

Trusts Used for Asset Protection



Estate Planning Council of North Texas

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Agenda

1. Overview
2. DAPTs
3. Risks
4. Case law and Recent Developments
5. Third Party Fully Discretionary
6. Hybrids
7. Suitability
8. The Practical
9. Distinctly South Dakota
10. Ethics



Trusts

- The term “Trust”
- All Trusts are:
 - **Revocable** or **Irrevocable**
- All Trusts have:
 - (1) Trustor (Grantor), (2) Trustee, (3) Beneficiary
- Optional Roles: Trust Advisors
 - Trust Protector
 - Investment Trust Advisor (not traditional ‘investment adviser’)
 - Distribution Committee

Domestic Asset Protection Trusts



- History
 - It all started with credit cards...
 - S.D. Cod. Laws §§ 55-16-1 - 55-16-16
- Self-Settled
- If properly structured, funded, administered, creditors generally cannot reach assets to satisfy claims against grantor.
- Basic Requirements:
 - (1) be irrevocable;
 - (2) expressly state that SD law governs validity, construction, and administration of trust;
 - (3) contain spendthrift clause;
 - (4) must have at least one “qualified person” as a trustee.
 - **Grantor** does **not** need to be SD resident.

Domestic Asset Protection Trusts

- Term: Typically Grantor's lifetime.
 - Options: perpetual or dynastic term provisions.
- Funding
 - There is no requirement that the trustor be a South Dakota resident, nor that all property of the trust be located in SD.
- While there are no limits to the amount of assets which can be transferred to a South Dakota DAPT, certain assets should not be transferred to such a trust.
 - Generally home (unless QPRT), vacation home, and vehicles are a bad idea.
 - 50% of Net Worth
 - Solvency

Domestic Asset Protection Trusts

- **Grantor may retain** the following rights
 - Veto
 - All income – best to keep fully discretionary
 - Principal
 - 5% annually, HEMS, or Discretionary principal
 - The power to remove or appoint fiduciaries
 - (but Trustee must not be a related or subordinate party)
 - Limited Testamentary or Inter Vivos Power of Appointment
 - Pour-back to RLT or Will
 - The grantor can be an **“Investment Trust Advisor”**
 - The grantor cannot be a Trustee or Trust Protector
- Retain or not?
 - Can disclaim retained powers

Domestic Asset Protection Trusts

- Other Trusts can be DAPT's
 - CRTs, SNTs, SD-INGs, GRATs, GRUTs, QPRTs...
 - Out of state trusts can be brought to SD.
- Contacts with SD
 - Required: SD qualified person designated as trustee meeting requirements of SDCL § 55-3-39. See SDCL § 55-3-41 for definition of "qualified person."
 - (1) SD Resident, (2) Trust Company with principal place of business in SD, (3) Bank with principal place of business in SD
 - Suggested:
 - (1) some or all of trust assets deposited in SD;
 - (2) "administration" of trust occurring wholly or partly in SD
 - (a) physically maintaining records;
 - (b) preparing or arranging for the preparation of income tax returns
 - (c) or otherwise materially participating in the administration of the trust

Domestic Asset Protection Trusts

- Taxes
- Typically styled as a grantor trust for income tax purposes.
- Typically incomplete gift for Gift Tax purposes.
- Advantages:
 - No tax changes. Adjusted or “stepped-up” basis.
- Disadvantages:
 - Exposed to Federal Estate Tax.
- In sum, this version of a DAPT is expressly for grantor’s benefit only, provides asset protection, and grantor’s tax situation should be unaffected.

Domestic Asset Protection Trusts

- Use of business entities
 - LLC or LLLP
- SD has statutorily provided for:
 - Charging Order Protection – sole and exclusive remedy
 - Simply a right to a distribution (if and when one is ever made)
 - Single Member LLC protection
 - DAPT as sole member of LLC

Risks with DAPTs

- Fraudulent Transfer Law.
 - Uniform Fraudulent Transfers Act applies and sets aside transfers with intent to hinder, delay or defraud a specific creditor.
 - Burden of proof: “clear and convincing” evidence.
 - Statute of Limitations
 - Two Years
 - Six Months
 - Uniform Voidable Transactions Act (UVTA). Not adopted in SD.

