



SALE TO A DEFECTIVE SOUTH DAKOTA DYNASTY TRUST:

LEVERAGING YOUR TRUST INTO PERPETUITY



By Steven J.
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The Perfect Estate Plan

In the quest for the perfect estate plan, it is important to consider the plan from as many different perspectives as possible. Although perfection can probably never be achieved, it certainly can be approached. If one were to list the features that are most important in approaching perfection, the list might be

as follows:

- Maintaining control in the senior generation and providing similar control at each successive generational level;
- Minimizing gift, estate and generation-skipping transfer taxes;
- Leveraging the gift, estate and generation-skipping transfer tax exemptions;
- Providing creditor protection, especially protection from divorce; and
- Leveraging these tax and creditor protection benefits into perpetuity.

In the author's opinion, the sale to a defective South Dakota dynasty trust accomplishes these objectives better than any other technique available under the current tax laws. Although this article focuses on accomplishing all of these goals, it is important to note that each client is different. The size of the estate, the asset makeup and the clients' desires should always be paramount. What is considered a nearly perfect estate plan for one client is not necessarily a nearly perfect estate plan for another.

The Dynasty Trust

The federal transfer tax system taxes property as it is transferred to each generation. The estate and gift taxes were unified in 1976 so that gifts and bequests are subject to the same tax, although the taxes are calculated differently making gifting a much more effective technique. The Internal Revenue Code allows each individual an exemption against

the individual's estate or gift taxes. This cumulative amount can either be used during life, at death or partially during life and partially at death. Under the Taxpayer Relief Act of 1997, the exemption amount is \$625,000 in the year 1998, \$650,000 in 1999, \$675,000 in 2000-2001, \$700,000 in 2002-2003, \$850,000 in 2004, \$950,000 in 2005 and \$1,000,000 in 2006. If the transferred property exceeds the exemption amount, the excess is taxed at rates as high as 55 percent.²

Prior to the changes in the tax laws in 1986, many well-advised individuals would set up irrevocable trusts that would last for multiple generations. They would allocate their estate and gift tax exemptions to the trusts, thus avoiding the estate tax at each generational level until state law required the trusts to terminate. Not only was the initial gift or bequest exempt from estate and gift taxes, but all of the growth and accumulated income on the property was also exempt.

In 1986, this opportunity was curtailed by the enactment of the generation-skipping transfer tax ("GSTT"). The GSTT is a tax on property that is transferred to or for the benefit of a person who is at least two generations below that of the transferor. For example, a transfer of property in trust for the benefit of the transferor's child which passes to the grandchild upon the child's death is subject to the GSTT. The GSTT is taxed at a flat rate equal to the highest estate and gift tax rate, currently 55 percent.

The GSTT allows each individual an exemption of \$1,000,000.³ Under the Taxpayer Relief Act of 1997, effective for gifts and bequests made after 1998, the GSTT exemption will increase each year by the cost of living, rounded down to the next lowest multiple of \$10,000. The GSTT exemption allows an individual to transfer up to \$1,000,000 (or \$2,000,000 if the donor's spouse elects to split the gift) to a dynasty trust without triggering the 55 percent GSTT. Because of the GSTT exemption, individuals can transfer up to \$1,000,000 to a trust that can continue forever. This type of trust is commonly referred to as a dynasty trust. Furthermore, the \$1,000,000 exemp-

tion can be leveraged significantly using installment sales to dynasty trusts that are defective for income tax purposes.

The dynasty trust is structured to last for as long as state law permits. Almost every state limits the duration of its trusts by a rule against perpetuities. The rule against perpetuities generally provides that the trust must vest and therefore be distributed no later than 21 years after the death of the last to die of the lives in being who are identified in the trust document.

The South Dakota Dynasty Trust⁴

South Dakota is one of only six states with no rule against perpetuities. If a dynasty trust is set up in South Dakota, it can theoretically last forever without any estate, gift or generation-skipping transfer taxes! South Dakota has traditionally been the jurisdiction of choice for these trusts, not only because it has no rule against perpetuities, but also because it has no state income tax.

Fortunately, it is not necessary for the grantor to live in South Dakota in order to have the trust domiciled there. Notwithstanding the perpetual estate tax savings and creditor protection benefits, the advantage in domiciling a trust in a state with no income taxes sometimes in and of itself is the primary motive for establishing a dynasty trust in South Dakota.⁵

In order to use the laws of South Dakota, a South Dakota bank should usually be named as a co-trustee. Unlike non-corporate trustees who often move out of state or eventually pass away, a bank, especially a large, well established bank, should last in South Dakota for many years. If the bank ever ceases doing business, it can be replaced at that time with a different bank.

