

## The Inheritance Trust™

By Estate Protection and Property Lawyer, Timothy B. Borchers

### The Asset Protection features of Tim Borchers' *Inheritance Trust™* can benefit all heirs – whether or not they are spendthrifts.

This article is written in the form of Frequently Asked Questions about the Inheritance Trust™:

#### 1. What is a “spendthrift trust?”

The classic “spendthrift” trust is established for beneficiaries who are not good with money or may have circumstances in their lives that make outright gifts or inheritance inadvisable for one reason or another. A trustee is given discretion to administer the assets for the benefit of the “spendthrift.”

The trustee is almost always “independent” – unrelated to the beneficiary - or at least “disinterested” – not having any interest in the trust assets. The independent trustee would usually be a professional (like a lawyer/law firm) or institutional trustee. The disinterested trustee might be a family member, but one who has no financial interest in the outcome of decisions , i.e., no financial interest in whether distributions are made to the beneficiary or anyone else who may be a beneficiary either now or later).

The key to protecting the assets for the beneficiary is the trustee’s discretionary *power* over the trust assets.

#### 2. What is an “Inheritance Trust™”

The Inheritance Trust™ is a trust arrangement whereby the inheritance received by a beneficiary is administered by a trustee for the benefit of the beneficiary, for the lifetime of the beneficiary. In general, the beneficiary himself or herself is allowed to be the trustee. (More on who can be the trustee – including the beneficiary him or herself in another *FAQ* below.)

An Inheritance Trust™ is a form of spendthrift trust, but the beneficiary does not need to be a spendthrift in order for the trust to be effective. **The inheritance trust is best described as an asset protection trust, protecting the beneficiary against hypothetical risks to the enjoyment and use of the inheritance.**

The Inheritance Trust™ is generally written with an “ascertainable standard” that the trustee must follow in making distributions from the trust. The most commonly used standard is “health, education, maintenance and support” (known by the acronym “HEMS”). Sometimes "support" is omitted from this list.) The trustee is charged with using its discretion to benefit the primary beneficiary and no one else, especially not creditors and others who would like to make claims against the assets. the trustee may pay the primary beneficiary for use in maintaining his or her family for concerns such as education, housing, health, and leisure, but those family members are themselves no beneficiaries and the trust expressly omits to provide for paying the legal obligations of the primary beneficiary. .

Although the Inheritance Trust™ may be a standalone document created by the parent, grandparent or other benefactor (the grantor), most often it is a sub-trust of the grantor’s trust. The Inheritance Trust™ therefore usually springs into effect at the time of the death of a trust grantor. At that time a separate Inheritance Trust™ is created for each beneficiary. John Doe, for example, might have three children, Jane, Sally, and James. Each child would receive her or his inheritance as follows: the Jane Doe Inheritance Trust™, the Sally Doe Inheritance Trust™ and the James Doe Inheritance Trust™.

Unless the Inheritance Trust™ has been written out as a separate document during the lifetime of the grantor, the trustee is required to fund the Inheritance Trust™ as a result of settling the estate or the trust

of the grantor, usually at the grantor's death, and the trustee is authorized to create a separate document memorializing its terms at that time.

The Inheritance Trust™ *might* be created as a standalone trust by the parent or grandparent in order to determine in advance *exactly* what terms shall be used for the trust and/or to have a separate trust to begin to fund during the grantor's lifetime. In this respect, the standalone Inheritance Trust™ would be an appropriate receptacle for gifts during the grantor's lifetime.

### 3. How does an Inheritance Trust™ work to protect assets for the beneficiary?

The trustee of an Inheritance Trust™ must use the assets strictly for the benefit of the beneficiary and cannot pay out to the creditors of the beneficiary. The trustee cannot

- split the beneficiary's inheritance that is contained in the trust with a *divorcing* spouse
- pay the beneficiary's *debts*
- use the funds in a way that would disqualify the beneficiary from a public or private benefits in the event of *disability*, and
- allow the beneficiary to *dissipate* the assets because they are to be used and/or preserved for the beneficiary's benefit.

I refer to these as the "4Ds" – four categories of risk that the trustee is empowered to avoid.

