

Estate Planning

May- June 2026

by Louis A. Mezzullo

Incentive Trusts

Drafting trust agreements to carry out our clients' nontax objectives is probably more important to the client than the tax issues, and in many cases, it is more difficult for the drafting attorney. Clients depend on us to obtain the best tax results and to reduce administration expenses and avoid controversy, including litigation. But we have to depend on the client to inform us of what he or she wishes to accomplish from a nontax standpoint, and then we have to draft the provisions that accomplish his or her wishes.

Definition of Incentive Trust

For purposes of this Study, an incentive trust is a trust that provides for distributions of income or principal to the trust beneficiary or beneficiaries upon the occurrence of certain events that the beneficiary or beneficiaries control, such as graduating from college or starting a new business, or the withholding of distributions of income or principal because of the behavior of the beneficiary or beneficiaries, such as drug or alcohol abuse or failure to be gainfully employed. Consequently, an incentive trust, as opposed to a traditional trust, is designed explicitly to encourage or discourage certain behavior by the beneficiaries of the trust, as opposed to providing for the health, education, support or maintenance of the beneficiary or beneficiaries or completely discretionary distributions to the beneficiary or beneficiaries.

Reason for the Popularity of Incentive Trusts

Trusts have traditionally been used to hold assets of wealthy individuals for investment management purposes. In addition, trusts have been used for protecting the trust assets from the creditors of the beneficiary or beneficiaries and claims of the spouses of the beneficiary or beneficiaries. Lifetime trusts have been used to avoid probate. Trusts have also been useful in achieving transfer tax savings. Finally, trusts have been a means of reducing income tax on income generated by assets held by the family by diverting it to more than one taxpayer.

In recent years, individuals who have achieved significant wealth accumulation because of their entrepreneurial successes or employment opportunities, but who were reared in less than wealthy families, have become concerned about the effect of the transfer of significant wealth to their children and more remote descendants. These concerns are exacerbated by the desire to preserve the assets from the beneficiaries' creditors and spouses. This concern has been expressed well by Warren Buffet, who said he wanted to leave enough to his children so that they could do anything they wanted, but not so much that they could do nothing. This concern is also evidenced by wealthy individuals, such as Bill and Melinda Gates, who have expressed the desire to leave substantially all of their assets to charitable organizations.

What is the Real Purpose of the Client in Creating a Trust?

Of course, there are the traditional reasons, such as: professional investment management; protection from creditors; protection from spouses; and protection for spendthrift beneficiaries. But, in reality, the primary objective in setting up trusts for children and grandchildren in many cases is to replicate what the parents would do if they were alive. The client needs to spell out his or her objectives as clearly as possible. The client also needs to make clear what characteristics the client wants to elicit from the beneficiary and how these objectives can be effectively administered.

Studies[®]



Montecito
Bank & Trust[®]
Wealth Management

1106-E Coast Village Road
Montecito, CA 93108

Trying to convert these objectives to a written trust agreement is almost an insurmountable task. The person drafting the agreement (or, as discussed below, an attachment to the agreement or a memo setting out the grantor's wishes) must elicit from the grantor (and usually the grantor's spouse) just exactly how they want the trustee to administer the dispositive provisions in the agreement, putting a premium on empathy.

TRADITIONAL TRUSTS

Types

Many individuals create trusts that are designed to qualify for the estate tax marital deduction but restrict the right of the surviving spouse to the income or principal of the trust.

An estate trust qualifies for the marital deduction because the assets remaining at the surviving spouse's death pass to his or her estate. However, the surviving spouse may be restricted with regard to his or her access to income or principal during his or her lifetime. Of course, the surviving spouse will have the power to determine where the remaining assets in the trust will go through his or her will.

A qualified terminable interest property trust (QTIP trust) provides for the payment of trust income at least annually to the surviving spouse and that no distributions can be made during the lifetime of the surviving spouse to anyone other than the surviving spouse; at the death of the surviving spouse, the remaining assets will pass as directed by the first spouse to die. Such a trust accomplishes the objectives of the first spouse to die to provide for the surviving spouse, to defer the payment of estate tax by qualifying for the marital deduction, and to control the disposition of any remaining assets at the death of the surviving spouse.

