# Southern Arizona Estate Planning Council

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**PRESENTS**

# "The Beneficiary Defective Inheritor's Trust"

SPEAKER: Richard A. Oshins, AEP (Distinguished)

**Oshins & Associates, LLC**
**Las Vegas, NV**

**February 15th, 2012**

Registration: 3:30 pm
Presentation: 4:00 pm
Dinner: 6:00 pm

**Arizona Inn**
**Tucson, AZ**

# The Beneficiary Defective Inheritor's Trust ("BDIT") Handout

**Southern Arizona**
**Estate Planning Council**
**Wednesday, February 15, 2012**
**Arizona Inn, Tucson, AZ**

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# POWER POINT PRESENTATION HANDOUT

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

*A Powerful New Wealth Planning Strategy*

Southern Arizona
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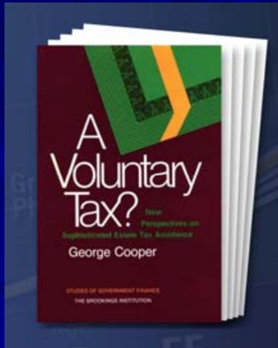
## A Voluntary Tax ?




## Quote
## Professor A. James Casner

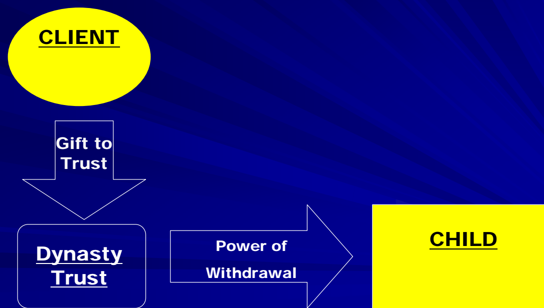
***"In fact, we haven't got an estate tax, what we have is, you pay an estate tax if you want to; if you don't want to, you don't have to."***

Estate and Gift Taxes: Hearings before the House Ways and Means Committee 94th Congress, 2d. Sess., pt. 2, 1335 (March 15-23, 1976)

## BDIT

- The Concept
- The Rules
- Planning Strategies
- Comparison to Alternative Strategies

## Does This Look Familiar to You?



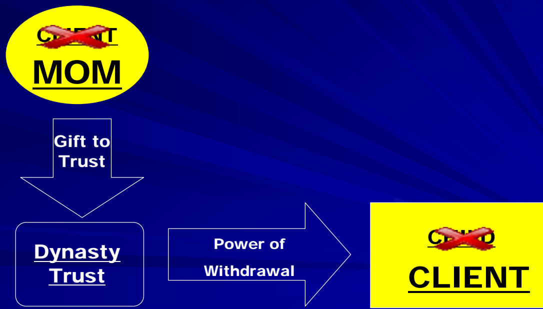

## What are the Tax Consequences?

- Donor
- Power-Holder
- Descendents of Power-Holder

## What are the Creditor Protection Rules?

- Third Party Created
- Spendthrift Trust

## Does This Look Familiar to You?




## Client's "Wish" List

- Control - Investment
- Use and Enjoyment of Their Wealth
- Control - Dispositive
- Creditor Protection
- Save Taxes

## Query

Can our wealthy client set up a trust for himself and protect his assets from taxes and predators?

## Primary Planning Choices of High-End Wealth Shifting

- Techniques
  - GRATS
  - Installment Sales to IDGTs
  - QPRTs
  - FLPs
  - ILITs

## Primary Planning Choices of High-End Wealth Shifting

- All Involve Transferring Wealth to Someone Else
- BDIT Alternative

## BDIT DISTINCTION
### Inherited Interests v. Retained Interests

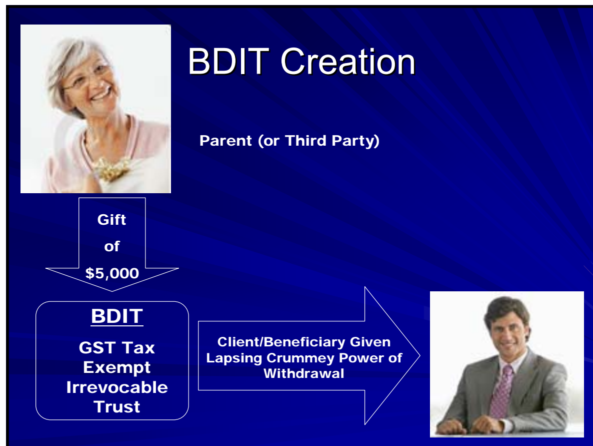
- If a Beneficiary makes a transfer to a trust
  - Taxes
  - Creditors
- Someone Else
  - Can “give” you Rights, Benefits and Controls
  - You cannot “retain”

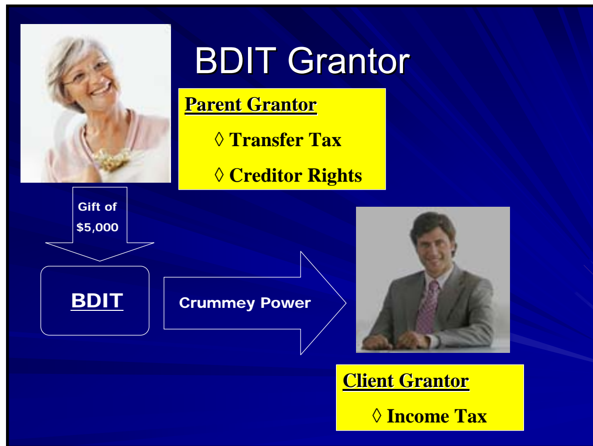
## Fundamental Fact of Estate Planning

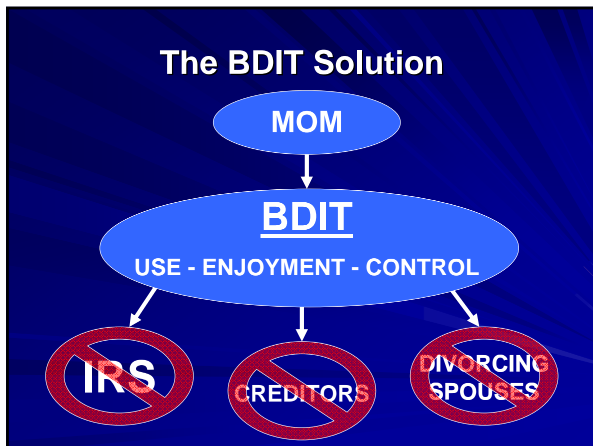
Assets Received and Retained in Trust Offer Many Significant Advantages That Cannot Exist for Assets Owned Outright

## Benefits of Receiving Assets in Trust

- Because Someone Else Set Up the Trust
  - Estate Gift and GST Tax Protected Forever
  - Creditor Protected Forever


BDIT Creation
Parent (or Third Party)
Gift
of
$5,000
BDIT
GST Tax
Exempt
Irrevocable
Trust
Client/Beneficiary Given
Lapsing Crummey Power of
Withdrawal


BDIT Grantor
Parent Grantor
◊ Transfer Tax
◊ Creditor Rights
Gift of
$5,000
BDIT
Crummey Power
Client Grantor
◊ Income Tax


The BDIT Solution
MOM
BDIT
USE - ENJOYMENT - CONTROL
IRS
CREDITORS
DIVORCING
SPOUSES

# Technical Rules

## The Technical Rules

- IRC §2036
- Asset Protection – Fraudulent Transfer Considerations

## IRC §2036(a)

General Rule – The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a ***transfer*** ***(except in case of a bona fide sale for an adequate and full consideration in money or money's worth),*** by trust or otherwise, under which he has ***retained***

(1) the possession or enjoyment of, or the right to the income from, the property, or

(2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.

## Asset Protection

- Reasonably Equivalent Value
- Key to Avoiding Constructive Fraud

## Third Party Settled Spendthrift Trust

"**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, or an IRS transfer tax agent (in the case of certain trusts). Thus, where the "transferor" of assets gifted 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). **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**." *Emphasis supplied*

* Keydel and Wallace II, *Design Strategies for Dynasty Trusts*, ACTEC Meeting March 6, 1999

# BDIT Key Concepts

## BDIT – KEY CONCEPTS

#1 Set Up and Funded by Someone Else

- ◊ "Given"
- ◊ Not "Retained"

## BDIT – KEY CONCEPTS

#2 Beneficiary Can Not Make Gifts to the Trust

- ◊ Directly or Indirectly
- ◊ Sales for Equal Value are OK

## BDIT – KEY CONCEPTS

*cont'd*

#3 Transfer Tax Consequences

- ◊ Measured by the Value of Transfer - Rev. Rul. 93-12
- ◊ Subsequent Growth Irrelevant

## BDIT – KEY CONCEPTS
*cont'd*

#4 Third Party Settled Spendthrift Trust
- ◊ Fully Discretionary
- ◊ Independent Trustee
- ◊ Domiciled in Trust Friendly Jurisdiction

## BDIT – KEY CONCEPTS
*cont'd*

#5 Beneficiary Given a Lapsing Power of Withdrawal Over Gift

## Income Tax Consequences of Power of Withdrawal

- ❑ Rev. Rul. 85-13
- ❑ Tax Burn

## "Tax Burn" Concept

- Client's Wealth Depleted by Tax Paid as a Result of Grantor Trust Status
- Compression of Personal Assets
  - Exposed to IRS
  - Exposed to Other Claimants

## "Tax Burn" Concept

*cont'd*

- Trust Grows Tax-free, creditor protected
- Client's Wealth Shifted Tax-free to BDIT
  - Income Tax-free
  - Transfer Tax-free

## Client's "Wish" List

- Control - Investment
- Use and Enjoyment of Their Wealth
- Control - Dispositive
- Creditor Protection
- Save Taxes

## Save Taxes

- Exempt From
  - Gift Tax
  - Estate Tax
  - GST Tax
- Certain Income Taxes
- Prof. Casner and Cooper quotes

## Creditor Protection

- Spendthrift Clause Protection
- Domiciled in a Trust Friendly Jurisdiction
  - No Exemption Creditors

# Control

“Beneficiary Controlled Trust”

## BCT - Goal

- To maximize the benefits that an "in trust" gift or inheritance can provide.
- Without Compromising
  - Control
  - Enjoyment of the Property

## Office of Trustee

- Family (Investment Trustee)
- Independent Trustee

## Family Trustee

- Control Investments
- Controls Identity of Independent Trustee

## Independent Trustee

- Controls all non-tax sensitive decisions
- Individual or institution who meets the criteria of IRC § 672 (c)
- "Independence" does not require a confrontational relationship

## Use and Enjoyment

- Avoid Leakage
- "Use" Concept

## Control Disposition

- Special Power of Appointment
  - "Re-Write Power"
  - Changes in Laws, Family Circumstances, etc
- Blocks Gift Tax

# Opportunity Shifting

Case Study #1

## Opportunity Shifting

- Client Has
  - A New Business or Investment Opportunity
  - Has an Ancillary Business Opportunity
- Typical Planning
  - Limited to Choice of Entity
- BDIT Solution

## Estate Planning Implications of Opportunity Shifting in a BDIT

- Client in Control
- The Business (or Investment Opportunity) is Never Exposed to:
  - Transfer Taxes, or
  - Creditors
- The Client's Personal Wealth is "Tax Burned"

# Installment Note Sales

Case Study #2

## Facts

- FMV of Business $20 Million
- Cash Flow and Taxable Income 10%
- Flow Through Entity

## Steps

- Third Party Sets Up and “Seeds” BDIT
- Client is Given Power of Withdrawal
- Client Sells Interests in the Entity to Trusts for Note

## INSTALLMENT NOTE SALE(S) TO BDIT

## Sales to BDIT

- Gifts Prohibited
- Sales for Equivalent Value Exception
  - Estate Tax
  - Creditor Rights

## Technical Rules We Must Follow

- Estate Tax
  - "Adequate and Fair Consideration" Exception
- Asset Protection
  - "Reasonably Equivalent Value" Exception

## "Seeding" the Trust

- Must Come From Donor's Funds
- Economic Substance
  - Debt-Equity Ratio
  - Rule of Thumb 10% or 9:1
- Legitimate Guarantees

## Guarantees as "Seed Money"

- Must be Legitimate
- Must Be Paid if Business Implodes
- Need not be for full amount of the note

## Economic Substance

$1 Million

C

+ $5,000

Guarantee

## Result – Tax
## Freeze, Squeeze and Burn

- Estate Freeze
  - Notes in Estate
  - Post-transfer Appreciation Shifted
- Discount Removed from Transfer Tax System (Squeeze)
- Estate Depletion – Grantor Trust Status

## Result – Non-Tax

- Client in Control of BCT
- Key Family Asset Creditor Protected for Client and Family
  - From Lawsuits
  - From Divorcing Spouses

## Result – Non-Tax
*cont.*

- Trust Controls and Protections More Extensive Than Entity Controls
- Trust Control Rules Are Easier to Modify Than Entity Fiduciary Obligations
- Assets Available to Client
- Rewrite Power – Protects Against Potential Family Conflicts and Changes in Law

## IRS Reporting of Sale to Trust

- Gift Tax
  - ◊ Timely File Form 709
  - ◊ Non-Gift Transfer
    Treas. Reg § 301-6501 (c) – 1(f)(4)

## IRS Reporting of Sale to Trust

*cont'd*

- If IRS Does Not Challenge Valuation
- If IRS Successfully Challenges Valuation
  - ◊ Incomplete Gift
    Treas. Reg § 25-2511 – 2(b)
  - ◊ Allocation Pro-rata Between Exempt and Non-exempt Trusts

# Broad Client Profile

Case Study #3

## Query
"Why Wouldn't Everyone do a BDIT?"

- Misperception – Only for Ultra Affluent
  - Planning Alternatives Involve Giving to Someone Else
  - BDIT Contains Virtues of Alternative Estate Planning Techniques
  - BDIT Benefits – Substantial and Forever

## Planning for the Mid-Range Client

- The Client with a
  - $10 Million Business
  - $1 Million Home
  - $1 Million Other Assets
- The Dilemma
  - Tax and Creditor Exposure
  - Can Not Afford to Give Wealth Away

## Mid – Range Client

- GRAT and IDGT
  - Prohibition Against Transfers with Retained Rights
- BDIT
  - "Adequate and Full Consideration" Exception
- Really the "Only" Option

# Funded ILIT

Case Study #4

## Funded ILIT

- BDIT Can be a Wonderful ILIT
  - Cash Flow From Assets Can Pay Premiums
  - No Crummey Limitations or Complications
- During Start-up Period
  - Can Use Split Dollar or Premium Financing
  - Exit Strategy

## Funded ILIT

*cont'd*

- BDIT Can Own LI on Client's Life
- Two Adjustments
  - Independent Trustee
  - No Power of Appointment
- Accessing Inside Buildup

# Retirement Planning Alternatives

Case Study #5

## Primary Retirement Planning Alternatives

- Goal – Tax Exempt or Tax Deferred Wealth Accumulation
- Vehicles
  - Qualified Retirement Plans ("QRPs")
  - Cash Value Life Insurance ("CVLI")

# Business Succession Planning

Case Study #6

One Child in the Business
One Child not in the Business
Client Owns Business
Worth $20 Million

Business Succession
Traditional Planning
Business
Voting
Non-Voting
Life Insurance
IRS

Business Succession
BDIT
Business
Life Insurance

# Buy-Sell Planning

Case Study #7

## Buy-Sell Planning

- Newco is Owned 50/50 by A and B
- A's Parent Sets Up A's BDIT Which Buys A's Entity Interest from A
- B's Parent Sets Up B's BDIT Which Buys B's Entity Interest from B

## Buy-Sell Planning *cont'd*

| A's BDIT | B's BDIT |
| --- | --- |
| Owns A's Interest<br>Buys Life Insurance on B's Life | Owns B's Interest<br>Buys Life Insurance on A's Life |

## BDIT and Other Planning Opportunities

- Gifting
- Pre-Nuptial
- Unmarried
  - Traditional
  - Non-Traditional

# BDIT v. Other Strategies

## BDIT vs. Note Sale to IDGTs

- Wealth Shifting Benefits
  - Retained interest often creates continued IRC § 2036 exposure
  - No Need to Retain Anything
- Control
- No Economic Risk
  - Managerial
  - Use and Enjoyment
  - Rewrite Power
  - Tax Burn

## BDIT vs. FLPs

- Historical Purpose of FLPs
  - Control
  - Valuation Discounts
- IRS FLP/LLC Audit Request
- Substantial Non-Tax Purpose
- IRC § 2036 Exposure
  - There is no IRC §2536

## BDIT vs. ILITs

- Built-in Funded ILIT
- No Crummey Complexities and Limitations
- Living Benefits of LI
  - Access to "Inside Build-Up"

## BDIT vs. APTs

- ❑ Greater Creditor Protection
  - ◊ Not a Self-Settled Trust
- ❑ Transfer Tax Savings
- ❑ Use and Enjoyment Determined by Client
- ❑ APTs Continuing Costs
- ❑ Planning with Existing APTs

## Freeze, Squeeze and Burn

# Component Comparison

## Freeze, Squeeze and Burn

- ❑ The Three Components of High End Wealth Shifting
  - ◊ Estate Freeze
  - ◊ Valuation Discounting
  - ◊ Tax Burn
- ❑ Perception

## Existing Business or Investment Facts

- Client Owns a Business Worth $10 Million
- Income/Cash Flow 10%
- Flow Through Entity
- Expected Growth – Double Every 10 Years

## Estate Freeze Component

- Concept
  - Freeze the Estate at Current Value
  - Shift Future Appreciation
- $40 Million
  - $10 Million in Estate
  - $30 Million Shifted

## 35% Discount – Squeeze Component

- Asset Transferred Worth $10 Million
- Receive Back a Note Worth $6.5 Million
- $3.5 Million Disappears From Transfer Tax System

## 35% Discount – Squeeze Component
*cont'd*

- Valuation Discounting
  - Principal Focus of IRS Attack
  - Larger Discounts Increase Risk of Audit

## "Tax Burn" Component

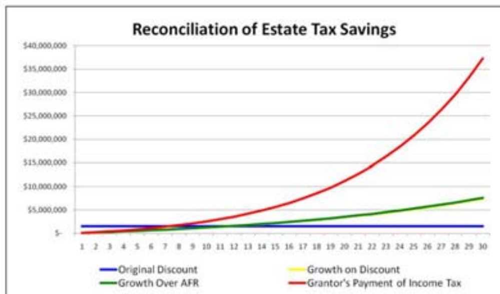
- Estate Depletion as a Result of Grantor Trust Status
  - Inherent in IDGTs, GRATs and BDITs
- Not Audit Sensitive
- Over Time Most Significant Factor

## Tax Burn Significance

- Over Time – 10% Income; 40% I/T
  - $10 Million Entity - $400,000
  - $20 Million Entity - $800,000
  - $40 Million Entity - $1.6 Million
- Estate Depletion
  - Payment of Income Tax
  - Living Expenses

## Significance

- Short Term
  - Discount
- Long Term
  - Tax Burn
  - Freeze
  - Discount

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# Life Insurance Correlation with BDIT

## Life Insurance Correlation with BDIT Win- Win

- Early Death
  - Negligible Tax Burn
  - Win on the Mortality Bet
- Later Death
  - Greater Estate Tax Depletion
  - Tax-free Build-up More Dramatic

# BDIT SCHEMATIC WITH FLOW CHARTS

# BDIT SCHEMATIC

- Schematic
- Outline of BDIT Planning
- BDIT Benefits
  Protection, Use, Control
- BDIT Control List
  Primary Beneficiary/Trustee Controls
- BDIT – Office of Trusteeship

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# BDIT SCHEMATIC

## WEALTH PROTECTION

Solely because assets are placed into an appropriate trust by someone else, and the beneficiary **never** transfers assets to the trust, except in exchange 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 (or by a trust funded by the beneficiary).

