

Estates, Gifts and Trusts Journal

BNATAX
Management®
America's Tax Authority™

Reproduced with permission from Tax Management Estates, Gifts, and Trusts Journal, x, 07/11/2013. Copyright © 2013 by The Bureau of National Affairs, Inc. (800-372-1033) <http://www.bna.com>

A Review and Critique of the Asset Protection Aspects of The 2013 Ohio Legacy Trust Act

by Howard D. Rosen, Esq.
and Patricia Donlevy-Rosen, Esq.
Donlevy-Rosen & Rosen, P.A.
Coral Gables, Florida¹

Effective March 27, 2013, Ohio joined the growing list of states² that have enacted asset protection trust legislation. This article provides a review and critique of the asset protection aspects of the Ohio Legacy Trust Act (Act).³ Trusts that are subject to the new

¹ The authors are shareholders in Donlevy-Rosen & Rosen, P.A., in Coral Gables, Florida.

² Alaska: Alaska Stat. §34.40.110 (1997); Colorado: Colo. Rev. Stat. §38-10-111 (2001); Delaware: Del. Code Ann. tit. 12, §§3570 to 3576 (1997); Hawaii: Haw. Rev. Stat. Ch. 554G (2011); Missouri: Mo. Ann. Stat. §456.5-505 (1989); Nevada: Nev. Rev. Stat. §§166.010 to 166.170 (1999); New Hampshire: N.H. Rev. Stat. Ann. §§564-D:1 to 564-D:18 (2009); Oklahoma: Okla. Stat. Ann. tit. 31, §§11, *et seq.* (2004); Rhode Island: R.I. Gen. Laws §§18-9.2-1, *et seq.* (1999); South Dakota: S.D. Codified Laws Ann. §§55-16-1 to 55-16-16 (2005); Tennessee: Tenn. Code Ann. §35-16-101 (2007); Utah: Utah Code Ann. §25-6-14 (2003); Virginia: Va. Code Ann. §§64.2-745.1 to 64.2-745.2 (2012); Wyoming: Wyo. Stat. §§4-10-510 to 4-10-523 (2007).

³ Ohio Rev. Code Ann. Ch. 5816 (2013). All citations are to the laws of Ohio unless noted to the contrary.

legislation are referred to therein and in this article as “legacy trusts.”

A spendthrift trust is customarily viewed as an asset protection tool. The core of the new legislation, Ohio Rev. Code Ann. §5816.03, permits the creation of self-settled spendthrift trusts⁴ on or after March 27, 2013: “Except as otherwise provided in this section, the spendthrift provisions of a legacy trust shall restrain both voluntary and involuntary transfer of a transferor’s [settlor’s] interest in that trust.” (Clarification supplied.)⁵

To qualify as a legacy trust, the transferor must irrevocably transfer property to a “qualified trustee,” defined as an individual resident of Ohio or a trust company⁶ authorized to engage in trust business in Ohio.⁷ The statute also permits a nonresident to serve

⁴ No specific language is required to create a spendthrift trust; rather, such a trust is recognized as such by the effect of an included provision that restrains both the voluntary and involuntary transfer of a beneficiary’s interest. In a “self-settled” spendthrift trust, that provision applies to the settlor’s beneficial interest.

⁵ The use of the generic term “transferor” (throughout the Act) is preferable to the use of the term “settlor” because a person might execute a trust instrument as a settlor, yet another person or persons might transfer property to the trust.

⁶ Ohio Rev. Code Ann. §5816.02(S). The definition also requires that person to: (1) maintain or arrange for custody of some or all of the trust property in Ohio (typical requirement for domestic asset protection trust statutes); (2) maintain records for the legacy trust on an exclusive or nonexclusive basis; (3) prepare or arrange for the preparation of required income tax returns for the legacy trust; or (4) otherwise materially participate in the administration of the legacy trust.

