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Asset Protection Trusts

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The use of an asset protection trust (APT) is gaining widespread attention among wealthy individuals as the legal system has become increasingly subject to predatory and unwarranted litigation. Asset protection planning involves protecting assets before the need arises to do so; it is not about protecting assets from existing creditors. In other words, the implementation of asset protection strategies is appropriate in situations where individuals are concerned about the claims of future creditors.

Establishing an asset protection trust

Normally, if a trust is "self-settled" — that is, the grantor is also a beneficiary — the grantor's creditors will be able to access trust assets. However, several U.S. states and foreign countries have adopted laws allowing a grantor to be a beneficiary of a discretionary trust to some extent without jeopardizing creditor protection. An APT must be irrevocable, and the trust document must contain express language stating that the trust will be governed by the laws of the U.S. state or foreign country in which the trust will be located. Generally, some of the trust assets must be located within the governing jurisdiction. The grantor can receive distributions from the trust, but only in the discretion of an independent trustee. The trust must contain a spendthrift provision, which means the language of the trust states that the beneficiaries cannot transfer their interests to other parties (e.g., creditors). Also, before executing an APT, the grantor typically must sign an affidavit of solvency, although this is not a universal requirement.

Situs of an asset protection trust

Domestic asset protection trust

As mentioned, several U.S. states have adopted asset protection statutes. An APT settled pursuant to one of these statutes is referred to as a domestic asset protection trust (DAPT). If the DAPT is properly drafted and executed, creditors may not be able to reach and apply the trust's assets. In addition to providing asset protection, a DAPT may offer other benefits, such as state income tax savings when the DAPT is located within a state that does not levy an income tax. The various DAPT provision — for example, the exception creditor issue, the statute of limitations for pre-existing and future creditors, whether an affidavit of solvency is required for every new transfer — depends on how the state statute strikes a balance between debtor and creditor rights.

DAPTs are allowed in 19 states. Alaska and Delaware enacted the first asset protection trust statutes in 1997, and since then have been followed by Nevada (1999), Rhode Island (1999), Utah (2003), Oklahoma (2004), South Dakota (2005), Missouri (2005), Wyoming (2007), Tennessee (2007), New Hampshire (2009), Hawaii (2010), Virginia (2012), Ohio (2013), Mississippi (2014), West Virginia (2016), Michigan (2016), Indiana (2019) and Connecticut (2020); the Indiana asset protection trust is referred to as the Indiana Legacy Trust. When establishing a DAPT, a grantor should check first to determine whether his/her state of domicile is one of the 19 states that allows DAPTs.

There are differences in the protections offered from state to state. For example, Nevada has no exception creditors, which means that with a Nevada DAPT, the grantor can keep assets away from ex-spouses who claim alimony and child support and even from creditors having preexisting tort claims. In other states, these creditors can reach into DAPTs without having to prove fraudulent transfer. It should be noted, however, that all states let creditors pierce a DAPT to get at assets if creditors can prove fraudulent transfer.

There is a question as to whether a grantor can establish an out-of-state DAPT. If a grantor does go out of state, the more ties that grantor has to that state, the better the nexus to that state's asset protection statutes. For example, a domiciliary of California who has a vacation condominium on the Las Vegas strip might establish a DAPT in Nevada. To build a record to stand the best chance of defending any challenge to a DAPT, the grantor should visit the state where the DAPT will be established, execute documents in person there, and make asset transfers to that jurisdiction. Ideally, the trustee and the investment manager of the DAPT will be located within the state where the DAPT is established, but this is not universally required.

With the federal government focusing on U.S. taxpayers moving money outside the country both legally and illegally, through the Foreign Account Tax Compliance Act (FATCA), it is likely that the trend will be towards using DAPTs and not foreign (or offshore) trusts.

Foreign asset protection trust

As the name implies, a foreign asset protection trust (FAPT) is an APT established outside of any jurisdiction inside of the U.S. orbit. A significant benefit of a foreign trust is that the creditor will generally have to commence an action in the foreign jurisdiction. Since foreign law will control the availability of those assets and certain other aspects, such as the statute of limitations, there is considerable discouragement for any creditor who wishes to seek recovery in the foreign jurisdiction. Additionally, most FAPTs offer a greater ability for the grantor to retain control and benefit, confidentiality, and privacy, and without any full faith and credit, comity, or supremacy clause issues. Also, unlike most DAPT jurisdictions, FAPT jurisdictions do not require that the FAPT hold any assets in the jurisdiction of its domicile. Therefore, most FAPTs can hold assets located anywhere in the world.

