

MICHIGAN ASSET PROTECTION TRUSTS

By Robert Tiplady

At common law, if a person created a trust and retained an interest in the trust, that person's creditors could reach the assets of the trust.¹ With the passage of the Qualified Dispositions in Trust Act (the act) and the tie-barred amendments to Michigan's Uniform Fraudulent Transfer Act (now called the Uniform Voidable Transaction Act),² Michigan became the 17th state to statutorily modify the common law to permit domestic asset protection trusts (DAPT's).³ As a result, a person is now permitted under Michigan law to create a trust and, provided the act's requirements are met, limit the ability of the transferor's creditors to reach the assets of the trust. In addition, a transferor complying with the act enjoys additional protections from creditor challenges in the form of shortened statutes of limitation and heightened burdens of proof not available for other transfers.⁴ Rather than a summary of the act's provisions, this article focuses on clients who may benefit from a DAPT and considerations when drafting one in Michigan.

Clients who may benefit

A DAPT is an important tool in the attorney's toolbox. It allows a client to establish a trust that will govern the use or potential use of the trust's assets for the client and the client's family during the client's lifetime and beyond while protecting the trust's assets from claims by creditors. Potential clients for DAPT's include physicians, real-estate developers, executives, business owners, and celebrities. In addition, in light of the *Allard* decision calling into question the permissible scope of prenuptial agreements,⁵ a DAPT funded more than 30 days before marriage can serve as a backstop to a prenuptial agreement (or an alternative if the parties cannot agree on the terms of a prenuptial agreement). Under the act, if the transfer occurs more than 30 days before the marriage, the property "is not considered marital property, is not considered, directly or indirectly, part of the trust beneficiary's real or personal estate, and shall not be awarded to the trust beneficiary's spouse in

a judgment for annulment of a marriage, divorce, or separate maintenance.”⁶

In my experience, DAPTs are not appropriate for every client. A client’s assets and potential liabilities should be considered. Given the costs of creating and properly maintaining a DAPT in most instances, a client should have significant assets before contemplating one. Also, the nature of the client’s assets should be taken into account when analyzing the appropriateness of a DAPT. If the client’s assets are already protected from creditors because of their nature (e.g., retirement accounts or tenancy by the entireties property), a DAPT may not add much additional protection. However, if there is a concern about the loss of an asset’s protected status on a spouse’s death, a DAPT is a potential solution, as the act has provisions facilitating the use of retirement benefits and tenancy by the entireties property.⁷ In considering which clients may benefit from a DAPT, it is not necessary that a client have immediate creditor concerns but, in most instances, there should be some potential for creditor exposure by the transferor or the transferor’s family. A client without potential creditor exposure is an unlikely candidate for a DAPT unless the client is exceedingly cautious or has concerns regarding future generations.

Finally, many clients, regardless of their finances, are unwilling to give up control. As discussed in more detail below, the client cannot serve as trustee of the DAPT and may not direct distributions from it. For many clients, those limitations are deal breakers.

Drafting considerations

The act’s protections apply to a transfer that constitutes a “qualified disposition.” A qualified disposition is a transfer of property that results in a “fiduciary relation between at least 1 trustee and a trust beneficiary” where at least one trustee is a *qualified trustee* and the “subject property is

governed by a *trust instrument*...under which the *transferor only has rights, powers and interests that are permitted*” and certain other limitations on the transferor and persons related to or subordinate to the transferor are met.⁸ (Emphasis added.) Provided that, the transferor may not be behind on child support by more than 30 days at the time of the transfer.⁹ Breaking this down further, the requirements for a DAPT fall into four categories: trust instrument requirements, trustee requirements, limitations on the transferor, and limitations on the transferor and persons related or subordinate to the transferor.

Trust instrument requirements

The technical requirements for a trust agreement that complies with the act’s requirements are straightforward. First, the agreement must “expressly [incorporate Michigan law] to govern the validity, construction and administration of the trust.”¹⁰ Second, the agreement must be irrevocable.¹¹ Third, the agreement must provide that:

the interest of the transferor or other trust beneficiary in trust property may not be transferred, assigned, pledged, or mortgaged, whether voluntarily or involuntarily, before the qualified trustee or qualified trustees actually distribute trust property to the trust beneficiary, and that provision of the trust instrument is considered a restriction on the transfer of the transferor’s beneficial interest in the trust that is enforceable under applicable nonbankruptcy law within the meaning of section 541(c)(2) of the bankruptcy code 11 USC 541(c)(2).¹²

Drafting to meet the first two requirements—irrevocability and governing law—is relatively clear-cut. As to the third requirement, the author’s recommendation is using the statute’s language as close to verbatim as possible in the trust agreement’s spendthrift clause to avoid argument if the transfer is challenged.

As a practical matter, attorneys may want to consider revising the governing law and spendthrift clauses of their revocable trust forms to comply with the act’s requirements. Depending on the other terms of the trust agreement, this might permit a trust to meet the act’s requirements after the transferor’s death and provide a beneficiary with the act’s additional protection against the beneficiary’s creditors.

