Should You Leave Assets in Trust for a Financially Savvy Beneficiary?

By Jeremy B. Spackman , Esq.

Absolutely! Traditionally, leaving assets to a beneficiary in trust, especially a financially savvy beneficiary, has been viewed as restricting the access and control the beneficiary would have over his or her inheritance. The common thought was that only spendthrifts should receive their inheritance in trust (with a third party in control of the trust), while the financially savvy beneficiary should receive his or her inheritance outright. This is not ideal since receiving an inheritance outright exposes those assets to the beneficiary's creditors, including divorcing spouses. Instead, clients should leave assets to financially savvy heirs in a beneficiary controlled trust, with the financially savvy heir as the primary beneficiary. If the trust is drafted properly, the primary beneficiary can have all the benefits of outright control with none of the risks, meaning their inheritance will be protected from creditors and divorcing spouses.

BENEFICIARY CONTROLLED TRUST

It is important to understand the term beneficiary controlled trust. A beneficiary controlled trust is a trust where the primary beneficiary is the controlling trustee. The primary beneficiary, as trustee, can be given essentially the same control of the trust assets as he or she would have with outright ownership. As the controlling trustee, the beneficiary has the sole power to make all investment decisions on behalf of the trust. As such, the beneficiary can elect to buy a home in the name of the trust or use assets in the trust as seed money to start a new business. Essentially, this is the same control the beneficiary would have over the assets if the beneficiary received them outright.

HEMS vs FULLY DISCRETIONARY

There are two different ways to structure the beneficiary controlled trust. One option is to limit trust distributions to a beneficiary for health, education, maintenance and support (a "HEMS Trust"). The advantage of a HEMS Trust is it allows the primary beneficiary to act as the sole trustee without causing an estate tax. The primary beneficiary controls all investment decisions and can make distributions to trust beneficiaries for their health, education, maintenance and support. The major disadvantage of a HEMS Trust is that many states have case law or statutory law that allow certain creditors, such as a divorcing spouse or health care provider, to pierce through a HEMS Trust if they have a judgment against the beneficiary.

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The other, and better, option is to structure the beneficiary controlled trust such that distributions are made in the sole and absolute discretion of an independent trustee (a "Discretionary Trust"). In a Discretionary Trust, the primary beneficiary typically acts as the investment trustee and therefore will still have full control over all investment decisions. A second trustee, generally referred to as an independent trustee, would also be appointed. The initial independent trustee can be anybody except for the grantor or a beneficiary. Any appointed successor independent trustee cannot be a related party or subordinate employee. Distributions from the trust to a beneficiary are made in the sole discretion of the independent trustee. A Discretionary Trust does not have the same creditor risk that a HEMS Trust does, meaning the assets in a Discretionary Trust are asset protected from all creditors, regardless of the beneficiary's state of residence, except for certain exceptions for trusts held under Florida law.

POWER TO REMOVE/REPLACE TRUSTEES

The trust can be structured such that the primary beneficiary has the power to remove and replace trustees. For example, if the primary beneficiary is not satisfied with the independent trustee, the beneficiary can remove and replace the trustee at any time and for any reason. The primary beneficiary can also name successors to this power. As such, if the primary beneficiary becomes incapacitated, a trusted person steps into the primary beneficiary's shoes and can appoint a successor investment trustee to manage the trust assets until the primary beneficiary regains capacity.

INCOME TAX PLANNING

One way to draft a beneficiary controlled trust is as a complex trust for income tax purposes, meaning the trust will be responsible for filing its own income tax return and paying its own income taxes. For 2015, a trust is in the highest federal income tax bracket at $12,301 of income to the extent the income is not distributed out to a beneficiary. If the primary beneficiary (or his or her descendants, who would also be beneficiaries of the trust) are in lower income tax brackets, the trustee can distribute income out to one or more of these beneficiaries. The beneficiaries would then pay income tax on the income at their tax rates, thus lowering the overall income tax burden.

For the reasons stated above, estate planners should always advise their clients to leave assets to their financially responsible heirs in a beneficiary controlled trust rather than outright.

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