Strategies to Keep Your Beneficiaries from Blowing Their Inheritance

You've worked hard to create a nest egg for yourself. Perhaps leaving a legacy is another goal. Creating "trust fund babies" or having your legacy blown by your beneficiaries is typically never the goal. So, what can you do to meet your legacy goals but also protect the assets from frivolous spending? There are several ideas to consider, all of which have trade-offs between many factors.

When people think of "trust funds" they often think about multiple millions of dollars and structures created to minimize estate tax. While that can be the case, the estate tax exclusion is at $13.61 million and less than 1% of all estates are subject to estate tax these days.

That said, trust planning has long been in place for reasons other than tax management. Spendthrift beneficiaries, potential asset protection, unwanted sons/daughters-in-law and simply desiring control from the grave have all motivated trust creation.

Consequently, the size of the estate doesn't necessarily matter when protecting your legacy is important. That's not to say that a $10,000 trust won't have significant inefficiencies but trusts that are the size of a few $100,000 are actually pretty common. Therefore, the first balancing question is whether you want to spend the time, effort and set up costs to create such a trust.

Assuming you want to create such a trust, there are several common planning techniques used to control your legacy. You can have limited distribution provisions such as only allowing income to be paid from the trust, or setting a fixed percentage (e.g., 3%) that can be paid from trust funds. More common, though, is allowing the trustee to make payments for specific needs like health, education, maintenance, support, to start a business, buy a home, etc. Another idea may be to incentivize the trust allowing distributions to be made either matching or paying a percentage of the beneficiary's earned income, making distributions for graduating college, or any other achievement you would like the beneficiary to reach.

Of course, you will need a trustee to handle all of this responsibility. That includes a trustee that has the ability to say "no" when necessary. While it's possible to name your beneficiary as trustee, often times that allows too much control. A trusted friend or relative, or even a corporate trustee is something to consider. Whoever you choose, it is an important and time-consuming task, so make sure your trustee selection is willing and able to take the role.

These are just a few ideas for controlling your legacy. It's important to remember that as long as your trust planning goals are legal, generally such provisions can be drafted by a skilled estate planning attorney. However, when you have trusts that may go on for years, you must balance your goal of control with the need for flexibility. For example, trusts that paid "all income" in the early 1980s were created at a time when 11-14% municipal bond coupons were fairly common.

Such a trust today may only generate 2-3% in income. If the document doesn't allow the trustee to make principal distributions, the perceived benefit of an all income trust may not be what you intended to pass along. On the other hand, if your desire it to assure the funds last for a lifetime, restrictive distribution provisions can achieve that goal.

Estate planning often symbolizes the quintessential example for the scales of justice. For every aspect of control you wish to exert, a cost of some type must be born. Locking down the beneficiary's access to the trust means you lose flexibility. Allowing too much access could mean the trust funds are gone before you know it. If you are concerned with protecting your legacy, you must balance these many factors and find the sweet spot for you that tips the scales just right. Work with your financial advisor, in partnership with your tax and legal advisors, to help find the estate planning strategy that meets your goals. ■

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