The Dallas Morning News
dallasnews.com

How to make a trust last for your heirs

The whole idea of setting up a trust is to provide for your loved ones after your death. But how do you ensure that the trust doesn't run out of money?

The keys, financial planners say, lie in setting up the right trust to accomplish your goals, being explicit in your directions about how the funds are distributed and ensuring that the trust's assets are invested prudently.

"If you do not both properly set up and operate the trust, then your failure to observe the formalities will give people hostile to you [the IRS or a creditor, for example] a better chance of attacking your trust and destroying your plan," said Norm Lofgren, an estate planning attorney at Looper Reed & McGraw PC in Dallas.

The first step in creating a trust is to ask yourself what you want to accomplish. "Serious consideration needs to be given as to the purpose of the trust, which in turn can drive the duration of the trust," Lofgren said.

Some examples include:

Setting up a trust that will manage and protect a family's assets until the children are old enough to manage the assets themselves.

"While the inheritance is in trust — the child is under the target age — the trustee is empowered to make distributions to the child for health, education, maintenance and support," Lofgren said.

One advantage: Texas law protects the assets from creditors of the child while in trust.

"The drawback," Lofgren said, "is that the trust terminates at the target age, exposing the assets to the child and his/her creditors."

Passing wealth to future generations in a tax-efficient manner so that the trust has as much left over as possible after paying taxes.

"The trust described above would not terminate at a specific age but continue for the lifetime of the child and on the child's death remain in trust for the child's descendants," Lofgren said. "The assets would be protected from creditors and not subject to estate tax until at least two generations later."

You also need to ask: Are your heirs ready to manage the money?

Would your child turn around and spend your hard-earned money on a fancy sports car? Or would he spend it responsibly?

“I have worked with families who have said, ‘We’ve been fortunate. We’ve established a tremendous amount of wealth, but we want our children to make it on their own,’” said R. Hugh Magill, chief fiduciary officer at the Northern Trust Co. “We’re going leave them very modest inheritances and the balance of our wealth will go to charity.”

On the other hand, “you might have an individual who might say, ‘It’s my strongest desire that our financial wealth be used to enrich and supplement my family members’ lives,’ in which case the assets will be placed in trust and the design of that trust will be to do just that,” he said.

Once you’ve settled on what you want the trust to do, you can take steps to ensure that it has enough money to carry out its purpose.

Control the burn rate

“The burn rate is essentially determined by what are called distribution standards in the trust,” Magill said. The distribution standards are the terms under which the trust’s assets are to be distributed.

“If you wanted to have a trust grow more, you would narrow those distribution standards,” he said.

For example, you can designate that the money be used only for the education and health care of the beneficiary, not for “general support or lifestyle.”

There also are trusts that distribute funds only for medical emergencies.

“A narrower distribution standard will mean that the trust is not sending as much out and, by implication, those beneficiaries have to look to other circumstances for their general support,” Magill said. “They need to work, they need to be productively employed or they have to be utilizing other assets for their general support so that trust can fulfill its mandate.”

Invest prudently

“This is similar, yet different, to the specter of retirement assets running dry before you die,” said Rick Salmeron, certified financial planner at the Salmeron Financial Network.

“Similar because beneficiaries don’t want the pot to empty,” he said. “Different because the time frame involved can be much, much longer. Beneficiaries of trusts can be young children, so you’re dealing with potentially multiple decades of time.”

Salmeron said people who want to generate more yield and income for a trust “may be tempted to buy long-term bonds, but that could prove disastrous when interest rates eventually start to rise. When rates rise, bond values will fall, so your principal would take a hit.”

Then there’s inflation.

“You will need an asset class active inside the trust that can challenge and beat inflation, and that asset class will be equities,” Salmeron said. “From the standpoint of investing trust assets so the money doesn’t run dry, multiple types of assets must be present that can keep up with every potential factor that the trust will experience over this time.”

Spell it out

“The trust instructions need to be clear that preservation of capital is a primary concern,” said Michael Wald, senior counsel and estate planning attorney at Underwood Perkins PC in Dallas. “Once this is clearly stated, the trustee is under a fiduciary duty to manage the trust to achieve this goal.”

You could place limits on how much money in the trust can be taken out each year, he said.

“For example, financial planners say that a 4 percent burn rate over time will lead the trust to not be depleted,” Wald said. “That is, over a long period of time, the gains on the trust will keep pace with a 4 percent withdrawal rate. This rate or something lower can be written into the instructions of the trust.”

Leave wiggle room

The trust’s instructions need to be flexible “so that the trustee has some discretion and they’re not absolutely locked in,” said Samuel E. Long Jr., estate planning attorney at Shackelford Melton McKinley in Dallas.

“Because if you say, ‘The trustee shall distribute $25,000 a year,’ if the investment earnings are poor, it may well run out of money before the time gets there,” he said

“You don’t know what the investment earnings are going to be of the assets in the trust,” Long added. “You don’t know what it’s going to cost to live, you don’t know what the income tax rates are going to be at that time. You don’t know what kind of other assets the beneficiary may have or [what kind of] income.”

Steps you can take to ensure that a trust has enough money to carry out its purpose

Control its “burn rate”: You can slow the depletion of a trust by narrowing the terms under which the assets are to be distributed.

Invest the assets prudently: You should invest in multiple types of assets to balance the risk/reward.

Spell it out: You need to specify in the trust’s instructions that preservation of capital is a primary concern.

Build in some wiggle room: Still, you should give the trustee some discretion to adjust to changing circumstances.