



# The Anatomy of the Perfect Modern Trust—Part 1

Estate planners best meet client needs with trusts that satisfy a six-factor “wish list.”

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If planners advising clients about business and estate planning had to consider just two questions most common to every engagement, those questions would be “What do clients really want?” and “What is the best way for them to obtain what they want?” This article addresses those questions. Regardless of how complicated and disparate the clients’ lives and circumstances may be, there are basic common elements and straightforward common solutions that every planner can recognize and use in every client situation. Most advisors concentrate on the *wealth shifting* process and often do not give adequate attention to *wealth receipt planning* (i.e., how the recipients should receive the transfers).

Wealth receipt planning is as important a component of the estate planning process as wealth shifting planning, and often has a greater impact. As a general proposition, most children, grandchildren, and others are, or are expect-

ed to become, competent functional adults—individuals to whom the transferor would transfer wealth outright at the proper time, but for the shield that trusts provide from taxing authorities and other potential claimants. All of us have experienced receiving gifts at some time in our lives that had “strings” attached (e.g., an allowance that

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could be spent only in a special manner).

The typical reaction of the donee is that the imposition of conditions marginalizes the full enjoyment of the gift, even though often the restrictions may have been justifiable. For the capable, mature, sensible recipient of wealth, the gift should be as enabling as possible, subject only to the restraints necessary to achieve the protections discussed in this article. The “key” here is to structure the trust to accomplish those goals. The thought process should be viewed from the following perspective: “If I were receiving a large gift or bequest, what would I want?”

Under U.S. law, persons can be given rights, controls, and protections in trust that they cannot “retain” for themselves once they have received the property without the risk of erosion from unnecessary taxes and creditor exposure. Trusts are not only an essential component of wealth shifting and

planning for inheritors who cannot (or should not) own or receive property outright, they are also an important ingredient of shifting assets to the “competent inheritor.”

The strategy discussed below is more than simply a trust. Rather it is an estate planning process that when planned, structured, implemented, and operated correctly will accomplish more than any traditional estate planning tool.

The essential steps for both the planner and the client are to determine:

1. Is there a “best” way to pass and receive wealth?
2. What is “best”?
3. If there is a “best” trust design pattern, why aren’t all trusts structured in that manner?
4. From whose perspective should the decision be made—the transferor’s or the recipient’s—particularly with respect to a person to whom the transferor would be inclined to pass the wealth outright?
5. If there is a “best” design pattern, how should it be explained to the client so that the decision-making process results in an “informed” choice?
6. How can the virtues of the trust plan be communicated to the beneficiary? In addition to explaining the trust arrangement to the client, it is key to explain the virtues of the trust plan to those receiving the inheritance. Often the receipt of wealth in trust is viewed negatively. It is essential to each beneficiary’s happiness and peace of mind that he or she understands that the trust enhances the gift rather than serves as an impediment.

### **Wealth receipt planning—what is “best”?**

Clients generally want to do what is best for their children, grandchildren, and other loved individuals, including determining how these inheritors will receive their gifts and bequests. The correct means for achieving this is *always* transferring wealth to and keeping it in a trust, unless the amount of the transfer is too small.

That conclusion is reached because a properly designed trust significantly *improves* the value of an inheritance. The prevailing minimal wealth rules of thumb used by some in the estate planning industry to justify trust planning are much too high, often determined by the estate tax applicable exclusion amount. The authors of this article, however, believe that the initial threshold for using a trust is under \$1 million. A million dollars is a lot of money to unnecessarily lose or expose to claimants.

It is impossible to select a single threshold amount as the standard minimal value to use even as a “rule of thumb.” Reasonable people can and will disagree in this regard; however, the threshold presently used is much too high. Often the selection is arbitrary and fact-driven. On the other hand, most clients and advisors are typically too dismissive of initiating discussions of this issue. It is difficult to envision the beneficiary who would not be better off receiving wealth in trust even if it was to provide for certain contingencies, such as the death of the beneficiary with children who are incapable of managing such an inheritance.

In addition, with *de minimis* exceptions, all trusts should incorporate the same design structure. For the competent inheritor (i.e., the person to whom the client would want to pass wealth outright, but for the vast benefits of

receiving assets in trust) the trust design pattern will contain these component parts:

A dynastic, discretionary *trust* (*with* distribution discretion *in the hands of an independent party who can be fired and replaced*) that is beneficiary controlled (*unless (a) controls are undesirable or (b) impermissible under law to avoid the taxing authorities and other claimants*) that encourages the use of trust assets, rather than distributions (*unless distributions are beneficial or desirable*) and is situated in a trust-friendly jurisdiction.

In almost all instances, these trusts should include features that are generally not incorporated in the “typical” trust, including:

- *Expanding* the list of permissible beneficiaries, although the distribution standards might be compressed for the subordinate beneficiaries. This will enable the inheritors to benefit from basis-bump planning, create “opportunity shifting” trusts for the benefiting of certain beneficiaries to the exclusion of others, etc. These enhancements are described below.
- *Providing* that the trust may own life insurance on the lives of all beneficiaries, and others, where there is an insurable interest. This facilitates other planning for inheritors, such as avoiding trust funding complexities and limitations (see the discussion below regarding “the ultimate irrevocable life insurance trust”).
- *Permitting* transfers to sub-trusts for the benefit of one or more of the beneficiaries, including trusts set up by the independent trustee or special trustee. For instance, assume that a beneficiary has a favorable business or investment opportunity that he or she

## EXHIBIT 1 Wish List

Wealth owners have the following planning desires:

1. *Control*—Primarily managerial and investment control.
2. *Use and enjoyment*—The use of gifted and inherited wealth, including the income generated by the trust assets, for any purpose until death, consistent with family goals and values.
3. *Flexibility*—The ability to revise or amend a plan if laws or family dynamics change or for any other reason.
4. *Creditor protection*—Shelter from creditors, including former, divorcing, or dissident spouses.
5. *Tax savings*—Proper avoidance or reduction of all taxes—income, gift, estate, and generation-skipping.
6. *Simplicity*—Everyone wants to avoid complexity.

wanted to pursue. It would be unreasonable for the beneficiary to share the potentially enormous fruits of his or her labor or intellect with siblings or other more remote beneficiaries. In this situation, the trustee of a traditional trust would ordinarily make a distribution outright to the beneficiary who would then start or acquire the favorable opportunity. It would be preferable for the distribution trustee to transfer the ‘seed’ money to a trust for the beneficiary and the beneficiary’s family to the exclusion of others, including a trust that is a beneficiary defective inheritors trust (BDIT)<sup>1</sup> in order for the beneficiary to maximize the protections inherent in trust planning discussed in this article.

