Morgan Stanley

STRATEGIC THINKING

Domestic Asset-Protection Trusts

INTRODUCTION

Limiting Liability in an Increasingly Litigious World

An interesting but controversial asset-protection strategy that has emerged over the last decade is the domestic asset-protection trust. This paper is written to familiarize the reader with general aspects of DAPTs, some of their potential uses as an asset-protection strategy and certain key issues regarding their effectiveness. "Asset protection" has become part of the common lexicon of asset management, financial planning and estate planning.

AUTHOR

KENNETH L. JORDAN
Planning Director
Morgan Stanley

Increasingly, clients are seeking strategies to help them preserve and protect the wealth they have accumulated in the face of risk. This shift in thinking is directly related to a general sense that our society is more litigious and hazardous to the preservation of wealth than ever before. There is increased exposure to liability as a result of expanded theories of liability, new government regulations, governmental involvement in commercial affairs, the challenges arising from the current economic problems worldwide and recognition that failed marriages, multiple marriages and blended families create additional exposure.

Many individuals have no need for asset-protection planning, but there are groups of people who have greater risk or exposure than others, such as physicians, lawyers, accountants, directors and officers of public companies, investment advisors and owners of real estate. Add to these groups anyone with significant wealth, whose exposure may be greater for that simple reason, and there is a substantial population that is concerned or should be concerned with asset protection.

BASIC ASSET-PROTECTION TECHNIQUES

One of the primary objectives in asset-protection planning is the avoidance of any strategy that is, or appears to be, a fraudulent transfer (i.e., any transfer of property that is or appears to have been made with the intent to hinder, delay or defraud creditors). If there are no existing or foreseeable liabilities or claims, then this hurdle should be satisfied.

Among the most easily used domestic asset-protection strategies are exempt-asset strategies. These involve assets that are exempt from claims under state law and may include an interest in the primary residence, certain business assets, retirement plans (including IRAs in some states), life insurance, annuities and property held as tenants by the entirety (in some states where such protection is provided).

Another basic domestic asset-protection strategy is to transfer assets to others. Transfers to, or put in trust for, a spouse or child may help shield transferred assets from the later liabilities of the transferor. Two of the possible downsides of this strategy are: The transferor would have to surrender control and the economic benefit of the assets transferred, and the transfer does not shelter the assets against claims that are made against both the transferor and the transferee. The transfer of assets to family limited partnerships or family limited liability companies is a common variant of this asset-protection strategy. The assets then should be considered to be owned by the entity rather than the partners or interest holders. Many states give these entities "charging order" protection, whereby creditors can only reach a distribution made from the entity to an individual owner. It may be necessary to conduct an analysis of one's finances and liabilities to be certain one of these strategies is appropriate.

ASSET-PROTECTION TRUSTS

Where greater risk of liability exists, consideration is often given to some form of asset-protection trust. Historically, foreign asset-protection trusts were considered most effective. However, in recent years, domestic asset-protection trusts (DAPTs) have been made possible by new statutory provisions and are growing in popularity.

A DAPT is an irrevocable trust set up under the law of a state that specifically provides for the creation of a trust with asset-protection qualities. The DAPT assigns an independent trustee who has absolute discretion to make distributions to a class of beneficiaries that usually includes the person creating the trust (i.e., the settlor). This type of trust, in which the settlor is one of the beneficiaries, may be referred to as a "self-settled trust." The principal purpose of the DAPT is to shelter assets from the claims of the settlor's future creditors, but under most authorizing statutes there is the added benefit that assets transferred to the trust may be removed from the settlor's estate even though the settlor may receive distributions from the trust. Therefore, any future appreciation could occur outside the settlor's estate, though the settlor would have to pay any applicable transfer taxes upon funding the DAPT.

