



Financial and Estate Planning

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In Search of the Perfect Estate Plan: A Pipe Dream Can Become a Reality

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It would come as a surprise to most estate planners, and certainly to most of their clients, that a large portion of their work could have been avoided, and is as a result of their clients either receiving wealth without adequate planning or not adopting advice which could have positioned the clients into a wealth plan vastly superior to a plan that even the most highly skilled advisor could now create for them.

An astonishingly large number of wealthy estate owners are unaware of the numerous wealth planning opportunities available to them, nor do they realize the potential economic diminishment of the family assets, which will be unnecessarily and irretrievably lost through exposure to the wealth transfer tax system. As a consequence, there is a significant portion of the population who have not engaged in the wealth planning process (or who have limited their planning to "basic" and "elementary" estate planning, i.e., wills, revocable living trusts and the like), due to their lack of understanding of the harsh reality awaiting their loved ones, who do not recognize the ability of the skilled estate planner, or better yet, the skilled estate planning team, to significantly erode the imposition of the somewhat punitive taxes by engaging in even some fairly simple wealth preservation maneuvers.

In addition to reducing, avoiding and deferring the imposition of taxes, asset protection has become a more integral part of the business and estate plan. Because of the general litigious nature of our society, coupled with the increasing success plaintiffs are enjoying and the proliferation of divorces, creditor protection is often the motivating factor and, from some clients' perspectives, an essential element in the planning process. Although there is a general dislike of paying taxes, paying the IRS is generally more palatable for most people than paying a judgment creditor or a divorce settlement. In addition to the traditional estate planning techniques used to pass wealth to the desired persons with a minimum of taxes and costs, the skilled

advisor will counsel his or her clients with respect to structuring the family wealth in a manner that will render it undesirable, unattractive and unreachable by creditors, including spouses in the context of divorce.

The Ideal Estate Plan

It is indeed rare that a client has his property owned in the most effective manner. In most instances that result is not attainable once the property is owned by the client, with certain exceptions discussed herein. Moreover, once the client has seen his advisor, the ideal result generally cannot be obtained. Inherent in outright ownership are certain risks and exposures. To obtain the ideal wealth structure we would want to create an infrastructure which would encompass all desires and goals of the client and maximize the rights of the estate owner. Thus, to set the stage for the planning opportunities discussed herein, we need to define the bundle of rights that an estate owner would desire if it were obtainable. The conclusion generally reached is that most of us, and most of our clients, would want to own our wealth whereby we:

- (i) will have access to the income from our property until our death;
- (ii) will have our assets available for our use and enjoyment until our death;
- (iii) will be able to decide who will receive our property at our death (or during our lifetime if we were to give it away), and in what form they will receive it;
- (iv) will be able to manage and control our property until our death;
- (v) will have our property protected from creditors, including our spouses in case of divorce; and
- (vi) will save taxes.

The foregoing list appears to contain all of the rights in property that anyone would desire. However, an estate owner could not effectively set up and fund a struc-

ture for himself under U.S. law which would enable him to access, enjoy and manage his assets and also obtain creditor protection and tax relief. On the other hand, anyone other than the estate owner/beneficiary can create an irrevocable trust for the benefit of the client which would satisfy all six of the objectives which comprise the ideal estate plan.

If the client set up and funded such a trust for himself, the client would be taxed for both income and transfer tax purposes as if the trust did not exist. The trust would also not protect the assets from the grantor's creditors. The creditors would be able to reach the maximum amount which could be paid to the grantor. Conversely, anyone other than the client could set up a trust for the benefit of the client and incorporate all six components of the "ideal estate plan."

This analysis leads to the general conclusion that a person can receive more rights in a trust than he can obtain by owning property outright, provided that the transfer to the trust is created and funded by a third party. Since a transferor can confer more rights and benefits by making transfers in trust than giving the property outright, it would also be reasonable to conclude that virtually all significant gifts and bequests should be made in trust.

The ability to improve or enhance a gift by placing it in a trust is often summarily dismissed without adequate and intelligent analysis of the benefits the recipient would be losing. Rejection comes in many ways, often in the form of a perceived flaw in the trust concept, particularly the belief that the beneficiary would have to relinquish control in order to obtain the tax benefits which trusts offer. Control can be preserved by structuring the trust as a Beneficiary Controlled Trust whereby the primary beneficiary will either be the sole trustee or will have all trustee powers, other than tax-sensitive powers, and also the ability to control the identity of the independent trustee. Moreover, virtually all concerns can easily be remedied in the trust design.¹ A second reason often cited for rejecting trusts is a concern as to complexity. Often these objections can be overcome by citing the magnitude of the available benefits that can be derived. Compared to the planning alternatives available to a recipient, a trust set up by a third party is more advantageous and less complex than the options available to an estate owner who holds the property outright.

Not Sufficient Foresight

Most clients visit their estate and business professionals primarily to obtain tax guidance. The second most popular reason that clients consult with their estate and business advisors is to seek asset protection advice. Often the consultation involves assets which could have been protected from the transfer tax system and the reach of creditors if planning for the property had been

previously undertaken. The most obvious illustration is inherited property. If the transferor, or the transferor's advisors, had sufficient foresight to set up the proper structure to hold the assets left to the client, the client would not need the planning. It is surprising how many advisors who are involved in complicated estate planning for their clients do not, in the normal course of business, recommend that their clients suggest to their parents that the parents leave their property to the clients in trust.

Another large segment of wealth which is the subject of inefficient planning are assets which have significantly increased in value, such as matured businesses or investment opportunities. Many clients have assets which have grown substantially in value but which were started with very little "seed" money. Had the "seed" money been placed in trust for the benefit of the client, the important elements of asset protection and transfer tax savings would not have been lost. Thus, for new ventures, the cardinal rule is that proper structuring of the entity or entities must be done both as to the planning vehicle being used and as to the ownership of the interest. It is much easier and tax efficient to properly structure the venture at its inception than to try to rearrange existing wealth, or to move wealth from one generation to another. Proper structuring includes not only the entity which owns the underlying asset, such as a partnership, LLC, etc., but also the proper arrangement of the design and ownership of the entity itself.

Use of Trust Counterintuitive to Most People

The premise that it is better to receive property in trust than to own it outright is counter to the normal reaction that trusts should be used under circumstances where third-party control is important, such as where the beneficiary is either legally, physically or mentally incapable of acting for himself. Most trusts are drafted whereby distributions are made at a certain age or at staggered ages, at least theoretically reflecting ages at which the transferor believes the beneficiary will have attained sufficient maturity to manage the property. If the beneficiary has already attained an age of perceived maturity, the traditional approach is to distribute the property outright to the beneficiary at the demise of the creator. In lieu of terminating the trust at the time of predicted maturity of the beneficiary, the enhanced benefits which are derived through the trust vehicle can be preserved, without denying the beneficiary control, by continuing the trust and making the beneficiary the trustee at the time it is deemed that the beneficiary has matured and it is appropriate to shift control.

If It's Good for the Goose—Why Isn't It Good for the Gander?

A rather fundamental estate planning technique is the use of a bypass trust to shelter the unified credit

equivalent from taxation in the estate of a surviving spouse. Because such a trust is so elementary, it is recommended in virtually all instances where an estate tax would otherwise be incurred at the death of the surviving spouse. Staggered distributions are not made out of a bypass trust.

