



ESTATE PLANNING

The Hybrid Domestic Asset Protection Trust

Steven J. Oshins, Esq., AEP (Distinguished)

Protecting Financial Assets

It is insufficient to sell financial products, such as cash value life insurance or marketable securities or bonds, without also considering the importance of protecting those assets from creditors. After all, the life insurance advisor's or financial planner's interests are aligned with those of the client. Both parties want the client's assets to be protected in the event that the client is sued. If the client is sued and loses these assets, the advisor no longer has these assets to manage.

The Domestic Asset Protection Trust

Asset protection has become one of the hottest areas of law and has become the ideal

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complement to estate planning. Consequently, the Domestic Asset Protection Trust ("DAPT") has become one of the most popular asset protection tools in the planner's toolbox. As more states have

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Editor's Comments

For this issue of the Estate Planning Section Newsletter we have a "two-fer." That is we have two excellent articles.

The first is by my good friend Steven J. Oshins, Esq., AEP[®] (Distinguished), of the law offices of Oshins & Associates in Las Vegas, Nevada, and is titled *The Hybrid Domestic Asset Protection Trust*. When it comes to asset protection, Steve is, by far, one of the leading attorneys in the country. In addition, Steve and his father Richard A. Oshins, JD, LL.M., MBA, AEP[®] (Distinguished) are the creators of some of the most

innovated estate planning techniques that have ever been produced. Some examples include the Beneficiary Defective Inheritor's Trust (BDIT) and the Net Income Make-up Charitable Remainder Unitrust (NIMCRUT), as well as the Hybrid Domestic Asset Protection Trust (Hybrid DAPT) which is the subject of Steve's article. Steve is the youngest person, so far, at the age of 43 to have ever been inducted into the National Association of Estate Planners & Councils Estate Planning Hall of Fame[®], a truly amazing accomplishment. It

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Hybrid DAPT

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enacted DAPT legislation, practitioners have started doing more DAPTs for their clients. Financial advisors must be knowledgeable in this area in order to understand the opportunities for their clients.

A DAPT is an irrevocable trust in which the trust settlor is a discretionary beneficiary along with other discretionary beneficiaries. After a period of time called the “statute of limitations” the DAPT assets should be protected from the settlor’s creditors. The statute of limitations applicable to the trust depends upon which of the DAPT jurisdictions is used for the trust. In addition, all DAPT jurisdictions except for Nevada have at least one type of exception creditor who can pierce through the DAPT. In many of these jurisdictions, divorcing spouses, alimony creditors, child support creditors, preexisting tort creditors, and other classes of creditors are exception creditors who can pierce through the trust.

After nearly 16 years since the first DAPT legislation passed, not a single DAPT has been tested all the way through the court system. Most likely this is because such a large supermajority believes that if tested the DAPT will work to protect its assets from a creditor of the settlor. However, despite the very high likelihood of protection, if there is a way to increase the odds of success even more, then such a strategy should be utilized whenever possible.

The Hybrid Domestic Asset Protection Trust

The Hybrid Domestic Asset Protection Trust (“Hybrid DAPT”) is a strategy that should increase the probability that the trust assets will be protected. And it is very simple. The Hybrid DAPT is just like a regular DAPT except that the settlor is not an initial discre-

tionary beneficiary of the trust, but can be added later by a trust protector. Thus, the trust is initially set up for the benefit of the settlor’s spouse and descendants, for example, but not for the settlor. By not including the settlor as a beneficiary of the trust, the Hybrid DAPT is by definition a third-party trust and therefore almost certainly avoids the potential risk of uncertainty of a regular DAPT.

Especially where the settlor is married and has a strong, trusting relationship with his or her spouse, is there any good reason that the settlor must have his or her name in the trust agreement as a beneficiary? It is very simple to indirectly access the trust assets through the spouse. And the trust agreement should define the “spouse” using a “floating spouse provision” that defines the spouse as the person the settlor is married to and living with from time to time. This gives the settlor the ability to access the trust assets through a subsequent spouse in the event of a divorce or the death of the settlor’s spouse.

If the settlor has no spouse, then it becomes more difficult to access the assets. However, since a good asset protection planner will be sure to leave sufficient wealth outside of the client’s asset protection trust, in most cases the settlor will not have to work through this issue anytime soon.

If the Settlor Is Added as a Beneficiary

In case the settlor needs to be a discretionary beneficiary of the Hybrid DAPT sometime in the future (i.e., if the settlor has no spouse or child that will “share” a distribution with the settlor and the settlor now needs a distribution), the trust agreement provides that the trust protector can add additional beneficiaries, including the settlor. However, if the settlor is added, then the Hybrid DAPT

becomes a regular DAPT and thus risks that the law is still unsettled on DAPTs (even though most people believe that they work).

