



Estate Planning Review

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THE WALTON GRAT—A 21st CENTURY PLANNING TOOL

CCH: The grantor retained annuity trust (GRAT) is a concept that has proved popular since GRATs were

sanctioned by the rules of Code Sec. 2702. Could you give us a brief synopsis of how and why GRATs work as an estate planning tool?

The Economic Growth and Tax Relief Reconciliation Act of 2001 (P.L. 107-16)(2001 Act) has created a strange new world for estate planners. It is a world in which the estate tax is scheduled to be repealed, but not until 2010 and, even then, only for one year. It is also a world in which the gift tax will continue to exist, but with a different exclusion amount from the estate tax after 2003. Accordingly, in this new world, strategies that involve making a taxable gift would appear to make little sense, at least for those individuals who have a reasonable expectation of surviving until the repeal of the estate tax is scheduled to occur. At the same time, however, the Tax Court has effectively sanctioned a technique that may prove invaluable to estate planners in the foreseeable future. In the following interview, attorney Richard A. Oshins provides us with his views on how this planning idea can work for you and your clients. Mr. Oshins is senior partner with the Law Offices of Oshins & Associates, Las Vegas, Nevada (www.oshins.com), a nationally recognized firm specializing in estate planning, business planning, and probate.

rate with little or, as a result of the recent Walton decision (A. Walton, 115 TC—, No. 41, CCH Dec. 54,165), no gift tax exposure, provided he or she survives the term. This lack of gift tax exposure is a point that

will become increasingly important as we go forward after passage of the 2001 Act.

As long as the grantor survives the trust term, the assets remaining in the trust after the term are removed from his or her estate with no additional gift tax implications. If the trust assets appreciate at a rate in excess of the applicable federal rate (AFR) under Code Sec. 7520, the appreciation will pass free of gift tax. If the growth does not exceed the AFR, nothing will pass to the remainder beneficiaries. Because the GRAT can be designed to zero out the gift, the grantor is in a no lose position except for the costs of doing the transaction and perhaps the lost opportunity of implementing another wealth-shifting device. GRATs are often formed with assets that are entitled to a valuation discount for transfer tax purposes and, thus, reduce the value of the gift to the trust. On the other hand, where assets having a cash flow are transferred, the cash flow is not reduced, enhancing the GRAT's ability to pay the annuity. In addition, the discounted assets will pass to the remainder beneficiaries without further gift tax implications at the end of the term.

CCH: Is there a potential downside to using a GRAT?

Mr. Oshins: The biggest risk in using the GRAT technique is the possibility that the grantor will not survive the term. If the grantor does not survive the annuity term, there is possible inclusion of all or part of the GRAT property in the grantor's estate. Many practitio-

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EXAMPLE 2.

Type of GRAT:	Zeroed-out
Term:	10 years (term)
Grantor's age:	50
Code Sec. 7520 rate:	6.2%
Annuity payment rate:	13.7159%
Property transferred:	\$1 million
Annuity factor:	7.2908
Retained (annuity) interest:	\$999,998.84
Remainder (gift) interest:	\$1.16

desirability is enhanced by the presumptively reduced willingness of taxpayers to risk a possible gift tax after passage of the 2001 Act by using what is generally considered to be the primary GRAT alternative—an installment note sale to an income tax defective trust—although I think this risk could be moderated by properly incorporating a defined value sale into the structure.

CCH: What exactly is a "defined value" sale and why would one use this technique?

Mr. Oshins: A defined value sale is a technique that restricts the IRS's ability to contest a good faith appraisal of the value of property being transferred. It is ordinarily used with hard-to-value assets to finesse the potential undervaluation risk occurring in an installment sale as a result of the possibility that the transferred asset could be successfully revalued by the IRS. It typically involves a sale or gift of a non-controlling interest in a family controlled entity, such as a family limited partnership (FLP), to a dynastic defective trust (DDT) according to a formula clause allocating a fixed dollar value of the asset to be satisfied by an in kind distribution (e.g., \$x of partnership units) with the residue going to a Walton GRAT or to a charity.