**Properly situated and structured BDITs are forever sheltered:**

1. From all estate, gift and GST taxes;
2. From the original and later beneficiary'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 as Income Tax Owner of the BDIT**

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 transfer tax-free into the "BDIT" away from creditors, without gift or GST tax consequences, and with no economic risk because the beneficiary is in control of trust investments.

**Insurance Funding**

1. Insured beneficiary may not have investment powers over insurance; and
2. Power of appointment cannot extend to insurance on the powerholder.

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

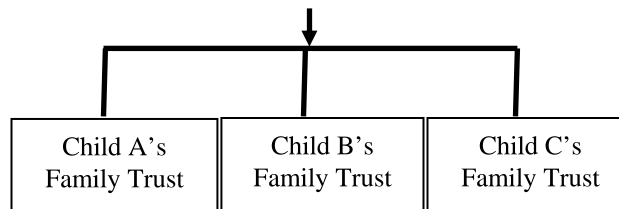
* * * * *

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, the trust is divided equally for each family branch and held on similar terms.




These continuing dynastic trusts are protected from creditors, spouses, and the transfer tax system.

## 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 is 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".

**Beneficiary Control:**

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

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BRYAN CAVE

# AN OUTLINE OF BDIT PLANNING

(1) A BDIT (a Beneficiary Defective Inheritor's Trust) is a trust created by a parent or other third party who contributes $5,000 in cash to the trust; no other gifts are made to the trust by anyone, especially the beneficiary.

(a) If it is finally determined that a sale to the trust by the beneficiary is partially a gift, the gift would be incomplete (because of his or her limited power of appointment, described below); any such gift would be held in a non-GST exempt share of the trust, under a defined value formula provision.

(2) The trust creator is the grantor of the trust for transfer tax purposes and creditor rights purposes, <u>but not for income tax purposes</u>.

(a) That is, the BDIT is intentionally created as a non-grantor trust from the creator's point of view.

(3) The trust is irrevocable, fully discretionary, dynastic, and GST exempt (because the creator allocated $5,000 of his or her GST exemption to the only gift to the trust), and the beneficiary has a limited power of appointment over the trust, exercisable during life or at death.

(a) The limited power cannot extend to insurance on the beneficiary's life.

(4) The beneficiary is given a "Crummey" type power to withdraw the original gift, which right lapses.

(a) While the power of withdrawal is outstanding, the beneficiary is treated as the owner of the trust for income tax purposes under Section 678(a)(1).

(b) After the withdrawal right has lapsed in accordance with Section 678(a)(2), the beneficiary is thereafter treated as the owner of the trust for income tax purposes.

(c) Again, the trust is drafted so that the creator is intentionally <u>not</u> treated as the owner for income tax purposes, so that Section 678(b) doesn't apply to "trump" the application of Section 678(a) to the beneficiary.

(d) Because the beneficiary's power to withdraw lapses within the $5,000/5% lapse protection amount for general powers of appointment, the lapse has no gift or estate tax consequences.

(5) As a wholly grantor trust from the beneficiary's point of view, the beneficiary pays tax on all trust income (with no gift consequences) – the "tax burn", and transactions between the beneficiary and the trust (such as sales or loans) are ignored for income tax purposes.

(6) The beneficiary could be the investment trustee, but an independent trustee should be the distribution trustee and must be the insurance trustee with respect to insurance on the life of the beneficiary/trustee.

(a) The beneficiary should have no powers over any trust-owned insurance on his or her life, even as a trustee.

(7) The BDIT can give the beneficiary investment control over the trust (except for insurance on his or her life) and a power of disposition over the trust assets at death (and again, except for insurance on his or her life), but the trust is creditor/predator proof and transfer tax protected from the beneficiary's point of view.

(8) As a GST-exempt dynastic trust, the BDIT will continue after the beneficiary's death, subject to his or her special power of appointment, for the beneficiary's descendants, for life, with the same protections (though not as a grantor trust from their point of view).

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# BDIT BENEFITS
# PROTECTION, USE, CONTROL

## ➢ CONTROL

- This does not apply to life insurance on the life of the beneficiary/power holder.

## ➢ FULL USE AND ENJOYMENT OF TRUST ASSETS

- Except for Life Insurance on the beneficiary's life.
- Life Insurance potentially indirectly accessible through Independent Trustee.

## ➢ RE-WRITE POWER

- Special Power of Appointment.
- Except for Life Insurance on beneficiary's life.

## ➢ CREDITOR PROTECTION

- Including divorcing or dissident spouses**.**
- Income taxes paid as a result of grantor trust status depletes original beneficiary's otherwise exposed estate.

## ➢ TAX SAVINGS

- Estate, Gift**,** and GST Tax Exempt - as long and the assets are kept in trust.
- Estate Depletion - of initial primary beneficiary's estate as a result of income tax grantor trust status.
- Trust Beneficiaries can increase and accelerate their estate planning transfers without economic exposure based upon the security of the controlled trust.
- Income Tax – after death of initial primary beneficiary.

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# BDIT CONTROL LIST
## PRIMARY BENEFICIARY/TRUSTEE CONTROLS

### ➢ ADMINISTRATIVE CONTROLS

- **Full Management/Investment Control Until Death** – as Investment Trustee. This does not apply to life insurance on the life of the beneficiary/trustee.

- **Right to Fire and Replace Independent (Distribution) Trustee** – Within Constraints of IRC §672 (c) and Rev. Rul. 95-58.

### ➢ BENEFICIARY CONTROLS

- **Full Use and Enjoyment of Trust Owned Assets Until Death** – (with or without rent and for any purpose whatsoever). The beneficiary may also use (or determine who uses) the trust owned property and terminate the use of the property. This does not apply to life insurance on the life of the beneficiary.

- **Re-Write Power** – The ability to essentially revise the trust to adjust for changes in tax laws, trust laws, family dynamics, economics, or for any other reason. This is a Special Power of Appointment and it is permissible as long as the beneficiary does not have the right to exercise this power for him/herself; his/her estate or the creditors of either. This does not apply to life insurance on the life of the beneficiary/power holder.

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# BDIT
# OFFICE OF TRUSTEESHIP

## ➢ Investment Trustee:

- **Initially Client/Beneficiary**
- **Full Managerial Control** – Except for Life Insurance on the Trustee/Beneficiary's life. Can create entities and invest in new business and investment opportunities.
- **Control of the Identity of the Independent Trustee** – Right to fire and replace, with or without cause, subject to IRC §672 (c) and Rev. Rul. 95-58.
- **Control Over Who Uses the Trust Assets** – Except for life insurance on the Trustee/Beneficiary's life.

## ➢ Independent Trustee:[1]

- **Makes Tax Sensitive Decisions** – Such as distributions.
- **Makes all Decisions Pertaining To Life Insurance on Beneficiary/Trustee's Life**
- **Makes Decisions Regarding the Purchase or Sale of Hard to Value Assets to or from a Beneficiary** – Although not technically required, the independence will add protection.

[1] The position of Independent Trustee can be fragmented into:

◊ A Distribution Trustee – Someone who is an Independent Trustee as provided in IRC §672 (c) and Rev. Rul. 95-58. This does not have to be a confrontational relation – It can be the client/beneficiary's best friend; and

◊ An Administrative Trustee – A person, but most often an entity who/which enables the client to obtain favorable jurisdiction. Caveat – the Administrative Trustee must perform sufficient services to access the superior state laws.

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# BDIT Flowchart #1

Attached Flowchart of a Sale of Business or Investment Assets to a Beneficiary Defective Inheritor's Trust (a "BDIT") on an Installment Basis

**CIRCULAR 230 DISCLOSURE**

**To ensure compliance with the requirements imposed by the IRS, we inform you that any U.S. federal tax advice contained in this communication is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code, or (ii) promoting, marketing, or recommending to another party any transaction or matter addressed herein.**

The attached flowchart depicts a simplified version of the series of steps that would be taken to: 1) have a third party create a BDIT, and 2) have the trust beneficiary sell business or investment assets to the BDIT, on an installment basis.

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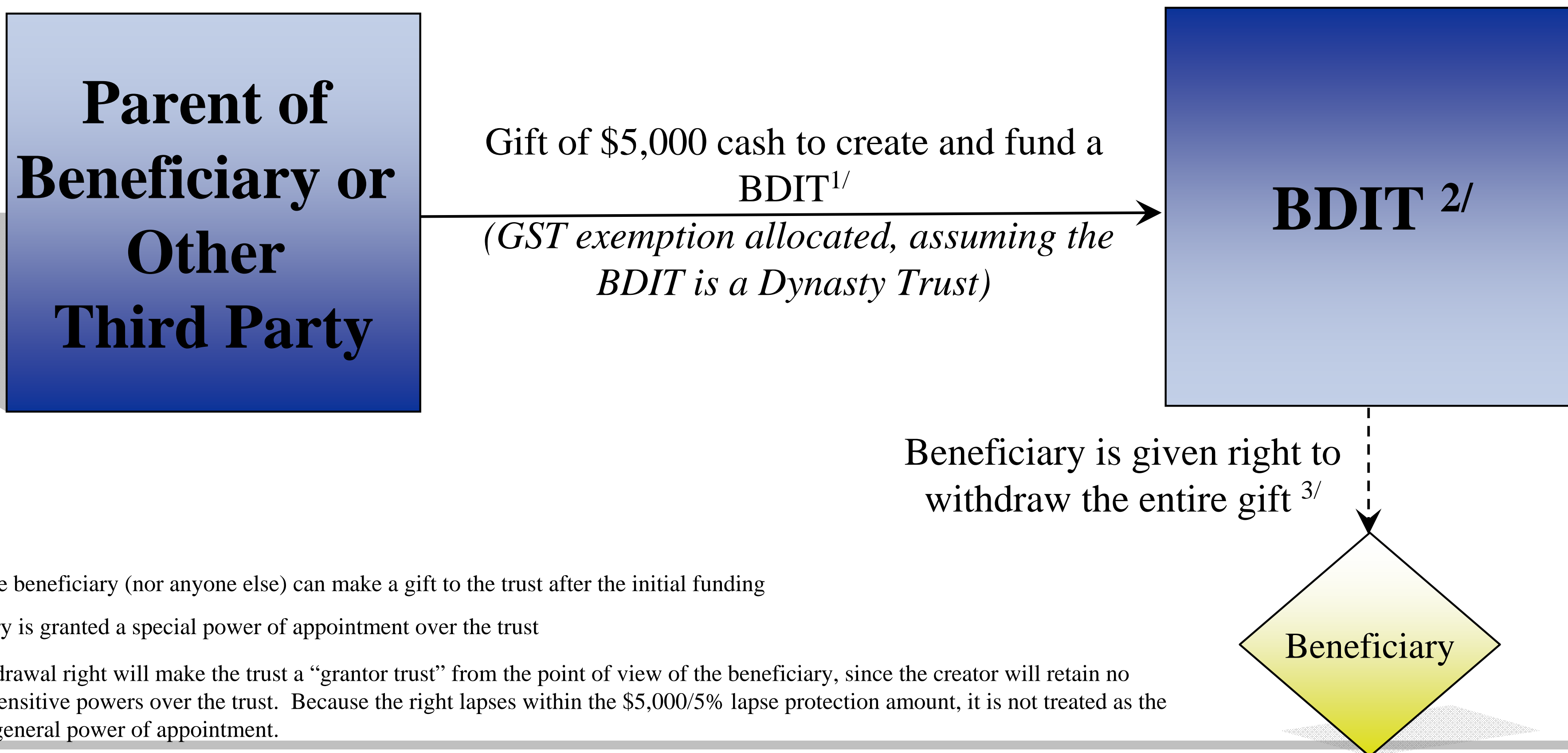
# CREATION OF BDIT
# FOR SALE OF BUSINESS OR INVESTMENT ASSETS

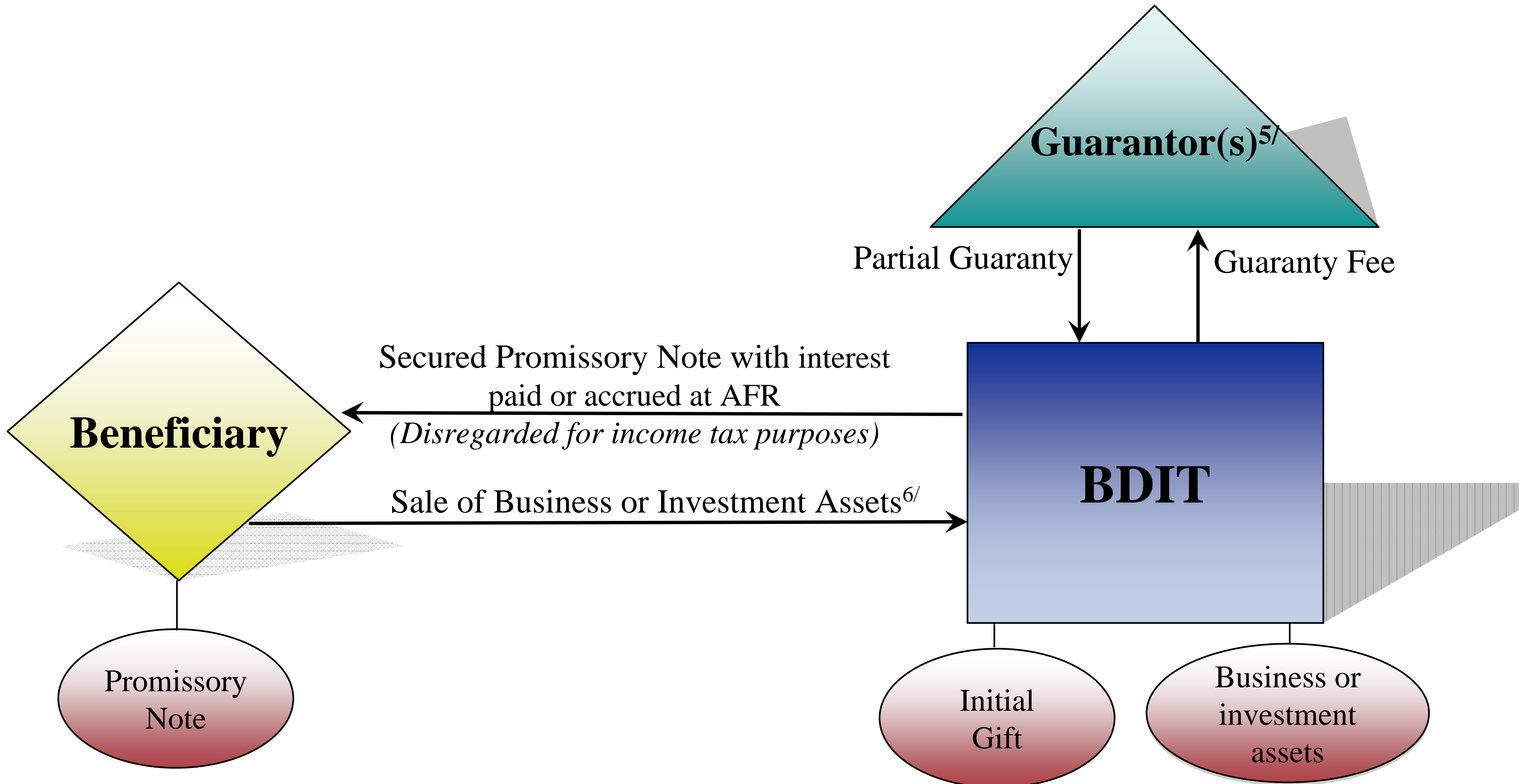



[1/] Neither the beneficiary (nor anyone else) can make a gift to the trust after the initial funding

[2/] Beneficiary is granted a special power of appointment over the trust

[3/] That withdrawal right will make the trust a "grantor trust" from the point of view of the beneficiary, since the creator will retain no income tax sensitive powers over the trust. Because the right lapses within the $5,000/5% lapse protection amount, it is not treated as the release of a general power of appointment.

