DOMESTIC ASSET PROTECTION TRUSTS

Domestic Asset Protection Trusts Created by Nonresident Settlors

This first part of a two-part article analyzes the various state domestic asset protection trust statutes, the purposes of these trusts, how they can be attacked by creditors or a tax agency, and how proper planning can avoid most challenges.

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A domestic asset protection trust ("DAPT") enacted under Alaska, Delaware, Nevada, Rhode Island, or Utah law is an irrevocable spendthrift trust formed under a state law which authorizes an independent trustee--in such trustee's absolute discretion (or pursuant to certain specific statutory standards)--to make distributions to a class of beneficiaries that includes the settlor. Prior to 1997, almost all states had statutory or case law which provided that it was against public policy to protect the assets of a DAPT from the settlor's creditors.

The transfer tax corollary of this public policy was that, because a settlor could relegate the settlor's creditors to the assets of the trust, transfers to the DAPT would be incomplete gifts and the assets would be included in the settlor's estate. In 1997, Alaska enacted a DAPT statute which expressly provided, with certain limited exceptions, that creditors of the settlor could not reach assets that the settlor had transferred to a DAPT. Several months later, Delaware followed with a similar statute. In 1999, Nevada and Rhode Island enacted such statutes. In 2003, Utah enacted a statute, effective 1/1/04.[1]

The newest statute: Oklahoma's revocable trust. In 2004, Oklahoma enacted a statute, effective 11/1/04.[2] Oklahoma's "Family Wealth Preservation Act" is unique in that it allows a DAPT to be either a revocable or irrevocable trust and places an asset protection "cap" of $1 million plus incremental growth. The Act expressly states that "[n]o court or other judicial body shall have the authority to compel a person holding a power of revocation over a preservation trust to exercise the revocation."[3]

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[1] In 1989, Missouri enacted a statute that appears to validate self-settled discretionary spendthrift trusts. (Mo. Rev. Stat. §456.5-505.3.) However, the statute does not appear to be easily usable by nonresident settlors.

[2] 31 Okla. Stat. Ann. §§9 through 17.

[3] *Id.*, §16.

The advantage of this new Oklahoma statute is that if a revocable trust is used, the settlor--rather than an independent trustee--will have control over distributions to the settlor. If a settlor desires a distribution, the settlor will revoke the trust to the extent of the desired distribution. The disadvantage of such a revocable trust is that the trust assets will be included in the settlor's estate for transfer tax purposes.[4] This consequence will not be a disadvantage for settlors with estates of less than the current applicable credit amount. As a result, Oklahoma DAPTs may become attractive for settlors who do not need transfer tax planning.

Over the past seven years, numerous commentators have analyzed DAPTs and their goals. These analyses have come from diverse sources: some from proponents of DAPTs; others from competing interests such as planners previously committed to foreign asset protection trusts; and finally, from the academic realm. Seven years of experience, numerous thoughtful commentaries, and continuing estate planners' interest have raised numerous issues with respect to DAPTs. The goals of this article are to discuss how a DAPT can be attacked by creditors, how proper planning will eliminate most attacks, and the key bankruptcy scenario for a settlor who is a nonresident of a DAPT state. It is hoped that this will provide the information desired by estate planners so that they can decide whether this approach is appropriate for specific clients.

Purposes

Asset protection. The initial purpose of a DAPT is to protect the trust assets from the settlor's creditors. In addition, DAPTs often include a perpetual trust plan which provides asset protection for other beneficiaries.

Estate freeze with access to assets. This purpose is to allow a settlor to use his applicable credit and annual exclusion gifting ability to transfer assets to an irrevocable trust, the assets of which will not be included in the settlor's gross estate. Therefore, the value of those assets plus all the growth after

[4] IRC Section 2038. See the discussion below in the section on "Transfer tax planning."

the transfer will be so excluded. However, if the settlor needs funds from the trust due to a financial reversal or other emergency, the independent trustee has discretion to make distributions to the settlor.

Anti-Strangi *planning*. The recent case of *Estate of Strangi*[5] created concern that Section 2036(a)(2) will apply to a partner of a family limited partnership ("FLP") or a member's interest in a family limited liability company ("FLLC") if that party is a general partner, manager, or just retains the right to vote upon liquidation of the entity. For example, H and W form an FLP and each contributes 50% of the assets. H is the general partner, and W is the limited partner. If the above *Strangi* consequence were to occur, when each spouse died 50% of the assets would be included in that spouse's estate, without discount.

One approach that may avoid this result is for H and W each to contribute their partnership interest to a DAPT. If they have used their applicable credit and annual exclusion gifting elsewhere, they can make their contributions incomplete gifts. Because an independent trustee would have absolute discretion to determine when distributions will be made, a good argument exists that the *Strangi* Section 2036(a)(2) holding will not apply. This approach also adds a tax purpose to planning that involves incomplete gifts to a DAPT.

Pre-immigration transfer tax planning. Substantial planning opportunities exist for nonresident aliens who anticipate immigrating to the U.S.[6] Prior to immigration, a nonresident alien may make unlimited transfers to a DAPT without incurring any U.S. gift tax liability. After immigration, if the settlor needs funds, they can be distributed by the independent trustee. The trust assets would not be

[5] TCM 2003-145.

[6] See Mirabello, "Charting a Course to America: Pre-Immigration Planning," 33 *U. Miami Heckerling Inst. on Est. Plan*. (1999).

included in the settlor's estate if Section 2036 and Section 2038 do not apply.[7]

State income tax planning. A DAPT may be used by a settlor to avoid the income tax imposed by the settlor's state of residence. Assuming that the settlor's state has incorporated the federal income tax grantor trust rules, the DAPT may be designed to avoid grantor trust status. One method to accomplish this avoidance is to require that distributions to the grantor must be approved by adverse parties.[8] Care must be taken in drafting the DAPT to avoid inadvertently including other grantor trust provisions.[9]

Substitute for prenuptial agreement. Frequently, persons entering into a marriage are reluctant to aggressively negotiate a prenuptial agreement for fear of damaging the relationship. A DAPT, formed well in advance of marriage, allows a party unilaterally to place assets beyond the reach of the new spouse under the statutes in Alaska, Delaware, Oklahoma, Rhode Island, and Nevada.[10]

Many DAPTs are created for both asset protection and transfer tax minimization purposes. Accordingly, the DAPT is an irrevocable trust and transfers to it are structured as completed gifts. However, often DAPTs are created only for asset protection purposes. For example, a settlor may wish to transfer to the DAPT an amount of assets greater than the amount that can be protected from out-of-pocket payment of gift tax. In those circumstances, the transfer in excess of the protected

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[7] Nenno, "The Domestic Asset Protection Trust Comes of Age," 38 *U. Miami Heckerling Inst. on Est. Plan*. ¶211.5 (2004).

[8] Section 677(a). See Ltr. Rul. 200247013 and Ltr. Rul. 200148028. Nenno, *id.*, Part XII(D). Unless the above planning technique is used, a DAPT will be a grantor trust for income tax purposes because the trustee may distribute trust income to the settlor or the settlor's spouse. Section 677(a). This will often be advantageous because such status will ease tax compliance and will allow the settlor to sell assets to the DAPT without the sale being a taxable event. See Mulligan, "Sale to an Intentionally Defective Irrevocable Trust for a Balloon Note--An End Run Around Chapter 14?," 32 *U. Miami Heckerling Inst. on Est. Plan*., pp.14-1 through 14-42 (1998).