In a case involving a charity, ideally, the charity's interests are purchased at a reasonable time in the future by the DDT or redeemed by the family controlled entity for fair market value generally established by an independent appraisal. The technique's overall impact is to limit the IRS's incentive to audit transfers which use a good faith appraisal, particularly where a charity is the recipient of the remainder interest gift. In most instances, the charity would prefer to receive cash and the family would prefer to own a greater interest in the family controlled entity because the value of that interest is much less in the hands of a stranger, real or hypothetical, than it is to members of the control group. Thus, since it is in each party's best economic interest to strike a deal, it is generally anticipated that after the gift is made, the parties, in an independent transaction, will

negotiate a sale of the remainder interest to the family or entity. At the time of sale, it is anticipated that the sales price for the remainder interest in the split-interest transaction (as distinguished from the number of partnership units) will be derived by hiring an independent appraiser, and that the parties will obtain finality by following the normal business practice of each signing a mutual release. Thus, an adjustment on audit will not (and should not) affect the transaction between the parties. Indeed, a negotiated settlement with the IRS would include factors which are not relative as to fair market value of the remainder interest, such as the expense of litigation, the taxpayer's personal audit tolerance, audit risk, etc. If, at the conclusion of the audit there is a reallocation in favor of the remainder interest, that means that the value of the charitable gift was understated and the taxpayer should be entitled to amend his or her return to reflect this undervaluation.

There is the concern that the IRS may attack this approach under the rationale of *F. Proctor*, CA-4, 44-1 usrc ¶10, 110, 142 F.2d 824, cert. denied 323 U.S. 756 (1944). Although distinguishable from *Proctor*, the defined value sales approach clearly cannot be considered to have the valuation certainty that can be incorporated in the GRAT. By expressing the annuity as a percentage of the initial value of the gift, the valuation issue is eliminated in a GRAT. Under Reg. §25.2702-3(b)(1)(ii),

A defined value sale is a technique that restricts the IRS's ability to contest a good faith appraisal of the value of property being transferred.

as a condition of qualification, the GRAT document must include a revaluation provision requiring any shortfall or over-payment to be paid back with interest.

CCH: Recently the IRS issued FSA Letter Ruling 200122011, which would seem to be the equivalent of a "warning shot" with respect to the defined value sale concept since the IRS ruled that this type of formula clause should not be respected for federal tax purposes. As I understand it, this FSA is based on a case pending in the Tax Court (*C. McCord*, Dkt. No. 7048-00). Is that true and what, generally, is your reaction to this FSA?

Mr. Oshins: First of all, I would suggest that the facts of the FSA are distinguishable from those of the *McCord* case and, secondly, I do not agree with the IRS's con-

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tage of the GRAT and hedge the downside risk of not surviving the term by the implementation of a well-conceived life insurance program.

The visceral reaction is that since the risk is for a term certain, the acquisition of term insurance for the annuity period should be the product of choice. In my experience, although the use of a permanent product is somewhat counterintuitive, it is typically preferable for longer term GRATs. Remember, the theoretical reason that there is little or no gift to the remainderman is that the value of the retained annuity is equal to the value of the property transferred. In fact, the IRS tables presume that the grantor will end up wealthier due to the interest assumption contained in the tables. Thus, the GRAT will not reduce the estate except if valuation adjustments are involved. It is merely an estate freeze and, to the extent of the interest factor, a "leaky freeze."

*For those clients
who have the
requisite risk
tolerance, a Walton
GRAT coupled
with a remainder
sale may achieve
unparalleled results*

CCH: What about the case in which the estate owner is uninsurable or subject to relatively high rates?

Mr. Oshins: In such an instance, the inability to obtain adequate insurance coverage is indicative of the likelihood that the estate owner will not be able to survive the term, and should be a signal that the GRAT approach should be reevaluated and substitute planning that does not require survival techniques should be considered.

CCH: Is there also a possible place for the GRAT in generation-skipping transfer (GST) tax planning with dynasty trusts?

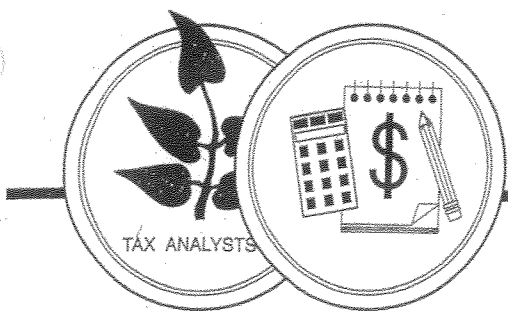
Mr. Oshins: One of the drawbacks associated with GRATs as compared to the installment note sale strategy is that GST tax exemption cannot be allocated to a GRAT until the grantor's retained interest has ceased because of the estate tax inclusion period (ETIP) rules contained in Code Sec. 2642(f). That section prohibits allocation of GST tax exemption during the period that the property would be includible in the transferor's estate if he or she died.

