Using Trusts for
Asset Protection for Individuals

All individuals come to estate planners with similar concerns. They either want to avoid probate, legally deplete their assets so they can apply for Medicaid, protect their assets from depletion by creditors (including judgment creditors, ex-spouses, bill collectors, etc.), preserve and pass their personal assets to their heirs while minimizing tax liability, or maintain a certain level of privacy. For a majority of individuals, we recommend trusts. The following is a brief discussion of trusts and different forms of asset protection.

I. *What Is a Trust?*

A trust is an entity created by a written trust document. The person creating the trust is called the settlor. He transfers real or personal property (also known as the trust corpus) to the trustee of the trust. The trustee is charged with holding the assets for the benefit of the trust beneficiaries and administering the trust corpus pursuant to the terms of the written trust agreement. The trust beneficiaries are those individuals who are entitled to receive distributions from the trustee of trust principal and/or income.

a. Are there different types?

Yes. Trusts exist in many forms and have many features. They can be created in three different ways: (1) testamentary; (2) *inter vivos*; and (3) by a court. The estate planner creating the trust can combine features like revocability, provisions for special needs, and provisions for tax avoidance and special funding to meet each client's individual goals.

A testamentary trust is a trust that is created in a will. Upon the decedent's death, the will is admitted to probate and the executor of the will is instructed to transfer some or all of the decedent's property to the trustees named in the testamentary trust. The primary focus of these trusts is to care and provide support for the beneficiaries. A testamentary trust may contain a "spendthrift clause" which will protect the trust assets from the beneficiaries' creditors.

An *inter vivos* trust is a trust that is created during the life of the settlor. It can be either revocable or irrevocable. The settlor of a revocable trust can terminate the trust and demand the return of trust assets at any time. A settlor may chose to terminate a trust if he becomes unhappy with the performance of a trustee or determines that the beneficiaries are no longer deserving of the distributions. Upon the death of the settlor of a revocable trust, the trust becomes irrevocable.

An irrevocable trust cannot be terminated by the settlor. Therefore, once the assets are placed into the trust, the settlor loses control. The trustee must administer the trust pursuant to the terms. Some clients are intimidated by this type of trust because they are afraid that their circumstances will change in the future and that they will not have the ability to change the trust terms. Common examples of this include instances of divorce, wayward children, substantial business losses, etc. However, the loss of control enables estate planners to shield the trust from beneficiary debts and some taxes.

One primary benefit of an inter vivos trust is that the assets that have been conveyed into the trust do not have to go through the probate procedure upon the settlor's death. The trust instructs the trustee how to dispose of the assets upon death. This saves the beneficiaries time and money. Additionally, the settlor's financial affairs do not become public record as they do in probate proceedings.

b. How is Property Conveyed into the Trust?

For a trust to officially exist, it must be funded. For testamentary trusts, the property is conveyed to the trust by the executor of the will. For inter vivos trusts, the settlor must actually transfer the property. A typical transfer will be from John Doe and Jane Doe, husband and wife, to John Doe and Jane Doe as Trustees of the Doe Family Trust under trust agreement dated January 1, 2008. Some common types of property transfers are discussed below:

<u>Real Property</u> – The settlor should execute a deed conveying the property to John Doe and Jane Doe as Trustees of the Doe Family Trust under trust agreement dated January 1, 2008

<u>Personal Property with titles</u> – the settlor should re-title personal property in the name of John Doe and Jane Doe as Trustees of the Doe Family Trust under trust agreement dated January 1, 2008

<u>Bank Accounts</u> – the name on the bank account should be changed to John Doe and Jane Doe as Trustees of the Doe Family Trust under trust agreement dated January 1, 2008

<u>Stock Certificates</u> – new stock certificates should be issued in the name of John Doe and Jane Doe as Trustees of the Doe Family Trust under trust agreement dated January 1, 2008

II. Tax Treatment

In addition to the benefits described above, estate planners are able to draft trusts which provide tax savings (either estate or income) to the settlors and beneficiaries.

Revocable trusts offer very little estate or income tax savings. Because the trust can be revoked at any time, the Internal Revenue Service disregards the trust entity for taxing purposes. Thus all income is attributable to the settlor and all estate taxes are attributed to the estate.

Conversely, for those individuals who wish to exclude the trust from the settlor's estate, the estate planner can draft an irrevocable trust without reversionary interests or a power of appointment. Additionally, the settlor may save some income tax liability under this structure because the tax is distributed.

III. Asset Protection with Trusts: A General Discussion

Assets held within a revocable trust are not protected from creditors. Because the settlor can revoke the trust at any time, he is deemed to have control over the assets. Therefore, the revocable trust is disregarded.