A life income/general power of appointment trust provides that the income will be payable at least annually to the surviving spouse and gives the surviving spouse either a lifetime or a testamentary general power of appointment (or both) over the assets. Because this type of marital deduction trust permits the surviving spouse to determine where the assets in the trust will go either during lifetime or at death, it does not accomplish the objective of the first spouse to die to control the disposition of the assets remaining at the death of the surviving spouse.

A charitable remainder trust with the surviving spouse as the beneficiary of the annuity or unitrust payment provides for the surviving spouse during his or her lifetime and qualifies the surviving spouse's interest for the marital deduction and the remainder interest for the charitable deduction at the death of the first spouse to die. While this

type of trust does provide for the surviving spouse during his or her lifetime and accomplishes the charitable objectives of the first spouse to die, it does not provide flexibility in the event that the surviving spouse needs more than the annuity or unitrust payment during his or her lifetime in order to continue in the same standard of living enjoyed before the death of the first spouse to die. A similar objective could be obtained by using a QTIP trust with a charitable remainder beneficiary. In this case, the remainder interest, although included in the surviving spouse's estate, would qualify for the estate tax charitable deduction in the surviving spouse's estate, and the surviving spouse could receive distributions in excess of the income if necessary.

Bypass trusts have been used to park the first spouse to die's applicable exclusion amount (\$15,000,000 in 2026) during the lifetime of the surviving spouse or—where there are sufficient other assets to provide for the surviving spouse—to provide for the children or other beneficiaries of the first spouse to die. Where there is concern that the surviving spouse may need the assets in the bypass trust, the surviving spouse is generally the primary beneficiary of the bypass trust. Because of the large amount of the applicable exclusion amount, more individuals will be concerned about providing for the surviving spouse under the bypass trust. For example, leaving the applicable exclusion amount to beneficiaries other than the surviving spouse may effectively disinherit many surviving spouses.

In situations where the husband and wife are happily married, the bypass trust generally provides for income payable to the surviving spouse and gives the surviving spouse lifetime and testamentary special powers of appointment and the right to withdraw principal for health, education, maintenance and support. Many commentators would advise against the automatic payment of income to the surviving spouse but instead would give the surviving spouse the right to withdraw the greater of 5% of the value of the trust assets or \$5,000 each year, so that to the extent that the surviving spouse did not need the income from the assets in the bypass trust, the income would be accumulated and would pass estate tax-free to the remainder beneficiaries upon the surviving spouse's death. Some clients may wish to terminate the spouse's interest if he or she remarries, which is, as a practical matter, a disincentive for the surviving spouse to remarry and may not be what the client really wants.

As a result of the so-called portability provision of Tax Relief, Unemployment Insurance Reauthorization, and Jobs Creation Act of 2010, clients may feel that a bypass

trust is no longer necessary. However, bypass trusts still have many benefits. Using a bypass trust would exclude from the survivor's estate any increase in the value of the assets in the trust plus income on the assets. Note that the deceased spousal unused exclusion amount is not indexed for inflation. Because portability does not apply to the GST tax exemption, using a bypass trust uses the unused GST tax exemption of the first spouse to die and preserves the assets for the surviving spouse. The use of a reverse QTIP election would accomplish the same purpose, but this would involve just about as much complexity as a bypass trust.

Using a bypass trust will preserve the deceased spouse's unused exclusion in the event the surviving spouse remarries or the applicable exclusion amount is reduced. A bypass trust may be necessary to use a state's estate tax exemption. Using a bypass trust also provides the traditional benefits of an irrevocable trust, including: protection from creditors; protection from the rights of future spouses; professional management; and preserving assets for children of the deceased spouse's prior marriage.

The use of a bypass trust also avoids the problem with the last deceased spouse requirement. Even though the bypass trust has been established by a former spouse, the surviving spouse could remarry and then have the benefit of the new spouse's unused exclusion amount if the new spouse died before the surviving spouse, thereby obtaining the first deceased spouse's unused applicable amount through the bypass trust and the second deceased spouse's unused applicable exclusion amount by electing portability. In many states, because a revocable trust is often used to avoid probate, adding a bypass trust will not involve significant costs.

