Shoo Creditors, Don't Bother Me - All You Need to Know About the Use of Self-Settled Asset Protection Trusts

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I. INTRODUCTION

A. It's no secret that the United States is a litigious society, and there's no indication that the trend line with respect to lawsuits goes anywhere from here but up. And, although some claims have merit, far too many do not. In such an atmosphere, one's clients are subject to an unacceptable level of risk.

B. Today, self-settled spendthrift trusts, more commonly called "asset protection trusts," are a common planning tool to protect clients against the claims of potential future creditors. A number of states within the United States, as well as certain foreign jurisdictions, now permit such trusts and, as time goes by, more jurisdictions (including, perhaps, New York), will enact self-settled spendthrift trust legislation.

II. BACKGROUND

A. A Brief (and Selective) History of Creditor-Proof Trusts

1. Spendthrift Trusts

a. "Trusts in which a beneficiary cannot assign the interest, or that provide that creditors cannot reach it, are known as 'spendthrift trusts.'" SCOTT AND ASCHER ON TRUSTS § 15.2, Vol. 3 at 898 (5th ed. 2007).

b. "The term 'spendthrift trust' refers to a trust that restrains voluntary and involuntary alienation of all or any of the beneficiaries' interests." RESTATEMENT (THIRD) OF TRUSTS § 58, Vol. 2 at 355 (2003).

c. In New York, § 7-1.5(a)(1) of the Estates, Powers and Trusts Law provides, in general, and in pertinent part, that "…[t]he right of a beneficiary of an express trust to receive the income from property and apply it to the use of or pay it to any person may not be transferred by assignment or otherwise unless a power to transfer such right, or any part thereof, is conferred upon such beneficiary by the instrument creating or declaring the trust."

2. Discretionary Trusts

a. A "discretionary" trust is a trust in which distributions to the beneficiary are left wholly within the discretion of the trustee, generally without regard to any ascertainable standard. RESTATEMENT (THIRD) OF TRUSTS § 58, Vol. 2 at 355 (2003).

3. Combined Discretionary and Spendthrift Trusts

a. "A spendthrift trust is to be distinguished from a discretionary trust but may or may not also contain discretionary interests…" RESTATEMENT (THIRD) OF TRUSTS § 58, Vol. 2 at 355 (2003).

b. A discretionary spendthrift trust has the potential to afford a beneficiary a significant amount of creditor protection. A series of cases is instructive in this regard; they are (i) *Nichols v. Eaton*, 91 U.S. 716 (1875), (ii) *Sligh v. First National Bank of Holmes County*, 704 So. 2d 1020 (Miss. 1997), (iii) *Scheffel v. Krueger*, 782 A.2d 410 (N.H. 2001), and (iv) *Gibson v. Speegle*, 1984 Del. Ch. LEXIS 475 (DE Ct. of Chancery, Sussex County, May 30, 1984).

(i) *Nichols v. Eaton*

(a) It was not until 1875, with the United States Supreme Court decision in *Nichols v. Eaton*, that a break with the English common law on spendthrift trusts was effected, and their validity became generally accepted throughout the United States.

(b) The theoretical basis underlying the general acceptance of the validity of spendthrift trusts in the United States, as demonstrated by the Supreme Court in *Nichols*, is the idea that an individual should be able to transfer property subject to certain limiting conditions upon which the property will be available to the beneficiary.

(1) In this regard, the maxim "*cujus est dare, ejus est disponere*," or "[w]hose it is to give, his it is to dispose" is frequently cited in connection with references to the validity of spendthrift trust restrictions.

(c) In *Nichols*, the trust in question was a testamentary trust established by a mother for her son who had failed in business and who had assigned all of his property for the benefit of his creditors and then later filed for bankruptcy. The mother's will included a provision that stated that if any of her sons should "alienate or dispose of the income to which they were entitled under the trusts of the will, or if, by reason of bankruptcy or insolvency, or any other means whatsoever, said income could no longer be personally enjoyed by them respectively, but the same would become vested in or payable to some other person, then the trust expressed in said will concerning so much thereof as would so vest should immediately cease and determine. In that case, during the residue of the life of such son, that part of the income of the trust fund was to be paid to the wife and children, or wife or child, as the case might be, of such son, and in default of any objects of the last-mentioned trust, the income was to accumulate in augmentation of the principal fund."

(d) In establishing the modern rule with regard to spendthrift trusts, the Supreme Court in *Nichols* stated that:

(1) "We concede that there are limitations which public policy or general statutes impose upon all dispositions of property, such as those designed to prevent perpetuities and accumulations of real estate...We also admit that there is a just and sound policy...to protect creditors against frauds upon their rights...But the doctrine, that the owner of property...cannot so dispose of it, but that the object of his bounty...must hold it subject to the debts due his creditors...is one which we are not prepared to announce as the doctrine of this court."

(ii) *Sligh v. First National Bank of Holmes County*

(a) In *Sligh*, the beneficiary of two spendthrift trusts established by the beneficiary's mother with the defendant bank, as trustee, was operating a motor vehicle while intoxicated and was involved in an accident with the plaintiff. The accident left the plaintiff paralyzed with the loss of the use of both legs, the loss of all sexual function and the loss of his ability to control his bowel and urinary functions. The plaintiff won a $5 million civil judgment against the beneficiary for compensatory and punitive damages and tried to collect against the trusts by alleging that the beneficiary's mother had actual knowledge that the beneficiary was an alcoholic and that the beneficiary's mother had created the trusts to shield her son's interest from the likely claims of involuntary tort creditors. The beneficiary had no other assets aside from his beneficial interests in the trusts.

(b) The plaintiff alleged that it was a violation of public policy to enforce and give priority to spendthrift trust provisions over involuntary tort judgments against a trust beneficiary, and urged the court to recognize and enforce a public policy exception to the spendthrift trust doctrine in favor of involuntary tort creditors. The Mississippi Supreme Court ultimately allowed the plaintiff to collect against the trusts by concluding that spendthrift protection should not extend to judgments for "gross negligence and intentional torts."

(1) Most significant, however, is the fact that the Mississippi legislature promptly negated the import of *Sligh* in future cases through the enactment of the "Family Trust Preservation Act of 1998." Miss. Code Ann. §§ 91-9-501, *et seq.* (1998). That act provides that except in the case of a self-settled trust, a beneficiary's interest in a spendthrift trust may not be transferred nor subjected to a money judgment until the interest is actually paid to the beneficiary.

(iii) *Scheffel v. Krueger*

(a) In *Scheffel v. Krueger*, the defendant was a convicted child molester who was the beneficiary of a discretionary spendthrift trust established by his grandmother in 1985. The plaintiff filed suit in 1998 asserting tort claims against the defendant in connection with the molestation charges and seeking an attachment of the defendant's beneficial interest in the discretionary spendthrift trust. Under the terms of the trust, all income was to be distributed to the defendant annually and distributions of principal were to be made in the trustee's discretion. The defendant had the power to invade the principal of the trust only following his fiftieth birthday on April 6, 2016.

(b) The court found no basis for relief for the plaintiff and held that nothing in the language of the relevant statute suggested that the New Hampshire legislature intended to exempt a tort creditor from the protection afforded by a spendthrift provision. The court also found that the defendant's ability to direct trust income and principal after attaining age fifty did not, in and of itself, disqualify the trust as a spendthrift trust.

(iv) *Gibson v. Speegle*

(a) In February, 1976, Gary Barwick pled guilty to several crimes, including arson, all of which resulted in damage to the Hawaiian Village Restaurant and Lounge in Delmar, Delaware, a property that Aetna insured and in connection with which Aetna paid out monies to the policyholder. At sentencing, Gary was ordered, *inter alia*, to pay restitution, including monies to Aetna. Less than five months after Gary's sentencing, his mother, Virginia, executed a Last Will and Testament which included a discretionary spendthrift trust for Gary until he should reach the age of forty (40) years. Virginia then died and Aetna made claim against Gary's new trust.

(b) Delaware Code § 3536(a) provides, in pertinent part, that "[a] creditor of a beneficiary of a trust shall have only such rights against such beneficiary's interest in the trust or the property of the trust as shall be expressly granted to such creditor by the terms of the instrument that creates or defines the trust or by the laws of [Delaware].

