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WRMarketplace

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The *WRMarketplace* is created exclusively for AALU members by experts at Greenberg Traurig and the AALU staff, led by Jonathan M. Forster, Steven B. Lapidus, Martin Kalb, Richard A. Sirus, and Rebecca Manicone. *WRMarketplace* #17-39 was written by Greenberg Traurig Shareholder Jonathan M. Forster.

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TOPIC: Mandatory or Discretionary Trusts – Which, When, and Why?

MARKET TREND: The use of trusts as a creative way to encourage certain desired behaviors in trust beneficiaries is becoming more common in legacy and life insurance plans.

SYNOPSIS: A chief concern of many senior family members is that transferring wealth to the next generation may create disincentives or disrupt the lives or work ethic of younger family members. Trusts, when properly structured, offer an ideal solution to this concern. By basing distributions upon a beneficiary's attainment of certain goals (graduating from college, matching a salary, buying a house, starting a business), trusts can transfer a legacy to the next generation while still encouraging responsibility and ambition. Instinctively, families may feel that these "incentive" distributions should be required, so they implement "mandatory trusts" to direct these distributions. Yet, mandatory trusts can have unintended consequences, including the loss of creditor protection (including in divorce proceedings) and untimely taxation. "Discretionary trusts," however, provide non-binding incentive guidance and offer greater flexibility for distributions to a beneficiary based on the family's objectives.

TAKE AWAYS: Both mandatory and discretionary trusts can encourage trust beneficiaries to engage in responsible behaviors or attain desirable goals. In most cases, however, discretionary trusts offer the same advantages as mandatory trusts, while providing additional benefits, such as enhanced creditor protection, tax deferral, financial stewardship, and flexibility to adapt to future circumstances. As these considerations are particularly important for long-term, multi-generational planning, families should strongly consider using discretionary trusts when crafting their legacy plans.

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A chief concern of many senior family members is that transferring wealth to the next generation may create disincentives or disrupt the lives or work ethic of younger family members. Trusts, when properly structured, offer an effective solution since they can provide a legacy to the next generation while also motivating beneficiaries with incentive distributions for taking certain actions or attaining certain desirable goals. When implementing this planning, families must decide whether the incentive distributions should be mandatory or discretionary. Understanding the advantages and disadvantages associated with each can help in selecting the best option.

MANDATORY TRUSTS

Mandatory trusts ***require*** distributions to trust beneficiaries of certain amounts (such as all trust income), for certain purposes (e.g., health, education, maintenance, and support), upon the occurrence of certain events (such as attaining a specified age) and/or the achievement of specified goals (like graduating from college). They remove any trustee discretion with regard to distributions by forcing the trustee to take action regardless of the circumstances.

Why Use: Mandatory trusts assure families that their beneficiaries will receive distributions without relying on the "kindness" of a trustee, which may be especially important if the trustee does not have a close relationship with the family (often an issue with corporate trustees or with dynasty trusts over time). Also, where a corporate or professional trustee is involved, mandatory distributions remove these decisions from a trustee's administrative approval protocols, which can delay, limit, or completely prevent distributions. Mandatory trusts also may be more suited to smaller and/or short-term trusts that are expected to terminate during a beneficiary's lifetime (such as an "age 21" trust for a grandchild).

What to Consider: If mandatory distribution provisions are not clearly drafted, they can lead to disputes and potentially costly litigation to determine if a beneficiary has achieved the stated goal and right to the distribution. For example, does graduation from college include a two-year community college, an on-line degree, or a vocational school? The incentives also may not operate as anticipated. A trust that requires matching salary distributions may discourage a beneficiary from pursuing a career in certain rewarding or worthwhile fields because they provide lower salaries and thus lower distributions (e.g., social workers, teachers, employees of charitable organizations).

Mandatory trusts also do not provide flexibility to adapt to changing circumstances or to time distributions so they are in the best interests of the trust or the beneficiary for investment, tax, and/or personal reasons. Further, mandatory trusts curtail creditor protection for trust assets. Since the beneficiary is entitled to certain distributions, the beneficiary's creditors can reach those assets often as soon as they come due. Finally, the trustee of a mandatory trust often needs court approval to modify or adjust a trust containing fixed distributions, when the trustee normally could engage in a ***non***-judicial trust decanting. The court approval process can be long and expensive, consuming trust assets and delaying distributions.