What happens if the settlor suspects that a creditor attack may be forthcoming? In either case, very far in advance of the problem occurring, the settlor would ask the trust protector to remove him or her as a discretionary beneficiary.

The Completed Gift Hybrid DAPT

Most DAPTs are designed as Incomplete Gift DAPTs where the sole objective is asset protection. However, many DAPTs are designed as Completed Gift DAPTs where the settlor is a discretionary beneficiary of a trust designed with the following attributes:

- (i) It is a completed gift for gift tax purposes
- (ii) The settlor is a discretionary beneficiary
- (iii) The trust assets are protected from the settlor's beneficiaries
- (iv) The trust assets are outside of the settlor's estate for estate tax purposes at the settlor's death

The Completed Gift DAPT strategy was approved by the Service in PLR 200944002 where a resident of a DAPT jurisdiction established the DAPT using the laws of that DAPT jurisdiction.

However, with respect to a resident of a non-DAPT jurisdiction, although most practitioners are comfortable that this strategy works, whether the trust assets are open to creditors of the settlor is still uncertain since it is unclear which state law will apply for creditor purposes. The DAPT will be includible in the settlor's estate at death if the trust assets are open to the settlor's creditors. If this were the case, this would occur under IRC §2036(a)(1) since the settlor would be treated as retaining the ability

to run up creditor debts which can be paid out of the trust at the settlor's death.

IRC § 2036(a)(1) provides that the value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in the case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which the decedent has retained for life or for any period not ascertainable without reference to the decedent's death or for any period that does not in fact end before death the possession or enjoyment of, or the right to the income from, the property.

The Completed Gift DAPT reduces this risk significantly since the settlor is not a discretionary beneficiary of the trust and, thus, it is not a self-settled trust. In an ideal scenario, the settlor will never need to be added as a discretionary beneficiary by the trust protector or independent trustee. However, if the settlor does need to be added at a later date, since the Completed Gift Hybrid DAPT also gives the trust protector or independent trustee the power to remove beneficiaries, as long as the settlor is removed as a discretionary beneficiary more than three years prior to death, there is no estate tax inclusion since IRC §2035 (the three-year contemplation of death rule) will not apply.

The Completed Gift Life Insurance Hybrid DAPT

Life insurance policies are often owned by an irrevocable life insurance trust ("ILIT") in order to remove the death benefit from the insured's taxable estate. However, especially for insurance products that have high cash value,

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the insured is often torn between saving estate taxes and having access to the cash value. Also important in this analysis is the perceived risk inherent in the uncertainty of whether a traditional Completed Gift DAPT will ultimately be determined to be out of the settlor's estate in case the IRS does not follow its holding in PLR 200944002 since a Private Letter Ruling is only applicable to that taxpayer.

The Completed Gift Life Insurance Hybrid

DAPT seems to be the ideal solution to this dilemma since it acts like a traditional third-party ILIT until and unless the trust protector adds the settlor in as a discretionary beneficiary and thus does not take any significant risk until this time. And if the settlor is at the point where accessing cash value is necessary, it likely means that the settlor's estate is to the point where estate taxes are not an issue or are less of an issue. If the settlor has significant assets and merely has a liquidity issue, then the settlor would have simply sold illiquid assets to the trust in order to access cash rather than asking the trust protector to add him as a discretionary beneficiary.

Summary

It is imperative that the asset protection planner create a plan with the highest probability of success. In most cases, it is possible to significantly increase the protection by simply using a Hybrid DAPT rather than a traditional DAPT. This article describes this structure and also describes a unique ability to take advantage of this technique in order to enhance the traditional ILIT. ●

Steven J. Oshins, Esq., AEP (Distinguished) is a member of the Law Offices of Oshins & Associates, LLC in Las Vegas, Nevada. Oshins is a nationally known attorney who is listed in The Best Lawyers in America® and has been named one of the Top 100 Attorneys in Worth magazine. He was inducted into the NAEPC Estate Planning Hall of Fame® in 2011. He has written some of Nevada's most important estate planning and creditor protection laws. He is also the author of the Annual Domestic Asset Protection Rankings at http://www.oshins.com/images/DAPT_Rankings.pdf. Oshins can be reached at 702-341-6000, x2 or at soshins@oshins.com or visit www.oshins.com.

Save the Date

Health Care: The Times They Are A-Changin'

FSP's February Video Teleconference, which will broadcast on February 20 and 21, 2013, features a distinguished panel of experts discussing the Patient Protection and Affordable Care Act and what it will mean for consumers, providers, and advisors.

