CHAPTER 27

Advanced Planning Strategies Using Grantor Trusts©

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§ 27.01 INTRODUCTION

In 1977, Professor George Cooper published his masterpiece, "A Voluntary Tax? New Perspectives on Sophisticated Estate Tax Avoidance."[1] The general thesis of the manuscript was that ". . . because the owners of great wealth retain estate planners skilled in legal stratagems for tax avoidance, the estate and gift tax laws have never seriously interfered with the intergenerational transfer of large fortunes."[2] Almost twenty-five years later, these observations and suggested tax avoidance techniques remain viable with little change.

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[1] COLUMBIA LAW REVIEW 161 (March 1977, reprinted in 1979 to reflect the Revenue Act of 1979 by the Brookings Inst.). References hereunder will be made to the Brookings Inst. version.

[2] *Id.* at back cover.

[1] Dynastic Trusts

The best of the family wealth preservation strategies continues to be the perpetual, or dynastic, trust. This article will often focus on the receipt of property from the perspective of the recipient and the techniques that will enhance their enjoyment of and benefits from transferred wealth. Thus, the use of a trust as a device to limit or minimize the management and beneficial enjoyment, including the beneficiary's right of disposition of the property belonging to the trust, is beyond the scope of this undertaking.

In the hands of a capable draftsperson, the trust could be drafted so that ". . . the intervening generation could be given the equivalent of absolute ownership of trust assets through powers of appointment and trust powers. [Therefore, for the trust beneficiaries] . . . estate planning is no problem, because the trust is the best possible built-in estate plan."[3] It is this technique Professor A. James Casner was referring to when he told Congress that "in fact, we haven't got an estate tax, what we have, you pay an estate tax if you want to; if you don't want to, you don't have to."[4] In the past, the overriding focus of perpetual trust planning dealt with the transfer tax savings that would accrue. However, in the current wealth planning environment, creditor protection with such trusts has achieved increasing recognition as the best vehicle available.

[2] Generation Skipping Transfer Tax ("GSTT")

In 1976, Congress attempted to reduce this ability to insulate wealth from the reach of the estate and gift tax systems by enacting the GSTT. The initial version was unsuccessful and was retroactively repealed and replaced in 1986 with the current version, which has received slight modifications. The present version taxes generation-skipping transfers in addition to the estate or gift tax that applies to the transfer. Each individual was given an exemption of $1 million that has been adjusted for cost-of-living and will be further adjusted under the recent tax reform.[5]

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[3] Cooper, *supra* note 1, at 57.

[4] *Hearings Before the House of Ways and Means Comm.*, 94th Cong., 2nd Sess. Pt. 2 1335 (1976) (statement of Prof. A. James Casner).

[5] The Economic Growth and Tax Relief Reconciliation Act, § 521(c) (2001); IRC § 2631(a).

[3] Exemption Can Easily Be Leveraged

The visceral reaction to this relatively modest exemption in planning for large estates is that the statute puts the kibosh on the effectiveness of this arrangement as a means of accumulating massive wealth that would avoid the imposition of the transfer tax system. The correct analysis is that a contrary result will be obtained for those families who aggressively engage in sophisticated wealth shifting strategies in conjunction with the funding of the dynastic trust. Indeed, the effectiveness of the GSTT provisions can be negated using many of the techniques such as many of the strategies discussed herein and, over time, knowledgeable estate planners can finesse the current tax laws, thus significantly mitigating the intent of the statute. Prior to the effective date of the GSTT, the funding of such a trust was unlimited. Under present law, in many instances, the assets that can be transferred into such a vehicle are not really limited by the amount of the exemption, but rather by the imagination of the estate planning advisors and the clients' desire to take advantage of the planning opportunities.

[4] Defective Trusts Significant in Avoiding GSTT Exemption Limitation

One of the most popular and powerful strategies available to the estate planner is the use of income tax defective trusts, particularly when they are dynastic and used in conjunction with other wealth shifting techniques. Although a trust may also be a "defective" or "grantor" trust under the gift and estate tax rules, for purposes of this article, the term "defective" or "grantor" trusts will refer to trusts that are defective solely for income tax purposes. Transfers to such trusts will be completed gifts and outside of the estate for estate and GSTT purposes[6] . Where grantor trust status is obtained

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[6] Care must be used in selecting the defect to achieve grantor trust status so that the taint "does not infect the transferred property for estate tax purposes." It is astounding how many practitioners as well as commentators do not exhibit the requisite care. For example, see discussion under § 27.14[3](d) herein concerning the WRAP trust. See also, Ziskin, "The Security Trust —Better Than A QPRT on Steroids" *Trusts and Estates* at 66 and 72 (October 2000), where the author issues the caveat that the planner use only those powers that achieve grantor trust status for income tax purposes which the author believes works, the power to borrow without security, which is a power that has both estate tax and gift tax risks; IRC §§ 2036(a)(1) and 2702 and the quoted language in § 1.14[3](d) herein.

over the entire trust, the general rule is that the existence of the trust is ignored[7] and the grantor (or pseudo-grantor) is treated as the owner of the trust. An exception to the general rule is where there is an overriding policy that requires a different result such as the assignment of income doctrine.[8]

The fact that the grantor trust rules do not work in *pari materia* creates some extremely attractive planning opportunities. This article will focus on (1) the concept that for family wealth planning purposes the receipt of property in trust, rather than outright, enhances a gift or bequest, and the use of a grantor trust expands the amount of wealth which can be placed in this preferred vehicle; (2) techniques which may be used with the installment sale of a presumptively undervalued asset (generally due to valuation discounts) to an intentionally defective trust (as well as pitfalls to avoid), which is by far the usual approach in wealth shifting using grantor trusts; (3) additional strategies which are improved by the use of defective trusts.

§ 27.02 THE RECEIPT OF PROPERTY IN TRUST ENHANCES A GIFT OR BEQUEST

[1] Unnecessary Tax Exposure

An astonishingly large number of wealthy estate owners are unaware of the numerous wealth planning opportunities available to them, nor do they realize the potential economic diminishment of the family assets, which will be unnecessarily and irretrievably lost through exposure to the wealth transfer tax system. As a consequence, there is a significant portion of the population who have not engaged in the wealth planning process (or who have limited their planning to "basic" estate planning, i.e., wills, revocable living trusts and the like), due to their lack of understanding of the harsh reality awaiting their loved ones. These individuals, who generally are extremely astute, often do not recognize the ability of the skilled estate planner, or better yet, the skilled estate planning team, to significantly erode the imposition of the

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7 Treas. Reg. §1.671-3(a)(1).

8 See Schmolka, *Selected Aspects of the Grantor Trust Rules*, 9th AM. INST. EST. PLAN. at Ch. 14 (1975); Ascher, *Ignoring Grantor Trusts*, 41 TAX L. REV. 253 (1985-1986).

somewhat punitive taxes by engaging in even some fairly simple wealth preservation maneuvers.

[2] Unnecessary Creditor Exposure

In addition to reducing, avoiding and deferring the imposition of taxes, asset protection has become a more integral part of the business and estate plan. Because of the general litigious nature of our society, coupled with the increasing success plaintiffs are enjoying and the proliferation of divorces, creditor protection is often the motivating factor and, from some clients' perspectives, an essential element in the planning process. Although there is a general dislike of paying taxes, paying the IRS is generally more palatable for most people than paying a judgment creditor or a divorce settlement. In addition to the traditional estate planning techniques used to pass wealth to the desired persons with a minimum of taxes and costs, the skilled advisor will counsel his or her clients with respect to structuring the family wealth in a manner that will render it undesirable, unattractive and unreachable by creditors, including spouses in the context of divorce.

§ 27.03 THE "IDEAL" ESTATE PLAN

It is indeed rare that a client has his property owned in the most effective or desirable manner. In most instances that result is not attainable once the client owns the property, with certain exceptions discussed herein. Inherent in outright ownership are certain risks and exposures. To obtain the ideal wealth structure we would want to create an infrastructure that would encompass all desires and goals of the client and maximize the rights of the estate owner. Thus, to set the stage for the planning opportunities reviewed in this article, we need to define the bundle of rights that an estate owner would desire if it were obtainable (hereinafter sometimes referred to as "the six attributes of the ideal estate plan"). The conclusion generally reached is that most of us, and most of our clients, would want to own our wealth whereby we:

(1) will have access to the income from our property until our death;

(2) will have our assets available for our use and enjoyment until our death;

(3) will be able to decide who will receive our property at our death (or during our lifetime if we were to give it away), and in what form they will receive it;

(4) will be able to manage and control our property until our death;

(5) will have our property protected from creditors, including our spouses in case of divorce; and

(6) will save taxes.

Although these six attributes do not have to be given by the transferor, and the transferor may restrict the beneficiary's rights, a process often selected in the trust design, the important lesson here is that the restriction is conferred by the transferor and not required as a part of maintaining the sanctity of the trust vehicle.

[1] Must be Created by Someone Else: Anyone Can Set up Such a Trust Except the Beneficiary

The foregoing list [§ 27.03 (1)-(6)] appears to contain all of the rights in property that anyone would desire. However, an estate owner could not effectively set up and fund a structure for himself under U.S. law that would enable him to access, enjoy and manage the assets and also obtain creditor protection and tax relief. On the other hand, anyone other than the prospective estate owner/ beneficiary can create an irrevocable trust for the benefit of the prospective recipient that would satisfy all six of the objectives that comprise the ideal estate plan.

[a] *Grantor Trust for Income and Transfer Tax Purposes*

If the client set up and funded such a trust for himself, the client would be taxed for both income and transfer tax purposes as if the trust did not exist.

[b] *Exposed to Creditors*

The trust would also not protect the assets from the grantor's creditors. The creditors would be able to reach the maximum amount that could be paid to the grantor.[9] Several states have enacted statutes attempting to permit self-settled, spendthrift trusts

[9] Restatement (second) of Trusts at § 156(2) (1952).

to protect assets from future creditors. The jury is out as to the effectiveness of such a statute, particularly with respect to trusts created by persons who are domiciled in jurisdictions outside of the state whose law is being selected in the trust agreement.[10] Conversely, anyone other than the client could set up a trust for the benefit of the client and incorporate all six components of the "ideal estate plan."

[2] More Rights In A Trust than Outright Ownership

The foregoing analysis leads to the general conclusion that a person can receive more rights in a trust than he can obtain by owning property outright, provided that the transfer to the trust is funded by a third party. Since a transferor can confer more rights and benefits by making transfers in trust than giving the property outright, it would also be reasonable to conclude that virtually all significant gifts and bequests should be made in trust and that the term of the trust should be as long as permitted under the law. Forum shopping for a state that has no RAP statute should be considered by balancing the costs of renting such jurisdiction against the benefits of the extended allowable term.

[3] Use of Trust Counterintuitive

The ability to improve or enhance a gift by placing it in a trust is often summarily dismissed without adequate and intelligent analysis of the benefits the recipient would be losing. Rejection comes in many ways, often in the form of a perceived flaw in the trust concept, such as the belief that the beneficiary would have to relinquish control in order to obtain the tax benefits which trusts offer. Loss of control can be avoided by structuring the trust as a "Beneficiary Controlled Trust" whereby the primary beneficiary will either be the sole trustee or will have all trustee powers, other

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[10] See Engel, Lockwood and Merric, *Asset Protection Planning Guide: A State-of-the-Art Approach to Integrated Estate Planning,* CCH at paragraph 1101.3; Giordani and Osborne, *Will the Alaska Trusts Work?* JOURNAL OF ASSET PROTECTION at 7 (Sept/Oct 1997); Rosen, 810 T.M., Asset Protection Planning A-16. Contra. various articles authored or co-authored by Jonathan G. Blattmachr; Perhaps the best arrangement for a self-settled trust to achieve success was suggested by Barry Engel to the author, combine foreign asset protection arrangement with a domestic counter-part. Barry is now often advising the combination of a foreign asset protection structure with a Nevada self-settled trust.

than tax-sensitive powers, and also the ability to control the identity of the independent trustee. Moreover, virtually all concerns can easily be remedied in the trust design.[11] Any inability to give the primary beneficiary the necessary control and beneficial enjoyment is the fault of the trust architecture and draftsman and not the trust concept.[12] A second reason often cited for rejecting trusts is a concern as to complexity. Often these objections can be overcome by citing the magnitude of the available benefits that can be derived. Compared to the planning alternatives available to a recipient, a trust set up by a third party is more advantageous and less complex than the options available to an estate owner who holds the property outright.

[4] Not Sufficient Foresight

Most clients visit their estate and business professional advisors primarily to obtain tax guidance. The second most popular reason that clients consult with their estate and business advisors is to seek asset protection advice. Often the consultation involves assets that could have been protected from the transfer tax system and the reach of creditors if planning for the property had been previously undertaken. The most obvious illustration is inherited property. In many instances, if the transferor, or the transferor's advisors, had sufficient foresight to set up a trust to hold the assets left to the client, the client would not need the planning. The trust would be the centerpiece of the estate plan. In fact, receiving the property in a well-designed trust will enable the client/beneficiary to more rapidly defend his estate using the trust as security. It is surprising how many advisors who are involved in complicated estate planning for their clients do not, in the normal course of business, recommend that their clients suggest to their parents that the parents leave their property to the clients in trust.

[5] Missed Planning Opportunities

Another large segment of wealth, which is the subject of inefficient planning, are assets that have significantly increased in value,

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[11] Frederick R. Keydel, *Trustee Selection, Succession, and Removal: Ways to Blend Expertise with Family Control*, 23 U. MIAMI INST. ON EST. PLAN at Ch. 4 (1989).

[12] *Id.*

such as matured businesses or investment opportunities. Many clients have assets which have grown substantially in value but which were started with very little "seed" money. Had the "seed" money been placed in trust for the benefit of the client, the important elements of asset protection and transfer tax savings would not have been lost. Both the opportunity for profit and the fruits of a successful undertaking would have been shifted to the trust vehicle. Thus, for new ventures, the cardinal rule is that proper structuring of the entity or entities must be done both as to the planning vehicle being used and as to the ownership of the interest. It is much easier and tax efficient to properly structure the venture at its inception than to try to rearrange existing wealth or to move wealth from one generation to another. Proper structuring includes not only the entity that owns the underlying asset, such as a partnership, LLC, or other entity, but also the proper arrangement of the design and ownership of the entity itself.

[6] Planning For Mature, Competent, Responsible Beneficiaries

For those clients who would like to give the property outright if it wasn't for the benefits trust offer, the trust blueprint should include using a "Beneficiary Controlled Trust" as the vehicle of choice rather than an outright gift or bequest or a trust which terminates. The trust can be drafted so that the primary beneficiary receives rights virtually tantamount to outright ownership, including all of the six attributes of the ideal estate plan. Properly educating the client should overcome the inherent fear that the trust will unduly restrict the benefits. Most trusts are designed to distribute assets to the beneficiaries at the time the transfer projects that the beneficiaries will have attained sufficient maturity to manage the property. Rather than make a distribution at that time, the preferable alternative is to make the intended recipient the trustee in a Beneficiary Controlled Trust.

[a] *Control—"The Beneficiary Controlled Trust"*

The Beneficiary Controlled Trust concept is simple. It is a trust where the primary beneficiary either is the sole trustee or has the broad ability to fire any co-trustee and select a successor co-trustee. Typically, control of the trusteeship is coupled with a special power

of appointment enabling the powerholder to deflect any anticipated rights of more remote beneficiaries elsewhere. The ability to terminate interests by exercising the power should have the effect of eliminating any potential interference by remote beneficiaries. Because the primary beneficiary/trustee possesses the ability to eliminate all participation in the enjoyment of the trust assets by secondary and remote beneficiaries, the latter will not be inclined to bring a lawsuit because their rights could be terminated.

