THE MYTHS AND REALITIES OF NEVADA SELF-SETTLED ASSET PROTECTION TRUSTS

BY ELIZABETH BRICKFIELD, ESQ., VAR LORDAHL, ESQ. AND MATTHEW POLICASTRO, ESQ.

For more than a decade, certain states have permitted individuals to create self-settled asset protection trusts without the need to rely on an off-shore locale's trust laws. Recognition of these domestic asset protection trusts (DAPTs), was first added to Nevada law in 1999. Nonetheless, the function and effect of a Nevada DAPT remains a mystery to many Nevada legal practitioners. This article will lay the basic groundwork for how a Nevada DAPT differs from a traditional third-party spendthrift trust, the protections it offers the settlor and current issues affecting its enforceability.

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What is a Traditional Third-Party Spendthrift Trust?

Individuals who make an outright gift of property to their children or other recipients run a number of risks. If the gift is money, the child may spend it; if the gift is property, the child may encumber it. A creditor of the child may levy upon the property, or a soon-to-be-former spouse may obtain a one-half interest in the property under certain circumstances.

One way to mitigate these risks is to simply not make the gift at all – in this scenario, neither the child, nor the child's creditor, has any access to the property. Another method is the use of a traditional third-party spendthrift trust, under which the child (or other beneficiary) is a third-party, subject to the protections and limitations of the trust. A common structure of such arrangements involves a settlor transferring property to an irrevocable trust, wherein the settlor also acts as trustee; the settlor's children (or any other third parties) are listed as beneficiaries.

The beneficiaries may receive distributions at the absolute discretion of the trustee, or often the trustee has the ability to make distributions of income and principal to the beneficiaries solely for the beneficiaries' "health, education, maintenance and support" (a HEMS provision). Generally, a creditor of a beneficiary may obtain only the same rights to the trust property as that beneficiary possesses. A beneficiary under such a trust has no enforceable right to demand distributions. Therefore, the beneficiaries' creditors are similarly unable to force distributions from the trust. Such a trust will also contain a spendthrift provision, which further limits the ability of a beneficiary to encumber his or her beneficial interest.

Therefore, third-party spendthrift trusts offer a middle ground between making an outright gift or not making a gift at all. The beneficiaries get the benefit of enjoying the property, subject to some level of trustee control, but the creditors of the beneficiaries are unable to reach the property in the trust. This basic arrangement has persevered in American legal doctrine for centuries.

What is a First-Party Spendthrift DAPT?

The preceding paragraphs focused exclusively on protecting a third-party beneficiary's interest in a trust from creditors; however, despite the benefits, settlors are often loath to relinquish complete ownership and usage of their property to an irrevocable trust.

Nonetheless, at common law, settlors naming themselves as beneficiaries of a spendthrift trust do not enjoy the above creditor protections — such self-settled first-party spendthrift trusts were not recognized by courts as valid devices against a settlor's creditors. In the past, in order to obtain such protections U.S. citizens often looked to offshore locales to create spendthrift trusts that would protect themselves and their beneficiaries from creditors.

The Nevada Self-Settled Domestic Asset Protection Trust

In 1999, in the wake of other states passing such laws, the Nevada Legislature amended NRS Chapter 166 to permit self-settled, first-party spendthrift trusts, commonly referred to as Nevada DAPTs. As long as settlors strictly comply with statutory requirements, they can name themselves as discretionary or HEMS beneficiaries of their own trusts and enjoy the same creditor protection as third-party beneficiaries of the trust.

Any attorney endeavoring to create a Nevada DAPT should take great pains to follow all the requirements of NRS Chapter 166. Subject to various other conditions, there are five main requirements when forming a Nevada DAPT:

1. At least one trustee must be a natural person who resides or is domiciled in Nevada, or a bank or trust company that maintains an office in Nevada;[1]
2. The trust must be in writing;[2]
3. The trust must be irrevocable;[3]
4. The trust must not require that any part of the income or principal of the trust be distributed to the settlor;[4] and
5. The trust must not be intended to hinder, delay or defraud known creditors.[5]

In addition to the above, NRS Chapter 166 also permits the settlor to retain various useful powers without affecting the creditor protection it affords. Such powers include, in part:

1. The power of the settlor to veto trust distributions;[6]
2. A retained special power of appointment by the settlor (either of these first two powers deem the transfer to the trust incomplete for federal gift tax purposes);[7] and
3. The power of the settlor to use real or personal property owned by the trust.[8]

Any transfers to a Nevada DAPT are still subject to Nevada's full range of fraudulent transfer laws under NRS Chapter 112. Such actions, however, are constrained by a special two-year statute of limitations. Specifically, NRS 166.170 provides, in pertinent part, that an action with respect to a transfer of property to a Nevada DAPT is only valid if commenced within two years after the transfer is made, or six months after the person discovers, or reasonably should have discovered, the transfer. Nevada's two-year statute of limitations is one of the shortest in the country, and combined with its other positive features, many practitioners believe a Nevada DAPT to be the best in the nation.