A FAPT typically includes two clauses not always found within a DAPT, a floating situs clause and a duress clause. A floating situs clause will allow a non-fiduciary trust protector of the FAPT to move the FAPT's situs to another asset protection jurisdiction. This strategy has been employed for years by wealthy Europeans who transferred assets among British Crown colonies – from Bermuda to the British Virgin Islands to Isle of Man to the Channel Islands, and so on. Recently, however, this strategy has fallen from favor as creditors may now freeze trust assets under the laws of both Bermuda and the Channel Islands.

The duress clause allows a trust protector located in a jurisdiction other than where the FAPT was established to ignore a court order compelling a trustee to distribute assets and replace the trustee. However, this clause will receive great scrutiny, and has been attacked successfully on one occasion, compelling a domestic trust protector to make a good faith effort to repatriate assets transferred to a FAPT.[1] Failure to achieve repatriation should not entail any dire consequences to the FAPT or to the domestic trust protector. As long as a duress clause permits the foreign trustee to ignore the pleas of a domestic trust protector acting under threat of a contempt order, the selection of a domestic protector should not jeopardize the integrity of the offshore asset protection trust. For utmost safety, however, consideration should be given to a trust protector located outside of the U.S. and in a jurisdiction other than the same jurisdiction as where the FAPT was established.

Several foreign jurisdictions offer protections that U.S. jurisdictions may not. For example, a FAPT established in Belize offers immediate protection from court action claiming fraudulent transfer. Cook Islands and Nevis have explicit asset protection statutes stating that court orders and judgements from other jurisdictions will not be recognized. Also, secrecy of ownership is championed by the British Virgin Islands, Switzerland, and Liechtenstein, although with the passage of FATCA, the days of such secrecy may be numbered.

Funding an asset protection trust

An APT is of no benefit until it is funded with assets. Trust assets typically include cash, marketable securities, limited liability company (LLC) membership certificates, business assets (including but not limited to intellectual property, inventory, and equipment), real estate, and recreational assets such as aircraft, boats, jet skis, motorcycles, and trailers. Each asset under consideration for transfer into an APT must be evaluated from many different viewpoints, including its effect on legal protection, taxation, business and growth potential, and the ability to make future distributions to spouses and descendants.

Substantial relationship

To withstand attack, an APT should be designed to have its most substantial relationship to the jurisdiction where the trust is formed, not to the grantor's state of domicile. In a closely contested legal battle, the location of the trust assets could be determinative. Consequently, on a case-by-case basis, it's wise to consider transferring the following assets into LLCs

1 U.S. v. Grant, 2008 WL 2894826, 101 A.F.T.R.2d 2008-2676 (S.D. Fl. May 27, 2008), assets transferred into a foreign asset protection trust remain outside the reach of creditors, and the debtor cannot be cited with contempt where control has truly been relinquished to the foreign trustee. A determined creditor, however, may ultimately obtain an order requiring any transfers into the U.S. to be held for the benefit of the creditor; this has the effect of producing a stalemate, where neither the creditor nor the beneficiaries can reach the assets of the trust for the duration of any court order that would otherwise require the beneficiaries to relinquish trust distributions received.

located in the same jurisdiction as the APT: cash and marketable securities, valuable and/or risky business and recreational assets, real estate, and the grantor's businesses.

Cash and marketable securities

Cash and marketable securities should be held in an LLC in a jurisdiction with favorable LLC protection and privacy laws. If the LLC-held securities are to be placed in an APT, the LLC should be formed in the trust state. Grantors should only fund APTs with assets having a long-term need horizon. This is particularly true for securities assets that, by nature, require watchful management. Also, long-term investment is consistent with the concept that withdrawals from an APT should be infrequent.

Convenience is an important element in managing an APT. It is optimal to hold cash and all securities in a single investment account. Such an account will allow the trust to easily invest cash in a variety of safe and effective cash-equivalent vehicles, such as money market funds, treasury funds, and short-term bond funds. To enhance the grantor's substantial relationship to the trust jurisdiction, it's also helpful to hold a portion of the cash in a local bank.