- *Allowing* the independent trustee to give, take away, and

design general powers of appointment (see the discussion of tax savings, below).

For the inheritor who is not competent, the controls would be reduced, deferred, or not given at all. Certain controls might be treated differently than other controls.

For all beneficiaries, the trust would provide no enforceable rights or entitlements. As a general rule, rights and entitlements are harmful and do not add any benefits that cannot be achieved by drafting the trust in a more protective manner.

### What rights, benefits, and controls do clients and inheritors want?

The planning desires of every wealth owner can be broken down into six categories that the authors call the “Wish List.” As explained in Exhibit 1, they are: control, use and enjoyment, flexibility, creditor protection, tax savings, and simplicity.

Donors and testators would want all of the components of the Wish List if they were going to be the recipient of a gift or bequest. All beneficiaries, whether spouses, significant others, children or grandchildren, or other inheritors want the same thing. Although their

individual priorities will differ, everyone wants the exact same six ownership attributes.

If a planner can create a vehicle for a client that achieves each of these six desires, the client should be satisfied, and the job is well done. All clients want to do what is “best” for their family and other intended inheritors. The advisor’s job is to make certain that clients are making informed decisions about what is “best.” The discussion that follows suggests a model that can achieve each of these goals for every client, regardless of what business, family, and personal issues that client presents. The authors call their model the “Perfect Modern Trust.” It is a trust design pattern that will achieve the maximum benefits and controls associated with outright ownership (to the extent desirable by the transferor), but it also provides the maximum permissible protections allowable by law. To the extent that the recipient and the transferor disagree on the structure, generally the desires of the transferor will prevail. Often, however, the client considers the recipient to be a mature, capable, person to whom they would wish to pass wealth outright, unless there is a better alternative. In such instance, the recommended strategy is to transfer the wealth to a trust that maximizes the (1) benefits, controls, and protections of the beneficiary, (2) is operationally simple, and (3) is designed from the viewpoint of the beneficiary.

### What is the Perfect Modern Trust?

The trust design being recommended is a *beneficiary controlled trust* where the *use* of trust assets (on a preferential basis) rather than their outright ownership is encouraged, although beneficial and desirable distributions are allowed.

<sup>1</sup> A BDIT is a trust created and funded by another person with a gift subject to a lapsing power of withdrawal so that income is taxed to the power-holder/beneficiary. The BDIT provides planning results not obtainable in any other planning strategy. The BDIT incorporates the planning opportunities discussed in this article, plus others. See Oshins, Brody, and McBride, “The BDIT: A Powerful Wealth Planning Strategy When Properly Designed and Implemented,” *LISI* (6/22/2011); Hesch, Brody, Oshins, and Rounds, “A Gift From Above: Estate Planning On a Higher Plane,” *150 Tr. & Est.* 17 (November 2011).

- The trust will have safeguards in case control by a particular beneficiary is undesirable or unlawful.
- The trust will be *discretionary*, with distribution discretion in the hands of an independent trustee who can be fired and replaced. The control of the identity of the independent trustee is typically ceded to the primary trust beneficiary, at the proper time, generation after generation, subject to (1) change through a special power of appointment if such control is undesirable, or (2) the grantor of a trust who wants to retain control of the office of trustee.
- The trust will be *dynastic*, designed to last as long as the law allows, generally subject to broad special powers of appointment to retain flexibility in order to deal with changed circumstances or changed laws, provided that each generation will have the ability to amend the trust to reduce (or eliminate) the powers of appointment of succeeding generations, if desired. If inheriting in trust always improves the inheritance, it would be irrational not to provide similar benefits to younger generation beneficiaries. The “in trust” enhancements, with appropriate controls, is a valuable commodity that inheritors could not provide for themselves, once they have or are entitled to the property itself.
- The trust will be *situated* in a trust-friendly jurisdiction that avoids unnecessary, avoidable state income tax being imposed on the trust income and provides strong protection against creditors’ claims.

Attrition of wealth primarily arises from mismanagement, lawsuits, divorces, and taxes. The well-designed trust with carefully selected trustees and control provisions can avoid unfavorable outcomes from all four of these causes.

### **Trust is beneficiary-controlled by the competent inheritor**

Every beneficiary wants to control his or her own destiny. The authors’ planning experience indicates that control is essential to the beneficiary’s happiness. Many property owners think that trusts are too controlling and believe that they must transfer wealth outright to children, grandchildren, and other loved ones in order to avoid imposing too many controls on the recipients. Many beneficiaries would rather forego the benefits of trusts unless they can be given what they consider to be adequate control.

In this article, a beneficiary who is a competent, mature, and capable adult is referred to as a “competent inheritor.” The seminal question to address is whether property should be passed to competent inheritors outright or in trust. Assets received and kept in a properly structured trust have many advantages that are not available to assets owned outright. An excellent outline on the topic, commenting on the magnitude of the exposure of outright distributions observes that—

[Many people,] including advisors who should know better ... do not realize the *enormous, unnecessary, and irretrievable* loss of assets their families will likely suffer by failing to appreciate the benefits that passing wealth from generation to generation in trust can achieve. [Emphasis added.]<sup>2</sup>

The benefits resulting from transferring wealth in trust make inheritances received in trust far more valuable to the recipient than inheritances received outright. Asset pro-

tection and tax sheltering are compromised when assets are transferred outright. Accordingly, a properly designed beneficiary-controlled trust should be the vehicle of choice for every competent inheritor. Such a trust can be designed to give the competent inheritor “full control” (as described below) over his or her trust.

The visceral reaction of many advisors and clients is: “But, isn’t the grantor the one creating the trust?” Because many clients, as well as their advisors, are typically exposed to the notion that the client can, and usually does, impose conditions on the wealth transfers, most trust forms are designed to saddle the recipients with unwanted limitations. That is contrary to the basic thesis of this article—that the wealth transfers are being designed to (1) do what is “best” for the competent inheritor and (2) the imposition of any unnecessary restrictions or controls, compresses the value of the transfer in the eyes of the inheritors. Clients and inheritors will often find the imposition of commonly used prototype enjoyment inhibitors to be somewhat reprehensible.