⁷ Ohio Rev. Code Ann. §5816.02(S)(1)(b) requires that the trust company be authorized by Ohio law or by an Ohio court to act as a trustee and that its activities be subject to supervision by the

as co-trustee with a qualified trustee.⁸ The trust instrument must expressly state that it is irrevocable, incorporate the laws of Ohio to wholly or partially govern its validity, construction and administration, and the instrument must contain a spendthrift provision that is applicable to the interests of any trust beneficiary, including the transferor.⁹

One issue that always arises in connection with self-settled spendthrift trusts is whether the corpus of such a trust would be included as “property of the estate” where a transferor-beneficiary seeks the protection of the bankruptcy laws. Bankruptcy Code §541(c)(1)¹⁰ provides that all of the debtor’s interests in property become property of the bankruptcy estate *except that*: “A restriction on the transfer of a beneficial interest of the debtor in a trust that is enforceable under applicable nonbankruptcy law is enforceable in a case under this title. . .”¹¹ (resulting in the exclusion of such property from the bankruptcy estate).

Under the common law, a settlor-beneficiary’s interest in a spendthrift trust is *not* “[a] restriction on the transfer of a beneficial interest of the debtor [settlor] in a trust that is enforceable under applicable nonbankruptcy law.”¹² To avoid any uncertainty regarding whether the transferor’s beneficial interest in a legacy trust would become property of the bankruptcy estate, Ohio Rev. Code Ann. §5816.03(B) provides that “Any spendthrift provision in a legacy trust is enforceable under any applicable nonbankruptcy law within the meaning of section 541(c)(2) of the Bankruptcy Code regardless of whether or not the relevant legacy trust instrument makes any reference to that enforceability.”

Except through the four avenues of attack discussed below, neither a creditor existing on the date the transferor transfers assets¹³ to the legacy trust nor a person who becomes a creditor thereafter (or any other person seeking to satisfy a claim from the transferor’s interest in the trust) will be able to satisfy a claim, either at law or in equity, from the transferor’s spendthrift interest in the legacy trust.

Ohio superintendent of banks, the federal deposit insurance corporation, the comptroller of the currency, or the office of thrift supervision or a successor of any of them.

⁸ By implication, Ohio Rev. Code Ann. §5816.02(K)(1)(a). Also, the Act does not preclude a transferor from serving as a co-trustee, but a transferor-trustee would not be a “qualified trustee” (from an asset protection perspective, it is not recommended to have the transferor serve as a trustee).

⁹ Ohio Rev. Code Ann. §5816.02(K)(1).

¹⁰ 11 USC §541(c)(1).

¹¹ 11 USC §541(c)(2).

¹² See, e.g., *Restatement (Third) of Trusts* §58 (2003): “(2) A restraint on the voluntary and involuntary alienation of a beneficial interest retained by the settlor of a trust is invalid.”

¹³ Including a judgment creditor, both of which are herein referred to as “existing creditors.”

The spendthrift restriction will not, however, prevent a claim from being satisfied from the transferor-beneficiary’s interest if either:

1. The transfer is a fraudulent transfer under the somewhat convoluted fraudulent transfer provision contained in the Act.¹⁴
2. The transferor can (or is deemed to be able to) revoke the trust or voluntarily or involuntarily transfer an interest in the trust.¹⁵ *Note*: Among the powers that may be retained by the transferor that will not constitute a power to revoke are powers to remove and appoint trustees and advisors (protectors).¹⁶ Although the Ohio spendthrift provision is declared by the statute to be a valid restraint on alienation enforceable under nonbankruptcy law, the omnipotent power to remove and appoint trustees and protectors (who can also remove and replace trustees), equivalent to complete control over the trust, could amount to property of the bankruptcy estate (requiring turnover to the bankruptcy trustee) under Bankruptcy Code §541 as was the situation in *In re Lawrence*,¹⁷ which resulted in Mr. Lawrence’s incarceration for contempt for failure to comply with a turnover order.
3. Pursuant to an agreement or court order the transferor owes: (a) child or spousal support or alimony to or for the transferor’s spouse, former spouse, child, or children, or to any governmental

¹⁴ Ohio Rev. Code Ann. §5816.07.

