Asset Protection for Physicians and High-Risk Business Owners

By Robert J. Mintz

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CHAPTER SEVEN

Trusts for Asset Protection and Tax Savings

The entity known as a *trust* will be essential in creating various strategies for accomplishing asset protection, estate planning, and privacy benefits. This chapter will provide a background for understanding how these techniques work and how a trust will be a part of your overall plan.

The legal arrangement, known as a trust, has been around for at least several hundred years. Every trust has certain essential characteristics. A trust has one or more *trustees*, who are responsible for administering and carrying out the terms of the trust. The *beneficiaries* are those who are entitled to trust income or principle either currently or at some time in the future.

A trust is typically in the form of a written trust agreement between the *settlor,* the person creating the trust, and the trustee. The written trust agreement provides that the settlor will transfer certain assets to the trustee and the trustee will hold those assets for the benefit of the named beneficiaries. (The terms "trustor" or "grantor" are used interchangeably with the term "settlor.")

Until recently, trusts were used almost exclusively by the wealthiest families to maintain privacy and to pass their wealth to succeeding generations. The privacy benefits were particularly important. Grandpa Robber Baron had no desire to allow the muckraking newspapers and the antagonistic public to know exactly what he owned and how much he was worth. Grandpa was savvy enough to know that revealing the details of his fortune was not good for business and wasn't smart politics. The Vanderbilts, Whitneys, Rockefellers, and Carnegies created trusts which have now successfully shielded from public scrutiny the family wealth of five or more generations.

But it is no longer only the wealthy who are attracted to the powerful benefits offered by a properly designed trust. Now, those with equity in the family home or some savings put away for retirement or college are using trusts as an essential ingredient in their asset protection and estate plans. Let's see how the different types of trusts can be used to accomplish your goals.

The Revocable Living Trust

A revocable living trust is a trust that can be revoked or canceled at any time by the settlor. The term "living trust" means simply that the trust is established during the lifetime of the settlor. (Testamentary trusts, those created upon the settlor's death, do not avoid probate and are not nearly as popular today as they once were.) During the past ten or fifteen years, revocable living trusts have gained enormous popularity as a sound technique for accomplishing a number of legitimate estate planning goals.

Avoiding Probate

A revocable trust (or irrevocable trust) that is properly drafted and funded will avoid probate. This is the most significant and valuable feature of a revocable trust. The benefits of avoiding probate can only be appreciated by understanding what happens when an estate must go through the probate process.

If a person dies owning property, not protected by a trust, a court will supervise the transfer of that property to those people named in his will. If someone dies without a will, his property passes to his relatives in the manner set forth under the laws of his state. The actual transfer of title to the decedent's property is carried out under the court's supervision by a person designated in the will as the Executor of the estate. If a person dies without a will, the court must appoint an Administrator to carry out the transfer of the decedent's property. An Executor or Administrator is known as a Personal Representative.

The Personal Representative has the responsibility to perform the following:

1. Locate, inventory, and appraise all of the assets of the decedent.

2. Make final payment to all of the decedent's creditors.

3. Prepare and file any federal and state death tax returns.

4. Distribute the assets of the decedent's estate according to the decedent's will or according to state law.

The Personal Representative will almost always hire an attorney to perform this work on his behalf. The attorneys collect their fees from the estate for these services. The amount of legal fees, depending upon the state, is either a fixed percentage of the estate or is based upon what a judge determines to be a reasonable fee.

The reason that most people do not want their estate to go through probate is that this process is expensive, time consuming, and inconvenient. Attorney's fees may range from 2 percent to 10 percent of the gross value of the estate. An estate of $1 million, depending upon the complications involved, may incur attorney's fees of $25,000. These fees are usually based upon the gross value of the estate rather than the net value. An estate of $1 million with $950,000 of liabilities might still pay attorney's fees of $25,000. But now this amount is 50 percent, not 2½ percent of the net value.

