Lowenstein Sandler's Trusts & Estates Podcast: Splitting Heirs

Episode 5 -
The Case of the Disappearing Trust

By Warren Racusin, Joseph Romano, Julie Jackson
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Julie Jackson: The way I look at it is a trust should be a cushion. It shouldn't be a crutch. As one very successful investor said, "Leave your children enough so that they can do anything, but not so much that they can do nothing." [background music] It shouldn't let them just lie on the beach and do nothing. Unless, of course, that's what you want. [background music]

Warren Racusin: From the law firm, Lowenstein Sandler, this is Splitting Heirs. I'm Warren Racusin. [background music] A wealthy couple's in the midst of a divorce. They fight for years, in and out of court. Finally, the only thing left to decide is who's going to pay the lawyers? And they fight about that too. Husband says, "You've got millions of dollars from a trust your dad created for you. Pay the lawyers with that." Wife says, "That money's still in the trust. I couldn't use it even if I wanted to, which I don't, of course."

Husband says, "But that trust ended when you reached age 40. It disappeared. It's your dough now." Wife said, "Yeah, but it never came out to me. Now I'm keeping it in." Who's right, who's wrong, and what can it all teach us about how trust work and how they can help or hurt your family? [background music] To unravel this mystery, or mysteries, we're joined by our colleague, Joe Romano, and our good friend, Julie Jackson, a Managing Director at 1919 Investment Counsel in New York City.

The first thing I will note is that this couple obviously didn't listen to our first podcast about prenuptial agreements. If they had, all these problems could have been avoided. But they didn't, so here we are. Joe, let's start with you. What the heck is a trust anyway?

Joseph Romano: Sure. Well, to oversimplify that, a trust is an arrangement in which one person transfers assets to someone for the benefit of someone else. I like to think of a trust as a game with three players. First, there's the person who sets up the trust. That's the grantor or settlor or trustor, different name for the same thing. That person sets up the trust, transfers the funds and designs the operating system.

Then there's the beneficiary, which is the name suggests as the person or persons who are supposed to benefit from this arrangement, and then there's the trustee, that's the person or the financial institution, or both, that take the operating instruction set out in the trust document and manages trust funds for the benefit of the beneficiary according to the grantor's wishes.

Warren Racusin: Trust come in a couple of different basic varieties, right?

Joseph Romano: Absolutely. There are trusts that are created during the grantor's lifetime. They're sometimes called inter-vivos trusts, that's Latin for during lifetime. Then there are testamentary trusts. Those are trust created in your will and don't take effect until you die. But that's not the end of the flavor chart, if you will. There are lots of different toppings that you can put on both lifetime trusts and testamentary trust to get the taste you want.

Warren Racusin: Let's start with testamentary trust. Why would you want to put a trust into your will in the first place?

Joseph Romano: Well, let's take a few examples. Let's say you have young children. If something happens to you, you can't just leave them your assets. Legally, they can't own assets in their name, and even if they could, they're not nearly ready to handle them. Instead, you create a trust, you name a trustee, and the trustee will use the funds to feed and clothe your kids, keep a roof over their heads, and educate them until they're ready to handle the money.

Warren Racusin: Great. Trust can come in handy sometimes even for adult children, right?

Joseph Romano: Sure. Say you have an adult child who has a disability or a substance abuse problem, or you're concerned about a divorce or like a matter we're working on right now, a child who simply says, "I'm not going to work because I know before long I'm going to inherit a lot of money and I don't have to work," trust can be useful in all these situations. For the disabled child, the trustee can use the money to take care of a child who may not be able to take care of herself. For the child with a substance abuse issue, the trustee can use the funds to help the child get treatment and can prevent the money from going up to child's noses or their veins.

For the child who may get divorced, the trustee can create an additional barrier preventing the divorcing spouse from getting his hands on the dough, over and above protections that are already in the law. For the child who just plans to be a trust fund baby, well, if the trust is designed properly, the trustee can say to the child, "You're not getting any of this money until you become a productive self-reliant person."