AT A GLANCE

- Michigan now permits Domestic Asset Protection Trusts (DAPTs).
- A DAPT can serve as a backstop to a prenuptial agreement.
- When drafting a DAPT agreement, the statutory language should be followed closely.

Trustee requirements

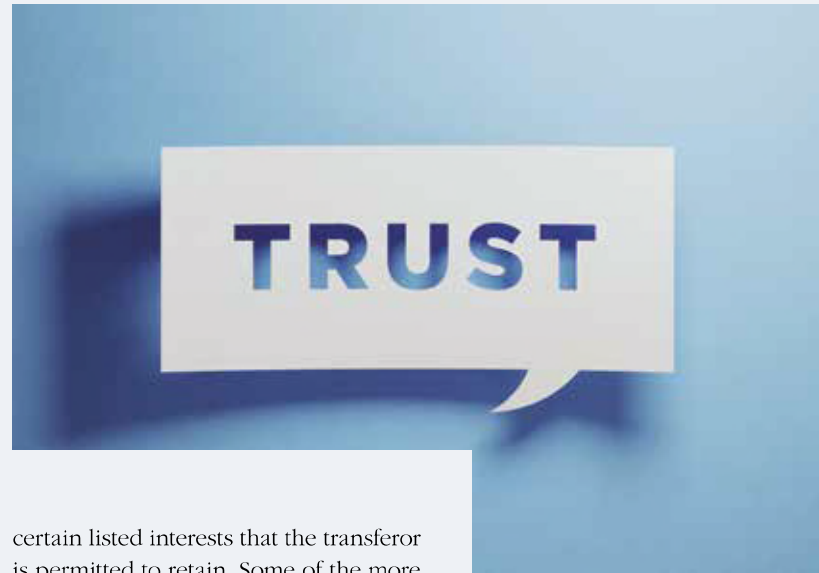
Given the limitations on the transferor's permissible retained interests, the transferor may not serve as a trustee; otherwise, the act permits a variety of trustee arrangements. The only requirement is that there must be at least one qualified trustee.¹³ Family members are not prohibited from serving as a trustee or qualified trustee, but an individual family member's ability to properly administer the trust should be carefully considered; it may become important if the DAPT is challenged. There are no limitations on how many trustees may serve, nor does the act limit how the trustees' responsibilities are divided as long as the qualified trustee retains authority to conduct sufficient trust activity in Michigan to meet the requirements to be considered a qualified trustee.

To be considered a qualified trustee, a person must be a Michigan resident if the qualified trustee is an individual. If the qualified trustee is not an individual, the person must be authorized under Michigan law to "act as a trustee" and the qualified trustee's activities must be "subject to supervision by the department of insurance and financial services, the Federal Deposit Insurance Corporation, the Comptroller of the Currency, or the Office of Thrift Supervision."¹⁴ In addition, the qualified trustee must conduct some trust activity in Michigan. In particular, the qualified trustee is required to "[maintain] or [arrange] for custody in [Michigan] of some or all of the property that is subject of the qualified disposition and [administer] all or part of the trust in this state."¹⁵ If the qualified trustee is a corporate trustee, the primary trust officer must be located in Michigan.¹⁶ If the qualified trustee is not a corporate trustee and the trustee has "a usual place of business where some of the records pertaining to the trust are kept," that location must be in Michigan or the qualified trustee must be a Michigan resident.¹⁷

In drafting to comply with the trustee requirements, the draftsman should include a provision expressly stating that the transferor is prohibited from serving as a trustee and requiring at least one qualified trustee. If qualification as a DAPT after the transferor's death is not important, the requirement to have a qualified trustee can expire on the transferor's death. As with any other trust agreement, including provisions for the appointment of successor trustees (qualified and non-qualified) is advised. If a person ceases to meet the requirements for a qualified trustee and there is no other qualified trustee serving, the act provides that the person is deemed to have resigned and a successor qualified trustee is appointed in the manner provided in the trust agreement or, if necessary, by the probate court.¹⁸

Limitations on the transferor

The transferor may only have the rights, powers, and interests permitted under section 4(2) of the act,¹⁹ which specifies



certain listed interests that the transferor is permitted to retain. Some of the more common rights for the transferor to retain are the power to direct investment decisions,²⁰ the power to veto distribution decisions,²¹ the retention of a special power of appointment effective on the transferor's death,²² the ability to receive income,²³ the ability to receive principal according to a support or discretionary trust provision,²⁴ and the right to remove and appoint trustees and trust advisors.²⁵ Retaining the powers to direct investment decisions and remove and appoint trustees and trust advisors is important to many clients. The power to direct investments has increased importance if the trust holds closely held business interests because it allows the client to retain control over whether assets are bought and sold. Retaining the power to veto distribution decisions and the special power of appointment are important if the transferor wants the transfer to the DAPT to be treated as an incomplete gift for federal transfer tax purposes. The powers to direct investment decisions and veto distribution decisions are discussed below. Otherwise, powers of appointment, income and principal distributions, and trustee removal and appointment provisions should follow typical models.

