

# POINTS OF Possibility

June 2015

## The Financial Skills Trust: A New Way to Combat the Negative Effects of Leaving Wealth to Your Heirs

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I wish I had a nickel for every time I've heard parents agonizing about leaving their money to their children. I frequently hear comments like, "I'm afraid my kids will blow through the money in record time," "I'm terrified that my son will quit his job the day after my funeral," or, "My investments are complex and sophisticated, but my adult children barely understand Roth IRAs."

Because of concerns like this, many successful families over the years have included so-called 'incentive trusts' in their estate plans. These trusts link beneficiary distributions to their behavior. Those who engage in behavior that the parents want to encourage are able to receive distributions. Those who behave in ways that the parents disapprove of are punished by not receiving distributions.

While this strategy might sound like a great solution, in reality, there are challenges which can actually prevent the desired effect among heirs who are beneficiaries of incentive trusts. The three main drawbacks are:

- Incentive trusts haven't been effective in developing the skills that parents seek to encourage in their children, like having a strong work ethic, exhibiting good money management, or serving others in need. Numerous studies have shown that using external rewards to create internal motivations actually creates the opposite effect in most people.
- They also frequently encourage unethical behavior in heirs who try to 'game' the system by creating fictitious jobs, or pretending to attend college.
- Beneficiaries often resent feeling like their parents are using money to force their values on them and control them from the grave.

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A common example of this dynamic occurs when parents make trust distributions contingent on a child graduating from college. The intent of the parents is understandable and even admirable, but what happens if the child is not inclined to attend college and instead wants to become a plumber, electrician, wedding photographer, or spiritual teacher? Is it fair to penalize him or her?

Similarly, what if an adult child chooses to become a stay-at-home parent, but their parents' trust says they must be employed in order to receive distributions? Other common incentive trust provisions require children to stay active in a particular church, work in specific employment fields, cohabitate only in married relationships, and avoid drugs or alcohol.

“When we use money to motivate our children, we are creating external motivation rather than relying on their own enthusiasms and passions... it is best for our children's motivation to come from inside and not be supplied from the outside. Using money to motivate children is as likely to produce a depressed adult as it is to produce a materially successful one.”

—Psychologist Eileen Gallo

## The Financial Skills Trust

Financial Skills Trusts were originally introduced by attorney Jon Gallo, his wife and psychologist Eileen Gallo, and psychologist Jim Grubman. Much of the information discussed in this article derives from their writings on the topic.

Rather than attempting to control heirs' specific behaviors, the Financial Skills Trust (FST) seeks to reward the results they create in their lives, *specifically the ability to stay out of financial trouble*. This ability can be demonstrated by a core set of eight financial literacy skills (outlined below), as emphasized by experts in financial literacy education, including the National Endowment for Financial Education and the Jump\$tart Coalition. The heirs are free to create the desired results any way they choose.

### 1 The Ability to Live Within One's Means

Arguably the most important life skills one can possess to stay out of financial trouble is to limit spending so it doesn't exceed available income. This means no matter what your income is (including trust distributions), you don't exceed it. Beneficiaries are not free to spend lavishly and then demand additional trust distributions to make up the shortfall.

This guideline does not concern itself with what the beneficiary spends their money on. As long as they are not overspending, they are demonstrating the desired skill.

### 2 The Ability to Save a Portion of Their Income for Future Needs

Some people may be able to live within their means, but are still essentially living paycheck to paycheck. As a result, they don't have a financial cushion to handle the unexpected expenses or opportunities that inevitably turn up. This guideline involves the ability to set aside financial reserves that can be accessed when needed. The skills needed to do this include the ability to delay immediate gratification by deferring spending and resisting the urge to spend the reserves one has been building.

Depending on the amount of assets in the trust, this guideline may also involve the ability to set aside sufficient funds to provide for one's own retirement needs.

