

Not Your Typical Incentive Trust: The ROTE and FST, Part 2

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We used the Money & Soul column in this issue to introduce the concept of the Results-Oriented Trust Environment (ROTE), which we first described at the 45th Annual Heckerling Institute on Estate Planning of the University of Miami School of Law. This column extends the discussion to show how a ROTE may be used to create a Financial Skills Trust (FST) as an alternative to a traditional incentive trust.

A financial skills trust is a ROTE based on four main components:

1. It uses the fundamental structure of a largely discretionary trust, and it does not attempt to control the beneficiary's behavior through

either: (1) a restricted definition of what health, education, maintenance, and support (the so-called HEMS ascertainable standard) mean in order to limit both the amount and purpose of distributions, or (2) incentive provisions that tie distributions to specific behaviors.

2. It captures the settlor's intent regarding financial skills through a statement of the trust's purpose, which addresses, among other things, such issues as trustee flexibility, desire to prepare the beneficiary, and handling of risks inherent in learning skills for money management in life. This purpose statement should be developed for each financial skills trust in conjunction with the client(s), proposed trustees, and, if possible, the beneficiaries. Professor Ed Halbach Jr. suggested this approach 50 years ago: "Too frequently the trust instruments provide no guidance as to the purpose and scope of the power. [The

trustee] should be informed of the purposes of the trust, the factors he is to consider, and something of the general frame of mind in which the settlor wishes him to act."¹

3. It elaborates the purpose statement by delineating guidelines, but not requirements, focused on the results of the beneficiary's learning and demonstrating money management skills. The trustee is directed to take those results into consideration when deciding

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whether to make discretionary distributions of income and/or principal and, possibly, whether and at what time the beneficiary becomes a co-trustee or sole trustee of his or her trust.

4. It provides increased transparency in trust administration by clearly describing objective guidelines on which the trustee's discretion is based. Those guidelines capitalize on our growing knowledge about motivation and financial literacy and help to prepare inheritors for handling wealth.

Financial Skills for Prudent Money Management

The financial skills trust uses financial skill benchmarks as guidelines for the exercise of the trustee's discretion. Based on the literature about financial literacy skills and our collective experience as wealth counselors and advisers, we have found there is a core set of six interrelated, primary financial skills fundamental to prudent money management, along with a secondary list of two skills that are commendable but not crucial.

1. The ability to live within one's means; in other words, not spending more than one's income. The trustee must work out with the beneficiary what this means in practice in a manner that is both transparent and understandable. However, no value judgments are made regarding how the beneficiary spends money as long as expenses do not exceed income. Amazingly, many trust beneficiaries have not learned this, so it is the very first financial skill. Expenses cannot exceed income for any reasonable period, but for special situations there could be exceptions (for example, starting a business, allowing expenses to exceed income by 10 percent for up to two years, etc.). The beneficiary will have to describe to the trustee what he or she is doing to maintain a budget and match spending with income. (One of the later skills deals with credit behavior, to avoid gaming this guideline by using credit cards or debt.)
2. The ability to manage spending in order to save a portion of one's income, as needed. The beneficiary would establish this skill by demonstrating the ability to create a reserve, delay immediate gratification, and resist spending the reserve. The beneficiary should document situations in which there is deferred spending and a cushion is retained for everyday living expenses and for special expenses. The application of this skill may depend largely on the size of the trust—if a trust is sufficiently large, the trust itself might legitimately be considered the beneficiary's retirement fund and savings account.
3. The ability to understand and manage credit and debt, thereby avoiding excessive debt. This skill relates to "closing the back door on an easy way to overspend." The trustee will examine credit spending by the beneficiary and determine whether the beneficiary is staying out of credit card debt. The trust agreement would include operational language providing that the trustee may ask the beneficiary for copies of credit reports that show how many credit accounts are open at any one time and the amounts. This would provide for strict confidence by the trustee and removal of the trustee if this information were not kept completely confidential.
4. The ability to maintain reasonable accounting of one's financial resources. Many beneficiaries lack this skill, which can lead to drastic financial mistakes. A beneficiary may be ashamed of his or her inability to keep track of assets. Can the beneficiary keep a budget that has any relation to reality and that keeps the beneficiary from constantly coming back to the trustee for extraordinary distributions? This skill relates not so much to being able to make a budget as being able to follow a budget.
5. The ability to understand and manage one's personal assets, either using basic investment procedures and principles oneself or delegating these actions responsibly to appropriate advisers. If the beneficiary is doing an effective job with guidelines 1 through 4, the beneficiary will build a reserve that will need to be managed. The beneficiary should understand the basics of sound investment principles. If the beneficiary delegates money management, the beneficiary will need to demonstrate the ability to responsibly oversee the money manager. Fifty percent of the population lives paycheck to paycheck. They think of money as *income*. The idea of having skills to manage money as an asset requires a different mind-set and different skills. For a beneficiary who has never had excess distributions, the beneficiary needs to develop skills to manage assets rather than *income*. One approach is to make the beneficiary an "apprentice trustee" at some age, and to participate in money management meetings.
6. The ability to generate additional income through employment if funds in addition to trust distributions are either required or desired. The beneficiary must be able to get and keep a job if the beneficiary wants more money than just the trust distributions. That involves specific skill sets, such as showing up on time, getting along with co-workers, etc. If the beneficiary does not wish to get a job but still lives within his or her means without using credit to do so, that would meet this criteria. The trustee makes no judgment on the kind of job the beneficiary pursues.

The following two skills are advisable though not crucial. Many settlors may object that the first six skills are too elementary and don't have values attached to them. For them, encouraging the last two skills may be very important. These last two skills are subjective, and it is much harder to come up with specific standards.

