What Does "ASSET PROTECTION" Really Mean?

By Douglas G. Chalgian

FAST FACTS:

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When clients talk to me about setting up a trust, they often believe that by doing so, they will "protect their assets," although they are rarely able to explain what that means or from what they are hoping to protect their assets. Having practiced in this area of the law for a number of years, I have come to understand that the phrase "asset protection" means different things to different people.

To understand the complex world of asset protection planning, you must distinguish the various threats to which assets are exposed and then look at the types of planning strategies available for those various situations. As discussed below, with few exceptions, there are tradeoffs to every asset protection planning strategy. Or said another way, while asset protection planning is real and can provide significant benefits to people in specific situations, there is nothing magic about creating a trust, and there is no asset protection silver bullet.

Protecting Assets from Probate

Of all the asset protection concerns that worry clients, probably the least important is the concern many clients have with "avoiding probate."

Years of so-called educational seminars—which, more often than not, are marketing programs designed to sell living trusts—have created an unjustified fear of the probate process in the minds of many people. At these seminars, the real costs and inconveniences of the probate process are often grossly exaggerated. While there is nothing wrong with using living trusts (also known as revocable trusts or grantor trusts) as estate planning tools, living trusts provide no meaningful asset protection, and if the only reason to create a trust is to "avoid probate," clients should consider whether a trust is even necessary.

Protecting Assets from Nursing Home Costs

Another common concern, especially among older clients, is the fear that if they or their spouse need care in a nursing home, their assets will be dissipated on those costs. Indeed, nursing homes are expensive—approximately $7,000 a month. And for people in some nursing homes (Medicaid facilities), restructuring assets to become eligible for Medicaid benefits may allow for a significant portion of their estate to be protected. For any person entering a Medicaid-certified nursing home with the expectation of an extended stay, consultation with a qualified Medicaid planning attorney is always a good idea.

The problem is that, for people who are not expecting to enter a nursing home anytime in the foreseeable future, trying to structure assets to qualify for Medicaid benefits if and when that situation arises will almost always involve more risks than benefits. When nursing home placement is not imminent, the only planning tool (if it can be called that) is to give away your assets or otherwise make them unavailable for your care needs and hope that nursing home placement does not occur for at least five years. Obvious shortcomings of such strategies include the following:

- Resources that have been made unavailable may be needed for care costs or other living expenses. Although those who promote these strategies often suggest that the resources, once placed in a trust or a child's control, can be returned, such planning relies on unenforceable understandings—always a recipe for disaster in legal matters.
- As people age and begin to look for assisted living facilities, they may find that many facilities do not take Medicaid. Having money means having options, and too much focus on Medicaid planning can mean that the only option left is a Medicaid-funded facility, which may not be the first or best choice.
- It is pure speculation to assume Medicaid will pay for this type of care in the future or know what the eligibility rules will be. Medicaid eligibility rules are always changing, and no one can presume to know what Medicaid will cover and what the rules will be five years or more in the future.

A more practical choice for some people who have this concern is to purchase long-term care insurance. Although expensive, a quality long-term care policy can provide protection of assets and offer options to policy owners regarding where they want their care provided if and when the need arises.

Protecting Assets from Divorce

For anyone considering marriage later in life or in situations where one or both of the individuals getting married enter the relationship with established wealth, prenuptial agreements are a critical asset protection planning consideration. Prenuptial agreements allow people to feel confident that the wealth they bring into a marriage is protected in the event of divorce. Prenuptial agreements also typically spell out the rights of a spouse in the event the other spouse dies while married. Rather than making marriage partners less trusting of one another, prenuptial agreements allow the parties to move forward with their marriage by eliminating concerns about "what would happen if…?"

In addition to prenuptial agreements, people sometimes receive inheritances when they are already married and want to prevent those inherited assets from becoming part of the marital estate that would be divided with their spouse if they become divorced. In such cases, it may be possible to protect assets by keeping them segregated during the marriage. If no prenuptial agreement is in place, divorce law in Michigan directs that only those assets accumulated during the marriage and obtained as a result of the efforts of the parties during the marriage can be split in a divorce.[1] Assets brought into the marriage by one party or inherited during the marriage may be protected, but must be handled carefully to avoid the claim that they have been commingled or have otherwise become part of the marital estate. Preventing assets from becoming marital property, in whole or part, is more than just keeping them titled in separate names. It also means not engaging in activities during marriage that enhance the value of the separate property, not using marital funds to pay taxes on earnings from the separate property, and not engaging in other activities that could allow a clever divorce attorney to claim the soon-to-be-ex-spouse has a right to some portion of those assets. Trusts can help in these situations, but protection may require more than that.

