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Domestic Asset Protection Trusts

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by

Leo J. Cushing, Esq., CPA, LLM
Cushing & Dolan, P.C.
10 Post Office Square, Suite 1205
Boston, MA 02109
(617) 523-1555
lcushing@cushingdolan.com

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I. Introduction

On September 9, 2008, New Hampshire enacted one of the most advanced asset protection statutes in the country. No longer will you need to look to establish off shore trusts or consider either Alaska or Delaware. You can now place your assets in a trust using New Hampshire's new Qualified Dispositions in Trust Act. Effective for transfers into trust occurring on or after January 1, 2009, you can now establish a trust in which you can be a beneficiary, not just your family members. New Hampshire Statutes Ch. 564-D, Qualified Dispositions in Trust Act.

II. Background & History

Asset protection with self-settled trusts has been somewhat problematic as a result of two Massachusetts cases decided years ago. In *Ware v. Gulda* 331 Mass. 68 (1954), the Massachusetts Supreme Judicial Court ruled that assets in an irrevocable trust would be subject to the settlor's creditors, if the settlor is a beneficiary even if the settlor does not have the right to request or demand distributions. The Court ruled that, in determining the extent to which the assets would be subject to the settlor's creditors, Courts will presume the maximum degree of discretion by the trustee, even if the trustee is unrelated to the settlor and independent. *State Street Bank & Trust Company v. Reiser*, 7 Mass. App. 633 (1979), Rev. Rul. 76-103; Rev. 77-378.

For example, if you set up a trust with an independent trustee, which provides that income and/or principal of the trust is payable to or for the benefit of the settlor in the trustee's sole and absolute discretion, specifically prohibits the settlor from requesting or demanding distributions, these trust assets nevertheless will be considered payable to satisfy the settlor's creditors.

The Massachusetts court decisions became the basis for the law of the land. As a result, in a state, which has not effectively repealed the mandates of the Massachusetts court decisions, so-called "self-settled" trusts will not protect the assets from the claims of the settlor. There were essentially two options, one is to establish an irrevocable trust for the benefit of the settlor's

spouse and/or children where the settlor is not a beneficiary and cannot receive distributions under any circumstances or the other option is to consider an off shore trust.

Off shore trust planning has become problematic as a result of certain criminal sanctions imposed on settlors. In the United States, Alaska was the first state to enact a law repealing the self-settled trust rule and was quickly followed by Delaware and even Rhode Island enacted a similar statute recently. New Hampshire is the most recent state to allow self-settled asset protection trusts, also known as domestic asset protection trusts (“DAPT”).

It should also be noted that New Hampshire also repealed its rule of perpetuities for transfers occurring on or after January 1, 2004, so that, once assets are placed in trust, the assets can remain in trust forever and avoid gift and estate taxation upon subsequent generations and avoid creditors of all lineal descendants.

III. Technical Requirements

In order to establish a New Hampshire DAPT, a donor, known as the settlor/trustor, creates a trust instrument that appoints a qualified trustee to hold the property that is the subject of the so-called Qualified Disposition. The trust must (a) expressly incorporate the law of New Hampshire to govern the validity, construction, administration of the trust, (b) the trust instrument must be irrevocable, and (c) the trust instrument must provide that the interest of the transferor or other beneficiary of the trust property or the income therefrom may not be transferred, assigned, pledged, or mortgaged, whether voluntarily or involuntarily, before the qualified trust or qualified trustee actually distributes the property or the income therefrom to the beneficiary. This provision is known as a spend thrift provision and is deemed to be a restriction on the transfer, assignment, pledge, or mortgage of the transferor’s beneficial interest in the trust that is enforceable under applicable non-bankruptcy law. Neither the Donor nor the Beneficiaries need to be New Hampshire residents. New Hampshire Statutes, Ch. 564-D; 2 I.

The law then provides for a number powers that can be retained by the transferor or powers given to the trustee or a third party which do not statutorily undermine the spendthrift provision. The transferor may retain a power to veto a distribution from the trust. The transferor may keep a so-called Power of Appointment to appoint the trust property to specific individuals exercisable by Will or other written instrument effective upon the death of the transferor, the transferor’s potential or actual receipt of income, the transferor’s right to remove a trustee or trust advisor and appoint a new trustee or trust advisor, other than a person who is related to or subordinate to the transferor and more importantly, the transferor’s potential or actual receipt or use of principal, if such potential or actual receipt or use of principal would be the result of a qualified trustee, including a qualified trustee or a qualified trustee acting at the direction of a trust advisor, acting either in such qualified trustee’s sole discretion or pursuant to an ascertainable standard in the trust instrument. New Hampshire Statutes, Ch. 564-D; 2 II

IV. Concern Over the Trustee’s Decision-Making Process

The trustee of the New Hampshire DAPT must be a person other than the transferor who, in the case of a natural person, is a resident of New Hampshire or who, in all other cases, is a state or federally chartered bank or trust company,

- (1) having a place of business in New Hampshire;
- (2) is authorized to engage in a trust business in New Hampshire;
- (3) maintains or arranges for custody in the state of some or all of the property that is the subject of the qualified disposition;
- (4) maintains records in the state for the trust on an exclusive or non-exclusive basis;
- (5) prepares or arranges for the preparation in New Hampshire of fiduciary income tax returns for the trust; and
- (6) otherwise materially participates in the state in the administration of the trust.

