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How to Control Your Heirs From the Grave

By Laura Saunders – August 10, 2012

Can you force a grandchild to take a drug test in order to receive an inheritance? Insist your heirs use trust funds only for tuition at your alma mater? Make sure your wife's future husbands can't run through money you worked hard to earn?

In many cases, the answer is yes—you can, in effect, control your heirs from the grave.

The issue of what you can give away and how is especially relevant now because unusually favorable estate- and gift-tax rules are set to expire. The "exemption" for both—which is the amount of assets a taxpayer can transfer to others, tax-free, either at death or through gifts while alive—is now $5.12 million per individual, and twice that for a couple. The top tax rate on amounts above that is 35%.

But not for long. In January the exemption is slated to drop to $1 million per person, and the top tax rate will jump to 55%. Although many experts don't think those changes will stick because they are so unfavorable, a new regime might well be less generous. President Barack Obama favors a $3.5 million exemption and a 45% top rate.

With the law in flux, experts are recommending that wealthier taxpayers who can afford to part with assets make gifts of them this year. The rationale: if the law becomes less favorable, this year's gifts either will be grandfathered in or, at worst, won't be "clawed back" until death.

Clients are listening. "For this year I'll be filing three times as many gift-tax returns as I have in the past," says Lauren Wolven, a tax expert at law firm Horwood, Marcus & Berk in Chicago.

"It's as if a cork popped out of a bottle," adds Joe McDonald, an attorney at McDonald & Kanyuk in Concord, N.H.

As with many good tax deals, there is a hitch: Taxpayers taking advantage of the exemption by making gifts have to give up control of assets today. Typically that means putting them into "irrevocable trusts" that require upfront decisions about who will get what, when and for how many years thereafter.

So what does the law permit? Surprises, at times. Leona Helmsley, the widow of billionaire real-estate magnate Harry Helmsley, left a trust to care for her beloved dog, Trouble, after her death. Ms. Helmsley also required her grandchildren to visit their father's grave once a year in order to receive payouts.

For people scrambling to set up trusts before year-end, here are some important considerations. And for those who don't have millions to give, the good news is that most of the same rules governing trusts apply to ordinary wills as well.

Give as You Wish—Sort Of

In general the law is biased toward allowing people to leave assets as they wish—even if the wish seems silly. Nearly 100 years ago, a Connecticut court upheld a requirement that heirs had to spell the family name in a certain way to receive a payout. (It was Tyrrel.)

But there are limits. One is for provisions "contrary to public policy." This category has always included

requirements that promote divorce or criminal behavior; now it extends to racial discrimination. For example, courts have struck down provisions leaving money for scholarships for white girls.

Discouraging marriage also is frowned on. A court would almost certainly invalidate a provision requiring a daughter to remain unmarried in order to receive her trust payout. But people are free to put assets in trusts that bypass the future partners of a spouse.

Also problematic are ambiguous, illegal or impossible-to-satisfy provisions—such as one that required a treasured snowball collection to be preserved in a freezer. (What if the electricity went out?)

What is allowed varies according to state law. A Missouri court once struck down as too vague a provision requiring brothers to be capable of "prudent exercise, control and ownership" of a piece of real estate so that "no further danger shall exist."

But vagueness didn't prevent Northern Trust Chief Fiduciary Officer Hugh Magill, based in Chicago, from recently requiring a man in his mid-50s to prove he was "of sound mind, good moral character and temperate financial habits"—as a trust for the man required. Among other things, the heir submitted three years of tax returns, a financial statement and a letter of support from his minister; he got the money.

What about religious restrictions, such as mandating that tuition payouts be used for a parochial school? Courts often uphold them if they don't violate other rules.

It is harder to predict the outcome of demands that an heir marry within a certain faith: An Ohio court validated such a provision in 1974, but an Illinois appellate court struck down another in 2008 (on public-policy grounds) and the state's Supreme Court sidestepped the issue. "Norms may be changing on this issue," says Ms. Wolven of Horwood, Marcus & Berk.

People who want to take advantage of this year's gift-tax exemption should beware of one giant constraint: The Internal Revenue Service will deny tax benefits to a trust if the person who sets it up retains control, either himself or through an agent.

Although new laws in some states allow trust modifications for shifting circumstances, experts say taxpayers shouldn't push these limits because they could wind up with a trust but without a current tax break.

Diving Into the Details

Here are more specifics to consider before setting up a trust or tinkering with a will.

Who is included? This is one of the most important decisions to make at the outset; much leeway is allowed, but taxpayers need to be clear given changing social mores. For example, consider carefully the definition of "spouse"—and decide whether that includes same-sex partners, and whether they have to be in a registered or long-term partnership.

Likewise, if a trust is to benefit descendants, make sure to define the term. Do adoptees count, or stepchildren, or the child of a surrogate? Is a child conceived with frozen sperm a descendant?

"Even experts are struggling with how to draft language on some issues," says Mr. McDonald.

Then there are decisions to make about shares. For example, if a matriarch's daughter has four children and her son has one, she will need to consider whether payouts to the grandchildren should be "per capita" (each gets the same amount) or "per stirpes" (the son's child gets one-half and the daughter's children split one-half).

Many trusts also have "spendthrift" provisions preventing creditors from reaching trust assets, although

the wall doesn't extend to claims for child support or taxes.

Incentive provisions. Want to promote your descendants' productivity by matching their income, or providing funds to help them start a business? Would making payouts to a stay-at-home parent of young children strengthen family ties? Many givers think about including incentives in trust or wills.

But experts counsel caution: "It's impossible to foresee every circumstance," Ms. Wolven says. What if you match income dollar for dollar, and the heir wants to enter a worthy but low-paid profession like teaching?

Norm Benford, an attorney at Greenberg Traurig in Miami, remembers a carefully written trust that matched private-sector pay one for one, public- and charitable-sector pay four for one and "sacrifice" public-sector pay (like the Peace Corps) six-for-one—but the heir became a jazz musician and didn't qualify for a payout at all.

That said, Ms. Wolven says she recently set up a trust for a younger person who had become wealthy and wanted to help his extended family. He empowered the trust to make loans to relatives for education, travel and mortgages. As long as the borrowers repay on schedule, the trust forgives half the payment. The trustee also can suspend collection if the borrower goes through a rough patch.

"It's a good structure for helping loved ones without encouraging lack of productivity," Ms. Wolven says.

Experts also caution about inserting a requirement to test heirs for drugs, because it can be hard to find a trustee willing to undertake this intrusive supervision.

"Heirloom asset" trusts. People set these up to hold a treasured asset, such as a vacation compound, in trust for heirs to enjoy. Mr. Magill recommends endowing the trust with sufficient funds so heirs don't wind up squabbling about maintenance of the asset. Sometimes such trusts make payouts for transportation costs so that far-flung relatives can visit.

Pet trusts. Leona Helmsley wasn't wrong. Experts say such trusts are a good idea if the owner is worried that informal arrangements might fall through after death, because otherwise the pet is at risk of being euthanized.

Typically the owner chooses a trustee, specifies the care to be provided and endows the trust with sufficient funds.

"No contest" provisions. In some states, people can bar heirs from receiving payouts from a trust or will if they challenge it in court. Sometimes the law voids these provisions, known as "in terrorem" clauses, if an heir challenges the will and wins.

It is wise to think carefully before encumbering a trust or will with this or other inflexible constraints, even if such moves are legal. Experts say one of the chief aims of planning should be to avoid leaving a "legacy of ill will." No matter how much money comes with it, that's the worst legacy of all.