ESTATE PLANNING THROUGH AN ASSET PROTECTION LENS –
IT'S NOT JUST SELF-SETTLED TRUSTS

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Synopsis

¶ 400. Introduction

The management, preservation and distribution of wealth is the primary goal of estate planning. In the past, however, many estate planners have limited their energies to minimizing taxes and providing for the orderly disposition of wealth to the client's intended beneficiaries to the exclusion of asset protection planning, to the potential disservice of their clients.

The concept of asset protection planning seemed to be a novel one to most people twenty years ago. Many viewed such planning as limited to offshore structures and were suspicious of clients' motivations when asset protection planning was sought. More recently, with estate taxes impacting fewer clients, asset protection planning has become recognized as an important and integral aspect of the estate planning process. Since Alaska enacted the first domestic self-settled trust legislation in 1997 almost 40% of the states have enacted one form or another of asset protection legislation. This suggests that the future of estate planning itself will require planners to pay as much, if not more, attention to preserving assets from creditors, predators and divorce as we have, in the past, paid to tax minimization. This is due, in no small part, to the increase in the federal estate tax exemption.

Modern society now requires that every estate planner account for the possibility that the client's estate plan may be defeated by his intended beneficiaries' exposure to a creditor risk. This article will focus on those concepts which can be easily integrated into the traditional domestic estate planning process which planners should consider to minimize creditor risk. Just as in other areas of estate planning, there is no one asset protection strategy that fits every client. Rather, the experienced attorney will recommend a combination of strategies which will depend on the client's age, risk exposure, nature of assets, marital status, state of domicile, etc. And if the client resides in a state that does not (yet) recognize the validity of self-settled trusts (vis-a-vis creditors), it may be that other strategies may provide the utmost protection. These include the use of the spendthrift, discretionary and support trusts as well as limited partnerships, limited liability companies, powers of appointment, disclaimers and other tools.

¶ 400.1 Potential Liabilities

Many consider today's social and economic environment both more litigious and more hazardous to the preservation of wealth than in years past. This view is supported when one observes the ever expanding theories of liability, the rise in jury awards, increasingly result oriented courts and the high incidence of marital separation and divorce. Based on these problems of modern society, it is clear that traditional forms of protection against potential liabilities may be inadequate. For example, in the area of insurance, a particular risk may be uninsurable or appropriate coverage may be prohibitively expensive or may become so while the risk remains outstanding.

Corporate officers and directors may also need additional protection. The "corporate veil" may be pierced and in certain circumstances, officers and shareholders can be held liable even without a piercing of the corporate veil. Similarly, a "responsible person" can be held personally liable for failing to withhold certain taxes. There is also potential for individual liability under the Comprehensive Environmental Response, Compensation and Liability Act of 1980 ("CERLCA").

Perhaps one of the areas most ripe for encountering possible liability focuses on pre- or post-nuptial agreements. First, the language in the agreements may be poorly drafted thus leading to potential court proceedings. With the rise in the divorce rate, the courts are deluged with actions which seek to set aside pre- and post-nuptial agreements on several fronts including duress, failure of adequate disclosure and the ineffective assistance of legal counsel. In addition, couples may not enter into an agreement, either because they feel uncomfortable in broaching the subject or for any number of other reasons including time or family pressures. Asset protection planning may work as an alternative or "backstop" to a pre- or post-nuptial agreement for anyone who is married or who is considering marriage.

As can be witnessed by the examples listed above, which are by no means exhaustive, certain classes of persons both obvious and not so obvious, may be at particular risk. These individuals include professionals such as doctors, lawyers, accountants and architects, officers and directors of widely held or public companies and owners, managers and developers of real estate, all of whom are candidates for incorporating asset protection features within an estate plan.

To illustrate the need for asset protection, we need look no further than two relatively recent cases. The first is a divorce proceeding wherein the defendant wife claimed that her husband's remainder interest in a 10 year term trust settled by his mother was subject to equitable distribution. The trust, which was to terminate soon after the divorce proceeding was commenced, provided that the trustee distribute the corpus to the grantor's children, per stirpes. The value of the husband's interest in the trust property was $19 million dollars. The Connecticut Court held that this was a vested property right, which, under state law, is transferable and awarded the spouse 20% of the corpus. Imagine the mother's reaction when she learned that her soon to be ex-daughter in law would receive almost $4 million dollars![1]

The second case involved a parcel of real property left in equal shares to the decedent's three children. The decedent's daughter had filed for bankruptcy two months prior to the decedent's death and, although she disclaimed her interest in the real property, the bankruptcy court found that the disclaimer was ineffective as against the bankruptcy estate and directed her one-third interest in the real property to be sold. Although the daughter attempted to "buy back" her interest in the real property from the bankruptcy trustee, she was ultimately outbid by another relative and forced to relinquish all ownership.[2]

Recently, in my own practice, I met with a young man who was just beginning his career as a real estate developer. In connection with one of his real estate projects, he signed a personal guarantee on a loan for $20 million. The project ultimately failed, the loan was not repaid, and the lender sought to recover its $20 million from the guarantor. As fate would have it, around this time the guarantor's uncle died and left him his New York City apartment outright, valued at approximately $20 million. The young man came to me, hoping that there was some way he could protect the apartment. Of course, a timely disclaimer might have helped (under New York law such a disclaimer would not be a fraudulent transfer) but the taker in default was a charity. Unfortunately, it was too late for any asset protection strategy to be implemented, and the young man was forced to part with his entire inheritance.

In each of these instances, had the donor/decedent provided for a continuing trust for the benefit of the legatee, the assets would have continued to be protected from their predators. Furthermore, even when trusts are provided for they all too often mandate distributions of income and/or principal upon the beneficiary attaining a certain age. Such an approach, however, exposes the assets, once distributed, to the beneficiary's creditors and potential divorce claims. Is this dispositive scheme a result of the client's wishes or a function of the draftperson's approach (and possible bias)? That is, if the attorney asks the client "At what age(s) do you want your beneficiary to receive his/her inheritance?" the client's response might be expected to be a specific age or ages. What if the question were phrased as – "would you want your inheritance to go to your future ex-son-in-law/daughter-in-law?" – which most likely will result in a strongly expressed negative response.

The foregoing examples are only a few which demonstrate why asset protection planning considerations should become a part of every estate planner's "tool box" and, when and where appropriate, incorporated into the client's estate plan. But one must always be mindful of the possible voidable transfer consequences if engaging in such planning too late.[3]

¶ 400.2 Transfers to (or in Trust for) One's Spouse

One of the most basic proactive techniques used in asset protection planning is for an individual who considers himself or herself to be at-risk of potential future creditor claims to simply give money or property to his or her spouse (who presumably is not also at substantial risk of potential future creditor claims). Colloquially, this technique is known as "poor man's asset protection planning" because it need not involve the assistance of an attorney and, therefore, is usually inexpensive to implement. The protection inherent in this technique lies in the fact that the assets are no longer owned by the at-risk spouse and, therefore, should not be subject to his or her potential future creditors.

As an asset protection technique, the most significant (and fairly obvious) downsides of simply giving money or property to one's spouse are (i) that it involves giving up control over the transferred money or property, and (ii) that it involves giving up any certainty of enjoying the transferred money or property since enjoyment must now be through one's spouse. Obviously, the most significant concern here is the possibility (and, tongue-in-cheek, some might even say the "likelihood") of divorce.

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[1] *Dryfoos v. Dryfoos*, 2000 Conn. Super. LEXIS 2004 (Conn. Super. Ct. July 28, 2000).
[2] *In re Stambaugh*, 2010 Bankr. LEXIS 3141 (Bankr. N.D. Iowa September 17, 2010).
[3] A discussion of voidable/fraudulent transfers is beyond the scope of this article.

Moreover, for certain individuals, a further issue exists where the transferee spouse is not a United States citizen since the unlimited marital gift tax deduction (which serves to negate any gift tax consequences in connection with the transfer of money or property to one's spouse) only applies where the transferee spouse is a United States citizen; where the transferee spouse is not a United States citizen, the transferor spouse is limited under current law to transfers of no more than $148,000 per annum unless he or she is prepared to make a taxable gift in connection with the transfer.

Another issue with the transfer of all of the assets of one spouse to the other spouse is the fact that it may be inefficient for estate tax purposes. Even with portability, unless the first spouse to die has money or property in his or her individual name in an amount at least equal to the state estate tax exemption amount, his or her state estate tax exemption will be wasted and an unnecessary estate tax will likely result upon the later death of the second spouse to die. Neither does portability apply in the generation skipping transfer tax context or to the potential increase in the value of the transferred assets after the first spouse's death. And, of course, no matter what the probability that one might be named as a defendant in a lawsuit, and ultimately lose that lawsuit, death is and always has been the one ultimate certainty.

In a typical community property jurisdiction, the community property is exposed to the debts and creditors of both spouses. Therefore, the community property form of ownership, imposed by state law, provides additional exposure. Planners desiring to implement effective asset protection strategies for residents of community property jurisdictions or, for the community property of residents of separate property jurisdictions, must first transmute the community property into separate property.

¶ 401. Trusts--in General

¶ 401.1 Overview

Today, trusts serve a number of purposes in estate planning. Most commonly, modern trusts are incorporated into an estate plan for the primary, if not exclusive, intended purpose of minimizing taxation. However, trusts should also be recognized as a useful device to protect assets from the beneficiary's predators and creditors.

A review of the history of trusts helps us to understand how this planning technique developed. The modern form of trust owes its origins (as well as an historical function as an asset protection tool) to the system of "uses" which is reported to exist as far back as the 13th century. In order to defeat creditors, a debtor would convey legal title to the debtor's land to another individual but, nevertheless, retain the use of the land to himself. Because the debtor no longer held legal title to the land, the debtor's creditors were unable to attach the land in satisfaction of their claims. The "use" arrangement was also popular since it avoided the onerous feudal taxes which were imposed upon the occurrence of various events including the death of the owner of the property. In order to recapture lost tax revenues, the Statute of Uses[4] was passed in 1536 converting the use interests into legal estates owned by the beneficiaries thereof. The restrictions imposed by the Statute of Uses were gradually reformed and by the 17th century the modern form of trust came into existence.

¶ 401.2 Trust Benefits

The trusts of today serve a number of estate planning purposes, including tax minimization. For example, a "credit shelter" trust is commonly used to preserve for the benefit of the surviving spouse that portion of the decedent's estate which is exempt from estate taxes by reason of the decedent's unified credit while at the same time preventing the property from later being taxed as a part of the surviving spouse's estate. In addition, property against which a sufficient amount of the transferor's GST exemption has been allocated can pass from generation to generation without further transfer tax if such property is transferred and retained in continuing trust.

Trusts can provide additional benefits, other than minimizing taxes. By creating a trust, assets may be protected from a beneficiary's own extravagance or bankruptcy. Trusts also serve to protect assets for the benefit of the intended beneficiary by limiting the exposure of the assets to possible claims which may arise in tort, in contract or by virtue of statute, by reason of the actions of the beneficiary. Another benefit of creating a trust lies in the fact that a trust serves to

[4] 27 Hen. VIII, c.10 (1536).

protect assets from the beneficiary's ex-spouse,[5] in-laws and other potential predators and preserves wealth within the intended class of beneficiaries (i.e., the descendants of the grantor). In particular, the potential to protect property from a beneficiary's creditors through the simple mechanism of transferring the property in trust, rather than outright, weighs heavily in favor of a more widespread use of trusts.

In certain planning situations, estate planners often fail to consider the benefits of using a trust. For example, where a parent decides to transfer the ownership of a life insurance policy to his or her children in order to permit the death benefit to pass without estate tax, the cash value and death benefit could be subject to the potential claims of the children's creditors.[6] Clearly, the same tax result could be achieved by using an irrevocable "insurance" trust while at the same time providing the guarantee that should one or more of the children predecease, the proceeds will not be paid to their surviving spouses. In addition, consideration should be given to continuing the asset protection by providing that the property be retained in trust for as long as possible under the trust's governing law.

Another common situation which should be re-evaluated is the outright marital bequest. Any outright transfer to a surviving spouse will be subject to the surviving spouse's creditors. Thus, a marital trust is in almost all situations preferable to an outright disposition because it can provide a significant level of asset protection.

¶ 401.3 Trusts as an Alternative to an UGMA/UTMA Account

Trusts should also be considered as an alternative to a Uniform Gifts/Transfers to Minors Act account ("UGMA/UTMA" account). In weighing whether to use a trust over a UGMA/UTMA account, one must look to the fact that the balance of the account must be paid outright to the beneficiary upon attaining either age eighteen or twenty-one; at which time, either because of the beneficiary's tender age or because of external circumstances, it may be inappropriate to distribute the account to the beneficiary. This may be especially true when one considers that substantial (and often unexpected) growth within the UGMA/UTMA account can occur over the course of those eighteen to twenty-one years.

Even where the account was established with the intent that it be used to cover a substantial expense such as higher education there is nothing that requires the beneficiary to use the account proceeds for such purpose. In light of the beneficiary's newfound "financial freedom", the beneficiary may decide not to continue his or her education, or may obtain a scholarship and, therefore, not need to use the account proceeds to cover his or her higher education expenses. Another factor favoring the use of a trust over an UGMA/UTMA account occurs when one considers that the beneficiary's maturity and financial ability are unlikely to be fully developed at the age when the law requires that the account be distributed to the beneficiary outright.

One potential risk lies in the fact that the beneficiary's spouse (or at the very least the strength of the beneficiary's marriage) is unlikely to be known when the child reaches majority. Similarly, the estate planner must recognize that the property will be subject to the child's creditors, both during the existence of the UGMA/UTMA account and following an outright distribution to the child. If an UGMA/UTMA account has previously been established, consider using a family limited partnership as a fall back option, if state law permits custodians to hold title to a partnership interest. The custodian of the UGMA/UTMA account can contribute the account assets to a family limited partnership (in which the beneficiary's parents are the general partners) in exchange for an interest therein. In this manner, when the beneficiary attains the age of majority, the beneficiary will only become entitled to an interest in the limited partnership (which provides its own asset protection) rather than the underlying assets. However, there is a risk that a transfer to a family limited partnership may constitute a breach of fiduciary duty by the custodian, which might invite a lawsuit by the beneficiary.

In contrast, a trust provides a number of benefits for a relatively young and immature beneficiary. Subject to the applicable rule against perpetuities, if any, a trust for the beneficiary and his or her issue can continue for the beneficiary's entire lifetime. A trust can also provide for professional financial management until such time as the beneficiary has acquired sufficient financial ability. With this in mind, when structuring distributions to the beneficiary, many attorneys

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[5] *See e.g, Pfannenstiehl v. Pfannenstiehl*, 55 N.E.3d 933 (Mass. 2016).

[6] For a state by state analysis of exemptions available for life insurance see, Gideon Rothschild and Daniel Rubin, "Creditor Protection for Life Insurance and Annuities," Journal of Asset Protection, May 1999, also available at http://www.mosessinger.com/site/files/CreditorProtectionLifeInsuranceAnnuities.pdf.

draft wills and trusts providing, for example, for the distribution of principal to the beneficiary in thirds at ages thirty, thirty-five and forty. If the beneficiary should waste the first third through excessive spending, and lose the second third through an unwise business venture, the beneficiary will hopefully have learned enough to preserve the final third when it is ultimately distributed. Such arrangements may be shortsighted however.

Despite all of the benefits associated with creating a trust over an UGMA/UTMA account, the additional cost inherent in creating, maintaining and accounting for trusts, not to mention the potential increased income taxation by reason of the substantially compressed income tax brackets applicable to trusts (where the trust is not a "grantor trust"), is a consideration which must be weighed when deciding whether to establish a trust for relatively small sums.

¶ 402. Spendthrift Trusts

¶ 402.1 Overview

A spendthrift trust is defined as a trust "in which the interest of a beneficiary cannot be assigned by him or reached by his creditors. ..."[7] This type of trust provides a fund for the maintenance of a beneficiary, while possessing many positive asset protection planning benefits.

Today, the validity of spendthrift trusts in protecting trust property from a beneficiary's creditors is practically universally accepted in the United States. Each of the fifty states recognizes the validity of spendthrift clauses to protect a third party beneficiary's interest from almost every type of creditor claim. Uniform Trust Code § 502(c) provides that "[a] beneficiary may not transfer an interest in a trust in violation of a valid spendthrift provision and, except as otherwise provided in this [article], a creditor or assignee of the beneficiary may not reach the interest or a distribution by the trustee before its receipt by the beneficiary." According to the Comment to Uniform Trust Code § 502, "[u]nless one of the exceptions under this article applies, a creditor of the beneficiary is prohibited from attaching a protected interest and may only attempt to collect directly from the beneficiary after payment is made." This section is similar to Restatement (Third) of Trusts § 58 (2003) and Restatement (Second) of Trusts §§ 152-153 (1959).

It is predicated on the public policy consideration that a person is free to make any desired disposition of his property.[8] It was actually not until the Supreme Court decision in *Nichols v. Eaton*[9] in 1875, however, that a break with the English common law on spendthrift trusts was effected and their validity became generally accepted throughout the United States. In establishing the modern rule with regard to spendthrift trusts, the Supreme Court stated that "[w]e concede that there are limitations which public policy or general statutes impose upon all dispositions of property, such as those designed to prevent perpetuities and accumulations of real estate ... We also admit that there is a just and sound policy ... to protect creditors against frauds upon their rights ... But the doctrine, that the owner of property ... cannot so dispose of it, but that the object of his bounty ... must hold it subject to the debts due his creditors ... is one which we are not prepared to announce as the doctrine of this court."[10] Interestingly, the pre-*Nichols* rule providing that disabling restraints are void as against an individual's creditors remains, upon public policy grounds, the law in England to this day.[11]

A spendthrift trust is usually created by a mere demonstration of the settlor's intent that the beneficiary's trust interest should not be subject to either voluntary or involuntary alienation. For example, Uniform Trust Code § 502(b) provides that "[a] term of a trust providing that the interest of a beneficiary is held subject to a "spendthrift trust," or words of similar import, is sufficient to restrain both voluntary and involuntary transfer of the beneficiary's interest." Similarly, in Texas, legislation provides that "[a] declaration in a trust instrument that the interest of a beneficiary shall be held subject to a 'spendthrift trust' is sufficient to restrain voluntary or involuntary alienation of the interest by a beneficiary

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[7] 2A Austin W. Scott & William F. Fratcher, The Law of Trusts § 151, at 83 (4th ed. 1989).

