The Beneficiary Defective Inheritor's Trust ("BDIT")*

By:
Richard A. Oshins
Oshins & Associates, LLC
1645 Village Center Circle
Suite 170
Las Vegas, NV 89134
(702) 341-6000
roshins@oshins.com
www.oshins.com

The Beneficiary Defective Inheritor's Trust ("BDIT")*

By:
Richard A. Oshins
Oshins & Associates, LLC
1645 Village Center Circle
Suite 170
Las Vegas, NV 89134
(702) 341-6000
roshins@oshins.com
www.oshins.com

I. Estate Planning Objective

A. Most effective disposition with least possible diminution in wealth consistent with family goals and values.

B. BDIT uses a (i) freeze,[1] (ii) squeeze,[2] and (iii) burn[3] as part of the estate depletion process. However, the client can control, use and enjoy the transferred assets, and can determine their disposition. See Exhibit A, for BDIT Schematic.

1. In addition, the assets in the BDIT are transfer tax and creditor protected.

2. The BDIT accomplishes the estate planning objectives outlined above without running afoul of the "Pipe Dream Trust" (III, infra) defects.

C. The client will continue to be in "control" of his wealth after the estate plan is implemented. (See II)

---

[1] A "freeze" is an estate freeze. The client will receive a note in exchange for an asset he expects to be growing in value. The note will bear interest, so in reality it will be a "leaky freeze." The post-transfer growth will be shifted to the transferee rather than increase the transferor's estate.

[2] The "squeeze" refers to the valuation discount. By exchanging discountable assets (generally, non-controlling interests in entities that do not have a viable market) for assets not subject to a valuation reduction, the discount is passed tax-free into the BDIT.

[3] The "burn" refers to the estate depletion (i.e., "tax burn") result of the trust beneficiary paying income tax on income earned by the trust.

II. Control

A. Without reasonable "control" many clients will not proceed with the planning. Keydel and Wallace, "Design Strategies for Dynasty Trusts," ACTEC Meeting, March 6, 1999; Ronald A. Aucutt, "Structuring Trust Arrangement for Flexibility," 35 U. Miami Inst. On Est. Plan., Ch 9 (2003) at §902.3; Theodore Calleton, Neill McBryde and Richard A. Oshins, "Building Flexibility and Control Mechanisms Into the Estate Plan – Drafting From the Recipient's Viewpoint," 2003 N.Y.U. 61st Institute on Federal Taxation.

B. With the BDIT the client will, at all times, be in "control."

1. "Control" means the maximum control permitted by law without exposing the trust assets to taxes and creditors. This control is substantially equivalent to the control one would have if he owned the trust assets outright.

2. In the absence of control that is the functional equivalent of outright ownership, most estate owners will not proceed, or will reduce their planning.

C. Because of the permissible controls a trust beneficiary can be given without exposing the trust assets to the IRS or predators, when combined with the tax and asset protection benefits of trusts, owning assets in a properly planned, beneficiary controlled, irrevocable trust is always superior to owning those same assets outright.

D. The controls fall into the following major categories:

1. Administrative controls

a. The client is the Investment Trustee and controls all managerial decisions. The client (and successor Investment Trustees) can hire skilled investment advisors to help, if needed or desired.

b. The client will be in control of the identity of the Independent (Distribution) Trustee who he can fire and replace, with or without cause.

2. Dispositive Controls

a. The client can determine who has the right to use the trust owned assets (rent free if desired).

b. The client will have a broad testamentary special power of appointment and
can essentially "re-write" the trust. This enables the client to adjust for changes in tax laws, trust laws, family dynamics, etc.

E. Unless otherwise directed by the exercise of the power of appointment ("re-write power"), upon the death of the client, the client's spouse, if desired, or, if not, the client's descendants will be placed in control.

1. The control is generally on a per stirpes basis.

2. The trust's primary beneficiary, upon obtaining adequate maturity, will be placed
in control of his separate trust.

3. At the death of each generation, the trust is "recycled" downstream from generation to generation down, subject to the preceding generations power of
appointment.

III. Major Causes of Wealth Erosion

A. Bad investments;

B. Taxes;

C. Divorces; and

D. Lawsuits.

IV. "Pipe Dream Trust"

A. *"Naïve clients, if they are completely candid, will say that they want a gift that helps their children and <u>saves taxes</u>. However, they also want a chance to <u>use</u> the property for <u>themselves</u> in case of adversity, desire <u>management</u> power over the trust estate, and wish to <u>decide later</u> when the children will receive the property."* (emphasis supplied) Drafting California Irrevocable Trusts, Secs. 8.11 and 8.12, John R. Cohan, Editor.

B. Component parts of the "Pipe Dream Trust"

1. Save taxes;

2. Provide use and enjoyment of the transferred assets if needed or desired;

3. Provide managerial control;

4. Retain right to decide who gets the property at death; and

5. Obtain protection from creditors[4].

C. The problem is that there is an estate tax inclusion in the transferor's estate for gratuitous transfers with a retained interest.

1. The Code sets forth the circumstances under which a transfer will be included in the transferor's estate in the "string" sections (IRC §§ 2036-2038).

2. Elements – all three must exist for inclusion:

(a) Transfer;

(b) Retained interest or enjoyment of the transferred assets; or right to control who enjoys such assets; and

(c) For less than full and adequate consideration.

3. If a transfer meets all three elements, it will result in full inclusion in the transferor's estate of the assets transferred to the trust (including growth); essentially, it will result in the inclusion in the transferor's estate of the entire trust.

(a) In addition to the exposure of the trust assets to taxation in the transferor's estate, the inclusion may change the value of the assets from a non-controlling interest to part of a control block.

(b) The included assets will be aggregated with the client's other includible assets.

(c) Thus, a client who has transferred 99% non-voting interests to "tainted" trusts for his children, while retaining the 1% control interest, will have estate inclusion of the 100% undiscounted interest in his estate.

(d) That may result in substantial tax, without the assets to pay the tax. It will also adversely impact the ability to obtain the marital deduction, since the tax bill must be paid, which reduces the assets available to fund the marital deduction.

[4] Creditor protection is my addition to John's analysis of the "Pipe Dream Trust."

D. Asset protection

1. The general rule is that self-settled trusts are exposed to creditors.

2. There are limited exceptions for certain Asset Protection Trusts which have been created in jurisdictions that have changed the general common law rule.

E. Conversely, anybody in the world may set up and fund a trust for a trust beneficiary, other than the beneficiary himself, and if properly structured, the trust assets will not be subject to tax in the beneficiary's estate or subject to the beneficiary's creditors, irrespective of how large the trust grows.

1. All gift transfers to the trust must be by someone other than a beneficiary.

2. The beneficiary may engage in transactions with the trust as long as he receives payment back of assets ("money or money's worth") equal (or greater) in value to the assets that he transfers.

3. Similar to the exception for exposure to estate tax for transfers for "full and adequate consideration," there is also an exception under the creditor's rights statutes for transfers where the transferor receives back "reasonably equivalent value" to avoid a constructive fraudulent transfer. Adkinson and Riser, Asset Protection: Concepts and Strategies for Protecting Your Wealth, McGraw Hill 2004.

F. If the trust is taxable to the beneficiary under subchapter J (herein a "Beneficiary Defective Trust"), IRC §§ 671-679, the following results occur:

1. Payment of income tax by the beneficiary on income earned by the trust is the functional equivalent of a gift to the trust of the tax paid, but not a prohibited transfer for gift tax purposes that would expose the trust to transfer tax or creditors.

2. Payment of income tax on account of Grantor Trust status reduces the beneficiary's own estate – the "Tax Burn."

3. Transactions between the trust and the beneficiary are income tax-free (essentially, for income tax purposes, it is as if the trust did not exist).

4. "In-kind" payments using appreciated assets from the trust do not create an income tax.

5. The trust is a permissible owner of "S" Corporation stock.

V. Overview – The Various Components of the BDIT Strategy

A. There is no reason not to proceed with the BDIT for most clients.

1. In addition to being a powerful estate planning technique compared to alternative wealth shifting strategies, the BDIT strategy opens up planning to those of our clients who otherwise will not otherwise proceed with their planning.

   (a) The technique enables clients to, in effect, put a wrapper around their assets and continue to control and enjoy the assets while obtaining transfer tax and creditor protection benefits.

   (b) In addition, because the client's descendants are beneficiaries of the trust, the descendants' enjoyment of the family wealth can be accelerated if the client so desires. Younger generation beneficiaries can receive the use and enjoyment of the trust assets immediately. However, the use and enjoyment is controlled by the client as trustee.

2. For clients who are considering alternative estate planning techniques, this appears to offer the maximum benefits and least risks. Jerry Hesch and David Handler, "Evaluating the Sometimes Surprising Impact of Grantor Trusts on Competing Strategies to Transfer Wealth," N.Y.U. 68th Institute on Federal Taxation.

   (a) Compared to GRATs, there is no survivorship requirement to obtain a wealth-shift and no ETIP rule to preclude having the transaction exempt from the GSTT immediately.

   (b) Compared to note sales to IDGTs, the Special Power of Appointment avoids gift tax exposure and exposure under IRC §§ 2701 and 2702. The special Power of Appointment would make a gift incomplete. Treas. Reg. § 25.2511 – 2(b).

B. Several counter-intuitive concepts enable us to obtain the benefits of the "Pipe Dream Trust" in a manner that will be respected by the IRS and protected from creditors. These counter- intuitive concepts are:

1. The string sections, IRC §§ 2036-2038, and the creditors' rights statutes catch you only if you make a gratuitous transfer to the trust. If you have

not made a gift to the trust, you can benefit from the trust property without exposure to the IRS or creditors. A third person can set up a trust giving you rights in property (tax and creditor protection) that you can not obtain for yourself;

2. The valuation process presumes a hypothetical transaction between strangers. See Treas. Reg. §§ 20.2031-1(b); 25.12-1.

3. The concept of the defective trust enables the client to transact with the trust income tax-free;

4. The "tax burn" effect of grantor trust status disgorges wealth from the client's estate into a trust he controls and benefits from – i.e., the fact that the grantor pays income tax on the trust income enables him to move assets from an exposed place to a protected place; and

5. The "use" concept enables a beneficiary to use an asset rent-free without exposing it to the transfer tax system or to creditors, simply because someone else set up the trust.

C. Transfer Tax and Creditor's Rights – Third Party Settlor

<u>Transfer Tax and Creditor Rights</u>

A third party, such as a parent or grandparent, sets up a trust for our client so that the third party is the Trust Creator for transfer tax and creditor protection purposes. The client never makes a gift to the trust. Any transactions between the trust and the client will be sales for adequate consideration – i.e., equal value.

1. The trust is set up and funded by someone other than the client/beneficiary;

2. The trust will be exempt from the GST tax due to allocation of the trust creator's GST exemption;

3. The client/beneficiary will not make any gratuitous transfers to the trust;

4. Because the trust is funded by someone other than the client/beneficiary with a gift that is 100% GST tax exempt, the trust will not be subject to the transfer tax system after the funding;

5. Because the trust is funded by someone other than the client/beneficiary, the trust is not a self-settled trust and the trust will provide creditor protection for the client.

D. Income Tax – Client/Beneficiary treated as "owner" of trust income

<u>Income Tax</u>

"If the beneficiary's demand power applies to all contributions to the trust, and if all the trust funds are held for possible future distribution to the beneficiary, as is often the case, the beneficiary would own the entire trust at all times." **Howard M. Zaritsky and Norman M. Lane, "Federal Income Taxation of Estates and Trusts," WGL, at ¶ 12.03(3)(a).**

t

1. Gifts to the trust will be subject to a "Crummey" power of withdrawal by the client/beneficiary.

2. No one other than the client/beneficiary will be given a power of withdrawal;

3. The donor will not retain any rights which would create grantor trust status to himself; and

4. The lapse of the power of withdrawal will cause the client/beneficiary to be treated as the "owner" of the entire trust for income tax purposes. (See VII C)

E. Typically, the client will sell discountable income-producing assets to the trust in exchange for an installment note.

1. The sale will be income tax-free. Rev. Rul. 85-13, 1985-1 C.B. 184 (1985).

2. The sales price will be the fair market value of the asset sold, so that the client/beneficiary will not have made a gratuitous transfer to the trust.

F. Trust Design (See Exhibit B for the preferred trust design.)

1. The trust will be a fully discretionary, dynastic trust and the client/beneficiary, as primary beneficiary, will have a special power of appointment ("SPA").

(a) The SPA is important for at least two reasons – (i) to enable the client and succeeding primary beneficiaries to "re-write" the trust as circumstances, family dynamics or laws change; and (ii) to prevent a completed gift from the primary beneficiary to the trust in situations where assets sold from the beneficiary to the trust are undervalued. Treas. Reg. § 25.2511-2(b).

(b) The protection against an inadvertent gift tax appears to offer complete protection and is superior to the use of a defined value sale, which is often used to protect against a gift tax in the more traditional installment note sale.

(c) Indeed, the protection from the gift tax makes this transaction almost a no-brainer for someone who would not be doing alternate transfers and also probably makes this transaction a safer alternative to the more traditional note sale to an IDGT.

(d) The trust may give the client/beneficiary the right to access the trust to receive distributions subject to one or more of the following standards: "health, education, support and/or maintenance" to come within PLR 200949012.