¹⁵ Ohio Rev. Code Ann. §5816.05.

¹⁶ Ohio Rev. Code Ann. §5816.05 additionally lists the following as *not* constituting a power to revoke or voluntarily or involuntarily transfer an interest in the trust: (1) a provision that, upon the happening of a defined event, results in the termination of a transferor’s right to mandatory income or principal; (2) a power to veto a distribution from the trust; (3) an *inter vivos* or testamentary special power of appointment or similar power; (4) the right to receive a distribution of income; (5) an interest in a charitable remainder unitrust or charitable remainder annuity trust and the right to release such an interest, in whole or in part; (6) a “five and five” power; (7) a right to receive principal subject to the discretion of a qualified trustee or advisor or an ascertainable standard set forth in the trust; (8) the transferor’s potential or actual use of trust property; (9) a provision requiring/permitting the potential or actual use of trust income or principal to pay, in whole or in part, income taxes due on the income of the trust; (10) the ability of a qualified trustee, whether pursuant to the qualified trustee’s discretion or the terms of the legacy trust instrument or at the direction of an advisor, to pay after the death of a transferor all or any part of the debts of the transferor outstanding on or before the transferor’s death, the expenses of administering the transferor’s estate, or any estate, gift, generation skipping transfer, or inheritance tax; and (11) any provision that pours back after the death of a transferor all or part of the trust property to the transferor’s estate or any trust.

¹⁷ 251 Bankr. 630 (S.D. Fla. 2000).

agency that is designated by statute, rule, or regulation to be the payee of that child or spousal support or alimony; or (b) a division or distribution of property in favor of the transferor's spouse or former spouse.¹⁸

4. The transfer renders the transferor insolvent after the transfer.¹⁹

Ohio Rev. Code Ann. §5816.07 contains an interesting, if not convoluted, fraudulent transfer provision that purports to provide the exclusive remedy (except for pre-recorded liens)²⁰ for a creditor seeking to set aside transfers to a legacy trust. The complaining creditor must prove by *clear and convincing* evidence²¹ that the subject transfer²² was made with the specific intent to defraud the specific creditor bringing the action.²³ Compare this with Ohio's uniform fraudulent transfer rule.²⁴ Any creditor can assert that a transfer was made to defraud any creditor of a transferor and prove it by the "preponderance of the evidence" standard (a lower standard of proof).²⁵ The Act's elevated level of proof and the "specific" intent and creditor requirements would seem to make bringing a successful fraudulent transfer action a bit more difficult and available to a narrower group than would be the case under Ohio's uniform fraudulent transfer statute.²⁶

Ohio Rev. Code Ann. §5816.07 requires an existing creditor of the transferor to bring his or her action within the later of 18 months after the transfer or six

¹⁸ Ohio Rev. Code Ann. §5816.03(C). Presumably the exposure of trust assets is limited by Ohio Rev. Code Ann. §5816.08(A) to the portion of the trust income and/or principal that is required to be distributed.

¹⁹ Ohio Rev. Code Ann. §5816.06(B)(3). No definition of solvency/insolvency is contained in the Act. Ohio Rev. Code Ann. §1336.02(A) contains the uniform fraudulent transfer act definition: (1) a debtor is insolvent if the sum of the debts of the debtor is greater than all of the assets of the debtor at a fair valuation; and (2) a debtor who generally is not paying his debts as they become due is presumed to be insolvent. Presumably the exposure of trust assets is limited by Ohio Rev. Code Ann. §5816.08(A) to the portion of the trust that would be required to render the transferor solvent.

²⁰ Ohio Rev. Code Ann. §5816.07(D).

