Can You Really Have Your Cake and Eat it Too?

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Mark Krogstad and Matthew Van Heuvelen, *Domestic Asset Protection Trusts: Examining the Effectiveness of South Dakota Asset Protection Trust Statutes for Removing Assets from a Settlor's Gross Estate*, 61 **S.D. L. Rev.** 378 (2016).

Self-settled domestic asset protection trust (DAPT) are trusts that permit a settlor to use a spendthrift provision in a trust where he is also a beneficiary to protect his assets from creditor claims. DAPTs evolved from offshore asset protection trusts which historically allowed self-settled asset protection trusts. Today, a majority of states within the US do not permit a settlor to create such a trust. DAPTs defy logic in that a person should not be able to place their assets in trusts, benefit from the trust, and then not have those funds available to pay to their debts. Yet, these trusts continue to gain popularity in the United States. A number of jurisdictions have enacted laws that permit self-settled DAPTs. Alaska was the first state in the U.S. to adopt DAPT law, and fifteen states, including South Dakota, the subject of this article, followed.

Since these trusts are relatively new, there are still questions regarding when or whether assets are protected from creditor claims and which transfer taxes are applicable. The answers to these question are found in the statutory provisions. In analyzing the DAPT, determining the level of control the settlor has retained in the trust is the key. In their article, Mark Krogstad and Matthew Van Heuvelen explore the estate and gift tax implication of South Dakota's DAPT laws. This interesting article provides practical information for practitioners, scholars and professors who, draft, study and/or teach DAPT laws from any state.

Although they acknowledge that the primary motivation for DAPTs is to protect assets from judgements and creditor claims, their article focuses on the estate and gift tax implications. The authors point out how creditor access to a DAPT affects whether the transfer to the trust was a completed gift for transfer tax purposes. For instance, a purely discretionary trust does not give beneficiaries an enforceable right to compel trustee to make a distribution. Since a creditor does not have more rights than a beneficiary, it follows that a creditor will also not have the power to compel a distribution.

The original version of South Dakota's DAPT laws provided exceptions for payments of alimony, child support and tort claims against the settlor. According to the authors, this could have been significant in that it risked creating liability for estate taxes because the trust was subject to creditor claims and thus treated as property of the settlor . Subsequently, however, South Dakota changed its laws to provide even more protections for settlors. In 2011, South Dakota eliminated the exception for tort claims and in 2013, it eliminated the exception for child support and alimony obligations that arose after a property transfer to a DAPT. These changes eliminated virtually all creditor claims against the trust and makes the transfer more like a completed gift than ever before.

While Krogstad and Van Heuvelen acknowledge that keeping the property out of the reach of creditors is a primary concern, they also acknowledge the settlor's competing interest—settlor must actually give up dominion and control, which could trigger a gift tax. They further explain that settlors tend to retain a certain level of control over the property based on the concern that they may need access to the property in the future. To balance these interests, settlors often retain an inter vivos or testamentary non-general power of appointment. Even with balancing the issue of retaining power, but not too much power, there is the added effect of the settlor as a beneficiary of his/her own trust. Krogstad and Van Heuvelen indicate this issue is often eliminated by choosing an independent trustee and making the trust a purely discretionary trust. In the case of a purely discretionary trust, the settlor does not have the right to compel a distribution and therefore lacks the kind of control that would be tantamount to ownership.

Krogstad and Van Heuvelen explain that if the transfer to the DAPT is not a completed gift, then the property will likely be included in the gross estate under I.R.C. §§ 2036 and/or 2038 because of the retained beneficial interest, direct (power of appointment) or indirect control (implied agreement). Even so, their focus, in determining whether the property was included in the gross estate, is whether creditors have a right to use the property to satisfy the settlor's debt under the South Dakota DAPT laws.

Guidance, the authors say, is found in the IRS's Private Letter Rulings (PLR) 98-37-007 and 2009-44-002. PLR 98-37-007 was requested to determine whether a proposed transfer to an Alaska Trust was subject to an estate or gift tax. The trust was a discretionary irrevocable trust with settlor/beneficiary as a permissible distributee with no express or implied agreement with the trustee. Further, the settlor had no known prior or future debt and was not under an obligation for an order child support. The PLR indicated the proposed transfer would be subject to the gift tax but made no definitive ruling as to whether the estate tax was applicable. PLR 2009-44-002 was also requested to determine the estate and gift tax implication of a transfer to an Alaska Trust. The trust was established as an irrevocable spendthrift trust in which settlor/beneficiary was also a permissible distributee. This trust specifically prohibited settlor, his estate, his creditors and the creditors of his estate from receiving income or principal at termination. This PLR also concluded that a gift tax was triggered and took a step further to indicate the trustee's discretionary authority to distribute income or principal to settlor was not, by itself, enough to implicate IRC § 2036.

While both PLRs were based on Alaska trusts and the IRS did not conclusively indicate the estate tax implications of these transfers, Krogstad and Van Heuvelen argue because creditors cannot reach the assets, the property should be excluded from the gross estate. In applying this logic to the revised South Dakota DAPT laws, which strengthened the protections against creditors, they conclude the new DAPTs laws are less susceptible to creditors and more likely to avoid estate taxes. They specifically suggest the South Dakota DAPT is an option for those settlors who are leery of traditional irrevocable trusts because they may need some access to the funds. As a result, these settlors would have the benefit of their property without exposing the property to creditor claims, in essence, they can have their cake and it too.

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