

Protecting and Preserving the Family: The True Goal of Estate Planning

Part I - Reasons and Philosophy

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"Try not to become a man of success, but rather become a man of value,"

Albert Einstein

In this era of tax avoidance it often seems that the guiding goal of estate planning has become to "*pass as much wealth to the next generation, as tax-free as possible*". However, clients are increasingly concerned that the passage of their wealth may do more harm than good to their family.

The tax-driven goal subtlety suggests that protecting the family assets is the primary goal of an estate plan. Clients and planners have begun to recognize that this is a misplaced emphasis which focuses attention on assets rather than family, on structure rather than perspective, on tax savings over family need. When "*protecting and preserving the assets*" is the (often unstated) primary goal, the emphasis is on structures which preserve the assets from taxes and/or family misuse. When "*protecting and preserving the family*" becomes the beginning point, the planning must deal with difficult family issues which might have been ignored - to the ultimate detriment of the client's family.

This new perspective was captured most succinctly by Warren Buffett in 1986 *Fortune* article: "*[The perfect inheritance is] enough money so that they feel they could do anything, but not so much that they could do nothing.*"

THE CHANGING LANDSCAPE

There are a number of elements causing the change, including the following:

Increased Wealth. There has been an explosion of wealth in this country in the last two decades. Boston College researcher Paul Schervish estimates that, by the year 2050, between \$41 and 136 trillion will have passed by gift or inheritance. It is not just the wealth, but also the demographics of that wealth (and related perspectives and implications) which are driving the revolution. In a study by US Trust, A Portrait of the Affluent in America Today, it noted that only 10% of today's millionaires inherited their wealth. The average millionaire comes from a middle class or lower background and worked his or her way through college.

Reduced Estate Taxes. The last two decades saw significant reductions in estate taxes. The 2001 tax bill provides for the elimination of the estate tax in 2010 and higher exemption amounts until 2010. However, unless the elimination is re-enacted before January 1, 2011, the current transfer tax rules will be reinstated. Will the estate tax be eliminated after 2011? As discussed in an article at my website www.scrogginlaw.com the continued elimination is highly unlikely. However, significant estate tax exemptions will probably remain for the foreseeable future, reducing the tax confiscation many parents expected and increasing the concerns about too much wealth passing to family.

Charitable Involvement. During the 1990s wealthy clients have tended to increase their charitable bequests more than their family inheritances. According to Paul Schervish at the Social Welfare Research Institute at Boston College: "*A growing number of wealthy Americans are shifting their financial legacies from heirs to charity.*" According to Mr. Schervish from 1992 to 1997 the value of charitable bequests went up 110% while bequests to heirs only grew 57% and for estates above \$20 million, charitable bequests went up 246% while heirs only received 75%. Increasingly, these wealthy citizens are not just giving to charity, they are making sure the funds are handled

in ways they approve. Clients are also increasingly encouraging their children's involvement with charitable activities.

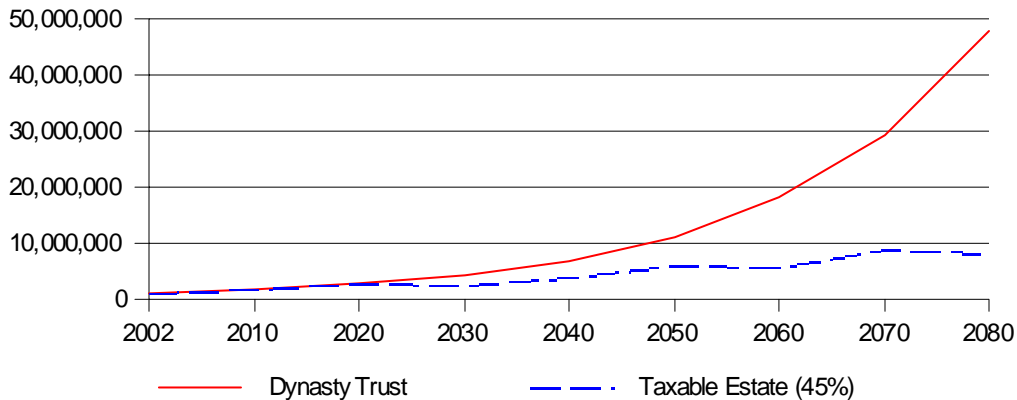
Dynasty Trusts. There has been an explosion of Dynasty Trusts in America. Why does a dynasty trust make sense? Assume a trust starts with \$1,060,000 in 2002 and grows at a 5% rate per year. It assumes that every 25 years, a generation dies. The lower line shows the tax impact (assuming the family did not spend the funds to support a lifestyle) over 78 years. Instead of losing 45% of the estate to a confiscation tax every 25 years, the dynasty trust continues to grow. In 77 years, almost \$48 million is held in the Dynasty Trust versus \$7.9 million held by the family.

The Dynasty Trust creates an inevitable issue: What will be its impact on future generations? Assume a great-grandson has a right to 10% of the above Dynasty Trust in 77 years. With a 5% return per year, his annual income for the rest of his life is almost \$240,000. When his father tries to convince him to go to college, the son's response is: "Dad, I have a quarter-million a year coming to me - Why do I need to go to college? Why do I need to work?" While there are significant economic reasons to create a Dynasty Trust, many clients have not addressed the long term psychological impact of such a trust on their families.

The Legacy. Increasingly clients are focusing their attention on their legacy. A 1992 study showed that almost 20% of the people who inherited as little as \$150,000 quit working. A 1999 Neuberger Berman study showed that 44% of the persons polled indicated they would quit work if they received a sizable inheritance. The above study by US. Trust noted that 91% of the women and 80% of the men expect their children to support themselves entirely from their own earnings. These perceptions are impacting the planning process.

Conflicts. From both their personal experiences and from frequent articles in the media, clients have seen horrible conflicts erupt among family members. Many clients have an abiding desire to establish structures which minimize the points of conflict and provide mechanisms to resolve family conflicts.

