

James Hamilton



Protecting and Preserving the Family— The True Goal of Estate Planning, Part I: Reasons and Philosophy

By John J. Scroggin

"Try not to become a man of success, but rather become a man of value."
—Albert Einstein

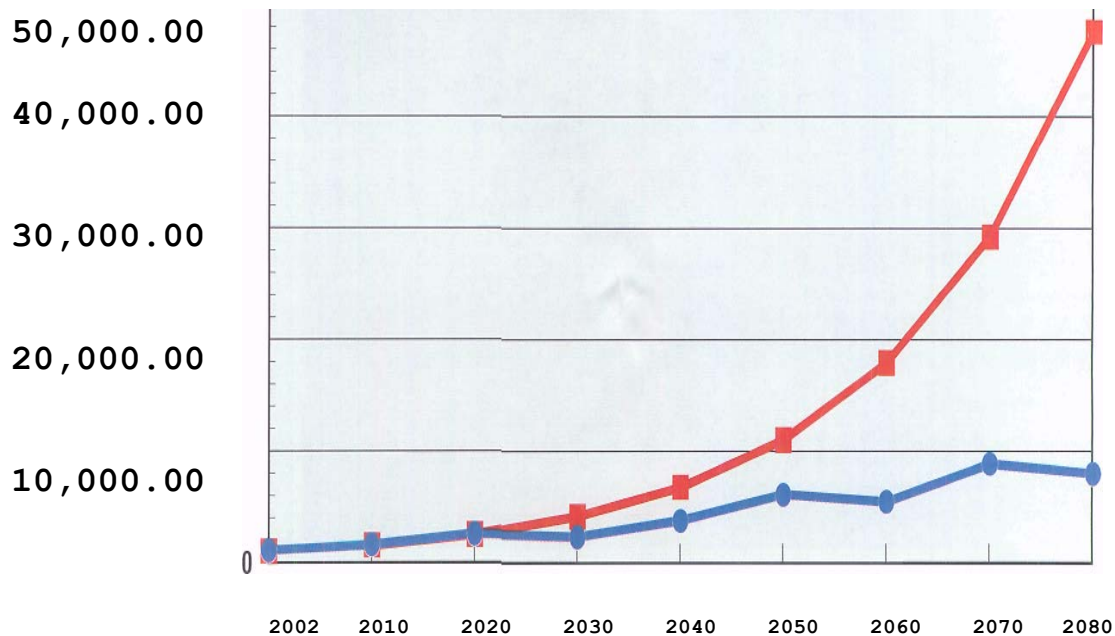
In this era of tax avoidance it often seems that the guiding goal of estate planning has become to pass as much wealth to the next generation as tax-free as possible. But clients are increasingly concerned that the passage of their wealth may do more harm than good to their family.

The tax-driven goal subtly suggests that protecting the family assets is the primary goal of an estate plan. Clients and planners have begun to recognize that this is a misplaced emphasis that focuses attention on assets rather than family, on structure rather than perspective, on tax savings over family need. When protecting and preserving the *assets* is the (often unstated) primary goal, the emphasis is on structures that preserve the assets from taxes and/or family misuse. When protecting and preserving the *family* becomes the beginning point, planning must deal with difficult family issues that might have been ignored—to the ultimate detriment of the client's family.

This new perspective was captured most succinctly by Warren Buffett in a 1986 *Fortune* article; "[The perfect inheritance is] enough money so that they would feel they could do anything, but not so much that they could do nothing." Richard I. Kirkland Jr., *Should You Leave It All to the Children?*, FORTUNE, September 29, 1986, at 18.

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Dynasty Trust vs. Taxable Estates



Dynasty Trust top line

Taxable Estate (45%) bottom line

The Changing Landscape

There are a number of elements causing the change, including the following:

Increased Wealth

There has been an explosion of wealth in this country in the last two decades. Boston College researcher Paul Schervish estimates that by the year 2050 between \$41 and \$136 trillion will have passed by gift or inheritance. It is not just the wealth, but also the demographics of that wealth (and related perspectives and implications) that are driving the revolution. A study by U.S. Trust, *A Portrait of the Affluent in America Today*, noted that only 10% of today's millionaires inherited their wealth. The average millionaire comes from a middle-class or lower background and worked his or her way through college.