It is difficult to reconcile a theory under which an estate owner would terminate a trust for a child, particularly if the trust would be exempt from generation-skipping transfer tax ("GST tax") and not terminate a bypass trust.² The rationale for the creation of a bypass trust is equally applicable to extending the term of the trust for the life of descendants. In fact, anticipated growth inside the trust would typically protect a greater amount from the transfer tax base in a trust for children and more remote descendants than for a surviving spouse, particularly where some of the planning techniques discussed in this article are implemented.

Since a trust offers more benefits than an outright gift or bequest, trusts should be the recommended option and the vehicle of choice in virtually every estate plan, particularly because the two major enhancements a trust offers, vis-a-vis an outright disposition, are the two most prominent benefits sought by clients from estate planners—tax savings and asset protection—once they become the property owners. None of the asset protection and wealth shifting planning techniques that can be used for an estate owner's existing wealth would be necessary to protect the assets had they been left in trust, nor are techniques to protect existing wealth as effective as the benefits and protection inherent in the trust vehicle.

Probably the major cause of the relative underutilization of trusts can be attributed to the lack of knowledge of the benefits that trusts offer and the general perception that trusts are restrictive, inflexible vehicles which reduce the recipient's beneficial enjoyment of the property, a fallacy which will be dispelled later in this article. Interestingly, prior to the GST tax legislation, many estate planners did not recommend taking advantage of the ability to avoid the application of tax on successive generations through the creation of trusts which would last through multiple generations.

With the enactment of the GST tax, probably under the theory that scarcity makes things more valuable, increased attention has been given to using such trusts to escape the heavy tax burden. For those who had sufficient foresight to establish a generation-skipping trust, the ability to avoid the imposition of tax for multiple generations was available prior to 1976 without a limitation as to its funding.

Comment. The use of a well drafted, flexible, multi-generational trust created prior to the enactment of the

GST tax was the ultimate estate plan for moving wealth outside the purview of the transfer tax system and protecting the wealth from potential creditors.

The ability to erode the transfer tax system by such a trust was acknowledged by Prof. A. James Casner in a statement to the House Ways and Means Committee, in which he stated: "[i]n fact, we haven't got an estate tax, what we have, you pay an estate tax if you want to; if you don't want to, you don't have to."³ The enactment of the statutory provisions to reduce generation-skipping opportunities in both 1976 and 1986 resulted in many seminars on maximizing exempt transfers and for many practitioners, it brought about an awareness of the value of generation-skipping benefits. As a result, a greater percentage of estate planners incorporate generation-skipping into the planning arsenal.

Other practitioners who were aware of the strategy closed the gap between awareness and actual implementation. Moreover, public knowledge of the opportunities inherent in dynastic trust planning has led to clients themselves becoming more receptive to the actual use of the trust as a transfer tax reduction device.

If the reader concurs with this conclusion as to the recommended composition of the "ideal estate plan," it would be reasonable to conclude that the estate owner would do all or most of the following: (i) adopt trust planning as the centerpiece of his estate plan; (ii) encourage a potential transferor (e.g., parent, spouse) to create and pass expected inheritances to him in trust; (iii) extend the duration of the trusts as long as possible, perhaps forum shopping for a state that does not have a rule against perpetuities; (iv) consider forum shopping for a state which does not impose a state income tax; (v) take advantage of funding techniques which leverage the \$1 million GST tax exemption; (vi) deflect income tax liability from the trust by violating the grantor trust provisions of Code Secs. 673 through 679 so that the trust can grow tax free; (vii) create grantor trust status so the trust "owner" under Code Secs. 673 through 679 can engage in favorable wealth shifting transactions with the trust income tax free; and (viii) adopt a forward-looking attitude by having potential transferors create a trust for the benefit of the client so that trusts would be the owners, rather than the client, of any ventures which would be undertaken in the future.

The "Beneficiary Controlled Trust"

Many clients believe that their intended beneficiaries are mature, competent and responsible and are able to manage and control property given or bequeathed to them. There is a fear that the use of a trust will unduly restrict the control of these beneficiaries. For those individuals, a Beneficiary Controlled Trust should be used rather than an outright gift or bequest.

The Beneficiary Controlled Trust can provide the primary beneficiary with the functional equivalent of outright ownership, in addition to tax savings opportunities and creditor and divorce protection benefits that are not obtainable with outright ownership. The ability to derive more benefits in a trust than one would obtain with outright ownership without giving up control leads one to wonder why Beneficiary Controlled Trusts are not used instead of outright transfers in almost every instance in which the transferor otherwise would be inclined to gift or bequeath the property outright.

The Beneficiary Controlled Trust concept is simple. It is a trust where the primary beneficiary either is the sole trustee or has the broad ability to fire any co-trustee and select a successor co-trustee. Typically, control of the trusteeship is coupled with a power of appointment enabling the powerholder to deflect any anticipated rights of more remote beneficiaries elsewhere. The ability to terminate interests by exercising the power should have the effect of eliminating any potential interference by remote beneficiaries. Because the primary beneficiary/trustee possesses the ability to eliminate all participation in the enjoyment of the trust assets by secondary and remote beneficiaries, the latter will not be inclined to bring a lawsuit because their rights could be terminated.

The use of a Beneficiary Controlled Trust satisfies all of the elements of the ideal estate plan. The beneficiary can have access to and use of all of the trust assets; the right to transfer the property to anyone he wishes, at the time and in the manner he desires; control and management of the trust property; and the property outside the reach of his creditors:

1. Ready Access to and Use of All of the Income and Corpus of the Trust. In its simplest form, the beneficiary can be the sole trustee and have the right to any or all of the income; plus distributions of principal for health, education, support and maintenance; plus a non-cumulative right to withdraw the greater of five percent or \$5,000 of trust corpus annually. The trustee/beneficiary can also use the property for virtually any purpose he desires. Because the beneficiary is also the trustee, he will decide what constitutes the appropriate distributions or usage to fall within the scope of his defined rights. His interpretation will not be subject to second guessing by more remote beneficiaries if these rights are coupled with a power of appointment.

Most trusts are drafted to distribute all of the income. This design alternative is not recommended because it moves the income from a transfer tax and asset protected area to one which is exposed. Contrary to the reaction of most people, a discretionary trust offers more benefits than a trust which distributes its income. Because income can be retained, the trust can grow more rapidly

than one which distributes its income, resulting in the availability of a large fund for the beneficiaries. Further, creditor protection is greater in a discretionary trust.

Although the trust should be drafted to permit distributions of income and principal, operational distributions should not be made unless there is a compelling reason to do so such as onerous income tax consequences. Rather than make distributions to the trust beneficiaries, the trustee (which can be the beneficiary himself) would be encouraged to acquire assets for the "use" of the beneficiaries, rather than distributing funds for the individuals' personal acquisition of the assets. The assets will remain in trust and will be entitled to the enhanced tax and creditor shelter. The right to "use" the trust assets may be for any purpose and need not be limited by an ascertainable standard without coming within the general power of appointment proscription contained in Code Sec. 2041(b) even though the decision to allow the use is in the hands of a person acting in the dual capacity of beneficiary and trustee. Rather than being a general power of appointment, use of the trust assets would be akin to a life estate.

2. The Ability to Decide Who Will Receive the Property. In addition to the beneficial enjoyment of the trust property, another feature of the ideal estate planning structure is the ability to determine who the transferees of the property will be and in what form they will receive it. This can be accomplished by giving the primary beneficiary a broad special power of appointment. In a dynastic trust, the power of appointment typically would also be given to a remote beneficiary (typically, a secondary beneficiary who will become a primary beneficiary at the death of a primary beneficiary) at such time as the beneficiary attains the status of a primary beneficiary. A power of appointment is a desirable ingredient in most trusts because it adds flexibility and permits the trust to be modified in order to deal with changes in the law or family circumstances. Its importance increases when the trust is dynastic because there is a greater possibility of change in family circumstances, laws, particularly tax laws, etc.