Dynasty Trust vs Taxable Estates



Asset Protection. Clients are increasingly examining estate planning approaches which provide for asset protection. States are adopting statutes which make it easier for clients to use trusts to restrict the claims of creditors. Asset protection is also focusing on the potential claims of divorcing spouses. For example, more than 40% of first marriages end in divorce. Clients are also reviewing how to protect their heirs from the expectation of divorce.

Governmental Programs. Two demographic imperatives are pressing governmental social programs and causing Congress to adopt tax benefits for taxpayers who can afford to privatize their retirement and long term care needs. Not only are the number of US citizens age 65 and older expanding rapidly, but people are also living longer. According to Social Security Administration by 2037 the system will be bankrupt. Some reports expect an earlier bankruptcy. Medicare may be insolvent by 2008.

There really is not an invested account for social security participants. The federal government has already spent the money and given the Social Security Administration an IOU. As long as the collected social security taxes exceeded the paid-out benefits, the IOU was relatively benign. However, somewhere around 2015, the government will have to start paying into the social security system - paying off its IOU. This cost will place additional stress on the federal budget and may cause Congress to reexamine how benefits are paid. Many people think the result may be a system which is more “needs-based” than the current system. Contrary to the general perception, social security benefits are not guaranteed. In Flemming v. Nestor, (363 U.S.603 (1960)) the Supreme Court ruled that Congress retains the ability to reduce or even eliminate benefits at any time. For an excellent review of this issue see: Andrew G. Biggs, “Social Security. Is it a Crisis That Doesn’t Exist?” Cato Institute, October 5, 2000 (SSP No. 21).

As a result of these demographic imperatives, clients are increasingly concerned about both their own and their heirs’ abilities to rely upon governmental benefits to provide some minimum level of support. Estate plans are beginning to reflect these concerns.

GENERAL PERSPECTIVES

In order to understand why these changes are so important, there are some basic perspectives which the planner must understand. First, while children with debilitating mental or physical disabilities are often treated differently in the estate plan (e.g., assets held in a supplemental needs trust), healthy children are generally treated as equals in most estate plans. Clients and planners have not delved into the personalities of heirs, or into their spending habits, or into the stability of their marriage, or into their relationships with other family members, or health, drug or alcohol problems. These largely psychological issues have not usually been perceived to be within the normal purview of the attorney’s drafting responsibility. Unpleasant experiences by clients or their friends are creating such evaluations in the planning process.. In many cases, a psychologist may be a part of the planning. The larger the potential inheritance, the greater the need to address these issues.

Second one of the basic laws of science is that change is never neutral. Every change creates an reaction. So too does an inheritance. Any inheritance will change behavior. The central question which must be addressed is how to encourage the change to be positive rather than negative. It is simplistic and potentially damaging to think that the best approach is to simply ignoring the impact.

Third, inherent in this new perspective is that values count. Any discussion of protecting family leads naturally to the issue of values and character. Phrases such as “drafting to influence behavior” or even “values based planning” recognize that values are at the core of this new perspective, but unfortunately provide critics of values an easy target. While values lie at the heart of this planning, the goal of the client should not to preserve his or her values, but to preserve the family - the two are not identical. For example, a plan which punitively demands today’s societal values 100 years from now, will probably prove destructive to the family. Just as the US Constitution was intended to be a living document to preserve the Union, this planning must include enough flexibility to adapt and change over time.

Contrary to some critics of this perspective, influencing the behavior of heirs have always been a part of the estate planning process. For example, placing assets marital assets in a QTIP trust by its nature will influence the behavior of both a surviving spouse and the remainder beneficiaries of the trust. Placing assets in a trust for children to delay their ownership of the funds beyond age 21 will influence the life decisions of the children.

Values based planning is not a single planning device or tool. Instead, it devises a plan designed to protect and preserve the family as the first priority of the plan. The concept does not focus on taxes. The tax structure is then built around the family’s intentions. It is not that the two ideas are in conflict. Rather, the priority of asset preservation, must come second to protecting the family. “Protecting the family” must by its nature take into account the unique personalities and family situation (e.g., multiple marriages) of each family. Because no two families are identical, the plans tend to be unique for each family. Moreover, the planning process does not necessarily begin at death. Having a family member or friend mentor an heir in financial responsibility should begin

in the early years of the heir's development, not when the heir reaches age 21.

Last, at its core this planning deals with a major psychological issue: how do we define ourselves as people? As Solomon said thousands of years ago: *"Whoever loves money never has money enough; whoever loves wealth is never satisfied with his income. This too is meaningless. As goods increase, so do those who consume them. And what benefit are they to the owner, except to feast his eyes on them?"* Ecclesiastes 5:10-11. Katherine Gibson of the Inheritance Project has said: *The guilt and shame of inheriting wealth increases with each generation. The farther a generation is from the initial creation of wealth, the greater the guilt and shame become."*