Prior to 1997, almost all states had statutory or case law that provided it was against public policy to protect the assets of a self-settled trust from the settlor's creditors. In 1997, Alaska became the first state to enact a statute specifically authorizing Alaskan DAPTs. Since then, other states have followed suit. There are now 12 states that allow the formation of DAPTs (Alaska, Colorado, Delaware, Missouri, Nevada, New Hampshire, Oklahoma, Rhode Island, South Dakota, Tennessee, Utah and Wyoming). However, state laws vary, and some statutes may be more suitable than others for persons creating DAPTs. The fact that 12 states now have DAPT statutes suggests this strategy is becoming more broadly accepted when considering asset-protection planning.

The number of states that have adopted self-settled asset-protection-trust statutes is limited, but residents of states that have not enacted such legislation may be able take advantage of the potential benefits of these new rules. A settlor may designate the law of a state that recognizes self-settled asset-protection trusts as the law governing a DAPT, even though the jurisdiction of the settlor's domicile does not have an applicable statute. Of course, the settlor will have to take steps to help ensure that such law is respected, which may include choosing a trustee that is located in the governing-law state or fulfilling other statutory requirements. Thus, a settlor could create a DAPT, name a trustee located in the governing-law state and deliver the assets to that trustee to be administered in that state. In such a case, the law of the governing-law state would presumably be applicable to the rights of creditors to reach the settlor's interest in the DAPT's assets. However, the legal sufficiency of such an arrangement has not yet been directly tested in any court, and there is some risk that a court may not allow a DAPT to shelter a DAPT's assets from the settlor's creditors.

Since more people are seeking to protect their assets, the possible opportunity to protect assets and remove assets from the client's gross estate — yet still have the ability to receive discretionary distributions of such assets — is very attractive. However, given the challenges of reversing the longstanding public policy against using self-settled trusts to shield assets from creditors, many commentators and planners express doubt about whether the asset-protection goals of DAPTs will ultimately be achieved.

WHAT MIGHT A DAPT ACCOMPLISH?

Asset Protection: The primary goal is to protect the assets of the settlor from the creditors of the settlor.

Transfer-Tax Minimization: Another goal may be to allow a settlor to transfer assets to an irrevocable trust so that the assets of the trust are not included in the settlor's gross estate. Any growth of those assets after the transfer to the trust also should be excluded from the settlor's estate.

Family Limited Partnership or Limited Liability Company Planning: Recent litigation has continued to highlight concerns that the interests in a limited partnership or limited liability company previously given away could be included in the donor's estate. There are legal arguments that transferring any remaining interest to an irrevocable trust such as a DAPT may help avoid the application of these rules while affording the donor access to distributions from the partnership or limited liability company.

Preimmigration Transfer-Tax Planning: Nonresident aliens who are anticipating immigrating to the United States could make unlimited transfers

Anyone establishing a DAPT under favorable state laws needs to be aware of specific steps that must be taken to give a trust the best chance of shielding the assets of the trust from creditors.

1. Select the proper jurisdiction. Settlors should review the various DAPT statutes in light of their personal objectives to determine where to locate the trust.
2. Make the trust irrevocable.
3. Choose a trustee who is independent of the settlor and is a resident of and has business contacts in the selected DAPT jurisdiction. Merely directing a nonresident trustee to apply the law of the DAPT state will not prevent a creditor from establishing jurisdiction over the trustee and successfully arguing that the laws of the state where the trustee is located and the trust is being administered should apply.
4. Deposit assets in the DAPT state rather than keeping them in the settlor's state of residence.
5. Do not transfer to the trust real estate located in a state other than the DAPT state, as a creditor may establish jurisdiction over the real estate and gain access to the trust assets.
6. Make sure the transfer is compliant with the fraudulent-transfer statutes in both the DAPT state and the residency state of the settlor.
7. Give the trustee absolute discretion over distributions from the trust to the settlor.
8. Do not allow the settlor to retain any interest in the trust assets.
9. If the settlor is seeking to protect assets in a divorce, check the statutes in the DAPT states, as some states provide exceptions for property division in the event of divorce — particularly if the spouses were married when the trust was created.
10. Determine whether or not the DAPT state taxes the income of trusts formed by nonresident settlors.
11. Be aware that most states will not provide DAPT protection for child-support claims.

to an irrevocable trust such as DAPT without incurring US gift-tax liability. After immigration, distributions from the trust can be made by the independent trustee to the settler, and the assets of the trust may not be included in the settlor's estate.