A trust designed to be exempt from the generation-skipping transfer (GST) tax, sometimes referred to as a dynasty trust, is often recommended for those individuals or couples who have significant assets or who have children who have significant assets and therefore do not need to receive additional assets from their parents. A dynasty trust is generally designed to last for the maximum period permitted by the rule against perpetuities in a particular state, which could be as long as three generations. In addition, in states that have eliminated the rule against perpetuities or extended the period, a dynasty trust could last for more than three generations. Such a trust places a premium on the provisions dealing with naming the successor trustees. It also requires more thought with respect to provisions dealing with distributions.

In addition to trusts generally exempt from the GST tax because of the allocation of the individual's generation-

skipping transfer tax exemption, many wealthier clients establish *trusts for the benefit of each grandchild* that are designed to qualify for the GST tax annual exclusion. Such trusts require that the only beneficiary of the trust be a skip person (such as a grandchild), and that, if the trust does not terminate while the skip person is alive, the assets be includable in the skip person's gross estate. Generally, the skip person is given a testamentary general power of appointment over the assets, such as the right to appoint the assets to the creditors of his or her estate, to cause the assets to be included in the skip person's estate. These trusts can be designed to last past the death of the grandchild by giving the grandchild a testamentary power of appointment limited to creditors of the estate and taking advantage of the grandchild's unused GST exemption to establish a wholly GST tax-exempt trust at the death of the grandchild.

Distribution Provisions

A traditional trust may provide for the payment of the income to one or more beneficiaries. A trust designed to qualify for the marital deduction, other than an estate trust, must provide for the payment of the income at least annually to the surviving spouse. Income may be required to be distributed annually to qualify the trust as a Qualified Subchapter S Trust (QSST).

A traditional trust may also provide for the payment of principal to one or more beneficiaries. The payment of principal can be in addition to the payment of income, and it may be made pursuant to a standard or a discretionary power. A typical standard used for transfer tax purposes is the so-called "ascertainable standard" that provides for distributions for the beneficiary's health, education, maintenance or support. Such a standard enables a beneficiary to have the right to make withdrawals for such purposes without having the assets in the trust included in the beneficiary's estate. In addition, a beneficiary may also serve as the trustee of a trust that provides for distributions for the beneficiary's health, education, maintenance or support without having the assets includable in the beneficiary's estate because the power to make distributions to himself or herself pursuant to such a standard is not a general power of appointment.

The trust agreement may provide that the trustee should consider other sources of income or support when deciding to make distributions under the standard. If the trustee has complete discretion, a beneficiary should not also be a trustee unless he or she is prohibited from exercising such discretion for his or her own benefit, unless restricted by an ascertainable standard. Distributions of both income and principal may be payable pursuant to a standard. Distributions of both income and principal may

be completely discretionary. In this case, subject to the trustee's abuse of discretion, a trustee could not be sued for withholding distributions from a particular beneficiary or for making distributions to a particular beneficiary. Some states do not subject the exercise of a wholly discretionary distribution power held by a trustee to a reasonableness standard.

Advantages and Disadvantages of Traditional Trusts

Because the use of traditional trusts is common and understood by practitioners, the drafting and administration of such trusts is generally not perceived to be difficult. The transfer and income tax consequences of the use of traditional trusts are fairly well-settled. On the other hand, the use of traditional trusts may not carry out the client's intent to encourage specific behavior by beneficiaries. For example, does a client generally want to provide for the support and maintenance of a healthy adult child? Even in the case of a discretionary trust, the trustee may not have the guidance to assist him or her in determining when to make distributions of income or principal.

INCENTIVE TRUSTS

Behavior to Encourage

Education, which may be broadly defined to include not only college but also private secondary education, post-graduate education, professional schools and other types of schooling, including vocational schools. *Industry*, in other words, hard work. *Service to society*, such as pursuing a career as a teacher, social worker, college professor or artist. *Stewardship*, which involves building and preserving the trust assets for future generations. *Philanthropy*, which can be accomplished through private foundations, charitable trusts and donor-advised funds.

Behavior to Discourage

Consumption, which may involve postponing the time when the beneficiary is entitled to assets outright. *Sloth*, which is related to consumption, but more focused on preventing a beneficiary from abstaining from any productive activity. *Self-destructive behavior*, such as drug abuse, alcohol abuse or criminal behavior. *Charity*, which may seem contradictory to the statement above concerning encouraging philanthropy, but in this context it usually means discouraging the beneficiary from contributing to charities that are not favored by the parents or grandparents, such as a religious cult.