As previously mentioned, the use of a special power of appointment enhances the objective of using a Beneficiary Controlled Trust in that it provides added control in the hands of the primary beneficiary and protection from interference from secondary beneficiaries because the powerholder can appoint the property away from any complaining beneficiaries, in effect disinheriting them. One argument often made in furtherance of not using a trust is that if there were no trust, there would be no accountability to more remote descendants. By coupling the power of appointment with broad discretionary powers in the hands of the trustee/beneficiary, the result would be that the trustee/beneficiary would have the functional equivalent of no accountability with respect to the trust. As

Professor Ed Halbach has often stated, “[a] power of appointment is also a power of disappointment.”

If the creator of the trust desires to provide the beneficiary with rights that are as close to outright ownership as possible, the powerholder can be given the power to appoint the property in favor of anyone, in trust or outright, other than himself, his estate, his creditors or the creditors of his estate⁴ without causing estate inclusion. None of these limitations should be viewed as a real restriction. Although one cannot appoint to himself, as previously mentioned he can generally access the property easily through a broad interpretation of the ascertainable standards or can use it for any purpose virtually without restriction if he is the trustee and the trust is properly drafted. The inability to appoint to one's estate is also not meaningful when one realizes that the powerholder can appoint to the beneficiaries of his estate, either outright or in trust, provided that the term of the recipient trust does not exceed the term of the existing trust.⁵ Further, it is inconceivable that anyone would desire to appoint property to his creditors or the creditors of his estate and negate the asset protection benefits inherent in the trust vehicle, in the absence of special circumstances, such as substituting an estate tax for a GST tax.

A concern often voiced by dynastic trust candidates and some of their advisors is that they don't want to be irrevocably locked into a trust arrangement forever. A power of appointment that can be exercised by making outright distributions, thus terminating the trust, can easily finesse that perceived problem. Alternatively, the power of appointment design can be broad enough to enable the trust to virtually be redrafted without exposing the trust to transfer tax, provided the duration of the restructured trust is not extended beyond its original term.

3. Control and Management of the Property. For the client who would transfer property to the objects of his bounty outright, it is difficult to reconcile not making the transfer to a trust that the primary beneficiary controls, since the primary beneficiary can control the trust virtually without limitation and interference from any secondary beneficiaries and still receive the tax and creditor benefits of the trust vehicle. As discussed previously, a trust designed with control in the hands of the primary beneficiary (and secondary beneficiaries who become primary beneficiaries upon the demise of the primary beneficiary), coupled with a special power of appointment that would enable the primary beneficiary to cut out a complaining secondary beneficiary, should be free of interference. Thus, for most clients such a trust should be the singularly most important component of the estate plan.

In most instances, however, it is recommended that the beneficiary not be the sole trustee because greater flex-

ibility, tax benefits and creditor protection can be obtained using a discretionary Beneficiary Controlled Trust with two trustees, the beneficiary/trustee and a friendly, independent trustee. The independent trustee would have the tax sensitive powers and the beneficiary/trustee would have all other powers, including managerial rights. The beneficiary/trustee would also have the ability to fire the independent trustee and replace him with another independent trustee.⁶

Obviously, not all clients share the foregoing philosophy, and sometimes circumstances preclude or suggest that all power not be lodged in a beneficiary. For such clients, the estate plan should be designed to take into account and reflect the specific variations and desires of the client to accomplish his or her objectives. Illustrations of circumstances where the client would not select a Beneficiary Controlled Trust would include situations where the beneficiary is either legally (a minor) or practically (e.g., inexperienced, disabled, lacking judgmental skills, etc.) incapable or unable to assume managerial responsibility; where the client wants to limit the beneficiary's enjoyment of the property, enabling others to enjoy and share in the wealth; or where the client wants to limit the beneficiary's power of disposition over the property. In such instances, a trust, although not a Beneficiary Controlled Trust, should be considered, even for transfers in which tax considerations are not a substantial factor.

4. Asset Protection. Although it has always been a worthwhile consideration, asset protection and liability planning have become an integral part of the business and estate planning process. In addition to traditional estate planning techniques used to pass wealth to or for the benefit of descendants with a minimum of taxes and costs, the skilled advisor will counsel his clients with respect to structuring the family wealth in a manner that will render it undesirable, unattractive and unreachable by creditors, including spouses in the context of a divorce.

An irrevocable trust set up by someone other than the beneficiary is the best creditor protection device available to the planner. A discretionary trust where distributions are subject to the absolute discretion of an independent trustee, has been described as “...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.”⁷

As the asset protection maxim goes—“If you don't own it, nobody can take it away from you.”⁸ Historically, the general rule has been that the creator of the trust can dictate who may receive the beneficial enjoyment of the property and the extent and circumstances under which this enjoyment may be obtained. As a result, except in a few egregious situations, unless trust prop-

erty is distributed to a beneficiary, it will be protected from the beneficiary's creditors.⁹ Thus, the trustee would be expected to acquire assets for the "use" of the beneficiaries rather than fund the beneficiaries' personal acquisition of the assets. For example, if the beneficiary has a business or investment opportunity, the trustee could acquire the business or investment as an asset of the trust, instead of distributing the funds to the beneficiary, who would then use the funds to acquire the business or investment personally. As a result, the beneficiary would have the use and enjoyment of the property without the creditor exposure. Because asset management is not a tax sensitive trustee power, the control would not have any tax impact. In fact, control over trust property will not be imputed to the trustee/beneficiary personally so as to be aggregated to form a control block. Therefore, if the trust owns a 30 percent interest in an entity and the trustee personally also owns a 30 percent interest, the interests will not be combined for tax purposes.¹⁰

5. Tax Savings. As a general rule, most clients are motivated to create trusts by the significant transfer tax savings that can be achieved. Since federal unified transfer tax brackets start at 37 percent for the first dollar taxed and reach 55 percent (and 60 percent if the five percent surcharge is applicable) and the GST tax is imposed at the highest estate tax bracket (currently 55 percent) for each generation skipped for all non-exempt transfers, the stakes are high. The ability to significantly erode the imposition of these somewhat punitive taxes by engaging in sophisticated estate planning maneuvers in conjunction with the trust vehicle is substantial. Thus, from a family wealth planning standpoint, advisors generally focus on avoiding the transfer tax system. The most effective technique to accomplish that result is a dynastic trust.

Under Chapter 13 of the Internal Revenue Code of 1986, each taxpayer may create a trust exempt from the GST tax with \$1 million or, if married, \$2 million. The visceral reaction to this relatively modest exemption in planning for large estates is that the statute puts the kibosh on the effectiveness of this arrangement as a means of accumulating massive wealth that would avoid the imposition of the transfer tax system. The contrary result will accrue for those families who aggressively engage in sophisticated wealth shifting strategies. Indeed, the effectiveness of the GST tax provisions can be negated using many of the techniques discussed herein and, over time, knowledgeable estate planners can finesse the current tax laws, thus significantly mitigating the intent of the statute.

Although trusts can also save income taxes, these savings have been substantially reduced during the last several years by the compression of the personal income tax brackets, the enactment of the kiddie tax, the present unfavorable trust income tax brackets and other

legislative changes. However, most practitioners are unwilling to assume that the current income tax laws will remain unchanged. The use of a discretionary trust will enable the trustee to react favorably to any changes in the income tax structure. Furthermore, in many instances, by forum shopping and selecting a state without an income tax, net income tax savings can be achieved despite the unfavorable rate schedule of trust accumulations.