[9] See Akers, "But I Just Wanted a Few Strings Over the Trust Assets for Me and My Family," 38 *U. Miami Heckerling Inst. on Est. Plan*., pp. 2-48 through 2-64 (2004); in general, see Pennell, 1 *Estate Planning* §5.11 (Aspen 2003).

[10] Utah does not protect DAPT assets from the claims of a spouse, whether the marriage was entered into before or after formation of the DAPT. Utah Code Ann. §25-6-14.

amount is structured as an incomplete gift.[11]

How can a creditor attack a DAPT?

There are three general avenues of attack which a creditor may use in an effort to reach assets that a settlor/debtor has transferred to a DAPT.

Choice of law. The creditor may argue that the court should apply the spendthrift trust law of the state of residence of the settlor, rather than the law of the DAPT state.

Fraudulent transfer. The facts may support an argument that the settlor's transfer to the DAPT was fraudulent and therefore should be set aside. Again, a choice of law issue may exist. The fraudulent transfer law of the settlor's state may be more creditor-friendly than the law of the DAPT state.

Improper implementation. The facts may support an argument that the settlor has, through an implied agreement or other improper implementation, retained control over the DAPT in a manner that will allow the court to conclude that the requirements of the DAPT statute have not been met. Attacks under this category include the following: (1) implied agreements between the settlor and the fiduciary; (2) the trust has been implemented so that it is merely the "alter-ego" of the settlor; or (3) the trust is a "sham" because of the manner in which it has been implemented.

The first general attack, choice of law, applies only when the settlor is a nonresident of the state where the DAPT is formed. The two other general attacks apply to both resident and nonresident settlors.

The above general attacks may be made in a state court, federal district court, or bankruptcy court

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[11] To prevent the transfer from being a completed gift, DAPT statutes allow the settlor to retain a power to veto a distribution from the trust, or retain a testamentary nongeneral power of appointment. (Alaska Stat. §34.40.110(b)(2); Del. Code tit. 12, §§3570(10), b, 1 and 2; R.I. Gen. Laws §18-9.2-2(9)(ii)(A); Nev. Rev. Stat. §166.040(2)(a); Utah Code Ann. §§25-6-14(2)(e)(i) and (ii).) Nevertheless, the retention of a testamentary power may not make gifts incomplete if the trustee has discretion to make distributions to beneficiaries other than the settlor. Retained powers may be structured so that they may be released, fully or partially, in the future in order to complete gifts to the trust. A new example of a method to make the gift incomplete is provided by the Oklahoma statute. Under that statute, if the settlor desires to retain control, the trust may be

located in either the settlor's state of residence or the DAPT state. Before examining each of these types of attacks, it is crucial to review the jurisdictional principles that apply when a creditor seeks to reach the assets in a DAPT.

Jurisdiction

It is very important to understand the difference between obtaining a valid judgment against the settlor as compared to such a judgment against the DAPT trustee or over DAPT assets. A judgment against the settlor will entitle the creditor to reach only the settlor's assets. The DAPT assets are no longer owned by the settlor. Consequently, even though a creditor is able to obtain jurisdiction over the settlor in the settlor's state of residence, and then obtain a judgment against the settlor, this does not permit the creditor to reach the DAPT assets.

To reach the DAPT assets, a creditor of the settlor will first have to bring an action in state or federal court which can obtain jurisdiction over the DAPT trustee or the DAPT's assets. If such jurisdiction is obtained, the creditor can assert one or more of the types of attacks discussed above.

It is generally assumed that if a creditor challenges a DAPT, it will be to the settlor/debtor's advantage to have the challenge occur in a court in the DAPT state. The theory is that a DAPT court (whether state, federal, or bankruptcy) will more likely apply DAPT law than would a court in another state. Therefore, jurisdiction planning for a DAPT is very important. Choices of trustees, lack of DAPT trustee contacts with the settlor's state of residence, and implementation planning can avoid or minimize the risk that a court outside the DAPT state will have jurisdiction over the trustee or the trust assets.

No trustee contacts; no personal jurisdiction. Assume that a nonresident of a DAPT state forms a DAPT that has a trustee located only in the DAPT state. Assume that the DAPT is funded by transferring assets, such as security accounts and other intangibles, to the trustee in the DAPT state.

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revocable. A transfer to a revocable trust is an incomplete gift. Reg. 25.2511-2(c).

Assume further that the trustee has no contacts with the settlor's state of residence. If a creditor of the settlor brings an action in the settlor's state, that state court will not be able to obtain personal jurisdiction over the DAPT trustee or the trust assets.[12]

If instead, the creditor had sued in a federal court in the settlor's state of residence, based on either diversity or federal question jurisdiction, the court would not be able to obtain personal jurisdiction over the DAPT trustee or the trust assets.[13] On the other hand, a bankruptcy court--whether located in the settlor's state or in the DAPT state--will have jurisdiction over the DAPT trustee and the trust assets. The reason is that a bankruptcy court has national jurisdiction.[14]

Trustee contacts. Even if the DAPT has only a corporate trustee located in the DAPT state, a state or federal court in the settlor's state of residence may be able to obtain personal jurisdiction over the trustee based on the forum state's long-arm statute and various contacts which the corporate trustee may have with that state. These contacts must be more than typical trustee communications with a

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[12] For example, in *Rose v. FirStar Bank*, 819 A.2d 1247 (R.I., 2003), the Rhode Island Supreme Court held that the lower court did not have personal jurisdiction over an Ohio corporate trustee which had periodically sent statements, checks, and other documents to a Rhode Island beneficiary and had communicated occasionally with the beneficiary by telephone. The court concluded that the trustee never purposely availed itself of the benefits of doing business in Rhode Island, and the beneficiaries' trust mismanagement claims did not arise out of the trustee's Rhode Island contacts. In *In the Matter of Estate of Ducey*, 241 Mont. 419, 787 P.2d 749 (1990), the Montana Supreme Court held that the state court did not have personal jurisdiction over a Nevada corporate trustee. The court held that the case was nearly identical to *Hanson v. Denckla*, 357 U.S. 235 (S.Ct., 1958), where the U.S. Supreme Court reversed a Florida Supreme Court decision which had tried to use a Florida probate proceeding to establish in rem jurisdiction over trust assets in Pennsylvania. The Montana estate, arguing for long-arm jurisdiction, said that the Nevada bank had transacted business in Montana based on: (1) the decedent was a Montana resident, (2) periodic trust payments were made to her, (3) the Nevada trustee amended the trust document while the decedent was a Montana resident, (4) at the decedent's request the trustee negotiated changes in the trust telephonically, (5) the trustee instructed the decedent to draft a will and send a copy to the trustee, and (6) the trustee received permission from the decedent to act as successor trustee. The Montana Supreme Court concluded that the Nevada trustee did not conduct any business in Montana in a manner so as to purposely avail itself of the benefits and protections of Montana's laws. The court distinguished *McGee v. Int'l Life Ins. Co.*, 355 U.S. 220 (S.Ct., 1957), finding that there was no solicitation of business in Montana to the degree that existed in *McGee*.

[13] Rule 4(k) of the Federal Rules of Civil Procedure provides that the federal court will have the same personal jurisdiction as a state court in the state where the federal court sits.

