

Encouraging Certain Beneficiary Behavior

By Gary Altman and Brenda Bosch

Gary Altman and Brenda Bosch discuss drafting estate planning documents to provide financial incentives to encourage certain behavior in the beneficiaries of the estate plan according to the client's wishes and planning goals.

Many clients want to influence and control their beneficiaries from the grave, sometimes in simple ways and sometimes in very elaborate, convoluted ways. In certain circumstances, the client's motives are noble and in others they are not. The most common way for clients to control their beneficiaries is by controlling how a beneficiary's inheritance is distributed. Estate planners frequently discuss with their clients whether to leave money outright or in trust to their children and grandchildren and this article will not rehash those general discussions. This article is not about protecting beneficiaries from divorces or creditors and will not discuss asset protection planning or the use of trusts for special needs planning or until the child reaches a certain age. The focus of this article is on those situations in which the client wants to encourage or discourage certain behavior or where the client wants to impart a particular value. The important thing for estate planners to do is to listen carefully to their clients so that the client's estate plan and documents are drafted in a manner that will achieve their client's goals, in both a legal and practical way. Accordingly, this article will explore various scenarios commonly presented to estate planners, giving examples of drafting language that will work and explaining why some may not work well in practice. Some of the most unusual clauses we have drafted are included here.

Imagine your client, Mr. Smith, has two adult children, John and Susan, neither of whom are married and neither of whom have children. Mr. Smith's current estate plan contemplates outright distributions to each of the children. Mr. Smith meets with you to discuss what to do about John's impending marriage. John is soon to marry his girlfriend, who seems to have dubious intentions regarding John's wealth. John has not held a job in several years, and may be abusing drugs. John's situation is at the heart of this article. One easy solution is to place John's inheritance in a trust and prevent Johnny from accessing his trust assets without supervision, *i.e.*, either by appointing a co-trustee to serve with John or to have someone other than John serve as sole trustee of John's trust. Many clients might initially prefer to have Susan, John's sister, serve as a co-trustee of John's trust, but we believe this inevitably leads to conflict between siblings and may not even achieve the client's goal of limiting John's access to the funds if Susan yields to pressure from her brother. Hence, there is often a need to appoint an independent trustee, such as a corporation, attorney or accountant.

Suppose the client wants to do more, however, than simply appoint an independent trustee of John's trust. Mr. Smith believes that with the right motivation, John can be encouraged to get a job and lead a more productive, self-sufficient life. In the example below, a total return trust is created for John, *i.e.*, an annuity equal to a certain percentage of the total trust assets are distributed annually to John. However, Mr. Smith does not want the payment to be made to John unless John is gainfully employed. Therefore, the payments

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will cease unless John meets what is referred to below as the “Employment Criteria”:

The Trustee shall, in each and every taxable year of such trust, at least as often as annually, pay to John or apply to or for the use and benefit of John, the unitrust amount; provided, however, that John, in the sole and absolute discretion of the trustee (i) is engaged in full-time, meaningful employment, including self-employment or (ii) is the full-time care-giver of his minor children, if any, who are under the age of thirteen (13), and, if Johnny is married, John’s spouse shall be engaged in full-time, meaningful employment, as provided herein or, if John has minor children under the age of thirteen, is the full time caregiver for such children or, (iii) is disabled because of illness or any other cause, as determined by John’s attending physician and a second consulting physician, which reasonably prevents him from working full-time, (iv) is a full-time student in good standing in an accredited graduate or masters program approved by the Trustee, in his or her sole and absolute discretion, for such period of time as the Trustee, in his or her sole and absolute discretion, determines is within the normal or acceptable time frame for such program, or (v) has attained at least age sixty (60) (hereinafter referred to as “Satisfying the Employment Criteria”).

The language here encourages certain behavior favored by the client, specifically, meaningful employment and education, while retaining flexibility for those circumstances where employment is not possible or desirable, *i.e.*, if the beneficiary is disabled, caring for young children, or retired. Note that the provision requires that if John is not working because he is a full-time care giver, his spouse, if any, must be so employed. A strict requirement that the beneficiary “be employed” before receiving distributions may lead to unintended consequences, such as working as a drug runner or working in an adult book store, and thwart the client’s social goals for his grantee. Moreover, tying annual distributions to a beneficiary’s earned income, as revealed by his or her W-2, may seem like a wonderful idea, but may

actually pervert the client’s intention. If the Trust distributes one dollar for every dollar earned, then that is encouraging the beneficiary to seek out the highest paid job possible and may keep the beneficiary from working in a lower salaried job, such as a teacher or policeman, or from working for the government or a charity, which career choice would be completely acceptable to the grantor.

