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A Conversation on Integrating Estate Planning and Asset Protection

An Exclusive Interview with:

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A Conversation on Integrating Estate Planning and Asset Protection

The need for traditional estate planning and asset protection planning has been well recognized and accepted for many years. However, the two are often looked upon as disparate elements in the planning process. According to interviewees, Barry S. Engel and Richard A. Oshins, they should instead be viewed as integral parts in the planning necessary to achieve the client's overall goal of transferring wealth as efficiently as possible. Barry Engel is the Senior Principal in the law firm of Engel Reiman & Lockwood pc (www.eryl-law.com), in Denver, Colorado. He is a well-traveled and frequent lecturer on the subject of asset protection planning and the lead author of the CCH Asset Protection Planning Guide—A State of the Art Approach to Integrated Estate Planning (also see CCH Solutions™ for Financial Planning). Richard Oshins is senior partner with the Law Offices of Oshins & Associates (www.oshins.com), Las Vegas, Nevada, a nationally recognized firm specializing in estate planning, business planning, and probate issues.

CCH: In general, what is asset protection planning and what are the basic goals of such planning?

Mr. Engel: Asset protection planning involves organizing one's assets and affairs *in advance* to protect against risks that otherwise would threaten those assets. I wish to stress the point that this planning must be "in advance" so as to avoid the negative implications of laws intended to prevent fraudulent conveyances. Although the goals of asset protection planning are varied, a well-thought-out plan must be user friendly and not only protect against the ramifications of an adverse judgment, but also serve as a deterrent to litigation or, at least, an incentive for a quick and relatively cheap settlement. I think it is important to keep in mind that asset protection planning is *not* a means to facilitate tax evasion. The ultimate goal is not to hide assets, but to protect them.

CCH: It would seem that no one technique or device could provide a universal form of asset protection. With that in mind, how would you describe the various strategies available in asset protection planning?

Mr. Engel: This question brings up what we affectionately refer to as the "Engel Ladder of Asset Protection Planning Tools." This is a ladder that lists the various planning tools available in ascending order of efficacy. In summary form, the Engel Ladder starts with gift giving as a tool at the bottom. A family limited partnership (FLP) is mid-way up the Ladder, and close to the top of the Ladder is the foreign integrated estate planning trust (IEPT). Expatriation is at the top of the Ladder, although this is a planning tool that is often discussed but in my experience is used relatively infrequently. In order to successfully protect the client and accomplish his or her goals, the planner must be familiar with the strengths and weaknesses of each asset protection vehicle.

CCH: There have been a number of reported instances in which it would appear that asset protection planning failed. What is your response to the comment that it does not work?

Mr. Engel: Let us first identify the proper frame of reference for the questions of whether asset protection and integrated estate planning "work." In my way of thinking, the proper frame of reference is whether, after all the dust has settled, the client ended up in a better position than he would have ended up in the absence of any planning. In our office we have seen 80 to 90 challenges out of the more than 1,000 plans we have designed and implemented over the last 15 years. I am proud to state that our plans have regularly and consistently met if not far surpassed this rather conservative frame of reference.

Just a few months ago, one of your colleagues wrote in a CCH article that "[w]e hear about the cases in which asset protection was improper. We do not hear about the cases in which it works." I certainly agree with this statement. I would add that even in the cases where the planning was "improper," the people involved obtained a strategic advantage that improved their outcome. This is not to say that I am an advocate of implementing protective planning when the creditor is knocking on the door, as one

tends to see in the improper cases you mention. This is to say, though, that if a strategic advantage obtains in even these cases, think of how well it must *work* in the proper cases.

CCH: With respect to your ladder analogy, could you elaborate on the reasons for foreign asset protection planning?

Mr. Engel: First, it is important to realize that any domestic alternative is going to rely for protection on the very legal system that clients are trying to protect themselves from in the first place. By moving the "battle" to a carefully chosen foreign legal system, a domestically obtained judgment will not be respected. Even if a trial on the merits takes place in the foreign jurisdiction and the creditor is successful in that endeavor, enforcement of the judgment against the trust in the foreign jurisdiction is not guaranteed. Plus, depending on the jurisdiction, there may be other impediments to a creditor's chances of success, such as a stricter burden of proof in order to prevail at trial, and such as an already-expired time period within which challenges against a trust may be brought. Proper selection of the appropriate foreign jurisdiction for the IEPT is paramount because many jurisdictions have enacted legislation that addresses whether and to what extent a creditor can access assets that have been placed in trust.

