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Guest Article

# The Pros And Cons Of Incentive Trusts

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Since a Wall Street Journal article in 1999 announced that incentive trusts were the wave of the future, there certainly has been a great deal of discussion around them.

Articles on incentive trusts have appeared in local newspapers virtually throughout the country, and in magazines such as Financial Planning, Trusts and Estates, Kiplinger's, Money, Estate Planning, National Underwriter, and the Dow Jones Investment Advisor.



Given all the attention and hype afforded to incentive trusts over the past five years, it seems fair to now assume some planners are using them.

What are incentive trusts and what are the pros and cons of using them?

**Incentive Trusts Basics**

Incentive trusts are created to encourage certain behavior and/or to discourage certain behavior by the beneficiary. These trusts may be created during your clients' lifetimes or post-death in their wills or revocable trusts. Either way, they are specifically designed to include language rewarding or punishing behavior.

Only your ingenuity and creativity limit the types of behavior to be motivated and the manners in which they are motivated. Here are some examples of behavior that may be included in incentive trust provisions:

- Substance abuse, gambling and other addictions

A fairly common clause in many estate plans suspends distributions to a beneficiary if he is abusing alcohol or drugs, is suffering with a gambling addiction or other similar problem. This type of a clause would generally be prepared as a negative type of incentive ("if the beneficiary is abusing drugs or alcohol, addicted to gambling ... then suspend distributions"), but it is a very important one. During periods of suspension, the trustee should be authorized to use trust funds to pay for support programs, rehabilitation, medical support or other treatments.

- Education

Incentives can be drafted to encourage educational achievements. For example, a distribution could be made if a 3.0 GPA is achieved, a higher amount might be distributed for a 3.5 GPA and an even higher amount for a 4.0. Or a clause could be drafted to pay for higher education including graduate degree programs. Some clients might wish to tie an incentive to attending a certain type of school - an Ivy League college or the decedent's alma mater, for example. Other educational incentives might be tied toward career advancement - such as incentives for attending law school, medical school, business school, etc.

- Marriage or family incentives

Some clients wish to encourage their beneficiaries to marry. Others may wish to encourage their beneficiaries to have children. Staying married for a certain length of time could be rewarded. Another concept is to incent a beneficiary to stay home and bring up a family. Payments may be made from the trust to make up for lost earnings, for example.

- Achievement incentives

Incentives can be created for all sorts of life achievements. They may be tied to career or success in business. Some clients might reward beneficiaries for joining the family business, while others might reward beneficiaries by supporting them in starting their own businesses. Some incentive clauses reward earnings - for example, a beneficiary may have a salary match from the trust ("trustee will pay an amount equal to gross earnings from employment").

- Non-remunerative careers

An interesting twist on the incentive clause is to pay beneficiaries who choose to follow career paths that are not as remunerative monetarily. For example, a beneficiary may be paid two times salary (or more) if employed as a school teacher, a city worker (police, fire), a politician, a social service worker, etc. Some clients may wish to incentivize their beneficiaries this way to support a career in music or the arts.

- Social welfare

Incentive clauses can be designed to encourage socially responsible behavior by beneficiaries. For example, money may be paid to a beneficiary for serving on charitable boards or volunteering in other ways. Incentives might be drawn to repay beneficiaries in part for making donations. Or perhaps a beneficiary would be rewarded for participating in managing a family private foundation.

**The Pros And Cons**

It seems pretty clear that some incentive trust planning should be a regular part of all your estate plans. There are legions of stories about the dangers of beneficiaries coming into too much money too fast (and/or too young). These stories usually end with wasted lives, drug addictions, and life-long emotional scars.

Rightfully, our clients want us to help them avoid spoiling their beneficiaries or putting their beneficiaries in a position that they may choose not to work or not to be productive at all. Many wealthy clients want to use trust opportunities to reinforce the importance of a good work ethic. These seem worthwhile goals for trust planning.

However, some critics would argue that too much ruling from the grave could be dangerous. Beneficiaries may grow up to resent the restrictions or to rebel against them. Other critics could argue that trying to legislate values via trust clauses is unlikely to succeed. If children grow to be adults, eventually their capacity for further maturing is limited. So the incentive clauses might fail to change behavior past a certain point while risking alienating and risking the ire of the client's future beneficiaries.

In some instances, there is likely to be little controversy. For example, incentive clauses that suspend distributions when beneficiaries are addicted or involved in dangerous behaviors seem prudent in virtually all cases. Indeed, it is hard to think of any downside to having that sort of provision in your trusts. If there is one, it would be that the provision can add some difficult responsibility onto the trustees.

However, other types of incentive trusts seem to have both pros and cons. While allowing trustees to pay for education should be standard in trusts, incentive clauses tied to certain behaviors may not be as clearly beneficial.

On the one hand, a provision paying a premium to a beneficiary for achieving a higher GPA seems like a fairly helpful clause. But not every beneficiary is going to be an Einstein. So suspending all distributions in case of a failure to achieve a certain GPA might be overly harsh. Further, not every beneficiary will want to go to graduate school or an Ivy League school or whatever other restriction might be in the trust. Of course there is another risk in providing for unlimited educational incentives - the beneficiaries may be incented to become perpetual students. That may not be the type of behavior the client wishes to reward either.

Marriage and family clauses can be quite controversial and even illegal. Incentive clauses requiring a beneficiary to get divorced or to avoid inter-racial marriage have been struck down. Clauses that provide incentive for parents to stay home with their children might be seen as very controversial. And incentives to have large families (or small) could also be very detrimental to a beneficiary who wants to gain the trust benefits but is not really interested in rearing a large (or small) family.

The costs and benefits of achievement and career incentives can also be quite unclear. As the discussion above pointed out, some parents might want to incentivize high wage earning (by paying a dollar-for-dollar match to earned income, for example) while others may want to incentivize charitable works or taking on low paying jobs (the non-remunerative career incentives, described above). Those are essentially conflicting provisions. It is hard to have both and still pass on a clear family value. But if a trust only incentivizes one or the other type of career behavior then it is quite possible that the beneficiaries will be unhappy with their careers. How does one properly incent career satisfaction?

Finally, even incentive clauses for social welfare can be controversial. The political aspects of which type of social causes to support can literally tear a family apart. If the client wishes to incent altruistic behavior, but only toward causes that the client supported (or ones in line with such), then the beneficiaries can be frustrated. And if the client is willing to allow the beneficiaries to choose their own causes for support, their choices may cause the client to pull his (or her) hair out. The opportunity for tension is ever-present.

**Conclusion**

While it appears most planners use incentive clauses of some type in most trusts, the real question is how much incentive clause planning to encourage. We can literally drive our clients crazy by making them worry about every little thing that could go wrong to mess up their beneficiaries lives. Moreover, we can push our clients too far with worrying about how to plan and incentivize behavior for all of life's contingencies.

While the use of incentive trusts has received a great deal of hype these past five years, I wonder how much of this planning is really going on. Are you encouraging all your clients to use incentive trust clauses, and if so what type? Have they responded well to this planning or has it just created another series of decisions the clients don't really enjoy making? Would those of you doing incentive planning be willing to share your experiences?

For now, at least, given all the hype in the media about incentive trusts, we at least need to know where incentive clauses make sense, and we should be prepared to discuss them with clients who come to see us.

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