TAX & WEALTH ADVISOR ALERT: CHOOSING A TRUSTEE: IT IS ALL ABOUT TRUST PART 1—DISCRETION VS. DIRECTION

Virtually all of my clients leave property to the next generation through trusts. Generally, these trusts last for the lifetimes of their children and oftentimes for further generations, as well. We setup trusts this way to protect those children from creditors, predators, and divorcing spouses, and previous blog posts have fully described how and why this works. This blog post covers a different issue—the amount of specific direction the trustee should receive regarding management of trust property.

At one extreme, the client can give the trustee very little guidance and allow the trustee to make all of the decisions over the trust. For example, the trust document can allow the trustee to decide what to invest in, who to retain for advice and counsel to the trust, and when (and for what reasons) to make distributions to the beneficiaries. At the other extreme, the trust document can give very specific direction. For example, the trust document can require that the trustee invest only in ETFs or dividend paying stock, maintain a 60/40 equity to debt allocation, and name specific advisers. The trust document can limit distributions of principal except in times of hardship, require the trustee to distribute an amount equal to five percent of the trust property each year or an amount equal to the beneficiary's W-2 income, or limit distributions for education unless the beneficiary maintains a 3.0 GPA. But, which method is better—discretion or direction?

Clients ask me this question often. I respond by reminding them that their estate plan needs to implement their own strategy to take care of the people they care about. Their strategy needs to be an extension of their parenting beliefs and values; at its best, it should mimic what they would do if they were alive and had no personal economic need for the trust property. With that context in mind, we begin to consider certain scenarios that test those beliefs. The answers to those "what if" questions provide guidance as to the right framework.

An example might be helpful. One of the fears of leaving large sums of money to children is a fear of laziness. To avoid their children becoming "trust fund babies," parents might put a provision in the trust that the trust shall make a distribution to the child each year equal to the child's W-2 income. On one hand, that is a perfect solution; the child is incentivized to be very productive and double his or her income. But, then we start scenario testing. What if your child was a doctor making $500,000 per year and wanted for nothing? If you were alive and had the money available, would you transfer another $500,000 to the child? The answer is consistently, no. What if your child was a teacher making $30,000 and, based on child care needs and the like, needed $50,000 to "make ends meet"? If you had it, would you give $50,000 to that child? Often the answer is, yes. What about a stay-at-home parent without W-2 income? Would you give that child nothing if you had plenty to give?

These discussions often lead to the client envisioning ever more complicated structures. For example, we could solve the doctor problem with a maximum distribution, the teacher problem with a "teacher (or other respected but underpaid profession) multiple," and the stay-at-home problem by creating a "stay-at-home-parent compensation equivalent." But, of course, for every solution, there is another question—what if the teacher is married to a well-paid CEO?

The point of this exercise is to point out the value of being able to solve each of these problems given their unique facts. I might still decide to provide money to the hard-charging doctor who is investing everything into her practice and her retirement to give her family some "fun money" to take a well-deserved vacation. I might decide not to give the teacher anything because he blows his paycheck at the bars and the casino. Simply put, if the test is what the parent would do if he or she were alive, the answer almost always is "we would make each decision as it comes and not constrain ourselves in any way." So, with that in mind, isn't the best trust design to provide the trustee the same full discretion to consider all of the circumstances and make a real-time decision?

The answer is yes, with one huge caveat. Is there a trustee the parents trust? And "trust" is not simply a matter of having a true-north moral compass; trust means the parents have to choose a person who can execute on the parents' values and beliefs. In other words, in the same situation, a trustee that would do what Mom and Dad would have done if they were alive. Perhaps surprisingly, in a vast majority of situations that I deal with, that person exists, and we have the perfect structure: A parental stand on whom we place no restriction. But what if that person does not exist? While some practitioners and clients then want to shift back to specific rules, in my opinion, there is a better way. We should still provide strong discretion to the trustee, but incorporate specific values and beliefs rather than hard or fast inflexible rules. For example, instead of matching the W-2 income, incorporate the parents' value of hard work, disdain for sloth, and respect for a stay-at-home parent. Instead of a hard and fast 3.0 GPA cut off for education expenses, we can provide a values statement that education expenses are an investment in a productive future wherein the child's coordinating investment needs to be hard work and academic rigor. The trustee can then determine whether a 2.5 GPA is the result of a hard-working child overstretching his abilities or a kid on the "Malt Monday, Tequila Tuesday, Wine Wednesday" education plan.

So, my advice: make the trust flexible enough to deal with every changing circumstance and ever-evolving people. Do not restrict the trustee, but rather choose a parenting clone, and if that perfect parent clone does not exist, pick a trustworthy, smart, thoughtful decision maker and have the parents put their values and beliefs in the trust document as a decision-making GPS for the trustee. This is the structure that will best take care of the people the client cares about.