Quite specific goals may be encouraged by financial rewards as well. A client may want to reward the grantee for obtaining an advanced degree. We have used the following language:

The most common way for clients to control their beneficiaries is by controlling how a beneficiary’s inheritance is distributed.

The Trustee shall distribute the sum of \$100,000 to such child upon such child’s graduation from an accredited graduate or masters program (such as in law, criminal justice, engineering, medicine, social work, economics, business or psychology) approved by the Trustee; provided, however, that only one such distribution shall be made to such child.

Without the provision in the last line, the child could go to successive graduate programs for the rest of his or her life, and each time receive an extra \$100,000. While clients may want their children and other descendants to pursue higher education, not many want to encourage a perpetual student. Moreover, many of our clients create multiple documents, each of which might create a trust for the same child. So, if the same language is included in an irrevocable life insurance trust, the husband’s revocable trust, and the wife’s revocable trust, when the child graduates from a graduate program, the child would receive \$300,000, which is not the clients’ goal. Therefore, in order to limit these types of rewards to only one distribution for each graduation or event, we add the following sentence to the above provision:

Notwithstanding any other provision of this trust agreement, if a distribution is made to such child for the same purpose from any other trust created by the grantor (or the grantor’s spouse), no distribution shall be made pursuant to this subparagraph for such purpose.

In addition to rewarding the achievement of specific goals, clients may want to have distributions made

in honor of certain events, for instance, birthdays, graduations and weddings. These distributions can be of a certain dollar amount or a certain percentage of the value of the trust. Both examples are demonstrated below:

On such child's birthday, the trustee of such trust shall pay over and distribute, outright and free of trust, \$100 to such child as a birthday present "from Aunt Anita." Upon such child graduating from high school, the Trustee of such trust shall pay over and distribute, outright and free of trust, \$1,000 to such child as a graduation present "from Aunt Anita." Upon such child obtaining a college degree, the Trustee of such trust shall pay over and distribute, outright and free of trust, one percent of the then remaining principal and undistributed income, if any, of such trust to such child as a graduation present "from Aunt Anita." Upon such child's marriage, the Trustee of such trust shall pay over and distribute, outright and free of trust, one percent of the then remaining principal and undistributed income, if any, of such trust to such child as a wedding present "from Aunt Anita."

In the example above, the client made the amount of the distributions reflect both the age of the beneficiary and the importance of the event. The beneficiary also received such distributions with the client's wishes, which recognition may be quite important to the client. The client's wishes can be embellished, either in this document or as part of an "ethical will." However, does this language encourage marriage or, at the very least, discourage a committed relationship that does not end in a "lawful" marriage? Care should always be taken to insure that whatever language is drafted, it does not unintentionally promote some sort of unintended behavior or discourage behavior that may be acceptable.

Another creative way to make a gift is to fund a beneficiary's retirement account. In this instance, the beneficiary's W-2 can be used constructively:

Each year following the death of the grantor, the trustee of such trust shall pay over and distribute from the then remaining principal and undistribut-

ed income, if any, of such trust an amount equal to the lesser of (i) such child's annual earned income as shown on his W-2 form and (ii) the maximum amount allowable by law to fund an individual retirement account (IRA) for such child's benefit. Such payment shall be made directly to the IRA custodian on behalf of such child.

This language can be further refined to include Roth IRAs, reimbursements for voluntarily contributions to 401k or 402(b) plans or nondeductible IRAs.

In addition to regular "gifts" to beneficiaries, a client may want to provide guidelines for financial support, for instance, including provisions to aid in the purchase of a home, the purchase of an automobile or the maintenance of a home for a young beneficiary. Here is one example we have used:

In addition to encouraging or discouraging the behavior of beneficiaries, clients sometimes want, at death, to replicate or reinforce their own lifetime behavior.