Second, attorneys rarely feel the same sense of urgency about completing the probate that is felt by the decedent's wife and children. While the decedent's family wishes to get on with things as quickly as possible, the attorney for the estate is often busy handling other matters and the time period for completing the probate may take from two to five years. Probate causes significant stress and frustration for the survivors, and avoiding the process is a legitimate planning concern.

Trustees and Beneficiaries

Revocable trusts are effective in avoiding probate only when the trust document has been properly drafted and only when all of the decedent's property has been transferred into the trust prior to his death. The trust document, like a will, provides for the disposition of trust assets upon the death of the settlor. In the typical arrangement, a husband and wife will create a revocable trust with both husband and wife as the initial trustees. They are also the beneficiaries of the trust. The trust provides that during their joint lifetimes the trust may be revoked at any time. Upon the death of either spouse, the trust typically becomes irrevocable and the surviving spouse becomes the sole trustee. When the surviving spouse dies, the trust property passes according to the wishes expressed in the trust document.

Funding the Trust

For the revocable trust to be effective in eliminating probate, it is essential that all family assets be transferred into the trust prior to a spouse's death. Any property that has not been transferred into the trust will be subject to probate, defeating the purpose of creating it in the first place. An amazing number of people go to the trouble and expense of forming a revocable trust and then fail to complete the work necessary to fund it.

Funding the trust involves transferring legal title from husband and wife into the name of the trust. For example, if Harry and Martha Jones are funding their revocable trust, they will change title to their assets from "Harry Jones and Martha Jones, husband and wife" to "Harry Jones and Martha Jones as Trustees of the Jones Family Trust, Dated January 1, 1999."

For real estate, the change in title is accomplished by executing and recording a deed to the property. Bank accounts and brokerage accounts can be transferred by simply changing the name on the accounts to reflect the trust as the new owner. Shares of stock and bonds in registered form are changed by notifying the transfer agent for the issuing company and requesting that the certificates be reissued in the name of the trust. Stock in a family owned corporation can be changed by endorsing the old stock certificate to the trust and having the corporation issue a new certificate to the trust. Other types of property can be transferred by a simple written declaration called an Assignment.

The living trust also can be funded indirectly by transferring interests in other entities. For example, if you hold your property in a Family Limited Partnership or Limited Liability Company, the living trust can hold your shares in those companies.

Estate Taxes

The trust must also contain the appropriate provisions in order to minimize federal taxes payable upon the death of either spouse. It is important to point out that estate taxes can be minimized with either a properly drawn will or a properly drawn revocable trust. The revocable trust does not provide any tax advantages that are not available to a person using a will or some other form of trust in order to accomplish a transfer of his property. But as long as you are using this type of trust to avoid probate and to take advantage of its unique features, you should make sure that the estate tax provisions are properly handled.

Federal taxes are imposed on most transfers of property during your lifetime or at the time of your death. Prior to 1977, estate taxes for transfers at death were distinct from gift taxes that were applied to transfers of property during lifetime. The gift tax rate was 75 percent of the estate tax rate. In 1977, this dual rate structure was abolished and a uniform rate was established for both gift and estate tax purposes. As a result of this change and additional changes in 1981 and 1996, there is an effective tax exemption of $650,000 (effective in 1999) for transfers during life or at death. (We will refer to this amount as the exemption amount.) Amounts in excess of the exemption amount are taxed at rates ranging from 37 percent to a maximum of 50 percent for total transfers exceeding $2.5 million. The exemption amount will increase incrementally until in reaches $1 million in 2006.

The law provides that annual gifts of $10,000 and under are excluded from tax. A husband and wife together can give $20,000 per year. This amount applies to each person to whom a gift is made. A husband and wife could give, as an example, a total of $100,000 per year to their five children and grandchildren.

Further, the 1981 law adopted a provision known as the Unlimited Marital Deduction. All amounts transferred between husband and wife, during lifetime or at death, are exempt from tax. This means that if a husband leaves all of his property to his surviving spouse, there will be no estate taxes on his death regardless of the size of his estate. The estate taxes will arise on the death of the second spouse, as she transfers her property to her children or other relatives.

