# HONEY WE CAN CANCEL OUR TRIP TO THE COOK ISLANDS – MICHIGAN HAS AN ASSET PROTECTION TRUST STATUTE!

By: Geoffrey N. Taylor, Esq.

## I. INTRODUCTION

A. On my list of favorite estate planning myths, number one is certainly that having a will avoids probate (it doesn't). A close second is the belief that having a trust avoids creditor claims (it doesn't).

B. Clients seeking legal advice often look for air-tight solutions. For asset protection, they don't exist. But as a practical matter, disincentives for creditors to pursue collection efforts can easily be created. I like to think of it as creating road blocks. If I cannot create a road block, I try to create speed bumps.

C. Michigan residents can avail themselves of many asset protection strategies, including:

1. Prenuptial agreements or post nuptial agreements.

2. Tenancy by the entireties for married couples.

3. IRAs.

4. Cash value and proceeds of life insurance payable to the debtor's spouse or his children or to a trust for their benefit.

5. LLCs. Assets in an LLC can be protected if debtor is not the sole member. Even if the creditor is successful, he will generally get only a "charging order" entitling him only to the debtor's financial rights and not entitling him

to participate in the management of the LLC. The creditor will also face possible phantom income issues.

D. Looming in the background of any asset protection planning is the Michigan Fraudulent Transfer Act. Under the Act, certain transfers of property are considered fraudulent, meaning that a creditor has a legal right to undo the transfer and recover the property from the transferee.

1. With respect to existing creditors (i.e., creditors whose claims arose before after the transfer was made), a transfer is fraudulent if (i) the debtor does not receive (or to the extent he does not receive) a reasonably equivalent value in exchange for the transfer, and (ii) the debtor was insolvent at that time or became insolvent as a result of the transfer. For this purpose, insolvency means liabilities in excess of assets (measured at the time of transfer).

2. With respect to existing or future creditors (i.e., creditors whose claims arose either before or after the transfer was made), a transfer is fraudulent if the debtor (i) had an actual intent to hinder, delay, or defraud any creditor, or (ii) failed to receive (or to the extent he does not receive) a reasonably equivalent value in exchange for the transfer and intended, believed, or reasonably should have believed, that he would incur debts beyond his ability to pay as they became due. For this purpose, a creditor is anyone with a claim, and a claim includes any right to payment, whether mature or unmatured, and whether fixed or contingent. In determining actual intent, consideration is given to whether the transfer was made

to an insider (e.g., a family member), whether the debtor transferred substantially all of his assets, and whether the debtor was rendered insolvent as a result of the transfer.

3. Note that the remedy for the creditor is a legal right to undo the transfer.

## II. TRUSTS IN ASSET PROTECTION PLANNING

A. Traditionally in all states, a person cannot protect his assets from the claims of his creditors by simply transferring his assets into a trust for his benefit. Public policy says you shouldn’t be able to do this. Shouldn’t have cake and eat it too.

B. Michigan case law, codified in MCL 700.7506(1)(c), provides that creditors of the grantor of a self-settled trust (i.e., a trust in which the grantor is also a beneficiary) can reach the maximum amount that can be distributed to or for the grantor’s benefit in satisfaction of the creditors’ claims. For example, let’s say I create and fund a self-settled trust under which I can receive distributions in a third party trustee’s discretion. My creditors can compel the trustee to distribute all assets to them in satisfaction of their claims. If the amount distributable to me were limited to $1 / day, the creditors would be subject to that limit (i.e., the maximum amount that can be distributed to me).

C. In the late 1990s, states began enacting "asset protection trust" statutes. States saw this is as a way to increase trust business in the state by attracting business from other states or at a minimum retain in-state trust business.

1. Delaware and Alaska led the charge.

2. Currently about 17 states offer protection.

3. Nevada is a popular choice.

4. Even Ohio recently joined the mix.

D. These statutes enable a grantor to transfer assets to a trust and retain certain beneficial interests in the trust, while preventing the grantor's creditors from reaching the assets in satisfaction of their claims. These statutes often except certain transfers from the afforded protection, including transfers made in bad faith or with the intent to defraud.

E. Most asset protection state statutes require that the trust be irrevocable, must have spendthrift provisions prohibiting a beneficiary from assigning his interest in the trust, and at least one trustee must be a resident of the state of creation. Since Michigan law did not previously provide this protection, a Michigan resident who wanted to establish such a trust had to do so elsewhere.

1. Another state. Generally have to pay a local, corporate trustee a significant annual fee. This trustee is often trustee in name only, having little to no administrative duties.

2. Off-shore. This can be scary for a lot of clients. "Sure I don't want my creditors to reach these assets, but I NEED TO BE ABLE TO REACH THEM!"

## III. MICHIGAN JUMPS ON BOARD - ENACTS THE QUALIFIED DISPOSITIONS IN TRUST ACT

A. Michigan enacted the Qualified Dispositions in Trust Act. The Act became effective March 8, 2017. If certain form and funding requirements are satisfied, a Michigan resident can create and transfer assets to a trust having another Michigan resident as trustee, continue to receive benefits from the assets, and protect the assets from claims of the grantor's creditors

B. The Act is significant in that it provides statutory authority for protection. However, because the legislation is new there are no Michigan cases interpreting it and not likely to be any for many years to come. There is very little judicial guidance in other states too.

C. The asset protection afforded by the Act is significant in several respects.

1. Creditors generally must bring claims within two years after the date of transfer and must prove fraud, either actual or constructive. Solvency is an issue.

2. The standard of proof for establishing actual or constructive fraud is clear and convincing evidence. This is significantly higher than the typical preponderance of evidence (i.e., greater than 50%).

