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DOMESTIC ASSET PROTECTION TRUSTS

Asset Protection in General

The term asset protection often means different things to different people. To some people, asset protection means trying to hide assets or other avoid legitimate debts and obligations. To others, asset protection means attempting to set aside or protect certain assets from the risks associated with other unrelated business activities or ventures.

The most effective asset protection simply involves a variety of planning techniques designed to place assets outside of the reach of potential future, unknown creditors. This is most often accomplished by the compartmentalization of risk and the strategic ownership of assets. The best asset protection strategy can be fully disclosed and yet still fully effective. Asset protection is not attempting to hide assets or misrepresenting the truth of the particular situation.

The two primary factors to consider when doing asset protection planning are the following:

1. **The type and nature of your assets**. Many assets provide "natural" asset protection. For example, qualified plan assets such as 401Ks, 403Bs, IRAs, and Roth IRAs are protected under both Federal and State law. In addition, life insurance policies are also afforded a certain amount of State law protection. Other assets, however, can be more difficult to protect and State law has a tremendous effect on the level of protection afforded to your assets.

2. **The type and source of your risks.** Risks typically come in two forms. The first is asset based risk – risk that someone have as a result of the assets that you own. Through the use of corporations and limited liability companies, we can try and compartmentalize those potential risks from other assets. The second is direct risk – risk that comes from personal and professional activities. We can help implement a variety of different strategies to deal with this type of risk, from fairly basic to the most advanced and sophisticated.

Domestic Asset Protection Trusts

Domestic Asset Protection Trusts ("DAPTs") are trusts which are established in certain States and which provide unique benefits not previously found in trusts established in the United States. In the late 1990's, South Dakota and Alaska became the first States to pass new trust laws to compete with offshore trusts, which were being used by thousands of U.S. citizens for estate planning and asset protection. Since then, several other States have passed similar laws, including Nevada in 2002 and Utah in 2013. These new trust laws allow individuals to create DAPTs, which allow them to do the following:

1. Continue in Perpetuity - DAPTs are sometimes also referred to as Dynasty Trusts because DAPT laws allow trusts to continue for multiple generations. Previously, State trust laws limited the term of a trust to no more than 21 years after the death of the last surviving beneficiary of the trust (the so-called "Rule Against Perpetuities").

2. Provide Asset Protection from Future Creditors - As a general rule, if you establish a trust and the assets of that trust are subject to the claims of your creditors, then those assets are includible in your estate for estate tax purposes. In most States, if you establish a trust for the benefit of yourself (a so-called "self settled trust"), then the assets of the self settled trust are subject to the claims of your creditors and thus included in your estate for estate tax purposes. States with DAPT Statutes have changed their laws to allow individuals to establish trusts and have those assets protected from the claims of future creditors, provided the transfer of assets to the trust is not a fraudulent conveyance. Each State has different requirements for the protection to apply. A DAPT can also protect children's inheritance from their creditors. By making discretionary distributions to children, they can be provided for, and yet those assets are not owned by them and cannot, therefore, be attached by their creditors. Children can also be protected from squandering assets because they have no interest to sell, assign to others, or to give away. The trust could even purchase assets for a child's rent-free use, thus keeping the asset itself out of the child's estate.

3. Establish a Situs for the Trust - Unlike most States, States with DAPTs have established specific statutes relating to what constitutes such a trust in their State. So long as the Trust meets the minimum requirements, a trust can qualify as a DAPT, even if the majority of assets are not in that State and even if some of the Trustees are residents of other States.

4. Ability to Generation-Skip Assets and Avoid Future Estate Taxes. The Internal Revenue Code places restrictions on transferring assets to generations which are more than one level removed from an individual. The purpose is to ensure that the IRS can tax the estate of a person each time it passes to the next generation. These "extra bites at the apple" can quickly erode the value of any estate. There is an exception under the Code which allows us to transfer a certain amount of assets to individuals who are "one or more" generations removed from the individual. By using a DAPT, we can generation-skip the assets of the estate for a potential

unlimited number of generations, and thereby deprive the IRS from the opportunity to tax the assets at each generation.

Fraudulent Conveyance Issues

As mentioned earlier, in order for a DAPT to be protected from the claims of a Settlor's creditor, the transfer of assets to the Trust must not be a fraudulent conveyance. A fraudulent conveyance is any transfer which is intended to hinder, defraud, or delay a creditor. Pursuant to 11 U.S.C.A. § 548 of the Bankruptcy Code, the Court may set aside any transfer made to a DAPT within 10 years of a bankruptcy filing as a fraudulent conveyance if the Settlor made such transfer with actual intent to hinder, delay, or defraud any entity to which the Settlor was or became indebted.

Utah Domestic Asset Protection Trusts

On March 28, 2013, Governor Herbert signed H.B. 222 in to law, which replaced the former Self Settled Asset Protection Statute found in Utah Code section 25-6-14. The new law, effective May 14, 2013, is now one of the most protective statutes of its kind in the Country. As a result of H.B. 222, two of the major flaws with Utah’s former law have been fixed. The first change is that a corporate trustee is no longer necessary to qualify under the law. This is a major advancement since many families did not like the fees and complexities associated with the required corporate trustee position. The second major advancement is that many of the exceptions to the asset protection of the Trusts (i.e., situations in which a creditor could still go after the assets of the Trust) have been eliminated. This also has a dramatic tax effect when it comes to the federal estate tax and what could potentially be included in a person’s estate for estate tax purposes.

