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**"Accumulating wealth is one thing. Preserving it is another.
Let our family help yours."**

Special Report

Asset Protection Trust

According to the Oxford University Press, a *Trust* is "an arrangement whereby a person (a trustee) is made the nominal owner of property to be held or used for the benefit of one or more others". In the practice of law there are numerous types of trusts which are commonly used to meet a variety of the needs of client [1].

An asset protection trust (APT), like the other specialty trusts, is designed to fit a particular need for our clients. A client who wishes to use an APT as part of their planning does so intending to insulate the assets within the trust from the claims of creditors of their intended heirs. In this day and age it seems litigation is the answer to so many problems facing clients and their heirs. As we lawyers know, a lawsuit is easy to start, but difficult to finish or extricate yourself from.

The APT is a technique which can be used to discourage creditors from seeking recovery of a judgment from the assets within the trust. Furthermore, if properly designed, an APT can protect the trust assets from claims of spouses and other dependents.

To understand the structure of an APT you have to first understand what it is not. Except in very limited circumstances, trusts are not a way for an individual to protect their own assets from their own creditors [2]. Such trusts are commonly referred to as self-settled asset protection trusts. Generally, the law prohibits an individual from transferring assets either outright or in trust to "hinder, delay or defraud a creditor". If you think a creditor might be seeking a recovery from you, it is probably too late to transfer your assets in hopes of protecting them. This APT is not about the protection of assets from your creditors.

The APT is about protecting <u>your</u> assets (which you leave to your heirs) from your heirs' creditors. It is not about protecting your assets from your creditors. Let's assume your heirs are your children. The APT is designed to protect your assets once they are inherited by your children from you. The APT can be presently funded with assets the parent generation gifts to

their children during the parent or parents' lifetime. It can also be funded at death. Many clients create the APT as part of their estate plan and then fund it upon their death with their assets. The parent's estate pours over into the trust when the parent or parents are both deceased.

Case Study 1: Let's take John and Jane Doe, who have three children, Able, Ben and Cathy. John and Jane have a modest estate of around $600,000. Their estate plan, through the use of a will or revocable trust, provides for their estate to be divided equally between their children, Able, Ben and Cathy. As a small business owner, Able has creditor problems and probably always will. Ben on the other hand, is disabled, and has trouble keeping a job. He is not on public benefits, but may be in the future. Cathy is married to a highly paid professional and money woes are not on the horizon. The marriage of Cathy is on the rocks and always has been and she may end up being the sole supporter of her two children, your grandchildren. On the other hand, her marriage may stay intact, and if so, she and her husband are likely to have a taxable estate.

How does an APT help John and Jane? First, let's look at the option of leaving their estate out right to Able, Ben and Cathy. If Able receives $200,000 as an inheritance, depending upon the way in which the business is organized, his creditors will likely be able to reach the inheritance to satisfy the claims of his business. In the case of Ben, although he has no current creditors, it is likely he will in the future as he turns to the safety net of public benefits to provide for his food and shelter.

In the case of Cathy, an inheritance itself would not be considered marital property, but the growth in the value of the asset could be considered a marital asset and subject to division in a divorce court. If Cathy and her husband stay married the value of the inherited assets would be subject to estate tax and the marginal rate on estate taxes in 2022 varies and depends upon the value of the decedent's estate in excess of the exemption amount. The rates vary from 18% to 40% on the first $1,000,000 in excess of the exempion amount. Once the value exceeds $1,000,000 over the exemption amount the marginal estate tax rate is 40% thereafter. Assuming any inheritance would be taxable along with their other assets, the additional $200,000 inheritance could create up to an additional $80,000 estate tax likely after the death of both Cathy and her husband, depending upon the structure of their estate plan.

If John and Jane were to transfer the inheritance to be received by each of their children to an APT for their benefit, the trust would limit their access to the funds within the trust. In fact, it is important to note their interest in the trust is not intended to be a "property interest" at all. Only if you have a property interest is a creditor, including a spouse, able to reach it to satisfy any claims they may have to marital property.

To accomplish its goals of insulating the assets within the trust from the claims of creditors, including spouses and taxing authorities, the trust must be designed with very special limitations. More specifically, the trust must be designed as a fully discretionary trust. This requires any distributions made from the trust to be approved by a totally independent person who is a co-distribution trustee along with the trust beneficiary or beneficiaries. Although the trust beneficiary can be the management trustee in charge of all investment decisions it is important the trust beneficiary is not able to control the distributions based on any type of ascertainable or enforceable standard.

To provide flexibility in the trust it is important to appoint a Trust Protector to be able to make technical changes to the trust. The Trust Protector must also be an independent person who is not related or subordinate to the interests of the trust beneficiary. As an additional safeguard, the trust is designed to have a Trustee Remover and Appointer able to provide for continuity of management of the trust assets.

John and Jane will likely want to have a separate trust for each child which provides for each child to be the management trustee to manage the trust assets, but have an independent party or institution act as the co-distribution trustee along with the trust beneficiary child and as the Trust Protector. Should any creditor try to reach the assets of the trusts established for the benefit of Able, Ben or Cathy, the distribution trustee would simply say no to any requests for payment or satisfaction of a creditor claim.

Case Study 2: Fred, who is 83 years old, managed to accumulate an estate of over $5 million. Additionally, his only child, Freida, is a specialist physician and has her own estate in excess of $5 million. Freida is not married and has two children. She intends on leaving her estate to those children.

The problem is both Fred and Freida have taxable estates. If Fred leaves his estate to his daughter Freida, and she dies with a $15 million estate of her own, the value of what Fred leaves to her estate will be taxed at a marginal 40% tax rate over and above the exclusion amount available at the time of her death [3].

Through the creation of an APT, to be funded at his death, Fred can place his entire estate into the trust and provide asset protection benefits for Freida and her children. Furthermore, the trust does not have to be funded until the death of Fred. It can simply be standing by and his current estate plan can pour his assets into the trust upon his death. The trust can provide for a portion of the trust assets to be removed from ever being subject to the estate tax in the future by allowing the Trustee to allocate a portion of the distribution by Fred to be exempt from the generation-skipping tax and the estate tax for the benefit of Freida and her children.

Who should consider the use of an APT? Almost anyone, really. If you have an estate and you want to leave it to individual heirs, as opposed to a charitable entity, you have the choice of leaving the inheritance outright to the heir or leaving it in trust. Leaving it in trust can still protect the assets to be used for the benefit of the heir, subject to the restrictions contained within the APT. Almost any value of inherited assets can be considered for placement into an APT. If you choose to leave the inheritance you plan to leave to an heir in trust, a trust other than an APT may be the better choice depending upon your circumstances and requires careful consideration.

Footnotes:

[1] For example, you probably have heard of the revocable trust, irrevocable life insurance trust (ILIT), grantor retained annuity trust (GRAT), special needs trust (SNT), qualified personal residence trust (QPRT), dynasty trust and the charitable remainder trust (CRT) to name a few.

[2] It is possible to transfer assets to a trust and shelter those assets from claims of creditors in the situation of public benefit planning. The two types of trusts commonly used in the area of public benefit law are referred to as the d4a trust and the pooled trust. These trusts are created by Federal law and are designed to protect assets for individuals

with special needs and seeking public benefit assistance generally through the Medicaid program. Also, there are off-shore trusts and domestic asset protection trusts allowed in certain states (not Colorado) which can be utilized to shelter assets.

[3] Currently, for decedents dying in 2022 the exclusion amount is $12,060,000. This amount increases to $12,920,000 for decedents dying in 2023.