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DOMESTIC ASSET PROTECTION TRUSTS CONTRASTED WITH FOREIGN TRUSTS

by

Barry S. Engel, Esq., F.O.I.

David L. Lockwood, Esq.

Principals

Engel Reiman & Lockwood pc

Denver, Colorado

Domestic Asset Protection Trusts Contrasted With Foreign Trusts

A number of states have enacted legislation allowing self-settled asset protection trusts. This article analyzes the role of these trusts in an integrated estate plan, and compares them to offshore asset protection trusts.

BARRY S. ENGEL AND DAVID L. LOCKWOOD, ATTORNEYS

Integrated Estate Planning (“IEP”) may be defined as the marriage of traditional estate planning with lifetime asset protection planning. IEP necessarily extends far beyond planning to minimize estate tax and to avoid probate. In fact, the asset protection planning component of IEP has for some clients become more important than the customary tax and probate aspects.

Background

Integrated Estate Planning Trusts (“IEPTs”) can be either domestic or foreign trusts. While developments surrounding the use of domestic trusts for asset protection purposes are significant and should not be ignored but rather should be encouraged and taken advan-

tage of, the use of foreign IEPTs ultimately is more protective for the following reasons:

1. Issues surrounding conflicts of laws and choice of laws often are definitively settled in the foreign context but for decades have been obscured by policy considerations retroactively applied with judicial hindsight in the U.S.
2. There are no Full Faith and Credit Clause issues in the foreign context.
3. There are no Supremacy Clause issues in the foreign setting that otherwise might alter the outcome if federal bankruptcy law, federal tax law, or federal securities laws are at issue.
4. A myriad of asset protection related issues, beyond the threshold question of the enforceability of self-settled spendthrift provisions, often are definitively and favorably determined in the foreign context but are left unaffected when using domestic IEPTs.

In 1997, Alaska’s legislature enacted landmark trust legislation that allows the enforceability of spendthrift provisions in certain self-settled trusts. The term “self-settled” in this context means that the settlor is also a beneficiary of the trust. Because most settlors of trusts established with asset protection goals want to protect the assets but do not want to relinquish benefiting from the assets (at least to a limited degree), self-settled trusts play a major role in IEP. The IEPT can be described as an “all perils” insurance policy. If properly conceived, designed and implemented, a self-settled IEPT will protect the trust assets in the event of any threat that materializes, regardless of the peril involved.

Most significantly, this Alaska legislation permits the settlor to be a discretionary beneficiary of the trust he or she settles without necessarily subjecting the trustees to the claims of the settlor’s creditors. In support of this concept, this Alaska legislation provides that Alaska law will govern the valid-

BARRY S. ENGEL and DAVID L. LOCKWOOD are principals with the law firm of Engel Reiman & Lockwood pc, in Denver. They specialize in asset protection planning, and have written and lectured extensively on this subject. They can be contacted by telephone at (303) 741-1111, by e-mail at erl@erl-law.com or by visiting the firm website at www.erl-law.com. Copyright © 2002, Engel Reiman & Lockwood pc.

ity, construction, and administration of these self-settled trusts.

Shortly after the Alaska legislation was adopted, the Delaware legislature quickly followed suit, and since the summer of 1997, domestic trusts as asset protection planning tools have become a popular topic.¹ On 5/25/99, Nevada's governor signed Nevada's legislative entry into this arena, and later the same year Rhode Island enacted a statute.

There is a substantial divergence of opinion as to the reliability or efficacy of domestic trusts under any of these states' statutes. Moreover, some practitioners suggest that an estate tax benefit can be accomplished as well so that, by satisfying certain conditions, the assets in such trusts can escape estate tax in the settlor's estate, even though the settlor has a discretionary beneficial interest in the trust. The main concern (discussed more below) is that if the desired estate tax result is dependent upon the asset protection result (as the IRS has suggested is the case), and if the asset protection aspects fail, then the estate planner may be associated with an impending disaster.

