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White Paper

*Domestic Self-Settled Spendthrift Trusts*

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# Domestic Self-Settled Spendthrift Trusts

## Introduction

In almost every state, when a person creates (or settles) a trust for his or her own benefit—even an irrevocable one—the assets held by the trust are not protected from the claims of his or her own creditors. However, there are a handful of states, including Alaska and Delaware, with laws authorizing trusts that purport to provide such protection. They are intended as a domestic alternative to the offshore trust arrangements that some wealthy people have used for years.

Details in the laws vary among the states that allow this type of trust (often referred to as a domestic asset protection trust (DAPT) or Alaska/Delaware trust), but all are similar. A DAPT is primarily designed to achieve three goals for people with a high net worth:

- Place assets out of the reach of creditors
- Keep the assets available to the creator of the trust (the grantor or settlor), but only at the trustee's discretion
- Remove the assets from the grantor's gross estate for estate tax purposes

**Tip:** The grantor need not be a resident of the DAPT state in order to establish a trust under that state's laws. All states generally allow their residents to choose to have their trusts administered according to the law of another state. As discussed below, however, this freedom of choice may not be absolute or honored in particular situations when litigation arises.

**Caution:** The DAPT is a relatively new and controversial financial and estate planning tool. There are many unanswered questions regarding its operation and usefulness in the event of a challenge by creditors. A DAPT may not be appropriate for everyone, and the pros and cons should be discussed with your financial professional before establishing this type of trust. You should not establish a DAPT intending to use it as a piggybank, with regular or repeated access to the trust property.

## How does a DAPT work?

While details vary, all DAPT statutes share the following elements:

- An irrevocable trust is established with specific reference to the DAPT state's laws, to which the trust grantor transfers a portion of his or her wealth. Once an irrevocable trust has been set up and assets transferred to it, the grantor relinquishes the right to undo the trust or get the assets back.
- At least one of the trustees is an individual resident of the DAPT state, or an institution authorized to serve as a trustee in that state.
- At least some trust property must be located (or managed) in the DAPT state.

- The grantor is one of the beneficiaries of the trust, but not the only beneficiary.
- Distributions must be solely in the discretion of the trustee, although the grantor can be given a veto power.
- The trust document contains a spendthrift provision that makes it difficult for creditors to reach trust assets to satisfy claims against the trust beneficiaries, including claims against the grantor.
- There is a time limit (e.g., four years) within which a creditor must file suit in the DAPT state. To prevail in reaching trust assets, the creditor must prove that the transfer of property to the DAPT was fraudulent, as defined by state law.

If these conditions are satisfied, and assuming the transfer of property into the DAPT was not a fraudulent transfer, the trust assets are, in theory, beyond the reach of the grantor's creditors. However, there are few, if any, court cases that have either confirmed or rejected the protection from creditors intended by the DAPT laws. The DAPT is not battle-tested, and its usefulness has been hotly debated.

## The legal landscape

### Fraudulent transfers

A creditor hoping to undo a transfer and satisfy a claim out of DAPT assets must first establish that the grantor fraudulently transferred assets to the trust. DAPT statutes were written with the expectation that creditors might challenge the terms of these trusts in an effort to reach the assets held by them. These laws, therefore, set out legal obstacles to such challenges, based on the state's Fraudulent Transfer Act. (These laws vary slightly among states.) The primary obstacle is a strict time limit within which a transfer to a DAPT can be challenged.

Creditors fall into two categories for fraudulent transfer purposes: those with claims that already exist when the DAPT is formed, and those whose claims do not arise until after that date. The distinction is crucial because the law makes it easier for an existing creditor to reach DAPT assets.

**Technical Note:** The law defines a creditor of the grantor simply as someone with a claim against him or her. Moreover, the existence of a claim does not require that a lawsuit has been filed, but only that the grounds for a lawsuit have occurred.

A transfer to a DAPT will be considered fraudulent as to a creditor whose claim arose before the transfer was made if the grantor was insolvent at the time of the transfer, or became insolvent as a result. The grantor is considered insolvent if the sum of his or her liabilities, including the claim at issue, is greater than all of his or her assets.

For these claims that exist prior to the DAPT's formation, the creditor must bring suit and claim a fraudulent transfer within four years from the creation of the trust, or one year after the creditor could have discovered the transfer, whichever is later. Since the law allows a creditor to fully probe for assets only after having won a judgment in a lawsuit, an existing creditor would typically have a year from that

date to discover and challenge a transfer to a DAPT. At best, a DAPT provides an uncertain degree of protection from existing creditors.

In the case of a future creditor, one whose claim arose only after the transfer was made, the court may examine a wide range of factors to determine whether a particular transfer to a DAPT will be considered fraudulent and, therefore, void. In looking at the most egregiously fraudulent transfers, the court will find actual intent to hinder, delay or defraud a creditor. If the court makes such a determination, then the creditor must bring suit and claim a fraudulent transfer within four years from the creation of the trust, or one year after the creditor could have discovered the transfer, whichever is later. In other words, the liberal time limit given to an existing creditor will be available even to future creditors in blatantly fraudulent transfer situations.

Because there is seldom direct evidence of the DAPT creator's subjective motivation, the courts in all states have traditionally looked for badges of fraud in scrutinizing transfers that creditors seek to undo, including transfers into DAPTs. In searching for badges of fraud, courts ask, among other questions:

- Was the transfer a gift, rather than a bona fide sale?
- Was the transfer to someone close to the person making the transfer?
- Was the transferor left with insufficient resources to pay debts as they became due?
- Was the transferor actually facing the possibility of a lawsuit?
- Did the transferor try to hide the transfer?
- Did the transferor retain a degree of continued benefit or control of the transferred property?

