Preserving Wealth With Trusts

By Mark Morrise

Protect the Goose That Lays the Golden Eggs

A well-known story is the tale of the goose that laid the golden eggs, in which the goose's owner is at first pleased with the magical goose's steady output, but eventually becomes impatient and seeks to obtain all the eggs at once by killing the goose, only to find nothing inside. At that moment, he realizes too late that his once reliable income stream has vanished.

In the real world, where the goose represents substantial assets accumulated over time or received by inheritance, a wise owner will seek to preserve their goose, both for themselves and for their families. Common concerns of clients in this situation include:

>> Will my children act responsibly or foolishly in using their inheritance?

>> Could my children lose their inheritance to a divorcing spouse or to creditors?

>> During my lifetime, is there a way to shield my assets from unexpected lawsuits and catastrophic financial losses?

Using Trusts to Preserve Wealth

If you share any of these concerns, you might consider using a trust to preserve and protect your assets. Although trusts are ordinarily used as an estate-planning tool, the right type of trust, if properly designed, will also provide significant asset protection.

How does a trust protect assets? This is best understood by first examining a trust's basic structure. The person

who sets up the trust (called a *settlor*) transfers assets to a *trustee*, who holds the trust assets for the benefit of the trust's *beneficiaries*. In a typical family, the parents are the settlors, they choose the trustee, and they or their children (or both) are the beneficiaries.

Because the trust assets are owned solely by the trustee, a creditor of the settlor or the beneficiaries must go through the trustee to get to the trust assets. With the right type of trust, this structure acts as a roadblock that prevents the creditor from reaching trust assets until they are distributed to the beneficiaries.

Protecting a Child's Inheritance

A common concern of parents with substantial assets is that a child might blow his or her inheritance on a red sports car instead of investing and using it wisely. Leaving the child's inheritance in a trust is a good way to protect the child from himself or herself, because the child's access to the trust funds is limited by the trust. For example, the trust may restrict distributions to basic living or educational expenses until the child reaches a certain age, thus preventing the child from withdrawing all of the funds at once until the child is mature enough to use them responsibly.

What if a child tries to mortgage his or her inheritance by pledging it as collateral for a loan? Most trusts have a *spendthrift* clause which prevents this and which also prevents a child's creditors (with a few exceptions) from reaching the trust assets before they are distributed to the child. A creditor could try to get around a spendthrift clause by seeking a court order compelling the trustee to distribute trust funds. A well-designed trust, however, will also prevent this because the trustee will not have to distribute funds unless the trustee chooses to do so.

One way to integrate asset protection with traditional estate planning is to set up separate *lifetime trusts* for children, which provide asset protection but also allow each child to become the trustee of his or her trust when they reach maturity.

Protection in Case of Divorce

Divorce is so common today that many parents worry about their child's inheritance being snagged by a divorcing spouse. This risk is real, because if a child mixes his or her inheritance money with the rest of the couple's funds, the inheritance could be considered part of the couple's marital property and, therefore, divided between the divorcing spouses as part of their property settlement. For example, if Susie has a $1 million inheritance and combines it with her husband's funds to purchase jointly owned investments, in a divorce her husband could get $500,000 of the inheritance as his one-half share of the couple's property.

A trust would keep Susie's inheritance separate from the couple's marital property and protect her from having to divide her inheritance with her husband. A divorce court may, however, consider Susie's income from the trust in determining the appropriate level of alimony and child support. If the tables were turned and the husband had the inheritance, under Utah law Susie could reach the trust assets for unpaid child support or could compel trust distributions for unpaid alimony.

Lifetime Protection Using a Self-Settled Trust

What about setting up a trust for your benefit that could also protect your assets during your lifetime? Until recently, a trust set up by a settlor for his or her own benefit (called a *self-settled trust*) provided no protection from a settlor's creditors. Within the past few years, however, several states, including Alaska, Delaware, Nevada and Utah, have passed laws that do provide creditor protection for a self-settled trust created under that state's laws.

The protection provided is not unlimited. For example, in each of those states a self-settled trust does not stop existing creditors from reaching the trust assets. Other limitations on creditor protection vary from state to state.

To qualify for creditor protection, a self-settled trust must meet the state's requirements. In all the states, the trust must be *irrevocable*, meaning that the settlor, acting alone, cannot modify or terminate the trust. Other common requirements include having at least one trustee and some trust assets in that state.

Comparison With Other Asset Protection Methods

The trusts described above are not, of course, the only way to protect assets. Other methods include family limited partnerships, limited liability companies and conversion of non-exempt assets to exempt assets.

Because of their simple structure, trusts avoid many of the administrative burdens imposed by family limited partnerships and limited liability companies. With a trust, no ownership interests are issued, no minute books are kept, and no annual report is due. Irrevocable trusts do have some administrative requirements, which include filing annual trust income tax returns if the trust has sufficient income and filing gift tax returns if gifts to the trust are taxable. An ongoing cost is an annual trustee's fee if the trustee is a bank or trust company.

Wealth preservation is a legitimate goal of every prudent person. With proper planning, a trust can not only be a central part of a person's estate plan, but it can provide significant asset protection as well. ■

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