[b] *"Use" Concept: Ready Access To and Use of the Income and Corpus of the Trust*

The basic philosophy of this article is that a transfer of property in trust improves the value of the property to the trust beneficiaries. The corollary of that thesis is that distributions from the trust, in the absence of a compelling reason to make distributions, such as onerous income tax consequences, should be avoided. The consequence of making distributions would be to move wealth from a tax and creditor protected environment into one that is exposed. For dynastic trusts, the adverse effect of such leakage would be greatly magnified. The trustee (who can be the beneficiary himself) should be encouraged to acquire assets that are expected to appreciate in value for the "use" of the beneficiaries, rather than making distributions to fund the individual's personal acquisition of the assets. The right to "use" the trust assets may be for any purpose and need not be limited by an ascertainable standard without coming within the general power of appointment definition contained in IRC § 2041(b)(1)(A) even though the decision to allow the use is in the hands of a person acting in the dual capacity of beneficiary and trustee. Rather than being a power of appointment, use of the trust assets would be akin to a life estate.

To illustrate, if the beneficiary has a business or investment opportunity, in lieu of distributing the funds to the beneficiary, who would then use the funds to acquire the business or investment personally the trustee instead should acquire the asset as an asset of the trust. As a result, the beneficiary would have the use and enjoyment of the property without the creditor exposure even if the trustee/beneficiary possessed this power. Because asset management is not a tax sensitive trustee power, the control would also

not have any adverse tax impact.[13] In fact, control over trust property will not be imputed to the trustee/beneficiary personally so as to be aggregated to form a control block.[14] Therefore, if the trust owns a 30 percent interest in an entity and the trustee personally also owns a 30 percent interest, the interests will not be combined for tax purposes.

[c] *The Ability to Decide Who Will Receive the Property*

In addition to having the beneficial enjoyment of the trust property, another feature of the ideal estate planning structure is the ability to determine who the transferees of the property will be and in what form they will receive it. This can be accomplished by giving the primary beneficiary a broad special power of appointment. In a dynastic trust, the power of appointment would usually also be given to a remote beneficiary, typically on a per stirpital basis, (a secondary beneficiary who will become a primary beneficiary at the death of a primary beneficiary) at such time as the beneficiary attains the status of a primary beneficiary. A power of appointment is a desirable ingredient in most trusts because it adds flexibility and permits the trust to be modified in order to deal with changes in the law or family circumstances. Its importance increases when the trust is dynastic because there is a greater possibility of change in family circumstances, laws, particularly tax laws, etc.

As previously mentioned, the use of a special power of appointment enhances the objective of using a Beneficiary Controlled Trust in that it provides added control in the hands of the primary beneficiary. It also adds protection from interference from secondary beneficiaries because the powerholder can appoint the property away from any complaining beneficiaries, in effect disinheriting them. One argument often made in furtherance of not using a trust is that if there were no trust, there would be no accountability to more remote descendants. By coupling the power of appointment with broad discretionary powers in the hands of the trustee/beneficiary, the result would be that the trustee/beneficiary would have the functional equivalent of no accountability with respect to

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[13] Harrison, Lou, *Structuring Trusts to Permit the Donor to Act as Trustee*, 22 ESTATE PLANNING 331 (November/December 1995).

[14] *Estate of Bright v. Comm'r.* 658 F.2d 999 (1981).

the trust. As Professor Ed Halbach has often stated, "[a] power of appointment is also a power of disappointment."

If the creator of the trust desires to provide the beneficiary with rights that are as close to outright ownership as possible, the powerholder can be given the power to appoint the property in favor of anyone, in trust or outright, other than himself, his estate, his creditors or the creditors of his estate[15] without causing estate inclusion. None of these limitations should be viewed as a real restriction. Although one cannot appoint to himself, he can generally access the property easily through a broad interpretation of the ascertainable standards or, preferably, can use it for any purpose virtually without restriction if he is the trustee and the trust is properly drafted. The inability to appoint to one's estate is also not meaningful when one realizes that the powerholder can appoint to the beneficiaries of his estate, either outright or in trust, provided that the term of the recipient trust does not exceed the term of the existing trust.[16] Further, it is inconceivable that anyone would desire to appoint property to his creditors or the creditors of his estate and negate the asset protection benefits inherent in the trust vehicle, in the absence of special circumstances, such as substituting an estate tax for a GSTT in GSTT planning.

A concern often voiced by dynastic trust candidates and some of their advisors is that they don't want to be irrevocably locked into a trust arrangement forever. A power of appointment that can be exercised by making outright distributions, thus terminating the trust, can easily finesse that perceived problem.[17] Alternatively, the power of appointment design can be broad enough to enable the trust to virtually be redrafted without exposing the trust to transfer tax, provided the duration of the restructured trust is not extended beyond its original term.

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[15] IRC § 2041(b)(1).

[16] IRC § 2041(a)(3).

[17] Of course, the powerholder cannot have the right to terminate the trust in favor of him or her self without being exposed to IRC § 2041 or subjecting the property to creditors.

§ 27.04 THE DUAL DEFICIENCIES OF OUTRIGHT OWNERSHIP—TAXES AND CREDITOR PROTECTION

[1] Creditor Protection

Although it has always been a worthwhile consideration, asset protection and liability planning have become an integral part of the business and estate planning process.

[a] *The Most Impenetrable Creditor Protection Strategy in American Jurisprudence*

An irrevocable trust set up by someone other than the beneficiary is the best creditor protection device available to the planner. A discretionary trust where distributions are subject to the absolute discretion of an independent trustee has been described as ". . . the ultimate in creditor and divorce claims protection—even in a state that restricts so called spendthrift trusts—since the beneficiary himself has no enforceable rights against the trust."[18] That conclusion is reached because "[t]he key characteristic of a discretionary interest in a trust is that the beneficiary of such interest has no right to any distribution; the beneficiary generally cannot obtain a court order compelling the trustee to distribute any amount to the beneficiary."[19]

[b] *General Rule*

As the asset protection maxim goes—"If you don't own it, nobody can take it away from you."[20] Historically, the general rule has been that the creator of the trust can dictate who may receive the beneficial enjoyment of the property and the extent and circumstances under which this enjoyment may be obtained.

[c] *Anomaly or Possible Exception*

Except in a few egregious situations, unless trust property is distributed to a beneficiary, it will be protected from the

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[18] Keydel, *supra* note 11, at § 409.1.

[19] Lischer, *Domestic Asset Protection Trusts: Pallbearers to Liability?* REAL PROPERTY AND TRUST JOURNAL at 487 (Fall 2000).

[20] Howard D. Rosen, 810 T.M., *Asset Protection Planning*, BNA TAX MANAGEMENT PORTFOLIO at A-1.

beneficiary's creditors.[21] In an anomalous decision, *Sligh v. First National Bank of Holms County*,[22] the Mississippi Supreme Court's resolution in favor of the judgment creditors was legislatively fixed soon after the unusual decision was rendered.

[d] *Illustration of the Present Status of the Law*

Scheffel v. Krueger[23] is illustrative of the present status of the law and is instructive as to the asset protection opportunities available through the use of a spendthrift trust even under a disturbing, morally reprehensible fact pattern. In *Scheffel*, the New Hampshire Supreme Court disallowed a claim of a tort creditor, the mother of a minor boy, who had obtained a judgment against the trust beneficiary for sexual assault even though the beneficiary/tort feasor had certain controls over the trust.

[e] *Planning—Independent Trustee to Make Distributions Advisable*

"The Restatement (Third) of the Law of Trusts, Tentative Draft No. 2 . . . takes the position in § 60, cmt. G. that a creditor of a trustee-beneficiary can reach as much as the trustee-beneficiary could properly distribute to himself under the terms of the trust instrument."[24] Thus, the prudent planner will allocate to an independent trustee the dispositive powers at least as to the trustee/beneficiary. With a Beneficiary Controlled Trust, I almost always use two trustees, the primary beneficiary having all of the non-tax sensitive powers, such as management, and an independent trustee,

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[21] Creditors have made some inroads into that general rule in cases holding that where the beneficiary had certain controls, such as extending the term of the trust or the ability to change trustees, the creditor protection may be lost; *Hatsfield v. Lescher*, 721 F.Supp. 1052 (E.D. Ark. 1989); *In re Baldwin*, 142 B.R. 210 (Bankr. S.D. Ohio 1992); *In re Herzig*, 167 B.R. (Bankr. E.D. Va. 1994); Hopefully these cases will prove to be anomalies. Otherwise, it could lead to the egregious result that one discretionary beneficiary who goes bankrupt could infect the entire family's wealth.

[22] 704 So.2d. 1020 (Miss. 1997).

[23] 2001 WL 839850 (N.H. 2001); See Steven J. Oshins and Christopher M. Riser, *Scheffel v. Krueger: The Effectiveness of Statutory Spendthrift Trust Protection*, TRUSTS AND ESTATES (October 2001).

[24] Oshins and Riser, *supra* note 23, at 16.

as described in IRC § 674(c) as augmented by IRC § 672(c),[25] who has the tax sensitive powers which includes the distribution power.

A variation of the foregoing theme is for the beneficiary/trustee to have the non-tax sensitive powers plus the power to distribute to others but not to himself or herself, and an independent or special trustee who would be available to make distributions to the trustee/beneficiary. To obtain greater tax planning flexibility, an ancillary trustee would be desirable irrespective of the creditor accessibility issue, for example, to hold certain tax sensitive powers such as the power to terminate the trust, give or take away general powers of appointment, and to amend the trust in favor of the primary beneficiary.

[2] Transfer Tax Savings—Voluntary Taxes Still May be the General Rule in Many Instances

As a general rule, most clients are motivated to create trusts by the significant transfer tax savings that can be achieved. The ability to significantly erode the imposition of these somewhat punitive taxes by engaging in sophisticated estate planning maneuvers in conjunction with the trust vehicle is substantial. "The fact that any substantial amount of tax is now being collected can be attributed only to taxpayer indifference to avoidance opportunities or a lack of aggressiveness on the part of estate planners in exploiting the loopholes that exist . . . For those who do not want to contribute their estates to the government (or to charity), there is an impressive array of strategies for moving wealth from one generation to another outside the purview of estate and gift taxation."[26]

[3] Income Tax Savings—Toggling

As a general proposition, income taxation follows the ownership of property and these owners are often in the highest income tax bracket. Moreover, the after tax income inures to the benefit of the property owner and augments his estate. On the other hand, with

[25] Keydel, *supra* note 11, for an outstanding analysis of design of Trustee selection and the allocation of Trustee powers.

[26] Cooper, *supra* note 1, at 4.

limited exceptions,[27] where a trust owns property the architect of the trust has at least three[28] choices as to how the trust is taxed. The general rule is that the trust is a separate taxpayer and is taxed under Subparts A through D of Subchapter J.[29] If the trust violates any one or more of IRC §§ 673-677 or 679, the grantor will be taxed on trust income and/or corpus. Alternatively, a trust may be taxed to a person other than the grantor (trust beneficiary) under IRC § 678 if that person has the sole power to vest corpus or income in him or herself.

In addition to the opportunity to achieve income tax economies by selecting the alternative which best suits the client,[30] in most instances, the client will be able to do some "toggling" and turn the spigot on and off by releasing powers and/or having someone[31] add powers which will change the ownership status under Subchapter J.

[4] Conclusion

From the viewpoint of the intended recipient, the receipt of property in a trust that is drafted whereby the trust beneficiary is given the rights and benefits almost identical to outright ownership is preferable to an outright transfer. Having concluded that property in a Beneficiary Controlled Trust is a more beneficial way to receive and enjoy wealth; that the use of a generation skipping trust exempt from Chapter 13 is the trust vehicle of choice; and that an income tax defective trust will enable the perpetual trust to be funded more rapidly since its growth will not be stunted by income taxes, the next step is to engage in an analysis of some of the various dynastic

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[27] For example, the general rule would not be applicable to the assignment of personal service income since the "fruits" can not be "attributed to a different tree from which it grew," *Lucas v. Earl*, 281 U.S. 111, 115 (1930).

[28] Choices of taxing ordinary income differently from gains also are available.

[29] IRC §§ 641-668; As a result of the compressed rate structure for trusts and the fact that the income tax payments by the grantor reduce the grantor's estate and enables the trust to grow income tax free and the payment of income is not subject to the transfer tax system (gift and GST), generally, grantor trust status is desirable.

[30] As will be seen later, the preferred alternative is obtained through trust design and funding.

[31] If the grantor has the right to add the powers, the mere possession of that right will create grantor trust status and flexibility will not be achieved.

defective trust packing techniques that are available, and the refinements which should be considered.

§ 27.05 TRADITIONAL INSTALLMENT SALE TO A DEFECTIVE TRUST TECHNIQUE

[1] Basic Structure

An installment sale to a defective trust in exchange for the trust's promissory note has become an increasingly popular wealth transfer strategy that offers many significant benefits. Generally, this technique is used to sell non-controlling interests in entities such as limited partnerships, LLCs and corporations, particularly S corporations, to defective dynastic trusts, taking advantage of valuation discounts. Other presumptively undervalued assets such as options or lettered stock are also excellent candidates for this technique.

The trust is set up as a grantor trust by intentionally violating one or more of the grantor trust rules. Typically, the note is structured as interest-only for a period of time with a balloon payment at the end of the term and a right of prepayment without penalty. The Service has opined in Rev. Rul. 85-13, and in several private letter rulings, that transactions between a trust and its "owner" for income tax purposes will be ignored. Thus, the person who is treated as the "owner" of the trust for income tax purposes can sell an asset to the trust without any income tax ramifications.[32] In addition, the trust can satisfy its obligation with appreciated assets without income tax consequences.

[2] Use of Deferred Payment Increases Leverage

Leveraging the sale using a deferred payment significantly enhances the sale of discounted assets. The interest-only installment sale with a balloon payment will be illustrated herein, but a private annuity or self-canceling installment note might also be considered if the client's situation makes one of these alternatives more favorable.

Illustration: The installment sale to a defective trust technique can best be illustrated by an example. Assume that the grantor gifts

[32] Rev. Rul. 85-13, 1985-1 C.B. 184.

$1 million to a defective trust and allocates $1 million of gift tax exemption and $1 million of GST tax exemption to the transfer with the result that the trust is wholly exempt from transfer taxes. The grantor then sells to the trust a limited partnership interest with a pro rata value of $16,666,667 (and a fair market value of $10 million after a 40% discount) in exchange for an interest-only promissory note with a balloon payment of $10 million due after nine years. The sale is for fair market value so that no additional gift tax exemption or GST tax exemption needs to be allocated to the trust. If the partnership assets and the initial $1 million gift are both earning income at a rate of 10% each year, then the trust will have an additional $1,766,667 (i.e., 10% of $16,666,667 plus 10% of $1 million "seed" money) at the end of the first year. If we assume an IRC § 1274(d) federal mid-term rate of 5.00%, the interest payable from the trust to the grantor at the end of the year would be 5.00% of $10 million, or $500,000. Each year, the trust continues to accumulate much more income than it must pay back to the grantor since (i) the trust is increasing income tax-free, and (ii) the interest is calculated against the discounted fair market value of the limited partnership interest. If the grantor were to die immediately after entering into the sales agreement, his estate would be reduced by the $16,666,667 pro rata value of the partnership assets and would be increased by the promissory note with a face value of only $10 million. This would result in immediate savings of the estate tax on the $6,666,667 difference between the two figures.

[3] Concept Works Well When Integrated with Large Life Insurance Acquisitions

The installment note concept works well in combining a large life insurance program with the other portions of the estate plan.

[a] *Funding Premiums*

The cash flow in excess of the interest payment provides a fantastic source of premium dollars and/or a source of cash flow to roll out of a split-dollar plan. The use of such a funded insurance trust avoids the problem of using *Crummey* powers of withdrawal, particularly where a sufficient number of legitimate power holders are insufficient to allow for the funding of the trust. Using the

illustrations set forth in the above illustration, the cash flow of $1,766,667 reduced by the interest payable each year of $500,000 would enable annual premiums of $1,266,667 to be paid without any transfer tax implications. The funds available for the payment of premiums are not reduced by income tax because the trust is defective for income tax purposes.