In addition, the trustee may (but shall not be required to) pay to or apply to or for the use and benefit of such child as much of the net income or principal or both of such trust, even to the extent of exhausting the principal, as the trustee, in his or her sole and absolute discretion, from time to time determines to be required for such child's medical and financial needs, including for the purchase of clothing, reasonable housing accommodations, a reasonable down payment on a house up to 20 percent of the purchase price of such house, but such down payment shall not exceed one percent of the trust assets (valued on the first day of the most recent calendar year), or to purchase an automobile no more often than every three years, but each such automobile purchase shall not exceed one-fifth of one percent (0.002 percent) of the trust assets (valued on the first day of the most recent calendar year). Notwithstanding any other provision of this trust agreement, if a distribution is made to such child for the same purpose from any other trust created by the grantor, no distribution shall be made pursuant to this subparagraph for such purpose.

The percentages or dollar amounts placed inside a document must be carefully considered. It was expected that the child's trust in the above example would have a value in excess of \$10M. So the down

payment would be \$100,000 and the automobile purchase would be no more than \$20,000. These numbers and percentages should be presented to the client in a manner that the client will be able to approve the dollar amount to be expended for the stated purpose. As another example, "Aunt Anita," the client above, included the following for a first time home purchase, only:

The first time such child purchases a residence, the trustee of such trust shall pay over and distribute from the then remaining principal and undistributed income, if any, of such trust an amount equal to the lesser of (i) five percent of the purchase price of such residence or (ii) 10 percent of the then value of such trust to be used for such child's down payment. Such down payment shall be made directly to the settlement agent to aid in such purchase.

In yet another example, the client had the beneficiary's trust undertake maintenance of a property until such time as the client felt the beneficiary ought to be able to do so himself:

So long as such child has not yet attained the age of 25 years, the trustee of such child's trust shall pay, from such child's trust, any and all expenses of the Florida condo, including, but not limited to, including, without limiting the generality of the foregoing, all real estate taxes, condominium fees and assessments, charges for utilities, water, sewer and fuel, ordinary and capital maintenance and structural repairs to keep the Florida condo in good repair, and all premiums for fire, casualty and liability insurance with respect to the Florida condo.

Alternatively, the trust could loan the money to the beneficiary to purchase a house, rather than making an outright distribution:

Notwithstanding the preceding provisions of this paragraph, the trustee may, in his or her sole discretion, loan such child the necessary down payment on a house rather than distribute outright to such child an amount equal to such down payment.

Some clients are then worried about what is going to happen with the money loaned or distributed to the child for the purchase of a house when the child

sells the house. Again, if these situations are not fully considered, it is possible for a child to buy and sell a house every year or few years, and keep the proceeds, including the original down payment, while having the trust expend additional money for another down payment for a new house. Consequently, an additional provision can be added that will require the child to either repay or reimburse the trust for the money distributed or loaned or to use the sale proceeds to purchase another house:

Moreover, upon the sale of any house purchased with a down payment funded from such trust, such child must either (i) use the gain, if any, on the sale of such house to purchase a new house or (ii) reimburse the trustee of such trust for such down payment and the gain, if any, attributable thereto.

Other behaviors that some of our clients have tried to encourage include engaging in community service. Here is an example:

Upon such child completing 100 hours of active, "hands-on" community service with Habitat for Humanity, or similar nonprofit organization, (hereinafter referred to as "the Community Service Requirement"), within three years following the death of the second to die of the grantor or the grantor's spouse, such trust shall terminate, and all of the trust assets shall continue to be held by the Trustees for the benefit of such child under the terms and conditions of paragraph C of this Section. Upon the disability of such child because of illness or any other cause, as determined by such child's attending physician and a second consulting physician, which reasonably prevents such child from completing his or her Community Service Requirement within three years of the creation of such trust, such trust shall terminate, and all of the trust assets shall continue to be held by the Trustees for the benefit of such child under the terms and conditions of paragraph C of this Section; provided, however, that if such disability is a temporary or minor disability (e.g., a broken leg), the Trustees, shall, in their sole discretion, determine whether such child made a reasonable effort towards completion of such child's Community Service Requirement prior to the onset of such disability, and accordingly, the Trustees shall, in their sole discretion, determine what percentage, if any, of the trust assets shall continue to be

held by the Trustees for the benefit of such child under the terms and conditions of paragraph C of this Section, and what percentage, if any, of the trust assets shall be deemed forfeited by such child for failure to complete such child's Community Service Requirement. Any assets so forfeited shall be paid over and distributed, outright and free of trust, to HABITAT FOR HUMANITY, of _____ for its general charitable purposes. If not sooner terminated, such trust shall terminate three years after the creation of such trust. Upon such termination, all of the trust assets shall be paid over and distributed, outright and free of trust, to HABITAT FOR HUMANITY, of _____ for its general charitable purposes.

