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Self-Settled Asset Protection Trusts

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The central theme of the authors' prior article for the *Estate Tax Planning Advisor* was that trusts, which are perhaps most often used (at least in the United States) for the purpose of minimizing transfer taxes, are also extremely effective in protecting wealth from creditors [see Rothschild and Rubin, "Planning with Spendthrift Trusts," *Estate Tax Planning Advisor*, May, 2002].

In fact, the authors noted that so-called "spendthrift" trusts are almost universally accepted in the United States as effective for the purpose of creditor protection and that there are few significant limitations on the latitude of their efficacy. Notwithstanding the foregoing, however, a distinction is often made between the circumstance in which one establishes a spendthrift trust for the benefit of another and that in which one attempts to establish a spendthrift trust for his or her own benefit (even if only as a member of a class).

A "self-settled" spendthrift trust is, in most jurisdictions, deemed invalid as against the settlor's own creditors for public policy reasons. That invalidity applies even where the settlor's only beneficial trust interest is the possibility of receiving distributions within the discretion of a third-party trustee. Moreover, in majority rule jurisdictions, it is treated as immaterial whether the settlor's creditors are present or future, or whether the creditors are reasonably anticipated or impossible to foresee. An intent to defraud creditors is not required for the application of that rule [see, e.g., 5A *Aston W. Scott & William F. Fratcher, The Law of Trusts* § 156, at 165-167 (4th ed. 1989); see also, *Restatement (Second) of Trusts* § 156, cmt. a (1959)].

The authors (among others) have challenged the proposition that public policy should per se preclude the recognition of self-settled spendthrift trusts [see Rothschild, Rubin, and Blattmachr, "Self-Settled Spendthrift Trusts: Should a Few Bad Apples Spoil the

Bunch?" 32 *Vand. J. Transnat'l L.* 763 (1999)]. It remains the case in most (though by no means all) jurisdictions, however, that self-settled spendthrift trusts will not be recognized as effective against the settlor's own creditors.

Trust Situs

The settlor of a trust may designate the law of any jurisdiction as governing the trust's administration, not just that of his or her own domicile. As a result, the settlor may designate a jurisdiction that recognizes self-settled spendthrift trusts as valid even though the jurisdiction of the settlor's domicile does not do so. Under established conflict-of-law rules, "[w]here 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 . . ." [see, e.g., *Restatement (Second) Conflict of Laws* § 273 (1971); see also, "Convention on the Law Applicable to Trusts and on Their Recognition," Oct. 8, 1984, art. 6 reprinted in 23 *I.L.M.* 1389, 1389 (1984) ("A trust shall be governed by the law chosen by the settlor.")].

A settlor domiciled in one state may create an *inter vivos* trust by conveying property to a trust company located in another state as trustee. The settlor would deliver the property to the trust company to be administered in a state in which the trust company is located. The law of the state in which the trust company is located applies as to the rights of creditors to reach the beneficiary's interest.

That shift in jurisdiction permits a person who is domiciled in a state that does not permit restraints on alienation to create an *inter vivos* trust in another state where restraints on alienation are permitted. Such a settlor can take advantage of the law of the state in which the trust is located [5A *Aston W. Scott*

and William F. Fratcher, *The Law of Trusts* § 626, at 419 (4th ed. 1989)]. More specifically, the policy of one jurisdiction relating to spendthrift trust protections is not thought to be so strong as to preclude the application of the law to the contrary prevailing in another jurisdiction [5A *The Law of Trusts* § 626 at 414; see, e.g., *Surman v. Fitzgerald (In re Fitzgerald)*, 1 Ch. 573 (1904), *rev'g* 1 Ch. 933 (1903); see also, "Self-Settled Spendthrift Trusts: Should a Few Bad Apples Spoil the Bunch?"].

Several courts use public policy considerations to justify the application of the forum's laws. The authors suggest, however, that such result-oriented applications were dictated by the egregious facts present in such cases.

Only a minority of jurisdictions, both onshore and offshore, permit the establishment of effective self-settled spendthrift trusts. Self-settled spendthrift trusts are available, however, to all persons regardless of domicile in much the same way as the benefits of Delaware corporate law are available regardless of the domicile of the corporation's organizers, shareholders, officers, and directors. Care must be taken, however, in order to achieve all of the desired benefits of an effective self-settled spendthrift trust. This article focuses on some of the considerations that the estate planner must work through in establishing an effective self-settled spendthrift trust for his or her clients.

Choice of Law

The primary consideration in establishing an effective self-settled spendthrift trust is the law under which the trust is established. In that regard, the practitioner has the choice of a fair (and constantly expanding) number of offshore jurisdictions, including . . .

- Anguilla
- Antigua

- The Bahamas
- Barbados
- Belize
- Bermuda
- The Cayman Islands
- The Cook Islands
- Cyprus
- Gibraltar
- Labuan
- The Marshall Islands
- Mauritius
- Nevis
- Niue
- St. Vincent and the Grenadines
- Seychelles
- The Turks and Caicos Islands

Moreover, in recent years, a small number of onshore jurisdictions have enacted specific legislation in order to garner for themselves domestic capital that would otherwise be diverted offshore for asset protection purposes. To date, those onshore jurisdictions include...