2. The trust will be a "Beneficiary Controlled Trust," whereby the client/beneficiary will be in control of the trust, having the right to make all non-tax sensitive decisions (such as investment and managerial decisions) and controlling of the identity of the Independent Trustee.

A trust, set up and funded by anyone other than the beneficiary himself, can provide the beneficiary with tax and creditor protection benefits that the beneficiary could not obtain for himself. The two key concepts are:
1. The trust must be funded by someone other than the beneficiary; and
2. The beneficiary can not make any gratuitous transfers to the trust.

e

3. The Independent Trustee will make all tax sensitive decisions such as distributions.

VI. Third Party Created Trusts- If you set up and fund a trust for someone else (traditional irrevocable trust) and do not retain a prohibited right, or if someone else sets up and funds a trust for you (with their own assets).

A. Trust assets are protected from future transfer taxes.

1. "Voluntary Taxes" – A must read to obtain a sense of what proper planning can accomplish is, "A Voluntary Tax? New Perspectives on

Sophisticated Tax Avoidance," by George Cooper. Although Professor Cooper's masterpiece that initially appeared in the 1977 Columbia Law Review is more than 30 years old, variations on many of the strategies are used in today's planning. Copies (1979) may be purchased from The Brookings Institute.

2. *"In fact, we haven't got an estate tax, what we have is, you pay an estate tax if you want to; if you don't want to, you don't have to."* Statement of Harvard Law Prof. A. James Casner, "Hearings Before the House Ways and Means Comm." (1976) Professor Casner was speaking about the transfer tax virtues of generation-skipping trusts.

3. *"..because the owners of great wealth retain estate planners skilled in legal stratagems for tax avoidance, the estate and gift tax laws have never seriously interfered with the intergenerational transfer of large fortunes."* Columbia Law Prof. George Cooper, "A Voluntary Tax? New Prospectives on Sophisticated Tax Avoidance," The Brookings Inst. 1979 Cover.

4. An interesting dichotomy exists – the estate tax rules enable a trust beneficiary to be given more rights in trust property than the transferor could retain for himself without adverse tax treatment. Indeed, the trust beneficiary can be given rights and controls which are virtually the same as if the beneficiary owned the trust property outright, and in various ways ownership in trust is more flexible than owning property outright.

B. Trust assets are protected from creditors and divorces.

1. Asset Protection Maxim: *"If you don't own it, it can't be taken away from you."* Howard D. Rosen, 810 T.M. Asset Protection Planning, BNA Tax Management Portfolio at A-1.

2. A discretionary trust with *"…the distribution discretion held by an independent trustee… is the <u>ultimate in creditor and divorce protection</u> – even in a state that restricts so called 'spendthrift' trusts – since the beneficiary himself has no enforceable rights against the trust."* (emphasis supplied) Fred Keydel, "Trustee Selection, Succession, and Removal: Ways to Blend Expertise with Family Control," 23 Miami Inst. On Est. Plan., Ch 4 (1989) as Sec.409.1.

3. Caveat – Although the trust assets are protected from a divorce award, a divorce court would probably make an adjustment to reflect the existence and availability of the trust assets when determining the rights of the parties.

4. *"In today's increasingly litigious environment, however, asset protection planning is becoming increasingly significant as a separate area of focus within the field of estate planning."* Skip Fox, "Asset Protection Planning and Dynasty Trusts," Real Property, Probate and Trust Journal, Summer 2002.

5. A trust set up by someone other than the beneficiary should be outside the 2005
Bankruptcy rules since the trust is not a "self-settled" trust.

6. See also Richard A. Oshins and Jerry Kasner, "The Dynastic Trust under the Relief Act of 2001," Tax Notes, Oct. 8, 2001, which concludes that the use of generation-skipping trusts is the preferred structure even if there is no Transfer Tax system (See Exhibit C).

C. Trusts set up by a third party are protected from <u>both</u> the transfer tax and creditors.

1. *"Assets put into a trust <u>by someone other than the beneficiary himself</u> have the advantage of being sheltered from the reach of many of the beneficiary's predators – such as a divorcing spouse, a creditor in bankruptcy, or an IRS transfer tax agent (in the case of certain trusts). Thus, where the 'transferor' of assets <u>gifted</u> or bequeathed to such a trust is the beneficiary's parent, aunt, uncle or grandparent, use of the trust 'enhances' those assets (as compared with an outright gift or bequest to the donee). <u>In other words the trust itself makes the transferred assets more valuable by protecting them from the reach of many of the donee's would be claimants.</u>"* (emphasis supplied) Keydel and Wallace, "Design Strategies for Dynasty Trusts," ACTEC Meeting, March 6, 1999.

2. *"In modern times, <u>a trust created by someone other than the beneficiary</u> can be a vital shelter (i) from at least some of the beneficiary's <u>taxes</u>, (ii) from the beneficiary's <u>creditors</u>, and (iii) from the beneficiary's potentially dissident spouse seeking alimony, property, or an undue share on the beneficiary's death."* (emphasis supplied) Keydel, "Trustee Selection, Succession, and Removal: Ways to Blend Expertise with Family Control," 23 U. Miami Inst. On Est. Plan. Ch 4 (1989) at Sec.403.3.

D. Planning Note - Extend the term of the trust as long as possible to pass on the benefits of trust-owned property hopefully into perpetuity. (See Exhibit D).

1. Forced distributions (such as requiring income to be paid out) and staggered distributions (such as 1/3 at 25, 1/2 at 30 and the remainder at 35) unnecessarily expose trust assets to the IRS and predators. It makes no sense to force wealth out from a trust that is protected from three of the

four major causes of wealth erosion (see II) into an unprotected environment. Instead of distributing the wealth, place the beneficiary in control of the wealth that would have been distributed to him.

2. *"… modern trusts seek to achieve and to continue from generation to generation, the shelter and other advantages of a gift or inheritance in trust. Terminating such a trust at the beneficiary's attainment of a stated age would defeat the purpose of a modern trust. If the beneficiary need[s] to feel 'in control,' rather than transfer the ownership of trust assets to the beneficiary, it would be better to simply transfer control of those assets to the beneficiary by making the beneficiary a trustee of the trust, perhaps even its controlling trustee."* Ronald A. Aucutt, "Structuring Trust Arrangement for Flexibility," 35 U. Miami Inst. On Est. Plan., Ch 9 (2003) at § 902.3.

3. *"Discussion with cutting-edge estate planning lawyers can shift one's perspective on this question rapidly. While the word 'dynasty' might conjure images of dead-hand control run amok in some kind of neo-feudalist, dystopian future, such visions are more whimsy than reality. Indeed, the old concerns with alienability or dead-hand control may be largely irrelevant in light of how such trusts are actually being used today. …Dynasty trusts do exactly the opposite of what rule defenders fear: rather than taking away control from the living, dynasty trusts actually increase control (or at least the ability to contain control) by future generations."* Garrett Maritz, "Dynasty Trusts and the Rule Against Perpetuity," Harvard Law Review, Vol. 116, No 8, June 2003, p. 2603.

4. Instead of making distributions, consider permitting the beneficiaries to "use" the property.

    i. *"The trustee is encouraged to acquire assets for the "use" of the beneficiaries rather than funding the individual's personal acquisition of the assets. For example, if a beneficiary wishes to acquire a home, the trustee could acquire the home as an asset of the Megatrust™, rather than distribute funds to the beneficiary who would utilize such funds to acquire the home personally. As a result, the beneficiary will have the use and enjoyment of the property without the transfer tax problems."* Richard A. Oshins, "Megatrusts: Representation Without Taxation," NYU Forty-Eight Inst. on Fed. Tax; Chapter 19 at § 19.02. See also Richard A. Oshins and Lawrence Brody, "Representation with Taxation Megatrusts and Megainsurancetrusts," Forty-Second Annual USG Inst. on Federal Taxation, 1990 Ch. 16.

ii. Sample language: *"Consistent with the objective of reducing wealth transfer taxes, the trustee shall have broad discretion in withholding distributions and providing the beneficiaries the use of trust assets, after taking into account all factors the trustee shall deem relevant, including, but not limited to, immediate and future income and transfer taxes."*

iii. *"Modern trusts can enhance the benefit of a gift or inheritance by making trust assets available for the use of the primary beneficiary on a preferential basis… For example, the beneficiary may use, on a rent-free basis, primary and seasonal homes, boats, and the like, which are bought and owned by the trust for that purpose,"* Ron Aucutt, "Structuring Trust Arrangement for Flexibility," 35 U. Miami Inst. on Est. Plan., Ch 9 (2003) at § 902.3.

iv. *"Capturing the advantages of gifts in trust without running around on the shoals of client distrust, hostile taxation, and beneficiary anger requires careful planning, skillful drafting, and client (and beneficiary education). The Beneficiary Controlled Trust (the 'BCT'), a trust that vests the non grantor beneficiary with broad rights to the use and enjoyment of the trust's income and principal while giving him or her the broadest possible control over the trust, maximizes these advantages."* (emphasis added) Theodore E. Calleton, Neill G. McBryde, and Richard A. Oshins, "Building Flexibility and Control into the Estate Plan – Drafting from the Recipient's Viewpoint," NYU 61st Institute on Federal Taxation 2003, p 21-5.

v. *"In addition to the myriad ways sophisticated use of trusts may reduce tax exposure, trusts can also pass use and enjoyment of wealth on to beneficiaries while shielding the wealth from the beneficiaries' creditors and from judgments in divorce."* (emphasis added) Garrett Moritz, "Dynasty Trusts and the Rule Against Perpetuities," Harvard Law Review Vol. 116, No. 8, June 2003, p. 2604.

vi. *"The most important of these special techniques has traditionally been the generation-skipping trust… The intervening generation could be given the equivalent of absolute ownership of trust assets through powers of appointment and trust powers. These trusts have offered incredible transfer tax avoidance benefits. For an intervening generation now the beneficiary of a generation-*

<u>skipping trust, estate planning is no problem, because the trust is already the best built-in estate plan</u>…. The perpetual generation-skipping trust may have been the ultimate estate-planning scheme for those who had the foresight to establish one." (emphasis added) George Cooper, "A Voluntary Tax? New Perspectives on Estate Tax Avoidance," p 57-58.

vii. The right to determine who uses the property can be in the hands of the client as trustee (or a successor beneficiary trustee) and need not be limited by an ascertainable standard. Prof. Jeff Pennell described the rationale for that conclusion to me as being similar to a life estate.

VII. The Concept – Transfer Tax/ Creditor Rights

A. The Grantor for transfer tax and creditor rights purposes is a third party, e.g., parent.

B. Client/ Inheritor is a trustee (in control of a Beneficiary Controlled Trust) and a beneficiary but should not make a gratuitous transfer to the trust. Any gift by the beneficiary would have the following adverse (potential serious) consequences:

1. For income tax purposes – note sales will be partially taxable; payments "in kind" will be partially taxable and the "tax burn" will be reduced.

2. For gift tax purposes – the gift will be a gift of a future interest.

3. For estate tax purposes—there will be inclusion, which includes post-transfer appreciation.

4. For generation-skipping purposes – the "ETIP" rule will prevent allocation of the GST exemption, thus, creating a partially exempt and partially non-exempt trust. IRC § 2642(f).

5. For creditor rights purposes it will become a self-settled trust to the extent of a gift by the beneficiary. Therefore, BDITs should be set up in states which have a self-settled trust law.

VIII. The Concept – Income Tax

A. The trust will be entirely a "Beneficiary Defective Trust" so that during the client/inheritor's lifetime, the client will be taxed on all items of income, deductions and credits. IRC §§ 671 and 678. [Alternatively, the trust can be defective to the client's spouse. IRC§677(a)(1) although there are several negative features to that approach. See VIII D.3 and J.]

B. Trust income tax options for discretionary trusts – three basic alternatives:

1. General Rule – The trust is taxed on the income except to the extent distributed to the beneficiaries, subject to "DNI" rules.

2. The trust settlor (grantor) pays the tax – the traditional "IDGT."

3. The beneficiary pays the tax – a "Beneficiary Defective Trust."

C. Obtaining "Beneficiary Defective Trust" Status – IRC §678

1. IRC § 678(a) provides the general rule that a person other than the grantor is treated as the owner of the trust income if that person has the power to vest the corpus or income in himself.

(a) A Crummey power of withdrawal is a power to withdraw corpus, and thus, is such a power.

(b) The general rule is applicable unless the settlor also has a power that causes him to be taxed under IRC §§ 673-677 or 679. In other words, under Subchapter J, a defect as to the trust settlor trumps an IRC § 678(a) power.

(c) Therefore, be sure that in planning for Beneficiary Defective Trust status the settlor does not retain a power or operate the trust in a manner that would make him the owner of the trust income. For example, do not have a BDIT acquire life insurance on the life of the settlor or the settlor's spouse.

2. IRC § 678(a)(1) deals with powers of withdrawal while the power is existing.

3. IRC § 678(a)(2) deals with powers of withdrawal that have been "…released or otherwise modified…"

4. A Potential Problem – Is a "lapse" a "release" under IRC § 678(a)(2)? If so, "Beneficiary Defective Trust" status is safe. If not, there is a mixed income tax result which is harmful to BDIT planning.

(a) As a general rule, a design feature of a properly crafted Crummey withdrawal power is that it will lapse within the "5% or $5,000" protection of IRC §§ 2514(e) and 2041(a)(2).

(b) If the power is "released" rather than permitted to "lapse," there are adverse transfer tax consequences.

