Protecting & Preserving Wealth Into The Next Millennium

THIS ARTICLE DISCUSSES THE CONCEPT that all significant gifts or bequests should be made in trust because more benefits can be given to beneficiaries if property is conveyed in trust than if wealth is received by gift or bequest outright. It examines how the principal beneficiaries can have the equivalent of outright ownership of the trust assets, including undisturbed control, while still enjoying tax and creditor benefits not available with outright ownership.

Editor's Note: This is the second in a two-part series on protecting and preserving family wealth.

Opportunity Shifting

One of the best, yet often overlooked, techniques to avoid the transfer tax system is the shifting or deflecting of the opportunity to earn income or generate wealth from the client to others, including trusts. For planning purposes, it is far simpler, less risky and more tax efficient to shift the opportunity to create wealth at the inception of an undertaking than to move wealth once value has matured and has become substantial. The shifting of an opportunity does not involve a transfer and therefore finesses the transfer tax.

In its simplest form, if a person was to refer business, customers or clients to another person, or give some gratuitous advice to the other person, no one would think a transfer subject to the gift tax has occurred. Those activities happen frequently. Similarly, the shifting of a business or investment opportunity is not an event that gives rise to the imposition of a gift tax, even if the result is detrimental to the referring party.

Thus, when a new business is formed, a new product is being developed, a new location is being considered 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 placed in irrevocable trusts. In many instances the "seed" money is negligible to enable the recipient of the opportunity to acquire a significant interest in a venture that can reasonably be predicted to explode in value. Moreover, a referring family member can determine how much opportunity to shift, and can structure the entity accordingly. Thus, the entity design can include a scenario whereby the opportunity provider obtains complete control of the new venture even though he or she owns only a small sliver of it.[29] For example, control of the general partner in a limited partnership, manager of a limited liability company or holder of the only share of voting stock in a corporation will obtain such a result.

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A capital structure whereby the opportunity shifter receives control of the entity will subject to the transfer tax system only the interest owned and not the opportunity "transferred." In addition, at such time as the retained interest is ultimately transferred, it should be taxed at a mere fraction of what the interest really means to its owner. The courts have generally imposed a relatively modest control premium when valuing a controlling interest in an entity. For example, in *Estate of Curry v. United States*,[30] the decedent had a controlling interest in the corporation large enough to liquidate the corporation under state law. The court held that the ability to cause a dissolution or liquidation should be ignored in the valuation process, stating:

> "[t]he chief problem with this argument [the Service's contention that the power to liquidate should result in a valuation no less than the proportionate liquidation value of the corporate assets] is its assumption that the controlling seller, or a party to whom he sold his interest, could automatically liquidate the company to realize its assets' value, unconstrained by the rigorous fiduciary duties that attach to possession of a controlling equity interest. While it is true that Indiana law permits a majority inter-

est to effect a liquidation of a corporation...it is settled law that the power to cause such extraordinary corporate actions as dissolution or liquidation may not be exercised without scrupulous loyalty to the interests of minority shareholders.... Indeed, the fiduciary duty owed to the minority interests is even greater where, as here, the corporation is small, non-public and closely held."

Because of the fiduciary obligation owed to non-controlling owners, the benefits that a controlling owner can derive are relatively minor. Therefore, the premium for control attributable to a controlling interest has generally been negligible.[31] In fact, in many cases the incremental increase for control has been more than offset by discounts for lack of marketability.[32]

An often cited illustration of the opportunity shifting strategy occurred where the senior members of the Lauder family, which owned the Estee Lauder Company, shifted the opportunity to develop the successful Clinique and Aramis products down a generation.[33] Had the senior Lauder family members desired control, the new entity could have been structured whereby the senior Lauders owned a one percent or less interest in the entity of choice, which interest would be designed to control the entity. Moreover, tax and creditor protection benefits could have been obtained had the wealth shifting opportunity been given to trusts for the benefit of their children, Leonard and Ronald, and their descendants rather than to them outright.

The Lauder-type plan is not an isolated instance but only an illustration of the opportunity shifting concept. Indeed, these planning opportunities occur often. The problem is that very few of these potential value shifting possibilities are exploited in the real world. This inaction is probably due primarily to several factors, including that many opportunity shifting situations are not recognized, to a large degree there is indifference on the part of many planners and their clients, and also possibly because the concept is more one of common sense than being a technical legal planning device that would likely be the subject of articles, speeches and other professional training. Further, since this is a strategy for moving wealth outside the scope of the transfer tax system, it is usually also not the subject of cases or rulings unless an error was made. The reason little attention is given to this type of undertaking is that in most instances where opportunity shifting occurs there is no reporting since there is no "transfer" that necessitates the filing of a tax return. Thus, it is reasonable to assume that much of this planning is not a result of strategizing, but rather is the result of wealthy people just using some common sense without recognizing that their actions have favorable estate planning results. Hopefully, they will recognize the beneficial implications of such actions and that the recipient of the wealth generating activity should be an irrevocable trust.

There are a myriad of situations in which this type of tax-free, intrafamily diversion of wealth is often overlooked. For instance, assume that a child wishes to go into the same business as his parents, just like the Lauder children. Rather than join the parents, irrevocable trusts can be set up to hold a newly formed entity, and the parents can refer some of their companies' business to the trust-owned entity. A striking illustration of this occurs in the situation where both the parents and children are developers, and the parents wish to retire during the next few years and pass the business to their descendants. A direct transfer often has costly tax implications. With proper advance planning, the tax bite can be mitigated or negated through the process of referrals by the parents to the children's trust-owned entity. This will have the dual effect of ballooning the value of the trust while concomitantly reducing the value of the parents' entity, perhaps over time even to zero, negating the necessity of selling or gifting the parents' entity to the trust.

An impressive variation of the opportunity shifting strategy exists where the child's trust owns a collateral business to which the parents may refer business. To illustrate, assume that the owner of a retail business wants to shift wealth that would inure to his own benefit if the estate and business planning process is not undertaken. The business owner could set up trusts for the benefit of his descendants (and perhaps his spouse) that does installation, repairs and warranty work on products sold by the retail business. The business owner would refer customers to the trust-owned entity for the service work. Additional sources of collateral fees could be generated by having a trust-owned entity (separate from the installation and repair shop for liability purposes) acquire, own and lease furniture, equipment or an office building to the business. The fact patterns under which opportunity shifting strategies can be employed are extensive and are virtually limited only by the imagination of the planner as long as the planner and/or client have been sensitized to the existence of the technique and its effectiveness as a tax avoidance and creditor protection device.

Not only does the use of multiple entities make sense from a tax planning perspective, but it also provides asset protection benefits.[34] Clients often want to keep things simple and put their business into a single large entity. Advisors, on the other hand, can be more effective using multiple entities.[35] From an asset protection standpoint, using multiple entities protects the assets of all entities other than the entity where the liability occurred. On the other hand, a single integrated entity subjects all of the entity's assets to any liability.

Getting An Advance On Your Inheritance

Estate planners tend to look down generations for planning purposes. Typically, the only upstream inquiries made as to the economic situation of the parents are whether the client anticipates an inheritance that should be taken into account in planning the client's estate, and whether the client may need to provide support for a parent in case of an unusual order of deaths. Planners often overlook inquiring as to whether the client's parent has the ability and inclination to fund a trust for the client's benefit. Even persons of somewhat modest means can often come up with, and are willing to part with, sufficient seed money for a predictably "hot" investment or business venture, such as a new business entity that will be designed to receive referrals from a present successful business, or another opportunity shifting scenario.

Many of our clients have the ability to take a small amount of money and create large wealth. An extraordinary opportunity exists by looking up a generation as part of the planning process. When the client is about to embark on a new venture or has an investment opportunity with significant potential, consideration should be given to having the client's parent(s) create and fund a trust for the client. Money placed in a dynastic beneficiary controlled trust funded by the client's parent(s) would provide the "seed" money for any such anticipated business venture or investment. As long as the client is not the original source of the "seed" money, that course of action would result in the transaction being recast as a trust created by the client under the step transaction or agency theories, the normal rules of taxation should apply and the existence of the trust should be respected for both tax and asset protection purposes. Thus, the client can control the trust by being trustee, and can benefit from the trust assets as the primary beneficiary. An even more potent planning opportunity exists where the senior generation sets up a beneficiary defective trust, a concept discussed later in this article.

The Defective Trust Concept

A trust that is taxed to the grantor is commonly known as a "grantor trust" or a "defective trust." A trust that violates one or more of the provisions contained in IRC Sec. 673-679 is a defective trust for income tax purposes. If a transfer to a trust is not a completed gift, the trust is defective for gift tax purposes. A trust that is includible in the grantor's estate is defective for estate tax purposes. Since the grantor trust rules are different for income tax purposes than they are for transfer tax purposes, grantor trust exposure for either income tax purposes or transfer tax purposes or both depends upon which code sections are being violated.[36]

Notwithstanding the foregoing, this article will use the term "defective trust" to refer to trusts that are defective solely for income tax purposes. Thus, as used herein, a transfer to a trust that has grantor status for income tax purposes will be a completed gift and outside the estate for estate and GST tax purposes.