Moderator Gayle Holcom, CLU, ChFC, will lead panelists Gerald Frye, CLU, ChFC, RHU, REBC, CASL, of The Benefit Services Group, and Arthur Tecchino, JD, of The American College, in a discussion of major issues such as state-based exchanges, episodes of care, and the "pay or play" feature. Anyone connected to the health care business will need to know how to advise clients on these and related issues under the law.

Attendees will learn about:

- What the Affordable Care Act will mean for their business
- State-based exchanges as a way to help insurers meet consumer protection requirements
- How an episode-of-care payment system will work
- The implications of "pay or play" (payments as alternatives to buying coverage)
- What the role of an agent will be regarding penalties in the health care reform environment

For information visit

http://www.financialpro.org/public/vtc_022013.cfm, or call Member Services at 800-392-6900.

2012 Tax Act Increases Income Taxation of Trusts

Julius Giarmarco, JD, LL.M.

The American Taxpayer Relief Act of 2012 (the "Act") increases the highest federal income tax bracket from 35 percent to 39.6 percent for individuals with taxable income over \$400,000 (single), \$450,000 (joint), or \$11,950 for estates and trusts. The Act also increases the tax rate for long-term capital gains and qualified dividends from 15 percent to 20 percent for individuals with taxable income over \$400,000 (single), \$450,000 (joint), or \$11,950 for estates and trusts. The Patient Protection and Affordable Care Act implemented (beginning in 2013) a 3.8 percent Medicare tax on the lesser of net investment income or taxable income above \$200,000 (single), \$250,000 (joint), or \$11,950 for estates and trusts. As a result, many estates and trusts will be taxable at 43.4 percent on ordinary income and 23.8 percent on qualified dividends and capital gains, while many beneficiaries, particularly young children and grandchildren, will be taxable at lower rates.

Leaving assets in trust to one's beneficiaries at death (or during lifetime) is a popular way to protect the beneficiaries from creditors, exspouses and estate taxes (to the extent of the grantor's generation-skipping tax exemption). Leaving assets in trust is also a way for the grantor to be assured his/her dispositive wishes are carried out and that the assets remain in his/her bloodline.

There is now an even larger tradeoff for the protection afforded by trusts. Trusts reach the highest tax bracket at \$11,950 of taxable income (for 2013, indexed for inflation). In addition, except for marital trusts, there is no basis step-up at the beneficiary's death for those assets held in trust. As a result of the higher tax

rates, and with portability (of the deceased spouse's unused estate tax exemption) becoming permanent under the Act, many married couples will dispense with credit shelter trusts. In their place, disclaimer trusts will likely be used to allow the surviving spouse to disclaim (all or a portion of the decedent's estate) into a credit shelter trust if desirable.

What about bequests and gifts to children and more remote descendants? Many clients will be unwilling to leave children—particularly young children—assets outright. In those situations, trusts will still be used to protect the beneficiaries from their inability, their disability, their creditors and their predators, including ex-spouses. For those clients, the tax consequences can be minimized by:

1. Investing the trust funds for qualified dividends, long-term capital gains, and tax exempt income. Paying a 23.8 percent tax is preferable to paying a 43.4 percent tax.
2. Limiting turnover to minimize gains.
3. When not threatened by creditors, distributing income and capital gains to the beneficiaries, in which case the beneficiaries will pay the taxes at their rates.
4. Investing trust funds in permanent life insurance. The build-up of cash value inside the policy, and policy loans and withdrawals (up to basis in the contract), will be income and Medicare tax free. An added benefit is that the death proceeds will also escape estate taxes. In addition, if a permanent policy on the grantor's life is purchased by the trust (with the grantor's spouse as the beneficiary), the trustee can access the cash values for the

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- benefit of the spouse. This arrangement not only has income tax benefits, but also financial/retirement options.
5. Where appropriate, investing trust funds in an annuity. Annuity contracts present special problems and raise special considerations when the owner is a trust. However, the IRS has ruled privately that ownership of an annuity by a trust can result in tax-deferral.
 6. Drafting irrevocable trusts to permit an independent trustee to distribute “so much, or all of, the principal...” This type of clause may suffice to distribute the trust to current beneficiaries and thereby terminate the trust.
 7. Drafting trusts to permit the trustee to distribute trust income to charitable organizations, including the grantor’s own private foundation.

With respect to trade or business income from partnerships, LLCs, and Subchapter S corporations, the income attributed to a taxpayer will not be subject to the 3.8 percent Medicare tax if the taxpayer materially participates in the trade or business. However, the Internal Revenue Code does not address how (or if) a trust “materially participates” in a trade or business.