The provisions of this subsection shall be effective regardless of the nature or extent of the beneficiary's interest or of any action taken or that might be taken by the beneficiary. Every interest in a trust or in trust property or the income therefrom that shall not be subject to the rights of creditors of such beneficiary as provided herein shall be exempt from execution, attachment, distress for rent, foreclosure, and from all other legal or equitable process or remedies instituted by or on behalf of any creditor, including, without limitation, actions at law or in equity against a trustee or beneficiary that seeks a remedy that directly or indirectly affects a beneficiary's interest…"

(c) The Delaware Court of Chancery stated: "I am not at all comfortable with the fact that Virginia Barwick, by use of a spendthrift trust, assisted her son in avoiding his obligation to pay for his crimes. However, it is not the Court's function to write the law but only to interpret it. The statute enacted by the General Assembly contains no exceptions."

4. Self-Settled Spendthrift (a/k/a "Asset Protection") Trusts

a. Domestic Asset Protection Trusts

(i) Although every state recognizes, in general, the validity of spendthrift trusts to protect a third party beneficiary's interest from creditor claims, such clauses, as a matter of public policy, have historically been unenforceable with respect to a settlor, who is also a beneficiary of such trust, to the extent of such settlor's interest in such trust. In this regard, many states have statutes or common law prohibiting such "self-settled spendthrift trusts" and provide that a settlor cannot create such a trust to protect himself or herself from creditors.

(a) In New York, § 7-3.1(a) of the Estates, Powers and Trusts Law provides, in general, and in pertinent part, that "[a] disposition in trust for the use of the creator is void as against the existing or subsequent creditors of the creator."

(ii) These prohibitions against self-settled spendthrift trusts apply irrespective of any number of considerations that one might logically consider to be relevant to the question of whether such trusts should actually be void as against public policy, including, most significantly:

(a) Whether or not the settlor is the sole beneficiary of the trust, or one of many discretionary beneficiaries of the trust.

(b) Whether the trustee is a friend or family member of the settlor, or a bank or trust company that is completely independent of the settlor.

(c) Whether the trust is funded with a nominal amount or a large portion of the settlor's overall net worth.

(d) Whether or not the settlor has ever received a discretionary distribution from the trust.

(e) Whether or not the settlor has any existing or anticipated future creditors at the time the trust is created.

(iii) However, since 1997 sixteen states have enacted legislation extending spendthrift trust protections to a settlor-beneficiary of a discretionary trust (provided that the funding of the trust is not a fraudulent transfer). Those states are:

(a) Alaska

(b) Delaware

(c) Hawaii

(d) Michigan

(e) Mississippi

(f) Missouri

(g) Nevada

(h) New Hampshire

(i) Ohio

(j) Rhode Island

(k) South Dakota

(l) Tennessee

(m) Utah

(n) Virginia

(o) West Virginia

(p) Wyoming

(q) In addition, Oklahoma, pursuant to the Family Wealth Preservation Trust Act of June 9, 2004, permits an individual to create a trust with a bank or trust company located in Oklahoma as trustee, for the benefit of such individual's spouse, descendants and any one or more Internal Revenue Code § 501(c)(3) charities, and to retain the right to revoke the trust without causing the trust to thereby be available to creditors. In addition, the law provides that no court shall have the authority to compel the settlor to exercise the settlor's power to revoke the trust. The law does, however, limit the protection to $1 million of transferred assets plus any subsequent appreciation thereon. In addition, the corpus of the trust must consist of assets in Oklahoma based banks, real estate located in Oklahoma, and securities issued by Oklahoma based companies (including corporations, limited liability companies and limited partnerships formed or domesticated in Oklahoma and having a principal place of business in Oklahoma). However, the Oklahoma law does not technically provide for "self-settled" spendthrift trusts because the settlor himself cannot be a beneficiary of such a trust.

b. Foreign Asset Protection Trusts

(i) Historically, it was individuals residing outside of the United States that used foreign asset protection trusts, and their purpose was to avoid forced heirship and government expropriation of assets, rather than the potential claims of third party creditors. However, in the modern litigation environment within the United States, such trusts are today most often used by United States persons for more "standard" asset protection purposes.

(ii) The following foreign jurisdictions have enacted favorable asset protection trust legislation:

(a) Anguilla

(b) Antigua

(c) Bahamas

(d) Barbados

(e) Belize

(f) Bermuda

(g) Cayman Islands

(h) Cook Islands

(i) Cyprus

(j) Gibraltar

(k) Labuan

(l) Marshall Islands

(m) Mauritius

(n) Nevis

(o) Niue

(p) St. Vincent

(q) St. Lucia

(r) Seychelles

(s) Turks and Caicos

III. FRAUDULENT TRANSFER ISSUES

A. Every asset protection plan, including those involving the creation of an asset protection trust, must in the very first instance account for the law of fraudulent transfers. In general, the law of fraudulent transfers, which dates back at least to the enactment of the *Statute of Elizabeth* in England in the year 1571, provides that the transfer of assets in anticipation of a creditor claim will be disregarded by the courts and the creditor will be allowed to enforce its judgment against a transferee of the property.

B. Fraudulent transfer law can be found within the federal Bankruptcy Code, the debtor/creditor law of every state and the law of almost all foreign jurisdictions, as well.

1. For federal purposes, Bankruptcy Code § 548, entitled *Fraudulent Transfers and Obligations*, provides for the avoidance of fraudulent transfers in the Bankruptcy context.

2. At the state level, fraudulent transfer law is largely governed by one of two main bodies of law promulgated by the National Conference of Commissioners on Uniform State Law (also known as the Uniform Law Commission).

a. The Uniform Fraudulent Conveyance Act (promulgated in 1918 by the National Conference of Commissioners on Uniform State Laws and in effect today in only two jurisdictions – Maryland and New York).

b. The Uniform Fraudulent Transfer Act (approved by the National Conference of Commissioners on Uniform State Laws in 1984 and in effect today in forty three states, as well as the District of Columbia and the U.S. Virgin Islands).

(i) In 2014, the National Conference of Commissioners on Uniform State Laws adopted amendments to the Uniform Fraudulent Transfer Act. Among other things, the amendments renamed the UFTA as the "Uniform

Voidable Transactions Act". To date, these amendments have been adopted in eighteen states.

(a) As of the preparation of this outline, the Uniform Voidable Transactions Act has been introduced in New York, but is not enacted. See, Assembly Bill 1853/Senate Bill 6180.

c. The remaining states follow either a version of the Statute of Elizabeth, or provide for a civil law analogue to the common law suit to set aside a fraudulent transfer (*i.e.*, Louisiana).

C. Notwithstanding the semantic similarity between the term "fraud" and the term "fraudulent conveyance" (or "fraudulent transfer"), the two concepts are wholly unrelated under the law.

1. According to Black's Law Dictionary, a "fraud" is "[a] knowing misrepresentation of the truth or concealment of a material fact to induce another to act to his or her detriment."

2. By contrast, the most common incidence of a "fraudulent conveyance" is as is set forth in § 276 of the New York Debtor Creditor Law, which provides that a "…conveyance made [or an]obligation incurred with actual intent, as distinguished from intent presumed in law, to hinder, delay, or defraud either present or future creditors…"

a. In addition, § 273 of the New York Debtor Creditor Law provides that "[e]very conveyance made and every obligation incurred by a person who is or will be thereby rendered insolvent is fraudulent as to creditors without regard to his actual intent if the conveyance is made or the obligation is incurred without a fair consideration."

b. Finally, the mere fact that a person has been named as a defendant in a lawsuit can render all transfers made by that person without the receipt of sufficient consideration therefore as *per se* fraudulent transfers irrespective of the transferor's actual intent, or solvency, at the time of the transfer.

(i) In this regard § 273-a of New York Debtor and Creditor Law provides that "[e]very conveyance made without fair consideration when the person making it is a defendant in an action for money damages or a judgment in such an action has been docketed against him, is fraudulent as to the plaintiff in that action without regard to the actual intent of the defendant if, after final judgment for the plaintiff, the defendant fails to satisfy the judgment."

3. The difference between a fraud and a fraudulent conveyance is also evidenced by the remedy available to the injured party; fraud vitiates all transactions *ab initio*, whereas a fraudulent transfer is merely voidable.

D. In determining when a transfer was made with the intent to hinder, delay or defraud a creditor, fraudulent conveyance law usually divides creditors into three categories:

1. Present creditors – being those persons of whom the transferor has notice when making transfers.

2. Probable future creditors – being those persons against whom the transferor harbored an actual fraudulent intent when transferring assets, including creditors whose rights arose after the transfer.

