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Using Third-Party Trusts for Asset Protection

Asset protection is the process that includes reorganizing how a client holds their assets to make them less vulnerable to claims against the client. You can apply asset protection planning concepts to almost every type of asset, including cash, stocks, bonds, business interests, insurance, art, and real property. An asset protection trust (APT) is an advanced vehicle for insulating a client from liability. An APT implements lifetime asset protection planning, which preserves assets during a client's lifetime, along with more traditional end-of-life estate planning goals. An offshore irrevocable trust, domiciled in a foreign jurisdiction with protective laws, is the most effective form of APT.

THE TYPICAL ASSET PROTECTION TRUST

In general, an APT can shield the transferred assets from creditors of the trust's nonsettlor beneficiaries. Specifically, a settlor can create a spendthrift trust to provide for a beneficiary while also protecting the trust against the beneficiary's poor financial decisions and creditors. In a real sense, an APT is set up to protect a beneficiary from spending all of the money to which they are entitled.[1] A spendthrift provision is simply a provision in a trust document that expressly prohibits beneficiaries from transferring, encumbering, or pledging their respective beneficial interests in the trust. It also typically expressly prohibits any creditor of a beneficiary from attaching, levying against,

1 *Asset Protection Trust*, Black's Law Dictionary (6th ed. 1990).

or seeking a forced sale of the beneficiary's respective beneficial interests.[2]

When a settlor establishes a spendthrift trust for their own or others' benefit, the trust is categorized as a self-settled spendthrift trust, which is a standard APT. The weight of authority supports the validity of self-settled spendthrift trusts; however, depending on the applicable law, such trusts may or may not afford protection against the settlor's creditors. If the trust does not afford protection against the settlor's creditors, the lack of protection would apply not only to the settlor's present or subsequent creditors but also to potential future creditors for as long as the trust may exist. Thus, in some jurisdictions, a self-settled spendthrift trust leaves the door to trust assets open to creditors, meaning that, to access trust assets, a judgment creditor would not need to resort to a fraudulent transfer (also known as a voidable transaction) theory or other similar claim.

Another typical characteristic of self-settled APTs is that they are usually incomplete gift trusts. A gift is not complete until the donor (in this case, the settlor) relinquishes sufficient dominion and control over the property.[3] If the donor (settlor) retains the power to change the interests among beneficiaries, a gift is incomplete.[4] Therefore, in the typical self-settled APT, the settlor usually retains the power to alter the beneficial interests by being able to add beneficiaries and holding certain powers of appointment. The settlor's retention of such powers ensures that any transfers to the APT will be incomplete gifts for gift tax purposes, and no gift tax will be due.

As of this writing, approximately twenty-five offshore jurisdictions and nineteen states[5] statutorily recognize a self-settled spendthrift trust's validity.

THIRD-PARTY TRUSTS

A third-party trust (TPT) is a spendthrift trust that a settlor creates for another individual's benefit.

An intentionally defective irrevocable trust (IDIT) is an example of a TPT. Pursuant to Internal Revenue Code sections 671 through 677, an IDIT is an irrevocable trust that is considered a grantor trust for income tax purposes, i.e., the settlor is responsible for paying any income tax generated by the trust's assets. By paying the income tax, the settlor is, in effect, making additional gift-tax-free transfers to the IDIT, further reducing the settlor's taxable estate and at the same time increasing the IDIT's value as it grows free of any tax burden.

A settlor may use either of two common methods to create an IDIT. One method is to include the power to substitute assets of equivalent value. If the settlor or another person has the power in a nonfiduciary capacity to reacquire trust property by substituting property of equivalent value, the trust will be classified as a grantor trust for tax purposes, and all the trust's income will be taxable to the grantor.[6] The other method is to include the power to lend to the settlor without adequate interest or security. If either the settlor or a nonadverse party has a specific power to make a loan to the settlor without adequate interest or security, the settlor will be treated as the owner of the entire trust.[7]

