

# Overview of Protecting and Safeguarding Inheritances

## Protect Your Children's Inheritance

Parents may spend their lifetime scrimping, saving, and sheltering their wealth, and leave their fortune to their children who spend or lose it. A trust can safeguard assets you will leave to your beneficiaries. They too have lawsuits, creditors, divorces, etc. How do you protect their inheritance from their financial and legal problems?

You may not want an irrevocable trust to protect your assets, but it's frequently smart to set up a trust to protect assets that you bequeath to your beneficiaries, particularly when the beneficiaries are your children or grandchildren.

Trusts can be *intervivos* or testamentary. With an *intervivos* trust you transfer assets to your trust during your lifetime. A testamentary trust receives your assets upon your death. Your assets are yours and stay vulnerable to your creditors until you die, when title to these assets passes to the trust.

A revocable trust can protect the trust assets from your beneficiaries' creditors. Whether you transfer your assets to the trust within your lifetime or upon your death, the one difference between a revocable and an irrevocable trust funded within your lifetime is that the revocable trust won't protect you as the grantor. Moreover, assets in your revocable trust will be included in your taxable estate. Assets transferred to your irrevocable trust during your lifetime will be excluded from your taxable estate – provided you live at least three or more years thereafter.

Additionally, it is seldom prudent planning to gift substantial amounts outright to children during your lifetime. You may make lifetime gifts to your children to reduce your taxable estate, yet you have those same ever-present dangers of your children squandering their gifts and you losing control over these assets. A trust may also not be the best decision in this scenario.

A smarter solution may be to title your assets in a limited partnership with yourself (and your spouse) as its general partner. You can then transfer to your children, through a trust, a portion of your limited partnership interests each year. In this way, you reduce your taxable estate as you shift your limited partnership interest to your children's trusts. Meanwhile, your assets will stay safe from your creditors because they are titled to a limited partnership. You remain in control of your assets because you would be the general partner. Your children's inheritance will be twice protected; once by the limited partnership and again by their irrevocable trust. When you die, your remaining partnership interest will have a discounted estate tax valuation. You can then bequeath this remaining limited partnership interest to your children's trust. You have hundreds of ways to effectively combine trusts, FLPs, LLCs, and corporations to achieve various lawsuit protection, tax, and estate planning objectives. You can achieve all this while retaining lifetime control over your assets. This should always be an important goal.

## Safeguarding Inheritances

For a trust to fully safeguard your beneficiaries' interest in the trust assets, you need the right trust provisions. These clauses will prevent your beneficiaries' creditors from claiming

their share of the trust principal or income. The provisions will also stop the creditor from asserting any rights that the beneficiaries may have to the income or exercise other powers that could forfeit your beneficiaries' protection.

The most important trust clause is the anti-alienation or spendthrift provision. This directly protects the trust assets from the beneficiaries' creditors. The anti-alienation clause prohibits the trustee from transferring the trust assets to anyone other than the beneficiaries. This includes the trust beneficiaries' creditors. The spendthrift or anti-alienation clause expressly precludes anyone whose interest is adverse to the beneficiaries (a creditor, ex-spouse, IRS, etc.) from claiming the beneficiaries' share – whether it be the trust principal or income distributions. This provision is vital for every trust.

The spendthrift clause won't completely protect the beneficiaries. There are limitations. Several states don't enforce spendthrift provisions. A spendthrift clause won't always protect the beneficiaries from bankruptcy, divorce, or tax claims. It won't protect income distributions previously received by the beneficiaries. Or a spendthrift provision may be poorly drafted or narrowly interpreted by the courts. Its protection largely depends on the drafter's skill.

Another important protective clause is to give your trustee distribution discretion. For example, your trust may provide that the beneficiaries would receive trust distributions at age 25. But would those distributions be safe if a beneficiary then has a judgment creditor? Or what if a divorce is imminent?

A discretionary clause gives your trustee the right to withhold income and principal distributions that would otherwise be payable to the beneficiaries; if the trustee believes that the distribution would be wasted or claimed by the beneficiaries' creditors. This discretionary clause can also prevent a wasteful beneficiary from depleting or wasting trust assets - an important consideration when the grantors' children are the beneficiaries. If you have concerns about whether money that you entrust for your children will be wasted, then add a discretionary provision in your trust. Your trustee can then regulate distributions to your children, avoid or minimize waste, and better prevent creditor seizure.

If your child is not a spendthrift, is his or her spouse? These same provisions can keep the trust assets safe if your child dies or divorces. These provisions can also apply to gifts to your grandchildren.

Spendthrift and discretionary clauses protect trust assets from your beneficiaries' creditors. The trustee can withhold payments to your beneficiaries. A beneficiaries' creditor cannot force a trustee to distribute trust assets to the beneficiaries. The creditor can only claim payments received by the beneficiaries. However, the trustee can directly pay third parties on behalf of a beneficiary. This circumvents a creditor attempting to seize funds from the beneficiaries.

For still more protection, add sprinkling provisions to your trust. Sprinkling provisions are common in trusts that are expected to remain in force for ten or more years, and where each beneficiary's future income or tax situation is uncertain. The trustee can then modify trust distributions through this sprinkling provision. The trustee can either disburse or retain the principal and income for the duration of the trust. The trustee thus determines what each beneficiary will receive, and when.

The trust grantor would specify criteria for the trustee to follow when making distributions. Required minimum income distributions are recommended when the beneficiary is a spouse or dependent child.

The sprinkling provision adds protection but you still cannot retain the right to modify or revoke your sprinkling trust. As with any other asset protection trust, your sprinkling trust must be irrevocable and you cannot retain control. Moreover, your beneficiary cannot be a trustee. Although legally permissible, the trust assets, in such instances, would become vulnerable to the creditors of your trustee-beneficiary. A trustee, who can distribute trust assets to himself as the beneficiary, gives his creditors the same right to force distributions, which the creditor can then seize.