PERSPECTIVES ON INFLUENCING BEHAVIOR

- There are certain criteria which should be addressed in this planning:
- X The approach should be calculated to create opportunities and incentives, not provide an unearned lifestyle to future generations. As with any plan such an approach will create its own problems. A detailed "risk-reward" evaluation should be made of each proposed opportunity or incentive to determine if the potential new problems outweigh the expected benefits.
 - X An attempt to influence behavior should encourage responsible behavior rather than punishing unacceptable behavior. For example, a provision which denies all trust benefit to a alcohol or drug addicted heir may be too punitive. Instead, the denial might be predicted upon the heir refusing treatment for his or her addiction, with the trust agreeing to pay for such treatment.
 - X The behavior that is being influenced necessitates careful drafting. For example, if the desire is to encourage people to attend college, drafting a trust which says '\$20,000 a year to my daughter as long as she is in college' may not be sufficient. The \$20,000 might be used to pay for a wild lifestyle.
 - X The behavior that is being influenced should be encouraged rather than paid for. If the attempt is to pay someone to do something he or she would not otherwise want to do, it will tend to be resented.
 - X Drafting to influence behavior must account for the fact that behaviors that are currently acceptable or unacceptable may change over time. Therefore, the behavior which is attempting to be influenced must be flexible enough to accommodate future technological, personal and sociological changes. For example, some day it may be that a computer chip is inserted into the brain as a part of our educational process. If the plan only provides for college education and does not allow some potential changes, this technological change might never be funded. Of course, that assumes you might want computer chips in the brains of your heirs.
 - X The approach must be well-drafted to protect the heirs and trustees. The US Constitution has survived as a living document because of the checks and balances built into it. So too, any planning which restricts an inheritance must include checks and balances to avoid abuses.
 - X The approach must allow some degree of discretion in the judgment of trustees, so that other factors that were not anticipated can be accounted for in the process. It is simply impossible to contemplate and draft for every possibility. Trustee discretion can allow for an unexpected results.
 - X The drafting approach must not be too restrictive. The more restrictive the approach, the greater the likelihood that either a need will exist outside of the permitted approaches, or that the approach will be seen as ruling from the grave.
 - X The approach must involve a recognition of the heirs as they are and as they may become in the future. Heirs are individuals not equals. People change over time and the plan must accommodate such unknown changes.
 - X The approach should provide at least some minimum level of family protection, such as basic medical, educational, and long term care.
 - X The plan should be one part of the larger estate plan. For example, providing enough assets to heirs to provide them life opportunities, coupled with assets placed in more restrictive vehicles (e.g., family partnerships) may be the best approach. Except in unusual fact patterns, placing all assets in restrictive trusts may just create more family conflict.
 - X In almost every instance it makes sense to discuss with the heirs the manner in which their inheritance will be handled. Death of a loved one is traumatic enough without the shock of finding out you are not

inheriting what you expected.

IS IT APPROPRIATE?

One of the most frequent criticisms on restricted inheritances or drafting to influence behavior is that it is a blatant attempt of existing generations to rule from the grave, by mandating that their value systems govern the behavior of future generations. The critique is fundamentally philosophical and takes many expressed and implied forms.

As a starting point remember the above quote from Warren Buffett: Mr. Buffett's goal is not to rule his heirs' lives from a musty, worm eaten grave. Rather is it to aid them to do whatever they want to do in their lives. The key is that they do something, not nothing.

"The parents did a bad job, now they want to do from the grave what they could not do during life." There is some truth in this statement. Many of today's millionaires survived the depression, went off to World War II, and came home determined to make a better life for their children. Now, many wonder whether they just spoiled their children and are concerned that their wealth will create an even greater negative legacy. However, the truth of the issue only supports the need for restricted inheritances. Having spoiled their children, do you just throw in the towel, with the expectation that the combination of their poor parenting skills and passage of wealth will only magnify the personality defects in their children? The goal of a restricted inheritance is not punitive, rather it is designed to place reasonable constraints which foster positive actions. It may not work with the first generation, but perhaps succeeding generations will benefit.

"Parents are paying their heirs to do what they think is important." Paying an heir to do something they do not want to do is courting disaster. For example, paying a mother to stay at home with a child when she wants to work outside the home may hurt both the mother and child. Instead, restricted inheritances may be designed to provide incentives which provide enough money to encourage people to make positive decisions. For example, providing \$5,000 annually to a college student with a B average is not enough to "pay" him to go to school, but it may sure provide encouragement. The key is that the payment is geared to a level which encourages, but does not pay for the desired activity.

"The Specter of a Boney Hand Reaching Out of the Grave Creates a Visual Image." It is without doubt a great visual image, but it is also a distorted one. Restricted inheritances should not be structured as a mechanism for a control freak to micro-manage the lives of his or her family from the grave. Rather, it is a means for a caring parent to provide opportunities and incentives to a family, without incurring the harmful aspects of wealth.

Moreover, as discussed above restrictions on an inheritance are a fundamental part of any estate plan. This is merely a question of degree.

In many cases, a beneficiary's personality foibles and defects are magnified as an unintended result of an inheritance. Wealth is a powerful tool, but as with anything powerful, its unrestricted power can be devastating. If a client knows something stands a good chance of harming the family, is the client more or less responsible by placing limitations on the source of the harm? What is the worst that may happen to their families? They might have to make it on their own - not such a bad thing.

"It is wrong to try and use the client's values to influence the behavior of future generations." Virtually everything done in the estate planning process influences behavior. It is naive to think that an inheritance has a neutral impact. The central question which must be addressed (particularly when dealing with more remote heirs) is how sensibly and **positively** try to influence the character of future generations. Not dealing with the issue is perhaps the worst legacy a client can leave for his or her heirs.

This criticism basically carries with it the perspective that one person cannot and should not place their value systems on another. However, it ignores the simple fact that one of the primary parental responsibilities is to mold the character of the children. That responsibility does not cease just because someone reaches age 18 or 21.

Many restricted inheritances are flexible enough to provide benefits to children whose character is already well developed (children in their 30's) by providing current income to children and incentive-based programs for grandchildren whose character is yet to be developed.

“Just Trust the Children.” Many critics say that placing restrictions on wealth creates a psychological issue of parents not trusting heirs. What critics fail to recognize is that the impact of this perceived “lack of trust” may be less significant than the impact of an unfettered inheritance. Moreover, in most cases it is not a “lack of trust,” but concerns about the reality of an unearned wealth which drives the process. The children may resent not being able to spend Mom’s wealth, but restricted inheritances may also require them to develop the ambition to make it themselves.

“It’s the Kids Money.” This implied criticism underlies many of the questions about restricted wealth transfers. It inherently states the children have some vested ownership in their parent’s assets. But it is not the kids’ money and a parent has a responsibility to protect his or her family from any danger which he or she perceives may hurt the family.

Fundamentally, the question ends up being a choice of alternatives, none of which will be perfect:
Disinheriting family (in whole or part) to avoid the negative impacts of inherited wealth,
Giving it all to family with the hope it will not harm them, or
Educating the family in the right values and designing a system that provides them enough money to do anything, but not so much to do nothing.

