Does Your Family Situation Call For A Spendthrift Trust?

You've likely spent most of your adult life accumulating wealth that you intend to eventually pass on to your loved ones. But are you concerned that the beneficiaries of your estate might squander their inheritance?

One solution is to establish a spendthrift trust that can provide protection for the rest of your lifetime and beyond. Along with certain other trusts, a spendthrift trust may incorporate various tax benefits, including taking advantage of the federal gift and estate tax exemption. But that's not its primary focus: Its main purpose is asset protection.

Restricting Trust Fund Access

The benefit of a spendthrift trust is that it restricts a beneficiary's ability to access and use trust funds. Briefly stated, the beneficiary can't tap directly into the principal or transfer rights to it to someone else. This can also deny access to creditors or a divorced spouse of a beneficiary.

Instead, the trust beneficiary relies on the trustee to provide payments based on the trust's terms. This could be in the form of regular periodic payouts or on an "as needed" basis. The trust document will spell out the nature and frequency, if any, of the payments. Once a payment has been made to a beneficiary, the money then becomes fair game to any creditors.

As previously mentioned, a spendthrift trust isn't designed primarily for tax-reduction purposes. Typically, this trust type is most beneficial when you want to leave money or property to a family member but worry that he or she may squander the inheritance. For example, you might think that the beneficiary doesn't handle money well based on past experience or that he or she could easily be defrauded, has had prior run-ins with creditors or suffers from an addiction that may result in a substantial loss of funds.

If any of these scenarios is a possibility, a spendthrift trust can provide asset protection. It enables the designated trustee to provide funds for the beneficiary without the risk of misuse or overspending. But that brings up another critical issue.

Appointing The Trustee

Depending on the trust terms, the trustee may be responsible for making scheduled payments or have wide discretion as to whether funds should be paid, how much and when. For instance, the trust may empower the trustee to make set payments or retain discretion over amounts to be paid or even if there should be any payment at all.

Or perhaps the trustee will be directed to pay a specified percentage of the trust assets, so the payouts fluctuate, depending on investment performance. Similarly, the trustee may be authorized to withhold payment upon the occurrence of certain events (for example, if the beneficiary exceeds a debt threshold or declares bankruptcy).

The designation of the trustee can take on even greater significance if you expect to provide this person with broad discretion. Frequently, the trustee will be a CPA, attorney, financial planner or investment advisor, or someone else with the requisite experience and financial know-how. You should also name a successor trustee in the event the designated trustee passes away before the term ends or otherwise becomes incapable of handling these duties.

Determining When To Terminate

Is that all there is? Not quite. Consider various other issues relating to spendthrift trusts. For example, you must establish how and when the trust should terminate. It could be set up for a term of years or for termination to occur upon a stated event, such as a child reaching the age of majority.

Finally, work with your estate planning advisor to anticipate other possibilities, such as enactment of new tax legislation or changes in family circumstances that could affect your spendthrift trust.

SIDEBAR: Drafting a spendthrift trust: Not for DIYers

Unless you're an experienced legal or financial professional, drafting a spendthrift trust isn't a do-it-yourself proposition. An experienced estate planning advisor or attorney will know how to satisfy all the legal formalities. Your advisor will consider applicable federal and state laws and can help ensure that no dire tax consequences will result.

Typically, the advisor will ask you a series of questions to determine the best way to proceed. The questions will likely touch on the method and timing of payments, plans should the beneficiary's circumstances change, and provisions for terminating the trust.

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