In order to obtain sufficient nexus to South Dakota, the bank will hold most of the trust assets or the certificates representing the trust assets. For example, if the dynasty trust owns an interest in a partnership, a copy of the partnership agreement will be held at the bank along with the partnership certificates showing ownership. The bank will also handle many of the administrative duties including the maintenance of trust accounting records.

The extent of the duties given to the South Dakota bank is determined by the grantor of the trust. The trust can be drafted so that the bank cannot make any investment or distribution decisions, or conversely, the trust can be drafted so that the bank is the sole trustee and therefore makes all of the trustee's decisions. In most cases, in order to satisfy most clients' desires that the beneficiary have all the control upon

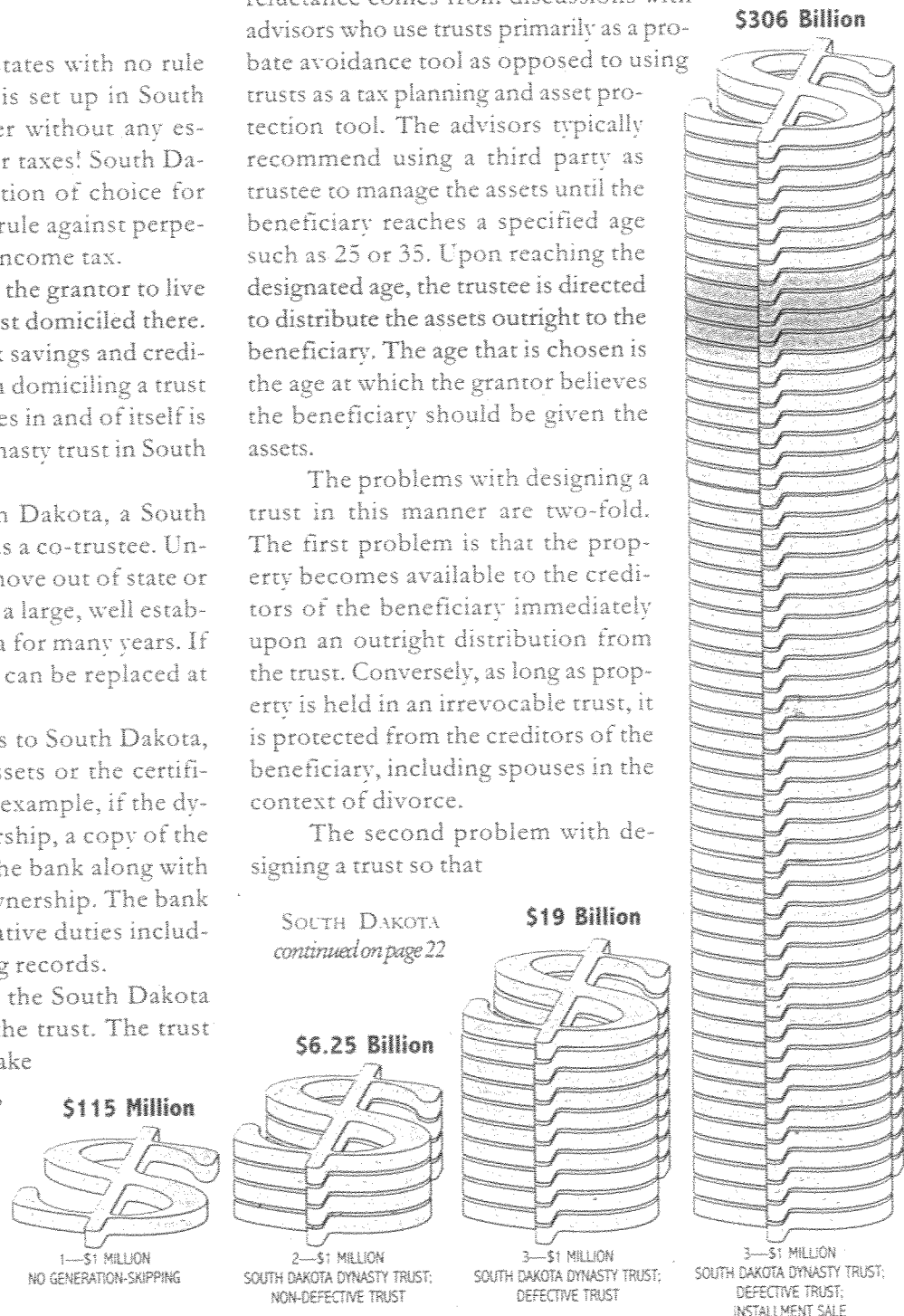
reaching a specified age, the bank is usually named as an "administrative" trustee to hold the assets and to provide many of the administrative duties. In this case, the bank is not given any investment or distribution authority.

