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# Incentive Trusts & the Importance of Meaningful Trustee Guidance

Parents typically establish trusts to control the distribution of assets and provide additional protection to their children. Parents of young children are concerned their children may not have the maturity or legal ability to manage assets. Parents of older or grown children often have concerns about spending issues or the potential for divorce. A combination of well-drafted trust provisions and thoughtful guidance to your trustee can ensure that your children—whether young or grown—are provided for in a manner consistent with your goals and values.

Testamentary trusts offer parents a great degree of flexibility and control regarding how and when their children receive distributions. Complex issues, however, can arise during the trust's administration - after both parents have passed away. Although the trust agreement itself includes provisions regarding when and how distributions should be made to your children, it is often desirable to provide additional direction to your trustee in the form of written guidelines describing how you would handle various situations. Although they are only guidelines, you should review them carefully with your attorney to ensure that they do not conflict with your trust provisions and accurately reflect your intentions.

This issue focuses on concerns we often see with respect to children and young adults. The next issue focuses on concerns more prevalent with respect to adult children, such as

divorce, the “predatory” in-law, and the “bad” child.


## **Children & Young Adults**

Most of our clients with young children are concerned about providing a reasonable standard of living for their children in the event of the parents' unexpected deaths.

Parents generally do not want an inheritance to pass outright to young children. Children under the age of 18 do not have the legal ability to manage certain assets and generally lack the maturity necessary to manage financial matters. Additionally, to protect the assets of a minor child, the court may establish a conservatorship or protective orders to oversee management and expenditures of the minor's property. The balance of the assets are then generally distributed to the child at age 18. Most parents are uncomfortable having their children's assets managed through court supervised proceedings and doubt their children's ability to wisely manage assets at 18.

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Accordingly, almost all parents conclude that a trust is the better option.

Parents may establish trusts for young children that are designed to terminate when the children reach a certain age—an age at which the parents hope their children will have the maturity to manage their inheritance. In the meantime, the trustee is generally instructed to make discretionary distributions of income and principal for each child’s health, education, maintenance and support. The trust agreement may specify partial disbursements be made as each child attains specified ages such as 25, 30, and 35.

The parents are making guesses at what ages their children will have the maturity to handle financial matters. The reality, though, is that it is impossible to predict what the future may hold for each child. Parents cannot know whether their children will, in fact, be mature enough to “handle” their inheritance at the ages that appear in the estate planning documents

Suppose today the children are 3, 6, and 9 years old. Parents select the age or ages at which they expect the children will be mature enough to handle financial responsibility. But what if the child is not? Should the trustee still disburse the funds at the predetermined age?

Moreover, the standards of health, education, maintenance and support can be broadly interpreted. Can and should parents provide some guidance to the trustee regarding their interpretation of those words? When should a trustee tell a child “no” and decline to make a discretionary distribution?

### **Guidelines for Discretionary Distributions**

There are substantial benefits to providing wide latitude for your trustee to act within the trust agreement itself. However, there are many real world issues that may confront the person you have selected as your trustee. Because the trust will not come into existence until both you and your spouse have passed away, it may be helpful to provide written

guidance to your trustee regarding how you would handle certain situations. The guidelines provide additional direction to the trustee. In a perfect world, this is how we, the children’s parents, would handle this situation. However, the guidelines are not mandatory and the trustee is still able to exercise discretion. Following are some dilemmas we’ve run across in working with children and young adults.

“**Health**” is generally understood to mean that the trustee should use funds to help pay for medical expenses that are not covered by medical insurance. However, medical insurance is expensive and a beneficiary may choose not to carry it if they know the trust will cover medical expenses. Yet uninsured medical expenses could quickly deplete trust resources. Should the trustee require the beneficiary to carry medical insurance? Should the trustee pay for elective procedures such as breast augmentation, cellulite removal, or a nose job?

