

# Incentive Trusts: The Good, The Bad and The Ugly

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*“There was never yet an uninteresting life. Such a thing is an impossibility. Inside of the dullest exterior there is a drama, a comedy, and a tragedy.”—Mark Twain (American Humorist, Writer and Lecturer. 1835-1910)*

I think that the life of the Incentive Trust is anything but uninteresting. Trustees working with incentive trusts report very interesting drama in the lives of the beneficiaries they serve. Perhaps some of the controlling schemes that clients come up with have made you chuckle. You may also agree with my conclusion that incentive trusts gone awry can lead to one of the greatest tragedies estate planners have to witness—wasted lives and fractured families. So in the life of an incentive trust we may find drama, comedy and perhaps tragedy behind the legal form.

Have you ever noticed that there seem to be cycles or fads which occur in the world of taxation and estate planning? These cycles may appear to be dull or of little consequence to many. Within these cycles we will often find each of the following elements: the good (that which should be refined and preserved); the bad (that which if not thoughtfully weighed and counterbalanced may lead to unintended consequences) and the ugly (that which will truly lead to serious harm or disappointment). Incentive trusts are a relatively fresh fad rolling through the estate planning community. I believe all three of those elements are present in what many today are calling Incentive Trusts or Beneficiary Performance Conditions.

## 1. What’s All The Buzz Surrounding Incentive Trusts – A Brief History

### 1.1. The Cycle of Legal Life

As I have contemplated the increasing popularity of Incentive Trusts I have asked myself whether this is a fad, a cycle or perhaps something more enduring.

I just entered the 30<sup>th</sup> year of professional service. I can now look back and see that there have not only been cycles within my profession, such as the tax shelter craze of the late 70’s and early 80’s which led to the “at-risk” rules and then less than thirty years later a proliferation of abusive tax strategies which culminated in “listed transactions”, significantly enhanced penalties and new standards for tax practice.

Likewise, within the estate planning world we have seen fads and trends such as charitable remainder trusts, Clifford trusts, dynasty trusts, family limited partnerships and LLCs, GRATs and GRITs. Some of these fads or trends stuck. Others were effectively abolished by legislation.

As I approach the topic of incentive trusts I realize that there are many, who like me, were initially curious about the emergence of a new legal tool: the incentive trust. I’ve noticed that is often the case that some practitioners quickly take sides and begin to either

zealously praise or criticize a new technique. My purpose with this presentation is not to either endorse or condemn the Incentive Trust. Instead I hope that my study of the incentive trust and its precursor--beneficiary control clauses--will help you understand the importance of thoughtfully analyzing fads which roll through the legal community and sifting through the substance of those fads to determine whether there are any golden nuggets, or whether it is all dross.

## 1.2. From Living Trusts to Loving Trusts to Incentive Trusts

In 1965 Norman Dacey published a book entitled "How to Avoid Probate" which became a consumer self-help best seller and helped ignite the popularity of the Living Trust. I never knew if it was true that this book had been "banned in Boston" but that claim certainly helped sell more copies. Clients would come in who had read Dacey's book and wanted to find a lawyer who would help them beat the "probate conspiracy". Like all fads the buzz surrounding the revocable Living Trust had both a good and a bad side. In states which weren't probate friendly, Living Trusts became an estate planning staple. But unfortunately trust mills began to mass produce living trust kits which were sold to consumers in all states, regardless of whether that state had adopted the Uniform Probate Code or whether the size and complexity of the client's estate justified a living trust.

After the Living Trust came the Loving Trust, a technique which was described in a best-selling book by Robert Esperti and Renno Peterson. If you practiced in the 1980's you probably had at least one client come into your office armed with a Loving Trust worksheet and expecting you to turn on that day's version of word processors and spit out a Loving Trust for half of what you normally charged for estate planning documents.

I actually felt that the Loving Trust made many valuable contributions to both the conversations estate planning lawyers had with their clients and with the types of clauses and structure we came to rely on in our forms systems.

Then in the 1990's we began to hear about the Incentive Trust. The Incentive Trust and the Loving Trust were both popularized in books written for the consumer, rather than the lawyer, and both were marketed through financial planners and insurance agents.

In 1999 John Scroggin, a Georgia attorney, and Robert S. Littell, an Atlanta life insurance agent, published a book entitled *The Family Incentive Trust Program* and began promoting the idea of provisions in trusts to influence beneficiary behaviors which they described as practically "brand new."<sup>i</sup>

I can't say that the Incentive Trust has become the rage which the Loving Trust rose to. But anecdotal evidence suggests that their use is increasing.<sup>ii</sup> One journalist recently concluded that more people are considering the possibility of incorporating conditions on inheritances or trust funds in an effort to influence their heirs' behavior and some financial planners are expecting that incentive trusts will help fuel the growth of their wealth management business.<sup>iii</sup> One estate planner in Seattle "who has many wealthy

clients in the technology and real estate fields” estimated that 60 percent of his clients with assets of \$10 million or more and young children have incentive trusts.<sup>iv</sup>

### 1.3. The Wealth Explosion

We recently have witnessed the seventh worst stock market of the last 100 years and economists have just acknowledged that the economy is officially in a recession. But less than six months ago we were still in a bull market and everyone was focused on the tremendous wealth explosion.

It is difficult during times of economic crisis to remember how bullish yesterday was. In the five years that preceded our entering into the 21<sup>st</sup> century the S&P 500 Index rose from 459 to 1469, an increase of almost 320 percent. At the end of November 2008 that index had fallen more than forty percent from its most recent 12 month high. Focusing on the ups and downs of the stock market or the strength or weakness of the economy ignores the reality that we are in the midst of an unprecedented intergenerational transmission of wealth.

Boston College researchers are estimating that \$41 trillion dollars will be transferred between generations in the fifty year period between 1999 and 2049. This prediction of a tremendous intergenerational transfer of wealth serves as the demographic backdrop for the emphasis on incentive trusts. Despite the recent declines in the stock market today’s retirees are the wealthiest ever recorded. Today’s baby boomer generation will inherit more money than any prior generation has ever received.