However, the ETIP rules should not apply if the remainderman were to sell or give his or her entire in-

terest within a reasonable time after the GRAT was created to a GST exempt trust because the transferor would not retain an interest that would cause estate inclusion. Under the so-called "strings provisions" of the Code (Code Secs. 2036-2038), inclusion only occurs if the transferor makes (1) a gratuitous transfer and (2) retains an interest in the transferred property. Therefore, the ETIP rules should not apply because if the transferor/remainderman were to die, at that time the transferred property would not be includible in his or her estate since the transfer was of the entire interest of the transferor. This approach is, however, not without risk. It is reasonable to assume that the IRS would attack the transaction under a "substance over form" theory (i.e., that the spirit of Code Sec. 2642(f) should govern the result) or "step-transaction" approach. The IRS has indeed fired its first shot in an analogous instance where a taxpayer desired to use a charitable lead annuity trust (CLAT) to virtually zero-out a remainder interest that would be transferred at a negligible value to a grandchild. In a private letter ruling, the IRS indicated that it would treat the creator of the CLAT as the transferor for GST purposes because "[t]he series of transactions proposed in the ruling request have the effect of circumventing the rules of §2642(e) using the same type of leveraging that prompted Congress to enact §2642(e)" (IRS Letter Ruling 200107015). I am personally aware of several large CLATs that have been designed by other advisors in the manner rejected by the IRS in this letter ruling. Moreover, I have taken my own informal poll of several highly respected practitioners who believe the IRS's position will not be sustained.

CCH: Finally, how would you evaluate the future of the Walton GRAT?

Mr. Oshins: The combination of the Walton decision enabling the GRAT to be zeroed-out and Reg. §25.2702-3(b)(1)(ii), which permits the annuity to be expressed as a percentage of the initial value of the gift, means that the GRAT strategy can be implemented gift tax-free. Thus, it is a risk-free, potentially high reward opportunity to shift wealth and should be a viable strategy for all clients who are engaging in the estate planning process. For those clients who have the requisite risk tolerance, a Walton GRAT coupled with a remainder sale may achieve unparalleled results. As for the insurance element described above, I would suggest that, although the insurance advisor cannot control the ability to obtain the anticipated appreciation or the tax result with respect to the remainder interest transfer, he or she can resolve the survivorship contingency risk with the use of life insurance. ♦



tax practice and accounting news

edited by David Lupi-Sher

The Dynastic Trust Under the Relief Act of 2001

By Richard Oshins and
Jerry Kasner

The Economic Growth and Tax Relief Reconciliation Act of 2001 (the Act) will require all practitioners to reexamine traditional estate planning techniques, and in particular, the use of trusts in estate planning. If, in fact, the federal estate and generation-skipping transfer (GST) taxes are repealed, which admittedly problematical, the focus of estate planning will shift to problems of family wealth preservation and creditor protection. If repeal does not occur, any vehicle used in estate planning should be flexible enough to adjust to that possibility.

A solution is a structure created for the benefit of one's descendants — which might also include his or her spouse — that can insulate the family wealth from creditors and erode the impact of any transfer taxes on that wealth. This vehicle can then be enjoyed and controlled by the family well into the future and is limited only by the applicable rule against perpetuities. Obtaining sufficient nexus to use the laws of a state that does not have a perpetuities restriction can eliminate this restraint.

Under both the current transfer tax system and the property laws in the United States, properly structured inherited wealth is a far more valuable commodity than wealth earned and saved. Earned wealth is subject to transfer taxes and may be subject to creditors. Although it is generally true that neither our transfer tax system nor our property law system distinguishes between wealth a transferee taxpayer owns and retransmits and wealth that is earned and subsequently transferred, proper planning can dramatically alter these general rules.

An excellent vehicle that can be used to achieve and maintain this differential is an irrevocable trust — particularly a dynastic trust. In the typical family setting, the trust is created by a senior family member for the benefit of his or her descendants,

and perhaps also for the creator's spouse. The trust corpus would form a "family wealth pool" for the use, benefit, and enjoyment of the family unit. Further, under the 2001 Act, such a dynastic trust can be structured to take advantage of larger exemptions, estate and GST tax repeal, or in the alternative, to operate very nicely under the existing transfer tax system, if it is preserved. The judicious use of special powers of appointment can enable the trust to avoid any adverse changes in the law.