Real estate

Difficulties often arise with real estate assets because, of course, a parcel of land can't be relocated to the trust jurisdiction. It's a legitimate concern that, if the LLC owns real property located in the client's domicile state, a local court may try to exercise jurisdiction over the property, notwithstanding its out-of-state ownership. Typically, the administration of a trust of an interest in land is supervised by the courts of the situs as long as the land remains subject to the trust. The best available solution may be to transfer ownership of the property into an LLC that is formed in the jurisdiction where the APT is settled.

LLC for businesses

In most cases, the grantor's business LLC will already be registered in his/her state of domicile. Depending on the state, this may be problematic. All LLCs are designed to insulate their members' personal assets from claims arising from their business. Without such protection, it would be too dangerous for entrepreneurs to invest capital in businesses with inherent risks. This internal protection concept was provided initially by traditional C corporations, but such entities suffer from double taxation of income. Contrarily, LLC income is directly passed through to its members and taxed only once. LLCs are also simpler to operate, and consequently, most business entities formed today are LLCs. Most states' laws don't include the language necessary for optimal LLC planning. For an LLC to be effective, it should be formed in one of just a few states with favorable LLC laws or in one of an even more limited number of states where true privacy can be ensured.

Generally, after a creditor obtains a personal judgment against a defendant, it's the creditor's responsibility to identify the defendant's assets, obtain a court order, and seize those assets adequately to satisfy its judgment. However, if properly planned for asset protection, the LLC members' interests won't be treated like other assets. Instead, the creditor's sole legal remedy will be limited to obtaining a charging order, which is essentially a lien against the assets. Charging orders allow the creditor to obtain a court lien against distributions made to the member's interest, but more importantly, charging orders do not allow the creditor to take the defendant's place and become a member of the LLC, with rights to its assets. Thus, if the LLC chooses not to distribute assets or income to its members, the assets won't be available to the judgment creditor. Moreover, only the members are entitled to determine whether distributions will be made, and when.

With greater understanding of LLC protection, the question of whether clients who've formed LLCs to hold their business assets should transfer the LLC assets into a trust settled in the same state as the LLC or leave them inside their home state LLC may be revisited. Technically, there are several viable techniques available for making tax-free transfers of LLC assets into a new LLC formed in the same state as the DAPT (or the same foreign jurisdiction as the FAPT). If the transfer at its core is the result of an effort to delay or defraud known or foreseeable creditors, it can be reversed as a voidable transaction (fraudulent transfer). Furthermore, in a subsequent legal challenge to the trust, the plaintiff may also raise legal theories such as alter ego and/or piercing the corporate veil, but these challenges already exist even if there's no transfer. Such risks can be reduced by maintaining and managing all LLCs with great scrutiny. Assuming the transfer isn't made to avoid an existing or future foreseeable creditor, there's no reason not to make the transfer. The legal issue should be strictly a matter of whether the transfer is a voidable transaction. So, in vetted cases, a reorganization of the LLC into the state where the APT is settled may be a viable option to be considered.

Assets with inherent risk

High-risk assets, like aircraft, boats, jet skis, motorcycles, and trailers, generally should be held in one or more LLCs. Where appropriate, the LLC should be formed in the jurisdiction where the APT is settled. There are, however, important considerations to be made about LLC protection for these assets. First, if the asset isn't used for business purposes (such as airplane leasing or charter boat rental), the LLC may be at greater risk for piercing the LLC veil claim. To reduce this concern, planning professionals should consider utilizing a multi-member LLC (rather than a single-member LLC) and, of course, maintain meticulous documentation and tax reporting.