(c) A "release" requires an affirmative act by the powerholder, whereas a "lapse" occurs as a result of a passive non-exercise of the power over time.

(d) The estate and gift tax statutes make a distinction between lapses and releases. For example, both §§ 2041 (b)(2) and 2514(e) state "(t)he lapse of a power …. shall be considered a release of a power". The income tax rules (and more specifically, IRC § 678) do not contain a similar provision.

(e) Read literally, a lapse would not be within the protection of IRC § 678(a)(2). Since it is no longer a withdrawable amount due to its lapse, then the beneficiary is not an "owner" for income tax purposes under IRC § 678(a)(1) and some practitioners are concerned that the powerholder is not taxed on the income.

(f) On the other hand, the IRS's consistent ruling policy is that for purposes of IRC § 678, a lapse and a release have the same effect, so the beneficiary remains taxed as the owner of the trust under IRC § 678(a)(2) subsequent to the lapse. All of the rulings that have addressed the issue have been PLRs. It is recognized that PLRs are effective only as to the taxpayer who obtained the ruling. It also recognized that there have been many PLRs issued on the question and it is clearly indicative of IRS policy as to the taxation of a lapsing power.[5] Most of the respected text books recognize the issue, and conclude that the better result is that reading the terms "lapse" and "release" as the same makes sense (See VIII E-H, infra).

D. There are several approaches that can be taken with regard to the lapse "problem":

---

[5] Although IRC § 6110(k)(3) provides that PLRs are not legal precedents, they are not ignored and appear to me to becoming more meaningful to planners than originally thought. Howard Zaritsky in his outline "Open Issues and Close Calls – Using Grantor Trusts in Modern Estate Planning" fn. 4 states: "Private letter rulings and technical advice memoranda are not legal precedents. Code § 6110(k)(3). PLRs and TAMs may, however, show how the IRS might address a similar case, and they have been cited and discussed by several courts, even though they are not precedents. See, *e.g.*, Wolpaw v. Comm'r, 747 F.3d 787 (6th Cir. 1995), *rev'g*, T.C. Memo. 1993-322 (allowing taxpayers to rely on a 20-year old PLR, in the absence of definitive regulations); *Estate of Blackford v. Comm'r*, 77 T.C. 1246 (1982) (noting that the IRS litigation position was contrary to a prior PLR); *Xerox Corp. v. U.S.*, 656 F.2d 659 (Ct. Cl. 1981) (stating that PLRs are useful in ascertaining the scope of the doctrine adopted by the IRS and demonstrating its continued and consistent application by the IRS); *Fanning v. U.S.*, 568 F. Supp. 823 (E..D Wash. 1983) (noting that a distinction between the facts of the instant case and those of prior cases had been cited in TAM, and that TAMs are often relied upon by the courts)."

1. Follow what the IRS rulings and the preponderance of the text books state is the answer and lapse the power within the "5 or 5" exception to IRC §§ 2514 and 2041(a)(2).

   (a) Interestingly, although the power of withdrawal is given to the beneficiary as to the entire contribution and the income tax consequences will apply as to the entire trust (including post-transfer appreciation), the portion exposed to estate tax inclusion in the beneficiary's estate is only the amount that is withdrawable at death.

   (b) The growth of the trust will not be exposed to estate tax inclusion in the beneficiary's estate.

   (c) Consider retaining the right for the power holder to withdraw for one or more of the ascertainable standard rights "health, education, support and maintenance." PLR 200949012.

2. Obtain a PLR.

3. Have client's spouse create the trust. (See VIII.J.).

E. *"Pursuant to IRC § 678, a person other than the grantor who has a power exercisable solely by himself to vest the corpus or the income of any portion of a trust in himself is treated as the owner of that portion. Further, a person other than the grantor who has partially released or otherwise modified such a power, and after the release or modification retains such control as would cause the grantor to be treated as the owner, will himself be treated as the owner. Thus, a beneficiary's power to withdraw assets (S corporation stock) from a trust established by his father causes the beneficiary to be a trust grantor under IRC § 678(a)(1) even though the withdrawal period is limited to 14 days after the transfer into trust, i.e., a Crummey power."* Byrle M. Abbin, "Income Taxation of Fiduciaries and Beneficiaries," CCH (2006) at § 1404.1.

F. *"Section 678 is unique. It is the only provision of Subpart E that can identify as an owner of a portion of a trust someone who is not its grantor. The general rule is simple. One other than the grantor is treated as owner of any portion of a trust that he or she can, by exercise of a power exercisable solely by himself or herself, vest in himself or herself, unless another provision of Subpart E identifies the grantor as owner of that portion."*

   * * * *

   "…Under § 678 anyone other than the grantor who has a power, exercisable solely by himself or herself, to vest a portion of a trust in himself or herself is treated as though he or she owned that portion."

   * * * *

   <u>*"…[I]f a person has the power to vest in himself or herself all of the trust principal, he or she is treated as owner of the entire trust."*</u>

   * * * *

"…Even powers that are no longer currently exercisable may cause § 678 to apply."

*   *   *   *

"…Under § 678(a)(2) <u>the release of the right of withdrawal…raises the former powerholder to a status similar to that of a grantor</u>."

*   *   *   *

"On a literal basis, powers that lapse are not 'partially released or otherwise modified.' A lapsing power does so entirely on its own; the powerholder does nothing to cause the lapse, other than refraining from exercising it in a timely fashion."

*   *   *   *

"The better argument for including lapsing powers within § 678(a)(2) is that doing so makes sense. The distinction between a power that the powerholder releases or modifies and one that the powerholder allows to lapse is not an economic one. In either case, the powerholder could have withdrawn the property and used it to create a trust that provided him or her the same benefits the original trust did. Therefore, the distinction probably should not have significant tax consequences. <u>Not surprisingly, the Service has ruled privately that§ 678(a)(2) applies to lapsed rights of withdrawal, including the portion that falls within the "5 and 5" exception for estate and gift tax purposes.</u>" (Emphasis added.) Ferguson, Freeland and Ascher, "Federal Income Taxation of Estates, Trusts & Beneficiaries," § 10.16.

G. *"If the beneficiary's demand power applies to all contributions to the trust, and if all the trust funds are held for possible future distribution to the beneficiary, as is often the case, the beneficiary would own the entire trust at all times. The beneficiary would own the portion of the trust attributable to the addition during the pendency of the demand power under § 678(a)(1), and he would own the balance of the trust under § 678(a)(2), because it would be held for future distribution to the beneficiary."* Howard M. Zaritsky and Norman M. Lane, "Federal Income Taxation of Estates and Trusts," WGL, at ¶ 12.03 (3)(a).

H. *"Pseudo Grantor Trusts"*

"Technically § 678 is not a "grantor trust" provision because it applies only to someone other than the grantor… however, [because it has the effect of treating that person as the owner of that portion of the trust as to which the power applies, just as if that person was a grantor who transferred property into the trust and retained certain powers or interests, [it creates a pseudo grantor trust].]

*   *   *   *

Under § 678 a person other than the grantor is treated as the owner of that portion of a trust as to which the person has a power to demand or withdraw either income or corpus… This provision applies regardless of whether the power is exercised, provided that the power is exercisable solely by the *powerholder. Classic forms of exposure under § 678(a)(1) stem from five or five and Crummey withdrawal rights, granted to qualify for the gift tax annual exclusion of § 2503(b) while avoiding taxable lapses under § 2514(e)…*

* * * *

Moreover, this pseudo grantor trust treatment applies to the entire amount subject to the power of withdrawal… and is avoided only to the extent that the trust's original grantor retains an interest or power that causes overriding grantor trust liability for income tax purposes.

* * * *

Indeed, as with the grantor trust rules themselves, one result of § 678 in general is that planners have the opportunity to cause income taxation to a person other than the recipient of certain income items, presumably with no transfer tax consequences to the pseudo grantor if the power of withdrawal properly is limited for wealth transfer tax power of appointment purposes.

* * * *

…[T]the lapse of a five or five withdrawal power is not harmless for income tax purposes the way it appears to be under § 2514(e) for most wealth transfer tax purposes. In many cases grantor trust status under § 678 is generated with respect to entire trusts because contributions to the trust do not exceed the beneficiary's withdrawal right, which may produce a favorable result if, for example, pseudo grantor trust status under § 678 allows the trusts to qualify as permissible S Corporation shareholders under § 61(c)(2)(A)(i)…"
A. James Casner and Jeffrey N. Pennell, "Estate Planning," Sixth Ed., CCH at §§ 5.11.1-5.11.7.

I. *"Concluding that a lapse is not a release … arguably would render I.R.C. § 678(a)(2) almost meaningless, or at least limit its scope to a relatively narrow class of cases."*

* * * *

Further, although the definition of a lapse as a release does not itself appear in I.R.C. § 678, the precise reasons for, and significance of, that omission are not readily discernible. The legislative history of the Internal Revenue Code of 1954, when discussing the new I.R.C. § 678, did not address the issue of whether a partial release includes a lapse, but merely referred to the statutory language and stated that the new statute was intended to codify the Mallinckrodt Regulations, from which the statute was largely copied." Jonathan G. Blattmachr and Frederick M. Sembler "Crummey Powers and Income Taxation", The Chase Review; July, 1995.

J. Alternative – Spousal Irrevocable Trust. For planning where the spouse sets up the trust, please see Richard A. Oshins, "Advanced Planning Strategies Using Grantor Trusts," N.Y.U., 60th Inst. On Fed Tax 2002, Ch 27 at §27.13.

1. If the spouse creates the trust, the general rule is that the spouse will be the owner of the trust income rather that the client/beneficiary unless

distributions to the client/beneficiary are subject to the consent of an adverse party. IRC §§ 677(a)(1) and 677(a)(2).

2. Grantor trust status to the spouse will continue even if there is a divorce, therefore, she would be exposed to tax on "phantom income." IRC § 672(e)(2)

3. The spouse generally cannot be a beneficiary of the trust she created without estate tax and creditor exposure. The general rule is subject to certain exceptions which are beyond the scope of this outline.

4. There appears to be no prohibition, however, to having the spouse receive the trust assets back through the exercise of a power of appointment by the beneficiary. The exercise should be made in trust so that it would not be includable in either spouses estates.

5. The nonrecognition treatment does not appear to extend to the interest paid on the note. See Linda Gibbs v. Comm'r, TC Memo. 1997-196, 73 TCM 2669, April 29, 1997 which held that the nonrecognition provisions for the transfer of property incident to a divorce under IRC § 1041 did not apply to the interest received by the taxpayer.

6. The spouse generally cannot be a beneficiary of the trust she created without estate tax and creditor exposure. The general rule is subject to certain exceptions which are beyond the scope of this outline.

7. There appears to be no prohibition, however, to having the spouse receive the trust assets back through the exercise of a power of appointment by the beneficiary provided that there is no understanding of that arrangement. The exercise should be made in trust so that it would not be includable in either spouses estates.

K. Benefits of Beneficiary Defective Trust status:

1. Transactions between the trust and the "owner" of the trust for income tax purposes (or his spouse) are income tax-free. Rev. Rul. 85-13; IRC § 1041(a).

   (a) This includes "in kind" payments in satisfaction of principal or income obligations.

(b) However, interest income on sales by the spouse will be taxed to the "owner." Linda Gibbs v. Comm'r, TC Memo. 1997-196, 73 TCM 2669, April 29, 1997
which held that nonrecognition provisions for the transfer of property incident to a divorce under IRC § 1041 did not apply to the interest received by the taxpayer.

2. By paying the income tax on the trust assets the client is making the functional
equivalent of a tax-free gift to the trust.

(a) *"[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."* Professor Edward Halbach, "Tax-Sensitive Trusteeships," 63 Or. L. Rev. 381, 384 n.11 (1984).

(b) The burden of payment of the tax by the beneficiary achieves superior benefits to placing the obligation on a settlor because the beneficiary can "get it back" as a trust distribution if needed. I believe that a reimbursement provision for a settlor is safe if the trust is domiciled in a state which protects the reimbursement from creditors. However, many planners are concerned with such a reimbursement provision.

(c) Payment of tax on account of trust earnings is not a prohibited transfer within the scope of IRC §§ 2036 and 2038 and is not a gift for GST tax purposes. Rev. Rul. 2004-64

3. "Tax Burn" – Payment of the tax reduces the beneficiary's wealth that would otherwise be exposed to estate tax and creditors.

(a) Over time, the estate tax benefits of the "tax burn" may far exceed the benefits of discounting. Jerry Hesch and David Handler, "Evaluating the Sometimes Surprising Impact of Grantor Trusts on Competing Strategies to Transfer Wealth," N.Y.U. 68th Institute on Federal Taxation.

(b) In fact, given ample time, the "tax burn" can result in sufficient wealth depletion and the client may not need to file a Form 706 because the estate may be reduced to below the threshold limits.

(c) A concern is often voiced where the settlor of the trust is taxed on the income (IDGT) since success in the strategy can create substantial income tax exposure in the absence of a properly structured "discretionary reimbursement" provision. Estate depletion in a Beneficiary Defective Inheritor's Trust, however, should not cause concern because of the beneficiary's access to distributions from the [beneficiary controlled] trust. Jerry Hesch and David Handler, "Evaluating the Sometimes Surprising Impact of Grantor Trusts on Competing Strategies to Transfer Wealth," N.Y.U. 68th Institute on Federal Taxation.

