Asset Protection Trusts in Texas? Really?

by Amy P. Jetel

The last hundred years of our history has fostered an increasing number of risks to individual wealth. For instance, the United States judicial system has developed in a way that causes many individuals to feel exposed to legal judgments that are wholly disproportionate to any actual liability. This fear, along with a general distrust of governmental regulatory agencies and the potential liability arising from future legislation, has led many individuals to look for ways to protect themselves from these risks.

The "spendthrift trust" (which protects a trust's assets from the claims of a non-settlor beneficiary's creditors) was created at the end of the 19th century in response to the general social fear and unease arising out of the unstable economic and business environment during those times.[1] Though creditors and many scholars disliked spendthrift trusts,[2] individuals demanded them, courts approved of them,[3] and by the first part of the 20th century, nearly every state had adopted the spendthrift trust concept by either statute or common law.[4] State legislation allowing spendthrift trusts was passed in response to a concern that property conveyed in trust for beneficiaries would be used as collateral for the beneficiary's debts or otherwise imprudently assigned by a financially irresponsible, or "spendthrift," beneficiary.

Given the merit of a settlor's desire to protect a beneficiary from himself, some states' legislatures agreed to codify this concept, and other states' courts approved it under common law. But they balanced this arguably pro-debtor result with the corresponding concept that an individual should not be able to use a trust to protect assets for his or her own benefit. Thus, in the United States, spendthrift trust statutes and case law historically prohibited a person from setting a spendthrift trust for his or her own benefit (called a "self-settled spendthrift trust"). Many non-U.S. jurisdictions, however, allow a settlor to be a beneficiary of a trust that contains anti-alienation provisions similar to a spendthrift trust, thereby protecting the settlor's beneficial interest in the trust from the claims of his creditors—this is otherwise known as an "asset protection trust." This feature of non-U.S. law, along with other asset-protective aspects of offshore jurisdictions, has led many U.S. persons to settle trusts in foreign jurisdictions.

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1 The worldwide economic downturn of 1873–1896 is referred to as the "Long Depression."

2 *See, e.g.*, Jesse Dukeminier and Stanley M. Johanson, *Wills, Trusts, and Estates* (Aspen Law & Business, 6th ed., 2000), at 632, citing J. Gray, *Restraints on the Alienation of Property* (1883).

3 *See Nichols v. Eaton*, 91 U.S. 716 (1875); *Broadway National Bank v. Adams*, 133 Mass. 170 (1882).

4 Dukeminier and Johanson at 632, citing J. Gray, *Restraints on the Alienation of Property* (2d ed., 1885) ("State after State has given in its adhesion to [the spendthrift trust] doctrine . . . and yet I cannot recant").

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However, over the last couple of decades, the attitude in the United States toward asset protection trusts has been shifting, and now 15 states have passed legislation that, to one extent or another, allows for the creation of domestic asset protection trusts.[5]

Although many estate planners think that "asset protection" planning is distinct from "traditional" trust and estate planning, limited liability has always been a fundamental part of our legal system and a core estate-planning concept. The fundamental nature of asset protection in our legal system can be seen most clearly in each state's statutory and common-law vehicles for sheltering assets from creditors' claims while allowing the debtor to have the continued use and benefit of the sheltered assets. For example, corporations, limited liability companies, limited partnerships, retirement plans, life insurance, annuities, homestead, and of course, spendthrift trusts, are all time-honored estate-planning and wealth-protective vehicles. In short, estate planning by its very nature has always been an exercise in asset protection planning, as its goal is to preserve wealth for current and future generations.

Texas, like most states, protects assets held in a spendthrift trust from the claims of the beneficiaries' creditors,[6] and Texas is one of the most protective states in this regard, as the only exception to spendthrift protection in Texas is a claim for child support.[7] However, also like most states, it was impossible to create an "asset protection" trust under Texas law[8]—until recently.

In 2013, the Texas legislature revised section 112.035 of the Texas Trust Code (the spendthrift trust statute) to add significant exceptions to the prohibition against spendthrift protection for self-settled trusts.[9] As discussed in greater detail below, the revised statute provides expansive opportunities for spouses to use inter vivos trusts to shield their assets from creditors, and it also opens the door to using powers of appointment as a mechanism for establishing an asset protection trust (of sorts) in Texas.[10]

A new subsection (g) to the Texas spendthrift trust statute opens with:

> "For the purpose of this section, property contributed to the following trusts is not considered to have been contributed by the settlor, and a person who would otherwise be treated as a settlor or a deemed settlor of the following trusts may not be treated as a settlor . . ."

At the outset, this new language begins to unwind the historical prohibition against spendthrift protection for self-settled trusts in Texas by no longer treating a settlor-beneficiary of certain types of trusts as the "settlor."

So what types of trusts get this special treatment? Primarily, trusts created for, or by, the settlor's spouse, and secondarily, trusts over which someone other than the settlor held a general power of appointment or exercised any power of appointment.

