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The next generation of family members: **what's new?**

# MOTIVATING CHILDREN OF MEANS

Beth D. Tractenberg, partner at Katten Muchin Rosenman LLP, explains how to plan to avoid *affluenza*.

**An issue faced by families across the board is how to transfer wealth to younger generations without causing them to lose the incentive to work and be productive. This overriding concern cuts across cultures and geographical locations. While it is undeniably a great advantage for a young person to know that he or she will never have to worry about money, parents worry that this knowledge and readily available funds may create a lack of motivation to become a contributing member of society. It is one of our greatest challenges to provide guidelines to govern how and when assets may be transferred to the younger generation which will be flexible enough to be appropriate in all circumstances, many of which cannot be anticipated, but will not de-incentivise the recipients.**



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Most individuals opt to plan for transfers to take place over the long-term by using trusts, many of which may potentially last forever. Those trusts must be planned and structured carefully to provide the flexibility to manage unforeseen circumstances. Many clients begin the planning process with ideas of detailed instructions to be drafted into the trust in order to encourage their children and grandchildren to work, complete a certain level of education or otherwise become productive members of society as measured by an objective standard. One frequent initial request is that trust distributions be limited to the amount that a beneficiary earns from a job.

However, when asked to consider whether they would like their child who is a hedge fund manager to be able to receive distributions of \$10m per year while limiting their child who is an elementary school teacher to \$40,000 per year, clients realise that this limitation does not work the way they had envisioned. Similarly, a requirement that a trust beneficiary graduate from a four-year college course before receiving distributions may not be appropriate, as a beneficiary may be developmentally challenged and not able to attend college or may decide to attend culinary or another specialised school.

Experience suggests that black and white limitations regarding access to trust fund assets to address the issue of motivating trust beneficiaries is not the most effective approach, although this conclusion is somewhat counter-intuitive. In fact, drafting a trust that grants the Trustees very broad discretion provides the most flexibility and ability to adapt to any and all circumstances. Although initially clients may not be comfortable with this approach, there are many safeguards and controls that may be layered onto the trust which can provide for years of beneficial distributions to generations of beneficiaries, while precluding distributions that can dampen a beneficiary's motivation.

One of the most effective methods of guiding the Trustees' exercise of discretion is for the Settlor to provide what is called a "Letter of Wishes" to the Trustees. This document is a statement written by the Settlor which contains his or her guidelines to the Trustees on any number of issues, such as the family philosophy as to the proper work ethic, standard of living as well as types of circumstances in which the Trustees should be particularly liberal or strict in considering trust distributions. The Letter



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of Wishes may be quite detailed and may even give specific dollar amounts that the Settlor wishes to set as the maximum for annual distributions until the beneficiaries reach certain specified ages. The Letter of Wishes may be updated as often as the Settlor desires. While the Letter contains only “wishes” and not binding instructions, it is invaluable in assisting the Trustees in exercising their discretion. It may also be shown to the beneficiaries to support the Trustees’ decisions and frequently serves to tamp down a beneficiary’s chafing at Trustees’ limited distributions. The Trust may provide that after the Settlor’s death, another family member may have the right to provide Letters of Wishes, unless the Settlor requests that only his or her wishes be considered by the Trustees.

A significant control that can and should be drafted directly into the trust instrument is the Settlor’s (and after his or her death, the Settlor’s spouse’s and then possibly the beneficiaries’) right to remove and replace and replace the Trustees. By so empowering these named individuals, if the Trustees are not conforming to the family’s values, a replacement Trustee can be named. Caution must be exercised though in determining to what extent to give the trust beneficiaries a power to remove and replace Trustees, as it would not be desirable to allow the beneficiaries to use this mechanism to gain greater access to the trust assets than the Settlor desires. This might be the case if, for example, a beneficiary could remove the Trustees and replace them with good friends who would do the beneficiary’s bidding. For this reason, a beneficiary’s power might be limited to provide that he or she may only remove a Corporate Trustee and replace with another Corporate Trustee.

Another alternative which provides control over a trust with broad discretion granted to the Trustees is to name a Trust “Protector”. The Protector is not a Trustee but is an independent person who safeguards the trust and its operations and assets. The Protector is usually granted certain very specific and limited powers, such as the power to remove and replace Trustees either before or after the Settlor’s death so that the beneficiaries do not have too much power over the assets. The Protector might also be given the power to veto distributions or to add or remove beneficiaries. In a very real sense, the Protector can be seen as standing in the shoes of the Settlor for some purposes, although the Protector is not controlled by the Settlor.

**“drafting a trust that grants the Trustees very broad discretion provides the most flexibility and ability to adapt to any and all circumstances”**

Choice of Trustees is another important way for the Settlor to make sure that the broad discretion granted will work as desired so that trust distributions will be adjusted appropriately to take into account changing circumstances. Generally when a trust is to last in perpetuity, a Corporate Trustee is selected. While many clients may initially be reluctant to name a Corporate Trustee stating that they don’t like the idea of a “stranger” making decisions as to their family and their assets, where a trust is anticipated to be in existence for generations, a Corporate Trustee provides continuity and certainty that there will be a Trustee in place over the years. Corporate Trustees also provide valuable services in providing



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» necessary “back office” services, such as tax return preparation and book-keeping. Clients can then appoint one or more individual co-trustees who know the family. Those individual Trustees can provide the “personal touch” that clients frequently desire. The corporate Trustee can also sometimes serve a very useful function in saying no and being “the bad guy” when difficult requests for distributions are made by beneficiaries, thus relieving the individual Trustees from being in an uncomfortable position.

Many clients are particularly concerned that if a trust specifies distributions at particular ages there will be a built-in mechanism to prevent such allocations if a beneficiary is suffering from an issue that would be exacerbated by the receipt of a large cash influx. For that reason, it is generally advisable if a trust is not purely discretionary, and may be desirable even if the trust is purely discretionary, to include what may be referred to as “best interests” language. That language states that if, for any reason, when considering making either a mandatory or a discretionary distribution, the Trustees think such a distribution would not be in the beneficiary’s best interests, they should refrain from making the distribution until such time as it would be in the beneficiary’s best interests. The trust instrument can give examples of the type of situation as to which the Settlor is particularly concerned, such as substance abuse, an ongoing divorce, inability to manage money, problems with creditors or not being employed full-time. Although where a trust is purely discretionary, Trustees should take these factors into consideration when deciding whether to make a distribution, sometimes clients prefer to spell out situations that would warrant special concern.

Where clients provide some or all of the safeguards discussed above to bolster and oversee the decision-making process of the Trustees, discretionary trusts can serve the purposes of Settlers in motivating future generations, while providing for their comfort well-being. The flexibility stands the family in good stead for generations to come. ■



**Beth D. Tractenberg** is a Partner at Katten Muchin Rosenman LLP, New York. She advises high net worth clients, family offices and family enterprises on estate planning, and cross-border tax planning; including succession planning for closely held businesses. Beth’s practice balances intra-family dynamics with efficient tax planning.