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THE INHERITOR'S TRUST™:
THE ART OF PROPERLY
INHERITING PROPERTY

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The Art of Properly Inheriting Property

The Inheritor's Trust™ is an innovative and flexible new strategy that can assume an unlimited number of forms to accomplish a wide range of estate planning goals. This first part of a two-part article explores this powerful technique.

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This article introduces a powerful new concept, which we believe expands the ability of trusts (and the dynastic trust in particular) to protect family wealth. Our mission is to demonstrate the vast opportunities available by structuring gifts and inheritances to our clients in trust, even when the visceral reaction is that the transfer is rather *de minimis* and not deserving of the costs and complexities of setting up the trust, and/or that the client's wealth is so large that generally a potential inheritance to be received by the client is not a compelling concern. Indeed, a small gift by a parent in a properly structured dynastic Inheritor's Trust™, invested as "seed" money in a startup venture that becomes economically successful, is the ultimate estate planning

vehicle. The parent's gift in trust will enable the client to achieve tax savings and a shelter from creditors that the client could not produce for himself.

Background: Upstream planning¹

When most planners do estate planning, they tend to look at structuring their client's wealth to pass to younger beneficiaries and to defund the client's estate. Insufficient attention is given to planning with wealth before it is received by the client/beneficiary, particularly in suggesting that the client request an "advance" on his or her inheritance. In many instances, such a gift can have a dramatic effect on the client's ability to plan.

A virtually untapped segment of the family wealth planning process is advising clients about how gifts and inheritances that they *receive* should be structured. We refer to such a receptacle trust, typically drafted from the viewpoint of the donee or Inheritor (hereinafter collectively referred to as the "Inheritor"), as the "Inheritor's

Trust™." The Inheritor's Trust™ significantly accentuates the thesis that all gifts and inheritances should be made in and retained in trust because holding assets in a trust controlled by the Inheritor improves the value of the assets to the Inheritor.²

Benefits of an 'in trust' inheritance

One benefit of *receiving* and *keeping* gifts and inheritances in trust is sheltering wealth from the claims of the beneficiary's three largest potential claimants: the IRS (taxes), divorcing spouses, and creditors in bankruptcy. This shelter attaches because, for purposes of transfer taxes and property rights, the beneficiary "owns" nothing.

Put in trust—keep in trust. From a wealth conservation perspective, no other technique offers as much protection from the IRS and other would-be claimants as an irrevocable trust, set up and funded by someone other than the Inheritor, and this is true even though the Inheritor has the full use and beneficial enjoyment of the "in trust" property, including vir-

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tually "full control" over the property. A "must read" syllabus on this topic concludes that "[i]nheriting in trust is better than inheriting outright."³

Despite the large tax bite of the wealth transfer tax system, our increasingly successfully litigious society, and the increasing proportion of unsuccessful marriages, many wealthy families do not sufficiently incorporate protective measures in their estate planning. The primary failure is the inadequate use of, and under-utilization of, trusts. Many important advantages can be obtained solely because assets are received and continue to be held in trust, rather than being received outright either from the transferor or from a trust distribution.

Transfer tax benefits. The transfer tax benefits of trusts are well known to estate planners. The enactment of the GST tax has eliminated the ability to simply place an unlimited amount of assets into a perpetual or dynastic trust. For many, though, the GST exemption limitation is merely a small bump in the road, because of leveraging techniques employed by knowledgeable estate planners.

Creditor rights. In addition to tax planning, asset protection should be an integral part of the estate planning process. It is reasonable to assume that virtually any client faced with the simple inquiry—do you desire that your children's and grandchildren's inherited wealth be sheltered from creditors—would answer "yes." A candid client who is asked if he would like his own assets to be insulated from potential claimants would also desire such protection. Although there is a general dislike of paying taxes, paying to the federal fisc would likely be more

palatable for most clients than paying a judgment creditor or a divorce settlement.

Each of us has met with clients who want creditor protection and who inquire about the usefulness of either an offshore or domestic asset protection trust. The jury is out on many aspects of these self-settled trusts. For transfers received and retained in a spendthrift trust, even the most avid proponent of the self-settled asset protection trusts would concede that the creditor protection (as well as the tax benefits) afforded by an Inheritor's TrustTM is superior to that of a self-settled trust. The trust design that we advocate, a discretionary trust with an independent trustee to make discretionary distributions, is not only the most tax efficient structure, but is also "...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."⁴ Even if we assume that the family unit will not do anything to cause liability, there are individuals, including ethically challenged lawyers, who will take advantage of the vagaries and risks inherent in the judicial system. Why expose the wealth to the wrong decision of a jury?

Characteristics of the Inheritor's TrustTM

Functional equivalent of outright ownership with creditor protection. Every gift or bequest (except de minimis transfers) should be made in trust because the fact that the assets are in trust improves their value to the Inheritor. In the hands of a capable drafter, a perpetual or dynastic trust can 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 built-in estate plan."⁵

The Inheritor's TrustTM is a trust typically designed from the viewpoint of the Inheritor which gives the Inheritor control and the beneficial enjoyment over the trust property, as close to outright ownership as possible, outside of the transfer tax system, without compromising the creditor protection that trusts offer. This trust must be funded by someone other than the Inheritor himself or herself.

By integrating many of the commonly-used sophisticated wealth shifting strategies into the Inheritor's TrustTM, considerable shelter from the IRS and creditors can be obtained which have previously been ignored. In addition, we have found that most clients are particularly enamored of the ability to have full use and control over the assets until death (sheltered from predators) and not have to "give" the assets away in order to achieve tax savings and creditor protection.

¹ R. Oshins, "Advanced Planning Strategies Using Grantor Trusts," 60 *N.Y.U. Inst. on Fed. Tax'n*, p. 2 (2002); R. Oshins and S. Oshins, "Protecting and Preserving Wealth into the Next Millennium," 137 *Tr. & Est.* 72 (Sept./Oct. 1998).

² An Inheritor's TrustTM can be set up by anyone other than the client (even by a spouse), and most of the benefits described here could be obtained. It would be unusual for someone other than an older generation to create such a trust, but it can occur and in our experience has happened.

³ Keydel and Wallace, "Design Strategies for Dynasty Trusts," ACTEC 1999 Annual Meeting (Mar. 1999); see also Calleton, McBryde, and R. Oshins, "Building Flexibility and Control into the Estate Plan—Drafting from the Recipient's Viewpoint," 61 *N.Y.U. Inst. on Fed. Tax'n* (2003); Aucutt, "Structuring Trust Arrangements for Flexibility," 35 *U. Miami Heckerling Inst. on Est. Plan.*, Ch. 9 (2001).

⁴ Keydel, "Trustee Selection, Succession, and Removal: Way to Blend Expertise With Family Control," 23 *U. Miami Heckerling Inst. on Est. Plan.*, Ch. 4 at ¶ 409.1 (1989).

⁵ Cooper, "A Voluntary Tax?," p. 57 (The Brookings Institute, Washington, D.C., 1979).

Structure. The Inheritor's Trust™ may be designed using a single trust indenture which breaks into separate trusts to accomplish maximum tax efficiency. For instance, there would usually be separate trusts for GST exempt and non-exempt transfers. Trusts that have different income tax consequences would also usually be separate so that a grantor trust would not be commingled with a nongrantor trust.