Basic Transfer Tax Provisions in the Act

Under the Act, section 501, estate and GST taxes are reduced and will, if nothing changes, be repealed in the year 2010. Here is the phase-in schedule for the repeal and new estate tax and GST tax (not gift tax) exemptions and rates under Act sections 511(a)-(c) and 521(a):

HIGHLIGHTS

Trusts. Richard A. Oshins and Jerry A. Kasner review the recently-enacted tax bill repealing the federal estate tax in 2010 and outline possible avenues in estate planning to shield trusts from further changes in the law. 247

FASB. The Financial Accounting Standards Board's Emerging Issues Task Force on September 28 decided not to treat the expenses and costs related to the recent terrorist incidents as extraordinary expenses for financial reporting purposes. 251

FASB. The Financial Accounting Standards Board's Emerging Issues Task Force met on September 21 to deal with a number of regularly scheduled issues but also to discuss the financial reporting implications of the recent terrorist acts. 252

FASB. The Financial Accounting Standards Board met on September 19, its first public board meeting since the terrorist attacks on the World Trade Center and the Pentagon. 252

Year	Exemption	Highest Transfer Tax Rate
2002	\$1 million	50 percent
2003	\$1 million	49 percent
2004	\$1.5 million	48 percent
2005	\$1.5 million	47 percent
2006	\$2 million	46 percent
2007	\$2 million	45 percent
2008	\$2 million	45 percent
2009	\$3.5 million	45 percent
2010	Estate and GST tax repealed	

All transfer taxes may be reinstated under the so-called "sunset" provision.

The GST exemption and rates will be adjusted by the same amounts under section 521(c) of the Act. However, the effective date of the provision is December 31, 2003, so the inflation adjustments over \$1 million will still apply to the GST exemption until 2004. Note that the 5 percent surtax on large estates is also repealed, effective January 1, 2002.

The gift tax exclusion amount will increase to \$1 million in 2002 and remain there. See the Act section 521(b). The gift tax rates will be the same as the estate tax rates, and after 2009 — when the estate tax is supposedly repealed — the top gift tax rate will be the top individual income tax rate (i.e., 35 percent). See section 511(a)-(d) of the Act.

Section 511(e) of the Act, effective December 31, 2009, provides that any transfer of property to a trust is a taxable gift unless the trust is treated as a grantor trust as to the grantor or grantor's spouse for income tax purposes in its entirety.

This particular provision has turned out to be the most perplexing in the Act. The authors' information, all hearsay, is that since the announced purpose of retaining the gift tax is to eliminate income-shifting devices, Congress decided that transfers to a trust that does not shift income is a nontaxable gift. Others dispute this. One alternative interpretation is that this is an indirect way of eliminating *Crummey* clauses. In other words, since all other transfers to trusts are deemed taxable gifts under section 2503, there would be no present interest exclusion. The authors have some doubts about this, since the annual gift tax exclusion applies only to taxable gifts to begin with.

The technical explanation of this provision from the Finance Committee states: "... except as provided in regulations, a transfer to a trust will be treated as a taxable gift, unless the trust is treated as wholly owned by the donor or the donor's spouse under the grantor trust provisions of the Code."

Regardless of the reasons for this special rule, in the opinion of the authors, it will become a solid basis for planning dynastic trusts.

A 'Congress Proof' Dynastic Trust?

While the dynastic trust may be structured to avoid creditors and the current transfer tax, it may also function to avoid future changes in the tax law by Congress. If, in fact, the federal estate tax is repealed, the assets

owned by a dynastic trust will or should be immune to any future return of the federal death tax in any form. There is considerable concern that what Congress gives, it can take away. A change in the political or economic climate could certainly result in either a suspension of the repeal of the federal estate and GST taxes, or the return of some form of the federal death tax. Since the dynastic trust results in a complete transfer of ownership rights in the trust assets by the grantor, there would appear to be no theory under the U.S. Constitution that Congress could subsequently seek to "get the trust assets back" by passing new legislation that would subject those trust assets to tax. Here is why — it would be almost impossible to impose a tax directly on the trust assets, since this would be a direct tax on property, which is unconstitutional under Article I, section 9, clause 4. It reads:

No capitation, or other direct, Tax shall be paid, unless in Proportion to the Census or Enumeration herein before directed to be taken.

