Consider the Implications

All estate planning must take into account clients' exposure to creditors—present or potential

By **Daniel S. Rubin**, partner, Moses & Singer LLP, New York, and **Karen Goldberg**, executive director, Grant Thornton LLP, New York

Many practitioners believe "asset protection planning" and "estate planning" are mutually exclusive. To some extent, this may be true; on rare occasions, clients may present issues so narrow that they can rightfully be classified as one sort of planning or the other. But no matter what clients may say they want, what they usually need is global planning designed to place them in the best possible circumstances for preserving, enhancing and distributing their wealth.

Most plans must cover both estate planning and asset protection to meet a typical client's needs. In recent years, especially, asset protection has become a significant concern in our increasingly litigious society. Accordingly, advisors must be aware of the asset protection implications of any recommendations they give clients—particularly in estate planning—including advice on wills, jointly owned assets, testamentary marital trusts, trusts subject to an estate tax inclusion period (like grantor retained annuity trusts), and personal residence trusts.

WILLS

Typical wills for married couples of a certain net worth (for example, couples with aggregate wealth exceeding their applicable exclusion amounts) provide that a so-called "credit shelter trust" will be funded at

the death of the first spouse. The balance of the deceased spouse's estate passes to the surviving spouse either outright or in a trust intended to qualify for the unlimited marital deduction. But providing for a credit shelter trust is academic if the first spouse to die does not individually own enough assets to fund the trust.

To ensure that each spouse individually owns sufficient assets to fully fund the credit shelter trust, clients are routinely advised to shift assets from the spouse who has more-than-sufficient assets (the monied spouse) to the spouse who has less-than-sufficient assets (the non-monied spouse). Transfers between spouses generally don't have gift tax implications,[1] and therefore are frequently made as a matter of course. But advisors should always consider the asset protection implications of such transfers, weighing these issues against the expected benefit of the credit shelter trust. Often, clients have made a conscious decision to title assets in the name of the spouse who has less creditor risk.

Advisors also should consider alternatives to making an outright transfer of assets from a monied spouse to a non-monied spouse. One option is for the monied spouse to create an *inter vivos* qualified terminable interest property (QTIP) trust in favor of the non-monied spouse. A properly structured QTIP trust protects the transferred property from claims of both spouses' creditors, yet it causes the property to be included in the estate of the non-monied transferee spouse, rather than that of the monied transferor spouse.[2] Because principal distributions are discretionary, creditors of the non-monied transferee spouse are unable to reach the trust principal—absent a distribution to the non-monied transferee spouse.[3]

The *inter vivos* QTIP trust also might be structured as a "spendthrift" trust to preclude the voluntary alienation of the transferee non-monied spouse's interest.[4] At the same time, absent an improper funding of the *inter vivos* QTIP trust (that is to say, via a fraudulent conveyance), creditors of the transferor monied spouse have no claim against the trust fund. When creditor protection is a particular concern, the transferor monied spouse should consider not retaining an interest in the trust property after the death of the transferee non-monied spouse.[5]

JOINTLY HELD ASSETS

Often spouses own the bulk of their assets as joint tenants with rights of survivorship (including as tenants by the entirety). The right of survivorship means, of course, that when the first spouse dies, such jointly owned property passes by law to the surviving spouse, regardless of the terms of the deceased spouse's will. To ensure that the first spouse to die can fund a credit shelter trust, it's generally necessary to sever one or more of such tenancies.

But severing a tenancy by the entirety can create problems, because such a tenancy often provides significant asset protection (unlike a joint tenancy). Specifically, because a tenancy by the entirety (which most states limit to real estate holdings) cannot be unilaterally severed by either spouse (unlike a joint tenancy), the property cannot be attached by either spouse's creditors. This protection is lost when the non-debtor spouse dies, because the debtor spouse then becomes the sole owner of the property by reason of the right of survivorship. The converse is that the creditor's lien is lost if the debtor spouse predeceases the non-debtor spouse.

Even when there are insufficient other assets to transfer appropriately to the non-monied spouse, clients should sever the tenancy by the entirety in favor of the non-monied spouse only when the non-monied spouse has little or no exposure to potential creditor problems. If the non-monied spouse has creditor risk and the clients still insist on taking such action, cautious advisors should have them acknowledge, in writing, that they are aware that they are forfeiting creditor protection.

