



## Incentive Trusts in Three-Part Harmony

By Robert L. Moshman

Parents have long employed incentives to encourage their children to work hard and excel in life. No television until you finish your homework. A new car if you graduate college. By logical extension, estate plans frequently apply similar conditions to the distribution of wealth.

An incentive trust, or incentive provisions that are part of another trust, can be an effective mechanism for accomplishing the parent's plan. Typically, a testamentary trust includes an incentive provision that provides a parent's final encouragement and reward, even after death.

Let's review the factors that affect the drafting of an incentive trust. To begin with, there is a critical decision for very large estates. How much wealth will spoil an heir?<sup>1</sup>

### Making Life Too Easy

For those concerned with spoiling an heir, the ceiling amount on an outright inheritance might be defined as that amount which causes the heir to become complacent or lazy, to fail to improve one's self or accomplish worthy goals. But the answer depends on context and therefore varies. A 1990s survey determined that millionaires felt that, on average, \$5.5 million was the most that could be transferred to an heir without affecting their character.<sup>2</sup>

Today, allowing for a decade or more of inflations, that amount would be closer to \$7.5 million. With earnings of 5%, that amount generates \$375,000 annually. That's enough to live well, and provide for children, but it is still small enough to encourage a beneficiary to be careful with it, to nurture those assets into a much larger fortune, to finance a business venture and, ultimately, to strive toward accomplishments with financial rewards. But consider this amount in different contexts.<sup>3</sup>

### Everything Is Relative

"I leave my only son the sum of \$7.5 million," reads the last will and testament, "so that he will have the incentive to work hard, spend carefully, invest his money wisely, and respect the value of money."

To some people, the day that a \$7.5-million inheritance arrives would become known as the first day of permanent vacation and would be marked each year with a celebration that would last 365 days. Regrettably, this would end all ambition toward education, self improvement, or accomplishment, exactly as feared.

However, \$7.5 million no longer looks the same way in a much larger estate. If a billionaire decides to make his only child morally stronger by leaving him only \$7.5 million, the rest of us may simply conclude that billionaires are eccentric, while the heir may conclude that he or she is unappreciated.

Perhaps those who are fortunate enough to have experience the verities of great wealth have a greater appreciation of the process of attaining that wealth. That may leave them more inclined to impose conditions on how much of a large estate a beneficiary will inherit or control.

What kind of strings should a parent put on an estate of \$10 million? Are the strings different if the estate is worth \$100 million? How should a child's inheritance be balanced with additional goals of the



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parent's estate? In the context of a large estate, an heir witnessing 99.5% of a parent's estate being diverted to other charities and causes may take that gesture personally and resent being such a miniscule consideration in the overall scheme of an estate.

Suppose there was another sibling who also received a \$7.5 million inheritance, but who worked with the parent in the family business and now has been placed in charge of a vast corporate holding company where he'll receive \$5 million of compensation every year. Or suppose the estate establishes a foundation, funds it with \$100 million, and appoints the testator's niece as the executive officer? Do the incentive clauses or conditions placed on the inheritance still make sense?

## Potential Pitfalls

There is no one-size-fits-all incentive trust that can make sense in different circumstances. Estates are multi-dimensional. An estate may have multiple children, a family business, a charitable foundation, and art holdings. Heirs vary in age, ability, and exposure to liability. And grantors may want to use incentive trusts to encourage personal growth, public accomplishment, philanthropy, or some combination of these or other goals.

In the past, an incentive trust might have involved a minor trust clause concerning a college education or some other goal with modest parameters in terms of time or money. The more recent rebirth of incentives in the form of a "family incentive trust" may be far more ambitious, involving much larger portions of an estate and covering open-ended periods of time. These incentives may attempt to encourage the next generation of grandchildren or beyond, causing the incentive trust to be structured as a dynasty trust.

An incentive trust on this scale, involving significant assets and time, must obviously be designed with taxation and investment management considerations in mind. As the potential duration of the trust increases, the need for greater flexibility increases. Incorporation of a "hold back" clause or a "trust protector" who can change or delay beneficial interests may be considered.

## Itemized Considerations

What types of issues affect the design and implementation of an incentive trust?