Income Tax Planning: A DAPT might be able to be used by the settlor to avoid state income tax on distributions from the trust, and the DAPT may be drafted to avoid being a grantor trust. Such a benefit might be achieved with any irrevocable trust.

Substitute for Prenuptial Agreement: A DAPT, created in advance of marriage, may allow a settlor to place assets beyond the reach of the new spouse under the statutes of several states.

Despite the perceived benefits of DAPTs and aggressive marketing efforts by proponents in the primary DAPT states, DAPTs are still not widely used, either for asset protection or estate planning. The strong public policy against the use of self-settled trusts for creditor protection, the lack of significant court decisions upholding the benefits of DAPTs in difficult debtor-creditor situations and the enactment of bankruptcy reform provisions that appear to undermine the efficacy of DAPTs have cast doubt among planners about the effectiveness of the strategy. Creditors may challenge DAPTs in a number of ways, which may result in the assets of the DAPT becoming exposed to the settlor's creditors.

HOW A CREDITOR MAY CHALLENGE DAPT PROTECTION

Choice of Law: A creditor may argue that a court should apply the self-settled trust law of the debtor's state of residence, rather than the law of the DAPT state chosen by the settlor, as the governing law of the trust.

Fraudulent Transfer: A creditor may argue that the facts indicate that the transfer to the self-settled trust was fraudulent and should be set aside under whatever law deems it as such. Some DAPT states have more creditor-friendly fraudulent-transfer provisions in their laws than the jurisdiction of the settlor's residence.

Full Faith and Credit: The US Constitution, in the "full faith and credit clause," requires that one state must recognize the judgment of any other state. A creditor would have an argument that the courts in the DAPT state should not use the self-settled trust to prevent a result that would be honored in the state of the settlor's residence.

Federal Courts May Ignore the Law of the DAPT State: Federal courts are not necessarily bound by state law pursuant to the Supremacy Clause of the US Constitution. Therefore, DAPT statutes may not protect debtors against judgments in federal courts or by federal administrative agencies.

New Bankruptcy Laws: In 2005, the bankruptcy code was amended to allow a bankruptcy trustee greater authority to set aside certain transfers that defeat creditors' rights. In addition to any other transfer that the trustee might otherwise avoid, the trustee may avoid any transfer of an interest of the debtor in property that was made within 10 years of the date of filing a bankruptcy petition if a transfer was made by the debtor to a self-settled trust, the debtor is a beneficiary of the trust and the transfer was made with the intent to hinder, delay or defraud any creditor.

In addition, trustees will be subject to discovery orders or subpoenas, which will allow creditors to discover the nature of the assets held by the trust. Creditors will be able to judge the benefits of pursuing an aggressive strategy to satisfy a judgment with those specific assets.

In conclusion, DAPTs have been marketed as a tool for protecting assets from creditors and as an estate-planning strategy. Since the strategy has not stood either the test of time or the test of law, caution is urged. In light of the limitations and risks associated with DAPTs, neither Morgan Stanley nor its affiliates recommend DAPTs for their clients. However, because such strategies come up in planning conversations with some regularity, it is worthwhile to be familiar with the concepts.

Ken Jordan joined the Wealth Advisory Resources division of Morgan Stanley as Midwest planning director in September of 1999. Previously, Ken spent 25 years in the private practice of law, concentrating on estate planning, trust administration and corporate and commercial law.

WP6987079 2011-PS-3271 12/11 7247776 10/12