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# Lifetime trusts for your heirs: Preserve and protect your legacy from creditors, predators, and taxes

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Trusts have been used for centuries to protect assets for young, inexperienced or spendthrift heirs, to reduce taxes and to keep wealth in families by protecting it from creditors, including a divorcing spouse. But, until a little less than two decades ago, laws in the U.S. limited the number of years that a trust could exist to provide these benefits. Many states are now repealing those laws, and trusts can last into perpetuity or something close to it.

After you decide how much your heirs will receive, it's time to examine how you may want to structure their inheritance. In this article, we will examine the benefits of passing down assets using a lifetime trust for a beneficiary rather than simply distributing assets, whether in a lump sum or at predetermined intervals.

### Potential benefits of lifetime trusts

The potential benefits of lifetime trusts for your heirs rather than outright distribution can include:

- Creditor protection
- Providing professional oversight, including investment management and tax planning
- Oversight of distributions
- Keeping the wealth in your family
- Reduction or elimination of future estate taxes

### Creditor protection

Divorce, debts and disaster can happen to anyone. If you want to insulate a child's inheritance from these occurrences, you could choose a lifetime trust that includes a "spendthrift clause." A spendthrift clause restricts trust assets from voluntarily or

involuntarily being transferred to a creditor. This means that although a creditor may make a claim against the beneficiary's own assets, including any trust money that has already been paid out to the beneficiary, most creditors may not enforce a claim against the assets held in the trust account. A spendthrift clause can also be drafted to prevent the beneficiary from pledging his or her interest in the trust as collateral for a loan, intending to pay the loan back once trust assets are distributed.

The creditor protection provided by such clauses may include:

- Professional liability claims against professionals such as physicians, engineers, attorneys, accountants and financial advisors
- Business debts of individuals who personally guaranteed a loan or did not establish a business entity to protect themselves
- Marital property claims
- Personal debt of those who don't manage money well

## Lifetime trusts and professional management

In many states, the beneficiary may personally serve as sole trustee or co-trustee of a trust for his or her own benefit without sacrificing protection from third-party creditors. But, if you are concerned that a loved one does not possess the skill or desire to manage money or to make good spending decisions, choosing a third party as trustee is a good option. The benefits of the third-party trustee are professional money management and impartial distribution decisions that adhere to the trust terms.

## Professional management

Professional trustees include banks, trust companies, accountants, private trustees and law firms. The professional trustee is usually well versed in the complexities of trust administration, including investments, taxation and property management. This third party can also provide impartiality, continuity and often has substantial capital backing in case of "fault." You may also have a third-party trustee who is not a professional, provided that the individual is "disinterested," meaning he or she is not a related or subordinate party under the tax code.

## Oversight of distributions

A trust will commonly instruct the trustee to make distributions pursuant to an "ascertainable standard." These typically provide for a beneficiary's support, healthcare needs, education and maintenance. Alternatively, you can instruct the trustee to distribute trust property pursuant to additional standards or for other reasons such as:

- **Employment:** You may require that your beneficiary be employed full time or at least be pursuing a full-time career.
- **Disability:** If the beneficiary has a physical or mental condition and can't meet trust requirements, you may authorize the trustee to make distributions to the beneficiary.
- **Service to others:** In addition to providing for any beneficiary's basic health and support needs, you may allow the trustee to support beneficiaries who prepare for and pursue careers in public or private service, the arts, education or in faith-based organizations.
- **Travel:** If travel is important to you, you may direct your trustee to pay for or reimburse your beneficiaries' travel expenses.
- **Special circumstances:** You can direct your trustee to make distributions for special circumstances that are important to you such as weddings, buying a home or starting a business.

- **Substance abuse:** If a beneficiary has substance abuse or other addiction issues, you can direct your trustee to limit distributions to such beneficiary under certain circumstances.

The trustee is generally the party that decides whether a certain expense or need fits within the categories and standards determined by you, and incorporated into the trust document. A third party may be more objective and can be instructed to work toward preserving funds for the life of the beneficiary and beyond, if desired.