[b] *Split-dollar Exit Strategy*

A popular method of acquiring life insurance is to use either a business or family split-dollar arrangement in conjunction with an irrevocable trust. The primary benefit, particularly with family split-dollar plans, is to minimize the gifts to the trust for both gift tax and GSTT purposes. A major potential problem exists by virtue of the fact that as the insured gets older, the insurance component gets more expensive and thus the amount of the gift to the trust (and income, if applicable) increases, and can get quite large at older ages. Thus, consideration must be given at the inception as to how the split-dollar plan will be unwound. The normal approach in terminating the arrangement is for the trust to buy out the cash value component from the owners using the cash value buildup inside of the policy as the source of funds.

A viable alternative is to use an external rather than an internal source for funding the rollout. Thus, in a funded life insurance trust, the cash flow from the non-insurance assets can be used to unwind the split dollar plan.

[4] Avoiding Income Tax Consequences at Death of "Owner"

Upon the death of the person who is treated as the "owner" of a trust for income tax purposes, if the promissory note is still outstanding there is an issue as to whether the owner must recognize gain. The issue arises as a result of the conversion of the defective trust to a non-defective trust, because death terminates grantor trust status. The commentators who believe that gain must be recognized[33] do so under the rationale of Treas. Reg. Sec. 1.1001-2(c), Ex. (5), *Madorin*[34] and Rev. Rul. 77-402.[35]

[33] See, Covey, *Practical Drafting* at 4365-4367.

[34] *Madorin v. Comm'r.* 84 T.C. 667 (1985).

[35] Rev. Rul. 77-402, 1977-2 C.B. 222.

[a] *Authority Suggesting Taxation*

Under each of these authorities, the grantor creates a trust in which the grantor is treated as the owner for income tax purposes. Each year, the grantor uses the deductions attributable to the trust assets to offset income on the grantor's personal tax return. When the defective trust is going to begin producing income that will be reported on the grantor's return, the trustee renounces the powers over the trust that caused it to be defective so that it becomes non-defective. Under each of these authorities, at the time the trust becomes non-defective, the grantor must realize gain (or loss) to the extent the liabilities exceed the adjusted basis.

These authorities are not directly on point. Since the possible income tax triggering event in the sale to a defective trust transaction is death, authorities providing an analysis with respect to other triggering events do not necessarily apply.

[b] *Election Out of Installment Reporting*

A concept that Prof. Jerry Kasner has suggested is that the transaction can be structured so that income tax can be avoided by having the seller elect out of installment reporting.[36] The taxpayer would report the transaction on his return, explain that under Rev. Rul. 85-13 the gain would not be recognized, that there would be carryover of basis and that the taxpayer elected to opt out of installment reporting. In the normal course of action, for example a sale to a non-defective trust, if the taxpayer elects not to use the installment method, the entire gain would be reported in the year of sale. Nothing further would be reported at death. Because the gain is not recognized by the trust, being a grantor trust, why would future years be affected? It would be reasonable to conclude that each successive year would stand on its own and if an estate owner were to die in year 10, for instance, we would not look back to year 1 to see if gain was recognized in determining the treatment for year 10.

Practice Pointer—Since there is no downside risk to making this election, it should be made as a matter of course.

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[36] IRC § 453(d); Jerry A. Kasner, *Maybe the Cup is Half Empty—Planning for Premature Death,* Outline (1998).

[c] *Prepaying the Note*

This issue as to whether there are income taxes at the seller's death may be avoided by having the defective trust pay off the entire note prior to the seller's death. Where practicable, it is advisable that the note should be paid off with appreciated assets so that the assets obtain a new income tax basis in the seller's estate.[37] Payment by the trust with appreciated assets is an income tax-free event.[38]

[5] Don't Mix Apples and Oranges

Just as it is desirable in GSTT planning that trusts be entirely exempt or entirely non-exempt, singular income tax status for a trust is also strongly recommended. Therefore, when designing and implementing the trust, it is imperative that the "defect" selected to secure grantor trust status will be a violation which affects both ordinary income as well as corpus and will infect the entire trust (and not just a portion of the trust) with the result that the grantor (or other person) will be treated as the owner of the entire trust and will be taxed on, and report, all items of income, deductions and credits on his return.

[a] *Hybrid Tax Consequences Discouraged*

If a trust has hybrid tax consequences, in many instances planning is restricted because the consequences of an action may have partially positive results and partially negative results. Dual tax treatment may also create an accounting nightmare. Consider, for example, Letter Ruling 9034004, which is illustrative of the Service's position on the proper way to compute the income tax consequences with respect to the lapse of a power of withdrawal for a trust that is otherwise not defective. The Service ruled that not only is there a pro rata grantor trust exposure to the powerholder as to the amount lapsing, but that such exposure will increase each time a withdrawal power lapses. In order to avoid this cascading transition in tax reporting, it is important that separate trusts be created if the funding would otherwise result in different income tax consequences.

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[37] IRC § 1014.

[38] Rev. Rul. 85-13.

[b] *Single Grantor*

It is also advisable not to have more than one grantor for each trust if the trust is defective. For example, husband and wife should not both be grantors of the same trust. In such instance, on the death of one spouse, grantor trust status will cease to the portion of the trust previously "owned" by the decedent, resulting in hybrid income tax treatment thereafter. This trap occurs frequently where community property is the source of funding.

§ 27.06 SOME STRATEGIES THAT ENHANCE DEFECTIVE TRUSTS

[1] Opportunity Shifting

One of the best, yet often overlooked, techniques to avoid the transfer tax system is the shifting or deflecting of the opportunity to earn income or generate wealth from the client to others, including trusts.

For planning purposes, it is far simpler, less risky and more tax efficient to shift the opportunity to create wealth at the inception of an undertaking than to move wealth once value has matured and has become substantial. The shifting of an opportunity does not involve a transfer and, therefore, finesses the transfer tax system.

In its simplest form, if a person was to refer business, customers or clients to another person, or give some gratuitous advice to the other person, no one would think a transfer subject to the gift tax has occurred. Those activities happen frequently.

Thus, when a new business is formed, a new product is being developed, a new location is being considered, or the family has an investment opportunity, a new entity should also be formed, and some or all of the equity interests offered in the new entity should be placed in irrevocable trusts. In many instances, the "seed" money is negligible to enable the recipient of the opportunity to acquire a significant interest in a venture that can reasonably be predicted to explode in value. Moreover, a referring family member can determine how much of the opportunity to shift, and can structure the entity accordingly. Thus, the entity design can include a scenario whereby the opportunity provider obtains complete control of the

new venture even though he or she owns only a small sliver of it.[39] For example, control of the general partner in a limited partnership, manager of a limited liability company, or holder of the only share of voting stock in a corporation will obtain such a result.

A capital structure, whereby the opportunity shifter receives control of the entity, will subject to the transfer tax system only the interest owned and not the opportunity "transferred." In addition, at such time as the retained interest is ultimately transferred, it should be taxed at a mere fraction of what the interest really means to its owner.

[2] Getting An Advance on Your Inheritance

Estate planners tend to look down generations for planning purposes. Typically, the only upstream inquiries made with regard to the economic situation of the parents are (i) whether the client anticipates an inheritance that should be taken into account in planning the client's estate, and (ii) whether the client may need to provide support for a parent in case of an unusual order of deaths. Planners often overlook inquiring as to whether the client's parent has the ability and inclination to fund a trust for the client's benefit. Even persons of somewhat modest means can often come up with, and are willing to part with, sufficient seed money for a predictably "hot" investment or business venture, such as a new business entity that will be designed to receive referrals from a present successful business, or another opportunity shifting scenario.

[a] *Look Up a Generation to "Seed" the Trust*

Many of our clients have the ability to take a small amount of money and create large wealth. An extraordinary opportunity exists by looking up a generation as part of the planning process. When the client is about to embark on a new venture or has an investment

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[39] Cooper, *A Voluntary Tax? New Perspectives On Sophisticated Estate Tax Avoidance*, 77 COL. L. REV. 161 (March 1977) at 19; Owen G. Fiore, *Ownership Shifting to Realize Family Goals, Including Tax Savings*, 37 NYU INST. ON FED. TAX at Sec. 38 (1979); Owen G. Fiore, *Estate and Value Opportunity Shifting Through Installment Sales, Private Annuities and Interest-Free Loans*, U. MIAMI 13TH INST. ON EST. PLAN. at Ch. 7 (1980). See, however, FSA 200128011 which indicates that the Service is now looking at opportunity shifting.4. *Estate of Bright v. Comm'r*, 658 F. 2d 999 (1981).

opportunity with significant potential, consideration should be given to having the client's parent(s) create and fund a trust for the client. Money placed in a dynastic Beneficiary Controlled Trust funded by the client's parent(s) would provide the "seed" money for any such anticipated business venture or investment.

[b] *Avoid Step Transition*

As long as the client is not the original source of the "seed" money, (which course of action would result in the transaction being recast as a trust created by the client under the step transaction or agency theories), the normal rules of taxation should apply and the existence of the trust should be respected for both tax and asset protection purposes. Thus, the client can control the trust by being trustee, and can benefit from the trust assets as the primary beneficiary. An even more potent planning opportunity exists where the senior generation sets up a beneficiary defective trust, a concept discussed later in this article.

[3] Practice Pointers

Don't dismiss situations where the client has far more wealth than the senior generation. For example, I have had clients' parents set up a dynastic trust with $5,000 of their own funds providing "seed" money for a new venture which had the potential for huge success even though the parent did not have a taxable estate. Remember, this is a planning strategy and the trust must be legitimately created and funded by a person other than the trust beneficiaries in order to avoid IRC §§ 2036-2038 which include transfers whereby the transferor has retained rights or benefits.

The opportunity for a parent, even one that has a relatively small estate, to set up a generation skipping exempt trust which during the lifetime of the child (as well as younger generation family members) can (1) enter into opportunity shifting arrangements, (2) be the controlling owner of a family entity (thus giving the child control without the tax consequences of control)[40] or (3) help accomplish other estate planning goals of the client is too often overlooked. This planning device is another illustration of the wisdom of why, with rare exceptions, all gifts and bequests should be made in trust.

[40] *Estate of Bright v. Comm'r*, 658 F. 2d 999 (1981).

§ 27.07 BENEFICIARY DEFECTIVE TRUSTS—IRC § 678(a)

A strategy that in many instances can exceed the benefits of the traditional defective trust, where the donor is treated as the owner of the trust income, is a trust arrangement where the donee/beneficiary is treated as owner of the trust income under IRC § 678(a).

[1] The Statutory Scheme—General Rule—IRC § 678(a)(1)

Section 678(a) sets forth the general rule that a person other than the grantor will be treated as the owner of any portion of a trust for income tax purposes if that person has the power exercisable solely by himself to vest the corpus or the income in himself,[41] or if that person has previously partially released or otherwise modified this power, and after the release or modification retained such control as would, within the principles of the grantor trust rules with respect to the trust creator, subject the grantor of the trust to treatment as the owner.[42]

A person having a withdrawal right has the type of power described in § 678(a)(1) because such person has the power exercisable solely by himself to vest the corpus in himself. Thus, under § 678(a)(1), it is clear that the owner of a withdrawal power should be treated as the owner during such time as the withdrawal power is outstanding.

[2] Effect of a Lapse—IRC § 678(a)(2)

What happens after the power lapses upon its nonexercise? Now the analysis shifts to § 678(a)(2). For any lapses of the power to withdraw, the IRS uses a "withdrawal-recontribution" theory. Thus, according to the Service, for income tax purposes the situation is treated as if the powerholder withdrew the property and then recontributed it to the trust. Therefore, grantor trust status usually continues to the beneficiary.[43]

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[41] IRC § 678(a)(1).

[42] IRC § 678(a)(2).

[43] IRC § 678(b); LTRs 8142061, 8521060, 9034004, 9141027, 9309023, 9311021, 9320018, 9448018, 9625031, 9739026, 9745010, 9809004, 9809005, 9809006, 9809007, 9809008, 9810006, 9810007, 9810008, 9812006, 199935046,

The Service's position is that the powerholder is treated as having partially released the power, and that consequently the powerholder remains the taxpayer after the lapse.[44]

[a] *IRS Position Flawed*

The Service's position appears to be technically flawed in that the rulings hold that a "lapse" of the withdrawal power is tantamount to a "release." However, they are not identical. A "release" requires an overt, affirmative act by the powerholder. A "lapse" is the result of a passive nonexercise of the power. For transfer tax purposes, a "lapse" and a "release" are not synonymous. Both § 2041(b)(2) and § 2514(e) recognize that they are not identical, stating "[t]he lapse of a power . . . shall be considered a release of a power." The income tax provisions (and more specifically, IRC § 678) do not contain a similar provision. It appears that the Service is attempting to use a transfer tax theory, that grantor trust status continues after a power is released, in the context of the income tax. This interpretation of a lapse as being a release in such circumstances is without statutory authority and is dubious at best.

[b] *Proper Technical Analysis*

The proper technical answer, notwithstanding the Service's position to the contrary, appears to be that with regard to a lapsed withdrawal power, IRC § 678(a)(1) does not apply after the power has lapsed, and IRC § 678(a)(2) should not apply because there was not a partial release; there was a lapse.

[c] *Planning Note—Preserving Grantor Trust Status*

In many cases in which a withdrawal right has lapsed, the beneficiary retains, after the lapse, the right to discretionary distributions from the trust which, had the beneficiary been the trust creator, would have caused him to be treated as the owner under § 677(a)(1).[45] If this is not the case, then to assure that the trust

199935047, 200011054, 200011055, 200011056, 200011058, 200022035 and 200147044 [hereinafter *Sections*].

[44] IRC § 678(b); LTRs 79090931, 8103074, 8142061, 8308033, 8326074, 9140217, 9309023, 9321050 and 9448018.

[45] Under IRC § 677(a)(1), the grantor is treated as the owner of a trust if the

is defective with respect to the powerholder after the lapse, the powerholder should be given another grantor trust power.[46]

[3] Dual Grantor Trusts Status—IRC § 678(b)

To muddy up the water even further, IRC § 678(b) provides an exception to the general rule that a person other than the grantor will be treated as the owner for income tax purposes. The heading of § 678(b) states, "Exception Where Grantor is Taxable." The Service's and most practitioners' belief is that § 678(b) overrides the § 678(a) general rule with respect to trusts funded with *Crummey* gifts.

[a] *Drafting Error in IRC § 678(b)*

The statute, however, provides that the general rule of § 678(a) ". . . shall not apply with respect to a power over *income* . . ." (emphasis supplied). A *Crummey* power is a power over principal, not income. When the statute is read literally, the § 678(b) exception should not apply to the general rule of § 678(a) that addresses the power to vest both ". . . the *corpus* or the *income* . . ." (emphasis supplied) in oneself. The problem with this is that the Committee reports make it apparent that the language of § 678(b) contains a drafting error and that it was intended to deal with a power over income and corpus, echoing the language contained in § 678(a)(1).[47] This drafting error has been left uncorrected since 1954.

[b] *Committee Reports Reflect Congressional Intent*

If one respects what the Committee reports say (and what Congress appears to have intended), the result would be that the trust should be taxable to the grantor.[48] If one believes what the statute says, the § 678(b) exception should not apply and the

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trust income, without the approval or consent of an adverse party is, or in the discretion of the grantor or a non-adverse party, or both, may be distributed to the grantor or the grantor's spouse.

[46] See LTR 9311021.

[47] See H.R. Rep. No. 1337, 83d Cong., 2d Sess. (1954); S. Rep. No. 1622, 83d Cong., 2d Sess. (1954).

[48] Sections, *supra* note 43.

Crummey power should be governed by § 678(a), thereby resulting in the trust being taxable to the beneficiary.

[4] Cessation of Transferor's Grantor Trust Status When Using *Crummey*

The traditional route in making annual exclusion gifts in trust is to create a single trust with multiple powers of withdrawal. Many of these trusts are created to hold life insurance and, according to the Service, are grantor trusts even though *Crummey* powers of withdrawal are granted.[49]

If a trust is funded with gifts subject to a power of withdrawal, but is otherwise defective as to the grantor under IRC § 678(b) and one or more of IRC §§ 673-677, an issue arises as to the proper income tax treatment of the trust after the trust is no longer defective as to the grantor. This issue will arise at the death of the grantor or upon another event, such as a lapse or release of the grantor trust powers.