New Hampshire Statutes, Ch. 564-D; III

V. Role of the Trust Advisor

New Hampshire legislature, understanding obvious concern over the corporate fiduciaries, solved this problem by allowing the transferor to appoint a so-called trust advisor. The statute provides that nothing would preclude the transferor from appointing one or more trust advisors, including trust advisors who have authority under the terms of the trust instrument to remove and appoint qualified trustees and/or trust advisors; and trust advisors who have authority to direct, consent to, or disapprove distributions from the trust. The transferor may serve as a trust advisor, but this would not be advisable in the writer's opinion, would stretch the limits of independence and perhaps undermine the asset protection benefits of the New Hampshire DAPT, Ch. 564-D; V

VI. Limitations on Creditor's Rights

A transferor's transfer of property to a New Hampshire DAPT will extinguish any creditor's claim, unless the creditor's claim arose before the qualified disposition was made and an action is brought within the limitations of RSA 545-A, in effect on the date of the qualified disposition, or notwithstanding the UFTA, the creditor's claim arose on or after the date of the qualified disposition and the action is brought within four years after such date. Ch.564-D; 10. The period of limitations as set forth in the Uniform Fraudulent Transfer Act is generally four years, or the creditor's claim arose on or after the date of the qualified disposition and the action is brought within four years of such date.

VII. Balance Sheet & Financial Statements

The individual financial statement should not include assets transferred to the New Hampshire DAPT since the transferor's beneficial interest in the trust is technically property owned by the transferor after the transfer. Failing to properly prepare financial statements reflecting the ownership of assets in a New Hampshire DAPT could be a basis for misrepresentation as to the underlying obligation.

VIII. Spouses

In addition to the foregoing types of claims, the New Hampshire DAPT trust assets would be subject to the claims of a spouse or a former spouse as of the date of the transfer on account of an obligation arising under a prenuptial agreement or an agreement or court order for the payment of support or alimony in favor of such transferor's spouse, former spouse, or children, or for the division or distribution of property in favor of such transferor's spouse or former spouse, but only to the extent of such debt. This provision, however, applies only to a spouse to whom the transferor was married or divorced on the date of the qualified disposition.

A transferor who is single, who makes a qualified disposition and then marries is not subject to these provisions. Additionally, 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 or whom such transferor is or was vicariously liable, is exempt from the provisions.

IX. Income Taxes

The DAPT can save state income taxes. New Hampshire imposes a tax on interest and dividends, but interest and dividends which are accumulated in the trust for out of state beneficiaries are not subject to the New Hampshire tax. Additionally, New Hampshire does not tax capital gains. This tax treatment assumes the trust is drafted as a non-grantor trust. It might be advisable, however, to draft the DAPT as an intentionally defective grantor trust. If the trust is a grantor trust, income and capital gains will be taxable to the grantor since the grantor trust is ignored for income tax purposes. A DAPT in which the grantor retains the right to receive discretionary distributions of income and/or principal will be a grantor trust as to both ordinary income and capital gains unless the distribution must be approved by an adverse party. IRC § 677(a). An adverse party would be a beneficiary, such as a child, who's interest in the trust would be adversely affected by the distribution to the grantor. If the DAPT is a grantor trust, the trustee is permitted to reimburse the grantor the incremental income taxes incurred as a result of the grantor trust income. Rev. Rul. 2004-64

X. Gift Taxes

A DAPT can be drafted to be either a completed gift or an incomplete gift. If the grantor retains a limited power to appoint principal by Will upon the grantor's death, the transfer to the trust will be an incomplete gift. Note that reserving a limited power to appoint principal by Will would not make the trust a grantor trust. PLR 200531004; 200523003. If the transfer is a completed gift, a gift tax return will need to be filed. In PLR 9837007, the IRS ruled that a transfer through an Alaska DAPT was a completed gift, but refused to rule on the question of estate tax includibility.

XI. Estate Taxes

A DAPT drafted to be a completed gift should also be excluded from the decedent's estate. Unfortunately, there is no case on point, but a number of estates have been settled involving Delaware DAPT and the IRS did not seek to include the trust assets in the gross estate.

XII. Federal Bankruptcy Limitations

There are two issues in terms of bankruptcy of the grantor. The first issue is whether the trust assets become part of the bankruptcy estate and the second issue is whether the transfer to the trust can be set aside by the bankruptcy trustee. It seems clear that the trust assets do not become part of the bankruptcy estate pursuant to Bankruptcy Code Section 541(c)(2), which provides:

“A restriction on the transfer of the beneficial interest of the debtor in a trust that is enforceable under applicable non-bankruptcy law is enforceable in a case under this title.” See, *Patterson v. Shumate*, 504 U.S. 753 (1992).”

As to the trustee's ability to set aside a transfer, Section 548(e) provides the following:

(e)(1) In addition to any transfer that the trustee may otherwise avoid, the trustee may avoid any transfer of an interest of the debtor in property that was made on or within ten years before the date of the filing of the petition, if (A) such transfer was made to a self-settled trust or similar device; (B) such transfer was by the debtor; (C) the Debtor is a beneficiary of such trust, or similar device; and (D) the debtor made such transfer with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made, indebted.

XIII. Rule of Perpetuities Not Applicable to New Hampshire Trusts

Since New Hampshire repealed its rule of perpetuities, a DAPT can be structured to last forever.