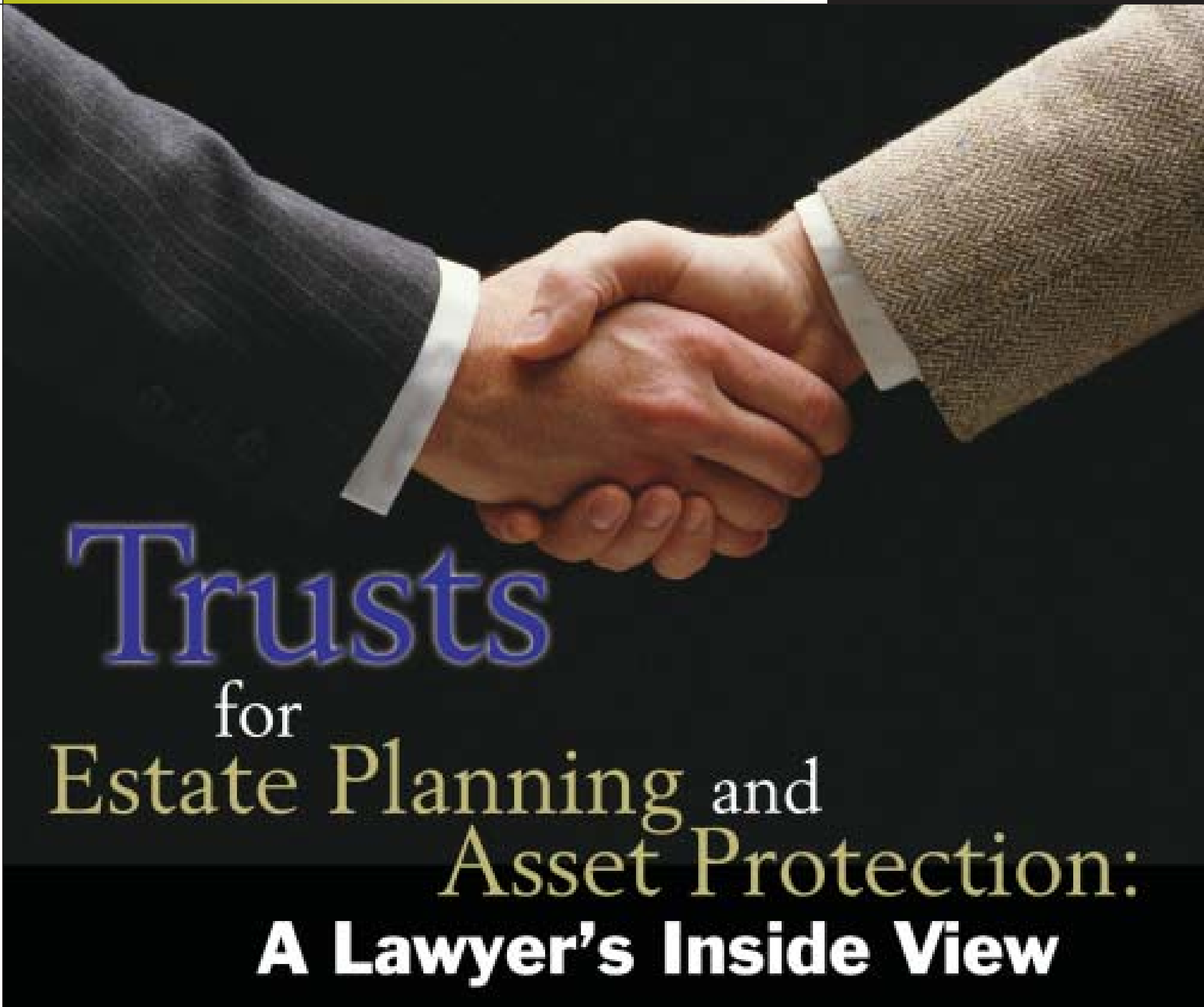

Trusts for Estate Planning and Asset Protection: A Lawyer's Inside View

By Robert J. Mintz, Esq.

