FEATURE:
ESTATE PLANNING & TAXATION

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Find the Best Situs for Domestic Asset Protection Trusts

Which jurisdictions are the most effective to set up this powerful tool?

Fifteen states now have domestic asset protection trust (DAPT) statutes. Some commentators thought that these statutes would be limited to less populated states, but with Ohio entering the DAPT arena, this assumption proved incorrect. While the history of asset protection trusts is fairly brief in the United States, beginning with Alaska in 1996,[1] it's anticipated that many more states will adopt asset protection statutes.

DAPTs are powerful tools to help clients legally shield assets from third-party liability and permit clients to be discretionary beneficiaries of their own trusts. Just as valuable is the DAPT's estate-planning potential.

In our analysis of the best situs for overall trust law, "Which Situs is Best in 2014" ("Best Situs"),[2] several states emerged as leaders. Similarly, several states have emerged as the leaders in providing DAPT legislation. We name six states in the top tier for best DAPT legislation: Alaska, Delaware, Ohio, Nevada, South Dakota and Tennessee. "Which DAPT Jurisdictions Make the Grade?" p. 46, compares 15 DAPT jurisdictions. While Oklahoma is included in the analysis, the Oklahoma statute only protects transfers of up to $1 million of DAPT assets and the appreciation thereon; as such, it tends to only be used by Oklahoma residents.

DAPTs and Estate Planning

Planners draft DAPTs with two primary, different objectives: (1) for "asset protection only"; or (2) for asset protection combined with a potential estate-planning benefit. With the first method of drafting, transfers to the DAPTs are an incomplete gift, and on the death of the settlor, the assets are included in the settlor's estate. With the second method, transfers to the trust are a completed gift and are potentially excluded from the assets of the settlor's estate.

We discussed the asset protection only method of drafting in our 2013 article, "Domestic Asset Protection Trusts" ("DAPT 2013").[3] In this piece, we'll discuss Internal Revenue Code Section 2036's possible estate tax inclusion issues with a DAPT and how best to minimize these problems under the asset protection and estate-planning method.

Discretionary Support Legislation

When reviewing the DAPT protection provided by a specific state's laws, it's critical to examine both the state's DAPT statute and its other discretionary support legislation. Importantly, there's a legal distinction regarding discretionary trusts in those states that have adopted the *Restatement (Second) of Trusts (Restatement Second)* position regarding discretionary trusts and those that may adopt the *Restatement (Third) of Trusts (Restatement Third)*. Some commentators are concerned that parts of the *Restatement Third* are incorporated into the Uniform Trust Code (UTC). Those states that have codified laws adopting *Restatement Second* discretionary trust legislation and those states that have greatly modified the UTC in this area have an advantage. This edge exists because the *Restatement Third* rewrites the definition of a discretionary trust, substantially reducing the asset protection it provides. This result is particularly troubling as it relates to marital claims against DAPTs, as well as to whether a settlor/beneficiary has an enforceable right to a distribution, creating an estate inclusion issue.

Also, with respect to a DAPT statute itself,[4] the

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asset protection is primarily based on spendthrift protection, which provides that no person may attach a beneficiary's interest, unless such creditor is an exception creditor.

Discretionary Interest

The asset protection of a discretionary trust has nothing to do with spendthrift protection with respect to claims from creditors and exception creditors. In this respect, there are primarily two types of asset protection under U.S. common law: (1) discretionary trust protection, and (2) spendthrift protection. Discretionary trust protection originated under English common law and is based on whether a beneficiary has an enforceable right to a

Which DAPT Jurisdictions Make the Grade?

Compare the elements of each state's domestic asset protection trust statute

Listed alphabetically	Discretionary protection	Type of exception creditors	Only remedy: fraudulent conveyance	Fraudulent Conveyance Law: No hinder or delay	Fraudulent Conveyance Law: Only that specific creditor	Burden of proof	Present creditor length of time (years)
Alaska	●	None	●	●	●	Clear and convincing	4/1
Delaware	Probably[1]	1, 2	●	●	●	Clear and convincing	4/1
Nevada	●	None	●		Probably	Clear and convincing	2 years/6 months
Ohio	●[1,2]	1, 2	●	●	●	Clear and convincing	18 months/6 months
South Dakota	●	None	●	●	●	Clear and convincing	2 years/6 months
Tennesse	●	1, 2, 4	●	●	●	Clear and convincing	2 years/6 months
Hawaii		1, 2, 3[3]	●			Clear and convincing	4/1
Mississippi		1, 2, 3	●			Clear and convincing	2/?
Missouri	●	1, 2, 3				Clear and convincing	4/1
New Hampshire	●	1, 2	●			Preponderance	4/1
Oklahoma	●	1				Clear and convincing	4/1
Rhode Island		1, 2	●			Clear and convincing	4/1
Utah		1	●			Preponderance	2/1
Virginia		1, 2, 3				Clear and convincing	5/?
Wyoming		1	●			Preponderance	4/1

Type of exception creditors key:

1. Child support
2. Maintenance
3. Governmental claims
4. Marital property

Endnotes

1. The Delaware and Ohio discretionary statutory protection is significantly weaker than that provided by the other top trust jurisdictions. Delaware's proposed solution is to prohibit a Delaware court from using Articles 50 and 60 of the *Restatement (Third) of Trusts (Restatement Third)*, and instead use the judicial standard of the *Restatement (Second) of Trusts (Restatement Second)* Section 187. Delaware doesn't have significant discretionary support trust case law to refer to. Therefore, it's questionable whether any court will spend close to over 100 hours to educate itself on items such as extended discretion and mere discretion, as well as the differences between the *Restatement Second and the Restatement Third*. For Ohio's wholly discretionary trust, it removes the reasonableness standard. However, it doesn't apply the more restrictive *Restatement Second* definition that the judicial review is limited to (1) improper motive; (2) failure of the trustee to use its judgment; or (3) dishonesty.
2. Ohio's definition of a discretionary trust is incredibly limited; it only provides for discretionary asset protection if the distribution standard contains no stan-

distribution[5] and whether a potential creditor may stand in the shoes of a beneficiary. If the beneficiary has no enforceable right, the beneficiary's interest isn't a property interest[6] and is nothing more than an expectancy that creditors can't attach.[7]

This lack of an enforceable right to force a discretionary DAPT is key to protecting against creditors' claims that may arise in the following types of marital issues:

1. Will the beneficiary's trust interest be considered marital property subject to division in a divorce;
2. Will an estranged spouse be able to force a distribution through a minor child beneficiary; and
3. Will a court impute undistributed income in the computation of a beneficiary's child support or alimony?

These issues are discussed in more detail in "Best Situs." As a summary of the above three issues, here are our conclusions: (1) 10 states create "marital property" rights in certain trust interests that rise to the level of property interests; (2) an estranged spouse may force a distribution through a minor child beneficiary based on the distribution standard if such child has an enforceable right to a distribution; and (3) the cases are just beginning in the states where domestic relation courts are considering whether income should be imputed for the purpose of child support or alimony when a beneficiary has an enforceable right to a distribution. DAPT statutes don't address these issues because such statutes rely solely on spendthrift protection.

In addition to these marital claim questions, there's an estate inclusion issue if the settlor/beneficiary of a DAPT has the ability to force a distribution in his capacity as a beneficiary. Whether the settlor retains an enforceable right to a distribution depends on the distribution standard. Under common law, there are three primary types of distribution standards: (1) mandatory; (2) support; and (3) discretionary.

Usually, a mandatory distribution standard requires that a fixed amount, percentage or definition of income be paid out annually. Therefore, if a settlor/ beneficiary holds a mandatory distribution interest in a trust, there's a retained life interest under IRC Section 2036(a)(1).

A support interest is generally created with mandatory words, such as "shall" or "must," combined with a distribution standard capable of interpretation. For example, courts have determined the following language to create a support trust:

- "[T]he trustee *shall* pay … [to the settlor's] daughters such reasonable sums as shall be needed for their care, support, maintenance, and education" [emphasis added]; or
- "[T]he Trustee *shall* use a sufficient amount of the income to provide for the grandchild's support, maintenance and education" [emphasis added].[8]

Future creditor length of time (years)	Forcing litigation to the DAPT state	Automatic removal of trustees	Charging order protection
4	●		Best LLC; LP
4	●	●	Best LLC; FLP
2	●		Best LLC; FLP
18 months	●	●	Best LLC; JF-FLP
2	●	●	Best LLC; FLP
2		●	SR-LLC; Silent FLP
2		●	JF-LLC; JF-FLP
2			SR-LLC; Silent FLP
4/1			Silent LLC; FLP
4			Silent LLC; JF-FLP
4/1			SR-LLC; JF-FLP
4			Silent LLC; FLP
2/1			JF-LLC; JF-FLP
5/?			Best LLC; FLP
4/1		●	Best LLC; Silent FLP

dards or guidelines. Ohio may want to look to the discretionary support trust acts of Nevada, Oklahoma or South Dakota or to Tennessee's Uniform Trust Code that was modified after South Dakota's statute.

3. Hawaii's statute allows only Hawaii income taxes as an exception creditor—not all governmental claims.

Charging order protection key:
SR: sole remedy
LLC: limited liability company
JF: judicial foreclosure
FLP: family limited partnership

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Similar to a mandatory interest, the settlor/beneficiary who holds a support interest has an enforceable right to sue the trustee for a distribution. Therefore, a support interest also creates an estate inclusion issue under the retained life interest rule of Section 2036(a)(1).[9]

It's only a discretionary interest if the settlor/beneficiary doesn't hold either an enforceable right to a distribution or a property interest that solves the estate inclusion issue of the retained life rule of Section 2036(a)(1).[10] For purposes of this article, the term "common law discretionary trust" refers to a trust in which a beneficiary has neither an enforceable right to compel a distribution nor a property interest, and no creditor may attach such interest. Under common law, the terms "purely discretionary trust" or "wholly discretionary trust" didn't require that the distribution interest have no standards. Rather, almost all common law discretionary trusts contained a standard for making distributions. Under the *Restatement Second*, the most important factor in determining a discretionary trust was granting the trustee sole, absolute or unrestricted discretion.[11]

