Trust Asset Protection: Recent Developments

by John Przybylski

It has long been possible to shield trust assets from a beneficiary's creditors— at least where the beneficiary did not create or fund the trust in question. This describes the traditional scenario where a grantor establishes and funds a trust for the benefit of a third party beneficiary. Trusts can be particularly effective at shielding assets when they include Spendthrift Provisions. ***Spendthrift Provisions*** prevent the beneficiary from pledging, selling or giving away his or her interest in a trust and thereby prevent creditors from reaching trust assets that have not been distributed.

Safeguarding trusts set up for third party beneficiaries is much easier than protecting your own assets. ***Self-Settled Trusts*** are a type of trust in which the grantor is also the primary beneficiary. Until 20 years ago, there was no effective legislation in the United States allowing for the creation of a ***Self-Settled Spendthrift Trust (SSST)***.[1] One solution was to set up an *Offshore Asset Protection Trust* (OAPT) in a country with defendant-friendly laws, such as the Cook Islands, Belize, or the Isle of Man. But for most, setting up an OAPT was a complicated and expensive ordeal, and therefore not a viable solution.

Starting in 1997, various states started to introduce modern ***Domestic Asset Protection Trust (DAPT)*** legislation allowing the creation of domestic *SSSTs*. As of September 2016, 17 states had implemented DAPT laws,[2] but most of these states included exceptions – claims which the trust would not provide protection against – including some or all of the following: child support, alimony, property division in divorce, tort claims and some other express exceptions.[3] Collectively, these are referred to as ***Exception Creditors***. Nevada is one state that does not include any Exception Creditors by statute, and many practitioners had been questioning how well the statute would stand up to judicial scrutiny. On May 25 of this year, the Nevada Supreme Court answered this question in its ruling in Klabacka v. Nelson, which upheld the Nevada statute.

[1] Colorado and Missouri had Domestic Asset Protection Statutes on the book prior to 1997, but their significance had been called into question by judicial decisions. *See* Hirsch, Adam J. (2006), Fear Not the Asset Protection Trust. Cardozo Law Review, Forthcoming; FSU College of Law, Public Law Research Paper No. 180, p. 101, fn. 1, retrieved from https://ssrn.com/abstract=878486

[2] Shaftel, David G. (2016). Tenth Annual ACTEC Comparison of the Domestic Asset Protection Statutes Updated Through September 2016, p. 47, retrieved from http://www.actec.org/assets/1/6/Shaftel-Comparison-of-the-Domestic-Asset-Protection-Trust-Statutes.pdf

[3] Id, pp. 1-46.

Klabacka involved a divorce settlement. While they were married, Eric and Lynita Nelson transmuted their community property into separate properties. The properties were then placed into separate SSSTs for each individual under Nevada law (i.e., NAPTs). The Nevada Supreme Court held that Eric's child support and alimony obligations were owed by him personally and not his trust, and that the trust could not be ordered to pay his personal obligations. The court noted that there were no spousal and child support obligations when the trusts were created and funded.

Considerations

Discretionary Trust is a Must

The power of an SSST can be enhanced if it is set up as a discretionary trust, giving the trustee full discretion to make or withhold distributions to the beneficiary. Since trusts cannot protect assets not owned by them, mandatory distributions in any asset protection trust can be counter-productive.

Sham-wow

A common claim made by creditors in an attempt to challenge a trust is that the grantor has not truly surrendered control over trust assets to a trustee, and that the trust is therefore a sham. To protect against this type of creditor attack, a grantor should only transfer a fraction (as opposed to a majority) of his or her assets to such a trust. The grantor should also relinquish significant control over the trust, include other beneficiaries in the trust, and avoid tacit agreements with the trustee.

Timing is Everything

There are limits to the protections provided by DAPTs. For instance, there is a statute of limitations (determined by state) that determines how long it will take for trust assets to be protected from either future or existing creditors. In Nevada, for example, a claim can be made by **future creditors** against a NAPT's assets for up to 2 years after the assets were contributed into trust. For **existing creditors** a claim can be brought until *the later of*:

- 2 years after the assets were contributed into trust; *or*
- 6 months after the creditor discovers or reasonably should have discovered the transfer.

This is designed to protect against fraudulent trust transfers: transfers made in an attempt to protect assets already subject to a creditor's claim. It is therefore advisable to contribute assets as soon as possible to avoid the claws of potential creditors.

Trust Location & Administration

Creditors often attempt to challenge DAPTs by arguing that the trust in question is not subject to the laws of the claimed state of situs, but rather subject to the laws of a different state (such as the grantor's state of residence). Protection against such a challenge depends largely on the location of both *administration* (i.e. trustees and other fiduciaries) as well as the *location* of any physical trust property. It may make sense to establish an LLC in the DAPT state to own the trust property, and have the DAPT own the LLC instead of the underlying assets

Other Options

There are other means of protecting assets that vary along a spectrum in complexity and effectiveness. Some means protect you from certain creditors but not others (e.g., they may protect you from a tort claim against you resulting from a car accident, but not from alimony obligations to a future ex-spouse). Here is a sampling, listed in order of lowest to highest complexity:

Insurance. The simplest method is to be to be sure you have sufficient property and casualty insurance, including auto, homeowners, umbrella, and professional malpractice insurance.

Retirement Assets. Employer sponsored plans such as 401(k), SEP IRAs, SIMPLE IRAs, and other defined contribution plans as well as defined benefit plans are governed by ERISA[4] and therefore have federal level asset protection from both corporate and personal creditors including in bankruptcy. Under the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, up to the first $1.283m of IRA and Roth IRA accounts are protected in bankruptcy, although outside of bankruptcy, these accounts are subject to applicable state law protections, if any.

State Exemptions. In addition to state laws sheltering IRAs / Roth IRAs, most states provide some level of protection for equity in a homestead, as well as protection for some level of life insurance cash value, death benefits, annuity value / payments, and some protect §529 plans as well. Some people move/retire to states such as Florida, in part to take advantage of, in the case of Florida, its unlimited homestead exemption.

Give it away. As alluded to at the beginning of this paper, giving assets away with no strings attached (either directly or in trust), is one of the most powerful ways to protect those assets from your creditors. Of course then you no longer have those assets yourself and depending on how you gave them away, they may be subject to the creditors of your beneficiary.

Spousal Lifetime Access Trusts. Set up non-reciprocal Spousal Lifetime Access Trusts (SLATs) for the lifetime benefit of your spouse with a remainder interest to your heirs. Since this is not a self-settled trust, asset protection is easily built into the terms, and each spouse can set one up for the other. However, it is important to be careful that the terms of each trust are sufficiently different from one another and cannot be deemed "reciprocal" and hence collapse.

Business Entities (LLCs, partnerships, S-Corps, etc.). Most business entities can provide inherent personal asset protection against claims of the business's creditors. In addition, to the extent assets are held in a business entity that may be hard to liquidate, they can be unattractive assets to creditors.

While the asset protection strategies described in this paper can provide excellent legal protection should you be sued, perhaps the greater benefit to them is that they can deter that lawsuit from being brought in the first place, or cause a creditor to settle for less than they might otherwise have done. While asset protection strategies can bring added complexity and as well as limit your access to your own funds, these trade-offs can be worth making for the risk-averse among us.

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4 The Employee Retirement Income Security Act of 1974 (ERISA) is a federal law that sets minimum requirements for most voluntarily established pension and health plans in private industry to provide protection for plan participants.

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