Heir tight: The dos and don'ts of creating rock-solid trusts

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Imagine working for decades so that one day you could pass your assets on to your children or grandchildren.

Wouldn't you like to know that when the day comes, they won't lose it all on bad investments or to a gold-digging spouse—or simply because they have no idea how to properly manage large sums of money?

Whether you're bestowing assets during your lifetime or leaving them as an inheritance, creating trusts with well-thought-out terms can ensure your money lands in the right hands and isn't squandered.

"When you write a will and leave money outright to your heirs … once it's inherited, there are no controls on how that money is being handled, and you don't know what will happen," said certified financial planner Ian Weinberg, CEO of Family Wealth and Pension Management.

"Using trusts helps protect your heirs against future catastrophes—[such as] bankruptcies, money-hungry predators disguised as friends, family looking for loans or business bailouts and other financial challenges—and can also provide for certain special needs of your children or grandchildren," he said.

Many trusts make multiple payouts over time, the hope being that spacing out distributions will prevent the beneficiary from blowing it all in one shot.

Russ Weiss, a certified financial planner with Marshall Financial Group, said that when it comes to setting the distribution terms with clients, "the conversations become tricky."

In many cases, his clients use age-based payouts, in which a percentage of assets is distributed at various ages.

"The child doesn't get it all at once," he said. "If they are irresponsible with money, hopefully they can manage [with spread-out distributions]."

Distribution options

Payouts at 25, 30 and 35 years of age have historically been common, though experts warn that in this day and age, 25 is too young to properly manage large sums of money.

Weiss also has clients who schedule periodic payouts after the benefactor dies, so beneficiaries may get a distribution, for example, every five years following the death.

While distribution schedules are common, others opt for more elaborate terms to allow for more contingencies.

For example, Weinberg has a client couple who planned to leave money outright to their children. However, after problems arose with one child, they created a trust that states certain conditions that must be met in order for the child to receive the inheritance.

There are various stipulations that can be dictated in a trust, depending on a given situation.

If an heir has a history of chemical dependency or mental health problems, Weinberg said, he or she might need to prove a consistent period of no drug use or have a report from a psychiatrist showing solid mental health before receiving a payout.

If work ethic is an issue, the trusts could require proof of employment or make income-matching distributions, where recipients get payouts equal to their salaries. In some trusts, distributions may even be contingent on whether the beneficiary is married or has children.

Though payout provisions are typically viewed as a simple solution, it's often better to avoid large distributions altogether, instead keeping the money in the trust, paying out any income generated and making distributions for certain expenditures.

"We like the idea of a trust remaining in effect for the child's lifetime," said John McManus, founding principal of McManus & Associates, a trusts and estates law firm. This is particularly beneficial when large sums are involved.

Who needs a trust?

- Trusts are not just for the ultrarich. If your heirs stand to inherit even **a few hundred thousand dollars**, a trust is worth considering.
- People with young children could benefit from a **testamentary trust**, established in a will and effective upon one's death. It dictates how assets will be distributed at later dates. The drawbacks? These trusts go through probate, delaying disbursements, and the records are public.
- **Revocable trusts**, or living trusts, are often a better option. You allocate, access and manage assets, and amend terms while you're alive. When you die, the trust can convert to an irrevocable trust with unchangeable terms. Other pluses: They're easy to set up, are flexible and protect privacy.**—J.W.**

Worst-case scenarios

Here's why: Say you set up a trust that finishes making distributions when your daughter reaches a certain age, by which point she's married with kids. If she dies, her husband is entitled to the money because it's now part of her estate. What happens if he remarries and then dies? The new spouse can take one-third of the assets—and can choose to redirect them to her own kids, depriving the true heirs.

Alternatively, he said, "the parents can direct that the inheritance pass in trust for the benefit of the daughter."

"The trust would provide for her on an as-needed basis during her lifetime and would require that any remaining assets pass to her children only upon her death."

One problem that can arise with perpetuating a trust is shackling the child to a trustee. That's why McManus often favors making the child the trustee.

In that case, the trust could include provisions limiting the beneficiary's access to the trust while allowing distributions to be made for expenses related to health, education, maintenance and support—referred to as the "HEMS standard." Some trusts also include a "5 by 5 clause" that provides $5,000, or 5 percent of the trust, per year in addition to HEMS.

While you can dictate how you want your money distributed, things get tricky when the money is in a custodial account for your children.

Because these accounts are created for minors to pay for their expenditures, once the child reaches a certain age—18 or 21, depending on the state—they retain full control.

You can put custodial accounts into a trust, but if you want to set terms that restrict the child's access to the money, the child will have to sign off on it once they reach the legal age.

If this is a concern, Weiss said, "it's often effective to make children aware of the value and protection a trust can provide ... as they age and that it's in their best interest to protect themselves from future spouses or potential creditors."

Is your trustee trustworthy?

When creating a trust, choosing the right trustee to manage the funds over time may be one of the most important decisions you'll have to make.

While many people are inclined to choose a close friend, that's often not the best course of action.

"If you pick someone you can rely on but who doesn't have financial savvy, that can be a challenge when talking about larger sums of money," said certified financial planner Ian Weinberg, CEO of Family Wealth and Pension Management. "It's a big responsibility, [and] that person needs to be able to take on that role."

Ideally, Weinberg said, the person should have a good amount of experience in some or all of the following: investing, taxes and law and perhaps some experience running a business.

"The trustee needs to have the savvy and disciple and experience to know when requests are being made that are legitimate and when it could be to the detriment of the trust," he said.

Typically, trusts are set up to provide income and then capital at certain age intervals and for certain specific uses, such as buying a home, paying college tuition or funding a business. But there could also be requests for distributions that aren't clearly defined in the trust—in which case, the trustee would have to make the decision.

If you do pick a trustee who's a friend, you should, at a minimum, also have a co-trustee, he said.

Additionally, when young children are involved, it's best to choose different people to act as trustee and as guardian; divvying up these roles can avoid many potential conflicts in the future.

Russ Weiss, a certified financial planner with Marshall Financial Group, said it's also important to choose a "friendly trustee," or someone who can understand the parents' values.

He added that you should have good communication ahead of time with the trustee as well as the kids—provided they're old enough—to explain to them why certain language was included in the trust and why someone was chosen as trustee.**—J.W.**