3. Remedy is return of debt amount to the grantor.

## IV. REQUIREMENTS

A. Like any good statute, the Act is riddled with defined terms. Here are some of the key ones.

B. “Qualified Trust Agreement.”

1. These requirements are typical of most irrevocable trusts executed for tax reduction purposes.

2. The trust must:

   a. be irrevocable. Irrevocable means the grantor must have no power, directly or indirectly, to amend or revoke the trust, although the grantor can retain a limited power of appointment over the trust assets (discussed below).

   b. contain a spendthrift provision. A spendthrift provision prohibits a trust beneficiary, including the grantor, from voluntarily or involuntarily assigning any interest the beneficiary has in the trust.

   c. expressly incorporate Michigan law to govern the validity, construction, and administration of the trust.

C. “Qualified Disposition.”

1. As the title of the Act indicates, it all starts with a “qualified disposition.” The grantor must transfer property to a “qualified trustee” (see below) subject to a trust agreement under which the grantor has only rights that are permitted under the Act.

2. A transfer is not a qualified disposition if the grantor is in arrears on a child support obligation by more than 30 days at the time of transfer. If the grantor subsequently falls behind more than 30 days, the trust assets are not available to satisfy the grantor’s child support obligations.

3. A transfer is not a qualified disposition with respect to the grantor's spouse if the transfer is less than 30 days before the marriage. If more than 30 days, the trust assets are not considered part of the marital estate.

4. Affidavit - The grantor must sign an affidavit stating generally that the grantor is solvent and the transfer is not an attempt to defraud creditors. Specifically, the affidavit must state:

   a. The Transferor has full right, title, and authority to transfer the Property.

   b. The transfer of the Property to the Trust will not render the Transferor insolvent.

   c. The Transferor does not intend to defraud a creditor by transferring the Property to the Trust.

   d. The Transferor does not know of or have reason to know of any pending or threatened court actions against the Transferor.

   e. The Transferor is not involved in any administrative proceedings.

   f. The Transferor is not currently in arrears on a child support obligation by more than 30 days.

   g. The Transferor does not contemplate filing for relief under the bankruptcy code, 11 USC 101 to 1532.

   h. The Property being transferred to the Trust was not derived from unlawful activities.

D. “Qualified Trustee.”

1. The trust must have at least one “qualified trustee."

a. An unrelated individual who is a Michigan resident is a qualified trustee.

b. A bank or trust company authorized to do business in Michigan.

c. The qualified trustee must maintain some of the trust property and records in Michigan.

2. This may be the most significant feature of the Act because now a Michigan resident does not have to appoint a bank or trust company.

3. The grantor cannot be trustee.

4. Can a family member be a trustee? Should a family member be a trustee?

IV. RETAINED RIGHTS

A. What rights can the grantor do and what rights can the grantor retain? The answer is A LOT.

B. Permitted administrative rights:

1. Direct investment decisions. This is especially significant for business owners, because they can continue to run the business. This often (and understandably) is a huge stumbling block for clients.

2. Veto a distribution. The grantor will normally want to include family members as beneficiaries, especially a spouse because

trust distributions can provide benefits to the marital household in lieu of direct distributions to the grantor. The trust agreement can contain a provision requiring the grantor be notified prior to a distribution being made. With this power, if grantor doesn't like it, distribution does not get made.

3. Appoint the trust assets effective on the death of the grantor. This allows the grantor to change the ultimate distribution of the trust assets and provides great flexibility for changed circumstances; e.g., a grantor who has two children, one of whom becomes the next Bill Gates and the other of whom becomes the next Mother Teresa. However, great care must be taken in drafting the provisions lest the trust assets become available to the grantor's creditors upon death.

4. Remove a trustee and appoint a new trustee. Can the grantor simply reappoint friendly trustee if the current trustee is not doing the grantor's will?

C. Permitted beneficial rights:

1. Income. The grantor can retain the right to receive income.

2. Principal. The grantor can retain the right to receive principal.

3. Principal distributions must be pursuant to a discretionary or support provision.

   a. A support provision means a provision in a trust that provides the trustee shall distribute principal for the health, education, support, or maintenance of a trust beneficiary.

b. A discretionary provision means a provision in a trust that provides a trustee has discretion whether to distribute principal.

## V. TAX ISSUES

A. Although the ultimate motivation in creating this type of trust is asset protection, these trusts also have certain federal income, gift, and estate tax implications.

B. Income Taxes. An asset protection trust is typically designed to be a "grantor trust" for federal income tax purpose, meaning the grantor will be taxable on all of the trust's items of income and gain (a grantor's ability to receive income and/or principal usually creates this result). This can remove additional assets from the grantor's taxable estate through the payment of income taxes on trust income and gain (which income and gain would not again be taxable to the ultimate recipient thereof).

C. Gift Taxes. Ordinarily a transfer to an irrevocable trust is a completed gift, meaning that the grantor will be liable for gift tax on the taxable value of the gift. The taxable value of the gift equals the fair market value of all property transferred, less any ascertainable interest the grantor retains therein. If the value of the interest retained by the grantor is not sufficiently ascertainable (which is preferable from an asset protection perspective, but not from a gift tax perspective), the taxable value of the gift will comprise all assets transferred by the grantor to the trust. This can be avoided by having the grantor retain the testamentary power of appointment.

D. Estate Taxes. Generally, assets over which a taxpayer has completely relinquished dominion and control are excluded from his taxable estate. As mentioned above, however, under the Act a grantor can retain the right to receive trust income and principal. This will cause the trust assets to be included in the grantor's estate for federal estate tax purposes under Internal Revenue Code Section 2036. Similarly, the retention of a limited power of appointment will cause the trust assets to be included in the grantor's estate for federal estate tax purposes under Internal Revenue Code Sections 2036 and 2038.