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CCH: That brings us to the question of how is a foreign IEPT ordinarily structured?

Mr. Engel: The ultimate structure is largely dependent on the specific goals of the client; however, there are certain elements that would typically be present.

For example, there would normally be a mix of U.S. and foreign trustees along with a "protector" who, at least initially, is also often the settlor of the trust. The protector would ordinarily have three types of powers, including the power to remove and replace trustees, the power to veto investment decisions of the trustees, and the power to veto distribution decisions. Beyond this, the IEPT may be combined with a domestic FLP of which the settlor is the general partner and there may actually be multiple IEPT and entity combinations.

CCH: Looking at this integrated planning process from the estate planning perspective, what financial or other benefits can be illustrated to the client?

Mr. Oshins: I think the way to convince clients of the importance of this type of planning is to illustrate that properly structured inherited wealth is considerably more valuable than wealth that has been earned and saved. This result can be achieved through the use of an irrevocable trust, particularly of the dynastic variety. It is relatively easy to show that assets received and maintained in trust will be afforded advantages and protections not available for assets that are received or owned outright. Irrevocable trusts effectively provide a dual function in that they provide benefits for both tax and asset protection purposes. They can provide significant upside rewards from a tax perspective, particularly with respect to estate, gift, and generation-skipping transfer (GST) taxes, while also protecting assets from the reach of creditors or from diminution in a divorce.

CCH: Based on your experience, are practitioners taking full advantage of the possibilities offered by irrevocable trusts and, if not, why not?

Mr. Oshins: Generally, I would say the answer to that question is "no." Most clients, as well as many of their advisors are not aware of how trusts operate and may be under the false impression that they are inflexible vehicles that would unduly restrict a beneficiary's enjoyment of the trust property. The truth is that a properly drawn trust can be very flexible and can help the client's family cope with anticipated and unanticipated difficulties. A trust can be customized to achieve virtually all of a client's goals.

CCH: In terms of trust design and operation, what basic suggestions would you make?

Mr. Oshins: One of the major tenets of trust design dictates that distributions be permissible, but in op-

eration, it is anticipated that they will not be made in the absence of a compelling reason. The trust corpus can effectively be utilized as a "family bank" for the benefit of the primary beneficiary (such as a child), his or her spouse, and their descendants. The class of beneficiaries may also include the creator's spouse, without adverse creditor or transfer tax exposure. The beneficiaries will have the use and enjoyment of the property without transfer tax or creditor exposure. Most basic family expenditures, such as meals, school, and vacations would be expected to be picked up by the beneficiaries individually or by using assets held in trusts that are not GST tax exempt. In addition, it would be advisable for the purchase of consumable assets (e.g., clothes, automobiles, etc.) to be made from other than protected assets.

CCH: An often-expressed negative reaction to the use of trusts concerns the loss of control over assets. How do you overcome that reaction?

Mr. Oshins: The object is to avoid the potential exposure inherent in outright ownership while also staying away from the controls and restrictions usually associated with a traditional trust arrangement. In my experience, most people would prefer to obtain the creditor and transfer tax protection that trusts offer, provided they have adequate control over the trust and understand this fact. My preferred concept in dealing with this issue is the Beneficiary Controlled Trust (BCT). Briefly, a BCT can provide a beneficiary with the benefits of a gift or inheritance in trust, plus the beneficiary will (initially or eventually) have a degree of control over the trust's assets and operations that approaches that of outright ownership.

CCH: Could you be more specific as to the actual characteristics of a BCT?

Mr. Oshins: A BCT is a totally discretionary trust that continues for the lifetime of the primary ben-

eficiary (such as a child) and for the successive lifetimes of the child's descendants. This is ordinarily done on a *per stirpital* basis with each family branch having a separate trust. Then, when certain specified ages are reached, rather than making distributions to the child, the BCT effectively puts the child in control of the child's trust. Of course, depending on the circumstances, this control could be deferred or eliminated if, for example, the child is for some reason, such as lack of maturity or substance dependency, not currently able to take on the responsibility of control.

CCH: What is the rationale for the separate trusts for each family branch?

Mr. Oshins: Basically, this is a structure to provide conflict avoidance and ease of operation. This way, one can avoid potential conflicts between siblings and allow ease of portability when a primary beneficiary moves to another state. It will also avoid the need to match benefits, distributions, or advances and enable each primary beneficiary to be in control of his or her family unit's investments. Taking the strategy one step further for transfer tax purposes, each family unit should have two separate trusts—one exempt and one non-exempt.

