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The Inheritor's Trust: Planning In Contemplation Of An Inheritance

By Steven J. Oshins - Special to Lawyers Weekly USA

Jane Dough was getting over the recent death of her mother and could hardly enjoy her million-dollar inheritance. Jane's mother's trust was like most trusts that make mandatory outright distributions to the grantor's child upon reaching a specified age. Since Jane had already attained the age set forth in the trust agreement, the trustee was in the process of transferring the trust assets to Jane outright and free of trust. Jane's mother had directed her attorney to draft the trust to give Jane her inheritance outright because Jane was capable of handling her inheritance without any help from an outside trustee.

Unfortunately, just a few years later, Jane's marriage fell apart and her husband John Dough filed for a divorce. To make matters worse, Jane was a defendant in a multi-million-dollar lawsuit because of a car accident she caused. Her attorney was able to negotiate a favorable divorce settlement, and her insurance covered much of the lawsuit settlement. Jane was happy to have \$200,000 left after both of these problems, especially after her attorney advised her that she could have been left with nothing.

In a perfect world, none of our clients' descendants will ever go through a divorce or a lawsuit. But this perfect world does not exist. This article introduces a concept called the Inheritor's Trust[™] that, if implemented by Jane Dough and her mother, would have protected Jane's entire million-dollar inheritance.

The Inheritor's Trust[™]

More sophisticated estate planners generally create multi-generational dynasty trusts for their clients' descendants that are (1) estate tax protected, (2) creditor protected and (3) divorce protected even though the primary beneficiary controls the trust as trustee. In fact, this should almost always be the centerpiece of the estate and asset protection plan.

However, estate planners often fail to realize the opportunity to plan in contemplation of an inheritance, even if the expected inheritance will not be received for many years. The emphasis is often focused on planning with existing wealth rather than future wealth, thereby missing numerous planning opportunities.

The Inheritor's Trust[™] is a special type of dynasty trust that is designed by the inheritor to receive an inheritance that would otherwise have been passed outright as a result of inferior single generation planning by the attorney for the future decedent.

By receiving the inheritance in trust rather than outright, the inheritance is not unnecessarily subjected to estate tax, creditors and divorcing spouses even though the inheritor controls the trust. The inheritor is either the sole trustee or is a co-trustee and has the ability to remove and replace any CO-trustee and select a successor CO-trustee. The Inheritor's Trust™ is often initially funded with as little as ten dollars until such time as the inheritance is received by the trust.

Control of the trusteeship is coupled with a broad nongeneral power of appointment that can have the effect of eliminating any potential interference by remote beneficiaries. Because the inheritor possesses the ability to eliminate all participation in the enjoyment of the trust assets by secondary and remote beneficiaries, such beneficiaries will not be inclined to interfere with the inheritor's decisions as trustee because their rights could be eliminated.

The Inheritor's Trust™ is designed to provide the inheritor with all of the rights, benefits and control over the trust property that the individual would have through outright ownership, in addition to tax, creditor and divorce protection benefits that are not obtainable with outright ownership. The Inheritor's Trust™ also creates certain additional opportunities that will be explained in detail below.

Designing The Inheritor's Trust™

In its simplest structure, the Inheritor's Trust™ can be designed whereby the inheritor would be the sole trustee and have the right to any or all of the trust's income, plus access to principal limited to health, education, maintenance and support, plus a broad nongeneral power of appointment during life and at death to anyone other than the inheritor, his creditors, his estate, or the creditors of his estate. However, in most instances this trust variation is not recommended because greater flexibility, tax benefits and creditor protection can be obtained using a discretionary Inheritor's Trust™ with a CO-trustee arrangement.

This superior version is designed with two trustees – the primary beneficiary (i.e., the inheritor) as the investment trustee, and an independent trustee such as the inheritor's best friend, or alternatively a corporate fiduciary, as the distribution trustee. The inheritor can be given the power to remove and replace the trustees, thereby maintaining the beneficiary controlled feature of this trust design, as long as the replacement distribution trustee is not a "related or subordinate party" as defined in IRC §672(c). Because this strategy creates a nearly insurmountable asset and divorce protection shield, the trust should be designed to continue for multiple generations so that the secondary and more remote beneficiaries also enjoy the same benefits.

By using a friendly independent trustee, certain powers can be drafted into the trust agreement that could not be granted if there was no independent trustee. This is so because certain powers that can be given to an independent trustee would cause tax and creditor problems if given to a beneficiary as trustee. Use of an independent CO-trustee is generally acceptable when one realizes that the inheritor may have broad removal and replacement powers as long as the replacement trustee is not a "related or subordinate party."