A prime illustration of the foregoing is an investment committee. Investment control given to a trust beneficiary is innocuous, except with respect to life insurance on the beneficiary’s life. If it is permissible for the competent inheritor to control investments, then why sub-

<sup>2</sup> Keydel and Wallace, ACTEC Symposium; 3/6/1999. See also Aucutt, “Structuring Trust Arrangements for Flexibility,” 35 U. Miami Inst. Est. Plan., Ch. 9 (2001); Calleton, McBryde, and Oshins, “Building Flexibility and Control Mechanisms Into the Estate Plan—Drafting From the Recipient’s Viewpoint,” NYU 61st Inst. on Federal Taxation (2003); Oshins and Oshins, “Protecting & Preserving Wealth Into the Next Millennium—Part 1,” 137 Tr. & Est. 52 (September 1998), and Oshins and Oshins, “Protecting & Preserving Wealth Into the Next Millennium—Part 2,” 137 Tr. & Est. 68 (October 1998)

<sup>3</sup> “If You Don’t Own It, It Can’t Be Taken Away From You,” Rothschild and Rubin 810 Tax Management Portfolio, p. A-2.



rogate these powers to an investment committee?

The desire is to come as close to outright ownership as possible, without compromising the shelters. The fact that a beneficiary has investment control does not alter the trust protections. A prevailing philosophy, not to use trusts, is based on the notion that trusts impose unnecessary restrictions and controls. The beneficiary-controlled trust avoids those concerns.

The beneficiary-controlled trust operates under the philosophy espoused by John D. Rockefeller: “Own nothing, but control everything.” If the beneficiary owns nothing, then nothing can be taken away from the beneficiary.<sup>3</sup> Having legal title to property is not only unimportant, it may often be detrimental, as the property is now subject to adverse creditor claims. Think of the trust as a “wrapper” surrounding and protecting the assets within it for the benefit of the inheritor. How can this combination be made to work—i.e., allow donors to select their chosen beneficiaries and allow the beneficiaries to have their desired control—and still provide the “wrap-

per” protection of the beneficiary through a trust? The design of the “Perfect Modern Trust” accomplishes all of these ends.

#### **What if the inheritor is not competent?**

Where an inheritor is not competent, whether still a minor or incapable of management, immature, spoiled, or spendthrift, the Perfect Modern Trust performs the traditional functions of a trust: protecting the beneficiary against his or her impairments. The trust assets will be sheltered from creditors; predators; and, to the greatest extent possible, the taxing authorities. In such cases, one or more of the permissible beneficiary controls will be adjusted or eliminated by the transferor.

There are three types of beneficiary controls:

1. Managerial/investment control.
2. Dispositive control (the ability to adjust the beneficial interests of others).
3. Control over the identity of the trustees.

The basic design of the competent inheritor’s trust would be modified to limit or possibly eliminate

entirely any one or more of the three beneficiary’s controls if he or she is not considered a competent inheritor. Partial control may be granted, or the beneficiary can be given the opportunity to earn greater control by reaching appropriate milestones.

The exception to the general rule that the competent inheritor will receive all three of the controls is where the transferor desires to limit the inheritor’s power of disposition. That might be done, for example, where the transferor does not wish an inheritor’s spouse to benefit from the transferred wealth. In such a situation, the power of appointment would be changed from “to anyone other than the beneficiary, his estate, or the creditors of either” to a more restricted class such as “descendants.” To prevent the indirect circumvention of undesirable beneficiaries, restrictions on the identity of the distribution trustee should also be considered.

#### **The beneficiary controlled trust format**

The competent inheritor wants to be in full control of his or her wealth, including any wealth that

has been inherited or is expected to be inherited. He or she would like to manage the trust and control its investments.

**Investment trustee.** The primary beneficiary of the trust can be named the investment trustee, also sometimes referred to as the family trustee or the management trustee. The trust will give the investment trustee full managerial and investment control at the proper time.<sup>4</sup> “At the proper time” is often the time or times (if control is staggered, or cascading) of projected maturity. The trigger dates are generally decided in the same manner that outright distributions would be determined to be prudent or for some inter vivos transfers, when the transferor is willing to relinquish control.

The investment trustee (in a beneficiary controlled trust, the competent inheritor) is given all controls over the trust other than those which by law must be given to a trustee who is not also a beneficiary. Although the investment trustee is acting in a fiduciary capacity, the trust will have enabling language that expands the allowable actions, such as negating limitations used in proto-type trusts (e.g., the “prudent person” rule, see below). It is understandable that often restrictions are desirable for certain trustees; however, it is not sensible to impose them on those persons who fit the definition of the prevailing competent inheritor. These controls will not expose the trust assets, or either fiduciary, to adverse claims from the IRS or from creditors.

The limitations on the controls that cannot be given to a beneficiary without disturbing the protection offered by the trust wrapper are essentially negligible and meaningless. For all desired and reasonable purposes, the controls that may be given to a beneficiary

are essentially the functional equivalent of outright ownership and full control. Thus, the term “full control” is used in this article to mean the maximum control permitted under law without exposure to the IRS or other potential creditors.

For example, as mentioned above, it is not necessary or desirable to burden the investment trustee with a requirement that investments be limited in accordance with a “prudent person” rule. Enable the beneficiary to invest freely for his or her own benefit in the following ways:

- Allow acquisition of interests in closely held businesses.
- Permit investment in assets that might be considered “illiquid.”
- Allow discounted minority interests to be held in the trust.

By negating the prudent person rule, the beneficiary to whom the client would be inclined to transfer property outright, essentially has the best of all worlds—full control and enjoyment of outright ownership, but the shelter from claimants that is not obtainable if the assets were received outright.

While one would assume that the trust beneficiary will want to serve as the investment trustee and appoint himself or herself to this role, such a determination is not necessarily a given. The flexibility of the trust allows the trust beneficiary to select another to serve as investment trustee (e.g., perhaps in case of disability), while still allowing the beneficiary the right and power to replace such trustee. After the replacement, the trust beneficiary can then control the identity of the independent trustee.

**Committees (e.g., investment and distribution committees) generally are undesirable.** The use of committees and trust protectors is often

the antithesis of “full control” and “simplicity.” Often, a potential inheritor will summarily reject trust planning because of the perception that it is too controlling or too complex. It is not irrational to give up the substantial protections of trusts if controls were imposed or other than minimal complexities interfered with their unilateral beneficial enjoyment. Unfortunately, rather than simply eliminating the unnecessary restrictions, many advisors and clients often dismiss trusts because the option is not adequately discussed, if mentioned at all, or the advisor is unaware that adjustments can be made to eliminate the concerns. Thus, discussion of committee-directed trusts and trust protectors is essential to understanding the beneficiary-controlled trust design.

Some planners favor the use of a “directed trust,” where the beneficiary directs the actions of the investment committee. That is not needed or desired here. The beneficiary can make investment decisions on his or her own, and avoid the complications, restraints, costs, and time delays of a directed trust. A distribution committee may be inclined to exercise more dispositive controls than a trustee who meets the definition of an independent trustee under Section 672(c) and Rev. Rul. 95-58,<sup>5</sup> while the independent trustee would be expected to impose no meaningful restrictions.