Spendthrift trusts in the U.S. that are self-settled

Traditionally, U.S. domestic trusts have offered only low levels of asset protection. If one establish-

es an irrevocable trust for the benefit of someone other than the settlor, a spendthrift provision can often shield the transferred assets from the creditors of the non-settlor trust beneficiaries. A spendthrift provision expressly prohibits a beneficiary from transferring, encumbering, or pledging his beneficial interest in the trust. Such a provision also typ-

ically expressly prohibits any creditor of a beneficiary from attaching, levying against, or seeking a forced sale of the beneficiary's beneficial interest.

Although there is some erosion of this concept,² generally spendthrift provisions are enforced by U.S. courts when the debtor-beneficiary is someone other than the transferor of the sought-after

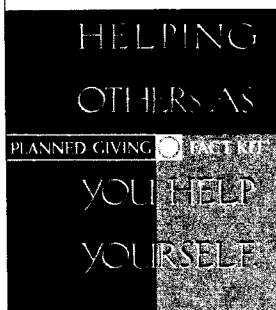
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¹ See, e.g., Korn, "Northern Exposure," *Financial Planning* (Aug. 1997); Asinof, "Protection of Offshore Trusts Comes Onshore in Two States," *Wall Street Journal* (7/23/97); Moore, "Comments on Alaska/Delaware Trusts," *ALI-ABA* (9/25/97); Engel, "Recent Statutory Developments in Asset Protection Trust Law—A False Sense of Security?," *Shore to Shore, The Official Publication of the Offshore Institute* (Oct. 1997); Ravo, "The Offshore Trust: A Shield Against Certain Swords," *N.Y. Times* (7/20/97); and McMenamin, "Flimsy Shelters," *Forbes* (9/8/97).

² E.g., *Sligh v. First Nat'l Bank*, 704 S.2d 1020 (Miss. S.Ct., 1997) (subsequently overridden by legislation).

property.³ As a result, except for a potential application of fraudulent conveyance laws to void the transfers, in theory the transferor's creditors would be unable to reach the transferred assets.

Importantly though, spendthrift provisions in self-settled trusts are unenforceable under the laws of most U.S. jurisdictions. However, even prior to the Alaska, Delaware, Nevada, and Rhode Island legislation, some inroads had been made in this area. For instance, Colorado and Missouri have interesting and arguably useful precedent.

Colo. Rev. Stat. § 38-10-11, entitled "Trusts for use of grantor void against creditors," states that "[a]ll deeds of gift, all conveyances, and all transfers or assignments, verbal or written, of goods, chattels, or things in action, or real property, made in trust for the use of the person making the same shall be void against the creditors existing of such person." At first blush, this statute would seem to be merely another authority against the enforceability of self-settled spendthrift provisions. The statute, though, does not say void for all purposes. Rather, it says "void against the creditors *existing* of such person" (emphasis added).

This statute was interpreted by the Tenth Circuit in *In re Baum*.⁴ There, the settlor had "transferred into the trusts his residence, some furniture and fixtures, and a collection of antique clocks" and had reserved the rights to live in the residence, and to require the trustee to sell the residence and purchase another home as substitute trust property. Six years later, the settlor filed for bankruptcy. In addressing the bankruptcy trustee's argument that the trusts were void at the inception (or at least voidable if necessary for the benefit of the creditors), the court

The trust laws of many foreign jurisdictions expressly provide that judgments foreign to the particular jurisdiction are to be given no force or effect.

noted that the creditors and bankruptcy were not existing on the date the trusts were created. The court refused to apply the statute, thereby denying the bankruptcy trustee's claim that the trust assets should be included in the bankruptcy estate.⁵

The Missouri legislature enacted some limited self-settled spendthrift trust legislation in 1989.⁶ It has been suggested that the statute is extremely narrow in scope and that the real purpose of these 1989 changes was to avoid an adverse tax outcome rather than to achieve asset protection. One bankruptcy court decision concludes that the statute did not alter the "existing rule regarding self-settled trusts," and therefore the assets of the trust at issue were available to satisfy creditors' claims.⁷ There are no state cases applying the statute, but it specifies that a self-settled spendthrift provision will be upheld against future creditors except with respect to trusts under which:

1. The settlor was the sole beneficiary of the income or the principal of the trust;
2. The settlor retained the power to revoke the trust;
3. The settlor retained the power to amend the trust; or
4. The settlor was one of a class of beneficiaries and retained the right to receive a specific portion of the income or the principal of the trust that was determinable solely from the provisions of the trust instrument.