²¹ Ohio Rev. Code Ann. §5816.07(C). Deemed a substantive rather than procedural rule. This standard is usually applied in civil cases involving the potential loss of important interests such as the termination of parental rights.

²² Ohio Rev. Code Ann. §5816.07(F)(1). Each transfer is separately evaluated.

²³ Ohio Rev. Code Ann. §5816.07(A).

²⁴ Ohio Rev. Code Ann. §1336.04(A).

²⁵ Clermont & Sherwin, "A Comparative View of Standards of Proof," *Cornell Law Faculty Publications* (Paper 222 2002).

²⁶ Ohio Rev. Code Ann. Ch. 1336 (Ohio Uniform Fraudulent Transfer Act).

months after the transfer is or reasonably could have been discovered by the creditor.²⁷ The six-month time limit applies only *if* the creditor files a (nonfraudulent transfer) suit against the transferor or makes a written demand for payment on the transferor that in either case asserts a claim based on an act or omission of the transferor that occurred before the transfer, and that suit is filed, or the written demand is delivered to the transferor, within three years after the transfer.²⁸ The Act's statute of limitations could conceivably extend the time within which to file the fraudulent transfer action for up to three years. A preferable asset protection statute would have a shorter and more clearly delineated limitations period.

For those who become creditors of the transferor after the transfer to the legacy trust, the statute is clear: The fraudulent transfer action must be brought within 18 months after the transfer.²⁹

What should a transferor do to shorten the statute of limitations to the 18-month minimum? Beyond properly transferring ownership and possession of the trust corpus to the trustee and making certain that statements for brokerage and bank accounts are addressed to the trustee, rather than the transferor, the transferor should revise his or her personal financial statements to delete the transferred assets.³⁰ If the transferor were only a discretionary beneficiary, this would be proper because a discretionary beneficial interest is not a property interest. If the transferor retained a mandatory beneficial interest, such as "50% of the trust income," that retention would be capable of valuation and would be required to be reflected on the transferor's personal balance sheet.

In determining the transfer date of property held in the legacy trust for purposes of applying the foregoing limitation periods, a "LIFO"³¹ rule is applied.³² Money distributed out of the legacy trust is deemed to be sourced from funds most recently contributed to

²⁷ A creditor could conceivably argue, in the case of a transfer that was incomplete for federal transfer tax purposes: "How could I have discovered the transfer? It was incomplete for federal transfer tax purposes, so no gift tax returns were filed, and, as the trust is a grantor trust for federal income tax purposes, the transferor is still reporting the income, so no income tax return was filed."

²⁸ Ohio Rev. Code Ann. §5816.07(B)(1).

²⁹ Ohio Rev. Code Ann. §5816.07(B)(2).

³⁰ See Donlevy-Rosen, RIA Tax Advisors Planning Series, Title 32, *Asset Protection Planning*, §4.04, addressing this issue and discussing "equitable tolling" and a six-year statute of limitations for the federal government that runs from the time when transfer facts are known or should have been known under 28 USC §2415.

³¹ An accounting inventory valuation technique: "last in, first out."

³² Ohio Rev. Code Ann. §5816.07(F)(2)(a). It is recommended that such a source rule be included in any asset protection trust instrument.

the trust (unless proven to the contrary *beyond a reasonable doubt*),³³ thus enhancing the “aging” process of money remaining in the trust (a clear and convincing rule applies for other fungible assets).³⁴

Liability protection is afforded planning professionals in Ohio Rev. Code Ann. §5816.07(D), which provides that no one can assert a claim or cause of action against a trustee, protector, or anyone involved in the counseling, drafting, preparation, execution, or funding of the trust. Liability protection is also provided for persons involved in counseling in connection with, or the drafting, preparation, execution, administration, or funding of, any limited partnership, limited liability company, corporation, or similar or comparable entity if the limited partnership interests, limited liability company interests, stock, or other similar or comparable ownership interests in the relevant entity are subsequently transferred to any trustee of any trust that is, was, or becomes a legacy trust.³⁵