[14] 28 U.S.C. §1334(e); and Bankruptcy Rule 7004(d).

settlor or beneficiary.[15] The ultimate long-arm question is whether the DAPT trustee purposely availed itself of the benefits of doing business in the settlor's state of residence. The court will analyze how numerous and deliberate the contacts were, and how close the relationship is between the contacts and the litigation.[16]

In rem jurisdiction. Assume the facts of the earlier example except that some of the assets transferred to the trust include real estate located in the settlor's state of residence. This will give a court in the settlor's state in rem jurisdiction over the asset.

Several approaches have been suggested to avoid such in rem jurisdiction. The real estate could be contributed to a limited partnership or LLC formed under DAPT state law. Such an interest should be considered intangible personal property with a situs in the DAPT state. However, if the real property is involved in any income-producing activity, the DAPT limited partnership or LLC may be required to register in the settlor's state of residence and submit to its jurisdiction.

One commentator has suggested the alternative approach of the settlor selling the real estate to another grantor trust in exchange for an installment note. The note would be secured by the real property. The note would then be contributed to the DAPT. Again, the note should be considered intangible personal property which has its situs in the DAPT state. While a court in the settlor's state of residence may be able to obtain jurisdiction over the real property, the realty will have reduced

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[15] See note 12, *supra*.

[16] See Boxx. "Gray's Ghost—A Conversation About the Onshore Trust," 85 Iowa L. Rev. 1195, 1211-1212 (2000). General media advertising, attendance at professional conferences, articles in national press and journals, and providing promotional materials and website material may not be enough to satisfy the due process requirements for jurisdiction. Is the fact that a trustee maintains an Internet website enough to provide a due process basis for jurisdiction in states where the Internet material can be accessed? The developing law in this new area of personal jurisdiction distinguishes between passive Internet sites that provide only information, and interactive sites that conduct business transactions. (*Zippo Manufacturing Co. v. Zippo Dot Com*, 952 F. Supp. 1119 (DC Pa., 1997).) Commentators suggest that the test should seek to determine if the defendant engaged in intentional conduct expressly aimed at the plaintiff in the forum state. Reid, "Operationalizing the Law of Jurisdiction: Where in the World Can I Be Sued for Operating a Worldwide Web Page?," 8 Comm. L. & Pol'y 227 (2003); Gasparini, "The Internet and Personal Jurisdiction: Traditional Jurisprudence for the Twenty-First Century Under the New York CPLR," 12 Alb. L.J. Sci. & Tech.

value due to the fact that it is subject to a lien securing the promissory note.[17]

Co-trustee located in settlor's state of residence. Here, the state or federal court in the settlor's state will be able to obtain personal jurisdiction over the co-trustee.[18]

Full faith and credit

Assume that a nonresident of a DAPT state establishes a DAPT. A creditor sues the settlor in a court in the settlor's state of residence and obtains a judgment. Next, assume that as part of that suit, or in a separate action in the settlor's state, the creditor proceeds against the trustee of the DAPT to enforce the judgment against the trust assets. Assume that the court in the state of residence chooses that state's spendthrift trust rules and/or fraudulent transfer rules and enters a judgment against the trustee. The creditor then proceeds to the DAPT state and asks a court there to enforce the judgment against the trustee based on the Full Faith and Credit Clause of the Constitution.[19]

A basic requirement for full faith and credit is that the judgment be valid.[20] One requisite for validity is that the forum court possessed jurisdiction.[21] Assume that the DAPT trustee did not participate in the court action in the settlor's state of residence and had few, if any, contacts with that state. Then, that state's jurisdiction over the DAPT trustee and the assets such trustee holds will be highly

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191, 228-229 (2001).

[17] The latter approach was suggested by Gideon Rothchild at the panel discussion entitled, "Everything You Always Wanted to Know About Domestic Asset Protection Trusts but Could Never Find Out," at 38 *U. Miami Heckerling Inst. on Est. Plan.* (2004).

[18] Another concern about co-trustees is whether they will attract a state income tax. If the trustee resides in a state that has an income tax, that state may assert its tax against the trust. Coleman, "State Fiduciary Income Tax Issues," ALI-ABA Advanced Estate Planning Techniques (2002); Gutierrez, "The State Income Taxation of Multi-Jurisdictional Trusts--The New Playing Field," 36 *U. Miami Heckerling Inst. on Est. Plan*. (2002).

[19] U.S. Const. art. IV, §1.

[20] 18 *Moore's Federal Practice* §130.04[3] (Matthew Bender 3d ed.).

[21] *Id*.; Restatement (Second) of Conflict of Laws §92, comment e.

questionable.[22] Consequently, full faith and credit may well be denied.[23]

Even if the court in the settlor's state had obtained jurisdiction over the trustee of the DAPT, Professor Scott points out that the judgment may still not be entitled to full faith and credit in the DAPT state. If the court of the DAPT state has primary supervision over the administration of the trust, either because the trustee has qualified as trustee in that state or because the administration of the trust is fixed in that state, then the decision of a court of another state may not be entitled to full faith and credit.[24]

Which state's spendthrift trust law applies?

Assume that a nonresident of a DAPT state establishes a DAPT. Subsequently, the settlor is sued in either state or federal court by a creditor. The court may be located in the settlor's state or in the DAPT state. Assume further that the court obtains jurisdiction over the trustee of the DAPT. The creditor will argue that the court should choose the spendthrift trust law of the settlor's state of residence, rather than the law of the DAPT state. If the court opts to apply the law of the state of residence, which does not allow DAPTs, then the creditor will be allowed to reach the trust assets. Thus, the issue is which state's spendthrift trust rules apply--those of the DAPT state or the rules of the settlor's state? A sub-issue is whether this question is one of administration or validity of the trust.

This issue is analyzed below based on the principles in the Restatement (Second) Conflict of Laws. It is assumed here that such principles would be applied by a court sitting in the DAPT state or in the settlor's state of residence. However, each state's conflict of laws rules should be researched to

[22] See Boxx, *supra* note 16, at 1227.

[23] The above type of situation is described in Boxx, *supra* note 16, at 1214-1215.

[24] Scott and Fratcher, *The Law of Trusts* §573, at 190 (4th ed. 1989).

determine if they differ from those of the Restatement.[25]

Administration. If the question is one of administration of the trust, the settlor's choice of DAPT law in the trust instrument controls. The Restatement (Second) Conflict of Laws section 273(b) provides that whether the interest of a beneficiary of a trust of movables is assignable by him and can be reached by his creditors is determined (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.

Validity. If the question is one of validity of the trust, section 270 of the Restatement again provides that the settlor's choice of DAPT law in the trust instrument will prevail if the DAPT state "has a substantial relation to the trust and that the application of its law does not violate a strong public policy of the state with which, as to the matter at issue, the trust has its most significant relationship under the principles stated in §6."

Generally, the DAPT state will satisfy the requirement of having a substantial relation to the trust. However, a factual determination will need to be made as to which state has the most significant relationship to the trust.

Strong public policy. Further, and equally important, a determination must be made as to whether application of the DAPT's state law will violate a "strong public policy" of the settlor's state of residence. For example, the settlor's state may allow one or more other approaches which are essentially the same as a self-settled spendthrift trust. Consider state statutes which provide creditor protection for "self-settled" techniques such as: IRAs, life insurance, annuities, homesteads, tenancies by the entirety, Section 529 plans, and similar planning approaches.[26] If the state of residence allows some or all of such self-settled approaches, a significant argument can be made that

[25] Review of Alaska case law indicates that it does not have any conflict of laws rules that differ from the Restatement with respect to the areas discussed here.

