Protecting Inheritances for Married Children

Presented by Christa Canavan

Statistics suggest that a high percentage of marriages will end in divorce. Although you may not be concerned about your own marriage, are you worried about protecting the assets of your married children?

Everything may be rosy now, but it's not uncommon for people's perspectives (and personalities) to change during a divorce. If that happens, what do you want for your children's inheritance? Would you continue to provide some level of financial support to your child's ex-spouse once he or she is no longer part of the family? Or would you prefer to omit this support for your former son- or daughter-in-law? If you wish to protect your child's inheritance, several planning options are available.

The First Line of Defense

Premarital agreements. For many high-net-worth individuals, particularly those with a family business or other generational family wealth, the first step may be to encourage your child to address the need for a premarital agreement—a binding contract between the prospective spouses that defines their rights in the event of a legal separation, divorce, annulment, or death. Although it can be an effective planning tool if executed correctly, a premarital agreement does require the child's involvement and can raise emotional concerns for the couple ("I love you so much and will always take care of you, but can you sign this premarital agreement?").

To help overcome any uneasiness, both parties should work with practiced attorneys who can educate your child with respect to his or her rights under the agreement, as well as any other rights that he or she may or may not be waiving in the event of a divorce. For example, beneficial rights to ERISA-governed retirement plans cannot be waived by a prospective spouse in a premarital agreement; however, the agreement can provide for the commitment to waive spousal rights once the parties are married. In addition, the couple may wish to discuss the intricacies of dividing specific assets, including tax considerations. Or, if the prospective spouses are young, they may wish to take a more flexible approach, perhaps restructuring their rights at certain predetermined points in the future.

Postmarital agreements. In contrast, postmarital agreements are entered into after the marriage. Initially, the enforceability of these agreements was in question. In recent years, however, they have increasingly been upheld by the courts, particularly if they follow the requirements of the Uniform Premarital Agreement Act or other state law governing premarital agreements. Nonetheless, postmarital agreements are still in their legal infancy and are considered less reliable than are premarital agreements.

Trusts: A Secondary Level of Protection

Trusts can also be a worthwhile tool if you wish to retain control of or protect potential inheritances. Trusts come in two broad categories: third-party spendthrift trusts and self-settled trusts (either domestic or offshore).

Third-party spendthrift trusts. An individual can establish this trust for the benefit of another individual (frequently, by individuals for their spouses and children); generally, the person who establishes the trust is not one of the beneficiaries. A key aspect of this type of trust is that it gives the trustee discretion over when and how distributions are to be made, making it an extremely effective vehicle for family members with potential creditor concerns, including divorce. If you wish to protect gifted or inherited assets, the trust should vest the trustee with complete discretion to make, or not make, distributions to your child and his or her descendants.

To ensure the highest potential level of protection, the trust shouldn't contain provisions that may be construed as granting your child a right to withdraw funds from the trust or force mandatory distributions of income. These types of provisions raise the concern that a court may assign all or a portion of such a right to a divorcing spouse. In all circumstances, the trust should include a spendthrift clause expressing the grantor's intent that the child's interest in the trust shall not be subject to assignment, whether voluntary or involuntary, to any creditor. The laws of some states provide automatic spendthrift protection for certain interests in a trust. Relying on these statutes isn't foolproof, however, as some states may make exceptions for spousal claims.

Self-settled trusts. Several states have adopted laws to protect assets held in an irrevocable trust from an individual's creditors, even if the individual is the grantor of the trust. These trusts can shield assets from the claims of a divorcing spouse, but most states have held that the trust must be established prior to the marriage. (Nevada, however, has protected against spousal claims for trusts established after marriage but before a divorce is anticipated.) Even if the trust is established prior to the marriage, the transfer to the trust must still pass muster under state fraudulent conveyance laws. Because of such complexities, you (and your attorneys, if outside the applicable state) should work with experienced counsel practicing under that state's laws.

Common distribution techniques. In a divorce, the battleground is often the question of whether the beneficiary has a right to receive the trust property. Keeping your family's circumstances in mind, you should weigh the benefits and drawbacks of various distribution methods with your attorney. Popular trust distribution techniques include the following:

- **Outright.** The funds are distributed outright and free of trust, no strings attached. This technique is often favored by individuals with mature, financially astute children. This distribution standard offers little to no asset protection.
- **Mandatory income/discretionary support.** Mandatory income provisions require the trustee to distribute income annually (or, quite commonly, at a more frequent interval) and provide distributions of principal either under a standard such as "health, education, maintenance, and support" or at the trustee's total discretion. The trust will not provide asset protection for mandatory distributions, and if the beneficiary can demand assets, they may be available for asset division.
- **Staggered distribution.** Trust assets are distributed in intervals, such as when the child reaches certain ages (e.g., 1/3 at 25, 1/3 at 30, and 1/3 at 35). These provisions are frequently used as a measure to keep the child from squandering the inheritance; on the positive side, they make funds available to the beneficiary at ages when major events, such as marriage or purchasing a first house, are likely to happen. Until the triggering ages are reached, the trustee typically makes discretionary distributions. Any mandatory distribution may be considered available and part of the marital estate.

The benefits of a corporate trustee. Because it removes the perception that family dynamics are part of the distribution decision, a corporate trustee may be more effective than a family member trustee. Through my relationship with Commonwealth Financial Network®, the Registered Investment Adviser–broker/dealer that I partner with to help me better serve you, I have access to several personal trust service companies. Each of these companies is experienced in all types of trusts, including life insurance, charitable, multigenerational, special needs, and minor trusts.

Last but Not Least . . .

Buy-sell agreements. Often, when a family business has several owners, neither they nor the divorcing owner wants to go into business with the ex-spouse. A buy-sell agreement is an important tool in these situations because it provides for the mandatory purchase (or right of first refusal) of a shareholder's interest by:

1. Other shareholders (in a cross-purchase agreement)
2. The business itself (in a redemption agreement)
3. Some combination of the other shareholders and the business (in the case of a hybrid agreement) upon the occurrence of certain events described in the agreement (the triggering events)

A buy-sell agreement's primary objective is to provide for the stability and continuity of the family business in a time of transition through the use of ownership transfer restrictions. Typically, such agreements prohibit the transfer to unwanted third parties, such as divorcing spouses, by setting forth how, and to whom, shares of a family business may be transferred. The agreement should also provide a mechanism for determining the sale price for the shares and how the purchase will be funded. This valuation can be important in the event that a court protects the business interest itself but values the interest for the purpose of allocating remaining marital estate assets.

Striking the Right Balance
Individually, premarital and postmarital agreements, spendthrift trusts, self-settled trusts, and buy-sell agreements can be valuable tools for protecting inheritances in a divorce. But they need not be used alone. Sometimes, a combination of these methods will best meet your needs.

Remember, before putting any of these measures into play, you should consider which strategy will deliver the balance of flexibility, control, and accessibility that you desire. Although it's impossible to predict the future, with careful planning, you can help ensure that your children's inheritances are protected according to their wishes.

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