Because the trustee of an Inheritance Trust™ is prohibited from making payments or distributions to anyone other than the beneficiary or for his or her benefit, the trustee can not be compelled in a lawsuit, divorce, collection, Medicaid application or in other settings to make distributions. The principal objective of an Inheritance Trust™ is to provide this *asset protection* structure.

### 4. What CAN Inheritance Trust™ be used for?

The beneficiary of the Inheritance Trust™ can expect that the assets will be used to supplement his or her income and property. Thus, the trust would commonly pay all of its income to the primary beneficiary.

Principal may be distributed for support purposes such as paying off personal loans, credit cards, paying down or paying off mortgages, educational expenses, weddings, special events, getting started in business, down payments and deposits for major purchases such as homes, second homes, business interests, enhancing one's income, especially in retirement and during other periods of unemployment or disability, and the like. The Inheritance Trust™ can be used to enhance and augment the lifestyle of the beneficiary, without regard to other assets available to the beneficiary.

The Inheritance Trust™ can also be used for similar expenses for the beneficiary's spouse and dependents. The key to the success of protecting assets inside the Inheritance Trust™ is maintaining the independence of the trustee as far as distributions that might benefit anyone else. In other words, no one else can require the trustee to make distributions to or for the benefit of other persons besides the beneficiary himself or herself.

While the possible purposes to which the inheritance trust may be applied is very flexible and quite liberal in most cases, the drafting of the content of the trust provisions is up to the original grantor to decide.

### 5. Is any kind of maintenance required for the Inheritance Trust™?

One thing that all Inheritance Trust™ beneficiaries are advised, is not to consider the trust as simply another checking account. Distributions from the trust, including the income, should be made after deliberation by the trustee. A record should be made of the purpose for setting up the income stream, the distribution of principal, major purchases, and so forth that the trustee engages in.

For this reason, it is recommended that an annual summary of trust activity should be maintained, and that advice of legal and tax counsel should be sought on a regular basis. Many law firms now have trust maintenance programs that are affordable for even modest sized trusts, the expense of which is justified – and tax-deductible – by the asset protection benefit that the inheritance trust provides.

The more objective the purpose for the trust in supporting support the beneficiary, the stronger the argument that the assets cannot, under any circumstances, be used to meet the beneficiary's obligations. An Inheritance Trust™ would not be drafted to for the beneficiary's "general welfare," for example. It is also advisable to avoid any possibility that "support" could be deemed to include paying the beneficiary's bills or judgments, or meeting a beneficiary's legal support obligations – such as child support. Not to be mean-spirited, but "support" should specifically exclude meeting the beneficiary's legal support obligations, *so as not to create a false sense of reliance on the assets of the trust for the support of others*. The beneficiaries (and more importantly their divorced spouses) must be encouraged to find ways to support their families without regard to the assets in the trust. If the assets are needed to support a family, then they may be used for this purpose, but there can be no compelling this use.

*Support* has not been interpreted in a trust that expressly prohibits the use of funds to pay the beneficiary's creditors or other obligations, to include distributions to third parties with their hands out for payment. However, state law should be consulted and trusts should be reformed – or *reformable* to provide stricter standards when necessary.

#### 6. Can't a person set up a trust for him/herself, doing the same thing that an Inheritance Trust™ does?

No! The beneficiary cannot establish a trust for his or her own benefit and expect to protect the principal from all or even most creditors.

There are legal prohibitions against establishing such trusts, and for good reason. It is against public policy to allow people to so protect themselves from liability that they are never responsible to have to pay for *anything*. Thus, you cannot set up a trust for yourself that allows you to have access to the principal for your own general welfare but prohibits others who you owe money to from accessing it by way of judicial process.

The general rule is that you cannot shelter your own assets from your creditors in a trust *you* create to which you retain access to any benefit. However, a common exception is where a beneficiary has established an irrevocable trust for his benefit and has relinquished all claims to the *principal but reserved the income* of the trust (the interest, dividends and perhaps capital gains produced by the trust assets). Such "income-only" or "income-discretionary" trusts are often used in *long term care planning* so that beneficiaries are not required to spend all their assets for their care and instead may qualify for a governmental benefit such as Medicaid. In such a trust the trustee is prohibited from paying the principal to the creator of the trust, under any circumstances, but the income generally does go to the grantor.

Note: An income-only trust means the beneficiary has given up the principal – that's a pretty price to pay. An Inheritance Trust™ does not prohibit access to the principal – quite the contrary: The entire trust can be spent – and often will be – on the beneficiary.