[26] See Danforth, "Rethinking the Law of Creditors' Rights," 53 Hastings L.J. 287, 325, 333 through 343 (2002).

the state does not have a "strong public policy" against self-settled asset protection planning.

In his treatise, Professor Scott states that differences in spendthrift trust law are not enough to establish a "strong public policy" which would justify disregarding the law of the state of administration chosen by the settlor.[27]

Professor Siegel, generally analyzing the public policy exception in the conflict of laws area, states the following:

The latter possibility makes the "public policy" issue germane here, but on the American scene, where the federal constitution imposes minimum standards of fairness on all of the states, uncommon is the appearance of a law so offensive to a forum's "public policy" that the forum will refuse to apply it. . . .

Before a foreign claim or law is rejected on the ground that it violates forum "public policy", the forum feeling about the matter must be shown to be a deep one, to touch on something the forum deems to involve moral values rather than just a different way of doing things. . . .

One may ask how much room there is today for an American court to refuse a sister-state claim on the ground that it offends forum public policy. The answer is: little.[28]

Rule of validation. Professor Siegel states that "[c]ourts favor a rule of validation, meaning that if of two related states the trust is valid under the law of one but invalid under the law of the other, the one that validates is chosen."[29]

@P:*Planning*. The above-discussed authorities favor application of the choice of law specified by

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[27] Scott and Fratcher, *supra* note 24, at §626, p. 414.

[28] Siegel, *Conflicts in a Nutshell* §57 (2d ed., West Pub. Co. 1994). Interesting examples of this choice of law issue are provided in *Hutchinson v. Ross*, 262 N.Y. 381, 187 N.E. 65 (1933); and *Intercontinental Hotels Corp. v. Golden*, 254 N.Y.S.2d 527, 203 N.E.2d 210 (1964).

[29] Siegel, *supra* note 28, at §96. The Restatement (Second) Conflict of Laws §6, comment g, reaffirms that ". . . the courts seek to apply a law that will sustain the validity of a trust of moveables (*see* §§269-270)." Also see Restatement (Second) Conflict of Laws §270, comment d.

the settlor in the trust instrument.[30] Certain of the Restatement principles are fact-dependent. The DAPT state must have a substantial relation to the trust. Moreover, a determination must be made as to the state with which, regarding the matter at issue, the trust has its most significant relationship. These factual determinations may well be affected by the manner in which the trust has been implemented. Careful planning will assure proper implementation.[31] In addition, the rule of thumb has been that the risk of non-DAPT law being applied is greater when the issue is being considered by a court outside the DAPT state. Planning will minimize the risk that such a court will have jurisdiction.[32]

Fraudulent transfers

Planning. If a creditor cannot avoid the application of the DAPT spendthrift trust law, an alternative may be to attack the transfer to the DAPT as fraudulent. Most fraudulent transfer situations can be avoided by good planning. Estate planners should carefully follow due diligence procedures to determine whether existing liabilities and foreseeable future liabilities are present.[33] If such liabilities have not been adequately provided for, the settlor's contemplated transfer to the DAPT may be found to be fraudulent. Hence, either the DAPT should not be formed, or its formation should be postponed until the liabilities have been satisfied or secured.

However, even when no known liabilities exist, the possibility that a future creditor will challenge a

[30] These authorities must be balanced against the foreign asset protection bankruptcy cases, which will be discussed in Part 2 of this article.

[31] See the section of this article entitled "Improper implementation, alter-ego, or sham," below.

[32] See the section entitled "Jurisdiction," above.

[33] Due diligence procedures are fully discussed in Shaftel, Special Session materials for "Everything You Always Wanted to Know About Domestic Asset Protection Trusts but Could Never Find Out," 38 *U. Miami Heckerling Inst. on Est. Plan.*, pp. I-C-31 through I-C-33 (2004); and in Shaftel, "Domestic Asset Protection Trusts: Key Issues and Answers," 30 ACTEC J. 27-28 (Summer 2004).

transfer to a DAPT as fraudulent cannot be completely eliminated. Consequently, from a settlor's standpoint, it will be advantageous if the fraudulent transfer law that is applied is law that is favorable to the settlor. The rule of thumb is that this will be the DAPT state fraudulent transfer law. For example, the Alaska fraudulent transfer law is described below.

Substantive law. Alaska, Delaware, Oklahoma, Rhode Island, and Utah all have express exceptions which exclude fraudulent transfers from their spendthrift trust protection.[34] Delaware, Nevada, Oklahoma, Rhode Island, and Utah are among 42 states that have adopted the Uniform Fraudulent

Transfer Act ("UFTA"). UFTA provides, in part:

A transfer made . . . by a debtor is fraudulent as to a creditor, whether the creditor's claim arose before or after the transfer was made . . ., if the debtor made the transfer . . .:

(1) with actual intent to hinder, delay or defraud any creditor of the debtor; or

(2) without receiving a reasonably equivalent value in exchange for the transfer . . ., and the debtor:

i. was engaged or was about to engage in a business or transaction for which the remaining assets of the debtor were unreasonably small in relation to the business or transaction; or

ii. intended to incur, or believed or reasonably should have believed that he [or she] would incur, debts beyond his [or her] ability to pay as they became due.[35]

Alaska has not adopted UFTA. Prior to 2003, Alaska law allowed a creditor to successfully challenge a transfer to a trust if the "transfer was intended in whole or in part to hinder, delay, or defraud creditors or other persons."[36] In 2003, the above provision was amended to restrict a creditor's challenge to situations where "[t]he settlor's transfer of property in trust was made with

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[34] Alaska Stat. §34.40.110(b)(1); Del. Code tit. 12, §§3572(a) and (b); 31 Okla. Stat. Ann. §8; R.I. Gen. Laws §§18-9.2-4(a) and (b); Utah Code Ann. §25-6-14(1)(c)(ii).

[35] UFTA §§5(a) and 4(a).

[36] Alaska Stat. §34.40.110(b)(1).

the intent to defraud that creditor." The terms "in part," "hinder," "delay," and "creditors or other persons" were considered too ambiguous to allow for consistent application.

Nevada's statutes do not expressly state that fraudulent transfers are exceptions to its spendthrift trust provisions. Rather, the statutes allow a creditor to bring an action within two years after the transfer is made, or six months after the creditor discovers, or reasonably should have discovered, the transfer, whichever is later.[37] Perhaps these provisions will be read together with Nevada's fraudulent transfer statute to require the creditor to establish that the transfer was fraudulent before it will be set aside.

Statute of limitations and the discovery exception. Many clients who form DAPTs do so pursuant to what has been called the "nest egg" concept. That is, they want to set aside a certain portion of their net worth in a trust that will be protected from future events. They generally will have no known existing liabilities but are involved in activities--either work or recreational related--which create risks. These clients want assurance that, after a certain period of time, a creditor cannot attack the DAPT and reach its assets.

One of the major asset protection goals of DAPT statutes is to set a time limit upon the period when assets transferred to the trust will be vulnerable to attack. This limit is generally set at four years (two years in Nevada). Nevertheless, each statute has a "discovery exception" which allows a creditor to assert a fraudulent transfer attack more than four years (two years in Nevada) after the transfer. This discovery exception provides for attacks "within one year (six months in Nevada) after the transfer was or could reasonably have been discovered by the claimant."[38]

Under UFTA, the creditors who may potentially use the discovery exception are both existing and

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[37] Nev. Rev. Stat. §166.170.