7. The ability to use a portion of one's income and/or financial resources to support charitable activities of one's choosing.
8. The ability to show initiative, engage in entrepreneurship, and demonstrate purpose in paid or unpaid work.

As with a results-oriented work environment, a financial skills trust supports autonomy and accountability because trust distributions are tied to the beneficiary's money skills and little else. It also stays away from attempting to control from the grave or the trustee's office the beneficiary's life choices or non-financial activities.

We use what we call "the car analogy" to explain why the financial skills trust is unique. Assume that a beneficiary asks the trustee to buy him or her a car. Under an ascertainable standard approach, the beneficiary must explain why he or she needs the car in the context of the HEMS standard: to drive to work, to drive to school, to drive to medical appointments. Under an incentive trust approach, the beneficiary may be entitled to receive the car by getting a college degree or making a certain amount of income. With a financial skills trust approach, there is only one question truly relevant: "Can you drive?" Furthermore, once the beneficiary has shown that he or she can drive, it is his or her judgment about how to use the vehicle, not the trustee's or even the settlor's. Of course, if the beneficiary keeps getting into accidents or does not have a valid driver's license (perhaps having lost the license for drunk driv-

ing), the trustee would take these facts into account when the beneficiary next requests the trustee to purchase a car for his or her use. The financial skills trust empowers the trustee to do the wise and appropriate action: withhold giving out any more cars until the beneficiary first (or finally) learns how to drive safely.

Focusing on Results

Surprising as this may seem, the fundamental aim of the financial skills trust is not that the beneficiary develops financial management skills. The fundamental aim is to focus on whether the beneficiary is avoiding financial problems—the *result* of having these skills. It is results-oriented in terms of how distributions or trusteeships are granted. If the beneficiary does not wish to grow or maintain financial self-management skills, that is the beneficiary's choice. What the financial skills trust is clear about is that discretionary distributions, acceleration of mandatory distribution dates, or granting of co- or sole trusteeships will not occur in the absence of an observable demonstration of effective financial skills. If a beneficiary is living within his or her means, avoiding excessive debt, knowing basically how much he or she has for income and expenses, etc., the beneficiary knows that the trustee is far more likely to make a discretionary distribution of income or principal than if the beneficiary is not demonstrating positive financial self-management skills. Such an approach encourages open, transparent, and periodic communication about the match between the trust's provisions and the beneficiary's behavior, including any necessary limit-setting on the part of the trustee when results seem to be missing in the beneficiary's financial self-management.

By using results-oriented criteria to evaluate beneficiaries' money skills, the financial skills trust achieves many positive objectives. It provides clarity for

both the trustee and the beneficiary. It uses money to reinforce behaviors that relate only to money, without trying to motivate other behaviors in ineffective and counterproductive ways. It balances beneficiaries' right to reasonable autonomy with settlors' reasonable expectations for accountability. And in encouraging (but not requiring) thoughtful financial self-management, it is consistent with fostering positive values conducive to a more happy and fulfilling life.

We think of a ROTE as an umbrella set of principles, beneath which various trusts may be developed emphasizing different life skills. In addition to a financial skills trust, a ROTE could be used to assist clients in developing a trust that emphasizes philanthropic or entrepreneurial skills, creating either a Philanthropic Skills Trust (PST) or an Entrepreneurial Skills Trust (EST).

The financial skills trust approach may be used in various drafting contexts:

- The trustee may be authorized to distribute income and principal to the beneficiaries in the trustee's absolute discretion, but requested to take into consideration the behavioral guidelines
- The trustee may be authorized but not required to distribute income and principal to those beneficiaries whose behavior meets some or all of the guidelines
- The trustee may be directed to distribute income and principal to those beneficiaries whose behavior meets some or all of the guidelines

The drafting question turns on whether the trustee is granted absolute, limited, or no discretion in distributing income and principal to beneficiaries. The financial skills trust approach may be used as a guideline to the trustee's exercise of discretion or in lieu of ascertainable standards or incentive provisions.

In a financial skills trust, the trustee's

focus is on the extent to which the beneficiary has mastered the six primary financial skills. As a result, it stays away from vague qualities that the settlor believes may be desirable but are so subjectively defined as to invite either overly judgmental parental attitudes or abuse of discretion by the trustee. It seeks to be as operational as possible in order to minimize mind reading on the part of the beneficiary and uncomfortable subjectivity on the part of the trustee. Second, it avoids placing trustees in the inevitably futile position of trying to undo those failures of parenting or circumstance that created poor results in beneficiaries' self-management.

Administering the Trust

Administration of any irrevocable trust, and especially a trust being administered as a ROTE, requires effective

periodic communication between the trustee and beneficiary. This typically involves meeting at least annually to talk over the beneficiary's activities, goals, and skills to maintain the relationship between the trustee and the beneficiary. The optimal situation involves collaboration and planning between the trustee and the beneficiary as well as looking ahead to understand the beneficiary's plans, review decision-making, and discuss any adjustments that may occur in the discretionary decision making of the trustee based on the beneficiary's abilities in mastering the six primary money skills. The trustee is empowered to set timelines, offer educational or tutoring opportunities, or any other method that may facilitate the development of needed skills by the beneficiary.

The financial skills trust avoids meddling with beneficiaries' life choices about career, spouse, place of residence,

religious faith, level of education, or level of earned income, to name the most common decisions that settlors seek to control through incentive trusts. In doing so, the FST seeks to preserve that which is highly precious to most people in life: autonomy. We believe that the financial skills trust provides the best balance between the beneficiary's right to autonomy in one's personal life choices and the settlor's right to hold beneficiaries accountable to manage inherited assets prudently.



Endnote

1. Halbach Jr., Edward. 1961. "Problems of Discretion in Discretionary Trusts." *Columbia Law Review* 61, 8: 1425.

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