- Alaska
- Delaware
- Nevada
- Rhode Island

Similar legislation has been proposed in at least two additional states [see, e.g., H.R. 1553, 76th Leg. (TX) (introduced Feb. 17, 1999), available in Westlaw, TX-BILLS Database, and New York State Assembly Bill 09053 (introduced August 5, 1999), available in Westlaw, NY-BILLS Database].

Among those jurisdictional choices, three aspects of the governing law are key:

1. The breadth of the jurisdiction's fraudulent conveyance law
2. The existence (or absence) of an express nonrecognition of foreign judgments within the jurisdiction's body of law
3. The existence (or absence) of an express recognition of the validity of self-settled trusts against the settlor's creditors.

Fraudulent Conveyance

With regard to the first point, the fraudulent conveyance law that most common-law

jurisdictions follow proceeds directly or indirectly from the English Statute of Elizabeth of 1571. That statute provides, without any inherent limitations period, that any transfer made with the "... intent to delay, hinder or defraud creditors . . . shall be clearly and utterly void . . ." Any jurisdiction that has not modified that draconian edict would make a poor choice for asset protection planning, since there can never be any certainty that a transfer to an otherwise valid trust would not ultimately be rendered void through a claim, made years or even decades after the fact, that the funding of the trust was made with an

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intent to delay, hinder, or defraud creditors.

Certain jurisdictions, such as Belize, have repealed the Statute of Elizabeth without having enacted other fraudulent conveyance law. Nevertheless, it is unlikely that other jurisdictions will respect such a state of affairs [see, e.g., *Brown v. Higashi (In re Brown)*, No. 95-3072 (Bankr. D. Alaska, Mar. 12, 1996)]. Clearly, some limitations period is appropriate as part of a fair balancing between the legitimate interests of debtors and creditors.

In addition, consideration should be given to whether it is the creditor or the debtor that bears the burden of proving (or disproving) that a fraudulent conveyance has occurred, as well as the standard of proof that is required. In Nevis, for example, the creditor bears the burden of proving, beyond a reasonable doubt, that the trust's funding was a fraudulent conveyance (and then, as to *that* particular creditor) [Nevis International Exempt Trust Ordinance, 1994, § 24(1)]. By contrast, in most other jurisdictions, the standard of proof requires a mere preponderance of the evidence.

Nonrecognition of Foreign Judgments

Seeking a jurisdiction that will not recognize a foreign judgment can become important in the selection process. An express nonrecognition of foreign judgments under the governing jurisdiction's law is an important consideration in choosing among those jurisdictions that recognize the validity of self-settled spendthrift trusts. Notwithstanding the legal precepts set forth above, those few cases that have considered the conflict-of-law issue in a forum whose own law deems such trusts void as against public policy have frequently applied such law in disregard of the settlor's designation of governing law [see, e.g., *Sattin v. Brooks (In re Brooks)*, 217 B.R. 98 (Bankr. D. Conn. 1998); *Marine Midland Bank v. Portnoy (In re Portnoy)*, 201 B.R. 685 (Bankr. S.D.N.Y. 1996)].

Those holdings arose under the most egregious factual circumstances imaginable, including allegations of fraud, perjury, and bankruptcy crime on the part of the settlor. Nevertheless, those holdings are strongly suggestive of the likelihood that most domestic courts suffer from strong prejudices against applying a legal principle that conflicts with that of the forum.

Where the trust's assets are situated outside of the forum jurisdiction, however, and the jurisdiction of the governing law does not recognize foreign judgments, the determination of the forum court to disregard settled law based upon its own subjective public policy concerns should be rendered of no consequence. By contrast, however, under the Full Faith and Credit Clause of the U.S. Constitution (Article IV, § 1), a domestic asset protection trust jurisdiction does not have the option of disregarding duly rendered judgments of its sister states. Such a domestic trust is inherently less protective because that trust remains subject to the vagaries of an often intemperate judiciary.

Additional myriad considerations of somewhat lesser significance, but by no means inconsequential, must be considered in choosing the law that will be designated as governing the trust. Those considerations include the following:

1. The effect of the local tax regime upon the

trust

2. The availability of professional trust services, ideally through a trustee with which an effective working relationship has previously been established
3. The political and economic stability of the jurisdiction
4. The existence of language, cultural, or other barriers that make administration of the trust in that jurisdiction inconvenient
5. Other practical and psychological hurdles for a creditor attempting to enforce a claim against a trust sited in that jurisdiction

Drafting Considerations

Within the determination of a choice of law to govern the trust, a further universe of drafting considerations exists, with a potential for significantly impacting the protections afforded by the trust. For example, under Cook Islands law, “[a]n international trust . . . shall not be declared invalid or a disposition declared void or be affected in any way by reason of the fact that the settlor, and if more than one, any of them, either -- (d) is a beneficiary, trustee or protector of the trust or instrument, either solely or together with others” [Cook Islands International Trusts Act § 13C(g)].