- ▣ **Goals:** A key starting point is to determine what grantors actually want. The discussion may begin with typical goals such as achieving a college education, but there are often other values and goals that may arise. Grantors may want to discourage drug use or encourage religious activity. Grantors may want to provide funds to assist with athletic, business, or musical endeavors.
- ▣ **Coordination With Estate:** Different considerations may apply to a free-standing incentive trust as opposed to a trust designed for some other purpose which has an incentive clause incorporated within it. It is quite possible to have incentive clauses built into a typical testamentary trust that is, for example, distributing portions of the estate when children reach 18, 21, 25, 30 and other pre-designated ages. Incentive clauses



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might also fit well in Crummey trusts, college education trusts, and many other trust arrangements.

▣ **Duration of Trust:** If trustees are going to be monitoring and rewarding the behavior of children and grandchildren for an extended period of time, long-term trust management must be provided in a manner that supervises investments effectively, remains impartial, and remains flexible enough to adapt to new circumstances.

▣ **The Beneficiaries:** What are the ages of the intended beneficiaries? Are there multiple beneficiaries? Are there siblings or competitive rivalries involved over a business? An incentive trust that encourages one beneficiary while triggering conflict within the family may not meet the grantor's goals.

▣ **Asset Protection:** Trusts are extremely useful in protecting assets from the debts and liabilities of beneficiaries. A beneficiary who gets divorced, or who is sued for malpractice in his professional career, or who falls into debt for any number of reasons, can quickly exhaust an inheritance. An incentive trust may be directed to reward various accomplishments, but it can't lose sight of the consequences of outright distribution of assets.

▣ **Objective Criteria:** Who gets to decide whether a beneficiary has accomplished the goals that qualify for reward? Are there objective tests and objective fiduciaries?

## Three Layers of Incentive

One way of breaking down the various considerations surrounding an incentive trust is to see whether it is harmonious on three levels. Focusing first on the component of personal development, the trust should be realistic in terms of the age, wealth, and lifestyle of the beneficiary and how other family members such as siblings would be treated.

A second focus is the harmony with the world of business and finance. The pertinent inquiry is whether the incentive trust will have a positive influence in encouraging career accomplishments and success in business and investment endeavors. Having a beneficiary jump through incentive hoops for years may not make sense if the same beneficiary may be a successor in the family business or if cousins, siblings, or other contemporaries of the beneficiary are benefiting from the grantor's estate without the "strings" that come with an incentive trust.

And finally, does the trust promote the grantor's philosophies in some way? Are the provisions in harmony with the grantor's philanthropic, religious, scientific, or other objectives or beliefs? Has the incentive trust (or related documents) fully articulated those philosophies?

This is critical. Why have an incentive trust if it is not effectuating what the grantor actually wants? And if the trust is to last for a considerable time, how shall the grantor's personal values be communicated in a manner that will help guide the trust in the future? Along with the terms of the trust document itself, one author notes the usefulness of handwritten letters from the grantor to the trustee:



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"Over the years of counseling clients on such matters, I have personally encouraged the use of flexible words in the legal document itself, coupled with handwritten letters from the donor to the trustee. These letters could explain in more detail the donor's values to be followed, philosophies about issues that are important to them such as private versus public schools, religious preferences, etc.<sup>4</sup>

## A Voice From Beyond

Some say the incentive trust is new. While it may be newly discovered or currently in vogue, incentive trusts have a long history. And this specific arrangement exists because parents have always tried to control, influence, cajole, encourage, and dominate children from beyond the grave.

Mort main (dead hand) statutes and the rule against perpetuities have attempted to curb the long-term controls retained by the dearly departed by putting some absolute limits on when they must let go.

Hopefully, the modern incentive trust can accomplish worthwhile goals that leave grantors fully gratified at having established a trust that will have a positive influence on beneficiaries, provide a harmonious balance of personal, public and philanthropic goals, and know when to let go.

## Transfers to FLP Were Gifts

Indirect gifts to three children took place as a result of a couple's transfer of stock to family limited partnerships (FLPs). Shares of stock were transferred to the FLPs and the parents simultaneously gave each child 30% shares. The IRS said these transfers to the children were not entitled to valuation discounts for lack of marketability or minority interests because the transfers to the FLP were simply indirect transfers of stock to the children and not of limited partnership interests.

