TESTAMENTARY TRUSTS IN ESTATE PLANNING

The use of trusts in estate planning continues to be a hot topic among estate planning professionals and their clients. For example, whether or not to use a revocable living trust to avoid probate continues to be a widely discussed option in estate planning. The purpose of this article, however, is to discuss the use of trusts in another arena of estate planning. Specifically, how does a client leave his estate to his children and whether the use of a trust is appropriate. This article will discuss two types of trusts that parents can use when transferring their wealth to their children.

These trusts are called testamentary trusts, meaning that they are not established until the client is deceased. In other words, the trust lays dormant in a client’s will until it is effectuated at the client’s death. There are two types of testamentary trusts to consider. The first trust can be referred to as the “three strikes and you’re out” trust. The second trust can be referred to as the “stealth prenuptial” trust.

The “three strikes and you’re out” trust is typically used where a client has minor children. Since the children are minors, they are not legally able to own the assets transferred to them at a parent’s death. If a trust does not exist, then those assets would have to be held in a conservatorship which can be time consuming and expensive to establish and administer. The trust established for minor children under a parent’s Will would provide distributions for their health and education, maintenance and support. If a child is going to college, the trust would be paying for books, room and board, and tuition for the child. If the child needed a car to commute to and from college, the trust could buy the car; the child simply could not have the ability to choose a Lamborghini over a Ford Explorer. The type of car would be determined by the trustee of the trust, someone other than the child. The trust then would provide for distributions of principal free of any control by the trustee at specific ages. A common scheme to distribute is one-third of the trust at ages 25, 30 and 35. The theory of this trust is that if a child makes a mistake and unwisely spends the first third he or she receives, the child may be more mature and thoughtful when he or she receives the subsequent installments.

The “stealth prenuptial” trust can be established for adult children who are in a risky business or profession and the parent wants to provide some asset protection for the child. This trust can also be used for a financially immature adult child or an adult child that cannot say no to a financially immature spouse. In both instances (i.e., asset protection and financial immaturity), the trust is for the life of the child.

In the first instance where the client is trying to provide asset protection for the surviving child, the child is typically his or her own trustee upon reaching a certain age, e.g., age 35. In the second circumstance, where an adult child is not financially immature or cannot say no to a financially immature spouse, the child is a co-trustee along with a third-party trustee. The co-trustee would be either a trusted family member, an advisor, or an institution such as a bank trust department. The advantage of a third-party trustee is that they will act as a governor over the child in making bad financial decisions. Again, the income and principal of the trust would be distributed for the child's health, education, maintenance and support. In the context of a third-party co-trustee, the trust should end up augmenting the child's life style for his or her entire life.

In selecting a third-party trustee, a preference can be to use a corporate trust department. Corporate trust departments are very effective managers of money in this type of planning for an adult child. It is important to provide that the adult child can always replace the corporate trustee with another corporate trustee. This allows for effective negotiation of trustee fees and flexibility in who the child wants to work with in administering the trust.

The use of trusts in estate planning can be confusing. There is no right or wrong answer to many of the questions and concerns facing clients. The two trusts described in this article are simply two examples of what a client and an estate planning professional should be discussing to see what fits the client's particular situation.