Securing Your Family's Future Using Inheritance Trusts

PART 2: The Benefits of Using Inheritance Trusts

In part 1 of this series, we described Inheritance Trusts and how they can achieve clients' desires 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. In this installment, we go over the particular benefits they offer at relatively little cost.

Benefits of Receiving Your Inheritance in Trust

There are three significant benefits to receiving your inheritance in trust rather than outright: (1) asset and creditor protection, (2) transfer (i.e., estate, gift, and GST) tax minimization, and (3) disability planning.

Asset Protection

As we discussed in Part 1 of this series, inheritances held in Inheritance Trusts are typically what are commonly referred to as "spendthrift" trusts. This term comes from the trust provisions that prevent a beneficiary from being able to pledge, assign, or otherwise anticipate their interest in the trust before he or she actually receives it. Because the beneficiary has no right to receive trust distributions ahead of the time when the Trustee (who may be the beneficiary himself but who acts in a fiduciary, as opposed to an individual, capacity) actually distributes them to him, the beneficiary's creditors similarly cannot reach his trust interest until it is actually in his possession. As a result, his individual judgment creditors will not be able to reach the assets owned by the beneficiary's Inheritance Trust unless they are creditors of the trustee (in his or her separate role as trustee) or creditors of a beneficiary with respect to alimony, child support, or taxes. In other words, the Inheritance Trusts' assets are protected from lawsuit judgments against the beneficiary (or the beneficiary's descendants or siblings).

Asset protection is important in a litigious society where the divorce rate hovers around 50%. The value of trust asset protection cannot be emphasized enough, especially since public policy generally makes it impossible for an individual to obtain this level of asset protection with respect to his or her personal assets. Spendthrift trust creditor protection is made possible by the law's view that, as long as he does not violate some important public policy in doing so, the manner in which a Trustmaker ties up his assets after death is his business and an entitlement resulting from his ownership of these assets in the first place. Spendthrift trusts are not deemed to be violative of public policy.

Future Transfer Tax Minimization

Inheritance Trusts also implement important estate and generation-skipping transfer tax planning. Under this type of planning, the assets in an Inheritance Trust will not be included in the beneficiary's gross estate for federal or state estate tax purposes, no matter how much they grow in value. While the beneficiary can control the trust as its Trustee and has powers in this regard that are quite broad, those Trustee powers are by design insufficient under federal and state law to make them the functional equivalent of outright ownership. The same is true as to inherited rights as a trust beneficiary. As a result, while retained in the Inheritance Trust, the trust assets are not taxed for estate tax purposes as a part of beneficiaries' respective taxable estates, and they can be passed on to the next generation (i.e., the Trustmaker's descendants) without being subjected to estate tax.

An Inheritance Trust can be passed on to the next generation tax-free because it is exempt for the federal generation-skipping transfer tax ("GST Tax"). This is a tax equal to the federal estate tax that becomes payable when trust assets are distributed to beneficiaries more than one generation below the person in whose taxable estate the trust assets were last included. In essence, the federal GST Tax is designed to capture the estate tax that would have been payable from a generation where estate tax on trust assets is skipped. To limit the reach of this GST Tax on "smaller" estates, Congress allows an exemption from GST Tax for each individual taxpayer. Inheritance Trusts can be specifically designed to take advantage of all of the GST Tax exemptions of both the Trustmaker and the Trustmaker's spouse. (The current GST Tax exemption available to a decedent is $5,450,000, but this amount will be indexed for future inflation. In the case of spouses, those exemptions can be doubled with careful planning). Unfortunately, unused GST Tax exemptions are not portable from a prior spouse to his survivor, so each spouse will need to use an estate plan utilizing Inheritance Trusts to take advantage of his or her GST Tax exemption.

Beneficiary Disability Planning

While a beneficiary is alive and able to manage his finances, he can serve as Trustee of the Inheritance Trust set up for his benefit. In addition, Inheritance Trusts often authorize the beneficiary to determine who will succeed him as Trustee when he is no longer willing or able to serve. To do so, the beneficiary will have to nominate a person, persons, or entity as Successor Trustee in a written document executed with the level of formality required in the trust instructions. If the beneficiary fails to nominate a successor trustee, the Trustee of the Inheritance Trust will be as the Trustmaker originally nominated in the trust by default. Please note that if a beneficiary wants his spouse to serve as Trustee of his Inheritance Trust if he cannot do so, he will usually need to create a writing that specifically makes this designation. To avoid complications of any potential divorce, a spouse is not generally otherwise named as a part of a line of succession.

In any event, if the beneficiary becomes disabled, management of his trust assets for his benefit is assured without court appointment of a guardian of his property or the ambiguities of enforcing a power of attorney.

In the final installment of this series about Inheritance Trusts, we will 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.