Alternatively, separate trusts can be set up. For example, one trust document might be prepared for a trust whereby the donor is treated as the owner, and a separate trust document creates a beneficiary defective trust.⁶ Because a trust under which the donor is treated as the owner ceases that status at the donor's death, bequests could be made to that trust. On the other hand, bequests should not be made to beneficiary defective trusts, since this would cause mixed income tax consequences.

The design of the Inheritor's Trust(s)™ generally includes all or most of the following attributes:

1. *Perpetual.* The Inheritor's Trust™ will be dynastic, designed to continue for as long as the

applicable law permits. Many clients will forum shop to obtain a longer perpetuities period than would be otherwise available. Often, this is accomplished by selecting a trust company with offices in a state that has abolished the rule against perpetuities. Even if transfer taxes were not important, the nontax considerations and benefits inherent in a trust suggest the use of that vehicle.⁷

2. *Separate exempt and non-exempt.* The trust instrument would provide for separate GST exempt and non-exempt trusts with inclusion ratios of either zero or one.

3. *Separate income tax.* If a single trust indenture were used, the main trust would provide for separate trusts for separate income tax payers in a manner similar to the segregation of separate trusts for GST tax purposes. Thus, separate trusts could be set up for: (1) gifts where the transferor is treated as the owner (the typical defective grantor trust under Sections 671-677 or 679); (2) gifts whereby the client/beneficiary is taxed as the owner under Section 678; (3) trusts whereby perhaps a child of the client would be treated as to income tax owner;⁸ and (4) transfers that are subject to the general trust income tax rules of Subchapter J, under which the trust is taxed as a separate entity. Each Crummey beneficiary would have his own separate trust, if the Crummey beneficiary were treated as the owner of the trust income under Section 678. The result of mixing different income tax results is an accounting⁹ and planning nightmare, and should be carefully avoided.¹⁰

4. *Trustee can set up or merge trusts.* The trust would provide that the trustee could set up "secondary trusts" or "sub-trusts" and could merge trusts in appropriate situa-

tions. For instance, after the death of the grantor, the grantor trust status would end and such a trust could be merged into a nongrantor trust without creating income tax complications. Alternatively, the trustee may carve out a portion of the trust creating a new sub-trust which might purchase a remainder interest in a GRAT.

5. *Full control.* It is our experience that clients are extremely pleased that their descendants and other objects of their bounty (and, if they respond candidly, themselves) receive protection from creditors to the extent property is received in an Inheritor's Trust™. In most instances, though, the trust vehicle is desirable to the Inheritor only if the Inheritor is placed in control or, if the Inheritor is not sufficiently mature, he will—at the appropriate time—be placed in control of the trust. The combination of (1) sheltering family wealth from the claims of predators and (2) the Beneficiary Controlled Trust leads to the "conclusion (that from the perspective of the donee/beneficiary), inheriting in trust is always better, *provided the beneficiary has adequate control over his trust!*"¹¹

Thus, the client would be in "full control" of the trust as trustee, except that an independent (or special) trustee would have tax-sensitive powers. Therefore, the client would have all investment and management control in his capacity as trustee just as he would if the property were owned outright, except in the case of insurance on his own life. There are several variations of this. For example, many of our clients use a professional trustee (such as a trust company) as the independent trustee. Some clients place full investment control in the hands of the primary beneficiary/trustee,

⁶ See the section, *infra*, of this article on Beneficiary Defective Inheritor's Trust™—Section 678(a).

⁷ See R. Oshins and Kasner, "The Dynastic Trust Under the Relief Act of 2001," Tax Notes, p. 246 (10/8/01), and Halbach, "Trusts in Estate Planning," Prob. Law., p.1 (Summer 1975).

⁸ Although the kiddie tax has reduced the income-shifting ability previously available, there often is a substantial opportunity to shift income after the child attains age 14 until the child reaches the high bracket of the parent. Section 1(g).

⁹ See Ltr. Rul. 9034004, which illustrates the computation of the income tax consequences of a lapsing 5% or \$5,000 power. The ruling concludes that the powerholder has increasing grantor trust exposure every time a power of withdrawal lapses.

¹⁰ From a planning perspective there is often both positive and adverse income tax treatment as to transactions by the grantor with the trust.

¹¹ Keydel and Wallace, *supra* note 3, at p. 3.

and some of those clients will hire the trust company to manage the assets. Other clients share the investment responsibilities with the trust company and have a veto power over the investments. The variations are virtually unlimited, so long as the tax-sensitive powers do not ever become lodged in a beneficiary/trustee's hands in a manner that would result in adverse tax or creditor exposure.

Use of a professional trustee has increased importance in these types of trusts since the enhancements of the "in trust" inheritance are lost only through poor investments or bad record-keeping. The use of an experienced capable trustee often makes sense so that the integrity of the trust vehicle is not compromised. Proper record-keeping increases in importance with dynastic trusts. Not only are the stakes higher but generally there are more trustees and a greater chance of using one without the requisite skill.

The client would have control over the identity of the independent trustee. The ability to fire and replace the trustee would be limited only by the restrictions necessary to preserve the tax status.¹² There is no requirement that a confrontational relationship exist. The office of independent trustee may be occupied by the client's best friend.

6. Special power of appointment (re-write power). The client would be given the power to literally re-write the trust. The re-write power is tax neutral as long as a general power of appointment is not created. Therefore, the client/powerholder may amend the trust by exercising the power in favor of anyone other than himself, his estate or the creditors of either, in trust¹³ or outright without transfer tax exposure.¹⁴ In most dynastic, beneficia-

ry-controlled trusts, the primary beneficiary (which in an Inheritor's TrustTM is initially the client) (on a per stirpital basis) is given a re-write power through a broad special power of appointment.

The restrictions that are necessary to avoid a general power of appointment are for practical reasons really meaningless. For example, although the client cannot exercise the power to benefit his estate, he may exercise it directly to the beneficiaries of his estate or to a trust (designed by the powerholder himself) for the benefit of the beneficiaries. If the powerholder desires to have the trust amended for his own benefit, the trust could permit a non-beneficiary to hold such a power of amendment. This person could be an independent trustee whose identity could be controlled by the client/powerholder within the restraints of Rev. Rul. 95-98¹⁵, or a "trust protector" whose identity can be determined by the primary beneficiary provided that a successor trust protector must be a permissible person who could be a substitute trustee as described in Rev. Rul. 95-98.

The virtually unrestricted ability to amend the trust adds flexibility to adapt to changes in the law, family circumstances, or the attitude of the primary beneficiary, at least equal to outright ownership, and—in many instances—in excess of outright ownership. For example, the trust, under the direction of the primary beneficiary as management trustee, could acquire a home for a child's use without adverse tax consequences. If there was not a trust, the parent would have to make gifts to the child and lose control, or alternatively, acquire a home individually, and let the child use it. Unlike the rent-free use of a home owned

by a trust, the rent-free use of a home owned by a parent could have adverse gift tax consequences. At death, the home would be included in the parent's estate.

