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The Nevada Asset Protection Trust

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Only four states have statutes that allow the settlor of a trust to establish a trust in which the settlor is a permissible beneficiary, which is also protected from the creditors of the settlor (a "self-settled spendthrift trust" or "asset protection trust"). Those states are Alaska, Delaware, Nevada and Rhode Island. Colorado and Missouri have statutes that are somewhat similar, but since there is a general belief that the statutes in those two states do not work, they are not included among the list of states that have effective self-settled spendthrift trust laws.

Of the four favorable jurisdictions, Alaska has received the most publicity, most likely because it was the first state to create such a law, and because of the heavy marketing being done by the Alaska trust companies.

However, as will be explained in more detail, Nevada has the most favorable self-settled spendthrift trust laws because of its much shorter statute of limitations period, and therefore should be the jurisdiction of choice for asset protection trusts.

Nevada's Spendthrift Trust Act

Effective Oct. 1, 1999, Chapter 166 of the Nevada Revised Statutes ("NRS") was amended to allow a settlor to create a trust under Nevada law that is protected from the creditors of the settlor.

More specifically, under NRS §166.040 (1)(b), the settlor of a Nevada self-settled spendthrift trust is protected" if the writing is irrevocable, does not require that any part of the income or principal of the trust be distributed to the settlor, and was not intended to hinder, delay or defraud known creditors."

In addition, under NRS §166.015(2), at least one trustee must be (a) a natural person who resides and has his domicile in Nevada, (b) a trust company that is organized under federal law or under the laws of Nevada or another state, and that maintains an office in Nevada for the transaction of business, or (c) a bank that is organized under federal law or under the laws of Nevada or another state, that maintains an office in Nevada for the transaction of business, and that possesses and exercises trust powers.

Why Nevada Laws Are Superior

The self-settled spendthrift trust laws of Alaska, Delaware and Rhode Island are very similar to those of Nevada, although each of the four states' laws have minor differences.

However, the Nevada laws have one major advantage that is so advantageous that it is difficult to justify establishing a self-settled spendthrift trust using the less favorable laws of Alaska, Delaware or Rhode Island. This advantage lies in the shorter period of time required under Nevada law between the date an asset is transferred to the trust and the date the asset is protected from the creditors of the settlor.

Under NRS §166.170, a person may not bring an action with respect to a transfer of property to a Nevada spendthrift trust (1) if he is a creditor when the transfer is made, unless the action is commenced within (a) two years after the transfer is made, or (b) six months after the creditor discovers or reasonably should have discovered the transfer, whichever is later, or (2) if he becomes a creditor after the transfer is made, unless the action is commenced within two years after the transfer is made

Conversely, under the laws of Alaska, Delaware and Rhode Island, if the creditor is a creditor when the trust is created, the creditor must bring the cause of action within the later of four years after the transfer is made or one year after the transfer could have reasonably been discovered by the creditor, or if a person becomes a creditor subsequent to the transfer, the creditor must bring the cause of action within four years after the transfer to the trust. See Alaska Stat. §34.40.110(d), Del. Code Ann. tit.12, §3572(b)(2) and R.I. Gen. Laws §18-9.2-4, respectively.

If an asset protection planner advises a client to establish a domestic self-settled spendthrift trust, all other things being equal, if the client is sued during years three or four (or between six months and one year after the transfer with respect to a creditor existing at the time of the transfer), it may be indefensible to have selected Alaska, Delaware or Rhode Island as the jurisdiction for the trust.

Just as people traditionally establish Nevada or Delaware corporations because of their favorable corporate laws, it is just as important, if not more important, to select the most favorable jurisdiction for asset protection trusts. As Mark Dreschler, president of Premier Trust of Nevada, Inc., often says, "[t]he primary reason people all over the country are

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choosing Nevada for their asset protection trusts is the shorter statute of limitations."

Combining The Trust With A Family Limited Partnership

Since the settlor of an asset protection trust may not act as a trustee, there is a perception that there will be a loss of control over the trust. However, control can be maintained by combining the trust with one or more family limited partnerships.