Divide and Conquer

For both estate and business planning purposes, the rule should be divide and conquer. The proper use, structure and combination of multiple entities is the very essence of modern family tax and wealth planning.¹¹ Generally, the techniques of choice should be family limited partnerships ("FLPs") or limited liability companies ("LLCs") as the entities to own the underlying assets and trusts which will own interests in these entities.

In the context of tax planning, it often makes sense to isolate assets which are more productive for gift giving purposes. For example, assets which are expected to increase significantly in value are generally considered the type of assets one would transfer when embarking on a gift giving program. Assets which generate significant taxable income also are often the subjects of lifetime gifts in today's estate planning environment. Wasting assets, on the other hand, may deserve creditor protection in an FLP or LLC vehicle, but are less likely to be the subject of an aggressive gift giving program. Therefore, they should be segregated into a separate entity. A common planning error is to use a single entity to own family wealth or a family business. It inhibits tax planning and increases exposure to creditors. For example, a liability incurred by one segment of a business will subject the entire enterprise to liability. Assets with a large cash flow relative to their value are viable assets for certain techniques such as GRATs and installment note sales. If these assets were combined with assets which have little or no cash flow, such as raw land, the planning opportunities would be restricted because the average cash flow would be reduced impeding the effectiveness of the technique.

In the context of protective asset planning, a distinction must be made between "internal" and "external" protection. Lawsuits against the partnership or LLC will result in external protection, i.e., the partners (provided that no individual is a general partner) or members are protected. Additionally, the use of multiple FLPs or LLCs will protect the assets in all such entities except for judgments against the entity which has committed the wrongful act. Lawsuits against the entity owners individually will result in complete internal protection, and the external protection of the owners through the limited charging order remedy.

The distinction between the internal and the external protection is illustrated as follows. Assume A and B are operating a business in the form of a limited partnership with a corporate general partner. If X obtains a judgment of \$600,000 against the partnership and the partnership is worth \$250,000, X can satisfy his or her judgment internally against the net partnership assets of \$250,000. X cannot satisfy the shortfall against the assets owned by A and B individually because a limited partnership shields the external assets held by the individual limited partners from liability. If either A or B individually was a general partner, the personal assets of that general partner would be subject to the internal liabilities of the limited partnership. On the other hand, judgment creditors of either A or B individually would be limited to the charging order remedy against the assets of the limited partnership, and would have no recourse against the partnership assets. In summary, creditors of the partnership itself have only an internal remedy limited to the assets of the partnership, and creditors of the individual partners have the limited remedy of a charging order. If A and B have more than one business venture, each should be in a separate entity in order to insulate all unexposed entities from the creditors of the exposed entity.

Estate/Gift Tax Variances¹²

For planning purposes, it is far simpler, less risky and more tax efficient to divert a wealth-generating opportunity at the inception of the undertaking than to disgorge existing wealth once value has matured and has become substantial.

For existing property and wealth which cannot be diverted, gift giving is far superior to passing property at death. The unified transfer tax enacted in 1976 was intended to integrate the separate estate and gift tax systems into a single, progressive tax which cumulates inter vivos and testamentary transfers so that approximately the same amount of tax will be paid regardless of whether transfers are made during life or at death. Although some of the advantage of lifetime gifts have been reduced, the disparity in the tax can often be substantial. There are several variations between the taxes and other factors which favor lifetime giving. The two most important distinctions are as follows:

First, the estate tax is a "tax inclusive" tax. For estate tax purposes, the tax is imposed on both the property transferred and the tax itself. In contrast, the gift tax is imposed only on the value of the property transferred.

Observation. This concept is illustrated by comparing the results that are obtained by planning with \$1,000,000 (out of which the transfer tax must be paid), which could be either transferred during life at a 55 percent bracket, or at death, subject to the same tax rate. Under the estate tax, the entire \$1,000,000 would be subject to the 55 percent tax bracket and would result in a \$550,000 tax and

\$450,000 passing to the beneficiary, a tax of 122 percent on the transferred property. Under the gift tax [if the transferor survived for three years from the date of the gift], using the same \$1,000,000, a transfer of approximately \$645,000 could be made to the beneficiary, resulting in a tax of only \$355,000.

A second major variance between the estate and gift taxes is illustrated by the facts of Rev. Rul. 93-12. In that ruling, 20 percent gifts of stock were made to each of the donor's five children. Each gift was valued as a separate minority interest gift. Had the same transfers taken place at death, because the decedent owned 100 percent at death, the stock value for transfer tax inclusion purposes would not have received a minority interest discount.

Both taxes are imposed on the "fair market value at the time of the transfer." The concept of fair market value is set forth by the IRS in both its Estate Tax Regulations¹³ and Gift Tax Regulations.¹⁴ That value is basically defined as the price at which the property would be transferred in a transaction between a "willing buyer" and "willing seller," neither being under any compulsion to buy or sell, and both having reasonable knowledge of relevant facts.

For estate tax purposes, the asset is valued by determining the decedent's interest in the property irrespective of its destination. The estate tax is an excise tax on the privilege of transferring property. For purposes of computing the gross estate, the tax is imposed upon what the decedent owned at death without regard to the fact that the asset may be fragmented and passed to several beneficiaries.¹⁵

For gift tax purposes, the value of an interest transferred is determined by what a hypothetical willing buyer would pay for it.¹⁶ The gift is measured by what each donee receives rather than the aggregate of all transfers made by the donor.¹⁷

The combination of moving from tax inclusive to tax exclusive and taking advantage of valuation discounting can have a dramatic effect on the transfer tax cost of passing property.

Example 1. Assume an estate owner is in a 55 percent marginal transfer tax bracket and wants to transfer a business worth \$1 million to the estate owner's five children. The following will illustrate the significant savings which can be derived by taking advantage of the benefits of a current gifting program as contrasted with holding the property until death.

(a) Estate tax route—bequest of five 20 percent interests to the children:

\$2,222,222	included in taxable estate
<u>(1,222,222)</u>	estate tax
\$1,000,000	net to children

The tax is 122 percent of the value of the property transferred ignoring the valuation adjustment. If the business grew at 7.2 percent a year for 10 years, it would double in value, requiring that the \$4,444,444 be in the estate in order to pass on the business to the children. The tax would be 244 percent of the original value of the business.

(b) Gift tax route—transfer to one beneficiary illustrating tax inclusive vs. tax exclusive:

\$1,000,000	gift
<u>550,000</u>	gift tax
\$1,550,000	amount needed to make gift

The tax is 55 percent of the value of the property transferred.

(c) Gift tax route—gift to five children combining valuation discounts (assume 40 percent) with tax inclusive vs. tax exclusive concept:

\$600,000	gifts (five 20% interests receiving 40% discounts)
330,000	gift tax

The tax is 33 percent of the value of the property transferred. Significant additional benefits can be derived by transferring the property into a trust exempt from the GST tax.