# SALE OF BUSINESS OR INVESTMENT ASSETS [4/]

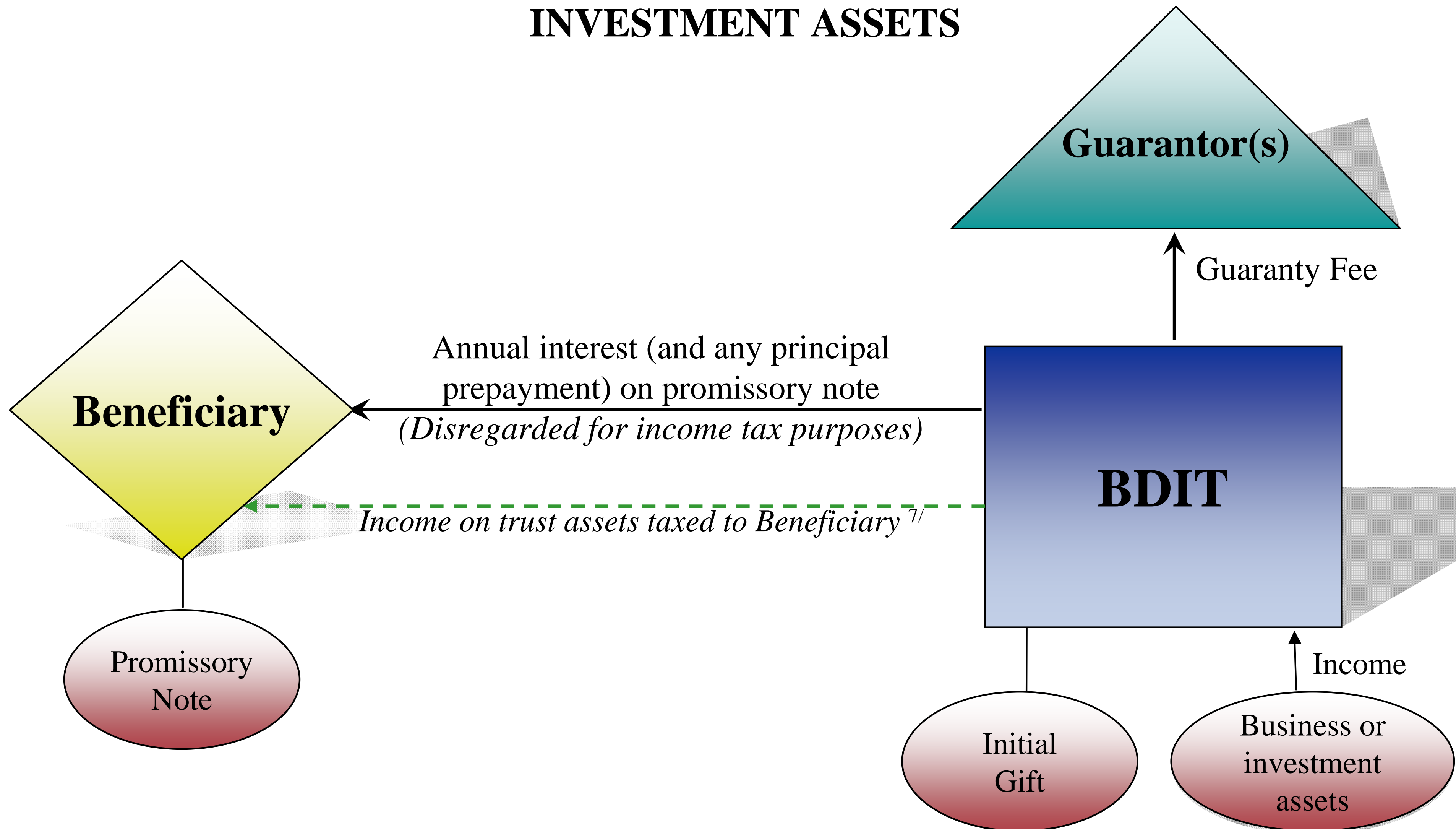



[4/] The sale would take place after the beneficiary's withdrawal right had lapsed; the sale will be of a defined value and a gift tax return would be filed reporting the transaction as a non-gift

[5/] May be an existing irrevocable trust, beneficiary's spouse, the creator of the trust, or any other party who or which has sufficient assets to satisfy the guarantee, if necessary

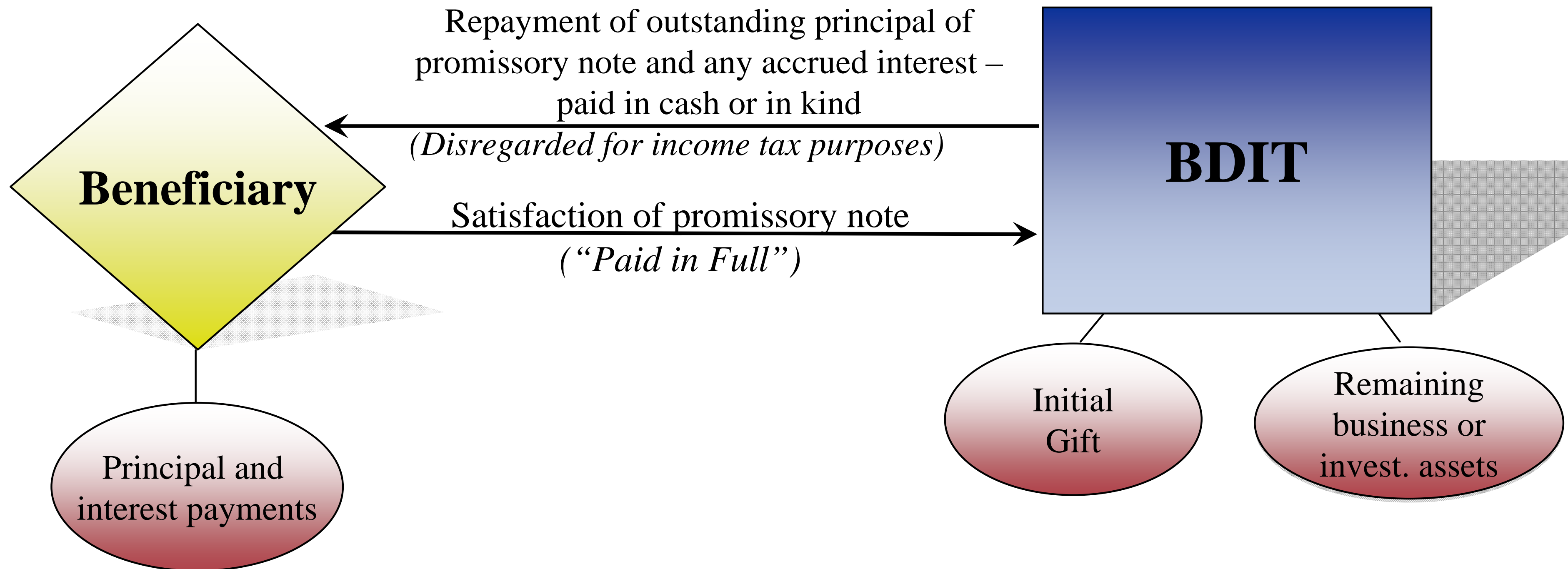
[6/] If the value of assets sold is adjusted by IRS resulting in an unintentional gift, then the beneficiary's testamentary power of appointment would avoid treating that excess as a completed gift; any excess would be allocated under a formula in the trust to a non-GST exempt share

# ANNUAL ADMINISTRATION OF SALE OF BUSINESS OR INVESTMENT ASSETS

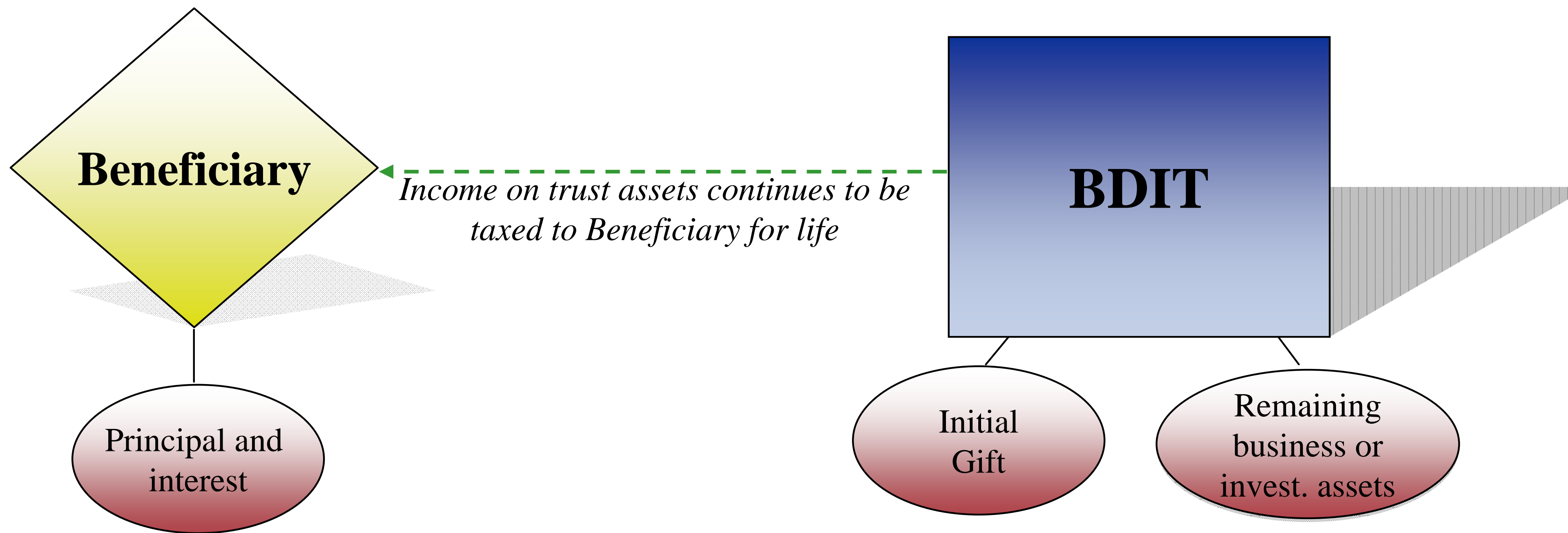



[7] Payment of income tax by the beneficiary on trust income is not a gift for gift tax purposes

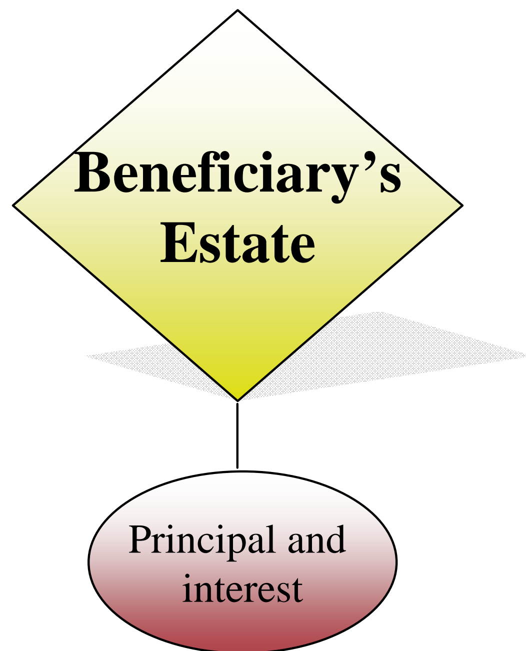
# COMPLETION OF SALE OF BUSINESS OR INVESTMENT ASSETS AFTER NOTE TERM

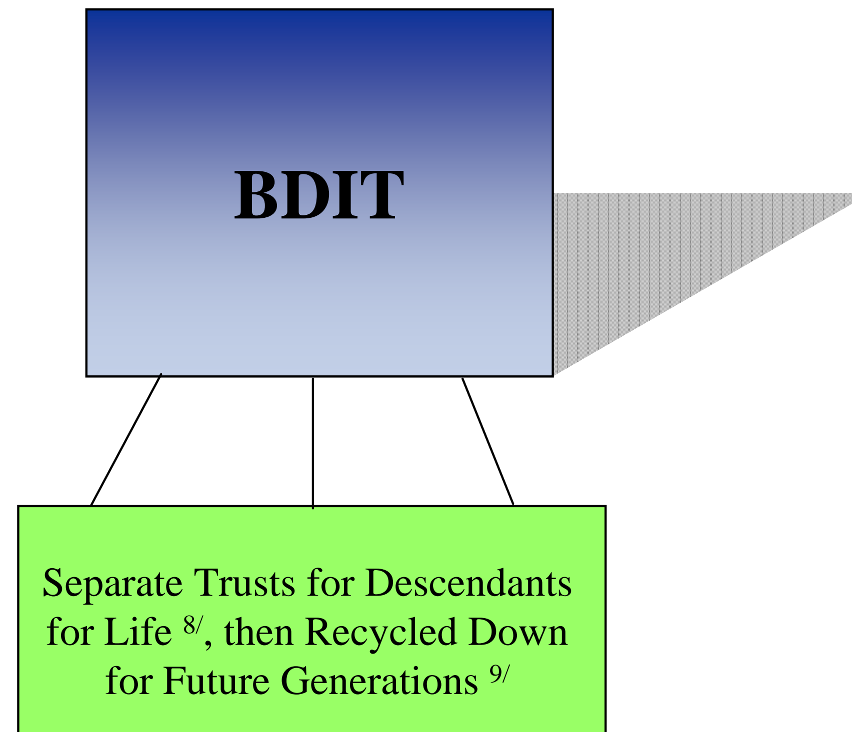


# FOLLOWING COMPLETION OF SALE OF ASSETS



# FOLLOWING DEATH OF BENEFICIARY




[8/] Protected from their creditors, spouses, and the transfer tax system

[9/] Unless modified by the exercise of a limited power of appointment

# BDIT Flowchart #2

Flowchart of a Sale of Business or Investment Assets to a Beneficiary Defective Inheritor's Trust (a "BDIT") on an Installment Basis and Purchase of a Life Insurance Policy on the Life of the Beneficiary

**CIRCULAR 230 DISCLOSURE**

**To ensure compliance with the requirements imposed by the IRS, we inform you that any U.S. federal tax advice contained in this communication is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code, or (ii) promoting, marketing, or recommending to another party any transaction or matter addressed herein.**

The attached flowchart depicts a simplified version of the series of steps that would be taken to: 1) have a third party create a BDIT, 2) have the trust beneficiary sell business or investment assets to the BDIT, on an installment basis and 3) have the BDIT acquire a life insurance policy on the life of the beneficiary.