As we consider the staggering amount of wealth which will pass to the baby boomers, we can ask if there is a point where a parent may leave too much to their heirs? In 1891 the steel magnate Andrew Carnegie wrote that “the parent who leaves his son enormous wealth generally deadens the talents and energies of the son, and tempts him to lead a less useful and less worthy life than he otherwise would.”<sup>v</sup>

### 1.4. The How Much is Too Much Problem

Warren Buffett has been quoted suggesting that “the perfect inheritance is enough money so that they feel they can do anything, but not so much that they could do nothing.”<sup>vi</sup> Recently, Mr. Buffett’s granddaughter, Nicole Buffett, appeared on the Oprah Winfrey shows and confessed that she worked as a housekeeper. She was scrubbing toilets and dirty dishes to make ends meet. “It’s a very weird thing,” she said. “I do come from one of the wealthiest families in America.” Her grandfather has decided to assist his grandchildren with their education and their philanthropic pursuits. When asked why her grandfather isn’t lavishing his loved ones with money and gifts, Nicole responded: “He would never want his children or grandchildren to be [born into money]. He thinks it would rob us of our experience.”

Not all wealthy Americans share Mr. Buffett's mindset. A recent survey by U.S. Trust determined that 80 percent of ultra-affluent Americans will leave their fortunes to their children and grandchildren. Interestingly enough from the perspective of our program, more than half of those surveyed said their children could do whatever they wanted with the money.

I have found in my own practice that most ultra-affluent clients greatly appreciate spending time on the "how much is enough?" and "how much might be too much?" questions. However, these discussions often center on the parents' concern that leaving their child too much will spoil them or stunt their drive to become productive and self-reliant. The incentive trust is becoming a popular suggestion for addressing these concerns but as we will discuss later there may be other approaches which should be considered in lieu of or as additional support for the incentive approach.

### 1.5. To Control or Not to Control

Many grantors' concerns over what their heirs will do with inherited wealth go beyond providing incentives to encourage positive outcomes. An article in the *Wall Street Journal* acknowledges that, "wealthy parents through the years have attached conditions to the passing of their fortunes."<sup>vii</sup> The *Journal* article suggests that, "what's new in the incentive approach is the wide-ranging and highly specific nature of the parental provisos."<sup>viii</sup>

Over the last decade or so I have noticed a trend that suggests clients are indeed moving away from what had been traditional age-based standards for distribution. Some have opted for dynastic trusts. Others are focusing on events such as graduation from college, marriage, starting a family, or completing a beneficiary curriculum which trains beneficiaries in financial and investment skills but also prepares them for their roles and responsibilities in life. Some clients are even considering a new concept I have pioneered with a team of wealth psychologists called "markers of maturity" which seeks to monitor a beneficiary's progress towards adulthood and to tie liberality in distributions to a client's mastery of financial skills and their accountability and responsibility.

With the advent of books and articles on Incentive Trusts I began to increasingly respond to client requests to impose conditions intended to control beneficiary performance rather than merely reward or encourage certain behaviors. More recently I've been asked to draft clauses whose effect is to "punish" beneficiaries who didn't meet parental expectations by foregoing or reducing their inheritance. These parents often justify these behavior conditions as means of insuring that their wealth passes to those who share their values and tell me they feel a duty to make sure that they entrust their wealth to those will appropriately steward it.

One of the most profound lessons I've learned was a warning from James E Hughes, Jr., known affectionately among his colleagues and clients as Jay Hughes. Jay is the author of *Family Wealth—Keeping It in the Family*. Jay began his odyssey of observing

how wealthy families around the world were trying to avoid the dissipation of their wealth by the passing of the third generation after an oriental business tycoon asked him what he knew about the Chinese proverb "rice paddy to rice paddy in three generations." He noticed that this cultural proverb turned up on every continent. Here in the U.S. we know it was the "shirtsleeves to shirtsleeves in three generations" proverb in family wealth. As the business tycoon explained it the first generation creates the wealth, the second generation preserves it and the third generation consumes it.

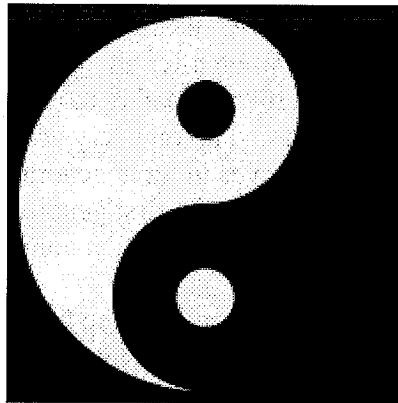
As Jay studied family wealth, and the families who had successfully defied the prediction that their wealth would be dissipated by the passing of the third generation, he began to realize that there were two ways that individuals come into significant wealth. They either acquire it through effort or chance or they inherit it.

The wealth creator's mindset is largely forged in the crucible of adversity, challenge and eventual success. The inheritor, on the other hand, faces what I call the silver spoon dilemma.

Two wealth psychologists have suggested that the wealth creator's mindset is similar to that of an immigrant. "They undergo the life changing experience of traveling to a more affluent homeland."<sup>ix</sup> In their journey the wealth creator is sustained by their dream and discovers the satisfaction of overcoming obstacles.

The inheritor, on the other hand, has to cope with the emotional issues that arise when one is the beneficiary of tremendous wealth but has done nothing, other than win the birth lottery, to earn the wealth. The inheritor's challenge is to find his or her identity and to be able to understand not only the meaning of wealth but what his or her roles and responsibilities are. This dilemma of the inheritor has been termed "hyperagency" by Paul Schervish, a Boston College researcher on philanthropy and wealth demographics. Even if they don't want to cast a giant shadow in society, the wealthy inheritor can't avoid the reality that through their hyperagency they have a greater voice and opportunity to make a difference than others.

Jay Hughes has taught us how the Chinese concept of Yin/Yang can be applied to the inheritor's dilemma. Basically interpreted, yang means "sunny", so it corresponds to the day and more active functions. Whereas yin, means "shady", and corresponds to night and less active functions. The taijitu is the traditional diagram that illustrates the opposing forces of yin and yang:



The meaning of the characters for yin and yang, has more than just one connotation as the following table illustrates:

<b>YIN</b>	Dark	Matter	Earth	Female	Passive	Moon	Cold	Water	Winter
<b>YANG</b>	Light	Spirit	Sky	Male	Active	Sun	Heat	Fire	Summer

In Chinese philosophy the Yin Yang symbol as illustrated in the taijitu represent **perfect balance**. The Chinese believe that evil results from an imbalance in Yin and Yang, and good comes from the two being in **harmonic** balance.