[a] *LTR 9026036—IRS Rules Beneficiary Taxed*

In Letter Ruling 9026036, the beneficiary of the trust was given a power of withdrawal for a period of 30 days. After the lapse of the power, the beneficiary retained a power over the trust that would have caused it to be defective as to him had he been the grantor. The grantor of the trust also retained a power over the trust that caused it to be defective as to him. The Service ruled that upon the death of the grantor, the beneficiary would be treated as the owner of the income and corpus of the trust for income tax purposes. The Service did not give any reasoning for this conclusion. Letter Ruling 9026036 was withdrawn by the Service in 1993 and replaced with Letter Ruling 9321050.

[b] *LTR 9321050—Same Facts, IRS Rules Beneficiary Not Taxed*

Letter Ruling 9321050 revisited the same facts as Letter Ruling 9026036. This time, however, the Service ruled that the beneficiary would not be treated as the owner of the income or the corpus of the trust for income tax purposes. Again, the Service failed to provide any reasoning. The conclusion reached in Letter Ruling

[49] Sections, *supra* note 43.

9026036 that the status of the power holders as owners of the trust income is merely suspended until the termination of the Grantor's status a subpart E owner seems to be more logical and proper than the holding in Letter Ruling 9321050.

[c] *Keeping Options Open*

As a practical matter, the reversal of the Service's position will stop most practitioners from treating the beneficiary as the owner for income tax purposes, unless and until there is judicial resolution to the contrary. Consideration might be given to structuring the trust so that it could accommodate sales if the Service changes its position or the position is rejected by the courts. Since most *Crummey* trusts are used for the acquisition of life insurance, separate trusts could be set up for each powerholder (e.g., each child of the grantor) and used for installment sales of appreciated assets if after the policy matures the status of the law is that there is grantor trust treatment as to the beneficiary.

[5] Planning Opportunity—Consider Setting Up Separate *Crummey* Trust

The general approach to drafting trusts expected to be funded with gifts subject to powers of withdrawal is to structure the trust as a single "pot" trust with multiple powers of withdrawal. I favor the alternative design which sets up separate trusts with only one person having a withdrawal power as to each trust in order to preserve single grantor trust status for each trust if the ultimate resolution of the issue of whether the trust will be defective as to the beneficiary upon cessation of grantor trust status is that the powerholder is treated as the owner under IRC § 678. Thus, for example, my life insurance is owned equally by two ILITs, one which is funded solely by giving my older son a power of withdrawal and the other funded solely by giving my younger son a power of withdrawal. My spouse is primary beneficiary of both trusts and both trusts also allow for distributions during our lifetimes to all my descendants and their spouses. At the death of the survivor of my spouse and myself, each trust continues for the benefit of the son who had the withdrawal power, his descendants and their spouses, subject to change by the exercise by my wife of a special power of appointment.

If the income tax issue discussed in Section 27.07 [4] is resolved in favor of the powerholder being taxed then we have created opportunities discussed in this Section. Both my estate because of the basis step-up under IRC § 1014 and the beneficiary under IRC § 678, would be able to transact with the trust tax-free. Indeed, the insurance money can provide the 10% cushion or "seed" money generally suggested in using the installment sale to a beneficiary defective trust technique.

[6] Structure

As previously mentioned, a trust which is designed to be defective as to the beneficiary rather than to the creator is an extremely attractive variation of the income tax grantor trust and for many clients, if properly implemented, can avoid the transfer tax system for massive amounts of wealth and protect those assets from creditors of the powerholder while the clients can enjoy the benefits and use of that property.

Grantor trust status could be achieved by funding the trust solely with gifts subject to a power of withdrawal, provided that the trust is not a trust that would be taxed to its creator. In such instance, the powerholder, who is treated as the owner, will have a trust with which he or she can transact, tax-free, and take advantage of the same estate planning opportunities the grantor would have in a trust defective as to the creator. Moreover, a trust defective as to the beneficiary may offer superior benefits in that the powerholder/ beneficiary may be the trustee and also enjoy the benefits of the trust assets.

[a] *Using Power of Withdrawal to Obtain Grantor Trust Status*

Under this scenario, the gifts need not be limited to the annual exclusion in order to obtain IRC § 678(a) treatment. As long as the beneficiary is given a power of withdrawal over the entire contribution, the entire trust would be defective as to the beneficiary. If the gifts were subject to a hanging power of withdrawal, the beneficiary would have estate tax inclusion only to the extent of the amount hanging at his death. All lapsed amounts and appreciation would not be includible. Because the funding would be done with "hot" assets, the lapses should occur rapidly under the 5% "safe harbor" rule of IRC § 2514(e).

[b] *The Six Attributes of the Ideal Estate Plan Obtained*

This proposed alternative can combine both the virtues of defective trusts and the enhancements that are generally inherent in trusts. For instance, assume that a wealthy client has a business opportunity that she predicts will be successful. The client suggests, and her parent agrees, that the parent set up and fund a trust for the client and her descendants. The trust is structured as both a Beneficiary Controlled Trust and a Beneficiary Defective Trust. The client can (i) manage and control the trust assets as the trustee; (ii) be the primary beneficiary of the trust; (iii) have a broad power of appointment to give the property to anyone other than herself, her estate, her creditors or the creditors of her estate; and (iv) make income tax-free installment note sales to the trust.[50] The trust assets would be transfer tax exempt as well as divorce and creditor protected.[51]

[7] Eroding the Transfer Tax System

Under the right fact pattern, it appears that over time the transfer tax exposure of many wealthy estate owners could be virtually eroded using this strategy. The income earned by a new venture (through opportunity shifting) could be used to acquire wealth presently owned by the estate owner, income tax-free, taking advantage of leveraging techniques such as installment note sales of non-controlling interests. Both the new venture and the acquired interests can provide cash flow to acquire assets presently owned by the client personally.[52] Because the wealthy estate owner is also the primary beneficiary and trustee there is no need to retain

[50] Some states prohibit self-dealing by a trustee. However, forum shopping can resolve any such imbroglio. The trust draftsman should include a waiver of the self-dealing proscriptions which would attach under normal fiduciary standards.

[51] It is arguable that a beneficiary could be treated as the grantor of the trust for creditor's rights purposes as a result of allowing his power of withdrawal to lapse. However, the better and more logical view is that the beneficiary should not be treated as the grantor unless the beneficiary actually makes a transfer to the trust. Any other interpretation would result in estate tax inclusion for the powerholder under IRC § 2041(b)(1) and render the five percent or $5,000 exception of IRC §§ 2041(b)(2) and 2514(e) meaningless.

[52] Care must be taken not to tie the cash flow from the asset sold into the purchase equation so as to trigger the application of IRC § 2036(a).

anything outside of the trust for the use, enjoyment and security of the estate owner.

[a] *R. Crowley v. Comm'r*

A variation of the facts contained in *R. Crowley*[53] may well offer the ideal estate plan. Mr. Crowley was the CEO of City Federal Savings and Loan Association, which generated ancillary income in the form of appraisal fees, insurance commissions and abstract and title policy commissions. These collateral business opportunities were shifted to a partnership (later incorporated) comprised of Mr. Crowley's four minor children. Mr. Crowley's oldest son, Robert, while in college and law school, was employed to handle the work and was paid a salary. The remainder of the income inured to the benefit of the ancillary entity. The Tax Court held that the income tax burden would be shifted to the children. Although *Crowley* was an income tax case, presumably it also stands for the proposition that no gift tax would be incurred. Many estate owners have situations similar to Mr. Crowley's, where a small amount of "seed" money, coupled with referrals, business or investment opportunities, can generate a significant cash flow.

[b] *Illustration*

To illustrate the foregoing, assume a savvy businessman has an opportunity to develop a new product, open a new location, create a collateral business, or make a favorable investment that requires a $200,000 capital contribution. The businessman's parent is able to supply the seed money and sets up a dynastic, GST exempt trust, giving the businessman a hanging power of withdrawal over the entire contribution, but providing that the power will lapse as to the greater of 5% or $5,000 per annum.

Under IRC § 678(a) the beneficiary will be taxed on all of the income. If the beneficiary dies prior to the full lapse of the power of withdrawal, the amount that could have been withdrawn at the date of death would be includible in his estate.[54] If we assume that the favorable business opportunity grows to a value of $500,000 in the first year, $1 million in the second year and $2.5 million

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[53] 34 TC 333, CCH Dec. 24, 198 (1960), acq., 1961-2 CB 4.

[54] IRC § 2041(b).

in the third year, the portion of the $200,000 annually lapsing would be $25,000, $50,000 and $125,000 respectively based upon 5% of the trust each year, so that his estate tax exposure would end after three years.

Under this arrangement, the beneficiary can aggressively de-fund his estate by making installment sales to the trust, which can be designed to give him control and use of the very assets he originally owned. The result of this arrangement should be transfer tax neutral and creditor protected as long as the client received fair market value for the property sold.[55]

[8] Caveats

In structuring Beneficiary Defective Trust planning, the following caveats should be kept in mind.

[a] *Use "Market Interest" Rates*

A popular method of funding a defective trust is to use an installment sale whereby interest is computed by reference to the IRS Tables under IRC § 1274. Although this method is acceptable for tax purposes, it may not reflect the fair value for creditors' rights or divorce purposes. Thus, it would be prudent, under circumstances where a beneficiary makes a sale to the trust, to use an interest rate that is reflective of interest that strangers would use in the market-place rather than by reference to the rates under the Tables or, alternatively to use a demand note. The risk is that if the transaction was treated as a transfer to the trust reachable by creditors or a bankruptcy trustee and the transaction is recast for creditors' rights purposes, the fact that the creditors could access the property would result in estate tax exposure under IRC § 2041.

[b] *Defective Only as to One Beneficiary*

Each trust can have more than one beneficiary, but the power of withdrawal for each trust should be limited to one beneficiary. If gifts subject to a power of withdrawal are made to more than one beneficiary in a single trust, the trust would be defective as to each beneficiary in proportion to the value of the property subject to that beneficiary's power of withdrawal. If the trust is not wholly

[55] IRC §§ 2036 and 2038.

defective as to only one beneficiary, then sales by the beneficiaries to the trust will be partially income tax-free and partially subject to income tax. In addition, adverse income tax problems can result in a transaction with the trust where the trust would have gain, such as in an instance where the trust makes a payment with an appreciated asset. Thus, having multiple "owners" of the trust for income tax purposes reduces flexibility and in many instances is incompatible with the sale to a defective trust technique.

§ 27.08 BENEFICIARY DEFECTIVE TRUST—IRC § 678(a): TAKING ADVANTAGE OF LOW BRACKETS

The preceding section examines the Beneficiary Defective Trust as a wealth shifting receptacle. A simple tax savings approach is to use a power of withdrawal to shift income to a beneficiary who can absorb shifted income as a result of being in a low bracket. Alternatively, it can be used to shift deductions or credits to a high bracket taxpayer who would benefit from the receipt of such tax benefits.[56]

[1] Playing the Income Tax Bracket Game

Illustration—Assume that a client has a parent who is not working and is in a low bracket. A trust can be structured whereby the parent is a discretionary beneficiary in addition to the client's descendents and the trust is funded by giving only the parent a power of withdrawal. Assume further that the contribution is invested in an entity that has a favorable business opportunity. The powerholder parent would be treated as the owner of the trust under IRC § 678(a). The powerholder parent must have a real, current beneficial interest in the trust but does not need to be the primary beneficiary or even a preferred beneficiary.[57] I have found that most clients who have a parent in this economic position would want the trust to be able to make discretionary distributions to the parent.

Because the parent's income tax exposure will increase, fairness would dictate that distributions (perhaps augmented by annual exempt gifts) to the parent be made in an amount at least equal

[56] IRC § 671.

[57] *Estate of Christofani v. Comm'r* 97 TC 74 (1991), acq. in result 1992-1 CB 1, 1996-10 IRB 1996-29.

to the increased income tax burden be made unless an ancillary goal of reducing the parent's estate was desired.

The trust and parent could engage in tax-free exchanges, which can be structured so that the parent could obtain low-basis assets from the trust, which would receive a step-up at the parent's death.[58] Alternatively, the low basis asset could be transferred to the parent as a trust distribution even if death were imminent. IRC § 1014(e), which applies to appreciated property acquired within one year of death, is not applicable in this situation. Another method of planning for a basis step-up is for the trustee to be authorized to give and take away general powers of appointment. This power is similar to the technique used in substituting an estate tax, whereby the trustee would give the general power of appointment to a beneficiary who would not have an estate tax problem.

§ 27.09 "DEFINED VALUE" SALE OR GIFT TO A DEFECTIVE TRUST—REDUCING THE VALUATION RISK

The installment sale to a defective trust is superior to its most popular alternatives in many ways. One of the risks associated with the installment sale to a defective trust strategy compared with the GRAT option is the additional gift tax exposure in the sales technique due to an under valuation of the property being transferred to the trust. Although there are several methods that can be used to mitigate the risk, none of them offers the risk avoidance that is inherent in a GRAT, which expresses the annuity interest as a percentage of the initial value of the asset transferred. With a GRAT, as a condition of qualification, the Regulations require a revaluation provision whereby any shortfall or overpayment must be repaid with interest.[59] This requirement negates the gift tax exposure.

[58] Rev. Rul. 85-13; IRC § 1014(b).

[59] Treas. Reg. § 1.671-3(a)(1).

[1] Formula Gifts and Sales[60]

One way that it may be possible to finesse the foregoing exposure and significantly reduce the IRS' incentive to unfairly contest a good faith appraisal of the property transferred to the trust is by structuring the interest gifted or sold to the trust as a transfer of a specified value to be satisfied by the proper number of limited partnership or LLC units or shares of stock, with the remainder going to "shield" vehicle (generally a charity or a GRAT). The intuitive reaction is that this approach is similar to the technique disallowed in *Procter.*[61] A more careful analysis would indicate a viable distinction as set forth below. This type of approach does not appear egregious when viewed in the context of its similarity to a pecuniary marital formula bequest with the residue going to the credit shelter trust, (as well as a reverse pecuniary bequest to the bypass trust), having the bequest being satisfied with assets representing the formula amount of the bequest.

[a] *Value Adjustment Clauses*

A value adjustment clause provides for either an increase in the price of an asset or a return of a portion of the transferred asset if the value of the transferred asset is determined to be greater than anticipated at the time of the transfer. However, this generally does not work because it is against public policy since it is a condition subsequent, which would have the effect of undoing a portion of a gift.[62]

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[60] See McCaffrey and Kalik, *Using Valuation Clauses to Avoid Gift Taxes,* 125 Trusts & Estates 47 (October 1986); McCaffrey, *Some Tips on Tax Tuning Gifts,* 137 TRUSTS & ESTATES 87 (August 1998); McCaffrey, *Tax Tuning the Estate Plan by Formula,* 33 U. MIAMI INST. ON EST. PLAN at Ch 4 (1999).

[61] *Comm'r v. Procter* 142 F. 2d 824 (4th Cir. 1944), cert denied, 373 US 75 (1944).

[62] See *Comm'r v. Proctor*, 142 F.2d 824 (4th Cir. 1944), cert. denied, 323 U.S. 756 (1944); *Estate of Gordon McLendon v. Comm'r*, T.C. Memo at 459 (1993); *Ward v. Comm'r*, 87 T.C. 78 (1986); *Harwood v. Comm'r*, 82 T.C. 239 (1984), *affirmed*, 786 F.2d 1174 (9th Cir. 1986); TAMs 9309001, 9246007, 9133001, 8549005 and 8531003. But, see *King v. U.S .*, 545 F.2d 700 (10th Cir. 1976) which is the only reported case in which a value adjustment clause was accepted.

[b] *Value Definition Clauses*

Unlike a value adjustment clause which attempts to take advantage of a condition subsequent to avoid a transfer in excess of that which is contemplated, a value definition clause defines the value of the gift or sale at the time of the transfer. Therefore, an adjustment on a revaluation by the Service will be upheld and will simply cause an adjustment of the interests allocated between the transferor and transferee.