[38] Alaska Stat. §34.40.110(d)(1)(B); Del. Code tit. 6, §1309, tit. 12, §3572; 24 Okla. Stat. Ann. §121; R.I. Gen. Laws §18-9.2-4(b)(1); Nev. Rev. Stat. §166.170(1)(b).

future creditors who are asserting that the debtor made the transfer with actual intent to hinder, delay, or defraud any creditor of the debtor. Because future creditors are included, the discovery exception under UFTA creates uncertainty as to whether the statute of limitations has run with respect to a transfer to a DAPT.

Under Alaska law prior to the 2003 amendment, only existing creditors could assert the discovery exception, but the definition of "existing creditors" was uncertain.[39] In 2003, the Alaska Legislature attempted to resolve this ambiguity by clarifying the distinction between an existing and future creditor. The 2003 Alaska amendment limits the definition of an existing creditor to a creditor who: "(1) can demonstrate, by a preponderance of the evidence, that the creditor asserted a specific claim against the settlor before the transfer; or (2) files another action, other than [a fraudulent conveyance action], against the settlor that asserts a claim based on an act or omission of the settlor that occurred before the transfer, and the action described in this sub-subparagraph is filed within four years after the transfer."[40] These new fraudulent conveyance provisions should provide much greater certainty concerning the fraudulent conveyance exception, and a settlor should know within four years of a transfer whether a creditor can attempt to challenge a transfer as fraudulent.

Which state's fraudulent transfer law applies?

The laws of the DAPT state and the settlor's state of residence may be significantly different with respect to what must be proved to establish a fraudulent transfer and the burden of proof. Accordingly, if a creditor attacks a transfer to a DAPT on the ground that the transfer was

[39] For example, consider an estate planning attorney who drafts a will, or an accountant who gives estate planning tax advice to a client. Subsequently, the attorney or accountant forms a DAPT. Ten years later, a beneficiary under the will determines that she has been harmed by the attorney or accountant, successfully sues and obtains a judgment, and then discovers that the professional had previously transferred a portion of his assets to the DAPT. At the time the attorney or accountant formed the DAPT, was this creditor an "existing creditor" who may qualify under the discovery exception?

[40] Alaska Stat. §34.40.110(d)(1)(B).

fraudulent, it will be necessary to determine which state's fraudulent transfer law will apply.

Choice of substantive law. The Restatement (Second) Conflict of Laws does not directly address this subject. Section 235, comment c, indicates that a transfer of land in fraud of the transferor's creditors may be determined by the law governing the tort (rather than the law of the situs). Section 244 provides that a claim for fraud between the transferor and the transferee is determined by the law of the state that has the most significant relationship to the parties, the chattel, and the conveyance. Section 245 provides that questions as to the effect of a conveyance upon a third party who has an existing interest in the chattel will be determined by the law of the state where the chattel was located at the time of the conveyance.[41]

Professor Siegel, discussing gratuitous transfers, states:

In the case of an ordinary gift by a living donor, it is made by the donor merely giving the thing to the donee. The validity of the transfer will be governed by the law of the place where the transfer is made. The Restatement couches this in terms of the "most significant relationship" test, but points to the law of "the location of the chattel" as having the "greater weight" (Rest.2d §244). It is also permissible to accompany the gift with a writing selecting the law to be applied, and the general rule here as in contract cases (§68) is that if the law selected is that of a reasonably related jurisdiction, the choice will be honored. . . .

If the interest is embodied in a more formal instrument, such as a check, note, bill, certificate of title or stock or the like, the instrument, as indicated, is likely to be deemed the property and a gift of it will be adjudged by the law of the place of its delivery.[42]

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[41] Professor Ehrenzweig, discussing the controversial New York Court of Appeals case of *James v. Powell*, 225 N.E.2d 741 (N.Y., 1967), concludes that the conflicts law of torts controls fraudulent conveyances, and therefore the tort rule of the forum applies. Ehrenzweig, "Fraudulent Conveyances in Conflicts Law," 66 Mich. L. Rev. 1679, 1689-1696 (1968).

[42] Siegel, *supra* note 28, at §90.

The above rules indicate that the choice of law may depend on where the transfer occurred. Good planning will make sure that all transfers funding the DAPT occur in the DAPT state.[43]

Choice of statute of limitations. Regardless of which state's substantive law is applied, it appears that the limitations period of the forum state will control. Assume that a court in the settlor's state of residence is not able to obtain personal jurisdiction over the DAPT trustee. Therefore, a creditor who desires to attack the settlor's transfer to the DAPT as fraudulent may decide to bring an action in the DAPT state. The question is whether the DAPT state limitations period applies to such a cause of action or whether the limitations period of the settlor's state controls.

Section 142 of the Restatement (Second) Conflict of Laws provides in part:

Statute of Limitations of Forum. (1) An action will not be maintained if it is barred by the statute of limitations of the forum, including a provision borrowing the statute of limitations of another state. Comment d to section 143 of the same Restatement provides that it is consistent with full faith and credit for a state to apply its statute of limitations to preclude "an action arising under the local law of a sister State even though the applicable statute of limitations of the sister State has not yet run and was of the sort that barred the right."

It is important to actively plan to minimize the risk that a transfer to a DAPT will be set aside as a fraudulent transfer. If jurisdiction over the DAPT trustee or assets cannot be obtained in the settlor's state, a creditor will be forced to proceed in a court in the DAPT state.[44] That court, whether state or federal, may apply the DAPT statute of limitations applicable to fraudulent transfers. If this law is

[43] For example, a nonresident settlor should travel to the DAPT state and execute documents that transfer securities (or security accounts) to the DAPT trustee. The trustee should then open new security accounts, either through a DAPT state local office or a national office in the name of the trustee. Similarly, while in the DAPT state, the settlor should deliver and transfer financial instruments (checks, notes, bills, certificates of title) and interests in entities such as FLPs and FLLCs to the DAPT trustee.

[44] However, see the discussion relating to bankruptcy, which will appear in Part 2 of this article.

similar to Alaska's 2003 provision, and if there were no existing creditors as narrowly defined by Alaska law, then the creditor will be required to proceed with a fraudulent transfer action within four years of the transfers to the DAPT.[45]

Improper implementation, alter-ego, or sham

The third type of creditor attack upon a DAPT can be generally described as improper implementation. This is a catch-all category that commentators have also labeled as the alter-ego theory or sham theory.[46] This is the same type of general concept that can be used to attack the validity of any entity--whether trust, limited partnership, LLC, or corporation. In essence, the theory is that after formation of the entity, the key parties failed to respect the separate existence of the entity and the basic requirements for proper implementation of the entity.

Trustee independence. Perhaps the most vulnerable area for a DAPT, created in a DAPT state other than Oklahoma, involves the independence of the trustee who has authority to make distributions to the beneficiaries, including the settlor. This is an area where a settlor, who was reluctant to give up control, may take actions that render the trust vulnerable. A typical DAPT will provide that the independent trustee has absolute discretion to make distributions to a class of beneficiaries that includes the settlor, the settlor's spouse, and the settlor's descendants.

This absolute discretion is provided to avoid an exception to some DAPT states' spendthrift rules for

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[45] Some commentators have speculated that adoption of the Uniform Enforcement of Foreign Judgments Act might provide a creditor with an argument that would prevent a court from denying full faith and credit based on expiration of its statute of limitations. (Nenno, *supra* note 7, at ¶212.3.) However, the uniform act expressly defines a "foreign judgment" as "any judgment, decree, or order of a court of the United States or of any other court which is entitled to full faith and credit in this state." See Alaska Stat. §09.30.260. Hence, it appears that the uniform act does not change the above conclusion with respect to the applicable statute of limitations.