3. Potential future creditors – being those nameless, faceless persons of whom the transferor had no awareness or expectation of a debtor/creditor relationship when the transfer was made.

E. One can easily imagine that it will be the rare debtor who expressly admits or otherwise voluntarily disgorges proof that his or her transfers of property were made with an actual intent to hinder, delay or defraud his or her creditors. As a consequence of this inherent difficulty in proving the debtor's intent, the courts have permitted various "badges of fraud", frequently thought to attend the fraudulent transfer of property, to be taken into account as "proof" of the requisite intent.

1. The Uniform Fraudulent Conveyance Act relies upon common law badges of fraud.

2. In contrast, the Uniform Fraudulent Transfer Act provides a non-exhaustive list of factors that may be considered in determining the debtor's actual intent in transferring property or incurring an obligation. Those factors are:

a. Whether the transfer or obligation was to an insider;

b. Whether the debtor retained possession or control of the property transferred after the transfer;

c. Whether the transfer or obligation was disclosed or concealed;

d. Whether before the transfer was made or the obligation was incurred, the debtor had been sued or threatened with suit;

e. Whether the transfer was of substantially all of the debtor's assets;

f. Whether the debtor absconded;

g. Whether the debtor removed or concealed assets;

h. Whether the value of the consideration received by the debtor was reasonably equivalent to the value of the asset transferred or the amount of the obligation incurred;

i. Whether the debtor was insolvent at the time the transfer was made or the obligation was incurred or became insolvent shortly after the transfer was made or the obligation was incurred;

j. Whether the transfer occurred shortly before or shortly after a substantial debt was incurred; and

k. Whether the debtor transferred the essential assets of his or her business to a lienor who transferred the assets to an insider of the debtor.

F. Effect of Finding a Fraudulent Conveyance and Transferee Liability

1. The Uniform Fraudulent Conveyance Act provides for several alternative remedies where a fraudulent conveyance is found to have been made. Those prospective remedies include:

a. Avoidance of the conveyance or obligation to the extent necessary to satisfy the creditor's claim;

b. An attachment or other provisional remedy against the asset conveyed or other property of the transferee; and

c. An injunction against further disposition by the debtor or a transferee, or both, of the asset conveyed or of other property of the transferee or any other relief the circumstances may require.

2. A ceiling imposed upon the relief available where a fraudulent conveyance has been found is that the creditor can obtain no greater relief in the face of the fraudulent conveyance than such creditor might have obtained had the fraudulent conveyance not been made.

a. However, under the Bankruptcy Code, the debtor's discharge may also be denied due to the debtor having made a fraudulent transfer. See, 11 U.S.C. § 727.

G. It is notable that, except as specified hereinabove, it is unimportant whether or not a creditor's claim has yet coalesced into a lawsuit (which, of course, might be months or years after the actual claim arose).

H. It is, therefore, absolutely imperative that asset protection planning be undertaken as far in advance of a potential creditor claim as possible in order to ensure that any transfer of property incident to such planning is not later undone as a fraudulent conveyance.

IV. UVTA CONTROVERSY RE SELF-SETTLED SPENDTHRIFT TRUSTS

A. Section 10 of the Uniform Voidable Transactions Act, entitled "Governing Law", provides, in pertinent part that "[a] claim for relief in the nature of a claim for relief under this [Act] is governed by the local law of the jurisdiction in which the debtor is located when the transfer is made or the obligation is incurred."

1. Section 10(a)(1) provides that "[a] debtor who is an individual is located at the individual's principal residence."

2. Thus, if the individual debtor happens to be the settlor of a self-settled spendthrift trust, it will be the law of the settlor/debtor's residence, and not necessarily that of the trust, that will control the question of whether or not a voidable transaction has occurred.

B. Section 4(a)(1) of the Uniform Voidable Transactions Act, entitled "Transfer or Obligation Voidable as to Present or Future Creditor", provides that "[a] transfer made or obligation incurred by a debtor is voidable as to a creditor, whether the creditor's claim arose before or after the transfer was made or the obligation was incurred, if the debtor made the transfer or incurred the obligation…with actual intent to hinder, delay, or defraud any creditor of the debtor."

C. Comment 8 to Section 4 of the Uniform Voidable Transactions Act, however, states, in pertinent part, as follows:

1. "Suppose that jurisdiction X, in which this Act is in force, also has in force a statute permitting an individual to establish a self-settled spendthrift trust and transfer assets thereto, subject to stated conditions. If an individual Debtor whose principal residence is in X establishes such a trust and transfers assets thereto, then under § 10 of this Act the voidable transfer law of X applies to that transfer. That transfer cannot be considered voidable in itself under § 4(a)(1) as in force in X, for the

legislature of X, having authorized the establishment of such trusts, must have expected them to be used. (Other facts might still render the transfer voidable under X's enactment of § 4(a)(1).)"

2. "By contrast, if Debtor's principal residence is in jurisdiction Y, which also has enacted this Act but has no legislation validating such trusts, and if Debtor establishes such a trust under the law of X and transfers assets to it, then the result <u>would be</u> different. Under § 10 of this Act, the voidable transfer law of Y would apply to the transfer. If Y follows the historical interpretation referred to in Comment 2, the transfer <u>would be</u> voidable under § 4(a)(1) as in force in Y."

3. Comment 8 to Section 4 of the Uniform Voidable Transactions Act thus appears to suggest, through the back door device of a Comment, and not an actual provision of the Act, that the creation of a self-settled spendthrift trust by anyone other than a residence of a self-settled spendthrift trust jurisdiction is a *per se* voidable transaction.

    a. Significantly, however, the NYC Bar Association Report submitted in connection with the possible enactment of the UVTA in New York states, in pertinent part, that:

        (i) Section 273 "…is the first of the two principal operative sections of the Act and sets out two of the four principal rules for the avoidance of transfers. Rights to avoid transfers are extended to both creditors existing at the time of the transfer and future creditors, for transfers that are voidable under Section 273. Section 273 is substantially similar to existing New York law and not intended to affect any material changes to that law. Because of this, the City Bar does not regard the general discussion of fraudulent transfer law in the Official Comments to Section 4 of the UVTA to be necessary or authoritative to interpret this section. Specifically… comment number 8 to Section 4 of the UVTA [is] inconsistent with New York law and [is] not supported by the text of the UVTA. Therefore, [this comment] should not be considered when interpreting the UVTA, as enacted in New York. It is worth noting that other jurisdictions have reached the same conclusion…"

4. For a much more thorough analysis on this issue, see Karibjanian, Nenno and Rubin, *The Uniform Voidable Transactions Act: Why Transfers to Self-Settled Spendthrift Trusts by Settlors in Non-APT States Are Not*

Voidable Transfers Per Se, Tax Management Estates, Gifts, and Trusts Journal, Vol. 42, No. 4, p. 173, 07/14/2017.

V. Delaware's "Qualified Dispositions in Trust Act," 1997 Del. Laws ch. 159 (H.B. 356)

A. Delaware's Qualified Dispositions in Trust Act (the "Act"), is a good example of self-settled spendthrift trust legislation and, as such, has served as a model for the self-settled spendthrift trust law of a number of other states. It is thus fairly representative of self-settled spendthrift trust legislation in the United States.

B. The Act affords spendthrift trust protections under Delaware law to properly established irrevocable discretionary self-settled trusts.

1. Specifically, the Act allows the settlor (referred to under the Act as a "transferor"), to retain a beneficial interest in the trust created by the settlor while at the same time protecting the trust's assets from the settlor's creditors by having the trust settlement provide that "...the interest of the transferor or other beneficiary in the trust property or income therefrom may not be transferred, assigned, pledged or mortgaged, whether voluntarily or involuntarily, before the qualified trustees actually distribute the property or income therefrom to the beneficiary..." Del. Code Ann. tit. 12, § 3570(11)(c).