Notwithstanding the foregoing, however, the very essence of being named as a trustee is direct control over the trust’s assets. It would seem difficult if not outright impossible to reconcile a settlor’s position as trustee with any reasonable level of asset protection for the trust fund.

In addition, the possibility of the settlor’s acting as protector should be carefully considered in view of the result in *Federal Trade Commission v. Affordable Media, LLC, et al.*, 179 F.3d 1228 (9th Cir. 1999) [see also *In re Brooks* and *In re Portnoy*]. The settlors’ position as the protectors of the trust gave them control over the trust at issue therein. That position vitiated their impossibility of performance defense when contempt proceedings were brought following their failure to repatriate the trust fund upon order of the District Court [179 F.3d 1228 at 1243]:

The provisions of the trust also

make clear that the Andersons’ position as protectors gives them control over the trust [since] . . . whether or not an event of duress has occurred depends upon the opinion of the protector . . . It is clear that the Andersons could have ordered the trust assets repatriated simply by certifying to the foreign trustee that in their opinion, as protectors, no event of duress had occurred.

Tax Considerations

Finally, it is also extremely important to consider that the manner in which the trust is drafted for asset protection purposes can potentially implicate a host of U.S. tax issues. A foreign asset protection trust can, with careful forethought, be drafted so as to impart significant asset protection while at the same time being totally income and transfer tax neutral for U.S. tax purposes. The converse is that an inadvertent clause can prove disastrous from a U.S. tax standpoint.

From a transfer tax standpoint, a foreign asset protection trust will most often be crafted so that transfers to the trust are deemed “incomplete” for U.S. gift tax purposes. That practice allows the settlor to fund the trust without being constrained by the settlor’s \$1 million exemption from the gift tax and without incurring gift tax. The trust can be settled so that transfers to the trust are deemed “incomplete” for U.S. gift tax purposes by including a power of appointment [see Treas. Reg. § 25.2511-2(b)]. To the extent that the power is limited in its scope of potential appointees, the settlor’s possession of such a power should not implicate any asset protection issues.

Under certain circumstances, of course, it may be desirable to structure the foreign asset protection trust so that transfers will be deemed to be completed gifts for gift tax purposes. In that manner, any appreciation to the value of the trust fund will be removed from the settlor’s gross estate. In fact, by settling the trust in a jurisdiction that recognizes the validity of self-settled trusts against claims of the settlor’s creditors, the settlor can remain a discretionary beneficiary of the trust while nevertheless excluding it from his or her es-

tate [see, e.g., Rev. Rul. 76-103, 1976-1 CB 293].

From an income tax perspective, a “foreign trust” is generally required to file Form 3520-A, *Annual Information Return of a Foreign Trust with a U.S. Owner*, and the settlor of such foreign trust must file Form 3520, *Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts*. In addition, the settlor of the foreign trust must report the existence of such trust by checking the appropriate box on Part III of Schedule B of Form 1040, *United States Individual Income Tax Return*.

It is often desirable to structure the foreign asset protection trust as a “United States person” under Internal Revenue Code § 7701(a)(30)(E). Structuring the foreign asset protection trust as a U.S. person will avoid the additional tax information reporting that is required for foreign trusts.

Such a foreign trust is sometimes called a “hybrid” trust, since it applies foreign law as the governing law but is deemed a domestic trust for tax purposes. Such a hybrid trust is possible under Treas. Reg. § 301.7701-7, since the test for determining a domestic trust under that section merely requires that . . .

1. A court within the United States is able to exercise primary supervision over the administration of the trust, and
2. One or more U.S. persons have the authority to control all substantial decisions of the trust.

Therefore, the designation of foreign law as governing the trust does not violate the trust’s domestic status. Similarly, the presence of a majority of domestic trustees, together with a foreign co-trustee, also does not violate the trust’s domestic status. Of course, from an asset protection perspective, it is generally preferable that U.S. persons not act as either protector or trustee. A judgment must be made as to whether the desire for domestic trust status is outweighed by the compromise to asset protection under such a trust.

Conclusion

Self-settled spendthrift trusts, unlike spendthrift trusts created exclusively for the benefit of others, generally cannot be created

under the laws of most of the United States. If the planner develops a practice with a global scope, however, the planner can achieve for his or her clients significant protections against the claims of potential future creditors through the use of self-settled spendthrift trusts.

At the same time, the complexity of that area of planning, situated as it is at a crossroads of legal and practical disciplines, requires at a minimum that the planner be well versed in both the law of the planner's own jurisdiction, as well as the law of a host of offshore jurisdictions [consider, for example, DR 6-101(A) of the Model Code of Professional Responsibility, as well as Rule 1.1 of the Model Rules of Professional Conduct]. The benefits, both to the planner and to his or her clients, however, will likely warrant a consideration of that very effective tool under the appropriate circumstances.

Editor's note: The authors will discuss the use of asset protection trusts for estate planning objectives in the next issue of Estate Tax Planning Advisor.

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