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Freeze, Squeeze, and Burn Trusts

& Scam Relief for Madoff Victims

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And now for something completely different. A super-charged multi-tasking trust that utilizes readily available techniques and turns them into a totally innovative and effective arrangement.

Estate-planning iconoclast Richard Oshins, key founder of the Inheritor's Trust™ concept, has taken this concept to another level and estate planning may never be the same. His new approach: A beneficiary defective inheritor's trust.

This is an arrangement that can 1) "freeze" estate asset values for estate tax purposes, 2) "squeeze" value for transfer tax purposes by exchanging minority or non-controlling interests in businesses that are subject to valuation discounts, and 3) "burn" off the trust's income tax strategically.

This is a triple threat that is uniquely suited to these difficult times and which has numerous advantages over other alternatives.

Perfect Timing For Trusts

Why utilize a trust now? If estates have already taken a huge hit and lost value, wouldn't a secure trust arriving after the fact be like…locking the barn after the horse is gone?

No! The most critical priority for estate planners is not simply about transfer taxation at death; it is about survival. Preserving what is left of estates from creditors, bankruptcy, divorce, and wasteful spending is the primary mission for all estates. It is particularly imperative to safeguard critical assets (e.g., businesses, income-producing real estate, intellectual property) as an engine of wealth for future generations.

And these dismal economic conditions are actually helpful for intra-family asset transfers in various contexts:

- **Depressed Values:** For estates that have been beaten up, thrown down, chewed up and spit out here is one silver lining: Assets can be transferred to a trust or a family member at the current low value and future appreciation can apply outside of the grantor's estate.
- **Low Interest Rates:** If an intra family sale with a loan or mortgage is involved, an extraordinarily low interest rate can be justified without being considered a net gift.
- **Low Capital Gains:** There is a top rate of 15% for long-term capital gains. With the application of the alternate minimum tax (AMT) the effective rate for those in higher income tax brackets may be more like 20%. Nevertheless, a transaction incurring modest capital gains now at current tax rates may be preferable to a) a transaction in the future with higher capital gains, or b) waiting many years in hope of having a stepped up basis apply at death.

Oshins' Omelette

In his estate-planning laboratory in Nevada, renowned attorney Richard Oshins has been perfecting an ensemble of techniques. The chassis for this vehicle is the Inheritor's Trust™, which he launched in a series of articles in 2003: Oshins and Ice, *The Inheritor's Trust™: The Art of Properly Inheriting Property*, 30 Estate Planning (WG&L) 9, p. 419 (Sept., 2003) and *The Inheritor's Trust™: Preserves Wealth as Well as Flexibility*, 30 Estate Planning 9, p. 475 (Oct., 2003).

We first covered the new concept in, *New Strategies, 2004*, The Estate Analyst (March, 2004), and then returned for a more in depth look in, *Spotlight on the Inheritor's Trust™* (August, 2005).

The Inheritor's Trust™ added an extra dimension to dynasty trusts by moving the starting point for planning to the previous generation, i.e., to assets that have not yet been inherited. Intercepting a gift or an inheritance and directing it into a separate trust before the assets can be received by the client's estate has impressive advantages.

The funds are directed in anticipation of what the client would have done. The client exercises great influence over the funds under the terms of the trust. Yet the assets, having never belonged outright to the client, avoid exposure to debts and liabilities. Consider the other benefits:

- Even if the inherited assets are relatively small, they can have a major role if they remain in a separate trust that can continue for many years and remain out of the reach of creditors.
- Having a separate pool of assets to use as "seed money" in several contexts. Wealth-earning opportunities can be shifted to the trust at their inception so that future earnings are kept out of the client's estate.
- A separately funded trust can also purchase life insurance, the benefits of which will not be included in the client's gross estate.
- The Inheritor's Trust™ can become the 1% general partner of an FLP. A relatively small amount of assets is needed, and if the funds are derived from a separate source, i.e., anyone other than the client, the trust will retain the controlling interest. The client could retain control over the FLP in a fiduciary capacity on behalf of the trust, yet his estate would only possess non-controlling interests in the FLP.

A New Twist: BDITs

A beneficiary defective inheritor's trust© is an ingenious evolution of the inheritor's trust concept. It not only steps back a generation and has the client's parent setting up a trust, but then enables the client's assets to be inserted into that trust. The client sells business or investment assets to the parent's trust and takes back an installment note. To further legitimize the transaction, another party, such as the client's spouse, can guarantee the note.

The trust is drafted so as to treat the beneficiary (the client) as the owner of the trust for tax purposes, i.e., defective beneficiary status for income tax purposes but not for estate tax or creditor purposes. This can be accomplished in various ways. One approach is by providing the beneficiary with *Crummey*-style withdrawal powers under IRC §678(a). By the same token, the BDIT should avoid making the settlor the owner of life insurance or settlor's spouse but can buy it on the client.

The net result is not a self-settled trust of the client that creditors and the IRS may scrutinize but an effective trust of the parent. Assets previously held by the client are now protected in the trust thanks to a bona fide transaction. See, Oshins, Alexander, and Simmons, *The Defective Beneficiary Inheritor's Trust: Finessing the Pipe Dream,* CCH (2008).

A Solid Premise

The net tax results of a BDIT are impressive. Assets are transferred to the BDIT at depressed values providing a freeze on transfer tax exposures by keeping future appreciation out of the client's estate along with those assets that the parent used to fund the trust initially. It is a slightly "leaky freeze" in that the asset sold to the trust is providing income or interest (at current low rates) to the client.

However, this is a "beneficiary defective" arrangement in that income is taxed to the client (as beneficiary of the trust) so there is a "burn" of the income rather than having the client's estate (and transfer tax exposure) keep growing.