Warren Racusin: Yeah. We're going to be having an intervention with that child shortly, which should be an interesting set of interactions. I think this is somebody who needs a little bit of reality testing, which we're about to provide. The grantor, the person who's creating the will, really can key up the trust in lots of different ways to achieve her goals.

Joseph Romano: Sure. When you're creating trust for young children or for the kinds of issues we just touched on, we typically recommend a discretionary trust. That's a trust in which the trustee has the authority to distribute money to the beneficiary or to retain the money, keep it safe and growing and available if the beneficiary needs it, or need a kick in the pants to get them going. But a trust can also require distributions at certain ages or under certain circumstances. You can even say that the income, which is your interest, dividends, rents, must be distributed, but the principle, which are the underlying assets of the trust, are only distributed if the trustee decides that it makes sense.

Warren Racusin: Trusts aren't always just for kids, right?

Joseph Romano: Right. Sometimes a client will create a trust for her surviving spouse instead of bequeathing assets to him outright. Why? Well, maybe it's a second marriage. Wife wants to protect hubby with her assets during his lifetime, but also wants to make sure that eventually the assets come back to her kids from a prior marriage. Or maybe they aren't married at all and she wants to protect her partner. She can create a trust that provides for and protects him financially during his lifetime, but then locks in her kids as the beneficiaries after his death. If the wife instead bequeath the assets outright, the husband could give them to anyone, his relatives, his friends, the Victoria's Secret model, you name it, and take the assets away from the wife's children.

Warren Racusin: Now, how about those crazy sounding inter-vivos trusts? They actually come in two varieties, right? Revocable trust, or revocable trusts, which you can use as part of your core estate planning documents, and irrevocable trust. The disappearing trust is one of the irrevocable kinds, right?

Joseph Romano: Right. This particular flavor of trust own an insurance policy on the life of the grantor. The trust said that once the grantor died, the insurance went into the trust and the trustee held it for the beneficiary, our heroine and the divorcee, until she reached certain ages. There are tax reasons to create trust like this and other lifetime trust as well. I know you're going to talk about them more in another podcast.

Warren Racusin: Which gets us to a really important question. How long does the trust have to last?

Joseph Romano: Well, it depends on what your goals are and the state that you live in. For centuries, there was a statute called the rule against perpetuities. The rule has terrorized generations of law students because it's really complicated. But basically it says that a trust can't last forever. It can only last for a period of time called lives in being plus 21 years. Don't try to understand it. But a growing number of states, including New Jersey, Delaware and others, have recently repealed the rule against perpetuities. In those states, a trust really can live indefinitely if you want it to.

Warren Racusin: The way we used to get around the rule against perpetuities or to lengthen the term of a trust was to say that the trust can last until 21 years after the death of the last surviving issue of Joseph P. Kennedy who was alive when the trust was created. There's a lot of surviving issue of Joseph P. Kennedy, and that gave us a lot of flexibility and options. In England, they would say the last surviving issue of Queen Victoria. But this since it's the United States and the Kennedy's are America's royalty, that's the benchmark that we use.

Joseph Romano: Absolutely. The grantor of the trust can say that it ends when the beneficiary reaches a certain age or ages. He can also say that it lasts as long as he or she has offspring, which could be forever. Or you can say that some of the trust ends at certain points and some of it lasts indefinitely.

Warren Racusin: Let's dive into our situation. What did the grantor of the disappearing trust do?

Joseph Romano: Well, as you said, the disappearing trust grantor said the trust ended when the divorcee reached age 40. At that point, the remaining property in the trust was supposed to be distributed to her. Probably thought, as many do, that when she reached age 40, his child would be old enough and mature enough to handle the money on her own. But in this case, for whatever reason, the trustee hadn't actually distributed the money to the daughter.

Warren Racusin: Well, isn't 40 it? Our heroine was more than age 40 when her ex said she had the dough from the trust to pay his legal fees. How did she try to get around that?

Joseph Romano: You're right. For tax reasons, the trust by its terms was irrevocable, meaning it couldn't be changed, amended or modified. But here's where it gets really interesting. States have started to realize that a trust that made sense when it was set up might not be such a good idea when life gets in the way. Watch this, they've passed laws that allow an irrevocable trust to be modified under certain circumstances. They've also passed laws that allow for decanting a trust.