2. The purpose of the Act, however, as set forth in the legislative history, was not necessarily to make a debtors' haven of the State of Delaware, but rather to allow a settlor to reduce his or her estate taxes through the expedient of a Delaware spendthrift trust without irrevocably removing all possibility that the transferred assets could be used for the settlor's future benefit. See Qualified Dispositions in Trust Act, Synopsis, Pub. Act 159, 71 Del. Laws 159 (1997).

a. This result is not obtainable through a self-settled trust that is not a valid and effective *spendthrift* trust because where the settlor's creditors can reach the settlor's interest in the trust the settlor will be deemed, at least indirectly, to have retained the "use and enjoyment" of the transferred assets and the Internal Revenue Code will cause the transferred property to be brought back into the settlor's estate due to the settlor's "retained right to possession or enjoyment, or to income".

(i) Internal Revenue Code § 2036(a)(1) provides that "[t]he value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death...the possession or enjoyment of, or the right to the income from, the property..."

(a) See, e.g., *Paxton v. Commissioner*, 86 T.C. 785 (1986); *German Est. v. U.S.*, 7 Cl. Ct. 641 (1985); *Outwin Est. v. Commissioner*, 76 T.C. 153 (1981), acq., 1981-2 C.B. 2; *Paolozzi v. Commissioner*, 23 T.C. 182 (1954), acq., 1962-1 CB 4 ("petitioner's creditors could at any time look to the trust of which she was settlor-beneficiary for settlement of their claims to the full extent of the income thereof. This being true, it follows that petitioner…could at any time obtain the enjoyment and economic benefit of the full amount of the trust income").

(ii) In contrast, in PLR 200944002 (which involved a self-settled spendthrift trust under Alaska law, where such a trust is also permissible), the Internal Revenue Service ruled that "…the trustee's discretionary authority to distribute income and/or principal to Grantor, does not, by itself, cause the Trust corpus to be includible in Grantor's gross estate under § 2036."

(iii) *See also*, Rev. Rul. 76-103, 1976-1 CB 293 ("if and when the grantor's dominion and control of the trust assets ceases, such as by the trustee's decision to move the situs of the trust to a State where the grantor's creditors cannot reach the trust assets, then the gift is complete for Federal gift tax purposes under the rules set forth in § 25.2511-2 of the regulations."). The consequence of a completed gift is generally that the gifted asset is excluded from the grantor's estate for estate tax purposes.

b. Of course, the Act is not limited to trusts that serve an estate planning purpose, and, thus, the Act permits self-settled spendthrift trusts to be established purely for purposes of "asset protection".

3. In order for a self-settled Delaware trust to be protected from the creditors of the settlor as a so-called "qualified disposition" under the Act, several express statutory requirements must be met.

a. The settlor must transfer property to a "qualified trustee".

(i) For this purpose, a "qualified trustee" is either an individual resident of Delaware (other than the transferor) or an entity authorized by Delaware law to act as a trustee and "whose activities are subject to supervision by the Bank Commissioner of the state, the Federal Deposit Insurance Company, the Comptroller of the Currency, or the Office of Thrift Supervision or any successor thereto." Del. Code Ann. tit. 12, §3570(8)(a).

(a) Notably, under Del. Code Ann. tit. 12, § 3570(8)(f), not all trustees are required to be qualified trustees in order for the disposition to be a qualified disposition.

(b) Although the settlor cannot act as a trustee, the settlor can, under Del. Code Ann. tit. 12, § 3570(8)(c), appoint one or more "advisors" to the trust which according to the Act includes one or more persons "who have authority under the terms of the trust instrument to remove and appoint qualified trustees or trust advisers" or " who have authority under the terms of the trust instrument to direct, consent to or disapprove distributions from the trust."

(c) In addition, under Del. Code Ann. tit. 12, § 3571, the settlor of a qualified disposition can serve as an "investment advisor" to a Delaware trust as such term is described in § 3313 of the Act. In this role, a settlor can "direct, consent to, or disapprove a fiduciary's actual or proposed investment decisions."

(ii) In order to provide a certain nexus between a "qualified disposition" and the state of Delaware, Del. Code Ann. tit. 12, §3570(8)(b) requires the qualified trustee to:

(a) Maintain or arrange for custody in the State of Delaware of some or all of the property that is the subject of the qualified disposition;

(b) Maintain records for the trust on an exclusive or nonexclusive basis;

(c) Prepare or arrange for the preparation of fiduciary income tax returns for the trust; or

(d) Otherwise materially participate in the administration of the trust.

4. There must be a valid "trust instrument", which the Act defines as "an instrument appointing a qualified trustee or qualified trustees for the property that is the subject of a disposition", and which meets certain express statutory requirements. Del. Code Ann. tit. 12, § 3570(11).

a. In particular, to receive the protection of the Act, the trust instrument must expressly incorporate Delaware law to govern the validity, construction and administration of the trust. Del. Code Ann. tit. 12, § 3570(11)(a).

b. The trust instrument must also be irrevocable, but under Del. Code Ann. tit. 12, § 3570(11)(b), the trust instrument will not be deemed revocable due to the inclusion in the trust instrument of any of the following:

(i) A power in the settlor to veto a distribution from the trust.

(ii) A testamentary special power of appointment in the settlor.

(iii) The settlor's potential or actual receipt of income from the trust, including rights to such income retained in the trust instrument.

(iv) The settlor's potential or actual receipt of income or principal from a charitable remainder unitrust or charitable remainder annuity trust.

(v) The settlor's potential or actual receipt of income or principal from a grantor retained annuity trust or a grantor retained unitrust.

(vi) The settlor's receipt each year of a percentage (not to exceed 5%), specified in the trust instrument, of the value of the trust determined from time to time pursuant to the trust instrument.

(vii) The settlor's potential or actual receipt of principal from the trust if it is either in the discretion of the trustees or an adviser or pursuant to an ascertainable standard contained in the trust instrument.

(viii) The settlor's right to remove a trustee or adviser and to appoint a new trustee or adviser.

(ix) The settlor's potential or actual use of real property held under a qualified personal residence trust or the transferor's possession and enjoyment of a qualified annuity interest.

(x) The settlor's potential or actual receipt, within the qualified trustees' discretion, or acting at the direction of an adviser, of income or principal to pay income taxes due on income of the trust if pursuant to a provision in the trust instrument.

(xi) The ability, whether pursuant to discretion, direction or the settlor's exercise of a testamentary power of appointment, of a qualified trustee to pay, after the death of the transferor, all or any part of the debts of the transferor outstanding at the time of the transferor's death, the expenses of administering the transferor's estate, or any estate or inheritance tax imposed on or with respect to the transferor's estate.

c. Of course, the trust instrument must also contain a spendthrift clause. Del. Code Ann. tit. 12, § 3570(11)(c).

5. The statute of limitations applicable to actions brought against property subject to a qualified disposition under the Act provides that:

a. A creditor may not bring an action if the creditor's claim against the transferor arose before the qualified disposition was made, unless the action is brought within four years after the qualified disposition is made or, if later, within one year after the qualified disposition was or could reasonably have been discovered by the creditor. Del. Code Ann. tit. 12, § 3572(b)(1); Del. Code Ann. tit., 6, § 1309.

b. For a creditor's claim that arose concurrent with or subsequent to the qualified disposition, an action must be brought within four years after the qualified disposition is made. Del. Code Ann. tit. 12, § 3572(b)(2).

c. In addition, under the Act, the amount of time that trust property is held in a predecessor trust may be tacked onto the time that property is considered held as a qualified disposition.

(i) Specifically, the Act provides that "a qualified disposition that is made by means of a disposition by a transferor who is a trustee shall be deemed to have been made as of the time (whether before or after July 1, 1997 [being the effective date of the Act]) the property that is the subject of the qualified disposition was originally transferred to the transferor (or any predecessor trustee) making the qualified disposition in a form that meets the requirements of §3570(10) b. and c." of title 12. Del. Code Ann. tit. 12, § 3572(c).

6. In addition to the statute of limitations, § 3572(a) of the Act attempts to protect a qualified disposition by providing that "no action of any kind, including…an action to enforce a judgment…shall be brought…for an attachment or other provisional remedy against property that is the subject of a qualified disposition or for avoidance of a qualified disposition unless such action shall be brought pursuant to the provisions of §1304 or §1305 of Title 6 [i.e., Delaware's Uniform Fraudulent Transfer Act]". 12 Del. Code Ann. tit. 12, § 3572(a).

