

## **Hull on Estate and Succession Planning Podcast #12**

### **The “Prudent Investor” Rule**

**Posted on June 13, 2006**

Suzana Popovic-Montag: Hi and welcome to Hull on Estate and Succession Planning. You're listening to Episode #12 of our podcast on Tuesday, June 13<sup>th</sup>, 2006.

*Welcome to Hull on Estate and Succession Planning, a series of podcasts hosted by Ian Hull and Suzana Popovic-Montag, that will provide information and insights into estate planning in Canada. From the offices of Hull Estate Mediation in Toronto, Ontario, Canada, here are Ian and Suzana.*

Ian Hull: Welcome Suzana.

Suzana Popovic-Montag: Hi there Ian.

Ian Hull: We have the pleasure of working through the whole question of trusts and not just choosing your trustee, which we talked about last podcast, but some of the sort of nitty gritty of a trust. And where we had left off last time was dealing with, well we had worked through an example, of a situation where you may want to consider a trust. And we talked about the fact that after that example, that a trustee must act in an even-handed and impartial manner regarding the investment of the estates. So why don't we work through that and continue to talk about our trusts review.

Suzana Popovic-Montag: That's a great idea Ian. We know that in making investment decisions, trustees are governed by the prudent investor rule, which requires the trustee to consider all options, to canvass those options with a trained investment advisor, to receive written advice from the advisor and to invest the assets in basically a prudent manner.

Ian Hull: Now recently in Ontario, there has been some changes to this, and when I say recent, actually it's not so recent now as in 1999 when Ontario brought in the *Trustee Act* amendments. But these amendments and this kind of terminology of prudent investor stems from the American experience and the U.S. courts have been using and the case law has been establishing, the expectation of what they call a prudent investor.

Suzana Popovic-Montag: We know that in practice Ian, trustees often will invest about 60% of the trust assets in equities and then the remaining 40% in low risk cash or bond type investments.

Ian Hull: And it used to be that they had in Ontario a special list that you had certain types of investments you would make, and now with the prudent investor rule, you need to look at the Act and look at the codification of the expectations of the investment advisor. And for example, and throughout the United States this is prevalent as well, is that they actually expect written reports from the investor, the investment advisor, to be

produced and given to the trustee so that the trustee is not just guessing at the old 60/40 split but is in fact getting advice on that.

Suzana Popovic-Montag: So if you're creating a trust in your Will, you'll want to discuss with your beneficiaries and with your family members both your choice of the trustee and the powers that you'll be giving him or her. And a really good forum to do that is basically the family conference.

Ian Hull: Because this is particularly true if you are giving trustees broad discretionary powers. Your children may be less willing to accept decisions made by the trustee than decisions made by you, so it's important that they fully understand why you have given those powers to a trustee, and that the trustee is someone that they respect. It's the family meeting that gives an opportunity for the individuals to sit down and consider just what it means to be a trustee, and it's not just about filing tax returns or thinking that you can pick the smartest stock. It is more about trying to figure out what the rules are going to govern and how you have to play the game, and the choice of the trustee can be very important in that regard.

Suzana Popovic-Montag: That, together with the fact, Ian, that a trustee is entitled to compensation, and if you've picked a family member as a trustee, you'll want to make sure that your other family members are aware of that, because, you know from my experience certainly, it has been quite the bone of contention in many instances.

Ian Hull: That's right, so many family members expect the trustee to do it for free and as we know, it is not an easy job and it's a job that is underpaid at best in most cases.

Suzana Popovic-Montag: So I thought, Ian, we might now turn to a discussion of incentive trusts, which as I said during our last podcast, was one of my favorite kinds of trusts.

Ian Hull: Yeah, and I think, I mean to be fair, this is a creative type of drafting. The concept has come from the U.S. experience and the idea of incentive trusts are, they are different from other types of trusts used in estate planning because their primary purpose really has little to do with the distribution of the assets.

Suzana Popovic-Montag: Instead, what they are intended to do is to motivate, which we used to call, trust babies, into becoming financially self-sufficient, notwithstanding the fact that they are going to be the beneficiaries of a substantial trust.