When one or more of these answers are affirmative, the suspicion arises that the transfer was indeed made with the intent to hinder, delay or defraud a creditor.

Of course, there are less clear-cut cases of fraudulent transfer. For example, assume a grantor transfers assets to a DAPT and remains solvent thereafter. Such a transfer might still be ruled fraudulent later, if the grantor was about to engage in a business or a transaction for which his or her remaining assets were unreasonably small. For this less flagrant class of fraudulent transfers, the law allows a less liberal time limit within which creditors must bring their claims: the creditor must bring suit and claim a fraudulent transfer within four years from the transfer.

## **The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005**

The U. S. Bankruptcy Court handles many cases in which creditors seek to undo a prior transfer of property by a debtor so that it may be used to satisfy the creditor's claim. Indeed, a creditor can force a debtor into bankruptcy involuntarily for this purpose. The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 allows a bankruptcy trustee to void any transfer of property by the debtor that was made within ten years before filing the bankruptcy petition if:

1. the transfer was made to a self-settled trust, including a DAPT
2. the debtor is a beneficiary of such trust, and

3. the debtor made the transfer with actual intent to hinder, delay, or defraud a creditor--present or future.

This is in addition to any other grounds upon which a bankruptcy trustee may void a transaction and bring a debtor's transferred property back into the bankruptcy estate.

On the one hand, the new bankruptcy law can be viewed as bad news for those contemplating a DAPT today. The ten-year look-back is a lengthy period during which the grantor cannot feel safe from the reach of creditors who choose to use the power of the Bankruptcy Court. As a federal rule, the ten-year look-back trumps the much shorter time limitations contained in state DAPT laws.

On the other hand, while ten years is a long asset protection planning gap, federal law has now expressly authorized the use of DAPTs. Additionally, DAPT proponents point out that undoing a transfer in bankruptcy requires a showing of actual intent to hinder, delay, or defraud--a difficult burden of proof for a creditor.

The bottom line is that until a significant number of case decisions are issued, there is only speculation as to the degree of protection the DAPT can offer if challenged in Bankruptcy Court.

### The public policies of DAPT and Non-DAPT states

In all states until the late 1990s, and in the vast majority of states today, it is considered bad public policy to allow the assets of a trust to be protected from the creditors of the person who created that trust. The question thus arises: When push comes to shove in litigation, how will a judge in a non-DAPT state regard a trust created by a resident who has chosen to have his or her trust governed by the laws of Alaska, Delaware, or another DAPT state?

For example, say a New York resident creates a Delaware DAPT, funded with New York real estate and financial assets held by a Wall Street firm. The New Yorker is successfully sued by a fellow resident, a judgment being entered against him in a New York court. Would a New York judge feel obligated to honor the laws of Delaware and deny the judgment creditor access to the DAPT assets?

Generally, the law of the state that governs a trust determines the answer to questions like this. Therefore, the answer is yes; the New York judge should and would follow Delaware law. However, the answer could be no; the New York judge would not follow Delaware law because to do so would violate the public policy of New York. Unfortunately, although DAPTs have existed since 1997, there are few, if any, published court decisions that address this question. You should therefore be aware of the inherent uncertainty in relying on a DAPT if you are a resident of a state that does not authorize such trusts.

**Tip:** Although it may be impractical, you may wish to relocate--with some or all of your assets--to a DAPT state. If you create a DAPT (before or after moving) and are later sued, the suit would probably have to be in your new home state--one that does not consider a DAPT to be against its public policy. In that setting, it is far more likely that the DAPT would offer meaningful protection.

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## Federal constitutional issues

The full faith and credit clause of the U.S. Constitution generally requires every state to recognize the legal judgments of every other state. Some experts believe that no matter which state's laws the grantor uses in creating a trust, if a lawsuit judgment is rendered against him or her in another state, even a DAPT state would be bound to honor that judgment. In other words, by this reasoning, the DAPT state courts would be compelled to disregard their own law and allow a sister-state judgment creditor access to DAPT assets that would otherwise be protected in the DAPT state.

Other legal authorities disagree with this analysis. They point out that a state may disregard a judgment rendered by a sister-state when enforcing that judgment would violate the public policy of the forum state. These issues remain unresolved.

## Tax considerations

### Income tax

Generally, DAPTs are grantor-type trusts--trust income and expenses flow through to the grantor on his or her personal income tax return. However, the trust may be deemed a separate taxpayer if an adverse party must approve distributions to the grantor.

### Gift tax

Generally, transfers to a DAPT are subject to gift tax unless the grantor retains a power of appointment.

### Estate tax

Whether assets remaining in a DAPT at the grantor's death are subject to estate tax depends on the degree of control retained by the grantor. Generally, a discretionary income interest is not considered a retained interest, whereas other retained interests could result in estate taxation.

## Disclosures

This material does not constitute the rendering of investment, legal, tax or insurance advice or services. It is intended for informational use only and is not a substitute for investment, legal, tax, and insurance advice.

State, national and international laws vary, as do individual circumstances; so always consult a qualified investment advisor, attorney, CPA, or insurance agent on all investment, legal, tax, or insurance matters.

The effectiveness of any of the strategies described will depend on your individual situation and on a number of other factors. After reviewing your personal situation, we may recommend that you not use any strategy in this document but instead consider various other strategies available through our practice.

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