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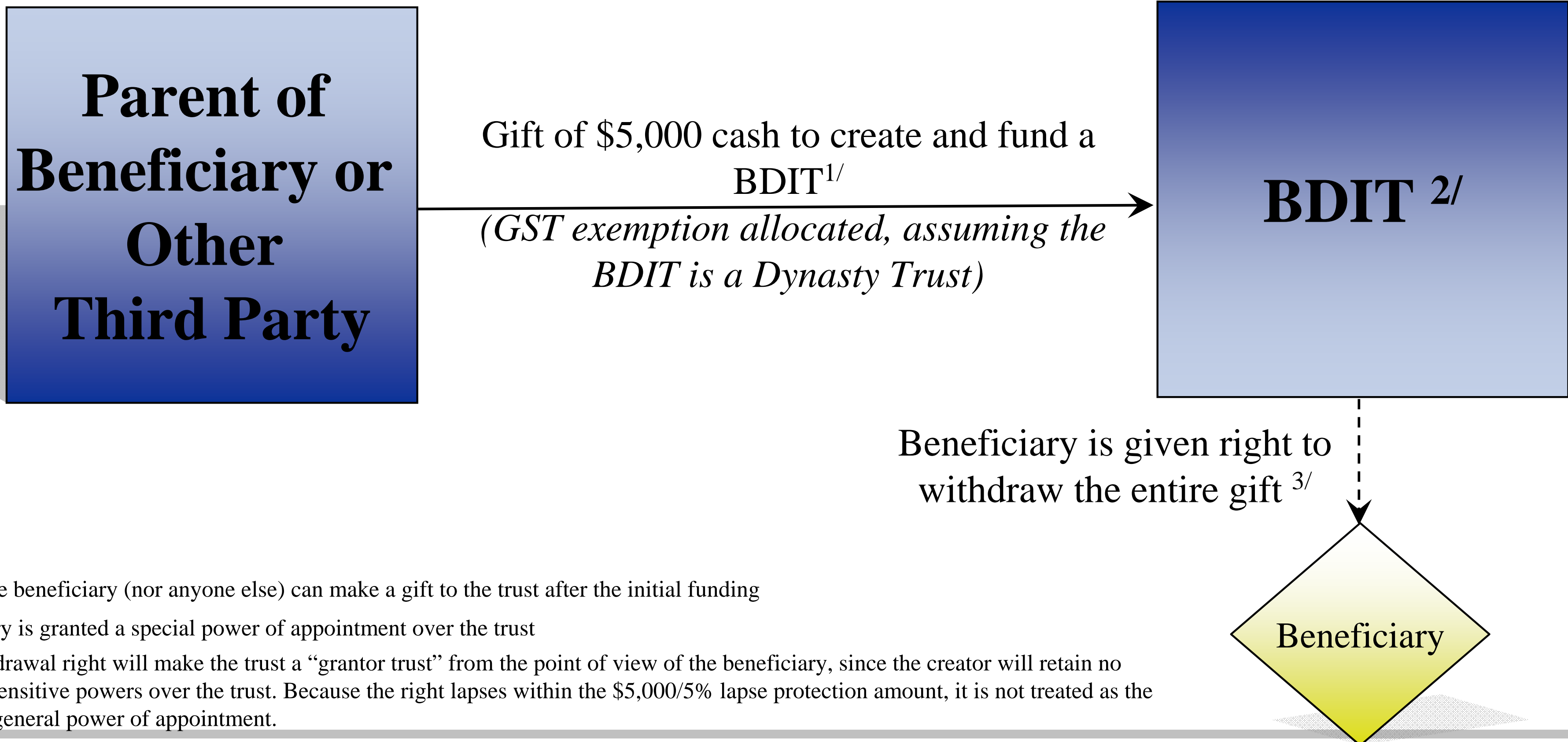
# CREATION OF BDIT
# FOR SALE OF BUSINESS OR INVESTMENT ASSETS AND PURCHASE OF INSURANCE

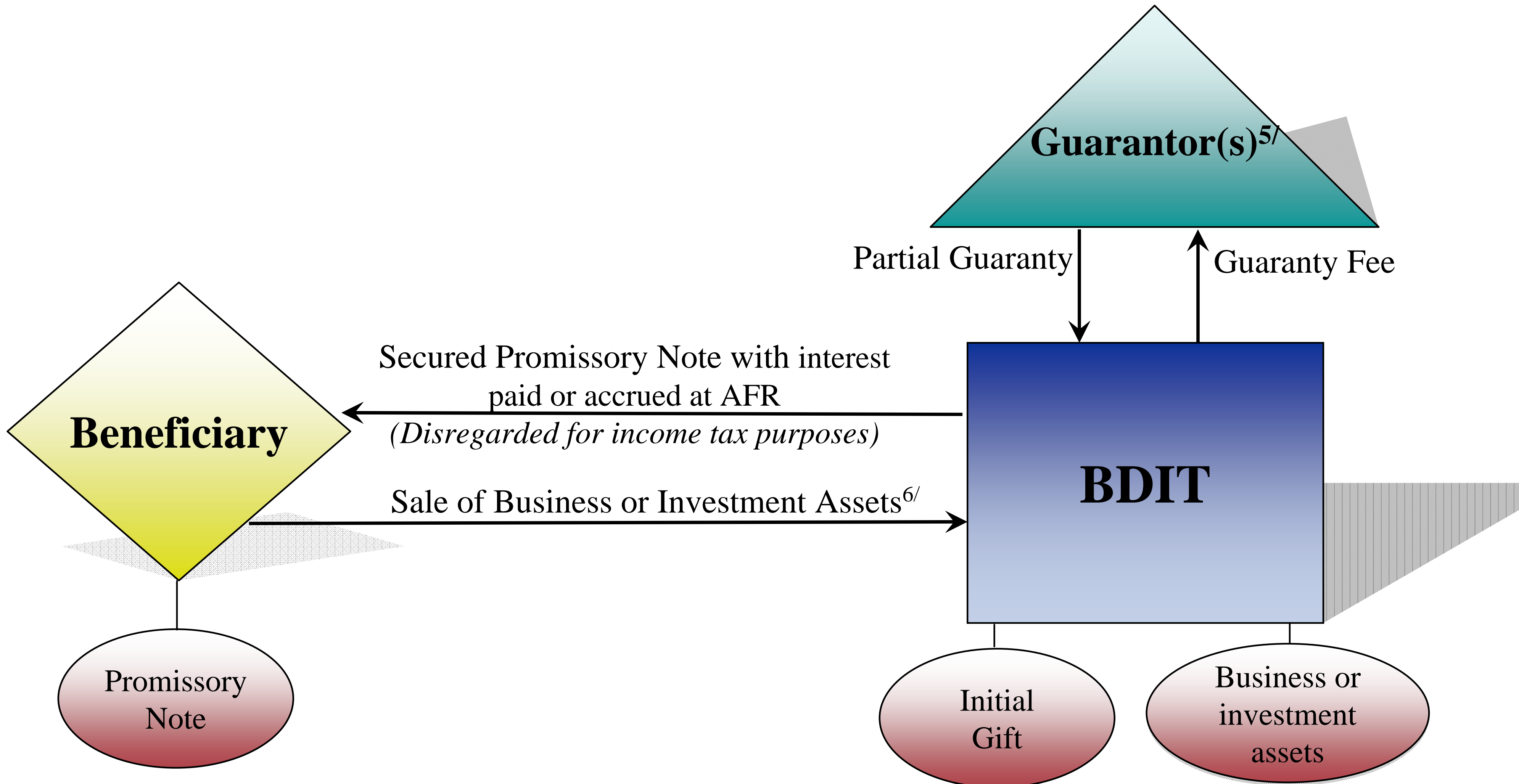



[1/] Neither the beneficiary (nor anyone else) can make a gift to the trust after the initial funding

[2/] Beneficiary is granted a special power of appointment over the trust

[3/] That withdrawal right will make the trust a "grantor trust" from the point of view of the beneficiary, since the creator will retain no income tax sensitive powers over the trust. Because the right lapses within the $5,000/5% lapse protection amount, it is not treated as the release of a general power of appointment.

# SALE OF BUSINESS OR INVESTMENT ASSETS [4/]

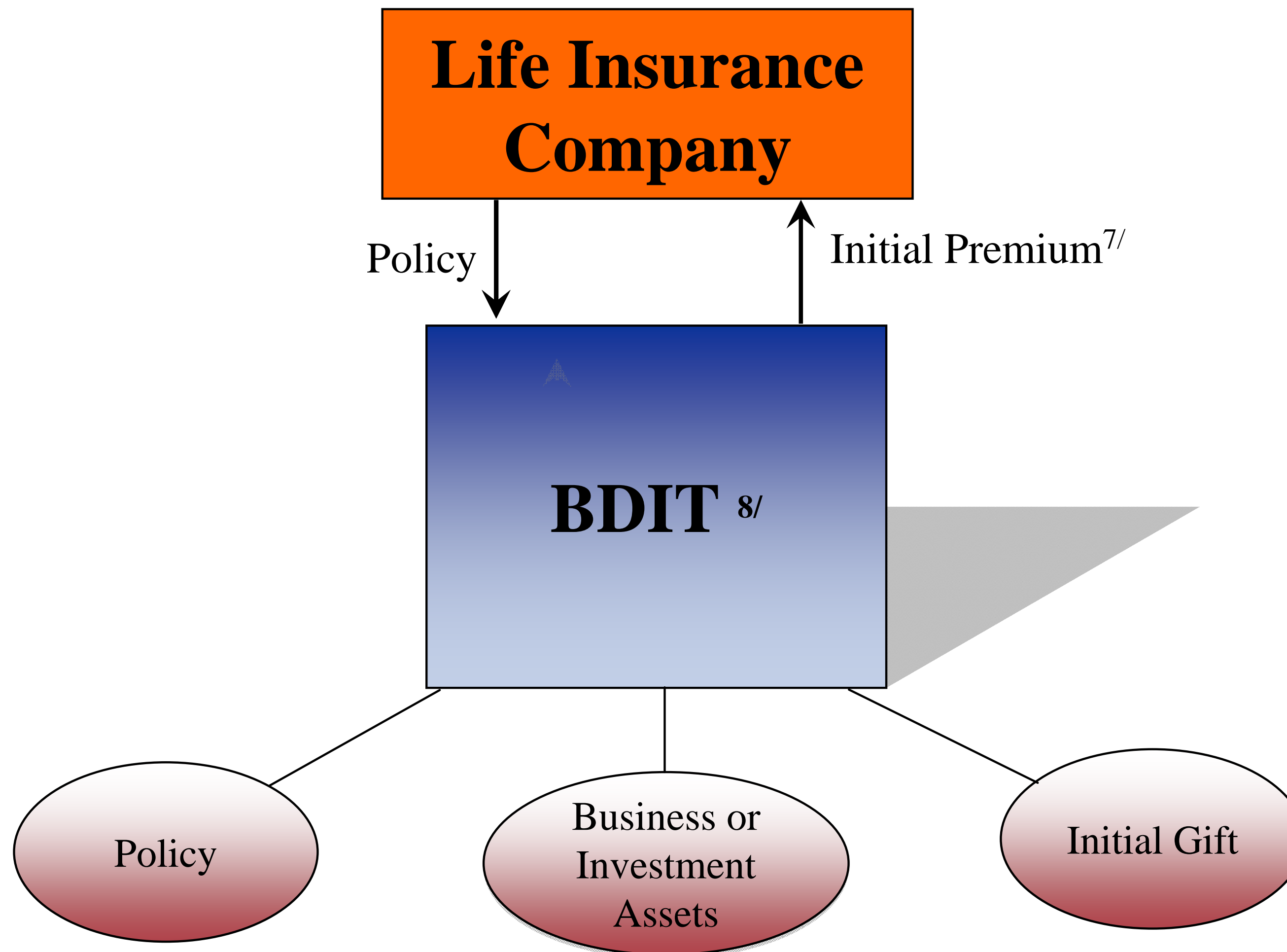



[4/] The sale would take place after the beneficiary's withdrawal right had lapsed; the sale will be of a defined value and a gift tax return would be filed reporting the transaction as a non-gift

[5/] May be an existing irrevocable trust, beneficiary's spouse, the creator of the trust, or any other party who or which has sufficient assets to satisfy the guarantee, if necessary

[6/] If the value of assets sold is adjusted by IRS resulting in an unintentional gift, then the beneficiary's testamentary power of appointment would avoid treating that excess as a completed gift; any excess would be allocated under a formula in the trust to a non-GST exempt share

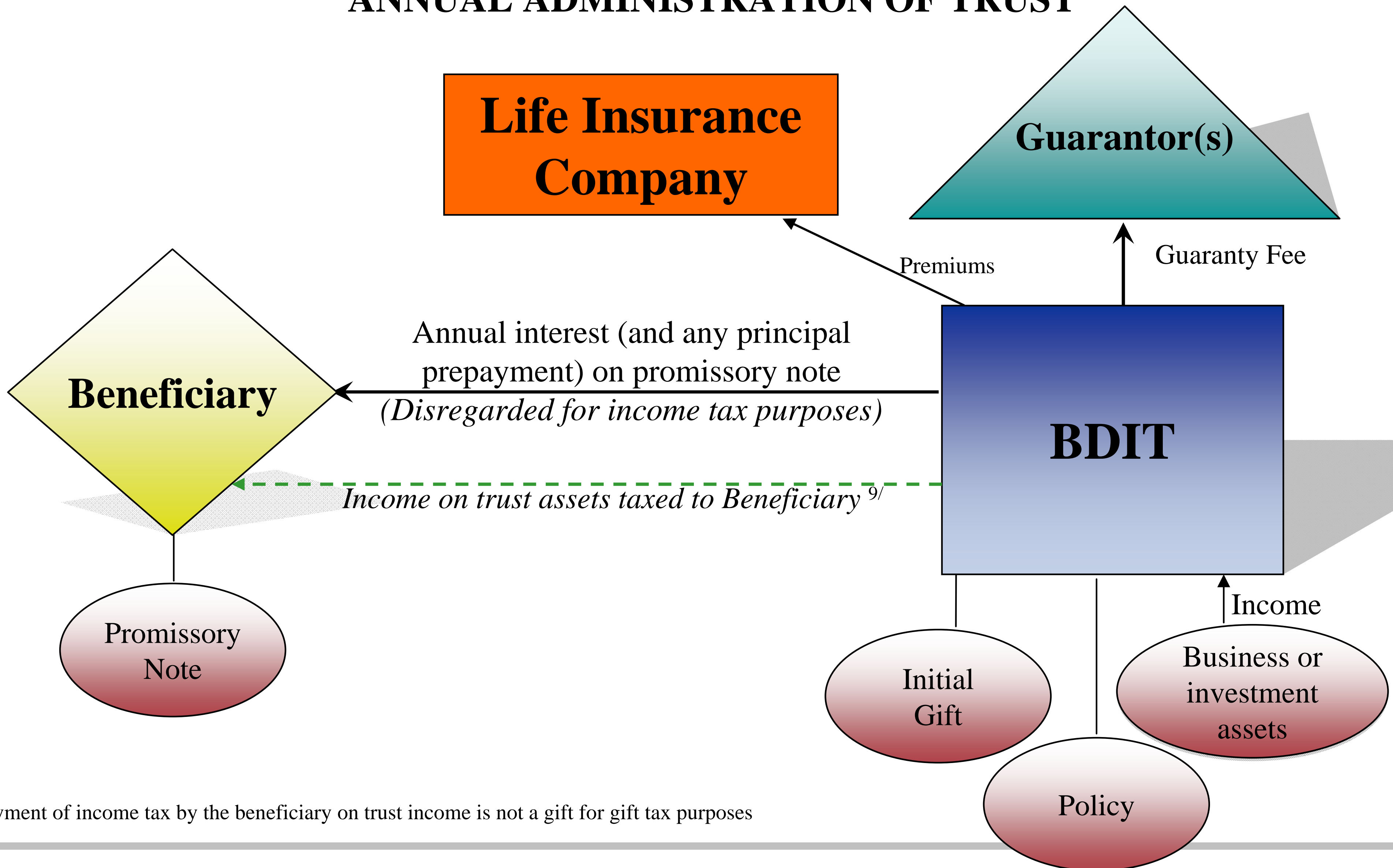
# PURCHASE OF INSURANCE




[7/] If the BDIT did not generate enough cash flow to pay premiums, the beneficiary would enter into a private premium financing split-dollar arrangement with the BDIT

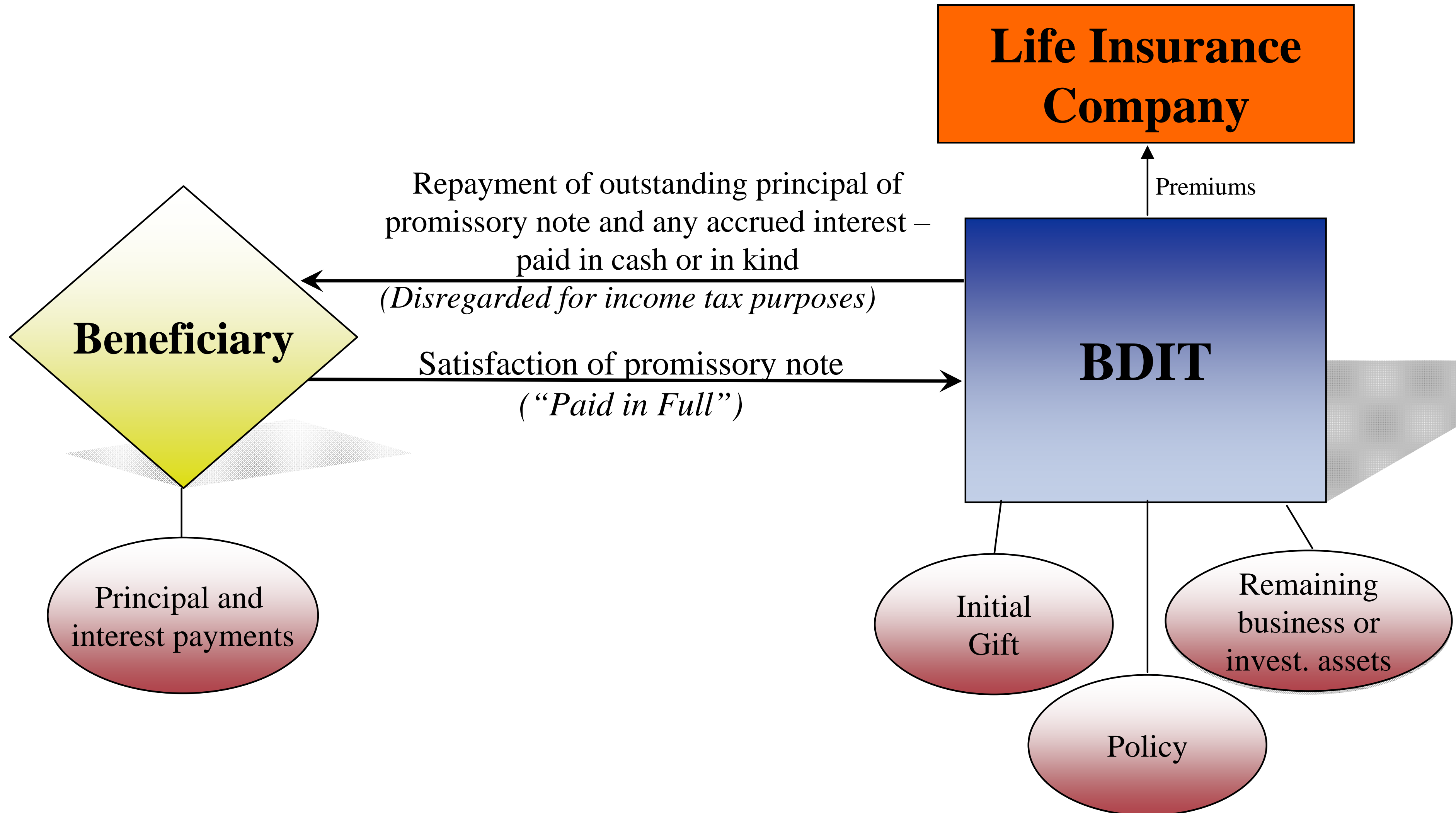
[8/] Beneficiary cannot hold Trustee powers over the insurance on his or her life, and his or her power of appointment can't extend to that insurance

