Securing Your Family's Future Using Inheritance Trusts

PART 1: Inheritance Trusts and How They Work

The key to estate planning is understanding clients' goals for the process. Generally, as a primary overarching goal, clients cite their desire to maintain their assets for as long as possible as a safety net protecting themselves and their loved ones from both anticipated and unforeseen threats and challenges. Nothing worries parents more than a creditor or divorcing spouse depriving their loved ones of the assets they worked so hard to pass on. Given this goal, it shouldn't be any surprise that in our practice, once clients understand how Inheritance Trusts work, they choose to leave their estates to their loved ones by such trusts over 90% of the time.

Inheritance trusts have been with us for many years, primarily to manage funds for minors and others who would otherwise have trouble maintaining them. The basic idea was originally to separate management from benefit to protect the benefits for as long as necessary. The modern "wrinkle" has been the recognition that, by making the capable beneficiary the manager (i.e., the trustee) and by maintaining the trust in place, the protections and safety net remain in place for as long as possible without significant loss of beneficiary control or enjoyment.

In this installment, we describe Inheritance Trusts and explain how they work. To do so, however, we first have to review some basics:

The Law Underpinning our Use of Trusts

Trust law has developed over hundreds of years as an outgrowth of our laws of property and judicial support of fundamental fairness (equity). Under our law of property, the bundle of rights held by an owner includes the right to transfer his property in the manner he chooses. The law of equity will support and enforce such transfer as long as the transfer does not violate a paramount principle of public policy. In particular, the law grants primacy to the intent of the transferor in transferring his property, regardless of whether he transfers his entire bundle of rights in the property to one or more persons or whether he chooses to parcel out different rights in the property to different persons. Such differing rights could include the right to control how and/or how long property is used in a particular fashion, the right to receive the benefits of the property as so utilized, and the rights to transfer the property in the future and to administer the proceeds of such future transfer. This potential, indeed likelihood, for court enforcement of the transferor's intent is the fundamental "glue" that underpins the use of trusts.

A trust is really nothing more than a transfer of property that separates the owner's bundle of rights in the property at the time of transfer. In the case of an Inheritance Trust, that separation generally occurs after someone's death, most likely, when a beneficiary might otherwise have inherited the property outright from the decedent.

What is a trust?

A trust is a court enforceable relationship established by a property owner when he transfers property to someone who will thereafter own and use the property according to a set of instructions that binds the new "owner" as to what he can or cannot do with the assets subject to those instructions. This relationship generally involves three types of parties: the original owner who is called a "settlor" or "Trustmaker", a "Trustee" who will thereafter own the property and put it to use, and a "Beneficiary" who will now or at some time in the future enjoy the benefits of the property while it is owned by the Trustee. (Please note that although the words, "Trustmaker", "Trustee", and "Beneficiary", are used here in the singular, there may be more than one Trustmaker, Trustee, and/or Beneficiary; and a person may simultaneously hold one or more of these capacities with respect to any trust.)

The Trustmaker is the party who establishes the trust by transferring property to the Trustee and by creating the instructions (i.e., in a will or trust agreement) that control that property in the Trustee's hands. The Trustee is the party who actually has title to the trust property and who carries out the instructions. As the name suggests, the Beneficiary is the person who is intended to benefit from the trust assets and the Trustmaker's instructions. It is the Trustee's legal fiduciary duty to carry out the Trustmaker's instructions for the benefit of the Beneficiary. If he or she fails to do so, the Trustee's personal wealth is subject to court order to rectify any breaches of the terms of the trust (i.e., the Trustmaker's intent).

If the Trustmaker retains the right to take back the property initially transferred to the Trustee or to change the instructions that control that property in the Trustee's hands, the trust is called a "revocable trust". If the Trustmaker expressly fails to retain or no longer has such rights (e.g. by reason of his death), the trust is called an "irrevocable trust". Additional distinctions exist depending on when the trust is created: If the owner/Trustmaker establishes a trust during his lifetime, the trust is called a "lifetime", "living", or "inter vivos" trust. If the trust is created after the owner/Trustmaker's death (e.g., a trust created under the Trustmaker's will), the trust is generally styled as a "testamentary" trust. Absent express language in the trust document to the contrary, a Maryland lifetime or living trust is deemed to be a revocable trust. Since the Trustmaker is no longer alive to change his instructions, a testamentary trust will be irrevocable unless a court finds that the Trustmaker's instructions (intent) have become impossible to achieve or that a unanimously agreed upon modification of trust terms is not inconsistent with a material purpose of the trust.

Examples Of Inheritance Trusts

Let's say you and your spouse would like to establish Inheritance Trusts for your two daughters after both your deaths. You and your spouse will first create a will or living trust as a Trustmaker. Each of these documents will contain instructions to establish trusts for your daughters together or for each of them and will transfer your property to the Trustees of those trusts after both of you have passed.

You believe your oldest daughter is already prepared to manage the assets transferred to her trust, so you name her as the trustee of her trust so that she can control that property and you give her discretion as to when she can distribute property income (or the trust property itself) to herself or her descendants.

You would like to see your younger daughter grow into her future role as Trustee, so you name her as a Co-Trustee of the trust (with her sister or another trusted family member or friend as the other Co-Trustee) until your younger daughter reaches a certain age (e.g., 30). At that time, the trust instructions say that she will become her trust's sole Trustee. While your younger daughter serves as a Co-Trustee with the consent of her Co-Trustee required to make decisions, your trust instructions require the Co-Trustees to distribute certain amounts to her annually so that she can count on receiving those annual benefits.

Once each daughter becomes sole Trustee of her respective trust, each will act as caretaker of the inheritances and manage their investment until they are ready to pass them on to their own children and/or more remote descendants.

In the meantime, while her trust remains in existence, you state in the trust document for each daughter that no right to benefit from the trust may be transferred by any beneficiary as such, and no creditor of a beneficiary may attach trust property or any trust interest. Trust property will remain transferrable by the Trustee, but under Maryland law, "[a] creditor may not . . . reach or otherwise compel distribution of the beneficial interest of a beneficiary that is a trustee or the sole trustee of the trust, . . . except to the extent that the interest would be subject to the claim of the creditor were the beneficiary not acting as cotrustee or sole trustee of the trust." Subject to certain limited public policy exceptions for unpaid taxes, child support, and alimony, each daughter's interest in the trust and the trust property itself is therefore protected from claims by potential creditors.

Stay tuned for future installments

In future installments of this series about Inheritance Trusts, we will explain these and other benefits of using Inheritance Trusts in your planning. We will also explain the process of receiving an inheritance in trust, as well as titling trust assets, setting up trust accounts, and the obligations of Trustee-beneficiaries to their other or future beneficiaries.

If in the meantime you would like to speak with us about securing your own plans for the future, please give us a call at (410) 224-7800.