A listing of the specifically stated prerequisites for the application

of a given state's statute is not as important as the underlying goal.⁸ The goal of establishing a domestic IEPT as part of a client's asset protection component of his IEP is to have U.S. courts apply Alaska, Delaware, Nevada or Rhode Island law, enforce the specific spendthrift trust provision preventing creditors of beneficiaries from attaching or involuntarily alienating the beneficiary's interest in the trust, and thereby protect the transferor's retained beneficial interest in the transferred assets. Because the list of conditions that must be satisfied in order for asset protection to be available are similar among the above jurisdictions, and are typically not going to be determinative when one analyzes which jurisdiction to choose, the following list uses the Alaska legislation as an example:

1. The trust must be irrevocable;
2. The settlor may not be a mandatory beneficiary but may be only a discretionary beneficiary;
3. Neither the settlor nor a related party may be a trustee;
4. Some assets of the trust must be located in the jurisdiction where the trust is established;⁹

³ See *Scott's Abridgement of the Law of Trusts*, § 5 151-152.1 (Little, Brown and Co., 1960), and *Scheffel v. Krueger*, 2001 WL 839850 (N.H., 2001).

⁴ 22 F.3d 1014 (CA-10, 1994).

⁵ The Court of Appeals refused to apply a sham argument, too.

⁶ Mo. Rev. Stat. § 456.080.

⁷ *In re Enfield*, 133 B.R. 515 (Bankr. E.D. Mo., 1991).

⁸ For the specifics of this legislation, see Blattmachr and Hompesch, "Alaska vs. Delaware: Heavyweight Competition in New Trust Laws," 12 Prob. & Prop. 32 (Jan./Feb. 1998).

⁹ Per Jonathan Blattmachr, \$10,000 in an Alaska bank account in the name of the trust "likely will qualify" Korn, *supra* note 1, at p. 97.

5. A trustee must be domiciled in that jurisdiction;¹⁰ and
6. Some part of the trust's administration must occur within that jurisdiction.¹¹

If the forgoing prerequisites are met, the validity, construction, and administration of the trust (including the enforceability of self-settled spendthrift provisions) are to be determined by the respective state's statutes. Under what authority? Under the authority of the statutes themselves. This might seem a bit like saying that the statutes apply when they say they apply. And conversely, they say they apply when they apply. More seriously, this aspect represents the risk of using domestic IEPTs, especially when the constitutional or federal preemption issues raised below are added to the equation.

The Delaware legislation carves out the following exceptions that can prevent the Delaware statutes from protecting a settlor's interest in a self-settled trust:

1. A transfer is made to the trust at a time that the settlor is indebted pursuant to an agreement for the payment of alimony to the settlor's spouse, child support, or for the division of property in favor of the spouse, but only to the extent of such debt; or
2. The liability of the settlor is a liability to any person who suffers death, personal injury, or property damage on or before the date that the assets are transferred to the trust.

Assets that are made available to a creditor under the above two provisions will be subjected to a first lien against the property for any legal fees incurred by the trustee of the trust in defending the action brought by the creditor against the trust, provided that the trustee has not acted in bad faith. And, if the court is satisfied that no trust beneficiary has acted in

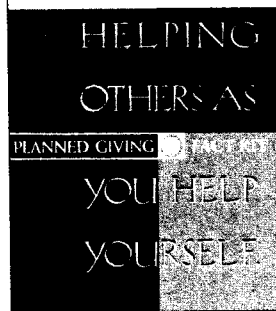
bad faith, the assets available to satisfy creditors' claims under the above exceptions are subject to the right of any trust beneficiaries to retain any distribution that was completed under the exercise of a power by the trustee prior to the commencement of the creditor's action against the trust.

The Nevada legislation has taken the approach that, as long as the

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¹⁰ Although only a handful of corporate trustees currently operate in Alaska, for example, CPAs are moving to fill the void.