One of the most important tools for both business and personal planning is the legal arrangement known as a trust. Although many forms of trusts, such as Living Trusts and Life Insurance Trusts, have been popular for many years and are fairly common in most estate plans, many people do not understand how their trusts work or the benefits trusts can provide. In this article, I'll give you a lawyer's inside view of how trusts are used, what to watch out for when setting up a trust, and how your own planning can be enhanced by the techniques that are available to you.

What is a Trust?

In order to take advantage of the benefits that can be provided by a trust, it is useful to understand exactly what that legal term means. What is a trust and how does it work?

A trust is a legal entity, separate from the individual who creates the trust. This is similar to a partnership or corporation that is regarded as distinct from its owner. A trust is governed by specific rules that are set out in an agreement (usually between two parties). One person (the *trustor*), puts money or other property in

the trust. A *trustee* is the person who agrees to hold the property according to the terms of the agreement. The trust agreement specifies what the trustee is required to do with the property, how he or she is to hold it, for how long, and who is to receive any benefits paid out by the trust. Those who are entitled to receive the benefits of the trust are called the *beneficiaries*.

For example, you might wish to set aside $10,000 for the future education of a newly born grandson, Max. In this case, Max is the beneficiary. Your friend Jim agrees to act as trustee. The trust agreement says that Jim is to hold and invest the $10,000 until Max is 21 years old. At that time, all funds that have been accumulated in the trust are to be paid out to him and the trust will end. It's pretty nice of Jim to take on this serious responsibility of carrying out your wishes. If you don't have a good friend or family member who will do this, there are professional trust companies that perform these services for a fee. Or, you can even act as trustee yourself. You can declare that you are holding the $10,000 for your grandchild, and if the proper rules are contained in the trust agreement, the law will treat the money as belonging to the trust and not to you.

You can even create a trust with yourself as both trustee and beneficiary. This is commonly seen in the arrangement known as a Living Trust. Typically, you are permitted to manage and enjoy the trust property during your lifetime, and the agreement provides for how it should be distributed after your death. You can change or cancel the trust at any time, which means it is a *revocable* trust. But since your property is treated as if legally "owned" by the trust and not by you, it is not subject to a court-supervised probate of your property at death. The inconvenience and expense of legal fees and court documents is avoided simply because your property is owned by this separate legal entity. Even though you are the trustee and beneficiary and you can revise or revoke the trust at any time, if the proper language is included, the trust will be a separate and distinct legal entity for probate purposes.

Avoiding probate in this manner accomplishes a great deal without any meaningful restrictions on what you can do with your property. That is because the legal definition of what is "owned" by you is very flexible for purposes of determining whether your property is subject to a probate. The law allows you to escape the definition of "ownership" in a fairly simple manner, because state governments have no financial interest in requiring a probate of a decedent's property. Probate, which is a court-supervised inventorying of assets, a payment to creditors, and a supervised distribution to specified beneficiaries, consumes limited court resources and takes time from judges without contributing any offsetting revenue. There is no economic benefit from the probate process for anyone other than the lawyers involved in the court process. Consequently, avoiding probate through the use of a funded Living Trust (or joint tenancy arrangement) is encouraged by law and is fairly simple to accomplish in most states.

As far as I can tell, the fact that lawyers in many states (especially, in my experience, on the east coast) are still reluctant to recommend estate plans that include a Living Trust is the biggest obstacle to avoiding probate with a Living Trust (there may be other reasons as well, but I'm not aware of them). Legal fees for handling probate matters can be significant, even for smaller estates, and thus many attorneys recommend an estate plan that includes a will but not a Living Trust. This is often because future probate fees represent a solid bankable annuity for the attorney who prepares the will, and what attorney worth his or her salt will forego such a revenue stream? And so, Living Trusts are usually not part of these estate plans. Cynical? Yes. All too often true? Unfortunately, also yes. In California, and the west coast in general, the level of client awareness of the probate problem seems to be higher, and very few attorneys prepare estate plans that do not include a Living Trust.