Minimizing Taxes

The unified tax credit allows each spouse to transfer up to the exemption amount to his children (or anyone else) free of any federal estate taxes. In its simplest form, a properly drawn revocable trust takes advantage of this benefit by providing for the creation of two separate trusts on the death of the first spouse. These two trusts are referred to as the A trust and the B trust.

In a large estate, the B trust will be funded with the exemption amount and the balance will go into the A trust. From the A trust, the surviving spouse will have the right to all income for life plus a power to use any portion of the principal that he or she so desires. The B trust will generally provide that the surviving spouse is entitled to all income during his or her life plus the right to use principal for health, education, maintenance, and support.

Any amount left in the A trust, in excess of the exemption amount, at the death of the surviving spouse will be taxable in his or her estate for estate tax purposes. However, since the surviving spouse is given only limited rights over the B trust, the amount in the B trust will not be taxable in the survivor's estate upon his or her death. The effect of these provisions is that the spouses' combined exemption amount (ultimately $2 million) can be passed from husband and wife to their beneficiaries without being subject to estate taxes.

Income Tax Treatment of Revocable Trusts

During one's lifetime, revocable trusts do not provide any income tax savings. For tax purposes, the trusts are treated as if they do not exist. A revocable trust is known, for tax purposes, as a grantor trust. A grantor trust is not a taxpaying entity. No annual tax return is required to be filed. Instead, all income and loss of the trust is reported on the tax returns of the husband and wife.

Revocable Trusts and Asset Protection

A revocable trust does not provide any protection of assets from judgment creditors. It is ignored for creditor purposes just as it is ignored for income tax purposes. In most states, the law provides that if a settlor has the right to revoke the trust, all of the assets are treated as owned by the settlor. Perhaps because of the promotion associated with these trusts, many people mistakenly believe that a revocable trust somehow shields assets from creditors. This is not correct. If there is a judgment against you, the creditor is entitled to seize any assets that you have in the trust. Asset protection can be accomplished when property is held in the FLP or LLC and those interests are owned by the trust.

Gifts Between Spouses

As we have stated, gifts between spouses qualify for the Unlimited Marital Deduction which eliminates federal gift taxes on these kinds of transfers. The ability to shift the ownership of property between husband and wife without creating a tax liability creates some useful opportunities for achieving valuable asset protection.

Community Property

In community property states, each spouse's interest in the community property is subject to the claims of the other spouse's creditors. If there is a judgment against the husband, all community property assets held by husband and wife are available to satisfy the judgment. On the other hand, the separate property of a spouse will generally not be subject to the claims of the creditors of the other spouse.

These rules provide some obvious opportunities to achieve a measure of asset protection. If community property is divided into equal shares of separate property of the husband and separate property of the wife, those separate property interests will not be available to satisfy the claims of the other spouse's creditor. Generally, a living trust would be created for each spouse—for the estate planning benefits and to confirm that the marital property has been divided. Those in community property states can at least limit their potential exposure to a creditor's claim to one-half of the marital property, rather than all of the marital property, by creating this type of division.

The primary drawback of this technique is that a division of community property into separate property trusts may be disadvantageous from an income tax standpoint. All property held as community property receives a stepped-up basis on the death of the first spouse. For example, a husband and wife buy a property during their marriage for $50,000 that is later worth $100,000. If they sell the property, they will have a gain of $50,000 and will pay taxes on that amount. Suppose that instead of selling, the property is held until the time the first spouse dies. All community property now receives a new tax basis equal to its value as of the date of death—$100,000 in this example. Therefore, if the property is held until the death of the first spouse, all taxable gain is eliminated.

This favorable situation does not occur when a husband and wife hold separate property. In this situation, only the deceased spouse's interest in the property receives the stepped-up basis. In the above example, if the property were held one-half each by Husband and Wife, only the interest of the deceased spouse would receive the new basis. This would result in a $75,000 basis, and a $25,000 gain, if the surviving spouse sold the property for $100,000.