Protecting Assets for Problem Beneficiaries

Many clients are concerned that the assets they leave to their beneficiaries may be wasted if those beneficiaries have creditor problems of their own (divorce, lawsuits, bankruptcy, etc.). The tools for planning to protect assets from beneficiaries' creditors are numerous and should always be considered anytime there is reason to believe that a beneficiary may be facing rough waters. In Michigan, the most common and reliable method of protecting assets left to a beneficiary from the reach of that beneficiary's creditors is to leave the assets in a "discretionary" trust. A discretionary trust allows the trust property to be used for the needs of the beneficiary but cannot be reached by the beneficiary's creditors. The newly adopted Michigan Trust Code[2] provides even greater reliability for people creating trusts for beneficiaries with creditor troubles.

Protecting Assets from Lawsuits

Many people think asset protection means that if they get sued, the person suing them can't reach the assets that have been "protected."

For starters, it's important to understand that the simple trusts most people create don't do anything to protect assets from these types of creditors. Assets held in the standard revocable trust are just as subject to recovery by a judgment creditor as they would be if no trust existed.

However, there are other planning tools that may protect assets from lawsuits and judgment creditors. These include (1) so-called "self-settled asset protection trusts," (2) business entities like corporations and partnerships, and (3) liability insurance coverage.

In Michigan, any trust into which you place your assets while reserving the right to have those assets distributed back to you or used to pay your expenses can be reached by your creditors. But that is not true everywhere. Some states and some foreign nations—most notably, certain island nations—have laws that differ from Michigan's in that they allow for self-settled asset protection trusts.

Michigan residents may choose to create trusts in jurisdictions where self-settled asset protection trusts are allowed to obtain the benefits of these protective trusts. To do so, trust investments are typically held in the other jurisdiction (state or foreign nation) and the person in charge of the trust (the trustee) is likewise in that state or foreign nation. This loss of control is often a barrier to people using self-settled asset protection trusts. Another concern is that, although the self-settled asset protection trusts may

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be subject to the laws of the foreign state or nation, if you are sued in Michigan, state laws will control the lawsuit and may control the rights of the judgment creditor to collect against your assets.

A more common and reliable form of asset protection, typically used by business people, is to create protective entities like corporations and partnerships. Done right, these entities allow business owners to separate business assets from personal assets and prevent creditors of the business (including someone who successfully sues the business) from reaching their personal assets.

Finally, the first line of defense for most people who get sued is their liability insurance coverage. Concerns about exposing one's assets to lawsuits can often be resolved by simply maintaining sufficient types and amounts of liability insurance coverage.

Protecting Assets from the "Death Tax"

Another common concern for clients is that their estate plan protects their assets from the "death tax"—more accurately called the federal estate and gift tax.[3]

Currently, the death tax applies only to estates in excess of $5 million.[4] While that figure could change—and will, in fact, drop to just $1 million if Congress fails to act before the end of 2012—commentators expect a deal will be reached that will cause this tax to remain relevant to only a very small percentage of the population. This means that many people who worry about avoiding the death tax are worrying unnecessarily; their estates are simply not that large. For those who face the prospect of the death tax, there are many well-established planning tools that can help. These include:

Trusts for Married Persons That Allow the Unified Credit Amount for Both Husband and Wife to be Exercised

This planning technique takes advantage of the fact that, for married couples, each spouse has his or her own unified credit. Such plans divide the marital assets when the first spouse dies, typically putting part of the assets in a trust that continues and is available to support the surviving spouse while the rest of the marital assets are left to the surviving spouse without restriction. Under current law, even this type of planning is largely unnecessary because of the fact that, even without specific provisions in the estate plan, the surviving spouse will be able to exercise any unused portion of the estate tax credit of the first spouse to die.

Annual Gifting Plans, Including Gifts into Trust

By taking advantage of the annual gift tax exclusion amount, people with estates subject to the death tax can give away a limited amount of assets each year in a manner that will allow them to preserve their full unified credit amount. These gifts can be made directly or in trust to children or other beneficiaries.

Life Insurance and Life Insurance Trusts

Purchasing life insurance is often one way to plan for a taxable estate. By purchasing life insurance and transferring ownership of the policy to an irrevocable life insurance trust, funds can be available to pay the death tax so assets in the estate do not have to be liquidated at death.

Conclusion

As is hopefully clear from the information in this article, asset protection is more complicated than simply putting your assets in a living trust. In fact, putting assets in a simple living trust provides no meaningful asset protection benefit. Rather, for people who have legitimate concerns about creditors, taxes, and lawsuits, a variety of legal tools are available to successfully protect assets. In each instance, however, those techniques involve risks and costs that must be considered before deciding whether such strategies make sense in a client's specific situation. ■

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FOOTNOTES

1. See MCL 552.19.
2. MCL 700.7101 *et seq.*
3. See 26 USC 2001 *et seq.* and 26 USC 2501 *et seq.*
4. See 26 USC 2505.