The fact that the grantor trust rules do not work in pari materia creates some extremely attractive planning opportunities. In designing a trust to obtain the benefits discussed herein, it is imperative that the "defect" selected to secure grantor trust status for income tax purposes does not result in inclusion in the grantor's estate. It is also important that the violation affects both ordinary income and corpus and will infect the entire trust and not just a portion of the trust with the result that the grantor (or other person) will be treated as the owner of the entire trust and will be taxed on, and report, all items of income, deductions and credits on his return.[37]

Just as it is desirable in GST tax planning that trusts be entirely exempt or entirely non-exempt, singular income tax status for a trust is also strongly recommended. If a trust has hybrid tax consequences, in many instances planning is restricted because the consequences of an action may have partially positive results and partially negative results.

Dual tax treatment may also create an accounting nightmare. Consider, for example, Letter Ruling 9034004 which is illustrative of the Service's position on the proper way to compute the income tax consequences with respect to the lapse of a power of withdrawal for a trust that is otherwise not defective. The Service ruled that not only is there a pro rata grantor trust exposure to the powerholder as to the amount lapsing, but that such exposure will increase each time a withdrawal power lapses. In order to avoid this cascading transition in tax reporting, it is important that separate trusts be created if the funding would otherwise result in different income tax consequences.

It is also advisable not to have more than one grantor for each trust if the trust is defective. For example, husband and wife should not both be grantors of the same trust. In such instance, on the death of one spouse, grantor trust status will cease to the portion of the trust previously "owned" by the decedent, resulting in hybrid income tax treatment thereafter.

The tax benefits of creating a defective trust 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. This benefit was stated by Prof. Ed Halbach as follows:

> "[A] settlor sometimes wishes to be taxable on trust income that is nevertheless payable to an adult child whose tax bracket is comparable to that of the settlor. By paying the income tax that would otherwise be charged to the child, the settlor makes what amounts to an additional transfer to the child each year without having an additional taxable gift."[38]

Because Ed's article was written two years prior to the enactment of the current GST tax, he did not discuss the beneficial GST tax implications that are even more dramatic than the gift tax benefits because the benefits grow exponentially.

To illustrate, consider a trust

Exhibit A

Economics

Assumptions: $1 million; Trust lasts 120 years and earns 8%; 55% Transfer tax every 30 years

• No Trust – $420,436,792 • Dynastic Trust – $10,252,992,943

Annual After-Tax Growth	Value of Dynastic Trust After 120 Years	Value of Property If No Trust*
6.00%	$1,088,187,748	$44,622,499
7.00%	$3,357,788,383	$137,690,310
8.00%	$10,252,992,943	$420,436,792
9.00%	$30,987,015,749	$1,270,661,315
10.00%	$92,709,068,818	$3,801,651,253
11.00%	$274,635,993,245	$11,261,792,198
12.00%	$805,680,255,013	$33,037,925,957

*Note That It Is Reasonable To Assume That This Amount Will Be Further Diminished By Divorce And Lawsuits.

funded with $1 million that earns ordinary income of 10 percent per annum and that both the trust and the grantor (or another person who would be treated as the owner of the trust for income tax purposes) are in the 40 percent income tax bracket. If the trust paid the tax, the effective growth rate of the trust would be six percent per annum. If, however, the tax were paid outside of the trust, the growth rate would be 10 percent per annum. After 30 years, the trust would grow to $5,743,491 if the trust paid the tax, and to $17,449,402 if the trust were defective. (See also Exhibit A illustrating the enormous difference even one percent makes where there is tax-free compounding over an extended period.)

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. The Service appeared to take the position several years ago in a controversial private letter ruling[39] that if the grantor was not reimbursed for tax he paid on account of income earned by the trust, a gift would be made for the taxes paid. In the ruling, reimbursement was required by the trust indenture. Thus, the conclusion reached by the ruling was proper. By not enforcing his right to reimbursement, a gift was made by the grantor. The ruling, however, contained some dicta that indicated the Service also felt a gift would have occurred if the trust did not contain a reimbursement provision. In reaction to strong criticism, the Service recanted on that position, issuing a private letter ruling deleting the controversial language.[40]

3. By designing the trust as a grantor trust, it will qualify as a permissible shareholder of an S corporation.[41]

4. Transactions between the trust and its "owner" are not recognized for income tax purposes.[42] Thus, techniques such as installment note sales and sales of non-controlling interests work well in this tax environment. In addition to the enormous tax planning opportunities available, the ability of the trust owner to deal with the trust itself is a valuable feature. This enables the trust owner to access cash earned by the trust in exchange for appreciated assets without the imposition of tax on the transaction.

5. A defective trust can acquire a life 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. Since for all intents and purposes the existence of the trust will be ignored for income tax purposes, this transaction will fall within one of the exceptions to the transfer for value rule[43] and will be treated as a sale to the insured. Moreover, if a third party, such as the insured's spouse, owned the policy, the spouse could sell it to a trust that is defective as to the insured.[44] By contrast, if the insured's spouse had gifted it to the trust and was a beneficiary of the trust, the transaction would be treated as a transfer with a retained interest, resulting in inclusion in the estate of the insured's spouse.[45]

The transfer tax results of *Crummey* powers of withdrawal are quite familiar to estate planners, particularly through experience obtained in working with irrevocable life insurance trusts. On the other hand, little thought or attention has been given to the income tax consequences of such powers. Unfortunately, even though *Crummey* powers have been used for over 30 years, the income tax consequences of these powers in many instances are uncertain. In part, this lack of clarity is a result of a drafting error in IRC Sec. 678(b), and also in part, from the questionable interpretation given to IRC Sec. 678(a)(2) by the Service in its rulings. We will discuss several issues in this section, including:

1. The income tax consequences of a trust funded solely with gifts subject to a power of withdrawal where the trust is not a trust that is also taxable to the transferor.

2. The income tax consequences of a power of withdrawal where the transferor is deemed the owner of the trust under Subchapter J.

3. The effect of the lapse of a power of withdrawal.

4. The effect of the cessation of grantor trust status as to the transferor where the trust is funded with gifts subject to powers of withdrawal.

The Service's ruling position over the last several years has been that where all transfers to a trust are subject to a withdrawal power by the beneficiary, the powerholder is treated as the owner of the trust under IRC Sec. 678(a).[46] For any lapses of the power to withdraw, the Service uses a "withdrawal-recontribution" theory. Thus, according to the Service, for income tax purposes the situation is treated as if the powerholder withdrew the property and then recontributed it to the trust. Therefore, grantor trust status usually continues as to the beneficiary.[47]

If, on the other hand, the trust has dual grantor trust status under IRC Sec. 678 and under one or more of the other grantor trust provisions, it is the Service's position that the grantor trust status as to the creator of the trust supersedes the grantor trust status obtained under IRC Sec. 678(a) as to the beneficiary.[48]

The Statutory Scheme - General Rule. Sec. 678(a) sets forth the general rule that a person other than the grantor will be treated as the owner of any portion of a trust for income tax purposes if that person has the power exercisable solely by himself to vest the corpus or the income in himself,[49] or if that person has previously partially released or otherwise modified this power, and after the release or modification retained such control as would, within the principles of the grantor trust rules with respect to the trust creator, subject the grantor of the trust to treatment as the owner.[50]

A person having a withdrawal right has the type of power described in Sec. 678(a)(1), because such person has the power exercisable solely by himself to vest the corpus in himself. Thus, under Sec. 678(a)(1), it is clear that the owner of a withdrawal power should be treated as the owner during such time as the withdrawal power is outstanding.

Effect of a Lapse. What happens after the power lapses upon its nonexercise? Now the analysis shifts to Sec. 678(a)(2). The Service's position is that the powerholder is treated as having partially released the power, and that consequently the powerholder remains the taxpayer after the lapse.[51] The Service's position appears to be technically flawed in that the rulings hold that a "lapse" of the withdrawal power is tantamount to a "release." However, they are not identical. A "release" requires an overt, affirmative act by the powerholder. A "lapse" is the result of a passive nonexercise of the power.

For transfer tax purposes, a "lapse" and a "release" are not synonymous. Both Sec. 2041(b)(2) and Sec. 2514(e) recognize that they are not identical, stating "[t]he lapse of a power...shall be considered a release of a power." The income tax provisions (and more specifically, IRC Sec. 678) do not contain a similar provision. It appears that the Service is attempting to use a transfer tax theory, that grantor trust status continues after a power is released, in the context of the income tax. This interpretation of a lapse as being a release in such circumstances is without statutory authority and is dubious at best. The proper technical answer, notwithstanding the Service's position to the contrary, appears to be that with regard to a lapsed withdrawal power, IRC Sec. 678(a)(1) does not apply because the power has lapsed, and IRC Sec. 678(a)(2) should not apply because there was not a partial release; there was a lapse.