If you hold community property that has substantially appreciated in value, it probably would not be advisable to divide the property into separate shares and thereby lose out on the significant tax savings that can otherwise be achieved. Alternative methods of asset protection should be explored.

Separate Property

Unequal Division of Property

For those living in states which do not recognize community property, gifts of separate property between a husband and wife can achieve some useful asset protection.

If one spouse is more vulnerable to potential lawsuits than the other spouse, property can simply be transferred by gift from that spouse to a living trust for the other. For example, if the husband is a physician with a high vulnerability to lawsuits and the wife is a school teacher with low lawsuit vulnerability, property can be transferred by gift from Husband to Wife's living trust to reduce the amount of assets subject to loss in the event of a lawsuit. In theory, all assets could be moved out of the name of Husband and into the name of Wife's trust. In the event of a subsequent lawsuit and judgment against the husband, no assets would be available to satisfy the creditor.

The advantage of this gift technique is that it is simple and inexpensive to utilize. Gifts between spouses do not create any gift tax liability because of the unlimited marital deductions for gifts between spouses.

One problem with this technique is that, in many cases, a spouse will be reluctant to relinquish all effective control over his property. If all family assets, including real estate and bank accounts are in the sole name of the wife's living trust, the husband may not feel comfortable with this arrangement. The threat of a potential lawsuit at some future time will rarely be sufficient to overcome the desire to maintain at least equal management and control over one's property.

Along these lines, in the event of a divorce, a court may be unwilling to rearrange any bona-fide transfers previously made between spouses. Although a court in a dissolution proceeding has broad equitable powers to divide marital assets in a fair and just manner, property which was the subject of a bona-fide gift from a

husband to his wife may or may not be reallocated by a judge. In our practice, we have found that many clients are not willing to risk the possibility that they will be permanently deprived of assets previously transferred to the other spouse.

Lastly, despite the fact that the wife has a low level of lawsuit vulnerability associated with her work, the fact remains that there are numerous ways she could still be sued. Remember, as the owner of substantial assets, she becomes an inviting target for a lawsuit. Putting all of your eggs in this basket is a dangerous proposition.

Equal Division of Property

An equal division of marital property, as opposed to a strict transfer from one spouse to the other, might provide greater lawsuit protection and might also allow each spouse to sleep more easily. Marital property can be divided according to a written agreement which states that each spouse is to hold one-half of all marital property as their own separate property. This is where a revocable trust may become particularly useful for our purposes. Once the marital property is divided, two separate revocable trusts can be established, one for each spouse. The husband's trust then holds title to his one-half of the property, and the wife's trust holds title to her one-half interest.

When marital property is divided in this manner, a number of our previous concerns are eliminated. First, when property is held pursuant to a written trust agreement, it is unlikely that a court would imply the existence of some other type of trust arrangement that is not consistent with the terms of the written trust. It is unlikely that a court would allow a creditor of the husband to reach into and claim the property held in the wife's revocable trust on the theory that she is holding that property for the benefit of her husband. As a result, property held by the wife in her trust would be immune to potential claims from the husband's creditors. Although the property in the husband's trust would still be available for these creditors' claims, at least one-half of the total estate has been removed from the reach of the husband's creditors. Admittedly this is only a partial solution to the problem, but it is a useful beginning.

This arrangement also minimizes concerns about losing management and control over one's assets. The husband would still have full management and control over the assets in his revocable trust and, in the event of a divorce, each spouse is likely to have no more property than they would otherwise be entitled to.

Gifts to Family Members

Making gifts of property to family members is a useful tool that may accomplish a variety of asset protection and estate panning objectives. A properly structured program of gift giving, to one's children or grandchildren, can result in a minimization of estate and income taxes and can also be useful for achieving a significant degree of lawsuit protection.