[8] *Estate of Johnson*, 252 Cal. App.2d, 923, 925 (1967)

[9] 91 U.S. 716 (1875).

[10] *Id.* at 725.

[11] *See, e.g., Surman v. Fitzgerald (In re Fitzgerald)*, 1 Ch. 573 (1904), rev'g 1 Ch. 933 (1903) (stating that although restraints on the alienation of beneficial trust interests are not permitted under English law, they are not so far contrary to public policy as to preclude the English courts from enforcing them in trusts validly created under Scottish law). *See also*, Adam J. Hirsch, "Spendthrift Trusts and Public Policy: Economic and Cognitive Perspectives," 73 Wash. U. L. Q. 1 (1995) (discussing the economic and social factors which warrant the recognition of spendthrift trust restrictions).

..."[12] In other jurisdictions, the creation of a spendthrift trust is effected by default.[13] In either such circumstance, however, the prudent estate planner should ensure that an express and inclusive "spendthrift" provision is drafted into the trust agreement.

A spendthrift trust which is valid under state law will also be excluded from the estate in bankruptcy.[14] The bankruptcy code provides that "[a] restriction on the transfer of a beneficial interest of the debtor in a trust that is enforceable under applicable non-bankruptcy law is enforceable in a case under this title."[15]

¶ 402.2 Self-Settled Spendthrift Trusts

When assessing the possibility of establishing a spendthrift trust, it is important to consider that a majority of states do not recognize the validity of spendthrift clauses to protect a settlor's retained beneficial interest in the trust (a so-called "self-settled trust"), even though the settlor's interest may be wholly discretionary. The law is well established on this point. "(1) Where a person creates for his own benefit a trust with a provision restraining the voluntary or involuntary transfer of his interest, his transferee or creditors can reach his interest. (2) Where a person creates for his own benefit a trust for support or a discretionary trust, his transferee or creditors can reach the maximum amount which the trustee under the terms of the trust could pay to him or apply for his benefit."[16] The fact that the settlor did not intend to defraud creditors is found to be immaterial.[17]

The foregoing rule is even applicable where the self-settled trust is a discretionary or support trust (each discussed in more detail hereinbelow). The reason being that where a trust is purely discretionary, there is a possibility that the trust may be invaded by the settlor to pay his or her debts. Thus, if the trustee has absolute discretion to pay the income or expend it for the settlor's benefit, then he or she could pay it all to the settlor even though the trustee had the discretion to pay it to others.[18] "The public policy which subjects to the demands of a settlor's creditors the income of a trust which the trustee in his discretion may pay to the settlor applies no less to a case where the trustee might in his discretion pay or use the income for others."[19] Since 1997, however, seventeen states have enacted legislation extending spendthrift protection to a settlor-beneficiary of a discretionary trust (provided that the funding of the trust is not a fraudulent transfer): Alaska, Delaware, Hawaii, Michigan, Mississippi, Missouri, Nevada, New Hampshire, Ohio, Oklahoma, Rhode Island, South Dakota, Tennessee, Utah, Virginia, West Virginia and Wyoming.

¶ 403. Exceptions to Spendthrift Trust Protection

¶ 403.1 Overview

Notwithstanding the general validity of the spendthrift trust rule, there are exceptions that exist with respect thereto. The interest of the beneficiary often can be reached in satisfaction of an enforceable claim against the beneficiary by the beneficiary's spouse or child for support, or by the spouse for alimony. Similarly the beneficiary's interest is not safe from creditors seeking to recover for necessary services rendered to the beneficiary or necessary supplies furnished to him or her. In the same vein, services rendered and materials furnished which preserve or benefit the interest of the

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[12] TEX. PROP. CODE, tit. 9 § 112.035 (2016).

[13] *See, e.g.,* N.Y. EST., POWERS AND TRUSTS § 7-1.5(a)(1) (2016). ("The right of a beneficiary of an express trust to receive the income from property and apply it to the use of or pay it to any person may not be transferred by assignment or otherwise unless a power to transfer such right, or any part thereof, is conferred upon such beneficiary by the instrument creating or declaring the trust"). *See also* Restatement (Third) of Trusts § 58 (2003). With regard to an exception for dependents, *see, e.g.,* N.Y. EST., POWERS & TRUSTS § 7-1.5(d). With regard to an exception for the United States, *see, e.g., First Northwestern Trust Company v. Internal Revenue Service*, 622 F.2d 387 (8th Cir. 1980); *United States v. Rye*, 550 F.2d 682 (1st Cir. 1977) (an interest in a spendthrift trust constitutes the taxpayer's property for purposes of a federal tax lien.).

[14] 11 U.S.C. § 541(c)(2).

[15] Id

[16] Restatement (Third) of Trusts § 58 (2003); Uniform Trust Code §505(a)(2).

[17] 2A Austin W. Scott & William F. Fratcher, The Law of Trusts § 156, at 165-167 (4th ed. 1989).

[18] 2A Austin W. Scott & William F. Fratcher, The Law of Trusts § 156, at 167 (4th ed. 1989).

[19] 120 Conn. 211, 223 (1942). As to purely discretionary trusts, *see, e.g., Greenwich Trust Company v. Tyson*, 120 Conn. 211, 223 (1942).

beneficiary are also enforceable claims, as are claims against the beneficiary by the United States or a State to enforce a tax claim.[20]

¶ 403.2 Public Policy Exceptions

In general, these exceptions to the protection afforded by a spendthrift trust concern themselves with the nature of the creditor's claim. On the one hand are those instances where the claimant dealt with the beneficiary of the claimant's own free will was and fully cognizant of the limitations on the claimant's potential for recovery of his or her claim and was willing to submit thereto. On the other hand is the case of the spouse or child of the beneficiary for support or alimony. It is clear that public policy dictates that the beneficiary should not be permitted to have the enjoyment of his or her interest under the trust while neglecting to support his or her dependents. Despite the exception with respect to support and alimony, "[e]ven though the beneficiary's wife has obtained a decree for alimony directing the beneficiary to pay certain sums to her, she cannot compel the trustee to pay her the full amount so decreed unless the court which has jurisdiction over the administration of the trust deems it to be fair to the beneficiary himself to compel the trustee to make such payment. The result is much the same as though the trust were created, not solely for the benefit of the beneficiary, but for the benefit of himself and his dependents."[21]

Whether or not a trust contains a spendthrift provision, Uniform Trust Code § 504(b), which speaks to discretionary trusts, provides that a creditor of a beneficiary generally may not compel a distribution from a discretionary trust, even if the discretion is expressed in the form of a standard of distribution, and even if the trustee has abused the discretion. As per the comment to Uniform Trust Code § 504, the power to force a distribution due to an abuse of discretion or failure to comply with a standard belongs solely to the beneficiary. Notwithstanding the foregoing, however, under Uniform Trust Code § 504(c), to the extent that a trustee has not complied with a standard of distribution, or has abused a discretion, a distribution may be ordered by the court to satisfy a judgment or court order against the beneficiary for support or maintenance of the beneficiary's child, spouse, or former spouse, and the court shall direct the trustee to pay to the child, spouse, or former spouse such amount as is equitable under the circumstances but not more than the amount the trustee would have been required to distribute to or for the benefit of the beneficiary had the trustee complied with the standard or not abused the discretion.

¶ 403.3 Tort Creditors

Another exception to spendthrift trust protection relates to tort creditors. It is possible that a person who has a claim in tort against the beneficiary of a spendthrift trust may be able to reach that interest under the trust.[22] In *Sligh v. First National Bank of Holmes County*[23], the defendant was a trustee of two spendthrift trusts which had been established for the beneficiary's benefit by his mother. In 1993, the trust beneficiary was involved in a motor vehicle accident which left the plaintiff paralyzed. The plaintiff won a civil judgment against the beneficiary and tried to collect against the trusts alleging that the beneficiary's mother had actual knowledge that the defendant was an alcoholic and had created the trusts to shield his interest from the likely claims of involuntary tort creditors. The Mississippi Supreme Court ultimately allowed the plaintiff to collect against the trusts by concluding that spendthrift protection should not extend to judgments arising from gross negligence and intentional torts.[24] The Mississippi legislature promptly negated the import of *Sligh* in future cases through enactment of the "Family Trust Preservation Act of 1998."[25] That act provides that except in the case of a self-settled trust, a beneficiary's interest in a spendthrift trust may not be transferred nor subjected to a money judgment until paid to the beneficiary.

¶ 403.4 Cases Involving United States or a State to Satisfy a Tax Claim

Another well recognized exception to the protection afforded by a spendthrift trust may be found in cases involving the United States or a State to satisfy a tax claim against the beneficiary. In *Internal Revenue Service v. Orr (In re*

[20] Restatement (Third) of Trusts § 59 (2003); Uniform Trust Code §503(b).

[21] Restatement (Third) of Trusts § 59, cmt. b. (2003); *See also, Read v. United States ex rel. Department of Treasury*, 169 F.3d 243 (5th Cir. 1999).

[22] Restatement (Third) of Trusts § 59, cmt. a-a(2). (2003).

[23] 704 So. 2d 1020 (Miss. 1997). *See also, Scheffel v. Krueger*, 782 Ad.2d 410 (N.H. 2001)(finding that tort claims were not excepted from the protections of spendthrift clauses).

[24] *Id.* at 1028.

[25] MISS. CODE ANN. §§ 91-9-501, et seq. (1998).

Orr)[26], the Fifth Circuit recognized the unique status held by the government as a creditor and found that "the government does not stand in the shoes of an ordinary creditor seeking to attach distributions from a spendthrift trust. Consistent with the imperative nature of tax collection, IRC § 6321 gives the government an advantage over ordinary creditors in collection matters. Moreover, the rationale for shifting the risk of default to creditors, who ought to examine the terms of a trust before agreeing to accept the right to future distributions as collateral, does not apply to the government, which imposes the income tax unilaterally and without reference to spendthrift protections."[27] Similarly, in *Leuschner v. First Western Bank and Trust*[28], the Court stated that "[t]here is no doubt that the paramount right to collect taxes of the federal government overrides a state statute providing for exemptions." However, it has been noted that the government cannot possess a greater right to property than the taxpayer himself,[29] and in *United States v. Butler*[30] the Court found that, because the beneficiary had no right to distributions from a spendthrift trust (the trustee had complete discretion to make (or not make) distributions to him), the IRS could not foreclose its tax lien on the undistributed assets of the trust.

¶ 403.5 Creditor Furnished Necessary Services or Supplies

As mentioned previously, another exception to the asset protection aspects of the spendthrift trust occurs where the claimants rendered necessary services or furnished necessary supplies to the beneficiary. Again, it appears that public policy dictates such an exception. Without this exception, a beneficiary would be unable to obtain necessary assistance, and a refusal to enforce such a claim is not required to protect the beneficiary's interest under the trust.[31] Similarly, where a claimant rendered services or furnished materials which preserve or benefit the interest of the beneficiary, an exception will be found. The basis for the exception lies in the doctrine of unjust enrichment.[32]

¶ 404. Support Trusts

¶ 404.1 Overview

A "support trust" is a trust which empowers the trustee to pay to the beneficiary as much of the trust income as is necessary for the beneficiary's support, education and maintenance.[33] Like a discretionary trust (and unlike a spendthrift trust) a support trust is protective of the beneficiary's interest by reason of the very nature of the beneficiary's trust interest; to wit, the beneficiary is only entitled to distributions which are required for his support.

¶ 404.2 Support Trust Suggestions

The definition of what constitutes support varies by jurisdiction. Some jurisdictions define support by reference to the beneficiary's station in life, and in other jurisdictions support is defined under a more objective standard. Since courts will generally defer to the intention of the settlor, the trust agreement ideally should define what the settlor intends to include within the concept of the beneficiary's "support." Notably, the term "support" is generally deemed to include the support of the beneficiary's dependents.

Support trusts are most appropriate when the settlor does not want to give the trustee expansive discretion over distributions. Notwithstanding the foregoing, however, an express spendthrift clause should nevertheless be included in any support trust.

¶ 405. Discretionary Trusts

¶ 405.1 Overview

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[26] 180 F.3d 656, 663 (5th Cir. 1999).
[27] *Id.*
[28] 1261 F.2d 705, 708 (9th Cir. 1958).
[29] *U.S. v. Durham Lumber Co.*, 363 U.S. 522, 525-526 (1958.
[30] 2009 U.S. Dist. LEXIS 39559 (W.D. Tex. February 12, 2009).
[31] Restatement (Third) of Trusts § 59, cmt. b. (2003).
[32] Restatement (Third) of Trusts § 59, cmt. b. (2003).
[33] Black's Law Dictionary 1654 (9th ed. 2009).

Other types of protective trusts can be used to protect the beneficiary's interest on the basis that the beneficiary's interest in the trust is sufficiently tenuous so that it does not qualify as a property right which is subject to attachment by creditors.

"Discretionary" trusts are trusts in which distributions to the beneficiary are left wholly within the discretion of the trustee and (generally) without regard to any ascertainable standard. Discretionary trusts are defined in Black's Law Dictionary as a "trust in which the settlor has delegated nearly complete or limited discretion to the trustee to decide when and how much income or property is distributed to a beneficiary."[34] By using a discretionary trust, the beneficiary's creditors cannot compel the trustee to pay any part of the income or principal.[35] This is so due to the nature of the beneficiary's interest rather than due to a prohibition of alienation. Because the beneficiary cannot compel payment to him or herself or for his or her benefit, the assets of the trust remain out of creditor reach.[36]

Thus, discretionary trusts differ from spendthrift trusts. The interest of a beneficiary of a discretionary trust does not, in the first instance, qualify as a property right; therefore, even preferred creditors are generally precluded from accessing a discretionary trust in satisfaction of their claims against the beneficiary.[37]

¶ 405.2 Requirements

Depending on the jurisdiction, a discretionary trust may or may not afford protection against claims of the beneficiary's creditors where the trustee's discretion is subject to a standard depending upon whether the standard is itself subject to the absolute and uncontrolled discretion of the trustee. For example, in a technical advice memorandum, the Internal Revenue Service determined that a taxpayer had an identifiable property interest in a trust to which a federal tax lien could attach where the trust provided that the trustee "shall pay to or apply for the benefit of [the taxpayer], as much of the net income [or, if the trustee should determine that the income payments are insufficient, so much of the principal, as well] as the trustee, in the ... trustee's discretion, *shall* deem necessary for [the taxpayer's] proper health, maintenance, support, and education".[38] In so holding, the Internal Revenue Service stated that "[w]e believe that, here, the taxpayer has, at a minimum, the right to an amount necessary for his health, maintenance, support, and education, as provided in the trust and that that right is subject to collection."[39]

Similarly, in *United States v. Taylor*[40], the trust provided that the trustees "shall pay" to the beneficiary so much of the income from the trust as the trustees deem necessary for the proper care, maintenance, and support of the beneficiary. The court held that because the "shall pay" language is mandatory it conveyed an intent of the testator that his son was to receive support payments from the net income of the trust if he needed such support. Thus, the Court found that the trust was *not* discretionary because the trustee could be compelled to exercise his or her discretion.[41] In contrast, however, in *First of America Trust Company v. United States*[42], the tax court held that a trust was discretionary notwithstanding language that the trustee "shall" pay the income and so much of the principal as the trustee in the exercise of sole discretion should deem necessary for the beneficiary's support, comfort and welfare. The prudent estate planner should, however, work to avoid creating a "discretionary" trust subject to a standard except in instances where the settlor insists upon the use of the standard and fully comprehends the potential problems which it may create.

Unless the discretionary trust also contains a valid spendthrift clause or is restricted under state law, the beneficiary can generally assign his interest in the trust. The fact that the trustee is given discretion as to the amount payable to the beneficiary, however, may in and of itself be held to be indicative of the settlor's intent that the beneficiary's interest also be inalienable.[43] Even if the beneficiary's interest in a discretionary trust is not also determined to be inalienable,

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[34] Black's Law Dictionary 1650 (9th ed. 2009).
[35] Restatement (Third) of Trusts § 60 (2003).
[36] *Id.*; 2A Austin W. Scott & William F. Fratcher, The Law of Trusts § 155, at 154 (4th ed. 1989).
[37] *See, e.g., First Northwestern Trust Co. v. Internal Revenue Service*, 622 F.2d 387 (8th Cir. 1980).
[38] Tech. Adv. Mem. 2000-176-65 (Sept. 11, 2000).
[39] *Id.*
[40] 254 F. Supp. 752 (N.D. Cal. 1966).
[41] *Id.* at 755.
[42] 93-2 T.C.M. (CCH) 50,507 (1993).
[43] *See, e.g.,* 2A Austin W. Scott & William F. Fratcher, The Law of Trusts § 152.4, at 119 and § 155 at 157 (4th ed. 1989).

however, a creditor that seizes the interest of the beneficiary can still only hope that the trustee will exercise the trustee's discretion to make a distribution; the creditor still cannot force the trustee to do so.

A court will generally not substitute its judgment for the judgment of a trustee, provided that the trustee exercises the trustee's judgment in good faith and within reasonable bounds.[44] Even where the trustee's discretion is stated to be absolute and uncontrolled (or in similar broad terms), however, the trustee's exercise of that discretion will nevertheless remain subject to judicial review. This rule, however, has been statutorily altered in several states so that a trustee's discretion which is stated to be absolute will not be interfered with for any reason.[45]

A trust does not protect the beneficiary's interest where the discretion of the trustees is merely as to the time of payment, and where the beneficiary is ultimately entitled to the whole or to a part of the trust property. For example in *In re Nicholson's Estate*[46], the Court found that a will providing that "all moneys remaining & other things of value [would be left to a trustee] to be kept in trust for his two boys to be given them at [trustee's] discretion" conferred discretion in the trustee merely as to the time and manner of payment.

¶ 405.3 Supplemental Needs Trusts

A different form of the discretionary trust is found in a "supplemental needs" trust. A supplemental needs trust is defined as "... a discretionary trust established for the benefit of a person with a severe and chronic or persistent disability. ..."[47] A supplemental needs trust is created with the intent of benefiting the beneficiary while at the same time accomplishing two related goals. The first is protecting the trust fund from the claims of governmental units charged with providing certain benefits to the beneficiary. The second is to preserve the beneficiary's entitlement to governmental services (i.e., "Medicaid") which are granted based upon the financial need of the recipient. The discretion granted to the trustee of a supplemental needs trust will generally expressly preclude the distribution of trust assets which may supplant, impair or diminish government benefits or assistance for which the beneficiary may otherwise be eligible or which the beneficiary may be receiving. Some states have enacted specific legislation to enable such trusts to enjoy protection from creditors.[48]

A supplemental needs trust should be considered where the beneficiary is already receiving government benefits at the time of the creation of a trust or such benefits are being contemplated or where the beneficiary is suffering under a physical or mental impairment which may qualify the beneficiary for government benefits at some point in the future.

