Asset Protection

Passing assets through trusts can help protect your family's estate.

By David R. Toups, JD, MBA, CFA, CFP, CTFA

As the well-known maxim states, only two things in life are certain, death and taxes. After working most of your life, upon death, you have the ability to do something for your loved ones that none of them can do for themselves—provide an exceptionally strong asset protection vehicle for the estate you leave to them. The risks and costs associated with doing so are minimal, and to paraphrase another often quoted adage, having it and not needing it is fine, but needing it and not having it may prove disastrous.

Control of assets

At the time of death, property held by the decedent passes as he or she directs by the terms of his or her will or by state statute, if no will exists, for probate assets; or by his or her beneficiary designations for non-probate assets such as insurance policies, retirement assets, or pay-on-death accounts at financial institutions. Specially titled property passes automatically upon his or her death such as property held as joint tenancy with a right of survivorship.

If the decedent's death triggers a trust's distribution or disbursement provisions, those trust assets also will flow as prescribed by that document. Knowing which documents control an asset's disposition is a fundamental, but sometimes overlooked, component of effective estate planning.

Character of assets

There are differing ways of holding title to property, and each has its own unique characteristics, body of law, and vulnerabilities to creditor claims. The way property is treated for taxation may vary for issues such as a step-up in basis at death or as an available asset for beneficiaries.

Assets held or transferred to a trust typically do not change their title's character unless doing so eliminates a necessary component. Absent an intentional change by the trustee, assets held in trust retain their character, which means community property or separate property contributed remain so. A trust does, however, separate title on a different dimension—by legal and beneficial owner.

Understanding these building block concepts can help immensely in structuring a smooth estate plan that will protect the family treasure you've accumulated over a lifetime.

Protection of assets

Rather than leaving assets outright to loved ones, those exact same assets may pass into a trust for their benefit and provide asset protection from creditors or adverse judgments. In addition, those same assets may carry estate and generation-skipping transfer tax protections that flow from the decedent's death.

If you create a trust for yourself, as both its grantor or donor as well as a beneficiary, it is referred to as a first party or self-settled trust. Very few states extend many asset protection benefits to such trusts, and those that do require the trust to be irrevocable.

In contrast, a third-party trust is created by a donor or grantor, who is not a beneficiary, for others.

Many Americans have enjoyed a short-lived respite from federal estate taxation since the Tax Cuts and Jobs Act of 2017 (TCJA); however, that relief is set to expire at the end of 2025, and many states impose their own separate estate tax on their residents and property. Some states, such as Massachusetts and Oregon, permit as little as $1 million per person to pass without imposing estate taxation.

But even if you have just a modest retirement savings balance and a home, you still may escape such low estate tax thresholds. Passing these assets that have already "paid" the estate tax, actually or by exemption, to a trust for loved ones eliminates that tax liability exposure for those assets, unless the beneficiary distributes the assets from the protected shelter of the trust.

Shrewd estate planners who understand this concept will rarely terminate trusts upon the beneficiary reaching financial maturity (age 25 to 40), much less biological maturity (age 18). Rather, upon the beneficiary attaining the specified age, the trust provides the beneficiary the keys to the vault by permitting him or her to serve as its sole trustee. At that point, a beneficiary/trustee can manage and retain the assets in the trust (like a protective asset fort) or self-distribute and terminate it.

Special needs

Another benefit of leaving assets in a trust for loved ones involves public benefits. Assets held in a third-party trust, if drafted with distinct provisions pertaining only to a beneficiary with special needs, would not affect his or her eligibility for or reduce public benefits that may be received at some point in the future. From a legal perspective, the assets have never been in his or her possession since the trust owns the assets.

Termination alternative

In a trust, the legal title holder is the trustee, and the beneficial or equitable titleholder is the beneficiary. Even though the same person may serve in those distinct roles at the same time, according to the trust's provisions, the person must manage and distribute the assets according to the ascertainable standard established under the trust's terms.

Also, the beneficiary may not receive the principal held within the trust because he or she may not survive until the trust's termination, or those assets may only be available to him or her for life and, at death, pass to the donor's other loved ones.

Taxation

Trust tax rates are highly compressed and climb quickly to the highest marginal rates. Even with the favorable TCJA rates, a trust reaches the highest federal income tax level of 37% with only $13,450 of income. Only individual incomes just shy of $600,000 slip into that marginal tax bracket. However, if properly managed, the trust may distribute the income and take a deduction for the distribution, and the income can be taxed at the beneficiary's income tax rate. Also, if the assets are invested in tax advantaged or growth oriented vehicles, the trust may have very little, if any, taxable income.

Dynasties

Some states, such as South Dakota and Nevada, have created very favorable asset protection laws and have greatly increased or eliminated their rules against perpetuities, which limits the number of years a trust may continue in existence. These states have created cottage industries and have attracted large sums of wealth from those familiar with these dynasty concepts.

Conclusion

As beautiful as leaving an inheritance to loved ones is, it is even more appreciated if it does not create an additional tax burden upon its recipients or impede the public or private benefits being received. Enhancing a gift that must eventually pass, since we can't take it with us, can prove to be a very worthwhile endeavor.

Discussing the possibilities in creating or improving your estate plan with a trusted advisor is a great first step.

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