Mr. Hughes points out that the competing forces in the lives of the members of a wealthy family are that of stewardship and dream. Often, the dream Yang is so strong in the wealth creator that it overpowers the stewardship Yin. Tragically, in too many wealthy families the second generation suborn their own dream to pursue a stewardship responsibility to the wealth produced by the dream and energy of the first generation.

Jay Hughes believes the path to a flourishing life lies in finding an appropriate balance between the Yin of stewardship and the Yang of dream. He points to the story of Henry and Edsel Ford as an example of the danger of a father seeking to control and micromanage his son's life. He finds a contrast to that story in the success of John D. Rockefeller Sr. and Jr. The Rockefeller saga demonstrates the positive results that flow from a father's decision to liberate his son and allow the son to pursue his own dream rather than steward the father's dream.

I find the details of the Ford and Rockefeller stories very helpful whenever I hear a parent seeking to micromanage their child. And I often climax such conversations with this question which I learned from Scott Fithian, author of Values Based Estate Planning and co-author of The Right Side of the Table: "[W]hat kind of a trust would you like if you were starting over and someone had left you significant trust? Those who feel a compulsion to control seldom want to be controlled and, in fact, would fiercely resist any efforts to micromanage their life or the path they have chosen to pursue. This question

doesn't always douse a client's zeal for micromanaging their heirs through incentive provisions but it can provide the basis for more thoughtful consideration of what the impact of such clauses might be.

## 2. The Good

### 2.1. Education

Perhaps the most common incentive provisions are those dealing with education. I have had clients include provisions rewarding graduation from high school with the purchase of a vehicle up to a certain dollar amount. The variations on the theme of incentive clauses tied to graduation from college are almost infinite, as the following list of possibilities compiled by SMU Law Professor Joshua C. Tate attests:

- "\$ 5,000 for each degree obtained"<sup>x</sup>
- Trustee "can be directed to give a beneficiary: \$ 25,000 upon graduation from college"<sup>xi</sup>
- "Charlie, a 20-year-old college dropout, learns that his Uncle Ed has provided him with \$ 500,000 in trust. But Charlie can withdraw the trust funds only if he returns to college and earns a bachelor's degree."<sup>xii</sup>
- "An incentive trust might pay income or principal, or perhaps pay a larger amount or pay it sooner, if the beneficiary graduates from college."<sup>xiii</sup>

If the client has very young children you might suggest taking into account the effects of inflation. This could have a tremendous influence on whether the reward they are offering for completion of a degree will be meaningful. I've had clients suggest we index the rewards for inflation using the CPI or an alternative index that is tied to the escalating costs of college education.

Another practical problem I've faced are parents who want to specify what type of educational institution the beneficiary must attend, e.g. graduation from the grantor's alma mater is rewarded with three times the amount that the beneficiary would receive upon graduation from any other institution. Another variation on this theme is the issue of conditioning any assistance for tuition on attendance at a certain institution or type of institution (e.g. religious or denominational affiliation).

Some of my clients who have sought to impose a requirement of carrying a specified grade point average in order to maintain eligibility for distributions to fund college education. You may want to consider including a provision that a beneficiary's failure to provide permission for the trustee or trust distribution advisor to obtain a transcript will be deemed to be performance below the mandated performance level for continuing eligibility for educational assistance.

Another problem I have discussed with clients is what I describe as the “professional student.” This dilemma was addressed by one proponent of incentive trusts with the following suggestion:

“An incentive to pay a monthly stipend to a full-time college student could lead to a never-ending career as a student. A more specific incentive would be to pay a monthly amount based on full-time attendance at an accredited institution, and maintaining a "B" average grade while in pursuit of the first bachelor, first master and first doctorate or medical degrees.”<sup>xiv</sup>

The reaction from parents, or from other uncles and aunts or grandparents, to the question of what do you want to do if a beneficiary constantly changes majors so it would appear to qualify for ongoing educational funding and more importantly support varies greatly. Some grantors are very concerned and impose a rigid timeline on how much time can elapse before a beneficiary graduates. For example, they might provide that education must be completed within five or seven years of commencement.

The “professional student” dilemma also needs to be considered in terms of what is happening in the world today and not just from the perspective of what the educational track of the parent or grandparent was. For instance, we know that the average age at graduation has risen significantly in the last few decades. Also, more and more students are dropping out and then restarting their educational path at much later points.

Others clients have preferred a softer approach where the trustee, or a trust distribution advisor, consults with the beneficiary on his or her progress and then issues a warning if it appears that the beneficiary isn’t making sufficient progress. That warning generally would include a timetable for completion which is realistic under the circumstances but which doesn’t necessarily fall inside of a rigid timetable.

As a final example how the opinions of clients vary dramatically on the specifics of incentive provisions, I have had several clients who tell me there are “a lot worse things in the world that my child (grandchild) could be doing than spending time in academia.”

## 2.2. Hard Work

I find that the second most prevalent behavior which clients seek to encourage is hard work. Some clients prefer to call this a “productive and self-reliant” lifestyle. But however you phrase the conditions or rewards the bottom line is clear: our clients don’t want to create “trust bums” or have their heirs end up with “remittance addiction.”

Howard M. McCue, in a paper presented at the Heckerling Institute, offered these suggestions: “Many of our clients wish to encourage industry-hard work. This is easier said than done. Some believe that this goal may best be accomplished through the use of



an incentive trust. Industry may also be encouraged by language in a more traditional discretionary trust directing the trustees to refrain from most distributions to younger beneficiaries who have not found employment, to limit the amount of discretionary distributions in various ways, and to favor those beneficiaries who demonstrate the industrious nature or hard work that the parent or the grandparent seeks to encourage.<sup>35</sup>

I've had clients insist on some form of income-matching provision. Your language should contemplate what the enforcement remedy is if a beneficiary refuses to cooperate. Can the trustee rely on a copy of an income-tax return? Must they verify the reported income with the beneficiary's employer? Are there sanctions if a beneficiary fails to cooperate. And what do you do with the self-employed beneficiary.

Other clients have insisted on proof of employment but don't seek to tie distributions to some multiple or percentage of earned income. Other clients merely state their wish that the beneficiary would engage in gainful employment or spend their time productively in efforts to make society better and leave it to the trustee to determine how, if at all, a beneficiary will be rewarded or punished for their industry or lack of productive effort. All of these provisions, with the exception of the income-matching clause, impose significant burdens on the trustee and whether the clauses will produce their expected consequences may depend in great part on how diligent a trustee is in enforcing the grantor's intentions.