Warren Racusin: Ooh! Decanting. That sounds exciting.

Joseph Romano: It is. That's like when you decant wine out of a bottle into a prettier bottle, or a decanter. In the right circumstances, a trustee can pour the assets of a trust into a prettier trust, or at least one that takes into account change circumstances that might not have existed when the trust was created.

Warren Racusin: The trustee and the beneficiary of the disappearing trust got together, try to modify the trust, even though it was irrevocable by its terms. They said that even though the trust had legally terminated because she was age 40, the assets hadn't actually been distributed yet, so they could change the trust so the assets could stay in the trust, out of the divorcee's hands and not available to pay hubby's legal fees. Did it work?

Joseph Romano: We don't know. The courts haven't decided the case yet, but we do know that the lawyers are winning. What it shows though is that when you create a trust, you have to think very carefully about the goals. If one of dad's goals was to protect his assets against a divorce or other bad things happening to his daughter, he could have built those protections into the trust in a bunch of different ways. In trust land, one size doesn't fit all. One size fits one.

Warren Racusin: Yeah. The only thing we don't know about whether the lawyers are winning or not is we don't know whether the lawyers actually got paid yet. But we weren't the lawyers in that case, so it's not our issue. I always say that these trusts we create are basically empty boxes. Some of them are really simple, some are really complicated, but they're basically all empty boxes and they have to be filled up with the right stuff to make them work the way they're intended. Julie, that's where you come in, making investment decisions for the trust. When the trustee and the family meet you, what are the questions you start asking?

Julie Jackson: The first question I ask the family is the same question you ask, what are the goals of this trust? If the trust is supposed to make sure that a very young child is, as you put it, fed, clothed, educated and has a roof over her head, I'm going to invest it very differently than if the child is a young adult who maybe is working and needs a pot of money that's going to grow, but also will protect the child over long periods of time.

I'm going to invest it very differently if the goal is, let's say, to provide funds to care for an elderly widower. Besides making sense, legally, I have to be mindful of the goals of the trust as I set up the portfolio. We actually prepare an investment policy statement after meeting with the family so that everybody knows and agrees on the goals.

Warren Racusin: Right. There's a law that almost every state has passed called the Prudent Investor Act. It says that a trust has to be invested and the performance of the trustees is measured, what the goals of the trust are and whether the portfolio is structured in a way that can reasonably be expected to meet those goals.

Julie Jackson: There's no asset that's automatically good or bad. It all has to do with the goal of the trust and whether you've invested to meet that goal.

Warren Racusin: You could invest in naked hog belly futures if that made sense in a particular trust?

Julie Jackson: Well, I probably wouldn't go there, but here's what I would be thinking. For a young child, I have to invest to provide current income to pay for her needs. I'm also going to look for some long-term growth as a hedge against inflation. I'd invest in that trust with a much more balanced asset allocation to account for both of those goals, current income and growth.

For the young adult who is working and has her own income from a salary, my gut reaction is to invest that for long-term growth because the child doesn't need current income. It becomes a pot that can be tapped for special things. Let's say a down payment on a home or seed money to start a business, and then eventually for retirement. With a longer time horizon, in this case, I'd invested trust like this with a higher allocation to stocks for growth potential, but maybe keeping enough liquidity for any unexpected short-term needs.

Warren Racusin: Because over long periods of time, the stock market tends to do better. For a trust that has a very long time horizon, you want to take advantage to that allocation that is most likely to grow over longer periods of time.

Julie Jackson: Exactly and also, is able to withstand the volatility that comes with owning a higher allocation to stocks.

Warren Racusin: But wait a minute. Let's take that trust for the widower. Investing for income is great for the widower, but there are other folks who take when the widower dies. They're beneficiaries too. We sometimes call them the remainder beneficiaries. They take at the death of the immediate or current beneficiary. They have goals that could be very different, right? You really have more than one master or mistress, we're a politically correct podcast, to serve.