CCH: In what ways does a BCT differ from a traditional trust?

Mr. Oshins: Typical drafting for a BCT would include provisions that may seem counterintuitive to many estate planners. Such provisions might include, for example, negating the "Prudent Person Rule" and expanding the universe of permissible investments to virtually anything the beneficiary/trustee would acquire individually. Although traditional trust language would ordinarily preclude investing in a non-controlling interest in a closely held business, such an investment would be encouraged as a means to fund a BCT.

CCH: Earlier you mentioned the importance of flexibility in trust design. How would you recommend that this goal be achieved?

Mr. Oshins: I would suggest that the primary beneficiary of each separate trust be given a broad special power of appointment (SPA). I sometimes like to refer to the SPA as a "rewrite power" in that it gives the power holder/beneficiary the right to appoint (i.e., give) the property to anyone other than "the holder of the power, his estate or the creditors of either, outright, or in trust." The SPA allows the

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primary beneficiary to adjust to changes in family circumstances and also helps protect the trustee from the interference of other beneficiaries by allowing the power holder to effectively "cut out" a disgruntled beneficiary. Coupling the SPA with a power of amendment granted to a trusted and disinterested third party (someone other than a beneficiary or the trust creator) has the effect of turning an irrevocable trust into a "revocable, amendable, irrevocable trust." In other words, you have created a trust with virtually unlimited flexibility without interfering with the tax and creditor protection elements.

CCH: How does the integration concept work in conjunction with other asset protection and estate planning devices, such as an FLP?

Mr. Oshins: A common asset protection strategy involves the creation of an FLP, in which the client creator is the one-percent general partner, plus a foreign asset protection trust (FAPT). The client is the general partner of the FLP and has managerial control over the limited partnership interests in the FAPT. However, there is a weakness in this strategy. In the event asset protection is required, the FLP will be dissolved, but the one-percent 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 a trust 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. 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. There does exist, however, the unfortunate possibility that a U.S. court could determine that the high degree of control given the BCT beneficiary is tantamount to ownership. David Lockwood has suggested to me that a solution to this would be for the BCT to be a foreign situs trust.

In addition, under the decision of the U.S. Court of Appeals for the Fifth Circuit in *M. Bright Est.* (CA-5, 81-2 usrc ¶13,436, 658 F2d 999), there would be transfer tax savings because assets controlled in a fiduciary capacity are not taken into account when valuing the decedent's interest, even if he or she has control by virtue of the fiduciary role (e.g., as a trustee or executor). Thus, in the situation described, the interest included in the client's gross estate would be the 99-percent limited part-

nership interest, which would be entitled to a valuation discount because it is a non-controlling interest in a non-marketable asset.

CCH: You have also been an advocate of the intentionally defective grantor trust (IDGT) strategy. Could you elaborate on this technique and on the potential benefits?

Mr. Oshins: Because the grantor trust rules work differently for income tax purposes than they do for transfer tax purposes, it is possible to create a trust that is "defective" for income tax purposes (in that it is deemed to be a grantor trust), but transfers to such a trust will be considered completed gifts for transfer tax purposes. This situation results in a number of favorable opportunities for wealth shifting and for asset protection. For one thing, by paying the tax on the trust's income, the grantor is effectively making an additional gift to the trust that is both gift tax and GST-tax free. In addition, the income tax payments will act to reduce the grantor's taxable estate while the fact that the trust will not have to expend funds for that purpose increases the potential growth inuring to the benefit of the trust. Such a strategy has further advantages in that: (1) the trust can qualify as a permissible S corporation shareholder; (2) a life insurance policy on the life of the grantor can be purchased by the trust without exposure to the transfer-for-value rule, and (3) because transfers between the trust and the grantor are not recognized for income tax purposes pursuant to Rev. Rul. 85-13, 1985-1CB 184, techniques, such as installment note sales, present an interesting option.

CCH: Are there any variations on the basic defective trust strategy that you would suggest?

