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Domestic Self-Settled Spendthrift Trust

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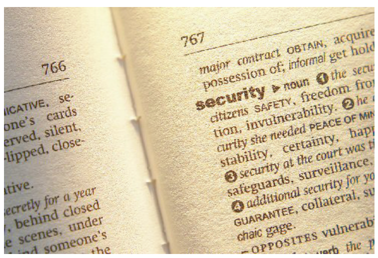
Domestic Self-Settled Spendthrift Trust (Domestic Asset Protection Trust, Alaska/Delaware Trust)

Summary:

Generally, to protect assets from creditors, owners must give up control over and access to those assets. A self-settled spendthrift trust allows individuals to put assets beyond the reach of creditors while retaining some control over and access to those assets. Previously only available in offshore jurisdictions, self-settled spendthrift trusts are currently authorized in eight states: Alaska, Delaware, Nevada, Rhode Island, Utah, Oklahoma, Missouri, and South Dakota.

What is a domestic self-settled spendthrift trust?



A self-settled trust is a trust where the grantor (i.e., the creator, settlor, or donor) is one of the beneficiaries, or the sole beneficiary, of the trust. A spendthrift trust is a trust that prevents trust beneficiaries from transferring their interests in the trust to other parties (e.g., creditors). Prior to April of 1997, a self-settled trust could not be a spendthrift trust under the laws in all 50 states, and U.S. citizens were forced to create such trusts in offshore or foreign jurisdictions.

In April of 1997, Alaska passed the first legislative act authorizing the use of self-settled spendthrift trusts (also called domestic asset protection trusts). In the same year, Delaware enacted similar legislation (hence this type of trust is often referred to as an Alaska/Delaware trust). A handful of states have since followed suit.

How does a domestic self-settled spendthrift trust work?

In general

With a spendthrift trust, the trustee is given discretion to make or not make distributions to beneficiaries. Because distributions are discretionary, beneficiaries are prevented from voluntarily or involuntarily transferring current or future rights in the trust. In other words, beneficiaries can't give away trust income or principal in advance of receiving it. One effect of such alienation language in a trust is that creditors of a trust beneficiary cannot claim that trust assets are assets of the beneficiary. Therefore, creditors cannot stake a claim against trust assets, but can only collect money that is actually distributed to the beneficiary.

Requirements

Though the states that allow this type of trust have their own requirements and exceptions, there are elements that are common to all domestic self-settled spendthrift trusts:

- The trust must be irrevocable
- The trust document must expressly state that the laws of the state in which the trust is located govern the trust
- The trust document must include a spendthrift provision
- Some trust assets must actually be held within the state
- The trustee must be a resident of the state (though the state may allow an out-of-state co-trustee)

Caution: *Trustees must be independent--the grantor cannot be a trustee or co-trustee, and must not perform any of the trustee's duties, such as filing fiduciary tax returns or maintaining trust records. However, the grantor can provide investment advice to the trustee and retain the power to veto trust distributions.*

Tip: *Grantors can add another layer of independent management by naming a trust protector. The trust protector is given the power to provide investment advice to the trustee and veto trust distributions instead of the grantor.*

Retained interests

Typically, grantors retain the following interests, although other rights may be permitted, depending on the state:

- Discretionary distributions of income and/or principal
- Veto power over distributions
- Special (or limited) testamentary power of appointment (i.e., the power to name or change the ultimate beneficiaries, excluding the grantor, grantor's creditors, grantor's estate, and creditors of the grantor's estate)

Limitations on claims

Each state limits the time in which creditors can make claims against the assets in the trust. For example, a state may provide that creditors whose claims arise after the trust has been created (i.e., future creditors) have only 4 years from the date the grantor transfers the assets to the trust to make such claims, and existing creditors have the later of 4 years from the date of transfer or one year after the creditor discovers (or should have discovered) the existence of the trust.

Generally, creditors' claims are barred after the statute of limitations period expires.

Fraudulent transfers

Creditors who make claims within the allowable time period must prove that transfers to the trust were fraudulent (i.e., made when the creditor's claims were already foreseen by the grantor). If the creditor is successful, the creditor can recover its debt and any costs allowed by the court.

Caution: *Self-settled spendthrift trusts, both domestic and offshore, protect assets from unforeseen creditors and liabilities only. If the court deems a transfer to be fraudulent, the grantor may not only have to make the assets available to the creditor and pay court costs, but may also face civil and criminal charges which may result in incarceration.*

Exempt creditors

Generally, spouses, children, and existing tort claimants are exempt from the statute of limitations and fraudulent transfer rules as explained above.