Notice that, in the community service example, we have provided time limits for when the community service must be completed and what constitutes acceptable reasons for failure to complete such service and still receive an inheritance. We also provided an example of the type of preferred community service as well as what would happen in the event a child failed to fulfill his or her requirement, in this case forfeiture to a charity supported by the client.

Mr. Smith may say that everything sounds good so far, but what if John's wife divorces him and tries to obtain some of the funds in the trust. One possible solution is to impose the requirement that John have a prenuptial or postnuptial agreement before any distributions from the trust can be made to him. While this provision does not prevent John from giving his distributions to his wife, and does not prevent him from leaving her those funds that have been distributed to him, it would protect the assets in the trust from a divorcing spouse or other creditors.

Notwithstanding any other provision of this trust agreement, if such child is married, no distributions, whether discretionary or mandatory, shall be made to such child unless such child has a valid prenuptial or postnuptial agreement that states that such child's spouse will waive any rights such spouse has in the income or principal of any trust created hereunder or otherwise by the grantor for the benefit of such child.

Again, this type of provision can be changed to just prohibit any mandatory distributions, but still allow the trustee to make discretionary distributions.

By contrast, a client may want to discourage certain behavior by tying distributions to an absence of prohibited behavior. For instance, under no circumstances does Mr. Smith want John to receive any of Mr. Smith's hard earned money if John is abusing drugs. We have used the following language in similar circumstances:

Notwithstanding any other provision of this agreement, the trustee shall not make any mandatory distributions to such child, if the trustee, in his or her sole and absolute discretion, believes that such child is using or selling any illegal drugs, abusing any illegal, recreational or prescription drug or alcohol, engaged in criminal activity of any sort, is in jail, or on parole or probation after being convicted of a felony (and is still engaging in the activity that such child was convicted of) (hereinafter any of such activities are referred to as a "Prohibited Activity").

We have also had clients who wanted to ensure that a child would not be able to give any of the child's distribution from the trust to the client's ex-wife or members of her new family.

Notwithstanding the preceding provisions of this agreement, if at any time the trustee determines, in his or her sole and absolute discretion, that such child has used any of the money received from the trust created for his benefit under the provisions of this paragraph for the benefit of his mother, his step-father, or any issue of his step-father, then no distributions shall be made to such child from such trust for the 12-month period after such determination.

As a corollary to many of the examples cited above, it is critical that the trustee be given access to the beneficiary's medical information. Without such information, the trustee cannot make an informed decision regarding disability or drug use and such clauses are virtually unenforceable. Accordingly, we have included the following language in our documents where appropriate:

Accordingly, the trustee may, in his or her sole discretion, require that such child take a drug test, provide any evidence that such child is not engaged in a Prohibited Activity or provide any other documentation, including a release

for medical information under the Health Insurance Portability and Accountability Act of 1996 (HIPAA), before any mandatory distributions are made pursuant to any provisions of this trust agreement.

In addition to encouraging or discouraging the behavior of beneficiaries, clients sometimes want, at death, to replicate or reinforce their own lifetime behavior. For instance, suppose the client has a history of charitable giving and wants to continue such giving post-death. The client does not, however, want to “hardwire” his list of charitable beneficiaries in his documents, nor does he want to update his documents every year. The following provision works quite well to maintain flexibility while satisfying the client’s charitable intent:

Whenever it is provided in this will that property shall be disposed of as provided in (relevant paragraph number) such property shall be paid over and distributed, outright and free of trust, and in equal shares, (i) to those charities or tax-exempt institutions to which I gave more than \$100 during the last full calendar year of my life, which gift was deductible under Code Sec. 170, as indicated on the federal income tax return filed for the last full calendar year of my life and (ii) to a tax-deductible foundation or charity associated with those noncharitable or nontax-exempt institutions to which I wrote a check for more than \$100 during the last full calendar year of my life, even though such check is not tax deductible; provided, however, that any such check was not, in full or in part, for goods or services (other than for nominal premiums or incentives). Such gifts (of more than \$100 to charities or tax-exempt institutions and such applicable payments (of more than \$100 to noncharitable or nontax-exempt institutions. which have tax-deductible foundations or charities associated with such institutions are collectively hereinafter referred as “Charitable Gifts.” Notwithstanding the provisions of the preceding sentence, if the total amount of my Charitable Gifts in the last full calendar year of my life is less than 75 percent of my average annual Charitable Gifts in the preceding five full calendar years of my life, then, the charities and institutions designated as beneficiaries under the provisions of the preceding sentence shall be determined by the most recent calendar year in which the

total amount of my Charitable Gifts in such most recent calendar year is equal to or greater than 75 percent of my average annual Charitable Gifts in the preceding five full calendar years prior to such most recent calendar year.

Because this provision has a verifiable mechanism (*i.e.*, use of the client’s federal income tax returns) for determining the client’s intended beneficiaries, this clause should work.

Less likely to work is the situation we have faced in which the client wants to give money to friends rather than charities at death, again, with the list of friends changing over the course of the client’s life. We advise clients that a trusted fiduciary who will not lose his or her place in the client’s affections (*e.g.*, a child or sibling) may be the best way to achieve the client’s wishes, though we also caution the client that this type of provision may just allow the trusted fiduciary to give the money to his or her own favored friends:

Whenever it is provided in this will that property shall be disposed of as provided in (relevant paragraph), such property shall be paid over and distributed, outright and free of trust, and in such shares as determined by my personal representatives, to those family and friends selected by my personal representative.

Although the drafting language may not be precatory, it is certainly hard to enforce. As a result, we are more comfortable using this type of language with the distribution of personal effects rather than as a residuary clause or the distribution of a percentage or dollar amount. One way to limit the personal representative is to prohibit a distribution to the personal representative, any person ever related to, or ever employed by the personal representative, the personal representative’s estate, the personal representative’s creditors or the creditors of the personal representative’s estate. If the client insists on this type of language, we suggest including an *in terrorem*, or no-contest clause:

To the extent permitted by law, it is my intention, and I hereby direct, that any person who contests this will or any provision hereof, claims against this will or fails to dismiss any such contest or claim, shall *ipso facto* forfeit any rights, titles or interest such person has or may at any time have under this will in any property distributable hereunder, except for the sum of \$100.

Other language that is hard to enforce, but quite worthwhile to include in a client's documents involve his or her wishes concerning guardians and minor children. These include circumstances where the client wishes to impart his or her values, for instance, that a child be raised in a certain religion, or that a child keep in contact with all members of such child's family, or even the client's belief that an ex-spouse would not be the best choice as guardian. Many of these provisions may be almost impossible to enforce. However, sometimes declaring the intent and the values are very important to a client and by placing these provisions in a client's will or revocable trust, the personal representative or trustee may feel morally obligated to comply. Moreover, specifying that funds may and should be spent on a religious school or bar or bat mitzvah celebration may increase the likelihood that such events take place. The same is true for contact with family members. For instance, we have included the following language quite frequently, especially where close family members live outside the United States:

It is my intention and strong conviction that my children remain in contact with all members of their family. To this end, I direct my guardians to make whatever arrangements may be necessary for this to be accomplished, and I direct my trustees to pay all expenses that may be incurred consistent with this direction, including, but not limited to, the cost of any domestic or international travel for any child of mine to visit any relative. In addition, if my guardians and trustees, in their absolute discretion, determine that it is appropriate for them to do so, my trustees may pay the travel costs for any relative of a child of mine to visit such child. For all purposes of relatives of a child of mine shall include such child's siblings, grandparents, aunts and uncles and cousins.

Again, while it may not be possible to enforce a client's wishes in all circumstances, there is value in stating a client's desires. As estate planners, we can further aid our clients by including financial incentives for engaging in desired behavior and financial disincentives for engaging in undesirable behavior.

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