Typical Provisions

Provisions to encourage specific behavior.

An incentive trust may provide that a beneficiary is

entitled to an annual distribution equal to the amount the beneficiary earns each year, as evidenced by a W-2 form or other evidence, perhaps up to a certain dollar amount, such as \$100,000 or \$200,000. The beneficiary may be entitled to distributions only if gainfully employed, or only if he or she maintains a certain grade point average in college. Distributions may be made upon certain events, such as graduation from college. The beneficiary may be entitled to a distribution to enable him or her to open a professional practice or to establish a business; again the distribution may be limited to a specific dollar amount. A female beneficiary who is married and has minor children may be entitled to periodic distributions, such as \$10,000 per month, if she refrains from active employment.

Provisions to discourage certain behavior.

Distributions may be withheld from a beneficiary who refuses to receive periodic drug tests. Distributions may be withheld from a beneficiary who is abusing alcohol or drugs. Distributions may be withheld from a beneficiary who refuses to enter into a premarital agreement before marriage. Distributions may be withheld from a beneficiary who has moving traffic violations during a particular year.

Advantages and Disadvantages of Incentive Trusts

Incentive trust provisions can generally be designed as bright-line tests so that a trustee knows exactly when a beneficiary is entitled to a distribution. A beneficiary knows exactly when he or she is entitled to distributions from the trust. It eliminates the beneficiary having to persuade the trustee to make distributions, which can result in a feeling of lack of control. Money incentives have generally been determined by researchers not to be effective in encouraging the desired behavior, and in many cases reward behavior the beneficiary was likely to engage in anyway.

As circumstances change, the incentive provisions may no longer operate to achieve a desirable result. Incentives may work unfairly if not properly drafted or coupled with discretionary distribution provisions. For example, distributions based on how much a beneficiary earns may discourage a beneficiary from pursuing certain careers, such as teaching school. In addition, such a provision may disinherit a beneficiary who becomes physically or mentally incapable of being gainfully employed. Women with children may want to continue their careers.

PRODUCTIVITY TRUSTS

For purposes of this discussion, a productivity trust is a trust described in the article by Marjorie J. Stephens, an attorney in Dallas, Texas, published in Volume 29, No. 1, Summer 2003, of the *ACTEC Journal*, titled "Incentive

Trusts: Considerations, Uses, and Alternatives.” The productivity trust is based on Marjorie’s analysis of research concerning the effect of incentive trusts on influencing the behavior of beneficiaries.

Productivity trusts are designed to engender self-efficacy in an individual, i.e., the person believes he or she has control over his or her life. Albert Bandura, in his book *Self Efficacy: the Exercise of Control*, and other researchers, have found that a high sense of self efficacy is a better predictor of career selection and success than actual ability, prior preparation, achievement, and level of interest. “A high sense of self-efficacy contributes significantly to the development of intellectual abilities and to academic achievement, advancement in one’s career, reemployment after a job loss, tenacity in the face of problems, creativity, and management of certain types of job stresses, to name a few.” “Sounds exactly what a client wants for their children.” Taken from Marjorie’s article in the *ACTEC Journal*.

Contrast extrinsic motivation from intrinsic motivation. The latter is what the client is really trying to achieve, although he or she can only apply extrinsic motivation. Control is essential in achieving intrinsic motivation. Knowledge is a key element in achieving the sense of control over one’s life. This includes knowledge of the factors over which one cannot control. Participation in the process is an additional important element in instilling intrinsic motivation.

Productivity trusts take into account the development of an individual as he or she grows older (and hopefully matures). According to Marjorie, the research indicated that the most critical period is between ages 20 and 40. Once an individual reaches age 40, outside influences are not likely to change his or her habits, personality or behavior. This does not mean that when an individual reaches age 40, he or she is capable of handling funds; it just means that it is unlikely that money incentives will change how he or she behaves or manages money.