In addition to its extraordinary flexibility, a broad special power of appointment is integral in placing the client, and successor primary beneficiaries, in "full control" of the trust. Because the client can re-write the trust and exclude secondary and more remote beneficiaries, it is reasonable to assume that there would not be any interference with the client's managerial and other functions by an adverse beneficiary whose participation could be eliminated.

Why this strategy works

An often overlooked point is that this planning must be done in advance. Once a gift or inheritance is received by the Inheritor, it is too late to maximize the predator protection. From a planning viewpoint, it is far easier to avoid the onerous taxes and creditor interference before the receipt of the property than to disgorge existing wealth, particularly where the desired benefactor retains an interest. The key here is that the shelter is available only if the trust is created and funded by someone other than the beneficiary and the assets remain in the trust segregated from the recipient's other assets.

If the client funded such a trust for the benefit of himself, the trust would be included in his estate for estate tax purposes.¹⁶ The so-called "string sections" of the Code include in a decedent's estate

¹² See Rev. Rul 95-58, 1995-2 CB 191.

¹³ One exception, beyond the scope of this article, is the Delaware Tax Trap whereby an exercise in trust may not extend the duration of the trust beyond the original perpetuity period. Sections 2041(a)(3) and 2514(d).

¹⁴ Sections 2041(b)(1) and 2514(c).

¹⁵ 1995-2 CB 191.

¹⁶ Sections 2036 and 2038.

transfers for less than adequate consideration if the decedent retained an interest in the transferred property. Because the Inheritor's Trust™ is funded by someone (including a spouse) other than the trust's beneficiary, the "string sections" do not apply, and inclusion, if any, would be via Section 2041 as a general power of appointment. Certainly, it is easy to draft a trust to avoid such exposure.¹⁷ Furthermore, in most states,¹⁸ a self-settled trust in would be accessible by creditors to the extent of the maximum amount that could be paid to the beneficiary,¹⁹ which would be the entire trust.

Consequently, it is essential to plan for the expectation before it matures. Once the client has an outright interest in a venture that has turned out to be valuable, the client will be unable to retain an interest while keeping the property out of his estate or out of the hands of his creditors.

Dramatic expansion of planning opportunities. An "in trust" gift and inheritance receptacle for transfers from a senior generation substantially expands family wealth protection by shifting it up a generation to the client's level, because the trust enables the client to obtain benefits that he could not create for himself. The trust cre-

ates significant opportunities not otherwise available to the Inheritor to erode the transfer tax system, to shift income taxes, and to avoid other claimants in addition to the IRS.

By having an Inheritor's Trust™ in place, or having one established in conjunction with setting up a business or investment opportunity, the estate planning process is simplified, and the client's goal of full control and enjoyment of the property can be achieved. When advised of the benefits of the Inheritor's Trust™, we find many clients accelerate the trust planning to the inception of the business or investment undertaking, rather than waiting to engage in the inferior, more expensive wealth shifting strategies they would need once the value has matured.

Use a 'Beneficiary Controlled Discretionary Trust.' Since wealth received and retained in trust is far superior to wealth received either outright or from trust distributions, we wonder why property is so often transferred outright, and why, when placed in trust, the trust is often created with a mandatory pay-out. For clients who wish to preserve their estates for the family unit (or for charity), rather than expose them to claimants, it is difficult to justify an estate plan that does not follow "a put it and keep it in trust" design.

Most planners approach trust design with a view toward restricting the access, beneficial enjoyment, and control of trust assets. For many beneficiaries, that approach makes sense—at least until the attainment of projected maturity. On the other hand, at the time outright distribution is considered, the restrictions should end, and the property should remain in trust subject to the control of the

intended recipient. Moreover, a large number of our clients believe that their children and other Inheritors are mature and responsible. They would be inclined to give the property outright but for the protections of a trust. These clients should consider the Beneficiary Controlled Inheritor's Trust™, rather than a "traditional trust" which provides for an inflexible mandatory pay-out and is controlled by someone other than the primary intended beneficiary.

For our clients (many of whom are savvy in business and often so affluent that they do not need the inheritance), most of whom are potential Inheritors and often recipients of periodic outright gifts, we suggest that the Inheritor's Trust™ be the recipient of gifts and subsequent bequests rather than the client individually (or rather than relying on the use of disclaimers). Consideration should be given to having the client approach the potential transferor and request that gifts and bequests be made in a trust whose design the client/Inheritor would control. Certainly, a transferor who would be inclined to transfer property outright should not object to making the transfer to an Inheritor's Trust™ which would be designed by the Inheritor with rights and controls that would give the Inheritor enjoyment virtually tantamount to (and as a result of predator protection, benefits in excess of) outright ownership. It is our experience that with proper counseling as to how an "in trust" gift or bequest improves the transfer, almost all potential donor/transfersors will cooperate with the advised course of action.

Opportunity shifting²⁰

The technique. One of the best, yet often overlooked, techniques to

¹⁷ Keydel and Wallace, *supra* note 3; Calleton, McBryde, and Oshins, *supra* note 3; Aucutt, *supra* note 3.

¹⁸ Certain states, Alaska, Delaware, Rhode Island, Nevada and Utah, have enacted statutes changing this general rule, at least for domiciliaries of those states. With regard to domiciliaries of other states who attempt to take advantage of these favorable domestic asset protection jurisdictions, if the creditor protection is unavailable, the property would be includable in the grantor's estate and any attempted use of the GST exemption would be unsuccessful because of the ETIP rule of Section 2642(f)(1).

¹⁹ Restatement (Second) Trusts § 156.

²⁰ R. Oshins, "Planning Strategies Using Grantor Trusts," 60 *N.Y.U. Inst. on Fed. Tax'n* § 27.06 (2002).

avoid the transfer tax system is to shift or deflect 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 referred business, customers, or clients to another person, or gave some gratuitous advice to the other person, no one would think that a transfer subject to the gift tax had occurred. These activities happen frequently. There is no restriction on the identity of the recipient of a valid shift of opportunity. Hence, the opportunity may be shifted to a trust rather than an individual. In its optimal form for most clients, the quintessential shift would be into an Inheritor's Trust™.

Accordingly, 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 in the new entity should be placed in irrevocable trusts. In many instances, the "seed" money is negligible to enable the recipient to acquire a significant interest in a venture that can reasonably be predicted to explode in value.

In the real world, a considerable portion of intra-family diversion of wealth-generating opportunities occur "...even though the parties engaging in it may not be conscious of the substantial estate-planning implications of their actions..."²¹ Especially if one is an active busi-

nessman or investor, opportunities for bringing one's prospective heir into a profitable activity occur regularly.

Advisors who counsel their clients at the inception of a new opportunity to set up a structure whereby the fruits of the new venture are shared by the family members are generally viewed as extremely sophisticated particularly if (1) the entity is structured so that the family patriarch or matriarch has voting control of the entity and (2) the opportunity shift is to a trust rather than outright. In most instances, the client, given a choice, would have the entire entity available to him (as well as other family members) but in his full control.

Getting an advance on your inheritance. 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.

If the Inheritor's Trust™ is most advantageously designed, the entity may be placed in: (1) an income tax defective trust so that the parent or grandparent is taxed, (2) a beneficiary defective trust so that the client is taxed, or (3) a traditionally taxed trust. Alternatively, interests in the entity may be allocated among these three types of trusts.