Risks with DAPTs

- Child Support

- Exception for child support but only “to the extent of the debt” existing “at the time of transfer.”

- Alimony

- Exception for alimony if ex-spouse was married to grantor before or on date of transfer of assets to trust, but the exception applies only “to the extent of the debt” existing “at the time of transfer.”

- Division Upon Divorce

- Possible if ex-spouse was married to grantor before or on date of transfer of assets to trust, but the exception applies only “to the extent of the debt” existing “at the time of transfer.”
- Further: (i) a grantor’s separate property is protected in a divorce, regardless of the date of marriage; and (ii) any marital property transferred to a DAPT is also protected if the settlor’s spouse either receives a specified statutory notice, or provides written consent after having received the information required by the notice.

Risks with DAPTs

- Distributions Received.
 - Once the Trustee actually makes a distribution to the Grantor, the funds cease to be protected from the Grantor's creditors.
- Bankruptcy Law Limitations.
 - Bankruptcy Code provides for a 10-year look-back period for assets transferred to a DAPT.
 - If a bankruptcy is commenced within ten years following a transfer of assets to the Trust, those transferred assets may still be considered a part of the bankruptcy estate (and therefore divisible among the bankrupt's creditors).
 - Important to carefully document all transfers to the Trust.
- Out-of-South Dakota Claims.

Case Law

- Toni 1 Trust v. Wacker, 2018 WL 1125033 (Alaska, Mar. 2, 2018)
- Campbell v. Commissioner, T.C. Memo 2019-14.
- In re Cyr, 2019 WL 1495137 (Bankr. W.D.Tex., April 1, 2019)
- In re Rensin, 2019 WL 2004000 (Bankr. S.D.Fla., May 3, 2019)
- Kaestner - North Carolina Department of Revenue v. The Kimberley Rice Kaestner 1992 Family Trust
- Why is there a lack of case law?

Third-Party Fully Discretionary Irrevocable Trust

- Is irrevocable.
- Grantor creates.
- Beneficiary(ies): Non-grantor spouse and/or children.
 - For asset protection purposes, we typically design the definition of “spouse” to mean the grantor’s legal spouse at the time.
- Term: All options.
 - Lifetime. Or the lifetimes of your children. Or the Trust could continue on in perpetuity.
- Ultimate distribution: All options.

Third-Party Fully Discretionary Irrevocable Trust

- Trustee:
 - Although grantor could be the Trustee, that is not recommended.
 - At least one Trustee of the Trust must be a resident of the State of South Dakota; or, if a corporate Trustee is utilized, a South Dakota trust company or bank.
- Grantor could be the Investment Trust Advisor.

Third-Party Fully Discretionary Irrevocable Trust

- Income taxes.
- Grantor Trust: all income and gains of Trust reported by grantor on individual income tax return.
 - IDGT
 - Trust assets could accumulate tax-free without the payment of the taxes counting as additional gifts to the trust.
- Non-grantor Trust for income tax purposes.
 - Trust itself pays income tax or passes through to beneficiaries.
 - The possible advantage to avoid income tax otherwise payable to other States.
- In some states, it can be difficult to avoid state income tax even with this structure. Special considerations for residents of California and New York.

Third-Party Fully Discretionary Irrevocable Trust

- Completed Gift.
 - The Trust would remove assets from grantor's taxable estate for estate and gift tax purposes.
 - Advantage: Not subject to the federal estate tax.
 - Disadvantage: No adjusted cost basis, although the Trustee could grant certain powers later which would cause estate inclusion (and a corresponding step-up in cost basis).
 - Disadvantage: Using up part of your lifetime "unified credit" against gift tax and estate tax. Currently (2020), that credit (to use during life for big gifts or at death) is \$11.58 Million per person.
- Incomplete Gift. SD-ING Trust option.