DISCRETIONARY TRUSTS

Unlike mandatory trusts, discretionary trusts authorize, but do not require, the trustees to make beneficiary distributions at specified times, for select purposes or achievements, and/or for any reason in a beneficiary's best interest.

Why Use: Discretionary trusts can incentivize trust beneficiaries to achieve desired goals while providing the trustee with the flexibility lacking in mandatory trusts. A discretionary structure is generally well-suited to perpetual, "dynasty" trusts, since it can (1) let trustees adapt to changing circumstances and beneficiary needs, (2) provide enhanced creditor protection, and (3) improve management of the trust's portfolio, gain/loss realization, and income taxes in terms of timing and amount of distributions.

What to Consider: With fully-discretionary trusts, families may have concerns that the trustee holds to much control over the trust assets to the detriment of the beneficiaries. Corporate and professional trustees also may be far more conservative in exercising the discretion to make distributions than a family desires. As distributions are not required, beneficiaries also cannot depend on receiving certain amounts at certain times, which may make it difficult for them to plan financially. Further, if beneficiaries receive unequal distributions, it may create resentment and conflict among family members.

BEST OF BOTH WORLDS

There are solutions to this trust dilemma that combine the benefits of mandatory and discretionary trusts while minimizing family concerns:

1. **Guidance to Trustees**. Trust creators (grantors) can create discretionary trusts and still provide significant guidance to the trustee regarding their intentions for discretionary distributions (including the desire for distribution equalization or distributions at certain ages or upon certain events). While the grantor can incorporate this precatory guidance directly into the trust instrument, a separate letter of wishes to the trustees may be preferred, as the grantor may modify the letter over time. Although non-binding, if clearly communicated, trustees generally will seek to follow this guidance as long as it does not violate their fiduciary duties to the trust or the beneficiaries.

2. **Bifurcation of Duties**. If a family wants further assurances that discretionary distributions will be made as desired, they can bifurcate the trustee duties, appointing a distribution trustee or advisor who has sole authority over trust distributions. In this manner, families can appoint someone close to them to exercise discretion over distributions, while allowing a professional or corporate trustee to handle investment and/or administrative duties.

3. **Withholding Powers**. Finally, families who still want mandatory distributions in the trust (perhaps to ensure children will get a certain amount outright at a specified age) may want to provide the trustee with the discretion to withhold or redirect the distribution depending on the then existing circumstances. For example, if the beneficiary is having marital issues or is struggling with substance abuse problems,

the trustee could be given discretion to withhold the distribution until the issues are resolved (e.g., the beneficiary is in recovery) or to apply the distribution to pay for services to help the beneficiary or the beneficiary's family.

Case in Point: Mark and Isabelle, both age 47, are married with three children, ages 17, 14, and 9. They are creating an irrevocable life insurance trust benefiting their descendants, which will acquire substantial, permanent life insurance coverage on their lives. Mark and Isabelle are very concerned with minimizing the adverse impact of wealth on their children, especially if they both pass while their children are relatively young. However, they also want to ensure that their children have some financial independence and opportunities to explore and take certain risks (such as traveling the world, starting a business, etc.). To balance these concerns, the advisor suggests a fully discretionary trust with a non-binding letter of wishes to the trustee that expresses Mark and Isabelle's intentions.

Mark and Isabelle's letter asks that the trustee focus distributions primarily on a beneficiary's health and education until he or she attains age 25. The letter clearly defines "education" to include any type of secondary or primary school (including private), accredited college (including on-line), vocational or arts school, graduate school, and similar. Among other items, the letter includes guidance for distributions for a beneficiary's travel, for starting a business, and for buying a house. It also requests that a beneficiary receive $50,000 (indexed for inflation) upon the earlier of graduating from college or attaining age 25, for use to get "started in life." Finally, the letter strongly recommends that the trustee not make any distributions if a beneficiary is engaged in "undesirable behavior," such as substance abuse, criminal activity, violent behavior, etc., with the distribution either being withheld until the behavior is resolved or re-directed to help pay for recovery services for the beneficiary or assist family members who may depend on that beneficiary.

TAKE AWAYS

Both mandatory and discretionary trusts can encourage trust beneficiaries to engage in responsible behaviors or attain desirable goals. In most cases, however, discretionary trusts offer the same advantages as mandatory trusts, while providing additional benefits, such as enhanced creditor protection, tax deferral, financial stewardship, and flexibility to adapt to future circumstances. As these considerations are particularly important for long-term, multi-generational planning, families should strongly consider using discretionary trusts when crafting their legacy plans.

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