[46] Osborne, "Asset Protection and Jurisdiction Selection: Clearing Up Your Situs Headaches," 33 *U. Miami Heckerling Inst. on Est. Plan*. at 14-20 (1999).

any portion of trust income or principal which must be distributed to the settlor.[47] Further, absolute discretion avoids contentions that a beneficiary (or the beneficiary's creditors) can force a trustee to make distributions pursuant to an ascertainable standard stated in the trust instrument.[48] For instance, a creditor could argue that maintenance or support includes the payment of the beneficiary's creditors. Alternatively, a creditor could argue that a trustee is required, pursuant to an ascertainable standard, to distribute assets to an insolvent beneficiary. Then, the creditor could attempt to attach the distributions.

No agreement. To preserve the independence of the trustee, there must not be any agreement between the independent trustee and the settlor regarding distributions. The existence of such an agreement would allow the settlor's creditors to reach the trust assets because the settlor would have a right to the distribution of the assets.[49] An additional result would be inclusion of the assets in the settlor's gross estate.[50] Such an agreement could be written, oral, or implied through a pattern of distributions.[51] If such a collusive relationship exists, the trust is a "sham," and is the settlor's "alter-ego."[52]

A court might be more likely to imply an agreement between the trustee and settlor if the independent trustee had a relationship with the settlor. Such relationships would include being a

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[47] E.g., Alaska Stat. §34.40.110(b)(3); Del. Code tit. 12, implied from §§3570(10)b and 3571; Nev. Rev. Stat. §166.040, 2(b); R.I. Gen. Laws §18-9.2-3; Utah Code Ann. §25-6-14(2)(c)(iv).

[48] Restatement (Second) of Trusts §155, comment b; Rothschild, "Protecting the Estate From In-Laws and Other Predators," 35 *U. Miami Heckerling Inst. on Est. Plan*. pp. 17-21 through 17-23 (2001).

[49] See note 47, *supra*, and the corresponding text.

[50] See Reg. 20.2036-1(a), which finds "retention" under Section 2036 if such an agreement exists.

[51] Cases involving Section 2036 and an implied understanding of grantor access are discussed in Boxx, *supra* note 16, at 1244-1251.

[52] See Danforth, *supra* note 26, at 302.

close relative, close friend, or employee. Because the transfer tax and asset protection advantages depend on the premise that the settlor's creditors cannot reach the trust assets, it is important to choose a trustee who will minimize the risk that an implied agreement will be found.[53]

A rule of thumb has developed concerning the portion of a client's assets which should be transferred to a DAPT. This "rule" limits such assets to no more than one-third (conservative) to one-half (aggressive) of the client's net worth. The rationale for this "rule" is that a settlor would not give away assets which the settlor knew with some certainty that he or she would need in the future unless the settlor also knew that he or she could get the assets back. Thus, the transfer of too large a proportion of the settlor's assets to a DAPT invites a court to find that an agreement exists between the settlor and the trustee.[54]

Statutory requirements. Another type of improper implementation would be to fail to comply with the requirements for applicability of DAPT state law. All DAPT states require that the DAPT trust have a situs trustee, who is a resident individual or trust company or bank of the DAPT state. Most states require that this trustee maintain records and prepare or arrange for the preparation of income tax returns, on an exclusive or non-exclusive basis, and must participate in trust administration.[55] Some trust assets need to be located in the DAPT state.[56] Failure to comply with these requirements

[53] The concerns about an implied agreement between the settlor and a trustee also apply with respect to settlors and trust protectors and trust advisors. Some DAPT statutes expressly recognize the use of trust protectors who have powers to change trustees and make certain modifications to the trust agreement. See Alaska Stat. §13.36.370. Similarly, some DAPT statutes authorize the use of a trust advisor who may advise the trustee but whose advice is not binding on the trustee. See Alaska Stat. §13.36.370.

[54] Some DAPT statutes attempt to nullify the risk of an implied agreement by stating, "[a]n agreement or understanding, express or implied," between the settlor and the trustee that attempts to grant or permit the retention of greater rights or authority than is stated in the trust instrument is void. See Alaska Stat. §34.40.110(j); Del. Code tit. 12, §3571.

[55] Alaska Stat. §13.36.035(c); Del. Code tit. 12, §3570(9); R.I. Gen. Laws §18-9.2-2(8); Nev. Rev. Stat. §166.015(1)(d). Under the revised Alaska Trust Company Act, individuals may serve as fiduciaries only pursuant to certain specific exemptions. Alaska Stat. §06.26.020.

[56] Alaska Stat. §13.36.035(c)(1); Del. Code tit. 12, §3570(9); Okla. Stat. Ann. tit. 31, §11;

will result in DAPT law not being applied to the trust.

Formalities. Another area where a DAPT would be vulnerable to the "alter-ego" theory is if the settlor or members of the settlor's family continued to manage trust assets that had been transferred to the DAPT. If such management is desired, the assets should first be contributed to an FLP or FLLC. The clients may desire that they, or family members, be the general partners or managers. Then, the clients transfer the FLP limited partnership interest or the FLLC nonmanagerial interest to the DAPT. In this way, clients or their family members may retain the ability to manage assets without violating the actual property ownership of the assets.

The contract clause

In addition to the general types of attacks discussed above, some commentators have suggested that a DAPT may be challenged as violating the Contract Clause of the U.S. Constitution.[57] For such a violation to occur, a DAPT statute must substantially impair the obligations of parties to existing contracts or make them unreasonably difficult to enforce.[58] The violation of the Contract Clause occurs because of the retroactive effect of the statute upon contracts that exist on the date of enactment of the statute.[59]

Creative arguments have been made in support of a Contract Clause violation by the new DAPT statutes.[60] The settlor's response would be that a contract creditor still has adequate remedies under the state's fraudulent transfer statute. The contract creditor would contend that if the transfer does not constitute a fraudulent transfer, then the settlor has successfully protected assets which the

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R.I. Gen. Laws §18-9.2-2(8)(ii); Utah Code Ann. §25-6-14(1).

[57] U.S. Const. art. I, §10, cl. 1.

[58] Osborne, *supra* note 46, at 14-26.

[59] *Id.*

[60] Osborne, *supra* note 46; and Boxx, *supra* note 16, at 1230.

contract creditor could otherwise have reached.[61]

The Contract Clause contention applies only to contract creditors who existed on the date of enactment of the DAPT statute. Therefore, with respect to, for example, Alaska and Delaware statutes, this argument could be made only by contract creditors who existed in 1997. As time passes, this argument will become factually irrelevant to settlors forming new DAPTs.[62]

Special types of claims

Each DAPT statute provides express exceptions to the statute's spendthrift protection. For example, Alaska allows a child support claimant to reach the trust assets if the settlor is in default by 30 or more days at the time of the transfer to the trust.[63] Delaware and Rhode Island provide exceptions for debts related to child support, and for alimony or property division claims that existed on or before the date of the qualified disposition.[64] Nevada and Oklahoma do not provide any statutory exceptions. Utah allows a child support claimant to reach the trust assets if the settlor is in default by 30 or more days at the time of the transfer to the trust, and allows spousal claims for alimony or property division whether they occurred before or after the time of the transfer.[65]

Child support. Federal statutes have been enacted to facilitate the collection of court-ordered child support, but personal jurisdiction is still required for full faith and credit.[66] Thus, a state court in the settlor's state of residence will need to obtain personal jurisdiction over the DAPT trustee in order to reach the DAPT assets.