[2] "Defined Value" Sale—Residue to Charity

One technique is to use a "defined value" sale (or gift) to the defective trust with a residuary amount passing to charity.

[a] *Structure*

For example, the client could assign (or sell) an X% limited partnership interest to be allocated (i) $Y worth to the defective dynastic trust and (ii) the residue (whatever that amount may be) to a charity.

A reasonable time after the transfer, the trust can purchase (or the partnership can redeem) the charity's interest for fair market value in an independent transaction. As a result of the acquisition of the residuary interest, all of the property that was the subject of the original transfer will be owned by the trust.

The interest should be purchased from the charity after the charity has had sufficient time to do its due diligence and obtain its appraisal of the remainder interest it had received. Furthermore, the purchase from the charity should not be pre-arranged.

[b] *IRS Incentive to Audit Reduced*

The IRS would have a reduced incentive to audit the transaction since the residuary amount passes to charity. Because the charity's interest is sold to the trust before the transaction is audited pursuant to an arm's length negotiation, the transaction is fixed at that time, except for the amount of the charitable deduction. If the IRS decreases the number of units transferred to the trust, there would be a larger amount passing to charity and, as a result, the client's charitable deduction is increased. As a result, an IRS audit "victory" on the valuation issue will result in a tax benefit to the transferor.

[3] "Defined Value" Sale—Residue to GRAT

Another technique is to use a "defined value" sale (or gift) to the defective trust with a residuary amount passing to a GRAT. For example, the client could assign an X% limited partnership interest to be allocated (i) $Y worth to the defective dynastic trust and (ii) the residue (whatever amount that may be) to a GRAT. The gift could be zeroed-out using a *Walton* GRAT.[63] Because of the self-adjusting nature of a GRAT with an annuity payment described as a percentage of the initial contribution to the GRAT, the potential gift tax liability is negated or minimized.

[4] FSA 20012211

FSA 20012211 issued in June indicates that the IRS will not respect the residue to charity type of formula clause for federal tax purposes. I have been advised that the FSA is based on a case pending in the Tax Court, *McCord v. Comm'r*, T.C. Docket No. 7048-00, tried in Houston on May 7, 2001, except that some of the facts in the FSA are shaded in favor of the government.[64] In fact, the visceral reaction of several well-regarded experts in the field was that the transaction as set forth in the FSA was so egregious that such gamesmanship would not survive the smell test. The facts in *McCord* are clearly distinguishable from the FSA. After careful analysis and a review of how the transaction is being structured in the real world, at least one highly regarded commentator has reversed his original position.[65]

[a] *No Prearranged Deal*

The FSA assumes that there was a prearranged understanding between the parties that effectively tainted the transaction. To my

[63] See discussion under *Walton* GRAT, *infra* at § 1.10.

[64] See Richard A. Oshins, *The Walton GRAT—A 21st Century Planning Tool*, CCH ESTATE PLANNING REVIEW REPORTER, (July 19, 2001); and L. Paul Hood, Jr., *Did the IRS Answer the Wrong Defined Value Gift Question?* PROBATE PRACTICE (August and September 2001).

[65] Hood, *supra* note 64, where the author concludes that "the IRS rationale stated above for a blanked disregard of gift tax formulae cannot withstand much intellectual scrutiny for several reasons" and that "[a]t this juncture, it would be highly inappropriate for the courts to step in and halt the usage of formulae for gift tax purposes, which simply are being used in attempt to build in some elusive valuation certainty into the gifting of hard-to-value assets."

knowledge, there was no such pre-arrangement present in the *McCord* case nor would that be typical of a defined value sale that has been properly structured and implemented.

[b] *Procter*[66]

Although the FSA cites *Procter* as authority for the proposition that any clause designed primarily to defeat the gift tax is void as against public policy, I would submit that there is a significant difference between a "value-definition clause" and a "value-adjustment clause," as found in *Procter*. A value-adjustment clause provides for a post-transfer adjustment of the amount of the gift. Thus, it provides for an increase in the price of an asset or an adjustment in the amount of property transferred if the value of the transferred asset is subsequently found to be greater than was anticipated at the time of the transfer. On the other hand, a value-definition clause simply defines the value of a gift or sale at the time of the transfer in terms of a formula. The value definition approach is used in virtually all marital deduction funding formula clauses and has been sanctioned in the charitable remainder trust regulations, the disclaimer regulations, the GSTT regulations, as well as the regulations under Code § 2702.

[c] *Redemption*

In addition, the FSA appears to take issue with the concept of redeeming the charity's interest even though the price paid was the fair market value of the interest, based upon a second appraisal. The redemption should be considered as the functional equivalent of a charitable stock bailout. The fact that the charity winds up with an undesirable asset that it wishes to convert to cash may have an impact on the value of the charitable deduction, but it should not affect the legitimacy of the transaction as a whole.

In the FSA, the partnership agreement permitted the partnership to redeem the assignee interests held by the charities at fair market value. Although that should not be sufficient to infect the entire transaction, a safer course of action would be to not have such a call right, but to leave it up in the air, recognizing that a redemption

[66] Oshins, *supra* note 64; *Comm'r v. Procter* 142 F. 2d 824 (4th Cir. 1944), cert denied, 373 US 756 (1944).

or sale to the trust that received the front-end interest is economically preferable to both the family and the charity.

[d] *Release*

Finally, the execution of a release acknowledging payment in full appears to bother the IRS since the charity would not participate if a readjustment occurred on audit.

Common business practice is to obtain such a release so there is closure. Perhaps the charity could have insisted that it receive more if there was a readjustment in value for tax purposes, but that is not normal in the typical business setting. The charity sold its interest for the then fair market value based upon the appraisal it obtained. Had the charity insisted on a revaluation clause, the taxpayer could have walked, leaving the charity holding an asset of little value in its hands. What if the valuation was wrong in the charity's favor and the trust interest was undervalued? The release was meaningful to both parties.

This concern of the IRS can be easily avoided by not using a call right in the partnership even though, in my opinion, the taxpayer's course of action in *McCord* is sustainable. The FSA is instructive as to the fact that the conservative planner should go forward with the initial transfer, but leave it up to the parties to follow the normal behavioral pattern and to strike a deal on their own.

§ 27.10 *WALTON* GRATS[67]

A GRAT is an irrevocable trust in which the grantor retains the right to receive an annuity for a fixed term, at which time the remaining trust assets pass to the remaindermen, or to trusts for their benefit, without any further gift tax implications.[68] The annuity payments are qualified interests pursuant to IRC § 2702(b) so that the value of the gift is reduced by the present value of those payments. For maximum leverage, the GRAT is usually structured so that the value of the gift is as close to zero as possible. This is commonly referred to as a zeroed-out GRAT.

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[67] Oshins, *supra* note 64.

[68] IRC §§ 2702(a)(2)(B), 2702(b).

[1] Example 5

Under Treasury Regs. § 25.2702-3(e), Example 5, a completely zeroed-out GRAT is not possible since Example 5 says that a GRUT (or GRAT) payable to the grantor or the grantor's estate (i.e., a "term" GRAT or GRUT) is valued as a "shorter of term or life" GRAT or GRUT. Example 5 states as follows:

> "A transfers property to an irrevocable trust, retaining the right to receive 5 percent of the net fair market value of the trust property, valued annually, for 10 years. If A dies within the 10-year term, the unitrust amount is to be paid to A's estate for the balance of the term. A's interest is a qualified unitrust interest to the extent of the right to receive the unitrust payment for 10 years *or until A's prior death*." (Emphasis supplied)

However, as anticipated by most knowledgeable practitioners, in a case decided December 22, 2000, the Tax Court in *Walton v. Comm'r* declared Example 5 invalid and that the retained annuity should be valued without regard to the taxpayer's life expectancy as required by Example 5. Thus, a term GRAT can now be zeroed out and no gift for transfer tax purposes is made.[69]

[2] The Facts of the *Walton* Case

On April 7, 1993, Audrey Walton (the ex-wife of Sam Walton's brother) established two substantially identical GRATs, each of which had a term of two years and each of which was funded with 3,611,739 shares of Wal-Mart stock. The fair market value of the stock on that date was $27.6875 per share. Therefore, the fair market value of the stock transferred to each GRAT was $100,000,023.56. According to the provisions of each GRAT, Ms. Walton was to receive an annuity amount equal to 49.35% of the initial trust value for the first 12-month period of the trust term and 59.22% of such initial value for the second 12-month period. In the event that she died before the end of the two-year period, the remaining annuity amounts were to be paid to her estate. The assets of each GRAT were exhausted upon the final payment since all income and principal had been distributed to Ms. Walton pursuant to the

[69] A safer approach is to design the GRAT with some amount of gift (i.e., $1) so that the Service could not argue that there is no gift because of public policy reasons.

scheduled annuity payments. In fact, each GRAT had a shortfall of $14,465,475.01. Thus, there were no assets left for the remainder beneficiary.

Ms. Walton filed a gift tax return reporting each gift at a value of zero. The Commissioner of Internal Revenue issued a notice of deficiency determining that Ms. Walton made a taxable gift to each GRAT of $3,821,522.12. Ms. Walton subsequently conceded on brief that the gift to each GRAT should be $6,195.10. Although Ms. Walton was unable to shift wealth due to the poor performance of the transferred stock, the *Walton* decision confirmed the general belief of estate planning practitioners with respect to the invalidity of Example 5.

[3] GRAT/IDIT Combination

A feature of a GRAT that is appealing to both the estate planner and estate owner is that, properly implemented, there is no gift tax exposure if the gift is zeroed-out. Thus, for the GRAT undertaking to be unsuccessful, either the property transferred must economically under perform or the Grantor must not survive the annuity term. When compared to the note sale wealth shifting variation, the downside cost for a GRAT is far less than if the investments under performed in a note sale. The price of an unsuccessful GRAT is the transactional cost and lost opportunity cost. With the note sale, the costs in addition to the foregoing include the inefficient or wasteful usage of the unified credit and GSTT exemption. The second concern, survivorship, may be negated by the acquisition of life insurance.

[a] *Valuation Risk Negated*

Often, the planner and client are faced with a choice of using a GRAT or an installment sale to a defective trust. One attribute, which is superior in the GRAT alternative, is that if the valuation of the interest transferred is incorrect, there is much greater gift tax exposure using the note alternative. Although there are several methods that can be used to mitigate the danger, such as the previously discussed in § 27.09 "defined value sale," none of them offers the risk avoidance that is inherent in a GRAT in which the annuity is expressed as a percentage of the initial value of the asset transferred. With a GRAT, as a condition of qualification, the

Treasury Regulations require a revaluation provision whereby any shortfall or overpayment must be repaid with interest. This requirement negates the gift tax exposure.

[b] *Productively Bridging the Gaps Before Implementation*

Most of my clients who desire to incorporate multigenerational wealth shifting, generally face the seminal question: Should they do a note sale, a GRAT, or both? If my experience reflects the normal process of fact finding, selecting and designing the wealth shifting device and the implementation process, it is time consuming, particularly where the note sale is contemplated. Considerable additional time is often attributable to the valuation process that must be finalized, at least as to the fair market value of the property to be sold in a note sale. Doing nothing during that gap period is often wasteful and can result in the unnecessary loss of the opportunity to move wealth, and, indeed, an increase in the client's wealth base.

One approach that has considerable merit is to immediately commence a short-term GRAT, relying on the fact that it is a virtually no loss proposition. The GRAT can be drafted using the IRS Tables even though the value of the property used to fund the GRAT is unknown, and, perhaps, speculative. The valuation is only necessary upon the earlier to occur of the date the first annuity payment must be made or when the gift tax return is due. The sole cost is the transaction fees (including appraisal fees) if the economic projections are inaccurate. Because the formula will zero-out (or nearly zero-out) the gift and the annuity would be expressed as a percentage of the original contribution, there will not be gift tax danger.

If, at the end of the gap period, the use of an installment sale is deemed appropriate and the property has performed well, either the grantor or the dynastic trust can purchase the property owned by the GRAT from the GRAT locking in the successful shift of wealth at least to the next generation. The acquisition by the dynastic trust (or the grantor) from the GRAT would be income tax free since both trusts are designed to be defective as to the grantor.

If at that time the use of the installment sale is deemed appropriate, but the assets belonging to the GRAT are down in value, the

grantor would acquire the property from the GRAT for cash and then execute the note sale. The GRAT would be unable to pay its annuity payments; and, therefore, the short-term wealth shifting gamble would fail. In such instance, the client should be pleased that she engaged in the GRAT technique rather than the installment sale. With the GRAT, the cost of the failure would be limited to the transaction costs and not the wastage of two valuable commodities the unified credit and GSTT exemption.

[c] *Finessing the 10% Rule of Thumb*

Most practitioners believe that in order to avoid a form-over-substance or sham argument that the IRS might use, the defective trust ought to be independently funded with some seed money and use a 10% rule of thumb as the threshold amount. It is generally understood that this amount will be administratively acceptable.[70]

For many clients, this threshold is insufficient to cover the wealth they desire to shift. One alternative that enables them to comply with the 10 percent rule of thumb is to shift some, or the balance, of the wealth through a GRAT, foregoing the ultimate wealth shifting obtained in dynastic trust planning and risking inclusion if the grantor dies during the GRAT term. A problem occurs where income producing assets are transferred and the cash flow will not generally be sufficient to pay the annuity payments particularly where a relatively short term is selected for the GRAT. Although these payments may be made in kind, this alternative is counter-productive because the "in kind" distributions back to the grantor are subject to the same valuation adjustments as they were in computing the original gift. In addition, a new appraisal must be done.

Alternatively, the client can wait until there is sufficient growth in the dynastic trust, which would support a subsequent sale under the 10% rule of thumb. During this period, the estate owner may consider placing the excess property in a GRAT, which would shift wealth during the waiting period.

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[70] Byrle M. Abbin, *[S]he Loves Me, [S]he Loves Me Not—Responding to Succession Planning Needs through a Three-Dimensional Analysis of Consideration to be Applied in Selecting from the Cafeteria of Techniques*, 31 U. OF MIAMI INST. ON EST. PLAN. at Ch. 13 (1997) who commented: "Informally, IRS has indicated that the trust should have assets equal to 10 percent of the purchase price to provide adequate security for payment of the acquisition obligation."

As previously mentioned, one of the problems with the GRAT approach is that the cash flow of the assets belonging to the GRAT will be insufficient to make the annuity payments. For example, with a three year GRAT, if the IRC § 7520 rate was 5%, and the GRAT was back-loaded, the payments would be approximately 30.5% the first year, 36.5% the second year, and 48.8% the third year. Rather than having the annuity being paid with in kind distributions, some or all of the annuity in excess of the cash flow attributable to the property owned by the GRAT can be obtained by having the trustee of the GRAT sell some of the discounted assets to the dynastic trust for cash. The cash would then be recycled to the grantor in payment of the annuity. My experience has been that in most instances the combination of cash distributed to the GRAT, plus cash from the cash flow in excess of the interest on the note (and if life insurance is owned by the dynastic trust, the premiums), will support the GRAT payments, and any shortage can be augmented by the initial "seed" money transferred to the dynastic trust.

Any assets remaining in the GRAT at the cessation of the GRAT term may remain in a continuing trust for the benefit of the children (although certain direct transfers for medical and educational expenses paid to the provider should be permissible if they qualify for the IRC § 2503(e) gift tax exclusion, since they are also GSTT exempt).[71] If the continuing trust is designed as a defective trust, it can transact with a defective dynastic trust income tax free under the protection of Rev. Rul. 85-13, allowing for the repositioning of undervalued assets into a multigenerational exempt trust. In addition, the property remaining in the GRAT after the term can support a leveraged sale from the grantor acting as the 10% seed money. This would remove the property from the grantor's estate in exchange for the note and a subsequent sale could be later made to the dynastic trust when the later trust has sufficient equity to come within the 10% rule of thumb.