¹¹ Again, per Jonathan Blattmachr, "Holding trustee meetings in Alaska, holding meetings in Alaska with trust beneficiaries, maintaining accounts in Alaska or initiating trades in Alaska should suffice." Korn, *supra* note 1, at p. 97.

transfer to an irrevocable, discretionary Nevada trust is not made with the intent to hinder, delay or defraud "known creditors," the self-settled spendthrift provision will be enforced. This assumes that one uses a Nevada trustee (i.e., a local resident of the state or a bank or trust company that maintains an office within the state) and that the Nevada trustee has the power to maintain records and prepare tax returns for the trust and, in fact, carries on a part of the administration of the trust within Nevada's boundaries. The Nevada statutes do not carve out an exception for circumstances dealing with child support or maintenance.

Issues concerning domestic trusts

Planners have raised the following issues regarding the use of U.S. domestic trust asset protection planning.¹²

The conflicts of law or choice of law issue

The trust laws of many foreign jurisdictions expressly provide that judgments foreign to the particular jurisdiction are to be given no force or effect. In contrast, one must ask whether the courts of another state in the U.S. agree that Alaska, Delaware, Nevada, or Rhode Island law is to be applied. The Restatement (2d) Conflicts 1969, section 273(b) and comment c, state that personal property owned by an inter vivos trust is governed by the local law designated by the settlor in the terms of the trust. As a result, the clause of the trust selecting the applicable law should control which law a court should apply.

The Restatement (2d) Conflicts section 280, however, does not follow the same rule for real property. For purposes of determining the rights of creditors, real estate is

A foreign asset protection trust is less likely to be an automatic target in litigation against the settlor than is a domestic asset protection trust.

governed by the law of the property's situs. So, if a court follows the Restatement (2d) Conflicts, creditors may attach a settlor's beneficial interest in a domestic trust that contains real property not located within the selected state's boundaries (i.e., not within Alaska, Delaware, Nevada, Rhode Island, and possibly Colorado and Missouri).

The Restatement (2d) Conflicts was written in 1969—over 30 years ago. Conflicts of law principles that existed prior to its publication provided that the law where the tort occurred governed for tort claims, the law where the contract was signed governed for contract claims, and the law of the trust's situs governed the rights of most personal property. Nebulous standards such as "the most significant relationship to the occurrence test," "the state of dominant interest test," and "the fundamental policy underlying the controversy test" have all been advocated. The result of the past decades of academic influence in the area of conflicts of law is that the rules are no longer definite and concrete.

For example, in *Boston Safe Deposit and Trust Co. v. Paris*,¹³ the court applied Massachusetts law instead of the applicable law chosen in the trust. The court ignored the Restatement (2d) of Trusts and reasoned that the place where the assets were held and where performance under the trust was to take place were more

important factors than the specified applicable law of the trust.

A similar result occurred in *In re Portnoy*,¹⁴ in which the bankruptcy court held:

Whereas under normal circumstances, parties are free to designate what state's or nation's law will govern their rights or duties, when another state or nation has a dominant interest in the transaction at issue, and the designated law offends the fundamental policy of that dominant state, the court may refuse to apply foreign law.

In *Portnoy*, the bankruptcy judge was particularly upset by the fact that the debtor did not disclose his interest in a Jersey trust, and therefore, it appeared the debtor was hiding assets from the court. The judge also seemed to be particularly offended by asset protection as he perceived it at the time. The judge disregarded the Restatement (2d) of Conflicts and combined the dominant interest theory with the fundamental policy theory in reaching a decision to apply the law of the debtor's residence. Under New York law, a settlor is not provided asset protection by a self-settled trust. Based on the egregious facts of *Portnoy* and the inclination of the bankruptcy judge, the outcome would have probably been the same if the trust had been an Alaska, Delaware, Nevada, or Rhode Island trust.

The same result occurred in *In Re Brown*.¹⁵ There, the debtor had created a Belize trust under

¹² Compare Giordani and Osborne, "Stateside Asset Protection Trusts: Will They Work?," *Est. & Personal Financial Plan.* (Nov. and Dec. 1997), with Blattmachr and Hompesch, *supra* note 8.

¹³ 447 N.E. 2d 1268 (Mass. App., 1983).

¹⁴ 201 B.R. 685, (S.D.N.Y., 1996).

¹⁵ 4 AK B.R. 279 (D. AK, 3/11/96).