Not to beat a dead horse, but the beneficiary cannot set up a trust that gives him or her access to principal except in unusual circumstances. The most common such circumstance is the creation of a Domestic Protection trust – more on that in another *FAQ* below.

### 7. Who can establish the Inheritance Trust™?

The Inheritance Trust™ must be established by a third party *before* the beneficiary has any rights to the assets being protected.

Inheritance Trusts™ *can* be established by *trustees* before giving out the inheritance, if given the authority to do so in the trust documents, or if authorized by a Trust Protector or Trust Advisor empowered by the trust document to approve changes to the trust or specific types of distributions. Note that the inheritance cannot have been received yet at the time of establishing the Inheritance Trust™. The Beneficiary cannot give the money back and let the trustee create the Inheritance Trust™ after the fact.

Third parties who volunteer their service for the purpose of declaring a trust can also help. For example, a sibling might establish a trust for his brother or sister and fund it with \$100 and thereafter the siblings' parent might leave the inheritance to that trust instead of directly to the brother or sister. This has been called an Inheritor's Trust™ by Attorney Steve Oshin.

For example, Susan wishes to have the benefit of an Inheritance Trust™. She cannot write her parents' estate plan for them and they may not be prepared to undertake to amend their plan for various reasons, so she says to her parents "Please leave my inheritance to the trust set up by my brother John for me." The parents make a simple amendment to their plan leaving the inheritance to John as trustee for Susan pursuant to the trust John declares. John declares an irrevocable trust agreement that benefits Susan and, let's say, her descendents. (To avoid confusion with the Inheritance Trust™, I prefer the term Heritage Trust™ when an instrument is created by a sibling or third party in this manner. I reserve the Inheritance Trust™ term for trust established by the person – usually the parent - who is leaving the inheritance.)

### 8. Can an Inheritance Trust™ ever be set up *after* an inheritance has been received?

No! The beneficiary cannot receive the inheritance outright or even have the *right* to receive the inheritance outright and then try to direct the inheritance to an asset protection trust that he or she sets up. Furthermore, a child who participates as a Trustee for example in setting up or funding a trust for himself when he *actually has* a creditor, divorcing spouse, or disability benefit that might put the assets at risk stands a greater chance of losing a challenge to the trust or to the transfer to the trust than one who has no current liabilities. It is simply far better for the asset protection trust to have been set up by a third party in advance of the inheritance and in advance of any actual financial difficulty.

### 9. Can the trustee change the distribution to beneficiaries such that they receive the inheritance *in trust*?

Maybe. It depends on the original trust instrument. In many cases, trusts are black and white in stating that the inheritance is to be paid out and distributed, *outright and free of trust*. Such language would preclude establishing the Inheritance Trust™.

The language – "free of trust" – while giving heirs maximum freedom, may actually do a very big disservice to them. The reason is that it does not allow the trustee any flexibility in protecting the distribution. What if the beneficiary is, at that moment, is experiencing a major claim against them? The creditor can just stand there and take the distribution right out of the hands of the beneficiary, if not immediately, then at any time thereafter. The trust might as well say "free to all" instead of free for the beneficiary.

We would much rather find out that a trust says "The Trustee may distribute to the beneficiaries, or for their benefit, outright or upon such terms and trusts as the trustee deems advisable," followed by other language regarding what makes such a distribution advisable, including principles like protecting the beneficiary from claims, and particular goals for the beneficiary like health, education, maintenance, and support, and so on.

The trust document may also provide that the trustee can write new trust instruments that fulfill the terms of the distribution in trust. The advantage of new trust instruments is that the beneficiaries can each go their own way, not having to stick together under the original umbrella of the parent's trust. In addition, the trust instrument may provide for distribution *to* existing trusts or the merger *with* other trusts for the beneficiary.

#### 10. How does an Inheritance Trust™ differ from an *irrevocable* trust that the beneficiary creates for him/herself?

An irrevocable trust that a beneficiary creates for him or herself is one, by definition, that cannot be revoked and its terms can almost never be altered by the beneficiary him or herself. In this respect, an Inheritance Trust™ is very similar – it is irrevocable as to the beneficiary.