Trust Design

Many individuals are reluctant to use trusts because of their belief that the purpose of a trust is to keep the property away from the beneficiaries. Perhaps this reluctance comes from discussions with advisors who use trusts primarily as a probate avoidance tool as opposed to using trusts as a tax planning and asset protection tool. The advisors typically recommend using a third party as trustee to manage the assets until the beneficiary reaches a specified age such as 25 or 35. Upon reaching the designated age, the trustee is directed to distribute the assets outright to the beneficiary. The age that is chosen is the age at which the grantor believes the beneficiary should be given the assets.

The problems with designing a trust in this manner are two-fold. The first problem is that the property becomes available to the creditors of the beneficiary immediately upon an outright distribution from the trust. Conversely, as long as property is held in an irrevocable trust, it is protected from the creditors of the beneficiary, including spouses in the context of divorce.

The second problem with designing a trust so that



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a mandatory distribution of the trust assets is made upon the child reaching a specified age is that the distributed property and all of its growth and income needlessly increase the size of the beneficiary's estate. Upon the death of the beneficiary, this may cause an estate tax that otherwise could have been avoided using a dynasty trust.


When the client tells the advisor that he wants the property distributed to the beneficiary upon reaching a specified age, in most instances the client has selected the age based upon his belief that this is the age at which the client believes the beneficiary should have control over the property. If this is the case, then this objective can be accomplished by naming the beneficiary as managing trustee of the trust upon reaching the specified age rather than requiring the property to be distributed.

It is difficult to imagine any rights the beneficiary can have owning the property outright that the beneficiary cannot also have as trustee. Outright ownership gives a person (i) the right to manage and control the property, (ii) the right to use⁶ the property, (iii) the right to access the income from the property, (iv) the right to access the principal, and (v) the right to determine who gets the property upon the person's death. These are all rights that can be given to the beneficiary as trustee. However, if the ben-

eficiary is given the right to distribute principal to himself, then such right must be limited by an ascertainable standard.⁷ In order to provide a broader distribution standard and more flexibility, an independent co-trustee is often named to make distributions and other tax sensitive decisions. The beneficiary is usually given the power to remove the independent co-trustee, with or without cause, and name a successor independent co-trustee.⁸ This leaves the control in the hands of the beneficiary. Thus, the beneficiary does not lose any of the rights that he would have had with outright ownership of the property. When these obvious benefits are combined with the estate tax savings and the creditor and divorce protection, it is not clear why anyone, when given the option to continue the trust, would decline to do so.

The Defective Trust

When designing a trust, there are three possible income tax payers: the trust, the grantor or one or more beneficiaries. In the past, attorneys were usually very careful to avoid causing the grantor to pay the income tax on income earned by the trust. If the trust income tax was being paid by the grantor, it was usually due to a drafting error made by the attorney. However, with the compression of the trust income tax brackets and with the newer planning



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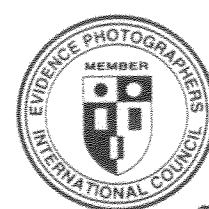
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concepts, the shift has been towards intentionally drafting trusts so that either the grantor or the beneficiary is treated as the "owner" for income tax purposes. Since the grantor (or the beneficiary) is the "owner" for income tax purposes, he is responsible for payment of the trust's income tax liability, and he gets the benefit of any deductions and credits attributable to the trust.⁹ A trust in which either the grantor or the beneficiary is treated as the "owner" for income tax purposes is commonly known as a defective trust.

The attorney can design the trust so that the grantor is the "owner" of the trust for income tax purposes by violating one or more of IRC §§673-677 or 679. Similarly, the attorney can design the trust so that the beneficiary is the "owner" of the trust for income tax purposes by violating IRC §678. In determining which Section(s) to violate, the attorney must be certain not to choose a Section which also makes the trust defective for estate tax purposes. This article focuses on the defective trust in which the grantor is the "owner" for income tax purposes, and in all cases hereafter any reference to a defective trust shall mean a trust which is defective with respect to the grantor.