[d] *Estate Reduction Implications*

In theory, neither the *Walton* GRAT nor the installment sale is an estate reduction device, but it is a leaky freeze, to the extent of the interest. The reason that there is no gift (or almost no gift

[71] IRC § 2611(b)(1).

in the case of a nearly zeroed-out GRAT) is that it is assumed that, the value of the property transferred is equal to what the grantor receives back either in the form of an annuity for a GRAT or in the form of a note in a sale. The major wealth shifting is attributable to:

(1) the valuation adjustments;

(2) the fact that the grantor pays the income taxes with respect to the property belonging to the trust; and

(3) the asset performing better than the tables anticipate.

Because the grantor will still receive significant funds back, the diffusion of wealth on account of the immediate GRAT in many instances will be a valuable planning enhancement.

[e] *Insurance Application*

As previously indicated, one of the dangers inherent in the GRAT is that the grantor will not survive the retained annuity interest. A popular approach to hedge this risk is to acquire life insurance. Where the GRAT/IDIT combination is used, the dynastic defective trust will also often serve as a funded life insurance trust.

Several years ago, some life insurance carriers created policies that pay an additional amount for a death in the first four years based upon the supposition that the life insurance trust may not be put in place in a timely manner. Where there was a life insurance need to cover during the drafting process, the policy could be acquired by the insured and subsequently transferred to the trust. The extra amount of coverage for the first four years, theoretically covered the estate tax exposure for a one-year set up period and three years of potential inclusion for transfers of life insurance under IRC § 2035. I am advised that this estate protection rider is issued at no extra charge. This estate protection rider is not often meaningful in most instances, since the creation and implementation of the life insurance trust can generally be accomplished timely so as to avoid a transfer by the insured. This insurance product, however, works well with the combination plan using the short-term GRAT in conjunction with the sale to the dynastic trust, to cover the mortality risk if the grantor does not survive the relatively short term.

§ 27.11 CHARITABLE LEAD TRUSTS

A charitable lead trust ("CLT") is another method of leveraging the amount being transferred. The value of the transfer is determined by subtracting the value of the front-end charitable interest from the value of the property transferred. For multigenerational planning, the charitable lead unitrust ("CLUT") is generally selected because GST tax exemption may be allocated immediately. Conversely, GST tax exemption may only be allocated to a charitable lead annuity trust ("CLAT") upon expiration of the charitable lead period.[72]

For the same reason that GRATs are favored over GRUTs, planners prefer to use the annuity version of the CLT rather than the unitrust alternative because more value can be allocated to the annuity interest than to the unitrust interest, even to the extent of zeroing out the gift. Thus, it appears that the planner is faced with balancing the option in doing multigenerational planning, of (i) doing a CLUT and having a long front-end charitable term and making a gift, as compared to (ii) doing a CLAT and being able to compress the term of the charitable interest and zero-out the gift at a cost of restricting the transfer to the generation below the transferor.

§ 27.12 GIFT OR SALE OF A REMAINDER INTEREST IN A GRAT OR CLAT TO A DYNASTIC TRUST

A strategy, which may provide some fantastic multi-generational transfer tax avoidance benefits is to combine a *Walton* GRAT or a zeroed-out CLAT with a gift or sale of the remainder interest to a defective dynastic trust.

[1] GRAT/CLAT Similarities

Both the *Walton* GRAT and the zeroed-out CLAT have several common threads. They are both designed to reduce the value of the remainder interest being transferred as a result of designing the annuity to equal 100% or close to 100% of the value of the property for transfer tax purposes.

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[72] IRC § 2642(e); TAMRA § 1014(g)(3)(A).

The "ETIP" rules set forth in IRC § 2642(f)(1) prevent the grantor of a GRAT from allocating GSTT exemption to the remainder interest during the estate tax inclusion period, i.e., until the annuity interest ends, at which time the leverage disappears and the value would be the full value of the property. IRC § 2642(e), in effect, prevents the use of a CLAT as a mechanism to leverage the GST exemption.

[2] Transfer of Remainder Interest

Many practitioners believe that an estate owner's inability to use generation-skipping leveraging with the GRAT and CLAT techniques can be finessed by having the remainder beneficiary either gift or sell his remainder interest to a dynastic trust a reasonable amount of time after the GRAT or CLAT is set up.[73]

[a] *GRAT Remainder*

The ETIP rules prevent the allocation of GST exemption until the estate tax inclusion period terminates. Because the remainder beneficiary would transfer his entire interest and not retain anything, the ETIP rules should not apply since, after the transfer, the property would not be subject to inclusion in the remaindermen/ transferor's estate.

Upon the end of the annuity term, the property then belonging to the original trust would pass to the dynastic trust, thereby protecting the property from the transfer tax system and providing creditor protection perpetually. As a result, the leveraging benefits of the GRAT technique will be available for GSTT purposes.

[b] *CLAT Remainder*

The transfer of a remainder interest in a CLAT is similar to the previously described sale or gift or a remainder interest in a GRAT. Although the statute operates slightly differently, the intended proscription of leveraging the GSTT exemption prohibits the election of GSTT status until the expiration of the annuity term.

[73] Adams, Roy M., *Proprietary Approaches for Planning with Individuals and Their Businesses*, TELECONFERENCE SERVICES at 13, (March 27, 2001).

[3] LTR 200107015

The IRS announced its position on the transfer of a remainder interest in LTR 200107015 in the context of a transfer of a remainder interest in a CLAT. The question answered in the ruling for our planning purposes was whether there was a change in transferor from the original creator of a CLAT or GRAT to a new transferor, the remainderman for GSTT purposes, so that the new transferor can allocate his own GSTT exemption to the transfer to keep it outside the scope of the GSTT.

Although the fact pattern was somewhat convoluted, and the transaction involved in the ruling was the transfer of a remainder interest following a CLAT, where the rules for allocating GSTT exemption are different than the ETIP rules applicable for a GRAT, the obvious lesson is that the IRS can be expected to apply the same reasoning in both to rule against the taxpayer.[74]

The Service ruled that there would be two transferors as of the date of the assignment, the remainderman with respect to the portion of the trust equal to the present value of his remainder interest and the creator of the original trust as to the balance. Thus, upon the end of the annuity term, the original transferor's interest, which generally would represent the bulk of the assets, would be subject to the GSTT.

The Service's position is based on policy, that the purpose of IRC § 2642(e) and (f) is to prevent the use of these types of leveraging transactions to circumvent the application of the GSTT. I, as well as other practitioners, believe that the Service's position is technically flawed and will not withstand judicial scrutiny.[75]

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[74] See IRC § 2642(e) for CLATs and IRC § 2642(f) for GRATs.

[75] Abbin, *supra* note 66; Gopman, Steinberg and S. Oshins, *Ruling on Assignment of Vested Remainder Interest May Have Reached Wrong Conclusion*, TAX MANAGEMENT: ESTATES, GIFTS AND TRUSTS JOURNAL, (September/October 2001); See also Jerry A. Kasner, *Hot Tax Topics for Estate Planners*, Outline at 71 (April 12, 2001), where Jerry states, "The IRS can't have it both ways, if the child is deemed to have made a gift, the child would now be the transferor, and the father cannot also be the transferor—the rule is the last transferor for gift or estate tax purposes is the transferor for GST purposes."

[a] *Planning—Sale or Gift*

If it is concluded that the IRS analysis in the ruling is incorrect, there are various alternatives that may be used to implement the remainder interest transfer. The first issue is whether to design the transfer as a gift or a sale. If the transfer is by sale, the equality of the consideration received is an issue and is of utmost importance if the sale is to a trust where the remainderman/beneficiary is a trustee and/or beneficiary of the trust receiving the remainder interest. In order to avoid a gift by the GRAT remaindermen to the dynastic trust, the purchase price paid by the dynastic trust should be the fair market value of the remainder, as determined under IRC § 7520. If the sale is for less than adequate consideration and the remainderman is a beneficiary of the acquiring trust there would be estate tax inclusion under IRC § 2036(a), and if the remainderman was the trustee under IRC § 2038.[76]

A sale will also create income tax exposure unless it is made to a trust that is defective as to the seller (or seller's spouse) if an individual or if a trust is the seller, both trusts are grantor trusts as to the same person or that person's spouse. A sale will not require the use of the seller's GSTT exemption or unified credit. If the gift route is used, the transferor will be required to use GSTT exemption to protect the continuation of GSTT exemption. The gift route would prohibit the transferor from being the trustee or a beneficiary of the recipient trust. A sale is safer than a gift with regard to avoiding a "step-transaction" argument by the IRS since two gifts followed closely in time may be recast as one gift with the initial donee serving as the strawman.

[b] *Alternative Structures*

One alternative structure for the transaction is to make the remainder payable to a trust for the benefit of the remainderman's descendants. The recipient trust could be one already established by the client, or a new one that is nominally funded (e.g., with $100). The trustee of the GRAT would own a vested remainder in the GRAT that it would be able to sell to the dynastic trust. If the remainder trust and the dynastic trust are both defective trusts as to the grantor of the GRAT, the sale of the remainder interest will be a non-event for income tax purposes.

[76] Harrison, *supra* note 13.

Another alternative structure is to make the remainder payable to the child outright. The child would have a vested interest that could be sold income tax-free to a dynastic trust that is defective as to the child.

It is best to have established the dynastic trust far in advance of the remainder sale to reduce the chance that the Service could successfully argue substance over form and recast the series of transfers as a generation-skipping GRAT.

[c] *Spendthrift Provision*

The spendthrift provision of the GRAT or CLUT should be designed to permit the sale of the remainder interest. Many boiler-slate spendthrift provisions do not permit such a transfer.

§ 27.13 SPOUSAL IRREVOCABLE TRUST

The fact that the income tax grantor trust rules do not work in *pari materia* with the transfer tax rules creates some extremely attractive intra-spousal wealth planning opportunities.[77] For transfer tax purposes, there is no family attribution; each person is treated separate and apart from each other person irrespective of their relationship.[78] For income tax purposes, there is attribution in several areas on the Code.[79]

A gift may be made in trust for the benefit of one's spouse thereby removing it from the donor's estate even though the donor is treated as the owner of the trust property for income tax purposes. If the disposition is into a non-marital trust, and the trust is properly drafted, the property belonging to the trust will be outside of the transfer tax system. This structure is very typical in irrevocable life insurance trust planning.

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[77] For excellent review of many of the concepts contained in this section see Acker, *Every Drafter's Dream: The Flexible Irrevocable Trust,* BNA TAX MANAGEMENT, ESTATES, GIFTS AND TRUSTS JOURNAL at 126 (May/June 1998).

[78] E.g. the "willing buyer-willing seller" test under Treas. Reg. § 25.2512-1, which deals with a hypothetical transaction between strangers and not the actual parties. See also Rev. Rul. 93-12.

[79] For example, several such illustrations occur in the context of grantor trust planning (e.g.; IRC §§ 672(e); 677(a) and 1041).

[1] Over the Course of Time

Assume over the course of time that the following occurs:

(1) An estate owner sets up and makes gifts to an irrevocable, non-marital trust for the benefit of his spouse and descendents, giving the spouse all of the six attributes of the ideal estate plan (See § 27.03 herein). The spouse could be the primary beneficiary as well as the trustee.

(2) The trustee successfully manages the trust using some of the leveraging strategies employed by imaginative wealth planners such as opportunity shifting, low interest loans, installment sales, purchases of remainder interests, etc. resulting in the trust owning substantial wealth.

(3) As part of the design of the initial trust, the spouse is given a special power of appointment, exercisable in favor of "anyone other than herself, her estate, her creditors or the creditors of her estate, either outright or in trust."

(4) The spouse exercises the power, in an independent action, in favor of a trust primarily for the benefit of the original estate owner. The recipient trust is designed whereby the creator of the original trust receives all of the six attributes of the ideal estate plan.

[a] *The Estate Owner's Position*

There should be no proscription to this arrangement under current law even though the result is that the estate owner set up a trust for the benefit of his spouse, who subsequently gave it back to him a in trust in which he is the primary beneficiary, has a broad special power of appointment and is also a trustee. The trust assets should be outside of the transfer tax system (other than the gift and GSTT implications of the original transfer to the trust). The assets of the trust would also not be exposed to either spouse's creditors.

[b] *The Expected IRS Position*

Viewed from the IRS standpoint, the end result is relatively certain to be regarded as at least viscerally egregious. Therefore, it is reasonable to anticipate that the Service would try to attack this transaction. In the instant case, however, upon an in depth legal

analysis, provided there are no factual modifications, the strategy can easily withstand technical scrutiny.

[c] *Where the Expected IRS Attack Will Come From*

On its face, each portion of the arrangement set forth in § 27.13[1](1-4) above is a common step in non-controversial, rather innocuous, estate plans. Thus:

(1) An irrevocable trust for one's spouse may be set up which would be transfer tax exempt except for the initial gift;

(2) the growth as a result of favorable investing would be outside of the transfer tax system;

(3) the special power of appointment is designed to be as broad as possible, but specifically excludes appointees that would expose the power holder to the transfer tax system;[80] and

(4) the exercise of a special power of appointment from one spouse to another in trust is a straightforward non-risky act.

It is the sum of the parts, which result in the use and enjoyment of the property by the original transferor, which the Service might find unsettling. The sole avenue of attack would be an attempt to aggregate the "steps" and try to tax the results under the "step transaction" doctrine.

[d] *LTR 9141027*[81]

In LTR 9141027, Husband proposed to create an inter vivos irrevocable trust ("Spousal Trust"), for the benefit of his wife and children. Wife was to be given a broad testamentary special power of appointment. On the same day Husband executes the Spousal Trust, Wife proposed to execute a Codicil to her will appointing the principal of the Spousal Trust to her revocable trust. At Wife's death the revocable trust was to divide into a marital trust and a family trust, of which Husband was a beneficiary.

The IRS concluded that the Spousal Trust is includable in Husband's estate under IRC § 2036(a) and Treas. Reg. § 20.2036-1(a) because ". . . *at the time of the transfer* there was an

[80] See IRC §§ 2041(b)(1) and 2514(c).

[81] July 11, 1991.

understanding, express or implied, that the interest or right would later be conferred" back to Husband. (Emphasis supplied).

The ruling restated the position as follows:

> "A will retain an interest in the transferred property because *at the time of the transfer* there will *be an implied agreement* between A and B that the transferred property will later be transferred for A's use and benefit. A's initial creation of the Spousal Trust and the transfer of property to the trust will be interrelated with B's testamentary exercise of her power of appointment under the trust . . . A and B have agreed that if A transfers property to the Spousal Trust for the benefit of B, B will execute a Codicil to her will that will appoint Spousal Trust principal to a trust under which A may be a beneficiary. This implied agreement between A and B results in A retaining benefits of property that he plans to transfer."[82] (Emphasis supplied).

Thus, the Service acknowledged that in order to consolidate the steps, the parties must have an understanding or agreement, although not binding, that the subsequent steps will be taken.

From a planning perspective, the issue is easily avoided by engaging in the setup and funding of the initial trust without the knowledge of the powerholder spouse, even though the trust vehicle is structured with the requisite provisions which would enable the spouse to exercise the power if she believes it to be appropriate. If the spouse did not know of the first step until after it had been implemented, how could it be argued that the parties contemplated that the creation and funding of the trust would not have been undertaken but for the understanding that the remainder of a series would have been agreed upon. The ruling is inapplicable because ". . . at the time of the [original] transfer there [could not have been] an implied agreement . . . that the transferred property will later be transferred . . . [for the original transferor's]use and benefit."

[e] *Step Transaction*

The step transaction doctrine is a judicial principal that consolidates a series of interrelated steps into a single step where the steps

[82] LTR 9141027.

at the outset were entered into and intended by the parties at the inception to reach an ultimate end result. The rule contemplates that the series of steps are interdependent upon each other and that the individual intermediate steps would not have occurred without a completion of the series.[83] Thus, the undertaking should be analyzed to see if the steps were taken pursuant to a unity plan[84] or are integrated parts of a single scheme.