As a result of this recent law change, it may make sense for Utah residents with DAPTs in other States to consider relocating them back to Utah. This law changes could also be a good opportunity to look at the structure and terms of the DAPT, especially in light of the changes to Federal Transfer Tax law that occurred at the beginning of 2013.

Income Tax Treatment of Domestic Asset Protection Trusts

Most DAPTs are drafted as grantor trusts for income tax purposes. This means that the income and expenses of the DAPT are taxed back to the Grantor/Settlor of the DAPT for income tax purposes. Depending upon the particular situation, the DAPT can alternately be taxed on its’ own for income tax purposes and could even have a provision which would allow the Trustee of the DAPT to pay any income tax obligation relating to the DAPT’s earnings for and on behalf of the Grantor/Settlor.

Complete Gift and Incomplete Gift Domestic Asset Protection Trusts

For Gift and Estate Tax purposes, a DAPT can be drafted so that the assets of the DAPT are still included in the Grantor/Settlor's estate for Estate Tax purposes (so called "Incomplete Gift DAPTs") or outside of the Grantor/Settlor's estate for Estate Tax purposes (so called "Complete Gift DAPTs"). Each type of DAPT has certain advantages and disadvantages.

Incomplete Gift DAPTs. Often times we will draft a DAPT as an Incomplete Gift Trust, which is designed to be used purely for asset protection planning. Transfers to an Incomplete Gift Trust do not trigger any Gift or Generation Skipping Transfer Taxes and the assets of the DAPT will receive a step-up in basis to fair market value upon the death of the Grantor/Settlor. This does mean, however, that the assets of the DAPT will ultimately be included in the Grantor/Settlor's estate for Estate Tax purposes. Accordingly, Incomplete Gift DAPTs are typically used when it is assumed that the total assets of a Grantor/Settlor's estate will be below the Estate Tax Exclusion amount ($5.34 million for single people in 2014 or $10.68 million for married couples), or in situations where additional estate planning will address the potential Estate Tax situation.

Complete Gift DAPTs. A DAPT can also be drafted as a Complete Gift Trust for Estate Tax purposes, meaning that the assets of the DAPT, if properly drafted and maintained, will not ultimately be included in the Grantor/Settlor's Estate for Estate Tax purposes. A Complete Gift DAPT is typically used by clients who are concerned about having a taxable estate upon their death. Because the DAPT is a Complete Gift Trust, transfers to the Trust are subject to the current gift tax limits and/or require a sale of assets to the DAPT by the Grantor/Settlor in exchange for a promissory note of equivalent value. In 2009, the IRS issued PLR 200944002. In that PLR, the IRS provided that transfers to a DAPT style trust are completed gifts, even though the Grantor/Settlor is a discretionary beneficiary, because he or she cannot revest beneficial title or change the beneficiaries. According to the PLR, the "trustee's authority to distribute income and/or principal to Settlor, does not, by itself, cause the Trust corpus to be includible in Settlor's gross estate under" the Internal Revenue Code. That said, the Ruling noted that the discretionary authority to make distributions to the Settlor "combined with other facts (such as, but not limited to an understanding or pre-existing arrangement between [Settlor] and trustee regarding the exercise of this discretion) may cause inclusion of Trust's assets in [Settlor's] gross estate for federal estate tax purposes under" the Internal Revenue Code.

General Recommendations

Based on this, we have the following general recommendations for effectively using a DAPT:

1. Plan before there is a problem. Transfers made after an issue arises can be set aside as a fraudulent conveyance.

2. Avoid personal guarantees whenever and however possible and use LLCs or other types of entities to engage in direct business activities.

3. Maintain sufficient insurance, including both malpractice insurance (if appropriate) and a healthy amount of Umbrella Liability coverage. Depending upon your particular situation, we typically recommend at least $3 million to $5 million of Umbrella coverage.

4. Utilize a State with strong laws protecting the assets of the Trust from the claims of a Settlor's creditor. Most commentators believe that currently the two best DAPT States are Alaska and Nevada, although for Utah residents it makes the most sense to utilize the Utah law, especially from a cost and convenience standpoint.

5. Ensure that transfers for the Trust do not constitute fraudulent conveyances. This would include having the Settlor retain sufficient assets outside of the Trust that the Settlor can use for their support, care, and maintenance, so that they are not dependent on the assets in the Trust. In addition, assets transferred to the Trust in exchange for good and valuable consideration (for example a promissory note), should not be considered a fraudulent conveyance.

6. Select a Trustee for the DAPT who is and will act independently and in the best interest of the Trust and its' beneficiaries. The key is that it not appear as though the Settlor has retained the actual or practical right to control the Trust or its assets.

7. Make sure the DAPT is properly drafted. A DAPT that is intended to be used exclusively for asset protection purposes should be designed and drafted very differently from a DAPT that is intended to be used for both asset protection and estate tax planning.