THE RESULT

As a result of the changing landscape, clients are examining their estate plans in an entirely different light. The wealthy client often has four goals for his plan:

- X First, the client wants to protect his or her family from ever being **DESTITUTE**. Many of these clients have been destitute and recognize how hard it is to drag yourself out of that hole.
- X Second, they want to provide **OPPORTUNITIES** to their family. They hope their descendants will take those opportunities and mature into productive citizens because of their ambition
- X Third, they do NOT want to provide a non-working **LIFESTYLE** to their heirs. As Andrew Carnegie said (as he gave his wealth to public libraries and charity): *“The parent who leaves his son enormous wealth generally deadens the talents and energies of the son and tempts him to lead a less useful and less worthy life than he otherwise would.”*
- X Finally, they want to minimize **INTRA-FAMILY CONFLICTS**. Family is more important than an inheritance and they want structures which take into account real or potential conflicts.

Estate planners will have to increasingly address each of these issues in the coming years. One of the more uncomfortable aspects of this approach is that standard forms will no longer be as helpful. Many documents will have to be client-specific. This may result in both higher fees and a cost-based counter balance to this growing revolution.

This article has discussed the reasons for the revolution. The perspectives given are clearly debatable, but should be useful for providing a framework for the on-going debate. The next article will discuss some the planning techniques which support these changes.

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Protecting and Preserving the Family: The True Goal of Estate Planning

Part II - Some of the Tools

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“Whoever loves money never has money enough; whoever loves wealth is never satisfied with his income. This too is meaningless” Ecclesiastes 5:10

“Just as ramifications of poverty can be devastating, so there are ramifications of affluence. It’s becoming epidemic.” Psychotherapist Henry Stein, reported in Forbes, June 19, 1995.

In the first article, we discussed some of the underlying reasons and philosophies for the changing nature of estate planning. The article pointed out that many wealthy clients are examining their estate plans with four primary goals for their heirs:

- X The client wants to protect his or her family from ever being **DESTITUTE**.
- X They want to provide **INCENTIVES and OPPORTUNITIES** to their family. They hope their descendants will take those opportunities and become productive because of their own sweat and blood.
- X They do NOT want to provide a unearned, non-working **LIFESTYLE** to their heirs. Giving a heir an unearned healthy annual income often takes away ambition and self worth.
- X Clients want to minimize **INTRA-FAMILY CONFLICTS**. Family harmony is more important than an inheritance.

The manner in which the clients address these issues are driven by the client’s family situation (e.g., spendthrift children, bad marriages or handicapped children), their assets (e.g., a family business), the client’s values and the particular concerns each client (generated by his or her personal experiences) has for family. The combination of these factors are unique to each family. So too, the planning process and planning structures are normally unique to each family.

This article will address some of the possible techniques. This article is designed to give planners the flavor of how the techniques can be structured. However, in a short article, it is impossible to address all of the available approaches.

Three preliminary points should be noted. First, the techniques discussed are generally not new concepts. The difference is in the emphasis and use of the technique to meet non-tax objectives. Second, this approach first focuses on the manner that a client will dispose of his or her assets. After the dispositional structure of a plan is designed, the tax structure can be adopted and sometimes modify the manner in which the client intends to dispose of the assets. This article will focus on dispositional issues, not tax issues. Last, the various techniques discussed can have multiple purposes. For example, a generation skipping trust can be drafted to provide a safety net to family members and minimize transfer taxes (while creating incentives for education and charitable work), but restrict the ability of future generations to live a lavish, unearned lifestyle.

UNDERSTANDING THE NATURE OF AN ASSET.

To understand many of the planning alternatives, the planner needs to understand the basic nature of each asset. Virtually any asset has four primary components which can be appropriately divided in the planning process. These components are:

- X **Control** - Often the most important element to the client is the ability to control the asset. For example, even when he makes gifts to family members of company stock, a closely held business owner generally wants to retain control of the business decisions (e.g., the payment of income and benefits, or employing

family members). A general partner owning only a 2% interest in a family limited partnership may still control the operations of the partnership, but may not have a significant portion of the allocated income, current equity, or future appreciation generated by the partnership's assets. The trustee of a generation skipping trust controls the trust, but normally is prohibited from using trust assets for his or her personal benefit.

- X Income - In many cases, the donor wants to retain the right to receive income and other present benefits from the asset. For example, the recipient of a charitable remainder annuity trust has a right to income, but does not share in the current equity, or future appreciation. In a residential GRIT, the present enjoyment of the residence may be enjoyed by the grantor, while future appreciation is passed to the heirs. A generation skipping trust may provide an income right to a spendthrift child, while restricting his or her ability to control the trust assets.
- X Current Equity - The current equity value of the asset (i.e., what the owner would receive if the asset were sold) is the third element. While a general partner may control a family partnership with a 2% equity share, the vast majority of the partnership's current equity value is normally owned by the limited partners.
- X Future Appreciation With effective transfer tax rates ranging from 41-50% (in 2002), a major part of tax planning is moving future appreciation out of the estate to avoid an increasing transfer tax burden and the resulting liquidity demands.

The proper division of these four basic components is at the core of virtually all planning strategies. If clients can understand these parts, they may make the difficult decisions that planning requires.

THE BASICS

Perhaps the single worst thing a client can do to his or her family is fail to provide for death or incapacity. At a bare minimum virtually every client should do the following basic documents:

A Will or Will Substitute. If a person dies intestate, state statutes list which relatives will receive the person's assets. For example, if a Georgia resident dies with a surviving spouse and two (2) children, the children and the spouse may each inherit a one-third interest. If a person dies intestate, children may have access to inherited assets by age 21 - long before they may have the maturity to handle the funds. By drafting a will that provides for a trust for children, distributions can be delayed until the children have the maturity to handle the funds. The greater complexity of intestate estates can create more conflicts (e.g., who gets the family business), delays and hardships to the family and create higher legal fees.

General Powers of Attorney. As Americans live longer, incapacity is becoming a growing issue. Every client should consider executing a durable general power of attorney. In many states the instrument can provide that it only becomes operative upon the client's incapacity. This avoids giving the power holder broad authority when the client can still act. Using a power of attorney in lieu of guardianship can reduce the expense (e.g., cost of a bond and attorney's fees), time delays, court oversight and transactional restrictions existing on guardians.