Unfortunately, with almost no case law to support its position, the *Restatement Third* reverses how a court should interpret a distribution standard so that it will almost always create an enforceable right in a discretionary trust.[12] Many estate planners believe that the national version of the UTC follows the *Restatement Third's* position regarding this issue. In response to this problem, states (including some UTC states) are beginning to respond with statutes codifying the *Restatement Second* in this area. Absent a statute codifying the *Restatement Second*, even if a state has strong *Restatement Second* case law, a court may reverse its position and inadvertently adopt the *Restatement Third's* new view of discretionary trusts. A statute codifying the *Restatement Second* is the only sure method to preserve the asset protection of a common law discretionary trust.

In response to the *Restatement Third's* attempt to rewrite common law regarding discretionary interests, several states have statutorily addressed the problem by codifying the *Restatement Second* in this area. The best codification of discretionary trust law is South Dakota's Discretionary-Support Trust Act[13] (the Act). The Act was substantially adopted by both Nevada and Oklahoma and incorporated into the Tennessee UTC. Alaska has also passed a discretionary trust statute.[14] Other DAPT states that have codified many parts of the *Restatement Second* are the New Hampshire UTC and the Wyoming UTC. The Missouri UTC addresses some of the issues, and Ohio has created a "wholly discretionary trust," but the distribution language is quite limited when compared to the other DAPT states that have addressed the issue.[15]

Exception Creditors/Estate Tax Inclusion

Some commentators focus on the existence of exception creditors as a key element regarding the strength of a state's DAPT statute. In "DAPT 2013," we posited that the existence of the exception creditor for child support or alimony with regard to the first method of drafting DAPTs was probably not much of a concern. We stated that a judge would use any equitable method to pierce a DAPT, should a debtor settlor/beneficiary be so foolish as to try to shirk a child support or maintenance obligation. For this and other reasons discussed in the article, we didn't find, under the first method of drafting (that is, a client created a DAPT that was an incomplete gift included in his estate), that these two exception creditors substantially reduced the asset protection of the DAPT.

Does the existence of an exception creator create estate tax inclusion for DAPTs that are drafted for both asset protection and estate planning? Some commentators have raised the concern that the existence of an exception creditor may create an estate tax inclusion issue as to the settlor/beneficiary's interest. The concern originates from Revenue Ruling 76-103, in which the IRS addresses the issue of whether the transfer to an irrevocable trust is an incomplete gift, because the assets of the trust are subject to the claims of the grantor's creditors.[16] Citing *Alice Spaulding Paolozzi,*[17] the IRS concludes that the transfer of the income interest to the trust isn't a completed gift, if the "grantor could . . . effectively enjoy all the trust income by relegating the creditors to the trust for settlement of their claims." We won't analyze the completed gift issue, as a few private letter rulings and a revenue ruling support that the gift is complete in a DAPT state under the second method of drafting.[18] Rather, we'll discuss whether an exception creditor creates an estate inclusion issue.

There are three lines of defense to an exception creditor's right to claim an estate inclusion issue:

1. If the existence of an exception creditor is classified as an act of independent significance,[19] then an estate inclusion issue is disregarded.
2. There's no case when an exception creditor has created an estate inclusion issue for a non-settlor/beneficiary. Therefore, by analogy,

why would such an issue be created for a settlor/beneficiary?

3. Rev. Rul. 76-103 (and its cite to *Alice Spaulding Paolozzi*) refers to regulating creditors to all of the settlor/beneficiary's interest. The revenue ruling and court case don't address whether regulating a limited class of exception creditors creates an estate inclusion issue.

Defense 1: In "DAPT 2013," we concluded that a child support exception creditor should be an act of independent significance and were hopeful for the same result with alimony. Conversely, many DAPT statutes also include an exception creditor for state and/or federal claims, and Tennessee provides a court order for the division of marital property as an exception creditor.[20] It's questionable whether these exception creditors would be classified as acts of independent significance.

Defense 2: Assuming that some exception creditors aren't acts of independent significance, some commentators have noted that exception creditors, such as governmental claims, attorney's fees and necessary expenses of a beneficiary, have never created an estate inclusion issue for a third-party (that is, a non-self-settled trust) beneficiary. Therefore, by analogy, why would exception creditors create an inclusion issue for a settlor/beneficiary?

First, even though there appears to be no case, revenue ruling or private letter ruling on point when the presence of a state exception creditor created an estate inclusion issue for a beneficiary of a third-party trust under IRC Section 2041, is there an analysis that supports this conclusion under Section 2041? Second, is there a difference between Section 2041, which applies to third-party trusts and their beneficiaries, and Section 2036, which applies to a settlor/beneficiary?