It is, of course, possible Congress will seek to get around this, as it has in the past, by arguing the tax is on the particular use of, or exercise of, power over the property. See *Bromley v. McCaughn*, 280 U.S. 124 (1929), 94 TNT 241-12, upholding the federal gift tax. However, that same decision pointed out that since one use of property is keeping it, a tax on the possession of property is no different from a tax on the property itself. Note the problem with defective trusts, discussed subsequently.

The authors are not constitutional scholars and claim no expertise in that area. However, the bottom line certainly appears to be that attempts to impose taxes on property held in trust will run into all kinds of obstacles, as well as political turbulence. In addition, such an attempt could also be seen as violating due process requirements.

Using the Gift Tax Exemption

Since the gift tax exemption will be fixed at \$1 million in 2002, a married couple can shelter up to approximately \$2 million through the use of the dynastic trust. This amount can be leveraged dramatically through the use of advanced estate planning techniques such as defective trusts, installment sales to the trust, shifting favorable economic opportunities to the trust, etc. Some clients may seek to use the 35 percent top gift tax bracket, after it phases in. It is, however, difficult to justify paying a gift tax when there is no estate tax. Assuming the estate tax repeal fully phases in, the basic estate plan at death may end up being a dynastic trust. Paradoxically, this could include a dynastic qualified terminable interest property (QTIP) trust, which would obtain a basis adjustment of up to \$3 million at the death of the first spouse, but no basis adjustment at the death of the second spouse.

Making the Trust 'Defective'

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 sections 673 through 679 is a defective trust for income tax purposes. Since the grantor trust rules for income tax purposes are different from those for transfer

tax purposes, grantor trust exposure for either income tax purposes or transfer tax purposes or both depends on which code sections are being violated.

For purposes of this discussion, a transfer to a trust that has grantor status for income tax purposes will be assumed to be a completed gift and outside the estate for estate and GST tax purposes. In addition, absent a transfer with intent to defraud creditors, the trust will be asset protected from future creditors of the grantor, and both current and future creditors of the trust beneficiaries. In designing a trust to obtain these benefits, 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 result in the grantor or other person being treated as the owner of the entire trust and not just a portion of the trust. That violation should also result in the grantor or other person being taxed on all items of income, deductions, and credits on his return under section 671.

These rules will remain unchanged under the Act. However, if the estate tax repeal does in fact happen, the gift tax rule changes. Under section 511(e) of the Act, transfers to completely defective trusts will not be taxable gifts. The trust may be funded now — or next year, within the new exemption limitation — with up to \$1 million if the donor is single and just over \$2 million if the donor is married, as adjusted. Additional amounts may be allocated to the trust as the estate and GST exemptions increase. The increased GST exemption could be allocated to this trust. If the grantors are willing to pay some gift tax, consideration should be given to funding the trusts up to the available GST exemption, which will exceed \$1 million, and is scheduled to increase to \$3.5 million.

Alternatively, the exemption and transfers can be augmented by *Crummey* gifts that are exempt from the gift tax but are allocated to the increased GST exemption. Finally, assuming the estate tax is repealed, the clients will be able to bequeath unlimited amounts to the trust under the authority of section 511(e) of the Act, effective December 31, 2009.

Whether the federal estate tax is repealed, the dynastic trust could function in the same manner as a bypass or credit shelter trust by pouring over assets from the decedent's estate at death.

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. Moreover, the grantor will reduce his or her taxable estate by the income 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.

Since the grantor will be taxed on the trust income, it may be desirable to include a provision authorizing the trustee to reimburse the grantor for any income tax liability he incurs. Such a trust provision will not have any adverse tax consequences. For example, in LTR 200120021, *Doc 2001-14281 (3 original pages)*, 2001 TNT 98-51, the IRS ruled that a trustee and trust protector who are not related or subordinate to the grantor had the reimbursement power. In the absence of reimburse-

ment authority, the tax on the trust income could become so large so as to create a hardship and even bankrupt the grantor.