Example 2. Suppose an estate owner wishes to pass the business in trust to a child for life with remainder after the death of the child to a grandchild. Assume that there is no appreciation (otherwise, the problem would be accentuated) and that the estate owner's \$1 million GST tax exemption has already been used. The estate owner would need to start with \$4,938,272, computed as follows:

\$4,938,272	in donor's taxable estate
<u>(2,716,050)</u>	FET at 55%
\$2,222,222	net to trust

The distribution to the grandchild is "tax inclusive," similar to the estate tax. Therefore:

\$2,222,222	taxable termination subject to GST tax
<u>(1,222,222)</u>	GST tax
\$1,000,000	to grandchild net of all transfer tax ¹⁸

There are many other tax advantages in making lifetime gifts. Two of the most important benefits are (1) any appreciation occurring after the gift will escape estate taxation at the death of the donor and (2) gifts may be made in a manner whereby considerable income tax benefits can be obtained, for instance by shifting what would otherwise be the donor's high bracket income down to the lower brackets of the donees, or alternatively, as will

be discussed later, shifting the income tax burden by using a "defective trust."

Planning in the Real World

In discussing intrafamily wealth shifting, we have concluded that in planning for transfers of wealth or diversions of wealth-generating opportunities, the preferred recipient should be a dynastic irrevocable trust. Where the primary beneficiary is capable of managing the property, the use of a Beneficiary Controlled Trust can satisfy the desire to retain control in the family. If the donor wishes, he can retain the power to remove and replace the trustee¹⁹ and pass the right to control the trustee selection to the primary beneficiary²⁰ or a third party without disturbing the tax benefits of the trust. Many estate owners do not want to part with control. That concern is easily resolved. If the transferor wishes, he can structure the arrangement so that he retains as much control as he wants by using a vehicle such as an FLP or LLC where the voting interest is retained.

We have also concluded that the shifting of a business or investment opportunity which is never owned by the opportunity shifter is preferable to transfers by an estate owner. Because the transfer tax system is based upon transfers of property, if the client never owned the property but instead engaged in "opportunity shifting," the "transfer" never comes within the scope of the tax system. With regard to disposing of wealth already accumulated, we have concluded that inter vivos transfers are far superior to testamentary transfers. In spite of the fact that substantial transfer tax savings can be obtained by gifting the non-controlling interest in the business, most clients are unwilling to pay a substantial gift tax. Thus, we have dual objectives: (1) taking advantage of the vagaries between the estate and gift tax system and (ii) not paying substantial gift taxes.

Observation. Assume a client in the 55 percent estate/gift tax bracket owns a business worth \$10 million which will double before death; desires to transfer the business to his five children; and would obtain a valuation discount of 40 percent for the transfer of non-controlling interests.

A testamentary transfer of the business would result in taxes of \$24,444,444 (55% x 44,444,444). An immediate gift would result in taxes of \$3.3 million ((\$10 million - 40%) x 55%). Although the tax bite could be significantly reduced, given a choice of objectives most clients would elect to defer the tax rather than incurring a current tax with the concomitant tax savings.

Certain tax planning arrangements can avoid the choice and thus accomplish both goals. The two best and most popular techniques for obtaining this tax relief involve making transfers of non-controlling interests in an entity either into a GRAT or, alternatively, into a defective irrevocable trust, in exchange for a promissory note. The

GRAT and installment note sale closely resemble each other; however, in most respects the note offers superior results and is more consistent with the philosophies set forth in this article. (See Exhibit A.)

The best asset for this type of planning is the closely-held business. What does a large business represent to its owner, particularly a business which the owner wants to pass to his heirs? For many it represents a job and compensation package as well as a large liability for his estate in the form of taxes. Substantial benefits may be derived if the business owner were to recapitalize the entity, retaining a small sliver of it for control purposes, so that he could continue to determine his compensation, perks and fringe benefits²¹ as well as a managerial control of the enterprise. A gift of the other interests, using some of the techniques discussed in this article, would enable the business owner to avoid a significant portion of the transfer tax without incurring gift tax.

Defective Trusts

A trust under which the grantor is treated as the owner is commonly known as a "grantor trust" or a "defective trust." A trust may be defective for any one or a combination of the income and transfer taxes.²² Notwithstanding the foregoing, the term "defective trust" as used in this article will refer to a trust that has the following two characteristics:

- (i) For income tax purposes, the grantor (or a third party) will be treated as the "owner" of the trust property and the existence of the trust for most purposes is ignored; and
- (ii) For transfer tax purposes, the transfer will be complete.

Since the grantor trust rules are different for income tax purposes than they are for transfer tax purposes, grantor trust exposure may be obtained for one tax but not the other. In the planning process, a defective trust is designed to contain provisions which would not cause the grantor to be taxed as the owner for estate tax purposes. For income tax purposes, grantor trust status is obtained by violating one or more of the provisions contained in Code Secs. 673 through 679.

The tax benefits of achieving defective trust status are:

1. By paying the tax on the trust income, the grantor is making the functional equivalent of a tax-free addition to the trust for both gift and GST tax purposes.
2. By paying tax on the trust income, the grantor will reduce his own taxable estate by the tax paid. Any potential growth on the "tax" money not paid will inure to the benefit of the trust rather than increase the wealth of the grantor.
3. By designing the trust as a grantor trust, it will qualify as a permissible shareholder of an S corporation.²³

4. Transactions between the trust and its "owner" are not recognized for income tax purposes.²⁴

5. A defective trust can purchase an existing insurance policy on the life of the owner without subjecting the policy to the "transfer for value" rule that would otherwise expose the policy proceeds to income tax.

Transfer Tax Benefit of Defective Trusts. One of the most powerful and viable planning strategies available to the planner is to take advantage of tax-free compounding. To illustrate, assume \$1 million was placed in a trust earning ordinary income at 10 percent. If the trust was in the 40 percent income tax bracket, the trust would grow at six percent per annum. After 30 years the trust would be worth \$5,743,491, and after 50 years it would be worth \$18,420,154. If the grantor (or another person) were to pay tax on the income of the trust, the trust would grow at 10 percent per annum and would be worth \$17,449,402 in 30 years and \$117,390,853 in 50 years. Because the tax burden would be borne by the grantor (or another person) individually, their taxable estates would be reduced because of the taxes paid by \$11,705,911 and \$98,970,699 respectively, under the foregoing fact pattern, if they were in the same bracket as the trust.

Income Tax Consequences. Although a thorough analysis of the individual grantor trust sections is beyond the scope of this article, a brief discussion of the general statutory scheme is necessary in order to set the table for the planning opportunities reviewed later. The basic rules are:

1. The separate existence of the trust as a taxpayer is ignored where the grantor or another person is treated as the owner under Code Secs. 671 through 679.
2. The grantor will be treated as the owner to the extent he retains any of the interests, rights or controls set forth in Code Sec. 673 (a reversionary interest in a portion of the trust worth more than five percent); Code Sec. 674 (a power to control the beneficial enjoyment); Code Sec. 675 (certain administrative powers); Code Sec. 676 (the power to revoke); Code Sec. 677 (the income may be distributed in certain circumstances for the benefit of the grantor); or Code Sec. 679 (foreign trusts having a U.S. beneficiary).
3. A person other than the grantor will be treated as the owner if he has the power, exercisable by himself, to vest corpus or income in himself.²⁵ A *Crummey* power of withdrawal is a power to vest corpus in himself and is thus within the scope of Code Sec. 678(a).
4. The IRS's position is that upon the lapse of the power of withdrawal the powerholder remains the taxpayer under Code Sec. 678(a)(2). Although the IRS's position appears technically flawed, it has consistently followed that posture in many private letter rulings.
5. Where the grantor would be treated as the owner under Code Secs. 673 through 677 or Code Sec. 679 and a person other than the grantor is also treated as

the owner under Code Sec. 678(a), the IRS position is that the grantor trust provisions of Code Secs. 673 through 677 and Code Sec. 679 override the provisions of Code Sec. 678(a) and the grantor will be treated as the owner of the trust rather than the person other than the grantor. This position is consistent with the analysis of most practitioners and the Committee Reports, but inconsistent with the literal language of Code Sec. 678(b).