THE RELATION-BACK DOCTRINE

The relation-back doctrine can be best illustrated with a scenario where a settlor creates and transfers assets into a spendthrift trust for their spouse's benefit. Hypothetically, let us assume that the trust's applicable law is in a state, e.g., Arizona, that has not enacted self-settled spendthrift trust legislation. Let us further assume that the trust agreement provides the spouse with a limited testamentary power of appointment, in which the spouse has the power to appoint the assets to a different trust for the settlor's benefit upon the spouse's death. When the trust is created and funded, the spouse receives asset protection from creditor claims because of the spendthrift clause. One would logically think that, upon the spouse's death, the remaining assets appointed to a trust for the settlor's benefit could arguably be categorized as a self-settled spendthrift trust because the settlor was the one who initially contributed the assets to the trust. Moreover, because Arizona does not recognize self-settled spendthrift trusts, the trust would then be declared void, being against public policy, and therefore the settlor's creditors could attach all remaining assets. However, Arizona Revised Statutes section 14-10505(E)(5) reaches the opposite conclusion, which allows the settlor to circuitously benefit from a de facto APT if the spouse predeceases the settlor. In Arizona, giving the spouse a limited testamentary power of appointment in the settlor's favor does not result in a self-settled spendthrift trust upon the spouse's death.

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2 Estate of Sowers, 574 P.2d 224, 228 (Kan. App. 1977).

3 *See* Treas. Reg. § 25.2511-2(b) (1999); *see also* I.R.S. Priv. Ltr. Rul. 85-51-040 (date) (a corporation's transfer to a trust is not a completed gift because it retained the right to designate charitable recipients).

4 Treas. Reg. § 25.2511-2(c) (1999).

5 *See* Twelfth ACTEC Comparison of the Domestic Asset Protection Trust Statutes (Aug. 2019).

6 *See* I.R.C. § 675(4)(C).

7 *See* I.R.C. § 675(2).

Other states, such as Texas, North Carolina, and Michigan, have similar statutes. Florida even has a statute with respect to inter vivos qualified terminable interest property (QTIP) trusts. If a trust was not created in either a state that has not enacted self-settled spendthrift legislation or a state where a settlor can benefit in a roundabout way, as if a self-settled spendthrift trust were created by the exercise of a testamentary power of appointment, its settlor should strongly consider changing the applicable law to such a state for the settlor's potential added protection.

HOW TO INTEGRATE A THIRD-PARTY TRUST INTO AN ESTATE PLAN

Third-party trusts are based on standard estate planning concepts, such as IDITs. Because many standard TPTs already provide at least some level of asset protection, they are effective vehicles for clients with asset protection goals. To add additional levels of protection, however, the trusts can be designed to eliminate any withdrawal rights or other vested interests, leaving all distribution decisions to a trustee's discretion. Also, these trusts can further instruct the trustee to withhold distributions from a beneficiary whenever a creditor risk such as a divorce or lawsuit appears imminent. Essentially, the goal of these changes is to remove any argument that a trust's beneficiary or settlor has any right to the trust assets while allowing the assets to remain available for the beneficiary.

A TPT can be integrated into a family's overall estate plan, potentially even through existing trusts if such trusts can be amended or decanted to implement more protective measures. Thus, these terms can be inserted into any completed gift trust, such as those formed to use the remainder of an individual's estate tax exemption amount. Such trusts can also be structured as either grantor or nongrantor trusts and can generally be funded with any type of asset.[8]

However, for various reasons, not everyone wants or has the means available to fund a TPT. In such cases, an inter vivos QTIP trust may be a good option. An inter vivos QTIP trust will use no estate tax exemption because it will qualify for the marital deduction, but if properly structured and administered, it can add a significant layer of asset protection. Of course, QTIP trusts do have certain requirements that reduce the offered protection, for example, that all income must be paid to the settlor's spouse. However, an inter vivos QTIP can protect the trust's principal from creditors, making it a significant asset protection tool for families who may not otherwise be able to create a more-traditional completed gift trust, such as a family that has already used its entire estate and gift tax exemption.

Regardless of which structure you use, however, the key to a successful asset protection trust is to remove from the settlor and the beneficiaries as much control over the assets held in trust as possible. The greater the control retained by either a settlor or a beneficiary, the more likely it is that a creditor can attach such assets. This is not to say that all powers must be relinquished (for example, a beneficiary could be the investment manager of a limited liability company held by a trust so that investment control remains in the family), but all retained powers must be carefully weighed against the risk that such powers could allow a creditor to attach the assets. The level of control required and the level of acceptable risk will be unique to each family. Practitioners should perform this analysis before finalizing any new asset protection plan, regardless of its structure.