Although opportunity shifting—particularly where the recipient is a trust—is an extremely powerful wealth planning technique, it is very seldom used. The advisor who does not consider it

when a new venture is being set up is not only short-changing the client who is relying on his advice but is forgoing his ability to earn additional fees.

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

Avoid step transaction. As long as the client is not the original source of the seed money (which would cause the transaction to be 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. Therefore, the client can control the trust by being trustee, and can benefit from the trust assets as the primary beneficiary.

Benefits of Inheritor's Trust™ opportunity shifting. Even though traditional planning would permit the opportunity provider to obtain complete control of the entity even though he owns only a small portion of it by being a controlling general partner of a limited partnership, a manager of an LLC, or a holder of the only voting stock

²¹ Cooper, *supra* note 5.

in a corporation, clients would be better served by having control of the entity (and preferably the entire entity) in a Beneficiary Controlled Trust. The risk is greater if a dissident donee sues the client for breach of fiduciary duty in his capacity as general partner, manager or director than if the complaining family member sues the trustee of a discretionary trust over which the client/trustee/beneficiary has a broad special power of appointment that would permit him to cut out the complainer.

A second (and perhaps a primary) benefit of having full control of, and access to, the entire wealth through the Inheritor's Trust™ is that many clients would not shift the wealth during their lifetimes. By shifting the opportunity to a trust controlled by the client and structuring the trust to provide full enjoyment of the property during lifetime and a "re-write power" (a special power of appointment), the client has the ultimate estate planning structure.

A third benefit is that the client can more comfortably defund his personal estate as a result of the accessible (and protected) wealth in the Inheritor's Trust™.

Example. An estate owner decides to acquire an automobile dealership. Typically, the entire business is conducted under the umbrella of a single entity. The better route is to use multiple entities in structuring the transaction. From an asset protection perspective, if a single entity were used, liability exposure from any separate unit would expose the entire business to creditors. The use of multiple entities would insulate from creditors all but the entity where the liability occurred.

From a tax planning standpoint, the use of multiple entities makes a great deal of sense. For instance, the parent of the family patriarch can set up Inheritor's Trusts™ for the benefit of the client and his descendants (and perhaps their spouses) that would own the shop doing repairs and warranty work on automobiles sold by the sales entity. The parent would allocate GST exemption to the gift to the trust. The trust-owned property and all assets acquired from the income derived from the business would be outside the transfer tax system for multiple generations.

Income tax sheltering: Inheritor's Trust™

By far the most popular use of a defective grantor trust is for a wealthy taxpayer intentionally to violate the grantor trust rules so that by being treated as the owner of the trust income, he is able to reduce his estate by the income tax paid. Grantor trust status enables the trust to grow income tax-free and allows the grantor to transact with the trust without income taxes to himself, his spouse, or the trust.²²

The Inheritor's Trust™ can be a fantastic income tax strategy. Suppose that a client's parent (or grandparent), who is not working and is in a low tax bracket, funds an Inheritor's Trust™ in a manner so that grantor trust status as to the parent (or grandparent) is obtained. If the trust corpus is invested in a favorable business opportunity that produces income, such income would be taxed to the parent (or grandparent), taking advantage of the bracket differential.

Because the parent's (or grandparent's) income tax exposure will increase as a result of the grantor trust, fairness would dictate that the parent's (or grandparent's)

income tax exposure be protected, assuming the elderly person is unable to comfortably absorb the deficiency. One remedy would be to permit the trust to reimburse the parent (or grandparent) for tax liability incurred as a result of the grantor trust status.

If the trust reimburses the parent, the growth of the trust will be adversely affected. Because most Inheritor's Trusts™ will be generation-skipping, the adverse impact of such "leakage" will be accentuated. An alternative would be for the client to make annual exclusion gifts to the parent/grantor as well as to make medical payments directly to the healthcare provider, up to the amount of the shortfall. If there is an excess of income tax obligations, the differential can be made up by the trust, through loans to the parent or by reimbursement.

Additional benefits might be obtained with this structure. If the business or investment opportunity matured as anticipated, the parent (or grandparent) could exchange higher basis property of equal value (even cash or a note) with the low-basis investment, with the result that there would be a basis step-up at the death of the parent (or grandparent) for the property originally owned by the trust. Alternatively, the parent (or grandparent) could retain a power, such as a power of appointment, which would cause estate tax inclusion at the parent's death and a step-up in basis, but would not result in any estate tax because of the unified credit.

Variation. A variation of the use of income shifting through drafting and funding alternatives is to give a person, such as a grandchild, a power of withdrawal so that the grandchild would be taxed on the

²² Rev. Rul. 85-13, 1985-1 CB 184; Section 1041(a)(1).

trust income in the grandchild's low bracket. Although the "kiddie tax" might have some adverse implications until the beneficiary attains 14 years of age, the gap between age 14 and the grandchild's real earning years in most instances is considerable and may enable the family unit to save significant taxes.

Beneficiary Defective Inheritor's Trust™: Section 678(a)

An Inheritor's Trust™ that is designed to be defective as to the beneficiary (via Section 678), rather than to the creator, is an extremely attractive variation of the grantor trust. We call such a trust a Beneficiary Defective Inheritor's Trust. If properly implemented, such a design strategy can avoid the transfer tax system for massive amounts of wealth and protect those assets from creditors of the powerholder while the client can enjoy the benefits and use of that property.

Grantor trust status as to the beneficiary 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. 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 trust corpus or income in himself,²³ 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.²⁴

A person having a withdrawal right has the type of power

described in Section 678(a)(1) because such person has the power exercisable solely by himself to vest the corpus in himself. Thus, under Section 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.

What happens after the power lapses upon its nonexercise? Now, the analysis shifts to Section 678(a)(2). With regard to 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.²⁵

The Beneficiary Defective Inheritor's Trust™ can achieve a result whereby the powerholder, who is treated as the owner, will have a trust with which he or she can transact business, including selling property to the trust, tax-free,²⁶ and can take advantage of the same estate planning opportunities available to the grantor of 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, as beneficiary, may enjoy the benefits of the trust assets. The trust assets would be transfer tax-exempt as well as divorce and creditor protected.²⁷ Although assets could be transferred from the trust beneficiary to the trust in a manner that would result in a taxable sale or exchange if the trust were not a grantor trust under Section 678, the transfer would not be subject to income tax recognition, nor would the assets be subject to estate tax inclusion

if the sale were for full and adequate consideration.²⁸

Under this scenario, the gifts to the trust by someone other than the beneficiary need not be limited to the annual exclusion in order to obtain Section 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 includable. Because the funding would be done with "hot" assets, the lapses should occur rapidly under the 5% "safe harbor" rule of Section 2514(e).

Example. 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.²⁹ The businessman's parent is able and willing to sup-

²³ Section 678(a)(1).

²⁴ Section 678(a)(2).

²⁵ Section 678(b); Ltr. Ruls. 8142061, 8521090, 9034004, 9141027, 9309023, 9311021, 9320018, 9448018, 9625031, 9739026, 9745010, 9809004, 9809005, 9809006, 9809007, 9809008, 9810006, 9810007, 9810008, 9812006, 199935046, 199935047, 200011054, 200011055, 200011056, 200011058, 200022035, and 200147044.