Sometimes clients have creditor concerns or, at a minimum, are unsure about the creditor issues they may face now or in the future, and are therefore not amenable to severing the tenancy by the entirety. In such cases, advisors should consider having the monied

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spouse disclaim the non-monied spouse's interest in the tenancy by the entirety property if the monied spouse survives the non-monied spouse. Under this scenario, when the surviving monied spouse disclaims the non-monied spouse's interest in some portion or all of the tenancy-by-the-entirety property, the disclaimed property passes to a credit shelter trust pursuant to the terms of the deceased, non-monied spouse's will.

If there is a valid disclaimer, the disclaiming spouse is deemed to have died before the deceased spouse, and so is treated as never having received the disclaimed property. Nevertheless, under certain circumstances, the disclaimed property may be subject to the creditors of the disclaiming spouse, whereby all or a portion of the disclaimed property may never reach the credit shelter trust. For example, the law of some states provides that a disclaimer is ineffective if the would-be disclaimant is insolvent at the time the disclaimer is made. In addition, the federal government can reach disclaimed property when the would-be disclaimant is subject to a federal tax lien.[6]

Many advisors dislike disclaimers, because disclaimants must strictly adhere to cumbersome requirements for a disclaimer to be effective. Two such requirements are: (1) the disclaimer, without exception, must be made within nine months after the death of the person owning the property; and (2) the would-be disclaimant must not accept, expressly or impliedly, the right to use or benefit from the disclaimed property.[7] But even disclaimer-adverse advisors usually will accept disclaimers as a posthumous tool for correcting planning errors. Still, a plan incorporating the use of a timely disclaimer seems appropriate when no better option exists. For example, when (1) a severance of the tenancy by the entirety is ill-advised, because of the potential for a creditor claim against the non-monied spouse, and (2) the non-monied spouse has insufficient other assets to fully fund a credit shelter trust.

MARITAL TRUST

Under the typical will, married couples provide that any amounts in excess of that which passes to the credit shelter trust free of estate taxation, pursuant to the applicable exclusion amount, passes to the surviving spouse, either outright or in trust, thereby qualifying for the marital deduction. Of course, any outright transfers to the surviving spouse are subject to the surviving spouse's creditors. Thus, a marital trust is in almost all situations preferable, because it can provide at least some level of asset protection.

The inherent difficulty with using a trust to hold the marital share lies in some clients' perception that trusts are overly restrictive. Although this same issue exists with a credit shelter trust, that trust's tax benefits are so well known they usually outweigh fears. It should be noted, however, that there is no estate tax reason for choosing a marital trust over an outright distribution of the marital share—either option provides an unlimited marital deduction.

The client's resistance can be overcome fairly easily by structuring the marital trust for maximum flexibility. In this way, the couple can be assured that the surviving spouse will have access to the marital share even though it's held in trust. The couple also can be made to understand that the use of a marital trust, instead of an outright bequest, actually enhances the spouse's access to the inheritance, by rendering its property inaccessible to involuntary creditor claims.

To achieve sufficient flexibility, each spouse should be asked to choose the person or persons who will be named as the trustees of the marital trust for his benefit under the other spouse's will. Most people can find at least one person whom they trust enough to act in this capacity, thereby ensuring that they will never have to beg for a distribution. Moreover, to the extent that the trustee's discretion over distributions is not limited by a "health, education, welfare and maintenance" or other artificial standard, the surviving spouse need not even provide justification for a distribution request. It's also acceptable for the surviving spouse to be a trustee of the marital trust.[8] It is inadvisable, however, for the spouse to be named as the sole trustee of the marital trust. That's because, when a beneficiary is the sole trustee of his trust, courts have held that the trust property is accessible to creditors, as it can be reached by the beneficiary, acting as a trustee, notwithstanding the existence of a spendthrift provision.[9]

Each spouse also can be named as a trust protector of the trust for his benefit, with authority to remove and replace the trustee. With such a power, the surviving spouse can fire a recalcitrant trustee and appoint a new, more amenable one. Because the new trustee will be bound by a fiduciary duty and have purely discretionary authority to make principal distributions, the power to remove and replace the trustee should not expose the marital trust to creditor claims. The courts have long been loath to substitute their own judgment for that of the trustees when it comes to the making or withholding of discretionary distributions,[10] and we expect that this result should apply notwithstanding the protector's ability to remove and replace trustees.

ETIP

Several types of commonly used trusts have an estate tax inclusion period (ETIP) during which the trust

fund is included in the grantor's estate if the grantor dies.[11] Perhaps the most frequently used trusts with ETIPs are grantor retained annuity trusts (GRATs) and qualified personal residence trusts (QPRTs).