Finally, inter vivos trusts can be designed as intentionally defective grantor trusts (IDGTs). As such, the grantor will report and pay the IDGT’s income tax liability, which will now be more burdensome (albeit a tax-free gift to the beneficiaries of the trust) because the top combined tax rate on investment income ranges from 23.8 percent (for long-term capital gains and qualified dividends) to 43.4 percent (for other passive investment income).

If it becomes too burdensome for the grantor to continue to pay the IDGT’s income taxes, with proper drafting, grantor trust status can be “turned off”. Alternatively, depending on state law, an independent trustee can be given a discretionary power to reimburse the grantor for taxes paid on trust income. And if the trust is a spousal lifetime access trust (SLAT), distributions to the beneficiary-spouse can be used to help the grantor-spouse with the payment of taxes.

While trusts will continue to be used to preserve and protect assets, the Act has increased the “cost” of such protection. But with careful planning it is possible to minimize the income tax cost of maintaining trusts. ●

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Editor's Comments

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is no wonder considering that among his many accomplishments is the drafting of estate planning and asset protection planning statutes for Nevada that have made that state one of the leading and most favorable states in the country for the situs of dynasty and asset protection trusts. You will enjoy reading his article.

Our second article for this month is by Julius Giarmarco, JD, LL.M., the head of the Trust and Estates Practice Group for the law firm of Giarmarco, Mullins & Horton, P.C. of New York. His article is titled *2012 Tax Act Increases Income Taxation of Trusts*. Quite frankly, I had planned not to feature any articles on the American Taxpayers Relief Act of 2012 because I figured that by the time this quarterly issue came out almost all of our readers would have either read plenty of articles about the

Act or attended various programs or seminars about the Act. Any article in the *Estate Planning Newsletter* would be a redundancy. However, Julius's article on the effect of the Act's increased income taxation of trusts and planning techniques to nullify the tax increases was, I thought, exceptional and needed to be published in our newsletter. For those of our readers who are life insurance professionals, you will find his comments on the tax advantages of life insurance as one of the possible planning techniques and assets of a trust to be of benefit to your practice.

So please enjoy these two articles and let us know if they were useful and beneficial to your practice.

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May VTC A New Tax Code for a New Generation

FSP's May Video Teleconference will provide clarity on what to tell your clients amid all the talk about tax increases, spending cuts, sequestration, and the debt ceiling. An expert panel includes Terence Stanaland, JD, ChFC, CPA, of counsel to the law firm Teague, Rotenstreich, Stanaland, Fox & Holt, PLLC, and Audrey Young, JD, LL.M., the Washington National Tax Director for estate, gift, and trust taxation for McGladrey, LLP, moderated by Lynne Stebbins, JD, AEP, CLU, ChFC, Senior Vice President, Advanced Planning with Marsh Private Client Solutions.

In the first hour, the panel will look at the most significant parts of the tax law and how they have changed the environment forever. In the second hour, panelists will focus on specific issues within the tax law, such as:

- Valuation discounting
- Life insurance and IRS Section 101(j) compliance
- Crummey Notices
- Decanting trust agreements
- Charitable trusts
- An expected Supreme Court ruling on the constitutionality of the Defense of Marriage Act as it relates to tax filings
- Social Security Survivor payments

The Video Teleconference will broadcast on May 15 and 16, 2013.
For information visit http://www.financialpro.org/public/VTC_051513.cfm
or call Member Services at 800-392-6900.



eGroup Activity: Questions and Answers on Sections Topics

The Estate Planning eGroup has been active lately with lively discussions on several topics. Here are a few highlights:

- **Sale of Policy from ILIT Valuation Issues**, in which a client was the grantor of an ILIT for the benefit of his exwife who has subsequently died. The ILIT's sole asset is a \$2 million universal life policy, which the client would like to transfer to a second ILIT established for the benefit of his current spouse and child.
- **Beneficiary Question**, in which a policy was discovered after first the Owner/Beneficiary and then the insured died. There is no contingent beneficiary.
- **Changing Policy Ownership**, in which a client wishes to change the ownership of a policy from an ILIT because the "trust is defunct and no longer in effect."
- **Portability in Second Marriage**, in which the clients would like to use gift tax exemptions from their first marriages (both original partners are deceased).

For these and other eGroup postings and responses, visit <http://social.financialpro.org/FINANCIALPRO/DigestViewer/?ListKey=cd3777c8-2aa1-4f34-8534-9aac3edf73df>. Questions? Call Member Services at 800-392-6900.

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