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[61] Osborne, *supra* note 46, at 14-26; Boxx, *supra* note 16, at 1240.

[62] Boxx, *supra* note 16, at 1240, n.295.

[63] Alaska Stat. §34.40.110(b)(4).

[64] Del. Code tit. 12, §3573; R.I. Gen. Laws §18-9.2-5(1).

[65] Utah Code Ann. §§25-6-14(2)(c)(v) and (ix).

[66] The Full Faith and Credit for Child Support Orders Act, 28 U.S.C. §1738B(c).

Alimony. Some states do not provide an exception for alimony. Others provide a limited exception, and one state provides an unlimited exception. An argument has been made that even if a DAPT state's law does not provide an express exception for alimony, the DAPT state courts may well construe the DAPT statutes to allow claims.[67] The legislative history of the relevant DAPT state statute may resolve this issue.

Property division. Similarly, three of the above states do not provide any exception for a property division. Two states provide a limited exception, and one state provides an unlimited exception. Here, it is less likely that the courts, for policy reasons, would construe the DAPT law to add an unlimited exception for a property division. However, a spouse may be able to reach some of the DAPT assets by claiming that the spouse owned such assets prior to their contribution to the DAPT. The success of such an argument may depend on the time the trust was created and the source of assets that were contributed to the trust. If the trust was created prior to marriage, or with assets that the settlor inherited during marriage, the spouse may have no rights to such assets. On the other hand, if the assets were contributed during marriage either from community property or from property in a common law state which is considered "marital property," then one-half of such assets may be considered to belong to the spouse.[68]

Federal tax liability. The question here is whether the federal government may satisfy a tax liability of the settlor from the assets in a DAPT which the settlor had created prior to incurring such tax liability. More specifically, does the federal tax lien[69] apply to the DAPT assets in such a situation? With respect to third-party settled trusts, the IRS' position is that if the trustee has absolute uncontrolled discretion to make distributions to the debtor-beneficiary, the debtor's interest in the

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[67] See Nenno, *supra* note 7, at ¶212.2, B; also see Restatement (Second) of Trusts §157.

[68] See Brooks v. Brooks, 733 P.2d 1044, 1055 (Alaska,1987).

[69] IRC Section 6321.

trust is not subject to the federal tax lien.[70] There does not appear to be any reason to treat self-settled discretionary spendthrift trusts differently from third-party created spendthrift trusts with respect to federal tax liability.[71]

Transfer tax planning

Often, transfer tax planning is a concurrent or a primary purpose of a DAPT.[72] Such planning may be accomplished with an irrevocable trust in any of the six DAPT states. But it cannot be accomplished with a revocable trust, such as the new Oklahoma revocable trust.[73] The issue here is whether Section 2036 or Section 2038 applies to include the DAPT assets in the settlor's estate. If not, the DAPT provides an excellent estate freeze vehicle.

In a state that has not enacted a DAPT statute, a settlor's creditors can reach the maximum amount that the trustee could distribute to the settlor. Consequently, the settlor could "run up" debts, and the settlor's creditors could reach the trust assets to satisfy these obligations. Another way of looking at the situation is that the settlor, indirectly, has retained the ability to reach the trust assets through incurring debts. The settlor can relegate his creditors to the trust assets.

The above-described indirect retention of the trust assets prevents the settlor's transfer to the trust from being a completed gift for gift tax purposes. Reg. 25.2511-2(b) provides that a gift is complete if the donor "has so parted with dominion and control as to leave in him no power to change its disposition, whether for his own benefit or for the benefit of another." The above reasoning illustrates that this test is not satisfied by DAPTs in non-DAPT states. Such indirect retention would

[70] Chief Counsel's Advice, ILM 200036045.

[71] See Nenno, *supra* note 7, at ¶210.5.

[72] See the section of the article entitled "Purposes," above.

[73] See the section on "The newest statute: Oklahoma's revocable trust," above.

result in the trust assets being included in the settlor's estate under Section 2036 and Section 2038.[74] When the policy that allows creditors to reach the assets of a self-settled discretionary spendthrift trust is reversed, the position can be taken that contributions to such trusts are complete for gift tax purposes and should be excluded from the settlor's gross estate. That is, because a settlor's creditors cannot reach the assets of a DAPT, the settlor has not retained the ability to relegate the settlor's creditors to the assets of the trust.

If applicable state law prevents the settlor's creditors from reaching the trust assets, the settlor has parted with dominion and control over the trust assets, and so the gift is complete.[75] Section 2038 does not apply because, as of the date of the settlor's death, the settlor does not have the power to revoke the trust by relegating creditors to the trust assets.

The remaining estate tax issue is whether, under Section 2036(a)(1), the settlor has retained enjoyment of, or the right to income from, the trust assets. Initially, the plain language of the statute which requires "retention" does not seem to apply to a settlor-beneficiary who may receive distributions only pursuant to the absolute discretion of an independent trustee. There are a number of authorities that support the conclusion that retention within the meaning of Section 2036(a)(1) does not exist with respect to the rights of a discretionary settlor-beneficiary.[76] Commentators have reached the same conclusion.[77]

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[74] Section 2036 would probably apply because the settlor has retained the enjoyment of, and income from, the property by the settlor's ability to incur debt which the settlor's creditors may satisfy from trust assets. Section 2038 would apply because the ability to relegate creditors to the trust assets allows the settlor to revoke the transfer of assets to the trust. Rev. Rul. 76-103, 1976-1 CB 293; Rev. Rul. 77-378, 1977-2 CB 347; Paolozzi, 23 TC 182 (1954), *acq*.

[75] The IRS agrees. See Ltr. Rul. 9837007.

[76] These authorities include: Ltr. Rul. 9332006; Ltr. Rul. 8037116; Estate of German, 7 Cl. Ct. 641, 55 AFTR2d 85-1577 (Ct. Cl., 1985); *cf.* Estate of Uhl, 241 F.2d 867, 50 AFTR 1746 (CA-7, 1957). See also Estate of Wells, TCM 1981-574.

[77] Prac. Drafting, (published by U.S. Trust Co. of N.Y.), at 4891 (July 1997); Dodge, 50-5th T.M. (BNA), *Transfers With Retained Interests and Powers*, p. A-23; Stephens, Maxfield, Lind, and Calfee, *Federal Estate and Gift Taxation*, ¶4.08[4][c], p. 4-154 (7th ed., Warren, Gorham & Lamont

Recent Rev. Rul. 2004-64[78] provides strong support for the conclusion that the assets of a well-planned DAPT will not be includable in the settlor's estate. That Ruling involved irrevocable inter vivos trusts that were grantor trusts for income tax purposes. The relevant issue in the Ruling was whether the trustee's reimbursement of the settlor for income tax that the settlor paid on the trust income constituted "the possession or enjoyment of, or the right to the income from" the trust assets so that the value of those assets would be included in the settlor's estate under Section 2036(a)(1). The Service ruled that the trustee's discretion to reimburse the settlor would not alone cause inclusion of the trust assets in the settlor's estate.