Hybrid DAPT

- A “Hybrid DAPT” is a Third-Party Irrevocable Trust that can have a DAPT option within it.
- A “Trust Protector” has the power to add the grantor, or remove grantor, (and add or remove others) as a permissible beneficiary.
- Stated another way, this is basically a Third-Party Fully Discretionary Irrevocable Trust where someone has the power to add or remove beneficiaries.
- However, if the grantor is added as a beneficiary, then a DAPT would be created as a separate sub-trust.

Hybrid DAPT

- So if the grantor is not initially named as a beneficiary, how can he or she access funds?
 - The Trust makes a distribution to spouse (who shares it with the grantor);
 - The Trust makes a distribution to another beneficiary (who shares it with grantor);
 - Grantor could sell assets to the Trust in exchange for a promissory note, so the Trust can get cash flow to grantor by paying down the promissory note; or
 - The Trust could loan money to the grantor for a promissory note in favor of the Trust.
- Only after consideration of all of the above options, the last resort is to ask the Trust Protector to add the grantor as a beneficiary.

Hybrid DAPT

- If grantor is added as a permissible beneficiary, then the Trustee splits the Hybrid Trust into two separate trusts:
 - Trust A = Still a Hybrid DAPT without grantor as a beneficiary; and
 - Trust B = grantor is added in as a discretionary beneficiary and distributions are made to grantor directly.
- Also, with any Trust you can retain the power to hire and fire Trustees, and other powers.

Suitability

- High Net Worth.
- Higher Risk.
 - E.g., doctor shouldn't be worried about malpractice.
- Risk Adverse.

The Practical

- What type to choose?
- Net Worth.
 - Solvency Requirements
- Married?
 - Spousal Notice
- Children?
- Estate Planning.
 - In Estate or Out?
- Grantor vs. Non-grantor.

Practical: Trustees and Trust Advisors

- What makes a good fiduciary?
 - Trust Company or Bank vs. Individual
- Willing and available to act.
- Experience managing another person's affairs.
- Willing to utilize professional advisors.
- Familiarity with your values, family background, preferences, and other special issues.
- Will the corporate trustee invest the time to understand my family and their needs?
- Fees
 - Base fees, set up fees, hourly, basis points (%)

Practical: Trustees and Trust Advisors

- What standards can I expect from the administrator whose decisions directly affect my family?
- Does the administrator realize the goals of my trust?
- Will a corporate trustee's administration and investment services be worth the fees the trustee charges the trust?
- Who handles the Investment Management – bank, trust company, my own advisor?
- Why do you exist serving clients?
- In what areas do you believe consistently need improvement?
- Where does the company inspiration come from to keep adapting?
- Why do you not serve certain types of clients?
- Give me examples of how your collaborative trustee distribution decisions?
- Continuity, generational plan?

Practical: Creating the Trust

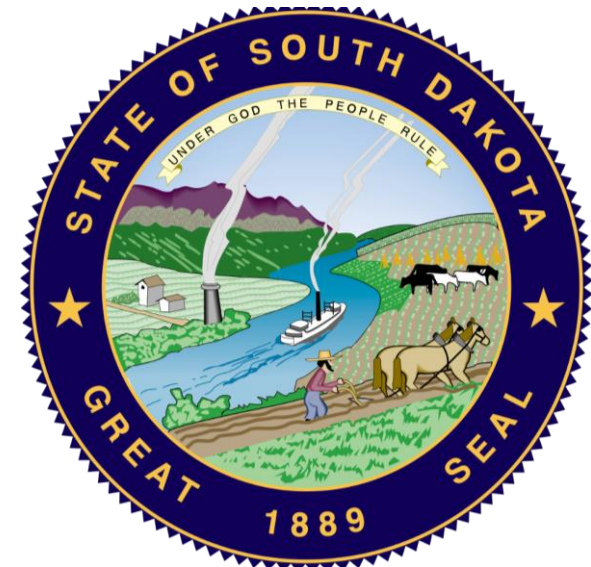
- Initial Meeting or Phone Conference
- Design
- Fees – Know once Design is Chosen
- Draft
- Follow up
- Execution
- Spousal Notice
- Affidavit of Solvency

