

Is a Trust Better Protection Than a Prenup?

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Preparing for your child's wedding should be a joyful experience, so it should come as no surprise when a family business owner avoids bringing up a prenuptial agreement. Business owners and families of wealth should know that a properly structured trust can be a very effective alternative to a prenuptial agreement.

When one or more generations of a family have worked hard in business to accumulate substantial wealth, they will frequently ask their children to enter into prenuptial agreements to protect the family business and other assets in the event of a future divorce. For a first marriage of relatively young persons, the concept of a prenuptial agreement is frequently considered offensive and a topic to be avoided. Even the discussion between parent and child can be stressful and considered by the child to be undue pressure ahead of what they believe will be the happiest day of their lives. When met with these circumstances, counsel can help alleviate the family strife by suggesting the use of trusts to protect assets in the event of a divorce at least as effectively as an actual prenuptial agreement signed by those about to be married. This article discusses some of the many ways that a trust can be a very effective alternative to a prenuptial agreement.

Each state has its own laws and customs regarding the division of property between divorcing spouses. These state laws can vary significantly (e.g., equitable distribution v. community property states), but they all will look at the extent to which a spouse owns or controls an asset and the right to receive income from that asset. It is the ownership or control of an asset by a spouse that will bring the asset within reach of a divorce court. This core concept of ownership or control is what allows a trust to be such an effective alternative to a prenuptial agreement.

As a general proposition, if a divorcing spouse does not own or control a particular asset or the right to income from that asset, a divorce court will not attempt to award that asset to the other spouse. Just because a trust is established for someone's benefit does not mean that the beneficiary automatically has ownership or control of the assets in the trust, or even the right to income generated by those assets. The key is structuring the trust in a way that does not give the spouse ownership or control over the assets in the trust while still giving the trustee broad discretion in how to utilize the assets for the benefit of the spouse.

Revocable Living Trusts

One of the most commonly used trusts is a revocable living trust or “RLT.” As suggested by its name, an RLT is fully revocable by the settlor and is typically used in conjunction with a simple will that leaves the assets of the testator to the RLT. Since an RLT does not provide savings on death taxes that can be achieved with a more complicated irrevocable trust, those without exposure to the federal estate tax often prefer an RLT as a cost-effective method to minimize the burden of the probate process and provide asset protection to the heirs.

An RLT does not complete a transfer of assets during the lifetime of the settlor since by nature an RLT may be revoked at any time. An RLT can work well for the generation owning the family business or otherwise having substantial wealth with the intent to hold on to their assets until death.

Irrevocable Trusts

An RLT immediately becomes an irrevocable trust upon the death of the settlor since the trust can no longer be revoked. An irrevocable trust upon formation transfers assets of the settlor to the trust during the lifetime of the settlor (an inter vivos transfer). The use of an irrevocable trust allows for more complex tax planning to minimize the burden of estate, gift and generation skipping taxes on the beneficiaries and future generations. For those fortunate enough to have wealth beyond the amount of the lifetime federal estate and gift tax exemption (\$13.61 million for an individual and \$27.22 million for a married couple in 2024), an irrevocable trust with tax planning provisions will be the preferred form of trust to use in lieu of a prenuptial agreement.

So How Does It Work?

Whether using an RLT or one of the many varieties of irrevocable trusts, it all comes down to making sure the language of the trust document cannot be fairly construed to give the spouse, as beneficiary, ownership or control of the assets in the trust. The following are some of the key points to address when drafting a trust to have the same impact as a prenuptial agreement but without the angst that goes along with putting one in place.

A Trustee You Can Trust

Selecting a trustee that you can readily trust (for lack of a better word) to act in the best interest of the spouse as the beneficiary is critical. The more independent the trustee is from influence by the beneficiary, the better for protecting the assets from a divorcing spouse. A corporate trust company will be viewed as highly independent while a sibling of the beneficiary spouse may be considered more susceptible to influence by the beneficiary. Identifying the trustee is often the most challenging task for the family. When in doubt, select a corporate fiduciary with a long history of serving as a trustee for multiple generations of families of substantial wealth.

No Absolute Right to Income or Principal Distributions

Clients are often tempted to provide terms in their trust that will give their child as a beneficiary the right to withdraw some or all of the principal in the trust at certain ages or other milestones. Providing beneficiaries with the absolute right to income from the trust or the ability to withdraw principle from the trust can significantly weaken the asset protection characteristics of the trust and its effectiveness as a substitute for a prenuptial agreement. Giving withdrawal rights or the absolute right to income to beneficiaries of a trust indirectly gives them a degree of ownership or control over the assets of the trust that springs into existence when the stated age or milestone is reached. In a divorce court setting, one can expect a special master or judge to consider a spouse to own or control some or all of the assets in the trust. Once ownership or control is established, one must assume that the divorce court will look to find a way to include the value of the assets in the trust as being subject to some form of distribution to the other spouse in the divorce.

In the end, a carefully crafted trust can be even better than a prenuptial agreement when seeking to protect assets in the event of a divorce.

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