Isle of Man, offer immediate protection (i.e. a zero open period of limitations) if the transfer to the trust did not render the transferor insolvent. Finally, in none of the offshore jurisdictions do attorneys work on a contingent fee basis in such matters, so the creditor must finance the full cost of the litigation in advance.

Establishing an offshore trust is not for the uninitiated advisor. There are many important steps critical to the transaction, as well as special provisions to be included in the trust. Furthermore, it is essential to make sure the offshore trust meshes with the client’s estate plan. See Bove and Suisman, “Coordinating An Asset Protection Plan With An Estate Plan: The Often Overlooked Essentials,” Asset Protection J., Autumn 1999, Vol. 1 No. 3. And of course, there is the key question of which jurisdiction to choose. See Engel, Lockwood, Merric, Asset Protection Planning Guide, s. 1375, CCH (2001). The potential serious problems resulting from selecting the wrong jurisdiction, the wrong trust provisions, the wrong protector or trustee are simply not worth the risk to the advisor, or the client. The well-known “Anderson” case, cited above as *FTC vs.*

Affordable Media, LLC is an excellent illustration of this. Accordingly, the best approach for an advisor new to the process would be to engage the assistance of an advisor who has had considerable experience in establishing offshore trusts and walk through the first one or two projects with that person.

Tax issues. Virtually all asset protection trusts are established as “grantor” trusts under the U.S. Tax Code, so that no income tax consequences result from transfers to such trusts. That is, the trust is ignored for income tax purposes and all income, losses, etc. pass through to and are reported by the Settlor. IRC sec. 671-679. In addition, the trusts, although irrevocable, usually contain a reserved special testamentary power of appointment held by the Settlor, so there is no completed gift. There are, however, new reporting requirements. To stem what the IRS felt was a serious underreporting of income earned by offshore trusts, in 1996 congress enacted laws characterizing the typical offshore asset protection trust as a “foreign” trust, imposing new and formidable reporting requirements (though still no tax) on such trusts. See generally IRC sec. 6048, and see B. Yacker, “Foreign Trust Reporting and Disclosure Obligations: Your Prescription to Prevent Unnecessary Headaches,” Asset Protection J., Winter 2000, Vol. 1 No. 4.

Conclusion. Asset protection planning consideration has come to be an essential part of virtually every estate plan, at least as much as tax planning. Advisors must be aware of the options available for their clients who wish to address the issue and since trusts are unquestionable the most common vehicle used in an estate plan, advisors must understand the asset protection options available through trusts, domestic and offshore, particularly where the client/Settlor wishes to be a beneficiary. These options range from irrevocable income-only trusts for the benefit of the Settlor, giving related or friendly parties a power over principal, to offshore trusts where a creditor must deal with a foreign jurisdiction that does not recognize US laws or judgments. Advisors who fail to acknowledge and counsel on these matters will expose their clients and themselves to unnecessary risks.

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