Under the series of transactions set forth above, each makes sense from a planning perspective and are often undertaken independently without the subsequent enhancement of the next planning procedure. Moreover, because the step-transaction doctrine assumes an interdependence, and that the various steps would not be taken but for the completion of all steps, if the original transferor did not discuss the possibility of a contemplated exercise of the power of appointment, or even the original creation and gift to the Spousal Trust, it would be illogical to conclude that the "but for" label could be placed on the arrangement.

[2] Estate Tax Analysis—Grantor

A transferor can create a trust giving his spouse (or any other trust beneficiary) more rights in the trust property than the transferor can retain for himself. Certain powers or rights, which are innocuous in the hands of anyone other than the transferor (including a trustee/beneficiary), would cause estate tax inclusion if they were retained by the transferor.

[3] Estate Tax Analysis—Transferor

The estate tax is an excise tax imposed upon the transfer or deemed transfer of property at death. To be includable, the property must be subject to inclusion by virtue of IRC §§ 2033-2044. For property transferred during lifetime, IRC §§ 2035-2038 are the relevant code provisions. If we assume that the three-year rule of

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[83] See Paul, SELECTED STUDIES IN FEDERAL TAXATION (2d) 200 (1938); *Comm'r v. Court Holding Co.* 324 U.S. 331, 65 S.Ct. 707 (1945); *Minnesota Tea Co. v. Helvering*, 302 U.S. 609, 58 S.Ct. 393 (1938) stating that "a given result at the end of a straight path is not a different result because reached by following a devious path."

[84] *U.S. v. Gendron Wheel Co.*, 100 F 2d 57, 6th Cir. (1938); *Comm'r v. Ashland Oil & Refining Co.* 99 F 2d 57, 6th Cir. (1938).

IRC § 2035 is inapplicable, the transaction must be examined with respect to the possible application of IRC §§ 2036-2038.

[a] *Requirement for Inclusion*

To cause inclusion under IRC §§ 2036-2038, three factors must be present:

(1) a decedent has made an inter vivos *transfer*;[85]

(2) for *less than adequate and full consideration* in money or money's worth;[86] and

(3) has *retained* an interest, benefit or right in or over the transferred property.

Unless all three of the factors, a "gratuitous" "transfer" with a "retained" right, benefit or power over the transferred property exist there is no inclusion.

[b] *Retention*

To cause inclusion, the retention does not have to be set forth in the actual transferring instrument. It could be as a result of a side agreement[87] or understanding, or by operation of law. In the case where there is no implied retention or retention by operation of law, a gift back in trust to the original transferor should not cause inclusion. Thus, as long as there is no pre-existing taint, the return of property in trust by the exercise of a power of appointment should not infect the original transfer.

[c] *IRC § 2036*

There will be estate inclusion under IRC § 2036(a)(i) where there is a *transfer*, for less than adequate and full consideration

[85] Stephens, Maxfield, Lind and Calfee, *Federal Estate and Gift Taxation*, WARREN, GORHAM & LAMONT, INC., 5th Ed. at paragraphs 4.08(7) and 4.10(1).

[86] *Id.* at paragraph 4.10(2).

[87] See LTR 9141027. Query, however, whether a substance over form or step transaction doctrine is applicable. For example, with charitable stock bailouts and Crummey gifts, there are basic understandings on how the recipient of the original transfer will act, but such transferor has the legal right to resist taking the second step. On the other hand, with a gift to a son/daughter-in-law with a subsequent gift over to the blood relative by the in-law in order to expand the number of present interests would not stand up.

(*gratuitous*) where the decedent has *retained* the possession, use, enjoyment or the income from the transferred property, or under IRC § 2036(b) where the decedent has retained the right to vote, directly or indirectly, stock of a controlled corporation.[88]

[d] *IRC § 2037*

There will be estate tax inclusion under IRC § 2037 where a *transfer* is made for less than adequate and full consideration (*gratuitous*) in which the decedent *retained* a reversionary interest of more than 5% of the trust corpus immediately before death. A gift back by the exercise of a special power of appointment, unless exercised pursuant to an agreement or understanding, will not subject the original transfer to inclusion.

[e] *IRC § 2038*

There will be estate inclusion under IRC § 2038 where a *transfer* is made for less than adequate and full consideration (*gratuitous*) in which the decedent, alone or in conjunction with another, *retained* the right to alter, amend, revoke or terminate.[89] The ability of a beneficiary/trustee to manage the trust property, make distributions to others and to exercise special powers of appointment will not cause inclusion.

[4] Permissible Retained Interests

The Grantor may retain rights and powers that will not, in and of themselves, result in adverse estate tax consequences. These powers include:

(1) Certain administrative powers, including the power to manage the trust property.

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[88] A beneficiary/trustee may be given the right to use, enjoy, possess and obtain the income from the trust property without subjecting the trust property to inclusion and such use, enjoyment, possession or right to income need not be limited by the ascertainable standard. It is the right to withdraw principal lodged in the hands of a beneficiary, which will create estate tax inclusion unless limited by ascertainable standard.

[89] The ability of a beneficiary/trustee to manage the trust property, make distributions to others and to exercise special powers of appointment will not cause inclusion.

(2) Dispositive powers limited by a definite external standard.[90]

(3) Control of the office of trusteeship. The transferor may retain the right to remove and substitute trustee with little restriction. The IRS ruled in Rev. Rul. 95-58 that the reservation of the power to remove the trustee and appoint a successor trustee that is not related or subordinate to the grantor within the meaning of IRC § 672(c) does not cause estate inclusion.

(4) The power to reacquire trust corpus by substituting other property of an equivalent value.

[a] *Managerial Power*

A transferor may retain certain administrative powers, including the power to manage the trust property, subject to the statutory exception that the retained right to vote, either directly or indirectly, the stock in a controlled corporation as defined in IRC § 2036(b)(2) will create inclusion.[91]

[b] *Dispositive Powers Limited by a Definite External Standard*[92]

The standard need not be limited to the ascertainable standard limitation of IRC §§ 2041(b)(1)(A) and 2514(c)(1), but if too broad a discretion is found to exist the retained string will produce "a rope burn" resulting in inclusion.[93]

[c] *Control of the Office of Trusteeship*

The transferor may retain the right to remove and substitute trustee with little restriction. The IRS ruled in Rev. Rul. 95-98 that the reservation of the power to remove the trustee and appoint a successor trustee that is not related or subordinate to the grantor within the meaning of IRC § 672(c) does not cause inclusion.

Observation: Although the restriction requiring the replacement not to be a related or subordinate party as defined in IRC § 672(c)

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[90] IRC § 2036(a)(2).

[91] IRC § 2036(b).

[92] See *Jennings v. Smith*, 161 F. 2d. 74, 2nd Cir. (1974).

[93] *Old Colony Trust Co. v. U.S.*, 423 F. 2d. 601 at 605.

does not appear too supportable, prudence would suggest that it be followed. The selection of the grantor's "best friend" with the right to substitute the grantor's "next best friend" should solve the control issue without violating the IRS's ruling position.

[d] *Swap-out Power*

Although the power to reacquire trust corpus by substituting other property of an equivalent value will result in grantor trust status for income tax purposes,[94] it will not taint the trust for transfer tax purposes because the transfer is for full and adequate consideration.

[5] Estate Tax Analysis—Donee

The spouse or other trust beneficiary may be given all or some of the six attributes of the Ideal Estate Plan.

[a] *Spouse as Trustee and/or Beneficiary*

Because the transfer tax system does not have spousal (or other family attribution) rules, there are no prohibitions under the transfer tax statutes against a spouse being a trustee and/or a beneficiary as long as the spouse does not make a transfer to the trust.

As beneficiary, the spouse may have a broad special power of appointment which must be restrictive enough so as not to invoke general power of appointment status, and not being a step in an agreed upon transaction.

[b] *Caveat*

Be careful that the power of appointment is not exercised in a manner that would extend the term of the trust beyond that of the original term so as to trigger the application of the Delaware Tax Trap.[95]

[c] *Planning Note*

The strategy outlined above creates grantor trust status without the flexibility to toggle or to switch out of grantor trust status. By

[94] This is the most popular power used to achieve grantor trust status for income tax purposes. IRC § 675(4)(c). See *Jordahl v. Comm'r*, 65 T.C. 92 (1975), acq. 1977-2 C.B.I.

[95] IRC §§ 2041(a)(3); 2514(d).

using an independent trustee to make distributions[96] and by prohibiting the spouse's right to distributions unless given with the consent of an adverse party, greater income tax planning may be achieved.[97] If this route is selected, and grantor trust status is desired initially, it can be obtained by using another defect such as a swap-out power. At such time a change of income tax treatment is deemed advisable the tainted power could be released.

[6] Estate Tax Analysis—Recipient Trust

The demise of the person who created the original trust conferring the special power of appointment should not result in the imposition of any transfer taxes. This analysis will stand even if that person was a trustee and beneficiary of the recipient trust created as a result of the exercise of the power of appointment the decedent originally gave to the power holder as long as the exercise was on account of an independent action and not as a result of a prearranged deal. Exclusion from the transfer tax system and creditor protection occurs even though the original source of the funds were obtained from the recipient trust's primary beneficiary and trustee, and that original grantor/trustee/beneficiary has virtually unrestricted use and enjoyment over the trust property as well as a broad special power of appointment.

[a] *Outside the Transfer Tax System*

The reason the property is excluded from the original transferor's estate is that he did not "retain" anything when he made the transfer to the trust. All rights, interest and enjoyment were as a result of the donee spouse's independent action—the exercise of the special power of appointment.

[b] *Structure of the Transfer Tax System*

This leads to the counterintuitive result that a transferor can create a trust giving his spouse (or any other trust beneficiary) more rights in the trust property than the transferor can retain for himself. Certain powers or rights which are innocuous in the hands of anyone

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[96] The spouse can have all of the non-income tax sensitive powers such as managerial control.

[97] IRC § 677(a).

other than the transferor (including a spouse/trustee/beneficiary) would cause estate tax inclusion of they are retained by the transferor/decedent.

[7] Planning to Prevent Unintended Results

[a] *Control of Identity of Trustee*

The transferor's retention of the control of the office of trustee will not have an adverse effect. The Service has ruled that such a retention will not result in inclusion as long as the revolving trusteeship specifically excludes the appointment of a related or subordinate party.[98]

[b] *"Floating Spouse" Provision*

Consider the use of a "floating spouse" clause to hedge against marital discord. The term "spouse" could be defined in the trust instrument as "the person who is married to and living with the grantor." Such a provision would not be a retained power as that concept is applied to IRC § 2036(a).[99] A power that is exercisable only in the event of divorce or legal separation constitutes acts of independent significance and will not cause inclusion.[100]

[c] *Imposing Conditions for Exercise*

To prevent an undesirable exercise of the power of appointment, consider limiting its availability only if at the time of the exercise (1) the grantor is living, (2) the spouses are married and living together, and (3) the power holder has given advance written notice, (for example, ten days) of the intent to exercise the power.[101] Upon the receipt of notice of an objectionable exercise of the power, the obvious course of action is for the grantor to move out of the residence resulting in the change in the power-holder from "spouse" to someone who does not have the capacity to exercise the power.

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[98] Rev. Rul. 95-58, 1995-36 I. R. B. 16.

[99] Dodge, 50-5th T.M., Transfers with Retained Interests and Powers, A45.

[100] *Estate of Tully v. U.S.*, 528 F. 2d. 1401, Ct. Cl. (1976); Rev. Rul. 80-255, 1980-2 C.B. 272.

[101] Acker, *supra* note 77.

[8] Asset Protection Planning Variation

There are a variety of applications of the spousal irrevocable trust. For example, an estate owner can set up and fund a trust for the benefit of the estate owner's spouse and descendants using leveraging techniques. The estate owner may use an independent trustee and the spouse does not even have to know of the trust's existence. Assume the estate owner is sued and creditors access all of the estate owner's wealth, but that through prudent investing the trust has grown substantially. The estate owner can then notify the spouse of the existence of the trust and request that the spouse exercise the special power of appointment over the bulk of the trust assets, appoint them into trust for the benefit of the original donor/spouse, and making the original estate owner, the trustee of the newly formed trust. From a practical standpoint, the spouse will be expected to comply. If the spouse refuses the request, the estate owner moves out of the residence, effectively cutting out the former "spouse" if the "floating spouse" definition is used.

[9] Broad Application

The creation of a spousal interest, which includes the granting of a broad special power of appointment, has been discussed in the context of dynastic trust planning. It is a concept with a much broader range of application, including the grantor conferring this power in the back end of a QPRT, a GRAT, as well as the whole plethora of trust vehicles.

§ 27.14 INTEGRATING CASH VALUE INSURANCE INTO DEFECTIVE DYNASTIC TRUSTS

A concept that has been receiving significant attention in the wealth planning community is the use of cash value life insurance. This vehicle takes advantage of the single most important concept of financial and estate planning—tax free compounding.

In the wealth transfer area, Professors Casner and Cooper, during the mid 1970s, both opined that the transfer tax free, multi-generational trust was the most important concept for the avoidance or possible erosion of the transfer tax system because of its transfer tax free compounding. Despite the imposition of the GSTT, the thesis of this article is that the dynastic trust remains the best vehicle

available to minimize the transfer tax system due to its tax free nature and that the skilled practitioner, in most instances, can leverage or finesse the exemption limitation. Although not advanced by Professors Casner and Cooper, the perpetual trust is also the best vehicle to avoid family wealth diminution from creditors.

Adding another enhancement, a tax-free capital accumulation component, will significantly increase the ability to accumulate wealth provided that the "cost" to obtain that type of treatment is not too severe. One vehicle that offers that opportunity is cash value life insurance. For many estate owners, the cost to purchase "the insurance wrapper" is negligible relative to the benefits obtained, principally the ability to grow the investment component income tax free. Because tax-free compounding is somewhat exponential, time is necessary to achieve magnified results. The death benefit feature of the life insurance policy creates a hedge and windfall against an unanticipated premature death of the insured. In addition, the death component offers the traditional benefit of the insurance product.

[1] Cash Value Life Insurance

Taking advantage of the tax-free build-up in a policy that qualifies as a life insurance policy under IRC § 7702 is not a new idea, and should be considered as an accumulation vehicle which has many preferable attributes when compared to its primary alternatives—pension plans and NIMCRUTs. In fact, the latter two techniques are tax deferral (as distinguished from tax-free) strategies where a tax will be due when the fund is accessed. The life insurance alternative, on the other hand, is far superior since the internal buildup is available tax free by loans or partial withdrawals during the life of the insured provided that the policy is not a modified endowment contract ("MEC"). At death the potential income tax exposure disappears. Thus, except in the most unusual of circumstances, cash value life insurance is a true tax exempt rather than tax deferral device.

Two popular accumulation, rather than mortality driven, products in the 1980s and early 1990s included single premium whole life ("SPWL") and the product marketed by the insurance fraternity as a retirement plan substitute under the name "Private Pension Plan." Both of these were, in reality, over-funded life insurance policies

designed to take advantage of the tax-free build-up of the investment component of the policy. Today's more sophisticated approaches include variable life insurance and the theoretically quintessential vehicle for high-end consumers, Private Placement Life Insurance ("PPLI"). Products that are now being sold, and have not been given the attention they deserve, combine most of the virtues of the variable product (avoiding one of the negative features of variable life, the fact that its growth is often stifled by its high front-end load) and PPLI (which is basically for the very high end). This policy structure is a hybrid of variable life and PPLI. It defers and reduces the bulk of the commission in the early years, which otherwise would stunt the growth of the investment component, allowing for the early and larger entry into the tax-free investment environment for the vast majority of the contributions.

The accessible tax-free buildup inherent in a non-MEC life insurance product is far superior to the two other primary tax deferral strategies, the pension plan and the NIMCRUT. Where the policy is a MEC, the tax-free internal growth feature is undisturbed, however, loans are taxable to the extent of income and are subject to a ten percent penalty if withdrawn before the taxpayer attains age 59½. Because a MEC can be funded more quickly with less being allocated to the pure insurance coverage, the investment feature would be expected to grow more rapidly and larger. For those who do not anticipate accessing the internal buildup and are using the life insurance as an income tax sheltered wealth accumulation vehicle, non-MEC status is irrelevant, and indeed counterproductive. When placed inside of a dynastic trust as a combined tax-free wealth accumulation and tax-free wealth transfer plan, the growth pattern can lead to dramatically favorable results.