## Keeping wealth in your family

If an inheritance is held in trust instead of being distributed outright to the heir, you may name remainder beneficiaries to receive the remaining trust assets at the death of a primary beneficiary rather than the primary beneficiary (or state law if the beneficiary does not have a will/trust) making the choice. For example, you may choose to ensure that the assets pass to your grandchildren instead of your child's spouse or other heirs of his or her choosing (such as friends, charities or others), or if your child is not survived by children, you may choose to have the assets revert to your other living children and/or grandchildren.

An additional bonus is that in most states, even those with community property laws, a trust for a beneficiary that limits access to the ascertainable standard discussed earlier may not be considered marital property even if the beneficiary does not have a marital agreement.

## Reduction or elimination of future estate taxes

When you leave assets to a child, whether outright or in trust, those assets may be subject to estate and/or inheritance taxes at your death. When assets are passed outright, any asset remaining at your child's death may again be subject to estate and/or inheritance taxes when passed to your grandchildren. In contrast, lifetime trusts may be structured so that the assets will avoid estate and inheritance tax following your child's death.

## The generation-skipping transfer tax

A generation-skipping transfer is the transfer of an asset to a beneficiary who is at least two generations below the transferor's generation (a.k.a., a "skip person," such as a grandchild). The transfer may be an outright transfer or it may be a transfer to a trust for the skip person's benefit. The generation-skipping transfer (GST) tax will be imposed in addition to any estate or gift tax.

This means that a trust for life for your child, which passes to your grandchildren following your child's death, is subject to the GST tax. Like with the estate tax and gift tax, there is a GST tax exemption. Proper use of the GST tax exemption will allow assets to be passed through multiple generations without being subjected to estate taxes at each successive death, as well as potential GST taxes.

Example: Jane's estate plan provides that her $5 million estate will be held in trust for the benefit of her son. In addition to being structured to provide professional investment management of the assets, insulate the inheritance from her son's creditors and to keep the assets in the family, the trust can be structured so that upon the son's future death, the assets remaining in the trust are not taxed in his estate.

At the time of her son's death, the value of those assets has grown to $7 million. Because Jane left the assets to a trust for him that provides the assets will pass to his children following his death, those assets will not be subject to estate tax in his estate. If she had left the assets outright to him, the full $7 million would be included in his gross estate and when combined with his other assets, any amount exceeding his own estate tax exemption would be subject to estate taxes.

An additional benefit of the lifetime trust for Jane's son may be protection of the trust assets from division during divorce, should Jane's son and his wife divorce.

While this example does not address all tax considerations, such as income or capital gains tax, it does illustrate how a lifetime trust for a child may protect against future estate tax and other unexpected claims.

### Creating the lifetime trust

While you must make provisions for the establishment of a trust for your child during your lifetime, the trust will not necessarily be funded or come into existence immediately. A trust can be created under your will (a testamentary trust) or your revocable trust (the terms will become irrevocable upon your death). You can also establish an irrevocable trust for the benefit of another while you are living.

Depending on the type of trust, it may be funded during life or at your death. The trust can be funded in numerous ways, including for example, a lump sum of cash or other property, annual gifts or the proceeds of a life insurance policy. The transfer of assets to the trust may be sheltered from the federal gift or estate tax by the use of your unified exemption from those taxes. Likewise, if a trust is funded for a "skip person" as discussed above, the transfer may also be sheltered by your exemption from the GST tax. Married couples can each fund one or more trusts, or can choose to "gift split," which simply means that the funds come from one spouse but the other agrees to allocate his or her lifetime gift tax exemption to the gift.

### The benefits of lifetime trust planning

There are many benefits to establishing trusts for your loved ones rather than simply making a gift or distributing the inheritance outright in a lump sum. In addition to being able to keep the wealth in your family by choosing the future recipients, the benefits from lifetime trusts with spendthrift clauses include:

- Protecting assets from creditors
- Providing professional management
- Oversight of distribution of assets
- Keeping the trust assets in your family
- Protecting assets from a divorce
- Minimizing federal estate tax liability

### What you should do

Work with a knowledgeable estate planning attorney to see if and how such trusts can benefit your family. Contact your TIAA advisor to discuss your overall financial planning needs.

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