There are two primary advantages in using a defective trust. First, the grantor's payment of the income taxes allows the trust to accumulate income tax-free and reduces the grantor's taxable estate by the amount of the tax. The payment of the income tax by the grantor is the functional equivalent of a tax-free gift to the trust.

The other advantage in using a defective trust is that transactions between the grantor and the trust are disregarded for income tax purposes.¹⁰ This is because a person cannot cause an income tax by selling an asset to himself. For income tax purposes, a sale to a defective trust by the grantor is a sale from the grantor to himself.

The Family Limited Partnership¹¹

A complete understanding of valuation planning is necessary in order to understand the sale to a defective trust technique. For transfer tax purposes, the fair market value of an asset is the price a willing buyer would pay a willing seller for the asset.¹² Under the willing buyer-willing seller test, it is often possible to arrange the assets in such a way that their value is significantly reduced. Although there are a number of methods to arrange the assets to reduce their value for transfer tax purposes, the most popular method is to place the assets in a family limited partnership ("FLP").

A FLP is a limited partnership among family members or trusts for their benefit. The general partners have the control and the limited partners have no control. The limited partnership interests can be transferred at a discount since they are non-voting interests in a closely-held entity.

There are two principal discounts that apply in valuing a limited partnership interest—a minority interest discount and a lack of marketability discount. The minority interest discount is applied because limited partnership interests have no voting power. The lack of marketability discount is applied because a partnership interest in an entity with few partners does not have a ready market and because of the transferability restrictions in the partnership agreement.

For example, assume a combined \$2,000,000 worth of assets is contributed to a family limited partnership by Husband and Wife. In exchange for the \$2,000,000 worth of assets, Husband and Wife each become 1 percent general partners and 49 percent limited partners. If Husband were to sell a 40 percent limited partnership interest, without considering the willing buyer-willing seller definition of fair market value one might be tempted to conclude that the fair sales price would be 40 percent of \$2,000,000 (i.e., \$800,000). However, due to the minority interest and marketability discounts, an appraisal might show that the fair market value is closer to \$400,000. This assumes a 50 percent discount.¹³ Estate planners frequently use this ability to discount to leverage the amount that the client may gift. With a 50 percent discount, twice as much "pro rata" value can be depleted from the client's estate.

The FLP also provides other benefits in the family estate plan. One benefit is that the senior family members can gift or sell limited partnership interests to the junior family members or to trusts for their benefit without losing control over the partnership assets since the senior family members usually retain the general partnership interests. Another benefit is that the limited partnership statutes provide a degree of asset protection since the statutes provide that the sole remedy of a judgment creditor of a partner is limited to a "charging order" against the partnership interests. The charging order remedy gives the creditor a right to distributions but does not give him the right to become a substituted partner. Care must be taken in relying too heavily on the asset protection aspects of the partnership, as some of the states have begun to allow the courts to authorize a foreclosure sale as an additional remedy.

The Sale to a Defective Trust Technique

An asset worth \$1,000,000 certainly may be sold by the grantor to a defective trust in exchange for \$1,000,000 cash without any income tax ramifications.¹⁴ Similarly, assuming a 50 percent discount, limited partnership interests with a non-discounted pro rata value of \$2,000,000 can also be sold to a defective trust for \$1,000,000 cash without any income tax ramifications.

The sale of assets at a discount is significantly enhanced

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by leveraging the sale using a deferred payment. The interest-only installment sale with a balloon payment will be illustrated herein, but a private annuity or a self-cancelling installment note might also be considered if the client's situation makes either of these alternatives more favorable. The general rule of thumb used by estate planners is that the trust must have a fair market value of at least 10 percent of the fair market value of the assets being sold to the trust. Thus, no more than a 10 to 1 ratio of assets being sold to assets independently owned by the trust should be used.

The technique can best be illustrated by an example. Assume the grantor gifts \$100,000 to a defective trust and allocates \$100,000 of gift tax exemption and \$100,000 of GSTT exemption to the transfer so that the trust is wholly exempt from transfer taxes. The grantor then sells to the trust a limited partnership interest with a pro rata value of \$2,000,000 (and a fair market value of \$1,000,000 after a 50 percent discount) in exchange for an interest-only promissory note with a balloon payment of \$1,000,000 due after nine years. The sale is for fair market value so that no additional gift tax exemption or GSTT exemption needs to be allocated to the trust.