Living Will In Cruzan v. Director, Missouri Dept. of Health (110 S.Ct. 2841 (1990)), the U.S. Supreme Court ruled that to be taken off life support (including intravenous nourishment and fluids), the person must have declared his or her desire before becoming incapacitated. A March 1994 study in the Archives of Internal Medicine reported that having a living will or medical power of attorney saves more than \$60,000 per patient in their final stay in the hospital. Without providing for a specific right to withdraw nourishment and/or hydration, state law may require that the client be kept on such life sustaining treatment.

Medical Power of Attorney. A living will is simply a declaration not to use life sustaining measures. A health care power of attorney (also called a medical power of attorney) gives someone the power to make all medical decisions upon the maker's incapacity, and may include the withdrawal of life support. By using a medical power of attorney, the client can reduce the costs, delays and court supervision of court ordered guardianship. Moreover, if the client only has a living will, the doctors, not the family, may ultimately have legal authority to

withdrawal life support. If the client is concerned about specific decisions the agent may make, review using a detailed, grid-based "medical directive" which can be obtained by going to www.Medicaldirective.org.

Providing Information to Your Family. Perhaps the most frustrating and time consuming aspect of dealing with the disability or death of a family member is the lack of necessary information. For example, the author has developed a form which provides basic information to the family if the client become disabled or dies. See www.Scrogginlaw.com for a copy of this "Family Love Letter." Clients should also be encouraged to create notebooks containing copies of important insurance, asset, estate and family documents, including the name, address and phone number of the principal advisors.

REDUCING CONFLICTS

One of the worst tragedies in the estate planning process is children who twenty years after their parent's death are barely talking, because of fights over insignificant assets or over real or mis-perceived abuses. One important legacy that a parent should leave is disposing of assets in a manner designed to minimize potential family conflicts - **LEAVING A LEGACY OF RELATIONSHIPS RATHER THAN A LEGACY OF CONFLICT.** This perspective should be at the core of any estate plan. While the planner will never be able to eliminate all family conflicts, careful planning can reduce the possible sources of conflict.

Personal Property Dispositions. The attention paid to personal property after its owner's death is often disproportionate to both its focus in the pre-death estate plan and its appraised value. For example, we had a client who ten years before her death told her son that he would receive an old grandfather clock. A few months before the client's death she promised the clock to her daughter. After the mother's death, the son started to take the grandfather clock out of the house and the children got into a fistfight over the clock, breaking the clock in the altercation. Today they barely speak to each other. To minimize these conflicts, there are a number of things which clients should consider, including:

- X Disposition List. To the extent the client wants a particular asset to go to a particular person, the client is best advised to provide a legally enforceable document that passes that particular asset (defined with specificity) to the particular heir. This is especially important when assets are being transferred to more remote heirs (e.g., family friends or remote cousins).
- X Family Discussions. Clients should be strongly encouraged to talk to their children about which assets they want to receive upon the parents' death. This discussion may reveal any potential ownership conflicts. Because the parents resolve the conflict, any long term damage in the children's relationships may be minimized.
- X Document Ownership. Clients should document the ownership of their assets. For example, if a daughter has loaned her mother a china cabinet, it needs to be documented that the cabinet belongs to the daughter. In the absence of such contrary information, it will be presumed that it belonged to the person in whose home it was found. If a married couple has children from prior marriages, they might create a notebook with pictures of their important assets, noting the heir who will receive the asset. Each spouse should sign a document irrevocably relinquishing the right to the other's assets, except where a written statement is signed by both.

Choice of Decision Makers. The choice of decision makers is one of the most important determinations a client can make. These choices can either avoid or create conflict. In selecting fiduciaries and power holders, the client often does not focus on the potential for conflict. It is the advisor's responsibility to focus the client's attention on avoiding a structure which breeds conflict. For example:

- X Choosing a person to make medical decisions for the client if the client is incapacitated. The use of a highly emotional family member is likely to breed problems in the family.
- X Choosing a person to make property and asset decisions for the client if they are incapacitated. A son who despises his step-mother may not make a good choice.
- X Choosing who will take care of minor children. Because clients cannot bequeath their children, the decision can be attacked by other family members. The client should address this issue directly by telling family

members who has been selected to raise the children. If there are strong reasons that certain family members should not obtain custody (e.g., a history of child or alcohol abuse), the client may want to create documents (in a form submittable to the court) apart from the will (i.e., to limit public disclosure) reflecting why the client did not want those family members to obtain custody. Moreover, we generally advise clients not to use the same person as guardian and trustee. This reduces the possibility of real or perceived self dealing by the guardian/trustee.

- X The choice of trustee is one of the most important decisions a client can make, especially for discretionary trusts. Choosing a estranged child as a co-trustee with a step-mother is not advisable. The choice of a trustee for minor beneficiaries should include an evaluation of both their financial management capabilities and, hopefully, their ability to mentor the child in financial responsibility.

Ownership of Family Businesses and Properties. Even though 90% of American's businesses are family owned, 70% do not survive the second generation and less than 5% survive to the third generation. This low survival rate is due to a combination of family conflicts and the confiscation of family business from an estate tax that takes 41-50% of the business's value. In the course of my practice, the author has found two consistent certainties in estate planning for businesses which might be added to Mr. Franklin's quote: "*But in this world nothing can be said to be certain, except death and taxes.*". Both certainties assume that the owner of a closely held family business has family members who may continue to operate the business after the current owner's retirement or death. If the owner instead desires to "cash out" by selling or liquidating the business, these realities cease to be an issue.

- X First Reality: "***The businesses' equity value is not an asset. Rather it is a liability waiting to happen.***" When the business owner intends to pass a business to family members, the equity value provides no significant benefit to the owner. In most cases, when the issue is properly addressed, the owner is interested in control of the entity and its income more than the equity value. Using readily available planning approaches (e.g., deferred compensation, family partnerships and trusts), the income and control of the business can be separated from the equity, and then the equity can be passed at a reduced tax cost to family members using various valuation adjustment techniques (e.g., minority and lack of marketability adjustments). By retaining ownership to death, the owner loses the ability to not only discount the present value of the business, but also causes the family to pay estate taxes on the appreciated value of the business.