7. Notwithstanding any of the foregoing, two classes of creditors are expressly excepted from the self-settled spendthrift trust protections otherwise uniformly afforded to qualified dispositions. Specifically, § 3573 of the Act provides that the spendthrift provision will not apply, as follows:

a. To any person who suffers death, personal injury or property damage on or before the date of a qualified disposition by a transferor, which death, personal injury or property damage is at any time determined to have been caused in whole or in part by the act or omission of either such transferor or by another person for whom such transferor is or was vicariously liable.

b. To any person to whom the transferor is indebted on account of an agreement or order of court for the payment of support or alimony (but not to any claim for forced heirship, legitime or elective share), in favor of such transferor's spouse, former spouse or children, or for a division or distribution of property in favor of such transferor's spouse or former spouse, to the extent of such debt.

(i) Importantly, however, for purposes of this rule a "spouse" or "former spouse" includes "…only persons to whom the transferor was married at, or before, the time the qualified disposition is made." Del. Code Ann. tit. 12, § 3570(9).

(a) It is upon this basis that if a person creates a Delaware "asset protection" trust prior to marriage, the trust assets should be protected from any debt for support or alimony, or for a division or [equitable] distribution of property, in favor of such person's spouse or former spouse (as well as for any claim for forced heirship, legitime or elective share).

VI. Conflict of Law Issues

A. As noted, sixteen states (not including New York), currently provide for self-settled spendthrift trust protections. Obviously, this means that thirty-four states (including New York), do not. What then will be the result when a creditor brings suit against a self-settled spendthrift trust suit in a state that does not recognize self-settled spendthrift trust protections as being valid under its own law?

B. The Restatement (Second) of Conflict of Laws § 273 (1971), speaks to the efficacy of a purported restraint on alienation of beneficial trust interests. It provides that:

1. "Whether the interest of a beneficiary of [an inter-vivos] trust of movables is assignable by him and can be reached by his creditors is determined…by the local law of the state, if any, in which the settlor has manifested an intention that the trust is to be administered, and otherwise by the local law of the state to which the administration of the trust is most substantially related."

2. Similarly, "[i]f the settlor creates a trust to be administered in a state other than that of his domicil, the law of the state of the place of administration, rather than that of his domicil, ordinarily is applicable. Thus a settlor

domiciled in one state may create an inter vivos trust by conveying property to a trust company of another state as trustee and delivering the property to it to be administered in that state. In that case the law of that state will be applicable as to the rights of creditors to reach the beneficiary's interest. This permits a person who is domiciled in a state in which restraints on alienation are not permitted, to create an inter vivos trust in another state where they are permitted and thereby take advantage of the law of the latter state." 5A ASTON W. SCOTT & WILLIAM F. FRATCHER, THE LAW OF TRUSTS § 626, at 419 (4th ed. 1989).

C. In fact, in some jurisdictions a settlor's ability to designate the law of a particular jurisdiction as the governing law of the trust is expressly provided for by statute.

1. For example, § 7-1.10 of New York's Estates, Powers and Trusts Law provides:

a. "Whenever a person, not domiciled in this state, creates a trust which provides that it shall be governed by the laws of this state, such provision shall be given effect in determining the validity, effect and interpretation of the disposition in such trust..."

(i) Interpreting a prior version of this statute, New York's highest court stated that "[t]he statute makes [a settlor's] express declaration of intention [of controlling law] conclusive..." *Hutchison v. Ross,* 262 N.Y. 381, 187 N.E. 65, 71, 89 A.L.R. 1007 (1933).

b. Furthermore, although the *prima facie* ability of a New York domiciliary settlor to create a valid trust governed by the laws of a foreign jurisdiction is not expressly conferred by this statute, it is either set forth under existing case law or can be logically inferred.

(i) For example, see *In re New York Trust Co.,* 87 N.Y.S.2d at 792 ("It is inconceivable that a state committed to [the policy of ESTATES, POWERS AND TRUSTS LAW § 7-1.10] would deny its own residents the corresponding right to establish trusts in other states...[U]nder the law of this state, a New York resident may choose another state as the situs of a trust as freely as a non-resident may create a trust in New York.").

c. A strong argument can also be made that principles of judicial comity require that a settlor's designation of controlling law be respected by the court. *See generally* 17 C.J.S. § 12(1).

D. The Restatement (Second) of Conflict of Laws § 270 (1971), however, provides that "[a]n inter vivos trust of interests in movables is valid if valid...under the local law of the state designated by the settlor to govern the validity of the trust, provided...that the application of its law does not violate a strong public policy of the state with which, as to the matter at issue, the trust has its most significant relationship under the principles stated in § 6."

1. Section 270 of the Restatement (Second) of Conflict of Laws has been cited by more than one court dealing with the question of the validity of self-settled spendthrift trusts, to the effect that the validity of a self-settled spendthrift trust should <u>not</u> be upheld. See, e.g., *In re Portnoy*, 201 B.R. 685 (Bankr. S.D.N.Y. 1996); *In re Brooks*, 217 B.R. 98 (Bankr. D. Conn. 1998); *In re Lawrence*, 227 B.R. 907 (Bankr. S.D. Fla. 1998).

   a. In contrast, see *Riechers v. Riechers*, 679 N.Y.S.2d 233 (1998), aff'd, 701 N.Y.S.2d 113 (1999). In *Riechers*, following the defense of several medical malpractice suits, the settlor, Dr. Riechers, established a self-settled spendthrift trust under the law of the Cook Islands ostensibly to guard against the likelihood of future medical malpractice claims. At the same time, Dr. Riechers and his wife were having marital difficulties, but Mrs. Riechers was alleged to have been aware that the trust was being established. Two years later, Mrs. Riechers commenced an action for divorce and sought to have the trust included in computing an equitable distribution award. The New York State Supreme Court, Westchester County, noted that since the trust was established "for the legitimate purpose of protecting family assets" the court did not have jurisdiction over the trust and that issues such as whether the wife would be entitled to any trust property should be left to a Cook Islands court to decide.

2. In any event, query whether the requirement under § 270 of the Restatement (Second) of Conflict of Laws that the court find that the application of the law of the non-forum state would violate a strong public policy of the forum state can exist where the self-settled spendthrift trust was established prior to the marriage.

3. Furthermore, the fact that the forum state might not permit self-settled spendthrift trusts to be created under its own law does not necessarily mean that it would violate a *strong* public policy of the forum state to recognize a self-settled spendthrift trust if it was validly created under the law of a foreign jurisdiction.

a. "It would seem that the policy of a state, whether it be to restrain alienation in order to protect the beneficiary, or to permit alienation in order to protect creditors and assignees, is not so strong as to preclude the application of the law to the contrary prevailing in another state." SCOTT & FRATCHER, *The Law of Trusts*, §626, at 414 (4th ed. 1989).

4. There are also a number of cases, some in the marital context, that have applied conflicts of law principles to spendthrift trusts without resort to an exception for public policy.

a. For example, in *The National Shawmut Bank of Boston v. Cumming*, 91 N.E.2d 337 (1950), the settlor, a domiciliary of Vermont, created a trust of "the greater part of his property," which trust the settlor designated to be "construed and the provisions thereof interpreted under and in accordance with the laws of the Commonwealth of Massachusetts." *Id*. at 339. As recognized by the lower court's opinion, the *Shawmut* settlor's clearly implied intent in designating Massachusetts law as controlling was to defeat his surviving spouse's significantly greater inheritance rights under Vermont law. According to the *Shawmut* court:

(i) "If the settlor had been domiciled in this Commonwealth and had transferred here personal property here to a trustee here for administration here, the transfer would have been valid even if his sole purpose had been to deprive his wife of any portion of it. The Vermont law we understand to be otherwise and to invalidate a transfer made there by one domiciled there of personal property there, if made with an actual, as distinguished from an implied, fraudulent intent to disinherit his spouse." *Id*. at 340.

(ii) In holding that Massachusetts law should apply, thereby depriving the surviving spouse of the greater part of her inheritance rights, the *Shawmut* court stated that "[t]he general tendency of authorities elsewhere is away from the adoption of the law of the settlor's domicil where the property, the domicil and place of business of the trustee, and the place of administration intended by the settlor are in another State." *Id.* at 341.