4. The client is able to exchange high basis property, or cash, for trust-owned low basis property to gain a step-up in basis at death. This strategy is particularly meaningful if the low-basis (or better yet negative basis) assets being swapped are interests in depreciable real estate.

L. After the death of the beneficiary, the trust will generally become a "complex trust." Housing the trust in a jurisdiction that does not have state income tax can often result in substantial benefits to the family in terms of income tax and wealth accumulation purposes.

IX. Traditional Wealth Planning Transaction – Installment Note Sale to an IDGT (See Exhibit E)

A. A popular transaction for estate planners is a sale of discountable, income-producing property to an IDGT for an installment note.

1. Most often the planning is downstream—the beneficiaries of the IDGT are typically younger generation beneficiaries and perhaps the client's spouse. The client will not be a beneficiary. IRC § 2036.

2. When the spouse is included as a beneficiary, we generally use a "floating spouse" concept, i.e., "the one I'm married to and living with at the time of death or distribution."

3. The client will not have the power to change the disposition since such a power would cause inclusion in the estate. IRC § 2038.

4. There is a potential gift tax issue if the property sold was undervalued, although most advisors believe that a defined value transfer should work. McCord v.U.S., 461 F. 3d 614 (5th Cir. 2006), rev'g, 120T.C. 358 (2003).

X. Wealth Planning Alternative Transaction – Installment Note Sale to a BDIT. See Exhibit E, Memorandum - F-1

A. The trust is set up by the parent (or someone other than the client). That person will be the grantor for transfer tax and creditor rights purposes.

B. Because the trust is funded solely by the parent, the property will be protected from the client's and other beneficiaries' creditors, and will be outside of the transfer tax system for the duration of the trust. If the trust is set up in a state with no rule against perpetuities, the trust-owned property is forever protected from the transfer tax system and creditors.

C. The client (and only the client) will be given a power of withdrawal (which will lapse)
over the entire contribution to the trust and the parent will not retain any powers which will create grantor trust status to the parent.

1. As a result, the client/beneficiary will be treated as the owner of the trusts for income tax purposes.

2. The parent will be entitled to the gift tax annual exclusion. The gifted amount will be GST tax exempt by reason of allocation of a portion of the donor's GST exemption.

D. The client will sell discountable interests in the entity (to the BDIT) for the FMV of the interest being sold.

1. The note will usually be interest only with a balloon payment.

2. Generally, installment note sales to IDGTs were use interest rates based upon the IRS tables for the month of the transaction.

E. Undercapitalization Risk - "Seeding" the trust to give it economic validity:

1. If the debt-to-equity ratio is too high, the IRS could attempt to re-characterize the sale to the trust as a gift (or part gift) with a retained income interest, exposing the
transaction to IRC § 2036, rather than a sale. Handler and Dunn, Drafting the Estate Plan, § 11.06(B)(2)(a).

2. To avoid a form over substance or sham argument that the IRS might use, conservative practitioners believe that the defective trust should independently funded with a reasonable amount of seed money.

3. The most popular "rule of thumb" is that there is "seed" money of at least 10% in the trust in order to legitimize the transaction. Under that scenario, a trust seeded with $1 million would tolerate a purchase of $9 million worth of assets.

3. As stated above, the 10% rule of thumb is based upon an informal conversation Byrle Abbin had with the IRS. Byrle 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." 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 Institute on Estate Planning, Ch. 13 (1997), p. 13-9.

(a) In discussions I have had with Byrle, he indicated to me that the 10% discussion with the IRS was in another context.

(b) Byrle's ruling was PLR 9535026. In that situation the parties agreed that at least 10% of the purchase price would be contributed as trust equity.

(c) Byrle has told me that he would feel comfortable if a $100 million asset was sold to a trust that had $1 million of seed money "because $1 million is a lot of money to lose."

4. Steve Akers also analogizes the 10% seeding to IRC § 2701(a)(4). Steve Akers, "Transfer Planning, Including Use of GRATs, Installment Sales to Grantor Trusts, and Defined Value Clauses to Limit Gift Exposure," Outline for ABA, Sept. 28, 2007 at p. 35.

5. Jerry Kasner told me that he felt that our office's use of the 10% "seed" money was extremely conservative.

6. Howard Zaritsky suggests a common sense approach, that there be sufficient assets to economically justify the transaction taking into account all relevant facts and circumstances. Thus, logically more seed money would be required to purchase assets which are not easily converted into cash, such as FLP interests. Howard Zaritsky, "Open Issues and Close Calls – Using Grantor Trusts in Modern Times", outline e-mailed to me by Howard, August 2008.

7. Although admittedly an anomaly, a 700:1 debt-equity ratio has been deemed to be legitimate. Baker Commodities, Inc. 48 TC 374, aff'd 24 AFTR 2d 69-5516, 415 F 2d 519, 69-2 USTC ¶ 9589, cert. den.

8. Assuming arguendo that you want to follow the 10% rule of thumb, what can a client do when the donor's seed money is insufficient to support the sale either because (i) the settlor of the trust is limited by the amount he is willing to gift, or (ii) the settlor is restricted because he does not want to pay a gift tax or exceed his GST tax exemption?

9. The client cannot give the "seed" money to the settlor to fund the trust. That would be treated as a "step-transaction." The settlor must use his independent assets.

10. A viable option is to obtain a third party guarantee.

F. Guarantees

"It is possible that the IRS may argue that any guarantee by the beneficiaries of the IDGT will result in taxable gifts from the beneficiaries to the trust, as the IRS has asserted in the past." **Milford Hatcher, "Planning for Existing FLPs," U of Miami Tax Inst., 2001, Ch. 3 at ¶302.2.**

1. M

1. Most advisors believe that the 10 percent rule of thumb on the initial funding can be
satisfied by funding the trust with less than 10 percent and having someone with
adequate financial resources personally guarantee the note.

2. The use of guarantees reduces the need for the settlor (trust creator) to make significant gifts to fund the trust.

3. *"Providing a bona fide guarantee by the IDGT beneficiaries instead of "old and cold" funding by the grantor can have significant advantages without adding appreciably more risk to what is admittedly an already high-risk technique. For the appropriate client, the possible income, gift, estate, and generation-skipping tax savings usually will be worth the risk. The greatest uncertainty – the consequences if the grantor dies before the note from the trust is paid off – remains, regardless of whether the trust is funded or the beneficiaries guarantee the note."* Milford B. Hatcher, Jr. and Edward M. Manigault, "Using Beneficiary Guarantees in Defective Grantor Trusts," Journal of Taxation, Vol. 92, Num. 03 (March 2000).[6]

---

[6] The Hatcher/Manigault quote refers to the note sale to an IDGT as a "high-risk technique." That appears to be as a substantial overstatement. Most lawyers who practice in the high-end wealth shifting area do not believe that the installment note sale to an IDGT is a high risk strategy. Practitioners have become far more comfortable with note sales to IDGTs since the Karmazin settlement (T.C. Docket No. 2127-03, filed Feb. 10, 2003) and considering the protective devices offered by "defined value sales." In addition to the enhanced comfort that practitioners are experiencing with the note sale to defective trust, the note sale to a BDIT offers additional safety because the power of appointment blocks a completed gift (Treas. Reg. § 25.2511-2(b) and PLR 9535008(TAM)) and reduces exposure to the estate tax (Treas. Reg. § 20.2043-1), resulting in only partial inclusion if the IRS challenges the valuation of the asset sold to a BDIT, rather than full inclusion if the IRS challenges the valuation of an asset sold to a traditional IDGT (IRC § 2036(a)). Moreover, since the special power of appointment will prevent a completed gift from occurring, the sale by the beneficiary to the BDIT is outside the scope of IRC § 2702. IRC § 2702 (a)(3)(A)(i). The IRS, in Karmazin, argued that IRC § 2702 had been violated, that the full value of the interest transferred was a gift and that the note was not a qualified interest and could not

(a) That outstanding article was written several years ago. Since the article was published, the use of guarantees has become an increasingly popular strategy to supplement gifted seed money, and lawyers have become more comfortable with the use of guarantees as seed money.

(b) Provided that the guarantor has the financial wherewithal to make a legitimate guarantee, there appears to be little distinction between assets in the trust and a guarantee by someone of sufficient wealth to satisfy an "economic substance test."

(c) There are no set rules; the 10% rule is only a rule of thumb and the visceral reaction is that guarantees appear to increase the uncertainty, but should not.

(d) At a minimum, however, the guarantee must be backed by sufficient assets to be legitimate and repayment should be reasonably expected to be made, should the guarantee be called upon.

(e) A guarantee should make the transaction more "commercially viable" in most instances because a seller would prefer a viable guarantee, rather than a security interest in the very asset that may be failing and unable to perform according to the sales agreement.

(f) "The guarantee seeks to make the loan a *bona fide* debt instrument, despite the lack of adequate assets in the trust to assure repayment of the debt. In conformity with commercial lending practices, personal guarantees should suffice to create a *bona fide* debt instrument irrespective of the adequacy of the trust assets, as long as the guarantors have sufficient personal assets to assure repayment of the debt. The personal guarantee of an insolvent beneficiary would appear to be useless for this purpose." Outline e-mailed to me by Howard Zaritsky, "Open Issues and Close Calls – Using Grantor Trusts in Modern Estate Planning", August 2008.

(g) While most of the literature deals with beneficiaries making the guarantee, there appears to be no proscription to having a non-beneficiary make the guarantee. I believe that the guarantee can be made by anyone other than the seller.

(h) For example, it would be reasonable if I made a note sale to an IDGT for the benefit of my descendants and my parent made the guarantee,

---

reduce the gift. With respect to the sale to the BDIT, the inability to subtract the "retained interest" is not harmful because there is no completed gift.

or alternatively, another trust that had been previously set up for my descendants could make the guarantee.

(i) Perhaps the distinction occurs when the trust does not pay a beneficiary for the guarantee under the theory that the beneficiary/guarantor is enhancing himself, so there is no gift.

(j) A guarantee by a trust beneficiary would have an advantage over non-beneficiary guarantees if the IRS tries to impose an imputed gift. The guarantor could argue that there was no donative intent. Rather, it was to enhance his own economic interest in the trust. Of course a third party stranger who makes a guarantee, as a business decision, would be outside of any gift tax exposure.

(k) Because we take a more conservative position and have the trust pay fair value for the guarantee (based on the independent appraisal), for our clients it appears that being a beneficiary of the trust is a distinction without a transfer tax difference.

(l) The guarantee does not need to be for the full amount of the sale, just a sufficient amount to give the transaction economic substance. The guarantee should be treated the same as "seed" money.

4. Is a "gratuitous" guarantee a gift?

(a) Current law appears to provide gift tax status only if, and when, the guarantor makes good on the guarantee at least where a beneficiary makes the guarantee. The theory is that if a beneficiary makes a guarantee he is protecting his own self interest. See Hatcher and Manigault, supra X.F.2; Bradford, 34 TC 1059 (1960).

(b) Letter Ruling 9113009 casts a shadow on that approach. The ruling entertained the issue of whether a personal guarantee of a note payable by another party is a taxable gift. It 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."

(c) Letter Ruling 9113009 was withdrawn by Letter Ruling 9409018. 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.

(d) It would not surprise me if the IRS and the courts take the alternative position that conferring the obvious economic benefit is a gift. Many authors on the topic recognize the uncertainty in the area.

(e) Some authorities that concern me are:

(i) Casner and Pennell. "With respect to a guarantee, if Parent is never called upon to make good on the guarantee – which would generate significant gift or discharge of indebtedness income considerations – <u>giving the guarantee alone should be treated only as a gift of the value of the guarantee – presumably what Child would pay an independent third party to obtain the guarantee, which could be quite expensive.</u>" A. James Casner and Jeffrey Pennell, Estate Planning, Vol. One-Sixth Edition, Sec. 6.3.3.6 (Emphasis supplied)

(ii) Henkel. "What if Dad guarantees Son's loan? The IRS has issued a private ruling that the value of the economic benefit conferred on Son by the guarantee constitutes a gift, if appropriate consideration is not paid. Assuming arguendo that this theory is correct, the value of the gift would presumably be measured by the fee which would be charged by a bank for a similar guarantee." Kathryn G. Henkel, *Estate Planning and Wealth Preservation,* Par. 28.07.

(iii) Zaritsky. Loan Guaranties. In Private Letter Ruling 9113009, the IRS considered for the first time the gift and estate tax consequences of a loan guaranty, and reached somewhat surprising conclusions. In the ruling, T made personal loan guaranties for debts incurred by corporations and other business entities owned by T's children. The guaranteed loans were secured from independent lenders, and the guaranty promises were made without compensation and without other security. T asked the IRS to rule on the effect of incurring the loan guaranties, the effect of payment on the guaranties, and the effect of the guaranties on bequest of assets to trusts for T's surviving spouse.