Ian Hull: And again, the experience is that the parents who know that their children will inherit a large amount of money have increasingly been worried about the dangers of a great term that I've seen in the States and then being used up here in Canada more and more, is the term "affluenza".

Suzana Popovic-Montag: What it is is that they're concerned that the children, who are expected to receive a large inheritance, may be disinclined to pursue higher education.

And that will depend on the fact that there is going to be a bunch of trust money available to them at the end of the day.

Ian Hull: So parents may use an incentive trust to encourage certain types of productive behaviour from their children.

Suzana Popovic-Montag: With an incentive trust, Ian, the trust rewards certain behaviour. For example, the trust can provide that the more money the child earns on his or her own, the more money he or she will receive from the trust.

Ian Hull: Or a trust can reward the child financially for attending university and achieving certain grades.

Suzana Popovic-Montag: The trust can also penalize the child for unacceptable behaviour. For instance, the child could be denied money from the trust if he or she fails a drug test, but then the money could be given to the child if he or she enters a treatment program.

Ian Hull: So it's often difficult to draft the terms of these incentive trusts because it is so hard to anticipate all of the different types of desirable behaviour.

Suzana Popovic-Montag: For example, should a stay-at-home parent be rewarded with maybe extra income? Or what about someone who earns very little money but spends say 20 hours a week volunteering for a charity?

Ian Hull: So tying specific benefits to the specific behaviour makes the trust easier to administer, yet the language of the trust needs to be broad enough to include unknown future events.

Suzana Popovic-Montag: If you're considering an incentive trust, Ian, you should think about both the broad and the specific behaviours that you want to encourage.

Ian Hull: So if the behaviour you describe is too general, or is too difficult to evaluate, it will be hard for the trustee to administer the trust.

Suzana Popovic-Montag: That's right. You want to keep in mind that the goal of an incentive trust is to encourage the child to take responsibility for his or her own behaviour.

Ian Hull: So in order for an incentive trust to work, the child must be motivated by money, and the person administering the trust must do so fairly with the ultimate goal of ensuring and encouraging the child's independence.

Suzana Popovic-Montag: And I think practically speaking, an incentive trust should be used in conjunction with open communication with your children about money.

Ian Hull: It seems to me that is the biggest struggle, and you should clearly discuss the financial arrangements you have made and address the emotional issues that arise from the financial support that you provide.

Suzana Popovic-Montag: You want your children to clearly understand your goals for them and that they may be financially dependent and notwithstanding that, you're confident that from the trust funds they'll understand the value of achieving financial self-sufficiency.

Ian Hull: A difficult balance but at the same time, you may want to involve your children in making the decisions about the trust's investments and distributions as well.

Suzana Popovic-Montag: And that's not always easy for people to do, Ian.

Ian Hull: Well, that's right. And helping your children acquire that financial knowledge is a valuable step in helping them, though, to achieve this goal of yours, and that is financial independence as well.

Suzana Popovic-Montag: As your children's maturity and financial resources and financial knowledge increase, you may find that they are ready to handle the income and the capital from the trust by themselves, and that's really a good place for them to be.

Ian Hull: For sure and I think as we continue to consider this whole area of trusts, for our next podcast, we'll talk a little bit about what is the classic financial estate planning step of an estate freeze but before we do that, I don't want to turn away from this trust concept without again embracing the general idea that it can provide some excellent tax advantages, creditor-proof advantages and then as we talked about today, some creative steps that you can bring into the family dynamic by using incentive trusts. And presumably the most effective way to make this all sink in and to make it last generations upon generations is to have discussions with your adult and no doubt bright young children in what might be best described as a family meeting to make sure they understand (a) what a trust is and then (b) what kind of flexibility you can bring to the table. And that flexibility will depend largely upon your individual beneficiaries and also your particular circumstances legally because as we said, the incentive trust, while it's a creative thing, I can tell you that lawyers still struggle with how to make them all appropriately and legally enforceable.

Suzana Popovic-Montag: Well, that's a great wrap up Ian, thank you very much.

Ian Hull: Thank you.

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