For example, the independent trustee can be the primary beneficiary’s best friend without adversely affecting the planning. From the viewpoint of recipients, distribution and investment committees institute unnecessary sanctions, complexities, and controls that are

<sup>4</sup> The one exception is life insurance on the life of the inheritor.

<sup>5</sup> 1995-2 CB 191.

<sup>6</sup> Section 2042.

unwanted and often considered as reprehensible.

For the donor/testator with multiple children, each child who meets the criteria of a competent inheritor will at the inception or eventually be the investment trustee for his or her separate trust.

If the donor of property to a trust wishes to use the trust format and serve as the investment trustee, several other tax concerns must be addressed. In such instance, a donor may not have control over life insurance policies on his or her own life.<sup>6</sup> A donor may not retain the voting rights in the stock of a “controlled corporation” within the requirements of Section 2036(b). A donor’s power to distribute trust property must be limited by an ascertainable standard.

**Independent trustee.** The use of an independent trustee is essential to maximize the benefits and protections of trusts. The authors are often asked, “If the goal is to start the trust designing process with a beneficiary-controlled trust and make adjustments only when desirable, based on the beneficiaries’ profiles, how do we correlate adding a ‘stranger’/‘independent trustee’ to the design?”

The independent trustee—also sometimes referred to as the distribution trustee—has all of the powers over the trust that a trustee who is also a beneficiary may not have without exposing the trust assets to creditors or taxes. Adding an independent trustee will permit the trust to include some tax-sensitive benefits and powers that are otherwise not allowable, such as the ability to make distributions which are not within the “ascertainable standard,” to give and take away general powers of appointment, to acquire life insurance on the life of a tax sensitive trustee, etc. Moreover, a non-beneficiary

trustee who has sole dispositive powers enhances creditor protection (as discussed below). Advisors should be comfortable explaining the realities of adding a second trustee to enhance and not interfere with the inheritor’s enjoyment of the property.

The primary powers given to the independent trustee are powers over distributions, the power to give and remove general powers of appointment, and all powers with respect to life insurance on the life of the investment trustee. If desired, the independent trustee may be given additional powers, including managerial powers, which may be broader than only those that are impermissible for someone who is both trustee and beneficiary. The trust can be written to allow these additional powers to be toggled off and on, as may prove to be desirable.

The independent trustee can be anyone except those persons referred to in Section 672(c) or in Rev. Rul. 95-58. Rev. Rul. 95-58 holds that a decedent/grantor’s reservation of an unqualified power to remove a trustee and to appoint an individual or corporate successor trustee that is not related or subordinate to the decedent/grantor within the meaning of Section 672(c) is not considered a reservation of the trustee’s discretionary powers of distribution over the property transferred by the decedent/grantor to the trust. Accordingly, the trust corpus is not included in the decedent’s gross estate under Sections 2036 or 2038. Section 672(c) defines the term “related or subordinate party” to mean any non-adverse party who is:

1. The grantor’s spouse if living with the grantor.
2. Any one of the following:
  - The grantor’s father, mother, issue, brother, or sister.

- An employee of the grantor.
- A corporation or any employee of a corporation in which the stock holdings of the grantor and the trust are significant from the viewpoint of voting control.
- A subordinate employee of a corporation in which the grantor is an executive.

It would be highly unusual that the controlling beneficiary could not find an acceptable person or entity who is not tainted by the Section 672(c) constraints.

Independent does not mean confrontational, or someone who is a stranger. For instance, the beneficiary’s “best friend” is includable in the class of permissible independent trustees who can be fired and replaced, if the beneficiary determines it is desirable (and advances the purposes of the trust). It should be infrequent that an

informed recipient will not trade off the additional benefits and protections that an independent trustee/fiduciary provides, for the inconsequential addition of such a co-trustee. At least, that has been the experience of the authors in their practices.

Significantly, the investment trustee will be given the power in the trust to remove and replace the independent trustee, so long as the replacement independent trustee is not himself or herself, or any of the related or subordinate persons referred to in Section 672(c) and Rev. Rul. 95-58. However, the right of removal is not permissible if it was done to improperly influence the independent trustee to make an impermissible distribution or other wrongful decision. Although that constraint might be unnecessary under current tax law, not having it may result in too much control and have an adverse impact for creditor rights purposes.<sup>7</sup> Thus, safety is enhanced if:

1. The investment trustee has the removal and replacement power, even though the investment trustee is generally the primary beneficiary and has the power of removal and replacement in his or her capacity as the investment trustee rather than functioning personally.
2. The power to fire and replace is exercisable in a fiduciary capacity in order to fully preserve the integrity of the trust arrangement. The trust indenture should reflect that fiduciary duties are imposed.
3. The independent trustee can fight an illegitimate removal in the courts of the state which was selected in the trust document as controlling jurisdiction.

Legitimate removal would be defined in the trust indenture in

very broad terms to include items such as a personality conflict, inconvenience, inattention of the independent trustee, etc.<sup>8</sup> The list is very inclusive (but not exclusive—using “such as” as the guiding criteria), which is the goal of wealth receipt planning, but should be sufficient to block an obstreperous judge from successfully ordering the primary beneficiary/independent trustee to fire and replace the distribution trustee in order to provide access to the trust assets for predators. That conclusion can be enhanced by precatory language in the trust indenture indicating the goals of the trust, with the fully discretionary language being directed to a third person acting in a fiduciary manner (i.e., “in the best interests of the trust”). Because the trust is controlled by the favored beneficiary, who generally has a broad special power of appointment, it is obvious that the intention of the trust creator was to favor that beneficiary.

#### **Distributions from the trust are fully discretionary**

The Perfect Modern Trust represents the essence of flexibility. The independent trustee is given complete discretion as to distributions to the trust beneficiaries. Because the independent trustee has the absolute discretion to make, *or not to make*, distributions, the trust will provide the maximum tax and creditor protection if the right situs is selected to govern the trust.

The distribution powers should be fully discretionary and not subject to standards. The independent trustee is a fiduciary and must respect all fiduciary rules, as well as proscriptions and savings clauses contained in the trust document. The duties of the independent trustee are to carry out the wishes of the testator or donor, and these desires should be apparent from the

enabling language in the trust instrument. Precatory words such as happiness, enjoyment, etc.; broad powers of appointment; and maximum controls over the identity of the trustees are indicative of the trust creator’s desire to provide maximum beneficial enjoyment to the competent inheritor while immunizing the trust assets from outsiders.

Many scrivener limit distributions to the theoretically “safe” language contained in Section 2041(b)(1)(A)—“health, education, support, or maintenance.”<sup>9</sup> Rather than securing safety, those words actually expose the trust.

