Discretionary Trusts

DISCRETIONARY TRUSTS

CARE OF YOUR CHILDREN AS YOU WOULD HAVE DONE IT

INTRODUCTION

You've worked hard and amassed a significant fortune. Your estate plan is simple. When you die, everything goes to your spouse with the intent of eventually passing it on to your children. But what happens if you both die accidently - before your time?

While you are alive, what you give your children is something that you determine in your best judgment. Lots of things can happen as your children grow up, but even with unexpected events its assumed that you will know best what to do and how to spend your money according to your means and priorities.

What priorities? Everyone is different and sees the world through their own perspective. Parents instinctively prioritize things for their children like security, support (i.e., good stable home), healthcare, education, religion, family, friends, events (marriage, bar/bat mitzvah), etc. Things change as the children grow older. But its assumed that you'll know what to do when various situations arise.

But what if you are suddenly not around to make these decisions? What happens to your estate vis a vie your children? This is a difficult question to answer and probably depends a lot on their age and particular circumstances.

Is it proper to make outright distributions to your children? Maybe, or maybe not. For example, if one of your children just turned 18 and receives substantial money, good chance they'll make a beeline to the nearest BMW dealer and invest (or squander) in a hot new car. Would that happen if you were still alive?

While you are alive, do you spend money on your children in equal amounts? Typically, the answer depends on circumstances. If one child has health issues, you may spend more money addressing that important issue. Or maybe one child has worked hard in school and is accepted to Stanford (massive tuition), while another child can only get into a free community college. Or

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maybe another child is accepted at the Naval Academy (no tuition). In real life, is everyone treated equally?

Or what happens if a child becomes addicted to drugs or alcohol? Or gets into trouble with the law? As a parent, how do you allocate your money to deal with these distasteful, conflicting and often-unanticipated circumstances?

The issue here is not how you would deal with these things. Rather, when both of you are prematurely gone, how would your successor trustee deal with them?

It's important that you choose your successor trustee wisely. You want someone who is mature, knows the beneficiaries, and shares your value system and priorities. But even if you find the perfect person, unexpected circumstances can arise where the successor trustee must make tough decisions or choices regarding your estate. Ones that some (or all) of your children may not understand or like.

It is helpful to provide the successor trustee with guidelines. They should mimic your priorities to provide direction to your trustee to act as you would if you were still alive. Guidelines cannot anticipate all things that can happen and won't be perfect. However, they are better than nothing and can be helpful to ensure your goals are met.

GUIDELINES

Prioritize the things important to you and your children - and communicate this to your successor trustee. For example, spend trust money to support the following (in order of priority):

- support (preferably in our home);
- quality health and dental care;
- education (through graduation from an accredited four-year college);

- housing (e.g., down payment for a new home);
- special events (e.g., bar mitzvath, first communion, first wedding, honeymoon);
- start a new business;
- travel;
- retirement.

Any set of guidelines must be based on your priorities and values - as well as realistic goals and aspirations for your children.

SAMPLE LANGUAGE FOR DISCRETIONARY TRUST

The following is sample language that could be used in the guidelines. These examples must be carefully considered and modified as required to meet your goals or criteria.

The children's health is our primary concern. Our trustee should purchase health insurance to ensure high quality and timely treatment of our children's medical issues. Insurance should be maintained up to the time each child is self-sufficient or turns age 26, whichever is earlier. Our trustee should purchase dental insurance if available at a reasonable cost to maintain good dental health of each child.

None of our children have any special needs. However, if a special need arises (e.g., injury from an auto accident, disabling disease...), our trustee should use trust funds to accommodate that special need, but only where using the funds does not interfere or reduce state aid where available. To ensure proper state aid, our trustee is empowered to establish a Special Needs Trust as required.

If any child is disabled, or otherwise in trouble, due to drug use, criminal activity, or a similar self-inflicted problem, we want our trustee to use his or her best judgment on the appropriate treatment or action under the circumstances. It should be noted that many drug or alcohol rehabilitation programs are insanely expensive - but have low success rates. Guidance from you on this sensitive topic would certainly be appreciated by a successor trustee.

Our children's education is very important to us. We want our trustee to provide funding for tuition, books, supplies, room and board at least through graduation from an accredited four-year college.

Our son/daughter [name] has an interest in [name the interest] and our trustee may use trust funds as it deems necessary, in its sole discretion, to achieve this.

After completion of their college education, we want our trustee to utilize residual trust funds for sound and meaningful investments to benefit our children, such as help with the purchase of a first house, or to be used as seed money to start a new business - but only after careful consideration of a thoughtful and thorough business plan. Our trustee should consider that some of our children have completed their education, which we paid for, while others have not.

Our trustee should exercise his or her best judgment regarding entitlements for our children, such as allowance, cell phones, computers, etc.

We want our trustee to encourage our children to participate in sports and provide service to the community. We encourage international travel, but not to countries on the State Department list of Current Travel Warnings.

Keeping with our stated priorities, we do not want trust funds used for elaborate gifts, toys, luxury cars, extravagant vacations, theme parks, etc. We don't discourage having these luxury items, but our children should pay for them out of the money they earn on their own. We do not want trust funds used for:

- loans or gifts to third parties (not specifically named as beneficiaries of this trust);
- business partners;

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- political contributions;
- religious groups or churches;
- charities, or other entities representing themselves as charities.

We do not want trust funds used for hazardous activities [need to elaborate what they are].

We do not want any of our children to be dependent on the trust for their livelihood - i.e., trust fund babies. We want our children to develop skills sufficient to make it on their own in the world. The trust may assist in developing these skills, but ultimately our children have to be independent and self sufficient - earning their own living.

