

## #24: Domestic Asset Protection Trust (DAPT)

According to the American Society for Asset Protection, millions of lawsuits are filed in the United States each year. These claims can arise in a number of different contexts—medical malpractice, premises liability, divorce, support claims, contract claims and violation of statutes (e.g., sexual harassment). Not only are there more claims, the amount of the claims has risen sharply in recent years. For example, the average medical malpractice settlement in the United States in 2019 was approximately \$425,000.

This has led family planners to develop a number of strategies to protect assets from creditors. These include outright gifts of property, various forms of co-ownership, family limited partnerships and LLCs. The most popular strategy, however, is an asset protection trust.

Trusts could always be used to provide creditor protection for beneficiaries. A spendthrift provision could be included in the trust to prevent attachment of trust assets by creditors or assignment of trust assets by beneficiaries. Discretionary distribution provisions provided the same creditor protection. Because the beneficiary of a discretionary trust cannot force the trustee to make distributions, a creditor of the beneficiary cannot do so either.

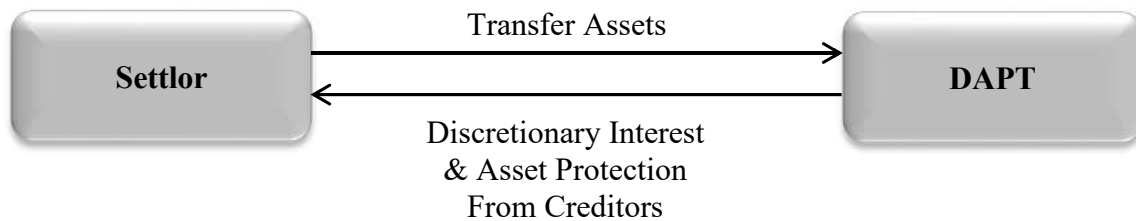
However, a spendthrift or discretionary distribution provision did not prevent creditors from reaching an interest retained in a trust by a settlor. The traditional rule was found in § 156 of The Restatement (Second) of Trusts, which provides that (1) a spendthrift provision does not prevent creditors from reaching a settlor's interest in a trust, and (2) if a trust provides for discretionary distributions to a settlor, creditors can reach the maximum amount that the trustee could pay the settlor or apply for the settlor's benefit. Prior to 1997, this rule applied in every state.

As the demand for asset protection increased, individuals started looking at asset protection trusts (APTs) as a possible solution. Because no state allowed an asset protection trust, however, they turned to foreign jurisdictions. This led to the creation of offshore APTs in the 1980's in places like Belize, the Cayman Islands, the Cook Islands, the Channel Islands, Bermuda and Nevis. Although these trusts became quite popular, many Americans were reluctant to use them because of their cost, complexity and the risk of fines or imprisonment.

As an alternative to an offshore APT, states began enacting new trust laws providing creditor protection for trusts in which the settlor retained a discretionary interest (self-settled APTs). Alaska enacted the first domestic APT (DAPT) statute in 1997 and as of the end of 2019 there were seventeen states that allow DAPTs—Alaska, Delaware, Hawaii, Michigan, Mississippi, Missouri, Nevada, New Hampshire, Ohio, Oklahoma, Rhode Island, South Dakota, Tennessee, Utah, Virginia, West Virginia and Wyoming. The statutes in these states vary substantially.<sup>79</sup>

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<sup>79</sup> See Steve Oshins' "10<sup>th</sup> Annual Domestic Asset Protection Trust State Rankings Chart," available at [http://www.oshins.com/images/DAPT\\_Rankings.pdf](http://www.oshins.com/images/DAPT_Rankings.pdf).



### **Structure of a DAPT**

DAPT statutes vary by state, but all DAPTs have the following features:

- (1) The trust is irrevocable;
- (2) The trustee has absolute discretion to make distributions to the settlor;
- (3) The trust includes a spendthrift clause prohibiting payments to most of the settlor's creditors;
- (4) The trustee is independent of the settlor and a resident of the selected DAPT state;
- (5) Some or all of the trust assets must be located in the DAPT state; and
- (6) Certain special creditors can reach the trust assets (e.g., for child support payments).

### **Estate Planning Benefit**

While the primary goal of a DAPT is to provide asset protection, it may also afford estate planning benefits, serving as an alternative to a spousal limited access trust (SLAT), discussed in another topic in this series. DAPTs enable a taxpayer to give away assets and remove future appreciation from his or her gross estate while retaining the benefit of the assets if needed. They provide more asset protection than a SLAT, but are more complex and require payment of trustee fees outside the family.

### NING Trusts

DAPTs can also be used as state income tax saving trusts. Because the settlor can be given a discretionary interest in these trusts only if creditors cannot reach the trust assets, a DAPT must be used. Of the DAPT jurisdictions, Nevada is currently the best for state income saving trusts. These trusts, commonly referred to as Nevada Incomplete Gift, Non-Grantor (NINGs) Trusts are discussed in another topic in this series.

