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Should You Consider Incentive Trusts?

You're looking for an effective way to ensure your heirs do what you think is best for them, for the family, and for the world. Is an incentive trust the right vehicle to accomplish that?

An incentive trust is much like a traditional irrevocable trust, except that it sets specific conditions on trust distributions. Some people establish incentive trusts to make sure beneficiaries stay in the family business. Others want to encourage higher education or public service. Some want to discourage behavior — laziness, reckless spending, or drug use. Still others want to encourage beneficiaries to get married and raise a family.

Incentive Trusts Have Advantages and Disadvantages

If you think an incentive trust may be a useful part of your estate plan, consider the advantages and disadvantages.

The advantages of incentive trusts include:

- If you write the conditions for disbursement properly, they provide objective criteria for when and how to make these disbursements.
- They encourage beneficiaries to behave in ways that are important to you.
- They allow you to condition disbursement on your beneficiary's age, so you can decide when he/she is old enough to responsibly manage the inheritance.
- They can help you accomplish goals through your beneficiaries, such as continuing the family business or pursuing philanthropic interests.

But there are also disadvantages:

- While incentive trusts allow you to specify conditions for distributions, they restrict the ability of trustees to make different decisions if new circumstances arise.
- Incentive trusts can cause resentment among beneficiaries, who may feel it is not your place to tell them how to live their lives.
- Encouraging goals you think are important may cause

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Frankly Speaking

More clients have been calling me lately to ask what's going on with their portfolios; why is there less money than a quarter or two ago. Why is inflation so high and what's going on with interest rates? We discuss the current polarized politics here in the US, look at other world 'leaders' and when will the brutality in Ukraine finally stop. How long must we put up with variants of Covid 19?

In such an environment it may be natural to want to make large portfolio moves to avoid risk and 'wait it out.' While such periods are difficult, investors must remember that volatility is as normal as is the recovery that follows.

The DJIA closed 6-1-2012 about 10 years ago at 12,118. Where did it close today? Yes, nearly triple! But you had to stay in for the last 10 years to enjoy that growth. You had to endure the challenging times because volatility works both ways! ❍❍❍

Incentive Trusts

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beneficiaries to neglect other good opportunities. For example, you may want a beneficiary to start a business, but she may be better suited to another career choice.

✔ Incentive trusts may be plagued by the law of unintended consequences. How can you foresee the future long after you've died? You may instruct the trust to pay out a stipend for your beneficiaries to go to school, but that can encourage them to become professional students.

✔ Because incentive trusts are often more complicated than traditional irrevocable trusts, they may be more expensive to establish and maintain.

What to Think About

There are a number of issues that could affect the design and implementation of an incentive trust. Consider these points carefully:

✔ **Goals** — What behaviors do you want to promote? Incentive trusts are often created to encourage beneficiaries to pursue higher education degrees. Discouraging reckless consumption and unproductive behavior are other common reasons behind incentive trusts. Think about what matters to you and your beneficiaries. What goals are fair and reasonable for you to expect your beneficiaries to achieve?

✔ **Coordination with your estate plan** — Incentive trusts are just one component of an estate plan. Decide whether you want to create a separate incentive trust or build incentive clauses into a trust designed for another purpose. Make sure the incentive trust doesn't conflict with or detract from other components of your estate plan.

✔ **Duration** — How long do you want the incentive trust to last? For grantors with substantial wealth, a trust may span many generations. Can you realistically set expectations for beneficiaries who aren't even born yet?

✔ **Beneficiaries** — Who will benefit from the monies disbursed from the incentive trust? Considerations here are similar to those for any kind of trust: who do you include and exclude?

✔ **Trustee designation** — The trustee of an incentive trust typically has a more difficult job than the trustee of a simple traditional trust, since he/she must decide when beneficiaries have met the conditions you specified. Make that job easier by writing conditions that are objective and easily measured.

How to Prepare an Incentive Trust

If you decide an incentive trust may be right for you, you should:

✔ Sit down with your beneficiaries and trustee to discuss your goals for the incentive trust. The likelihood that your beneficiaries will later resent the incentives is greater without this discussion.