We understand there could be emergencies or situations where one or more of our children may need money before the trust terminates. One or more of our children may be confronted with serious problems which require immediate attention and funding. Examples of such problems would be diagnosis of cancer, urgent need for drug abuse treatment, or some other serious disease requiring immediate treatment and funding. Or a child may face criminal charges, such as DUI, where prompt legal assistance must avoid a personal tragedy. The catalog of dire consequences that one could encounter in life is a long one – especially those situations where immediate funding from this trust would be appropriate. With this general guidance, we give our trustee complete discretion on when to make emergency distributions before trust termination.

We want our trustee to follow a reasonable and conservative strategy when investing trust funds generally according to the Prudent Investor Rule -- Probate Code §16046. However, we want our children to participate in investment decisions. Ultimately, our trustee will make final decisions on investment decisions and will not be liable for any investment selected by our children, acting together, even if it does not conform with the standards and guidelines in Probate Code §16047.

Trust funds advanced for a new business venture or startup in which child is involved will not be considered a typical trust "investment" as described above.

Our trustee should evaluate each distribution request and determine, in its sole discretion, whether an outright distribution, a loan, or a combination of both is most appropriate. For example, a beneficiary may have a short term need for cash and there is a high expectation that the money will be recovered. There, a loan may be the most appropriate for equity among the beneficiaries and the long-term health of the trust. The loan vs. distribution decision will be made by our trustee in its sole discretion.

When the youngest of our surviving children reaches XX years old, our trustee shall distribute our remaining trust property outright to them in equal shares. Note, there may be a question about "equal shares." Should the successor trustee account for all money spent from the trust since the beginning when considering equal shares? Should the trustee consider money we spent while we were alive (i.e., college tuition for the older children)? Or should the trustee distribute what's left in equal shares?

DISCRETION

It is very important to give the successor absolute discretion on how and when to use trust funds to benefit the children. At first this may sound harsh, but there is a good reason for it – asset protection (discussed below) requires this. Theoretically, you shouldn't worry about absolute discretion because you have chosen a successor trustee who you trust to do the right thing. Further, you've provided guidelines for the trustee to follow.

Note, guidelines are just that - guidance to the successor trustee. With absolute discretion, the successor trustee's actions cannot be challenged because someone didn't think they conform to the guidelines. Again, this puts a lot of power into the hands of the successor trustee and its why the choice of the right person is so important.

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Notwithstanding your precautions, things may not go well down the road. In this case, you may want to provide for a trust protector who can, if the need arises, replace the trustee.

EQUALITY

It probably goes without saying you love each of your children equally. But does that also mean that your estate must be equally distributed to each of your children? This requires careful consideration and specific direction to your successor trustee. Some of your children may have special needs that will place a drain on the estate. One or more of your children may be successful in business and not need the money. The possibilities are all over the map.

A common technique, before making a significant distribution, is to have the trustee evaluate the proposed recipient's other sources of funds. For example, should two of your children get equal treatment from the trust where one is a successful cardiac surgeon married to an heiress and the other child who is a wounded double-amputee veteran of a foreign war?

Again, provide guidance to your trustee on how you would act in various situations then depend on the trustee's good judgment. And remember, this is why you chose this person to be the successor trustee.

ASSET PROTECTION

A trust with a lot of money presents a tempting target for creditors of your beneficiaries. After you are gone, a lot of things can happen to your children. They might be in a bad car accident with liabilities exceeding insurance coverage. They could incur large medical bills. One or more could have a failed business. Or divorce – by far the most common threat. How would you like a divorcing spouse bolting with a significant portion of your estate?

California is a creditor friendly state and not the best place for asset protection. However, there are things you can do to protect the trust corpus and discourage creditors. Generally if a person can get at the money, so can his creditor. If one of your children can compel the trustee to distribute money to him, so can his creditor.

The primary protection is the discretionary trust. All distributions are left in the absolute discretion of the trustee. The children can ask, or beg, all they want, but no distribution until the trustee, in its absolute discretion, makes it. Same thing with a creditor. He can demand payment from the trustee, but the trustee in its absolute discretion can say no. That should be the final answer.

Once a distribution is made to the beneficiary, that beneficiary's creditor can go after the beneficiary for payment. But as a practical matter, if there is a creditor lurking about, the trustee isn't likely to make any distributions. Or the trustee may negotiate with the creditor and pay pennies on the dollar to make the debt go away.

WHEN IS A DISCRETIONARY TRUST APPROPRIATE?

There is no simple or universal answer to this question. Each family is different. Mostly we deal with, or are concerned about, relatively young children. But the beneficiaries could be other family members or friends. Regardless, following factors seem to encourage the use of a discretionary trust:

- Multiple young children;
- Children with different talent or needs;
- Health of the children (i.e., one or more has a disability);
- Limited funds in the estate – need to prioritize on what's important; or
- Real or potential dysfunction in the family.

The general thinking is that adult children can manage their own money, so outright distributions are more justifiable the older they are. Accordingly, most discretionary trusts are terminated based on the beneficiaries reaching a certain age. But again, every family situation is different and you are the best one to make this decision.

Possibly the most important criterion for whether or not to create a discretionary trust is your ability to identify an appropriate successor trustee suited to this role. This must be a person you trust implicitly and preferably someone who is familiar with you and the beneficiaries.

Lastly is establishing family harmony after you are gone. Most people want to be treated equally and my resent unequal distributions from the trust. Hopefully your successor trustee will be able to explain actions or distributions based on your guidelines. Its important for your beneficiaries to understand that you are calling the shots.

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