Many Faces of the Defective Dynastic Trust

The trust device discussed in this article is designed to cover a variety of contingencies and circumstances including future change in the law. These may be summarized as follows:

1. During the life of the grantor until 2010, the trust functions as a gift-giving vehicle, intended to take advantage of increased estate and GST tax exemptions. It is made defective to maximize several advantages of defective trusts, such as the ability to hold S corporation stock, to transfer life insurance on the life of the grantor in and out of the trust without concern about the transfer for value rule of section 101, installment sales to the trust, and the transfer tax benefits of the grantor paying tax on wealth owned by the trust.
2. During this period, for large estate owners, consideration should be given to making taxable gifts to the trust to take advantage of all or part of the larger GST exemptions as they phase in.
3. On the death of the grantor, that individual's will or revocable trust may provide for a pour-over of other assets to the trust if the estate tax is repealed. This provision should be expressly conditioned on repeal of the tax at the date of death to deal with the sunset provision, or preferably incorporating a formula clause separating the GST exempt trust disposition from the nonexempt.
4. If the grantor dies during the phase-in period, or the estate tax repeal does not happen, or the sunset provision kicks in, the trust is in place, exempt from any additional transfer taxes.
5. If the donor dies during a time when the estate tax is repealed, the carryover basis rules would apply. If so, the trust may be drafted to carve out a QTIP in favor of a surviving spouse. This would permit the executor to elect to adjust the basis of assets added to the trust at the death of the grantor by up to \$3 million (indexed for inflation), not to exceed the fair market value of the property. This provision would apply only if the repeal was in effect at the date of death.
6. The trust may also grant the trustee power to make a direct distribution of assets from the trust to the surviving spouse or any other trust beneficiary to take advantage of the \$1.3 million — indexed for inflation — basis adjustment for assets in the survivor's estate. However, there will be no creditor protection for such assets.

Structure and Operation After Death

In most instances the trust will be designed as a single "pot" trust for the benefit of the family as a whole and often will include the grantor's spouse. On the grantor's death — and perhaps his spouse's — the trust would split into separate trusts *per stirpes*.

A viable alternative is for separate trusts to be set up for each branch of the family at the inception, for example, of each child or the grantor. The grantor's spouse can be a beneficiary, and perhaps the primary beneficiary of each child's trust, without adversely affecting either the transfer tax or creditor protection inherent in the trust vehicle. In fact, the inclusion of the spouse as a beneficiary will enable the trust to achieve grantor trust status under section 677(a). The problem with this approach is that it restricts the ability to toggle — or get out of — grantor trust treatment. The planner might consider including the spouse as a beneficiary, even a preferred beneficiary, but only with the consent of an adverse party.

By giving the spouse a power of appointment enabling the spouse to eliminate the adverse party as a trust beneficiary, the family should feel fairly comfortable that the spouse is protected and will receive appropriate distributions if necessary. Alternatively, giving the spouse the "use" of the property without consent of the adverse party can eliminate the problem. In either case, a different defect would be used, terminating the grantor trust tax treatment.

To maximize the flexibility, tax savings, and creditor protection, the trust should be designed as a discretionary trust whereby the trustee will have broad power to distribute income or principal to, and provide the use of trust assets for, the trust beneficiaries, subject to a set of guidelines.

Operationally, however, it is anticipated that few if any distributions will be made in the absence of a compelling reason to make these distributions. The beneficiaries will be expected to absorb most family expenditures such as food, schooling, vacations, etc. Additionally, the trust funds will generally not be expended on consumable assets since the use of protected funds in this manner would be wasteful.

The trustee would be encouraged to acquire assets for the "use" of the beneficiaries rather than funding the individual's personal acquisition of the assets. To allow for this result, the trust should contain specific language to permit investments in assets such as homes, artwork, jewelry, businesses (including start-up businesses), and the like, that have significant potential for appreciation. For example, if a beneficiary wishes to go into business, the trustee could acquire the business as an asset of the trust, rather than distribute funds to the beneficiary who would use these funds to acquire the business personally. As a result, the beneficiary will have the use and enjoyment of the business (including distributions therefrom) without the transfer tax problems and creditor exposure.

Broad use of powers of appointment should also be considered to deal with changing family circumstances and changing tax law. Typically in dynastic trust planning, the power holder will be the member of the oldest generation of any separate trust (representing a family branch) of the trust. Thus, adjustment can be made in the event of changes in the law or family circumstances. Generally, the primary beneficiary of each would be given a broad power of appointment in situations where the trust creator wishes to give the beneficiary the functional equivalent of outright

ownership and control while obtaining the tax and creditor benefits not obtainable with outright ownership. Armed with a broad power of appointment, the primary beneficiary could rewrite the trust. This ability to effectively redraft the trust should negate any argument that the trust vehicle will "lock" the family into an inflexible arrangement.