✔ Build flexibility into the trust to accommodate changes in circumstances. This will mitigate unintended and undesirable consequences.

✔ Ensure that the conditions you want to include comply with state and federal laws.

If you don't want to establish an incentive trust, you can limit each beneficiary's inheritance to an amount that isn't likely to encourage reckless consumption and unproductive behavior. Another alternative, if your interest lies in philanthropy, is to establish a private foundation and name your beneficiaries as board members. That way, your money is still controlled by your beneficiaries, but it is put to charitable use.

Please call if you'd like to discuss incentive trusts in more detail. ❍❍❍

Avoid This Mistake

Finding a way to live decades in retirement without worrying about running out of money can seem like an overwhelming task. That goal depends on many variables and assumptions. If you're wrong on even one of those variables, funding your retirement could be in danger.

With all the potential for missteps, what is the one mistake you want to avoid at all costs? Dipping into your retirement savings. Unfortunately, since the funds in your 401(k) plan or individual retirement account (IRA) belong to you, they often seem like a tempting place to get funds needed for other purposes. Tax laws don't help, since they often provide tax-advantaged ways for you to access those funds.

Saving for retirement is a difficult task for most people, without making it more difficult by using retirement funds for other purposes. Even if the amount seems small, don't withdraw funds from your retirement account. It can grow to significant sums over the long term. For instance, assume you have $10,000 in your 401(k) plan. If you withdraw the funds and are in the 22% tax bracket, you'll have $6,800 left after paying income taxes and the 10% federal tax penalty. Keep the funds invested earning 8% annually on a tax-deferred basis and your funds could grow to $68,426 after 30 years, before paying any income taxes. *(This example is provided for illustrative purposes only and is not intended to project the performance of a specific investment.)* ❍❍❍

Reassess Your Retirement Plans

Approximately five years before you plan to retire, thoroughly reassess your retirement plans and ensure that all significant financial pieces are in place. Once you retire, you probably won't have the option of going back to your former job. So, first, consider these points:

✔**Take a serious look at your retirement plans.** You're close enough to retirement that you should have a good feel for your expenses and expected income. While you may be anxious to retire, remain flexible about your retirement date. Working an additional year or two can add substantially to your savings and may boost your retirement benefits.

✔**Get a fix on your Social Security and pension benefits.** Make sure you know exactly how much you can expect from Social Security and defined-benefit plans. How much will your benefits increase if you delay retirement by one year, five years, etc.? If you retire before full retirement age for Social Security purposes, do you plan on working? Be aware that for those under full retirement age for Social Security purposes, earnings over $19,560 in 2022 will cause you to lose $1 of benefits for every $2 of earnings over this threshold. Make sure you understand your distribution options for any defined-benefit plans. In most cases, those decisions are irrevocable, so you'll want to take some time to assess those options.

✔**Determine how much income your retirement investments will generate.** As a general rule of thumb, you can multiply your retirement investments by 4% to get an idea of how much you can withdraw annually. You can go through a more detailed analysis, reviewing a wide range of variables, for a more precise answer. However, the younger you retire, the more conservative your withdrawals should be, since your funds will have to last for a longer time period.

✔**Investigate work options.** If you plan to work at least part-time during retirement, have you decided what you'll do and how much it'll pay? Make sure you investigate your options, including asking your current employer about part-time opportunities after retirement.

✔**Finalize living arrangements.** Determine whether you want to stay in your current home or move to another one, either in the same city or a different location. At this point, you should be able to determine whether you'll have a mortgage and how much equity you'll have in your home. While most retirees continue to live in their current home, explore whether it makes sense to downsize, freeing up home equity for investments or retirement income.