At death, both the insurance and the investment component, cured of basis problems, are paid to the trust free of income tax, in addition to being outside of the transfer tax system. Because the benefits of tax-free compounding grow exponentially over time, in the short run, the tax-exempt feature is far less dramatic, a trait which is shared with tax-deferred devices. Thus, survivorship is an important element of cash value insurance as to the capital accumulation component of the product. The other component of the policy, the pure insurance feature, is a built-in hedge against the retardation of the investment due to early death. Therefore, with a shortened

life the economics result in the life insurance death benefit being a productive return on investment, and with a long life the lower return of the death benefit compared to investments is offset by the multiplier effect of the investment component. As a result, the consumer either wins on time (the death bet) or wins on the technique.

The usual alternatives to the life insurance product, NIMCRUTs and qualified retirement plans ("QRPs"), have severe repercussions upon a premature demise of the estate owner. QRPs are IRD, subject to both the income tax and transfer tax and with a NIMCRUT the entire property passes to the charitable remainder beneficiary and not the family.

[2] Costs of Moving Into an Income Tax Free Accumulation Vehicle

As a general proposition there are significant costs associated with obtaining tax-free growth. With municipal bonds the cost is a lower yield than can be obtained by taxable investments of equal quality, and the growth possibility is severely restricted, and more apparent over time. With QRPs, the statutory restrictions and IRD tax issue severely reduces the family's beneficial enjoyment; and with a CRT, the fact that the property goes to charity, although often a desired result, ultimately reduces the wealth of the family unit.

[3] Transfer Tax Planning With Cash Value Life Insurance

Most advisors, as well as their clients, are familiar with estate planning using mortality driven life insurance, recognizing that the ILIT is generally the preferred vehicle of choice. Where accumulation products are involved, there are two features that must be addressed. First, in its embryonic stage, SPWL and the Private Pension Plan were sold with little or no thought as to how the estate tax could be avoided without foregoing the more compelling aspect of the policy, its use as an accessible tax free accumulation vehicle, often designed as a retirement substitute. In most instances, estate tax inclusion was generally conceded at the point of sale. If the experience we've had with QRPs and the desire to dribble out the money as slowly as possible retaining the rest in the tax advantaged vehicle, are indicative of the projected experience with the internal build-up in policies, the accumulated wealth will not be needed at

retirement. In the latter instance, transfer tax exposure would be harmful and unnecessary.

The second problem is moving the life insurance into a vehicle, outside of the transfer tax system and accessible by the client. Because we are over-funding the policy, premiums will be larger than what would be required to fund for traditional death benefit structured insurance. That feature will often require more imaginative trust packing techniques than where the funding of pure prototypical insurance is owned by the trust.

In addition to most of the planning techniques discussed in the article, such as opportunity shifting, installment sales, defective trusts, spousal irrevocable trusts, split-dollar planning, including family split dollar, has great utility. Because the Internal Revenue Code treats life insurance differently from all other assets[102] , we need to focus on planning for cash value life insurance for the estate owner where the transfer tax exposure is eliminated without giving up the beneficial enjoyment of, and access to, the investment component.

[a] *Transfer for Value Rules—Interaction Between IRC § 101 and Subchapter J*

If we are dealing with an existing policy the transfer for value rules of IRC § 101 must be considered so that the gain in the policy when it matures is not taxable. If the client is the owner of the policy and also a beneficiary of the trust, the client cannot transfer the policy to the trust by gift without exposure to the estate tax by virtue of IRC § 2036(a). Thus, the transfer must be made by sale, and the sale must be for fair market value. A sale to the trust would result in income tax gain unless the purchaser is exempt from the transfer for value rules contained in IRC § 101(a).

One category of exempt party listed in IRC § 101(b) would be a transfer to the insured. Therefore, if the trust were wholly a grantor trust as to the insured, income taxation at death would be avoided. Unless the client/beneficiary was both the insured and owner of the trust income, the sale would not be protected from the income tax system when made, because Rev. Rul. 85-13 would be inapplicable.

[102] IRC §§ 2035(d) and 2042.

If the insured is not the owner of the trust under Subchapter J, then the most viable option in most instances is to create a scenario whereby insured and the owner of the trust, either individually, or as owner of the trust are partners to come within the IRC § 101(a)(2)(B) exception so that the general rule of IRC § 101(a) will not apply since the transfer is to a partner of the insured.

[b] *Solving the Dilemma—Access Without Estate Tax*

The dilemma often faced with cash value life insurance usable for retirement planning is that the estate owner wants both access to the internal build-up and also desires to keep the death benefits outside of the estate tax system. The estate tax exposure can be finessed by having the trust be created by anyone other than the client, again supporting the propositions that all gifts or inheritances should be made in trust and a dynastic trust should be the vehicle of choice.

The trust can be designed as a Beneficiary Controlled Trust and the beneficiary can have all six attributes of the Ideal Estate Plan[103] except that if the insurance is on the beneficiary's life, the beneficiary may not be a trustee who makes decisions with regard to the insurance[104] nor have a power of appointment as to the insurance portion of the corpus without estate tax exposure under IRC § 2042. Therefore, if life insurance on the beneficiary/trustee's life is an asset of the trust, the strategy is to use a special or independent trustee who would be the trustee as to the life insurance, and the beneficiary/trustee would not be given, or if given in the original trust, would release, the power to appoint the life insurance. The beneficiary can also have the right to fire and replace the special trustee. If the life insurance is on another person the foregoing restrictions would not apply. Thus, life insurance can be acquired on a child or grandchild, which could be used as a tax-exempt accumulation vehicle without restriction on account of IRC § 2042. From an economic perspective, if the parent doesn't need or desire the death component, the purchase of life insurance on a younger person is preferable because of the cheaper mortality costs as well

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[103] See § 27.03 *infra*.

[104] See Zaritsky and Leimberg, *Tax Planning with Life Insurance*, WARREN, GORHAM & LAMONT, 2nd Ed. at paragraph 5.03(6)(a) and Slade, 807 T.M., Personal Life Insurance Trusts at pA-25.

as the anticipated longer tax-free growth due to a longer life expectancy.

[c] *Accessing the Cash Value—The Beneficiary*

We have concluded that, without exception, a trust may be designed giving the trustee/beneficiary all six attributes of the ideal estate plan and if insurance is to be acquired by the trust, the minimal alteration in trust design would require a separate trustee to handle the insurance on an insured trustee, as well as the insurance not being subject to a power of appointment by the insured/beneficiary.

If it were desirable for the beneficiary to access the cash value, the process would be done in two steps. First, the trustee, (other than a trustee who is also the insured) would borrow the money from the policy. The second step has the following three options:

(1) Loan money to the beneficiary. If the loan is from a trust which is a grantor trust as to the beneficiary, interest payments made to the beneficiary or his spouse during the beneficiary's lifetime do not have income tax consequences. The visceral reaction is use a low loan rate. The opposite approach is more beneficial from a planning view since it will enable the beneficiary to move greater wealth into the trust outside of the transfer tax system subject to the caveat that excessive interest could be recast as a contribution to the trust by the beneficiary. That course of action would also create estate tax exposure.[105] Any unpaid amount at death would be deductible as a debt of the estate. Any unpaid interest would be taxable when paid, since grantor trust status would have ceased.

(2) Purchase other assets from the beneficiary. Because the trust is a beneficiary defective trust assets can be sold to it (and from it) without gain. Assuming that the beneficiary spends the cash, the assets exchanged for the cash will be owned by the trust, useable by the beneficiary, resulting in an estate reduction. If the beneficiary desired to invest the cash, the probable desired strategy would be to make the investment inside of the trust so that its growth will

[105] IRC § 2036(a) and possibly IRC §§ 2038 and 2041 (reachable by creditors).

inure to the benefit of the trust. If the investment was in a wasting asset, such as an automobile, a loan or sale followed externally by the asset purchase is recommended. The beneficiary may also access the cash without estate tax exposure after it is borrowed from the policy if he has a swap out power.[106]

(3) Distribution: The worst option is a distribution, since it moves the assets from a protected arena to a non-protected one thereby diluting the transfer tax and creditor protection advantages inherent in trusts. It would generally not be anticipated that a distribution will be made unless dictated by the otherwise adverse income tax consequences.

[d] *Accessing the Cash Value—The Grantor*

The grantor of the trust can also access the cash value build-up. As in the case for a beneficiary the transaction would be done in two simple steps. First, the trustee would borrow against the policy. The second step of the transaction can be structured in any of three ways.

(1) Loan—the trustee can loan money to any person, including the trustee, individually, provided, the trust indenture allows such self-dealing, subject to a prohibition under state law. A state law restriction can be avoided by forum shopping.

Caveat—A technique promoted by some members of the insurance industry is "The WRAP Trust™." Proponents of the technique advocate: "The WRAP Trust™ is marketed as a new type of trust that allows an insured to transfer an insurance policy containing a cash value build-up out of the insured's estate for tax purposes and outside the reach of the insured's creditors, without eliminating the insured's lifetime ability to borrow on the cash value of the policy."[107]

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[106] *Estate of Jordahl v. Comm'r*, 65 T.C. 92 (1975), acq. 1977-1 C.B.I.; LTR 9413045 (January 4, 1994).

[107] Blasé, *The WRAP Trust*, JOURNAL OF THE AMER. SOC. OF CLU & CHFC at 120 (Sept. 1997); See also, O'Sullivan and Thiessen, *Avoiding Estate Tax Problems Unique to Life Insurance*, JOURNAL OF FINANCIAL SERVICE PROFESSIONALS at 68 and 83, which cites the Blasé article (November 2001).

The concept is to acquire cash value life insurance inside of an irrevocable trust, taking advantage of the tax-free build-up inherent in the life insurance product, the ability to take tax-free withdrawals and loans from the policy, and retaining the right to borrow from the trust as a means to create a retirement fund free from the transfer tax system as well as providing asset protection. Those marketing the program advise potential consumers that this gives the client absolute unilateral access to the inside build-up outside of the transfer tax system and free from potential creditor interference.

"[T]he insured individual is given the power to borrow funds from the trust at any time, on a demand note basis, provided only that he pays the trustee a market rate of interest on the promissory note at least equal to the interest rate the insurance company charges on policy loans (which interest may be added to the loan on an annual basis, if desired) and provides the trustee with adequate security for the loan."[108]

The theory is that since the trustee may only be able to borrow from the trust on demand at a market rate of interest and adequate security that this arrangement would be outside the scope of IRC § 2036(a) dealing with a retained interest and IRC § 2042 an incident of ownership in the policy.[109]

I believe that this analysis is misplaced. The grantor has created and retained a line of credit that lending institutions, and others who may offer this service do not do for free; they charge for such a benefit. Thus, as advocated, the technique certainly should be subject to inclusion under IRC § 2036(a).

The WRAP Trust(TM) article concludes that the retained power to borrow is essentially the ability to exchange

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[108] O'Sullivan and Thiessen, *supra* at 121.

[109] It is imperative when selecting a power to achieve grantor trust status that the defect does not also expose the trust to the grantor trust provisions of the estate tax. At least two other articles of relatively recent vintage have suggested powers that could taint the trust for estate tax purposes. One article first points out that powers which cause estate inclusion should be avoided, then states: "Among the powers that often work are the powers to borrow without adequate security (IRC § 675(2))."

property for property of an equivalent value. I again do not agree. I believe that the retention of the right to borrow, even under terms that would be commercially reasonable, is distinguishable from a "swap-out" power and unnecessarily risks inclusion under IRC § 2036(a) as a retained interest.

I believe that the better analysis of the tax exposure, and the more prudent rule for practitioners to follow, is:

> "**Transfer Tax.** A transfer to a trust that confers a power on the grantor to borrow from the trust without furnishing adequate security or paying adequate interest is an incomplete transfer if its effect is to allow the grantor to revest the trust property in himself. Treas. Reg. § 25.2511-2(c). If the grantor cannot revest all of the trust in himself because the note given in exchange for the property has some value, the amount of the gift will not likely be ascertainable, *see* Treas. Reg. § 25.2511-2(b), but because the power to borrow without furnishing adequate interest or security is not a qualifying interest under section 2702, it will cause the full value of the property transferred to be subject to gift tax. Such a power will also cause the portion of the trust subject to it to be included in the grantor's estate. *See* I.R.C. § 2036(a)(1); Treas. Reg. § 20.2036-1(b)(3). Conversely, a transfer to a trust that gives a nonadverse party the power to vest the grantor with the power to borrow from the trust without furnishing adequate security or paying adequate interest will be complete since the grantor will have given up dominion and control. Treas. Reg. § 25.2511-2(b). For the same reason, a trust containing such a provision will not be included in the grantor's estate since the grantor will have retained no section 2036 or 2038 powers.
>
> If actual borrowing that runs afoul of section 675(3) occurs, there will already have been a completed gift to the trust, so the borrowing will have no effect on the completeness of the gift at the establishment of the trust. However, as indicated in the income tax discussion above, payment of interest on a "non-note" may be characterized as an additional gift to the trust. On the other hand, any borrowing by grantor or grantor's spouse for less than

adequate interest or security from a trust that contains a general lending power is certainly not a gift by the grantor and should not cause the trust to be included in the grantor's estate since the breach is by the trustee who allowed the borrowing. *See* Estate of Goodwyn v. Comm'r, 32 T.C.M. 740 (1973). The funds borrowed will, however, be included in the grantor's estate (presumable with an offsetting deduction for the amount due the trust). I.R.C. §§ 2033; 2053.

The GST tax consequences of holding a proscribed borrowing power or engaging in prohibited borrowing will depend on the completeness of the gift and the fact that the trust, or a portion, might be included in the grantor's estate were she to die during its term."[110]

The simple solution is not to "retain" that right, but to obtain accessibility to the transferred property by selecting a "friendly" trustee and coupling that with the safer power to replace the trustee. Alternatively, the grantor's spouse can be given the right to borrow. Moreover, the right to borrow given to a spouse even without adequate security or interest, is not attributable to the grantor for transfer tax purposes, but will create defective trust status for income tax purposes.[111]

(2) Sales—The grantor may access the cash value by making sales to the trust. If the trust is a beneficiary defective trust the sale will not be income tax free. For example, Parent sets up the trust for the benefit of child and child's descendents. The trustee acquires life insurance on the life of child or grandchild. This trust is outside the scope of IRC § 677(a)(3) because the insurance is not on the life of the grantor or the grantor's spouse. If grantor trust status is desired as to the beneficiary a swap-out power cannot be given to the trust creator.[112] If the sale would cause severe

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[110] Calleton, *Grantor Trusts,* 18, U.C.L.A.—C.E.B. ESTATE PLANNING INSTITUTE at 57 (1996). Ted's article is perhaps the best article available on the technical aspects of Subchapter J.

[111] IRC §§ 672(e); 675(2).

[112] IRC § 6754.

adverse income tax, if the trust indenture permits, the trustee can take some action, which would change the income tax reporting status of the parties. To illustrate, the trustee can give the grantor the right to exchange property for property of an equivalent value, make a loan without adequate security, or grant some other administrative power which would shift the grantor trust status from the powerholder to the grantor.

(3) Have the beneficiary exercise a broad power of appointment in favor of a trust for the original grantor. The power may be exercised directly to the original grantor, however, using a trust as a recipient of the power is preferable to an individual unless there is a compelling reason to deviate from the general thesis woven into this article.

§ 27.15 CONCLUSION

The use of dynastic trust planning coordinated with wealth shifting techniques can provide unique opportunities to create a family "wealth pool" which may benefit the creator's descendents with perpetuity. A judicious blending of defective trust planning into that process will significantly expand and compound the assets owned by the trust. It is, perhaps, the ultimate opportunity to protect and preserve family wealth on a multigenerational basis without disturbing the beneficial enjoyment of the transferred property.