Law Trends

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Asset Protection Using a Third-Party Trust

By Gary L. Miller

Generally, a trust established by an individual for his or her own assets (a "self-settled trust"), and for his or her own benefit, is fully available to his or her creditors. The only exceptions are specially-designed trusts in those eight states (not including Ohio) that have asset protection trust legislation. A properly structured trust established by a third party, on the other hand, can provide significant protection for a beneficiary in any state. As a result, for individuals who are concerned about creditor protection (e.g., those in professions with significant litigation exposure), inheriting assets in trust could be significantly more valuable than inheriting the same assets outright.

Inheriting assets in trusts can also have significant estate tax advantages. If the third-party grantor allocates a portion of his or her generation-skipping transfer (GST) exemption to transfers to the trust, the trust will be excluded from the beneficiary's estate and the estates of remainder beneficiaries. As a result, such trusts offer significant potential for "opportunity-shifting"; that is, the grantor could gift the "seed money" for a venture with high growth potential, thereby removing the resulting growth from the taxable estates of the trust beneficiaries.

The key to creditor protection is that the trust be a "pure discretionary" trust. In other words, distributions to the beneficiary must be at the sole discretion of the trustee. The beneficiary can be a trustee, but an independent co-trustee (who could be a close friend or business associate of the beneficiary) is needed. The beneficiary can have the right to replace the co-trustee provided the replacement trustee is not a "related or subordinate party."

More common "support trusts" (trusts which provide a standard for distributions, typically health, education, support or maintenance), even with a "spendthrift provision" which protects against most creditors, are subject to certain "exception creditors" such as a divorcing spouse and the IRS. A pure discretionary trust, on the other hand, should protect even against exception creditors.

A great deal of flexibility can be drafted into the third-party trust. For example, as discussed above, the beneficiary can be given the power to replace the co-trustee. In addition, the beneficiary can be given a special testamentary power of appointment to modify the distribution provisions at the beneficiary's death without causing inclusion of the trust in the beneficiary's estate or exposing the trust to the beneficiary's creditors.

Individuals who have significant assets and/or concerns about creditor protection should consider discussing the possibility of a third-party asset protection trust with those from whom they expect to inherit.

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