In many cases in which a withdrawal right has lapsed, the beneficiary retains, after the lapse, the right to discretionary distributions from the trust which, had the beneficiary been the trust creator, would have caused him to be treated as the owner under Sec. 677(a)(1).[52] If this is not the case, then to assure that the trust is defective with respect to the powerholder after the lapse, the powerholder should be given another grantor trust power.

For example, in Letter Ruling 9311021, the grantor created separate irrevocable trusts for each of his three sons and desired to make each son owner of the entire trust under Sec. 678 so that the trust could own stock in an S corporation. The trusts were discretionary trusts as to both income and corpus. In addition, the primary beneficiary of each trust had the right at any time to exchange all or any part of the trust property by substituting for it property of equal value. The ruling held that the Sec. 675(4)(c) power of substitution enabled the beneficiary to maintain grantor trust status after the lapse. The ruling stated:

> "The primary beneficiary is treated as the owner of that portion of the trust in that his withdrawal right has not yet lapsed under Sec. 678(a)(1) of the Code, because of his ability to withdraw any additions to the trust. In addition, upon the lapse of the withdrawal power the primary beneficiary still has a Sec. 675(4)(C) power over the trust property because he may, at his option, exercisable in a non-fiduciary capacity, acquire all or any part of the property of the trust by exchanging for it property of equal value. Thus, under Sec. 678(a)(2), the primary beneficiary is also treated as the owner of the trust property for which his withdrawal power has lapsed. Therefore, the primary beneficiaries, A, B, and C, are treated as the owners of their entire trust, Trust A, Trust B, and Trust C, respectively, under Sec. 678."

Multiple Grantors Having Possible Grantor Trust Status. To muddy up the water even further, IRC Sec. 678(b) provides an exception to the general rule that a person other than the grantor will be treated as the owner for income tax purposes. The heading of Sec. 678(b) states, "Exception Where Grantor is Taxable." The Service's and most practitioners' belief is that Sec. 678(b) overrides the Sec. 678(a) general rule in trusts funded with *Crummey* gifts. The statute, however, provides that the general rule of Sec. 678(a) "...shall not apply with respect to a power over *income*..." (emphasis supplied). A *Crummey* power is a power over principal, not income. When the statute is read literally, the Sec. 678(b) exception should not apply to the general rule of Sec. 678(a) that addresses the power to vest both "...the *corpus* or the *income*..." (emphasis supplied) in oneself.

The problem with this is that the Committee reports make it apparent that the language of Sec. 678(b) contains a drafting error and that it was intended to deal with a power over income and corpus, echoing the language contained in Sec. 678(a)(1). This drafting error has been left uncorrected since 1954. Therefore, if one respects what the Committee reports say (and what Congress appears to have intended), the result would be that the trust should be taxable to the grantor.[53] If one believes what the statute says, the Sec. 678(b) exception should not apply and the *Crummey* power should be governed by Sec. 678(a), there-by resulting in the trust being taxable to the beneficiary.

Cessation of Transferor's Grantor Trust Status When Using Crummey. The traditional route in making annual exclusion gifts in trust is to create a single pot trust with multiple powers of withdrawal. Many of these trusts are created to hold life insurance and, according to the Service, are grantor trusts even though *Crummey* powers of withdrawal are granted.[54]

If a trust is funded with gifts subject to a power of withdrawal, but is otherwise defective as to the grantor under IRC Sec. 678(b) and one or more of IRC Sec. 673-677, an issue arises as to the proper income tax treatment of the trust after the trust is no longer defective as to the grantor. This issue will arise at the death of the grantor or upon another event, such as a lapse or release of the grantor trust powers.

In Letter Ruling 9026036, the beneficiary of the trust was given a power of withdrawal for a period of 30 days. After the lapse of the power, the beneficiary retained a power over the trust that would have caused it to be defective to him had he been the grantor. The grantor of the trust also retained a power over the trust that caused it to be defective to her. The Service ruled that upon the death of the grantor, the beneficiary would be treated as the owner of the income and corpus of the trust for income tax purposes. The Service did not give any reasoning for this conclusion. Letter Ruling 9026036 was withdrawn by the Service in 1993 and replaced with Letter Ruling 9321050.

Letter Ruling 9321050 revisited the same facts as Letter Ruling 9026036. This time, however, the Service ruled that the beneficiary would not be treated as the owner of the income or the corpus of the trust for income tax purposes. Again, the Service failed to provide any reasoning. The conclusion reached in Letter Ruling 9026036 seems to be more logical and proper than the holding in Letter Ruling 9321050.

As a practical matter, the reversal of the Service's position will stop most practitioners from treating the beneficiary as the owner for income tax purposes, unless and until there is judicial resolution to the contrary. Consideration might be given to structuring the trust so that it could accommodate sales if the Service changes its position or the position is rejected by the courts or, preferably, by adopting one of the strategies discussed in the next section of this article relating to beneficiary defective trusts. Since most Crummey trusts are used for the acquisition of life insurance, separate trusts could be set up for each powerholder and used for installment sales of appreciated assets if after the policy matures the status of the law is that there is grantor trust treatment as to the beneficiary.

IRC Sec. 678(a) — Beneficiary Defective Trusts

A strategy that in many instances can exceed the benefits of the traditional defective trust where the donor pays the tax is a trust arrangement where the donee/beneficiary is treated as the owner of the trust income under IRC Sec. 678(a). The result could be accomplished by funding the trust solely with gifts subject to a power of withdrawal, provided that the trust is not a trust that would be taxed to its creator. In such instance, the powerholder, who is treated as the owner, will have a trust with which he or she can transact, tax-free, and take advantage of the same estate planning opportunities the grantor would have in a trust defective as to the creator. Moreover, a trust defective as to the beneficiary may offer superior benefits in that the powerholder/beneficiary may be the trustee and also enjoy the benefits of the trust assets.

Under this scenario, the gifts need not be limited to the annual exclusion in order to obtain IRC Sec. 678(a) treatment. As long as the beneficiary is given a power of withdrawal over the entire contribution, the entire trust would be defective as to the beneficiary. If the gifts were subject to a hanging power of withdrawal, the beneficiary would have estate tax inclusion only to the extent of the amount hanging at his death. All lapsed amounts and appreciation would not be includible. Because the funding will be done with "hot" assets, the lapses should occur rapidly under the five percent "safe harbor" rule permitted by IRC Sec. 2514(e).

This proposed alternative can combine both the virtues of defective trusts and the enhancements that are generally inherent in trusts. For instance, assume that a wealthy client has a business opportunity that he predicts will be successful. The client suggests, and his parent agrees, that the parent set up and fund a trust for the client and his descendants. The trust is structured as both a beneficiary controlled trust and a beneficiary defective trust. The client can (i) manage and control the trust assets as the trustee; (ii) be the primary beneficiary of the trust; (iii) have a broad power of appointment to give the property to anyone other than himself, his estate, his creditors or the creditors of his estate; and (iv) make income tax-free installment note sales to the trust.[55] The trust assets would be transfer tax exempt as well as divorce and creditor protected.[56]

Under the right fact pattern, it appears that over time the transfer tax exposure of many wealthy estate owners could be virtually eroded using this strategy. The income earned by a new venture (through opportunity shifting) could be used to acquire wealth presently owned by the estate owner, income tax-free, taking advantage of leveraging techniques such as installment note sales of non-controlling interests. Both the new venture and the acquired interests can provide cash flow to acquire assets presently owned by the client personally.[57]

To illustrate the foregoing, assume a savvy businessman has an opportunity to develop a new product, open a new location, create a collateral business or make a favorable investment that requires a $200,000 capital contribution. The businessman's parent is able to supply the seed money and sets up a dynastic trust, giving the businessman a hanging power of withdrawal over the entire contribution, but providing that the power will lapse as to the greater of five percent or $5,000 per annum. Under IRC Sec. 678(a) the beneficiary will be taxed on all of the income. If the beneficiary dies prior to the full lapse of the power of withdrawal, the amount that could have been withdrawn at the date of death would be includible in the businessman's estate.[58] If we assume that the favorable business opportunity grows to a value of $500,000 in the first year, $1 million in the second year and $2.5 million in the third year, the portion of the $200,000 annually lapsing would be $25,000, $50,000 and $125,000 respectively based upon five percent of the trust each year, so that the businessman's estate tax exposure would end after three years.

Under this arrangement, the beneficiary can aggressively defund his estate based upon the security of the trust that can be designed to give him control and use of the very assets he originally owned. The result of this arrangement should be transfer tax neutral as long as the client received fair market value for the property sold.[59]

In structuring beneficiary defective trusts, the following caveats should be kept in mind. First, a popular method of funding a defective trust is to use an installment sale whereby interest is computed by reference to the IRS tables under IRC Sec. 1274. Although this method is acceptable for tax purposes, it may not reflect the fair value for creditors' rights or divorce purposes. Thus, it would be prudent, under circumstances where a beneficiary makes a sale to the trust, to use an interest rate that is reflective of interest that strangers would use in the outside world rather than the rates under the tables.