- X Second Reality: "***Conflicts are inevitable between operators of the family business and family members who are outsiders.***" Many entrepreneurs intend to pass down their businesses to designated heirs who will run the business after the entrepreneur's death or retirement. But because the business is often the largest single asset of the estate, the owner may also pass ownership in the business to other family members. During the owner's lifetime the owner has been able to make sure that there is peace in the family and serve as the "benevolent dictator" of the family business. Unfortunately, this powerful role disappears with the entrepreneur's death or incapacity. Conflicts inevitably develop, particularly between those who operate the business and those who are outside the business.

* The outsiders feel that the compensation and perks provided to the insiders are "excessive." Outsiders question the business decisions (e.g., capital expenditures) of the insiders even when they know little about the business's operations or competition.

* Meanwhile, the insiders (who often feel they are working much too hard) resent that their sweat is increasing the equity value of the business interest of the outside family members who are continually asking for more and more income to which they are not "justifiably entitled". The insiders often fail to see that the outsiders have a right to a return on their "investment" in the business.

* This conflict is inevitable as each business owner attempts to direct his or her own financial destiny and feels increasingly unable to do so because of the common ownership with other family members. This is not a matter of "good" and "bad" family members. It is a matter of increasingly different life goals - a normal part of life.

The solution lies in setting up a structure which assures that those in the business own and control as much of the business as possible, while giving outsiders other assets so that they can effectively control their own financial destiny. Life insurance is often a necessary element of this planning. This planning process traditionally must be

done by the entrepreneur during life so the entrepreneur can dictate the terms to family members (i.e., the values may never be equal, especially when one or more children have worked in the business for years and are being rewarded for their sweat equity).

Planning for Divorce. The estate planning process needs to address the possibility that the client or one or more heirs may face a divorce. While a discussion may be awkward with the client and their advisors, it a prospect which should be strongly addressed. Among the ideas which should be addressed in this perspective are the following:

- X Pre-Nuptial Agreements. Prenuptial agreements tend to take a bit of the romance out of the first marriage, but by the second or third marriage the potential reality of divorce will often create a different perspective. Properly drafted such documents have become a significant part of the estate planning and asset protection process. The key is proper drafting and disclosure to assure enforceability of the agreement. Relinquishment of ERISA retirement benefits must be executed after the marriage.
- X Spendthrift Trusts. Traditionally, states have not allowed individuals to set up “self-funded” spendthrift trusts. That is, the grantor of a trust was not allowed to set up a trust to which his creditors (including a divorcing spouse) could not make claim. A number of states in the last few years have begun changing these rules to allow limited protection for a grantor of such trust. This may open up the opportunity for a client to create a trust which is protected from a new spouse without mandating an unromantic prenuptial agreement.
- X Divorcing Heirs. Many parents recognize that their children’s marriages are not in a stable condition. Because 49% of the marriages end in divorce, a couple with four children (on average) can expect almost two divorces within their family. In contemplation of this, clients may be advised to use inheritance vehicles which restrict the ability of a divorced spouse to obtain part of the family money. For example, use spendthrift generation skipping trusts to restrict the ability of divorcing spouses to put pressure on a child to put assets into a joint name.
- X Irrevocable Trusts. Virtually all irrevocable trusts should be drafted (and maybe even some revocable trusts), in contemplation of the possibility that one or more of the beneficiaries may get divorced. For example, assume a client creates an irrevocable life insurance trust. The spouse is named as a beneficiary and co-trustee and is given significant power, such as the right to remove other trustees and a limited power of appointment to reconfigure the trust for the benefit of the couple’s joint heirs. The documents should contemplate the possibility that the insured grantor and the beneficiary/spouse become divorced. The document could provide that all rights and powers of the spouse, including her right to serve as co-trustee, immediately terminate upon either legal separation or divorce. Few clients want an ex-spouse to financially benefit from their death or be able to control the inheritance of their assets.
- X Powers of Attorney. Many clients have drafted powers of attorney to provide for someone to handle their medical and property issues upon their incapacity. Such powers of attorney are not generally revoked by divorce or legal separation. In many cases, the clients do not get around to revising these documents during those traumatic times. Having an ex-spouse or a divorcing spouse in charge of your medical and property decisions is probably not advisable. Either the client should be strongly encouraged upon the first vestiges of divorce to change his or her powers of attorney or the document may provide that in the event that divorce or legal separation proceedings are initiated, then the right of the spouse to serve as power holder immediately terminates and the next named successor is automatically appointed.
- X Buy-Outs. In many cases, a client’s spouse or the spouses of his or her children may hold interests in a family business or obtain an interest in a family business as a result of divorce. Buy-sell agreements should contemplate this possibility and provide a mechanism that allows other family members to buy-out the divorcing spouse on reasonable terms. Included in those terms should probably be a long term buy-out at a reduced interest rate (i.e., the minimum IRS rate) to minimize the cash flow problems for the business. Such terms may also reduce the risk that their spouse would want to receive business interests in the divorce.

PROVIDING A SAFETY NET

The demographics noted in the first article demonstrate that there are serious concerns about the level of governmental benefits that future generations will enjoy. This demographic imperative encourages clients to create trust funds which may provide some minimum levels of support to family members, without supporting a lavish lifestyle. Among the mechanisms are:

Spend Thrift Trust. Basically a spendthrift trust is any trust which provides for two major restrictions. First, it restricts the ability of any beneficiary to assign or otherwise transfer his or her beneficial interest in the trust. In many states a trust right is freely assigned by the beneficiary (e.g., as collateral for loans or for other personal purposes). Second, a spendthrift trust restricts the right of creditors of a beneficiary to demand payment of income or principal to satisfy the obligations of the beneficiary. In some states creditors are still free to garnish actual distributions to the beneficiary but are unable to force distributions to the creditor. A spendthrift trust combined with the trustees' rights to make discretionary income or principal distributions to any beneficiary is often the most best approach. Trustees can be left to use their judgment in deciding when distributions are in the best interest of beneficiary. For example, a son who has been in bankruptcy twice and been married four times may need some constraints on his inheritance. The best solution may be placing the inheritance in a spendthrift trust to create barriers to the child's control of the funds, while still providing help - in the discretion of trustees. Obviously the grantor of the trust needs to have significant confidence in the trustees' judgment.

