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Armour for your assets

Gideon Rothschild TEP , November 2014

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Gideon Rothschild looks at US estate planning through an asset-protection lens.

The primary goal of estate planning is to provide for the management and transfer of wealth at the smallest financial and emotional cost to family and loved ones. Despite the recent increase in the federal estate tax exemption, having a comprehensive estate plan is as critical as ever.

Given our litigious society and the high incidence of divorce, very few people are completely insulated from the risks of future creditors. An expertly drafted estate plan will be all encompassing and fulfil both estate and asset-protection planning objectives.

Unanticipated tax consequences

With the current federal estate tax exemption at USD5,340,000 (and indexed for inflation), many individuals mistakenly think their estates no longer require planning. The permanence of 'portability' (which permits the estat of a decedent's spouse to elect to transfer the decedent's unused exemption amount to the surviving spouse) ha equally contributed to this false and widespread notion.

Those who are content to rely on portability may encounter unintended tax consequences in the future. Portabilit does not apply to the generation-skipping transfer (GST) tax exemption, nor is it provided for in most states that impose an estate tax.

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Portability is also only available for the estate tax exemption of the last predeceased spouse – thus, reliance on portability will waste the predeceased spouse's unused exemption if the surviving spouse remarries and then survives their new spouse. Furthermore, the amount of exemption that is 'ported' from one estate to another is nc adjusted to account for inflation.

While the *laissez-faire* approach precipitated by higher federal exemptions and portability may have unanticipate tax consequences, the non-tax consequences, particularly those resulting from inadequately protecting assets from future creditors, may prove to be the most detrimental.

The financial and emotional hardship posed by a future creditor can be largely mitigated by taking a proactive approach and structuring an estate plan with an eye towards asset protection.

Protecting assets

Conventional estate-planning devices, such as a trust formed under a will or an inter vivos trust, can be drafted with certain features that yield asset-protection benefits. Frequently, a will is drafted to provide for distributions to children (or more remote descendants) to be made either outright, if the children are of a certain age and financi maturity, or in trusts that terminate at a specified time. Providing for the outright distribution of assets to descendants at any age, no matter how financially mature they might be, engenders several unfavourable consequences:

- A descendant may be in a bad marriage, in the middle of a divorce, or already divorced with a support obligatic to an ex-spouse, and property distributed outright will potentially lose any protection that it might otherwise hav had if retained in trust.
- A descendant may have other third-party creditor issues, and property distributed out of trust will lose the significant creditor protections that it would have had if left in trust.
- A certain amount of property, equal to the transferor's GST tax exemption, can be retained in trust for the lifetir of the transferor's children, and can then pass to the transferor's grandchildren free of any further transfer tax the death of the children. To the extent that such property was instead transferred outright, the opportunity afforded by the transferor's GST tax exemption would have been wasted.

For optimal protection, these trusts should be drafted to last for the lifetime of the beneficiary and not mandate th distribution of income or principal but leave all distribution decisions to the discretion of the trustees.

The flexible discretionary trust

The inherent difficulty with a discretionary trust lies in the perception that this type of trust is overly restrictive and cannot reflect changing circumstances and needs. Client resistance to a discretionary trust can generally be

overcome by structuring the trust so that it is extremely flexible. For example, designating the beneficiary as the trust protector (upon attaining a certain age) provides the beneficiary with 'leverage' over the trustee.

Most importantly, the protector can have the power to remove and replace the trustee. Designating a protector ensures that the trustee will be appropriately responsive to the needs of the beneficiary.

To add extra flexibility to deal with the many unforeseen circumstances that can arise over the lifetime of a trust, the beneficiary can be granted a lifetime or testamentary power of appointment. A testamentary power of appointment is a versatile tool that can enable the beneficiary to decide how, when and to whom the trust will be distributed on their death. This gives the beneficiary control over the trust principal without subjecting it to the beneficiary's creditors.

There may also be numerous tax benefits to including powers of appointment in a trust.

In order to permit the uninhibited use of trust funds in a situation where the beneficiary may have an existing creditor issue, clients can consider naming the beneficiary's spouse as an additional discretionary beneficiary of the trust. In this manner, the beneficiary's spouse might be used as a conduit for the use of the trust funds for the benefit of the beneficiary where a direct distribution to the beneficiary, or for the beneficiary's use or benefit, cannot be made.

Reviewing estate plans

Trusts that have already been funded, though irrevocable, should be reviewed, as there may be opportunities to modify their terms to meet current estate- and asset-protection objectives. For example, an existing irrevocable trust may provide for the mandatory payment of income or principal to the beneficiary.

Since such a trust does not provide optimal protection from creditors, it will probably be desirable to modify its terms. Such modification in the past might have required a court proceeding with attendant delays, costs and the consent of all interested parties.

More recently, many states (approximately 21) have enacted legislation permitting trust decantings. Trust decanting is the exercise of a trustee's discretion to distribute assets from the existing trust to a new trust with different terms, without the consent of the beneficiaries and without a court proceeding. For trusts located in a state that does not currently provide for decanting, it may be possible to change the situs of the trust to a state th does permit decanting.

Decanting can be used to modify a trust to add the critical asset-protection features discussed above, extend the term of a trust (subject to the existing rule against perpetuity), modify the terms to create a purely discretionary trust (subject to statutory limitations that prohibit reducing any beneficiary's vested income interest), and add or modify powers of appointment.

Another frequently encountered situation arises when clients are on the fence in terms of deciding whether to utilise their lifetime gift exemption (anticipated to be USD5,430,000 in 2015 and twice that if married) by making irrevocable gifts. The use of self-settled trusts, which permit the settlor to be a discretionary beneficiary, has increased as a result of the enactment of state statutes (in 15 states) that provide for creditor protection to such

trusts.

By settling trusts in these jurisdictions (or foreign jurisdictions with similar legislation) clients can have their cake and eat it too. That is, should they suffer a financial reversal and require access to the trust's assets, the trustee will have discretion to make distributions to them.

However, given the fact that such self-settled trusts have not been adequately tested in the courts (even though the Internal Revenue Service (IRS) has issued several private letter rulings on the matter), it may be safer to give third party the power to add the settlor as a beneficiary should the need arise, thereby not risking, in the first instance, an IRS challenge.

By applying some of the foregoing concepts, asset protection can be easily integrated into complex plans, as well as plans of a simpler variety. Failing to integrate asset protection into the estate plan can have a devastating financial and emotional impact.

This article is based on Gideon's presentation at STEP Wyoming's International Tax Conference