Mr. Oshins: Following Rev. Rul. 81-6, 1981-1 CB 385, the IRS takes the position that, if all transfers to a trust are subject to a withdrawal power by the beneficiary, then the powerholder is treated as owner of the trust under Code Sec. 678(a). Alternatively, if the trust has dual grantor trust status under this provision and one of the other grantor trust provisions, the IRS has ruled that grantor trust status with respect to the grantor trumps grantor trust status obtained for the beneficiary under a Code Sec. 678(a). With these considerations in mind, a strategy that can often exceed the benefits of a standard IDGT would involve an arrangement in which the beneficiary/donee is treated as the owner of the trust income under Code Sec. 678(a). This is what I like to refer to as a beneficiary defective trust (BDT).

CCH: Specifically, how would you use the BDT and what would you hope to accomplish by doing so?

Mr. Oshins: After funding the BDT solely with gifts subject to a *Crummey* power of withdrawal, the resulting trust will be one with which the power holder can transact for estate planning purposes, tax free, in the same way a grantor would with respect to a more traditional IDGT. With a BDT, the powerholder/beneficiary may be the trustee (a BCT) and may also enjoy the benefits of the trust. Gifts to the trust do not have to be limited to the annual exclusion amount to obtain beneficiary defective status under Code Sec. 678(a). So long as the beneficiary is given a power of withdrawal over the entire contribution, the entire trust should be defective as to the beneficiary. In the case of gifts that are subject to a "hanging" power of withdrawal, estate tax inclusion for the beneficiary would involve only the amount left hanging at his or her death. All lapsed amounts and the related appreciation would not be includible for estate tax purposes. If funding is done with rapidly appreciating assets, the lapses should occur relatively rapidly under the five-percent safe harbor rule (Code Sec. 2514(e)).

CCH: What pitfalls or caveats would you describe in structuring a BDT?

Mr. Oshins: Installment sales are often used as a funding device for a BDT. For a non-BDT, such a sale involves an interest computation using the tables promulgated under Code Sec. 1274. Although use of these tables is acceptable for transfer tax purposes, it may not be a proper reflection of fair value in the context of a creditor suit or a divorce. Consequently, it might be advisable to use a "real world" interest rate (i.e., one that would be used by strangers) rather than the Code Sec. 1274 table rates, or in the alternative, to use a demand note.

Another possible problem involves multiple beneficiaries. Although each trust can have more than one beneficiary, the power of withdrawal for each trust should be limited to one beneficiary. If gifts subject to a power of withdrawal are made to more than one beneficiary in a single trust, that trust would be defective as to each beneficiary in proportion to the value of the property subject to that beneficiary's power of withdrawal. Accordingly, if the trust is not wholly defective as to only one beneficiary, sales by the beneficiaries to the trust will be only partially income tax free. Additional income tax problems may arise in a transaction with the trust that results in the trust having to

recognize gain, such as in a case where the trust makes a payment with an appreciated asset. In essence, the multiple-owner situation reduces trust flexibility and serves to defeat many of the benefits of the defective trust technique.

CCH: Are there other instances in which the use of irrevocable trusts can be enhanced with the use of additional techniques?

Mr. Oshins: An installment sale to a defective trust in return for a promissory note from the trust is a popular technique, particularly for selling non-controlling interests in limited partnerships, limited liability companies, and S corporations to take advantage of the valuation discounts. The discounts can be enhanced by leveraging the sale via deferral using an interest-only installment note with a balloon payment. Alternatively, a private annuity or self-canceling installment note might be appropriate depending on the circumstances.

Opportunity shifting of wealth to other individuals or to trusts is much less risky and more efficient if accomplished at the inception of a venture rather than once value has been established and become substantial. The absence of a "transfer" effectively eliminates the issue of transfer taxes and the possibility of a fraudulent transfer for asset protection purposes. Anytime a new business is being formed, a new product is being developed, or a new investment opportunity is presented, a new entity should be formed and at least a portion of the equity interests in that entity should be placed into irrevocable trusts by someone other than a trust beneficiary. Through entity design, a referring family member can exert control over the venture with minimal ownership (e.g., by being general partner in a limited partnership or by owning the only share of voting stock in a corporation).

A variation on this idea would involve some "outside-the-box thinking" by planners. Instead of looking down the generations for planning purposes as is traditionally done, it may be much more advantageous to look up a generation. Using a parent as the source of "seed" money for a dynastic BCT established for new venture can have enormously beneficial results. Creating a BCT that is also a BDT creates an even more potent planning tool.

CCH: Could you provide a practical example of when it would be appropriate to combine a BCT with a BDT?