### 2.3. Savings or Investment Funds

A variation on the "earn a dollar, get a trust fund distribution" approach is an incentive clause that rewards retirement savings or investment funding. I have had clients create a Trust 401(k) program on the assumption that their children (grandchildren) won't be able to amass the type of retirement savings which their employer provided to them. This approach could match each dollar the beneficiary saves or elects to defer from their distributions. Or alternatively it could simply make a contribution to a Roth IRA or some form of retirement fund based on some percentage of the beneficiary's earned income.

### 2.4. Entrepreneurship

The Family Bank is an approach which many wealthy families use to encourage entrepreneurship among their heirs. The Family Bank is also being used as a generic description for efforts to teach children or grandchildren the value of money, basic financial planning and investment theory concepts, etc. The entrepreneurial model of the Family Bank is discussed extensively in Jay Hughes' book, *Family Wealth—Keeping It In The Family*. Mr. Hughes first learned of the Family Bank technique from his father, who was a successful corporate lawyer with a major international law firm.

The most successful example of a family bank cited by Jay Hughes would be the Rothschild family. It proved to not only be a valuable tool for sharing investment

opportunities among the family but allowed the Rothschild to diversify their wealth geopolitically.

Working with a number of successful entrepreneurs I have been privileged to see great thinking around what terms and guidelines should go into the Family Bank. One client, for instance, offered this suggestion to his trustees:

*“While I want the business consultant or CPA engaged by the Trustees to vigorously review and challenge the business plan, I also realize that most start-up businesses fail. I hope that by insisting on a business plan I will increase the probabilities of success for my beneficiaries. However, I don’t want the desired objective of successful launching a business to rule out investing in or making a loan to a start-up which wouldn’t be able to secure funding from conventional sources. The beneficiary’s business plan doesn’t have to suggest that they are founding the next Google or Microsoft. And, I would want the Trustees to help the beneficiaries to understand that whether or not the business succeeds the really important lessons to be learned from this experience are those which only come by exposing yourself to the rigors of the marketplace and having the courage to risk failure. I’d like my beneficiaries to know that I failed twice before I finally was successful and that if they don’t manage to make it on their first attempt they won’t be foreclosed from seeking another investment or loan from the Family Bank.”*

Here is another sample clause I’ve used:

### **1.01 Family Bank.**

(a) I want to support and encourage entrepreneurial business activities by the beneficiaries of the trusts established hereunder. Consequently, in addition to the rights of the Trustee to make the distributions for such purposes as set forth in **Error! Reference source not found.**, the Trustee may dedicate a specific portion of any separate trusts hereunder for what I will describe as the Family Bank. In making the determination of what portion of any separate trust should be set aside for the Family Bank the Trustee should be mindful of my goal of encouraging the beneficiaries to become involved in entrepreneurial business activities, should solicit the suggestions and advice of the Trust Advisor, and should also take into account what might need to be reasonably preserved in liquid assets to fulfill the safety net purpose of this trust. In making these judgments the Trustee, in consultation with the Trust Advisor, should evaluate what other resources are available to the beneficiaries for purposes of their safety net and what other resources are available to any beneficiary who is requesting funds from the Family Bank. The resources that would be considered should include a

beneficiary's sources of income as well as medical insurance, long-term care policies, governmental benefits and an individual beneficiary's disposable assets.

(b) If a beneficiary desires to purchase, expand, or start a business enterprise, a professional practice, etc., and wants to utilize capital from the trust, the beneficiary shall prepare and submit a detailed plan and request to the Trustee and Trust Advisor. The Trustee and/or Trust Advisor may elect to submit this plan to a CPA or consultant hired by the Trustee to evaluate the feasibility of the business venture or the proposed professional activity. The Trustee may also suggest seminars, classes or coursework that a beneficiary should successfully complete before the Trustee approves his or her plan. The Trustee should give great weight to the recommendations of the CPA or business consultant hired but the Trustee may make their own independent judgment on whether, taking into account all relevant information and circumstances I have suggested, the beneficiary's plan should be approved.

(c) If the Trustee approves the beneficiary's plan, the Trustee shall make a capital investment or loan from the Family Bank as contemplated in the approved plan. However, this investment must be made in such a fashion that the trust and Trustee have no liability exposure or risk other than the loss of the capital investment or loan. Any income which is generated by the capital investment may be reinvested in the venture or lent to such venture after any taxes have been paid which are attributable to such interest or may be used by the Trustee for conventional investments.

(d) In either a business or professional activity, the beneficiary does not need to be responsible for the day-to-day operations of the business or activity as a condition to obtaining funding from the Family Bank but I would generally give preference to those opportunities where the beneficiary has significant interest or time commitment.

(e) I want the Trustee to give the beneficiary a chance to access the Family Bank for a business investment or other opportunity as set forth in this Section 1.01 if he or she comes up with a suitable plan, but the Trustee is entitled to a complete release from the beneficiary and/or his/her spouse before the Trustee makes this advance. In addition, as a condition to making the investment or loan, the Trustee may require that the beneficiary and/or any co-venturer indemnify and hold the Trustee and the trust harmless from any claims that may arise therefrom.

(f) The determination of the Trustee of whether to make any such advance or loan shall be final and shall not be subject to judicial review. Under no circumstances, however, shall the Family Bank be used

to make a direct loan to the spouse of a beneficiary, but the beneficiary's spouse may be an equity owner in a business so long as the Trustee is satisfied that the loan or capital investment by the beneficiary's trust will not be subordinate to the claims or interest of the beneficiary's spouse.

One of the most important facets of the Family Bank should be dealing with the issue of what happens if an "investment" or loan goes sour. If the Family Bank is set up as part of a separate share trust then this problem isn't as acute but you still need to address what lengths a trustee is to go to in enforcing the terms of a loan and whether future distributions from the trust would be used to repay the loan. If the Family Bank loan was made from a pot trust the issue of balancing any disparity in trust resources which may arise in the operation of the Family Bank must be addressed.

## 2.5. Public Service

One of the drawbacks of incentive provisions that match earned income is that while they encourage employment they reward beneficiaries according to the relative value of the profession they have chosen. Almost twenty years ago I had a very wealthy client reject such a matching provision because her daughter was married to a minister while her sons had chosen much more financially rewarding careers.