Secondly, the trust should be made defective only as to one beneficiary. Each trust can have more than one beneficiary, but the power of withdrawal for each trust should be limited to one beneficiary. If gifts subject to a power of withdrawal are made to more than one beneficiary in a single trust, the trust would be defective as to each beneficiary in proportion to the value of the property subject to that beneficiary's power of withdrawal.

If the trust is not wholly defective as to only one beneficiary, then sales by the beneficiaries to the trust will be partially income tax-free and partially subject to income tax.In addition, adverse income tax problems can result in a transaction with the trust where the trust would have gain, such as in an instance where the trust makes a payment with an appreciated asset.Thus, having multiple "owners" of the trust for income tax purposes reduces flexibility and in many instances is incompatible with the sale to a defective trust technique.

Leveraging The Generation-Skipping Transfer Tax Exemption

Similar to the strategies that are commonly used to leverage the estate and gift tax exemption, the $1 million GST tax exemption is leveraged using a combination of valuation discounting techniques. The rest of this article will focus on some of the most powerful leveraging techniques available to the practitioner.

In order to further enhance the benefits obtained by using a generation-skipping trust, the term of the trust should be extended for as long as possible. Most states have a rule against perpetuities that limits the duration of trusts. The rule against perpetuities typically states that a trust must vest no later than 21 years after the death of all lives in being who are living when the trust becomes irrevocable.

Seven states do not limit the term of a trust: Alaska, Arizona, Delaware, Idaho, Illinois, South Dakota and Wisconsin. In these states, a trust can continue forever. It is not essential that the grantor live in any of these seven states in order to take advantage of these favorable laws. All that is generally necessary is that at least one trustee resides in the desired state and that there is sufficient activity in that state to give it jurisdiction. If the client is not inclined to bring one of these states' perpetuities laws into play, careful selection of measuring lives in a well-drafted perpetuities savings clause (e.g., descendants of the grantor's parents, or the grantor's grandparents, alive when the transfer is made) can virtually assure that the vesting for perpetuity purposes will not occur for over 100 years. Since vesting will not result in tax, the transfer tax on the trust assets will be postponed further into the future until the death of the vested beneficiary. It is difficult to imagine a more superior estate plan than one that gives the primary beneficiary the control over the trust assets at each generational level, without the assets and their accumulated income and growth ever being subject to estate, gift or GST taxes, and which provides creditor and spousal protection forever.

All other things being equal, the trust vehicle can be further enhanced by domiciling the trust in a state with no state income tax. Of the seven states with no rule against perpetuities, Alaska and South Dakota are the only ones with no state income tax. Delaware and Illinois both have a state income tax, but the tax does not apply to nonresident grantors. Arizona, Idaho and Wisconsin have state income taxes that can reach 5.17 percent, 8.2 percent and 6.93 percent, respectively.

Many trusts are drafted so that they are defective for income tax purposes. As long as the trust is defective, no immediate income tax benefits will be derived from domiciling the trust in a state with no income tax. The benefits will be substantial, however, once the trust is no longer defective. At that point, in most instances, the trust will grow state income tax-free, creating a significant difference in the size of the trust as the trust continues to accumulate into perpetuity.[60] See Exhibit A which illustrates the enormous difference one percent makes in compounding over 120 years. Such a differential might be solely attributable to state income taxes.

Installment Sale To A Defective Trust

An installment sale to a defective trust in exchange for the trust's promissory note has become an increasingly popular wealth transfer strategy that offers many significant benefits.[61] Generally, this technique is used to sell non-controlling interests in entities such as limited partnerships, LLCs and corporations, particularly S corporations, to defective dynastic trusts, taking advantage of valuation discounts. Other presumptively undervalued assets such as options or lettered stock are also excellent candidates for this technique. The trust is set up as a grantor trust by intentionally violating one or more of the grantor trust rules. Typically, the note is structured as interest-only for a period of time with a balloon payment at the end of the term and a right of prepayment.

The IRS has opined in Rev. Rul. 85-13, and in several private letter rulings, that transactions between a trust and its owner for income tax purposes will be ignored. Thus, the person who is treated as the "owner" of the trust for income tax purposes can sell an asset to the trust without any income tax ramifications.[62] In addition, the trust can satisfy its obligation with appreciated assets without income tax consequences. For income tax purposes, it is as if the trust did not exist.

The sale of assets at a discount is significantly enhanced by leveraging the sale using a deferred payment. The interest-only installment sale with a balloon payment will be illustrated herein, but a private annuity, annuity per autre vie, or self-cancelling installment note might also be considered if the client's situation makes one of these alternatives more favorable.[63]

The technique can best be illustrated by an example. Assume that the grantor gifts $100,000 to a defective trust and allocates $100,000 of gift tax exemption and $100,000 of GST tax exemption to the transfer with the result that the trust is wholly exempt from transfer taxes. The grantor then sells to the trust a limited partnership interest with a pro rata value of $1,666,667 (and a fair market value of $1,000,000 after a 40 percent discount) in exchange for an interest-only promissory note with a balloon payment of $1,000,000 due after nine years. The sale is for fair market value so that no additional gift tax exemption or GST tax exemption needs to be allocated to the trust.

If the partnership assets and the initial $100,000 gift are both earning income at a rate of 10 percent each year, then the trust will have an additional $176,667 (i.e., 10 percent of $1,666,667 plus 10 percent of $100,000) at the end of the first year. Using the April 1998 IRC Sec. 1274(d) federal mid-term rate of 5.70 percent, the interest payable from the trust to the grantor at the end of the year would be 5.70 percent of $1,000,000, or $57,000. Each year, the trust continues to accumulate much more income than it must pay back to the grantor since (i) the trust is increasing income tax-free, and (ii) the interest is calculated against the discounted fair market value of the limited partnership interest.

If the grantor were to die immediately after entering into the sales agreement, his estate would be reduced by the $1,666,667 pro rata value of the partnership assets and would be increased by the promissory note with a face value of only $1,000,000. This would result in an immediate savings of the estate tax on the difference between the two figures. In addition, the promissory note may be further discounted because of its long-term and low interest rate.

Sale to Defective Trust Compared to GRAT. The installment sale to a defective trust technique resembles a grantor retained annuity trust (GRAT). A GRAT is an irrevocable trust in which the grantor retains the right to receive an annuity for a fixed term, at which time the remaining trust assets pass to the remaindermen or to trusts for their benefit without any further gift tax implications.[64]

In most respects, the installment sale to a defective trust technique is superior to the GRAT technique (see Exhibit B). In contrast to the sale technique, one shortfall of the GRAT is that GST tax exemption may not be allocated until the end of the initial term of the trust, thus precluding leveraging of the GST tax. Under IRC Sec. 2642(f), the GST tax exemption may not be allocated during the estate tax inclusion period (ETIP), which is any period in which the trust would be included in the grantor's estate if the grantor were to die, other than by reason of the three-year rule under IRC Sec. 2035. Conversely, the sale technique does not have an ETIP problem since no interest in the trust is retained that would make the trust defective for estate tax purposes.

A second disadvantage of the GRAT, as compared to the sale, is that the grantor must survive the initial term for the transaction to be successful. If the grantor does not survive the term, it is the position of the Service that the entire trust, including post-transfer appreciation, is includible in the grantor's estate.[65] The sale to a defective trust technique works even if the grantor dies immediately after entering into the sales agreement, since discounted assets are removed from the grantor's estate and replaced by a promissory note with a face value equal to the discounted fair market value of the assets transferred. Moreover, the note will receive a valuation discount to reflect the long-term and the low interest rate. Further, in many instances, the tax exposure of failing to survive the GRAT term will be far more significant than the foregoing. This occurs where the estate owner makes a transfer to the GRAT of a minority interest that was part of a control block in the estate owner's hands, but was subject to a minority discount for gift tax purposes when transferred to the GRAT. If the interest is includible in and returned to the estate due to premature death, it will be valued for estate tax purposes as part of a reconstituted control block. Because of the differential in operation between the estate tax and the gift tax, inclusion will result in the transfer being a tax-inclusive transfer rather than a tax-exclusive transfer, making the result of a premature death even more onerous. By electing the installment sale option, the estate owner is assured of obtaining a valuation discount to reflect a non-controlling interest.

A third advantage of using the sale technique is that the assumed rate of return that can be used for the transaction is almost always going to be lower than the rate used for a GRAT. The note is always lower for a sale with a term of more than three and not more than nine years since the IRC Sec. 1274 rate, the appropriate rate for the sale transaction, uses the federal midterm rate for a sale of such a term, whereas the IRC Sec. 7520 rate, the appropriate rate for a GRAT, is 120 percent of the federal midterm rate. If the term of the promissory note is greater than nine years, then the federal long-term rate is used, which could be greater than the rate for the GRAT in some circumstances. The lower interest rate reduces the amount paid back to the original estate owner and increases the amount passing as a result of the estate planning maneuver.

