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Beneficiary-Controlled Trusts

Would you like to provide your children or loved ones with an inheritance but protect them from the risks that may accompany a large windfall? If so, you can create a beneficiary-controlled trust in which the person you name as the trust's primary beneficiary has rights, benefits, and control over the property held by the trust, but with important protections. In a beneficiary-controlled trust, you can name the primary beneficiary as the sole trustee.

What Are the Pros?

If you want to provide an inheritance to a mature child or loved one that you trust to make prudent financial decisions, a beneficiary-controlled trust is a strategy that you should consider. Even beneficiaries who handle money wisely could encounter situations in which their money and property are vulnerable to creditors' claims, divorce, lawsuits, or estate taxes: a beneficiary-controlled trust can protect the property held in the trust against those claims. Although you can include terms in the trust document that limit the degree of involvement and control you would like the beneficiary to have, a beneficiary-controlled trust can still enable the beneficiary to have a considerable amount of control over their inheritance and how it is used.

Under most states' laws, even if a beneficiary is the sole trustee, most creditors may not reach the beneficiary's interest in the trust or compel the trustee to make a distribution if the trustee is not required, but has the discretion, to make distributions based on an ascertainable standard, for example, distributions for the beneficiary's health, education, maintenance, and support (HEMS). However, once the trustee makes a distribution to themselves as a beneficiary, the creditor may then be able to reach the funds.

This type of provision provides two additional benefits. First, the HEMS standard provides a safe harbor under the Internal Revenue Code (I.R.C.), and its use will prevent the value of the money and property in the trust from being included in your beneficiary's gross estate for estate tax purposes. Second, depending upon the unique circumstances of each beneficiary and if there is a low risk of creditors' claims or lawsuits, naming the primary beneficiary as the trustee, along with the HEMS standard for distributions, may reduce expenses during the administration of the trust because the fees required for an independent co-trustee would not be incurred.

What Are the Cons?

May not protect against all creditors

Some states' laws provide exceptions that preclude beneficiary-controlled trusts from being used to protect trust assets from claims by certain creditors, for example, a former spouse's claim for alimony or a claim for child support. In those states, the creditor may be able to reach the trust's property to satisfy those claims or to compel a distribution that it can then use to satisfy the claims.

Trusts are more complex than outright gifts and typically require legal drafting, administration, and sometimes ongoing legal or tax advice. The trusts will likely have required annual tax filings, investment management, or legal reviews, creating additional expenses.

May provide too much control for some beneficiaries

For beneficiaries who are not skilled at managing money or have poor judgment, a beneficiary-controlled trust may not be the best estate planning strategy. Although the trust document will specify the beneficiary's responsibilities as a fiduciary, a beneficiary-controlled trust provides the beneficiary with considerable control over their inheritance. Even if a beneficiary trustee may only make HEMS distributions to themselves, to a large extent, it is up to them to determine if a particular distribution meets that standard, permitting them substantial leeway in how the money or property held by the trust is expended. If you are concerned that a beneficiary will not be able to handle the responsibility of also being a trustee for a beneficiary-controlled trust, other estate planning solutions may provide you with more peace of mind.

What if the Beneficiary Wants a Distribution Exceeding HEMS or Wants to Terminate the Trust?

The trust can give the beneficiary trustee the ability to appoint an independent trustee who can make discretionary distributions to the beneficiary. An independent trustee is someone not related to and not subordinate to the beneficiary (as defined under IRS rules). Typically, this means they are not a family member, not an employee or subordinate of the beneficiary, and not someone who stands to inherit from the trust. An independent trustee can be a trusted friend or advisor, a professional fiduciary (such as a CPA, attorney, or corporate trustee), or a trust company or bank.

So the beneficiary can appoint his or her best friend to be trustee for one day and then the best friend trustee can distribute the entire trust or any portion of it to the beneficiary.

Best of Both Worlds

Beneficiary-controlled trusts are often used when parents want to provide flexibility and empowerment for a responsible adult child, while still protecting the legacy from future risk. Careful drafting is essential to strike the right balance between access and protection.

If you would like to find out more about whether a beneficiary-controlled trust is a strategy that will work for you and your family, give us a call to set up an appointment. We can help you think through how to design your beneficiary-controlled trust in a way that achieves your goals and protects the inheritance you want to leave for family members and loved ones.