Professor Pennell, at the October 2004 Great Western Tax & Estate Planning Conference, pointed out the close analogy between the Ruling's conclusion and the question of whether the assets of a typical DAPT are subject to estate tax inclusion. In a typical DAPT, an independent trustee has absolute discretion concerning whether to make distributions to the settlor. Professor Pennell pointed out that perhaps the IRS will conclude that the assets of a well-planned DAPT will not be includable in the settlor's estate.

Finding "retention" under the existing language of Section 2036, based only on the settlor's status as a discretionary beneficiary, is a significant stretch.[79] In a similar situation involving questionable coverage by Section 2036 of joint purchases of property, the Treasury Department found the need for a statutory change.[80] Professor Pennell concluded, "[i]t was sufficiently unclear whether I.R.C.

1996); but see Pennell, *2 Estate Planning* §7.3.4.2 (Aspen 2003).

[78] 2004-27 IRB 7.

[79] Faulty implementation of the trust could result in estate tax inclusion. The specific choices of trustees, documentation, and pattern of distributions may justify a court finding that an agreement existed between the settlor and the trustee to make certain distributions. This would constitute the retention of an income interest, and Section 2036 would apply. (See Reg. 20.2036-1(a), which finds "retention" under Section 2036 if such an agreement exists; see Rev. Rul. 2004-64.) The result would be inclusion of trust assets in the settlor's estate.

[80] Section 2702(c)(2), enacted in 1990.

§2036(a)(1) would apply to such a case that I.R.C. §2702(c)(2) specifically addresses this form of transaction."[81]

Life insurance. DAPTs have also become a vehicle for the ownership of insurance on settlors' lives. For example, suppose the clients wish to purchase a second-to-die life insurance policy that will develop substantial cash value and will benefit from income tax-free inside buildup. However, the clients want the ability to reach the value of the policy if they have a financial reversal. If the policy is owned by a DAPT, the independent trustee may borrow from the insurance company, or even cash in the policy, in order to make discretionary distributions of cash needed by the settlors.

The fact that the settlors are discretionary beneficiaries of the trust does not appear to be enough to conclude that they have retained "incidents of ownership" in the policy.[82] Nevertheless, careful choices of trustees and drafting are necessary to ensure that such incidents of ownership are not attributable to the settlors.

Statutory exceptions to asset protection. Most of the DAPT states have created exceptions to their spendthrift protection.[83] Some of these exceptions arguably allow the settlor to relegate the settlor's creditors to the assets of the trust to satisfy the excepted type of liability. The issue is whether such exceptions are significant enough to render the settlor's transfers to the trust incomplete for gift tax purposes and includable in the settlor's estate. Certain of these exceptions should not do so. For example, the exceptions for Alaska, Delaware, and Rhode Island would all be known at the time the DAPT was created. If such exceptions existed, either the DAPT would not be formed or sufficient assets would be set aside to satisfy such liabilities. However, the Utah statute appears to go too far.

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[81] Pennell, *supra* note 77, at §7.3.4.1, p. 7.334.

[82] See Ltr. Rul. 9434028; Reg. 20.2042-1(c).

[83] See the discussion under "Special types of claims," *supra*. See Alaska Stat. §34.40.110. Delaware and Rhode Island, for example, provide an exception for tort claimants who suffer injury on or before the date of the qualified disposition by a settlor. Del. Code tit. 12, §3573(2); R.I. Gen.

As a result, transfers to a DAPT created under present Utah law may be incomplete gifts with the above tax consequences.

Is absolute asset protection necessary for estate tax exclusion? It is important to consider the difference between pure asset protection cases and transfer tax litigation. The highly publicized recent foreign trust asset protection cases involved extreme facts and equities that would influence most courts to sympathize with the plaintiff-creditor.[84] The situation is quite different when the asset protection issue is hypothetical and needs resolution only so that the transfer tax issue may be determined.

With respect to residents of DAPT states, sound arguments exist that their DAPTs, if well-planned and implemented, will provide asset protection for the settlors. As a result, strong arguments exist that assets of the DAPT should not be included in the settlor's estate. The asset protection foundation for a nonresident settlor using a DAPT is not absolute. The interesting question is whether such a foundation needs to be perfect for transfer tax purposes.

Theoretical approaches exist for a creditor to reach assets of the DAPT, if the facts are right and if the court follows a specific decision-tree. Are these approaches certain enough to undermine the asset protection foundation, for transfer tax purposes, of a carefully planned and implemented DAPT created for a nonresident? A court, considering only the transfer tax question, could reasonably take the position that the IRS must establish that it is more probable than not that the asset protection foundation will fail before including the DAPT in the settlor's estate.[85]

Laws §18-9.2-5(2). Utah provides numerous exceptions. Utah Code Ann. §25-6-14(2)(c).

[84] E.g., FTC v. Affordable Media, LLC, 179 F.3d 1228 (CA-9, 1999); In re Portnoy, 201 B.R. 685 (DC N.Y., 1996); and In re Brown, 4 Alaska B.R. 279 (DC Alaska, 3/11/96).

[85] For analysis of transfer tax planning and consequences, see Shaftel, "Alaska's Experience With Self-Settled Discretionary Spendthrift Trusts," 29 ETPL 506 (Oct. 2002). See also Shaftel, Special Session materials, *supra* note 33, at pp. I-C-36 through I-C-39; Shaftel, 30 ACTEC J., *supra* note 33, at pp. 24 and 27; and Shaftel, "Domestic Asset Protection Trusts: What You Need to Know," 2004 Great Western Tax & Est. Plan. Conference (Nat'l Law Foundation, 2004).

Conclusion

Six states now have DAPT statutes which provide varying degrees of asset protection and transfer tax benefits. Proper planning and implementation should avoid attacks based on fraudulent transfer, implied agreement, alter-ego, and sham theories. Similarly, good planing will require a "choice of spendthrift trust law" attack to be brought in a state or federal court located in the DAPT state, unless the attack is brought in bankruptcy court.

A "choice of spendthrift trust law" attack may not be successful. The authorities leave significant leeway for a court to apply the choice of law designated in the trust instrument. It seems more likely that such a result would be reached by a court in the DAPT state. Appropriate jurisdictional planning will require that the attack be brought in the DAPT state, unless it occurs in bankruptcy court.

The bankruptcy forum for the choice of law issue is the crucial scenario for the nonresident settlor. The bankruptcy court sitting in the settlor's state of residence can obtain jurisdiction over the DAPT trustee and its assets.

Part 2 of this article, which will appear in the next issue of ESTATE PLANNNING, will analyze a creditor attack in bankruptcy court of a DAPT created by a settlor who is a nonresident of the DAPT state. Part 2 will focus on the special issues that arise under federal bankruptcy law and how a bankruptcy court will approach the key choice of spendthrift trust law issue.

Many DAPTs are created for both asset protection and transfer tax minimization purposes.

A creditor may argue that the court should apply the spendthrift trust law of the state of residence of the settlor, rather than the law of the DAPT state.

The risk of non-DAPT law being applied is thought to be greater when the issue is being considered by a court outside the DAPT state.

Proper planning and implementation of DAPTs should avoid attacks based on fraudulent transfer, implied agreement, alter-ego, and sham theories.

The bankruptcy forum for the choice of law issue is the crucial scenario for the nonresident settlor.

PRACTICE NOTES

Perhaps the most vulnerable area for a DAPT, created in a DAPT state other than Oklahoma, involves the independence of the trustee who has authority to make distributions to the beneficiaries, including the settlor.