The answer to the first question depends on whether a distribution interest is a power of appointment (POA). If not, Section 2041 doesn't apply, and an exception creditor can't create an estate inclusion issue. Conversely, if a distribution interest is classified as a POA and there's no other theory, such as an act of independent significance, then all third-party trusts in states that provide for exception creditors might have estate inclusion issues. The beneficiary could potentially regulate these exception creditors to the trust for payment.

Treasury Regulations Section 20.2041-1(c)(1) states, "A power of appointment exercisable for the purpose of discharging a legal obligation of the decedent or for his pecuniary benefit is considered a power of appointment exercisable in favor of the decedent or his creditors." A power exercisable in favor of one's creditors is a general POA, and an ascertainable standard won't cure the estate tax inclusion issue of a legal (for example, support) obligation. Treas. Regs. Section 20.2041-1(b) doesn't provide a precise definition of a POA. Rather, it holds:

(1) In general. The term 'power of appointment' includes all powers which are in substance and effect powers of appointment regardless of the nomenclature used in creating the power and regardless of local property law connotations. For example, if a trust instrument provides that the beneficiary may appropriate or consume the principal of the trust, the power to consume or appropriate is a power of appointment.

To better understand what constitutes a POA, here's a summary of various beneficial interests in trust. For these examples, assume that the trustee is an independent trustee within the meaning of IRC Section 672(c).

(1) With the *Crummey* withdrawal power, the holder alone, almost always without any restrictions, such as a limitation for health, education, maintenance and support, may withdraw from $5,000 to the annual exclusion amount annually during a specified period of time. Because the holder may unilaterally withdraw the amount, it's a power. It's also a general POA.

(2) Some trusts are drafted so that a beneficiary has an unconditional withdrawal right of one-third of the principal at a specified age, one-half of the principal at a later age and the balance of the principal at a still later age. This is also a power that may be unilaterally executed by the beneficiary and is a POA.

(3) Instead of giving the beneficiary a withdrawal right, the trustee is required to distribute one-third of the assets at three specified ages. Here, the beneficiary doesn't have a unilateral power to withdraw the assets. Rather, the beneficiary must sue the trustee if the trustee doesn't distribute the trust assets pursuant to the trust terms.

One might wonder whether (3) is a POA. In (1) and (2), the beneficiary unilaterally has the power to demand the distribution, not subject to any fiduciary powers. In (3), the beneficiary may also make a demand that the distribution is due; however, if the trustee doesn't follow the trust terms, the beneficiary may also have to sue the trustee to force a distribution. Conversely, the same is true for (1) and

(2)—a beneficiary may have to sue a trustee to follow the terms of a trust regarding a POA. Based on the above, some planners might classify (3) as a POA, while others might conclude it's a distribution interest.

The analysis becomes more convoluted when one attempts to distinguish between current distribution interests.

(4) If a beneficiary has a mandatory right to a quarterly distribution of income, is it a POA? Similar to the discussion in (3) above, once the quarter has passed and there's no distribution, the beneficiary may sue the trustee for a distribution. If (3) is classified as a POA, the same result seems to apply with a mandatory interest.

(5) With a support interest, when the beneficiary requests a distribution, he has an enforceable right to a distribution pursuant to the standard. When the trustee is also a beneficiary, this is a POA. However, such a power is deemed not to be a general POA if the trustee/beneficiary is limited in making distributions to himself by an ascertainable standard.[21]

(6) With a common law discretionary interest, a beneficiary has neither an enforceable right to a distribution nor a property interest. Therefore, these interests aren't classified as either a "power" or a "right."

Regarding (6), there appears to be considerable authority that a third-party common law discretionary interest[22] *with an independent trustee,* isn't a POA. Rev. Rul. 76-378 states:

> While the decedent had the power to invoke a process of judicial review if the trustee, in the judgment of the decedent, failed to liberally exercise its discretionary power of invasion on the decedent's behalf, this kind of power does not transfer a power of invasion granted an independent trustee to the beneficiary of the trust.[23]

In *Estate of Cox,*[24] the Tax Court held that the trustee, not the beneficiary, had the power of invasion. In other words, the Tax Court didn't even get to the analysis of whether there was a general POA, because the beneficiary of a discretionary interest didn't have a power to force a distribution. The court further held, "To decide that the beneficiary had an implied power of invasion would be inconsistent with such arrangement and with the provision expressly granting the trustee sole and exclusive management [distribution] powers." When interpreting the management powers, the Tax Court concluded that, "it seems clear that the petitioner's power of management was intended to include the power of determining when Mrs. Cox's income was insufficient and when the corpus should be invaded." Conversely, the district court in *Security-Peoples Trust Co.* held that the beneficial interest wasn't a general POA.[25] At the same time, the court seemed to imply that the beneficial interest alone wasn't a POA by holding that the trustee had the discretion alone to invade income or principal for the beneficiaries with regard to protection of interests of future and remainder beneficiaries. Rev. Rul. 82-63 provides further authority that a distribution interest isn't a POA. When the power is vested in a trustee, not the beneficiary, there isn't a POA.