¶ 406. Split/Interest Trusts

In light of the self-settled trust rule, it is imperative to consider the impact on certain split-interest trusts (i.e., "QPRTs," "GRATs," "CRATs" and "CRUTs") which are commonly used for estate planning purposes. It is well settled that "[w]here the only interest that the settlor has created for himself under the trust is a right to the income for life or for some other period, it is this interest alone that his creditors can reach, unless the creation of the trust was a disposition in fraud of his creditor."[49]

While Qualified Personal Residence Trusts ("QPRTs") are commonly used to leverage the settlor's unified credit in connection with a transfer of a personal residence of the settlor; the same trust may also provide substantial asset protection to the settlor. In creating the QPRT, the settlor has transmuted his or her interest in real property from an absolute interest, subject to foreclosure and sale, into a mere right to reside in the residence for a term of years. Moreover, the settlor's right to reside in the property may be coincident to a concurrent right of the settlor's spouse. If the settlor does not have a spouse with a concurrent right to the use of the residence, a creditor of the settlor may be able to cause the sale of the property within the trust, which (under a properly drafted QPRT) would have the effect of converting the QPRT into a grantor retained annuity trust for the remainder of its initial term of years. Even then, however, the annuity interest which the creditor can reach is substantially less valuable than an immediate right to possess the entire corpus.

[44] *Read v. United States ex rel. Department of Treasury*, 169 F 243, 254 (5th Cir. 1999).
[45] See e..g., NEV. REV. STAT. § 166.110 (1991); DEL. CODE ANN., tit. 12 §3526
[46] 50 A.2d 283 (1946).
[47] N.Y. EST., POWERS AND TRUSTS § 7-1.12(5).
[48] *See, e.g.*, N.Y. EST., POWERS AND TRUSTS § 7-1.12(a)(5)(ii).
[49] 2A Austin W. Scott & Willliam F. Frachter, The Law of Trusts at § 156, at 167 (4th ed. 1989).

Estate planners should also consider continuing the property in trust past the required initial term of years in order to maintain the spendthrift protection for the benefit of the settlor's beneficiaries.

An undisputed benefit of creating a QPRT is that by establishing the trust, one can counter a future creditor's claim that the transfer of the settlor's personal residence to the QPRT should be voided as a fraudulent transfer. Specifically, since a substantial estate tax savings was likely realized in connection with the creation of the QPRT, it is at least as likely that the settlor's intent was estate tax savings rather than an intent to defraud his creditors.

While the benefits of creating a QPRT are numerous, there are certain circumstances where a transfer of the settlor's principal residence to a QPRT may be inappropriate. For example, where the settlor is domiciled in a state with an unlimited homestead exemption which may or may not extend to a residence held in a QPRT. Another such situation arises where the settlor may own the real estate together with the settlor's spouse as tenants by the entirety (which may provide its own asset protection) and, under the circumstances at issue, ownership of the real property as tenants by the entirety is believed to afford greater protection than would a QPRT.

¶ 407. Spousal Lifetime Access Trusts (SLATs)

If the client is married, a spousal lifetime access trust (or SLAT), which is nothing more than a discretionary trust for the benefit of the settlor's spouse, and which might also sprinkle distributions among descendants, may be the best strategy as there is no question that such trusts would be protected from the settlor's creditors in every state. Assuming both the client/settlor and the spouse are US citizens, unlimited distributions can be made to the spouse which can be expended for the couple's mutual benefit. The trust can be drafted as an incomplete gift by having the settlor retain a veto power over distributions as well as a testamentary limited power of appointment.[50]

A concern with the foregoing strategy, however, is what happens if the client gets divorced or the donee spouse predeceases the settlor. There are a few possible tweaks that one might consider incorporating into a SLAT in light of these issues. One option would be to provide that if the settlor is unmarried at any time (due to divorce or death) he or she then becomes a trust beneficiary[51]. If the settlor remarries, the trust can provide that "spouse" shall be defined as the person to whom the settlor is married to from time to time (the "floating" spouse provision).[52] Other options include giving the trustee the power to make loans to the settlor, giving a third party the power to add to the class of beneficiaries (including the settlor) or giving the donee spouse a limited power to appoint in favor of the donor spouse if she predeceases the donor. However, the latter approach may not avoid the self-settled trust exposure due to the relation back doctrine[53].

Another factor to consider is whether the settlor's beneficial trust interest will be protected where the settlor transfers property in trust for the benefit of his or her spouse with only a remainder interest retained for the settlor's own benefit. If effective, this type of trust presents useful planning opportunities since the settlor is unlikely to need to have the trust property directly available to him so long as the trust property is available for the benefit of his spouse. Although it has been noted both that "[t]he mere fact that the interest of a beneficiary of a trust is a future rather than a present interest does not prevent him from assigning it or prevent his creditors from reaching it" and that "[w]here his interest is vested, the mere fact that it is subject to being divested does not prevent his creditor from reaching it ...," the delay in vesting together with the potential of divestiture should serve to reduce the value of the settlor's retained interest *vis a vis* his creditors and provide substantial leverage in settlement negotiations.[54]

Although a "self-settled" spendthrift trust may not be protected from the settlor's creditors in most states, this is not to say that a non-self-settled spendthrift trust cannot still indirectly benefit the settlor. A trust of this sort can also provide

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[50] See I.R.S. Chief Couns. Mem. 201208026 (February 24, 2012).

[51] See, e.g., *Greenwich Trust Co. v. Tyson*, 27 A.2d 166 (Conn. 1942).

[52] However, if the attorney is representing both husband and wife, the attorney must consider the potential conflict of including such a provision that could be detrimental to one of the clients (here, the non-settlor spouse). Such a discussion is outside the scope of this article, but see the discussion of conflicts in representing a husband and wife 801-2nd T.M., *Conflicts, Confidentiality, and Other Ethical Considerations in Estate Planning*.

[53] "According to [the relation back] doctrine, the exercise of the power [of appointment] is regarded as a part of the instrument creating the power. The appointee is said to take the property from the donor and not from the donee." Simes, Lewis M., Handbook of the Law of Future Interests, 128 (2d ed.1966)

[54] 2A Austin W. Scott & William F. Fratcher, The Law of Trusts § 162, at 236 (4th ed. 1989).

a potential estate planning benefit since the transferred property, together with any appreciation thereon, need not be taxed upon the death of either spouse assuming that the transfer is a completed gift. Since, assuming a seven percent return, the transferred property will double in value every ten years, this can be a significant benefit if the trust is established as early as possible in life. From an asset protection planning perspective, a trust created with an estate tax planning benefit is also a more effective asset protection planning vehicle since a potential future creditor would be less likely to successfully argue that the funding of the trust was engendered with an intent to hinder, delay or defraud creditors.

A major desire for most clients, of course, is to have access to the transferred assets. However, as noted above, the greater the access the settlor has to trust assets, the greater the risk of those trust assets being subject to creditors' reach, but that is not the only factor. A SLAT established in a DAPT jurisdiction with an institutional trustee is likely more secure than a SLAT established in the client's home state with the spouse/beneficiary as a trustee or, even worse, the sole trustee. Yet many clients are loath to incur the costs, or deal with the formalities, of a trust formed in another jurisdiction or of working with an institutional trustee. Clients routinely make decisions that reduce creditor protection, but which in their perspective achieve other goals that the client deems more important. The problem with this calculus is that there are no measures to compare the impact on the plan's risk to the other benefits achieved.

¶ 408. Reciprocal but Non-Reciprocal Trusts

"Reciprocal" or "crossed" trusts (also sometimes called "parallel" trusts) are also unlikely to be upheld as protective of the beneficiary's interest where the settlor of the first trust is a beneficiary of the second trust and *vice versa*.[55] This is because the trusts, when uncrossed, are effectively "self-settled" trusts. It should, of course, be noted that the reciprocal trust doctrine has actually developed as a tax construct for the purpose of preventing a form over substance avoidance of the estate tax. However, while there is no available case law to the express effect that reciprocal trusts are to be deemed "self-settled" for asset protection purposes, consider that most reciprocal trust cases find for inclusion in the deceased settlor's taxable estate pursuant to Internal Revenue Code § 2036(a)(1) as a transfer of property with a retained interest. One can avoid creating reciprocal or crossed trusts by varying certain terms of each trust, for example, adding children to one trust as permissible beneficiaries but not to the other, having different lifetime powers in each trust, having differing trustees in each trust, and/or adding a power of appointment to one trust but not the other. Alternatively, one might consider creating such trusts in a jurisdiction that permits self-settled spendthrift trusts.

Due to the continued uncertainty of the protection afforded settlors residing in non-DAPT states, planners should consider non-self-settled trusts to reduce the risk of challenge. If the client establishes a trust of which the client's spouse and descendants are beneficiaries, and the client's spouse in turn establishes a similar but not identical (non-reciprocal) trust, the risk to creditors is likely somewhere in between the single SLAT and the DAPT risk levels. The two SLATs and the economic results they create, however, have to be sufficiently different to avoid a creditor arguing that the trusts leave each of the settlors in a similar economic position as they were before the transfer. If this occurred then the reciprocal trust doctrine could be applied to unwind both trusts. The reciprocal trust doctrine applies where the trusts are interrelated, and where the arrangement, to the extent of mutual value, leaves each spouse in approximately the same economic position as if each had created a trust naming himself of herself as beneficiary.[56] A prudent approach would be to settle the trusts under the laws of one of the DAPT states to provide additional obstacles in case of a challenge.

¶ 409. Inter Vivos QTIP Trusts

A basic tenet of estate planning (and particularly prior to the introduction of "portability" under IRC § 2010) is that each spouse should own sufficient assets in his or her own name to utilize his or her own estate tax exemption. However, due to the possibility that the transferee spouse may have existing or future creditor issues, an outright transfer from the "moneyed" spouse might be ill advised from an asset protection perspective.

An alternative to an outright transfer to a spouse is to effect such transfer via an *inter vivos* QTIP trust which would qualify for the unlimited marital deduction from federal gift tax under Internal Revenue Code § 2523(f). If, however, the settlor-spouse survives the donee-spouse, the trust may then have been structured to continue for the settlor-spouse's

[55] But see A.R.S. §14-10505(E) which appears to protect reciprocal trusts from creditors.
[56] *U.S. v. Grace*, 395 U.S. 316 (1969).

benefit. Technically, the result in such a case would be a self-settled trust which, in most states, would then subject the trust property to the claims of the settlor-spouse's creditors under the relation back doctrine.[57]

While Treas. Reg. § 25.2523(f)-1(f), Ex. 11 provides that assets held in trust for the settlor-spouse's benefit after the donee-spouse's death will not be includable in the settlor-spouse's estate under IRC §§ 2036 and 2038, this does not govern the question of the availability of such assets to the settlor-spouse's creditors under state law.

A number of states have, however, enacted legislation to provide that such trusts will not be treated as self-settled trusts in the hands of the donor-spouse[58]. For example, in Arizona, A.R.S. § 14-10505(E)(1) provides that "…amounts and property contributed to the following trusts are not deemed to have been contributed by the settlor, and a person who would otherwise be treated as a settlor or a deemed settlor of the following trusts shall not be treated as a settlor:…[a]n irrevocable inter vivos marital trust that is treated as qualified terminable interest property under section 2523(f) of the Internal Revenue Code if the settlor is a beneficiary of the trust after the death of the settlor's spouse."[59]

One major drawback of the use of an *inter vivos* QTIP trust (in those states where one is required, or where the settlor wishes to utilize the unlimited marital deduction in connection with a gift in trust to the settlor's spouse), is that in the event of divorce the donee spouse must, of course, continue to receive all the net income from the trust for his/her lifetime. A partial solution to this potential problem would be to have a post-nuptial agreement concurrently entered into (with representation of each spouse by separate counsel) to provide for an appropriate division of assets in the event of divorce.

¶ 410. Domestic Asset Protection Trusts

¶ 410.1 Overview

Although the general rule in this country is one of non-recognition of self-settled spendthrift trusts, seventeen states grant spendthrift trust protections, to a greater or lesser extent, even where the settlor has retained a beneficial trust interest (provided, of course, that the transfer is not a fraudulent transfer): Alaska, Delaware, Hawaii, Michigan, Mississippi, Missouri, Nevada, New Hampshire, Ohio, Oklahoma, Rhode Island, South Dakota, Tennessee, Utah, Virginia, West Virginia and Wyoming.

A. Alaska[60]

The Alaska Trust Act, (effective April 2, 1997) modified Alaska's previously undistinguished common law body of trust legislation in an effort generally touted as making the State of Alaska a domestic alternative to foreign situs asset protection trusts. Alaska permits a settlor to create a trust for his own benefit which will be protected from the settlor's future creditors so long as the settlor does not retain the right to revoke or terminate the trust. In addition, the settlor must not be in default by thirty (30) days or more in making a child support payment and the settlor's ability to receive distributions from the trust must be within the discretion of the trustees rather than mandatory.

To protect existing creditors, the transfer of property to the trust must not be intended to hinder, delay or defraud creditors (i.e. a "fraudulent transfer" which is generally subject to a four (4) year statute of limitations under Alaska

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[57] *See*, Barry A. Nelson, "Asset Protection & Estate Planning: Why Not Have Both?" p. 15-6, 46th Annual Heckerling Institute on Estate Planning, available at http://www.ficpa.org/Content/Files/Docs/Ematerials/Materials_12AS_NelsonCombinedSupplementalMaterials.pdf.

[58] Arizona, Delaware, Florida, Kentucky, Maryland, Michigan, North Carolina, Ohio, Oregon, South Carolina, Tennessee, Texas, Virginia and Wyoming.

[59] The Arizona statute does not, however limit this result to QTIP trusts, and further provides that amounts and property contributed to the following trusts are also not to be deemed to be self-settled: (1) an irrevocable inter vivos marital trust that is treated as a general power of appointment trust under Internal Revenue Code § 2523(e) if the settlor is a beneficiary of the trust after the death of the settlor's spouse, and (2) an irrevocable inter vivos trust for the settlor's spouse if the settlor is a beneficiary of the trust after the death of the settlor's spouse. In other states, however, only an inter-vivos QTIP trust would engender protection as having been deemed to not be self-settled. *See, e.g.*, FLA. STAT. § 736.0505, which provides such a result only for "[a] trust described in s. 2523(e) of the Internal Revenue Code of 1986, as amended, or a trust for which the election described in s. 2523(f) of the Internal Revenue Code of 1986, as amended, has been made…."

[60] ALASKA STAT. § 34.40.110.

law).[61] Under the Alaska statute, a creditor existing at the time the trust is created must bring suit within the later of four (4) years from the transfer or one (1) year after the transfer is, or reasonably could have been, discovered. A creditor arising after the transfer to the trust is made must bring suit within four (4) years from the transfer. The statute further prohibits a challenge to a trust (except as otherwise provided above) on the grounds "... that the trust or transfer avoids or defeats a right, claim, or interest conferred by law on any person by reason of a personal or business relationship with the settlor or by way of a marital or similar right."[62]

Several formalities must be met in order to successfully establish an "Alaska" trust. A mere choice of law clause will not be sufficient to establish the trust as an Alaska trust. At least one trustee must be either a trust company or a bank with trust powers with its principal place of business in Alaska, or an individual resident of Alaska.[63] In addition, some of the trust assets must be deposited in Alaska, either in a checking or brokerage account or other similar account located in Alaska, and the Alaska trustee's duties must include both the obligation to maintain the trust's records and to prepare or arrange for the preparation of the trust's income tax returns. Although neither of these latter requirements must be exclusive to the Alaska trustee, part or all of the trust's administration must occur in Alaska, including the physical maintenance of the trust's records in Alaska.[64] Consistent with the foregoing requirements, an Alaska trust may be settled by any person, regardless of whether or not they are domiciled in Alaska.[65]

B. Delaware[66]

The synopsis of the Delaware Qualified Dispositions in Trust Act notes that the purpose of the legislation is to allow settlors to reduce their estate tax by excluding creditors' claims against self-settled trusts. The Act notes that it "is intended to maintain Delaware's role as the most favored jurisdiction for the establishment of trusts." The Delaware Statute applies to "qualified dispositions" made on or after July 1, 1997.[67] A "qualified disposition" is defined as a disposition by or from a transferor to a trustee who is (i) a Delaware resident, bank or institution authorized by Delaware law to act as a trustee, and who (ii) maintains or arranges for custody in Delaware of some or all of the trust corpus, maintains records (on an exclusive or nonexclusive basis), prepares or arranges for the preparation of fiduciary tax returns or otherwise materially participates in the trust's administration.

In Delaware, a trust must be irrevocable and must contain a spendthrift clause but can include several of the following favorable provisions for the settlor. The trust may provide that the settlor may retain the power to veto distributions and the power to reacquire corpus by substituting property of equivalent value. Provisions may also be included which permit the settlor to retain a special power of appointment and to receive income, principal or both in the sole discretion of a trustee who is neither the settlor nor related or subordinated to the settlor. The Act also permits the settlor to retain a specific percentage (not to exceed 5%) of the principal annually.

Provided that the transfer of property to the trust was not intended to hinder, delay or defraud creditors (i.e., a fraudulent conveyance) no action to enforce a judgment shall be brought for attachment against such qualified disposition. Under the relevant Delaware code provisions, a creditor existing at the time a transfer to a trust is made must commence an action to enforce a judgment within the later of four years of the transfer or one year after the transfer was or could reasonably have been discovered by the creditor.[68] If the creditor's claim arose after the transfer the action must be brought within four years of the transfer.

Despite the protections afforded by the Delaware statute, certain creditors may, however, avoid qualified dispositions. Those creditors include any person to whom the settlor is indebted on account of an agreement or court order for support, alimony or property distribution in favor of a spouse, former spouse or children; or any person who suffers death, personal injury or property damage on or before the qualified disposition, which death, personal injury or property damage was caused by the transferor or another person for whom the transferor is liable.

