Report 4

A complete listing of the proceedings and speakers is available on **the Institute's Web site**

Tuesday, January 6 (Continued)

9:00 - 9:45 a.m.
The Domestic Asset Protection Trust Comes of Age
Richard W. Nenno, Wilmington Trust Company

Reporter: John Warnick Esq.

Dick Nenno used the "Biker Bob" family to illustrate at least seven different ways in which a domestic asset protection trust ("DAPT") can be utilized.

The worst possible candidate for asset protection planning is a client who has or is about to incur a large obligation and wants to hide assets to avoid satisfying this debt.

The "best candidate" for a domestic asset protection trust would be the client who:

1. has no current creditor problems (or at least assets substantially in excess of what is needed to cover current and foreseeable claims);

2. is worried about claims that might arise in the future;

3. has assets that aren't needed to meet current and foreseeable living expenses; and

4. does want frequent access to the assets which are to be protected.

Mr. Nenno noted that virtually all U.S. jurisdictions hold that trusts created for third parties are generally not reachable by the beneficiaries' creditors. Five states (Delaware, Alaska, Nevada, Rhode Island and Utah) now recognize irrevocable self-settled spendthrift trusts.

Mr. Nenno acknowledged a bias against DAPTs and questioned Professor Bogert's assertion that self-settled trusts are generally created with evil intent. After addressing the three reasons offered for refusing to recognize DAPTs, he gave nine reasons why domestic asset protection trusts should be recognized. He noted that all U.S. jurisdictions have rules to set aside fraudulent transfers and cited two recent cases illustrating the application of these rules: U.S. v. Engh, 330 F.3d 954 (7th Cir. 2003) and Nastro v. D'Onofrio, 263 F. Supp. 2d 446 (D. Conn. 2003). Since all five of the domestic asset protection trust states have fraudulent transfer rules, Mr. Nenno concludes that a creditor should be able to reach assets that were the subject of an improper transfer to a DAPT. However, domestic asset protection trusts that do not run afoul of the fraudulent transfer rules should be effective.

Mr. Nenno next reviewed the potential liability of an attorney who either assists or declines to assist a client to create a domestic asset protection trust. He noted that ethical opinions or cases involving the propriety of an attorney's participation in asset protection planning have come down in four states: California, Connecticut, Oregon and South Carolina. They indicate that an attorney might be engaging in an ethical violation if he or she helps a client defraud known or foreseeable creditors, but that there should be no ethical violation if the planning involves unknown and unforeseeable creditors. He also cautioned that the attorney cannot assume he or she will escape ethical problems simply by choosing not to participate in asset protection planning and noted commentators have suggested that it is only a matter of time before a case arises questioning whether an attorney has discharged the duty to represent a client zealously if he refuses to promote a client's lawful asset protection plan.

In his discussion of the tax consequences of domestic asset protection trusts, Mr. Nenno noted that the creator of a DAPT can choose to structure the trust as a completed gift for federal gift tax purposes while still excluding the trust principal from his or her gross estate for federal estate tax purposes if the settler can only receive distributions from the trust in the absolute discretion of an independent trustee. Conversely, the trustor of a DAPT can intentionally prevent a completed gift by retaining a special testamentary power of appointment.

From an income tax standpoint, the domestic asset protection trust will be treated as a grantor trust unless the distributions to the trustor must be approved by an adverse party such as a child who would receive the assets not distributed to the trustor. Mr. Nenno also pointed out that domestic asset protection trusts are being utilized to avoid state and local income and intangible taxes.
Mr. Nenno acknowledged that no case has yet upheld the effectiveness of domestic asset protection trusts. He noted that in early 2003 a rumor had circulated that an Alaska asset protection trust had been breached. In fact, the case in question involved a transfer from an Alaska resident to a foreign asset protection trust that was to be administered in Alaska and was probably fraudulent.

In his discussion of the full faith and credit clause, Mr. Nenno refuted the argument of offshore trust proponents that this constitutional provision and related issues are fatal to domestic asset protection trusts. He noted that the full faith and credit clause will only be relevant when a creditor obtains a judgment against the trustor of a domestic asset protection trust and tries to enforce it in the state where the trust was created or when a creditor seeks to obtain a judgment against a domestic asset protection trust in a jurisdiction that doesn't recognize such trusts.

The full faith and credit clause applies to the "acts" as well as to the "judgments" of another state. Citing *Franchise Tax Board of California v. Hyatt*, 123 S. Ct. 1683 (2003), he noted that the Supreme Court has held that the full faith and credit clause is exacting with respect to a final judgment rendered by a court with subject matter and personal jurisdiction but does not compel a state to adopt a statute adopted by another state. Mr. Nenno pointed out that the Supreme Court has also said "full faith and credit . . . does not mean that states must adopt the practices of other states regarding the time, manner and mechanisms for enforcing judgments." *Baker by Thomas v. General Motors Corp*., 522 U.S. 222, 235. And he cited *Phillips Petroleum Co. v. Shutts*, 105 S. Ct. 2965 (1985) for the proposition that a state court can't ignore statutes of other states.