✔**Deal with health insurance and long-term-care costs.** Two of the most significant costs in retirement are medical care and long-term care. Make sure you have plans to deal with both. If you are retiring at age 65 or later, you'll be eligible for Medicare, although a spouse under age 65 will not be eligible. You will probably need supplemental coverage with Medicare. If you are retiring before age 65, make sure you know exactly how much coverage will cost you, especially if it is not provided by your employer. Now is also a good time to take a look at long-term-care insurance, since premiums get significantly more expensive as you age.

✔**Live with your retirement budget for a couple of years.** Want to really make sure your retirement budget is reasonable? Try living with your retirement budget for a couple of years before retirement. If you can do so without increasing your debt, you can be reasonably confident that your budget will work during retirement.

Please call if you'd like help assessing your retirement plans before you actually retire. ❍❍❍

Don't Forget Digital Assets

When preparing an estate plan, people often forget about their digital assets. But with so many managing their lives online, digital assets are an integral part of your estate plan.

Types of Digital Assets

There are a myriad of digital assets to think about as part of your plan, including:

- ✔ Computers, external hard drives, smart phones, cameras, flash drives, and other electronic devices.
- ✔ Online accounts such as bank accounts, investment accounts, utilities, mileage and reward accounts, and social media accounts.
- ✔ Any important documents that you have stored in electronic files, such as tax returns, insurance documents, wills, and trusts.

Take Stock of Your Digital Assets

The first step is to conduct a thorough inventory of all of your digital assets. Make a list that includes the type of asset, the location of each asset, website addresses where applicable, usernames, and passwords. You should provide the written list to the person you are entrusting to take care of these assets or keep a copy with your will and clearly identify the person in charge of managing them.

Other options to consider for storage of these assets is an online vault and a password manager. The online vault allows you to store all of your important documents in one secure online account. The password manager stores all of your usernames and passwords for all of your online accounts. The person who is responsible for your digital assets only needs access to one password that will give him/her the information for all of your other accounts.

Define the Plan

In your estate plan, you will want to provide clear instructions as to who is responsible for your digital assets and how you want them handled. You will want to select someone you trust, because you may have details that you want kept private. Make sure you indicate if you want accounts closed, documents deleted, and any accounts or documents to go to a certain person, especially if there is any associat-

Sharing an Inheritance

Married individuals who receive a large inheritance face a tough decision — should you share the inheritance with your spouse or hold the assets separately? Legally, you aren't required to share the inheritance. Even if all other marital assets are owned jointly, you might want to consider keeping an inheritance separate for a couple of reasons:

- ✔ Should you get divorced, you probably wouldn't have to split a separately-held inheritance with your spouse.
- ✔ When you die, you control who receives the inheritance. If the inheritance is owned jointly, it goes to your spouse. If your spouse remarries, there is a chance the inheritance will ultimately go to a second spouse or children from a second marriage. You can get around that result through the use of a trust, but it may be simpler to just keep the assets separate.

While there may be sound financial reasons for keeping the inheritance separate, those reasons may be difficult to explain. Rather than remaining evasive, discuss your concerns openly. Even if you keep the inheritance separate, that doesn't mean you can't share some of the assets for common goals. ❍❍❍

Financial Thoughts

Three trends regarding the actions that a majority of preretirees and new retirees take with their portfolios were found. 1.75% of retirees reduced their investment risk after rolling 401(k) funds into an IRA, decreasing the equity portion of their asset allocation on a median basis by 17%. Those who made the adjustment at an inopportune time locked in market losses for the entirety of their retirement.
2. Required minimum distributions (RMDs) were the primary guideline in determining withdrawal rates from IRAs, regardless of income needs. Overall, 80% of retirees below the RMD age didn't begin withdrawals when entering retirement.
3. Income and spending were highly correlated — the more regular income retirees had, the more they spent. Of those in the study, about 30% had an annuity or a pension, most began to receive Social Security benefits at age 66, and most retired between the ages of 65 and 70 (Source: JPMorgan Asset Management, August 2021).

As of year-end 2018, 62% of 401(k) plan participants in their 20s held target-date funds versus 50% of those in their 60s (Source: *EBRI Issue Brief*, September 9, 2021). ❍❍❍