While a discretionary interest in a third-party trust isn't a POA, we still need to analyze whether a support interest (that is, the beneficiary has an enforceable right to a distribution) is. For example, let's say the trust instrument states, "the trustee shall make distributions for health, education, maintenance, and support." Assume the irrevocable trust is sitused in Ohio. Under Ohio's UTC, both governmental claims and attorney's fees are exception creditors. The spouse and children are named as beneficiaries. The spouse isn't a trustee, and she passes away. She had an enforceable right to a distribution that was based on an ascertainable standard. So at first, it doesn't appear that she has a general POA. Yet, under Ohio law, governmental claims as well as attorneys defending a beneficiary's interest may reach the assets of a support trust as an exception creditor.

Except for Rev. Rul. 82-63, all of the cases cited above deal with a discretionary interest combined with an independent trustee. Therefore, one might narrowly conclude that the above authority may not apply to a support interest. However, Rev. Rul. 82-63 makes another possible distinction between a distribution interest and what it calls "a power of invasion," meaning a POA. The ruling states, "a power of invasion is different than a power of distribution." In this revenue ruling, the IRS noted that in *Dana v. Gring,*[26] the decedent was to receive income for life and as much of the principal as the trustees deemed necessary for his reasonable welfare or happiness. Unlike Rev. Rul. 76-368 and cases cited above, the decedent/beneficiary was one of three

trustees. Generally, this scenario would result in an automatic estate inclusion issue because, in her power as one of the three co-trustees, the beneficiary could make discretionary distributions to herself.[27] Therefore, her powers as a co-trustee would create a power of invasion when coupled with her beneficial interests. However, with quite a few contortions, the Massachusetts Supreme Court concluded that based on the circumstances, "happiness" was an ascertainable standard. Part of this reason was that a co-trustee with fiduciary duties couldn't have distributed trust principal to a life beneficiary solely on the basis of her subjective desires. "In the absence of instructions to the contrary (a trustee is bound) to administer his trust with an eye to the remainder interest as well as to the interest of a life beneficiary." The court also noted that, as a general rule, a trustee beneficiary may not participate in decisions regarding distributions of principal to himself. Therefore, the court, in essence, concluded the trust was an ascertainable standard. But, more important is that the fiduciary duties of a trustee, in combination with the distribution standard, prevented the distribution power from being classified as a POA.

While many authorities will have different opinions regarding the Massachusetts holding that in certain circumstances "happiness" is an ascertainable standard, this issue isn't the critical point of discussion under Rev. Rul. 82-63. The IRS published the revenue ruling to advise taxpayers that it wouldn't follow a factually distinguishable case—*Brantingham v. U.S.*[28] In *Brantingham*, the decedent had a power in a non-fiduciary capacity to invade the corpus for the beneficiary's maintenance, comfort, and happiness." The revenue rule notes that:

> The discretionary power in *Gring* was a fiduciary power of distribution and was, therefore, limited by the fiduciaries' obligation to preserve the corpus for all beneficiaries. The court noted that the trustees had to administer the trust with 'an eye to the remainder interest. The power in *Brantingham* was a power of invasion, exercisable by the decedent in an individual capacity and, therefore, was not limited by any fiduciary considerations regarding preservation of the corpus for other beneficiaries. . .'

The analysis in Rev. Rul. 82-63 brings forth a very important distinction. A power held in an individual capacity, unless otherwise stated in the trust document, may be exercised in a non-fiduciary capacity. There's no requirement to look at any other interests that a different beneficiary may hold before the beneficiary demands a distribution. Conversely, if a beneficiary is serving as a trustee, he has fiduciary obligations before making any distribution to himself. These fiduciary obligations still don't prevent an estate inclusion issue if the beneficiary's distribution interest isn't limited to an ascertainable standard. However, Rev. Rul. 82-63 may be interpreted to mean that a distribution interest alone limited by an ascertainable standard isn't a POA. If a distribution interest isn't a POA, an exception creditor doesn't create an estate inclusion issue for a third-party trust. We agree with this interpretation when: (1) the beneficiary isn't a trustee; or (2) the beneficiary is a trustee but limited to making distributions based on an ascertainable standard.[29]

This brings us to the second component of our analysis: Is the estate tax inclusion issue for a POA held by a third-party beneficiary under Section 2041 the same as that under Section 2036 for a settlor/beneficiary? As noted above, Section 2041 regarding estate inclusion issues for a donee requires that the decedent hold a POA. Conversely, Section 2036 doesn't require the settlor/decedent to hold a POA as a condition precedent to whether there's an estate inclusion issue due to the assets being used to satisfy a legal obligation. Treas. Regs. Section 20.2036-1 provides:

> The 'use, possession, right to the income, or other enjoyment of the transferred property' is considered as having been retained by or reserved to the decedent to the extent that the use, possession, right to the income, or other enjoyment is to be applied toward the discharge of a legal obligation of the decedent, or otherwise for his pecuniary benefit.