VII. FOREIGN VERSUS DOMESTIC ASSET PROTECTION TRUSTS

A. Protection Issues Relating to Application of the United States Constitution

1. Notwithstanding the enactment of self-settled spendthrift trust protections under the laws of a significant minority of the states within the United States over the course of the past twenty-one years, foreign asset protection trusts will likely offer a more substantial barrier to creditors than will domestic asset protection trusts because of certain issues under the United States Constitution.

   a. Full Faith and Credit Clause

      (i) Article IV, Section 1, of the United States Constitution, commonly called the "Full Faith and Credit Clause", provides in pertinent part that "Full Faith and Credit shall be given in each State to the public Acts, Records, and judicial Proceedings of every other State."

         (a) Full Faith and Credit principles are so broadly construed that they generally require the judgment of another state to be recognized and enforced even though the original claim is illegal in, or contrary to the strong public policy of, the second state. *See, e.g., United Nat'l Bank v. Lamb,* 337 U.S. 38, 41-42 (1949); *M & R Investments Co. v. Hacker,* 511 So.2d 1099 (Ct. App. Fl. 1987).

      (ii) Assuming that personal jurisdiction is obtained over the trustee, there are only two apparent limitations upon the application of the Full Faith and Credit Clause to an asset protection trust.

         (a) The first limitation upon application of the Full Faith and Credit Clause is that "for a State's substantive law to be selected in a constitutionally permissible manner, that State must have a significant contact or significant aggregation of contacts, creating state interests, such that choice of its law is neither arbitrary nor fundamentally unfair." *Allstate Ins. Co. v. Hague*, 449 U.S. 302, 312-13 (1981).

         (b) The second limitation upon application of the Full Faith and Credit Clause is that the issue has been fully and fairly litigated and finally decided in the court rendering the original judgment. *Durfee v. Duke*, 375 U.S. 106, 111 (1963).

(iii) Judicial Comity

(a) In contrast, the Full Faith and Credit Clause has no application internationally. Instead, principles of judicial comity may apply. "Judicial comity" is a doctrine whereby the courts of one jurisdiction will give effect to the judicial decisions of another jurisdiction as a matter of deference and mutual respect.

(b) Therefore, for a foreign asset protection trust to achieve its maximum possible creditor protection it is important that the trust be settled in a jurisdiction which has, by statute, negated the potential application of judicial comity

(c) For example, Section 13D of the International Trusts Act 1984 of the Cook Islands, entitled *Foreign Judgements Not Enforceable*, provides that:

(i) "Notwithstanding the provisions of any treaty or statute, or any rule of law, or equity, to the contrary, no proceedings for or in relation to the enforcement or recognition of a judgement obtained in a jurisdiction other than the Cook Islands against any interested party shall be in any way entertained, recognized or enforced by any Court in the Cook Islands to the extent that the judgement:

a) Is based upon the application of any law inconsistent with the provisions of this Act or of the Trustee Companies Act 1981-2; or

b) Relates to a matter or particular aspect that is governed by the law of the Cook Islands."

b. Supremacy Clause

(i) Article VI, Section 2, of the United States Constitution, which is commonly called the "Supremacy Clause", provides that:

(a) "This Constitution, and the Laws of the United States which shall be made in Pursuance thereof; and all Treaties made, or which shall be made, under the Authority of the United States, shall be the supreme Law of the Land; and the Judges in every State shall be bound thereby, any Thing in the Constitution or Laws of any State to the Contrary notwithstanding."

(ii) In the asset protection trust context there is concern that the Supremacy Clause might apply, for example, where a federal bankruptcy court issues an order directing the trustee of a domestic asset protection trust to distribute trust assets to a creditor.

(a) Note, however, that Section 541(c)(2) of the Bankruptcy Code provides that "[a] restriction on the transfer of a beneficial interest of the debtor in a trust that is enforceable under applicable nonbankruptcy law is enforceable in a case under this title."

(b) In addition, note that since the enactment of the 2005 Bankruptcy Abuse Prevention and Consumer Protection Act, which amended § 548(e) of the Bankruptcy Code, the power of the trustee of the bankruptcy estate to avoid transfers to a "self-settled trust or similar device" is limited to situations where:

(1) The transfer is a fraudulent transfer; and

(2) The transfer was made within ten years before the date of the filing of the bankruptcy petition.

(c) In the case of *In re Mortensen* (*Battley v. Mortensen*, Adv. D. Alaska, No. A09-90036-DMD, May 26, 2011), Mr. Mortensen, a resident of Alaska, without the aid of counsel, drafted a trust document in 2005 called the "Mortensen Seldovia Trust (An Alaska Asset Preservation Trust)" intending for the Trust to qualify as an asset protection trust under Alaska law. Following his creation and funding of the Trust, Mortensen's financial condition deteriorated, his income became "sporadic," and he ultimately filed for bankruptcy. Although the Bankruptcy Court concluded that Mortensen was not insolvent when he established and funded the Trust, due to the specific circumstances of the case the Bankruptcy Court nevertheless held that Mr. Mortensen's funding of the trust still fell under Section 548(e) of the Bankruptcy Code as a fraudulent transfer to a self-settled trust made within ten years prior his bankruptcy filing.

(1) Notably, at the time of the filing of the Bankruptcy petition, the transfer to the Trust was outside of Alaska's own fraudulent transfer statute of limitations period, which would have led to a completely difference result had the matter been determined under state, rather than federal, law.

c. Contract Clause

(i) Article I, Section 10[1], of the United States Constitution, which is commonly called the "Contract Clause", provides in pertinent part that "[n]o State shall…pass any Bill of Attainder, ex post facto Law, or Law impairing the Obligation of Contracts…"

(ii) In the asset protection trust context, the concern over the Contract Clause, albeit somewhat ill defined, is that domestic asset protection trust legislation potentially infringes upon the ability of persons to contract with each other by allowing a contracting party to avoid the effect of certain contracts by protecting his or her assets from contract claims through the use of such trust.

B. Issues of Taxation and Tax Reporting

1. Background

a. It is important to note that the taxation of an asset protection trust (or any type of trust for that matter) may differ substantially depending upon whether or not the trust is a domestic trust or a foreign trust under United States tax law. It is, therefore, necessary in the first instance to determine whether the asset protection trust at issue is a "domestic trust" or a "foreign trust".

(i) Although it may seem curious to question whether an "offshore" or "foreign" asset protection trust will be deemed to be a foreign or domestic trust for United States tax purposes, in point of fact an "offshore" or "foreign" asset protection trust is simply a trust that provides that the law governing the trust will be the law of some non-U.S. jurisdiction and that will have at least one trustee not resident in the U.S. These two factors, however, do not control the tax characterization of the trust under United States law.

(ii) As a consequence, an "offshore" or "foreign" asset protection trust can be either a domestic trust or a foreign trust for United State tax purposes.

b. Internal Revenue Code § 7701(a)(31)(B) defines a "foreign trust" as a trust which does not qualify as a "United States person" under §7701(a)(30)(E). Internal Revenue Code§ 7701(a)(30)(E) defines a trust as a "United States person" if the trust meets *both* of the following requirements: (1) a court within the United States is able to exercise primary supervision over the administration of the trust (the so-called "court test"); and (2) one or more U.S. persons have the authority to control all substantial decisions of the trust (the so-called "control test"). A trust which fails either of these requirements is, therefore, a "foreign trust."

(i) Note that Treas. Regs. § 301.7701-7(a)(2) provides that "[f]or purposes of the regulations in this chapter, the term domestic trust means a trust that is a United States person".

c. The Court Test and the Control Test for Determining Trust Status

(i) The Court Test

(a) A trust will meet the court test by being under the "primary supervision" of a U.S. court.

(1) "Primary supervision" means that a court has or would have the authority to determine substantially all issues regarding the administration of the entire trust.

(2) A court may have "primary supervision" notwithstanding the fact that another court has jurisdiction over a trustee, a beneficiary, or trust property.

(b) If both a U.S. court and a foreign court are able to exercise primary supervision over the administration of the trust, the trust would still meet the court test.

(c) The term "administration" means the carrying out of the duties imposed by the terms of the trust instrument and applicable law, including maintaining the books and records of the trust, filing tax returns, managing and investing the assets of the trust, defending suits by creditors, and determining the amount and timing of distributions.

(ii) A safe harbor exists for finding the court test to have been met if three conditions are satisfied:

(a) The trust instrument does not direct that the trust be administered outside the United States;

(b) The trust is, in fact, administered exclusively in the United States; and

(c) The trust does not have an automatic migration provision (also known as an automatic "flee" clause).

(iii) The Control Test

(a) The control test requires that one or more U.S. persons have the authority to control all substantial decisions of the trust.