When a client sees this problem and feels a desire to address that inequity or perhaps to actually provide incentives to enter public service the following suggestions compiled by Professor Tate might be considered:

- The trust could provide "more for serving society"<sup>xxvi</sup>
- The trust provides "a \$15,000 income supplement for any descendant who becomes a teacher"<sup>xxvii</sup>
- "[F]or those who use their talents in ways that don't necessarily garner a high wage, such as work in the nonprofit world, you could ensure that they, too, are recognized for their efforts."<sup>xxviii</sup>
- "Trusts can be . . . used to offer focused financial support to beneficiaries who opt to follow paths that are personally and socially rewarding yet generally less lucrative."<sup>xxix</sup>
- "[In some cases,] the heads of the family want to communicate the value of service to their offspring. In these cases the donors provide special supplements for those children who become nurses, teachers, college professors, artists, social workers and the like."<sup>xxx</sup>
- The trust could provide "[a]dditional compensation for performing public benefit work (e.g., teaching, social work), so that their total earnings approximate what he/she might make as a private industry executive."<sup>xxxi</sup>
- "[I]f the goal is to encourage a social conscience, the trust could provide for supplemental payments when a child enters a career that you favor--for instance, as a teacher, social worker or member of the clergy."<sup>xxxii</sup>

- “[O]ne child may be a special education teacher while another is a top executive for an international company. It can be a delicate balance to try to determine exactly how to develop a benefit plan for these vastly different career choices . . . . One way would be to provide an added benefit to the heir who has chosen a career path that benefits society but may not be as lucrative.”<sup>xxiii</sup>

Another clause that I have been frequently asked by parents of certain religious faiths that have a tradition of missionary, humanitarian or evangelical service is one which either defines education to include such service or specifically authorizes distributions by the trustee to support a child or grandchild who is engaged in such service.

## 2.6. Philanthropy

Those clients who place a significant value on “giving back” often wish to encourage their children to be philanthropic. Many seek to “accomplish this goal by involving their children in the family's own philanthropy, through the use of family foundations, charitable trusts of all sorts, donor advised funds and the like.”<sup>xxiv</sup>

While incentive provisions to encourage philanthropic activities or generosity are not as common as those which promote the values of education and industry, I have had clients suggest several innovative ways in which they want their trusts to support a philanthropic mission or purpose.

For instance, I have had clients include “matching” provisions that encourage charitable contributions by matching in some manner any gifts which a child or grandchild makes to their favorite charities. I have also had clients permit a beneficiary to direct that distributions of income be made to charities of the beneficiary's choice or from a list of “approved charities” that the grantor had supported during his or her lifetime.

Other clients with very young children sometimes engage in a formal charitable training program and want to have the trustee and their trust continue to support that program if they should pass away. John Scroggin suggests creating a “Family Nobel Prize,” disbursed every five years to reward the settlor's descendant “who has been designated by [third party] to have made the most significant contribution in the field of [charity, education, science, law, humanities, medicine, etc.]”<sup>xxv</sup>

## 2.7. Family Life

Some clients want to create incentives to allow their grandchildren to have a stay at home mom or dad. Other clients recognize it is unfair to penalize a child who chooses to become a child-rearer and allows the income of their spouse to be counted for purposes of an income-matching clause. Another possibility is an outright exception to an incentive clause requiring gainful employment when a “beneficiary is either (i) occupied

on a full-time basis caring for other family members such as children or disabled or elderly relatives, or (ii) married and [the family's homemaker], and, in either case, the beneficiary's spouse, if any, works full-time or is unable to work full-time for medical or other reasons<sup>xxvi</sup>

Professor Tate has complied the following suggestions of potential incentive clauses in this area:

- An incentive trust offers "a possible monthly payment of as much as \$ 10,000 if [the beneficiary] is a stay-at-home mother"<sup>xxvii</sup>
- A provision paying "\$ 30,000 annually to any parent or guardian who stays home with a minor descendant of mine"<sup>xxviii</sup>

## 2.8. Family Leadership

Clients will often wish to encourage children (and sometimes more remote beneficiaries) to involve themselves in the process of building and preserving assets for future generations. One way in which I have often suggested clients introduce their children or grandchildren to the concepts that are integral to stewarding family wealth is through the Apprentice Trusteeship. This is a "shadow trustee" role where most commonly the beneficiary upon reaching a certain age or attaining some milestone of maturity is offered the opportunity to observe and learn from the trustee. The Apprentice Trustee attends trust meetings and is often given responsibilities to study particular investment opportunities, sectors or companies and to report to the trustees. There may be a set number of years of service before the Apprentice Trustee becomes a fully integrated voting co-trustee. Or it may be left to the judgment of the trustees, a trust protector or trust advisor to determine when the beneficiary has sufficiently mastered the skills of the trusteeship that they should be elevated.

Not all clients will embrace the suggestion of permitting their children to serve as trustees or co-trustees. It is possible, however, to involve the children in other family leadership roles such as investment advisors, general partners, or asset managers. I believe we have a duty to caution clients on the dangers of putting a child into a role they are neither prepared for nor have any genuine interest in. The family business consulting literature urges family business owners to require if not strongly encourage family members who may want to enter the family business to spend time in employment outside the family business.

I suggest to clients that part of the antagonism that beneficiaries often have towards trusts, and particularly those trusts which seek to control their life and restrict their choices, is the fact that the beneficiary hasn't had an opportunity to learn what it takes, in the words of Jay Hughes, to "become a Great Beneficiary." In this book family wealth Jay Hughes proposes that every beneficiary has an obligation to educate himself or herself about the duties of a beneficiary, as well as the duties of the family trustees. Here

are a list of tasks Mr. Hughes suggests the Great Beneficiary will undertake in his or her quest to fully understand the role and responsibilities of a beneficiary:

- To gain a clear comprehension of each trust in which the beneficiary has an interest and a specific understanding of the mission statement for each trust as prepared by the trustee
- To educate himself or herself about all trustee responsibilities
- To understand the trustee's responsibility to maintain the purchasing power of the trust's capital while maintaining a reasonable distribution rate for the income beneficiaries
- To have a general understanding of modern portfolio theory and the formation and process of asset allocation
- To recognize and look for proof that each trustee represents all beneficiaries
- To meet with each trustee once each year to discuss his or her personal financial circumstances and personal goals and to advise the trustee of his or her assessment of the trustee's performance of the trustee roles and responsibilities to the trust, to the beneficiary, and to the family governance
- To become knowledgeable about the functions and importance of each element of the family's trust governance structure
- To attend the annual family business meeting and to accept responsible roles within the family governance structure, based on his or her qualifications for such roles
- To develop a general capacity to understand fiduciary accounting
- To demonstrate a willingness to participate in educational sessions and to become financially literate (through family seminars and family-funded educational programs)
- To know how and in what amount trustees and other professionals are compensated and to obtain a general understanding of the budgets for the trust and investment entities in which the trust will be invested<sup>xxix</sup>

I ask the clients to consider the possibility that "My (the parents') Trust" can become "Your (the child's) Trust" and to seek to find ways to give their children or grandchildren an ownership mentality regarding the trust structure. One of the ways in which a beneficiary can get to that "My Trust" mindset is to realize that the trust is really a vehicle which can carry them to whatever life-enhancing opportunities and goals they want to pursue.

Using the vehicle metaphor I ask clients to consider how differently beneficiaries might react to the trust vehicle if they were given an "Owner's Manual" like you receive in the glovebox of that powerful car you last purchased. This Owner's Manual often becomes a program of beneficiary training and education which will thoughtfully prepare

the beneficiary to be able to take full advantages of the opportunities the trust opens up for them.

I have had one client who insisted that her children would not be given full control of their respective trusts until they had completed a beneficiary preparation program. This particular client was fond of saying “the first generation makes it: the second generation grows it.” Here is a sample of what such a curriculum might look like:

Trust 101: The Legal “Ins and Outs” of a Trust

1. Advantages of My Trust
2. Asset Protection Implications
3. The Roles and Responsibilities of a “Great Trustee”
4. The Role and Responsibilities of a “Great Beneficiary”

Trust 102: Financial Planning Basics for Trust Beneficiaries

1. Guide the Beneficiary in Defining Her Financial Planning Goals
2. Challenge the Beneficiary To Adopt a Personal Financial Philosophy
3. Correlate the Purposes of the Trust With The Beneficiary’s Financial Planning Goals
4. Increase the Beneficiary’s Self-Awareness Through Annual Review of Personal Financial Philosophy and Planning Goals

Trust 201: Investment Theory and Management from the Trust Perspective

1. Asset Allocation
2. Modern Portfolio Theory
3. Value vs. Growth Investing
4. Fundamentals of Fixed Income Investing
5. The Role of Real Estate and Other Alternative Investments
6. Investment Tax Strategies

Trust 301: Maximizing the Growth Opportunities of Your Trust

1. Illuminating The Positive Opportunities of Wealth
2. What Excites and Interests Me?
3. Goal-Setting, Life Plans, and Coaching
4. Trustee Apprenticeships and Shadowing the Trustee

Trust 302: Life Skills Seminar

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1. Self-Reflection
2. Communicating With Your Trustee and With Your Family
3. Thanks! How the New Science of Gratitude Can Make You Happier
4. Leveraging a Positive Attitude and a Belief in Myself
5. Fiscal Inequality in Marriage and Relationships
6. Budgeting, Financial Security and Accountability
7. Finding Advisors Who Sit on My Side of the Table

#### Trust 401: How to Be a Great Trust Beneficiary – Graduate Level

1. The Yin/Yang of Dream and Stewardship
2. Mastering the Magic of Powers of Appointment
3. Selecting and Working with Investment Managers
4. Opportunity Grants and Family Bank Loans and Investments

Not all advisors or families have embraced the concept of beneficiary preparation. However there is research which suggests it is one of the two most important factors to consider to ensure a successful wealth transition between generations.<sup>xxx</sup>

### 3. The Bad

The following types of provisions aren't necessarily bad in the sense that I would discourage a client from using it. But what I'm going to focus on next are the "negative" types of behaviors and clauses which clients want to use when they fear a child or grandchild may become "bad".

#### 3.1. Substance Abuse and Other Detrimental Life Behaviors

While it may not be regarded as an "incentive clause" we routinely employ various clauses which put the trustee in the role of being a watchdog or policeman. The substance of these clauses range from provisions which cut-off a beneficiary from any further access to their trust funds to those which provide treatment rehabilitation assistance or other services.

Corporate trustees generally dislike being placed in these roles. I have found it useful to work through a distribution trustee or distribution trust advisor rather than place these responsibilities on a corporate trustee who is either uncomfortable or unfamiliar with the tough love provisions which these types of clauses call for.

I also think it is highly advisable to include language in the trust which would permit the trustee to rely on outside experts to make the determinations of how a beneficiary might best be assisted in their efforts to recover from any type of physiological or emotional impairment. William Messinger and Samuel Dresser in a recent article I

highly recommend have suggested the following language would be helpful in trust documents where the grantor expects the trustee to deal with beneficiaries who struggling with addictive behaviors and other mental health issues:

Authorization to Hire and Rely on Professional Expertise to Implement this Section

The Trustee is authorized to utilize and rely on the professional judgment of a reputable treatment center, utilizing an abstinence based chemical dependency treatment model and recognized by the Joint Commission on Accreditation of Health Care Organizations for evaluations and recommendations regarding the Beneficiary's alcohol/drug dependence and abuse. The Trustee is similarly authorized regarding any other suspected or actual addictions, compulsive or destructive behaviors, and/or mental health concerns.

The Trustee is further authorized to employ and retain experts on alcohol and drug addiction, other addictions or mental health issues to advise him/her regarding any matters, issues or determinations in this Section. The Trustee may designate such experts to receive information or perform tasks on his/her behalf in order to implement this section. Further, the Trustee may employ experts to recommend a comprehensive treatment and post-treatment recovery program and to oversee and implement such program. The Trustee is also authorized to use the recovery programs for addicted pilots and physicians as part of an oversight program for the Beneficiary (or similar programs in the event the pilot or physician program is unavailable.)

The Trustee has sole discretion regarding the employ and use of any such experts, treatment centers or other resources, as needed (however, all such experts shall be licensed or credentialed as per applicable state guidelines). Experts providing advice to the trustee shall be indemnified by the Trust for any adverse claims arising from such advice.<sup>xxx1</sup>

#### 4. The Ugly

The Ugly side of Incentive Trusts surfaces when the draftsman allows the grantor to cross over the line of what the courts have traditionally upheld and enters the space where the efforts to control a beneficiary's personal life will be deemed to violate public policy.