Reduced Estate Taxes

The last two decades saw significant reductions in estate taxes. The 2001 tax bill provides for the elimination of the estate tax in 2010 and higher exemption amounts until 2010. But unless the elimination is re-enacted before January 1, 2011, the current transfer tax rules will be reinstated. Will the estate tax be eliminated after 2011? The continued elimination is highly unlikely, but significant estate tax exemptions will probably remain for the foreseeable future, reducing the tax confiscation many parents expected and increasing the concerns about too much wealth passing to family.

Charitable Involvement

During the 1990s wealthy clients have tended to increase their charitable bequests more than their family inheritances. According to Paul Schervish of the Social Welfare Research Institute at Boston College: "A growing number of wealthy Americans are shifting their financial legacies from heirs to charity." According to Mr. Schervish, from 1992 to 1997 the value of charitable bequests went up

110%, but bequests to heirs only grew 57%; for estates above \$20 million, charitable bequests went up 246%, yet heirs only received 75% more. Increasingly, these wealthy citizens are not just giving to charity, but also they are making sure the funds are handled in ways they approve. Clients are also increasingly encouraging family involvement in charitable activities.

Dynasty Trusts

There has been an explosion of dynasty trusts in America. Why does a dynasty trust make sense? The case illustrated by the graph above is a good example. Assume the trust starts with \$1,060,000 in 2002 and grows at a 5% rate per year. It assumes that every 25 years, a generation dies. The lower line shows the tax effect (assuming the family did not spend the funds to support a lifestyle) over 78 years. Instead of losing 45% of the estate to a confiscation tax every 25 years, the dynasty trust continues to grow. In 77 years, almost \$48 million is held in the dynasty trust versus \$7.9 million held by the family.

The dynasty trust creates an inevitable issue: What will be its effect on future generations? Assume a great-grandson has a right to 10% of the above dynasty trust in 77 years. With a 5% return per year, his annual income for the rest of his life is almost \$240,000. When his father tries to convince him to go to college, the son's response is: "Dad, I have a quarter-million a year coming to me—Why do I need to go to college? Why do I need to work?" Although there are significant economic reasons to create a dynasty trust, many clients have not addressed the long-term psychological impact of such a trust on their families.

The Legacy

Increasingly, clients are focusing their attention on their legacies. A 1992 study showed that almost 20% of the people who inherited as little as \$150,000 quit working. A 1999 Neuberger Berman study showed that 44% of the persons polled indicated they would quit work if they received a sizable inheritance. The above study by U.S. Trust noted that 91% of the women and 80% of the men expect their children to support themselves entirely from their own earnings. These perceptions are affecting the estate planning process.

Conflicts

Both from their personal experiences and from frequent articles in the media, clients have seen horrible conflicts erupt among family members. Many clients have an abiding desire to establish planning structures that minimize the points of conflict and provide mechanisms to resolve family conflicts.

Asset Protection

Clients are increasingly examining estate planning approaches that provide for asset protection. States are adopting laws that make it easier for clients to use trusts to restrict the claims of creditors. Asset protection also focuses on the potential claims of divorcing spouses. For example, more than 40% of first marriages end in divorce. Clients are reviewing how to protect their heirs from the expectation of divorce.

Government Programs

Two demographic imperatives are pressing government social programs and causing Congress to adopt tax benefits for taxpayers who can afford to privatize their retirement and long-term care needs. Not only is the number of U.S. citizens age 65 and older expanding rapidly, but also people are living longer. According to the Social Security Administration the system will be bankrupt by 2037. Some reports expect an earlier bankruptcy Medicare may be insolvent by 2008.