²⁶ Rev. Rul. 85-13, *supra* note 22.

²⁷ It is arguable that a beneficiary could be treated as the trust grantor 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 Section 2041(b)(1) and would render the 5% or \$5,000 exception of Sections 2041(b)(2) and 2514(e) meaningless.

²⁸ The "...adequate and full consideration..." exceptions to Sections 2036-2038 protect against estate tax inclusion. See Sections 2036(a), 2037(a), and 2038(a)(1).

²⁹ Alternatively, the parent can make a part gift, part loan. The loan would be paid with the cash flow of the business.

ply the seed money, and sets up an Inheritor's 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 year.

If the trust is a Beneficiary Defective Inheritor's Trust, Section 678(a) should cause the beneficiary to be taxed on all the income. This

is a good result, because the beneficiary will not be treated as having made a gift to the trust simply because the law requires that the beneficiary owes and pays the tax with the beneficiary's own funds. 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 includable in his estate.³⁰ If the favorable business opportunity grows to \$500,000 in the first year, \$1 million in the sec-

ond year, and \$2.5 million in the third year, the portion of the \$200,000 annually lapsing would be \$25,000, \$50,000, and \$125,000, respectively, based on 5% of the trust each year, so that the beneficiary's estate tax exposure would end after three years.

Part 2 of this article, which will appear in the next issue, explores such aspects of the Inheritor's Trust as valuation planning, asset protection planning, retirement planning, and business succession planning. ■

³⁰ Section 2041(b).

The Inheritor's TrustTM Preserves Wealth as Well as Flexibility

The Inheritor's TrustTM is particularly well-suited for the modern estate plan because of this trust's flexibility in the face of changing tax laws, family structures, and investment climate. This second part of a two-part article explores this technique.

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Valuation planning

Estate tax is levied on the fair market value (FMV) of all property the decedent owned (or is deemed to have owned¹) at death. In many instances, the client is willing to part with an interest in property, but desires to retain control over the property.

A classic example of this is a client who forms a family limited partnership (FLP) and is willing to transfer limited partnership interests, provided the client can control the partnership through retention of the general partnership interest. The property transferred will receive a significant valuation reduction for gift tax purposes by virtue of being a non-controlling interest; however, if the client has retained liquidation control, the value of the underlying assets

reflected in the limited partnership interests retained at death will very likely be included and aggregated as part of the control block—because of the general partner's control.

For example, assume that an FLP has a 1% general partnership interest and a 99% limited partnership interest, and that the client owns the 1% general partnership interest and a 39% limited partner interest. In this case, the client would probably be deemed by the IRS to own the 40% as part of a control block. One argument that could be successful is that the 40% interest should be entitled to a significant valuation reduction because a "buyer" of that interest would be receiving only an "assignee" interest and would not receive control.²

The use of an Inheritor's TrustTM can resolve this problem. The Inheritor's TrustTM can be the general partner of the client's FLP. Even if the client is the trustee of the Inheritor's TrustTM and, as a result, controls the FLP in that capacity, the fiduciary control will not be imputed to him at death for

estate tax purposes. Control held in a fiduciary capacity is not attributed to the decedent in his individual capacity.³ Hence, all the decedent owned and transferred at death would be non-controlling interests, which would reduce the transfer tax substantially.

The same result would be obtained if other entities were used. For instance, if the Inheritor's TrustTM owned the one share of voting stock of a corporation and the 99% nonvoting stock was owned outright by the client, estate tax would be imposed on only the FMV of the nonvoting shares, regardless of the fact that the decedent had full control of the corporation as trustee.

Asset protection planning

A common asset protection strategy involves the creation of an FLP, in which the client creator is the 1% general partner, and a foreign asset protection trust (FAPT) is the 99% limited partner. The client as the general partner has managerial control over the limited partnership interests in the FAPT. However, there is a weakness in

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this strategy. In the event an enhanced level of asset protection is desired, the FLP often is dissolved, but the 1% general partnership interest would be exposed to creditors, and the managerial control mechanism would be lost.

On the other hand, if even a relatively small amount of assets were gifted or bequeathed to an Inheritor's TrustTM from someone other than the client (e.g., a parent, grandparent, or spouse), that trust could then invest in the FLP by purchasing all, or, at least, a controlling interest in the general partnership interest. The trust's spendthrift clause would shield the interest from creditors, and control over the limited partnership interests owned by the FLP would continue, because the general partnership interest is protected by a trust created by a third party. If there is a concern that a U.S. court could determine that the high degree of control given the Beneficiary Controlled Trust beneficiary is tantamount to ownership, additional protection might be obtained if the Inheritor's TrustTM is structured as a foreign situs trust.⁴

The Inheritor's TrustTM personal retirement plan scenario

The Inheritor's TrustTM offers other benefits that cannot otherwise be achieved. A longstanding concept that has been receiving significant attention in the wealth planning community is the use of cash value life insurance. This insurance takes advantage of the single most important concept of financial and estate planning—tax-free compounding.

The Inheritor's TrustTM offers a ready-made vehicle for purchasing life insurance benefits that will not be included in the insured's estate. In many instances, it might be the

quintessential irrevocable life insurance trust (ILIT) avoiding funding issues, and the Inheritor can be in full control of the trust if the insurance is on the life of someone other than the Inheritor. Estate tax avoidance can be accomplished by appointing an independent trustee over any insurance in the trust on the Inheritor's life, and by eliminating the Inheritor's power of appointment over the insurance on his own life. The Inheritor may be given the power to remove and replace the insurance trustee.⁵

The perpetual trust is the best vehicle to achieve transfer tax-free compounding and 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 the unanticipated premature death of the insured. In addition, the death component offers the traditional benefit of the insurance product.

Taking advantage of the tax-free build-up in a policy that qualifies as a life insurance policy under Section 7702 should be considered as an accumulation vehicle that has many preferable attributes when compared to its primary

alternatives—pension plans and NIMCRUTs (i.e., net income with make-up charitable remainder unitrusts). The latter two techniques are tax-deferral (as distinguished from tax-free) strategies, and a tax will be due when the fund is accessed. The life insurance alternative is far superior because the internal build-up is available tax-free via loans or partial withdrawals during the life of the insured, if the policy is not a modified endowment contract (MEC). At death, the potential income tax exposure disappears. Therefore, except in the most unusual 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 were 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 ultimate vehicle for high-end consumers, Private Placement Life Insurance (PPLI).

¹ Certain types of interests or entitlements are includable in the estate even though the decedent did not own them in the classic sense, such as certain transfers within three years of death, revocable transfers, retained life estates, transfers that take effect at death, powers of appointment, etc.

² Porter, *Current Valuation Issues Regarding Closely-Held Entities and Fractional Interests*, p. 6-7.

³ Estate of Bonner, 84 F.3d 196, 77 AFTR2d 96-2369 (CA-5, 1996); Estate of Mellinger, 112 TC 26 (1999), acq. Cf. Byrum, 408 U.S. 125, 30 AFTR2d 72-5811 (S.Ct., 1972).