Inasmuch as the trust fund is includible in the grantor's estate if the grantor dies during the ETIP, these trusts are commonly drafted to provide that, in such event, the balance of the trust fund is payable to the grantor's estate. A significant benefit of paying the trust fund to the grantor's estate is that it simplifies matters by allowing the disposition of the ETIP trust property to be coordinated with the disposition of the grantor's other property pursuant to the terms of the grantor's will. In this way, the grantor's entire estate can be cleanly allocated between (1) the credit shelter trust, the marital share and, in many cases, a reverse QTIP trust, in the event that the grantor's spouse has survived, or (2) between generation skipping transfer (GST) tax exempt and GST tax non-exempt trusts for the grantor's descendants in the event that the grantor's spouse has not survived.

When advisors factor in asset protection concerns, however, it becomes clear that the trust should not be payable to the grantor's estate—even if the grantor should die during the ETIP. Instead, the trust should provide for a separate QTIP trust to be funded in the event that the grantor should die during the ETIP survived by the grantor's spouse. By including a QTIP trust in the ETIP trust agreement, the unlimited marital deduction can be obtained without unnecessarily exposing the ETIP trust to the creditors of the grantor's estate.

To the extent that there is insufficient other property remaining in the grantor's estate to fully fund the credit shelter trust, advisors have two options: (1) to carefully draft a formula allocation whereby the property held in the ETIP trust is allocated between a QTIP trust and a credit shelter trust under the terms of the ETIP trust, after accounting for all other property included in the grantor's estate; or (2) to provide the grantor's executor and/or trustee with the authority to split the QTIP trust under the ETIP trust into separate shares with a QTIP election made with respect to one share, but not the other.

QPRT

Personal residence trusts under IRC Section 2702 present unique asset protection concerns, because such trusts involve the home—an asset that the grantor frequently intends to continue using notwithstanding the ETIP's expiration. The grantor of a QPRT often expects to be able to lease back the home from the remainder beneficiaries at a fair market rent after the ETIP expires.

It should be obvious that there are significant flaws in a plan that relies upon the beneficiaries' willingness to lease the residence to the grantor when the ETIP expires. Even assuming that there is no question the beneficiaries will be amenable to doing as expected (potentially many years in the future), the plan has serious asset protection problems, as the grantor's home at that point becomes subject to any present or future creditor claims of the remainder beneficiaries. Moreover, considering that about 50 percent of all marriages now end in divorce, the grantor's home could become subject to equitable distribution in a remainder beneficiary's matrimonial proceeding (notwithstanding that property received by gift is generally considered the separate property of the donee). Even if none of the beneficiaries divorce, it's conceivable that one or more of them might predecease the grantor. As a result, the beneficiary's interest in the grantor's residence would pass as part of the beneficiary's estate, potentially in further subshares and/or outside of the grantor's family, further exacerbating these potential issues.

As an alternative to an outright disposition of the grantor's residence to the trust beneficiaries at the expiration of the ETIP, advisors should recommend that the grantor's personal residence be retained in another "pot trust" for the beneficiaries, until the death of the grantor or such time as the grantor no longer wants to use the residence, whichever is earlier. This ensures that the grantor will be able to lease the residence at the expiration of the ETIP, as the trust agreement can provide the grantor with a right of first refusal to lease the residence.

By having the residence go to a pot trust at the expiration of the ETIP, the grantor also retains a level of control over the lessor, because (1)

COLLECTORS' SPOTLIGHT

Monumental Mickeys: **This 700-pound 6-foot tall "Mickey Through The Years" statute designed by Tuck (James) Morgan, a Disney character artist for more than 18 years, was sold for $25,000 on Sept. 27. The proceeds of the sale went to the Make-A-Wish Foundation of America in Phoenix.**

the lessor would be a trustee preselected by the grantor, and (2) the lessor, as trustee, would be subject to removal and replacement by the grantor, as protector. Moreover, if the pot trust is structured as a grantor trust, the trust's receipt of a fair market rent would not be taxable income either to the trust or the beneficiaries. At the same time, the grantor would have retained all of the income tax benefits inherent in home ownership for the remainder of his life. If the net rental income of the pot trust is then invested, it can effectively grow tax-free inside the trust, because the grantor, not the trust or the beneficiaries, would be responsible for any income tax generated by the trust property. Finally, any income tax paid by the grantor on the trust income would not be deemed a further gift to the trust. If the obligation to pay income tax associated with the trust's income ever becomes burdensome to the grantor, the trust agreement can provide the trustee with discretion to reimburse the grantor, without such discretion having the effect of including the trust property in the grantor's estate for estate tax purposes.[12] It should be noted, however, that depending upon state law, trustee discretion to reimburse the grantor for taxes may present an asset protection problem as a self-settled trust.