## ANNUAL ADMINISTRATION OF TRUST

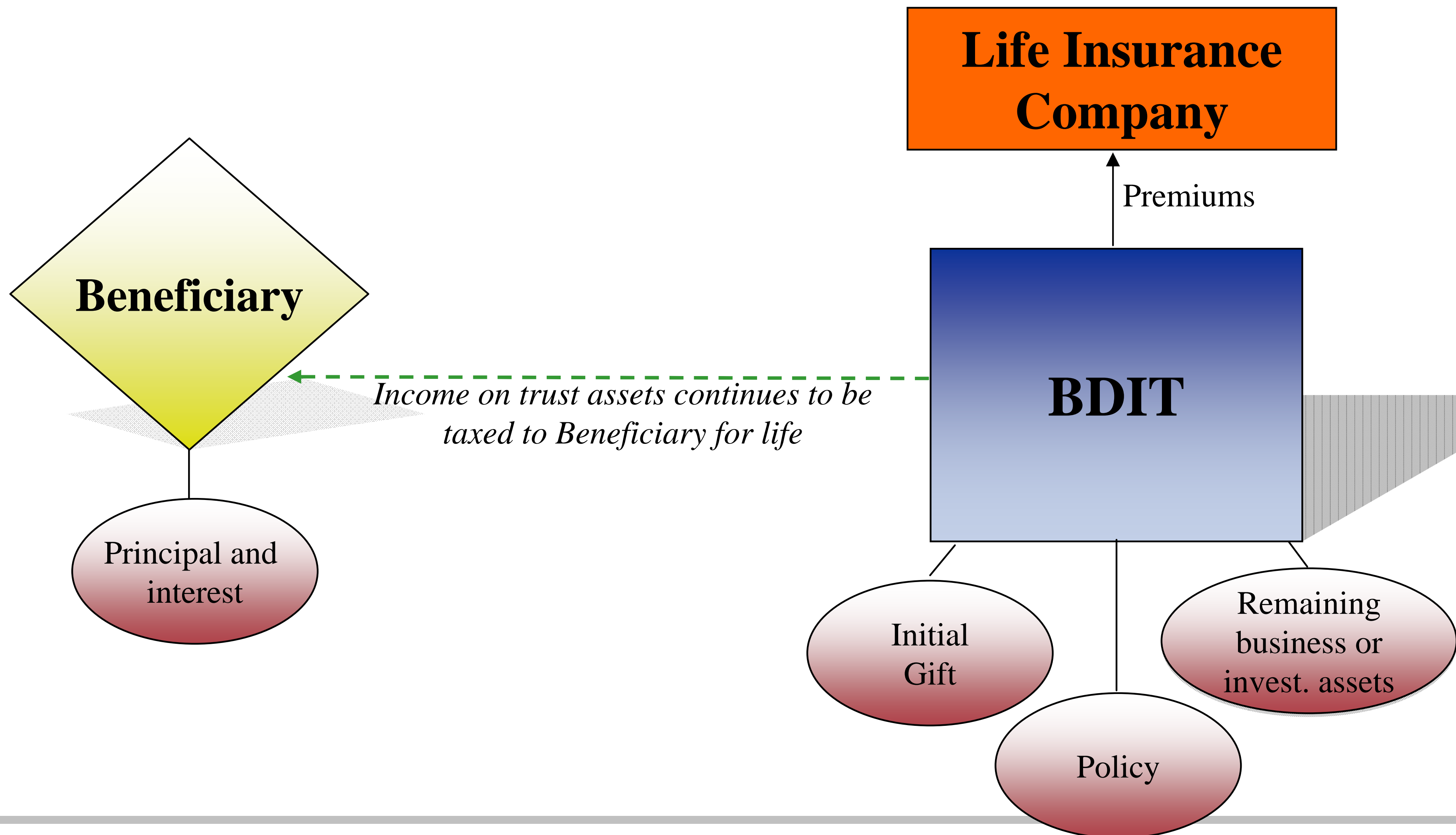



[9] Payment of income tax by the beneficiary on trust income is not a gift for gift tax purposes

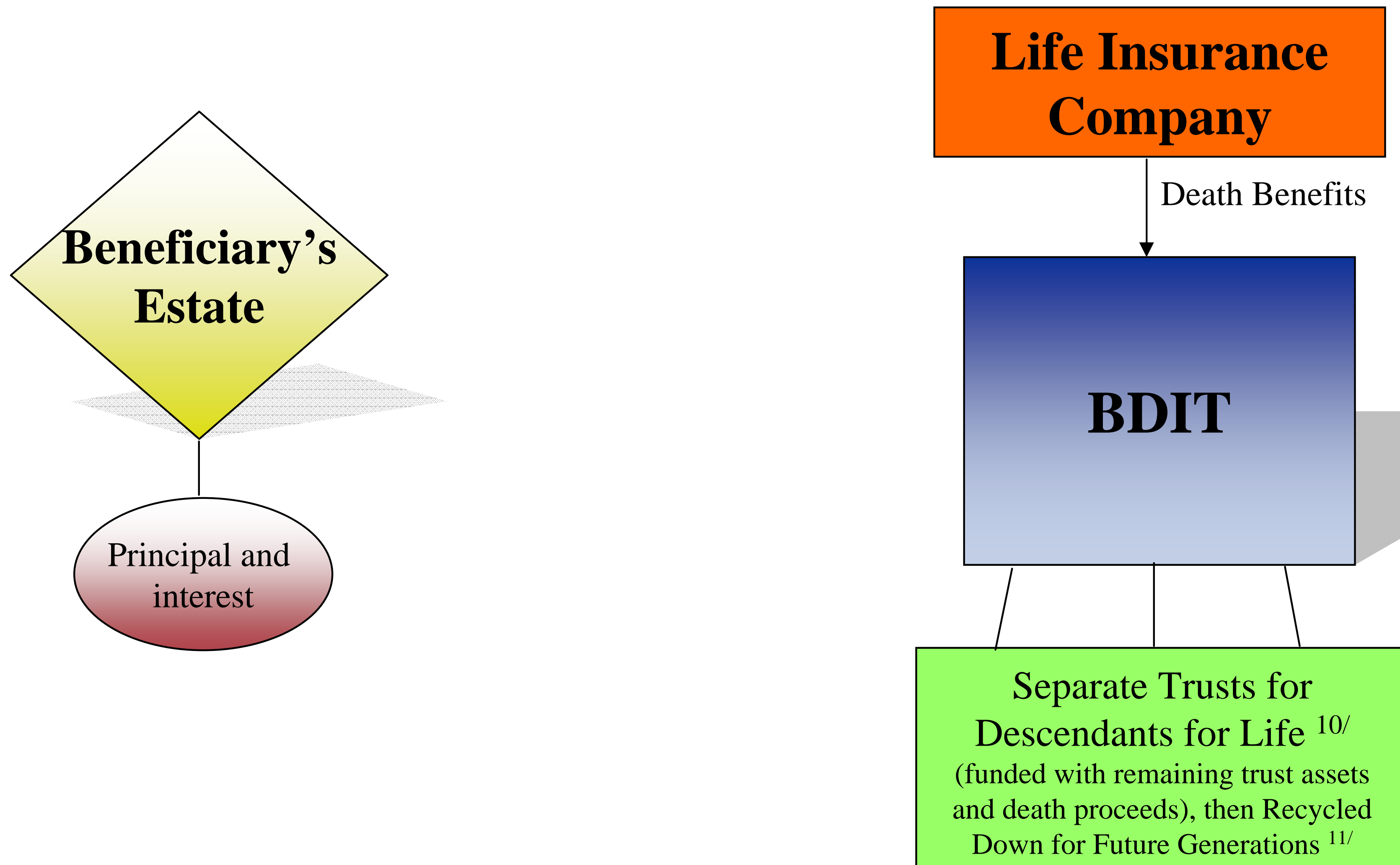
# COMPLETION OF SALE OF BUSINESS OR INVESTMENT ASSETS AFTER NOTE TERM



# FOLLOWING COMPLETION OF SALE OF ASSETS



# FOLLOWING DEATH OF BENEFICIARY




[10] Protected from their creditors, spouses, and the transfer tax system

[11] Unless modified by the exercise of a limited power of appointment

# THE BDIT: A POWERFUL WEALTH PLANNING STRATEGY WHEN PROPERLY DESIGNED AND IMPLEMENTED

**Steve Leimberg's Estate Planning Email Newsletter - Archive Message #1824**
**Date:** 22-Jun-11
**From:** Steve Leimberg's Estate Planning Newsletter
**Subject:** **The BDIT: A Powerful Wealth Planning Strategy When Properly Designed and Implemented**

Now, **Dick Oshins, Larry Brody and Katarinna McBride** provide **LISI** members with an analysis and clarification of the functionality of the BDIT (Beneficiary Defective Inheritor's Trust), as well as an explanation as to why attempts to modify the BDIT steps can actually deteriorate the purity of this largely codified but creative strategy.

**Richard A. Oshins ("Dick")** is a member of the Las Vegas law firm, **Oshins & Associates, LLC** where he represents high-net-worth individuals and business owners on wealth transfer planning with a special emphasis on leveraged transfer strategies and multigenerational planning. He has been an advisor and consultant to many of the largest financial institutions in the United States. Dick has been honored as a recipient of the "Distinguished Accredited Estate Planner" award by the National Association of Estate Planners & Councils. He has lectured at most of the nation's major tax institutes and written extensively on innovative tax and estate planning strategies. Dick is on the Advisory Board of the NYU Institute on Federal Taxation, the Editorial Board of Estate Planning Magazine and the Advisory Board of CCH.

**Lawrence ("Larry") Brody** is a partner in the private client group at **Bryan Cave, LLP**. Larry received the designation of Accredited Estate Planner by the National Association of Estate Planners and Councils, and was one of ten individuals awarded its Distinguished Accredited Estate Planner designation in the initial class, in 2004. Larry is a fellow at the American College of Trust and Estate Counsel, is a member and serves on the Advisory Committee of the Philip E. Heckerling Institute on Estate Planning of the University of Miami School of Law, and serves on the Editorial Board of BNA's *Estates, Gifts and Trusts Journal* as well as the Society of Financial Service Professionals' *CLU Journal*. Larry also gives back to the legal community as an adjunct professor at Washington University School of Law and a visiting adjunct professor at the University of Miami, School of Law. Larry has authored numerous books and publications, including two BNA Tax Management Portfolios and two books for the National Underwriter Company. Larry is a frequent lecturer at national conferences on estate and insurance planning.

**Katarinna McBride ("Katarinna")** is a Partner in the Advanced Planning & Family Office Group at the nationally recognized law firm of **Handler Thayer, LLP**, whose boutique practice and attorneys have been recognized in Worth Magazine as top estate planning attorneys and structure experts in the family office and advanced estate

planning space. Katarinna is a member of STEP, ABA RPTE, CEPC and is on the advisory board to create a Masters in Estate Planning. Katarinna has served as the Editor of the Trusts & Estates newsletter for the Illinois State Bar Association for over six years, and drafts the estate planning column for the Illinois Bar Journal. She has been quoted and published in multiple newspapers and journals, including the Wall Street Journal, Business Week, Probate & Property and has appeared as a tax expert on ABC News, NBC News, FOX News & Special Reports and CBS News. Katarinna serves as an adjunct professor to several Chicago law schools' LLM programs and employee benefits programs, and is a frequent speaker and lecturer. Katarinna and Dick Oshins have upcoming publications in Trusts & Estates Magazine and CCH.

The authors would like to extend their thanks to **Professor Jerome ("Jerry") M. Hesch** for his scholarly review and comments, as well as **Susan P. Rounds**, JD, CPA, LLM for her revisions.

Now, here is their commentary:

# EXECUTIVE SUMMARY:

If our clients were able to express to us what they would want to accomplish during the estate planning process, assuming that it was obtainable, it would consist of a combination, with varying emphasis, of the following:

- Control - Including the managerial control, of their wealth until death;
- Beneficial enjoyment - The use and enjoyment of the property for any purpose until death;
- Power to amend - The ability to change who has the right to use or receive the assets if there is a change in family dynamics, the law or for any other reason;
- Creditor protection - Including protection from divorcing or dissident spouses, for them and their descendants; and
- Tax Savings – For them and their descendants.

The Beneficiary Defective Inheritor's Trust ("BDIT") is a trust funded solely by a third party for the benefit of a client (often an affluent individual) which will enable the client, as the beneficiary of the BDIT, to accomplish the goals outlined above, provided that it is structured properly. Think of the BDIT as the third party's Dynasty Trust created for the beneficiary and his or her descendants.

# FACTS:

## THE "PIPE DREAM TRUST" – WHAT DOES NOT WORK[1]

The perceived obstacle our clients, and we as their advisors, face is that clients cannot create an estate planning vehicle for themselves and accomplish all of these goals. If clients create this for themselves, it has been referred to as the "Pipe Dream Trust." Not only would the Client be subject to income and transfer taxes as if the trust had not been created, the trust would be a "self-settled" trust and potentially expose the trust assets to the Client's creditors. Even though an individual cannot create such a trust for him or herself, any other person can create a trust for someone else, even for the client's spouse, and accomplish the desired benefits for the trust beneficiaries. This is a typical trust with a spendthrift clause.

Why can a third party create a trust for someone else that accomplishes the desired goals, while an individual cannot establish a trust for his or her own benefit with the same result? Property transferred during life may be pulled back into the estate at death under the "string provisions" of IRC §§2036-2038. For example, in the context of FLPs, the IRS has been successful in taxing transfers under §2036 when the decedent has transferred assets during lifetime and has retained an interest, either express or implied, in the transferred property. (Note – if the transferor had received assets of equivalent value in exchange, the transfer would be protected from inclusion under the "adequate and full consideration" exception to §2036.)

The string provisions are only applicable to transfers during lifetime where the transferor (i) makes a transfer, (ii) retains an interest in the transferred property, and (iii) the transfer was for less than "adequate and full consideration." If *any* of these three conditions does not exist, §§2036-2038 will not apply and the property will not be pulled back into the estate.

Why is this important here? If someone other than the decedent made the transfer, the string provisions would not be triggered, and as long as other estate tax inclusion provisions were not violated, the property would not be brought back into the estate. In addition, if the client makes a transfer to an otherwise safe trust set up by someone else and receives something of equal value in exchange, the assets transferred will not be exposed to the estate tax. If this is done properly in a state with an unlimited perpetuity period, the assets can be protected from all estate, gift and GST taxes, forever, as long as they remain in trust.

### Finessing the "Pipe Dream"

The BDIT can enable the client to reasonably accomplish the goals set forth in the

introductory paragraph without running afoul of the nefarious string provisions. This article will discuss the BDIT and how to avoid, or finesse the various traps which would otherwise expose the estate owner to taxes or creditors, and still leave the estate owner with reasonable control and the beneficial enjoyment of the property.

Skilled estate planners are aware of the fundamental fact of estate planning: Assets placed into a trust by someone else have substantial advantages relative to assets that are received outright by gift or bequest. A perpetual trust will extend these enhanced benefits for multiple generations, subject only to the applicable rule against perpetuities, if any.

## COMMENT:

Solely because assets are transferred to a trust by someone other than the trust beneficiary, and as long as they are retained in trust, those assets are well positioned to be sheltered from the estate, gift, and GST tax, as well as from the beneficiary's present and potential creditors. This is true even though the beneficiary is given the use and enjoyment of the trust assets, in addition to substantial control of the trust. Forum shopping for a favorable trust jurisdiction is encouraged when designing BDITs.[ii]

There are four general components which enable the BDIT to accomplish the desired benefits.

- **Third Party Funding**: The trust funding cannot be attributable to the beneficiary. The trust must be funded solely by someone other than the beneficiary, and the beneficiary cannot reimburse the donor either directly or indirectly.

- **No Gift by Beneficiary**: The beneficiary must never make a gratuitous transfer to the trust.

- **Valuation Dat**e: The value of the transfer is measured at the time of the transfer and subsequent growth is irrelevant. This is true for both the original gift to the trust, as well for as any assets sold to the trust.

- **Grantor Trust**: The BDIT will be designed and funded so that it will be treated as a Grantor Trust under §678 of the Code as to the beneficiary, but intentionally not as to the creator.

**Steps of the BDIT**

Although the BDIT can be used in many ways to accomplish estate and business planning objectives, this article focuses primarily on transferring the client's existing assets into the trust through an installment note sale to the BDIT. To ease the discussion, we will refer to the donor as "Parent" and to the beneficiary as "Client or Beneficiary." This transaction is similar in many respects to the installment note sale to an IDGT transaction. The following steps should be observed:

1. ***Set up a BDIT*****:** A BDIT is set up as a fully discretionary GST trust, (wholly exempt from the GST tax, by allocation of the creator's GST exemption), set up in a state which has a "self-settled trust" statute and the Beneficiary is given a broad Special Power of Appointment ("SPA"). The BDIT will have a formula clause which shifts unintended gifted assets to a non-exempt BDIT and/or permits a qualified severance allowing the trustee to divide the trust into separate trusts.