⁴ The source of this foreign situs Beneficiary Controlled Trust idea is David Lockwood, an attorney in Denver.

⁵ Ltr. Rul. 9832039.

The accessible tax-free build-up 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.⁶ When the insurance is placed inside 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 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 shared with tax-deferred devices. Accordingly, survivorship is an important element with respect to the capital accumulation component of cash value insurance. 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 repercus-

sions upon the premature death of the estate owner. QRPs are IRD, subject to both the income tax and transfer tax. In the case of a NIMCRUT, the entire property passes to the charitable remainder beneficiary and not to the family.

Costs of moving into an income tax-free accumulation vehicle.

Generally, there are significant costs associated with obtaining tax-free growth. With municipal bonds, the cost is a lower yield than can be obtained with taxable investments of equal quality, and the growth possibility is severely restricted, and more apparent over time. With QRPs, the statutory restrictions and IRD issue severely reduce 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.

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, and recognize that the ILIT is generally the preferred vehicle. When accumulation products are involved, two features must be addressed. First, SPWL and the Private Pension Plan initially were sold with little or no thought as to how 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 plan substitute. In most instances, estate tax inclusion was generally conceded at the point of sale by having the insured own the policy. If the experience we've had with QRPs and the desire to dribble out the money as slowly as possible, while retaining the rest in

the tax-advantaged vehicle, are indicative of the projected experience with the internal build-up in insurance 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 that is outside 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 insurance structured to pay a traditional death benefit. This feature will often require more imaginative trust packing techniques than the funding of pure prototypical insurance owned by the trust.

Because the Internal Revenue Code treats life insurance differently from all other assets,⁷ 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.

Solving the dilemma—access without estate tax. The dilemma often faced with cash value life insurance used for retirement planning is that the estate owner both wants access to the internal build-up and also desires to keep the death benefits outside the estate tax system. The estate tax exposure can be finessed by using an Inheritor's TrustTM because the trust must be created by someone other than the client.

The Inheritor's TrustTM can be designed as a Beneficiary Controlled Trust, but if the insurance is on the beneficiary's life, the beneficiary may not be a trustee who makes decisions with regard

⁶ If access to the internal build-up is unimportant to the Inheritor, a MEC policy might be preferable because it permits a larger front-end funding and thus an earlier tax-free accumulation period.

⁷ Sections 2035 and 2042.

to the insurance⁸ nor can the beneficiary have a power of appointment as to the insurance portion of the corpus without estate tax exposure under Section 2042. Consequently, if 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 insured/beneficiary can be the trustee as to the rest of the trust and have a power of appointment over the non-insurance assets. The beneficiary can also have the right to fire and replace the special trustee provided that the replacement power is limited to permissibles under Section 672.

If the life insurance is on another person, the foregoing restrictions would not apply. Accordingly, life insurance can be acquired on a child or grandchild, and could be used as a tax-exempt accumulation vehicle without restriction on account of Section 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 as the anticipated longer tax-free growth due to a longer life expectancy.

If the prospective Inheritor needs the death component, the insurance becomes far more valuable to him if the death benefit is outside the estate but the investment or cash value portion is obtainable through a friendly co-trustee who could be fired and replaced by the insured/beneficiary.

*Accessing the cash value by the beneficiary.*⁹ If it were desirable for the beneficiary to access the cash value of the life insurance in the trust, 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 that is a grantor trust as to the beneficiary, interest payments made by the beneficiary or his spouse during the beneficiary's lifetime do not have income tax consequences. The visceral reaction is to 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 the transfer tax system; one caveat is 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.¹⁰ Any unpaid amount of the loan 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. If 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, usable by the beneficiary, resulting in an estate reduction. If the beneficiary wished to invest the cash, the probable desired strategy would be to make the investment inside the trust so that its growth will 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.¹¹

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

Vehicle to purchase remainder interest—A generation-skipping GRAT or CLAT

Because of the taxpayer victory in *Walton*¹² (where the Tax Court unanimously blessed a "zeroed-

⁸ See Zaritsky and Leimberg, *Tax Planning with Life Insurance*, ¶ 5.03(6)(a) (Warren Gorham & Lamont, 2nd ed.); and Slade, 807 T.M., *Personal Life Insurance Trusts*, p. A-25.

⁹ A variation of this strategy which has been promoted by some is "The WRAP Trust"™. Proponents of the technique believe that access to the cash value build-up can be available to the trust grantor by providing in the trust document the right to borrow funds from the trust, if the grantor pays market interest and provides adequate security. See Blasé, "The Wrap Trust," J. Amer. Soc. of CLU & CHFC at 120 (Sept. 1997); O'Sullivan and Thiessen, "Avoiding Estate Tax Problems Unique to Life Insurance," J. Financial Service Professionals at 68 and 83, which cites the Blasé article (Nov. 2001). Contra, Calleton, "Grantor Trusts," 18 UCLA-C.E.B. Estate Planning Institute at 57 (1996). We believe

that this analysis is incorrect and such a retained right will result in estate tax inclusion under Section 2036(a). Inclusion under that section occurs if the decedent made (1) a transfer (2) for less than adequate and full consideration and (3) retained the enjoyment of the property. In *The Wrap Trust*™, the decedent retains the right to borrow (i.e., the enjoyment of the property), without paying for it. On the other hand, with the *Inheritor's Trust*™, the beneficiary has not made a gratuitous transfer to the trust and, therefore, cannot have retained a right in property he transferred to the trust.

¹⁰ Section 2036(a) and possibly Sections 2038 and 2041 (reachable by creditors).

¹¹ *Estate of Jordahl*, 65 TC 92 (1975), acq.; Ltr. Rul. 9413045.

¹² 115 TC 589 (2000).

out" GRAT (grantor retained annuity trust)), the current low interest rates, and the ability to avoid valuation controversy and risk of gift tax, the GRAT (and CLAT (charitable lead annuity trust)) have become increasingly popular. The ETIP (estate tax inclusion period) provisions under Section 2642(f)(1) (and Section 2642(e)(1) for CLATs) prevent the grantor from leveraging the transfer for GST tax purposes by prohibiting him from allocating his GST exemption until after the front-end annuity interest terminates. Many planners faced with the ETIP provisions simply believed that leveraging the GST exemption could not be achieved with proper planning, but we believe that generation-skipping can be obtained.

Although the ETIP rules prohibit the allocation of GST exemption until there would be no inclusion in the transferor's estate,¹³ many practitioners believe that the inability to use generation-skipping leveraging techniques with the GRAT and CLAT can be finessed by having the remainder beneficiary either give or sell his remain-

der interest to a dynastic trust.¹⁴ 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 remainderman/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 GST tax purposes.

If a parent, grandparent, or some other third person were to set up an Inheritor's TrustTM for a client, the client could set up a Walton GRAT which would sell the GRAT remainder interest to the Inheritor's TrustTM for fair and adequate consideration. At the end of the GRAT term, the property remaining in the GRAT would be transferred to the client's Inheritor's TrustTM. This should not be subject to the transfer tax system since it was not a gratuitous transfer (one of the requirements for estate tax inclusion).