Another asset protection issue unique to personal residence trusts arises out of the requirement under the Treasury Regulations that if the trust should cease to qualify as a personal residence trust at any time during the ETIP (for example, because the residence is sold and not substituted with another personal residence within the requisite time period), the trust agreement must require either (1) distribution of the trust assets to the grantor, or (2) conversion of the personal residence trust into a GRAT. Alternatively, the trustee can be granted discretion to choose between these two options.[13] If the trust agreement provides that the trust assets will be returned to the grantor under such circumstances, the trust should be deemed to be a self-settled trust available in its entirety to the grantor's creditors—including all future creditors, until the ETIP expires. Moreover, even if the trust agreement provides the trustee with discretion only to choose to distribute the trust assets to the grantor under such a circumstance, the entirety of the trust property will likely be available to the grantor's creditors.[14] Thus, the potential benefit of providing the maximum possible flexibility permitted under the Treasury Regulations should be weighed against the asset protection implications of such flexibility.

DON'T RISK IT

Perhaps, once upon a time, a well-designed estate plan did not need to involve deliberate consideration of asset protection implications. That time has long passed. The last several decades have seen asset protection considerations grow increasingly important to every estate plan, if only because the future, and therefore future creditor issues, can never be known. We've pointed to just a few key areas of concern. But, clearly, thought must be given to the asset protection implications of any estate planning. Planners who choose to do otherwise are proceeding at their own—and their client's—peril. ▮

Endnotes

1. *See* Internal Revenue Code Section 2523(a). *But also see* IRC Section 2523(i)(1) ("If the spouse of the donor is not a citizen of the United States—no deduction shall be allowed under this section").
2. An *inter vivos* QTIP trust cannot, however, be created for the benefit of a spouse who's not a citizen of the United States. *See* 26 U.S. Code Section 2523(i)(1) ("If the spouse of the donor is not a citizen of the United States—no deduction shall be allowed under this section"). This is the case even if such non-citizen spouse resides in the United States. Note that transfer tax deferral through a qualified domestic trust (QDOT) is available only for testamentary transfers. 26 USC Section 2056A.
3. *See Restatement (Third) of Trusts,* Section 60, comment e. (2003) ("A transferee or creditor of a beneficiary cannot compel the trustee to make discretionary distributions if the beneficiary personally could not do so.")
4. *See, for example,* Austin W. Scott and William F. Fratcher, *The Law of Trusts,* Section 152.4 at p. 119 and Section 155 at p. 157 (4th ed. 1989).
5. *See, for example, Forbes v. Snow,* 140 N.E. 418, 420-21 (Mass. 1923). Note that for tax purposes, however, it is permissible for the transferor monied spouse to be a beneficiary of the trust following the demise of the transferee non-monied spouse. *See* Treasury Regulations Section 25.2523(f)-1(f), Example 11.
6. *See Drye Family 1995 Trust v. U.S.* 152 F.3d 892 (8th Cir. 1998), *aff'd* 528 U.S. 49 (1999).
7. *See* IRC Section 2518(b)(3); Treas. Reg. Section 25.2518-2(d)(1).
8. *In re Hersloff,* 147 B.R. 262 (M.D. Fla. 1992); *In re Schwen,* 240 B.R. 754 (D. Minn. 1999).
9. *See, for example, In re Bottom,* 176 B.R. 950 (N.D. Fla. 1994).
10. "To the extent the trustee has discretion, the court will not control his exercise of it, as long as he does not exceed the limits of discretion conferred upon him. The court will not substitute its own judgment for his. . . [W]ithin the bounds of a reasonable judgment, the court will not interfere." *See,* Scott and Fratcher, *The Law of Trusts,* Section 187, p. 14 (4th ed. 1989).
11. Treas. Reg. Section 26.2632-1(c)(2).
12. Revenue Ruling 2004-64, 2004-27 I.R.B. 7.
13. Treas. Reg. Section 25.2702-5(c)(8).
14. *See, for example, Outwin v. Comm'r,* 76 TC 153 (1981), acq., 1981-2 CB 2.