You have the family in for the first meeting about the trust. Widower says, "Yes, please, generate as much income as you can for me." The little darlings who will get the trust when the widower die says, "Not so fast. I'm planning to be lazy the rest of my life, and so you have to get that trust to grow so I can be really lazy."

Julie Jackson: I've had meetings that aren't so different than that. The problem often is I don't know what the person who set up the trust wanted. As you know, the legal language of these trust is usually very generic, and I understand why. You want to give the trustees as much flexibility and latitude in managing the trust as you can, but it often doesn't give us a lot of clues as to what the creator of the trust really had in mind.

Warren Racusin: We were talking before we started today and you actually have that case with a daughter who is a trustee of a trust for her dad, who's in a nursing home, who needs income to pay for the nursing home or facility and her siblings who are the remainder beneficiaries said, "No, but dad always gave us money. Dad always wanted us to have money." The hidden agenda being, "We don't really care so much about whether you pay for dad's nursing home expenses or not." Right? It sounds like you're having a lot of fun with that one.

Julie Jackson: Exactly. The trustee is now in a very contentious situation with her siblings who are angry that, under our advice, she is not willing to give them money while her father's still alive because she's concerned about the trust running out of money if he lives a longer life than is expected.

Warren Racusin: What family doesn't have its little problems?

Julie Jackson: But generally, what I would say to the family, it's almost in this exact example, is, "Look, mom said dad comes first, and you'll get what's ever left after dad goes. But the money is going to be invested for his benefits so he can live as well as possible."

Warren Racusin: In one of our earlier podcasts, we talked about letters of wishes, a side letter that the creator of the trust prepares that tells everyone of her beliefs, her values, the things she wants to encourage or discourage in her heirs. Would a letter of wishes that talks about the financial goals of the trust, Julie, would that help you in running the money in the trust?

Julie Jackson: Absolutely. That way I can say to the family, just as one example, "Look, mom said dad comes first and you'll get what's ever left after dad goes. But the money is going to be invested for his benefit so he can live as well as possible."

Warren Racusin: Right. That means that mom, or whoever created this trust, has to actually think about this when meeting with the lawyers to set up the trust. That takes some time, maybe some more legal fees, but it's going to save a lot of hard ache and strife and a lot of legal fees down the road. That communication between trust creator and lawyer, and then between trust creator and family, can go a long way to eliminate or tamp down the kinds of problems that you're having in the case that you've got in front of you right now.

Julie Jackson: I've seen trust do wonderful things for a family, but I've also seen them screw up a family, and that's why people worry so much about trust fund babies. The way I look at it is a trust should be a cushion. It shouldn't be a crutch. As one very successful investor said, "Leave your children enough so that they can do anything, but not so much that do nothing." It should allow the child to do things that make the world a better place, even if those things don't pay a big salary, maybe like being an artist or joining the Peace Corps. It shouldn't let them just lie on the beach and do nothing. Unless, of course, that's what you want.

Warren Racusin: Unless, of course, that's what you want. That's the real key here, right? Not every baby with a trust fund is a trust fund baby. Caroline Kennedy, Warren Buffet's children, there are many others you can name were born into great wealth, but are doing great things. Sure, we can create trust that influence beneficiaries to be productive members of society. We can create trust, as lawyers that make it harder to turn a kid into the bad kind of trust fund baby.

How you raise your children, how you teach them about the importance of money and being responsible with it and communicating that to them on an ongoing basis, that's going to have a lot to do with how they deal with the inheritance and the assets and the gifts that you give to them. At the end of the day, we can do a lot, but we can't do everything. At the end of the day, it's not on the lawyers, it's not on the accountants, it's not on the wealth advisors. At the end of the day, my friends, that's up to you. [background music]

That's all we've got for today. Thanks so much to our friend, Julie Jackson. Thanks to Joe Romano. Thanks to everybody at Lowenstein who helped make this possible. Thanks to our friends in Good2bSocial, including my main man, Byron, on the control board. Thanks to all of you for listening. We'll see you again soon. Until then, as we say in these parts, have a good one.

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