A fourth reason the deferred payment technique is superior to the GRAT technique is that each year's annuity payment from the GRAT may not exceed 120 percent of the amount paid in the preceding year, and the payment schedule must be set up at the inception of the undertaking.[66] Conversely, the installment sale can be endloaded by structuring it as an interest-only note with a balloon payment at the end of the term. Because less money is returning to the original estate owner using the sale technique than using the GRAT, the difference will inure to the benefit of the trust and its beneficiaries income tax-free.

The fifth advantage of the sale technique is that there is no gift tax on the transaction because the sale to the defective trust is made in exchange for a promissory note with a face value equal to the fair market value of the assets being sold. Since the transaction is for fair market value, there is no gift element in the transaction. On the other hand, it is the IRSs position that the GRAT transaction cannot be completely zeroed out. Under Example 5 of Treas. Reg. Sec. 25.2702-3(e), the annuity payments must be valued as if they are payable until the grantor's death or until the trust is depleted. Therefore, the GRAT always produces a taxable gift if the Service is correct. Most practitioners believe that the IRSs position in Example 5 is incorrect. Until this position has been resolved, planners and their clients must take into account this gift tax exposure as well as audit exposure.

A sixth advantage of the note sale over a GRAT is that distributions from a GRAT are prohibited to anyone other than the owner of the retained interest.[67] Conversely, the beneficiaries can participate in immediate trust distributions, or derive benefits from the trust at all times from the defective trust.

It has been stated that the GRAT may be preferable to the sale technique if the transaction involves a hard to value asset.[68] In the governing instrument, the annuity interests may be expressed as either a dollar amount or a percentage of the initial value of the asset transferred. By expressing the annuity as a percentage, the gift tax issue is finessed.[69] Under Treas. Reg. 25.2702-3(b)(1)(ii), the GRAT document must include a revaluation provision in case the asset gifted to the GRAT is valued incorrectly. Any shortfall or overpayment must be paid back with interest. Conversely, such a protective provision is not available for a note sale. Under the holdings of *Proctor*[70] and *McLendon*,[71] a revaluation clause in a sales agreement most likely would be ignored. In both *Proctor* and *McLendon*, the courts held that a revaluation savings clause was ineffective in avoiding a taxable gift, ruling that such a provision was against public policy.

This risk may be mitigated in a variety of ways. First, and foremost, the appraisal must be top-notch and able to withstand scrutiny. Some lawyers frame the property transferred in a fixed dollar amount to be satisfied by assets in kind, such as "$X worth of partnership units" or as a fraction of the asset being transferred.[72] Alternatively, some planners use a fixed amount with any excess going to charity or a private foundation, the theory being that there is no incentive for the IRS to audit the transaction since there is no additional tax — only a larger portion reverting to charity.[73] If the trust, in an independent arm's length transaction, were to purchase "the charity's interest" for fair market value down the road, the total interest would end up in the trust. The foregoing approaches are distinguishable from *Proctor*[74] in that they use a "definition clause" rather than an "adjustment clause." The differential has been explained as follows:

> "The IRS does not seem to have focused on valuation definition clauses to the same extent as it has focused on adjustment clauses. To the extent it has dealt with them, it has not indicated an opposition to their use. These kinds of clauses, to which we now turn our attention, may be more effective as a means of reducing the gift tax risk associated with the transfer of hard to value assets than are adjustment clauses.
> "A valuation definition clause functions by leaving open the determination of how much property has been transferred to the purchaser or donee until value has been determined. It may be distinguished from adjustment clauses because it does not require a price adjustment or an adjustment in the amount of property transferred. The transaction is complete, but the extent of the property sold or given is not fully known."[75]

A second benefit in using the GRAT is that there is specific statutory authority in IRC Sec. 2702 and administrative guidance in the regulations and rulings that can be used to give the practitioner a better roadmap to follow in structuring the transaction correctly. Since the sale to a defective trust is not specifically authorized in the Internal Revenue Code, there is greater margin for error in structuring the transaction correctly and a lower comfort level for some clients and practitioners.

Income Tax Consequences at Death of "Owner." Upon the death of the person who is treated as the "owner" for income tax purposes,[76] if the promissory note is still outstanding there is an issue as to whether the owner must recognize gain. The issue arises as a result of the conversion of the defective trust to a non-defective trust.

The commentators who believe that gain must be recognized[77] do so under the rationale of Treas. Reg. Sec. 1.1001-2(c), Ex. (5), *Madorin*[78] and Rev. Rul. 77-402.[79] Under each of these authorities, the grantor creates a trust in which the grantor is treated as the owner for income tax purposes. Each year, the grantor uses the deductions attributable to the trust assets to offset income on the grantor's personal tax return. When the defective trust is going to begin producing income that will be reported on the grantor's return, the grantor renounces his powers over the trust that caused it to be defective so that it becomes non-defective. Under each of these authorities, at the time the trust becomes non-defective, the grantor must realize gain (or loss). These authorities are not directly on point, however. Since the possible income tax triggering event in the sale to a defective trust transaction is death, authorities providing an analysis with respect to other triggering events do not necessarily apply.

The other view is that death has no income tax consequences and that the aforementioned authorities should not apply.[80] A concept that Prof. Jerry Kasner has suggested is that the transaction can be structured so that income tax can be avoided by having the seller elect out of installment reporting.[81] The taxpayer would report the transaction on his return, explain that under Rev. Rul. 85-13 the gain would not be recognized, that there would be carryover of basis and that the taxpayer elected to opt out of installment reporting. In the normal course of action, for example a sale to a non-defective trust, if the taxpayer elects not to use the installment method, the entire gain would be reported in the year of sale. Nothing further would be reported at death. Because the gain is not recognized by the trust, being a grantor trust, why would future years be affected? It would be reasonable to conclude that each successive year would stand on its own and if an estate owner were to die in year 10, for instance, we would not look back to year one to see if gain was recognized in determining the treatment for year 10.

This issue of whether there are income taxes at the seller's death may be avoided by having the defective trust pay off the entire note prior to the seller's death. Where practicable, it is advisable that the note should be paid off with appreciated assets so that the assets obtain a new income tax basis in the seller's estate.[82] Payment by the trust with appreciated assets is an income tax-free event.[83]

Many commentators strongly advocate paying the note off prior to death. Often clients have advance warning of impending death and the note can be satisfied. Another position that should be considered is the alternative of not paying the note off so that there is a long-term, low interest note included in the estate at a low value for estate tax purposes. That benefit, often in the 55 percent to 60 percent bracket, should be balanced against the basis issues involved and the additional income tax burden (if any), albeit delayed, when the note is paid off. For example, if the note is subject to income tax, the amount of the discount from face value would receive ordinary income tax treatment, rather than capital gain treatment, that may mitigate or even negate the estate tax savings.

Income Tax Basis at Death. Upon the death of the person who is treated as the owner of the trust for income tax purposes, the trust is no longer defective. Some practitioners believe that the sale takes place immediately before death,[84] and others take the position that it takes place immediately after death.[85]

If the sale takes place immediately before death, there is no new income tax basis. Advocates of the position that the sale takes place before death base their opinion under Treas. Reg. Sec. 1.1001-2(c), Ex. 5, *Madorin* and Rev. Rul. 77-402. However, none of these authorities addresses the issue of when the realization event occurs. Therefore, none of them can be used as authority in determining when the transfer occurs.[86]

A more compelling view is that the sale takes place immediately after death. Since the event that triggers the sale is death, common sense would dictate that the sale cannot take place immediately before the triggering event. Since IRC Sec. 1014(a) does not require an asset to be included in the decedent's gross estate, but instead only requires that the asset be acquired from the decedent in order to get a new income tax basis, the new income tax basis of the property should be equal to its value at the date of the death of the decedent.[87] Even if there is a realization event at death, there is no gain since the value of the asset is equal to its basis.

Avoiding IRC Sec. 2036 in Structuring the Sale. One concern in structuring the sale is that IRC Sec. 2036(a)(1) may apply. Under IRC Sec. 2036(a)(1), property transferred in which the transferor retains an interest is included in the transferor's taxable estate. This code section should not apply if the transaction is carefully structured and the advisor makes sure the facts surrounding the transaction indicate that it is a bona fide sale. Preferably, the funds to pay the note would be generated by another asset.[88] Certainly the payment schedule should not follow the income stream earned by the trust. Where the transferred asset is the source of payment of the note, the safest route is to pay off the note prior to death.

We believe that, in order to avoid form over substance or sham arguments that the IRS might use, the defective trust should be independently funded with some seed money. It appears that 10 percent has been the rule of thumb that most practitioners have used as a threshold amount.[89] It also appears that this amount will be administratively acceptable.[90]

It has been suggested by a number of commentators that the 10 percent rule of thumb on the initial funding can be circumvented by funding the trust with less than 10 percent and having a beneficiary of the defective trust personally guarantee the note. They believe that the gift does not take place upon the guarantee, but only, if and when, the guarantor makes good on his guarantee. Letter Ruling 9113009 has cast a shadow on that approach. Letter Ruling 9113009 entertained the issue of whether a personal guarantee of a note payable by another party is a taxable gift. The ruling held that the personal guarantees were gifts subject to the gift tax since "[t]he agreements by [the guarantor] to guarantee payment of debts are valuable economic benefits conferred upon [the debtors]." The date of the gift under the facts of the ruling was held to be the date the debt was guaranteed. The ruling further concluded that "in the event that the primary obligors subsequently default on the loans and [the guarantor] pays any outstanding obligation under the terms of the agreements, any amounts paid by [the guarantor], less any reimbursement from the primary obligors, will be gifts subject to the gift tax."