Funding

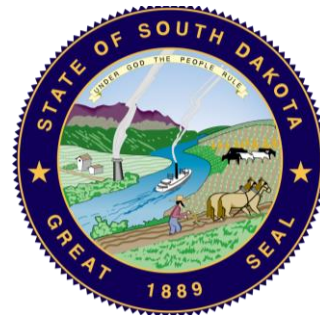
- Who's in charge of getting done?
- Important to Carefully document. Time Tables:
 - 2 years
 - 6 months
 - 10 years

Distinctly South Dakota

- Jurisdiction truly matters, not just APT statutes. Seventeen states now allow for self-settled Domestic Asset Protection Trusts.
- Consistently ranked #1 for Trusts
 - Best Trust Privacy Laws
 - Best DAPT jurisdiction
 - Excellent LLC, LLLP, and Corp liability laws
 - E.g., charging order
 - Best Decanting / Trust modification statutes

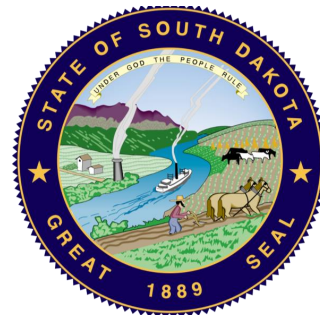


Distinctly South Dakota



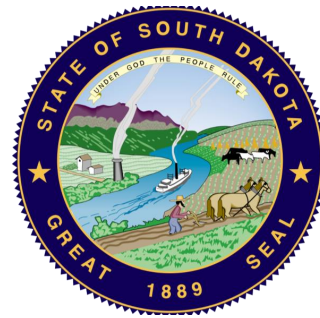
- SD Governor's Trust Task Force on Trust Administration and Reform.
 - State legislature consistently supports DAPTs and related estate planning by continued amendments.
 - Amendments enacted virtually every year from 2005-2019.
- Most state chartered private and public non-depository fiduciary services only trust companies.
- SD leads the nation on the amount of bank assets – assets under management. More than the next two states (Delaware and New York) combined. ~\$3Trillion.
- SD enjoys a Triple A Bond Rating.

Distinctly South Dakota



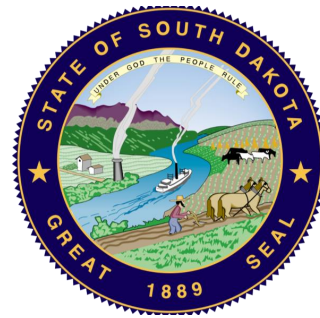
- SD has a constitutional prohibition on the taxation of inheritances.
- SD First state to repeal its RAP in 1983. (DE 1995).
- SD's trust privacy seal is absolute and permanent. Delaware is 3 years.
- SD enjoys 20+ year tradition of enhancing and preserving grantor sovereignty.
- SOL for creditor claim to fraudulent transfer is 2 years and can be shortened to 6 months.
- SD one of only two states that allow for court to award attorney fees and costs to any prevailing party.

Distinctly South Dakota



- SD's quiet trust statutes are most effective.
 - SDCL 55-2-13
- Consistently, for many years, either the #1 or #2 (i) asset protection jurisdiction (trust laws and charging order statutes) and (ii) DAPT statutes. Trust and Estate magazine.
- In 2007 SD adopted first in the nation Third Party Discretionary Trust statutes, SDCL 55-1-24 – 55-1-43.
 - “Discretionary Support Statute” – discretionary interest is not a property interest or an entitlement.
 - AK, NV, DE have more limited versions of these statutes.
- SD has precise conflict of law and public policy statements embedded in state to defend against UVTA.
 - The UVTA.

Distinctly South Dakota



- Special Spousal Trusts – Community Property Trusts by election.
- 1997 – first trust protector statute.
- 2011 – first statutorily authorized special purpose entities to serve as trust advisors.
- 2013 – first to authorize trust owned captive insurance company.
- 2017 – first to modernize virtual representation statutes.
- SD does not have a “tax trap”.
- Statutory protection for attorneys, trustees, and others involved in creation and administration of a DAPT. SDCL 55-16-12.

Ethics

- Myths
- Privacy vs. Hiding



Thank You



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