Using Beneficiary-Directed Trusts to Protect Your Heirs

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Article Highlights

- A beneficiary-directed trust continues for the lifetime of the beneficiary and protects them from losing the inherited trust assets to creditors and claimants even after the beneficiary takes over control of the trust.
- Putting a spendthrift provision in place prevents creditors from attaching the interest of the beneficiary in the trust before that interest (cash or property) is actually distributed to them. It should be included even if the beneficiary is not known to be a spendthrift.
- The most well-known distribution standard is to distribute funds to the beneficiary for health, education, maintenance and support (HEMS). It allows trust funds to be used for essentially anything except pure luxuries.

If you have an estate plan in place, it will often include your children or grandchildren as beneficiaries.

Following your death (or if you are married, then following the death of the second spouse to pass), your ultimate beneficiaries will receive their shares of your estate. Such shares will only be distributed one of two ways: outright or in some kind of trust for the benefit of the ultimate beneficiaries. It is increasingly prevalent to avoid the outright distribution of estate assets and instead to distribute them into a "beneficiary-directed" trust.

Generally, a beneficiary-directed trust would be a type of trust that continues for the lifetime of the beneficiary. Significantly, however, the beneficiary would become their own trustee at a certain age determined by the trust maker. Depending on which state law is utilized, this type of trust can advantage the beneficiary substantially by protecting them from losing the inherited trust assets in divorce or bankruptcy proceedings or by the efforts of general creditors and personal injury claimants. In short, the key purpose of a beneficiary-directed trust is that it remains protected from creditors even after the beneficiary takes over control of the trust.

Divorce is the most terrifying prospect for most inheritors. Still, the prospect of any financial catastrophe is worth some deliberation and planning. A discussion of beneficiary-directed trusts should be part of any modern estate planning.

The problem is that trusts can be whatever you want them to be. Here, there is infinite variety. As a result, a quick search on the internet discloses no current and clear guidance for those who are not attorneys about beneficiary-directed trusts. Instead, you would need to research many separate attributes.

Even after self-education about the beneficiary-directed trust, there is no simple way to carry out this strategy. Most attorneys aren't even aware of it. Ultimately, you need a very experienced estate planning attorney to create a proper beneficiary-directed trust. We believe it is strongly advisable to create a time-tested, safe and secure beneficiary-directed trust, rather than making a test case of your family wealth.

The Key Attributes of a Beneficiary-Directed Trust

A beneficiary-directed trust would typically have the following attributes, in one form or another.

Created by You, As a "Third Party"

You, as a third party in relation to your beneficiaries, create this protective trust for them inside your own estate plan. Your children do not create it.

By contrast, a "first-party" protective trust—sometimes known as a domestic asset protection trust (or DAPT)—is only available in a handful of states. Unfortunately, the DAPT is also undergoing many court and creditor challenges. It requires a professional trustee located in the state in which the DAPT was created, and has many other strings attached. It is not currently recommended for anyone but the very wealthy whose enterprises involve greater-than-average legal risk.

The beneficiary-directed trust we are discussing in this article is not a DAPT.

Irrevocable by the Beneficiary

The trust must be irrevocable after you and your spouse have passed. You may revoke or change it at any time until death, however.

There are also several ways to terminate or outright revoke the trust:

- Some state statutes may allow for revocation of an irrevocable trust under certain conditions. In this case, we would look to the laws of the state in which the trust was created.
- The trustee and beneficiary may decide not to fund the trust in the first place, following your death. They may even waive this protection. Beneficiary-directed trusts are created for the protection and convenience of the beneficiary; they are not designed to "handcuff" the beneficiary. Such trusts are simply designed to present the beneficiary with a protective possibility that they would otherwise not have. If a beneficiary decides to waive the deployment of their trust after your death, then they are no worse off than if they'd received an outright distribution.
- The beneficiary can empty the trust when they become the trustee of the trust. Fully distributing the assets from the trust would effectively revoke it.

Spendthrift Provisions

Without a spendthrift provision in place, a creditor could lay claim to an inherited asset before the asset has even been distributed to the beneficiary by initiating a court proceeding or, in the event the estate is subject to a probate proceeding, by simply filing a claim in probate court. A judge could then issue a judgment compelling payment of the beneficiary's debt using assets obtained through an inheritance. In certain circumstances, the judgment could even force the liquidation of a tax-deferred inherited asset such as an IRA, thus creating a taxable event for the beneficiary. To illustrate this, in the 2014 Clark v. Rameker Supreme Court decision, the courts acknowledged that while the bankruptcy code is intended to protect the retirement accounts of debtors, it is not meant to protect the inherited IRAs that debtors may have been bequeathed by someone else. [Editor's note: For more about this ruling, see "Supreme Court: No Bankruptcy Protection for Inherited IRAs" in the Briefly Noted section of the July 2014 *AAII Journal*.]

A spendthrift provision creates an irrevocable trust preventing creditors (whether they are general creditors, divorcing spouses, personal injury claims, bankruptcy court, etc.) from attaching the interest of the beneficiary in the trust before that interest (cash or property) is actually distributed to them. Most well-drafted irrevocable trusts contain spendthrift provisions even though the beneficiaries are not known to be spendthrifts. This is because such a provision protects the trust and the beneficiary in the event that a beneficiary is sued and a judgment creditor attempts to attach the beneficiary's interest in the trust.