Therefore, it's uncertain whether this subtle difference between Section 2041 and Section 2036 results in an estate inclusion issue for exception creditors of DAPTs that aren't deemed to be independent acts of significance.

Defense 3: The third line of defense that an exception creditor doesn't create an estate tax inclusion issue is the concept that a legal obligation creates an estate inclusion issue in that a beneficiary could "regulate creditors" to the trust for payment.[30]

One might think that a quick look at this Treasury regulation seems to imply that the beneficiary is regulating many creditors, instead of just a few potential limited classes of creditors to the trust for payment. However, this isn't what the revenue ruling and related case stated. The ruling stated to "regulate creditors to all of the settlor/beneficiary's interest." It didn't state "regulate all creditors to the beneficiary's interest." For this reason, we don't have authority to support this position. Conversely, an analogy may be made to Rev. Rul. 76-152. In this revenue ruling, the husband created an irrevocable trust for the benefit of his wife and minor children in which distributions were based on an ascertainable standard. The revenue ruling concluded that there was an estate tax inclusion issue if the wife died before the children reached the age of majority, because she "*was trustee and she*" had a support obligation "*for the children that could be discharged from the trust assets.*" The revenue ruling didn't look to see if there were sufficient assets outside of the trust to support the children. Rather, an estate inclusion issue was created by the mere fact that the wife had the "opportunity to use trust assets in her capacity to satisfy a support obligation."[31]

Due to all these factors, there's a range of opinions regarding whether there's an estate tax inclusion issue for a settlor/beneficiary of a DAPT that's under a state statute that provides for exception creditors. Conservative planners may choose to situs a self-settled estate-planning trust only in a jurisdiction that provides for no exception creditors, such as Alaska, Nevada or South Dakota. Conversely, many planners may agree with us that child support should be an act of independent significance and, hopefully, the same is true for maintenance. If this interpretation is correct, then these exception creditors wouldn't create an estate tax inclusion issue. Finally, there will be those that may conclude the difference between Sections 2041 and 2036 doesn't create an estate inclusion issue because they're not broad enough to be included in the definition of to "regulate" creditors to the assets of the trust.

How Lead DAPT Statutes Work

With the exceptions of Missouri, Oklahoma and Virginia, the other 12 DAPT statutes provide that the only remedy a creditor may bring is a claim that there was a fraudulent transfer to the DAPT. In essence, this provision should eliminate all other legal and equitable claims against trust property, such as constructive trust, resulting trust, alter ego, pierce the veil or dominion and control type of arguments. Equitable remedies require the client to dot all "i's" and cross all "t's" in the administration of the trust. Further, the dominion and control argument allows any court (whether DAPT state or non-DAPT state) to use its standards to determine whether the settlor retained too much control.[32] We find that the elimination of all remedies other than a fraudulent conveyance is a major asset protection that distinguishes 12 states from the other three.

Fraudulent Transfer

If the only remedy a creditor can bring is to prove a fraudulent transfer, then the question becomes: How debtor-favorable is the DAPT fraudulent transfer statute? The standard Uniform Fraudulent Transfer Act (UFTA) allows any creditor to prove a fraudulent conveyance, based on a preponderance of the evidence, if the transfer was made to hinder, delay or defraud any creditor. The standard period of time for a creditor to bring a fraudulent transfer action is typically four years.

When reviewing the debtor-friendliness of a DAPT fraudulent transfer statute, here are five key questions to ask:

1. Does the statute limit claims to fraudulent intent?
2. Does the statute require the specific creditor alleging a fraudulent transfer to prove intent as applied to that specific creditor?
3. Does the statute require the creditor to prove the transfer was fraudulent by clear and convincing evidence?
4. What's the statute of limitations period for a present creditor?
5. What's the statute of limitations period for a future creditor?

A standard fraudulent transfer law allows avoidance of any transfer that "hinders, delays or defrauds" a creditor. While direct authority regarding "hinder" and "delay" is sparse, what little authority that does exist indicates that transfers can hinder or delay without involving fraud.[33] Alaska, Delaware, Ohio, South Dakota and Tennessee have a competitive advantage over Nevada on this point, as their statutes limit a fraudulent conveyance action against an asset protection trust to only actual fraudulent intent.

Eleven DAPT states make a substantial asset protection improvement to the UFTA by eliminating the date of discovery rule. In other words, a future creditor can't claim he was unaware of the transfer and then file a fraudulent transfer action based on the date of discovery of the DAPT. Conversely, the date of discovery rule remains for future creditors in Missouri, Oklahoma, Virginia and Wyoming.

If the debtor is in bankruptcy, differences in DAPT state fraudulent conveyance law are irrelevant. The Bankruptcy Code extends the statute of limitations to ten years for a bankruptcy trustee to exercise his avoidance powers if transfers were made to a self-settled trust or equivalent with the intent to hinder, delay or defraud a creditor. The Bankruptcy Code also retains the date of discovery rule for future creditors, provides that any creditor may be used to prove a fraudulent conveyance and uses the preponderance of evidence burden of proof.