(1) The term "United States person" is defined for this purpose as generally including a citizen or resident of the United States, a domestic partnership or a domestic corporation.

(2) "Control" is defined as having the power, by vote or otherwise, to make all of the substantial decisions of the trust, with no other person having the power to veto any of the substantial decisions.

i) To determine whether U.S. persons have control it is necessary to consider all persons who have authority to make a substantial decision of the trust, not only trust fiduciaries such as trustees.

ii) Thus, a trust which has U.S. persons as trustees, but a non-U.S. person as the protector would fail to meet the control test (assuming that one of more of the protector's authorities under the trust agreement or governing law constitutes a "substantial decision").

(3) "Substantial decisions" are defined as those decisions that persons are authorized or required to make under the terms of the trust instrument and applicable law, and that are not merely ministerial.

(4) The regulations provide a non-exclusive list of "substantial decisions" which includes decisions made with respect to:

i) Whether and when to distribute income or corpus.

ii) The amount of any distribution.

iii) The selection of a beneficiary.

iv) Whether a receipt is allocable to income or principal.

v) Whether to terminate the trust.

vi) Whether to compromise, arbitrate or abandon claims of the trust.

vii) Whether to sue on behalf of the trust or to defend suits against the trust.

viii) Whether to remove, add or replace a trustee.

ix) Whether to appoint a successor trustee to succeed a trustee who has died, resigned, or otherwise ceased to act as a trustee, even if the power to make such a decision is not accompanied by an unrestricted power to remove a trustee, unless the power to make such a decision is limited such that it cannot be exercised in a manner that would change the trust's residency from foreign to domestic or vice versa.

x) Investment decisions.

(b) Separately, the Treasury Regulations provide that a U.S. person will not be considered to control all substantial decisions of the trust if an attempt by any government agency or creditor to collect information from or assert a claim against the trust would cause one or more substantial decisions of the trust to no longer be controlled by the U.S. person, for example by reason of the operation of an automatic migration provision.

2. Income Taxation

a. Provided that the grantor is a United States person, the very nature of an asset protection trust as a self-settled trust (whether foreign or domestic) will cause it to be taxed during the grantor's lifetime as a grantor trust for United States income tax purposes.

(i) This is because Internal Revenue Code § 677 provides that if trust income is or may be used for the benefit of the grantor (or the spouse of the grantor), either directly or indirectly, then the grantor will be treated as the owner of the trust.

(a) Specifically, the grantor is taxable as the owner of any portion of a trust over which the grantor or a non-adverse party has the ability, without the consent or approval of an adverse party:

(1) To distribute trust income to the grantor or the spouse of the grantor; or

(2) To hold or accumulate trust income for future distribution to the grantor or the spouse of the grantor.

b. Moreover, to the extent that the trust has been structured so that the grantor's transfer of assets to the trust constitutes an incomplete gift for gift tax purposes, typically through inclusion of a power for the grantor to veto trustee distribution decisions during the grantor's lifetime and the inclusion of a limited testamentary power of appointment for the grantor, other grantor trust powers will also have been implicated. Specifically, under Internal Revenue Code § 674, the grantor will be taxable as the owner of any trust or portion thereof over which the settlor or a "non-adverse party" (or both) has a power, exercisable without the approval of any "adverse party," to dispose of the beneficial enjoyment of either income or principal.

c. In addition, the nature of the trust as self-settled makes it a grantor trust since Internal Revenue Code § 673(a) provides that the grantor shall be treated as the owner of any trust or portion thereof in which the grantor has a reversionary interest in either the income or principal with a value (determined at the time of that transfer to the trust) that exceeds 5% of the total value of such portion of the trust.

d. Finally it should be noted that almost any foreign trust created by a United States person will be treated as a grantor trust pursuant to Internal Revenue Code § 679. This is because Internal Revenue Code § 679(a) provides that a United Statesperson who transfers property to a foreign trust shall be treated as the owner of the trust, irrespective of whether or not the grantor retained any other power under Internal Revenue Code §§ 673-677, if the trust has one or more United States persons as beneficiaries.

(i) For purposes of § 679(a), a foreign trust that has received property from a United States transferor is treated as having a United States beneficiary unless:

(a) No part of the income or corpus of the trust may be paid or accumulated to or for the benefit of a United States person; and

(b) If the trust is terminated no income or corpus of the trust could be paid to, or for the benefit of, a United States person.

e. As a grantor trust, the grantor will be treated for income tax purposes as the "owner" of all or a portion of the asset protection trust. As a consequence of the foregoing, the grantor must include in the settlor's individual income tax computation all items of income, deductions, and credits attributable to the portion of the asset protection trust for which the grantor is deemed to be the owner. Therefore, there will be no benefit or detriment to creating a domestic asset protection trust over a foreign asset protection trust, or vice versa, in terms of the income taxation of the trust's income during the grantor's lifetime.

f. An income tax issue would, however, exist upon the grantor's death, when the trust, by definition, will cease to be a grantor trust, if the trust (i) was a foreign trust, and (ii) the funding of the trust was a completed gift (which is not typically the case with an asset protection trust).

(i) In this regard, although Internal Revenue Code § 684(a) requires that a United States person that transfers appreciated property to a foreign trust treat that transfer as a sale or exchange of such property for an amount equal to the fair market value of the property transferred, and thus recognize gain on the excess of the property's fair market value over its adjusted basis, (i) Internal Revenue Code § 684(b) provides that this rule shall not apply to a to the extent that the United States person is treated as the owner of such trust under Internal Revenue Code § 671, and (ii) Treas. Regs. § 1.684-3(c) provides that "[t]he general rule of gain recognition … shall not apply to any transfer of property by reason of death of the U.S. transferor if the basis of the property in the hands of the foreign trust is determined under § 1014(a)."

(a) Of course, the basis of the property in the hands of the foreign trust will not be determined under Internal Revenue Code § 1014(a) unless the trust property is included in the grantor's gross estate for tax purposes, which typically would not be the case where the trust was funded through one or more completed gifts.

3. Income Tax Reporting

a. With regard to a domestic asset protection trust, the trustee is required to report all items of income, deduction and credit of the trust on a separate statement attached to Form 1041, *U.S. Income Tax Return for Estates and Trusts*, rather than within the body of the return itself.

b. With regard to a foreign asset protection trust, the appropriate return is Form 1040NR, *U.S. Nonresident Alien Income Tax Return*, prepared in the same manner as Form 1041 would have been prepared for a grantor trust.

c. As a grantor trust, no United States income tax will be payable by either the domestic asset protection trust or the foreign asset protection trust; instead, the trust's items of income, deduction, and credit shown on the statement attached to Form 1041 or Form

1040NR will be transferred to and reported on the grantor's Form 1040, *U.S. Individual Income Tax Return*.

(i) It should be noted that alternative reporting methods applicable to certain simple grantor trusts are provided for under the Treasury Regulations. Generally, under these methods, the trustee must provide the grantor with a statement of all items of income, credit, and deduction of the trust and inform the grantor that the grantor must report such items directly on the grantor's individual income tax return. However, these reporting alternatives are not available if a trust has its situs outside of the United States or if any of the assets of the trust are located outside of the United States.

4. Information Reporting in Connection with Foreign Trusts

a. Background

(i) Under §6048, distinct information reporting requirements are imposed on foreign trusts, the settlors of foreign trusts, and the beneficiaries of foreign trusts.

(ii) Proper and timely information reporting pursuant to these requirements is important since such information reporting:

(a) Avoids the serious penalties that can result from failing to properly report pursuant to such requirements.

(b) Documents in an official, structured way the fact that the foreign trust is an entity separate and apart from the grantor and, therefore, should be respected as such by the courts.

b. Reporting Obligation Relating to Transfers to Foreign Trusts

(i) Internal Revenue Code § 6048(a)(1) requires the reporting of several types of occurrences, each of which is called a "reportable event" and which are defined under Internal Revenue Code § 6048(a)(2), as follows:

(a) The creation of any foreign trust by a United States person.

(b) The transfer of any money or property (directly or indirectly) to a foreign trust by a United States person, including a transfer by reason of death.

(c) The death of a citizen or resident of the United States if the decedent was treated as the owner of any portion of a foreign trust under the grantor trust rules, or any portion of a foreign trust was included in the gross estate of the decedent.