If the partnership assets and the initial \$100,000 gift are both earning income at a rate of 10 percent each year, then the trust will have an additional \$210,000 (i.e., 10 percent of \$2,000,000 plus 10 percent of \$100,000) at the end of the first year. Using the January 1998 IRC §1274(d) federal mid-term rate of 5.93 percent, the interest payable from the trust to the grantor at the end of the year would be 5.93 percent of \$1,000,000, or \$59,300. Each year, the trust continues to accumulate much more income than it must pay back to the grantor since (i) the trust is increasing income tax-free, and (ii) the interest is applied against the discounted fair market value of the limited partnership interest.

If the grantor were to die immediately after entering into the sales agreement, his estate would be reduced by the \$2,000,000 pro rata value of the partnership assets and would be increased by the promissory note with a face value of only \$1,000,000. This would result in an immediate savings of the estate tax on the difference between the two figures. In addition, the promissory note may be further discounted because of its low interest rate. The fact that there is no requirement that the grantor survive the term of the note along with the ability to immediately apply the GSTT exemption are the two primary reasons that this technique is superior to the grantor retained annuity trust¹⁵ technique.

A Numerical Comparison

Without even considering any leveraging enhance-

ments using defective trusts, discount planning or installment sales, \$1 million¹⁶ earning 10 percent per annum before taxes (6 percent per annum after taxes in the assumed 40 percent income tax bracket) in a non-defective South Dakota dynasty trust will grow to approximately \$6.25 billion¹⁷ in 150 years versus only \$115 million¹⁸ if no generation-skipping is done and the assets are taxed at 55 percent each 30-year generation. This alone demonstrates why a single generation trust should seldom be used. If the South Dakota dynasty trust was drafted so that it was defective for income tax purposes, and the grantor survived for 30 years after making the gift to the trust (so that the trust would be defective for the initial 30 years and non-defective for the remaining 120 years), this simple enhancement would magnify the results after 150 years to nearly \$19 billion¹⁹ remaining in the dynasty trust for the descendants.

Assume that the grantor gifted the \$1 million to the defective South Dakota dynasty trust and then sold to the trust \$20 million in pro rata value of limited partnership interests (with a fair market value of \$10 million after an assumed 50 percent discount). Assume further that the sale was for an interest-only promissory note at the January 1998 IRC §1274(d) federal long-term rate of 6.13 percent with a balloon payment of \$10 million due after thirty²⁰ years. Under this enhanced scenario, after the same 150 years, the South Dakota dynasty trust would have over \$306 BILLION²¹ in value! [This computation was done using the South Dakota version of the author's Sale to "Defective" Trust MegaanalyzerSM software.]²² This result actually understates the potential leverage that can be achieved using this technique since a grantor with an extremely large estate would most likely make further installment sales to the trust beyond the initial sale thereby causing the dynasty trust to grow exponentially.

Conclusion

It is impossible to create the perfect estate plan. However, as estate planners, we should always try to create estate plans for our clients that are as close to perfection as possible. For many of our clients, the sale to a defective South Dakota dynasty trust technique accomplishes this. For other clients, some but not all of the concepts introduced herein should be used. Even for a client with a small estate, the concept of leaving the property in trust as opposed to drafting the trust to terminate when the beneficiary reaches a specified age should almost always be adhered to. This principal applies to all trusts, whether revocable or irrevocable. **G**

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Endnotes

1. Copyright 1998 by Steven J. Oshins. All rights reserved. Much of the ideas presented herein are based on the ideas presented by Steven J. Oshins on October 11, 1997 in his presentation to the Southern Nevada Estate Planning Council titled Sale to a Defective Trust: The Ultimate Leveraging Technique.

2. For estates between \$10,000,000 and \$21,040,000, the 5 percent surtax causes the highest rate to be 60 percent.

3. IRC §2631(a).

4. See Steven J. Oshins, Al King III and Pierce H. McDowell III, "Sale to a 'Defective' Trust: Application as a Life Insurance Technique," Trusts and Estates (April 1998); see also Al W. King, III, Pierce H. McDowell, III and Dr. Daniel G. Worthington, "Dynasty Trusts: What the Future Holds for Today's Technique," Trusts and Estates (April 1996); see also Pierce H. McDowell, III, "The Dynasty Trust: Protective Armor for Generations to Come," Trusts and Estates (October 1993); see also Daniel G. Worthington and Peter M. Williams, "Retirement Planning with South Dakota Trusts," Trusts and Estates (September 1997); see also Al W. King, III and Ralph M. Engel, "The Dynasty Trust: The Ultimate Estate Planning Vehicle," CPA Journal (September 1996).

