Trusts: Safeguarding an Inheritance

It's a common estate planning worry. Would a large inheritance squelch your children's drive to carve their own paths in life? Billionaire Warren Buffett of Berkshire Hathaway has been suggesting for decades that you should leave your children enough money so they feel they can do anything, but not enough so they'll do nothing.

It's a conundrum many parents and grandparents will have to face in the coming decades. Over the next 25 years, a staggering $68.4 trillion in wealth is expected to transfer between generations, according to a 2018 report from research firm Cerulli Associates.

Are the heirs prepared to handle all that money? There's a lot to worry about. A nest egg intended to cushion kids' lives could instead lead to failure to launch. Kids could spend their way through hard-earned fortunes in a few years. Too much comfort could sap their natural ambition. Also, they might be treated differently by people because of their money or fall victim to gold diggers and false friends.

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The best solution? Estate planners say a well-designed trust can provide families with plenty of protection against inheritance loss or inadvertently creating a stereotypical trust fund baby.

Influencing Heirs from the Great Beyond

Estate planning attorney Tyler Britton says he’s noticed an interesting difference in the way baby boomers are now using trusts for the upcoming generation of millennial heirs. “As an estate planner, I am seeing an increase in the amount of conditions found in trust documents,” says Britton, professor of trust and wealth management at the Lundy-Fetterman School of Business at Campbell University in Buies Creek, North Carolina.

The individuals creating the trusts want to set up guardrails that take into account the beneficiaries’ different lifestyles, priorities, and desires. These conditions allow a grantor to feel like he or she is still in control during his or her lifetime or after death. Perhaps it’s no surprise that the cohort that invented helicopter parenting would try various avenues to micromanage their survivors’ financial paths—even after they depart this life.

A trust is basically a legal agreement in which one party—called the grantor or trustmaker—puts assets (like real estate, cash, stocks, or bonds) in the care of another party, the trustee. The trustee manages the assets and carries out the instructions over time, for the benefit of a third party, the beneficiary, who could be a person or an institution.

Doesn't a last will and testament take care of all that? Only partially.

A will gives instructions for distributing your property and is essential for naming guardians for minor children. But you typically can't set specific conditions in a will, such as requiring your daughter to finish medical school in order to inherit your house. With a trust, you could make such a condition—or virtually any condition—giving you greater control over the distributions that are made.

The Flexibility of Revocable Living Trusts

There are many types of trusts, but the most common is a revocable living trust. It's called "living" simply because it goes into effect while you're alive, and "revocable" in that you are free to change the instructions you provide.

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For example, you can set age-based payouts. "Twenty or 30 years ago, it was common for a grantor to specify that his or her heir could not access trust principal until the heir attained the age of 21 or 25," says Britton. "With millennial heirs, some grantors are opting to set the age to receive trust principal to 30, 35, or even 40. Their reasoning varies from apprehensions about millennial spending, saving, and work ethic to concerns about creating trust fund babies."

A trust can be set up for a specific number of years or for the child's lifetime, for example. The trustee could manage the principal and use investment income to pay distributions to the child. A drawn-out payment schedule, such as a distribution every five years, can prevent the inheritance from being spent too quickly.

WHERE TO GET STARTED

The type of trust used, and the mechanics of its creation, will differ depending on what you are trying to accomplish. In fact, you may need more than one type of trust to achieve all of your goals.

And since some of the following disadvantages may affect you, discuss the pros and cons of setting up any trust with your attorney and financial professional before you proceed:

- Generally, you need a significant lump sum to initiate a trust.
- A trust can be expensive to maintain—trustee fees, professional fees, and filing fees must be paid.
- Depending on the type of trust you choose, you may give up some control over the assets in the trust.
- Maintaining the trust and complying with recording and notice requirements can take up considerable time.
- Income generated by trust assets and not distributed to trust

“Other common conditions include postsecondary education requirements and drug testing,” says Britton.

Irrevocable Living Trusts Provide Liability Protection

Irrevocable living trusts can't be terminated and are very difficult to change. Such trusts can be used to reduce taxes or protect assets against creditors or lawsuits.

"A common use for an irrevocable trust is to provide asset protection for a grantor and his or her family. By placing assets into an irrevocable trust and naming an independent trustee, a grantor relinquishes control over and loses access to trust assets. Therefore, if structured properly, the assets in an irrevocable trust cannot be reached by a grantor's creditors," says Britton.

That doesn't mean you can escape existing legitimate debts just by moving all your money into an irrevocable trust.

"If a grantor conveys assets to an irrevocable trust in order to defraud or delay a legitimate creditor, a grantor is engaging in fraudulent conveyance. If a creditor can prove fraudulent conveyance, a court can reverse a grantor's asset transfer to a trust and allow creditors to access trust property to satisfy judgments," cautions Britton.

Spendthrift Trusts Protect Heirs from Themselves and Others

A spendthrift trust won't turn your heirs into financial whizzes, but it can safeguard property in the trust from loss. "The term 'spendthrift' is often misleading. Not only does this type of trust protect heirs who lack proper judgment when it comes to spending money; this trust also protects financially responsible heirs from certain lawsuits and creditors," says Britton.

While money is in the trust, your heir can't spend it, give it away, or lose it. "In other words, a beneficiary cannot spend or pledge his or her interest in a trust, and certain creditors cannot seize a beneficiary's interest in the hands of a trustee," says Britton. Once it's paid out from the trust, however, the beneficiary can spend the money in any way he or she sees fit, and it would no longer be protected from creditors.

Special Needs Trusts Protect Eligibility for Benefits

Another reason for an irrevocable trust would be to provide financial support for a child with a disability, while protecting his or her eligibility for public assistance. You can put money or property into a special needs trust and appoint a trustee to use the funds to purchase necessities for the beneficiary. The beneficiary doesn't own the property in the trust, so it would not prevent the person from applying for government benefits.

Trusts are traditionally associated with the very wealthy, but even middle-class families can take advantage of trusts to clarify how assets should be distributed after death. An estate planning professional can help you design a trust that best fits your particular situation.