Limitations on the transferor and related or subordinate persons

In addition to the limitations on rights, powers, and interests the transferor may retain, there are limitations on the rights, powers, and interests that the transferor and persons related or subordinate to the transferor ("related persons") may hold. In defining "related or subordinate to the transferor," the act incorporates the definition under section 672(c) of the Internal Revenue Code.²⁶ This definition essentially means a family member or an employee of a business where

the transferor is an executive or significant owner.²⁷ The act's wording is convoluted, but there are two limitations. First, the transferor and related persons may not hold the power to consent, approve, or veto investment decisions, but may direct investment decisions.²⁸ Second, the transferor and related persons may not hold the power to direct, consent, or approve distribution decisions, but may veto distribution decisions.²⁹ While it is possible to argue that the power to consent, approve, or veto investment decisions is merely a form of direction and that there is no difference between a power to consent to or approve distribution decisions and the power to veto distribution decisions, the draftsman will want to use the term "direct" when referring to investment decisions and "veto" when referring to distribution decisions to avoid any issues.

Additional documents

In addition to the trust agreement, the transferor is required to execute a qualified affidavit in conjunction with most transfers.³⁰ The qualified affidavit is not truly mandatory, as the failure to timely sign a qualified affidavit does not affect the validity of the qualified disposition; however, the failure to sign or a defect in the qualified affidavit may be used as evidence in a proceeding to challenge the transfer.³¹ To avoid arguments that it was defective, the qualified affidavit should follow the statute's wording closely. In most instances, the qualified affidavit will not present a significant hurdle because the transferor is merely required to state that the transfer will not render the transferor insolvent; the transferred property was not derived from unlawful activity; and the transferor (1) has the title and authority to transfer the property, (2) does not intend to defraud a creditor, (3) does not know of any pending or threatened litigation or administrative proceedings (except as disclosed in the affidavit), (4) is not behind on child support, and (5) does not contemplate filing for bankruptcy.³² However, a client involved in an activity legal under state law but illegal under federal law (e.g., medical marijuana) will have to carefully consider how to handle the statement that the property was not derived from unlawful activity.

When working to establish a DAPT, it is useful for the client to prepare and retain a balance sheet detailing the client's assets and liabilities. The balance sheet serves several purposes. First, it assists in determining whether a DAPT is appropriate for the client. Second, it frequently helps identify which assets to transfer to the DAPT. Third, it will be useful if the transfer to the DAPT is challenged; if this occurs, a creditor may attempt to argue that the transfer was of substantially all of the transferor's assets or rendered the transferor insolvent.³³ Having a balance sheet—the more detailed the better—prepared contemporaneously with the transfer would assist in defending against those types of allegations.

Conclusion

The availability of DAPTs in Michigan is a significant new tool for attorneys to use in conjunction with clients' estate and asset protection planning, particularly for clients with significant assets who are concerned about potential creditors they or their family members may have. Attorneys desiring to prepare Michigan DAPTs for their clients should familiarize themselves with the Qualified Dispositions in Trust Act requirements, particularly the requirements regarding the trust agreement; the trustee; the limitations on the transferor's powers, rights, and interests; and the limitations on the transferor's and related persons' powers. ■



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ENDNOTES

1. *In re Hertsberg Inter Vivos Trust*, 457 Mich 430, 434; 578 NW2d 289 (1998).
2. MCL 700.1041 *et seq.* and MCL 566.31 *et seq.*
3. Burkhardt, *Michigan Enacts New Qualified Dispositions in Trust Act*, 97 Mich B J 3, 22 (March 2018) <<http://www.michbar.org/file/barjournal/article/documents/pdf4article3338.pdf>> (accessed October 9, 2018).
4. MCL 700.1045(2)(a) and (3).
5. *Allard v Allard*, 318 Mich App 583; 899 NW2d 420 (2017).
6. MCL 700.1045(4)(b).
7. MCL 700.1044(2)(l) and MCL 700.1047(6).
8. MCL 700.1042(g) and (p).
9. MCL 700.1042(p)(iii).
10. MCL 700.1042(aa)(i).
11. MCL 700.1042(aa)(ii).
12. MCL 700.1042(aa)(iii).
13. MCL 700.1042(p)(i).
14. MCL 700.1042(r)(i).
15. MCL 700.1042(r)(ii).
16. MCL 700.1042(r)(iii).
17. *Id.*
18. MCL 700.1048(1).
19. MCL 700.1042(p)(ii).
20. MCL 700.1044(2)(a).
21. MCL 700.1044(2)(b).
22. MCL 700.1044(2)(c).
23. MCL 700.1044(2)(d).
24. MCL 700.1044(2)(g).
25. MCL 700.1044(2)(h).
26. 26 USC 672(c).
27. MCL 700.1042(p)(iv).
28. MCL 700.1042(a) and (p)(iv).
29. *Id.*
30. MCL 700.1046(2) and (4).
31. MCL 700.1046(5).
32. MCL 700.1046(1).
33. MCL 566.34(2).