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[61] ALASKA STAT. § 34.40.110.
[62] ALASKA STAT. § 13.36.310.
[63] ALASKA STAT. § 13.36.390(1).
[64] ALASKA STAT. § 13.36.035.
[65] ALASKA STAT. § 13.36.035.
[66] DEL. CODE ANN. tit. 12, Secs. 3570-3576.
[67] DEL. CODE ANN., tit. 12, § 3570, et seq.
[68] DEL. CODE ANN., tit. 12 § 3572(b).

C. Hawaii[69]

Hawaii enacted the "Permitted Transfers in Trust Act" on June 30, 2010 to "…increase the assets under management by Hawaii's private financial sector, increase state tax revenues, and position the State as a world-class financial management jurisdiction." The Permitted Transfers in Trust Act provides for enforceability of a spendthrift provision in a trust, including with respect to a beneficiary who is also the transferor of the trust, if the transfer to the trust was a "permitted transfer." A "permitted transfer" is a transfer to a "permitted trustee" of property pursuant to a trust instrument. A permitted trustee is a person, other than the transferor, who is a resident of Hawaii, or a bank or trust company authorized to do business in Hawaii that possesses and exercises trust powers and has its principal place of business in Hawaii, and (1) maintains or arranges for custody of some or all of the property that is the subject of the permitted transfer; (2) maintains records for the trust on an exclusive or nonexclusive basis; (3) prepares or arranges for the preparation of fiduciary income tax returns; or (4) otherwise materially participates in the administration of the trust."

A transfer is effective upon completion of the delivery and acceptance of the property and the delivery to a permitted trustee of the transferor's signed and notarized certificate of solvency. To be a permitted transfer, the trust instrument must be irrevocable and expressly incorporate the laws of the State of Hawaii as governing the validity, construction, and administration of the trust. No claim, including an action to enforce a judgment or avoid a permitted transfer, is allowed unless: (1) the creditor proves that the transfer was made with actual intent to defraud, hinder, or delay and the claim arose before the permitted transfer and the action is brought before the permitted transfer; or (2) the claim arose concurrent with or subsequent to the permitted transfer and the action is brought within two years thereafter.

Exception creditors include (1) "…any person to whom the transferor is indebted on account of a family court-supervised agreement or family court order for the payment of support or alimony to the transferor's spouse, former spouse, or children, or for a division or distribution of property to the transferor's spouse or former spouse, but not for any claim for forced heirship, legitime, or elective share"[70]; (2) tort creditors with claims arising on or before the date of the permitted transfer; (3) lenders secured by the transferred property; and (4) Hawaii, in connection with tax liabilities.

D. Michigan[71]

Effective February 5, 2017, Michigan's Qualified Dispositions in Trust Act protects the assets of a self-settled spendthrift trust from the claims of creditors where the trust instrument names at least one qualified trustee, expressly incorporates the laws of Michigan as the governing law of the trust, is irrevocable and contains a spendthrift provision that by its terms restrains both the voluntary and involuntary transfer of the settlor's interest in the trust.

Further, before or at the time of making a transfer to the trust, the settlor must execute an affidavit of solvency. The settlor may retain the following with respect to the trust: the right to receive income; the right to use real or personal property; the right to receive distributtions in the trustee's discretion; the right to remove and replace trustees; the right to control investments; the power to veto a distribution from the trust; the power to provide for the use of trust income or principal to pay income taxes due on the income of the trust; testamentary limited power of appointment; and the right to receive annuity payments from a charaitable reaminder trust or grantor retained annuity trust.

The Act provides that the transferor's creditors may not reach the assets tranferred beyomd the later of two years after the transfer was made or one year after the transfer was or could have reasonably been discovered if the claim arose prior to the disposition.

E. Mississippi[72]

[69] HAW. CODE R. § 554G-1 et seq.

[70] However, under Hawaii law, for this purpose, "…'[s]pouse' means a person to whom the transferor is married at the time of the permitted transfer…" and '…[f]ormer spouse' means a person to whom the transferor was married where the marriage was dissolved before the time of the permitted transfer.

[71] MI 2016 PA 330

[72] MISS. CODE ANN. § 91-9-701 *et seq.*

Effective July 1, 2014, Mississippi's Qualified Disposition in Trust Act allows spendthrift protection for self-settled trusts and applies to qualified dispositions to a qualified trustee. A qualified disposition is a transfer, conveyance or assignment of property to a qualified trustee by means of a qualified disposition trust. A qualified trustee is a natural person who is a resident of Mississippi or an entity authorized by Mississippi law to act as a trustee. Only one qualified trustee is required – other non-qualified trustees are permitted.

A qualified disposition trust is a trust instrument that appoints a qualified trustee and is irrevocable, expressly incorporates the laws of the State of Mississippi as governing the validity, construction, and administration of the trust and contains a spendthrift clause. The transferor may retain the power to veto distributions, a non-general testamentary power of appointment, the power to replace the trustee or advisor with a non-related, non-subordinate party and the right to serve as an investment advisor. No action, including an action to enforce a judgment, may be brought at law or in equity for an attachment or other remedy against the trust property unless it is brought pursuant to the Uniform Fraudulent Transfer Act. However, the qualified dispositions in trusts law does not apply: (1) to any person to whom the transferor is indebted on account of an agreement or order of court for the payment of support or alimony in favor of the transferor's spouse, former spouse or children, or for a division or distribution of property in favor of the transferor's spouse or former spouse, but only to the extent of such debt; (2) to any person who suffers death, personal injury or property damage on or before the date of a qualified disposition by a transferor, which death, personal injury or property damage is at any time determined to have been caused, in whole or in part, by the tortious act or omission of the transferor or another person for whom the transferor is vicariously liable; (3) if the creditor is the State of Mississippi or any political subdivision thereof; or (4) for any creditor in an amount not to exceed $1,500,000 if the transferor failed to maintain a $1,000,000 general liability policy.

F. Missouri[73]

Missouri law provides that "[a] spendthrift provision will prevent the settlor's creditors from satisfying claims from the trust assets except ... [t]o the extent of the settlor's beneficial interest in the trust assets, if at the time the trust was established or amended: (a) The settlor was the sole beneficiary of either the income or principal of the trust or retained the power to revoke or amend the trust; or (b) The settlor was one of a class of beneficiaries and retained a right to receive a specific portion of the income or principal of the trust that was determinable solely from the provisions of the trust instrument." Under the statute, the Settlor may specifically retain a testamentary limited power of appointment. The legislation further provides that except for a spouse, former spouse or child who has a judgment against a beneficiary for support, the creditor may not compel a distribution subject to the trustee's discretion.[74]

G. Nevada[75]

Effective October 1, 1999, Nevada amended its trust law to provide spendthrift protection for self-settled trusts meeting certain requirements. Those requirements are as follows: (i) the trust must be irrevocable; (ii) the settlor may only be a discretionary beneficiary of the trust: (iii) the transfer cannot have been intended to hinder, delay or defraud any known creditors; (iv) all or part of the trust property must be located in the State of Nevada; all or part of the administration of the trust must be performed in the State of Nevada: and (vi) at least one Nevada resident is a trustee of the trust and has powers which, at a minimum, include maintaining the trust's records and preparing the trust's tax returns.

Under Nevada law, the settlor may retain a veto power over trust distributions or hold a testamentary special power of appointment without defeating the spendthrift trust protections. In addition, a creditor may not bring an action with respect to property transferred to a spendthrift trust unless brought within two years after the transfer or six months after the creditor discovers or reasonably should have discovered the transfer, whichever is later. If a person becomes a creditor after the transfer is made, he or she must bring the action within two years after the transfer.

H. New Hampshire[76]

[73] MO. REV. STAT. § 456.5-505.
[74] MO. Rev. Stat. § 456.5-504.
[75] NEV. REV. STAT. § 166.010-166.170.
[76] N.H. REV. STAT. ANN. § 564-D:1-18.

Under New Hampshire's Qualified Dispositions in Trust Act, a self-settled trust must appoint at least one qualified trustee (a New Hampshire resident other than the settlor or a bank or trust company with a place of business in New Hampshire), must expressly incorporate New Hampshire law as the governing law of the trust, must be irrevocable and must contain a spendthrift clause.

The settlor may serve as a trust adviser, although the settlor's authority in that role will be limited to vetoing distributions and consenting to trustee action in investing trust assets. Regardless of whether the settlor chooses to act as trust adviser, the settlor may retain: (1) the power to veto distributions; (2) the power to replace a trustee or trust adviser; (3) a special power of appointment and a limited lifetime power of appointment; (4) the right to receive distributions of income and principal; (5) the right to receive payments from the trust for income taxes attributable thereto; and (6) an interest in a qualified personal residence trust or annuity.

New Hampshire's statute extends to trusts formed in other states (including states that do not provide for self-settled asset protection trusts) if they are transferred to New Hampshire. These trusts do not need to be governed by New Hampshire law – according to the statute, an out of state trust transferred to a qualified trustee need not comply with the New Hampshire governance requirement – but they must meet all other requirements of the Qualified Dispositions in Trust Act. A qualified disposition is deemed to have been made at the time of the original transfer into the trust rather than the subsequent transfer to New Hampshire.

Creditor claims against such self-settled trusts are only allowed for tort claims for injury suffered before the date of the qualified disposition, claims for support or alimony by the settlor's spouse or former spouse who was married to the transferor at or before the date of the qualified disposition, claims for child support and fraudulent transfers under the Uniform Fraudulent Transfer Act.

I. Ohio[77]

Passed on March 27, 2013, the Ohio Legacy Trust Act protects the assets of a self-settled spendthrift trust from the claims of creditors where the trust instrument names at least one qualified trustee (someone other than the settlor who is a resident of Ohio or an entity authorized to serve as a trustee in Ohio), expressly incorporates the laws of Ohio as the governing law of the trust, affirmatively states that it is irrevocable and contains a spendthrift provision that by its terms restrains both the voluntary and involuntary transfer of the settlor's interest in the trust.

Further, before or at the time of making a transfer to the trust, the settlor must execute an affidavit stating that (1) the property transferred was not derived from unlawful activities, (2) the settlor has full right and title to the property, (3) the Settlor will not be rendered insolvent immediately after the transfer, (4) the settlor does not intend to defraud any creditor by reason of the transfer, (5) there are no pending or threatened court actions, except as identified, (6) the settlor is not involved in any administrative proceedings, except as identified, and (7) the settlor does not contemplate the filing for relief under the Bankruptcy Code at the time of transfer.

The settlor may retain the following with respect to the trust: the right to receive income; the right to use real or personal property; the right to receive principal as long as distributions are subject to the trustee's discretion or an ascertainable standard; the right to remove and replace trustees; the right to control investments; the power to veto a distribution from the trust; the power to provide for the use of trust income or principal to pay income taxes due on the income of the trust; the power to provide for the use of trust income or principal to pay all or any part of the debts of the settlor after death, the expenses of administering the settlor 's estate or any estate, gift, generation-skipping transfer or inheritance tax; and the right to provide that some or all of the trust assets will pour back into the settlor 's estate.

The settlor 's interest in the trust may be attached in connection with any debt the settlor owes for payment of child support, as well as spousal support, alimony or in connection with the division of property in favor of the settlor 's spouse or former spouse, but only to the extent the Settlor was married to the spouse on or before the particular transfer was made. The IRS may also attach trust property.

J. Oklahoma

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[77] OHIO REV. CODE ANN. § 5816.01 *et seq.*

Oklahoma enacted asset protection trust legislation with the Family Wealth Preservation Trust Act, effective June 10, 2004. Under the Act, as amended, the corpus and income of a "preservation trust" is exempt from attachment or execution and any other type of forced sale, and no judgment, decree, or execution can be a lien on the trust for the payment of debts of a grantor, except for child support judgments and any additional property contributed to the trust having an fair market value, as of the date of the contribution, of over $1 million. Any incremental growth derived from income or an increase in the value of the corpus of a preservation trust is also protected.

A "preservation trust" is a trust: (a) established by a grantor under Oklahoma law; (b) with an Oklahoma-based bank or trust company as trustee or co-trustee; (c) with only qualified beneficiaries or a qualified beneficiary; (d) with a majority in value of its assets comprised of Oklahoma assets; and (e) with a recitation in its terms that the income generated from the corpus of the trust is subject to the Oklahoma income tax laws.

"Oklahoma assets" include (a) a stock, bond, debenture, membership interest, partnership interest, or other equity or debt interest issued by an Oklahoma-based company; (b) a bond or other obligation issued by [Oklahoma] or an Oklahoma governmental agency; (c) a bond or other obligation issued by [an Oklahoma] county, by [an Oklahoma] municipal government, by a school district located in [Oklahoma] or by any public trust for the benefit of [Oklahoma] or one or more political subdivisions of [Oklahoma]; (d) an account in an Oklahoma-based bank [(e.g., a demand, time, savings, or passbook type of account or a certificate of deposit type of account)]; (e) real or tangible personal property, or any interest therein, having a situs in [Oklahoma], which … include[s], but [is] not … limited to, mineral interests or promissory notes secured primarily by real or tangible personal property or both; (f) any security backed exclusively by promissory notes, if at least a majority in value of such promissory notes are secured by real or tangible personal property having a situs in [Oklahoma] or both; (g) mutual funds, as defined pursuant to the Investment Company Act of 1940, 15 USC §80a-1, et seq., and the Securities Act of 1933, 15 USC §77a, et seq., and common trust funds, as defined pursuant to Section 1010 of Title 6 of the Oklahoma Statutes, to the extent the assets within such funds meet one or more of the requirements listed in [(a) through (f), above].

"Qualified beneficiaries" include: (a) the lineal ancestors and descendants of the grantor or the grantor's spouse, including adopted lineal descendants under the age of 18 at the time of the adoption; (b) the grantor's spouse; (c) §501(c)(3) nonprofit organizations; and (d) a trust with one or more qualified beneficiaries as the only beneficiaries.

Notably, an Oklahoma preservation trust may be either revocable and amendable or irrevocable. If the grantor revokes the preservation trust, the exemption under Okla. Stat. tit. 31, §12, will not apply to any property received by the grantor as a result of the revocation.

K. Rhode Island[78]

The explanation to the Rhode Island legislation provides that "[t]his act facilitates the establishment in Rhode Island of irrevocable trusts which will allow trust settlors to transfer assets in trust in order to protect them from the claims of certain creditors." The legislation applies to "qualified dispositions" made after June 30, 1999. A qualified disposition is a transfer to a trust which is irrevocable, incorporates the laws of Rhode Island to govern the validity, construction and administration of the trust and contains a restriction on the assignment of income or property, and further provides that the settlor may retain only the following powers: a power to veto trust distributions; a testamentary special power of appointment; and a right to receive distributions in the sole discretion of one or more trustees who are neither related to nor subordinate to the settlor.

With respect to a Rhode Island trust, a creditor may not bring an action to avoid a qualified disposition if the creditor's claim arose before the transfer was made unless the action is brought within four years after the transfer or, if later, within one year after the transfer was or could reasonably have been discovered by the creditor. Similarly, an action may not be brought where the creditor's claim arose after the transfer, unless the action is brought within four years after the transfer is made.

L. South Dakota[79]

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[78] R.I. GEN. LAWS §§ 18-9.2-1 – 18-9.2-7.
[79] S.D. CODIFIED LAWS §§ 55-16-1 – 55-16-17.

The Act to Authorize Qualified Dispositions, effective for trusts settled on or after July 1 2005, permits self-settled spendthrift trusts to be created under the law of South Dakota. In order to qualify, the governing law of the trust must be that of South Dakota, the trust must be irrevocable and the trust must prohibit voluntary or involuntary assignment. In addition to the receipt of income, principal or both, in the discretion of a trustee who is neither the settlor nor a related or subordinated party within the meaning of Section 672(c) of the US Internal Revenue Code, the settlor may also retain the following rights and powers: (1) the power to veto trust distributions; (2) a limited testamentary power of appointment; (3) the right to receive distribution of current income; (4) the right to receive payments under a charitable remainder trust; (5) the right to receive annual payments of up to 5% of the initial value of the trust, or of its value as determined from time to time; (6) the right to receive principal distributions under an ascertainable standard (such as health, maintenance, education or support); (7) the power to remove and appoint trustees; and (8) the right to the use of a residence in a qualified personal residence trust.

The trustee must be either an individual resident of the state of South Dakota or a South Dakota bank or trust company. In either case the trustee is required to maintain or arrange for custody of some or all of the property in the state of South Dakota, to maintain records on an exclusive or non-exclusive basis, to prepare or arrange for the preparation of the trust's tax returns or to otherwise materially participate in the administration of the trust.

The act also permits the appointment of a non-resident trust adviser, including a trust protector, who may hold one or more trust powers. The settlor may even be designated as the trust adviser.

Transfers are subject to provisions of South Dakota's version of the Uniform Fraudulent Transfer Act. With respect to fraudulent transfer claims, pre-transfer creditors have either two years from the date of the transfer or six months from discovery of the transfer to challenge the transfer, or they are barred from bringing a claim. In order to prevail on a claim, the creditor must establish by "clear and convincing evidence" that the transfer was for the purpose of defrauding that creditor

Moreover, certain additional creditors can avoid qualified dispositions even though these may not be a fraudulent transfer. They are: (1) any person to whom the settlor is indebted on account of an agreement or court order for support, alimony or property distribution in favour of a spouse, former spouse or children; or (2) any person who suffers death, personal injury or property damage on or before the qualified disposition, which was caused by the transferor or another person for whom the transferor is liable.

M. Tennessee[80]

The Tennessee Investment Services Act permits self-settled trusts to be created after July 1 2007. The act has provisions similar to that of South Dakota; however, under Tennessee law tort claimants are not exception creditors.

N. Utah[81]

The state of Utah permits self-settled spendthrift trusts created after May 5, 2003 to qualify as valid with respect to the settlor's creditors if the trust meets the following requirements: (1) at least one trustee is a trust company resident in Utah; (2) only personal property or interests therein are transferred to the trust; (3) the settlor does not retain the right to revoke the trust; (4) the settlor can receive income or principal only in the discretion of the trustee; and (5) the settlor was not in default by 30 days or more under a child support order at the time of the creation of the trust.

The trust will be subject to Utah's governing law if some or all of the assets are deposited in the state in a bank, brokerage or trust company, the trust has at least one resident trustee and some administration (e.g., maintaining of trust records or arranging for tax return preparation) occurs in the state.