Under the conclusion of that ruling, this proposed route may create both transfer tax problems and income tax problems unless adequate consideration is given for the guarantee. If the beneficiary is considered to have made a gift to the defective trust of which he is a beneficiary, IRC Sec. 2036(a)(1) will apply to the beneficiary (who is now also a grantor), and a portion of the trust will be included in the beneficiary's taxable estate. In addition, the beneficiary/grantor would be considered a transferor for GST tax purposes. Because the beneficiary/grantor would be precluded from allocating GST tax exemption to the trust until his death under the ETIP rules under IRC Sec. 2642(f), the time value advantages of early allocation would not be available.

The beneficiary/owner would also be considered a partial "owner" of the trust for income tax purposes under IRC Sec. 677(a)(1) since he is making a transfer to a trust of which he is a permissible beneficiary. Not only would this cause a reporting nightmare, as now there would be two "owners" for income tax purposes, but it would also affect the taxation of the initial grantor's (i.e., the grantor who is not also a beneficiary) installment sale to the defective trust. If a trust is defective as to two different persons and one of them sells an asset to the trust, the transaction would be partially income tax-free under Rev. Rul. 85-13 and partially subject to income tax.

In most cases the original grantor would be the owner of most of the trust, and the guarantor/beneficiary/grantor would only own a small portion of the trust for income tax purposes. As a result, the damage from an income tax standpoint may be minimal. This de minimis exposure may be tolerable for some practitioners; however, purists would generally avoid these issues and exposures.

Notwithstanding the foregoing caveats, most estate planners do not subscribe to the IRSs position that the guarantee is a gift at the time it is made. The more supportable position is that the gift occurs at the time the guarantor actually discharges the obligation and is unable to enforce his or her subrogation rights against the primary obligors.[91] In addition, it is arguable not only that the IRSs position in Letter Ruling 9113009 is incorrect, but the guarantee of a trust beneficiary is distinguishable from the letter ruling in that the guarantee of the installment obligation is not for the benefit of a third party, but is for the benefit of the guarantor/beneficiary himself. Since the donor is also the donee, there would not be a gift at the time the guarantee is signed.

Letter Ruling 9113009 was withdrawn by Letter Ruling 9409018.[92] However, Letter Ruling 9409018 only dealt with the marital deduction issues under the facts of the earlier ruling. There was no mention of the gift tax issues. The 1994 ruling specifically held that, "[e]xcept as we have specifically ruled above, we express no opinion at this time about the tax treatment of the transactions under the cited provisions or any other provision of the Code." Thus, the treatment of a personal guarantee as a gift is still in question and creates a risk that many clients would not undertake.

Low Interest Loans

There appears to be no proscription to making loans to the trust at rates that would satisfy IRC Sec. 7872 so as not to result in a gift.[93] For term loans, the interest must at least equal the applicable federal rate under IRC Sec. 1274(d) on the date the loan was made, compounded semiannually.[94] If a demand loan is used, the interest must be at least equal to the federal short-term rate under IRC Sec. 1274(d) for the period in which the interest is being determined, compounded semiannually.[95] The trust would then hopefully make investments that produce a return in excess of these favorable interest rates. This differential would inure to the benefit of the trust.

The IRS has ruled that loans by a grantor to an irrevocable trust to enable the trust to pay life insurance premiums would not cause inclusion of the insurance proceeds in the grantor's gross estate.[96] Since insurance on the life of the grantor has more potential for estate inclusion than other assets, it would be reasonable to conclude that a properly designed and implemented loan would not cause estate tax inclusion of the trust assets.

Sale Of GRAT Remainder Interest To A Dynastic Trust

As previously mentioned, a GRAT is a popular wealth transferring strategy. Although we generally believe that, for previously stated reasons, in most instances the installment sale is preferable to the GRAT, many advisors and their clients prefer the GRAT alternative, even where multi-generational planning is a viable consideration. The rationale for the GRAT selection under those circumstances would probably be that there is authority for the GRAT, both statutorily[97] and administratively and, if properly drafted, there is little valuation risk in setting up a GRAT.[98] Additionally, the installment sale to a defective trust is generally considered to be a riskier transaction to structure and implement.

The inability to take advantage of generation-skipping leveraging with the GRAT technique can be finessed by having the remainder beneficiary either gift or sell his remainder interest to a dynastic trust. Because the remainderman would transfer his entire interest and not retain anything, the ETIP rules would not apply. It appears that the sale could be made to a trust of which the remainderman is a beneficiary without the interest being includible in the seller's estate, as long as the sale is for adequate consideration. If the sale is made to a trust defective as to the remainderman, the sale would be income tax-free. Thus, upon the end of the initial term of the GRAT, the remaining property can pass to a dynastic trust in order to prolong the tax, creditor and divorce protection benefits for multiple generations. If a remainder interest transfer is contemplated, the spendthrift provision in the trust document should be drafted so that it does not preclude the sale.

Charitable Lead Trust

A charitable lead trust (CLT) is another method of leveraging the amount being transferred. The value of the transfer is determined by subtracting the value of the front-end charitable interest from the value of the property transferred. For multi-generational planning, the charitable lead unitrust (CLUT) is generally selected because GST tax exemption may be allocated immediately. Conversely, GST tax exemption may only be allocated to a charitable lead annuity trust (CLAT) upon expiration of the charitable lead period.[99]

For the same reason that GRATs are favored over GRUTs, planners prefer to use the annuity version of the CLT rather than the unitrust alternative because more value can be allocated to the annuity interest than to the unitrust interest, even to the extent of zeroing out the gift. Thus, it appears that the planner is faced with balancing the option in doing multi-generational planning, of (i) doing a CLUT and having a long front-end charitable term and making a gift, as compared to (ii) doing a CLAT and being able to compress the term of the charitable interest and zero-out the gift at a cost of restricting the transfer to the generation below the transferor.

This problem may be finessed, since there appears to be no proscription in creating a CLAT with very low transfer tax value, and having the remainderman sell or gift his interest to a dynastic trust.[100] The transaction is similar to the previously discussed sale of a remainder interest in a GRAT. If this alternative is contemplated, the spendthrift provision in the trust should be drafted so that it does not preclude the transfer.

Split-Dollar Life Insurance

Virtually everybody familiar with estate planning knows the benefits of irrevocable life insurance trusts. Life insurance is generally regarded as a leveraged asset, and thus, a popular choice in dynastic trust planning. With the proliferation of large policies requiring large premiums, alternative straightforward gifts of the premiums to fund the policy often will not result in the most favorable transfer tax result. In addition, gifts of the entire premium will use more GST tax exemption than some of the alternative funding devices. Split-dollar is a popular solution to this funding problem. By utilizing a split-dollar arrangement, the gift and GST tax exemption used will be measured by the economic benefit — the lower of the P.S. 58 (or for survivorship policies, P.S. 38) tables or one-year term cost. As a result of this gift being much lower than the cost of the insurance, the trust can acquire, and protect from transfer taxes, significantly more life insurance than could be purchased if a split-dollar arrangement was not used.[101]

Insurance Funding Opportunities Other Than Split-Dollar

Estate planners who work in the upscale marketplace are often faced with the problem of funding large life insurance policies within the annual exclusion limitations. Despite taxpayer victories in cases such as *Cristofani*[102] it is well recognized that the use of naked powers of withdrawal should be rejected as too risky. For many practitioners, the solution is to make taxable gifts. We haven't met anybody who likes paying insurance premiums but it certainly is much more tolerable than paying gift tax on the premiums. The forward-looking advisor will seek alternatives to resolve this problem.

In addition to the gift tax issue, for those who wish to do dynastic planning, all transfers in trust, including a multi-generational insurance trust, have generation-skipping implications. Prior to April 1, 1988, annual exclusion gifts also avoided the GST tax. For transfers subsequent to March 31, 1988, annual exclusion gifts in trust are not so protected unless made in a trust for a single beneficiary and includible in the beneficiary's gross estate.[103] As a result, but for the limited exception, all gifts to trusts have a "cost" for GST tax purposes, and those in excess of the annual exclusion will have a "cost" for estate and gift tax purposes. Further, many larger policies require premiums that can be projected to exceed the GST limitation. Although the use of split-dollar policies is often a viable solution, that approach has its own problems, particularly with regard to the rollout.[104]

Two techniques discussed earlier in this article, opportunity shifting and the installment note sale, will often offer better results than the split-dollar arrangement, or are extremely comparable with split-dollar. These approaches, as well as integrating some of the various strategies this article has covered, show that the variations are only limited by the imagination of the advisor.