The protection of the spendthrift trust extends solely to the property that is in the trust. Once the property has been distributed to the beneficiary, that property can be reached by a creditor—except to the extent that the distributed property is used to support the beneficiary. If a trust calls for a distribution to the beneficiary, but the beneficiary refuses such distribution and elects instead to retain property in the trust, the spendthrift protection of the trust ceases with respect to that distribution and the beneficiary's creditors can now reach those trust assets that would otherwise have been distributed to the beneficiary.

Generally, we recommend a liberal distribution admonishment to the trustee. Liberal means that the trustee can use principal and not just income. It also means that the trustee can even distribute the entirety of the trust's principal (assets), if the reasonable needs of the beneficiary are being met (i.e., post-doctoral education costs) and the objective justifies the use of all principal.

The primary goal of the trust is not the conservation of the principal. Rather, the reason for creating the trust is to assist the beneficiary with their reasonable needs.

Ascertainable Distribution Standard

We also recommend an ascertainable distribution standard. The standard should not be vague, squishy or uncommon. Ascertainable means that everyone can more or less figure out what the standard is.

It is advisable that the trustee would be required to distribute funds to the beneficiary for health, education, maintenance and support (HEMS). This is the most well-known distribution standard. It also has Internal Revenue Service backing and countless judicial decisions in support of it, including spendthrift/asset protection support.

The HEMS standard allows trust funds to be used for essentially anything except pure luxuries. Using trust funds to pay for luxuries might open the door to creditors, and luxuries may be had by other means.

Even with the requirement that the trustee distribute for HEMS, the final decision-making responsibility is still reserved for the trustee, at their discretion.

Distributions Are 100% Discretionary

Specific distributions of income or principal are not required. The trustee does not have to distribute all income annually, for example. Nor is there a requirement for the trust to distribute an annuitized percentage or pecuniary dollar amount each year.

Rather, the trustee determines whether the distribution is necessary, reasonable, justified, etc., with the understanding that the guiding purpose is HEMS: health, education, maintenance and support.

Could Be Written as a Tax-Qualified Trust

Including very specific language recognized by the Internal Revenue Code within the trust could allow tax-qualified accounts [i.e., tax-deferred accounts like 401(k) or 403(b) or IRAs] to be linked to the trust and protected by it, just like nonqualified (aftertax) assets. This is a very complex area and will require an experienced estate planning attorney.

The provisions could be drafted and included in the trust documents even if not utilized. If either spouse, or both, then decides to link their tax-deferred funds to the beneficiary-directed trust, they could do so without any attorney involvement.

The Beneficiary Could Become the Trustee

The trust could be written so that, at a particular age, the beneficiary becomes their own trustee. Were this to occur, the trust would become beneficiary-directed.

Under Wisconsin law, a trust may continue to be a spendthrift trust (creditor/divorce/bankruptcy protected trust) even if the beneficiary serves as their own trustee. If the beneficiary is not located in Wisconsin or moves away, the law of Wisconsin can remain as the law of the trust and would govern the trust. This means that even if the beneficiary becomes their own trustee, the spendthrift provisions remain intact and creditors would not be able to break in and demand trust assets (regardless of whether they are general creditors, divorcing spouses, a personal injury claimant, a bankruptcy claimant, etc.). This is not always the case in every jurisdiction.

If the trust will be run by the beneficiary at a certain point, the trust can (and should) be a lifetime trust. In other words, it does not self-terminate. This assists with credit protection.

By contrast, the trust could be drafted so that it terminated automatically when the beneficiary reaches a certain age, such as 35, for example. Then, the beneficiary would have to withdraw the trust assets, and necessarily expose themselves to awaiting creditors.

Conclusion

At first glance, it may appear that your beneficiaries are not in need of any type of creditor protection—particularly when they are responsible adults in happy, long-term marriages. However, it is important to consider that almost 50% of all marriages will end in divorce or separation. Further, according to research by Bowling Green State University, the divorce rate among people 50 and older has doubled in the past 20 years.

In addition to considering the possibility of divorce, you should also strongly consider the potential future medical expenses of your beneficiaries (and their family members). Medical debt is still one of the leading causes of bankruptcies in the U.S.

Finally, you should consider the possibility of lawsuits based on unexpected events such as automobile accidents or, for beneficiaries who are in high-risk professions such as doctors and lawyers, the possibility of malpractice lawsuits. Without your own comprehensive estate plan in place, including creditor-protected beneficiary-directed trusts, your beneficiaries could lose their inheritance to creditors through no fault of their own.

You have worked hard throughout your lifetime, and as a member of AAII you have invested wisely, perhaps with the hope that you can provide some financial security for your loved ones when you're gone. Why not go the extra step to ensure that the inheritance you leave is there for its intended purpose? If you are interested in discussing comprehensive estate planning options, including the use of beneficiary-directed trusts, you will need to work with an experienced estate planning attorney. ➤

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