However, the crucial difference is that the Inheritance Trust™ is established by a third party and never by the individual for him or herself. An Irrevocable Trust established by the beneficiary for himself can provide *no access to the principal* for the beneficiary in order to be affective! The only exception is a trust established in a jurisdiction that allows for a so called “Asset Protection Trust” - see below.

#### 11. How does an Inheritance Trust™ differ from a “Domestic Asset Protection Trust?”

The domestic asset protection trust (DAPT) is an irrevocable trust established by a beneficiary for his or her own benefit in a U.S. jurisdiction that specifically authorizes such “self-settled” (created for oneself) trusts. Delaware, Alaska, New Hampshire, and Rhode Island are among 10 or so states that allow such trusts to be created. The advantage of DAPT is that one can set up an asset protection environment for him or herself by submitting the assets to a trustee located in the applicable jurisdiction.

A DAPT cannot be a device to avoid specific a debt or divorce payment. In other words, it cannot be used to “hinder, delay, or defraud” of a creditor of the beneficiary establishing the trust. There is a statute of limitations looking back on transfers to the DAPT, usually four years in length, during which time transfers will be required to be paid back to the creator of the trust or (more likely) to his or her creditor.

If the transfer was not fraudulent as to creditors in the first place, then there is no four year look back and the DAPT will provide for immediate asset protection without a waiting period. Often times the mere presence of a DAPT results in more favorable settlements of lawsuits, helping to protect some of the assets, even if total protection is not achieved. Following the four year statute of limitations even transfers that were allegedly fraudulent are protected in the environment of the trust. For bankruptcy law purposes, the U.S. Bankruptcy code has a different rule: transfers to DAPTs within ten years of bankruptcy will be pulled back by the bankruptcy trustee to pay off creditors.

#### 12. Why concern oneself with *hypothetical* claims?

This is a case where the expression “nothing ventured, nothing gained” aptly applies. If a parent does not establish an Inheritance Trust™ for children, or a Domestic Asset Protection Trust for him or herself, then when one of the “4Ds” rears its ugly head, there is little defense for the assets. The 4Ds, recall, are ***Divorce, Debt, Disability, and Dissipation***. Once there is a real threat to the assets, the child cannot protect the inheritance without going to great lengths, expense or loss of access to the assets.

Therefore, we think it is best to assume that there could be claims and creditors against which the Inheritance Trust™ fortress would be potentially useful. I have witnessed many trusts serving as protection for beneficiaries in all four categories of the 4Ds, even though at the time of the grantors created the trusts, no beneficiary appeared to be in any difficulty. Because of the foresight of the grantors, the Inheritance Trust™ protected each of these beneficiaries from losing their inheritance.

### 13. What about current creditors, divorces, etc.? Can you create a trust to protect assets against actual claims against you?

If by current creditors you mean those presently trying to collect debts, the answer is “No.” Transfers to shield one’s assets against creditors trying to collect bills or judgments will not work, unless one is willing to go to considerable lengths. Establishing trusts in foreign jurisdictions (off-shore trusts in other words), may work. Some jurisdictions have no look back period and are beyond the reach of U.S. creditors for all intents and purposes. Aside from these extremes, “fraudulent transfer” laws prevent most gratuitous transfers to trusts – or to anyone for that matter – from being an effective deterrent. A creditor can sue to have the transfer to “defraud, hinder to delay” them set aside and get the money that way.

Nonetheless, a trust set up by a parent, grandparent or other benefactor for the benefit of another person definitely does act as a protection against the actual claims against the beneficiary. Therefore, the Inheritance Trust™ does protect against actual claims.

### 14. What are the risks to the inheritance? The 4Ds as you call them?

The 4Ds, as I refer to them, are *Divorce*, *Debt*, *Disability*, and *Dissipation*. The meaning of *divorce* and *debt* are clear enough and it is easy to see how they will threaten the inheritance. The risk posed by *disability* is that accepts generally have to be spent down in order for the disabled beneficiary to qualify for disability benefits such as health insurance provided by the state. Disabilities can be devastating to the beneficiary’s assets and to the well-being of his or her family. I recall one child of a wealthy parent who was required to spend all his inheritance – while his stay-at-home wife and three young children sat by and watched the money disappear, before qualifying for government benefits. The Inheritance Trust™ can prevent this unfortunate result.

