Protect your assets with a “hybrid” DAPT

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One benefit of the current federal gift and estate tax exemption amount ($11.7 million in 2021) is that it allows most people to focus their estate planning efforts on asset protection and other wealth preservation strategies, rather than tax minimization. (Although, be aware that President Biden has indicated that he’d like to roll back the exemption to $3.5 million for estate taxes. He proposes to exempt $1 million for the gift tax and impose a top estate tax rate of 45%. Of course, any proposals would have to be passed in Congress.)

If you’re currently more concerned about personal liability, you might consider an asset protection trust to shield your hard-earned wealth against frivolous creditors’ claims and lawsuits. Foreign asset protection trusts offer the greatest protection, although they can be complex and expensive. Another option is to establish a domestic asset protection trust ("DAPT").

DAPT vs. hybrid DAPT

The benefit of a standard DAPT is that it offers creditor protection even if you’re a beneficiary of the trust. But there’s also some risk involved: Although many experts believe they’ll hold up in court, DAPTs haven’t been the subject of a great deal of litigation, so there’s some uncertainty over their ability to repel creditors’ claims. In addition, some experts believe that a DAPT may not work to shield creditor's claims against a settlor-beneficiary who creates a DAPT in a state that authorizes it if the settlor-beneficiary resides in a state that doesn't authorize self-settled trusts (on the theory that it would be against the public policy of the settlor-beneficiary's state of residence and afford no creditor protection against assets of the self-settled trust if it had been instead created in such that state).

A “hybrid” DAPT offers the best of both worlds. Initially, you’re not named as a beneficiary of the trust, which virtually eliminates the risk described above. But if you need access to the funds in the future, the trustee or trust protector can add you as a beneficiary, converting the trust into a DAPT.

Before you consider a hybrid DAPT, determine whether you need such a trust at all. The most effective asset protection strategy is to place assets beyond the grasp of creditors by transferring them to your spouse, children or other family members, either outright or in a trust, without retaining any control. If the transfer isn’t designed to defraud known creditors, your creditors won’t be able to reach the assets. And even though you’ve given up control, you’ll have indirect access to the assets through your spouse or children (provided your relationship with them remains strong).

If, however, you want to retain access to the assets later in life, without relying on your spouse or children, a DAPT may be the answer.

Setting up a hybrid DAPT

A hybrid DAPT is initially created as a third-party trust — that is, it benefits your spouse and children or other family members, but not you. Because you're not named as a beneficiary, the trust isn't a self-settled trust, so it avoids the uncertainty associated with regular DAPTs.

There's little doubt that a properly structured third-party trust avoids creditors' claims. If, however, you need access to the trust assets in the future, the trustee or trust protector has the authority to add additional beneficiaries, including you. If that happens, the hybrid account is converted into a regular DAPT subject to the previously discussed risks.

If you have additional questions regarding a DAPT, a hybrid DAPT or other asset protection strategies, please contact us.

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