For estate tax purposes, the dispositive power for “any purpose” in the hands of an independent trustee is safe. The estate tax inclusion arises only if a decedent possessed rights of distribution to himself or herself that were not protected by the ascertainable standard. On the other hand, because the ascertainable standards are often used to provide access to the trust corpus, a court may deem those standards to be indicative of an enforceable right of the beneficiary (or a minimal obligation of the distribution trustee) and therefore expose the trust to claimants. Thus, contrary to the normal visceral reaction, full and absolute distribution (or use) discretion will better insulate the trust assets than will discretion using an ascertainable standard.<sup>10</sup>

The draftsperson should consider enabling distributions to be

<sup>7</sup> See e.g., *Pfannenstiehl v. Pfannenstiehl*, Mass. App., Slip # 13-P-906 (2015).

<sup>8</sup> See Ltr. Rul. 9303018 for a list of “proper causes” for the removal of the independent trustee to use as guidance in designing a list. Prior to the issuance of Rev. Rul. 95-58, *supra* note 5, Ltr. Rul. 9303018, was the standard guidance that draftsman used.

<sup>9</sup> S. Oshins, 39th Annual Heckerling Institute on Estate Planning, “Asset Protection Other Than Self-Settled Trusts: Beneficiary Controlled Trusts, FLPs, LLCs, Retirement Plans and Other Creditor Protection Strategies,” (2005).

<sup>10</sup> *Id.*



made “for any purpose” in the independent trustee’s “absolute, uncontrolled, and unreviewable discretion.” Because there is not a standard to enforce, subordinate beneficiaries, predators, and courts will not become involved implementing perceived legal entitlements. In addition, there is a movement in some states to take even discretionary trusts into account for equitable distribution proceedings. A fully discretionary trust will provide the greatest shelter against this contingency

Operationally, the authors’ recommended behavioral pattern is not to make distributions unless there is a reason to make them, such as beneficial tax planning, or if a beneficiary simply wants a distribution even if is tax inefficient. Where the independent trustee is dealing with a beneficiary who is a

competent inheritor, the assumption would be that distributions would be made generously if the competent inheritor wants them—even using “happiness” as the criteria—unless the competent inheritor is dealing with creditor or matrimonial problems, in which case distributions may be withheld. The “key” here is that the primary design goal is to provide inheriting loved ones with all of the benefits of outright ownership, but also passing on the compelling virtues of the trust shelter benefits.

For example, if the competent inheritor desired a distribution to acquire an extravagant asset, or to take an expensive excessive vacation, such a distribution would usually not be considered to be prudent under normal trust administration practice. However, because the overriding goal (reflected in the trust

instrument) of wealth receipt planning is to give the competent inheritor full beneficial enjoyment of the assets, the distribution should generally be made (unless making it would be irrational and a breach of fiduciary duties—e.g., to acquire drugs), and is permissible by broad trust language, such as “happiness.” To do otherwise would be disingenuous.

***Incompetent inheritor.*** If the independent trustee is dealing with a beneficiary who is an incompetent inheritor, distributions may be withheld, or made directly to someone “for the benefit of” the inheritor such as for the payment of bills, or made carefully to possible third parties charged with the care of the incompetent inheritor. If the incompetent inheritor qualifies as a special-needs beneficiary, language

in the trust will guide the independent trustee as to appropriate distributions.

In certain circumstances, the incompetent inheritor may have the discretion to replace the independent trustee. This discretion may be limited (where an incompetent inheritor is still a minor) or eliminated (where an incompetent inheritor lacks the capacity to make decisions), depending on that person's circumstances.

### **Situs of the trust is a critical element**

Does the location chosen for the Perfect Modern Trust matter? Absolutely! The situs of the trust is a crucial element in its success. Many advisors simply assume clients want a trust to be administered locally. But why is that a valid assumption? The situs of the trust need not be the state where the beneficiaries live. If the client is properly advised about the advantages of certain jurisdictions over others, the client will wisely select a jurisdiction that offers the most advantages.

If the client favors a local jurisdiction with few planning advantages over a more distant jurisdiction with distinct advantages, the client has not been well-advised by the planner. While the location of either the investment trustee or the independent trustee may provide situs for the trust, selection of the "right" jurisdiction is central to the success of the Perfect Modern Trust. Forum shopping is certainly an integral part of the estate planning process.

**Rule against perpetuities.** What are the distinctions among different jurisdictions that make the situs of the trust such a critical element? First, what is the law in the jurisdiction with respect to the rule against perpetuities? Has the rule been abolished, or at least extend-

ed for hundreds of years? If so, that is a primary factor to be considered in the selection of the jurisdiction of the trust. As discussed further below, the trust should be dynastic—designed to be used and enjoyed by generations of inheritors free from diminution by successive generations of transfer tax imposition.

**Asset protection.** Next, the jurisdiction should have the most favorable laws offering protection from creditors. If wealth is received and owned outright by a beneficiary, whether it is gifted or inherited, planning alternatives for creditors' rights purposes are limited. Trusts can have spendthrift clauses to limit the claims of creditors of the trust beneficiaries, but some state laws contain a series of rules allowing "exception creditors"—opportunities for certain creditors to take advantage of exceptions to spendthrift clauses.

For example, Delaware provides that spouses who are beneficiaries of discretionary trusts do not receive protection of their trust assets from alimony claims of a divorced spouse.<sup>11</sup> A divorcing or divorced spouse is the person who is most likely to sue trust beneficiaries. Why would advisors ever compromise this protection, absent a compelling reason to do so, which would be very unusual? Allowing "exception creditors" is a trust impediment that should be avoided. Nevada, for example, provides that no creditor can get at a discretionary trust; therefore, no exceptions are allowed to the spendthrift rule.<sup>12</sup>

If the trust is located in a state with unfavorable creditor laws, a judge in that state could compel the trustee to make distributions from the trust that then become accessible to creditors. In states which do not have favorable asset protection laws, there seems to be an evol-

ing trend in the law to compress the protection of spendthrift clauses and expand access of claimants to trust property. The Perfect Modern Trust will certainly include a spendthrift clause, and will direct trustees to act in a fiduciary capacity and prohibit compelled distributions, but such clauses and directions might be overruled in a jurisdiction that aggressively favors rights for creditors. This is a practical risk that must not be discounted. The importance of the laws of the jurisdiction chosen for the situs of the trust cannot be minimized.

Some states have amended their spendthrift statutes to provide that a trustee/beneficiary may distribute trust property to himself or herself in accordance with an ascertainable standard. There are risks that a beneficiary may move to a state with less protective laws and a recalcitrant judge might ignore the situs named in the trust instrument under the theory that (1) there are no (or minimal) then-existing contacts with the original jurisdiction and (2) the trustee, the beneficiary, and the assets are in front of him or her.