Using Trusts to Avoid Taxes

In addition to avoiding probate, trusts can also be used in many ways to reduce income and estate taxes. One popular example of this involves shifting income from a high tax bracket individual (the parents) to lower bracket family members. Depending on the circumstances, significant tax savings can be produced with this and other planning techniques. In terms of estate taxes, trusts are commonly used to avoid estate taxes on life insurance proceeds and investment property.

These tax savings techniques can be accomplished because property held in a trust is not considered to be owned by you—just as we saw in the case of the Living Trust. There is however a difference in the legal definition of "ownership" when it comes to the use of trusts for this purpose, since this involves an attempt to accomplish a result in which the government clearly has an

adverse interest. Unlike probate avoidance, which actually saves the government money, using trusts for tax savings produces a direct cost in the loss of tax revenue. As we would expect, the rules concerning "ownership" are considerably less flexible and are subject to closer scrutiny when we use trusts to accomplish tax savings measures.

To illustrate, remember that the Living Trust, used for probate avoidance, can be revoked or modified at any time and the trustor can be the beneficiary of the trust. In a Tax Trust (designed to accomplish certain tax advantages), the benefits will not be available if the trustor has retained significant powers over the trust. Tax law does not recognize the legal distinction of a trust if the trustor retains the right to revoke the trust, use trust property, modify the terms of the trust, or exert similar control over trust assets. If too much power is left in the hands of the trustor, the trust is ignored for tax purposes and none of the attempted tax benefits will be accomplished. The type of trust that is ignored for tax purposes is known as a Grantor Trust. Grantor Trusts may be extremely useful in other situations, as we'll see below, but to achieve desired tax results specified rules must be followed.

Trusts for Asset Protection

We have seen that the use of trusts to avoid probate have very modest requirements because avoiding a court process at death produces an actual cost saving for the state by reducing the use of valuable court resources. Tax Trusts, on the other hand, cost the government revenue, so the restrictions on various tax saving techniques are generally tightly prescribed.

What about trusts used for asset protection? Are the rules very restrictive for these types of trusts? In general, the answer is that we are now permitted considerable flexibility in structuring asset protection trusts. There is much greater freedom of design in this area than is available for Tax Trusts. Unlike Tax Trusts the government is not an adverse party in the asset protection arena. It has no direct stake in the outcome of litigation between two private parties. The government does however have a legitimate interest in promoting the flow of commerce. To this end, public policy has developed over the years in favor of limiting personal liability from business activities; but it stops well short of permitting one to avoid legitimate debts and obligations. In other words, operating your business and personal affairs to minimize the risk of unexpected loss is sound financial management. Each state sanctions the use of trusts, corporations, limited liability companies, and limited partnerships in order to control personal liability for unanticipated obligations. What is not permitted is for individuals or businesses to abandon existing obligations or refuse to pay the debts they incur. The Fraudulent Transfer rules of every state prohibit attempts to defraud creditors by hiding or transferring property.

As long as we act within the boundaries of the Fraudulent Transfer rules, we have considerable latitude in preparing a trust to accomplish asset protection goals. If we attempt to combine asset protection with tax savings, we are handicapped by the stricter rules limiting the administration of Tax Trusts. When our primary purpose is asset protection, rather than tax saving, we will make the trust a Grantor Trust—ignored for tax purposes—allowing us the greatest possible freedom in designing the features of the trust. Unlike the Tax Trust, asset protection laws generally allow for the design of effective trusts that maintain the important benefits of property ownership without compromising the quality of the asset protection. There are certainly rules to be followed and traps to be avoided, but as long as we do not violate the Fraudulent Transfer prohibitions we can exercise broad discretion in choosing the terms and features appropriate for any individual circumstances.

Closing Statement

The level of government scrutiny and regulation that applies to the formation of trusts for business and personal planning depends upon the level of government interest in the particular activity. The use of trusts to avoid probate is favored because it reduces the cost and burden on the court system. Trusts for tax saving directly reduce revenue, so permissible uses and features are more restricted. Asset protection trusts are revenue neutral and are generally permitted as consistent with public policy and proper regard for the rights of creditors. As always, our recommendation is to seek competent legal advice about your particular circumstances before adopting any of these strategies within your own plan. MDNG

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