“**Education**” poses the issues of what type and how long? Should your children attend public school or private? Does it depend upon the quality of the public school? How should limited resources be allocated if one child has special opportunities or special needs that could potentially limit resources available to other children? Although a trustee who depletes the trust by providing an expensive education to the oldest child violates the trustee’s fiduciary obligations to the younger children, how would you counsel your trustee to make various trade-offs?

Post-secondary education poses additional dilemmas. A group of twenty-somethings recently explained that four-year undergraduate degrees are a thing of the past. They informed me that many of their friends have stayed in college for six years or more without meeting their degree requirements! What should your trustee do if faced with a perpetual student? If faced with

this dilemma what would you do? Should the trustee pay only for a set number of years or credits for undergraduate education? If a child stays in college longer than the specified timeframe, should the child pay for the additional expense him or herself? Does “education” include funds for room and board, socializing, laptops, cell phones? Must your child maintain a minimum grade point average?



Remember, your guidelines are just that—guidelines. If, for example, you indicated that college must be completed within four years, the trustee would still have the discretion to continue paying tuition for a child who was injured in an auto accident or suffered a debilitating illness that made completion within four years impossible.

“**Maintenance and Support**” can mean virtually anything. It is difficult to imagine a beneficiary’s need for money that cannot somehow be tied to maintenance and support. The risk, however, is the “trust baby” phenomenon, where children neglect their own abilities and fail to achieve their potential because their plan is to simply live off of the trust. Children may expect lavish homes, fine dining, extravagant vacations, expensive cars, and exorbitant weekly allowances. Imagine what you would say under these circumstances. At what point should the trustee respond to the beneficiary’s request with an emphatic “no”?

Some trust agreements contemplate the trustee’s discretionary distribution of principal to enable the child to purchase a home or start a business. I have had experience with some beneficiaries in their early twenties who expected the trustee to buy them an expensive home even though the purchase would wipe out all of the trust assets. As parents, what guidance would you give the trustee.

Your guidelines could, for example, provide that for each of these purposes, the trustee should distribute no more than the amount invested by the child. If the child has his or her own money invested in the new business, and not just money from a parent’s trust, it is much more likely that the child’s personal commitment to the success of the business will increase dramatically. You may want distributions contingent upon a written business plan from the child. If the child does not provide a feasible business plan, then no funds should be disbursed.

Should children be required to be gainfully employed in order to receive discretionary funds for maintenance and support? To avoid the “trust baby” phenomenon, guidelines could provide that the trustee can only distribute an amount equal to the child’s earned income from the prior year after he or she reaches a stated age, such as 23.

### **When Should Scheduled Distributions be Postponed?**

In some situations parents may want to permit the trustee to delay a scheduled distribution for an indefinite or specified period of time. Examples of your thinking must be included, such as drug or alcohol dependency or failure to obtain employment. You may also want the trustee to delay distribution if funds would be taken by the child’s creditors to satisfy unreasonable debts the child has incurred.

Of course, your trustee could still be sued by a disappointed child who disagreed with your trustee’s behavioral assessment. However, if you have provided clear guidance, the judge will have a roadmap to your intentions. Where trustees are given no guidance regarding whether to make a distribution in such circumstances, they may be unwilling to risk being sued and make the distribution even though it was not in your child’s best interest.



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## Join Us at Michigan State University for AgExpo 2010 July 20 - 22

This year, Michael will be presenting ***“Succession Planning In An Uncertain Tax Environment.”*** Stop by to hear how changing and uncertain tax rules affect your planning strategy.

Tuesday 1:00 p.m.

Wednesday 1:00 p.m.

Thursday 1:00 p.m.

All presentations will occur at the CANR Tent.

We will also have a booth

at AgExpo located in Tent A #9. Stop by to explore your legal concerns or just to say “Hello.”

AgExpo will be held on the MSU grounds on July 20 from 9:00 a.m.—5:00 p.m.; July 21 from 9:00 a.m.—5:00 p.m., and July 22 from 9:00 a.m.—3:00 p.m. For more information about AgExpo 2010 visit

[www.agexpo.msu.edu](http://www.agexpo.msu.edu).



Michael, Hannah, and Debi at AgExpo 2009

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