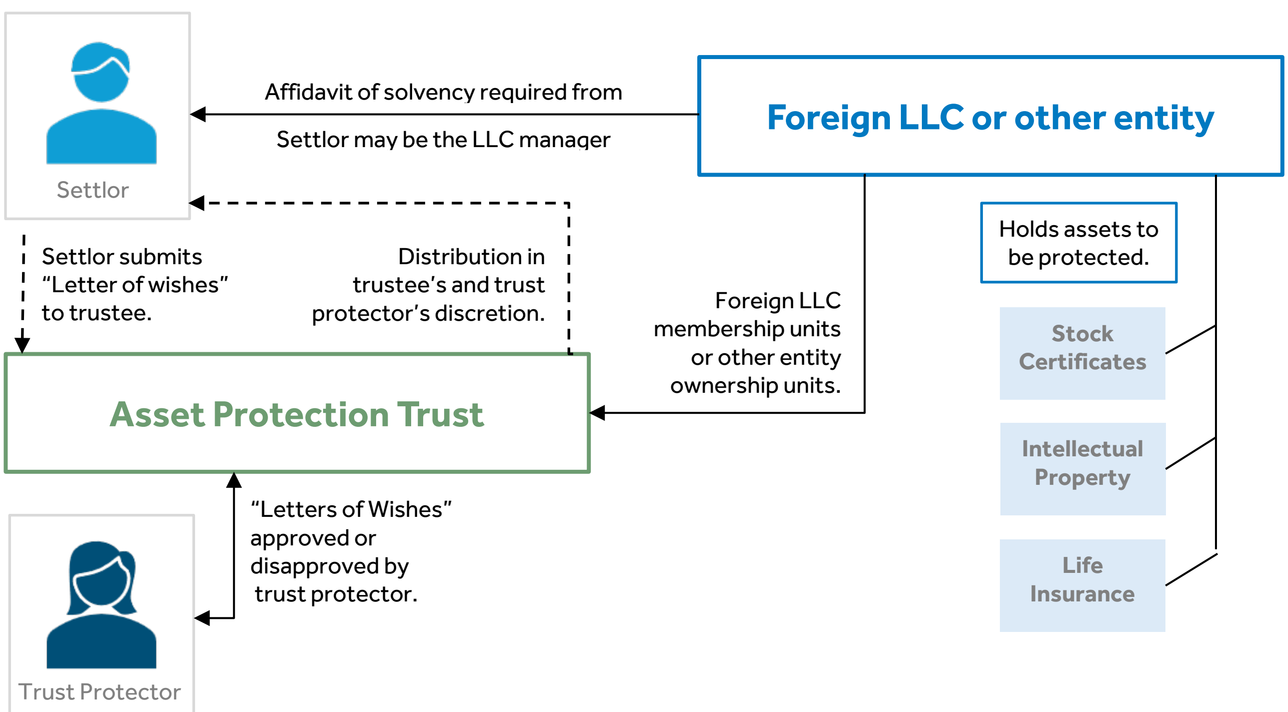
Next, even though the vehicle or other asset is held in an LLC, an injured plaintiff may claim that the transferor is individually liable if he/she caused or contributed to the injury through negligent or deliberate action. Although the injured defendant may argue that the accident was caused by a malfunction – for example, to the aircraft or boat owned by the LLC – it's easily seen how holding the aircraft or boat in the LLC will not spare the defendant completely from liability.

Initiating distributions from an asset protection trust

APTs provide trustees with wide-ranging powers which can be used at the trustees' discretion. How these powers are used can be critical as to whether trustees meet the intent of the grantor. A "Letter of Wishes" can be of great help meeting that goal. A letter of wishes is a way for the grantor of an APT to inform the trustees of matters to be considered when those trustees are exercising their discretionary powers. While a letter of wishes is not legally binding on the trustees, it will be addressed by them. Typically, a letter of wishes is concerned with the exercise of discretions in relation to the distribution of the trust property (wholly or in part). Occasionally a letter of wishes may also include comments in relation to the exercise of powers of investment, or of other purely administrative powers. A letter of wishes should be reviewed by the grantor regularly. Letters of wishes should be kept by the trustees and should be shared with the trust protector for its consideration too.

Diagram of typical asset protection trust structure

Note that the federal Bankruptcy Reform Act of 2005 added a provision that allows a bankruptcy trustee to avoid any transfer made within 10 years prior to the date of filing the bankruptcy petition if "such transfer was made to a self-settled trust or similar device …" and the "debtor made such transfer with actual intent to hinder, delay, or defraud." Legal commentators expect the existing bankruptcy laws may reduce the use of DAPTs and FAPTs.



The National Conference of Commissioners on Uniform State Laws adopted the Uniform Voidable Transactions Act (UVTA) in July 2014. The UVTA may adversely affect a debtor who lives in a non-DAPT state that has adopted the UVTA and makes a transfer to a DAPT in another state that has not adopted the UTVA. In comments accompanying the UVTA, the commissioners indicated that because the transfer was made from a UVTA state, the transfer to the DAPT in another state could be voided without regard to whether the transfer affects an existing or identified creditor. This result is not certain, but counsel should be especially careful when a transfer to a DAPT in another state is made from a state that has adopted the UVTA.