Some advisors who subscribe to the ascertainable standard/single trustee theory have suggested that they would caution their clients of the risk or tell them to have the trust amended to incorporate protective provisions before they move to another jurisdiction. Normal behavioral patterns of clients (i.e.,

<sup>11</sup> *Garretson v. Garretson*, 306 A. 2d 737 (1973).

<sup>12</sup> NRS § 21.090.1(dd).

<sup>13</sup> The authors are concerned that with the ever-evolving compression of the spendthrift protections in some jurisdictions, courts will order a distribution trustee to make distributions, even though that might breach the trust provisions and frustrate the intention of the transferor, citing an overriding strong public policy of the state deciding the matter, so that the aggrieved judgment creditor should prevail. From a practical standpoint, what would an independent trustee do if a judge simply ordered that the trustee make a distribution or face contempt charges? It is always better to protect against such a potential risk.

procrastination) would lead the present authors to conclude otherwise and that the monitoring route will fail. This suggests that the trust should always be designed to be governed by the laws of a state with protective statutes, and preferably, the distribution trustee should be located in a protective state.<sup>13</sup>

**Choosing trustee.** The selection of a trust situs requires that there be adequate contact between the trust and the selected jurisdiction. Most state laws recognize the situs of the trust based on the location of the trustee, and the fact that at least a portion of the trust assets are administered by the trustee in the chosen jurisdiction. This consideration leads to the important choice of designating the trustee in the chosen jurisdiction.

Clients will appropriately inquire about the cost of selecting a jurisdiction, especially if it is not their “home” state. Assuming the selected trustee will expect to be paid a fee, what is the cost of essentially “renting” a jurisdiction for the situs of the trust? This does not have to be an expensive proposition. Many banks in “friendly” trust jurisdictions have adopted rea-

sonable trustee fee policies. Trust companies have been created in several jurisdictions with the ideal combination of favorable (or repealed) rules against perpetuities, favorable rules providing protection from creditors, and no state income tax. There are reputable companies that compete for the business of out-of-state trust creators and charge very reasonable fees for serving as the situs trustee of the trust. The authors often use an independent trustee to act in a dual capacity:

1. To make distributions and other tax sensitive decisions.
2. To secure favorable governing trust laws.

Many of these companies do not insist that they take on the role of investment manager as a condition of their engagement. This can be an advantage for the investment trustee who does not seek such advice, and who wants to keep the trustee fee under control. Recommending a trust company that does not invest or sell products is also a desirable attribute for many advisors who do sell investments or life insurance. Because the independent trustee can be removed and

replaced at any time by the decision of the investment trustee, the independent trustee, located in the favorable situs, has a strong incentive (to the extent it is consistent with his, hers, or its fiduciary duties) to act cooperatively with the investment trustee.

#### **Dynastic in design— but still flexible**

The Perfect Modern Trust will be designed to last as long as the law permits. Selection of the appropriate jurisdiction for the situs of the trust will focus on a state that has repealed or significantly extended the rule against perpetuities. Accordingly, state law will not be an impediment to the duration of the trust. The chosen situs will also focus on a state that does not impose an income tax on the income of the trust, so that diminution of the trust assets by local taxation will not be a concern for the trust. Compounding of growth over many years is an extremely powerful wealth-building force. In addressing the Wish List with the client, it is reasonable to conclude that all of the benefits that the client seeks in the Perfect Modern Trust for his or her children are similar-

ly desired to be preserved for grandchildren and successive generations.

The prevailing philosophy is that all competent advisors would have recommended the use of a credit shelter trust when planning for married spouses (at least prior to portability). Assuming that limiting the power of disposition is not an overriding concern, why should an inheritance from someone else, such as a parent or grandparent, be planned for differently than an inheritance from a predeceasing spouse? Once the identity of the transferor is eliminated, the benefits are essentially synonymous.

If a credit shelter trust makes sense for the inter-spousal transfer then it should make sense for other inheritors. If the credit shelter trust was not best for spousal planning, then the estate planning community has historically been giving flawed advice. Because in-trust transfers are so powerful, the same pattern should repeat generation after generation (typically on a per stirpital basis), subject to broad special powers of appointment to allow amendment of the trust by the senior generation of inheritors who would have received the property outright but for the virtues of trusts.

Recognize, of course, that over time change is likely to occur. The Perfect Modern Trust is designed to be flexible and adaptable for changing circumstances in the family and in the law. Since trust distributions are completely discretionary, the independent trustee is always able to adapt quickly to any change in circumstances. In addition, the existence of broad special (limited) powers of appointment to beneficiaries will give future beneficiaries the ability to “fine tune” changing family dynamics. These powers can address changing federal and state tax laws, alter the situs of a trust if a jurisdiction becomes less favorable (although the authors suggest the

jurisdictional changing provisions also always be incorporated into the trust agreement) or if another jurisdiction becomes more favorable, and react to the realities of competent inheritors and incompetent inheritors.

While every generation expresses concern about how future generations will fare, there is a great deal of concern expressed currently that future generations will not succeed to the same level that current generations enjoy. That perception, regardless of whether it proves to be accurate, certainly allows advisors to encourage clients to adopt a dynastic trust to protect and preserve the wealth of the current wealth creators for future generations as a “hedge” against what the future may hold.

#### **Divisible dynastic trust**

Although the trust will be designed to be dynastic, it should not be viewed as a single entity with one ever-increasing “pot” to distribute. Instead, as the family evolves, so should the trust. To do otherwise tends to reward the lazy, inefficient beneficiaries and harm hard-working, productive beneficiaries whose efforts inure to others. As separate family branches emerge and siblings age and have their own families, the trust should be divided into separate (but generally equal) trusts to accommodate the disparate family interests.

The “pot” trust may be preserved when members of a generation are young and education expenses are a primary focus. Perhaps when the youngest child of a generation reaches a particular age where education expenses are likely to have been addressed would be a good time to split the “pot” into separate trusts. This suggestion carries with it the sense of fairness that all beneficiaries had the opportunity to be educated from the same

“pot.” If the family is especially wealthy, the “fairness” issue may not be a concern, and the “pot” can be split earlier. This division of the trust into separate trusts can be analogized to splitting a trust into exempt and non-exempt generation-skipping trusts.

These separate family trusts will prove to be the most efficient manner to administer the ongoing trust. Conflicts among siblings should be avoided. Siblings will not want shared ownership or shared controls. They will want different trustees, different investments, different advisors and different distribution patterns. If a family member creates a business within the wrapper of the trust, it may be unfair to share the success—or failure—of that business with other family members who are not involved. Accounting and accountability are simplified and enhanced when the trust is divided into separate trusts at the appropriate time.

