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Use of Trusts and Creditor Implications

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What are the creditor implications of using trusts?

Certain types of trusts can protect your assets from future claims of creditors and future lawsuits. Trusts that have this protective feature are often referred to as asset protection trusts. Setting up an asset protection trust is a preventative measure that can keep you from losing your possessions. However, if you don't take steps to protect your assets until your creditors are pounding on your door or until you have a judgment against you, it's already too late. If you have assets you want to protect, you should take the necessary precautions now, before those assets are in jeopardy. There are various types of trusts that can help you achieve this goal. Depending on the value of your assets and certain other considerations, one or more of these may be appropriate for you.

Types of asset protection trusts

Irrevocable trusts

All trusts are either revocable or irrevocable. As the name implies, an irrevocable trust is one you cannot revoke or amend. Once you have established the trust, you cannot dissolve the trust, change the beneficiaries, remove assets from the trust, or change its terms. In short, you lose control of the assets once they become part of the trust. However, because the assets are out of your control and because you're not a beneficiary, they're generally beyond the reach of creditors too. As an added bonus, assets in an irrevocable trust typically are not included in your gross estate, which can significantly reduce your estate tax liability.

Caution: *If the creator is not a beneficiary, the transfer of assets to a trust is considered a taxable gift and federal gift tax may be incurred at the time of the transfer. The annual gift tax exclusion (currently $16,000) and the applicable exclusion amount ($12,060,000 in 2022) may reduce the amount of the taxable gift. If the creator is a trustee, his or her ability to make distributions to the beneficiaries must be limited to ascertainable standards; otherwise creditors may reach the assets.*

There are many types of irrevocable trusts that may fulfill your needs. For example, charitable remainder trusts provide you or your family with lifetime income, while assets are donated to charity at the death of the income beneficiary. A qualified terminable interest property trust provides your spouse with lifetime income and allows you to choose the ultimate beneficiaries (usually your children). You should consult an estate planning attorney to determine what type of trust is best suited to your situation.

Offshore or foreign trusts

An offshore or foreign trust is a trust established in a country outside of the United States. Typically, the trust is set up in a country that does not recognize judgments from U.S. courts. This means that in order to reach your assets, a creditor would have to go through the legal system of the country where the trust is located. Many countries also have more lenient laws regarding fraudulent conveyances, which can make it easier to shelter assets from creditors. Additionally, many foreign countries allow you to set up an asset protection trust and still retain a beneficial interest in the trust assets. This means the trustee can be authorized to distribute trust income or assets to you.

On the downside, offshore trusts can be extremely expensive and complicated to set up. Typically, an attorney in the country where you wish to set up the trust will have to draft the trust document. You may also need to select a foreign trustee, a foreign custodian, and an investment manager. Additionally, travel to the foreign country may be necessary in order to sign the trust documents. Finally, annual maintenance fees can be substantial. Some of the more popular countries for offshore trusts include the Bahamas, the Cayman Islands, the Cook Islands, the British Virgin Islands, Bermuda, Belize, and Liechtenstein.

Caution: *Employee benefit trusts and investment trusts will be treated as domestic trusts if U.S. trustees control all of the substantial decisions of the trust.*

Domestic self-settled spendthrift trusts

Alaska, Delaware, and a number of other states have passed legislation making it easier to set up asset protection trusts (DAPTs). These states allow individuals to set up an irrevocable trust to protect assets against future claims of creditors. These laws also allow the creator (or grantor) of the trust to be a discretionary beneficiary of the trust. This means that the trustee can be given the authority to distribute income or assets from the trust back to the creator. Additionally, some states have eliminated the limit on the life of the trust, which means that trust assets can theoretically continue to compound into eternity without gift, estate, or generation-skipping transfer tax consequences.

However, there are some drawbacks. This type of trust will not protect your assets if the trust is set up to hinder, delay, or defraud a creditor. Further, these states require that at least one trustee be located in the state, and that this trustee be responsible for keeping records and preparing tax returns.

Caution: *Because the grantor can still reach the assets in a domestic self-settled spendthrift trust (albeit indirectly), there is a* *great deal of controversy as to whether these trusts will be able to protect your assets if challenged in court. Additionally, there is some question as to whether assets in the trust should be included in the grantor's gross estate for estate tax purposes. It may be several years before the courts and the IRS determine whether these trusts work as the state statutes intend.*

Revocable and irrevocable life insurance trusts

Although revocable and irrevocable life insurance trusts are mainly used as estate planning tools, they also have some value as asset protection tools. Both of these are trusts are funded, at least in part, by life insurance policies or proceeds. Their purpose, generally, is to provide liquid funds for the payment of estate taxes, debts, and other expenses, and, in the case of an irrevocable life insurance trust, help minimize gift, estate, and generation-skipping transfer taxes. Both the revocable and irrevocable life insurance trusts may also protect trust assets from claims that creditors might make against the estate.

Important tips

Don't wait

As mentioned, to be effective, sheltering strategies must be in place before there is a claim against your assets. If there is already a claim against you, it probably won't help to set up a trust. Under the doctrine of fraudulent conveyances, a judge would likely rule that the assets are still yours. Similarly, setting up a trust to fend off an impending claim would also be ineffective. As one court stated, it is permissible to transfer assets out of reach from possible creditors, but not from probable creditors.

Seek out competent professional help

You will need to work with an experienced attorney in order to make an asset protection trust work to your advantage. Setting one up can be extremely complex, and continuing administration is necessary to avoid running afoul of tax and other laws. Additionally, make sure the reasons for your actions are clearly documented. If the validity of your trust is challenged, your position will be much stronger if there is evidence that you set up a trust for a legitimate purpose, such as the reduction of estate taxes.

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