6. Upon the cessation of the transferor's grantor trust status in situations where there are dual violations by the grantor and a person other than the grantor, the IRS has opined in a letter ruling²⁶ that the income tax treatment will not attach to the person holding the Code Sec. 678(a) power. This issue will arise at the death of the grantor or upon the occurrence of another event, such as a lapse or release of the grantor trust powers.

The dual power situation can be illustrated by a typical irrevocable trust fact pattern whereby the trust creator has a power which would expose him to grantor trust treatment, such as a Code Sec. 675(4)(c) power to swap assets (2. above) and the trust is funded giving the beneficiary a *Crummey* power of withdrawal, which is a power described in Code Sec. 678(a), that would cause the beneficiary to be treated as the owner of the trust (3. and 4. above). The grantor trust treatment as to the creator of the trust would override the ownership treatment under Code Sec. 678(a) and the trust creator would be taxed on the income rather than the powerholder (5. above). If the power causing inclusion was released, or the grantor died, the trust would be taxed under normal trust rules, ignoring the Code Sec. 678(a) power (6. above).

Planning Note. It is not advisable to create trusts which are not entirely taxable in the same manner. For instance, a trust which is partially defective and partially taxable will restrict planning. Transactions with the trust will be partially taxable, both to the grantor and to the trust. Furthermore, those portions will be difficult to ascertain.²⁷

Case Studies

The opportunities available to leverage trust transfers are considerable. The following case studies will illustrate some of the better planning techniques available.

Case Study 1. Opportunity Shifting

The best, but often overlooked, wealth planning strategy is never to own the property yourself, but rather to shift or deflect the opportunity to earn income or generate wealth from the client to others, particularly trusts, at the inception of the undertaking. The shifting of an opportunity does not involve a transfer and therefore is not subject to the transfer tax system. If a person were to refer business, customers or clients to another person or entity, or give gratuitous advice to

the other person or entity, no one would conclude that a gift had occurred for transfer tax purposes. Similarly, the shifting of a favorable business or investment opportunity is not a circumstance which would give rise to a transfer tax.

When a new business is formed, a new product is being developed, a new location is being considered, a collateral business to which the estate owner can refer business, or the family has an investment opportunity, a new entity should also be formed and some or all of the equity interests offered in the new entity should be acquired by irrevocable trusts. If the opportunity shifter desires control of the new enterprise, he would acquire that interest at the inception of the arrangement. Only the interest owned and not the opportunity "transferred" will be subjected to the transfer tax system.

Illustration. 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 all but the entity where the liability occurred from creditors. From a tax planning standpoint, the use of multiple entities makes a great deal of sense. For example, the family patriarch can set up trusts for the benefit of his descendants (and perhaps his spouse) that would own the shop doing repairs and warranty work on automobiles sold by the sales entity. The grantor would create the trust electing GST exemption on the gift. 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. If the patriarch wanted to control the entity, he could form an LLC and be the manager owning one percent or form an FLP and own a controlling interest in the general partner.

By integrating opportunity shifting and life insurance planning, a trust can be set up which owns the life insurance and the new entity, avoiding the need to make annual gifts to the trust which would otherwise be needed to pay premiums.

Example 3. H and W have one child and must pay life insurance premiums of \$50,000 per annum. An opportunity shift resulting in \$50,000 of income to the trust would avoid unnecessary gift tax and GST tax exposure. Because the trust is defective, the full amount, unreduced by income tax, is available to pay premiums.

Case Study 2. Installment Sales to Defective Trusts

An increasingly popular and extremely effective wealth shifting strategy is the use of an installment sale to a

defective trust in exchange for the trust's promissory note. Generally, the technique is used to sell presumptively undervalued assets, such as non-controlling interests in closely held entities, options, lettered stock or other assets which have large appreciation potential relative to their current value to the trust. Usually the note is structured as interest only, based on the rates under Code Sec. 1274, with a balloon payment at the end of the note term and a right to accelerate the payment. To the extent that the trust assets produce a return in excess of the relatively low Code Sec. 1274 rate, value will be shifted from the estate owner to the trust gift and GST tax free. By virtue of the grantor being considered the owner of the trust assets for income tax purposes, the IRS has ruled²⁶ that transactions between the trust and the grantor will be ignored.

Illustration. Assume a business owner has a business worth \$5,000,000 with a cash flow of 10 percent per annum. The business owner desires to transfer a 30 percent interest to trusts for each of his three children. Each 30 percent portion of the business is valued at \$900,000 after a valuation discount of 40 percent to reflect the fact that the interest is a non-controlling interest in a closely held entity.

If the transferor desired to retain control of the business entity, it would be recapitalized into voting and non-voting interests. The transferor would then sell the interests for \$900,000 to a defective dynastic trust in exchange for an interest-only promissory note with a balloon payment at the end of the term. Because the sale would be for fair market value, there would not be a gift nor would any GST tax exemption have to be allocated to the trust on account of the transaction. The interest rate would be determined by referring to Code Sec. 1274(d).

Each 30 percent interest would earn \$150,000 per annum. If we assume that term of the note was 20 years and the sale was consummated in November, 1998, the applicable Code Sec. 1274(d) rate would be 5.1 percent. Thus, interest of \$45,900 annually would be paid ($5.1\% \times \$900,000$) or 3.06 percent of pre-discounted value of the transfer. Based upon the internal growth of the trust (compounded tax free because the trust is a grantor trust), the note can be paid off in less than 7 years. If the notes were to be paid off at that time, the economic result would be that the former business owner would have moved 90 percent of the stock, together with its appreciation from date of sale, out of his estate at zero transfer tax cost; he would retain full control of the entity; and only the value of the retained interest would be includible in his estate.

Planning Note. Although the trust will be capable of paying off some of the principal annually, it is generally considered advisable to retain the incremental income inside the trust so that its earnings will inure to the ben-

efit of the trust growing in a tax-free environment. One technique which can produce beneficial results is to combine life insurance planning with the installment sale technique. The difference between the interest payment and the income earned of \$104,100 ($\$150,000 - \$45,900$) may be applied toward the payment of life insurance premiums. The internal cash buildup in the policy can subsequently be used to pay off the note.

Case Study 3. Gift (or Sale) and Leaseback

A popular estate freezing technique is a gift or sale (generally of appreciating property) to younger family members (or trusts) with the property being leased back by the transferor. One advantage of this tactic is that the transferor can continue to use the property without estate tax inclusion. Assets which work well in this arrangement include land, office buildings, furnishings 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 as well as limit the tax planning possibilities.

To illustrate the technique, assume that four physicians wish to acquire some medical equipment for \$1,000,000. 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, it is suggested that they acquire the equipment in an LLC. If a physician gifted (or sold) his 25 percent interest and that interest received a 40 percent valuation discount, the value of the transferred interest would be \$150,000.²⁹ The LLC would then lease the equipment to the operating entity. If we determine that this type of equipment is normally leased for 20 percent 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.

For planning purposes, an ideal recipient of the transferred interest is a defective dynastic trust. That trust could be used to acquire other assets from the physician or the physician's spouse income tax free,³⁰ can be used to pay life insurance premiums, to start other business ventures, or make investments, or to benefit the family in a variety of other ways, virtually limited only by the imagination of the planner.