There really is no invested account for Social Security participants. The federal government has already spent the money and given the Social Security Administration an IOU. As long as the collected Social Security taxes exceed the paid-out benefits, the IOU is relatively benign. But somewhere around 2015, the government will have to start paying into the Social Security system—paying off its IOU. This cost will place additional stress on the federal budget and may cause Congress to reexamine how benefits are paid. Many people think the result may be a system that is more "needs-based" than the current system. Contrary to the general perception, Social Security benefits are not guaranteed. In *Hemming v. Nestor*, 363 U.S. 603 (1960), the Supreme Court ruled that Congress retains the ability to reduce or even eliminate benefits at any time. For an excellent review of this issue, see Andrew G. Biggs et al., *Social Security: Is It "A Crisis That Doesn't Exist"?*, Cato Institute,

October 5, 2000 (SSP No. 21) (transcript available at www.cato.org/events/001005pf.html).

As a result of these demographic imperatives, clients are increasingly concerned about both their own and their heirs' abilities to rely upon government benefits to provide some minimum level of support. Estate plans are beginning to reflect these concerns.

General Perspectives

In order to understand why these changes are so important, there are some basic perspectives that the planner must understand. First, although children with debilitating mental or physical disabilities are often treated differently in the estate plan (e.g., assets held in a supplemental needs trust), healthy children are generally treated as equals in most estate plans. Clients and planners have not delved into the personalities of heirs, or into their spending habits, or into the stability of their marriages, or into

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their relationships with other family members, or the health, drug, or alcohol problems of family members. These largely psychological issues have not usually been perceived to be within the normal purview of the lawyer's drafting responsibility. Unpleasant experiences by clients or their friends are creating such evaluations in the planning process. In many cases, a psychologist may be a part of the planning. The larger the potential inheritance, the greater the need to address these issues.

Second, one of the basic laws of science is that change is never neutral. Every change creates a reaction. So too does an inheritance. Any inheritance will change behavior. The central question that must be addressed is how to encourage the change to be positive rather than negative. It is simplistic and potentially damaging to think that the best approach is to ignore the effect.

Third, inherent in this new perspective is that values count. Any discussion of protecting family leads naturally to the issue of values and character. Phrases such as "drafting to influence behavior" or even "values-based planning" recognize that values are at the core of this new perspective but unfortunately provide critics of values an easy target. Although values lie at the heart of this planning, the goal of the client should not be to preserve his or her values, but to preserve the family—the two are not identical. For example, a plan that punitively demands today's societal values 100 years from now will probably prove destructive to the family. Just as the U.S. Constitution was intended to be a living document to preserve the Union, this planning must include enough flexibility to adapt and change over time.

Contrary to some critics of this perspective, influencing the behavior of heirs has always been a part of the estate planning process. For example, placing marital assets in a QTIP trust by its nature will influence the behavior of both a surviving spouse and the remainder beneficiaries of the trust. Placing assets in a trust for children to delay their ownership of the funds beyond age 21 will influence the life decisions of the children.

Such planning is not a single planning device or tool. Instead, it devises a plan designed to protect and preserve the family as the first priority of the plan. The concept does not initially focus on taxes. The tax structure is then built around the family's intentions. It is not that the two ideas are in conflict. Rather, the priority of asset preservation must come second to protecting the family. "Protecting the family" must by its nature take into account the unique personalities and family situation (e.g., multiple marriages) of each family. Because no two families are identical, the plans tend to be unique for each family. Moreover, the planning process does not necessarily begin at death. Having a family member or friend mentor an heir in financial responsibility should begin in the early years of the heir's development, not when the heir reaches age 21.

Last, at its core this planning deals with a major psychological issue: how do we define ourselves as people? As Solomon said thousands of years ago: "The lover of money will not be satisfied with money; nor the lover of wealth, with gain. This also is vanity. When goods increase,

those who eat them increase; and what gain has their owner but to see them with his eyes?" Eccles. 5:10-11 NRSV. Katherine Gibson of the Inheritance Project has said: "The guilt and shame of inheriting wealth increases with each generation. The farther a generation is from the initial creation of wealth, the greater the guilt and shame become."