Opportunity Shifting. To illustrate, assume an estate owner has the opportunity to create a new product, move into a new location, start a collateral business, etc. By shifting the opportunity to a dynastic trust, the trust could fund the policy with earnings from the new venture. If the estate owner desires control, a limited partnership or limited liability company could be set up where the client would own the controlling interest and the trust could own the remaining interest, that interest could be the bulk of the entity, but not the controlling interest. If the insurance were on the life of the estate owner and/or his spouse, and the trust was entirely defective as to the grantor, the trust income would be taxed to the estate owner and all earnings, undiminished by income tax, would be available to pay premiums.[105] If the insurance policy were on the life of someone other than the insured or insured's spouse, for example on the client's parent(s) or client's child, a beneficiary defective trust could be created. In such an instance, the life insurance proceeds could be used to acquire assets income tax-free from the insured's estate, due to a step-up in basis,[106] as well as from the "owner" of the trust as a result of IRC Sec. 678(a). During the embryonic stage of the business venture where earnings often are not sufficient to fund the premiums, the policy could be split-dollared. The inherent problem of terminating split-dollar arrangements, in addition to problems such as those income tax problems discussed in TAM 9604001, and the concomitant gift and GST tax problems, can be avoided by using funds earned by the trust outside of the policy rather than by the policy through the internal cash buildup.

Installment Sale to Defective Trust.[107] Assume that an estate owner with three children has a business valued at $10 million dollars that has a cash flow after expenses of 10 percent or $1 million; that the value of a 33 percent interest after valuation adjustments is $2 million and that the interest rate under IRC Sec. 1274 is 6.5 percent. Assume further that the business is operated either as a limited partnership or an LLC, or was placed in one of these entities prior to the note sale portion of the planning process. The estate owner could set up defective trusts for the benefit of each of his children. Each trust could include as a beneficiary the estate owner's spouse. In an independent transaction, the estate owner could sell each of the three trusts a 33 percent interest in the entity for installment notes with face values of $2 million, and interest payments of $130,000 a year. If the entity distributes its net cash flow, each trust would have $200,000 available annually to pay premiums ($330,000 pro rata cash flow less $130,000 allocable to interest). Alternatively, the entity could acquire the policy. In such instance, under current law, only one percent of the proceeds (perhaps increased by a small premium attributable to control) would be includible in the estate owner's estate. Although not required under current law, if this alternative is selected, a more conservative approach in drafting the entity agreement would be to provide that a partner, other than the insured, would make all decisions regarding the insurance.

Conclusion

Receiving property in trust is a superior alternative to outright ownership. For those who desire that control be lodged in the hands of a specific beneficiary or beneficiaries, rather than making distributions to the beneficiary upon reaching the age at which the donor believes the beneficiary will be able to manage the property, the beneficiary controlled trust should be used. The beneficiary should become the controlling trustee upon attaining the specified age. This alternative is preferred over outright ownership because it offers the beneficiary estate tax, creditor and divorce protection.

If the beneficiary controlled trust concept is the preferred trust design for one generation, then it logically follows that the same trust design should be considered for successive generations. In fact, the trust should be drafted to continue for as long as state law permits. A limited number of jurisdictions do not have a limit on the duration of a trust. A co-trustee domiciled in one of those states can be used in order to establish the necessary contacts with the chosen state to use its favorable laws. The beneficiary controlled trust can give the primary beneficiary the power to remove and replace the co-trustee.

The trust can be drafted so that it is defective for income tax purposes. By having either the grantor or the beneficiary pay the income taxes, the trust grows income tax-free while at the same time reducing the grantor's or the beneficiary's estate. Since the "owner" of the defective trust can transact with the trust without any income tax ramifications, the "owner" can leverage the amount of assets in the trust by selling discounted assets to the trust for an installment note. Although the sale to a defective trust is the primary leveraging technique, other leveraging techniques are also available. Practitioners should be more sensitive to opportunity shifting into a defective, dynastic trust and possibly combining that technique with installment sales or other leveraging strategies. Despite the fact that the GST tax only permits a $1 million exemption, proper utilization of creative funding and leveraging designs can revitalize the dynastic trust as the ultimate family wealth tool and, indeed, for many families, virtually erode their tax and creditor exposure into perpetuity.

Benjamin Franklin stated, "...nothing in this world is certain but death and taxes."[108] Prof. Erwin N. Griswold distinguished the two stating: "We have long had death and taxes as the two standards of inevitability. But there are those who believe that death is the preferable of the two. 'At least,' as one man said, 'there's one advantage about death; it does not get worse every time Congress meets.'"[109] We believe there is another differential. Despite all of the efforts of medical science there is still no way to avoid death. However, in this article we have attempted to show that while taxes cannot be completely avoided, through proper planning they can be reduced to more palatable levels. Indeed, we conclude that many taxes are voluntary,[110] paid by persons who do not engage in sophisticated tax planning techniques rather than inevitable results of the creation and ownership of wealth. ◆

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Exhibit B

Comparison Of Note Sale To IDIT vs. GRAT

Interest Rate In Structuring Transaction Favors IDIT
- IDIT – IRC Sec. 1274 – e.g., 3-9 years federal midterm rate
- GRAT – IRC Sec. 7520 – 120% federal midterm 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 dynamic trust

Taxable Gift – Favors IDIT
- GRAT – Gift – Example 5 of Treas. Reg. Sec. 25.2702-3(e)
- IDIT – No gift involved – Sale for FMV

Payment Structure – Favors IDIT
- IDIT – Note structure flexible – All principal can be back loaded – Right to prepay
- GRAT – Annuity payments cannot exceed 120% 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

End Notes

29. Cooper, fn. 9, *supra*, at p. 19; Owen G. Fiore, "Ownership Shifting to Realize Family Goals, Including Tax Savings," 37 NYU Inst. on Fed. Tax., Sec. 38 (1979); Owen G. Fiore, "Estate and Value Opportunity Shifting Through Installment Sales, Private Annuities and Interest-Free Loans," U. Miami 13th Inst. on Est. Plan., Ch. 7 (1980).
30. 706 F.2d 1424, 1430 (7th Cir. 1983); See also *vonHagke v. United States*, 79-1 USTC ¶13,290 (1979), where the Tax Court rejected the government's argument that the ability to cause the corporation to liquidate is negated by the fiduciary duty owed to minority shareholders.
31. *Estate of Joseph E. Salsbury*, 34 T.C.M. (CCH) 1441 (1975).
32. See, e.g., *Estate of T. John Folks, Jr.*, 43 T.C.M. 427 (1982); *Estate of Albert L. Doherty*, 59 T.C.M. 772 (1990); *Estate of Charles Russell Bennett*, 65 T.C.M. 1816 (1993).
33. Cooper, fn. 9, *supra*, at p. 20.
34. Richard A. Oshins, "Family Wealth Protection and Preservation," *Trusts & Estates* (February 1993).
35. Fiore, fn. 30, *supra*; Oshins, fn. 35, *supra*.
36. Randall D. Roth, "The Intentional Use of Tax-Defective Trusts," U. Miami, 26th Inst. on Est. Plan., Ch. 4 (1992).
37. IRC Sec. 671.
38. 63 Or. L. Rev. 381, 384 n. 11 (1984).
39. LTR 944033.
40. LTR 9543049.
41. IRC Sec. 1361(c)(2)(A)(i).
42. Rev. Rul. 85-13, 1985-1 C.B. 184.
43. IRC Sec. 101(a)(2)(B).
44. Under IRC Sec. 1041(a), transactions between spouses are income tax-free.
45. IRC Sec. 2036.
46. Rev. Rul. 81-6, 1981-1 C.B. 385.
47. LTR 8142061; LTR 8521060; LTR 9034004.
48. IRC Sec. 678(b); LTRs 79090931, 8103074, 8142061, 8326074, 8308033, 9140127, 9309023, 9320018, 9321050 and 9448018.
49. IRC Sec. 678(a)(1).
50. IRC Sec. 678(a)(2).
51. See fn. 48, *supra*.
52. Under IRC Sec. 677(a)(1), the grantor is treated as the owner of a trust if the trust income, without the approval or consent of an adverse party is, or in the discretion of the grantor or a non-adverse party, or both, may be distributed to the grantor or the grantor's spouse.
53. See LTRs listed in fn. 49, *supra*.
54. LTRs 9140127, 9309023, 9320018, 9321050 and 9448018.
55. Some states prohibit self-dealing by a trustee. However, forum shopping can resolve any such imbroglio. The trust draftsman should include a waiver of the self-dealing proscriptions which would attach under normal fiduciary standards.
56. It is arguable that a beneficiary could be treated as the grantor of the trust for creditor's rights purposes as a result of allowing his power of withdrawal to lapse. However, the better and more logical view is that the beneficiary should not be treated as the grantor unless the beneficiary actually makes a transfer to the trust.
57. Care must be taken not to tie the cash flow from the asset sold into the purchase equation so as to trigger the application of IRC Sec. 2036(a).
58. IRC Sec. 2041(b).
59. IRC Sec. 2036 and 2038.
60. Some states, such as California, have long-arm statutes which may cause part of the trust to be subject to state income tax.
61. See Michael D. Mulligan, "Sale to a Defective Grantor Trust: An Alternative to a GRAT," *Estate Planning* (January 1996); Frederic A. Nicholson, "Sale to a Grantor Controlled Trust: Better Than a GRAT?," *Tax Management Memorandum* (February 22, 1996); H. Allan Shore and Craig T. McClung, "Beyond the Basic SUPER-FREEZE - An Update and Additional Planning Opportunities," *Taxes* (January 1997); Steven J. Oshins, Al King, III and Pierce McDowell, III, "Sale to a Defective Trust: A Life Insurance Technique,"

Trusts & Estates (April 1998); Steven J. Oshins, "Sale to a Defective South Dakota Dynasty Trust: Leveraging your Trust into Perpetuity," *Communique* (April 1998); Jerome M. Hesch, "Installment Sale, SCIN and Private Annuity Sales to a Grantor Trust: Income Tax and Transfer Tax Elements," *Tax Management Estates, Gifts and Trusts Journal*, Vol. 23, No. 3 (May 14, 1998).