#### **Tax savings**

Before addressing the many key tax-saving opportunities available with the recommended trust design, it is essential to mention that tax economies are only one of the elements of the arrangement, and tax-efficient elections should not be controlling. The goal is to provide full beneficial enjoyment without unnecessarily sacrificing the shield from predators that trusts offer. Often those goals will be mutually exclusive. In that instance, elections will need to be made.

<sup>14</sup> Professor A. James Casner, Harvard Law School, Hearings before the House Ways and Means Committee, 94th Congress, 2d Session, pt. 2, 1335 (3/15/1976 - 3/23/1976); Cooper, *A Voluntary Tax? New Perspectives on Sophisticated Tax Avoidance* (Brookings Institution, 1979).

<sup>15</sup> Siegel, *The Grantor Trust Answer Book* (Wolters Kluwer/CCH, 2016).

<sup>16</sup> Hesch and Handler, “Evaluating the Sometimes Surprising Impact of Grantor Trusts on Competing Strategies to Transfer Wealth,” NYU 68th Inst. on Federal Taxation (2009).



Because of the controls of the competent inheritor, the selection of sacrifices is determinable, either directly or indirectly, by him or her. The resultant decision will not be worse than it would be if the wealth was owned outright or in an alternative trust design.

The dynastic feature of the Perfect Modern Trust is at the core of its tax-saving characterization. It has long been recognized that the federal estate tax can be viewed as a “voluntary tax.” Planning with tax exemptions and charitable gifts can be designed so that no estate tax need ever be paid.<sup>14</sup>

The combination of generous exclusions from transfer taxes (i.e., estate, gift, and generation-skipping transfer taxes)—\$5.45 million in 2016, indexed annually for inflation—with a dynastic trust design providing for generation-skipping bequests and powers can allow substantial amounts of assets to pass from one generation to another without transfer tax imposition. For many families, timely and adequate planning will extinguish transfer taxes entirely.

The trust is the parent’s dynasty trust funded by the parent. The beneficiary has never made a gratuitous transfer to the trust. For the wealthiest families, exposure to transfer taxes can be significantly reduced, or if combined with other planning strategies, even eliminated. Planning is best started as early as possible to both use the available exclusions before appreciation has occurred and to address an ideal asset composition.

Assuming that assets will appreciate in value from one generation to the next, there is a compounding effect of wealth building through the generations. If the trust were not dynastic, and if a tax were imposed as each generation passed on through a “voluntary” plan of outright bequests, that compounding

of wealth would either not occur, or occur at a far lower rate than would a dynastic trust which circumvents tax as one generation passes its assets to another.

Modern planning techniques feature trusts employed to use and leverage the generation-skipping exemptions available to single and married individuals. Appropriate valuation discounting, reverse QTIP elections, and skillful use of general and limited powers of appointment are among these leveraging techniques. Grantor trusts<sup>15</sup> are being increasingly used to enhance the process of estate depletion of wealthy senior family members while benefitting younger family members. In most instances the “tax burn” as a result of the grantor trust status (the trust grantor continues to pay income taxes on the income of the trust while that income passes to the trust beneficiaries or is accumulated in the trust) is more powerful than both discounting and the use of freezing techniques combined.<sup>16</sup>

**Income taxes.** The Perfect Modern Trust addresses concerns about state income taxes by selecting the situs of the trust in a jurisdiction that does not have a state income tax, as described above. The difference in compounding the growth of trust assets by avoiding the impact of state income taxes over a prolonged period of time is quite dramatic.

What about federal income taxes? Many planners steer their clients away from trusts because they focus on the severely compressed federal income tax rates imposed on trusts. Trusts reach the highest tax brackets for the 39.6% rate, the 20% rate on capital gains and qualified dividends, and the net investment income tax at the threshold of just \$12,400 in 2016

(which threshold is adjusted annually for inflation). This thinking (i.e., steering clients away from trusts) is too narrow.

A well-conceived complex trust with the independent trustee given the discretion to “sprinkle” income to, or for the benefit of, all beneficiaries is not locked into the highest tax rates at low thresholds. Distributions to beneficiaries are subject to income taxation at the thresholds of the beneficiaries, which are dramatically higher than the threshold of a trust. Distributions of income by a well-advised distribution trustee can be made to beneficiaries because they need the income, or want the income, or to provide appropriate income tax savings from the trust’s compressed tax brackets. Many beneficiaries are in individual tax brackets well below the top rates. The advisor’s wealthiest clients are already in the

top income tax brackets as individuals, so taxing income in the trust in the same brackets is not a detrimental factor. If the beneficiary is permitted to use certain trust assets, such use is not subject to income taxation.

Bear in mind that the competent inheritor, in the role of investment trustee, has the power in the Perfect Modern Trust to remove and replace the independent trustee. This should increase the likelihood that appropriate and tax-favorable distributions will be made to the competent inheritor.

**Tax basis planning.** Many planners correctly note the importance of income tax basis planning. However, they often advocate outright transfers to beneficiaries at the death of each member of a generation to gain the basis step-up under Section 1014. Again, it is submitted that this thinking is too narrow. Basis planning can be managed. The independent trustee can be given the power to grant a general power of appointment to trust beneficiaries. This will allow the beneficiary to appoint the trust property subject to such a power to themselves, their estate, their creditors, or to the creditors of their estate.

The general power of appointment can be designed so that the power is in reality non-exercisable to prevent an undesirable exercise without affecting its identity as a general power of appointment.<sup>17</sup> If such a power is not exercised, the trust property will pass by default in accordance with the trust dispositive provisions.

**Applicable exclusion planning.** Many permitted trust beneficiaries will not have personal estates exceeding the applicable exclusion from transfer taxes. Granting them a general power of appointment will require inclusion of the trust

property in their estates, and result in a date-of-death value basis to their appointees or to the trust in default of the exercise of the power.<sup>18</sup> When those estates fall short of the taxable threshold, this is a desirable technique with a positive tax planning outcome—improving the value of the assets in the trust to the surviving trust beneficiaries.

Many family members have a valuable asset that will expire at death if not used—their unused applicable exclusion amount. The granting of a general power of appointment to these family members can absorb their unused exclusion while gaining the advantage of a potentially stepped-up basis adjustment. The desired basis adjustment is accomplished here within the wrapper of the Perfect Modern Trust without the necessity to forego the advantages of the trust in pursuit of the desired basis adjustment.<sup>19</sup>

Consider incorporating “upstream beneficiaries” in consideration of how the powers of appointment should be exercised. This suggests granting powers to parents and possibly in-laws or others who have available applicable transfer tax and generation-skipping tax exclusions to allow these beneficiaries, in turn, to pass assets to other family members in younger generations taking advantage of the available exclusions.