The Tax Court agreed and cited *Shepherd*, 115 TC 376, aff'd. CA-11, in which it was held that transfers to a partnership were indirect gifts to a taxpayer's sons. Here, there was no reliable evidence that the transfers to the FLP took place prior to the transfers to the children. There were no records of the transactions, leading to conclude that at best the transactions were simultaneous. *Senda v. Comm'r.*, TC Memo. 2004-160 (2004). Overpayment v. Underpayment

Following a Tax Court case (*Smith Estate*, 82 TCM 909), the IRS and an estate stipulated that there had been an overpayment of estate tax in the amount of \$238,847 and this amount became final upon appeal (*Smith Estate*, CA-5 2002-2). But even after agreeing on the refund amount of \$238,847, the IRS proceeded to refund \$153,510!

The IRS had subtracted \$85,337 based on unpaid interest on a previous tax underpayment. The estate filed a motion to enforce the Tax Court's overpayment decision. A divided court ruled in the estate's favor.

The majority of the Tax Court held that the agreed-upon amount of the overpayment included, by definition, the amount by which payments exceeded the tax and interest on the underpayment. Nor did Court have the jurisdiction to modify its final decision based on the IRS's failure to previously include the interest on the underpayment in its calculations of the overpayment.



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A dissenting opinion took the position that the result was contrary to statutory law and the Court's rules of practice. It argued that the parties had agreed to keep the overpayment and interest amounts separate and that the result rewarded the estate for misleading the Court and avoiding an agreement reached pursuant to Rule 155(a). *Smith Estate v. Comm'r.*, 123 TC --, No. 2, July 13, 2004.

## Walton Revisited

The IRS announced its acquiescence in *Walton v. Commissioner*, 115 T.C. 589 (2000). In that case, the Tax Court invalidated Example 5 of §25.2702-3(e) as an unreasonable interpretation of §2702. *Walton*, involved GRATs funded with Wal-Mart stock which would pay the grantor (or his estate) an annuity for two years, and then benefit his heirs as remainder beneficiaries. If the retained annuity was not a "qualified interest" under §2702, the grantor's interest would be valued at zero and the entire GRAT would be treated as a taxable gift. If the retained interest is "qualified," it is valued under §2702 and the value of the taxable gift is reduced by the value of the grantor's retained interest. *Notice 2003-72*, published in I.R.B. 2003-44.

## Power of Attorney

A revocable trust gave grantor's spouse a testamentary power of appointment over the spouse's applicable exclusion amount. The spouse then exercised the power of appointment in her will, naming her own estate as the beneficiary and then establishing a credit shelter trust from her residuary estate. In combination, these arrangements enabled a sufficient amount of funds to reach spouse's estate and take full advantage of spouse's applicable exclusion amount.

The IRS concluded that since the trust was revocable, the initial funding of the trust did not constitute a completed gift. However, upon the exercise of the power of appointment, grantor would be giving up control over the assets. Therefore a gift was completed when the power of appointment was exercised. (This transfer was a gift to the spouse, which qualified for the marital deduction. It was not a gift to the beneficiaries of the spouse's testamentary trust.)

Once the spouse exercised the power of appointment, she controlled those assets. Therefore, the assets which passed from the revocable trust to the wife's separate trust were not includible in the grantor's gross estate; they were includible in the spouse's estate. *Letter Ruling 200403094*.

## TECHNICAL REFERENCES

<sup>1</sup> Barwick, Ruling from the grave? *Journal of Retirement Planning* (July/Aug., 2001).

<sup>2</sup> This appears to be an early 1990 survey of millionaires. It is noted in Scroggin, "Family Incentive Trust™", *Journal of Financial Service Professionals*. July 2000 and found online at [www.scrogginlaw.com/aboutfit.htm](http://www.scrogginlaw.com/aboutfit.htm). This article cites Thomas J. Stanley, *The Millionaire Next Door* (1997).

<sup>3</sup> In lieu of empirical data concerning the impact of \$7.5-million inheritances on productivity, this editor volunteers his services as an experimental beneficiary.

<sup>4</sup> Bartwick, "Ruling from the Grave?" *Journal of Retirement Planning* (July/Aug. 2001).



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20 North Wacker Drive, Suite 2900, Chicago, Illinois 60606  
Telephone: 312-621-4400 | Fax: 312-621-0268