A creditor existing at the time the trust is settled must bring suit within the later of three years after the transfer is made or one year after the transfer is or reasonably could have been discovered. A creditor arising after the transfer has two years from the transfer date to bring a suit.

[80] TENN. CODE ANN. § 35-16-101.
[81] UTAH CODE ANN. § 25-6-14.

O. Virginia[82]

A qualified self-settled spendthrift trust under Virginia law must be irrevocable, created during the settlor's lifetime, have at least one beneficiary other than the settlor to whom income and/or principal may be paid, has at least one "qualified trustee" (who must be independent), expressly incorporates Virginia law to govern the validity, construction and administration of the trust and contains a spendthrift provision that restrains both voluntary and involuntary transfers. The settlor, however, may not retain a veto power which may result in the transfer being deemed complete for gift tax purposes.[83] Creditors existing at the creation of the trust have five years to bring a claim.

P. West Virginia[84]

Effective June 8, 2016, under the West Virginia Uniform Trust Code, a qualified self-settled spendthrift trust is one (1) in which the trust agreement expressly incorporates the law of West Virginia to govern the validity, construction and administration of the trust, (2) that is irrevocable, (3) that is created during the grantor's lifetime and (4) that provides for at least one beneficiary other than the grantor to whom income may be distributed (if the grantor's interest relates to trust income), principal may be distributed (if the grantor's interest relates to trust principal) or both income and principal may be distributed (if the grantor's interest relates to both trust income and principal). The trust must at all times have at least one qualified trustee – a natural person who resides in West Virginia or a legal entity authorized to engage in trust business within West Virginia. A trustee is not a qualified trustee if such trustee's authority to make distributions is subject to the direction of someone who would not meet the requirements of a qualified trustee.

In order for trust property to be protected from creditors, the grantor must execute an affidavit of solvency upon the formation of the trust and when any contribution is made to the trust. If the grantor makes a transfer without executing such an affidavit, creditor protection may be lost with respect to such transfer. Further, a transfer may be set aside if the affidavit contains a material misstatement of fact.

The grantor may retain the following powers with respect to the trust: a testamentary power of appointment, the right to receive income or principal pursuant to an ascertainable standard, the right to receive a percentage (not to exceed five percent) of the trust assets, the right to remove and replace a qualified trustee, the right to use real property owned by the trust, the right to receive an annuity and the right to receive income or principal to pay income taxes due on the income of the trust. However, the grantor may not retain any veto powers that may be necessary to prevent a gratuitous transfer to the trust from being considered a completed gift.[85]

Q. Wyoming[86]

Wyoming's Uniform Trust Code provides for the creation of a qualified spendthrift trust if: (1) the trust instrument expressly states that it is a qualified spendthrift trust under Wyoming law; (2) the trust instrument expressly incorporates Wyoming law to govern the validity, construction and administration of the trust; (3) the trust contains a spendthrift provision and (4) the trust is irrevocable. The trust must also have at least one Wyoming qualified trustee (a Wyoming resident or regulated financial institution) and transfers to the trust must not violate the Wyoming Uniform Fraudulent Transfers Act. Once these requirements have been satisfied, creditor protection is immediate.

The settlor may retain the power to veto distributions, lifetime and testamentary limited powers of appointment, the power to add or remove a trustee, trust protector or trust advisor and the right to serve as an investment advisor. Further, the settlor may retain the right to receive income and principal from the trust, interests in charitable remainder trusts, qualified personal residence trusts, grantor retained annuity trusts and unitrusts, the right to be reimbursed for income taxes attributable to the trust and the right to direct debts, expenses and taxes of the settlor's estate to be paid from the trust.

[82] VA. CODE ANN. § 64.2-745.1.
[83] C.C.A. 201208026 (September 28, 2011).
[84] W. VA. CODE § 44D-5-503a.
[85] C.C.A. 201208026 (September 28, 2011).
[86] WYO. STAT. §§ 4-10-502, 504, 506(c) and 510 – 523.

The trust will be protected from the claims of all creditors except with respect to child support, property listed on an application or financial statement used to obtain or maintain credit, and fraudulent transfers.

¶ 410.2 Possible Challenges to Domestic Asset Protection Trusts

Although one-third of the states now offer protection to self-settled trusts, planners should beware of potential problems which may arise with the use of such domestic trusts for asset protection. Substantial uncertainty exists as to the degree of protection which is actually provided by domestic asset protection trusts in states which have a public policy against them. What will be the result when the spouse or former spouse of a settlor living in a state that does not recognize self-settled spendthrift trust protections as being valid under its own law seeks to enforce a claim for equitable distribution (or spousal support), against a self-settled spendthrift trust validly established and existing under the law of another state?

The Restatement (Second) of Conflict of Laws § 273 speaks to the efficacy of a purported restraint on alienation of beneficial trust interests. It provides that: "Whether the interest of a beneficiary of [an inter-vivos] trust of movables is assignable by him and can be reached by his creditors is determined…by the local law of the state, if any, in which the settlor has manifested an intention that the trust is to be administered, and otherwise by the local law of the state to which the administration of the trust is most substantially related."

Similarly, "[i]f the settlor creates a trust to be administered in a state other than that of his domicile, the law of the state of the place of administration, rather than that of his domicile, ordinarily is applicable. Thus a settlor domiciled in one state may create an inter vivos trust by conveying property to a trust company of another state as trustee and delivering the property to it to be administered in that state. In that case the law of that state will be applicable as to the rights of creditors to reach the beneficiary's interest. This permits a person who is domiciled in a state in which restraints on alienation are not permitted, to create an inter vivos trust in another state where they are permitted and thereby take advantage of the law of the latter state." [87]

In fact, in some jurisdictions a settlor's ability to designate the law of a particular jurisdiction as the governing law of the trust is expressly provided for by statute. For example, Section 7-1.10 of New York's Estates, Powers and Trusts Law provides: "Whenever a person, not domiciled in this state, creates a trust which provides that it shall be governed by the laws of this state, such provision shall be given effect in determining the validity, effect and interpretation of the disposition in such trust..."

A strong argument can also be made that principles of judicial comity require that a settlor's designation of controlling law be respected by the court.[88]

The Restatement (Second) of Conflict of Laws § 270 (1971), however, provides that "[a]n inter vivos trust of interests in movables is valid if valid...under the local law of the state designated by the settlor to govern the validity of the trust, provided...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." Section 270 has been cited by more than one court dealing with the question of the validity of self-settled spendthrift trusts (although not in the marital context), to the effect that the validity of a NV self-settled spendthrift trust should <u>not</u> be upheld.[89]

In contrast, see *Riechers v. Riechers*[90], a New York case which actually involved a self-settled spendthrift trust in a matrimonial action. In *Riechers*, following the defense of several medical malpractice suits, the settlor, Dr. Riechers, established a self-settled spendthrift trust under the law of the Cook Islands ostensibly to guard against the likelihood of future medical malpractice claims. At the same time, Dr. Riechers and his wife were having marital difficulties, but Mrs. Riechers was alleged to have been aware that the trust was being established. Two years later, Mrs. Riechers commenced an action for divorce and sought to have the trust included in computing an equitable distribution award.

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[87] 5A ASTON W. SCOTT & WILLIAM F. FRATCHER, THE LAW OF TRUSTS § 626, at 419 (4th ed. 1989).

[88] *See generally* 17 C.J.S. § 12(1).

[89] See, e.g., *In re Portnoy*, 201 B.R. 685 (Bankr. S.D.N.Y. 1996); *In re Brooks*, 217 B.R. 98 (Bankr. D. Conn. 1998); *In re Lawrence*, 227 B.R. 907 (Bankr. S.D. Fla. 1998) ("This Court is persuaded by the decisions of *Portnoy*, *Brooks* and *Cameron*"). *Id*. at 917.

[90] 178 Misc. 2d 170, 679 N.Y.S.2d 233, 1998 N.Y. Slip. Op. 98522 (1998), aff'd, 267 A.D.2d 445, 701 N.Y.S.2d 113, 1999 N.Y. Slip. Op. 11143 (1999

The New York State Supreme Court noted that the trust was established "for the legitimate purpose of protecting family assets", that the court did not have jurisdiction over the trust and that issues such as whether the wife would be entitled to any trust property should be left to a Cook Islands court to decide."[91]

In any event, query whether the requirement under § 270 of the Restatement (Second) of Conflict of Laws that the court find that the application of the law of the non-forum state would violate a strong public policy of the forum state can exist where the self-settled spendthrift trust was established prior to the marriage. Furthermore, the fact that the forum state might not permit self-settled spendthrift trusts to be created under its own law does not necessarily mean that it would violate a *strong* public policy of the forum state to recognize a self-settled spendthrift trust if it was validly created under the law of a foreign jurisdiction. "It would seem that the policy of a state, whether it be to restrain alienation in order to protect the beneficiary, or to permit alienation in order to protect creditors and assignees, is not so strong as to preclude the application of the law to the contrary prevailing in another state."[92]

There are also a number of cases, some in the marital context, that have applied conflicts of law principles to spendthrift trusts without resort to an exception for public policy. For example, in *The National Shawmut Bank of Boston v. Cumming*[93], the settlor, a domiciliary of Vermont, created a trust of "the greater part of his property," which trust the settlor designated to be "construed and the provisions thereof interpreted under and in accordance with the laws of the Commonwealth of Massachusetts."[94] As recognized by the lower court's opinion, the *Shawmut* settlor's clearly implied intent in designating Massachusetts law as controlling was to defeat his surviving spouse's significantly greater inheritance rights under Vermont law. According to the *Shawmut* court: "If the settlor had been domiciled in this Commonwealth and had transferred his personal property here to a trustee for administration here, the transfer would have been valid even if his sole purpose had been to deprive his wife of any portion of it. The Vermont law we understand to be otherwise and to invalidate a transfer made there by one domiciled there of personal property there, if made with an actual, as distinguished from an implied, fraudulent intent to disinherit his spouse." [95] In holding that Massachusetts law should apply, thereby depriving the surviving spouse of the greater part of her inheritance rights, the *Shawmut* court stated that "[t]he general tendency of authorities elsewhere is away from the adoption of the law of the settlor's domicile where the property, the domicile and place of business of the trustee, and the place of administration intended by the settlor are in another State."[96].

If, however, public policy does provide an exception to the normal application of conflict of law rules when applied to self-settled spendthrift trusts, then an issue might exist in the marital and family context because the marital and family context is thought to raise uniquely powerful public policy issues. "Although a trust is a spendthrift trust or a trust for support, the interest of the beneficiary can be reached in satisfaction of an enforceable claim against him or her for support by his or her spouse or children, because the beneficiary should not be permitted to have the enjoyment of his or her interest under the trust while neglecting to support his or her dependents." [97]

Unlike an offshore jurisdiction, the "Full Faith and Credit Clause" of the United States Constitution requires each state to recognize and enforce the validly rendered judgment of a sister state.[98] By contrast, the asset protection legislation of select offshore jurisdictions will provide for the non-recognition of foreign (i.e., United States) judgments. This will require a plaintiff to re-litigate the plaintiff's case in the offshore jurisdiction (and potentially after the statute of limitations on the plaintiff's claim has already run). If the creditor brings suit in a state which does not recognize the validity of self-settled spendthrift trusts, the creditor will be much more likely to obtain a judgment against the domestic trust. Pursuant to the Full Faith and Credit Clause, the creditor may then be able to enforce that judgment in the state in which the trust is sited without being hampered by that state's asset protection legislation.

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[91] *Id.*
[92] SCOTT & FRATCHER, *The Law of Trusts*, §626, at 414 (4th ed. 1989)
[92] SCOTT & FRATCHER, *The Law of Trusts*, §626, at 414 (4th ed. 1989)
[93] 325 Mass. 457, 91 N.E.2d 337 (1950)
[94] *Id*. at 339
[95] *Id*. at 340.
[96] *Id*. at 341.
[97] *Restatement (Second) of Trusts § 157, comment b*
[98] U.S. Constitution, Article IV, Sec. 1.

Domestic asset protection legislation may also be held to violate the "Contract Clause" of the United States Constitution.[99] Since the Contract Clause prohibits the enactment of any state law which impairs the obligation of contracts, legislation which precludes the enforcement of judgments against property which remains for the beneficial use of the settlor/debtor is arguably unconstitutional.

Another significant consideration with respect to domestic asset protection arises in relation to the "Supremacy Clause" of the United States Constitution. Under that Clause, federal law (i.e., the Bankruptcy Code) may override domestic asset protection legislation where the two are in conflict.[100]

Perhaps most significant is the fact that various factors which serve to enhance the asset protection afforded to self-settled trusts under the law of select offshore jurisdictions are not replicated under domestic asset protection legislation. A domestic asset protection trust will remain subject to the jurisdiction of the domestic court system, which may prove less sympathetic to the concept of a valid self-settled spendthrift trust than will courts of certain select offshore jurisdictions which are decidedly pro-debtor. Additionally, in some offshore jurisdictions proof beyond a reasonable doubt is required to prove a fraudulent transfer and the statute of limitations applicable to fraudulent transfer is as short as one year. Finally, many offshore jurisdictions do not permit attorneys to provide legal services in exchange for a contingent fee. Therefore, where the asset protection afforded a self-settled trust is an overriding concern, strong consideration should be given to the use of an offshore jurisdiction in lieu of a domestic one, particularly where the client does not reside in one of the state's affording protection to self-settled trusts.

While domestic asset protection trusts will remain subject to the jurisdiction of the domestic court system, which may, in some circumstances, be less favorable than certain offshore jurisdictions, such trusts can be structured to prevent claims from being asserted against the trusts and trustees in jurisdictions that do not recognize domestic asset protection trusts (and would seek to undo the creditor protections inherent therein). In addition to providing that the law of the formation state shall govern the validity, construction and administration of the domestic asset protection trust, planners can eliminate the ability of creditors to bring their claims in non-domestic asset protection trust friendly jurisdictions by limiting the trust's "contacts" to the formation state. If the trustee of a domestic asset protection trust has extensive contacts in another jurisdiction (i.e. the jurisdiction in which the settlor is domiciled) and/or the assets of the trust are held and administered in another jurisdiction, the courts of that jurisdiction will be entitled to decide claims against the trust and trustee (possibly seeking to apply the law of that jurisdiction, which may not be favorable from an asset protection standpoint). However, if all trustees and trust assets are located in the state where the trust was established and if the trustees have insufficient contacts in the non-domestic asset protection trust state, then the courts of that state will fail to have jurisdiction over the trust. While the minimum contacts issue has provoked sharp debate, it is still a significant hurdle for plaintiffs to overcome. Although the facts of a particular case can sometimes be murky, the law is very clear – a court from outside domestic asset protection trust states cannot enter valid orders or judgments against a domestic asset protection trust trustee unless the court has personal jurisdiction over the trustee, nor can the court enter orders or judgments against trust assets that are outside the forum state's borders.[101]

One final consideration in the public policy debate is the impact of the recent adoption of the Uniform Voidable Transactions Act (formerly the Uniform Fraudulent Transfer Act) in several jurisdictions[102]. Several commentators have raised concerns that Comment 2 under section 4 would cause a transfer by a settlor, who resides in state X which has adopted the Act but has no legislation validating self-settled trusts, to a self-settled trust in state Y to be voidable per se.

¶ 410.3 Estate Planning Opportunities Using Asset Protection Trusts

Planning towards the goal of minimizing U.S. estate, gift, and generation-skipping transfer (GST) taxes must, in practice, often be reconciled with the client's concurrent desire to retain control of his or her assets during life. Unfortunately, IRC §§2036 and 2038 each act as a "Catch-22" in this regard, making it difficult, if not impossible, to accomplish

[99] U.S. Constitution, Article I, Sec. 10; *See, e.g.,* Richard W. Hompesch II, Gideon Rothschild and Jonathan G. Blattmachr, J. Asset Protection, July/August 1997, at 9.

[100] U.S. Constitution, Article VI, Sec. 2.

[101] Richard W. Nenno, Esq. and John E. Sullivan, III, Esq., "Domestic Asset Protection Trusts," 868-1st Tax Mgmt. (BNA) Estates, Gifts, and Trusts, at IV.C.2 (2010).

[102] Nine states have enacted the Uniform Voidable Transaction Act - California, Georgia, Idaho, Iowa, Kentucky, Minnesota, New Mexico, North Carolina and North Dakota.

both goals. Specifically, IRC §2036 provides that the value of the transferor's gross estate includes the value of any transferred property over which the transferor has retained the right to possession or enjoyment, or the right to income, for a period not ascertainable without reference to his or her death. Similarly, §2038 provides that the transferor's gross estate includes the value of any transferred property where the enjoyment thereof was subject at the date of the transferor's death to any change through the exercise of a power by the transferor (either alone or in conjunction with any other person), to alter, amend, revoke, or terminate.

Without question, if a settlor retains the right to mandatory distributions from a trust which the settlor has created, the transfer will be brought back into the settlor's estate under IRC §2036(a)(1) as a retained right to possession or enjoyment, or to income. Moreover, in most jurisdictions IRC §2036(a)(1) will also apply even where the settlor's so-called "right" is wholly within the discretion of one or more independent trustees. This is because, as noted above, the general rule is that "[w]here a person creates a trust for his own benefit, a trust for support or a discretionary trust, his creditors can reach the maximum amount which the trustee under the terms of the trust could pay to him or apply for his benefit."[103] It follows that where a settlor's creditors can reach the settlor's interest in the trust, the settlor will be deemed, at least indirectly, to have retained the "use and enjoyment" of the transferred assets.[104] Where a settlor's creditors can reach the settlor's interest in the trust, the settlor may also be deemed to have an indirect power to revoke or terminate the transfer of assets by incurring debts and leaving his or her creditors no recourse other than to the transferred property.[105]

In a jurisdiction which has extended creditor protection to self-settled spendthrift trusts, however, the settlor's creditors will not be able to reach the trust's assets. In recognition of this fact, "[i]f and when the grantor's dominion and control of the trust assets ceases, such as by the trustee's decision to move the situs of the trust to a State where the grantor's creditors cannot reach the trust assets, then the gift is complete for Federal gift tax purposes under the rules set forth in [Treasury Regs.] §25.2511-2."[106] As a consequence, an asset protection trust can be settled in a jurisdiction which has extended the protection of the spendthrift trust rule to self-settled trusts, and thereby ensure that any transfers to the trust constitute completed gifts for U.S. gift tax purposes.