Planning Opportunity. One viable use of the trust is to fund a buyout of the LLC. Where licensing is not a constraint, such as a lease in a business setting, the buyout

can extend to the operating entity as well. Under this alternative, the trust 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 interests") with a combined value of \$6 million. In the normal cross-purchase buyout 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 \$3.3 million to pay the estate tax at their own death.

Alternatively, if each original party created a life insurance trust for the benefit of his descendants (and possibly his spouse) which acquired insurance on the other two owners the trusts would acquire the business interests at the death of a co-owner, the acquired interests would not be subject to estate tax at the death of either of the surviving owners. The property subject to estate tax and insurance funding would be \$6 million, rather than \$11 million, before valuation discounting. The more likely scenario would be estate tax inclusion of \$2 million at the first two deaths and \$1.2 million (if a 40 percent valuation discount is used) at the survivor's death, resulting in a total of \$5.2 million of estate tax exposure rather than \$11 million. The trusts can be funded defective trusts using the cash flow from the leasing entity to pay for the insurance. Control mechanisms, such as recapitalizing the entities or having voting rights disappear upon transfer, can be used to maintain control at the senior generational level.

Case Study 4. The Beneficiary Defective Trust

Possibly the best estate and business planning technique is to combine elements of the previously discussed methods with a "Beneficiary Defective Trust." A Beneficiary Defective Trust is a trust which is defective as to the beneficiary rather than the trust creator. Grantor trust status is obtained by violating Code Sec. 678(a) and not violating any Code provision which would tax the trust to the creator of the trust. A *Crummey* power of withdrawal is an example of a power which would trigger the application of Code Sec. 678(a) and result in the powerholder being treated as the owner of trust property.

In order to obtain the tax and creditor benefits, the trust must be set up by a person other than a beneficiary. The primary candidate to set up such a trust and provide the seed money is a parent of the client. One of the virtues

of the Beneficiary Defective Trust set up by a third party is that the client can be trustee and primary beneficiary of the trust without disturbing the tax benefits inherent in the trust vehicle.

A variation of the facts contained in *R. Crowley*³¹ may well offer the ideal estate plan. Mr. Crowley was the CEO of City Federal Savings and Loan Association, which generated ancillary income in the form of appraisal fees, insurance commissions and abstract and title policy commissions. These collateral business opportunities were shifted to a partnership (later incorporated) comprised of Mr. Crowley's four minor children. Mr. Crowley's oldest son, Robert, while in college and law school, was employed to handle the work and was paid a salary. The remainder of the income inured to the benefit of the ancillary entity. The Tax Court held that the income tax burden would be shifted to the children. Although *Crowley* was an income tax case, presumably it also stands for the proposition that no gift tax would be incurred. Many estate owners have situations similar to Mr. Crowley's, where a small amount of "seed" money, coupled with referrals, business or investment opportunities, can generate a significant cash flow.

Illustration. Estate owner has an opportunity to open up an ancillary business, such as a repair shop, to which he will send referrals. The "seed" money is \$100,000 and it is expected to generate income of \$250,000 per annum. Assume that the estate owner calls his parent and asks for "an advance on his inheritance." The parent has the financial ability and the desire to help the estate owner. The parent would create a GST tax exempt dynastic irrevocable trust, giving the client a hanging power of withdrawal over the entire contribution, which lapses as to the greater of five percent or \$5,000 per annum. Because the beneficiary is given a power of withdrawal over the entire contribution, the whole trust will be defective as to the beneficiary under Code Sec. 678, enabling the beneficiary to transact with the trust income tax free. The beneficiary would have estate tax exposure as to any portion of the initial gift to the trust which is hanging and subject to his withdrawal at death. All lapsed amounts and post-transfer appreciation would not be includible. Because the value of the investment is expected to grow rapidly into an entity of substantial value, the lapse should also be rapid.

Planning Note. Most planning with *Crummey* trusts involves a single "pot" trust with multiple powers of withdrawal. This course of action is not recommended when planning the Beneficiary Defective Trust because the goal is to have the entire trust taxable to a single beneficiary at all times in order to prevent a result whereby transactions between the beneficiary and the trust would be partially tax free and partially taxable.

In most instances, the trust structure would combine the concepts and virtues of the Beneficiary Controlled

Trust with the Beneficiary Defective Trust. Because the beneficiary's parent set up the trust, the beneficiary can (1) be the trustee and manage and control the assets; (2) be the primary beneficiary and use the trust assets for whatever purpose he desires, plus receive distributions for his health, education, maintenance and support and, if an independent trustee is involved, receive distributions for any purpose; (3) have a broad power to appoint the property to anyone other than himself, his estate, his creditors or the creditors of his estate; and (4) make income tax sales to or purchases from his estate. The trust estate would pass tax free at his death and would be creditor protected. If the trust were dynastic, all of these virtues except the ability to transact tax free would be extended to his descendants or any other beneficiaries.

Planning Note. If the beneficiary desires to access the cash flow rather than make trust distributions, the beneficiary can sell his assets to the trust, moving the assets out of his estate and into the trust he controls and of which he is the primary beneficiary.

Illustration. The owner of a cleaning business desires to produce his own cleaning chemicals rather than purchasing them from outside vendors. The cleaning business is worth \$5 million and has a cash flow of \$600,000 per annum after expenses. The business owner needs \$100,000 to start the chemical business. Parent gifts the \$100,000 to a Beneficiary Defective Trust, which will start and own the chemical business. The business owner/child is given a power of withdrawal over the entire contribution which lapses as to the greater of five percent or \$5,000 per annum. The business owner is the trustee and primary beneficiary of the trust. The chemical business earns \$200,000 per annum from sales of chemicals to the cleaning business. Client then sells 40 percent of the cleaning business to the trust for \$1.2 million, taking a 40 percent valuation discount. The Beneficiary Defective Trust would then have cash flow from the chemical business of \$200,000 and cash flow from the 40 percent of the cleaning business interest or \$240,000, which would result in having \$440,000 available to fund the purchase price. If we assume that in years two and three the client sells an additional 40 percent and 20 percent respectively

of the business to the trust, the entire purchase of the business can be accomplished in approximately five years, removing it from the transfer tax base.

Conclusion

Most wealth planners recognize that there are two tax systems, one for the informed and another for the uninformed. The same rule is applicable for those who use creditor protection strategies as compared to those who do not. The tax and asset protection benefits which can be derived through a well-conceived family wealth planning structure as compared to an unplanned arrangement are substantial.

The thesis that one can obtain more rights and benefits by receiving property in a trust than they can by owning the transferred property outright is counterintuitive, but also easily demonstrable. With proper planning, a trust can be created for the benefit of one's descendants that can insulate the family wealth from creditors and significantly reduce the impact of the transfer tax system on vast wealth that can be enjoyed and controlled by the family into perpetuity. To the extent this structure is implemented in a perpetual trust, it may be possible to form the perfect estate plan. The GST tax restricts transfers to GST tax-exempt trusts; however, leveraging techniques can be employed to expand the amount of the protected fund. A Dynastic Beneficiary Defective, Beneficially Controlled Trust offers planners new and exciting opportunities to benefit their clients.

Many years ago Ben Franklin set forth the two standards of inevitability—death and taxes. Experience has taught us that the number of certainties has expanded to include tax reform and increased creditor exposure. Estate planners can use strategies which moderate the impact of taxes and creditor intervention. Rapid implementation can avoid the danger of adverse Congressional legislation reducing these planning opportunities. The reward is great for those willing to engage in upscale innovative transactional planning in conjunction with sophisticated trust structuring. For them, the two standards of inevitability may well become death and tax and creditor avoidance.

