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Asset Protecting a Child's Inheritance

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When leaving property to a minor or adult child, clients can choose exactly how they want to leave it to them. The property can be left outright, in trust until the beneficiary reaches a certain age or achieves a certain goal, achieve a certain goal, or in a continuing trust for that child's lifetime. For the last option, there is a special technique that allows us to "asset protect" the money in a continuing trust for that child for his or her lifetime. I have done this in my own trust to benefit my children and always discuss this option with my clients.

To obtain "asset protection" for the beneficiary of a continuing trust, there are two basic requirements. The first is no demand right by the beneficiary and the second is the selection of the trustee.

To address the first consideration, what does it mean to have no demand right? Does the trust have language that allows the beneficiary to "demand" money from the trustee? Another common term used to explain this is the beneficiary's "withdrawal right." An example might be Johnny has the right to withdraw up to 25% of the principal and income from his trust when he reaches the age of 25 and may exercise an unlimited withdrawal right when he reaches 30. Although this might seem like a perfectly fine thing to draft for Johnny, having this type of demand right allows a future creditor to potentially tap into Johnny's trust for up to the percentage that he has a demand right for. Some examples of future creditors include a future divorcing spouse, a bankruptcy trustee, or a plaintiff in a lawsuit.

Here is where it gets interesting. There are two types of trustees: (1) the "interested" trustee and (2) the "discretionary" trustee. Under IRC 672(c), an interested trustee is a related or subordinate party to the beneficiary or grantor. Someone that is a first degree relative is a related party (so think, parent, sibling or child of the beneficiary or grantor). By subordinate we mean someone working directly for the beneficiary. One note, a beneficiary's CPA or attorney is not considered a subordinate under the Code.

For the best asset protection, we want a "discretionary" trustee in the driver's seat. This is because a discretionary trustee may make distributions for any purpose and may refuse to make distributions to the beneficiary for any reason. So, if the beneficiary was being sued and plaintiff's counsel was seeking money from the beneficiary's trust, a discretionary trustee can decide not to make a distribution to pay the judgment. That discretionary trustee could also use his or her discretionary status as a bargaining chip to settle the claim for a lesser amount on behalf of the beneficiary.

On the other hand, although there is some asset protection with an interested trustee who is limited to the HEMS Standard (Health, Education, Maintenance or Support), there are some holes. One such hole could be a divorcing spouse. Because an interested trustee must make HEMS standard distribu-

tions, a divorcing spouse might be able to argue and successfully force an interested trustee to distribute for alimony or child support.

Even if a client wants to list an interested party to serve as trustee, we can still provide more asset protection by listing a discretionary trustee in succession after the interested trustee. That way if a creditor, predator, or divorcing spouse claim were to arise, the interested trustee could resign and the discretionary trustee could accept the trusteeship. There has been debate among practitioners as to how far removed from the grantor or beneficiary that the trustee should be to provide the best asset protection. I believe it is a continuum of protection. For example, not many could argue the true discretionary nature of a bank trustee. Now, on the other hand, although a cousin might be a discretionary trustee, there is probably an argument that can be made that that type of discretionary trustee is not as far removed and might be subject to some influence by the beneficiary.

Regardless, there is a distinct advantage to having any discretionary trustee serve over an interested trustee. The beneficiary can use it as a bargaining chip in negotiations with a creditor. Additionally, the grantor can provide asset protection for their children, but not rule from the grave by allowing the child of a separate share trust to act as sole trustee at a stated age. Then, later on down the road, if a creditor issue arises, the beneficiary trustee (who is an interested trustee) can simply resign and a discretionary trustee already named can take over as trustee. In the alternative, the grantor could give the beneficiary the right to choose his or her own successor discretionary trustee.

If nothing bad ever happens, then the beneficiary trustee simply continues to drive the bus so to speak. If upon death there are still assets inside the continuing trust, there can be provisions in the trust that shift that money to the next generation (or to anyone, really) with the same trust provisions.

In the alternative, if the trust share were left outright to the beneficiary, he or she would likely not be able to attain the same asset protection, even with a DAPT (Domestic Asset Protection Trust). For example, if the bulk of the beneficiary's assets are from an inheritance, the beneficiary is not likely going to be able to place all of the assets into a DAPT because this would make him insolvent. However, if that money is left in a protective continuing trust by a parent, the entire amount can remain protected. This is pretty powerful stuff.

About the Author:
Brenda is an Estate and Business Planning Attorney with her primary office located in Carlsbad, California. Brenda graduated from the University of San Diego School of Law where she served as an Editor on the San Diego International Law Journal and published a journal article in the San Diego International Law Journal. She enjoys writing and has written a book on estate planning titled "Safeguarding the Nest, Third Edition" and co-authored a book on Elder Law titled, "How to Avoid the Catastrophic Costs and Effects of Long Term Care, a California Elder Law Guide" (set to be released in April 2013). Her passion is helping families protect their children and their parents and helping business owners preserve and protect their businesses. On a more personal note, Brenda is married to Len, the CEO of a San Diego based company and they have two children, Lenny (7) and Taylor (5), and two German Shepherds, Starsky and Semper. For more information or media requests, please visit www.GeigerLawOffice.net or contact Lexi Davis at (760) 448-2220.

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