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The Magic Of Irrevocable Trusts In Asset Protection

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This article shall cover some of the basics of how trusts can provide asset protection. First, I will cover some basic terms and principles of trusts and then I will provide some examples of how trusts can be a very powerful asset protection tool.

A trust is an arrangement in which someone, the Settlor, transfers property to a Trustee who agrees to hold the property for the benefit of one or more beneficiaries. A trust can be either revocable or irrevocable by the Settlor.

In Texas, the Settlor can be both the Trustee and Beneficiary of the trust he or she creates. If a trust is revocable by the Settlor, it will not provide any asset protection for the Settlor. Similarly, if the Settlor is a beneficiary of an irrevocable trust, it will not provide any asset protection for him or her, except in very unique circumstances.

So, in Texas, in order to provide asset protection with a trust, it must be irrevocable and the Settlor must not be a beneficiary. This kind of trust is frequently called a “Spendthrift trust”. Spendthrift trusts originated to protect the beneficiary’s ability to transfer his or her right to future payments of income or capital from the trust, and his or her creditors are unable to subject the beneficiary’s interest in the trust to the payment of his or her debts.

Spendthrift trusts are usually established with the object of providing a fund for the maintenance of another person, known as the spendthrift, while also protecting the trust against the beneficiary’s imprudence, extravagance, and inability to manage financial affairs.

For example, a Settlor establishes a spendthrift trust for his son, a compulsive gambler, who spends money injudiciously with no concern for the future. Under the terms of the \$400,000 trust, which is to be administered by a trusted person or financial institution as Trustee, the son is to receive \$15,000 a year. Any words that indicate the Settlor’s intention to impose a direct restraint on the transferability of the beneficiary’s interest can be used to create a spendthrift trust.

Such trusts do not limit the rights of the beneficiary's creditors to the income or property the trust distributes to him after it is received by the beneficiary from the trustee, but his creditors cannot compel the trustee to pay them directly. This means that any of the beneficiary's creditors can seek to have the money the spendthrift has already received applied to satisfy their claims, but creditor's claims to future payments under the trust, however, are denied. The beneficiary's creditors cannot reach the \$15,000 that he is to be paid in a subsequent year until it is actually paid out to him. If the beneficiary could dispose of his right to receive income or principal from the trust, his incompetence or carelessness might lead him to sell his interest in the trust and transfer it to a lender or purchaser and creditors the right to receive future income as it became due. By providing in the trust that no beneficiary can sell, pledge or otherwise give someone rights to his rights in the trust, no creditor of the beneficiary can do anything with the income until it is paid into his hands by the trustee. Therefore, he is more likely to be protected, at least to some extent, against losing what his father wanted to leave to him.

Now, how does this kind of a trust help a Settlor to protect his or her assets from a creditor since he or she cannot transfer assets into a trust with spendthrift provisions and remain a beneficiary and protect it from his or her creditors? The answer is you wouldn't use this technique for assets that you need to support yourself. Those assets that are not already exempt under Texas law should be put in an LLC that you control and in which you still own the lion's share of the equity. But once you have accumulated sufficient assets in your exempt buckets (IRA, 401(k), annuities, etc) and then in your LLC, to provide for your future needs, the spendthrift irrevocable trust for your children or other loved ones is the best vehicle to protect excess assets. This trust is much better than an LLC because you no longer own the assets that you put in the trust. They never appear on your balance sheet or estate, if properly implemented.

I have many clients that have difficulty pulling the trigger on setting up irrevocable trusts for their children and other loved ones because they think they will lose control. Far from it, you can remain the Trustee! The Trustee is the only one who manages the assets in the trust and determines if the beneficiary is entitled to distributions.

When should you consider doing this? As said above when you have a comfort level on your own exempt and otherwise protected assets, but also consider setting up a trust like this for a new business venture or a new location for your current business. Hopefully, the endeavor is a success and since these trust assets are not part of your balance sheet, they can never be attached by a creditor of yours or estate taxed. Yet, you still control it and if you work in the business endeavor, you can get paid from the business owned by the trust. These trusts can last for several generations and can be perpetual in some jurisdictions. A trust like this needs to be very carefully drafted so that 50 years from now it still has the flexibility to handle an unforeseen circumstance. They also must be carefully drafted so as not to bring the assets into your estate for federal estate tax imposition.

These trusts have many different names in the public, such as generation skipping trust, legacy trust, and heritage trust. It doesn't matter what it is called, what matters is what it says.

Another planning tip is to approach your parents to set up a trust for you like I have described in this article and give you control over it as Trustee and beneficiary. It is still not your asset and is totally “bullet proof” if properly structured and administered. For sure, your parents should do this for you in their estate planning documents, but if they set one up for you now and seed it with gifts, you can start that new business venture or location inside your trust in which you are the beneficiary and Trustee!

There are many more planning opportunities using trusts that are beyond the scope of this article, but I hope I have whetted your appetite to jump into the world of irrevocable trusts.

WealthKeepers® is an asset protection and wealth transfer planning firm. We offer a 1-hour initial conference at no charge to discuss your asset protection issues. Call us at 713-461-9699 to schedule an appointment today.

James C. Mulder, a Houston based attorney with over thirty years of experience in Wealth Transfer, Tax and Asset Protection Planning is Board Certified by the Texas Board of Legal Specialization. He is one of only nine attorneys in the Houston area that are Board certified in both Estate Planning and Probate Law and in Tax Law. Mr. Mulder concentrates his practice primarily in the areas of Wealth Transfer, Tax and Asset Protection Planning, which includes the development and preparation of very comprehensive Wills and Trusts, Business Organizations and Family Partnerships. Mr. Mulder has prepared over 1,000 asset protection plans.