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Perspectives on Influencing Behavior

Certain perspectives should be addressed in this planning:

- The approach should be calculated to create opportunities and incentives, not provide an unearned lifestyle to future generations. As with any plan such an approach will create its own problems. A detailed "risk-reward" evaluation should be made of each proposed opportunity or incentive to determine if the potential new problems outweigh the expected benefits.
- An attempt to influence behavior should encourage responsible behavior rather than punish unacceptable behavior. For example, a provision that denies all trust benefit to an alcohol or drug-addicted heir may be too punitive. Instead, the denial might be predicated upon the heir refusing treatment for his or her addiction, with the trust agreeing to pay for such treatment.
- The behavior that is being influenced necessitates careful drafting. For example, if the desire is to encourage people to attend college, drafting a trust that says "\$20,000 a year to my daughter as long as she is in college" may not be sufficient. The \$20,000 might be used to pay for a wild lifestyle.
- The behavior that is being influenced should be encouraged rather than paid for. If the attempt is to pay someone to do something he or she would not otherwise want to do, it will tend to be resented.
- Drafting to influence behavior must account for the fact that behaviors that are currently acceptable or unacceptable may change over time. Therefore, the plan must be flexible enough to accommodate future technological, personal, and sociological changes.
- The approach must be well-drafted to protect the heirs and trustees. The U.S. Constitution has survived as a living document because of the checks and balances built into it. So too, any planning that restricts an inheritance must include checks and balances to avoid abuses.
- The approach must allow some degree of discretion in the judgment of trustees, so that other factors that were not anticipated can be accounted for in the process. It is simply impossible to contemplate and draft for every possibility. Trustee discretion can deal with unexpected results.
- The drafting approach must not be too restrictive. The more restrictive the approach, the greater the likelihood that either a need will exist outside of the permitted approaches or that the approach will be seen as ruling from the grave.
- The approach must involve a recognition of the heirs as they are and as they may become in the future. Heirs are individuals, not equals. People change over time and the plan must accommodate such unknown future changes.
- The approach should provide at least some minimum level of family protection, such as basic medical, educational, and long-term care.
- The plan should be one part of the larger estate plan. For example, providing enough assets to heirs to provide them life opportunities, coupled with assets placed in more restrictive vehicles (e.g., family partnerships) may be the best approach. Except in unusual fact patterns, placing all assets in restrictive trusts may just create more family conflict.
- In almost every instance it makes sense to discuss with the heirs the manner in which their inheritance will be handled. Death of a loved one is traumatic enough without the shock of discovering you are not inheriting what you expected.

Is It Appropriate?

One of the most frequent criticisms of restricted inheritances or drafting to influence behavior is that it is a blatant attempt by existing generations to rule from the grave by mandating that their value

systems govern the behavior of future generations. The critique is fundamentally philosophical and takes many expressed and implied forms.

As a starting point, remember the quote from Warren Buffett: his goal is not to rule his heirs' lives from a musty, worm-eaten grave. Rather it is to help them to do whatever they desire during their lifetimes. The key is that they do something, not nothing.

"The parents did a bad job— now they want to do from the grave what they could not do during life." There is some truth in this statement. Many of today's millionaires survived the Depression, went off to World War II, and came home determined to make a better life for their children. Now, many of them wonder whether they just spoiled their children and are concerned that their wealth will create an even greater negative legacy. But the truth of the issue only supports the need for restricted inheritances. Having spoiled their children, do they just throw in the towel, with the expectation that the combination of their poor parenting skills and passage of wealth will only magnify the personality defects in their children? The goal of a restricted inheritance is not punitive; instead, it is designed to place reasonable constraints that foster positive actions. It may not work with the first generation, but perhaps succeeding generations will benefit.

"Parents are paying their heirs to do what they think is important." Paying an heir to do something he or she does not want to do is courting disaster. For example, paying a mother to stay at home with a child when she wants to work outside the home may hurt both the mother and child. Instead, restricted inheritances may be designed to provide incentives that provide enough money to encourage people to make positive decisions. For example, providing 55,000 annually to a college student with a B average is not enough to "pay" him to go to school, but it may provide encouragement. The key is that the payment is geared to a level that encourages, but does not pay for the desired activity.