The IRS, relying on the Supreme Court's 1984 decision in Dickman v. Commissioner, concluded that making a loan guaranty for one's child (or an enterprise in which the child is beneficially interested) is itself a gift, because a financial benefit is bestowed on the child. The IRS noted that the children could not have obtained the loans without the guaranties, or at least would have had to pay a higher interest rate. The difference between the value of the debt that the children incurred with the guaranties and that they would have had to incur without the guaranties would be a gift on the date the guaranty is made. The IRS also stated that if the primary obligors default on their loans, T could be deemed to have made an additional gift if the amount T is required to pay is not reimbursed by the children, and if it exceeds the amount of the initial gift." Howard M. Zaritsky, *Tax Planning for Family Wealth Transfers*, Third. Ed., Par. 3.09(1)(d) (Emphasis supplied)

(iv) Milford B. Harcher, Jr. "It is impossible that the IRS may argue that any guarantee by the beneficiaries of the IDGT will result in taxable gifts from the beneficiaries to the trust, as the IRS has asserted in the past. Of particular concern is PLR 9113009, which the IRS withdrew in PLR 9409018 without any comment as to the gift tax provisions of the previous ruling….The IRS may argue, at least in the absence of reasonable guarantee fees, that the guarantee by the beneficiaries will effectively permit the gratuitous use of the beneficiaries' credit for the benefit of the trust."

If such an argument by the IRS is successful, it will clearly cause gift tax problems for the beneficiary/guarantor, as well as possible estate, generation-skipping, and income tax problems. In all probability, if any guarantee results in a taxable gift, it will be a future interest gift that will not be offset by the annual exclusion,…and will thus be a taxable gift to the full extent of the value of the guarantee. The timing and amount of the gift, if any, is unclear. Probably the closest commercial analogy is a bank's charge for a letter of credit. Generally, the bank makes an annual or more frequent charge for such a letter. By analogy, there will be an annual gift, probably in the range of one or two percent of the amount guaranteed, so long as the guarantee is outstanding. However, it may also be argued that a much larger, one-time taxable gift will occur at the inception of the guarantee, especially if the loan precludes prepayment." Milford B. Hatcher, Jr., *Planning for Existing FLPs,* 2001 Miami Institute on Estate Planning, Ch. 3 at Par. 3.02.B.2, raising the same concerns. (Emphasis supplied)

(f) There is no safe harbor for the amount to be paid for the guarantee. "The Section 1274 rate is a safe harbor rate for intra-family loans. There is no similar safe harbor for a guarantee fee. Interest on third party loans will be at least market rates, higher than the Section 1274 rate due to credit risks." Ellen K. Harrison, *Factors Relevant to Choosing the Best Split Interest Technique.* P.33

(g) As a result of the uncertain gift tax status, our firm advises that the trust pay a reasonable fee for the guarantee.

(h) We work with an appraiser in determining a reasonable fee and the terms of the guarantee agreement.

(i) An essential part of the design of the note sale to a BDIT is that all the gifts to the trust are subject to a power of withdrawal to ensure that the trust is 100% income tax defective to the beneficiary. Because of the downside risk, we do not use gratuitous guarantees. See X.F.4, infra.

(j) Payment of a guarantee fee is income tax neutral if paid to a trust that is also defective to the owner of the trust income or to his spouse. Rev. Rul. 85-13; IRC § 1041(a).

(k) If a guarantee fee is paid, there is some leakage in the wealth shift. However, the leakage is inconsequential after taking into account (i) the estate freeze, (ii) the discount and (iii) the tax burn.

5. Because there are multiple adverse consequences if a guarantee is a gift for gift tax purposes, all reasonable efforts should be made to avoid that occurrence. These risks include:

(a) Guarantor's gift tax – If a gift were found it would be a gift of a future interest and not qualify for the annual exclusion.

(b) Guarantor's estate tax – If the guarantee is determined to be a gift and is made by a trust beneficiary, it may result in pro rata inclusion of trust assets in the estate of the guarantor beneficiary under IRS § 2036 (the portion of the trust assets attributable to the amount "gifted" by the trust beneficiary as a result of the guarantee should be included in the guarantor beneficiary's estate).

(c) Guarantor's GST Tax – If the guarantee is deemed to be a gift with a retained interest by the beneficiary, the ETIP rule precludes the automatic allocation of the GST tax exemption and the trust will be partially exempt and partially non-exempt. The GSTT Regs. allow for a partition of the trust into exempt and non-exempt trusts if the trust either directs or permits the trustee to divide the trust when assets are gifted to the trust.

(d) Guarantor's income taxes – The guarantor would be treated as owner of a portion of the trust income and would have to pay income tax on that portion of income of the trust, and there would be a pro-rata gain on transfers of "in-kind" appreciated property in satisfaction of a trust obligation.

(e) Inheritor's income tax – The sale to the trust, interest payments and in-kind distributions in satisfaction of either will be partially taxed, because the trust will no longer be 100% "defective" as to the beneficiary who was granted the power of withdrawal.

(f) Notwithstanding the foregoing, if the beneficiary is the guarantor, if that beneficiary has a power of appointment, there is no completed gift for gift tax purposes and other transfer tax purposes.

G. Miscellaneous Refinements

1. There must be a quality appraisal. We have the appraiser give us (i) the value of the interest transferred; (ii) the interest and terms of the guarantee fee; and (iii) the market rate of interest that will be paid to the seller.

2. Each party should be represented by separate counsel.

(a) Cases in the FLP area have opined that the representation of the parties by separate counsel was an important factor in justifying the validity of the entity. Stone v. Comm'r, 86 T.C.M. (CCH) 551 (2003); Rector v. Comm'r, T.C. Memo. 2007-367.

(b) Certainly, in the context of the enhancing legitimacy of a sales transaction, the buyer, seller and guarantor should be represented by separate counsel. The use of separate counsel is the normal course of action for most large asset sales.

3. The client should not be both the seller and the trustee who represents the trust when "hard to value" assets are being sold by the client to the trust.

    (a) The more independent the trust representative, the better.

    (b) We strongly recommend the trust be represented by an independent financial institution, such as a trust company.

    (c) Some states (e.g., Delaware and South Dakota) have enacted legislation that permits a trust company to acquire hard to value assets when directed to by a trust beneficiary, and then be held harmless.

        (i) That course of action may be legally permissible, however, it negates the very reason we want the trust company to act.

        (ii) We want accountability and fiduciary responsibility of an independent financial entity to enhance the viability of the transaction.

        (iii) Acting pursuant to a beneficiary direction would undermine that goal.

4. The client should elect out of installment reporting if the asset sold would have gain. This is an idea suggested to me by Prof. Jerry Kasner when he reviewed an article I prepared several years ago discussing traditional note sales to IDGTs.

    (a) At the death of the client, the trust will no longer be income tax defective.

    (b) The income tax consequences of an unpaid installment note at death is uncertain and many commentators believe that death is a triggering event which will result in an income tax.

    (c) Prof. Kasner's advice is to elect out of installment reporting on the Form 1040 and advise the IRS that although the election would result in gain, that Rev. Rul. 85-13 would prevent the gain from being recognized and therefore no tax would be due.

    (d) If the taxpayer died in a subsequent year, since gain was recognized in the year of sale, there is no authority for the IRS to take the position that gain is recognized in the year of death.

(e) This strategy appears to be a no lose proposition and we recommend it in all cases to which Rev. Rul. 85-13 would apply.

5. Report the sale on a timely filed gift tax return in order to start the statute of limitations running on the valuation. Carlyn S. McCaffrey "Formula Valuation – Shield Against Gift Tax Risk or Invitation to Audit", Univ. of Miami Law Center on Est. Planning, 2008, Ch. 11 at ¶1104.

(a) The transaction is reported as a non-gift completed transfer under Treas. Reg. § 301-6501(c)-1(f)(4).

(b) If the IRS does not timely challenge the valuation, the statute of limitations will run on the valuation.

(c) If the IRS successfully challenges the valuation, the special power of appointment will avoid a taxable gift because the gift is incomplete. Treas. Reg. § 25-2511-2(b).

(d) If it is found that there was an inadvertent incomplete gift to the trust by client/inheritor, the client/inheritor will be treated as a transferor to the trust. The portion of the trust treated as an incomplete gift will be included in the client/inheritor's estate under the rules of IRC § 2043. Additionally, the portion of the trust attributable to the incomplete gift will be exposed to the other negative attributes described in VII.B, supra. To remedy this potential problem, the following steps should be taken:

i. The trust should be drafted where the trustee is mandated, or permitted, to divide the trust into separate trusts so that the gratuitous portion of the transaction is segregated into a separate trust.

ii. Our trust design requires the trustee who receives a gift to the trust, unless otherwise directed, to allocate the transfer first to the GSTT exempt trust and then to the non-exempt trust. In addition, we require a partition into separate trusts for transfers which have different income taxpayers.

iii. Once the trusts are segregated into a safe trust and an exposed trust, the trustee should spend and make distributions first from the exposed trust.

(e) Alternatively, a qualified severance could be made, and the trust would be divided in fractional shares with one being entirely exempt and the other not exempt IRC § 2642(a)(3).

XI. Opportunity Shifting

A. Opportunity shifting can be defined as the shifting or deflecting the opportunity to earn income or to generate wealth (by the estate owner client to others including trusts).

B. The intrafamily deflection of wealth by shifting a favorable investment or business opportunity is not a transfer that is subject to the gift tax. See e.g., <u>Crowley v.Comm'r</u>, 34 T.C. 333 (1960).

1. "*Creative … estate planners encourage their clients to consider a similar arrangement whenever any new venture is being undertaken. At this point, the developer of the new venture can decide exactly how much of the potential he wishes to accrue directly to himself and how much he wishes to bypass him and accrue directly to his respective heirs. The capital structure can be established accordingly*." George Cooper, "A Voluntary Tax? - New Perspectives on Sophisticated Estate Tax Avoidance," Columbia Law Review 161 (March 1977); Reprinted by the Brookings Inst. (1979) reflecting the Revenue Act of 1979. Reference is made to the Brookings Inst. Version, p. 12.

2. " *An 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 own the very successful Clinique and Aramis products down a generation to their sons, Leonard and Ronald.*" George Cooper, "A Voluntary Tax? New Perspectives on Sophisticated Estate Tax Avoidance," Columbia Law Review 161 (March 1977); Reprinted by the Brookings Inst. (1979) reflecting the Revenue Act of 1979. Reference is made to the Brookings Inst. Version, p. 12.

3. There appears to be no proscription to shifting the opportunity to trusts, including an Inheritor's Trust, where the opportunity shifter is a beneficiary and/or trustee.
   Indeed, in instances where the opportunity shifter is also a trustee, the shift would be in compliance with the fiduciary obligation that he has as a trustee. To do otherwise would breach his duty to the trust.

4. In our practice, when a client meets with us to structure a new business or investment, our normal response is to either find an existing Inheritor's Trust that would be suitable to own the business or investment or suggest

that one be set up. This is our approach, unless the economics suggest that the strategy is not suitable relative to the transaction costs.

5. In Blass v. Comm'r, 11 T.C.M. (CCH) 622 (1952), husband recommended a promising investment opportunity to his wife, who, as trustee for his children, made the successful investment. The Tax Court held that there was no gift.

6. Not only may the trust be the original owner of favorable investment or business opportunities that can explode in value outside of the transfer tax system and be protected from creditors, the opportunity shift to a BDIT can:

   (a) Have the ancillary benefit of having the "tax burn" soak up the client's estate. The "tax burn" effect is a significantly underappreciated result of the opportunity shift into a BDIT. In many instances the estate depletion in the inheritor's estate by the payment of income tax will exceed the value of the asset diversion from the estate.

   (b) Enable the client to make sales of discountable assets to the trust, even if the asset throws off no income, such as land. The cash flow from the opportunity-shifted property can pay the installment obligations on low or non-income producing assets.

   (c) The client can often aggressively "defund" his estate because of the security of being able to access the wealth accumulated inside of the BDIT.

C. *"Despite the obvious implications of such diversions (wealthy individuals diverting wealth generating opportunities to their prospective heirs; e.g., bringing one's prospective heirs into a profitable acitivity)… no sensible person would suggest that a tax be imposed on the giving of parental advice. Frequently, however, these diversions involve more than mere advice, as the parent provides his child with a valuable opportunity, created by the parent, whose economic worth is a direct reflection of the parent's activities. … The common factor in all these transactions is the transfer to a child of valuable parental talents and services, which are seemingly not subject to the gift tax."* George Cooper, "A Voluntary Tax? – New Perspectives on Sophisticated Estate Tax Avoidance," p 4.

D. See also Howard M. Zaritsky, "Tax Planning for Family Wealth Transfers," Sec. 11.07, which discusses the tax-free shifting of favorable business opportunities, "sweetheart" contracts, collateral business opportunities and favorable investments. Howard states: "One of the most common, yet seldom recognized, forms of special-asset transfer is the "gift" of a business or investment opportunity. An individual may transfer business opportunities to family members in various ways: for example, by offering free giving advice or services to the donee, by entering into contracts with the donee on favorable terms, or by operating a business that can shift collateral work to the donee's enterprise. All of these techniques can shift significant amounts of family wealth and income to selected family members without incurring federal gift tax, estate tax, or GST tax. (Emphasis supplied)

E. Services and advice from an astute advisor are not gifts.

1. See, for example, the often-quoted case of <u>Comm'r v. Hogle</u>, 165 F2d 352 (10th Cir. 1947), where Hogle established trusts for his children and successfully managed the trading accounts of the trust. The Tenth Circuit held that there were no gifts.