### 3 The Ability to Understand and Manage Credit and Debt, and Avoid Excessive Debt

Trust beneficiaries who struggle with or refuse to limit overspending often end up imprudently using debt, especially consumer debt, to finance their lifestyles. This guideline is about avoiding these behaviors, which can lead to bankruptcy and financial ruin. Recognizing that prudent use of debt can be beneficial, the guideline might specify minimum credit rating or FICO scores, or a maximum allowable debt-to-income ratio.

### 4 The Ability to Maintain a Reasonable Accounting of One's Financial Resources

It's almost impossible to live within your means if you have no idea how much your income and expense are, how much you have in savings, or how much you owe. Being able to keep track of one's finances is often missing from those who habitually overspend, or those who avoid dealing with money for a variety of personal reasons.

### 5 The Ability to Understand and Manage One's Personal Assets, Either on Their Own or by Delegating This Function Responsibly to Qualified Financial Advisors

It is important for most people to have at least a basic understanding of investing. This guideline allows for beneficiaries who prefer not to develop their own abilities beyond the basics, to delegate this responsibility to a professional advisor. In the film *Magnum Force*, Dirty Harry (played by Clint Eastwood) says, "A man's got to know his limitations." For this guideline, that means that it is a wise beneficiary who understands that their abilities and interest in finance will never make them as good as a well-chosen financial professional (we'll expand on this in our next issue about Business Skills Trusts).

### 6 The Ability to Generate Additional Income for Spending Needs if Additional Resources are Needed or Desired

This guideline reminds the beneficiary that if they need additional income beyond their current income (including trust distributions), they're going to have to do it the old fashioned way—by earning it. Guidelines two and three say they shouldn't expect to tap their financial reserves or go into debt to generate additional income. Instead they should go out and earn it. This could include improving employment skills to qualify for a higher paying job, or taking on a second job, as needed.

They don't *have* to go out and earn more money, of course. If they don't want to, they can find other ways to live within their means, such as reducing their spending in other areas.

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## 7 The Ability to Use a Portion of One's Income and/or Financial Resources to Support Charitable Activities of One's Choosing (Optional)

The first six skills focus on the ability to manage one's own life. This guideline is about focusing outward, to consider how one might be able to give succor to those around us who are in need. It's about altruism and fulfillment by being in the service of our fellow man. It's also about restraining our own spending in order to help someone else.

This guideline ideally would avoid judgement of, and support the autonomy of the beneficiary to live life according to their own conscience. As a result, there should not be any constraints or restrictions placed upon the beneficiary in the selection of charities.

## 8 The Ability to Show Initiative, Become an Entrepreneur, or Demonstrate Purpose in Paid or Unpaid Work (Optional)

This guideline is about helping the beneficiary live a purposeful life. Some of the skills demonstrated here could include goal-oriented advancement in employment, going above and beyond in their job or field of employment by continually developing their skills and abilities, devoting significant time to professional activities versus leisure time activities, and receiving honors or promotions at work.

For those so inclined, purposeful activity might also include entrepreneurship, helping grow good ideas into successful products or services.

It's critical to be careful with these last two—it can be all too easy to slip back into dictating to heirs how to accomplish these results, or behaviors they should be exhibiting.

The Financial Skills Trust can provide wealth-creating parents with great peace of mind. They can feel secure in the knowledge that the financial rewards gained from their lifetime of hard work can uplift and benefit their children instead of destroying their work ethic and creating dependency. Equally important is the understanding that they can achieve these outcomes without sacrificing their children's happiness, internal motivation, or freedom to live their lives on their own terms and in accordance with their own values. It's one of estate planning's versions of a true win-win.

We have seen these types of trust provisions used with great success in families, and I have included similar provisions in my own estate planning. The beauty of these trusts is that in addition to preparing the heir, they send a message to the heir that their success and happiness in life is a priority, and that they are worthy of receiving mentorship and training on these skills.

Our next issue will discuss how a Business Skills Trust can help prepare the rising generation to take over leadership of a family business or a significant portfolio of investment assets. 🚩