Irrevocable trusts are generally protected from claims of creditors. However, a creditor may be able to seize some of the trust property if the settlor retains too much control over the asset. Generally, the more discretionary the trust, the greater the creditor protection of the trust. A trust with flexible terms is safer than a trust that has the beneficiary as its sole trustee or a trust that provides for fixed distributions rather than discretionary distributions. For maximum asset-protection, the trust agreement should allow distributions subject to the absolute discretion of an independent trustee and the settlor should not be a beneficiary of the trust. These discretionary trusts give the trustee unlimited discretion over distributions to or on behalf of the beneficiary. The beneficiary is not entitled to the assets and he has no property interest in the trust reachable by creditors. Of course, many clients find this level of protection unacceptable because in creating this type of trust, the settlor completely loses control of the asset.

A limited term trust is a creation that attempts to bridge the gap between irrevocability and the desire to keep control. They are often used to support children during their minority and then the parents during their retirement years. This trust shields the assets during the time they are being used to support the children and only reverts to the settlor, once the settlor's potential liability has decreased, e.g. in retirement.

Another problem that we often encounter is a large life insurance policy that increases the settlor's estate tax liability. A life insurance trust can be created to avoid paying estate taxes on life insurance proceeds. The trust will hold the policy on the life of the parent for the children's benefit. Because the trust is outside the estate, it is excluded from estate taxes. Therefore, the proceeds will pass to the beneficiaries free from estate tax consequences.

For those clients wishing to qualify for Medicaid in the future, special needs trusts, discretionary trusts and nongrantor trusts are available. In a special needs trust, the trust income is reserved for the beneficiary's supplemental needs – it cannot be used for anything that would normally be covered by a public assistance program, including Medicaid. In these trusts, the beneficiary does not have the power to direct distributions for food, housing, or clothing.

A. Asset Protection Issues: Passive planning

The passive planning is a "wait and see" type of planning. With this type of planning, we try to retain and emphasize what you are already doing correctly, and add to that with your estate plan. We do not do transfers or change ownership of assets in passive planning.

1. Estate Planning

Careful estate planning has asset protection advantages. Upon the death of you or your spouse, certain assets will go into trust for the benefit of the surviving spouse. You want to have your estate plan designed so that the maximum about possible will go into trust. For example, instead of just having a family trust for tax purposes, you can have a second trust to hold assets for the surviving spouse. The assets in both of these trusts will be separated from the surviving spouse. Thus, there will be at least one layer between potential liability and the surviving spouse. These irrevocable trusts (they will be irrevocable when you or your spouse passes away) are very powerful, proven asset protection tools.

In addition, your estate plan can also allow for the protection of your child or children. When both you and your spouse have passed away, your children will have an irrevocable trust for their benefit. This trust will allow them estate tax, creditor, divorce and bankruptcy protection.

2. Protected assets you already own

An important aspect of passive asset protection is to know which assets are protected by law from creditors, and to maintain those assets in their protected state. Here are some examples:

<u>Retirement assets</u>. 401(k) plans are protected assets by federal law. Moreover, even were a 401(k) to come out of the company and become an IRA, North Carolina allows individual retirement plans to be exempt from judgments of creditors.

<u>Real Property owned by husband and wife</u>. Assets that are held as tenants by the entirety with your spouse are also protected assets.

<u>Insurance</u>. Insurance policies are protected from creditors. This rule applies to policies, of course, and not to the cash proceeds once someone has passed away. When I am doing asset protection planning, one of the things that we try not to do is have insurance, which is a protected asset, become a non-protected asset.

For example, a $500,000 life insurance policy on your spouse should not be payable to you. This policy should be made payable to your spouse's revocable trust. In that way, the cash will be held for your benefit, but would not be subject to your own creditors, adding a powerful layer of protection. This trust would be completely protected from creditors.

3. Theory behind passive planning

The passive planning involved in these assets is to make certain that you do not take an asset that is asset protected and change it into a non-protected asset. To be direct, if you were to have any type of asset protection problems, we would suggest that (i) you should not liquidate your 401(k), (ii) you should not cash in an insurance policy and (iii) you should not sever the tenants by the entirety with your spouse, but rather keep these assets intact.

B. Asset Protection Issues: Active planning

Active planning for asset protection involves transfers and changes in ownership of assets. An irrevocable life insurance trust, as discussed above is an example of what I call “active” planning. Here are some other examples below”

1. Limited liability company protection

The next level of asset protection would involve putting a layer of protection between yourself and your assets by placing some assets in a limited liability company (“LLC”). LLC’s are a way to manage and keep assets in one pot without adverse income tax consequences. This LLC can be sought after by creditors, but usually only in the form of a “charging order.” A charging order allows a creditor to siphon off income that comes out of the LLC. Obviously, however, depending on who the manager of the LLC is, there may be no income coming out of the LLC. This would protect the assets in the LLC certainly for the next generation and make the assets very unattractive to creditors.

2. Aggressive Planning

These options come with high cost and low flexibility. One such option would involve placing assets into international LLC’s or international trusts.