EXHIBIT A
COMPARISON OF NOTE SALE TO IDIT VS. GRAT

- Interest Rate in Structuring Transaction Favors IDIT
 - IDIT—Code Sec. 1274—e.g., 3-9 Years Federal Mid-term Rate
 - GRAT—Code Sec. 7520—120 Percent Federal Mid-term Rate
 - Lower the Rate—Less to Grantor—More Tax Free to Beneficiaries
- Survivorship Feature—Favors IDIT
 - GRAT—Must Survive Term or Trust Assets (Including Post-Transfer Appreciation) in Taxable Estate
 - IDIT—Only Value of Note in Estate Post-Sale Appreciation Escapes Transfer Tax
- GST Tax—ETIP (Estate Tax Inclusion Period)—Favors IDIT
 - IDIT—Immediately GST Tax Exempt
 - GRAT—Can Only Allocate at End of Term—Inefficient for GST Tax Planning—Unless Remainderman Sells Remainder Interest to Dynastic Trust
- Amount of Taxable Gift—Favors IDIT
 - GRAT—Gift—Example 5 of Reg. §25.2702-3(e) (can't reduce amount of taxable gift to zero).
 - IDIT—No Taxable Gift Involved—Sale for FMV
- Payment Structure—Favors IDIT
 - IDIT—Note Structure Flexible—All Principal Payments Can Be Back Loaded—Right to Prepay
 - GRAT—Annuity Payments Cannot Exceed 120 Percent of Amount Paid During Preceding Year—Payments Fixed at Inception
 - By Delaying Payments, Income and Growth on Retained Payments Inures to Trust Rather Than Grantor
- Distributions to Trust Beneficiaries—Favors IDIT
 - GRAT—Distributions May Be Made Only to Owner of Annuity Interest During GRAT Term
 - IDIT—Distributions May Be Made to Trust Beneficiaries at All Times
- Gift Tax Exposure—Favors GRAT
 - IDIT—If Note Less Than FMV, Gift Made
 - GRAT—Can Finesse Gift Tax by Expressing Annuity As Percentage of FMV
- Statutory Authority—Favors GRAT
 - IDIT—Not Specifically Authorized Under the Code and the Structuring of the Arrangement is Based upon the Judgment of the Practitioner Rather Than by Following Published Judicial and Administrative Guidance
 - GRAT—Specific Statutory Authority Under Code Sec. 2702 and Administrative Guidance Available

Endnotes:

- ¹ Richard A. Oshins of the Law Offices of Oshins & Associates, Las Vegas, Nevada.
- ² Frederick R. Keydel, "Trustee Selection, Succession, and Removal: Ways to Blend Expertise with Family Control," 23 U. Miami Inst. on Est. Plan., Ch. 4 (1989).
- ³ This is true unless the trust was also used in order to limit the surviving spouse's power of disposition over the trust assets, which is not an item usually cited as precipitating the use of the bypass trust.
- ⁴ A. James Casner, Hearing before the House Ways and Means Comm., 94th Cong., 2d Sess., Pt. 2, 1335 (1976).
- ⁵ Code Sec. 2041(b)(1).
- ⁶ Code Sec. 2041(a)(3).
- ⁷ IRS Letter Ruling 9746007.
- ⁸ Keydel, fn. 1, *supra*, at §409.1.
- ⁹ Howard D. Rosen, 810 T.M., Asset Protection Planning, BNA Tax Management Portfolio at A-1.
- ¹⁰ Creditors have made some inroads into that general rule in cases holding that where the beneficiary had certain controls, such as extending the term of the trust or the ability to change trustees, the creditor protection may be lost. *Hatsfield v. Lescher*, 721 F.Supp. 1052 (E.D. Ark. 1989). *In re Baldwin*, 142 B.R. 210 (Bankr. S.D. Ohio 1992); *In re Herzig*, 167 B.R. (Bankr. E.D. Va. 1994). Hopefully these cases will prove to be anomalies. Otherwise it could lead to the egregious result that one discretionary beneficiary who goes bankrupt could infect the entire family's wealth.
- ¹¹ *M.F. Bright Est.*, 619 F2d 407 (N.D. Tex. 6/18/89), *rev'd and rem'd* CA-5, 80-2 USTC ¶13,359 (10/2/80) and *aff'd en banc* 10/1/81; *L.F. Bonner Est.*, CA-5, 96-2 USTC ¶60,237, 84 F3d 196-197 (1996).
- ¹² Owen G. Fiore, "Ownership Shifting to Realize Family Goals, Including Tax Savings," N.Y.U. 37th Ann. Inst. Fed. Tax, Ch. 38 (1979).
- ¹³ See Professor Stanley M. Johanson's (of the University of Texas) excellent outline, "Estate Planning for the Very Rich."
- ¹⁴ Reg. §20.2031-1(b).
- ¹⁵ Reg. §25.2512-1.
- ¹⁶ "The estate tax is a tax...imposed on the privilege of transferring property, not a tax on the privilege of receiving property." *Ahmanson Foundation*, CA-9, 81-2 USTC ¶13,438, 674 F2d 761, 768.
- ¹⁷ *C. Land, Exr.*, CA-5, 62-1 USTC ¶12,078, 303 F2d 170, cert den. 371 US 862.
- ¹⁸ "Unlike the estate tax where the tax is imposed on an aggregation of all the decedent's assets, the gift tax is imposed on the property passing from the donor to each donee and it is the value of that property passing from the donor to the donee that is the basis for measuring the tax. Thus, where a donor makes simultaneous gifts of property to multiple donees, the gift tax is imposed on the value of each separate gift." Technical Advice Memorandum 9436005; See also Pennell, "Valuation Discord: An Exegesis of Wealth Transfer Tax Valuation Theory and Practice," U. Miami 30th Inst. on Est. Plan., Ch. 9 (1996).
- ¹⁹ See Johanson, fn. 12.
- ²⁰ Rev. Rul. 95-58, 1995-2 CB 191.
- ²¹ IRS Letter Ruling 9746007.
- ²² Assuming that the compensation package is reasonable, albeit large, and it is not classified as a retained interest under Code Sec. 2036, the transferred interest will be outside of the aegis of the estate tax, even if the control is retained.
- ²³ Randall D. Roth, "Intentional Use of Tax-Defective Trusts," U. Miami, 26th Inst. on Est. Plan., Ch. 4 (1992).
- ²⁴ Code Sec. 1361(c)(2)(A)(i).
- ²⁵ Rev. Rul. 85-13, 1985-1, CB 184.
- ²⁶ Code Sec. 678.
- ²⁷ IRS Letter Ruling 9321050 (Reversing IRS Letter Ruling 9026036).
- ²⁸ See for example IRS Letter Rulings 8142061 and 9034004 which provide for an annually expanding portion of the trust being taxed to the beneficiary if the beneficiary fails to exercise his power of withdrawal.
- ²⁹ Rev. Rul. 85-13, 1985-1 CB 184.
- ³⁰ If the medical entity used the equipment prior to the transfer, perhaps the value of the LLC should be reduced since the value of used equipment is certainly less than that of new equipment. Because valuation is a two-step process, first a value of the underlying entity would be determined, which value would be lower if used equipment was the asset it held, and then the various factors such as minority interest and marketability would be applied.
- ³¹ Rev. Rul. 85-13, fn. 28; Code Sec. 1041(a).
- ³² 34 TC 333, CCH Dec. 24,198 (1960) Acq., 1961-2 CB 4.