##### 4.1. In Terrorem Clauses

Traditionally, courts in most states have upheld an "in terrorem" provision which is defined as "by way of threat; as a warning."<sup>xxx2</sup>

##### 4.2. Marriage and Family Relationships

I have had at least three instances in my practice where an individual has sought to impose conditions on either the amount of money or whether the money would be

distributed outright or held in trust that were dependent on a beneficiary's marital or family relationships. A provision of a will or a trust is usually invalid if it tends to encourage disruption or formation of a family relationship.<sup>xxxiii</sup> Courts have struck down clauses in trusts which invalidated discriminatory regulations, such as a condition that an individual must only marry someone of a particular racial, ethnic, or religious background.<sup>xxxiv</sup>

However, a valid exception to the rule is the termination of a spouse's interest in a testator's trust if the testator's spouse remarries.<sup>xxxv</sup>

## 5. The Invitation to View Incentive Trusts Through the Lens of Gifts of Opportunity and Enhancement

I hope that this presentation will help you see that there is a tremendous opportunity to "do harm" as well as good when we venture into counseling with clients regarding Incentive Trusts and other conditions which seek to control a beneficiary's personal conduct. I would like to close with some very thoughtful suggestions and questions raised in a recent article.

"The senior generation has the right to pass on an explicit philosophy that reflects a standard for the succeeding generations to follow in order to enjoy the benefits of the family's wealth. Incentive trusts represent the statement: 'This is what I value and I want to ensure my legacy is not wasted through the irresponsible spending of my hard-earned resources.' Accountability to the legacy of the senior generation may provide peace of mind in spite of the personal and financial complexity that incentive trusts bring to the next generation. It is also important that the client be alerted to the potential consequences of conditional giving by hearing the attorney's professional and life experiences.

If income is going to be based on conforming to standards set by a previous generation, it is safe to assume that some successors will conform and some will not. Leaving out "special needs" issues, it is still a challenge for the creators of a dynasty trust that extends several generations into the future to address the potential range of intellectual, emotional, and social skills of those to come.

Polarization will surely occur between those who conform and those who do not conform to behavioral standards set by incentive trusts. Competition may breed animosity and distrust....

Competition, envy, and resentment may pass from one generation to the next. Estate planners may suggest governance structures that provide each generation with a level of autonomy that avoids some of the toll on the family caused by unequal distributions.<sup>xxxvi</sup>

That author then offers these three questions that we might consider and ask each of our clients to consider:

*How might unequal distributions affect family relationships in future generations? Does that concern you?*

*Will those who have succeeded in meeting behavior standards influence distributions made to siblings and cousins?*

*If so, will they be trained to look after the interests of all members of their generation, even those who have not met the conditional terms of the dynasty trust and therefore have less access to the wealth?*

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<sup>i</sup> Donna Barwick, J.D., *Estate Planning—Ruling From the Grave*, CCH Journal of Retirement Planning, Vol. 4, No. 4 (July-August 2001).

<sup>ii</sup> See, e.g., Catherine M. Allchin, *In Some Trusts, the Heirs Must Work for the Money*, N.Y. TIMES, Jan. 29, 2006, § 3, at 6; Peter S. Green, *Planning an Estate to Preserve a Family*, INT'L HERALD TRIBUNE, Oct. 27, 2004, at 20; Mary Hickok, *Family Incentive Trusts Pass Along Values Too*, NAT'L LAW JOURNAL, Mar. 1, 2004, at 16; Monica Langley, *Trust Me, Baby: The House, the Money—It'll All Be Yours; There's Just One Thing—Rich Parents Find New Way to Keep Tabs on Heirs: "Family Incentive Plans,"* WALL ST. J., Nov. 17, 1999, at A1; Pamela Yip, *Attaching Strings: Children Now Inheriting Rules Along with Money*, DALLAS MORNING NEWS, Sept. 13, 1999, at 1D; J. Peder Zanè, *The Rise of Incentive Trusts; Six Feet Under and Overbearing*, N.Y. TIMES, Mar. 12, 1995, § 4, at 5.

<sup>iii</sup> David Prizinsky, *Estate Planning With Strings*, a Special Report in Crain's Cleveland Business Journal, August 20, 2007, p. 15.

<sup>iv</sup> Catherine M. Allchin, *supra* note iii quoting George S. Holzapfel, at 6.

<sup>v</sup> ANDREW CARNEGIE, *The Advantages of Poverty, in THE GOSPEL OF WEALTH AND OTHER TIMELY ESSAYS* (Edward C. Kirkland ed., Harvard Univ. Press 1962), at p. 56.

<sup>vi</sup> Ellen E. Whiting, *Controlling Behavior by Controlling the Inheritance: Considerations in Drafting Incentive Provisions*, 15 PROB. & PROP. (Sept./Oct. 2001) at page 6.

<sup>vii</sup> Monica Langley, *Trust Me, Baby: The House, the Money -- It'll All Be Yours; There's Just One Thing/Rich Parents Find New Way To Keep Tabs On Heirs; 'Family Incentive Plans'/Bonus for an At-Home Mom*, Wall St. J., November 17, 1999, at A1.

<sup>viii</sup> *Id.*

<sup>ix</sup> Dennis T. Jaffe and James A. Grubman, *Acquirers' and Inheritors' Dilemma: Discovering Life Purpose and Building Personal Identity in the Presence of Wealth*, Journal of Wealth Management, Fall 2007 at p. 5.

<sup>x</sup> Langley, *supra* note ii, at A1.

<sup>xi</sup> City National Bank, *Incentive Trusts: A Chance to Have It Your Way*, <http://www.citynfl.com/wms/insights/incentivetrusts.asp>.

<sup>xii</sup> Clark Hill PLC, *Use Incentive Trusts To Reinforce Values*, INSIGHT ON EST. PLAN., available at [http://www.clarkhill.com/LAW\\_MEDIA/IEP2002-06.pdf](http://www.clarkhill.com/LAW_MEDIA/IEP2002-06.pdf).

<sup>xiii</sup> Terry Balding & Associates, *Incentive Trust*, <http://www.plannr.com/pdf/IncentiveTrust.PDF> (last visited Sept. 11, 2006).