Ltr. Rul. 200107015. The IRS announced its position on the transfer of a remainder interest in *Ltr. Rul. 200107015* in the context of a transfer of a remainder interest in a CLAT. The ruling addressed whether there was a change in transferor from the original creator of a CLAT or GRAT to a new transferor (the remainderman for GST tax purposes), so that the new transferor could allocate his own GST exemption to the transfer to keep it outside the scope of the GST tax.

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 GST tax.

The Service's position is based on policy—that the purpose of Sections 2642(e) and 2642(f) is to prevent the use of these types of leveraging transactions to circumvent the application of the GST tax. We, as well as other practitioners, believe that the Service's position is technically flawed and will not withstand judicial scrutiny.¹⁵

Protective planning. Although we believe that the IRS position lacks merit, prudent advisors might protect against the downside risk if the IRS did prevail. For example, deferral of GST tax could be achieved by transferring the remainder interest to an Inheritor's TrustTM drafted to include all the GRAT grantor's children, and perhaps their spouses would have present discretionary interests. The GST tax would be postponed until the death of the last to survive of the persons interested in the trust assigned to the generation just below that of the grantor of the GRAT.¹⁶ If a child of the grantor of the GRAT is deceased leaving a surviving child or children, that child or children will be assigned to the preceding generation, thereby enabling a taxable termination to be postponed until the death of such grandchild or grandchildren.¹⁷

¹³ Section 2642(e)(1) creates a similar prescription for a CLAT, prohibiting election of GST tax-exempt status until the expiration of the annuity period.

¹⁴ S. Oshins and Handler, "GRAT Remainder Sale to a Dynasty Trust," 138 Tr. & Est. 20 (Dec. 1999), and Adams, "Proprietary Approaches for Planning with Individuals and Their Businesses," Teleconference Services at 13 (3/27/01).

¹⁵ 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. Miami Heckerling Inst. on Est. Plan. Ch. 13 (1997); Gopman, Steinberg, and S. Oshins, "Ruling on Assignment of Vested Remainder Interest May Have Reached Wrong Conclusion," T.M. Est., Gifts and Tr. J. (Sept./Oct. 2001); R. Oshins and Sederbaum, "Generation-Skipping and the GRAT: Sale or Gift of the Remainder," 30 ETPL 259 (June 2003). See also Kasner, "Hot Tax Topics for Estate Planners, Outline" at 71 (4/12/01).

¹⁶ Section 2613(a).

¹⁷ Section 2651(e).

Sale and leaseback

A popular estate freezing technique is a gift or sale (generally of appreciated property) to younger family members (or trusts), with the property being leased back by the transferor. One advantage of this strategy is that the transferor can continue to use the property without estate tax inclusion. Assets that work well in this arrangement include land, office buildings, furniture, and equipment. Often, business owners inadvisably acquire or transfer these assets into the operating entity. That course of action will expose the assets to creditors of the operating entity, and will limit the tax planning possibilities and can preclude a basis step-up if the entity is a corporation. On the other hand, owning the operating assets outright will expose them to the owner's personal creditors as well as to the transfer tax system. An Inheritor's TrustTM may resolve that.

Example. Four physicians wish to acquire some medical equipment for \$1 million. Although they are extremely competent doctors, they are concerned about malpractice lawsuits. They are also interested in tax planning.

If the equipment was acquired in their professional entity, it would be exposed to lawsuits arising out of the medical practice. Instead, they should acquire the equipment in an LLC. If a physician has his parent set up a Beneficiary Defective Inheritor's Trust that acquires his 25% interest and that interest received a 40% valuation discount, the value of the transferred interest would be \$150,000.¹⁸ The LLC would then lease the equipment to the operating entity. If this type of equipment is normally leased for 20% of its cost, the proportionate cash

flow for the transferred interest would be \$50,000.

Planning note. The transfer of the interest should precede the lease because if the lease is in place when the transfer is made, the value of the underlying entity would be enhanced. Given physicians' concern over medical malpractice, it is shocking how little this planning technique is used.

Business buy-out¹⁹

An Inheritor's TrustTM can open considerable planning alternatives when used in conjunction with a buy-sell agreement. In most instances, a cross-purchase agreement is the method of choice because the acquirer will obtain a basis step-up. A problem often occurs because the last surviving purchaser will own 100% of the entity and, in the absence of additional planning, the entire business—including all appreciation—will expose his estate to unnecessary estate taxes.

Rather than have the interest acquired by the surviving owner, the planner should consider structuring the transaction so that the purchase is made by an Inheritor's TrustTM. If the buy-out is funded by insurance, the insurance on the other owners' lives would be acquired by the Inheritor's TrustTM. Upon the death of a co-owner, the decedent's interest would be transferred to a vehicle outside the reach of the transfer tax system even though the control is in the hands of the surviving owner.

Example. Three business owners wish to fund a buy-out agreement. An Inheritor's TrustTM might be set up for the benefit of an owner; the trust has a cash flow from either an opportunity shift or a sale and leaseback. Thus, the client could segregate the "hard" assets

of the operation into a leasing company that is outside the transfer tax system.

Can extend to the operating entity as well. Under this alternative, the Inheritor's TrustTM would acquire insurance on the lives of the other owners of the leasing company, using the cash flow from the leasing company to pay the premiums. For example, assume A, B, and C each own a one-third interest in a business and leasing company (collectively, "the business interest") with a combined value of \$6 million. In the normal cross-purchase buy-out arrangement, if A died, B and C would purchase A's shares for \$1 million each and would each then own one-half of a \$6 million business.

If B then died, C would acquire B's interest for \$3 million and would own the entire entity worth \$6 million. Under this scenario, \$11 million would be exposed to the transfer tax system. If the purchase was funded with life insurance, each party would need \$2 million of life insurance initially (\$1 million on each of the other owners); \$3 million at the death of the first to die (to acquire the interest of the non-deceased co-owner); and using round numbers (assuming a 50% estate tax), \$3 million to pay the estate tax at their own death.

Variation. Suppose that A and B each own 50% of an entity. A's parent sets up an Inheritor's TrustTM for the benefit of A and his

¹⁸ Because the trust would be defective as to the doctor, the sale would be income tax-free.

¹⁹ Rothchild, "The BILIT—Business Irrevocable Life Insurance Trust," 140 Tr. & Est. 22 (July 2001). See Rothchild and Slane, "Creative Life Insurance Funding for Individuals and Alternative Arrangements for Buy-Sell Agreements," 61 N.Y.U. Inst. on Fed. Tax'n Ch. 23 (2003).

family which acquires insurance on B's life to fund a buy-out. B dies and the Inheritor's TrustTM acquires B's 50% interest. A could then redeem his interest and have full control of the entity as trustee of the Inheritor's TrustTM without any inclusion of the entity in his estate for estate tax purposes. At the very least, A should consider redeeming one share or unit of the entity so that he has estate tax inclusion of less than 50% of the entity.

Avoiding state income taxes

Do state income taxes apply to an Inheritor's TrustTM, and if so, can anything be done about it? The answer is largely a matter of state law. An Inheritor's TrustTM, with a trustee in a state with no income taxes, can be used to escape substantial state income taxes. For example, if a New York City domiciliary created a trust with a trustee in a state that did not have income tax, and the trust contained income-producing intangible assets, both state and city taxes could be avoided.²⁰

Alternatively, if the trust situs is in a state that taxes trusts, the problem may still be fixable—whether as a result of a change of law or otherwise. A properly drafted Inheritor's TrustTM should contain powers to change the trust situs, in addition to the power to create subtrusts. It may therefore be beneficial and possible to change the trust situs to a jurisdiction that does not tax trusts.