Litigation Issues

Alaska, Delaware, South Dakota and, arguably, Nevada all have provisions stating that their courts have exclusive jurisdiction over actions involving their DAPTs. (That is, while this point is clear for Alaska, Delaware and South Dakota, it's not as clear in Nevada.) This is a critical difference between lead trust jurisdictions and the next tier. Assume that a creditor files first in a Colorado court (a non-DAPT state) against a DAPT. Will the DAPT state accept a concurrent action? When a DAPT statute states that it has exclusive jurisdiction, it appears that the answer is "yes." Conversely, in non-lead DAPT states, the courts may well state that the foreign court already has jurisdiction over the matter.

Automatic Removal of Trustees

Even if the action isn't brought within the DAPT state's forum (that is, the non-DAPT state doesn't respect the jurisdiction provision), Delaware, Hawaii, Ohio, South Dakota, Tennessee and Wyoming provide for the automatic removal of the trustee if a foreign court doesn't follow these states' DAPT laws. A successor trustee or new trustee under these DAPT statutes will be appointed. It's uncertain whether these provisions will survive a constitutional challenge, but they still create a major statutory hurdle that a creditor must surmount.

Charging Order Protection

Most of the time, either a family limited partnership (FLP) or limited liability company (LLC) is owned partially or wholly by a DAPT. This structure strengthens the likelihood that an out-of-state judge will apply the governing law of the trust under conflict-of-laws principles because an LLC or FLP interest is personal property. Thus, in addition to the factors of the governing law of the trust and the place of administration, some of the trust property is now held in the same state.

When evaluating state charging order statutes, consider that the "best" jurisdictions have a statute that: (1) prevents the judicial foreclosure sale of the partner's or member's interest; and (2) provides either a provision denying any legal or equitable remedies against the partnership or a provision preventing a court from issuing a broad charging order interfering with the activities of the partnership. We use the label "SR" in "Which DAPT Jurisdictions Make the Grade?" to indicate the jurisdictions where a charging order is the sole remedy and where there's no other language in the statute (or comments in the case of a state UTC) stating that a court may issue additional orders to effect the charging order or a court may order the judicial foreclosure sale of the partner's or member's interest. The label "JF" designates that either the statute or case law allows the judicial foreclosure sale of the partner's or member's interest.

Most Important Factors

Practitioners may disagree regarding what are the most important factors when evaluating a jurisdiction.[34] Because over 60 percent of the population will experience divorce, protection against marital claims is one of the most significant factors when evaluating the strength of a trust statute. The primary key to protecting against a marital claim may well be whether a beneficiary has an enforceable right to a distribution. This protection isn't found in the DAPT statute but is in discretionary-support legislation being enacted by many states. Some of the more important DAPT statute provisions include limiting a creditor's claim solely to a fraudulent conveyance, debtor friendly fraudulent conveyance law and forcing the litigation to the DAPT state. Finally, because most DAPTs are combined with either an LLC or an FLP, the strength of the DAPT state's charging order statute is also a major factor to consider.