"The specter of a boney hand reaching out of the grave creates a visual image." This is without doubt a great visual image, but it is also a distorted one.

Restricted inheritances should not be structured as a mechanism for a control freak to micro-manage the lives of his or her family from the grave. Rather, it is designed as a means for a caring parent to provide opportunities and incentives to a family, without incurring the harmful aspects of wealth.

In many cases, a beneficiary's personality foibles and defects are magnified as an unintended result of an inheritance. Wealth is a powerful tool, but as with anything powerful, its unrestricted power can be devastating. If a client knows something stands a good chance of harming the family, is the client more or less responsible by placing limitations on the source of the harm? What is the worst that may happen to their families? They might have to make it on their own—not such a bad thing.

"It is wrong to try to use the client's values to influence the behavior of future generations." Virtually everything done in the estate planning process influences behavior. It is naive to think that an inheritance has a neutral effect. The central question that must be addressed (particularly when dealing with more remote heirs) is how sensibly and *positively* to influence the character of future generations. Not dealing with the issue is perhaps the worst legacy a client can leave for his or her heirs.

This criticism basically carries with it the perspective that one person cannot and should not place his or her value systems on another. But it ignores the simple fact that one of the primary parental responsibilities is to mold the character of the children. That responsibility does not cease just because someone reaches age 18 or

21. Many restricted inheritances are flexible enough to provide benefits to children whose character is already well-developed (children in their thirties) by providing current income to children and incentive-based programs for grandchildren whose character is yet to be developed.

"Just trust the children." Many critics say that placing restrictions on wealth creates a psychological issue of parents not trusting heirs. What critics fail to recognize is that the effect of this perceived lack of trust may be less significant than the effect of an unfettered inheritance. Moreover, in most cases it is not a lack of trust but concerns about the reality of an unearned wealth that drives the process. The children may resent not being able to spend Mom's wealth, but restricted inheritances

may also require them to develop the ambition to make it themselves.

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"It's the kids' money." This implied criticism underlies many of the questions about restricted wealth transfers. It inherently states the children have some vested ownership in their parent's assets. But it is not the kids' money, and a parent has a responsibility to protect his or her family from any danger that he or she perceives may hurt the family.

Fundamentally, the question ends up being a choice of alternatives, none of which will be perfect:

- disinheriting the family (in whole or in part) to avoid the negative impacts of inherited wealth,
- giving it all to the family with the hope it will not harm them, or
- educating the family in the right values and designing a system that provides them enough money to do anything, but not enough to do nothing.

The Result

As a result of the changing landscape, clients are examining their estate plans in an entirely different light. The wealthy client often has four primary goals for his plan:

- First, the client wants to protect his or her family from ever being *destitute*. Many of these clients have been destitute and recognize how hard it is to drag oneself out of that hole.
- Second, they want to provide *opportunities* to their family. They hope their descendants will take those opportunities and mature into productive citizens because of their ambition.
- Third, they do *not* want to provide a nonworking *lifestyle* to their heirs. As Andrew Carnegie said (as he gave his wealth to public libraries and charity): "The parent who leaves his son enormous wealth generally deadens the talents and energies of the son and tempts him to lead a less useful and less worthy life than he otherwise would."
- Finally, they want to minimize *intm-family conflicts*. Family is more important than an inheritance, and clients want structures that take into account real or potential conflicts.

Estate planners will have to increasingly address each of these issues in the coming years. One of the more uncomfortable aspects of this approach is that standard forms will no longer be as helpful. Many documents will have to be client-specific. This may result in both higher fees and a cost-based counterbalance to this growing revolution.

This article has discussed the reasons for the revolution. The perspectives given are clearly debatable but should be useful for providing a framework for the ongoing debate. The next article will discuss some of the planning techniques that support these changes. •