62. Rev. Rul. 85-13, 1985-1 C.B. 184.
63. See Hesch, *supra*, at p. 114.
64. IRC Sec. 2702(a)(2)(B), 2702(b).
65. LTR 9451056. It is arguable, however, that the inclusion should be limited to the amount required to produce the unpaid annuity. Most commentators on this issue believe that since inclusion is under IRC Sec. 2039 rather than IRC Sec. 2036, the Service's position is misplaced. For support of this proposition, see Rev. Rul. 82-105, 1982-1 C.B. 133.
66. Treas. Reg. Sec. 25.2702-3(b)(1)(ii).
67. Treas. Regs. Sec. 25.2702-3(d)(2).
68. Richard B. Covey, Practical Drafting, pp. 4365-4367.
69. The opposite approach was used in *Estate of J. Howard Marshall, II v. Comm'r.*, Tax Ct. Docket No. 543-98, where the Service has asserted an additional gift in excess of $18 million.
70. *Comm'r. v. Proctor*, 44-1 USTC ¶10, 110, 142 F.2d 824 (CA-4), cert. denied 323 U.S. 756 (1944).
71. *Estate of McLendon v. Comm'r.*, 66 T.C.M. 946 (1993).
72. See Malcolm A. Moore, "Attempting to Achieve Finality in Potentially 'Open' Transactions," 29 U. Miami Inst. on Est. Plan., Ch. 13 at 1301.4 (1995).
73. See various writings by Stacy Eastland.
74. *Comm'r. v. Proctor*, fn. 71.
75. See Carlyn S. McCaffrey and Mildred E. Kalik, "Using Valuation Clauses to Avoid Gift Taxes," *Trusts & Estates* (Oct. 1986).
76. As discussed above, this can be either the grantor or the beneficiary.
77. See, e.g., Covey, *Practical Drafting*, pp. 4365-4367.
78. *Madorin v. Comm'r.*, 84 T.C. 667 (1985).
79. Rev. Rul. 77-402, 1977-2 C.B. 222.
80. See H. Allan Shore and Craig T. McClung, "Beyond the Basic SUPERFREEZE - An Update and Additional Planning Opportunities," *Taxes* (January 1997).
81. IRC Sec. 453(d); Jerry A. Kasner, "Maybe the Cup is Half Empty - Planning for Premature Death," Outline (1998).
82. IRC Sec. 1014.
83. Rev. Rul. 85-13, fn. 43.
84. Covey, Practical Drafting at p. 4368; Frederic A. Nicholson, "Sale To a Grantor Controlled Trust Better than a GRAT?" 37 Tax Mgmt. Memo. 99 (Apr. 15, 1996) at 102.
85. Hesch, fn. 61, *supra*, at p. 121.
86. Id.
87. Id. Jerry states: "The better-reasoned view is that because the cessation of grantor trust status occurs by reason of death, the transfer occurs after the cessation of grantor trust status. In other words, the immediately-before-death position is not supportable because death is the cessation event. Because death has to be taken into account, i.e., death is the triggering event, the deemed transfer from the grantor to the trust cannot take place immediately before death. Because the death of the grantor must be taken into account for income tax purposes, the deemed transfer occurs by reason of death and the deemed transferor of the property can only be the grantor's estate. Furthermore, Sec. 1014(a) provides that the basis of property acquired from a decedent is its value at the time of death. The view that there is a pre-death transfer results in the anomalous situation of a sale by the grantor prior to his death to an entity which, for income tax purposes, becomes a separate entity only after the grantor's death. Accordingly, the basis step-up under Sec. 1014(a), as property passing from a decedent, must be available. Even though there is a realization event, there is no gain because the newly acquired basis under Sec. 1014(a) equals the amount realized on the deemed sale which occurs at death. As long as the IRS adheres to its victory in *Frane*, it is conceding step-up basis at death."
88. See, however, Hesch, *supra*, at p. 116 where the author states that the promissory note sale is outside the scope of IRC Sec. 2036(a). The article draws an interesting analogy to *Comm'r. v. Clay Brown*, where the sole source of funding for a sale-leaseback with a charity was the property sold and the U.S. Supreme Court ruled that the bootstrap sale would be valid. Thus, he concludes that by analogy such sale should also be valid for transfer tax purposes.
89. See, however, Hesch, *supra*, at p. 118 for a more aggressive approach. Jerry takes the position that independent seed money is not required. He states: "Commentators suggest that the independent funding equal 10 percent of the value of the assets the trust intends to purchase. But, there is no statutory or regulatory requirement which says the trust must be independently funded. All that is required is that the note term be shorter than the seller's life expectancy. If the note term is shorter, there should be no inference that the transaction was intended at its inception to be a substitute for an income interest for the life of the individual. Therefore, it is recommended that the note term be shorter than the seller's life expectancy age. If the seller has a concern about loss of an income stream, the note can always be extended when it approaches maturity."
90. Byrle M. Abbin, "[S]he Loves Me, [S]he Loves Me Not - Responding To Succession Planning Needs Through a Three-Dimensional Analysis Of Considerations To Be Applied In Selecting From The Cafeteria Of Techniques," 31 U. of Miami Inst. on Est. Plan., Ch. 13 (1997) who commented: "...Informally, IRS has indicated that the trust should have assets equal to 10 percent of the purchase price to provide adequate security for payment of the acquisition obligation." p. 13-9.
91. Jerald David August, "Planning Around Contingent Liabilities," 26 U. Miami Inst. on Est. Plan., Ch. 18 (1992) ¶1802.2; Howard M. Zaritsky, Tax Planning for Family Wealth Transfers, 3rd Ed, Warren Gorham & Lamont, ¶3.09(1)(d).
92. The authors understand that a loan guarantee regulation project began several years ago and that the tentative position of the Service is that a gift will not occur at the time of the guarantee, but rather at the time the guarantor pays the loan and is unable to recover from the primary obligor. Sarah Jane Pavlik, Memorandum - Guaranty of a Loan as a Taxable Transaction (March 1, 1994).
93. *Frazee*, 98 T.C. 554 (1992); LTR 9535026.
94. IRC Sec. 7872(f)(2)(A).
95. IRC Sec. 7872(f)(2)(B).
96. LTR 9809032.
97. IRC Sec. 2702.
98. See text at fn. 70, *supra*.
99. IRC Sec. 2642(e); TAMRA Sec. 1014(g)(3)(A).
100. See, however, Michael D. Mulligan, "Allocating a Client's GST Exemption Most Effectively," *Estate Planning* (May 1997), p. 154, which takes the position that for purposes of Chapter 13 "[i]t is a trust's status as a CLAT that precludes allocation of GST exemption, not the question of whether the trust is includible in the transferor's estate. Status of a trust as a CLAT prevents allocation under Sec. 2642(e) by any party, whether the original transferor or a subsequent transferor of a remainder interest in the trust."
101. Howard M. Zaritsky and Stephan R. Leimberg, *Tax planning With Life Insurance*, Warren Gorham and Lamont, Sec. 5.03(7)(e) at 55-37.
102. *Estate of Cristofani v. Comm'r.*, 97 T.C. 74.
103. IRC Sec. 2642(c).
104. TAM 9604001.
105. IRC Sec. 677(a)(3).
106. IRC Sec. 1014.
107. See Steven J. Oshins, Al King, III and Pierce McDowell, III, "Sale to a Defective Trust: A Life Insurance Technique," *Trusts and Estates* (April 1998) for more information on the life insurance opportunities available using the sale to a defective trust technique.
108. Jeffrey L. Yablon, "As Certain as Death - Quotations About Taxes," *Tax Notes*, Dec. 29, 1997 at 1485.
109. Id.
110. Cooper, fn. 9, *supra*.