Endnotes

1. Prior to 1996, 18 nations provided offshore asset protection trust statutes. While Missouri amended its spendthrift trust statute in 1986 in a way that may have permitted the creation of asset protection trusts, the law lacked information about the intent of the statute and caused many concerns that it wouldn't be an effective asset protection trust statute. Richard Bacon, "The Domestic Asset Protection Trust at Five Years—Has its Time Arrived?" ALI-ABA course materials, *Asset Protection Planning* (Nov. 5, 2002), at p. 84. Also, note that Colorado hasn't been listed on the chart as an asset protection trust legislation due to case interpretation that severely questions whether Colorado's 1800's statute C.R.S. Section 38-10-111 was ever intended for such a purpose. *See In Re Cohen*, 8, P.3d 429 (Colo. 1999) and *In Re Bryan*, 415 B.R. 454 (Bankr. D. Colo 2009); contrast with *In Re Baum*, 22 F.3d 1014 (10th Cir. 1994).
2. Daniel G. Worthington and Mark Merric, "Which Situs is Best in 2014?" *Trusts & Estates* (January 2014) at p. 53.
3. Mark Merric and Daniel G. Worthington, "Domestic Asset Protection Trusts," *Trusts & Estates* (January 2013) at p. 52.
4. Hawaii is the only domestic asset protection trust (DAPT) statute that doesn't use a spendthrift provision for determining whether a settlor/beneficiary's interest in trust was protected. Rather, Hawaii requires that the trust only be "irrevocable."
5. *Restatement (Second) of Trusts*, Section 155(1) and comment (1)b.
6. Mark Merric, "How to Draft Distribution Standards for Discretionary Dynasty Trusts—Part II," *Estate Planning Magazine* (March 2009). Endnote 41 lists cases from 16 states noting that a discretionary distribution interest isn't a property interest.
7. *Ibid.* Endnote 42 lists cases from 18 states noting discretionary interests couldn't be attached at common law. *The Restatement (Third) of Trusts* and the Uniform Trust Code (UTC) reverse common law in this area allowing a creditor to attach a discretionary interest. However, five UTC states have modified the national version of the UTC to retain common law in this area.
8. *McElrath v. Citizens and Southern Nat. Bank*, 189 S.E.2d 49 (Ga. 1972).
9. *Estate of Boardman v. Commissioner*, 20 T.C. 871 (1953); *Estate of John J. Toeller*, 165 F.2d 665 (7th Cir. 1946); and *Blunt v. Kelly*, 131 F.2d 632 (3rd Cir. 1941). For creditor purposes, when a beneficiary has an enforceable right to a distribution, it's referred to as a "support trust."
10. *Estate of Uhl*, 241 F.2d 867 (7th Cir. 1957), as to the principal that was wholly in the discretion of the trustee "the settlor reserved no right to compel the trustee to pay him any sums . . ." Both *Estate of German*, 7 Cl. Ct. 641 (1985) and *Estate of Wells*, 475 F2d 1142 (Ct. of Claims 1964) are self-settled discretionary trust cases in which the court held in favor of the taxpayer, and it appears the Internal Revenue Service didn't attempt to argue that there was an enforceable right in a discretionary trust.
11. For a further discussion in drafting discretionary dynasty trusts, *see* the three part series, Mark Merric, "How to Draft Distribution Standards For Discretionary Dynasty Trusts," *Estate Planning Magazine* (February 2009, March 2009 and April 2009), *InternationalCounselor.com.*
12. *Supra* note 6.
13. S.D.L. Section 55-1-24 through Section 55-1-43.
14. Ala. Stat. Section 34.40.113.
15. An Ohio "wholly discretionary trust" is restricted to distribution language when a beneficiary has no distribution standard and no guidelines for distributions. Richard Covey, in *Practical Drafting* (April 2007) at p. 8,918, criticized the Ohio's UTC due to its very limited definition of a discretionary trust.
16. Revenue Ruling 76-103, 1976-1 C.B. 293.
17. *Alice Spaulding Paolozz* , 23 T.C. 182 (1954), acq. 1962-1 C.B. 4.
18. Private Letter Ruling 93326006 (Aug. 22, 1992) (dealing with an offshore trust); PLR 9837007 (June 10, 1998); PLR 200944002; and Rev. Rul. 2004-64.
19. An act of independent significance is a legal term that may be defined generally as a condition that's so remote, it's likely to be disregarded. For example, in the context of estate tax inclusion, a husband incurring the cost to divorce his wife solely for the purpose to change an insurance beneficiary has been classified as an act of independence. *See* Merric and Worthington, *supra* note 3.
20. Delaware, Hawaii, Mississippi, New Hampshire and Rhode Island provide for a tort creditor exception that only applies for a tort creditor existing at the time of funding the trust. Hawaii and Wyoming provide for an exception creditor for transfers that violate a contract creditor's reliance on the assets transferred. Nevada has an exception creditor for a transfer that violates a legal obligation. All of these exception creditors are unique in that they depend on the settlor violating a written contract, violating a legal obligation or transferring assets out of the reach of a present creditor. As such, these transactions are considered unusual and may have elements more resembling a fraudulent transfer than an exception creditor. *See* Merric and Worthington, *supra* note 3.
21. Internal Revenue Code Section 2041(b)(1)(A).
22. Meaning a non-settlor/beneficiary.
23. Rev. Rul. 76-378 cites *Estate of Mary Joyce Cox*, 59 T.C. 825 (1973) and *Security-Peoples Trust Co.*, 238 F. Supp 40 (W.D. Pa. 1965).
24. *Estate of Mary Joyce Cox*, *ibid.*
25. *Security-Peoples Trust Co.*, *supra* note 23.
26. *Dana v. Gring*, 371 N.E.2d 755 (Mass. 1977).
27. IRC Section 2036(a)(2).
28. *Brantingham v. U.S.*, 631 F.2d 542 (7th Cir. 1980).
29. Technically, a trustee/beneficiary holds a general power of appointment (POA). However, when the distribution standard is based on an ascertainable standard, it's deemed not to be a general POA. IRC Section 2014(b)(1)(A).
30. *Supra* note 21.
31. For a detailed analysis of "Who Can Be a Trustee Without an Estate Inclusion Issue," *see* the four part Leimberg LISI series #1414 Feb. 8, 2009; #1444 April 13, 2009; #1610 Feb. 25, 2010; and #1621 March 25, 2010, *www.internationalcounselor.com.*
32. Mark Merric, "How to Draft Distribution Standards for Discretionary Dynasty Trusts-Part III," *Estate Planning Magazine* (April 2009).
33. *In re Mortensen*, 2011 WL 5025249 (Bkr. D. Ala. May 26, 2011).
34. *See, e.g.*, David G. Shaftel, "Comparison of Domestic Asset Protection Trust Statutes," updated through June 30, 2013, published by the American College of Trust and Estate Counsel.