To protect the trust and the trustee, a no-contest provision should be considered. Such a provision can provide that if a beneficiary contests the trust and loses, the beneficiary loses all trust benefits - a significant disincentive to starting a contest. The trust may also provide for indemnification of the trustee for actions taken in good faith. To protect the beneficiaries from wayward trustees, the trust might allow a majority of the beneficiaries, the right to remove a trustee, without or without cause. If a vacancy in the office of trustee occurs, the beneficiaries might be required to appoint an institutional trustee as successor trustee.

Family Partnerships. Family partnerships have long been used as a device to separate control of an asset from the right to participate in the earnings of the asset. A client may place responsible family members in charge of the family FLP and allow them to operate the partnership and decide when and how distributions are made to the limited partners. Such partnerships may provide for a minimum required distribution of income from the partnership to cover the minimum living costs and taxes of participant members.

Corporations. Voting control of a corporation can be separated from the equity ownership in the entity. If the corporation is taxed as an S corporation, a shareholder's agreement may allow for minimum required distributions of income to shareholders. If the corporation is taxed as a C corporation, it may be harder to provide an income stream to shareholders who are not working in the business.

The key to these approaches is to develop an approach which provides some minimum level of support to family members, without providing a lavish lifestyle. The distributions might be in the nature of a required amount (e.g., 40% of the income allocated to them by a family partnership) or be at the discretion of an independent party (e.g., a discretionary spray power in spendthrift trust).

RESTRICTING WEALTH USING TRUSTS

The manner in which clients can restrict wealth transfers are as broad as the imagination of the planner and the client. Obviously, the safety nets expressed above also serve as a means of limiting the access of an heir to a family's wealth. A client might restrict an inheritance by simply disinheriting the heir and giving all of the client's wealth to public charities. If the desire is to place restraints on an inheritance, the above approaches and/or the use of trusts often make sense. By nature, any inheritance placed in trust is restricted in some manner. Among some of the possible trust possibilities are:

Staggered Trust Distributions. Few heirs are ready to handle a substantial fortune at any early age. Because of this, most estate planners provide for staggered trust distributions to young heirs allowing them to mature over the time as they receive their inheritance. For example, a trust might provide that an heir receives 10% of an inheritance

at age 21, 20% of an inheritance at age 26, 30% of an inheritance at age 30 and the remaining balance at age 35. This delays the heir's ability to control the asset until (hopefully) the heir has acquired the maturity and skill sets to manage the money. In most cases, the trustees would have authority to make discretionary income and principal distributions to the heir during the term of the trust.

Life Estates and Remainders. The plan may provide that an heir receives an inheritance for life, with the remainder passing to a remainderman at the heir's death. For example, a child may have the right to use a lake house for life, with the remainder interest passing to other heirs. If granted a limited power of appointment the owner of the life interest could determine how the trust remainder would pass to a declared class of beneficiaries (e.g., the grantor's descendants or public charities).

Charitable Remainder Unitrusts Charitable remainder trust have long been used to minimize an heirs access to an inheritance. For example, a charitable remainder unitrust instrument might provide that the heir receives a 7% annual return on the trust assets for life, with the balance passing to a charitable beneficiary named by the trust grantor. The heir's ability to control and manage the trust assets can be minimized or eliminated in the trust instrument.

Transfers to Minors. Many clients provide gifts to minors in custodial accounts. However, they may have inadvertently created the wrong incentive. For example, the author recently had a client who had funded a custodial account for a grandchild for over 15 years. When the grandchild reached age 21 (after bouncing in and out of college), he went to the custodian and demanded the \$200,000 which was then in the account. When asked why, he told the family he wanted the funds to go to Europe to "discover himself." Legally, the child owned the funds, and the custodial account created an incentive to leave, not attend college.

Both a 2503(c) Minor's Trust and a custodial account generally require distribution by age 21. In lieu of a trust or custodial which terminates at age 21, a "Crummey" trust can be established for a minor. Unlike the minor's trust, the trustee of a Crummey trust can have broad discretion on distribution of income and principal. The primary benefit of using Crummey Minor's Trusts is the ability for the trustees to maintain the funds well beyond age 21. Others could also have a right to benefit from the inheritance. Thus, if a child does not go to college, the funds could fund the education of other descendants who go to college. If an account has already been created, consider making all distributions for the benefit of the minor from the previously established 2503(c) trust or custodial account to reduce its value as much as possible before age 21.

Dynasty Trusts. The estate planning process has increasingly focused on the inter-generational confiscation of wealth. A Dynasty Trust is a generation skipping trust designed to exist for the maximum period permitted by applicable state law - the so called "Rule Against Perpetuities" Especially for family business interests and insurance trusts, this may be an excellent tool to avoid future estate taxes for family members. The Dynasty Trust should probably be created as a "spendthrift trust." Because the assets are held in trust and not by the family members, the management of the trust assets may be retained in the most competent hands (e.g., professional money managers, or family members who run the family business). Planners are increasingly examining the benefits of a Dynasty Trust. Because the trust may exist forever, it cannot be cavalierly created. It requires considerable thought and expert drafting. Poor drafting is bound to increase family conflict and litigation. Because these trusts are irrevocable, many people believe they must be inflexible. This is not the case. Through creative and flexible drafting, a living document can be for future generations.