Interestingly, however, the finding of a completed gift will not necessarily cause the trust to also be excluded from the settlor's estate. In a 1998 private letter ruling, the IRS refused to rule on this latter issue stating, in essence, that excludability from the settlor's estate of the assets in an Alaska self-settled spendthrift trust is dependent upon the facts and circumstances existing at the settlor's death.[107]

In 2009, the IRS issued a private letter ruling which again considered the issue of estate tax inclusion in connection with an Alaska self-settled spendthrift trust. In PLR 200944002, the IRS ruled, significantly, that "the trustee's discretionary authority to distribute income and/or principal to the grantor, does not, by itself, cause the trust corpus to be includible in the grantor's gross estate under IRC §2036."[108] However, the IRS, again, specifically refused to rule on whether the trustee's discretion to distribute income and principal of the trust to the settlor, when combined with other facts (such as, but not limited to, an understanding or pre-existing arrangement between the settlor and the trustee regarding the exercise of such discretion) may cause inclusion of the trust's assets in the settlor's gross estate for federal estate tax purposes under IRC §2036.[109]

Thus, to preclude even the possibility of inclusion in the settlor's gross estate, it may be advisable to provide a third party with the discretion to exclude the settlor as a discretionary beneficiary at some point prior to the settlor's death.

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[103] Restatement (Third) of Trusts §60 & cmts. (2003).

[104] *See, e.g.*, *Paxton v. Comr.*, 86 T.C. 785 (1986); *German Est. v. U.S.*, 7 Cl. Ct. 641 (1985); *Outwin Est. v. Comr.*, 76 T.C. 153 (1981), acq., 1981-2 C.B. 2; *Paolozzi v. Comr.*, 23 T.C. 182, 187 (1954), acq., 1962-1 C.B. 4 ("petitioner's creditors could at any time look to the trust of which she was settlor-beneficiary for settlement of their claims to the full extent of the income thereof. This being true, it follows that petitioner … could at any time obtain the enjoyment and economic benefit of the full amount of the trust income.").

[105] *See, e.g.*, *German Est.*, 7 Cl. Ct. at 641.

[106] Rev. Rul. 76-103, 1976-1 C.B. 293.

[107] PLR 9837007.

[108] PLR 200944002.

[109] *See* Rothschild et al., "IRS Rules Self-Settled Alaska Trust Will Not Be in Grantor's Estate," 37 Est. Plan. 3 (Jan. 2010).

To the extent that a completed gift assures that the gifted property will not be includable in the settlor's gross estate at death, the use of an asset protection trust for estate planning purposes can provide the tax planning benefits commonly associated with more traditional trusts while at the same time enabling the settlor to receive distributions of trust income and capital, if necessary, within the discretion of the trustee.

¶ 411. Suggestions to Maximize Trust Protection

¶ 411.1 Overview

Within the broad outlines of "spendthrift" trusts, "discretionary" trusts and "support" trusts, certain factors, including, significantly, the inclusion of certain special trust provisions within the trust agreement, can maximize the protection afforded by such trusts.

In this regard the general rule of thumb is that the greater the beneficiary's control and/or access to the trust property, the less protection is afforded the trust property from the beneficiary's creditors.

¶ 411.2 Spendthrift Provision

All trust agreements should include an express spendthrift provision and the trust should be situated in a jurisdiction which recognizes the validity of spendthrift trusts. When drafting a trust with spendthrift provisions, language substantially similar to the following should be incorporated in order to maximize the protection of the trust fund:

> "During the continuance of any trust established hereunder, no beneficiary of said trust, whether as life tenant or remainderman, shall have any right or power to assign or otherwise anticipate, mortgage, alienate, charge or encumber either income or principal, or to give orders in advance upon the Trustees for the payment of income or principal, nor shall such trust and Trustees in any way become liable for any of the indebtedness of such beneficiary or be subject to any legal process, bankruptcy proceedings, or the claims, interference, or control of the creditors of such beneficiary.
>
> If the Trustees shall determine that a beneficiary would not benefit as greatly from any outright distribution of trust income or principal because of the availability of the distribution to the beneficiary's creditors, the Trustees shall instead expend those amounts for the benefit of the beneficiary. This direction is intended to enable the Trustees to give the beneficiary the maximum possible benefit and enjoyment of all of the trust income and principal to which the beneficiary is entitled.
>
> All benefits granted to a beneficiary under this Agreement shall be the separate and individual property of such beneficiary (as distinguished from marital property, community property, quasi-community property or any other form of property as to which such beneficiary's spouse might have a claim or interest arising out of the marital relationship under the law of any jurisdiction, domestic or foreign). All benefits granted to a beneficiary hereunder shall also be free of any interference from, or control or marital power of, his or her spouse. For purposes of this paragraph, the term 'benefits' shall include real or personal property, tangible or intangible, and the provisions of this paragraph shall apply not only to benefits actually paid to any beneficiary but also to trust property allocated to a trust in which the beneficiary possesses an interest hereunder. "

¶ 411.3 Sprinkling Provision

Ideally, the trust should give the trustee the power to "sprinkle" trust property among more than one beneficiary (perhaps, the beneficiary and the beneficiary's descendants), rather than limiting the trustee's discretion to a single beneficiary.

¶ 411.4 Trustee/Protector Provisions

The instrument should provide for at least one independent trustee whose consent is required for the distribution of trust property to the beneficiary. A restraint on alienation will be found ineffective where the same person is given both the entire legal and beneficial interest in the property (i.e., the sole trustee is also the sole beneficiary) under the theory that no trust exists where there is no separation of the legal and equitable interest in property.[110] Where the trustee is one of several beneficiaries, however, a valid trust is held to exist as to both the trustee/ beneficiary's interest and the other beneficiaries' interests. Therefore, "[i]f A holds upon a spendthrift trust for A and B, A's interest, being an interest under the trust and not a legal interest merely, cannot be assigned by him or reached by his creditors."[111] It is still advisable to provide for the appointment of an independent trustee in an effort to foreclose any suggestion by the trustee/beneficiary's creditors that the law should be otherwise or that the trust is, in fact, somehow a "sham." The inclusion of an objectively independent trustee is especially important in the case of a self-settled trust; where the more independent the trustee, the less merit will be given to a creditor's potential argument that the trustee's "discretionary" power to distribute trust assets is a "sham" by reason of some prearranged understanding between the parties. Even where the trust is not self-settled, where maximum asset protection is desired, a bank or trust company can be named as trustee in lieu of an individual, and the settlor can give a third party (or himself) the power to remove the trustee.

Where an asset protection trust names a protector, the trust protector should be someone other than the settlor. By doing so, any potential claims that the settlor has retained excessive control over the trust are negated. This is so notwithstanding the fact that an ability to remove and replace trustees (i.e., the "standard" power of a protector) does not rise to the level of a right to affect beneficial enjoyment under the IRC § 2036(a)(1).[112]

¶ 411.5 Discretionary Distributions and Beneficiaries

The trust agreement should provide that the beneficiary's receipt of a distribution of either income or principal is solely within the discretion of the trustee without reference to any identifiable or ascertainable standard and provide the trustee with the power to make distributions on *behalf of* the beneficiary rather than permitting only the direct distribution of trust property to the beneficiary. In a similar vein, consideration should be given to including the beneficiary's spouse or significant other as an additional discretionary beneficiary. By including such a provision, if and when there exists a creditor issue which prevents distributions from being made directly to the beneficiary, distributions can instead be made to the beneficiary's spouse or significant other for the benefit of that individual as well as the beneficiary. The following language implements the above suggestion and serves to maximize the protection of the trust fund:

> "During the Beneficiary's lifetime, the Trustee may pay to or apply for the benefit of such one or more of the Beneficiary, the Beneficiary's descendants and/or a Beneficiary's spouse, in such amounts and proportions, as the Trustee, in its sole and absolute discretion may determine, from time to time, for any purpose."

Where a beneficiary's spouse is named as a beneficiary of the trust it may be preferable to name the beneficiary's spouse by reference to a defined term rather than by name. By doing so, the beneficiary's spouse can be automatically excluded as a beneficiary upon a divorce and the beneficiary's new spouse will be automatically included upon the beneficiary's remarriage. The following language may be used in order to maximize the protection of the trust fund in this regard:

> "The 'spouse' of an individual means the person to whom the individual is married and living with (unless the individual or spouse is institutionalized) as of the time reference to a particular provision hereof is made and is to be applied. If there is no such person for a given period

[110] *See*, 2A Austin W. Scott & William F. Fratcher, The Law of Trusts § 99.

[111] 2A Austin W. Scott & William F. Fratcher, The Law of Trusts § 99.3, at 57; *See also, Avera v. Avera*, 253 Ga. 16 (1984).

[112] *See, e.g., Wall v. Commissioner*, 101 T.C. 300 (1993); Rev. Rul. 95-58, 1995-36 I.R.B. 16.

of time, due to any reason whatsoever (other than the death of the individual during the individual's lifetime while the individual is married to the particular person), then during such time this Agreement shall be read, interpreted and construed as if the spouse of the individual had failed to survive the individual. An individual's 'surviving spouse' means the person (if any) surviving the individual to whom the individual is married at the time of the individual's death."

¶ 411.6 Trust Term

Estate planners should also consider a lengthy trust term when creating a trust; ideally, the trust agreement should provide that the trust property remain in trust for the maximum possible period. It is, therefore, beneficial to create the trust in a jurisdiction which provides for the perpetual existence of trusts. In many states, however, the term of a trust is limited so that it cannot continue to exist beyond the "Rule Against Perpetuities" period (generally, no later than twenty-one years after the death of a discernible group of individuals then living or ninety years after the trust's creation). To date, twenty-eight states and the District of Columbia have repealed (or effectively repealed) the Rule Against Perpetuities thereby encouraging the creation of dynasty trusts in those jurisdictions. Those jurisdictions are: Alaska, Arizona, Colorado, Delaware, District of Columbia, Florida, Hawaii, Idaho, Illinois, Kentucky, Maine, Maryland, Michigan, Missouri, Nebraska, Nevada, New Hampshire, New Jersey, North Carolina, Ohio, Pennsylvania, Rhode Island, South Dakota, Tennessee, Utah, Virginia, Washington, Wisconsin and Wyoming. Where the grantor wishes to provide for an outright distribution at a specified point in time, the trustee or another person (other than the beneficiary) should be granted the right to extend the term of the trust (which power would be exercised in the event that a creditor problem exists at the time the trust would otherwise terminate). A slight variation on this provision is a "hold back" provision (discussed below in the paragraph titled "Power to Withhold Mandatory Distributions") which allows the trustee to withhold an otherwise mandatory distribution in the event of a creditor problem. Note, however, that where the beneficiary himself has affirmatively allowed property to which he is entitled to remain in trust, he has most likely thereby created a "self-settled" trust.[113]

¶ 411.7 State Income Tax Considerations

When drafting the trust, additional consideration should be given as to whether a state other than the state of trust administration or trustee residence can impose a tax on the income of the trust.[114]

State level income tax may, nevertheless, be imposed where the trust is structured as a "grantor trust" for income tax purposes. The law is well established that a settlor's designation of controlling law will govern the administration of a trust. "If the settlor creates a trust to be administered in a state other than that of his domicile, the law of the state of the place of administration, rather than that of his domicile, ordinarily is applicable. Thus a settlor domiciled in one state may create an inter vivos trust by conveying property to a trust company of another state as trustee and delivering the property to it to be administered in that state."[115]

¶ 411.8 Use of Property

In conjunction with continuing the trust for the maximum possible period, the trust agreement should also encourage the trustee to acquire assets for the use of the beneficiary in lieu of making distributions of trust property to the beneficiary. The following language is an example of how to maximize the protection of the trust fund in this regard:

"The Settlor has established this trust as a vehicle to provide the current beneficiaries with the use and enjoyment of the trust property free of charge, rather than making distributions of trust assets to such beneficiaries; the purpose being to preserve the trust principal from creditors, future ex-spouses and income and transfer taxes. In making distributions, the Trustee should take into account a beneficiary's other resources, it being the Settlor's intent that each

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[113] *See, e.g., In re Doris L. Morris*, 151 B.R. 900 (C.D. Ill. 1993); *Hartsfield v. Lescher*, 721 F.Supp 1052 (E.D. Ark. 1989). *Compare Matter of Dornbush*, 627 N.Y.S.2d 232 (N.Y. Surr. Ct. 1995); *In re St. Joseph's Hospital*, 133 B.R. 453 (S.D. Ill. 1991).

[114] *See, e.g., Chase Manhattan Bank v. Gavin*, 249 Conn. 172 (1999).

[115] 2A Austin W. Scott & William F. Fratcher, The Law of Trusts § 626, at 419 (4th ed. 1989). *See also* Restatement (Second) of Conflict of Law § 270.

> of the beneficiaries, to the extent they are capable of so doing, should provide for their own support and living expenses. The foregoing is to guide the Trustee only and, notwithstanding such guidance, the discretion of the Trustee is absolute and shall be exercised by the Trustee in accordance with the Trustee's best judgment, guided by what appear to be the best interests, as interpreted by the Trustee alone, of the eldest beneficiary of each such trust and such beneficiary's family as a whole, as may seem appropriate in carrying out the Settlor's original intent hereunder."

Similarly, the trustee should also be empowered to make loans to the beneficiary (whether they be secured or unsecured) or to make equity investments in business entities controlled by the beneficiary, rather than distributing trust property outright to the beneficiary.

¶ 411.9 Minor Beneficiaries

When a trust is created for a minor beneficiary pursuant to IRC § 2503(c), in order to qualify the transferred property for the exclusion from gift tax thereunder, in lieu of an automatic distribution at age twenty-one consider providing the beneficiary with a mere withdrawal window. Under the applicable Treasury Regulations, "... a transfer does not fail to satisfy the conditions of section 2503(c) by reason of the mere fact that ... (2) The donee, upon reaching age 21, has the right to extend the term of the trust. ..."[116] Still, an estate planner should consider that the beneficiary's failure to withdraw the property to which the beneficiary is entitled, would effectively create a self-settled trust.

¶ 411.10 Split Interest Trusts

Notwithstanding the clear asset protection benefit of continuing property in trust for the maximum allowable period, split-interest trusts (i.e., "QPRTs" and "GRATs") lend themselves to the commonly made mistake of an outright distribution upon the expiration of the initial trust period. Because the existence of the estate tax inclusion period precludes the possibility of leveraging the settlor's GST Exemption in connection with a split-interest trust, the estate planner's "knee jerk" reaction in drafting a split-interest trust is to draft an outright distribution of the trust property to the settlor's children upon the expiration of the term of the retained interest. Instead, consider a continuing trust for the children, grandchildren and more remote descendants until the expiration of the rule against perpetuities period. A continuing trust will preserve the trust property from the beneficiaries' potential creditors and will also ensure that the trust property does not pass to an in-law or other unintended beneficiary in the event that the beneficiary should die prematurely--a potentially catastrophic event under certain circumstances.

The trustee can be given the power to grant a testamentary general power of appointment to the beneficiaries in appropriate cases to ensure that the estate tax will be imposed in lieu of the generation-skipping transfer tax where to do so would reduce overall transfer taxes. In addition, other techniques (which are beyond the scope of this article) may exist to leverage GST exemption on the property transferred to a split-interest trust (i.e., a "GRAT remainder sale").

¶ 411.11 Terminating Beneficial Interest

In extreme cases, the trust agreement should provide for the termination of the beneficiary's beneficial trust interest upon the occurrence of an event which calls into question the protection of the trust fund. For example, the trust agreement may provide that the beneficiary's beneficial trust interest terminates in favor of another beneficiary in the event that the first beneficiary is at any time deemed insolvent, or the trust agreement may provide that an attempted alienation by the trust beneficiary, or an attempted attachment by the beneficiary's creditors will cause the beneficiary's beneficial trust interest to be forfeited in favor of another beneficiary. The Ninth Circuit has held such a provision effective to withstand even a federal tax claim on the basis that such provision left no property interest remaining which could be attached by the beneficiary's creditors.[117]

¶ 411.12 Conversion of Absolute Trust Interest into Discretionary Trust Interest

[116] Treas. Reg. § 25.2503-4(b).
[117] *In re Fitzsimmons*, 896 F.2d 373 (9th Cir. 1990).

A less drastic alternative involves the conversion of an absolute trust interest into a discretionary trust interest. In *Domo v. McCarthy*[118], the Court recognized such an alternative and found that the newly created discretionary trust could not be reached by creditors. In the alternative, consider giving the trustee the power to exclude beneficiaries by revising the trust's beneficial interests. Such a provision may prove of particular use within a self-settled spendthrift trust. If the settlor/beneficiary's beneficial trust interest is ultimately determined to subject the trust to estate tax inclusion or to creditors, the trustee (or a third party) can then exclude the settlor as a potential beneficiary of the trust. Such a provision may also prove useful if the settlor's relationship with one or more of the trust beneficiaries deteriorates after the trust is funded.

To accomplish this result of converting the trust from an absolute trust to a discretionary trust, the following language may be used:

> "During the Settlor's lifetime the Trustee may, in the exercise of sole and absolute discretion, by a signed declaration in writing declare that the person or persons or members of a class named or specified (whether or not ascertained in such declaration) who are, would be or might be or become (but for this provision) a Beneficiary hereof: (i) shall be partially excluded from future benefit hereunder; or (ii) shall cease to be a Beneficiary hereunder. Any such declaration may be revocable during the continuance of this Trust or irrevocable and shall have effect from the date specified in the declaration."

¶ 411.13 Powers of Appointment

The trust agreement should also limit any power of appointment given to a beneficiary so that the power does not rise to the level of a "general" power of appointment. The Internal Revenue Code defines a "general power of appointment" as "... a power which is exercisable in favor of the decedent, his estate, his creditors, or the creditors of his estate. ..."[119] Although this definition is most significant for federal tax purposes, it is also a useful definition for determining whether a beneficiary's power of appointment is too broad for asset protection purposes. Powers of appointment are addressed in greater detail below.

¶ 411.14 Power to Withdraw Trust Principal

A provision commonly found in trusts provides the beneficiaries with the power to withdraw trust principal. Even where such power would cause little or no adverse tax consequence as with a so-called "five and five" power or a withdrawal power limited to the beneficiary's health, education, support or maintenance,[120] such power could potentially cause the trust property subject thereto to be deemed available to the beneficiary's creditors.[121] Where so-called "Crummey" powers are required to be included in the trust agreement, consider providing the trustee with the power to exclude trust beneficiaries from receiving a Crummey power with respect to future contributions to the trust. In this regard, the following language is suggested:

> "The Trustee may, by an instrument in writing executed before a contribution, exclude one or more individuals from having withdrawal rights over that contribution or any future contribution or both. The Trustee may not, however, limit or alter any rights resulting from prior contributions."