2. *"One way a client can effectively make a tax-free gift to his or her parents or siblings is by providing services to the parent or sibling without charge. A child who is an investment advisor, for example, can advise his parents or siblings on their asset allocation and investment selection, thereby providing for free what the parent or sibling would otherwise pay for. Making a 'gift' in this way can be especially powerful in the case of a child who is a hedge fund or venture capital manager.…the gift tax applies to gifts of property. 'Property' of course, can mean many things.…one thing that is not property, however, is services, and as a general matter gifts of services are not subject to the gift tax.…the principle that the gift tax applies only to gifts of property and not to gifts of services is so fundamental that it is difficult to find court decisions or IRS rulings that even address the issue."* M. Reed Moore, "Transferring Wealth to Parents and Siblings in a Tax-Effective Manner," 42nd Annual Heckerling Inst. On Estate Planning, 2008, Ch. 8 at § 802.1.

3. Because the person acting as an investment trustee of a Beneficiary Controlled Trust is making managerial decisions in a trust of which he is a beneficiary, the non-gift treatment of services and advice is enhanced (under the same theory that gratuitous guarantees by a beneficiary should not be a gift since the beneficiary is protecting his own interests).

XII. Life Insurance Planning

A. The BDIT can be used as a funded life insurance trust. Exhibit F, Memorandum – F-2

1. The trust can buy life insurance on anyone on whom the trust has an insurable interest.

2. Generally, the life insurance would be on the life(lives) of one (or more) of the trust beneficiaries.

3. If the life insurance is on the life of the inheritor/client, two adjustments must be made to avoid estate tax inclusion under IRC § 2042:

    (a) All decisions with respect to the life insurance on the inheritor/insured's life must be made by a non-insured trustee. We generally use the Independent Trustee for those decisions.

    (b) The insured, as beneficiary, cannot have a power of appointment over the life insurance or its proceeds.

4. In reviewing an earlier draft of this outline, Larry Brody pointed out to me that until there is adequate cash flow to pay premiums (and fund the installment note) that the strategy "will either involve using a donor/donee split-dollar arrangement (if the policy is survivorship) or a premium financing transaction, either with the insured or with a third-party lender loaning money to the trust to provide a source of premiums." See Exhibit G, Memorandum – F-3 and Exhibit H, Memorandum – F-4.

B. There is an interesting correlation between life insurance, particularly where life insurance is used as an "asset" class (often compared to municipal bonds), or as a tax-free accumulation vehicle (similar to a QRP or NIMCRUT) and the "tax burn." (For a comparison of cash value life insurance, QRPs and NIMCRUTs, please see Exhibit I.)

1. Life insurance, other than a term policy, has two component parts: the (i) death benefit and (ii) the inside buildup.

2. The death benefit is more important during the earlier portion of the "tax burn" because the earlier the client dies the greater the potential tax.

    (a) The death benefit becomes less important as estate depletion is occurring.

    (b) However, if you look at the massive amount of investments being made in existing policies, you would conclude that often the policy has value as an investment.

3. The tax-free inside buildup forms a viable asset class, which can be viewed as:

(a) An alternative to a municipal bond; tax-free buildup with a minimum guaranteed return, plus an upside if investment performs and exceeds the guarantee or the insured dies substantially prior to projected life expectancy;

(b) A tax-free wealth accumulation vehicle substituting (or adding to) a qualified retirement plan or a NIMCRUT. This retirement plan alternative was marketed years ago as the "Private Pension Plan." It is simply an over-funded life insurance policy, which is not a MEC. The problem with this planning arrangement as typically marketed was that the ability to access the cash value resulted in estate tax inclusion. The Inheritor's Trust finesses this problem.

4. *"Life insurance as an asset class"*

For this brief explanation of MPT [Modern Portfolio Theory] <u>and the categorization of asset classes</u>, we believe that life insurance meets the important criteria of this designation: The death benefit is cash (itself a major asset class) at the precise time it is needed and without valuation adjustment based on up or down phases of the equity or bond markets; <u>The living benefits – the cash value – takes on the asset class attributes of the policy itself</u>. A universal life or whole life policy's cash value has the dominant characteristic of a fixed account with a minimum guaranteed return. A variable universal life policy's cash value is itself a portfolio with the opportunity to reflect the asset allocation of the policy owner. The unique characteristics of life insurance – income tax deferred accumulation of cash value, income tax-free and possibly estate tax-free death proceeds, the ability to make policy proceeds free from the reach of creditors, the possibility of drawing upon policy cash values to produce significant retirement income, and the inherent leverage or relatively low periodic payments into a capital sum – <u>are attributes that allow a life insurance policy the tendency to be at least uncorrelated against virtually any other asset class</u>. The death benefit is based on the event of death – not a market event which in turn can cause a change in value. Individuals with sufficient assets to retain portfolio managers are most often buyers of significant amounts of life insurance that are funded with capital rather than budgeted income. Determining from which 'pockets' of portfolio investments the premiums should be paid is inherently an activity of asset allocation and re-allocation. <u>Permanent life insurance intended for a lifetime can produce at least as favorable a long-term return with less risk within a portfolio of equity and fixed components than a portfolio without life insurance (a favorable efficient frontier result)</u> (Emphasis supplied). Richard M. Weber and Christopher Hause, "Life Insurance as an Asset Class: A Value-added Component of an Asset Allocation," copyright

2008. I have found that Dick Weber's writings in the area are extremely insightful. See, www.ethicaledge.biz.

5. The benefits of tax-free accumulation expand over time on somewhat of an exponential basis.

   (a) For example, a pension plan for only a couple of years (assuming no change in income tax rates) makes no sense. The tax-free compounding is more valuable the longer the term. The inside build-up should have the same result.

   (b) The death benefit feature of a life insurance policy hedges the possibility of a reduced term. If the insured dies early, the death benefit is a windfall. If the insured survives for the expected term, the inside build-up can be dramatic.

C. The BDIT can own life insurance which could be used for buy-sell purposes. This is a variation of the BILIT concept devised by Stephen O. Rothschild, C.L.U.

1. Assume A and B own an entity 50-50. The traditional buy-sell would be designed so each would own life insurance on the other's life. At death the survivor would purchase the decedent's interest and own 100% of the entity.

2. Alternatively, if an Inheritor's Trust owned life insurance on the co-owner's life and purchased the interest at death, the client would own 50% of the entity and the Inheritor's Trust would own 50% of the entity.

3. If the client redeemed or transferred 1% of the entity, he would own a 49% minority interest in the entity for estate tax purposes, but as trustee of the BDIT would be in full control of the entity.

XIII. Coordination with Asset Protection

A. *"In today's increasingly litigious environment, however, asset protection planning is becoming increasing significant as a separate area of focus within the field of estate planning."* Skip Fox, "Asset Protection Planning and Dynasty Trusts," Real Property, Probate and Trust Journal, Summer 2002.

B. The typical asset protection planning integrates either a Foreign Asset Protection Trust ("FAPT") or a Domestic Asset Protection Trust ("DAPT") with one or more FLPs or LLCs.

1. The client will own a 1% controlling interest in the entity so he manages the assets; and

2. The APT will own the remaining 99% interest.

C. The BDIT offers more secure protection than an APT.

1. Many cases have come down where the court has not respected FAPTs.

2. There have been no cases on the validity of DAPTs, but most lawyers in the field believe that they work. See comments by Skip Fox in Financial and Estate Planning, CCH, Nov. 26, 2007. Skip told me that there have been several attacks on the DAPT, however, they were settled for pennies on the dollar.

D. A sale of non-controlling interests in the entity from a FAPT or a DAPT will have the ancillary virtues of GST tax savings, similar to what is obtainable by a sale from the inheritor himself.

E. A sale of the retained control interest by the client to a BDIT for its FMV should:

1. Enhance the asset protection since the BDIT will own the interest.

2. Change the estate tax value of the property in the APT to that of a non-controlling interest.

3. Enable the client as managing trustee to control the entity.

<u>Exhibit A</u>

BDIT SCHEMATIC

WEALTH PROTECTION

Solely because assets are placed into an appropriate trust by someone else, and the beneficiary **never** adds assets to the trust, except for full value, as long as they are kept in trust, these assets have benefits that do not, and cannot, exist if the same assets were owned outright.

BDITs are forever sheltered:

1. From all estate, gift and GST taxes;
2. From the beneficiary's(s') creditors (including divorcing or dissident spouses);
3. From probate and incapacity headaches and delays; and
4. From certain income taxes after the death of the original beneficiary.

Beneficiary Defective Trust

Because the original beneficiary is taxed on the trust income, the beneficiary's estate will be "tax burned," i.e., depleted by income tax paid on trust income. This, in effect shifts the beneficiary's personal wealth tax-free into the Beneficiary Controlled Trust ("BDIT") away from transfer tax and creditors, without gift or GST tax consequences, and with no economic risk because the beneficiary is in control of the trust.

Parent or Other Third Party creates trust
and contributes $5,000 in cash; no other gifts are made
to the trust by anyone
Trust Creator is the Grantor of the Trust for:
Transfer Tax Purposes
Creditor Rights Purposes
But Not Income Tax Purposes

↓

BDIT

Irrevocable; Fully Discretionary; GST Exempt;
Beneficiary has limited power of appointment
* * * * *
Beneficiary given limited time power to withdraw the original gift; Beneficiary is therefore the "Owner" of the Trust for Income Tax Purposes
* * * *
Beneficiary – Investment Trustee
Independent Trustee – Distribution Trustee

Unless otherwise directed by exercise of beneficiary's power of appointment ("re-write power") upon death of beneficiary.

↓

Trust for Surviving Spouse (if desired) and Descendants
* * * * *
Surviving Spouse - Investment Trustee
Independent Trustee – Distribution Trustee
* * * *
Income Taxed to Trust Unless Distributed

Unless otherwise directed by exercise of power of appointment ("re-write power") upon death of surviving spouse divided equally for each family branch.

↓

Child A's Family Trust	Child B's Family Trust	Child C's Family Trust

At the death of each child, that child's trust is "recycled" a generation down, subject to the power of appointment.

CONTROL

Without exposing the trust assets to estate taxes and creditors, the trust beneficiary can have substantial controls.

The original primary beneficiary and each successive primary beneficiary are in control (at the proper time) subject to amendment by the exercise of the power of appointment by the preceding generation.

Administrative Control:

1. The original primary beneficiary is the Investment Trustee.
2. The Independent Trustee makes all distributions (if any) and makes other tax sensitive decisions.
3. The primary beneficiary can fire and replace the Independent Trustee with another Independent Trustee, with or without cause. Independent does not require a corporate fiduciary, nor a confrontational relationship; it could be a "best friend".

Dispositive Control:

1. The right to use the trust-owned assets (rent-free if desired).
2. The primary beneficiary can essentially re-write the trust. This enables the primary beneficiary to adjust for changes in tax laws, trust laws, family dynamics, etc.

OSHINS & ASSOCIATES LLC

BRYAN CAVE

Exhibit B

BUILDING FLEXIBILITY AND CONTROL MECHANISMS INTO THE ESTATE PLAN – DRAFTING FROM THE RECIPIENT'S VIEWPOINT

THEODORE E. CALLETON, ESQ.
Pasadena, California

NEILL G. MCBRYDE, ESQ.
Moore & Van Allen PLLC
Charlotte, North Carolina

RICHARD A. OSHINS, ESQ.
Oshins & Associates
Las Vegas, Nevada

I. INHERITING IN TRUST IS BETTER THAN INHERITING OUTRIGHT[1]

Many families with substantial wealth (as well as some of their advisors who should know better) are unaware of or simply overlook a fundamental fact of estate planning. The key concept they unfortunately so often miss is that assets received in trust are much more valuable to the inheritor or donee then those same assets received outright. Solely because assets are received and continue to be held in trust gives those assets many advantages that cannot exist for assets received outright. In order to achieve these results, it is essential that the planning and documents be put in place before the transfer. A person other than the beneficiary, including the spouse of the proposed recipient, can set up, and fund the trust. This shelter is not available for a person to do for himself once he is individually entitled to the property.

The benefits that can be achieved by receiving and retaining gifts and inherited assets in an irrevocable trust (rather than being commingled with a donee's own assets) are significant. A perpetual dynastic trust will extend these enhancements for multiple generations, subject only to the applicable rule against perpetuities, if any. These improvements fall into three categories –

---

[1] See Richard A. Oshins and Steven J. Oshins, Protecting and Preserving Wealth Into The Next Millenium, Trusts and Estates Magazines, page 52 (September, 1998) and page 88 (October, 1988).

A. A trust "shelters" inherited assets from the donee's "predators".

Assets put into a trust by someone other than the beneficiary himself have the advantage of being sheltered from the reach of many of the beneficiary's predators – such as a divorcing spouse, a creditor in bankruptcy, and the IRS (in the case of certain trusts). Thus, where the "transferor" of assets gifted or bequeathed to such a trust is someone other than the beneficiary, eg. the beneficiary's parent, aunt, uncle, or grandparent, use of the trust "enhances" those assets (as compared with an outright gift or bequest to the donee). In other words, the trust itself makes the transferred assets more valuable by protecting them from the reach of many of the donee's would be claimants. These shelter benefits include –

1. Protection from donee's death, gift, and generation-skipping taxes (but only insofar as the trust is GST "exempt").

   a. If the trust is an "exempt trust", no transfer taxes of any kind will be levied when the donee passes those trust assets on to others (whether outright or in a continuing trust), either during his lifetime or on death. The "exempt" status of the trust (and its successor trusts) continues no matter how large the value of the trust's assets may grow through successful investment performance and/or income accumulations.

   b. Thus, the full value of the trust can be passed on to the donee's family or, within the limits of the donee's special power of appointment, to or for the benefit of any particular person or persons selected by the donee.

   c. Without such protection (and assuming the donee would otherwise be in the 50% estate tax bracket), the estate and GST taxes together take 75% - leaving only 25% for the grandchildren.[4]

2. Protection from donee's creditors, bankruptcy, and divorce (subject to some state law aberrations). As the asset protection maximum goes, "If you don't own it, no one can take it from you."[5]

   a. In the event of the donee's divorce, those third party transferred assets, while they remain in such a trust, are not "marital property" to be equitably divided by the court. Likewise, such "in trust" assets are not a part of the donee's estate for purposes of determining a surviving spouse's elective share rights.

