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TAX AND WEALTH ADVISOR ALERT: HOW TO MAKE SPENDTHRIFT TRUSTS WORK FOR YOU

When we think of children blowing through trust funds, we often envision the rich and famous. The reality, though, is that everyday folks waste vast inheritances, too. Take, for example, Mary McClelland who, throughout her 20s, squandered her tri-annual $5,000 and $10,000 payments from her grandfather's investments on traveling and shopping and ran out of money by age 30.

Unfortunately, McClelland's story is far from unique. The Williams Group wealth consultancy estimates that 70% of wealthy families lose their fortune by the second generation; that percentage rises to 90% by the third generation.

If these cautionary tales and statistics scare you, they shouldn't—but they are excellent reminders of what could happen if you don't plan to pass down your wealth in a smart way. The good news is that if you'd like to pass down your wealth to your heirs but also want to make sure they won't fritter away your hard-earned assets, you have options, and spendthrift trusts just may be the answer.

What are spendthrift trusts?

Merriam-Webster defines "spendthrift" as "a person who spends improvidently or wastefully." Not surprisingly, this textbook definition is the origin of the name of the legal concept of "spendthrift trusts."

With spendthrift trusts, you as the creator can protect the trust's assets from creditors as well as from your heirs' potentially dangerous spending habits by placing certain conditions on the distribution of funds.

At its initial set-up, a spendthrift trust works like any other trust. You choose assets to place in the trust—money, property, etc.—and transfer them into it. You name a beneficiary, who is the person who will benefit from the trust. You must also name a trustee to manage the trust's assets.

With a spendthrift trust, you would include in the trust document certain restrictions on the beneficiary's receipt of trust assets. These conditions may involve the beneficiary having to reach a minimum age or achieving a life event, such as graduating college, before receiving trust property. Alternately, you may decide that doling out smaller amounts of trust property at specified times (monthly, bi-monthly, bi-annually) may make the most sense for your situation.

The late actor and comedian Robin Williams, for instance, had set up spendthrift trusts for his children before his death. Under the conditions of the trusts, each of Williams' children is scheduled to receive shares of the trust at specified intervals: one-third at age 21; one-half of what remains at age 25; and the rest at age 30.

In any event, a spendthrift trustee has a fiduciary duty to the trust and is also obligated to act in the best interests of the beneficiary. The trustee acts as protector of the trust's assets both from creditors and the potential wasteful behavior of the beneficiary as well.

You may also choose to have the trustee make direct payments such as tuition and rent for the benefit of the beneficiary; this may be the best idea if you have serious reservations about how your heir will handle even periodic, smaller monetary distributions. After all, once the beneficiary receives the funds, there isn't a whole lot you can do to make sure they use the funds wisely. Indeed, once the money is out of the trust, it is no longer protected from creditors.

While you're still alive, though, you can discuss financial responsibility with your heirs to help ensure that your family avoids becoming part of the dire statistic of families who lose their wealth by the second or third generations.