<sup>xiv</sup> Duane Sharpe, *Incentive Trust May Be Good Choice*, DAYTON BUS. J., Apr. 1, 2005, available at <http://www.bizjournals.com/dayton/stories/2005/04/04/newscolumn1.html>.

<sup>xv</sup> Howard C. McCue, III, Esq., *PLANNING AND DRAFTING TO INFLUENCE BEHAVIOR*, 34-6, University of Miami Law Center on Estate Planning, at §602.2.

<sup>xvi</sup> Candy J. Cooper, *Where There's a Will . . . Experts Show Wealthy How to Prevent "Affluenza" in Children*, DALLAS MORNING NEWS, Feb. 18, 2001, at 26A.

<sup>xvii</sup> Langley, *supra* note ii, at A1.

<sup>xviii</sup> *The Bank of New York, Intergenerational Transfer of Wealth--and Values--with a Family Incentive Trust*, <http://web.archive.org> (search "<http://www.bankofny.com/pbni/spring00/pbni/page2.html>").

- <sup>xix</sup> Bell Capital Management, *Incentive Trusts: Keeping a Steady Hand on the Tiller*, [http://www.bellcapital.com/pdf/q4\\_04.pdf](http://www.bellcapital.com/pdf/q4_04.pdf).
- <sup>xx</sup> Gary W. Buffone, Ph.D., *The Psychology of Inheritance: Securing Your Legacy*, [http://www.grandtimes.com/articles/The\\_Psychology.html](http://www.grandtimes.com/articles/The_Psychology.html).
- <sup>xxi</sup> City National Bank, *supra* note xi.
- <sup>xxii</sup> The Glenview Trust Company, "Values-Based" Estate Planning, [http://www.glenviewtrust.com/topics/WealthTransfer/Values based estate plans.pdf](http://www.glenviewtrust.com/topics/WealthTransfer/Values%20based%20estate%20plans.pdf).
- <sup>xxiii</sup> Sharpe, *supra* note xiv.
- <sup>xxiv</sup> McCue, *supra* note xv at 602.5.
- <sup>xxv</sup> John J. Scroggin, *Family Incentive Trusts*, J. FIN. SERV. PROF'LS, July 2000, at 74, 82.
- <sup>xxvi</sup> Wells Marble & Hurst, *Incentive Trusts: An Idea Whose Time Has Come (and Gone?)*, <http://www.wellsmar.com/CM/NewsandArticles/NewsandArticles42.asp>
- <sup>xxvii</sup> Langley, *supra* note ii, at A1.
- <sup>xxviii</sup> Scroggin, *supra* note xxv at 87.
- <sup>xxix</sup> James E. Hughes, Jr., *Family Wealth—Keeping It in The Family: How Family Members and Their Advisers Preserve Human, Intellectual and Financial Assets for Generations*, Bloomberg (2<sup>nd</sup> Edition May 2004) at page 108.
- <sup>xxx</sup> Roy Williams and Vic Preisser, *Preparing Heirs—Five Steps to a Successful Transition of Family Wealth and Values* published April 2003.
- <sup>xxxi</sup> William F. Messinger, J.D., LADC and Samuel Dresser, MBA, LADC, *The Demise of Trustee Discretion and Ascertainable Standards as Effective Controls on Dysfunctional and Underperforming Beneficiaries: Solutions for Trustees*, available from the authors at Addiction Recovery Professionals, Inc., 325 Cedar Street, Suite 700, St. Paul, MN 55101 (651-209-7670). This paper has been posted on the web-site of Family Office Exchange but isn't available to the public through that web-site.
- <sup>xxxii</sup> BLACK'S LAW DICTIONARY 839 (8th ed. 1999). In addition, "in terrorem" has been defined as "[i]n terror, or warning; by way of threat." *U.S. Nat'l Bank of Portland v. Snodgrass*, 275 P.2d 860, 871 (Or. 1954). "The term is applied to gifts or legacies given on conditions subsequent, because it is said that the possibility of losing the gift tends to inspire fear or dread." *Id.*
- <sup>xxxiii</sup> See *RESTATEMENT (THIRD) OF TRUSTS* § 29 cmt. i (2003). Regarding what happens to trust corpus and income after an individual provision is held invalid, the Restatement gives both the courts and the trustees the power to eliminate provisions at their discretion. *RESTATEMENT (THIRD) OF TRUSTS* § 66 (2003) provides:
- (1) The court may modify an administrative or distributive provision of a trust, or direct or permit the trustee to deviate from an administrative or distributive provision, if because of circumstances not anticipated by the settlor the modification or deviation will further the purposes of the trust. (2) If a trustee knows or should know of circumstances that justify judicial action under Subsection (1) with respect to an administrative provision, and of the potential of those circumstances to cause substantial harm to the trust or its beneficiaries, the trustee has a duty to petition the court for appropriate modification of or deviation from the terms of the trust.
- <sup>xxxiv</sup> See, for example, *IND. CODE* § 29-1-6-2 (2004) (stating that a provision in a will or trust that puts a restraint on marriage is acceptable, but the actual condition is void). A will in which a husband gave his wife land containing the restriction that the wife remained a widow was not a restraint on marriage because the condition contained only words of limitation. *Summit v. Yount*, 9 N.E. 582, 582-84 (Ind. 1886). Compare *Crawford v. Thompson*, 91 Ind. 266, 277 (1883) (holding invalid a provision in a will stating that a girl will not get an annual amount of money set aside for her if she married a second time), with *Summit*, 9 N.E. at 582-84 (holding valid a provision in a will that limited a beneficiary's inheritance on her not marrying). Also see *Maddox v. Maddox*, 52 Va. 804 (1854), at 808, where the Virginia Supreme Court held that a provision in a will allowed an inheritance to go to a woman only if she married one of six men was void as an unreasonable restraint on marriage.
- <sup>xxxv</sup> For an excellent discussion on this subject as well as the related territory which is restrictions on religion or religious practices, see Shelly Steiner,

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*INCENTIVE CONDITIONS: THE VALIDITY OF INNOVATIVE FINANCIAL PARENTING  
BY PASSING ALONG WEALTH AND VALUES, 40 Val. U.L. Rev. 897*  
<sup>xxxvi</sup> Judy Barber, *The Psychology of Conditional Giving: What's the Motivation*, 21 *Probate & Property*

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