Marjorie also bases her concept of the productivity trust on the seven habits of a highly effective person, as described in Covey, Stephen R., *The 7 Habits of Highly Effective People: Powerful Lessons in Personal Change*, New York, Simon & Schuster, 1989. The trustee should be proactive and not reactive, as in the case of an incentive trust where a certain act occurs and then a certain response follows. In addition, the beneficiary should participate in the decision-making process so that he or she can exercise some control.

The client—and if possible, the entire family—should decide the objectives that they want accomplished through the trust, which can be memorialized in a mission

or purpose statement. The beneficiary’s needs and desires should be the focus of the trust and the beneficiary should play a role, if appropriate, in the development of the distribution guidelines. By involving beneficiaries in the decision-making process, a win-win situation develops where the beneficiary participates in the decision-making process, but the result continues to be subject to the purposes of the trust. The trustee and beneficiaries need to communicate with each other. By involving the beneficiaries, the administration of the trust will benefit from a team approach. Finally, periodic review and revision of the guidelines will keep the trust functioning efficiently as originally intended.

Provisions of Productivity Trust

The productivity trust would be similar to traditional trusts, except that distributions of income and principal would be discretionary. The trust agreement would contain a mission or purpose statement, which would be based on the philosophy or desires of the creator of the trust. The mission or purpose statement could only be changed by the grantor while alive and competent.

The creator of the trust would also provide guidelines for the trustee to use in exercising the trustee’s discretionary authority, designed to carry out the mission or purpose statement. The guidelines would be in a separate document and would be subject to amendment as circumstances change, and the amendment process would involve adult beneficiaries. The trust agreement would also require that information about the trust, including the current value of the assets in the trust, be given to adult beneficiaries. Under § 813 of the Uniform Trust Code, a trustee is required to keep qualified beneficiaries informed about the administration of the trust and of the material facts necessary for them to protect their interests.

The trust would also provide for one or more committees, depending upon who was named as the trustee. If there are no corporate trustees, an administrative committee would be established to administer the trust and would include various professionals, such as a CPA, a financial or investment advisor, and an attorney. There would be a trust committee that would include one or more beneficiaries in addition to the trustee or trustees and members of the administrative committee if there were no corporate trustees.

There would also be regularly scheduled meetings of the trustee and the beneficiaries to keep the beneficiaries informed and to deal with requests for distributions. The trust agreement would provide for mediation, followed by binding arbitration should mediation not prove successful in resolving the conflict. Perhaps a majority of the

beneficiaries could decide to litigate the issue instead. There would be a procedure to amend the trust to take into account changes in the law, although the mission or purposes statement would not be amendable. Because of the use of guidelines to provide flexibility in the event of changed circumstances, including the ability to change the guidelines from time to time, amendments should not otherwise be necessary.

Advantages and Disadvantages of the Productivity Trust

The productivity trust would provide for flexibility in the event of changing circumstances. The productivity trust would involve the beneficiaries, not only in amending the guidelines as needed, but also in the administration of the trust and, perhaps, in the naming of successor trustees.

A premium would be placed on the naming of capable trustees to ensure that the trustees were able to carry out the intent of the creator of the trust. Although the mission or purpose statement would be in the trust agreement, the guidelines would be in a separate document that was hopefully not legally binding on the trustee. Some commentators have argued that such guidelines could be treated as part of the trust agreement and therefore legally binding. In addition, they argue that the guidelines might be subject to disclosure to the beneficiaries.

However, in most cases, the beneficiaries should be informed of the guidelines anyway. If the grantor wants to inform the trustee of problems with one or more of the beneficiaries to assist the trustee in exercising the trustee's discretion—such as the fact that the beneficiary has a drug problem or is financially irresponsible—this information could be placed in a separate document. It would be hoped that a court would not require the trustee to reveal this information to a beneficiary. For a discussion of this issue, see Bove, "The Letter of Wishes: Can We Influence Discretion in Discretionary Trusts," 35 *ACTEC Journal* 38 (2009). Because there would not be bright lines for making distributions, the trustees may be susceptible to being sued by disgruntled beneficiaries.

DISCRETIONARY TRUSTS

In General

A completely discretionary trust for purposes of this outline is a trust where the trustee has complete discretion with respect to distributions of income or principal. A completely discretionary trust differs from a productivity trust only in the sense that the mission statement would not be contained in the trust agreement and some of the more formal requirements for meetings, etc., would not be included. Consequently, there would be no provisions

in the trust agreement that could be used by a disgruntled beneficiary to challenge the exercise of discretion by the trustee.