There are significant tax advantages to a gift giving program. Lifetime gifts reduce the size of one's estate and consequently minimize the ultimate amount of estate taxes. Since estate tax rates are high, substantial savings will be realized from this technique.

A gift giving program may also produce some annual income tax savings. If a donee is fourteen years or older, income earned on the property transferred to him will be taxable to the child rather than to the parent. If a child is in a lower income tax bracket than the parent, a gift program will effectively spread the income tax liability of the family among lower bracket taxpayers and will thereby reduce the overall income tax burden.

A gift program also provides significant lawsuit protection. If a gift transfer does not violate the fraudulent conveyance laws, property that has been transferred to a child or a grandchild cannot be reached by a judgment creditor of the husband or wife. Once an effective gift has been made from a parent to a child, this asset cannot be seized by the parents' creditors.

Drawbacks of Outright Gifts

The most obvious difficulty with outright gifts is the total loss of ownership and control of the gifted property. In our years of legal practice, we have rarely encountered instances in which parents are willing to transfer complete control over large sums of money to their children. Despite considerable estate and income tax savings, few people are willing to give up a portion of their wealth which they have worked hard to accumulate during their lifetime.

Even when their wealth is beyond what they reasonably need to live comfortably, parents are concerned about the wisdom of making outright gifts to their children. Sometimes there is an issue concerning the child's marital status and what will happen to the gifted property in the event the child is divorced. Sometimes there are concerns about the child's level of financial responsibility and whether the funds will be squandered. Many times the parents are concerned about the creditors of a child reaching the property. When the situation involves minor children or grandchildren, who are not legally capable of holding title to property, there are questions about who will act on the child's behalf in holding the property and when the property should be distributed to the child. These are all matters of great consequence and must be carefully considered by parents contemplating this type of gift giving program.

Trust Strategies

Most of the problems of an outright gift to a child can be eliminated through the use of a trust designed for this purpose. Trusts are extremely flexible in form and almost any asset protection and estate planning goal can be accomplished by an attorney who is knowledgeable and experienced in this field. Using creative trust strategies, the planning opportunities for achieving tax savings and asset protection advantages are unlimited.

The following examples will provide you with an overview of some of the techniques that can be used to achieve particular objectives in a variety of circumstances.

Limited Term Trust

A Limited Term Trust is designed to last for a specified term of years with the trust assets returned to the settlor at the end of that period. For instance, Dr. X is forty-five years old, married with two young children, and earning a comfortable living. He has $2 million in savings and doesn't currently need the income generated from these investments.

His primary goal is to protect his savings from any type of lawsuit or claim, and he wants to make sure the funds are available for his planned retirement in twenty years.

We set up a trust with the $2 million dollars which provided that income and principal be used to pay for support and education of the children until they complete their education. At that time, the remaining balance of the funds is returned. The benefits of this arrangement are that the amount in the trust is well-protected from potential claims during the period that the children require support. Ten or fifteen years later, when they are on their own—and the parents need the funds for their retirement—the money is available. At that point, since Dr. X will no longer be practicing medicine, asset protection concerns will be minimized.

A similar result could be accomplished if Dr. X put his savings in a Family Limited Partnership. He would retain a 1 or 2 percent interest as general partner. The remaining 98 percent of the limited partnership interests could be placed in the trust for the children.

Life Insurance Trust

One of the most popular and effective estate planning and asset protection strategies is to use a Life Insurance Trust to hold one or more policies on the life of either parent.

An important purpose of this trust is to exclude the proceeds of a policy from estate tax. Simply put, if you own an insurance policy on your life, the proceeds are subject to estate tax. If your total property exceeds the exemption amount ($1.3 million), 50 percent or more of the policy proceeds can be lost to estate taxes. If you have $1 million of assets and an insurance policy for $1 million, you would pay approximately $300,000 in estate taxes.

The simple solution is to create a Life Insurance Trust to own the policy. A properly drawn trust keeps the proceeds out of your estate—free of estate tax—so that the entire amount of the proceeds are available for your family.