Particularly from a creditor and divorce protection standpoint, the sole trustee health, education, maintenance and support version of the Inheritor's Trust™ is significantly inferior

to the co-trusteed version. The Restatement (Third) of the Law of Trusts, Tentative Draft No. 2, supra, takes the position in §60, cmt. g, that a creditor of a trustee-beneficiary can reach as much as the trustee-beneficiary could properly distribute to himself under the terms of the trust instrument.

Fund Prior To Death

A common alternative is to have the future decedent (i.e., generally the inheritor's parent or grandparent) fund the Inheritor's Trust™ with a substantial gift (i.e., more than the \$10) before death. This amount may be as little as \$1,000, or it may be a much larger amount. If the trust is funded with a gift now, then the inheritor can make use of the trust immediately instead of having to wait until the grantor's death. When one considers the significant benefits of the trust, as described below, the reasons to fund it immediately are obvious.

Advanced Uses

There are numerous advanced uses for the Inheritor's Trust™, some of which will be described below.

Opportunity Shifting

One such use is for opportunity shifting transactions. Opportunity shifting, in its simplest form, is the shifting of the opportunity to make money or generate wealth from one person to one or more others, usually descendants or trusts for the benefit of family members.

Most advisors, in counseling their clients with respect to new opportunities to make money, concentrate primarily on what type of entity should own and invest in the opportunity rather than taking one additional step – examining who should be the beneficial owner of the entity that owns the business or investment opportunity. The Inheritor's Trust™ can be the initial owner of each such opportunity so that the inheritor can protect the entity and the income earned from such opportunities from estate taxes, creditors and divorcing spouses.

Owning GP Interest Or Voting Interest

The Inheritor's Trust™ can also be used to own the general partnership interest in a limited partnership or the voting interest in a corporation or limited liability company. This can be a newly formed entity, or the inheritor can recapitalize an existing business or investment entity into 1 percent voting and 99 percent non-voting and sell the 1 percent voting interest to the Inheritor's Trust™ so that the Inheritor's Trust™ owns the controlling interest.

For creditor protection purposes, this structure adds a wall between the voting interest and the creditor. Protecting the 1 percent voting interest is more important than protecting the 99 percent nonvoting interest. This is especially important if the inheritor owns a corporation since a corporation does not obtain the benefit of the charging order protection of a limited liability company or limited partnership that certain states offer.

For estate tax purposes, this structure creates a valuation discount in the inheritor's estate since the estate now includes only a 99 percent nonvoting interest. This is the case even

though the inheritor controls the entity as the trustee of the Inheritor's Trust™.

Pseudo-Marital Agreement

Yet another use for the Inheritor's Trust™ is as a prenuptial or postnuptial agreement avoidance document. Married couples and soon-to-be married couples often do not have a marital agreement in place. This frequently occurs when they either do not agree that such an agreement should be drafted or when the wealthier partner is afraid to raise the issue.

Although a marital agreement is certainly recommended in addition to creating the Inheritor's Trust™ since it sets forth the agreement of the parties, the Inheritor's Trust™ can be used as a vehicle to protect some of the wealthier marital partner's assets from divorce.

The most fascinating aspect of using the Inheritor's Trust(™) as a pseudo-marital agreement is that since all wealth is earned within the trust, such wealth never becomes community property even if the inheritor is a resident of a community property state, and it never even becomes separate property subject to possible division in a divorce for the same reason. Since the inheritor can be given a testamentary power of appointment to appoint the trust property to anyone but the inheritor, the inheritor's estate, the inheritor's creditors or the creditors of the inheritor's estate, the inheritor can essentially write his or her own marital agreement. The inheritor can choose how much wealth to leave to a spouse, and how to leave the wealth, whether in trust or outright.

By implementing various opportunity shifting strategies into the Inheritor's Trust™, as well as structuring the assets so that the Inheritor's Trust™ owns the voting interests in one or more entities in which the inheritor owns most of the nonvoting interests, the inheritor is taking divorce protection steps far beyond any steps taken by even the most competent and capable family law attorneys to protect their clients' assets from divorce. In fact, perhaps every prenuptial or postnuptial agreement should be coupled with an Inheritor's Trust™.

Conclusion

The Inheritor's Trust™ is an exciting new technique in which future wealth is sheltered from the inheritor's creditors, divorcing spouses and estate taxes even though the inheritor controls the trust as trustee. There are numerous uses for the trust, each enhancing the inheritor's creditor, divorce and estate tax protection.



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