---

[4] Exhibit A attached at the end of this explanation (entitled "The Power of Compound Growth") compares \$1M left outright (after compounding for 120 years at total return growth rates ranging from 6% to 10%) with \$1M left in trust. The difference is the estate tax to which the outright inheritance is subjected – assumed to be a 50% tax every 30 years.

[5] Howard D. Rosen, 810 T.M., Asset Protection Planning, BNA Tax Management Portfolio at A-1.

b. The donee's creditors cannot reach those assets. Lifetime or testamentary gifts made in trust (rather than outright) insulate those assets from the reach of the donee's creditors – which also provides some "peace of mind" benefits. For example –

- If the donee is a doctor, lawyer, architect, CPA, or other professional, it is reassuring to know that those gift or inherited assets are held in trust and thus will be sheltered from the donee's potential professional malpractice liability.

- Having the donee's "core assets" (inherited family wealth) sheltered in such a trust provides another frequently overlooked benefit. It allows the donee (or the donee's spouse) to borrow for business or investment purposes without putting those core assets at risk on account of the personal guarantees that lending institutions typically require of business owners and their spouses.
- Alternatively, a favorable business opportunity or other predictably profitable venture might be acquired by the trust itself as an investment of the trust with the wealth inurement being protected from liability and transfer taxes by the trust wrapper.

B. <u>Incapacity and probate avoidance benefits.</u>

As compared with an outright gift or inheritance, if a donee receives (and keeps) gifted or bequeathed assets in a trust, those assets are protected by the trust:

1. From the mistakes and "improper influences" that often result from a donee's"

a. Inability (that is, immaturity, inexperience, poor judgement, etc.),

b. Incapacity (including legal incapacity to act due to not having attained legal age under state law), or

c. Possible substance abuse addition, and

2. From probate on the donee's death.

a. On the death of a trust's beneficiary, the trust simply continues to administer its assets, privately and without court involvement of any kind, for the beneficiary and his successor beneficiaries.

b. Avoidance of probate under any of those circumstances (i) preserves privacy, (ii) reduces expense, and (iii) generally results in a more expedient administration of the assets.

C. <u>Inherited wealth often benefits from the respect shown by its segregation.</u>

Inherited wealth received outright often loses its identity due to commingling. On the other hand, when wealth is received and retained in trust, there is the increased propensity to preserve the wealth for the benefit of future generations.

This segregation advantage seems to apply even though, after attaining certain ages, the donee succeeds to full control over his trust and the assets that were left for him and his family.

a. If a donee/beneficiary has a fund which is ample and protected from predators, the beneficiary is better able to aggressively use wealth shifting devices to reduce his own estate, due to the fact that his well-being is protected by the assets in the trust.

D. <u>Conclusion-Inheriting in trust is always better, provided the beneficiary has adequate control over his trust!</u>

A donee-beneficiary whose inheritance is received in trust will almost certainly be pleased by the added benefits that the trust makes possible (when compared with an outright inheritance). However, this will often be true only:

- If either initially or on attaining a properly mature age, the beneficiary will possess reasonable controls over his trust (ie, a "Beneficiary Controlled Trust"-"BCT"), and sometimes only
- If someone with expert practical knowledge of the trust has taken the time to be sure that the donee-beneficiary fully understands how the benefits made possible by the trust will enhance his personal well being.

1) <u>The importance of control to a donee-beneficiary's peace of mind.</u>

Control is a very important element in determining how happy (or frustrated) a beneficiary may be with the gift or inheritance trust he has received. Depending on the circumstances, a donee-beneficiary will often be discontented with a trust gift or inheritance unless if he has some reasonable level of control over his trust.

2) <u>Nevertheless, in some cases a donee-beneficiary may not have control</u>.

If the terms of the trust do not permit the beneficiary to ultimately succeed to reasonable controls over his trust, he may wish that this particular gift or inheritance had come to him outright rather than in trust. Before making such a judgment, however, the beneficiary should seek to understand the reasons why he was not given certain otherwise normal beneficiary controls. The absence of such controls may be the result of:

(a) **Inadvertence** (as where the trust was drafted following traditional, rather than contemporary, patterns and choices relating to beneficiary controls),
(b) **The beneficiary's personal circumstances** (these sometimes suggest the need to limit certain controls that would otherwise be given to a beneficiary), or
(c) **A desire on the trust's creator's part** to have family wealth preserved and passed on to others (in other words, an outright inheritance would have been out of the question, regardless of the other circumstances).

3) If the desire of the transfer is to improve the gift, a BCT should be the choice. If it was not for the tax, divorce and other benefit that an "in trust" gift or inheritance can provide, if the transfer would be made outright, the transfer should be made in trust.

- For mature, competent potential recipients a totally discretionary BCT should be the vehicle of choice,
- If the beneficiary has not attained a properly mature age or responsibility, the trust should become a BCT at the projected age of such maturity. Certainly, this should be favored over a direct distribution.

In any case, the donee-beneficiary should at least be pleased by the asset protections and other benefits afforded by the trust.

II. WHAT IS A "BENEFICIARY CONTROLLED TRUST" ("BCT")

A. An Overview.

1. The "Pipe Dream"[6]

a. If it were attainable most property owners would love to have the ability to place their property into a structure whereby they -

- Could manage and control it;

- Use the property, and income from it, for whatever purpose they desire;

[6] Drafting California Irrevocable Trusts, John R. Cohan, ¶ 8.11

- Be able to give the property to whomever they want to, whenever they want to, however they want to, with or without strings;

- And protect the property against lawsuits and taxes

b. Many property owners would like to pass their wealth to their children and more remote descendants (at such time or times, that they perceive that these donee's have attained sufficient maturity and responsibility) where the donees could also obtain the foregoing beneficial enjoyment of the wealth. The beneficiary controlled trust gives the primary beneficiary (and those succeeding to the status of being the primary beneficiary) control and enjoyment of the transferred property, including its income and growth virtually equivalent to outright ownership over the property without the exposure to predators.

c. The desire is to avoid the exposures of outright ownership while also avoiding the restrictions and controls inherent in the traditional trust arrangement gives the recipient/beneficiary the best of all worlds-full enjoyment without exposure.

2. <u>The BCT concept is an attempt to answer those questions.</u>

The "beneficiary controlled trust" has evolved as an attractive middle ground answer to those basic questions. It can be designed to give a beneficiary control virtually tantamount to outright ownership as well as insulation of the assets from taxes and creditors, provided the trust is property setup and funded by someone other than the beneficiary.

3. BCTs are a way for a beneficiary (i) to have the benefits of inheriting in trust, (ii) for life, (iii) with full control at the "right" time.

Briefly summarized, a BCT gives the primary beneficiary:

a. All of the benefits of an inheritance "in trust",

b. Which will continue for the beneficiary's entire lifetime, and

c. Either initially or ultimately, the beneficiary will be in full control of the trust - the controls over the trusts assets and operations approaching outright ownership.

4. A typical perpetual BCT continues this structure into for as long as the trust continues, giving the control to the senior generation on a per stirpital basis, subject to alteration by the use of a special power of appointment.

B. How a BCT differs from traditional trusts.

1. Traditional trusts.

   Traditional trust for an adult child typically provide that:

   a. The income from the trust's assets shall be distributed periodically to the child,

   b. The trust's principal may be invaded, in the trustee's discretion, if necessary, to meet certain standards – such as, "if needed for the child's health, education, and support in reasonable comfort", and

   c. The trust continues in existence only until its assets are distributed to the child, often in fractional amounts as certain specified ages are attained such as, ½ at 25 and the rest at 35.

   d. In theory, these distributions are expected to be made at the time of the beneficiary's anticipated ages of maturity.

   e. Distributions have the residual effect of moving the assets from a protected status to an exposed environment.

2. The three key characteristics of a typical BCT.

   a. A BCT is a "totally discretionary" trust.

   b. It is a trust arrangement that continues (i) for the child's lifetime and (ii) for the successive lifetimes of the child's descendants.

   c. When specified ages are attained, instead of requiring outright distributions to the child, a BCT puts the child "in control" of the trust.

   However, this transfer of control may be deferred if the child's parents (or their designees) believe the child is not currently able to take on the responsibilities of control. This deferment might be until (and to the extent) the age(s) that outright distributions would have been made had a traditional trust been used.

C. The approach of the BCT

1. The premise on which the BCT concept rests

The following statement best expresses the premise on which the base form BCT rests.

> "If it were not for the benefits that an "in trust" inheritance can provide, I would leave it all outright."

A pure BCT is intended to be "living proof" of the conclusion that inheriting in trust can be far better then inheriting outright.

2. The BCT's primary goal is to maximize "in trust" benefits.

The BCT's totally discretionary distribution pattern, by its very nature, maximizes "the benefits that an in trust inheritance can provide". As pointed out in the discussion of that distribution pattern, the use of this pattern also means that the BCT's primary goal will be achieved with maximum flexibility to meet changing circumstances.

3. The essence of the BCT concept is beneficiary control.

The basic premise, "I would leave it all outright", expresses the key condition or prerequisite of the arrangement- beneficiary control and beneficiary responsibility. That means "full control". The beneficiary as family trustee would control all non-tax sensitive decisions as well as the identity of the independent trustee, who would control the tax sensitive decisions.

4. What to look for in an independent trustee.

From a purely technical point of view, an independent trustee should be an individual or institution:

- Who meets (i) the tax that is, IRC section 672(c)] and (ii) creditors' rights criteria of independence – and, if an individual is to act, usually one
- Who is knowledgeable in investment, business, or tax matters.

However –

a. "Independence" does not require a confrontational relationship.

Rather a cooperative relationship is what the trust's creator intends – with the trust's primary beneficiary (eg; the adult child) normally becoming, in due course, what is described below as the "top of the control list person".

b. The independent trustee should be "a caring friend".

Ideally, the independent trustee should be "a caring friend' of the primary beneficiary, trusted and trusting – a person:

(1) Who seeks to understand and be understood and

(2) Who has experience, maturity of judgement, and a sense of the enduring values of the beneficiary's family.

(3) The independent trustee may be the primary beneficiary's best friend.

D. <u>BCTs keep inherited assets in trust over mulitple lifetimes.</u>

A BCT is a trust arrangement that recognized the benefits that can be achieved by the continued holding of inherited wealth in trust, not just for a child's lifetime but also for the successive lifetimes of the child's descendants.

1. <u>Most traditional trusts distribute outright at certain ages.</u>

In the case of traditional trusts, the governing document often directs that, upon the trust beneficiary's attainment of a certain age (or certain ages), part or all the trust's assets shall be distributed outright to the beneficiary. The outright distribution of trust assets, in affect and to that extent, terminates the trust – and thus also terminates the benefits that would otherwise have continued if the assets had been kept in trust.

2. <u>A BCT instead gives the beneficiary control over the trust's assets.</u>

What makes the BCT concept so advantageous is that, instead of terminating the trust at a certain age or on someone's death, the trust continues on indefinitely (with the primary beneficiary in full control of the trust and its assets). In this way, the BCT preserves for the beneficiary (and his descendants) all of the benefits that continuing an inheritance in trust can achieve (as described in part I above).

D. <u>At the "right" time, "full control" over the BCT shifts to the primary beneficiary (eg; the child).</u>

A unique aspect of the beneficiary controlled trust concept is the way in which full control over the trust may be gradually shifted to the trust' primary beneficiary.

1. <u>In traditional trusts, the "dead hand" controls.</u>

During the period that a traditional trust continues, whether it is until certain ages are attained or for the child's entire lifetime, the child typically has no voice in the trust's management.

b. The “dead hand” directions of the testator usually continue throughout the traditional trust’s existence.

c. Such “control from the grave” is usually evidenced by:

- Rigid distribution provisions,
- An unchangeable trustee appointment, and
- The fact that often the beneficiary is not a trustee and has no special power of appointment.

III. PERPETUAL(OR DYNASTIC) BENEFICIARY CONTROLLED TRUST (“PBCT”) FORMAT

A. The “perpetual or dynastic trust” concept

A “perpetual or dynastic trust” is any long term, noncharitable trust.

1. It is a “trust arrangement” (not a single trust).

Actually, in almost all cases, this type of trust should be referred to as “**a trust arrangement”.** This is because the governing trust document normally creates separate trusts, one for each family branch (and, in due course, for each lower generation family branch), depending on the makeup of the grantor’s family. The reasons for having separate trusts for each family branch are discussed below.

2. The rule against perpetuities and its effect

Dynastic trusts are normally expected to continue in existence for the maximum time period allowed by the rule against perpetuities.

3. A growing number of states have repealed the rule

In a growing number of states, the rule against perpetuities has a trust created in one of those states may continue in perpetuity as a perpetual trust arrangement going on indefinitely for as long as there are assets and one or more beneficiaries.