When a policy is held by the trust, the cash value and the proceeds are also protected from potential lawsuits and claims. A portion of family savings can be transferred to the trust each year and that amount can be used to fund a policy. Amounts invested in the policy are permitted by favorable tax laws to accumulate free of income tax. In this manner, large amounts of value can be built up over a period of years.

As an example, a 45-year-old client of ours had a good income and was saving about $50,000 per year. We set up a Life Insurance Trust with a plan to transfer $20,000 per year into the trust. He achieved these significant benefits:

- All amounts transferred into the trust and plan proceeds were fully protected against potential claims and lawsuits.
- Investment earnings grew and compounded without annual income taxes.
- The cash value of the policy could be withdrawn or borrowed for any needs of the trust.
- Plan proceeds of $5 million dollars would be available for his family—free of income and estate taxes—upon the client's death.

The Life Insurance Trust is an important foundation of any asset protection and estate plan where the value of the estate is likely to exceed the exemption amount. Proper planning in this manner can prevent a significant loss of 50 percent or more of your accumulated wealth from taxes and can protect assets from future claims.

Estate Freeze Trust

A trust can be created as a part of an overall plan to avoid estate taxes on future appreciation of particular assets. If it is anticipated that certain property will appreciate in value over the years, it often makes sense to transfer full or partial ownership to an Estate Freeze Trust—to avoid estate taxes on the asset.

A client in his mid-forties owned Microsoft stock with a value of about $2 million. We calculated that if the value of his portfolio increased at about 7 percent per year, at age 75 the stock would be worth $16 million.

The potential estate tax liability was roughly $9 million. Also, of immediate concern, the entire amount of his savings was exposed to lawsuit risks from his business.

To solve both problems, we put the stock into a Family Limited Partnership. The client and his wife were the general partners—retaining control over the assets. The Limited Partnership interests were transferred to the Estate Freeze Trust. The $2 million value was discounted for tax purposes so that the total amount of the gift was equal to the exemption amount. (After the discount was applied to the $2 million, the gift was valued at $1.3 million.) The stock was fully shielded from any potential claim, and the entire value of the asset was removed from the client's estate. If the value of the stock appreciates even slightly, millions of dollars in taxes will be saved for the family.

The same principle would apply to ownership in a start-up company which you believe will increase in value over a number of years. When you start a business, the initial value is generally low. That presents an opportunity to transfer ownership and remove future appreciation from your estate without creating a taxable gift or using a portion of your lifetime exemption. A real estate investment, which has little initial equity but has potential to appreciate, is also a good candidate for the Estate Freeze Trust.

Personal Residence Trust

The most popular strategy for protecting the family home from lawsuits and claims is called the Personal Residence Trust. We use this technique because the home can't be placed directly in the Family Limited Partnership or an LLC without jeopardizing the important tax advantages of the mortgage interest deduction and the ability to avoid up to $500,000 of gain on sale. Although there is no clear law on the subject, it would be foolish to risk a denial of these benefits.

The Personal Residence Trust is a grantor-type of trust, specifically permitted under the Internal Revenue Code. You or you and your spouse can be the trustees of the trust. As such, you have full power to buy, sell, or refinance the property. The interest deduction is reported directly on your tax return, and all of the other advantages of home ownership are preserved. The Family Limited Partnership/LLC is designated as the beneficiary of the trust. In this manner, your home receives all the protection provided by these entities without creating any tax difficulties.

Summary

In this chapter, we have looked at accomplishing estate planning and asset protection goals with a variety of different trusts. We spent some time discussing the Revocable Living Trust, which is a common estate planning tool and the foundation of many plans.

Then we gave you some brief examples of how different types of trusts can be created to accomplish specific purposes and to solve particular problems. The unmatched power of a trust as a legal strategy is that it can be designed in limitless ways—restricted only by the skill and imagination of the parties.

In the next two chapters, we look more closely at trusts specifically intended for individuals who wish to achieve superior levels of privacy and/or asset protection for their accumulated wealth.