5. It is important to note that certain jurisdictions have long-arm statutes that may cause some or all of the South Dakota trust to be subject to the other state's income tax. This often depends on the domiciles of the grantor, the beneficiaries and the trustees. In most cases, the decision to use a South Dakota dynasty trust is primarily made for transfer tax purposes anyway. Whether or not income tax benefits can be obtained is often looked at as an ancillary benefit. It is also important to note that a defective trust will be subject to the state income tax of the person who is treated as the "owner" for income tax purposes until the death of such "owner".

6. For a detailed explanation of giving the beneficiaries the "use" of assets rather than making distributions, see Richard A. Oshins and Jonathan Blattmachr, "The MegatrusterSM: An Ideal Wealth Preservation Tool," Trusts and Estates, (November 1991). This article should be read by anybody who is considering using a dynasty trust. The MegatrusterSM is an enhanced dynasty trust which is usually controlled by the primary beneficiary as trustee as opposed to the typical trust which is controlled by a third party as trustee.

7. IRC §2041. An attorney should never deviate from the ascertainable

standard relating to health, education, maintenance and support suggested in IRC §2041.

8. Revenue Ruling 95-58.

9. IRC §671.

10. Revenue Ruling 85-13.

11. The preeminent outline on family limited partnerships is Thomas C. Baird's Drafting Guide to the Family Limited Partnership.

12. Treas. Reg. §20.2031-1(b); Treas. Reg. §25.2512-1.

13. In the author's experience, most discounts are between about 35 percent and 65 percent. The discount depends upon the provisions of the partnership agreement and the assets owned by the partnership. A 50 percent discount is used in this article because it is an easy number with which to work. A qualified appraisal should always be obtained prior to a sale.

14. Rev. Rul. 85-13.

15. A grantor retained annuity trust is an irrevocable trust in which the grantor retained an annuity payment for a term of years. A complete explanation of this technique is beyond the scope of this article.

16. Note that a gift tax will be due on the difference between the \$1 million gift and the available gift tax exemption. There may be no tax if the donor's spouse elects to split the gift. In most cases the donor will not wish to pay any gift tax. In such case, the initial gift to the South Dakota dynasty trust should be limited to the amount of the available gift tax exemption. In 1998, each taxpayer has a gift tax exemption of \$625,000.

17. The actual figure is \$6,249,996,724. This figure is computed by compounding \$1 million at 6 percent per annum for 150 years.

18. The actual figure is \$115,330,018. This figure is computed by compounding \$1 million by 6 percent per annum for five 30-year periods and after each period reducing the cumulative total by 55 percent.

19. The actual figure is \$18,988,225,756. This figure is computed by compounding \$1 million by 10 percent per annum for the initial 30-year period then compounding that figure by 6 percent per annum for the remaining 120 years.

20. The 30-year term was chosen for this example so that the end of the term would coincide with the death of the grantor in order to illustrate thirty years of leverage with the promissory note. In most cases, however, a 9-year term is preferred so that the federal mid-term rate may be used for the transaction rather than the higher federal long-term rate that is used for a note with a 30-year term.

21. The actual figure is \$306,379,122,108.

22. Sale to "Defective" Trust MegaanalyzerSM is a software program that was designed and developed by Steven J. Oshins. Both the general version and the South Dakota version are service marks of Steven J. Oshins.

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penalty" (i.e. those who are sentenced to a punishment less than the death penalty for crimes more heinous than others who do receive the death penalty). But I find it hard to believe that Mr. Michaelides would have had the inclination to describe Mr. Cline as a black busboy who started a fire with a marijuana cigarette following a sexual tryst with his girlfriend. One would not include the busboy's race in the description for the simple reason that the person's race is irrelevant to the crime he committed. Additionally, the author who chose to describe the race of the defendant could be considered perpetuating a stereotype, or worse yet, he could be considered racist.

I am certain neither Mr. Michaelides nor the CCBA condones discrimination of any type. Hereafter, please let your articles reflect the relevant facts of a case rather than including those that have no significance other than to perpetuate unfounded stereotypes.

Very truly yours,

Denise A. Yates

Member of the California State Bar