Again, some commentators have argued that a memo or letter setting forth the grantor's wishes could be treated as part of the trust agreement. See the earlier discussion of this issue, particularly the possibility that a beneficiary could get a court to require the trustee to disclose the memo or letter to the beneficiary. As discussed below, for the discretionary trust to best carry out the grantor's wishes, the adult beneficiaries should be involved in either establishing the guidelines or keeping them current, particularly after the grantor's death. At a minimum, they should be informed of the guidelines.

Mission Statement

When a purely discretionary trust is to be used, it is important for the family to adopt a mission statement, but the mission statement would not be contained in the trust agreement itself. Like the productivity trust, the creator of the trust, usually a parent, would establish guidelines for the trustee to follow with respect to making discretionary distributions of income and principal, which would be contained in a memo or a letter to the trustee. Subsequent changes to the guidelines could be made by the creator of the trust and perhaps the adult beneficiaries. After the creator's death, subsequent changes to the guidelines could be made by the adult beneficiaries, with or without the approval of the trustees.

Important Provisions in a Completely Discretionary Trust

Exculpatory provisions, relieving the trustee of liability for exercising his or her discretion should be included in the trust document. Such a provision may eliminate a trustee's liability in cases where the trustee perhaps should have been liable, putting a premium on naming the proper person or persons to serve as trustee.

Compensation provisions should provide that the trustee who is playing such an important role in the financial affairs of the family is properly remunerated.

Successor trustee provisions should be included to ensure that there is always a proper trustee. Usually this can be achieved by giving the current trustee or trustees the right to name his or her or their successors. In many cases, it will be appropriate to give adult beneficiaries the right to remove the current trustee or trustees and appoint successor trustees, although certain requirements may be included to ensure that the successor trustee is qualified and trustees are not subject to inappropriate pressure from the beneficiaries with regard to the exercise of their discretion.

The use of *in terrorem* and payment of litigation costs clauses may be advisable. Even though in many states an *in terrorem* clause—which provides that if any beneficiary challenges the discretionary authority of the trustee, the beneficiary will lose his or right to distributions—may not be enforceable, the mere existence of such a clause may discourage such attacks on the trustee’s exercise of discretion. A provision requiring that any beneficiary who brings an action against a trustee pay any litigation costs in the event that the beneficiary is unsuccessful may also discourage unwarranted attacks on the trustee’s exercise of discretion. A provision providing for arbitration or mediation may also prevent unnecessary litigation expenses.

Advantages

The completely discretionary trust perhaps provides for the greatest degree of flexibility. Also, the completely discretionary trust, with the proper trustee, mission statement, and guidelines, may achieve the desired objectives of the creator of the trust with regard to influencing the behavior of the beneficiaries. Such a trust may come closest to accomplishing the most important goals of the creator—a replication of what the creator would do if alive.

Disadvantages

The completely discretionary trust puts a premium on the identity of the trustee. The completely discretionary trust may result in litigation over the trustee’s exercise of discretion. Although the trust agreement would be clear that the trustee’s discretion was not subject to review by the courts, the courts may nevertheless intercede when the trustee’s exercise of discretion is challenged by the beneficiary or beneficiaries. As discussed earlier, the beneficiaries may be able to force the trustee to disclose any precatory instructions that the creator provided to the trustee.

**Louis A. Mezzullo is Of Counsel with the International Law Firm of Withers Bergman LLP. His areas of practice include estate planning, business succession planning, and planning for distributions from qualified benefit plans and IRAs. He has written 14 books and numerous articles on these subjects. He also serves as an expert witness in the areas of his practice, including malpractice cases. He is past president of the American College of Trust and Estate Counsel, past chair of the American College of Tax Counsel, and past chair of the American Bar Association Section of Real Property, Trust and Estate Law. The author acknowledges that some of the material concerning Incentive Trusts was inspired by an outline by Howard M. McCue, III, "Guiding (Controlling?) The Children and Grandchildren: Planning and Drafting to Influence Behavior," 34th Annual Philip E. Heckerling Institute on Estate Planning, Miami Beach, Florida, January 10-14, 2000.*