¶ 411.15 Segregation

A trustee should be advised to segregate trust assets which have the potential for creating liability (i.e., rental real estate) from other trust property. This can be accomplished by the trust creating a separate single member limited liability company to separately hold each asset which could potentially cause liability to the trust fund. As an additional precaution against the "corporate" veil being pierced, a single trust holding some assets which potentially expose the trust to liability and other assets which do not, can be split into two separate trusts. This approach was addressed in *In the Mat-*

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[118] 66 Ohio St. 3d 312, 317 (1993).

[119] 26 U.S.C. § 2041(b)(1).

[120] *See* 26 U.S.C. §§ 2514(e) and 2041(b)(1)(A).

[121] At least one state, Texas, statutorily provides that a limited Crummey power of withdrawal does not cause the powerholder to be a settlor for purposes of the self-settled trust rule. TEX. CODE ANN. § 112.035(e).

ter of Joseph Heller Inter Vivos Trust[122], whereby the Court permitted the trustees to divide the trust into two trusts, one to hold the real estate and the other to hold the securities expressly for the purpose of creditor protection.

¶ 411.16 Power to Withhold Mandatory Distributions

The trust agreement should also provide the trustee with the power to withhold otherwise mandatory distributions if the trustee, in the exercise of sole and absolute discretion, should deem the distribution to be adverse to the beneficiary's interest (for example, due to the existence of a creditor problem at the time the distribution would otherwise be required to be made). Since a "hold-back" provision creates, in effect, a discretionary trust at such point in time as a distribution would otherwise have to be made, it should serve to protect the beneficiary's trust interest from creditor claims in the same manner as had the trust been wholly discretionary from the outset. However, a non-discretionary trust with a hold back provision differs from a purely discretionary trust in that it places the onus upon the trustee to justify, to the beneficiary, and potentially to the court as well, the trustee's decision to withhold what would otherwise have been a mandatory distribution. In order to maximize the protection of the trust fund in this regard, the following language is useful:

> "If the Trustee shall, in the exercise of sole and absolute discretion, determine that circumstances exist making it clearly contrary to the best interests of a Beneficiary to receive a distribution of principal which is otherwise required to be made hereunder, the Trustee may refrain from making all or any part of such distribution until the Trustee shall determine that such circumstances no longer exist. Circumstances in a Beneficiary's life which would justify exercising that discretion include, without limitation, being a defendant in serious litigation or being involved in bankruptcy proceedings or similar financial or matrimonial difficulties, being physically, mentally or emotionally unable to properly administer the assets to be distributed, or living under a form of government or other condition making it highly likely that the assets to be distributed would be subject to confiscation or expropriation."

¶ 411.17 Power to Change Trust Situs

The trust agreement should grant the trustee the discretion to change the situs of the trust from its current situs to that of another jurisdiction, either within or without the United States, and to appoint either a successor trustee or a co-trustee in order to enable the trust to be validly governed by the law of such other jurisdiction. This type of provision is useful in several situations. For example, where the law governing the original trust situs changes to the detriment of the beneficiaries, or the law of another jurisdiction changes so as to become more appealing than the law governing the original trust situs. Giving the trustee this type of power is also helpful where the particular circumstances surrounding the trust warrant a change of situs as, for example, where increased asset protection concerns warrant that the trust be sited under the laws of an "asset protection haven" such as Alaska, Delaware, the Cook Islands or Nevis. The following language may be used to provide such discretion:

> "The original situs of the Trust created hereunder shall be the State of ____________________. The situs of any Trust created hereunder may be maintained in any jurisdiction (including outside the United States), as the Trustee, in the exercise of sole and absolute discretion, may at any time determine, and may thereafter be transferred at any time or times to any other jurisdiction selected by the Trustee without any need to obtain the approval of any court. Upon any such transfer of situs, the Trust fund may thereafter, at the election of the Trustee of said Trust, be administered exclusively under the laws of (and subject, as required, to the exclusive supervision of the courts of), the jurisdiction to which it has been transferred. Accordingly, if the Trustee of any Trust created hereunder elects to change the situs of any such Trust, the Trustee of said Trust is hereby relieved of any requirement of having to qualify in any other jurisdiction and of any requirement of having to account in any court of such other jurisdiction."

¶ 411.18 Trust/LP/LLC Combination

[122] 613 N.Y.S.2d 809, 810 (N.Y. Surr. Ct. 1994).

Another planning technique to consider is that of combining a trust with a limited partnership or limited liability company in order to provide an additional layer of asset protection, since a creditor's remedy (against the trust, or against a beneficiary's interest therein) may thereby be limited to a charging order against the limited partnership or limited liability company interest. Where the trust is a self-settled trust created under the law of a domestic jurisdiction, such as Alaska or Delaware, the use of an Alaska or Delaware limited partnership or limited liability company will also increase the settlor's contacts with that state, providing further justification for the application of that state's law to the trust. The use of an underlying limited partnership or limited liability company may also permit continued investment management and control of the trust assets by the trust settlor (in the capacity of a general partner of the limited partnership or a manager of the limited liability company).

¶ 412. Joint Ownership of Property

¶ 412.1 There are four types of joint ownership of property, with the following characteristics significant asset protection.

A. Community Property

The community property system has been adopted by nine states: Arizona, California, Idaho, Louisiana, New Mexico, Nevada, Texas, Washington and Wisconsin. The U.S. Territory of Puerto Rico is also a community property jurisdiction. Alaska has also adopted a community property system, but it is optional – spouses may create community property by entering into a community property agreement or by creating a community property trust.[123]

The theory underlying community property is analogous to that of a partnership. Each spouse contributes labor (and in some states, capital) for the benefit of the community, and shares equally in the profits and income earned by the community. Thus, each spouse owns an automatic 50% interest in all community property, regardless of which spouse acquired the community property. Spouses may also hold separate property, which they solely own and control, but the law in the community property states does not favor this.

Spouses are also considered to share debts. Depending on state law, creditors of spouses may be able to reach all or part of the community property, regardless of how it is titled, to satisfy debts incurred by either spouse. State laws vary greatly on what property can be reached.

B. Tenancy in Common

Although a tenancy in common may be had as to either real or personal property, and although there are far fewer restrictions on the establishment of a tenancy in common than there are for other forms of joint ownership of property, the ownership of property with another as tenants in common provides only negligible benefits for asset protection purposes. This is so because each tenant may, voluntarily or involuntarily, alienate his or her interest in the property without the consent of his or her co-tenants. Of course, the creditor of a co-tenant will not actually be able to enjoy the use of the property subject to the tenancy in common exclusive of the remaining co-tenants without first obtaining a judicial partition of the property. This may diminish the value of the property to a creditor and afford some slight leverage to the debtor tenant in common in settling the creditor's claim at less than its full value.

C. Joint Tenancy

Like a tenancy in common, a joint tenancy provides only negligible protection, because each tenant may, voluntarily or involuntarily, alienate his or her interest in the property without the consent of the remaining tenants. To the extent that the interest is not alienated during life, it will pass to the surviving joint tenant or tenants upon the death of a joint tenant. When an interest in a joint tenancy is alienated, either voluntarily or involuntarily, the recipient of the alienated interest takes title as a tenant in common with the remaining tenants (who remain joint tenants as between themselves).

The same small modicum of leverage applies to a creditor of a tenant to a joint tenancy as applies to a creditor of a tenant to a tenancy in common; to wit, the creditor will not be able to enjoy the use of the property exclusive of the remaining co-tenants without first obtaining a judicial partition of the property.

[123] *See* Alaska Stat. §§ 34.77.020 - 34.77.995.

D. Tenancy By The Entireties

A "tenancy by the entireties" is a special form of joint ownership of property that can only exist between spouses. The common law tenancy by the entireties was characterized by five coincident unities, as follows: (1) unity of possession, meaning joint ownership and control of the property; (2) unity of interest, meaning that the interests must be the same; (3) unity of title, meaning that the interests must originate in the same instrument; (4) unity of time, meaning that the interests must commence simultaneously; and (5) unity of marriage, meaning that the tenants must be married to each other at the time title to the property is acquired.

The unity of possession has the effect of requiring each spouse (who have historically been considered to constitute an indivisible unit) to act together to convey title to tenancy by the entireties property, thereby generally precluding a unilateral severance and giving life to a rule whereby a creditor of only one of the spouses cannot execute a judgment against the tenancy by the entireties property. "A tenancy by the entireties differs from a joint tenancy with right of survivorship in that a tenancy by the entireties cannot be partitioned during the marriage of the parties without the consent of the cotenants…Consequently, unlike a joint tenancy with right of survivorship, property held by tenancy by the entireties is not subject to execution or levy for the debts of only one of the cotenants."[124]

Such result is sometimes provided for by statute. For example, Section 12-112 of the Illinois Code of Civil Procedure provides, in pertinent part, that "…Any real property…held in tenancy by the entirety shall not be liable to be sold upon judgment entered on or after October 1, 1990 against only one of the tenants, except if the property was transferred into tenancy by the entirety with the sole intent to avoid the payment of debts existing at the time of the transfer beyond the transferor's ability to pay those debts as they become due."

Not all states continue to follow the common law rule, however, and at least one state, Alaska, has enacted a statute specifically rejecting the common law rule and permitting the levy and sale of an interest in property held as a tenancy by the entiretries.[125]

Property that is exempt from creditors under state law by reason of a tenancy by the entireties (in those states that follow the common law rule) will also be exempted from an estate in bankruptcy by reason of Bankruptcy Code § 522(b)(3)(B) which exempts "any interest in property in which the debtor had, immediately before the commencement of the case, an interest as a tenant by the entirety…to the extent that such interest as a tenant by the entirety or joint tenant is exempt from process under applicable non-bankruptcy law". Where, however, the entireties property is not exempt from the claims of creditors under state law (or other applicable non-bankruptcy law) Bankruptcy Code § 363(h) would allow the bankruptcy trustee to force a sale of the co-tenant's interest, together with the estate's interest, if: (1) partition in kind of such property among the estate and such co-owner is impracticable; (2) sale of the estate's undivided interest in such property would realize significantly less for the estate than sale of such property free of the interests of such co-owner; (3) the benefit to the estate of a sale of such property free of the interests of the co-owner outweighs the detriment, if any, to such co-owner; and (4) such property is not used in the production, transmission, or distribution, for sale, of electric energy or of natural or synthetic gas for heat, light, or power.

Even where the entireties property is exempt from the claims of creditors under applicable non-bankruptcy law, however, the protection may still not be sufficient to overcome claims of state, local or federal government.[126]

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[124] *Roberts & Lloyd, Inc. v. Zyblut*, 691 A.2d 635, 638 (D.C. 1997).

[125] *See*, ALASKA STAT. § 09.38.100 (a), which provides that "[i]f an individual and another own property in this state as…tenants by the entirety, a creditor of the individual… may obtain a levy on and sale of the interest of the individual in the property. A creditor who has obtained a levy, or a purchaser who has purchased the individual's interest at the sale, may have the property partitioned or the individual's interest severed."

[126] In *United States v. Craft*, 535 U.S. 274 (2002), the Internal Revenue Service assessed substantial unpaid income taxes against Don Craft, the husband of Sandra Craft. When Mr. Craft failed to pay his income tax liabilities, pursuant to Internal Revenue Code § 6321 a federal tax lien attached to "all property and rights to property, whether real or personal, belonging to…" Mr. Craft. At the time the lien attached, Mr. and Mrs. Craft owned Michigan real property as tenants by the entirety. After notice of the lien was filed, Mr. and Mrs. Craft jointly executed a quitclaim deed transferring the couple's interest in the property to Mrs. Craft for one dollar. When Mrs. Craft attempted to sell the property a few years later, a title search revealed the lien. The Internal Revenue Service agreed to release the lien and allow the sale with the stipulation that half of the net proceeds be held in escrow pending determination of the government's interest in the property. The government claimed

Where the common law rule is followed (and unless, as noted *infra*, there exists a joint creditor of both tenants, or the creation of the tenancy by the entireties was itself a fraudulent transfer) no fraudulent transfer can result from a transfer of one spouse's interest in the tenancy by the entireties property to the other spouse, or to a third party.[127]

E. Issues in Connection With Tenancies by the Entireties

In some states, only real estate can be held in a tenancy by the entireties form, while in other states personal property may also be held as tenants by the entiretries.[128]

Significantly, and notwithstanding "portability", the asset protection afforded by spouses holding title to property as tenants by the entiretries is frequently at odds with another aspect of the couple's personal planning, since proper estate tax planning often still requires that the joint estate be divided between the spouses for purposes of estate equalization or so as to ensure that each spouse's estate can make maximum use of the generation skipping tax exemption and state law exemptions (since portability does not apply for such purposes). The potential asset protection afforded by spouses holding property as tenants by the entireties must, therefore, be considered against the potential that such structure will garner transfer tax which could otherwise have been avoided, bearing in mind that post-mortem planning techniques such as disclaimers may be employed to "divide" an estate between spouses after the fact, thereby avoiding such transfer tax (although it should be noted that some states, such as New Jersey, treat disclaimers as fraudulent transfer if the disclaimant has creditors at the time).

Any asset protection afforded by this form of ownership will disappear in the event of divorce or death, unless, in the case of death, the decedent is the debtor spouse or, in the case of a divorce, the property is awarded to the non-debtor spouse. Additionally, a tenancy by the entirety, of course, provides no asset protection to a joint creditor of the two tenants.

One solution to this problem that the creditor protection afforded by a tenancy by the entireties will be lost in the event of the death of the non-debtor spouse, is to title the assets entirely in the name of the spouse with less creditor exposure, and to provide under that spouse's last will and testament that should he or she die survived by his or her spouse, that the assets in question pass to the surviving spouse in trust, rather than outright. This approach may not be desirable, however, where (1) the spouses were previously married, with children from their prior marriages who

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that its lien had attached to the husband's interest in the tenancy by the entireties and it further asserted that the transfer of the property by Mr. and Mrs. Craft to Mrs. Craft was invalid as a fraudulent transfer. The Michigan Uniform Fraudulent Transfer Act provided, however, that a tenancy by the entireties property cannot be the subject of a fraudulent transfer in a case where only one spouse is the debtor. Under long-standing doctrine, federal law looks to state law to determine what rights a taxpayer has in property the Internal Revenue Service seeks to reach, and then looks to federal law to determine whether a taxpayer's state-law delineated rights qualify as "property" or "rights to property" within the meaning of the federal tax lien legislation. In *Craft*, however, the United States Supreme Court, after recognizing that under Michigan law one tenant by the entirety has no interest in the property separable from that of the other, each being vested with an entire title, found that Mr. Craft had individual rights in the property to which the federal tax lien could attach.

In addition, "[a]lthough *Craft* only dealt with tax liens, Congress has unequivocally stated that criminal fines are to be treated in the same fashion as federal tax liabilities." *In re Huchins*, 306 BR 82 at 90 (Bankr. D. Vt. 2004).

See also, U.S. v. Barczyk, 434 Fed. Appx. 488 (6th Cir. 2011) (once tax lien properly attaches to jointly-held marital property, i.e., property held by entireties, court may order forced sale over objection of non-liable spouse; absent compelling reason, such as atypically wide age difference between spouses, court will not use actuarial valuation to determine amount non-liable spouse entitled to from forced sale; thus, non-liable spouse entitled to 50% of proceeds of forced sale, with other 50% going to government to satisfy defaulting spouse's tax debt).

[127] *See, e.g., Plastipak Packaging, Inc. v.* DePasquale 363 Fed. Appx. 188, 191 (3d Cir. 2010)(applying Pennsylvania law); *Valvanis v. Milgroom*, No. 06-00144 JMS-KSC, 2008 U.S. Dist. LEXIS 109253, *11-12 (D. Haw. May 20, 2008); *Watterson v. Edgerly*, 388 A.2d 934, 939 (Md. Ct. Spec. App. 1978) ("When, as here, a husband and wife hold title as tenants by the entirety, the judgment creditor of the husband or of the wife has no lien against the property held as entireties, and has no standing to complain of a conveyance which prevents the property from falling into his grasp.").

[128] N.Y. EST., POWERS & TRUSTS LAW § 6-2.1(4) allows a tenancy by the entireties form of ownership only as to real property except that, on and after January 1, 1996, a tenancy by the entireties form of ownership is also permissible as to shares of stock of a cooperative apartment corporation allocated to an apartment or unit together with the appurtenant proprietary lease.

might, therefore, inherit disproportionately if the assets are transferred outright to the spouse with less creditor exposure, or (2) the spouse with "less creditor exposure" nevertheless still has significant creditor exposure.

F. Tenancy by the Entireties Trusts.

An alternative solution would be to create a tenancy by the entireties trust in a jurisdiction that has extended tenancy by the entireties protections to property held in trust. [129] For example, Tennessee Trust Code Sec 35-15-510(b) provides that: "[a]ny property of a husband and wife that was held by them as tenants by the entirety and subsequently conveyed as tenants by the entirety to the trustee or trustees of one (1) or more trusts, and the proceeds of that property, shall have the same immunity from the claims of their separate creditors as would exist if the husband and wife had continued to hold the property or its proceeds as tenants by the entirety, so long as: (1) The husband and wife remain married; (2) The property or its proceeds continues to be held in trust by the trustee or trustees or their successors in trust; (3) The trust or trusts are, while both settlers are living, revocable by either settlor or both settlers, acting together; (4) Both the husband and the wife are permissible current beneficiaries of the trust or trusts while living; and (5) The trust instrument, deed, or other instrument of conveyance provides that this section shall apply to the property or its proceeds."