Some planners may object to the possible granting of a general power of appointment to a beneficiary out of concern that such a power may be actually exercised by the beneficiary in a manner that may be viewed as somehow detrimental to the interests of the family or the family assets. Does this mean that there must be a difficult choice made between the desired basis adjustment or a potentially unwanted appointment? No.

The general power of appointment status will occur even though (1) the power requires prior notice of its exercise,<sup>20</sup> (2) the power requires the consent of a non-adverse party,<sup>21</sup> or (3) the beneficiary does not know of the existence of the power.<sup>22</sup>

Alternatively, another technique is possible that will accomplish the basis adjustment at the death of a beneficiary without granting the beneficiary the “freedom” of a general power of appointment. That is the technique known as the “Delaware tax trap.”

**Delaware tax trap.** While it is certainly the broad general rule that possessing or exercising a limited power of appointment does not result in a taxable transfer for federal estate and gift tax purposes, one important exception is notable. This exception refers to what is known as the “Delaware tax trap.”<sup>23</sup>

Under Delaware’s rule against perpetuities as it existed prior to 1995 (when the rule was abolished), the rule applied to trusts created by the exercise of a power of

<sup>17</sup> Section 2041. See the material below and footnotes 20 through 22, *infra*.

<sup>18</sup> Sections 1014 and 2041.

<sup>19</sup> For those trusts that are not GST exempt, the use of a trust beneficiary’s available GST exemption is obtainable. Further discussion of that opportunity is beyond the scope of this article.

<sup>20</sup> Reg. 20.2041-3(b).

<sup>21</sup> Section 2041(b)(1)(C)(2).

<sup>22</sup> Estate of Freeman, 67 TC 202 (1976).

<sup>23</sup> Sections 2041(a)(3) and 2514(d).

<sup>24</sup> For two outstanding discussions on this topic, see Morrow, “The Optimal Basis Increase and Income Tax Efficiency Trust,” available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2436964](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2436964) (last viewed 10/9/2015) or from the author at [edwin.morrow3@gmail.com](mailto:edwin.morrow3@gmail.com); Lee, “Run the Basis and Catch Maximum Tax Savings—Part 1,” 42 ETPL 3 (January 2015), and Lee, “Run the Basis and Catch Maximum Tax Savings—Part 2,” 42 ETPL 11 (February 2015) For a comprehensive comparison of using a formula general power of appointment rather than the Delaware tax trap, see Morrow, “The Optimal Basis Increase and Income Tax Efficiency Trust,” available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2436964](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2436964) (last viewed 10/9/2015) or from the author at [edwin.morrow3@gmail.com](mailto:edwin.morrow3@gmail.com).

<sup>25</sup> Rev. Rul. 2004-64, 2004-2 CB 7.

appointment measured from the time of the power's exercise, rather than from the time of the trust's creation. Thus, a perpetual trust was possible in Delaware by simply creating and exercising successive powers of appointment.

To prevent this result, Congress enacted what became Section 2041(a)(3), which subjects a trust to federal estate tax at a beneficiary's death if the beneficiary "exercises a power of appointment created after October 21, 1942 by creating another power of appointment which under applicable local law can be validly exercised so as to postpone the vesting of any estate or interest in such property, or suspend the absolute ownership or power of alienation of such property, for a period ascertainable without regard to the date of the creation of the first power." In short, the Delaware tax trap may be an issue when a beneficiary may exercise a non-general power of appointment to create a successive non-general power of appointment that can extend the term of the trust beyond the duration originally contemplated.

Consider using the Delaware tax trap as a strategy to intentionally include property in a decedent's estate that would otherwise be excluded where the decedent exercises the limited power so as to "spring" the trap.<sup>24</sup> This should be considered in an estate where the estate tax and GST exclusions will not be exceeded, but where a stepped-up basis at the death of the power-holder can be obtained by having the power-holder exercise the power—resulting in an estate inclusion that will not be subject to transfer tax, will not give the power-holder a possibly "dangerous" general power of appointment, but that will achieve a date of death value as the basis for the heirs.

**Basis bump planning.** This important focus on the basis of inherited assets may be referred to as "basis bump planning." It is at the intersection of estate planning and income tax planning. Because many family members are likely to have personal estates that fall short of the applicable transfer tax exclusion available to them, having an active independent trustee or trust protector monitoring the wealth of family members will allow the trustee to grant appropriate powers of appointment to those persons with "room" in their personal wealth to accept additional assets as includable in their estates for transfer tax purposes without generating transfer tax liability, and either exercising such powers in favor of surviving trust beneficiaries to be continued to be held in the dynastic trust, or allowing the same result to occur through lapse provisions if the powers are not exercised.

Consider the benefits of this planning when the family assets may consist of low-basis real estate investments that may have been the subject of a series of Section 1031 exchanges, or properties with negative basis implications. The opportunity to gain a step-up in the basis of these assets for depreciation or sale purposes is substantial. This planning avoids any implications of the applicability of Section 1014(e) (which denies basis adjustments when property is transferred by a person to another who dies within one year and the property returns to the original transferor). Here, the independent trustee or trust protector can grant the appropriate power of appointment in close proximity to the recipient's death, and the rules of Sections 2041 and 1014 should allow the estate inclusion and the corresponding basis adjustment.

**Grantor trust.** Where beneficiaries have their own assets outside the Perfect Modern Trust, planning suggests that they be owned in a grantor trust designed to have all of the income taxed to the grantor. Strategies designed to cause the trust grantor to "tax burn" the trust assets and deplete his or her estate in the payment of income taxes are useful not only in the context of income tax planning, but they also serve to compress the grantor's estate for purposes of possible creditor access.

When the grantor pays his or her own income tax liability, thereby reducing his or her estate, the grantor is satisfying his or her own obligations, and is not making a gift to other trust beneficiaries or committing a fraud on creditors.<sup>25</sup> Moreover, the grantor trust status will enable the trust to sell before death low-basis assets to the beneficiary in exchange for high-basis assets or cash of the same amount. That exchange is a very powerful planning opportunity and can take place at any time before death.

## Conclusion

The Perfect Modern Trust is an estate planner's answer to a variety of client needs and wishes. It can allow a client to maximize the control granted over trust assets while allowing flexibility for changed circumstances, asset protection from creditors, and favorable tax treatment. Part 2 of this article, which will be published in a subsequent issue of ESTATE PLANNING, will explore how the Perfect Modern Trust outperforms conventional trust planning techniques and will identify common client misconceptions that estate planners should be prepared to clear up. ■