In short, Nevada's DAPT laws extend the same creditor protection third-party beneficiaries have always enjoyed, to the settlor of the trust, while still prohibiting the creation of DAPTs to fraudulently thwart creditors. Just as an individual with no known creditors is free to give away his property (and thereby protect it from future, unknown creditors), an individual may instead contribute that property to a Nevada DAPT.

Are There Any Pitfalls or Concerns Associated With Nevada DAPTs?

Given the relative recentness of domestic DAPT laws, there are a number of legal vagaries and pitfalls associated with their usage. First, in the case of bankruptcy, Bankruptcy Code 548(e)(1) provides the bankruptcy trustee with a 10-year look-back period, during which property fraudulently transferred to a DAPT may be unwound. Though the case law is sparse, a recent bankruptcy court decision confirmed that, in cases of transfers to a DAPT with obvious subjective fraudulent intent, a bankruptcy trustee may reach such property.[9]

Additionally, while a Nevada court resolving a dispute over Nevada property

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transferred to a Nevada DAPT would be bound by NRS Chapter 166, it is unclear whether or not courts in other states would have to follow Nevada law. For example, if a dispute arose over a piece of California real estate transferred to a Nevada DAPT, such a suit would likely arise in a California court. Historically, California has a strong public-policy objection to self-settled DAPTs; for this reason a California court may decline to enforce Nevada's law. These concerns are also present in a federal court setting, wherein the federal court must select which state's laws apply — and public policy concerns often sway such a decision.

One unpublished California Court of Appeals decision upheld a trial court's determination that a transfer to a Nevada DAPT constituted a fraudulent conveyance under both California's and Nevada's Uniform Fraudulent Transfer Act, even where no creditor claims existed at the time of transfer, and no creditor claims were "reasonably foreseeable."[10]

Finally, some practitioners believe that where (for example) a judgment is entered in California against certain property held in a Nevada DAPT, a Nevada court would be required to carry out the judgment under the Full Faith and Credit Clause of the United States Constitution.

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Until some additional substantive, relevant case law is generated in this area, every practitioner will have his or her own view as to the effectiveness of a Nevada DAPT in a multi-state, choice-of-law setting. At the very least, it appears, from the current case law, that the fewer contacts between a Nevada DAPT and other jurisdictions, the better. Nonetheless, placing assets (even out-of-state assets), into a Nevada DAPT often provides strong negotiating leverage against out-of-state creditors, who are also often stymied by the lack of available legal precedent.

Thus, so long as the settlor did not fraudulently transfer property into the trust, the Nevada DAPT attempts to extend to the settlor the same protections that have traditionally been afforded only to third-party beneficiaries. NL

1. NRS 166.015(2).
2. *Id.*
3. NRS 166.040(1)(b).
4. *Id.*
5. *Id.*
6. NRS 166.040(2)(a).
7. NRS 166.040(2)(b).
8. NRS 166.040(2)*(h)*.
9. *Waldron v. Huber* (*In re Huber*), 2013 WL 2154218 (Bk.W.D.Wa., Slip Copy, May 17, 2013).
10. *Kilker v. Stillman,* 2012 Cal. App. Unpub. LEXIS 8542 at *6-7.

ELIZABETH BRICKFIELD is a member in the Las Vegas office of Dickinson Wright PLLC, whose practice includes probate, guardianship, trust and estate administration and litigation, family law and estate planning. Brickfield obtained her J.D. from Brooklyn Law School and her LL.M. in taxation from New York University.

VAR LORDAHL is of counsel to the Las Vegas office of Dickinson Wright PLLC, whose practice includes estate planning, taxation, nonprofit and probate law. Lordahl obtained his J.D. from the University of Illinois and his LL.M. in taxation from New York University.

MATTHEW POLICASTRO is a member in the Las Vegas office of Dickinson Wright PLLC, whose practice includes estate planning, taxation, nonprofit and probate law. Policastro obtained his J.D. from Syracuse University and his LL.M. in taxation from Georgetown University.