The tenancy by the entireties trust is potentially better than a standard tenancy by the entireties because it will provide for a continuing protection for the property from the creditors of the surviving spouse after the death of the first spouse to die. For example, Tennessee Trust Code Sec 35-15-510(c) provides, in pertinent part that "[a]fter the death of the first of the husband and wife to die, all property held in trust that was immune from the claims of their separate creditors…immediately prior to the individual's death shall continue to have the same immunity from the claims of the decedent's separate creditors as would have existed if the husband and wife had continued while both were alive to hold the property conveyed in trust, or its proceeds, as tenants by the entirety..." However, such immunity would not continue "[t]o the extent that the surviving spouse…has the power, exercisable in the individual capacity of the surviving spouse, to vest in the surviving spouse individually title to the property that was immune from the claims of the separate creditors of the decedent…"

¶ 413. Miscellaneous Asset Protection Considerations

¶ 413.1 Disclaimers

A. Definition

A "disclaimer" is defined in Black's Law Dictionary as "[a] renunciation of one's legal right or claim."[130]

B. Requirements

The requirements of an effective ("qualified") disclaimer are set forth under IRC § 2518. In order to be effective, the disclaimer must be in writing and such writing must be received by the transferor of the interest, his or her legal representative, or the holder of the legal title to the property to which the interest relates. Such writing must be received not later than the date which is nine months after the later of: the date on which the transfer creating the interest in the would-be disclaimant is made; and the day on which the would-be disclaimant attains age twenty-one.[131] An additional requirement specifies that the would-be disclaimant must not have accepted the interest or any of its benefits. Finally, as a result of such refusal, the interest must pass without any direction on the part of the would-be disclaimant and pass to either the spouse of the decedent; or to a person other than the would-be disclaimant.[132]

Based on the fact that the tax consequences of a "qualified" disclaimer for gift tax purposes are so important, the requirements for an effective disclaimer under the law of most states is often at least as restrictive as is required under the Internal Revenue Code.[133] Where the requirements for an effective disclaimer under state law are less restrictive than

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[129] See e.g. See, 12 Del. C. § 3334 (2016); HRS § 509-2 (2016); 765 ILCS 1005/1c (2016) and 735 ILCS 5/12-112 (2016); Ind. Code Ann. § 30-4-3-35 (2016); Md. Code Ann. Estates and Trusts MIchigan§ 14.5-511(b) (2016); RSMo § 456.9-501;TCA § 35-15-510 (2016); Va. Code Ann. § 55-20.2 (2016); Wyo. Stat. § 4-10-402 (2016).

[130] Black's Law Dictionary 531 (9th ed. 2009).

[131] 26 U.S.C. § 2518.

[132] *Id.*

[133] *See, e.g.*, N.Y. EST., POWERS AND TRUSTS § 2-1.11.

under the Internal Revenue Code, however, a disclaimer can exist which is effective under state law (i.e., for asset protection purposes) but which carries adverse federal gift tax consequences. For example, "[i]f a New York court allows a person to disclaim more than nine months after the transfer, it will constitute a gift (for gift tax purposes) to the person who gets the property as a result of the disclaimer, but it will successfully insulate the property from the disclaiming party's creditors since the renunciation is retroactive to the date of the transfer."[134] In order to make the disclaimer palatable to a would-be disclaimant, however, care should be taken to qualify the disclaimer under IRC § 2518, even where the terms of that section are more restrictive than is required under the governing state law.

C. Effect of Disclaimer

Since, at common law, a person is not obligated to accept a gift, where a disclaimer is effectively made the individual who would have otherwise received the property at issue (the "disclaimant") is often deemed to have predeceased the transferor. Similarly, the Internal Revenue Code provides that "... if a person makes a qualified disclaimer with respect to any interest in property, this subtitle shall apply with respect to such interest as if the interest had never been transferred to such person."[135] An effective disclaimer will relate back in time to the original gift, so that the disclaimant is considered as never having obtained an interest in the property at issue to which a creditor's lien can attach. The disclaimer will relate back to a time immediately before a decedent's death.[136] As a result, generally, the disclaimed interest is not transferred to the disclaimant at the decedent's death. As there is no transfer of an interest to the disclaimant, there is nothing to which a lien can attach. Consequently, creditors of the disclaimant and his estate have no claim against or right in the disclaimed property."[137] It is, therefore, because of the relation back doctrine that disclaimers are a powerful asset protection tool.

D. Disclaimers as a Planning Tool

An estate planner might consider using a disclaimer where a lack of forethought has allowed a gift to be made to a beneficiary who is facing a creditor problem. In the alternative, and where the beneficiary is the transferor's spouse, one planning technique is to consider drafting disclaimer provisions into a trust or last will and testament where the beneficiary spouse's creditor problems are contemplated, but are not considered a sufficiently serious problem to warrant an automatic distribution in trust. For example, such circumstances might warrant an outright gift with a contingent trust for the beneficiary spouse in the event that the beneficiary spouse should ultimately disclaim the outright gift.

E. Exceptions to General Rule

There are exceptions to effective disclaimers for asset protection purposes. Where they would be disclaimant is a minor, an effective disclaimer may not be possible. Although the disclaimer could, in theory be effected by the minor's guardian, there is a possibility that the disclaimer would not be deemed to be within the minor's "best interests" by the court. Some states have statutorily provided an additional exception that a disclaimer is ineffective if the would-be disclaimant is insolvent at the time the disclaimer is made.[138] In addition, many states do not respect disclaimers for Medicaid eligibility purposes.[139] Yet, other states statutorily provide that the creditors of a disclaimant have no interest in the property which is disclaimed.[140]

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[134] Turano, Practice Commentary, McKinney's Cons. Laws of NY, Book 17B, EPTL 2-1.11, at 242; *See also, Matter of Dominguez*, 143 Misc.2d 1010, 541 N.Y.S.2d 934 (NY Cty. Surr. Ct. 1989).

[135] 26 U.S.C. § 2518(a).

[136] *National City Bank of Evansville v. Oldham*, 537 N.E. 2d 1193, 1196 (Ind. Ct. App. 1989); *But see, Pennington v. Bigham*, 512 So. 2d 1344 (Ala. 1987) (holding that by virtue of judgment creditor's lien on inherited real property, disclaimer by insolvent debtor was of no effect).

[137] *National City Bank of Evansville, Oldham, supra*.

[138] *See, e.g.*, FLA. STAT. ANN. § 732.801(6) (West Cum. Supp. 2000); MASS. GEN. LAWS ANN. Ch. 191A § 8 (West 1990); MINN. STAT. ANN. § 525.532 (West 1986); N.J. STAT. ANN. § 3B:9-9 (West Cum. Supp. 1999); WASH. REV. CODE ANN. § 11.86.051 (West 1998).

[139] See e.g., *Troy v. Hart*, 697A. 2d. 113 (Md. Ct. Spec. App 1997)

[140] MD. CODE ANN., EST. & TRUSTS § 9-204(f); MO. REV. STAT. § 469.010 (1997); TEX. PROB. CODE ANN. § 37A (2000).

In a dispute with the Internal Revenue Service, the Supreme Court held that disclaimed property can be reached by the federal government in order to pay off the disclaimant's federal tax liens. In *Drye Family Trust v. U.S.*[141], the Court held that state property law has no effect on the ability of the federal government to reach disclaimed property to satisfy tax liens of the disclaimant. The Court found that the right to inherit is a property right subject to the federal tax lien, and the fact that the inheritance is subsequently voided by an effective state law disclaimer will not affect the federal government's interest in that property right.

¶ 414. Powers of Appointment

¶ 414.1 Overview

A "power of appointment" has been defined as "[a] power created or reserved by a person having property subject to disposition, enabling the donee of the power to designate transferees of the property or shares in which it will be received."[142] In general, there are two classes of powers of appointment, "general" powers of appointment and "non-general" (also sometimes called "special" or "limited") powers of appointment.

A general power is defined as a right to appoint to whomsoever the donee pleases including himself or his estate. By contrast, under a non-general power the donee is restricted to the objects [other than the donee or his estate] as is designated in the deed or will creating the power.[143] For example, a non-general power can give the donee the limited right to appoint to his issue or can be broader by allowing the donee to appoint to anyone except himself, his creditors, his estate or the creditors of his estate. The foregoing distinction between general and non-general powers of appointment is extremely important for asset protection purposes since property subject to a *non-general* power will not be subject to the claims of the donee's creditors and property subject to a *general* power *may* be subject to the claims of the donee's creditors.

¶ 414.2 Distinctions--General versus Non-General Powers of Appointment

The question arises as to why this distinction is made? Non-general powers of appointment are not subject to creditor claims because the donee of the power has no beneficial interest in the property subject to the power.[144] This is also the case under the Federal Bankruptcy Code, which provides that "[p]roperty of the [bankruptcy] estate does not include ... any power that the debtor may exercise solely for the benefit of an entity other than the debtor."[145]

Since the donee of a general power of appointment, however, does have a beneficial interest in the property subject to the power, under certain circumstances the property will be subject to the claims of the donee's creditors. The general rule, however, is that not even property subject to a general power of appointment can be reached by the donee's creditors (provided that the donee was not also the creator of the general power) until the power is actually exercised by the donee, unless it is otherwise provided by statute.[146] The justification for the foregoing rule was well summarized in *Gilman v. Bell*[147], which found that "the donee of the power only receives the naked power to make the property or fund his own. And when he exercises the power, he thereby consents to receive it, and the title thereby vests in him, although it may pass out of him *eo instanti*, to the appointee." A number of states, however, statutorily provide that creditors *can* reach property subject to an unexercised general power of appointment. For example, in Alabama, "[e]very special and beneficial power is liable to the claims of creditors, and the execution of the same may be ordered for their benefit."[148] A similar rule applies in New York,[149] Tennessee[150] and in the context of bankruptcy.[151]

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[141] 528 U.S. 49 (1999).

[142] Black's Law Dictionary 1290 (9th ed. 2009).

[143] *Id.*

[144] 2A Austin W. Scott & William F. Fratcher, The Law of Trusts § 147.3, at 69 (4th ed. 1989); *See, e.g.,* N.Y. EST., POWERS AND TRUSTS § 10-7.1, which provides that "[p]roperty covered by a special power of appointment is not subject to the payment of the claims of creditors of the donee, his estate or the expenses of administering his estate."

[145] 11 U.S.C. § 541(b)(1).

[146] 2A Austin W. Scott & William F. Fratcher, The Law of Trusts § 147.3, at 69-70 (4th ed. 1989).

[147] 99 Ill. 144, 149-150 (1881).

[148] ALA. CODE § 35-4-305 (2000).

[149] N.Y. EST., POWERS AND TRUSTS § 10-7.2.

[150] TENN. CODE. ANN. § 66-1-106 (2000).

Where a person creates a general power of appointment in himself, the property can be reached by such person's creditors, whether or not the power is exercised or even presently exercisable.[152]

¶ 414.3 Asset Protection and Powers of Appointment

There are several ways in which a power of appointment can be used to provide creditor protection.[153] In those jurisdictions which follow the general rule that an unexercised general power of appointment is not subject to the claims of the donee's creditors, a general power of appointment over property can be transferred to the donee in lieu of a transfer of the actual property with the intent that the beneficiary exercise the power in his favor, as he comes to require the property, and only in the absence of immediate creditor claims. A limited power of appointment exercisable in favor of an extremely limited class (which includes, of course, the intended beneficiary) can be granted to the intended beneficiary's spouse with the intent that the property be meted out to the beneficiary as required. The grant of a limited power of appointment to the spouse has three main benefits over an actual gift of the property itself to such spouse. The donee will have no conflict of interest since in no event will the donee be able to vest the property in him or herself. In addition, the property cannot become subject to the claims of the donee's creditors. .

¶ 415. Exemption Planning

Although public policy favors the enforcement of creditors' claims generally, the undeniable importance of certain assets to what might be termed the "subsistence" of a debtor and his or her family will often trump the enforcement of creditors' claims. Such assets are frequently referred to as "exempt" assets. While some exempt assets (i.e., the family bible) have no asset protection utility, other exempt assets provide potentially significant asset protection planning opportunities which should be considered in connection with one's asset protection plan. As a preliminary matter, however, it must be noted that the question of an asset's status as exempt or non-exempt, and the extent of the exemption, varies significantly among the states. Therefore, one must look to local law to determine the particulars of any exemptions likely applicable to one's specific situation.

¶ 415.1 Pensions and Individual Retirement Accounts

Pension plans which are qualified under the Employee Retirement Income Security Act ("ERISA"), and hence contain an anti-alienation provision as required under that Act, have been held by the United States Supreme Court to be protected from creditors.[154] By contrast, the creditor protection afforded non-ERISA plans varies on a state by state basis. Even those states which statutorily exempt individual retirement accounts from the reach of creditors, do not necessarily exempt "Roth IRAs or inherited IRAs." Further, the exemption for individual retirement accounts under the Bankruptcy Code is limited to $1,000,000 (adjusted for cost of living), although this limitation does not apply to employer-sponsored IRAs or rollovers from employer-sponsored IRAs.[155]

Where the client resides in a state in which an individual retirement account is not exempt from creditors, when available the client should retain his fund within the qualified plan rather than effecting a roll-over into an individual retirement account. Similarly, in order to preserve the fund from the beneficiary's potential creditors after the death of the employee, consider the use of a qualifying type of trust as the account beneficiary.

By contrast, where an individual retirement account is exempt from creditors, a roll-over into an individual retirement account in the name of the surviving spouse is doubly advisable. A roll-over will enable the surviving spouse to maximize the deferral of income taxation on the account by minimizing the minimum required distributions through use of an extended pay-out period and will also ensure protection of the individual retirement account from the spouse's credi-

[151] 11 U.S.C. § 541(a)(1); *In re Shurley*, 171 B.R. 769 (Bankr. W.D. Tex. 1994) (because a general power of appointment can be exercised for the benefit of the donee herself, it is included in the donee's bankruptcy estate), *rev'd on other grounds*, 115 F.3d 333 (5th Cir. 1997).

[152] N.Y. EST., POWERS AND TRUSTS § 10-7.4, which provides that "[p]roperty covered by a general power of appointment which, when created, is not presently exercisable is subject to the payment of the claims of creditors of the donee, his estate and the expenses of administering his estate, only (1) If the power was created by the donee in favor of himself. ..."

[153] The author is grateful to Alexander Bove, Esq., who first brought the use of powers of appointment as an asset protection tool to his attention.

[154] *Patterson v. Shumate*, 112 S.Ct. 2242 (1992).

[155] 11 U.S.C. 522(b).

tors. However, it should be noted that inherited individual retirement accounts are not entitled to the exemption extended to individual retirement accounts under the Bankruptcy Code.[156]Some states have recently enacted legislation to extend the exemption to inherited IRAs.

¶ 415.2 Qualified State Tuition Programs

Under IRC § 529, a person may make contributions to an account for the purpose of providing for qualified higher education expenses for a designated beneficiary.[157] Such contributions qualify for the gift tax annual exclusion under IRC § 2503(b). The donor can contribute up to $50,000 (indexed) per donee and elect to apply such amount ratably over a five-year period for purposes of the gift tax exclusion. A major benefit of such account is the ability of the donor to use such funds for his or her own benefit (subject to a 10% penalty). As a result, it would appear that such accounts would generally be available to the donor's and beneficiary's creditors. Recognizing such potential, some states have enacted legislation which exempt such accounts from both the donor's and beneficiary's creditors.[158] Accordingly, planners may wish to consider establishing these accounts in those states which offer creditor protection for clients who may have creditor exposure and who may otherwise be reluctant to make completed gifts or establish more costly trusts.

¶ 415.3 Homestead

One asset that is frequently granted an exemption from creditors' claims is an individual's principal residence. This exemption is most often referred to as a "homestead exemption". The fairly obvious legislative purpose behind the enactment of a statutory homestead exemption is the preservation of that asset most necessary for the subsistence of an individual and his or her dependents – their home. In fact, so significant is the family homestead deemed to be to one's subsistence that forty-seven of the fifty states provide at least some level of exemption for an individual's principal residence. Unfortunately, however, only Florida, Iowa, Kansas, South Dakota and Texas provide for a so-called "unlimited" homestead exemption. And, even where the homestead exemption is unlimited, this does not necessarily also mean that the exemption is unqualified – for example, certain specially protected classes of creditors (i.e., the Internal Revenue Service or an ex-spouse) might be permitted to avoid this exemption and enforce a judgment against the home.

In order to maximize use of the homestead exemption, one might consider moving, subject to the time requirement of the Bankruptcy Code[159] for establishing residency in that jurisdiction, to a jurisdiction that allows a more generous or even an unlimited homestead exemption. Alternatively, where one is already domiciled in such a jurisdiction, or even where one wants to make the best use of the limited homestead exemption available in one's current jurisdiction, one might pay down one's mortgage, improve one's home, or purchase a larger, more expensive home in furtherance of one's asset protection plan. Florida's exemption is provided for under its constitution and this has been used to provide absolute exemption (in a non-bankruptcy situation) even if accomplished with fraudulent intent.[160]

¶ 415.4 Life Insurance and Annuities

Another potentially significant exemption often attaches to life insurance (including the cash value that might exist within a permanent life insurance policy) and/or annuity contracts. Again, the protection depends upon state law, which varies significantly amongst states, with the law of some states wholly exempting the contract, irrespective of value, and the law of other states severely limiting the exemption (for example, sometimes to that amount necessary for the support of the individual and/or his or her dependents). Where one resides in a state with a generous exemption for life insurance or annuities, one might consider investing in such assets (and, in particular, private placement type "variable" life insurance or annuity contracts, which most closely resemble a direct investment in the stock market, in hedge funds, in private equity funds and the like), in lieu of a less protected or, more likely a wholly unprotected, form of investment.

¶ 415.5 Conclusion

[156] *Clark v. Rameker*, 134 S.Ct. 2242 (2014).
[157] I.R.C. § 529(b)(1)(A).
[158] *See, e.g.*, ALASKA STAT. § 14.40.802(h)(1); VA. CODE ANN. § 23-38.81(E).
[159] 11 U.S.C. § 522.
[160] *Havoco of Am. v. Hill*, 790 So. 2d 1018 (Fla. 2001).

By definition, "planning" involves thinking out one's acts and purposes, or structuring one's affairs, prior to the occurrence of a particular event. And, asset protection planning, constrained as it is by the law of fraudulent transfers, requires action in advance of any potential future creditor claim – and, ideally as far in advance of any potential future creditor claim as possible.

It is, of course, natural and understandable not to think about the need to protect one's assets until after a lawsuit is commenced or a claim accrues. It is not, however, planning and most importantly, it is not effective. Therefore, whether one's asset protection plan involves, at one extreme, a simple transfer of money or property to one's spouse or, at the other extreme, involves the creation of an offshore asset protection trust, the planning should be placed on today's agenda – not tomorrow's agenda.

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