So what's the catch? Is this arrangement going to withstand scrutiny by the IRS? Will it be too costly to set up and administer? Will it be embraced by practitioners over some of the alternatives?

Estate planning arrangements are slow to develop and catch on but there is good reason to think the BDIT will be widely embraced.

BDIT vs. IDGT

The BDIT concept is not really that alien. In fact, it resembles the intentionally defective grantor trust (IDGT) which is recognized as an effective estate planning and asset protection arrangement. Let's have an acronym showdown.

Both the BDIT and the IDGT are sophisticated plans involving the benefits of trusts. Both are excellent right now while values and interest rates are low because the gifted assets or assets exchanged for a promissory note can be expected to appreciate more significantly in the future.

Both the BDIT and the IDGT can be used to "freeze, squeeze and burn" to some extent. The purpose of a beneficiary defective arrangement for a BDIT or a grantor defective arrangement for a IDGT have the same end result of income from trust assets being taxed in the client's estate, further reducing that estate for future transfer tax purposes and not taxing future generations.

Both techniques can be used to transfer business assets and both can utilize sales of discountable assets to avoid exceeding gift tax exemption limits. Both can involve an FLP and the transfer of limited partnership assets to the trust with a discounted valuation (i.e., the "squeeze" component).

The biggest difference is that the BDIT involves an inheritor's trust that is created by a third party so that the client becomes a beneficiary and trustee of the trust rather than a grantor. This means greater control and use of the trust assets for the client than with a traditional IDGT, where the client cannot be the beneficiary.

With that premise, the client (i.e., the beneficiary of the trust), can even have power to modify the trust in the future. The client can not only be the trustee but can have broad powers of appointment to rewrite key provisions of the trust to adapt to changed circumstances. An irrevocable grantor trust that provides the grantor with too much power risks having the entire trust invalidated.

Your Questions?

This article about the BDIT has only scratched the surface and sets the stage for an interview that will take place with attorney Richard Oshins later in the year. Your questions and comments would be greatly appreciated. Please direct questions about the new defective beneficiary inheritor's trust to the Editor at: *bmoshman@optonline.net.*

Scam Relief for Madoff Victims

Charles Ponzi is experiencing a renaissance of interest lately thanks to the exploits of Bernard Madoff. In December, 2008, Madoff was accused of losing $50 billion of investments for his clients utilizing a Ponzi or pyramid scheme.

A pyramid scheme pays investors with the contributions of subsequent investors rather than profits. In Ponzi's case, investors of 1920 were lured by 50% returns in just 45 days. A frenzy resulted. Investors mortgaged homes and placed their life savings with Ponzi. Then came a day of reckoning.

In Bernard Madoff's case, 15% returns and a exclusive club-like membership lured investors. Madoff, a former head of NASDAQ, had served as Chairman of Bernard L. .Madoff Investment Securities LLC for 48 years prior to being arrested and charged on December 11, 2008.

Formal indictment of Mr. Madoff is expected by February 11, 2009 and his bankruptcy creditors will meet on February 20, 2009.

Six Degrees of Schadenfreude

The victims are large and small. International banks, huge hedge funds, charities, celebrities and normal individuals who invested their life savings.

A Spanish bank may have lost $3.2 billion. So many retirement plans are involved that the Pension Benefit Guaranty Corporation (PBGC) has filed a claim. Nobel laureate Elie Wiesel's Foundation For Humanity lost all of its assets.

René-Thierry Magon de la Villehuchet, a French aristocrat who ran Access International Advisers on Madison Avenue in New York, lost $1.4 billion of his own money and that of his clients with Madoff. Taking personal responsibility for the losses, he committed suicide as the scandal unfolded.

Under the six degrees of Kevin Bacon trivia game, any celebrity named has some connection with the actor. Unfortunately, Kevin Bacon IS one of the victims along with his wife Kyra Sedgewick, the star of television's "The Closer."

Other well-known victims include "Today Show" co-anchor Matt Lauer; famed pitcher Sandy Koufax, industrialist Ronald Perelman; singer Rod Stewart; New Jersey Senator Frank Lautenberg, New York Mets owner Fred Wilpon; the charitable foundation of film director Steven Spielberg; a lawyer for Zsa Zsa Gabor (91) reports that the actress may have lost $10 million in the Madoff scandal.

Investment Loss Claims

It is hard to make sense of a fraud of such magnitude. Madoff victims have formed their own support group. But the solutions are limited.

The most basic relief available is to treat the losses as bad investments and deduct the losses against other gains. To demonstrate the value of worthless assets and the timing of the loss, an investor can transfer the worthless asset to a third party for $1.

Once assets are proven worthless as of a particular date, they can be deducted against capital gains. However, few investors have sufficient gains to offset a major loss. Although investment losses can be carried forward and deducted against ordinary income, such deductions are limited to $3,000 per year.

For an individual investor facing a significant fraud, there are several additional remedies to pursue.

The Securities Investor Protection Corporation (SIPC) has a reserve fund to help defrauded investors when a brokerage goes under. Individual investors can recover up to $500,000 from the SIPC. Madoff investors have until March 4, 2009 to file for this. Taking these funds may limit the other available deductions that can be taken.

Assuming that Mr. Madoff is found guilty of fraud, and that there is no reasonable hope of recovery, investors would be able to utilize more favorable theft loss rules.

Taxpayers can deduct theft losses if they exceed 10 percent of their adjusted gross income in the year the fraud was discovered, which is 2008. Those deductions can be made on income taxes going back to 2005 and unused losses can be carried forward for 20 years.

Those pursuing class-actions may be ineligible if they have a chance of recovery. Deductions might also not apply to investors buying Madoff funds indirectly through other funds. Charities and pension funds that are tax exempt also can't utilize deductions.