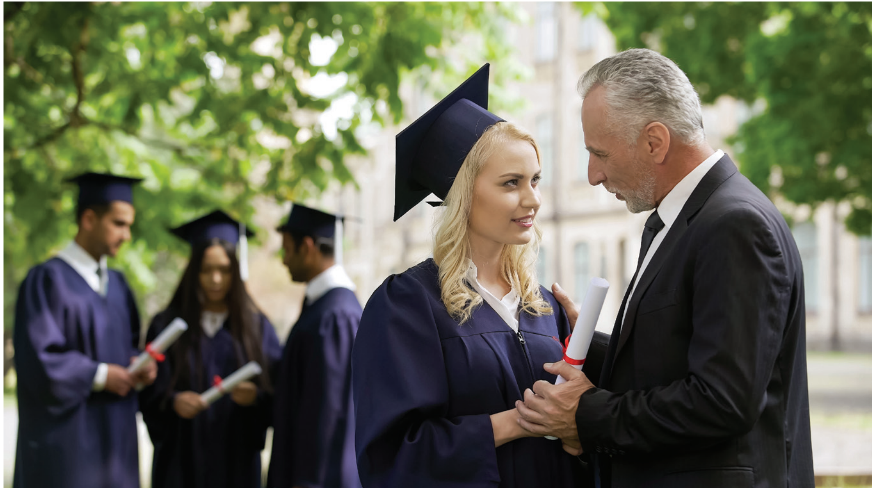
AVOIDING TRUST FUND BABIES

THE INCENTIVE TRUST

By Robert Prior



The baby boomer generation is wealthy. According to a recent study by CNBC, those born between 1946 and 1964 are expected to transfer over $30 trillion to lower generations over the coming decades. This means that more wealth will pass into the hands of those who didn't earn it than ever before. How that wealth passes to our children and grandchildren, and what impact it will have on them, is something that should be given thoughtful consideration.

For the few Americans who have estate plans, most leave their assets to their children without any thought on what happens to those assets after their children receive them, but many have learned the benefits of leaving an inheritance to their offspring in trust. Under this arrangement, the parents appoint a trustee to manage and invest trust property and make distributions as directed by the trust agreement. A properly drafted trust ensures a child's inheritance is properly managed, that homes and other parcels of real estate are transferred to specific beneficiaries, and even that a business is kept in family hands. Most importantly, assets left to your descendants in a properly drafted trust are protected in case a child later divorces, is sued, or even files bankruptcy.

The perceived downside of trust planning is the creation of the trust fund baby. This stereotype elicits thoughts of a spoiled brat who is given everything, never develops a work ethic, never becomes a contributing member of society and lives an unfulfilled and unproductive life. Through proper trust planning, this stereotype does not have to be a reality for your trust beneficiaries.

The first step in preventing bad results for trust beneficiaries is the selection of the right trustee. The trustee controls and invests the trust property, and pays and files all taxes on income from the trust. Most importantly, the trustee makes distributions to the trust beneficiaries under guidelines established in the trust agreement. As trustees are often granted discretion on when to make distributions, a trustee must be able to say "no" to a beneficiary if they request a distribution for something that is beyond that contemplated by the trust. For example, a trust that grants the trustee discretion to make distributions of principal for the beneficiary's "health, education, maintenance, or support" (a typical trust provision) needs to be able to refuse a request for a distribution for an extravagant trip or to purchase an expensive car.

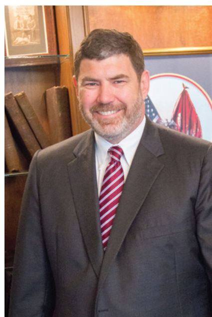
The other protection against creating a trust fund baby lies in the written instructions left by the parents in the trust agreement itself. While a trust should always make provisions for future problems like medical emergencies or financial hardships, it should be seen as a safety net for the trust beneficiary rather than the beneficiary's primary means of support.

The beauty of trust planning is that the provisions of a trust, within the broad bounds of trust law, are limited only by the trust creator's imagination. This means that parents can design a trust that does not provide for automatic distributions of income

or principal to trust beneficiaries, but rather requires the beneficiary to earn those distributions.

These trusts are commonly known as "incentive trusts." Incentive trusts impose restrictions on distributions so that a beneficiary can't just sit back and wait for a check. Rather, the beneficiary is required to achieve some objective (to the trustee's satisfaction) before distributions are made. For example, a trust may require that the trust beneficiary graduate from college, achieve a certain grade point average or complete graduate school in order to receive money from the trust assets. It could require employment or charitable work and reduce or stop distributions if the beneficiary does not comply. The trust guidelines could even increase or decrease distributions on a sliding scale based upon the earnings of the beneficiary. The objectives are limited only by the parents' creativity.

Ensure that any wealth you leave your children is properly planned for and that you don't create a trust fund baby. Talk to your estate planning attorney about selecting the right trustee and drafting an incentive trust.



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