B. As noted above, the term “perpetual or dynastic trust” typically refers to an expanding group of trusts (which might be referred to as a trust arrangement).

- At a minimum, the generation-skipping transfer (GST) tax requires that pairs of trusts (GST tax exempt and nonexempt) be established.
- As the family branches of beneficiaries expand, additional trusts or pairs of trusts are desirable from an administrative and family harmony perspective

- If spouses of family member beneficiaries also are or may become beneficiaries, even more separate trusts may be appropriate.
- Finally, if a plan of lifetime giving is undertaken, the PBCT arrangement is the appropriate receptacle for gifts (both annual exclusion gifts for the benefit of children and grandchildren and major gifts). Although separate trusts are suggested if the gifts were to create different income tax treatment.[4]

The following is a brief description of the patterns utilized in our practice with respect to PBCT arrangements.

A. Threshold decisions

Preliminary questions that must be answered before the trust agreement can be prepared include, in the case of a married couple, who the grantors of the PBCT will be. Also, whether (and to what extent) sons in-law and daughters in-law should be provided for and what the scope of the powers of appointment to be given to children and lower generation beneficiaries should be.

1. Should both husband and wife be grantors?

In the case of a trust (that is, one that benefits only descendants and future generations), there are generally no income, gift, or estate tax concerns in having a husband and wife serve as cograntors of that trust arrangement because neither cograntor is a beneficiary provided, that the trust is not an income grantor trust as to either spouse or as to a beneficiary under IRC 678.

a. Reasons to have a married couple be cograntors.

A trust created for the benefit of one spouse by the other spouse will have no adverse creditor or transfer tax implications for income tax purposes, the trust would be a grantor trust during the lifetime of the beneficiary spouse unless distributions to the spouse are subject to the consent of an adverse party. IRC 677.

b. Reasons not to have a married couple be cograntors

In the case of a trust designed to be a "grantor trust" for income tax purposes, it may be difficult, from an accounting perspective, to determine what portion of the fund is "owned" by the surviving grantor for income tax purposes.

2. Establishing a separate trust (or trusts) for each family branch

One key suggestion is to have a separate trust, with its own set of trustees, for each "family branch". For many reasons (see below), this kind of trust plan is usually

[4] It is important to separate exempt and non exempt trusts for GST tax purposes, to avoid an accounting nightmare it is important to be sure that there is single income tax treatment for entire trust. Thus a trust which is a grantor trust as to the beneficiary pursuant to IRC 678 should not be the recipient which would be taxed to someone other than the beneficiary or the trust itself.

preferable to a single trust shared by all the family branches (all of whom are then forced to endure working with one set of trustees who must please everyone). There are really two concepts at work here:

- Separate Trusts, one for each "family", and

- A separate set of trustees for each separate trust.

At the outset, the trustees of all of the trusts may often be the same (typically one of the parents, with our without one or more other persons of the parents' choice, until neither parent is available to serve). After the parents are gone, if the trust objectives and the child's maturity so permit, each child often takes over responsibility for his or her own trust, with the result that the child and/or another person of the child's choice often become the trustees of that child's trust (without regard to what each other sibling may do by way of trustees for that sibling's own trust).Thus each primary beneficiary should have his or her own separate trust and trustees.

a. The benefits of separate trusts for each family branch.

There are many benefits of having separate trusts with a separate set of trustees for each trust. For instance –

(1) Avoiding sibling conflicts.

First, separate trusts and trustees will avoid sibling conflicts. Having to get a brother's or sister's approval of trust investments or administrative actions can be intrusive on the privacy rights of each and lead to family disharmony. Each family branch needs to choose its own trustees (just as it chooses its own attorneys, accountants, bankers, and so on).

(2) Trust portability

Second, each primary beneficiary's own trust becomes portable. If he or she moves to another state (or country), the trust's administration can move to that state with the beneficiary (leaving the brothers' and sisters' separate trusts back home undisturbed).

(3) Varying distribution patterns

With separate trusts, distributions to one child do not have to be "matched" by equivalent distributions to each other child – or treated as "advances" on that child's ultimate share – as would be necessary with a single "pot" trust in order to fairly treat all children alike.

B. The need for separate GST "exempt" and "nonexempt" trusts

In the typical postdeath estate planning situation (and even in the case of many inter vivos irrevocable trusts), the GST tax is having the unfortunate effect of doubling the number of separate trusts expected to come into existence. In order:

- To protect allocations of the trust creator's GST exemption from being "wasted" on trust distributions that are made to nonskip persons and

- To allow assets thus exempted from future GST taxes for all generations to continue in trust for the rule against perpetuities period (or beyond),

practitioners are having to plan for separate "exempt" and "nonexempt" trusts for each primary beneficiary at each level. There is no prescription to having the same trustee arrangement as to each pair of trust. Considering the purposes such a pair of trusts are to serve, the trustees of each should be the same.

IV. <u>Trust Design – "Totally Discretionary"</u>

A. <u>The "totally discretionary" distribution pattern should be the design of choice</u>.

Selection of a totally discretionary distribution pattern for a child's or grandchild's gift or inheritance trust means that an independent trustee will at all times have the power, in such trustee's absolute discretion, to distribute any part, or even all, of the trust assets, and to or for the benefit of any members of the beneficiary's family (or trusts for the benefit of any of the foregoing) to the child or grandchild (as that trust's primary beneficiary). The following are some observations regarding this distribution pattern.

1) <u>Offers the greatest flexibility</u>

The absence of any standards (or even any guidelines of any kind whatsoever) for the making of distributions makes the distribution pattern the most flexible for dealing with future family circumstances.

2). <u>Insulates the trustee from litigation</u>

The total absence of standards and guidelines also serves to insulate the independent trustee to the greatest extent possible from litigation that would attempt to second guess the trustee's exercise of discretion in making (or failing to make) distributions.

3) <u>Equals outright ownership if/when beneficiary gains "full control"</u>

If and when "full control" over a totally discretionary trust has been given to the trust's primary beneficiary, a totally discretionary distribution pattern provides the beneficiary with almost the same enjoyment of the trust's assets as outright ownership would provide. Such a shift over to the primary beneficiary of what amounts to full control normally occurs at the "right" time.

4) <u>Requires an IRC section 672(c)(2) Independent trustee</u>

Achieving the tax and other shelter benefits described in paragraph 1a(1) above requires that the totally discretionary distribution power be held solely by a trustee who is neither a donor or beneficiary nor related or subordinate to either within the meaning of IRC section 672(c)(2).

5) Alternative distribution pattern – "Entitlement Trusts"

The alternative dispositive scheme all to often selected is a trust in which some entitlement to distributions is specifically set forth (giving the beneficiary certain measurable rights to receive distributions). Because the beneficiary has defined enforceable rights, flexibility is reduced, creditor protection is diminished (since creditors may step in the beneficiary's shoes and enforce their rights against the beneficiary's entitlement), and many tax planning opportunities are lost.

6) Usually the Requirement of Impartiality is Waived

Traditional trust theory incorporates a fiduciary duty of impartiality upon the trustee. In a "I'd give it outright but for the tax and creditor benefits trusts offer" situation the trust's creator generally will want to favor the "primary beneficiary" with the remainder men receiving "whatever is left" at the primary beneficiary's death.

B. Determining the extent of the beneficiary's controls over the trust and its assets.

A practitioner who is assisting his client with the creation of a trust will often be asked by the client to make recommendations regarding various controls that might or might not be given to the trust's primary beneficiary. The choices and combinations are virtually infinite. The following overview is intended to highlight some of the more significant considerations:

1. **Kinds of controls**.

The kinds of controls that a beneficiary might be given over his trust can be divided into three general categories-

(a) Dispositive controls-meaning special powers of appointment.

In view of the tremendous flexibility in dealing with changing circumstances that special powers of appointment[4] provide, it is our judgement that, absent unusual circumstances, each trust's primary beneficiary should have a special power of appointment over his trust, either broad or restricted. In our practice, such powers are exercisable both on death and during lifetime. This will permit the primary beneficiary (as the holder of the power), within the specified limits, to:

[4] Special powers of appointment are discussed as a part of the flexibility topic in part IV below.

(1) Make gifts of the trust's assets, either outright or in trust, during the remainder of the beneficiary's lifetime.

(2) Direct what happens to the remaining trust assets on the beneficiary's death. In other words, within the limits specified in the power, the beneficiary has what amounts to a "rewrite power" over all of the trust's provisions.

From the point of view of a future generation beneficiary of an inheritance trust, the so called "golden rule" ("he who has the gold rules") is brought to life by the predecessor primary beneficiary's power of appointment-even if viewed only as "a power to disappoint".

C. <u>Administrative and investment controls</u>

The most extreme variations in the extent to which a trust's primary beneficiary may or may not have some control involve the management of the trust and its investments. As noted below, in "traditional trusts", the primary beneficiary rarely has any voice in the trust's management. Modern trusts (particularly a BCT), on the other hand, often give the primary beneficiary every possible control. And, of course, special circumstances such as the beneficiary's capabilities, the settlor's outlook, family tradition, and so on, will have their effect as well.

(1) <u>Traditional trusts</u>

Historically, trusts have been viewed primarily as a way to protect immature or otherwise dysfunctional beneficiaries who are unable to protect themselves.

(a) Traditional trusts for children and grand-children, therefore, have usually sought only to protect them until they attain a proper age of maturity. Such trusts typically direct that, upon the trust beneficiary's attainment of a certain age (or certain ages), part or all the trust's assets shall be distributed outright to the beneficiary.

(b) The resulting outright distribution of trust assets, in effect (to that extent), terminates the trust.

(i) Ignored is the fact that terminating the trust results in terminating the shelter and other benefits that were made possible by receiving the gift or inheritance in trust. Unless there is a good reason or thus terminating the trust as certain ages are attained, doing so needlessly wastes the benefits that otherwise could have been continued for the rest of the beneficiary's lifetime.

(ii) Such a continuation of those inheritance benefits, for life, could have been accomplished by simply putting the primary beneficiary in control of his trust and, instead of distributing the assets to the beneficiary, retaining them in trust under the child's control, with all of the benefits continuing for the rest of the child's lifetime.

(b) <u>Lifetime trusts intended to take advantage of the shelter and other benefits created by any trust gift or inheritance</u>

Modern trusts, intending to continue the shelter and other advantages of any trust in gift or inheritance, typically adopt a quite different approach.

(i) First, when the appropriate specified age of maturity is attained, such modern trusts provide for the beneficiary to receive, in stages if more than one age is thought appropriate, control over the trust (rather than distribution of the trust assets).

(ii) This shift of control is accomplished by treating that attainment of age as the time when the trust's primary beneficiary is to become the trust's family trustee.

(A) As family trustee, the primary beneficiary will then have control over the trust's investments and administration (the independent trustee, while still responsible for making investment recommend-ations, is exculpated as to actions taken at the direction of the family trustee).

(B) In other words, as family trustee (and therefore acting in the best interests of the trust and in furtherance of its purposes), the primary beneficiary is given the power (by the governing trust agreement) to require that the family trustee's decisions control the trust's administration within specified limits. These limits require the family trustee to:

(I) Hear the views of the independent trustee prior to deciding issues and

(II) Recognize that certain decisions (for example, discretionary distribution decisions) are vested solely in the independent trustee acting alone.

(3) <u>Controls relating to the availability of trust assets for the beneficiary's use and enjoyment</u>

A "modern" trust's primary beneficiary is often given what might be referred to as "full control" over his trust. The free use and enjoyment of trust owned property also may be given in the sole discretion of the primary beneficiary/family trustee. However, the availability of distributions from a totally discretionary trust, prior approval (or concurrence) by the trust's independent trustee is till required.

(a) <u>"Full control".</u>

Subject to concurrence by the independent trustee, "full control" means **the maximum control permitted** by the laws that shelter a trust's assets from a beneficiary's "predators" – that is, from:

(i) Creditors,

(ii) An overreaching spouse, and

(iii) The IRS

(b) <u>Removal rights over the independent trustee</u>

Most trusts being drafted currently, especially those that use family and independent trustees, provide a mechanism for trustee removals. Typically, the family trustee has the power, for any proper reason, to remove the independent trustee[6] and to fill any vacancy in that trustee office with a properly qualified successor and independent trustee.

(c) <u>The use of trust owned property</u>

Full control also implies that a trust's primary beneficiary shall have the right to use certain trust assets on a preferential basis. For example- the beneficiary may use, on a rent-free basis (except for utilities and sometimes maintenance), primary and seasonal **homes, boats, etc.** that are bought and owned by the trust for that purpose.

b. **<u>Circumstances often determined what control a beneficiary can have</u>**

The extent to which a beneficiary may ultimately be given control over his trust will also depend on various circumstances at the time the trust was created. These include:

(1) **The wishes of the trust's creator** (for example, a desire to limit beneficiary controls in order to assure that family wealth be preserved and passed on),

(2) **The beneficiary's personal circumstances** (such as age, inexperience, or personal problems, each of which may suggest the need for protective limits on the controls that the beneficiary might otherwise be given), **and, often of greatest significance,**

(3) **The outlook of the advisor** (who is helping the grantor or testator create the trust).

---

[6] Since the issuance of Revenue Ruling 95-58 [following the Tax Court's decision in Wall, 101 TC 300 (1993)], the IRS gave taxpayers reliable assurance as to circumstances under which an independent trustee may be removed and replaced by the trust's settlor or a beneficiary without adverse tax consequences.