For those grantors who desire to "keep it in the family" *per stirpes* basis, the trust need not provide for powers of appointment. Alternatively, a limited power of appointment exercisable only *per stirpes* could be used to retain some degree of flexibility within the family unit.

Some Planning Opportunities and Caveats

Do not mix apples and oranges. As a general rule, do not create a trust with hybrid tax results. The adverse tax and planning problems for GST tax purposes of partially exempt trusts are well known to estate planners. The most tax efficient use of the GST exemption is to create separate trusts that are wholly exempt and wholly nonexempt. A partially exempt trust will waste some exemption on distributions made to children and cause some unnecessary tax on distributions to grandchildren. A separate, non-exempt trust can make distributions to children without wasting GST protected assets and distributions of protected funds from an exempt trust can be made to members of younger generations without incurring GST tax.

It is important to create separate trusts if the funding results in different income tax consequences. For example, don't mix annual exclusion gifts and taxable gifts in the same trust. The result will be an accounting nightmare.

The separateness should even be observed between spouses, although initially it is immaterial because of section 1041. On death or divorce, dual income tax treatment will occur. Certainly in operation that rule should be observed. Consideration should be given to drafting a requirement that the trustee establish separate trusts for separate income tax payers just like GST exempt trusts and nonexempt trusts are generally mandated as a matter of course.

Consider authorizing an independent trustee to set up a secondary or subtrust for the benefit of a trust beneficiary whereby that person would be given a temporary, lapsing power of withdrawal so as to obtain grantor trust status as to the trust beneficiary under section 678. For example, assume that a beneficiary has the opportunity to get into a predictably highly profitable venture that requires a relatively modest investment. If a secondary trust were created by the independent trustee with a hanging power of withdrawal over the entire initial trust corpus, grantor trust status could be obtained, offering income tax-free growth for the trust as well as the ability of the beneficiary to transact with the trust tax-free, taking advantage of Rev. Rul. 85-13, 1985-1 C.B. 184. This would enhance the ability of the family to move a greater amount of assets into a transfer tax-free and creditor protected arena from one without these attributes.

In sum, the use of dynastic trusts as a significant wealth planning vehicle continues after the Relief Act of 2001 and should be considered by many to form the centerpiece of their estate plan.

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ACCOUNTING NEWS

FASB'S EITF DECIDES TERRORIST LOSSES AREN'T EXTRAORDINARY. The Financial Accounting Standards Board's Emerging Issues Task Force on September 28 decided not to treat the expenses and costs related to the recent terrorist incidents as extraordinary expenses for financial reporting purposes.

Earlier, on September 21, the EITF had tentatively agreed that the losses resulting from the September 11 World Trade Center attacks should be treated as extraordinary losses. This decision, however, was vigorously debated. (See related story in this issue.)

At its September 28 meeting the EITF performed an abrupt reversal. Its position now is that the costs and expenses related to the disaster will not be treated as extraordinary items for purposes of financial statements filed with government agencies, such as the Securities and Exchange Commission.

Ordinarily, items classified as extraordinary losses are shown as a separate line item net of tax effects and after a subtotal of income. Thus, the costs that companies consider related to the attacks will not be broken out as a separate line item below income from continuing operations. Instead, they will be considered costs that are part of normal business operations.

EITF Chairman Timothy S. Lucas said, "Because of the far-reaching effects of the September 11 events, coupled with a weakening economy that predated those events, it would be difficult to capture the resulting economic effects in companies' financial statements. As one example, the events impacted airlines in multiple ways. Air carriers were unable to fly for two days, suffered the effects of rerouting and initiated layoffs in anticipation of lower passenger demand. No single line item can capture all of those effects. Other companies representing a broad range of industries are experiencing similar impacts."

This conclusion stems from the EITF's September 28 determination that while the terrorist incidents were extraordinary, using that appellation for financial reporting purposes "would not be an effective way to communicate the financial effects of those events and should not be used in this case." This followed the EITF's conclusion that the economic effects were so widespread that it was difficult to isolate them in any one particular line item in a financial statement. The EITF also decided that demonstrating the impact of the attacks in financial statements would be impaired if the expenses were segregated as extraordinary items.

The EITF also decided that it was almost impossible to differentiate between the direct and indirect expenses arising from the attacks. As such, the EITF expressed concern that applying guidance to this event and identifying losses would be something about which reasonable people could easily disagree. Consequently, in line with the EITF's objective of providing financial reports that communicate "effec-