Dick's conclusion is that the full faith and credit clause is more likely to protect trusts established in Delaware, Rhode Island, Nevada and Utah that have even-handed restrictions on the enforcement of foreign judgments than to be used as a tool to strike down such trusts. He also pointed out that the laws of foreign countries warrant no respect under the full faith and credit clause.

Mr. Nenno offered the following examples of possible uses of the domestic asset protection trusts:

1. to shield a gift or inheritance that is received outright rather than in trust;

2. to protect children who receive significant assets at the age of majority;

3. to protect officers and directors from heightened risks or to allow them to use "blind" domestic asset protection trusts to comply with security law restrictions while keeping the ability to benefit from the trust assets;

4. to avoid state income or intangible taxes;

5. to protect the assets of clients who are mentally, physically or financially vulnerable;

6. to protect assets from claims of future spouses and avoid providing the type of financial disclosure that is required to implement effective prenuptial agreements;

7. to protect personal injury awards (see In re Jordan, 914 F.2d 197 (9th Cir. 1990) for an example of where such a trust would have been helpful);

8. to protect CRTs and other estate planning vehicles such as GRATs, QPRTs, etc. Mr.Nenno pointed out that trustors may be more likely to engage in sophisticated estate planning transfers if they know that the funds might still be available to them in the event of an emergency;

9. nonresident aliens may use domestic asset protection trust before they immigrate to the US to remove assets from their estates while still retaining the ability to get funds back in the event of a future need or catastrophe; and

10. to provide protection for offshore or ineffective domestic self-settled trusts. Mr.Nenno noted that careful consideration must be taken to determine if such a move will causethe trustor/beneficiary to make a completed gift.

Mr. Nenno concluded with an abbreviated comparison of the relative benefits of some of the domestic asset protection trust jurisdictions. For the workshop Wednesday afternoon on domestic asset protection trusts, he has assembled a panel of lawyers from each of the five DAPT jurisdictions. We will report in greater detail on the comparative merits of these jurisdictions after we listen to all five of the panelists.

2:00 - 2:45 p.m.
Bulletproofing the Family Limited Partnership Current Issues.
John Porter

Reporter: Carol Warnick Esq.

For purposes of his discussion, the arguments used by the Service apply to both FLPs and LLCs, but he is going to refer to FLPs.

Various arguments have been used by the IRS to attack FLPs, and to varying degrees of success. Some are:

1. Entity designed solely to reduce transfer taxes. (this is really "lack of economic substance" argument.)

The IRS argument is missing a step. You must identity the property rights that are being transferred. What is being transferred in an interest in the partnership, either an assignee interest or an FLP interest. As appraisers will tell you, discounts apply for lack of control and lack of marketability.

Before you ever look at the gift, you have to see what rights were transferred, and was full and adequate consideration received. The partners have no rights to the underlying assets.

In both the *Lappo* and Peracchio cases discussed in the outline, the Service dropped this argument. This argument is continuing to be dropped out by the Service.

2. Section 2703 Argument.

Strangi addressed this issue. 2703 is not an estate or gift tax inclusion statute. It is a valuation statute, an exception to the willing buyer, willing seller test. It is getting to buy-sell agreements and other types of restrictions on transfer. This is what Judge Cohen said in *Strangi* I that was affirmed by the 5th Circuit. 2703(b) provides a safe harbor.

This argument is dropping out as well, but still being raised a little. Make sure the provisions in your agreement are commercially reasonable. Look to what kinds of restrictions are present in nonfamily partnerships.

3. Gift on formation argument.

Courts have said that where you have a pro-rata partnership and capital accounts are properly handled, there is no gift on formation.

He discussed the *Shepherd* case where a father gifted 25% of the partnership at formation to each son. In this case there was a gift.

The Service is trying to raise a similar argument (depletion of value) in a properly formed pro-rata partnership, but they are losing that argument. It may be raised at the audit level because examining agents often throw in the kitchen sink and expect that the real arguments will be sorted out as the case goes along.

Stone case was a case John Porter handled. He also just tried two other cases which have not been decided yet.

The 2036(a) argument. Elements are a transfer with a retention of interest or retention of the right to designate the persons who will enjoy the property.

(a)(1) involves respecting the entity. At issue here are bad facts such as commingling assets, failure to respect entity, contribution of personal assets (personal residence), insufficient assets outside the partnership upon which to live (helps Service argue there is an implied agreement.), paying taxes out of partnership.

The Service is also looking at what happens after death, even though they probably should not be considering after death actions. He suggests paying taxes through a borrowing arrangement with the partnership, rather then with a distribution or even a redemption because there are valuation issues involved there.

The bona fide sale exception. Do you have to have a bona fide sale **and** full and adequate consideration? In *Stone*, the children's attorneys had input into the terms of the partnership agreement. This is consistent with a commercial partnership.

There is no one fact that the courts have all hung their hats on.

He reviewed an audit letter he received from the IRS and suggests going through such letters as a way of thinking through everything prior to creation of the entity.

Make sure your files show nontax reasons for setting up this partnership.

Mentioned defined value clauses and noted that they just filed the appeal in *McCord* on Monday.

More specifics will be discussed at the break-out session tomorrow.