A family limited partnership ("FLP") is a limited partnership among family members or trusts for the benefit of family members. Just like any limited partnership, there must be at least one general partner and at least one limited partner. Like all limited partnerships, the general partners have control over the partnership and are liable for partnership debts. The limited partners have no voting control, and their liability to creditors is limited to their capital contribution.

Under the laws of most states, a creditor who obtains a judgment against a partner of a limited partnership may obtain a charging order against the partnership interest.

A charging order gives the judgment creditor the right to some or all distributions made from the partnership on account of the charged interest. The charging order is an unattractive remedy for the creditor because the family will probably never make a distribution from the partnership knowing that the creditor will take it.

In addition, there is a popular belief that under Revenue Ruling 77-137 the owner of the charging order would be taxed on the partnership income attributable the charged interest whether or not the partnership distributes any of its income. Most practitioners do not believe that Revenue Ruling 77-137 stands for this proposition. However, just the threat of this so-called "KO by the K-1" is often enough to persuade a favorable settlement for the debtor.

The FLP is used in order to keep the control in the hands of the client rather than in the hands of the trustee of the asset protection trust. For example, the client can be the 1 percent general partner, thereby exercising the control over the partnership assets, and the asset protection trust can be the 99 percent limited partner, having no control. If the client is sued after the statute of limitations period, 99 percent of the partnership is protected from the creditor.

It is important to establish the family limited partnership in a state (such as Nevada) in which the charging order is the exclusive remedy of a judgment creditor. Many asset protection planners do not realize that although the charging order is a remedy in most states, only a few states actually make it the *exclusive* remedy.

Combining The Trust With A Limited Liability Company

Another option to maintain control in the hands of the client is to form a limited liability company ("LLC") to own the trust assets. The asset protection trust can own 100 percent of the LLC, yet the client can maintain control over the assets by acting as the operating manager of the LLC.

As a second layer of protection, and similar to the FLP strategy, the LLC should be formed under the laws of a state (such as Nevada) which makes the charging order the *exclusive* remedy of a judgment creditor.

Integrating A Third-Party Created Trust

An even greater degree of asset protection can be achieved if the client sells the 1 percent general partnership interest to an irrevocable trust set up by the client's parent for the benefit of the client and his family.

Similarly, the trustee of the asset protection trust can sell the 1 percent voting membership interest (in an LLC structured as 1 percent voting and 99 percent non-voting) to such an irrevocable trust. The 99 percent limited partnership interest (or the 99 percent non-voting membership interest) would continue to be held by the Nevada self-settled asset protection trust.

Because the irrevocable trust is set up by the client's parent, it is asset and divorce protected even though the client can serve as trustee. For maximum asset protection, an independent trustee should be given absolute discretion over discretionary distributions to the beneficiaries. In such case, the client would serve as investment trustee and would have the power to remove and replace trustees so as to maintain indirect control over the distributions. Additionally, the trust would be drafted so that its assets are not included in the client's estate.

As an ancillary benefit of moving the 1 percent controlling interest out of the client's estate, upon his death the fair market value of his estate would be reduced by a valuation discount to reflect the fact that the assets in the estate are all non-voting. Thus, even though the client maintains control of all of the assets in a fiduciary capacity, since the controlling interest has been removed from his estate, the value of the estate assets is reduced for estate tax purposes. Consequently, not only is asset protection achieved, but significant estate tax savings may be obtained as well.

Summary

Only four domestic jurisdictions allow the functional equivalent of an offshore asset protection trust. Of the four states, Nevada has the shortest statute of limitations and thus should be the jurisdiction of choice for domestic asset protection planning.

One or more FLPs or LLCs may be integrated into the asset protection plan in order for the client to maintain control over the trust assets.

In addition, the voting interests may be sold to a third-party created trust for the benefit of the client in order to obtain an additional layer of asset protection, as well as to reduce the value of his taxable estate.

Thus, asset protection and estate tax protection may be obtained even though the client is the controlling trustee of the trust created by his parent.

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