INFLUENCING BEHAVIOR

What tools are available to accomplish these the goal of influencing the behavior of known or even unknown heirs? Obviously the above tools which provide for safety nets and restrict control of an inheritance will impact an heir's behavior, but many clients want to more directly impact the behavior of heirs. Among the techniques are:

The Incentive Trusts. An incentive trust is designed to create opportunities and minimum protections to

family, without providing future generations with an unearned lifestyle. The trust is typically a dynasty, irrevocable, discretionary trust, which provides benefits across future generations. Unless truly destitute, no family member can live off the trust funds! The incentive trust is a recent device designed to create incentives for the behavior which the client would like to see achieved among his or her heirs, while restricting the ability of beneficiaries to live off of the trust fund. The terms of a FIT varies widely, but it generally involves one or more of the following approaches:

- X Trust income is designed to first provide a safety net to heirs, second to provide an incentive for desired activities, third to match earned income and last, any remaining income is paid to one or more charities or accumulated in the trust. No family member can live off the trust income.
- X Trust principal is designed to first provide a safety net to heirs, second to provide incentives and last to serve as a private family bank/venture capital source for family members.
- X The safety net may include help for medical, educational, long term care needs and to help destitute heirs. The aid is generally “needs based”.
- X Family incentives are driven by the behavior which the client wants to encourage. For example:
 - X *“Match 50% of the earned income of any beneficiary under age 30.”*
 - X *“Pay 5% of the trust principal, as a “Family Nobel Price” every five years to the person designated by [third party] to have made the most significant contribution in the field of [charity, education, science, law, humanities, medicine, etc.]”*
 - X *“Pay \$20,000 to each of my descendants who obtains a graduate degree.”*
 - X *“Pay \$5,000 to each of my descendants who graduate from high school with a 3.0 or better average.”*
 - X *“Pay \$30,000 annually to any parent who stays at home with a minor descendant of mine.”*
- X The corpus may be a capital pool from which any family member can request loans or capital investments in their business. See the discussion below.

The incentive trust requires a careful, thoughtful review by the client of all the alternatives and a focusing on the behavior which is important to the client - something that often requires significant soul searching. The trust focuses less on tax issues and more on family character issues and us just one part of the overall estate plan. For example, a married couple may provide that assets equal to their Unified Credit goes to their children, but that the insurance trust is created as a FIT. This assures the family a source of inheritance, while still leaving a legacy in a incentive trust.

Charitable Responsibility & Involvement. Some clients have decided that transferring wealth directly to their children is inadvisable and therefore have conveyed substantial assets to either private foundations, charitable “donor directed funds” or supporting organizations. In case of prior foundations and supporting organizations, family members can run the charity and receive reasonable compensation for their work efforts, without being able to spend the underlying dollars in the charity. The nature of the charity’s ownership of the funds encourages the family’s active involvement in socially beneficial activities (i.e., the making of grants to worthwhile charitable purposes). Other approaches are also available. For example, one of our clients has his grandchildren do the review and on-site inspections of grant requests for the family foundation and requires the grandchildren to submit proposals to the board of the family foundation. He pays each child for the work they perform.

Education Funding. We frequently see clients transferring lump sums into educational trusts for the benefit of less wealthy family members. For example, a wealthy brother may transfer \$200,000 into a trust to educate his nieces and nephews. The nieces and nephews attendance at college is encouraged by the creation of the trust, but those who do not want to go to college receive no trust benefits.

Mentoring Perhaps as a result of the number of inheritances lost to mismanagement, more and more clients are beginning the financial training of their beneficiaries at an early age. This planning process typically involves not only understanding financial management and administration, but also goes to issues of how a beneficiary views the family’s wealth and themselves. A number of organizations have been established in the last several years to deal with the negative affects of inherited wealth. A related approach involves getting children involved in charitable activities early in their development. In many cases this approach has less to do with charitable

benevolence than providing a perspective of how others live and the stewardship responsibility of wealth.

THE FAMILY BANK

As the first article pointed out, the majority of today's millionaires were entrepreneurs who created their own wealth. Many of them remember how hard it was to obtain the capital to grow their businesses. One part of this new planning approach is to develop a mechanism by which a family trust can provide sources of capital (by loan or investment) for heirs. The central issue with such decisions is an evaluation of proposed loan or investment. Few entrepreneurs would want to fund the latest multi-level marketing fad, but may be willing to provide capital for worthwhile family businesses. For example, the trust might provide for a two part test for such investments or loans. First, the trustees are required to hire an outsider capable of performing a due diligence evaluation of the proposed investment and the business. If the reviewer turns down the proposal, the trustees do not have authority to complete the transfer. If the reviewer approves the transaction, the trustees by unanimous decision may still be able to turn it down. This double negative is designed to protect the process from abuse. Such capital may also be provided in a form which is not necessarily commercially reasonable. For example, interest rates might be at the minimum IRS rate rather than the prime rate, or the reviewer might be told to review the proposed investment from a standard that is less onerous than the prudent investment standard of a trustee.

SUMMARY

Should every estate plan include an approach to influence the behavior of heirs and restrict an inheritance? That, obviously, is left to the discretion of the client and his advisors, but certainly there needs to be greater discussion of the topic with the client. The most critical issue is that the plan must be well-crafted or it may create greater harm than the problems it was intended to fix. Obviously not every estate plan needs to accommodate these approaches, but they can be a useful part of an overall estate plan which includes other transfer techniques which are not designed to directly influence behavior. Many parents have just begun to understand their own mortality. While some may want to "rule from the grave," more want to leave a positive legacy which will have lasting impact on their families and society at large.

Do these techniques assure "good" descendants? Absolutely not, but it does help to make sure the ones who would have been "good" are not turned "to the dark side" by their inherited wealth. Moreover, these approaches provide protections and opportunities to future generations which might have been lost if the inheritance were dissipated by a lavish lifestyle of predecessor generations. Further, they may provide a productive legacy to future generations.

Do these techniques assure that there will be no family conflicts in the future? No, in fact, the approach is structured with the understanding that conflict is probably inevitable as family wealth grows. As much as possible, this approach tries to create checks and balances to minimize the conflict. Greed is a basic human tendency. By placing constraints on inherited wealth, these techniques are designed to inhibit the conflict which often arises when wealth has no constraints.

Do these techniques solve every estate issue? Absolutely not - any more than the living trust is the solution to every estate need. It is merely one more arrow in the quiver of estate planning tools.

These articles have discussed the reasons for the revolution. The perspectives given are clearly debatable, but should be useful for providing a framework for the on-going debate. Additional information on these concepts and a master list of articles which have discussed these concepts can be found at www.scrogginlaw.com,

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