IV. Conclusion

Based upon the individual needs and desires of the client, a creative estate planner can structure a trust that marries the client’s need for access to the trust assets to the client’s need to protect the assets from taxes and creditors.

I. Where you are now

Well, what do you do when you find out a law suit is pending? What planning can you do?

Of course, it is impossible to plan for the protection of your assets until you know the guidelines of asset protection, and which assets do not need protecting. Following is a typical balance sheet for a successful small business owner for review:

Asset	**Value**
Home, in NC, held as tenants by the entirety	$250,000
Insurance proceeds on both spouses, payable to the other spouse	$1,000,000
401(k)	$350,000
Brokerage Account	$125,000
Bank Account	$7,500
Stock in S Corporation	$2,000,000
Interest in Limited Liability Company	$800,000
Total Assets	$4,532,500

ASSET BY ASSET: WHAT IS PROTECTED

1. The Home

Real property held as tenants by the entirety in North Carolina is a protected asset. For the most part, creditors of one spouse cannot get the home. Please note, however, that not every state has that real estate advantage. If a husband and wife purchase a real estate in South Carolina, for example, they cannot own that home as tenants by the entirety, and the property is not protected.

Please note that this protection is only for real property held by husband and wife. If you were to transfer the property to the spouse who is not being sued, you have lost this protection for both spouses!

2. Insurance

Insurance proceeds made payable to a surviving spouse or children are protected under North Carolina law.

3. 401(k)

IRA funds are protected under state law, and ERISA type retirement benefits are protected under federal and North Carolina law.

Be careful, however: the assets are protected only if left in the account. If you use these funds to pay for the defense of your case, you have lost your protection.

4. Brokerage Accounts/Bank Accounts

Brokerage accounts, other than those holding retirement benefits, are not protected, regardless how held. Bank accounts are treated similarly.

5. Stock in Corporation/Interest in Limited Liability Company (LLC)

Certainly you have always heard that corporations and LLCs are protected from creditors. Why else would they be called "limited liability?"

Indeed, if you own a Corporation or an LLC, your assets are more protected from the creditors of the Corporation or the LLC. That is, <u>a suit against the corporation</u> will go after assets of the corporation, and would not normally go after your own assets. This is a great protection, is effective in many cases and is relatively inexpensive.

However, in <u>a suit against you</u>, the corporate stock by itself is not protected. The stock can be sold, and the proceeds can be used to satisfy the debt.

In a suit against the LLC, however, there is a recent court case that the LLC interests cannot be sold. Therefore, the creditor could sit and receive any distributions from the LLC that you would have received, but cannot sell the interests to satisfy the debt/judgement.

II. What can you <u>not</u> do to help now

Once a law suit is pending, the ability to plan has diminished. In fact, planning that may have been fine before the suit (such as transfers of assets) may now lead to civil or criminal fraud actions.

Assuming your spouse is not already on the hook due to ownership or co-signing or personal guarantee, transferring assets to your spouse will not protect the assets. In addition, transferring assets to persons other than your spouse not only is not effective to shelter the assets, it also may be considered criminal activity.

Can you move assets to onshore/offshore trusts? Transfers to most trusts are ineffective once the debt/judgement is anticipated. Some trusts will continue to accept assets and may shelter assets; however, once you have a law suit pending, a transfer to such a trust will be considered fraud in most situations, and may make you subject to criminal prosecution.

III. Where you could have been

So now you have a pending law suit, and options are few. How could you have protected the Brokerage accounts, the S Corporation stock and the LLC interests before any suit?

1. Offshore/Onshore Trusts

If you have ever heard of an Offshore Trust, you know that some countries have different laws about creditors than we do. If you are a business owner and are worried about being sued, perhaps you take as much of your assets as possible and move them to another climate. Certain countries, such as the Cayman Islands, the Bahamas, and others, have laws that can protect your assets from creditors. But setting up trusts in those areas can be very expensive, and it is uncertain how much control you can keep over your assets, and whether your assets are actually protected.

If not a warm climate, then perhaps a cold climate? You can do "offshore trusts" "onshore" now in certain states. Delaware, Alaska, Rhode Island and Nevada all have laws that provide much more creditor protection than most states. Again, however, the cost is high, you may loose control and it is hard to tell how well your assets are actually protected.

2. Family Estate planning: Trusts

As strange as it may sound, the best way to protect an asset is to never own it! Regardless of whether a successful business person will inherit the business from parents, or will inherit other assets from the parents, we often suggest that the inherited assets be directed into a trust for the business person.

Well drafted Trusts can remain protected from your creditors for your entire lives. The Trust would be a "spendthrift trust," which would only distribute certain amounts for certain reasons. In addition, you could be your own Trustee. You could make your own management decisions, decide whether to continue the Trust, and determine when distributions are appropriate. In addition, you could name a successor trustee, such as a bank or a sibling, if you are unable to continue to act as Trustee.