Because it may be necessary to change the trustee as well, in order to obtain these benefits (as in the New York example above), the client may want to create a subtrust with the assets that would

otherwise be subject to state income tax, and to transfer those assets to another jurisdiction, perhaps appointing another trustee, but retaining a local trustee (e.g., the beneficiary) for other assets not likely to generate taxable income. One way or another, a properly drafted Inheritor's TrustTM ought to be flexible enough to solve the state income tax problem, if there is one. With the Inheritor's TrustTM, flexibility is the key, and this is just one example of how flexible trustee appointment provisions and subtrust creation provisions can solve a problem.

Step-up in basis opportunities through exercise of powers of appointment

Retained power. If the grantor has a relatively small estate and is expected to have unused unified credit, the grantor might consider retaining a special power of appointment over the property in the trust, which would cause the trust to be taxable in the grantor's estate under Section 2038, resulting in a basis step-up. If the dispositive provisions of the Inheritor's TrustTM prohibit distributions without the consent of an adverse party, the trust would not be a grantor trust for income tax purposes.²¹ So, just as it is possible to have a grantor trust that is not in the grantor's estate, it is possible to have a non-grantor trust that is in the grantor's estate.

Variation. But what if the grantor did not retain a power that would place the property in the grantor's estate? In most cases, a grantor would take pains not to retain such a power. However, with the unified credit increasing yearly, that initial decision may not have been the best one. Further, there may be family members other than the grantor whose estates are not tax-

able, and for whom a step-up in basis at death could be beneficial. A possible variation of the original technique would be for the beneficiary of the Inheritor's TrustTM to transfer the property back up the line, with the expectation of inheriting it later, and thus getting the step-up in basis. However, there are two hurdles to overcome. One is the gift tax. The other is Section 1014(e). It may be that the Inheritor's TrustTM can solve both problems.

In the past, it was not unheard of for a child to transfer low-basis assets to an elderly parent (whose estate was not large enough to attract an estate tax), with the expectation that the child/donor would inherit the assets with a step-up in basis at some point in the future. This would be practical only if the child was not in a high gift tax bracket. That loophole was closed by Section 1014(e), which provides that if appreciated property was acquired by the decedent by gift within one year of death, and if that property is acquired from the decedent by (or passes from the decedent to) the donor of the property (or the donor's spouse), then the basis of the property in the hands of the donor (or spouse) is the basis of the property in the decedent's hands immediately before death.

However, what if the decedent, instead of bequeathing the property back to the original donor, leaves the property to a trust for the donor? As a technical matter, that ought to work, since it does not literally fall within Section 1014(e). Nevertheless, Ltr. Rul. 200101021 and TAM 9308002 held that the spirit of Section 1014(e) was violated, and that the technique did not work, in the case of a joint revocable trust set up by a husband and wife, where

²⁰ Roth, "The Intentional Use of Tax-Defective Trusts," 26 *U. Miami Heckerling Inst. on Est. Plan.* Ch 4 (1992).

²¹ Ltr. Rul. 200148028.

the first spouse to die was given a general power of appointment over the entire trust, and where the surviving spouse owned and held the power to revoke up to the moment of death of the first spouse. We believe that if the property were given to the decedent, and the decedent independently and without prior arrangement left it to an Inheritor's TrustTM for the original donor, then Ltr. Rul. 200101021 and TAM 9308002 ought not to apply because the beneficiary did not hold on to the trust property up to the moment of the donor's death.

The argument that neither Ltr. Rul. 200101021, TAM 9308002, nor Section 1014(e) applies is even stronger if the "donor" was not an individual but an Inheritor's TrustTM. The deceased recipient of the property could have received it in one of two ways: either as a discretionary distribution from an Inheritor's TrustTM, or possibly as the result of the exercise of an inter vivos power of appointment under a trust. (There is some risk that the exercise of this power could be considered a gift if the powerholder was also a beneficiary of the trust—for example, if the powerholder had a nondiscretionary right to the trust income.) The decedent would then leave the property to another Inheritor's TrustTM. We believe that a step-up in basis can be obtained tax-free, even if the powerholder—or better yet, an Inheritor's TrustTM for the powerholder—receives the property in question after the decedent's death.

The issue boils down to who is the "donor" if the property is transferred pursuant to a discretionary distribution power or even pursuant to a power of appointment by someone who has never technically owned the property,

someone who cannot properly be said to be or ever to have been the donor of it (e.g., the beneficiary of an Inheritor's TrustTM for which someone else was the "donor"). We believe that it is probable that Section 1014(e) will not apply in that case, even if the property is inherited within a year of transfer.

Conclusion

The Inheritor's TrustTM, in all its varieties and with all its uses, should be the centerpiece of an estate planner's tool box. There are several characteristics that one would commonly expect to find in an Inheritor's TrustTM. First, and primary, the trust would be "beneficiary controlled" for all practical purposes (functional equivalent of outright ownership), by use of broad distribution and investment standards. In virtually every case, the trust would be "dynastic," designed to last as long as the law permits. This perpetuity provision would almost always be coupled with a power in the client to change who eventually receives the trust property, and under what conditions and in what form. This would be achieved through the use of liberal and creative powers of appointment ("re-write powers"), something central to the concept of an Inheritor's TrustTM.

In most cases, the beneficiary would also have some form of power to remove and replace the independent trustee. In addition, the independent trustee (whose identity is controlled by the beneficiary) will usually be given a power to merge or terminate the trust, including the power to create subtrusts, perhaps with separate trustees and separate tax and investment objectives.

Some of the more popular varieties of the Inheritor's TrustTM include:

- The GST tax-exempt variety.
- The GST non-tax-exempt variety.
- The "intentionally defective" donor grantor trust variety under Sections 671-677 or 679, with a power to turn off grantor income taxation.
- The Beneficiary Defective Inheritor's TrustTM under Section 678(a) (perhaps the most important), possibly with a power to turn off grantor income taxation.
- The intentionally non-grantor tax paying trust variety.

What does, or can, the Inheritor's TrustTM achieve: (1) estate tax savings; (2) GST tax savings; (3) income tax savings by shifting the ordinary income to the individual or the trust that is taxed at the lowest rate (with low capital gains and dividend rates, it may be that even if income taxes are paid at trust tax rates, this will not be of any importance, and may even result in alternative minimum tax savings); (4) state income tax savings, by shifting the trust domicile to a state that does not tax trusts; (5) favorable capital gains results via provisions that cause capital gains to be either unrealized, or stepped up to FMV without recognition at all; and (6) creditor/predator protection. Additionally, and perhaps just as important, the beneficiary of the Inheritor's TrustTM can use the trust to achieve virtually all his or her personal nontax estate planning objectives and needs through the use of pervasive powers of appointment. While the Inheritor's TrustTM is especially useful for the super-wealthy, it is also of great benefit to persons of moderate wealth, *and to their families.* ■