COMPARING SELF-SETTLED TRUSTS TO THIRD PARTY TRUSTS

Now that we have addressed some specifics of each type of trust, we will explore the true distinctions. The most evident distinction is whether the trust's settlor is named as a trust beneficiary.

A common feature, as opposed to a distinction, pertains to the trustee's instructions concerning when to make distributions to the beneficiaries. A purely discretionary power held by the trustee is usually the most protective. When the trustee has the absolute and sole discretion to make any distributions, including the full discretion to withhold all distributions, the trust is better positioned to be protected against the beneficiaries' creditors because the beneficiaries' interest in the trust is nothing more than a mere expectancy and should not rise to the level of a property right. The reasoning behind the protection is that, if the beneficiary has no vested property rights to the trust assets, a creditor should not be in a better position than the beneficiary to obtain any trust assets held for the beneficiary.

Not being a beneficiary of the trust you created. While TPTs have many tax and creditor protection benefits, the thought of placing substantial assets into a trust of which you are not a beneficiary can have a chilling effect. On a broader scale, a settlor names specific persons in the trust as its beneficiaries, but as life changes, people often change as well. What if the

8 However, before transferring any entity interests to a completed gift trust, consider the principles of *Comm'r v. Powell*, 148 T.C. 392 (May 18, 2017). If the settlor retains too much control over the transferred entity interest, the Internal Revenue Service may attempt to pull the interest back into the settlor's taxable estate. In addition, the more control a settlor retains over a transferred asset, the greater the chance that a creditor can reach the asset.

client later wants to remove a beneficiary or add additional beneficiaries? There are some ways to address that.

For example, the trust agreement can include provisions to appoint a protector. In some states and jurisdictions, a protector is a person with few or no fiduciary obligations who is charged with ensuring that the client's original intentions are carried out and not derailed by changing circumstances or laws. The agreement can authorize a protector to expand the class of beneficiaries to include other family members or charities. You can recommend this provision for tax reasons, i.e., so the trust will be treated as a grantor trust.[9] A protector can also be given broad trust amendment powers so that the trust will remain a viable tool to achieve its originally intended goals despite continuing changes in family circumstances and the laws.

Adding the settlor as a beneficiary. Individuals may hesitate to transfer significant amounts to a trust for fear that, if the individual later encounters tough economic times or the trust assets are less accessible to the family, they can no longer enjoy the benefits of the trust assets. Such a rainy-day scenario may result in the desire to give a trustee or protector the ability to add the settlor as a beneficiary if financial difficulties or other impediments occur. A trustee may be hesitant to exercise this power because of anticipated complaints from other beneficiaries that the trustee is diluting the pot. In a jurisdiction in which the protector's fiduciary duties are reduced or nonexistent, they may have greater latitude and less reluctance to exercise this power, especially if the power is clearly denominated as a power of appointment and not a fiduciary power. To ensure that the protector has guidelines concerning the exercise of this power, the trust agreement may contain a list of scenarios in which the settlor could be added as a beneficiary. However, such scenarios should not be situations that the settlor can easily create. Instead, the scenarios should be of sufficient independent significance, such as death of the settlor's spouse, a divorce, or retirement, that it is clear that the protector is an independent decision maker. Keep in mind that, if the protector is contemplating adding the settlor as a beneficiary, you should revisit the trust's applicable law to consider whether you should use an offshore or domestic asset protection jurisdiction.

CONCLUSION

In light of the optics and risks inherent to self-settled spendthrift trusts (which, if structured properly, can still be very effective), the TPT offers a domestic design that has a long-established legal foundation. The trade-offs, however, include the need to surrender a certain level of control over the trust assets and a more restricted ability to benefit financially from the trust's investment performance. Then again, the upside is a more traditional and widely accepted design in which the trust is created by one family member for other family members (and other beneficiaries) who can enjoy the fruits of the trust's activities in a more protective environment. The third-party design mitigates the fear that a court would view the trust as the settlor's own accessible assets.

9 The tax laws state that if someone can name additional beneficiaries (such as in the protector discussion above), this will cause the trust to be a grantor trust.