We will review each provision of the 2013 amendments in turn, but first it will be helpful to provide context with a short summary of the Texas spendthrift trust statute as it was originally enacted and the amendments that were made to the statute prior to 2013.

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5 Alaska, Delaware, Hawaii, Mississippi, Missouri, Nevada, New Hampshire, Ohio, Oklahoma, Rhode Island, South Dakota, Tennessee, Utah, Virginia, and Wyoming.

6 Tex. Prop. Code Ann. § 112.035(a), (b). (Note that Subtitle B of Title 9 of the Texas Property code is referred to as the "Texas Trust Code").

7 Tex. Fam. Code. Ann. § 154.005.

8 Tex. Prop. Code Ann. § 112.035(d); *Daniels v. Pecan Valley Ranch, Inc.* 831 S.W.2d 372 (App. 4 Dist. 1992, writ denied) (holding that a "[s]ettlor cannot create [a] spendthrift trust for his own benefit and have [the] trust insulated from [the] rights of creditors."); *see also First Bank and Trust v. Goss*, 533 S.W.2d (Civ. App. 1976).

9 See Exhibit A for a copy of Section 112.035 reflecting the 2013 amendments.

10 All asset protection planning is subject to fraudulent transfer restrictions—that is, a person cannot make a transfer with the intent to hinder, delay, or defraud existing or reasonably foreseeable creditors; future creditors are not protected by fraudulent transfer law, and rightfully so. *See* Tex. Bus. & C. Code, Title 3, Ch. 24, for the Texas Uniform Fraudulent Transfer Act. An in-depth discussion of fraudulent transfer considerations is outside the scope of this paper.

Brief History of Amendments to the Texas Spendthrift Trust Statute Prior to 2013

The current Texas spendthrift trust statute was enacted in 1983. The statute as originally enacted stated that a settlor may provide in the terms of a trust instrument that the interest of a beneficiary may not be voluntarily or involuntarily transferred, and that a declaration in a trust instrument that the interest of a beneficiary shall be held subject to a "spendthrift trust" is sufficient to restrain the voluntary or involuntary alienation of a beneficiary's interest in the trust.[11]

The original statute went on to provide that if the settlor is also a beneficiary of the trust, a spendthrift provision will not prevent the settlor's creditors from satisfying claims from the settlor's interest in the trust estate.[12] For this purpose, a beneficiary is not considered a "settlor" of the trust if the beneficiary: (1) holds or exercises the power to consume, invade, appropriate, or distribute property to himself, if the power is exercisable only with the consent of an adverse party or is limited by an ascertainable standard (health, education, maintenance, and support); or (2) holds or exercises a lifetime limited power of appointment or a testamentary limited or general power of appointment.[13]

In 1995, as a matter of public policy, a specific exception to spendthrift trust protection was added to the Texas Family Code which allows a court to order the trustee of a spendthrift trust to make distributions from the trust to satisfy the beneficiary's child-support obligations.[14]

In 1997, the spendthrift trust statute was amended to provide that a beneficiary will not be considered a "settlor" of a trust merely because of a lapse, waiver, or release of: (1) a lifetime limited power of appointment or a testamentary limited or general power of appointment; or (2) a right to withdraw a part of the trust property to the extent that the value of the property affected by the lapse, waiver, or release in any calendar year does not exceed: (i) the greater of $5,000 or 5% of the trust assets; or (ii) the federal gift tax annual exclusion amount, whichever is greater.[15]

In 2007, a clause was added to the general prohibition against spendthrift protection for a self-settled trust, stating that a settlor will not be considered a "beneficiary" of a trust "solely because a trustee who is not the settlor is authorized to pay or reimburse the settlor for, or pay directly to the taxing authorities, any tax on trust income or principal that is payable by the settlor under the law imposing the tax."[16]

This brings us to the 2013 amendments to the Texas spendthrift trust statute, which are the focus of this paper.

Section 112.035(g)(1):
Spousal Trusts That Qualified for the Federal Gift Tax Marital Deduction

The first 2013 addition to the Texas spendthrift trust statute provides that the settlor will not be deemed a "settlor" of an irrevocable inter vivos marital trust, as long as the settlor's gift to the trust qualified for the federal gift tax marital deduction, either by making the "QTIP" election[17] or by giving the spouse a testamentary or inter vivos general power of appointment ("GPOA") over the trust property.[18] (In each case, the donee spouse is entitled to receive the income of the trust for life.) If either of these requirements is met under the Internal Revenue Code, then the settlor can become a beneficiary of the trust upon the death of his spouse—at which time he will no longer be considered the "settlor"—and the trust assets will be fully protected from the claims of his creditors under the Texas spendthrift trust statute.[19]

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11 Tex. Prop. Code Ann. § 112.035(a) and (b).

