Why You Can't Always Trust Incentive Trusts

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Illustration by Jon Krause

INCENTIVE TRUSTS, WHICH TIE payouts to specific goals or punish certain behaviors, have been around for as long as trusts have been in existence. However, Susan Gell Meyers, a Grand Rapids, Mich.–based trusts and estates attorney with Warner Norcross & Judd, has witnessed during the past few years a spike in the number of clients interested in this particular type of trust.

That doesn't mean they're necessarily well suited for today. Incentive trusts are highly contentious, can engender deep-seated resentment, and may trigger unintended consequences. "It's not an end-all or a Band-Aid," she says, adding, "Done poorly, they can be an absolute disaster."

Charles Lowenhaupt, a tax and estates lawyer, and chairman and CEO of wealth management firm Lowenhaupt Global Advisors in St. Louis, goes further: "They're damaging, not helpful. We've been in the business for 108 years...I've never seen incentive provisions working."

Our advice: Think long and hard before you add explicit behavioral conditions to any trust. Rather than tie up your trust—and trustee—in knots, draft your trust document in the broadest possible language. Choose your trustee wisely and empower that individual with maximum flexibility, allowing him or her to make decisions in the beneficiary's best interests. The standard trust distribution term of art—"health, education, maintenance, and support"—should be adequate to arm a professional trustee with enough clout to prevent, or at least minimize, damaging conduct, and to underwrite good.

So why the current attraction of incentive trusts? Meyers suggests that a combination of factors may be in play: First, there's the unprecedented transfer of trillions of dollars of wealth as baby boomers die. That's coupled with the internet, which gives individuals more knowledge of these trusts.

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John Burke, a financial advisor whose firm is based in Iselin, N.J., adds a third reason—the current opioid epidemic. The motivation for his clients in establishing incentive trusts has been "where there's a family member with addiction problems," he says, describing conditions where a beneficiary must be clean or in a drug-treatment program to gain funds.

Lowenhaupt nixes this use. "You don't solve addiction by throwing money at it or taking money away from it," he says.

Trusts should be written for longevity and flexibility. Incentive trusts often fail to anticipate what can happen to a beneficiary personally and in the world at large.

Situations change, as do societal norms and mores. Decades back, some trusts contained provisions that blocked funds if a beneficiary married outside his or her religion, ethnicity, or race. Those would be considered abhorrent now, not to mention legally unenforceable.

Job-related incentive criteria can create a particularly slippery slope. Some high-net-worth individuals want to demand that children hold down jobs or don't rely solely on trust funds for income. But how about stay-at-home parents or missionaries?

Some of these requirements can be onerous; others are relatively benign. Meyers drafted one trust requiring the beneficiary to attend a course on financial stewardship.

But be careful about where positive support ends and coercive pressure begins. Providing funds for, say, starting a business or buying a house isn't considered an incentive trust; a strict condition that no funds can be distributed unless a beneficiary starts a business or buys a house is.

Trust grantors' rationales for their giving can be written as side letters, sometimes called ethical wills or legacy letters. They aren't legally binding.

When advising her clients, Meyers says, "Let's include statements of your intentions as to the purpose of the trust, but let's not state these in terms of hard-and-fast rules." ■