### **Do DAPTs Work?**

DAPTs remain a controversial strategy. No court has ruled directly on whether they protect assets from creditors. Creditors could make the following arguments that they should not work.

### Fraudulent Transfer

Transfers to a DAPT can be set aside if they violate the fraudulent conveyance statute of the DAPT state or the Federal Bankruptcy Code.<sup>80</sup> The argument can be avoided, however, by creating the DAPT and making transfers before the transferor has any current or foreseeable creditor problems. Full Faith and Credit Clause of the U.S. Constitution<sup>81</sup>

The full faith and credit clause of the U.S. Constitution requires that the courts of one state must recognize the judgments of courts in other states. Thus, if a creditor obtained a judgment in its home state or in the state of the DAPT settlor, the judgment would generally have to be respected in the DAPT state. There is an important exception, however. The DAPT state could refuse to enforce the decision if it had strong public policy reasons for doing so; but it is unclear whether a state's interest in enforcing its DAPT statute would be considered a strong public policy reason.

### Choice of Law Provision May Not Be Respected

DAPTs typically include a choice of law provision requiring that all issues relating to the trust be decided by a court in the DAPT state. If a creditor brought a lawsuit in the debtor's home state (a non-DAPT state), however, the home state might not respect the choice of law provision.

### Bankruptcy Courts

A bankruptcy court must generally apply the law of the state in which it sits. Because the bankruptcy court generally sits in the settlor's home state, it provides no asset protection in bankruptcy for a DAPT settlor from a non-DAPT state.

### **Bottom Line**

DAPTs should work if the settlor is a resident of the DAPT jurisdiction where the trust is created, provided there is no fraudulent transfer. However, if the settlor is from a non-DAPT state, it is not clear whether a DAPT will protect assets from creditors. Although DAPTs have been used for 16 years, there are still no cases addressing this question. This lack of case law suggests, however, that creditors have been deterred from trying to reach DAPT assets, perhaps believing either that such an attempt would be fruitless or that it would not be worth the trouble and expense. Nevertheless, DAPTs should be considered a fairly aggressive strategy and clients should consult an attorney who practices in this area of the law before considering them.

### Income Tax Issues

DAPTs are generally structured as grantor trusts, making them tax neutral for the settlor. The settlor continues to pay income tax on the trust income just as he or she did before the trust was created. Grantor trust status does have important implications for gift and estate tax purposes, though. Payment by the settlor of the trust's income tax liability results in a gift tax-free transfer to the trust beneficiaries. Over time, this transfer of value could be quite substantial. DAPTs can also be structured as non-grantor trusts if the trustees are adverse parties.

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<sup>80</sup> See 11 U.S.C. § 548(e) (allowing courts to look back 10 years for fraudulent transfers).

<sup>81</sup> Article IV, Section 1.

## Gift and Estate Tax Issues

An important advantage of lifetime gifts is that they remove future appreciation from the transferor's estate. Nevertheless, many taxpayers are unwilling to make lifetime gifts because they are concerned that they might need the assets in the future. DAPTs can arguably give a taxpayer the best of both worlds--the tax benefits of a lifetime transfer and the continuing enjoyment of the transferred property as a discretionary beneficiary. To accomplish this result, the transfer to the DAPT must be complete for gift and estate tax purposes so the date of death value is not included in the transferor's gross estate. A transfer to a DAPT is only a completed gift if creditors cannot reach the assets. Because there is still no clear law on whether DAPTs are effective to protect assets from creditors, whether a transfer to a DAPT is a completed gift is still uncertain.

Even if the transfer is complete for gift tax purposes, the transferred property could still be included in the transferor's estate at its date of death value under IRC § 2036 if the transferor retained the possession or enjoyment of the property for life. Thus, there is a question of whether the trustee's discretion to distribute income or principal triggers IRC § 2036. This section will apply if (1) there is an express or implied understanding between the settlor and the trustee that distributions will be made, or (2) that the settlor's creditors can reach the trust assets. Whether there is an implied agreement must be determined by looking at all the facts of the case.<sup>82</sup> Whether creditors can reach trust assets again depends on whether DAPTs are effective against creditors. There is authority holding that if creditors cannot reach trust assets under applicable state law and there is no express or implied agreement, the transfer to the trust is complete for estate tax purposes.<sup>83</sup>

If the DAPT is used as a state income tax saving trust (e.g., a NING), the transferor typically has the opposite objective—making the transfer to the trust incomplete to avoid gift tax or use of unified credit. See the NING topic in this series for a discussion of this issue.

### Disclosures

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<sup>82</sup> See, for example, *Estate of Wells*, TC Memo 1981-574.

<sup>83</sup> *Estate of Uhl*, 241 F2d 867 (7<sup>th</sup> Cir. 1957); *Estate of German*, 7 Cl. Ct. 641 (1985).