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Divorce and Asset Protection for Your Beneficiaries

Deciding How to Distribute Assets to Heirs: One of the key decisions in preparing your estate plan is deciding who your beneficiaries will be upon your death. A sub-part of that decision is deciding in what manner you will leave your assets to these beneficiaries. Years ago it was quite common to leave inheritances outright to beneficiaries. In more recent times, "staggered" distributions were favored, which distributed the inheritance to the beneficiary in pieces such as one half at death and the balance five years later, or one-third when the beneficiary attained ages 25, 30 and 35.

With the recent proliferation of lawsuits, and the divorce rate at about 50%, these types of distribution plans are becoming more common. More and more often, parents are leaving inheritances in trust for their children and grandchildren. The advantages of leaving an inheritance in trust are many:

1. Lawsuit protection, if the trust is properly structured;
2. Protection from a divorcing spouse of the beneficiary;
3. A potential reduction in estate and generation-skipping transfer taxes at your death as well as at the death of future generations through the use of generation skipping trust provisions;
4. In the case of a "spendthrift" beneficiary, or one who is prone to drug, alcohol, or gambling addictions, the ability to have a third party manage the inheritance for the beneficiary;
5. In the case of a "special needs" beneficiary, the ability to avoid disqualifying the special needs beneficiary from receiving valuable government benefits such as Medicaid or SSI while, at the same time, making inheritance funds available for their supplemental needs.

Choosing Successor Trustees: Should you decide to leave your beneficiaries' inheritances in trust for them, you will need to decide who will be the Trustee for those beneficiaries' trusts. If your main concern is giving as much flexibility and freedom to the beneficiary as possible, you may want the beneficiary to be the Trustee of his or her own trust. While this choice offers the greatest flexibility and freedom, it offers the least amount of protection from the creditors of the beneficiary.

A second alternative is to name a Co-Trustee to act with beneficiary. Because the beneficiary is not able to make decisions regarding distributions on his or her own, this affords greater asset protection for the trust assets. It also provides the option of the beneficiary resigning as Co-Trustee in the event it appears that trouble from a divorcing spouse or creditors may be on the horizon.

A final alternative would be to have a third party act as Trustee. The third party Trustee could be a friend or relative, a trusted advisor such as your attorney, or a corporate Trustee. This alternative offers the greatest asset protection. It is also generally the best choice where the beneficiary is a spendthrift or has an addiction, or where the beneficiary has special needs.

How Is the Inheritance Distributed?: Distributions from trusts to beneficiaries can be structured in a variety of ways. One option is allow the beneficiary to demand distributions at any time he or she desires. While this option offers the greatest flexibility and freedom to the beneficiary, it offers the least amount of asset protection. It is probably effective for sheltering the inheritance from a divorcing spouse, but is unlikely to provide much protection from other creditors. A second option is to mandate distribution of income (or a set percentage of the trust) and allow access to principal for specified reasons such as health and education. While this option provides good protection for the undistributed trust principal, the distributed income and principal may be subject to the claims of divorcing spouses and creditors. A third option is to give the Trustee discretion as to when and if to make distributions. These "discretionary" trusts offer the greatest divorce and asset protection because the decision to make or not make a distribution is in the hands of the Trustee, and not under the control of the beneficiary. For this reason, trusts with spendthrift or addicted beneficiaries are usually drafted as discretionary trusts. Finally, trusts for special needs beneficiaries must contain special provisions that protect the inheritance from being claimed by any government agency or causing the special needs beneficiary to lose eligibility for government assistance programs.

A Common Misunderstanding: One reason that is often given for not leaving inheritances in trust is that the parent wants the child or other beneficiary to be able to use the inheritance to buy a house, start a business or invest for retirement. This is a common misunderstanding. Just because an inheritance is left in trust for a beneficiary does not prevent the inheritance from being used for these purposes. The Trustee of the beneficiary's trust can invest in these types of assets the only difference is that the title to the asset, such as the house, business, or retirement savings, will be in the name of the beneficiary's trust as opposed to the name of the individual beneficiary.

Although this difference in how title is held seems small, it can make a big difference in the event the beneficiary's spouse files for divorce or the beneficiary is sued for an auto accident or for malpractice in his or her profession or is otherwise being pursued by creditors. It can be the difference between losing the house, business or retirement assets or being able to continue to use those assets and passing them on to the beneficiary's heirs upon his or her death.