(ii) The information required to be reported pursuant to Internal Revenue Code § 6048(a) includes:

(a) The amount of money or other property (if any) transferred to the trust in connection with the reportable event.

(b) The identity of the trust and of each trustee and beneficiary.

c. Reporting Obligation Relating to Beneficiaries of Foreign Trusts

(i) Under Internal Revenue Code § 6048(c), a United States person who receives a distribution, directly or indirectly, from a foreign trust is required to report for that year the name of the foreign trust, and the aggregate amount of the distributions so received from such foreign trust during the taxable year, as well as such other information as the Secretary of the Treasury may prescribe.

(a) Notice 97-34 provides that the distribution from a foreign trust is required to be reported if it is either actually or constructively received by a United States person.

(1) For example, where obligations incurred by a United States beneficiary are paid by a foreign trust, the amounts incurred will be treated as a distribution from the foreign trust that must be reported under Internal Revenue Code § 6048(c).

d. Reporting Obligation Relating to Owners of Foreign Trusts

(i) Under Internal Revenue Code § 6048(b), each United States person that is treated as an owner of a foreign trust under the grantor trust rules is responsible for ensuring that the foreign trust:

(a) Files an annual return setting forth a full and complete accounting of all trust activities and operations for the year, the name of the "United States agent" for the foreign trust, and such other information as the Secretary of the Treasury may prescribe.

(1) Under Internal Revenue Code § 6048(b)(2), if a foreign trust with a United States owner does not have a United States agent appointed, the Secretary of the Treasury may determine the amounts required to be taken into account with respect to the foreign trust under the grantor trust rules.

(b) Furnishes such information as the Secretary of the Treasury may prescribe to each United States owner of the foreign trust, as well as to any United States person who receives any distribution, directly or indirectly, from the foreign trust.

(c) Note that with regard to the potential adverse impact, from an asset protection perspective, of having a U.S. agent appointed for a foreign asset protection trust, Internal Revenue Code §6048(b)(2) expressly provides that:

(1) "The appearance of persons or production of records by reason of a U.S. person being such an agent shall not subject such persons or records to legal process for any purpose other than determining the correct treatment under [the Code] of the amounts required to be taken into account…A foreign trust which appoints an [agent] described in this subparagraph shall not be considered to have an office or a

permanent establishment in the United States, or to be engaged in a trade or business in the United States solely because of the activities of such agent pursuant to this subsection."

(ii) Method of Information Reporting

(a) The Grantor's Obligation

(1) Form 3520, *Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts*, is to be filed by the grantor of a foreign trust on an annual basis for the purpose of reporting any transfers to the foreign trust that occurred during the preceding taxable year.

i) After having made a transfer, the grantor of the foreign trust must then continue to file Form 3520 for every succeeding year, even those when no additional transfer is made.

(2) Form 3520 is due on the same date as the grantor's individual income tax return, including any extensions, and should be attached to the grantor's individual income tax return. A separate copy of Form 3520 must also be filed with the IRS Philadelphia Service Center.

(3) Note that an extension of time to file Form 3520 is to be requested on Form 2758, *Application for Extension of Time To File Certain Excise, Income, Information and Other Returns*.

(b) The Trustees' Obligation

(1) Form 3520-A, *Annual Information Return of Foreign Trust with a U.S. Owner*, is intended to provide sufficient information

to the United States owners of the foreign trust, as well as the trust beneficiaries, so that they can satisfy their obligation to report transactions with the foreign trust on Form 3520.

i) Form 3520-A requires, among other things, the foreign trust to send a "Foreign Grantor Trust Ownership Statement" to each United States owner, and a "Foreign Grantor Trust Beneficiary Statement" to each United States beneficiary who received a distribution from the foreign trust during the taxable year at issue.

(2) Form 3520-A must be filed with the IRS Philadelphia Service Center by the 15th day of the third month following the end of the foreign trust's taxable year. Copies of the owner and beneficiary statements must be furnished to the United States owners and beneficiaries by the same date.

(3) Note that as with Form 3520, an extension of time to file Form 3520-A is to be requested on Form 2758, *Application for Extension of Time To File Certain Excise, Income, Information and Other Returns*.

e. Penalties for Failure to Provide Information

(i) Substantial civil penalties exist under Internal Revenue Code § 6677 when information required by Internal Revenue Code § 6048 is not timely reported, or, if such information is timely reported, it is reported inaccurately.

(ii) Under Internal Revenue Code § 6677, any United States person who fails to comply with the reporting requirements of Internal Revenue Code § 6048(a) will be subject to a penalty equal to 35% of the "gross reportable amount."

(iii) If it is the foreign trust itself which fails to furnish the information required by §6048(b), the United States owner of the foreign trust will be subject to a penalty under Internal Revenue Code § 6677, but only equal to 5% of the "gross reportable amount."

(iv) The term "gross reportable amount" is defined in Internal Revenue Code § 6677(c) as:

(a) The gross value of the property involved in the event (determined as of the date of the event) in the case of a failure to report relating to Internal Revenue Code § 6048(a).

(b) The gross value of the portion of the trust's assets at the close of the year treated as owned by the United States person in the case of a failure to report relating to Internal Revenue Code § 6048(b)(1).

(v) Under Internal Revenue Code § 6677(d), no penalty shall be imposed, however, if the failure to report is shown to be due to "reasonable cause" rather than "willful neglect."

(a) The fact that a foreign jurisdiction would impose a civil or even a criminal penalty on the taxpayer (or on any person) for disclosing the required information, however, is not deemed "reasonable cause" for failing to report under Internal Revenue § 6677.

(b) In addition, Notice 97-34 provides that a refusal on the part of a foreign trustee to provide information for any other reason, including difficulty in producing the required information or provisions in the trust instrument that prevent the disclosure of required information, will not be considered "reasonable cause."

5. Foreign Account and Foreign Asset Reporting

a. As a preliminary matter it is important to note that a foreign asset protection trust might not necessarily have foreign accounts or foreign assets; conversely, a domestic asset protection trust might have such foreign accounts or foreign assets.

(i) However, where the grantor wants the foreign asset protection trust to maximize the creditor protections that a foreign asset protection trust might engender, it will be necessary for the foreign asset protection trust to have only foreign accounts or foreign assets constituting the trust fund.

b. Foreign Account Reporting

(i) FinCen Form 114, *Report of Foreign Bank and Financial Accounts* (commonly known as the "FBAR") (previously, Form TD F 90-22.1), is required to be electronically filed by April 15th of each year with the Financial Crimes Enforcement Network by any United States person who has a financial interest in or signature or other authority over a foreign financial account, including a bank account, brokerage account, mutual fund, trust, or other type of foreign financial account, the value of which exceeds $10,000 at any time during the prior year.

(ii) A United States person is deemed to have a financial interest if the owner of record or holder of legal title is a trust if the United States person:

(a) Is the trust grantor.

(b) Has an ownership interest in the trust for United States federal tax purposes under Internal Revenue Code §§ 671-679.

(c) The owner of record or holder of legal title is a trust in which the United States person has a greater than fifty percent present beneficial interest in the assets or income of the trust for the calendar year.

(iii) Those required to file an FBAR who fail to properly file a complete and correct FBAR may be subject to a civil penalty not to exceed $10,000 per violation for non-willful violations that are not due to reasonable cause.

(a) For willful violations, the penalty may be the greater of $100,000 or fifty percent of the balance in the account at the time of the violation, for each violation.

c. Foreign Asset Reporting

(i) United States citizens and resident aliens are required to file Form 8938, *Statement of Specified Foreign Financial Assets*, with the individual's income tax return by April 15th of each year (or the extended due date), if they own:

(a) A financial account (i.e., depository account or custodial account), which is maintained by a foreign financial institution.

(b) Other foreign financial assets (i.e. stock issued by a non-United States person, interests in foreign entities or financial instruments or contracts that have a non-United States person as the counterparty).

(ii) However, the foreign financial account or other asset must have an aggregate value in excess of $50,000 on December 31st (or more than $75,000 at any time during the tax year).

(a) Higher monetary thresholds may apply depending upon various factors including the taxpayer's marital status and residence.

(iii) Although a beneficiary should not be deemed to own an interest in a foreign financial asset held by a trust, an individual who is considered to be the owner of all or a part of a trust under the grantor trust rules is considered to have an interest in any foreign financial asset held by such trust.