12 Tex. Prop. Code Ann. § 112.035(d).

13 Tex. Prop. Code Ann. § 112.035(f) (originally, subsection (e)). The recent case of *Faulkner v. Kornman*, 2015 WL 6444955, illustrates the protection of spendthrift trusts in the bankruptcy context. In that case, the Bankruptcy Court recognized a Texas trust as being a valid spendthrift trust when the sole beneficiary was serving as trustee and the trustee's power to make distributions was limited by an ascertainable standard. Although the Bankruptcy Court held that the trust corpus could not be reached to satisfy a judgment, the Court left open the question whether distributions in excess of the ascertainable standard would be reachable.

14 Tex. Fam. Code Ann. § 154.005.

15 Tex. Prop. Code Ann. § 112.035(e).

16 Tex. Prop. Code Ann. § 112.035(d).

17 That is, the "Qualified Terminable Interest Property" election under IRC § 2523(f).

18 Under IRC § 2523(e).

19 Tex. Prop. Code Ann. § 112.035(g)(1).

Assets held in a QTIP or GPOA trust will be included in the donee spouse's gross estate, and the donee spouse becomes the new "transferor" of those assets for federal tax purposes.[20] Therefore, this change to the Texas statute merely causes Texas debtor/creditor law to follow federal transfer tax law's view of who the new "settlor" should be.

Section 112.035(g)(2): Spousal Trusts That Did Not Qualify for the Gift Tax Marital Deduction

While it is easy to see the logic behind the special treatment of QTIP and GPOA trusts, the legislature's reasoning behind the second new provision of the Texas spendthrift trust statue is less easy to discern. Simply stated, this subsection provides that a settlor will not be treated as the "settlor" for purposes of the spendthrift trust statute of any irrevocable trust created for his spouse of which he becomes a beneficiary at the spouse's death—no QTIP election or GPOA required.

The question here is: why did the Texas legislature go to the trouble of specifically requiring a QTIP election or the inclusion of a spousal GPOA in the previous subsection, when this provision catches all spousal trusts? We don't know, but we're happy to accept the legislature's gift of planning opportunities, two of which we can identify immediately. First, high-net-worth clients can use this provision to engage in asset-protected, estate-freeze transactions, where assets that are expected to appreciate significantly in value over time can be gifted at a low value now, with the appreciation escaping estate taxation in both the settlor-spouse's estate and in the donee-spouse's estate, and with neither spouse's creditors being able to reach the trust's assets.[21] Second, clients whose net worth falls below the estate tax exemption, and who are thus otherwise not typical candidates for advanced estate planning, can also engage in estate-freeze planning and receive creditor protection to boot.[22] Thanks, Texas legislature.

Section 112.035(g)(3)(A): Reciprocal (Non-Reciprocal) Spousal Trusts

The third new provision of the Texas spendthrift trust statute provides that the beneficiary of an irrevocable trust established by the beneficiary's spouse will not be deemed the "settlor" of that trust under the spendthrift trust statute, "regardless of whether or when the [spouse-beneficiary] was the settlor of an irrevocable trust for the benefit of that [spouse-settlor]." In short, this provision allows for the assets in "reciprocal" or "non-reciprocal" (i.e., nearly reciprocal) spousal trusts to be protected from both spouses' creditors. As such, Texas spouses could partition all of their community property to be the 50-50 separate property of each spouse, and then each spouse could transfer his or her separate property to a trust for the other spouse—both trusts would enjoy spendthrift protection.[23]

Typically, there is no good estate planning reason to create truly reciprocal trusts. The IRS will ignore such trusts for transfer tax purposes because it views them as taxpayer antics aimed at shielding the gifted assets from transfer taxes while allowing the donor to benefit from assets that he received as the beneficiary of an identical trust that someone else created for him. This is also referred to as a "cross" transaction, leaving both transferors in a nearly identical position that they would have occupied if they had created trusts for themselves. If reciprocal trusts are found to have been created to avoid inclusion in the transferors' gross estates, the trusts will be "uncrossed" so that each transferor is treated as both the beneficiary and the settlor of the trust that was established for his benefit, thus pulling all of the transferred assets back into the transferor's gross estate under

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[20] IRC § 2044.

[21] To the extent that the donor spouse retains a beneficial interest in the trust following the donee spouse's death, special care must be taken in structuring the trust's provisions to avoid inclusion of the trust assets in the donor spouse's gross estate for federal tax purposes. IRC § 2037.

[22] Note that low-basis assets gifted to trusts in an estate-freeze transaction will retain their low basis and will not receive a basis adjustment at the donee spouse's death. IRC §§ 1014; 1015. With the recent increase in federal income tax rates and the imposition of the net investment income tax, the costs and benefits of paying estate tax and receiving a basis adjustment versus paying no estate tax and incurring capital gains tax should be quantified. When no estate tax would otherwise be due in the case of clients with lower net worth, the tax benefits of such a transaction are greatly reduced, and the use of a QTIP or GPOA trust might actually be preferable.

[23] Of course, all marital property planning should be carefully considered with respect to the spouses' rights between themselves, as partitioning community property to separate property divests each spouse of rights to the community that they would otherwise have absent a partition.