2. ***BDIT Design*****:** The BDIT is designed as a Beneficiary Controlled Trust ("BCT"). The Client is given as much control over the trust as possible without exposing the trust to taxes or creditors. That control is substantial. The Client controls (i) the management of the trust, (ii) the selection of the parties who are permitted to use the trust assets (including the Client ), and (iii) the identity of the Independent Trustee subject to the restrictions of IRC §672 (c) and Rev. Rul. 95-58. The Client can alter both the dispositive scheme and the trusteeship structure through a special power of appointment without exposing the trust assets to estate tax or creditors. The BCT trust is designed as discussed in the various articles cited in footnote ii.

   Planning Note: *Some advisors have suggested using a single trustee with a "health, education, support and maintenance" distribution standard. We strongly recommend the use of a discretionary trust with an Independent Trustee designed in the manner discussed in the articles listed in footnote* ii. *The use of such a trust will provide the client and future beneficiaries with the maximum tax and creditor protection.* [iii] *The Client will be the Investment Trustee. The use of an Independent Trustee in a preferable state will enable the Client to benefit from that state's laws. Some clients will prefer the BDIT arrangement where there are two separate Independent Trustees, one who is a trusted friend as the Distribution Trustee and the other who will be sufficiently connected to the state of choice such that the BDIT can be governed under that state's laws.*

3. ***Gift of $5,000*****:** Parent (or some other third party) gives $5,000 to the BDIT, subject to a power of withdrawal in the Client which lapses in 30 days. The $5,000 is not invested during the 30 day period; thus, the entire contribution lapses 30 days from the date of gift. As a result of the power of withdrawal, the Client will be treated as the owner of the trust income. Because the Client is treated as the Grantor for income tax purposes, (i) he or she can transact with the trust income tax free [iv] and (ii) by paying the income tax on the trust income, the client's estate will be depleted for both transfer tax purposes and creditor purposes. $5,000 of Parent's GST tax exemption is allocated to the BDIT so that the trust is 100% GST exempt.

4. ***Defined Value Sale ("DVS") to BDIT for a Note*****:** The Client will sell assets to the trust in return for a note, interest-only at the AFR, with a balloon payment at the end of the term, which is generally nine years. The sale will be structured as a DVS. [v]

5. ***Quality Appraisal*****:** The sales price will be determined by a quality appraisal. We recommend that the Independent Trustee (or Special Trustee) which is a trust company (or other independent institution with appropriate fiduciary responsibility) represent the BDIT in the sale or purchase of hard-to-value assets to or from the BDIT. The trust company is represented by separate counsel. The trust company and its counsel discuss the transaction with the appraiser.

   Planning Note: There is little incentive to obtain an aggressive appraisal. As a general rule, the estate depletion as a result of grantor trust status will, over time, "tax burn" the Client's estate. Because the Client is a beneficiary and in substantial control of the trust, the BDIT does not have the economic risks of alternative defective trust wealth shifting arrangements. [vi]

6. ***Legitimate Guaranty*****:** In order to give the sale economic substance, the note is guaranteed by a person or entity who or which has the financial wherewithal to guaranty the sale if the guaranty is called. The amount guaranteed in these transactions is normally double the amount which we would use if we did a note sale to an IDGT. We discuss the economic viability with the appraiser during the planning process. The Guarantor is paid a guaranty fee in order to avoid a potential gift from the guaranty. The appraiser reviews the financial statement of the guarantor and determines the appropriate guaranty fee. [vii] The guarantor is represented by separate counsel. The guaranty is a very real guaranty and will

expose the guarantor to liability if it is called. It should be reflected on the balance sheet of the guarantor as a contingent liability.

Planning Note: *A concern has been raised that the funding of a BDIT with only $5,000 would lack "economic substance" and might result in the transaction being recast as something other than a legitimate sale. Surely, a legitimate guaranty as outlined above will support the same transaction as the more traditional note sale to a trust with seed money. In addition, the use of guarantees is more synonymous with transactions as they are structured in the real world, as opposed to a sale to an entity which only has assets worth 10% of the property it is acquiring.*

7. ***File a Gift Tax Return*****:** "A timely filed gift tax return as a non-gift completed transfer under Treas. Reg. §301.6501(c)-(f)(4)"[viii] should be filed. This will start the statute of limitations period running. If the Service does not audit it within three years, the statute will have run. If the Service comes in and successfully adjusts the valuation, the Client will adjust the allocation of the asset sold to reflect the change by shifting the gift portion into a non-exempt trust. Because of the special power of appointment, there will not be a gift tax owed.[ix] With respect to the BDIT, there will be certainty going forward and because there has not been a gratuitous transfer to the BDIT, the trust will be outside the transfer tax system similar to any other Dynasty Trust.

   Planning Note: *By using a DVS (see Step #4) there will not be a gratuitous transfer to the BDIT. By filing a timely gift tax return, the statute of limitations will run on the sale, or upon adjustment of the valuation the allocation to a non-exempt trust will be made in accordance with the formula. Thus, the Client will have achieved certainty going forward that there has not been a gratuitous transfer to the BDIT, and that the trust is outside the estate tax system. The trust will be treated as a Dynasty Trust, a trust we all are comfortable with. That protection is not, and cannot be obtained by the alternative techniques suggested below.*

**Results:**

As a result of the compliance with these steps:

- The trust can be protected from all estate, gift and GST taxes forever – It's Parent's Dynasty Trust and the Beneficiary/Client has never made a gratuitous transfer to the BDIT. The use of a DVS and the filing of the

gift tax return assure that result.

- Protected from creditors forever - The Beneficiary/Client has received back assets of equal value to any assets sold to the trust.
- The Beneficiary/Client may "use" the trust assets for any purpose.[x]
- The Beneficiary/Client is in control of the trust, except for distributions.
- The Beneficiary/Client's wealth is depleted, but moved into the trust transfer tax and income tax free.

## COMPARISON WITH ALTERNATIVE RECOMMENDATIONS

Over the past year there have been a number of articles written on the BDIT which have raised some concerns and have suggested alternative solutions that attempt to achieve the same results as the BDIT/note sale. The following compares the recommended solutions to the BDIT. We will assume that the BDIT is structured as set forth previously and compare it to the alternatives using the objections set forth in the LISI article dated Dec. 14, 2010.[xi]

Two of the recommended "alternatives" to the BDIT pursuant to that article are the Private Annuity Sale and the Beneficiary Grantor Trust:

1. ***The Private Annuity Sale (hereinafter "PAS")*:** [xii] The client makes a sale to an IDGT in exchange for a Private Annuity for life. The client is provided with upside growth using "options to repurchase, 'waterfall' provisions and appropriate management fees and provisions in LLC and FLP documents keying into contingent and extraordinary growth." The authors conclude that this transaction "mimics" or "surpasses" the economic advantages of the BDIT.

**Comments:**

1. The PAS transaction, as advocated, is a high risk plan. The PAS transaction is intended to achieve the benefits of the BDIT, however, it does not result in the Client obtaining any of the five components detailed in the Executive Summary Section – (i) control, (ii) use and enjoyment of "all" of the property, (iii) the ability to alter the beneficial enjoyment over the property, (iv) creditor protection, and (v) similar estate tax benefits (if any are achieved). The Client

has only the right to receive the annuity when paid and that right is exposed to potential creditors. The Client is taxed on all of the trust income and thus is economically exposed if the income tax depletes the Client's estate too much. Furthermore, a PAS to a grantor trust must meet the IRS exhaustion test, while an installment sale does not have the same requirement.

The retention of the rights, which are designed to "mimic" the BDIT, exposes the transaction to being treated as a transfer with a retained interest, thus causing exposure to possible estate inclusion. For example, if the compensation is even $1.00 too high, the Client will fail the "full and adequate" consideration exception to the string provisions. The Client cannot effectively enter into a "Defined Value **Compensation**" agreement or file a gift tax return on the compensation, so the statute of limitations cannot run and certainty cannot be achieved. The annuity will be paid until death; therefore, unlike a term note where the estate tax inclusion risk ceases[xiii] when the note is paid, the PAS transaction is always exposed because the annuity term is determined with reference to death. The more the transaction attempts to "mimic" the BDIT, the greater the exposure the PAS transaction has to being treated as a transfer with a retained interest.

In almost all BDIT transactions, the Client will transfer his or her entire ownership interest to the BDIT. There is no reason to retain any interest because the Client is a beneficiary of the BDIT which is designed as a BCT. The Client can receive distributions from the trust as a beneficiary in the discretion of the independent trustee whose identity is determined by the Client. This eliminates the economic necessity of having to retain the risky compensation and option arrangements which continuously expose the transaction to §2036 risks.

2. ***The Beneficiary Grantor Trust/Opportunity Shifting (hereinafter "BGT")*:**[xiv] The Client has a business which is expanding. The Client's parent makes a gift of $5,000 into a trust subject to a lapsing power of withdrawal. The Client sets up an LLC which makes a deal with the business to build a building and lease it to the business (presumably on the land that the LLC acquired). Based upon the strength of the lease, the Client obtains the financing to accomplish this result.

**Comments:**

The structure of the BGT/Opportunity Shifting transaction creates a far greater risk than if the transaction had been structured as an installment note sale to a BDIT. This is counter-intuitive to the visceral reaction of most planners, but it is the obvious

result. As a general rule, "Opportunity Shifting" is considered to be a safer transaction than the use of a sale to the trust. This conclusion is based upon the presumption that the client is not transferring anything to the trust which would expose the transaction to being treated as a transaction with a retained interest and putting the fair value exception into issue.

Under the fact pattern suggested by the BGT proponents, the BGT enters into a lease with the Client's business. This, in and of itself, reverses the risk feature of the transaction. If the lease is greater than "market rate" (even by $1.00) the Client will have been deemed to have made a gift to the trust, thereby exposing all of the assets (other than the original $5,000) to estate tax inclusion and creditors of the Client because the Client will have made a gratuitous transfer to the trust. The BGT would have the estate tax inclusion risk forever.

Furthermore, it is difficult to accept the economics of the transaction as suggested. However, we will accept the facts as set forth. In any case, the ability to design a "fair market" lease is quite problematic. There is no guidance to design the lease, remembering that the trust funded with $5,000 must buy the land and build the building and the Client's business must wait until that has occurred in order to occupy the premises. The Client cannot establish a "Defined Value **Lease**" and cannot file a realistic gift tax return. Because the risk is exposure of the entire wealth shift into the trust, this transaction is far riskier than the BDIT and should never be attempted.

The risk could be easily avoided by changing the ordering of the planning and following the steps set out previously. If the Client were to buy the land himself and construct the building, he could then sell the office building to a BDIT using a DVS and file a gift tax return. The correct ordering of the steps would change the transaction from a high risk transaction into one which has the built-in safety features.

## DISCUSSION OF PRIMARY ISSUES RAISED ABOUT THE BDIT:

### *Issue # 1 – Economic Substance/Thin Capitalization:*

The economic substance issue deals with the economic legitimacy of the transaction. If the trust is too thinly capitalized, the Service may try to recast the sale as a gift. In addition, if there is insufficient economic substance, the value of the note could be reduced resulting in the seller not receiving assets equal in value to the asset transferred.[xv] The "rule of thumb" often used is that 10% will provide adequate "seed" funding. In support of an IDGT transaction having more economic substance, the authors suggest that the BDIT proponents "dismiss the 10% requirement". [xvi]

In order to easily compare a BDIT and an IDGT transaction, we will assume that the value of the asset that will be sold to the trust is $9 million. The IDGT alternative would involve funding the trust with 10%, or $1 million. In the BDIT transaction, the trust is capitalized with $5,000 and a legitimate guaranty of $2 million is made by a party (or another trust) which has the economic wherewithal to pay to the guaranty if called. Thus, the cushion is $2,005,000. In comparing the BDIT and IDGT transactions as recommended, it is difficult to conclude that the BDIT does not have more economic substance than an IDGT transaction. Given the alternatives, the owner of a $9 million asset should prefer selling the asset to the trust seeded with $5,000 with a legitimate guaranty of $2 million, over selling the asset to a trust capitalized with $1 million.

***Other Perceived Issues – Step Transaction:***

The authors that recommended the PAS with the retained features suggest that the separate steps (seeding the trust and the sale) would be aggregated and treated as a single transaction. They cite three cases where the courts applied the step transaction involving FLPs: Linton[xvii], Heckerman[xviii] and Pierre[xix]. In each case, the steps occurred in the same day. With the BDIT, we wait at least 30 days from funding until the lapse of the withdrawal right, and often the time gap is much greater. It should be noted that in the Linton appeal, the Ninth Circuit held that if the "ordering" of the steps were correct, then the step transaction would not apply.

Before examining the results of a successful "step transaction" argument by the Service, a level playing field should be established. We will assume that the same time gap between the funding of the trust and the sales transaction occurs for both the BDIT and PAS strategies. In such instance, the step transaction would be less likely to be applied to the BDIT than the PAS because the BDIT is set up by a third party who, in our experience, does not even know about the transaction. In the PAS transaction, the same person is seeding the trust and making the sale. Moreover, the various additional components, such as the compensation arrangement and the option, add to the exposure. In other words, the BDIT has less risk of a step transaction attach than a traditional PAS transaction and significantly less risk than a PAS transaction that includes the additional retained features

Assuming arguendo, that the IRS was successful with the "step transaction," position the BDIT would be protected by the "full and adequate consideration" exception. The PAS and the BGT would be fully exposed to the string provisions.

In Pierre, a case which opens the door to an interesting and very reasonable position for the Service to attack sales to IDGTs, the IRS was successful in arguing step transaction. In Pierre, the taxpayer formed an LLC and made gifts of 9.5 percent of the LLC and a sale of 40.5 percent interests to two trusts, one for each child. The Tax Court held that the step transaction doctrine applied and aggregated the gift and sale transactions for valuation purposes, so that two 50% interests were valued, rather than the four minority interests.

Why is the step transaction a major concern in the context of a sale to an IDGT or a PAS? As previously mentioned, to have inclusion under §2036, three things must occur – (i) a transfer; (ii) with a retained interest; (iii) for less than full and adequate consideration. Assume that an IDGT is set up and funded with $1 million and the estate owner sells $9 million worth of an entity – which is quite typical.

If the Service successfully argues that the "seed" gift and the sale were part of a step transaction, the seller will have transferred $10 million to the trust and received only the $9 million note back. That would cause the transaction to fail §2036 and if the note was outstanding at death, there would be estate tax inclusion, including appreciation. Because the PAS transaction is designed so that the annuity is paid until death, if the Service were to prevail on the step transaction argument, there could be estate tax inclusion. In most instances, the amount included would also be valued as part of a control block, and the discount would be includable. The same result would occur if the BGT lease was a "favorable" lease. The gift portion would expose the BGT to §2036 inclusion. This result does not occur with the note sale to the BDIT since the third party would have transferred the "seed" money. Since the estate owner never transferred the "seed" money, the step transaction does not apply to aggregate the two transfers.

**HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!**

# Richard A. Oshins
# Larry Brody
# Katarinna McBride

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[i] As with any newly-developed planning technique (think about installment sales to grantor trusts some 15 years ago which some practitioners in the 1990's felt were risky) the BDIT is in a similar position. By analogy, before defined value clauses were upheld by the courts (most recently in Hendrix v. Comm'r., T.C. Memo 2011-133) similar concerns were voiced about defined value clauses. Recently, several articles have expressed concern about the BDIT. This newsletter will address how to structure a BDIT so as to eliminate or protect against these concerns. In addition, some of these critical articles made assumptions that can easily be overcome. For example, if a client desires asset protection, attorneys often recommend Nevada, South Dakota, Delaware or Alaska trusts. If an article evaluates the creditor protection concerns of a N.Y. trust, it is natural to be critical. Despite raising concerns with the strategy, several authors are now writing and lecturing on the virtues of the BDIT concept, albeit calling the BDIT by different names (such as the Beneficiary Grantor Trust "BGT"), and adding variances which they suggest enhance the strategy. As will be discussed, the perceived enhancements can actually add significant risks to the strategy and expose the transaction to IRS and creditor attack. The principal conceptual defects in the alternative advice come from a misunderstanding of IRC §2036. Steven B. Gorin, *Letter Ruling 201039010 – The Latest Beneficiary Grantor Trust Ruling*, Estate, Gifts and Trusts Journal 179 (May 12, 2011); See also Steven B. Gorin and Jeffery Galant, ACTEC 2011 Summer Meeting Presentation, Atlanta, Georgia; See also Steven B. Gorin, *A Balanced Solution*, Trusts & Estates (May 2011); See also Avi Kestenbaum, Jeffery Galant and Eli Akhavan, *The Beneficiary Defective Inheritor's Trust: Is It Really Defective,* LISI (December 14, 2010).

[ii] Richard A. Oshins and Jerry Kasner, *The Dynastic Trust Under the Relief Act of 2001*, Tax Notes (October 8, 2001) at 247; See also Frederick Keydel, *Trustee Selection, Succession, and Removal Ways to Blend Expertise with Family Control*, 23 U. Miami Inst. On Est. Plan., Ch. 4 (1989).

[iii] Steven J. Oshins and Mark Merric, *Effect of the UTC on the Asset Protection of Spendthrift Trusts,* Estate Planning (August, September and October 2004).

[iv] Rev. Rul. 85-13.