Tax considerations

Income Tax

Generally, domestic self-settled spendthrift trusts are grantor-type trusts--income earned by and expenses incurred by trust assets 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.

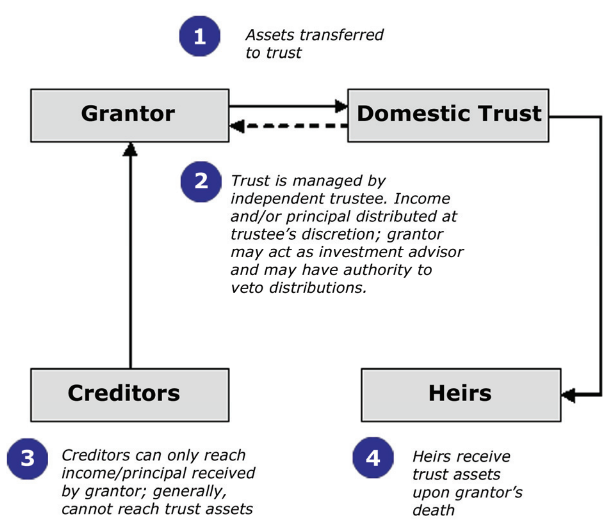
Gift Tax

Generally, transfers to a domestic self-settled spendthrift trust are subject to gift tax unless the grantor retains a power of appointment.

Estate Tax

Whether assets remaining in a domestic self-settled spendthrift trust 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.

How a domestic self-settled spendthrift trust works



Suitable clients

- Professionals (e.g., doctors, lawyers, engineers)
- Business owners
- Officers, directors, and fiduciaries
- Real estate owners who may be vulnerable to environmental claims
- Other individuals who are exposed to liability or contractual claims

Example

Larry buys a large tract of land that he plans to develop into an upscale residential community of single-family homes and condominium units, as well as health and recreation facilities, and commercial spaces for conveniences such as a small grocery or dry cleaning business. The project will take several years to complete. Currently, the land is not fenced in and is abutted by other residential neighborhoods. Larry lives with his family in a $1.5 million home that is titled in his wife's name. Larry and his wife live in a state that protects their retirement plans, life insurance, and annuities from creditor claims. But, Larry is the sole owner of an investment portfolio valued at close to $4 million, and he wants to protect those assets in the event of a large lawsuit in connection with the land.

Larry lives in State A, which is adjacent to State B, which allows self-settled spendthrift trusts. Larry creates such a trust in State B, naming a trust company in State B as trustee, and he and his spouse as sole beneficiaries during their lives, and their children as the ultimate beneficiaries. The trustee is given complete discretion to make or not make distributions to Larry and his spouse. Larry transfers his entire investment portfolio to the trust.

Over the next 2 years, the trust company administers the trust and manages the investment portfolio according to Larry's advice. One year later, with about two-thirds of the project completed, a serious accident occurred on Larry's land. The resulting lawsuits produced judgments against Larry far in excess of Larry's liability insurance limits, but the claimants were unable to reach Larry's investment portfolio to satisfy the judgments.

Advantages

Permits grantor to be beneficiary of spendthrift trust

Grantors can form a trust for their own benefit that protects them against creditors, something that is expressly prohibited by the majority of states. Generally, the states that allow self-settled spendthrift trusts have laws that shorten the time period for a creditor to challenge transfers, and make it more difficult for creditors to prove transfers were fraudulent.

Familiar jurisdiction to grantors

Some grantors will feel more comfortable with a trust located within the United States as opposed to an offshore jurisdiction.

Simpler and less costly than offshore trust

Generally, creating and maintaining an offshore trust is more complex and more expensive than a domestic trust.

Disadvantages

Fraudulent conveyance issues

Grantors must take care not to trigger fraudulent transfer laws, which might subject them to very severe penalties including hefty fines and jail time. Grantors must not:

- Create the trust to avoid known creditor claims, spousal support, or child support

- Make themselves insolvent by transferring too many assets to the trust
- Act as the independent trustee

Full faith and supremacy clause issues

Should a creditor be successful in a non self-settled spendthrift trust state, the state in which the trust is located is obligated to enforce the judgment under the Full Faith and Credit clause of the U.S. Constitution. Similarly, under the supremacy clause of the U.S. Constitution, federal law will preempt state law.

May not offer as much protection as an offshore trust

An offshore trust may be less likely than a domestic trust to be attacked by creditors as they generally present more hurdles that must be overcome by the creditor, including the psychological barrier of dealing with foreign persons and systems.

Untested law

The validity of self-settled spendthrift trusts has yet to be tested in the United States Supreme Court. Until the law is firmly established, care should be taken to create and fund such trusts under appropriate circumstances.

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