### 15. What is “Dissipation”?

The risk that I intend to protect against in the case of *dissipation* is the tendency of inherited assets to disappear. An inheritance is usually mixed in with the rest of the beneficiary’s assets. Once intermingled, the inheritance is spent without regard to their source, their intended usefulness for “rainy days,” for the education of grandchildren, and so forth. Heirs tend to live higher on the hog as a result of the inheritance – and there’s no reason to think that they shouldn’t, except when such living comes at the expense of planning for life’s unexpected circumstances, such as being laid off late in one’s career when it will be difficult for many to get another job, or when it’s necessary to go back to school for another degree in order to change careers, or where unexpected medical expenses or disability arise, or when a spouse dies without life insurance, greatly impacting the beneficiary’s ability to support herself and her family.

When assets are inherited *outright* instead of in trust, they are usually unrecognizable as a resource for the beneficiary and her family after a few months, let alone after a few years. The inheritance will have been spent, comingled with other assets, lost in a divorce, lost to a bad investment, and so forth. When assets are inherited in trust on the other hand, they tend to be held for their intended purposes and invested more wisely than they otherwise would be.

Assets inherited in trust may allow for a degree of higher living by the beneficiary, and if so, terrific! Perhaps all of the assets the Inheritance Trust™ will get spent and enjoyed, and this may be a good thing. But it is less likely that the money will be spent all at once, frivolously and without planning, or comingled without or regard for the intended purposes of the funds.

## 16. Why leave assets in trust for the lifetime of the beneficiary?

I can think of numerous reasons: Here's my Top Ten:

1. Life is expensive and seems to be getting more so. Think of the cost of health care, good housing, and education. Inheriting assets in trust protects against prematurely spending the funds without regard to the future.
2. Younger generations, statistics show, are not as good savers as their parents or grandparents. Assets held in trust will encourage savings, a least of the assets inherited anyway.
3. Children and grandchildren might be great savers after all, but since we don't know in advance, the Inheritance Trust™ approach encourages having some extra money on hand when it may really count.
4. Taxes are probably on the rise after years of decline since the Reagan administration. Money in trust is a hedge against this future expense.
5. Assets held in trust are more likely to receive professional financial advice or management and are less likely to be lost to bad investment.
6. There is the perception on the part of the inheritor that what they receive *in trust* is to be regarded in a special manner, in keeping with the purposes or principles that benefit the long-term good of the family – for health, education and support of beneficiaries or members of their families in times of need.
7. There is a greater likelihood of assets being passed down to subsequent generations or for charitable purposes when they are held in trust and perceived as the heirloom legacy of the previous generations.

Assets inherited and held in a discretionary trust like the Inheritance Trust™ are protected against:

8. Being taken in the course of the divorce of a beneficiary.
9. Being taken by a creditor to pay a beneficiary's debt, a debt which the beneficiary could negotiate better if the assets were in trust and therefore not susceptible to being taken to satisfy the debt.
10. Having to be spent down in order to qualify for government disability benefits. Perhaps the assets *should* be used for the disabled beneficiary, but they may be better directed toward the beneficiary's own dependents who are not being sufficiently supported because of the beneficiary's disability.

## 17. How practical is it to provide an Inheritance Trust™ for Children? Is this only for the rich and "infamous"?

The Inheritance Trust™ is VERY practical. I have many examples from my own experience where the Inheritance Trust™ has been useful for families with ordinary levels of wealth. The risks of Disability, Divorce, Debt and a tendency to Dissipate are very ordinary and very real. Therefore, we recommend the Inheritance Trusts™ for almost every estate.

## 18. Why is the common technique of giving the estate to your children a little bit at a time, like 1/3 at 30, 1/3 at 35 and the balance at 40 not good enough protection?

The stages of distribution – commonly 21, 25, 30, and so on, are not desirable because it means that at these stages the child has the right to some and eventually all of the principal of the trust. If the child has the right to it, then so do his claimants - the 4Ds (Divorce, Debt, Disability, Dissipation) all over again – the claimant has only to wait until the age milestone is reached, and then the trustee has to pay the claimant (the creditor, the divorcing spouse, the government) or the potentially spendthrift children themselves. The lifetime aspect of the Inheritance Trust™ stands between the trust funds and the claimant, unlike the outright distributions, whether they are in stages or not.

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