[v] Carlyn S. McCaffrey, *Formula Valuation – Shield Against Gift Tax Risks or Invitation to Audit*, 42 U. Miami Inst. On Est. Plan., Ch. 11 at §1101.2 [B] (2008); See also Carlyn S. McCaffrey, *Tax Turning the Estate Plan by Formula,* 33 U. Miami Inst. On Est. Plan., Ch. 4 (1998); See also Carlyn S. McCaffrey and Mildred E. Kalik, *Using Valuation Clauses to Avoid Gift Taxes*, 125 Trusts & Estates 47 (October 1986); See also John Porter, *A Formula for Avoiding Transfer Tax Litigation*, Williamette Law Review (Autumn 2010) at 86.

[vi] "Although valuation discounts receive most of the attention, over a long period of time the grantor's payment of the income taxes on the trust's taxable income will almost always have a far greater impact on the amount of wealth transferred without exposure to the gift, estate and generation skipping transfer taxes than valuation discounts…."
"Although the primary objective of most freeze techniques is to shift future appreciation in value to the trust without any gift taxes, a separate wealth shifting benefit arises by the grantor's payment of the grantor's trust's Federal and state income tax liabilities. If grantor trust status continues for a significant period of time, this wealth transfer feature can transfer far more wealth without transfer taxes than the use of low interest rates or valuation discounts." Jerome M. Hesch and David A. Handler, *Evaluating the Sometimes Surprising Impact of Grantor Trusts on Competing Strategies to Transfer Wealth*, 68 N.Y.U Tax. Inst. On Fed. Tax'n. (2009).

[vii] A. James Casner and Jeffrey N. Pennell, Estate Planning, Vol. One - Sixth Edition, Shifting Opportunities at §6.3.3.6; See also Milford Hatcher, *Planning for Existing FLPs,* U. of Miami Tax Inst., 2001, Ch. 3 at Section 302.2.

[viii] Carlyn S. McCaffrey, *Formula Valuation – Shield Against Gift Tax Risks or Invitation to Audit*, 42 U. Miami Inst. On Est. Plan., Ch. 11 at §1101.2 [B] (2008);

[ix] Treas. Reg. §301-6501(c)-(f)(4).

[x] Ron Aucutt, *Structuring Trust Arrangement for Flexibility*, 35 U. of Miami Inst. on Est. Plan., Ch. 9 (2003) at §902.3.

[xi] Avi Kestenbaum, Jeffery Galant and Eli Akhavan, *The Beneficiary Defective Inheritor's Trust: Is It Really Defective,* LISI (December 14, 2010).

[xii] *Id.*

[xiii] Except if there is an implied understanding that the transferred assets may be enjoyed by the Client, such as through excessive compensation.

[xiv] Steven B. Gorin, *Letter Ruling 201039010 – The Latest Beneficiary Grantor Trust Ruling*, Estate, Gifts and Trusts Journal 179 (May 12, 2011); See also Steven B. Gorin and Jeffery Galant, ACTEC 2011 Summer Meeting Presentation, Atlanta, Georgia; See also Steven B. Gorin, *A Balanced Solution*, Trusts & Estates (May 2011); See also Avi Kestenbaum, Jeffery Galant and Eli Akhavan, *The Beneficiary Defective Inheritor's Trust: Is It Really Defective,* LISI Estate Planning Newsletter #1730 (December 14, 2010).

[xv] David H. Handler and Deborah V. Dunn, *Drafting the Estate Plan,* Section 11.06(B)(2)(a) (Discussing seed money and economic substance/thin capitalization).

[xvi] The 10% is only a rule of thumb. Further discussion of that is beyond the scope of this article, except to point out that we discuss the issue with the appraiser and generally double what we would have used if the sale was to an IDGT. The amount of the guaranty and the guaranty fee generally varies depending upon the nature of the asset being transferred and other factors.

[xvii] *Linton v. U.S.,* 107 AFTR 2011-375 (9th Cir. 2011).

[xviii] *Heckerman v. U.S.,* U.S. Dist. Ct., W.D. Washington, Cause No. C08-0211-JCC (July 27, 2009).

[xix] *Pierre v. Comm'r,* 99, T.C.M. (CCH) 1436 (2010).


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# A GIFT FROM ABOVE: ESTATE PLANNING ON A HIGHER PLANE

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By Richard A. Oshins, Lawrence Brody, Jerome M. Hesch & Susan P. Rounds

# A Gift From Above: Estate Planning On a Higher Plane

The unique design of a BDIT minimizes—even eliminates—many tax and non-tax problems

Generally, most clients want the same thing: control, use and enjoyment of their assets until death and protection of their assets from potential claimants. They also want these same benefits for their family members after the clients pass away. Ideally, these goals can be met in a tax efficient manner.

It's a fundamental fact of estate planning that to best accomplish these goals, the assets must be passed on in a generation-skipping trust. The trust can be designed to achieve the desired benefits, generation after generation, even though the trust beneficiaries are given "in trust benefits and controls." This designation makes assets inherited in trust much more valuable and desirable for a beneficiary than receiving the same assets outright. Additionally, a beneficiary will prefer "in trust" receipt of gifts and bequests, provided he's given adequate control and understands the virtues of receiving assets in a continuing trust.

Unfortunately, as estate-planning professionals are aware, many commonly used estate-planning techniques can't simultaneously achieve all of a client's goals. For most clients, those goals are:

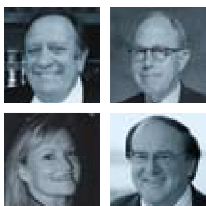
1. The ability to maintain investment and managerial control over the transferred assets;
2. Liberal economic access to the income and principal from the transferred assets or the use and enjoyment of the transferred assets;
3. The ability to decide how the income and principal from the transferred assets are to be disposed among junior family members (and other potential inheritors);
4. The protection of the transferred assets from creditors (for both the client and his family); and
5. The transfer of assets from generation to generation at little or no transfer taxes.

Looking through the arsenal of typical estate-planning strategies, most advisors realize that if a client is the creator of the trust receiving the transferred assets, at least two, and maybe three, of the above goals can't be satisfied.

If a client is able to transfer assets to a trust that he established at little or no transfer tax exposure, such as a $5 million taxable gift to a trust for the benefit of a spouse and his descendants, the second and third goals stated above can't be satisfied. Namely, a client's economic access to the income and principal from the transferred assets, or his use and enjoyment of the transferred assets, will result in the entire value of the transferred assets being included in the client's gross estate on his death. Likewise, the ability to decide how the income and principal from the transferred assets are to be disposed among family members will result in estate taxation upon a client's death.

Further, the current best-in-class wealth shifting strategies that use trusts set up by an individual client, such as a grantor retained annuity trust (GRAT), an outright gift in trust or an installment sale to an intentionally defective grantor trust (IDGT) can at most satisfy three of the above five goals.

Clockwise from top left: Richard A. Oshins is a member of Oshins & Associates, LLC in Las Vegas. Lawrence Brody is a partner in the St. Louis office of Bryan Cave LLP. Jerome M. Hesch is of counsel to Carlton Fields P.A. in its Miami office and special tax counsel to Oshins & Associates, LLC in Las Vegas. Susan P. Rounds is the author of several articles on estate planning and previously taught at the University of Georgia School of Law and Terry College of Business.



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But there's one strategy that can satisfy all of a client's goals. We call this type of trust a "beneficiary defective inheritor's trust" (BDIT). A BDIT incorporates the virtues of the more typical estate-planning strategies, but eliminates their negative features. Because of a BDIT's unique design, we can minimize and potentially eliminate common tax and non-tax obstacles. The blueprint for a BDIT is designed to minimize transfer taxes and protect trust assets from creditors, yet still provide a client with control over the management and the beneficial enjoyment of the trust property. It allows a client to enjoy more benefits as a beneficiary than the client would enjoy with outright ownership of the property. The key is that a trust beneficiary may be "given" powers over a trust by someone else that he can't "retain" for himself without tax and creditor exposure.

## BDIT Creation

Here are the key elements in establishing and preserving a BDIT:

1) The client's parent or other third party (the trust creator) establishes an irrevocable, fully discretionary trust in a jurisdiction that has extended or revoked its perpetuities law, has enacted a "self-settled trust" statute and has other beneficial trust laws;
2) The trust creator contributes $5,000 in cash (as long as such cash doesn't originate with the beneficiary)[1] to the trust and allocates $5,000 of GST tax exemption to the trust;[2]
3) The trust creator grants a *Crummey* demand power of withdrawal over the $5,000 to the beneficiary for a limited time, often 30 days, and then the power lapses;
4) The trust creator retains no income tax sensitive powers over the trust that could trigger the operation of the grantor trust rules for income tax purposes with respect to trust creator. For example, the BDIT can't own life insurance on the trust creator or the trust creator's spouse;[3]
5) The trust creator grants full discretion over distributions of trust income and principal to an independent trustee;
6) Subject to usual restrictions, the beneficiary (the client) is granted the power to remove and replace an independent trustee with another independent trustee;[4]
7) The trust creator doesn't grant any power to the beneficiary over trust-owned life insurance on the beneficiary.[5] Instead, an independent trustee is the insurance trustee with respect to insurance on life of the beneficiary;
8) The trust creator grants a broad special power of appointment (SPA)[6] to the beneficiary, exercisable by the beneficiary during life or at death. This special power can't extend to life insurance on the beneficiary's life because of Section 2042 concerns. This special power is also known as a "rewrite power;"
9) The beneficiary will be the investment trustee and control all managerial decisions (but not over life insurance on his own life); and
10) The BDIT includes a formula clause that will be used to shift unintended gifted assets to a non-GST tax-exempt BDIT.

No one, including the trust creator, can make additional gift transfers to the BDIT.

## BDIT Mechanisms

Here's how the BDIT operates:

1) No one, including the trust creator, can make additional gift transfers to the BDIT. The beneficiary never transfers assets to the trust unless it's in exchange for full value;
2) The trust creator continues to be treated as the settlor of the trust for transfer tax purposes and under state

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law for asset protection purposes, but the trust isn't a grantor trust with respect to the trust creator for federal income tax purposes;

3) While the beneficiary's power of withdrawal is outstanding, the beneficiary is treated as the owner of the trust for income tax purposes under Internal Revenue Code Section 678(a)(1);
4) Once the withdrawal right lapses, the beneficiary continues to be treated as the owner of the trust for income tax purposes under IRC Section 678(a)(2);
5) The lapsed power over the $5,000 fits squarely within the "5 and 5" exemption of IRC Sections 2041(b)(2) and 2514(e), so minimal estate or gift tax consequences are created for the beneficiary; the maximum estate tax exposure is $5,000, if the beneficiary dies during the 30-day withdrawal period;
6) Deferred payment sales to the BDIT are made as follows:

a. Any sale to the BDIT will be structured as a m defined value sale (DVS).[7] A qualified appraiser will determine the sales price unless the asset sold has a readily ascertainable value;
b. Since the beneficiary is treated as the grantor of the trust for federal income tax purposes, there's no sale for federal income tax purposes and thus no gain nor interest income is reported on any income tax return;
c. If a sale to the trust by the beneficiary were later determined to be a partial gift, any gift portion would be shifted pursuant to the defined value formula provision described above. The gift would be incomplete because of the beneficiary's SPA and no gift tax will be owed;[8]
d. If a promissory note satisfies the sale price, then to provide economic substance, the note must be guaranteed by a person or entity in a financial position to make good on the guarantee. In return, the guarantor should receive a market value guarantee fee for the transaction, which has been set by a qualified appraiser who has also reviewed the guarantor's financial statements.[9] The guarantor should be represented by separate counsel, and the contingent liability must be reflected on the guarantor's financial statements; that is, it must be a "legitimate" guarantee; and
e. Finally, INSERT should timely file a gift tax return reporting the non-gift completed transfer pursuant to Treasury Regulations Section 301.6501(c)-(f)(4), to start the running of the gift tax statute of limitations.[10]

## BDIT Outcomes

Here are the results of a BDIT:

1. As a trust beneficiary holding an SPA who's also a co-trustee of the BDIT, the beneficiary has virtually unlimited enjoyment of the economic benefit of the trust property, full managerial control over trust assets, creditor protection (including from an ex-spouse), maximum transfer tax savings and the flexibility, within limitations, to adapt to changing circumstances within the family, tax, legal system or economy by exercising the SPA;
2. By design, the trust creator is the settlor of the trust for transfer tax purposes and creditor rights purposes, but he isn't taxed on trust income. Instead, the trust is taxed as a grantor trust as to the beneficiary. The trust creator has purposefully avoided retention of any income tax sensitive powers so that IRC Section 678(b) doesn't apply to "trump" the application of IRC Section 678(a) to the beneficiary. This result allows a tax "burn," because it's a grantor trust as to the beneficiary and the beneficiary must pay the income tax on the trust's income from personal funds, thus further depleting the assets remaining in the beneficiary's estate;
3. As the beneficiary pays the income taxes on all trust income, the assets in the trust grow income tax-free during the beneficiary's lifetime, with no gift tax consequences;[11]
4. All transactions, such as sales and loans, between the beneficiary and the BDIT are ignored for federal income tax purposes pursuant to the grantor trust rules;[12]
5. From the beneficiary's point of view, the trust is creditor-proof and protected from all transfer taxes;
6. The BDIT continues as a creditor protected, gift and estate tax-shielded, GST tax-exempt dynastic trust, subject to the beneficiary's SPA (though the BDIT won't be treated as a grantor trust for the beneficiary's spouse or descendants);

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7. If the beneficiary sells an asset, typically discounted income-producing property, to the BDIT in exchange for an installment note representing full and adequate consideration, the transaction will be free of the complications of the nefarious "string provisions" embedded in the Internal Revenue Code, which can trigger inclusion in the grantor's estate at death due to the retention of certain powers , because the beneficiary isn't the person who created the trust for all transfer tax purposes, only for income tax purposes. Accordingly, the beneficiary isn't subject to IRC Sections 2036 through 2038, which can operate to "pull" the fully appreciated date of death value of the transferred assets back into the beneficiary's gross estate. Thus, the sale will successfully effect a freeze (shift appreciation out of beneficiary's estate) at the discounted value of the asset sold to the BDIT.

Note that the BDIT accomplishes many significant non-tax objectives. Because the typical assets transferred to a BDIT are interests in closely held businesses, representing the "core" family asset, the protection from creditors is meaningful. The potential to retain the family business is much greater within a protective wrapper than if the business interests are simply owned outright. Buy-sell agreements with restrictions are much more tax inefficient than transfer restrictions in a trust. Further, restrictions with regard to the design of "S" stock status can be finessed by proper trust structuring. In addition, the seller has the opportunity to convert a non-marketable asset into a liquid asset via a note sale.

## BDITs vs. IDGTs

Let's look at the difference between a BDIT and an IDGT, a frequently used strategy that can accomplish all but two of the objectives on your client's list of goals. The IDGT takes advantage of provisions in both the income tax and the transfer tax code to accomplish an estate freeze. More importantly, an IDGT allows a grantor to further deplete the estate through the payment of income taxes on all trust income with no gift tax consequences. The income in the trust is left to grow free of the burden of income tax for the ultimate benefit of the trust beneficiaries. In addition, assets sold to an IDGT are very often entitled to a valuation discount. Thus, the IDGT provides the desired freeze, preserves the valuation discount and provides for continued burn.[13]

After the grantor establishes the IDGT, he may sell assets, typically income-producing assets such as a business interest, to the trust and take back an installment note in full satisfaction of the purchase price. The assets sold to the grantor trust are intended to generate enough income to make the note payments to the grantor. Any income in excess of what's necessary to pay the note is left in the trust to grow tax-free for the ultimate benefit of the trust beneficiaries. There's no taxable gain and thus no tax due on the sale or interest income on the note payments.[14]

> When comparing a BDIT to the IDGT, it's crucial to remember that IRC Sections 2036 and 2038 are only applicable to the individual who made gifts to the trust.

But there are traps that could befall a client who uses an IDGT. Traps that a BDIT can avoid. When the grantor sells assets to an IDGT, the grantor is selling assets to a trust that he established. Since IRC Sections 2036 and 2038 could apply to expose all trusts set up by an individual to estate tax inclusion when that individual dies, the cautious estate planner will make sure that the grantor doesn't retain any powers that would subject the trust assets to inclusion under the string provisions.[15] If assets are pulled back into the grantor's estate, they will be aggregated with the assets already there; accordingly, estate inclusion of business interests may change the valuation from a non-controlling interest to part of a control block.
Let's look at an example:

> A grantor establishes a trust for the benefit of junior family members and gifts asset #1, valued at $1 million, to the trust. The grantor retains

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the right to determine how trust assets are to be divided among his children while he's living and by a designation in his will for when he's deceased. The grantor subsequently sells asset #2, valued at $9 million, to the grantor trust, taking back an interest-only, 20 year installment note with adequate stated interest at the long-term applicable federal rate (AFR) in satisfaction of the entire purchase price. Before the note has matured, the grantor dies. At the date of his death, assets #1 and #2 are valued at $19 million. Taking into account the trust's $9 million note obligation, the equity value of the trust is $10 million. Because of the grantor's limited power to decide how the trust beneficiaries will share in trust assets, the entire equity value of the trust is included in the grantor's gross estate, subject to a consideration offset of the $9 million installment note.[16] Under IRC Section 2043, the consideration received by the deceased grantor is frozen, while appreciation in the value of the property transferred will be includible in the estate.