Ohio Rev. Code Ann. §5816.09 contains what might be called a “flight provision.”³⁶ Usually, a flight provision is language in a trust instrument that permits or effects a relocation of a trust from the current situs to another jurisdiction under specified circumstances.³⁷ Here is how this is implemented in the Act: The qualified trustee is automatically removed if the legacy trust or a qualified trustee is involved in any legal action in which the court declines to apply Ohio law regarding: (1) the validity, construction, or administration of the trust; (2) the effect of any term or condition of the trust, including, but not limited to, a spendthrift provision; or (3) the rights and remedies of any creditor or other suitor in connection with any transfer of an asset by or from a transferor to any trustee of a trust that is, was, or becomes a legacy trust. Under this circumstance, the removed qualified trustee has the power to convey trust property to the successor trustee, and has no other authority.³⁸ If an offshore trustee were already serving as a co-trustee, then, upon the automatic removal of the qualified trustee, the trust will have been “moved” offshore. Trust assets must also be relocated beyond the jurisdiction of the intransigent court, however, and that may present certain practical issues. Unless the trust

assets are already properly situated³⁹ and the trust instrument is carefully drafted to properly integrate with the statutory flight provision,⁴⁰ it is unclear what, if any, protection will be afforded the trust assets by Ohio Rev. Code Ann. §5816.09. For example, a legacy trust has a qualified trustee and an offshore trustee serving as co-trustees. The trust instrument provides that, if the qualified trustee is removed pursuant to Ohio Rev. Code Ann. §5816.09, the remaining co-trustee may serve as the sole trustee. Litigation ensues, and the court refuses to recognize aspects of the legacy trust’s validity. The qualified trustee is removed under the Act, leaving the offshore trustee as the sole trustee. What is the protection? To the extent that trust assets are located in the United States, the court could conceivably issue a restraining order preventing their movement offshore. To the extent that trust assets are already located offshore under the control of the offshore trustee, they are probably protected. This is not a “slam dunk.”

Finally, whenever domestic asset protection trusts are discussed, U.S. Constitutional issues arise. Specifically, the full faith and credit clause,⁴¹ the supremacy clause,⁴² and the contract clause⁴³ of the U.S. Constitution may be in issue.

Under the full faith and credit clause, each state is required to recognize the judgments of the courts of the other states. Under the supremacy clause, the federal government and its laws are supreme to the extent they conflict with state laws. Under the contract clause, no state may pass a law that infringes on the ability of persons to contract with each other in interstate commerce.

In summary, the protective efficacy of the Ohio statute, as is the case with any U.S.-based protective planning, ultimately depends upon a U.S. court upholding the planning in the transferor’s favor and the inapplicability of the above clauses of the U.S. Constitution.

³³ The standard of proof usually reserved for criminal cases in the United States.

³⁴ Ohio Rev. Code Ann. §5816.07(F)(2)(b).

³⁵ Ohio Rev. Code Ann. §5816.07(G).

³⁶ Ohio Rev. Code Ann. §5816.09(A)(1).

³⁷ 810 T.M., *Asset Protection Planning*.

³⁸ Ohio Rev. Code Ann. §5816.09(A)(2).

³⁹ This means that they are located offshore. Note that Ohio Rev. Code Ann. §5816.02(S)(2) requires that “some” trust property be custodied in Ohio. The “some” requirement is vague.

⁴⁰ For example, Ohio Rev. Code Ann. §5816.09(B)(1) provides that, if a qualified trustee is removed under this section, another qualified trustee must be appointed unless the trust instrument expressly provides otherwise. Lacking such an express provision, the trust would remain subject to the jurisdiction of the court that was refusing to uphold Ohio law.

⁴¹ U.S. Const., art. IV, §1.

⁴² U.S. Const., art. VI, §2.

⁴³ U.S. Const., art. I, §10.