Mr. Oshins: One such possibility would be the client who has an opportunity for a business venture that looks very promising. He suggests to his father, and his father agrees, that the father will set up a trust and fund it for the client and his descendants. By structuring this trust as both a BCT and a BDT, the client can: manage and control the trust assets as trustee; be the trust's primary beneficiary; have a broad power of appointment to give trust property to anyone except himself, his estate, or creditors of himself or his estate; and make income-tax free note sales to the trust. Additionally, the assets would be protected from divorce or creditors and exempt from transfer taxes.

I would suggest that your subscribers take a look at *R. Crowley*, 34 TC 333, CCH Dec. 24, 198, acq. 1961-1 CB 4, which involved the CEO of a savings and loan association that generated ancillary income from such activities as appraisal fees, insurance commissions, and real estate title insurance and abstract fees. These ancillary activities were shifted to another entity run by Mr. Crowley's children. The oldest son handled the bulk of the work and was paid a salary while the remainder of the income flowed to the ancillary entity. The Tax Court ruled favorably on the question of the income tax burden being shifted to the children, but I believe the case could also stand for the proposition that no gift tax would be incurred either. This fact pattern represents a fairly typical case in which a relatively small amount of seed money, coupled with the appropriate referrals, and business opportunities can result in a significant cash flow.

CCH: Could you describe a technique that clearly illustrates the melding of estate and asset protection planning?

Mr. Oshins: The combination of an installment sale between a FAPT and a parent-funded trust that is a BCT/BDT combination would be an example of high-level integration of the two disciplines. Limited partnership interests could be sold to the BCT/BDT in exchange for an installment note. Such a sale would be income tax free because both trusts would be deemed to be grantor trusts for income tax purposes. Valuation discounts would be available for the limited partnership interests since they would be non-controlling, non-marketable interests. In turn, the note received by the FAPT would benefit from the asset protection status of that entity.

Taking this one step further would involve opportunity shifting to increase the funds in the BCT/

BDT. For example, consider the possibility of a physician who is contemplating the purchase of some expensive equipment for his practice and whose parent (or perhaps a spouse) has the resources to set up a BCT/BDT. In order to protect other assets in the BCT/BDT from potential claims involving faulty equipment and to take advantage of valuation discounts on a sale to the trust, the equipment is held in an LLC. The physician then sells his interest in the equipment LLC for an amount that reflects its discounted value, in exchange for an interest-only note with a balloon payment feature. The physician's operating entity would then lease the equipment, creating enough cash flow to allow the physician to acquire limited partnership interests from the FAPT.

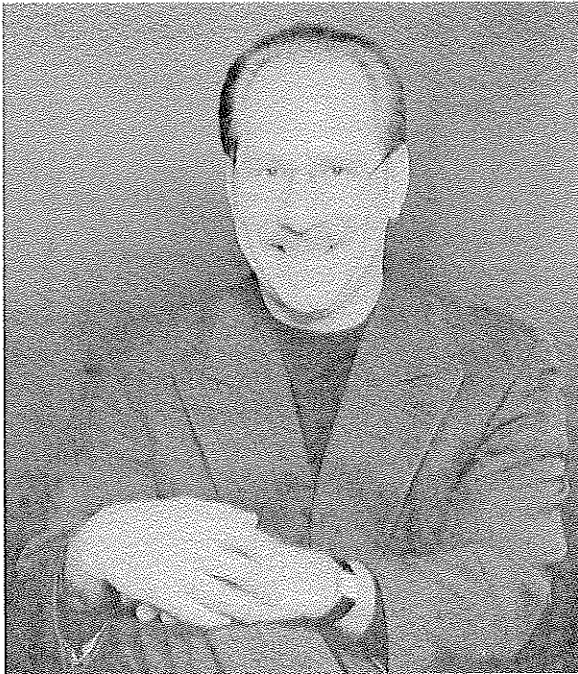
CCH: Do you see any trends in the use of integrated estate planning trusts that you would like to close out with?

Mr. Engel: I find it very interesting that we have come full circle since the birth of this form of planning in the mid-

1980s. At that time, a sagging economy and an insurance crisis prompted Americans to consider alternate forms of coverage and protection. Today, we again have the convergence of a sagging economy and what at least some refer to as a "crisis" in the insurance markets and the insurance industry. Coupled with that fact, integrated estate planning

has matured, is accepted, is tested and proven, and the trend lines for integrated estate planning are very positive. Planners and their clients are thinking more and more of integrated estate planning trusts like we in our office have for years—as an "all-perils" insurance policy.

*Opportunity
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become
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