working hard *for the money*

USING INCENTIVE TRUSTS TO MOTIVATE BENEFICIARIES

Despite the struggling economy, Americans are at the beginning of a 41-trillion-dollar intergenerational transfer of wealth that will continue for another four decades. Most of us like to think that the loved ones to whom this wealth passes—our children and grandchildren—will be able to handle the pressures and responsibilities of an inheritance. But many heirs will not, due to immaturity, financial inexperience or irresponsibility, substance abuse, mental health problems, or some combination of those factors. Although inherited wealth can provide desirable financial security, it also can reduce or eliminate a beneficiary's incentive to work and be productive. How do you pass on wealth to future generations without spoiling your heirs? ▸

ESTABLISH ELIGIBILITY CRITERIA

An "incentive" trust may provide some answers. Incentive trusts are traditional trusts in which a trustee holds and manages assets for the benefit of another person or group of people (the "beneficiaries"), but have the added twist of establishing criteria for when and if a beneficiary will be entitled to or eligible for a distribution. The criteria, which are unique to each trust, are intended to motivate the beneficiaries to engage in or refrain from some type of behavior and to provide a financial reward for those beneficiaries whose behavior complies with the criteria. As long as the incentives don't violate public policy (such as requiring a beneficiary to divorce in order to receive funds), they can be included in the trust.

For example, a trust might authorize the trustee to distribute property from the incentive trust to a child if certain educational goals are met, such as being a full-time student at an accredited institution, maintaining a certain GPA, and progressing toward the completion of an undergraduate or other degree at the rate of a full-time student. It would be unwise for the trust to require payment to a beneficiary simply for staying in school, since that could produce a professional student, rather than an educated member of the workforce.

The trust also could reward full-time, socially productive employment. Although some trusts match beneficiaries' earned income dollar for dollar, this type of plan can penalize those beneficiaries who are stay-at-home parents or who choose careers, such as teaching or the arts, that benefit society but aren't lucrative. For this reason, the incentives should be linked to productivity and social contribution, rather than the number on a beneficiary's W-2.

Incentive trusts are also very useful for addressing the special challenges presented by beneficiaries with substance abuse problems or a history of criminal behavior. Distributions should be structured to reward positive behavior—such as being drug free or staying out of jail—rather than punishing negative behavior. However, the trust should empower the trustee to not make outright distributions to a beneficiary with self-destructive behavior, since money usually makes the situation worse. Incentive trusts can encourage philanthropy as well. Requiring the trust to match a beneficiary's charitable donations may help the beneficiary develop an appreciation for community involvement and other charitable habits. If the family has established a donor-advised fund or a foundation, distributions from the incentive trust could be tied to participation in the fund or foundation.

FLEXIBILITY IS KEY

When structuring an incentive trust, it's very important to give the trustee flexibility to adapt to circumstances as they develop over time, not just as they exist at the time the trust is created. Requirements for distributions, especially those tied to education and employment, should not be so rigid that they penalize those beneficiaries who simply cannot comply with them. Not everyone is cut out for the Ivy League or for heading up the family business.

One way to achieve flexibility is to make the incentive trust a "discretionary" trust. This means that if the beneficiary meets the requirements stated in the trust, he or she becomes eligible for, but not entitled to, a distribution. This provides the trustee with a "second look" at whether a distribution is advisable at the time the beneficiary meets the requirement and protects the trust property from the beneficiary's creditors, including the beneficiary's spouse in the event of a divorce. Flexibility can be enhanced by authorizing the trustee to make distributions either outright to a beneficiary or for his or her benefit. For example, a trustee who is wary of making an outright distribution of cash to a beneficiary with a history of substance abuse may be more inclined to pay that beneficiary's basic living expenses, such as rent or utilities, directly to the service provider.

POSITIVE MOTIVATION

The key to the success of an incentive trust is good communication. The trustee needs to understand clearly your goals and intentions. Writing these down in a family mission statement can help you crystallize your objectives and provide the trustee with a valuable reference for making decisions after you're gone. If appropriate, discussing the structure of the trust (but not necessarily the dollar amount) with your heirs will help manage their expectations about their inheritance.

Many people think that passing on their values and a strong work ethic is as important as passing on their money. An incentive trust can help promote success within a family and reinforce values by using wealth as a positive motivator.

Amy Kanyuk speaks and writes frequently about tax and estate planning topics and has been selected numerous times by her peers for inclusion in Best Lawyers in America *in the fields of tax law and trusts and estates.*