When comparing a BDIT to the IDGT, it's crucial to remember that IRC Sections 2036 and 2038 are only applicable to the individual who made gifts to the trust. The individual who funded the trust can't retain direct or indirect enjoyment of the trust's property, nor any power to affect a beneficiary's right to the trust assets. The BDIT beats out the IDGT on this issue. Because the BDIT is created and funded solely by someone other than the trust beneficiary, the string sections can't apply to the beneficiary.[17] As long as other estate tax inclusion provisions, such as IRC Sections 2041 and 2042, aren't violated, the property won't be pulled back and taxed in the beneficiary's estate. Thus, a BDIT beneficiary can be given a SPA that won't trigger the general power of appointment inclusion under Section 2041. Indeed, "the BDIT is less risky than an installment sale to a grantor trust settled by the grantor because §§2036 and 2038 only apply to someone who has made a gratuitous transfer to a trust."[18]

## Estate Tax Inclusion Period

As noted, when an individual establishes a trust, such as an IDGT, to be used as the vehicle to receive transfer of his assets, it's possible that the indirect retention of a power may inadvertently cause the trust to be exposed to inclusion under IRC Sections 2036 or 2038. Likewise, the improper management of the assets owned by the trust can cause estate tax inclusion. Inclusion in an individual's estate exposes trust assets to the GST tax because of the estate tax inclusion period (ETIP) rules under IRC Section 2642(f)(3). These rules provide that no GST tax exemption can be allocated to transferred property while the transferor has retained certain rights or interests that would cause the assets to be included in the transferor's estate for estate tax purposes under Sections 2036, 2037, 2038, 2041 and 2042 (but not Section 2035). Application of these provisions can be triggered by the indirect retention of prohibited powers, including through "implied understandings." The ETIP expires only when the trust would no longer be included in the transferor's estate or at the date of INSERT death.

**Example:** Grandmother owns 100 percent of a family business valued at $6 million and organized as an S corporation. The S corporation is reorganized into one voting share and 99 non-voting shares. During 2011, Grandmother retains the voting share and gifts all 99 non-voting shares to an irrevocable trust for the benefit of her grandchildren. The non-voting shares are discounted, and the gift in trust is valued at $5 million. Grandmother applies her $5 million GST tax exemption to the direct skip transfer. Grandmother dies still owning the voting share. At the time of death, the S corporation's assets are valued at $20 million. The Internal Revenue Service successfully argues that since Grandmother had voting control, she could control the payment and timing of the dividends to beneficiaries, and therefore, the entire corporation is included in her gross estate under Section 2036(a) and 2038.[19] Not only is the estate tax imposed on the entire $20 million of value, but also the ETIP period remained open due to Grandmother's retained power, precluding the application of the $5 million GST tax exemption until Grandmother's death, by which time only 25 percent of the value of the business could be sheltered from the GST.

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Let's compare this result to what would have happened if someone such as child set up a BDIT for Grandmother and her grandchild. The string provisions don't apply to a beneficiary of a BDIT (because the only gratuitous transfer in trust is from a third party). If Grandmother and her grandchildren are the beneficiaries of a BDIT, and if Grandmother sold her 99 nonvoting shares to the BDIT, retaining her voting control, there's no estate tax inclusion exposure and thus no ETIP exposure either. Instead, the trust creator applies the GST tax exemption to the gift in trust, and it's immediately and forever GST tax-exempt. Since the GST tax inclusion ratio is now 0 percent, there won't be a GST tax due when the grandchildren receive distributions from the BDIT. Additionally, with a BDIT, Grandmother can be the BDIT's investment trustee, thus eliminating Grandmother's need to retain an interest in the entity to retain control. A sale of all interests for adequate and full consideration will eliminate the exposure to estate tax under IRC Sections 2036(a) and 2038. Note that neither child, nor child's spouse, may be a beneficiary of the BDIT.

## Loss of Control and Enjoyment

Unlike an IDGT, a BDIT also allows the trust beneficiary to have control over the trust. If an individual who establishes a trust with a gift wants to be treated as the owner of the trust for income tax purposes, the trust agreement must reserve to the trust creator one or more of the powers under the grantor trust rules[20] that will accomplish that result. But, the retained power must be limited so that estate tax exposure under the string provisions won't apply on the trust creator's death. Therefore, the trust creator can't retain powers to decide how the trust's income and principal are to be distributed to his descendants. In effect, the trust creator must relinquish most of the power and control over the property to avoid being treated as the owner for estate tax purposes.

To circumvent the possibility of estate inclusion for IDGTs, the trust creator must be divested of almost all powers, such as control over enjoyment of the trust,[21] an SPA, certain administrative powers (such as the power to vote stock in a controlled corporation transferred to the trust)[22] or retention of the income.[23] The trust creator can retain the power in a non-fiduciary capacity to remove trust assets and substitute other assets of equal value without estate tax consequences.[24] But, the issue as to when the trust creator is acting in a non-fiduciary capacity is a question of fact. Other than the power to reacquire the property, the trust creator has no access to the property that was transferred.

A trust creator can't retain any power to alter, amend, defer or terminate a beneficiary's interest under the trust. For example, a power that would be an SPA under Section 2041 would constitute a "string" under Sections 2036 and 2038. Since the trust creator can't change what a beneficiary is entitled to receive after the trust is established, there's a reduced ability to influence the conduct of a beneficiary by altering the trust terms. And, the trust creator can't use the trust to control a dissident beneficiary.

> The ability under a BDIT to change the beneficial enjoyment of existing beneficiaries makes it a preferred strategy compared to its alternatives.

That's why the ability under a BDIT to change the beneficial enjoyment of existing beneficiaries makes it a preferred strategy compared to its alternatives. And, a BDIT doesn't need any reorganization into voting and non-voting interests, because the desired control can be given to a beneficiary in the form of an SPA under the trust agreement.

Another attractive feature of the BDIT is that the beneficiary who sold an asset to the BDIT for an installment note is still a beneficiary of the BDIT. Therefore, an independent trustee can be permitted to make discretionary distributions of income and principal to that beneficiary. Receiving a discretionary distribution authorized by the independent trustee of a third-party created trust doesn't expose the trust to estate taxation as part of the beneficiary's estate, so long as there's no

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evidence of a pre-arrangement to make distributions.

The BDIT is also attractive for creditor protection purposes, as the beneficiary has no retained right in trust assets. Since the independent trustee has the exclusive power to make any distributions to the beneficiary, the beneficiary isn't exposed to Section 2036 and 2038.

## Wealth Depletion

A downside to an IDGT is that the strategy can be, economically, too successful!

The IDGT is designed to require the trust creator to report all grantor trust income and pay the income taxes on that income. Thus, the grantor trust can grow in value for succeeding generations at no additional transfer tax cost. Eventually, the grantor/transferor may face the possibility that his remaining estate will be depleted far too much if grantor trust status continues, especially after the installment note has been fully paid. And, if trust income is higher than expected, the grantor's obligation to pay the income taxes on trust income will increase. If the grantor, the trustee or a trust protector has the power to cancel the grantor trust status or has the right to "toggle off" or release that power, the exercise of the right may create cancellation of indebtedness income for the grantor.[25]

This isn't the result in a BDIT. If the trust is a grantor trust with respect to the beneficiary and if grantor trust status results in an excessive reduction in the grantor-beneficiary's remaining assets, the independent trustee can authorize discretionary distributions to the beneficiary (the client) to protect against economic exposure. Thus, the BDIT provides a financial safety net if the client needs additional funds. This is a significant safeguard against the risk of too much depletion.[26] Although a discretionary income tax reimbursement provision can be included in an IDGT, it's a complicated clause to both compute and to administer—in essence, an accountant's nightmare. And not all tax reimbursement clauses are sheltered from the string provisions. For example, Revenue Ruling 2004-64 specifies that if a trustee's discretion can be combined with any of the following facts, Section 2036 might apply: (1) a prearranged or pre-existing agreement regarding the trustee's use of discretion;[27] (2) the grantor retained the power to remove the trustee and name a successor; or (3) local law subjects the trust assets to any of the grantor's creditors. Since the beneficiary of the BDIT can receive trust distributions, in the discretion of the independent trustee, there's no need to use tax reimbursement clauses.

The clear advantage of the BDIT over the IDGT is that the BDIT is less risky, because Sections 2036 and 2038 can only apply to the individual who established the trust.[28]

## Gift Tax Risk

A gift tax risk arises if the IRS challenges the value placed on property sold to an IDGT. If the note given in satisfaction of the purchase price is less than the higher value determined by the IRS, the IRS may recast the transaction as part sale, part gift. Based on recent case law, most advisors believe that a defined value clause (DVC) (that is, a clause that limits the quantity of assets gifted or sold until there's a final determination of the asset's value) should be effective to eliminate the gift.[29] Even so, is there a way for the client to secure closure on the matter? First, he should start the statute of limitations running by reporting the installment sale on a timely filed gift tax return as a "non-gift completed transfer" under Treas. Regs. Section 301.6501(c)-1(f)(4).[30] If the IRS doesn't challenge the valuation, the three-year statute of limitation will expire and the transaction should be fine.

For those advisors who are still concerned about DVCs, the BDIT will provide an additional layer of comfort. With a BDIT, if the IRS successfully challenges the valuation of the asset the beneficiary sold to the BDIT, the BDIT beneficiary won't incur a taxable gift of the excess value of the asset over the value of the note transfer-because of the SPA, the transfer can't be a completed gift.[31]

## Step Transaction Doctrine

The unique structure of the BDIT safeguards against the IRS successfully applying the step transaction doctrine (that is, when the IRS combines a series of separate transactions and treats them as one taxable event). With an IDGT, it's crucial that your client spaces out his transfers and adheres to transfer formalities. Several court opinions address the step transaction doctrine. In *Linton v. U.S.*,[32] the appellate court overturned a lower court's summary judgment in favor of the IRS and held for the taxpayers. The appellate court held that the sequencing

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of the transactions was critical to its determination of whether to apply the step transaction doctrine and remanded the case back to the trial court for the taxpayers to substantiate that there was a meaningful lapse of time between the transactions. The lower court in *Linton*[33] had based its analysis, in part, on *Holman v. Commissioner*,[34] one of the first gift tax cases to address the step transaction doctrine with respect to the transfer of assets to an entity and later gifts of interests in that equity. The Holman court refused to extend step transaction treatment to collapse a series of transfers that occurred just six days apart, even though the family limited partnership held only marketable securities.

In a case that didn't go well for the taxpayer, *Suzanne J. Pierre v. Comm'r*,[35] the IRS was able to successfully collapse four transactions—two 9.5 percent gifts and two 40.5 percent installment note sales. The note amounts were based on an appraised value of a 40.5 percent non-managing interest in a limited liability company discounted for lack of control and lack of marketability. Because the transactions were collapsed, the valuations applied to two 50 percent interests rather than to minority interests, so the assets sold were undervalued.

The BDIT provides a safer haven than an IDGT and can backstop a step transaction attack. For example, assume that an IDGT is set up and funded with a $1 million gift and, shortly thereafter, the trust creator sells property worth $9 million to the IDGT for an installment note, intending to use the income from the trust to pay the note. If the IRS successfully argues that the "seed" money gift and the sale were part of an integrated transaction, the seller will have transferred $10 million to the trust and received less than adequate and full consideration-the note for only $9 million in return. As previously mentioned, to have inclusion under Section 2036, three things must occur: a transfer; with a retained interest; and for less than adequate and full consideration. Having failed the adequate and full consideration test, the trust might be exposed to Section 2036; there could be estate tax inclusion of the property at the fully appreciated date-of-death value.

Under the BDIT structure, however, a third party (not the beneficiary) is the only party making a gratuitous transfer to the trust. Thus, the DVS would protect the BDIT from estate tax inclusion. The beneficiary would have received a note back for the full value of what was sold to the trust, satisfying the adequate and full consideration test.

## Asset Protection Trusts

Asset protection is, or should be, as much a part of estate planning as transfer tax savings. The rise in popularity of the self-settled trust as an asset protection trust (APT) is one testament to this fact. So situs your client's BDIT in a state that allows asset protection for self-settled trusts.

The BDIT has a major advantage over transfers to APTs—there's no waiting period! Typical APTs have a waiting period before assets transferred to a trust can be protected from the transferor's creditors. The shortest waiting period is two years (in Nevada).36 However, the waiting period is four years in most other self-settled trust jurisdictions.[37]

> Properly drafted, the BDIT will allow the maximum control permitted without exposing the trust assets to taxes and creditors.

The BDIT, however, isn't a self-settled trust. It's established by a third party. A third party settled discretionary trust with "… the distribution discretion held by an independent trustee… is the ultimate in creditor and divorce claims protection–even in a state that restricts so called 'spendthrift' trusts–since the beneficiary himself has no enforceable rights against the trust."[38]

Importantly, it's possible for an individual to transfer property to an APT during life and exclude the property from his estate. To do this, an individual's transfer must be structured as a completed gift.[39] This transfer requires substantial restrictions on the use and control of the property to achieve creditor protection under appreciable state statutes. In addition, the transferor can't retain any powers that would constitute a retained interest under Sections 2036 and 2038. In contrast, the beneficiary of a BDIT would avoid these restrictions

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because the beneficiary didn't set up the trust for his own benefit—a third party did. Thus, with the BDIT, the beneficiary can have control of the use and enjoyment of the property in the BDIT and still protect the property in the trust from being subject to estate tax.

There's a substantial concern with respect to the theory that property transferred to an APT as a completed gift will in fact be outside the transfer tax system. The apparent exposure is a result of situations in which there's an implied understanding that the transferor will be able to access the assets transferred to the trust. This can easily occur when the trust creator transfers the bulk of his assets to an APT and is then unable to maintain the same standard of living without the use of those assets or has been receiving continuing periodic distributions from the APT.

## FLPs

Initially, most FLPs were designed to obtain valuation discounts and shift future appreciation of the limited partnership (LP) interests, while allowing the transferor to retain control through retention of a general partnership interest.

Over the years, the IRS has successfully launched attacks in two principal areas: 1) on discounts; and 2) on entities such as FLPs, which are used to obtain such discounts. The IRS' success has resulted in reducing discounts, or ignoring the entity itself, under the theory that such entities needed to show a substantial non-tax purpose under Section 2036.

The BDIT, however, doesn't have the retained interest problem that the FLP suffers from, because Sections 2036 and 2038 only apply to the settlor of a trust.[40] The BDIT, by design, is settled by someone other than the beneficiary. Because the beneficiary never makes a gift transfer to the BDIT, the BDIT is tested under Section 2041 which, as noted above, enables the beneficiary to have rights and controls he can't have under the string sections.

Just as the FLP is designed to afford control to the transferor, the BDIT is designed to afford control to the beneficiary, who will enjoy control over the BDIT trust property as a management trustee without the inclusion risk under Section 2036. Properly drafted, the BDIT will allow the maximum control permitted without exposing the trust assets to taxes and creditors. Such control includes administrative and managerial decision-making power and a dispositive power (that is, a broad SPA).[41] A broad SPA can give the power holder control over how the other trust beneficiaries receive trust distributions, or to remove them entirely.

The ability to indirectly control distributions during life is obtained in a BDIT through the independent trustee whose identity is controlled by the beneficiary. Such control in an FLP, however, would expose the FLP to estate tax inclusion under Sections 2036 (implied understanding) and 2038 ("in conjunction with any other person").

Another weapon the IRS uses against the FLP is the "substantial business purpose" requirement. Any good FLP checklist will assure that there must be legitimate, non-tax reasons for its formation. Because the cases on this issue are fact-sensitive, there should be several non-tax reasons for creating an FLP. The transferor of an FLP must document his non-tax reasons for the FLP's formation, and the actual operation of the FLP must be consistent with those reasons. However, there's no substantial business or non-tax purpose requirement for a BDIT. For those clients who have existing FLPs, consider advising them to avoid a potential audit risk by selling any retained interest in the FLP to a BDIT for fair market value (FMV). Another suggestion is to terminate a successful FLP, in which the wealth shift has already been accomplished, to eliminate Section 2036 exposure.

## Irrevocable Life Insurance Trusts

Clients have come to recognize life insurance as a separate asset class in its own right, similar to a municipal bond, and in these risky economic times, clients often view life insurance as safer and better. A BDIT can be used as a funded life insurance trust. It can purchase life insurance for anyone in whom the trust has an insurable interest and, generally, that would be on the life of one or more of the trust beneficiaries (but caution: Without proper planning, the BDIT shouldn't buy insurance on the life of the third party creator or the creator's spouse, as that destroys the objective of having the beneficiary treated as the grantor for income tax purposes because of Section 677(a)(3)). If the BDIT acquires a policy on the life of a beneficiary, then the independent trustee or a separate insurance trustee must handle any decisions regarding that policy. In addition, the insurance can't be

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subject to the beneficiary's SPA. Both of these safeguards must be put in place to avoid running afoul of IRC Section 2042, which would result in estate inclusion of many proceeds for the beneficiary. If a beneficiary is the insured, hey may hold the power to remove and replace the independent or insurance trustee with certain constraints.[42]

Until there's adequate cash flow to pay premiums (and fund the interest on any installment note), the strategy will often either involve using a donor/donee split-dollar arrangement (if the policy is a survivorship policy) or a premium financing transaction, with either the insured or a third-party lender loaning money to the trust to provide a source of premium payment. Because the trust creator shouldn't make any additional transfers to the trust after the initial contribution, the trust creator won't be making gift transfers to pay premiums. Instead, clients must use assets owned by the BDIT for cash flow.

Importantly, the IRC treats life insurance differently from all other assets.[43] The dilemma often faced with cash value life insurance (CVLI) used for retirement planning is that the estate owner wants both access to the internal build-up and to keep the death benefits not includible for estate tax purposes. The BDIT finesses this problem because the trust is created by someone other than the beneficiary. If the BDIT owns life insurance, and the beneficiary needs to access the cash value, there are several ways he can accomplish this.

One way is for the insurance trustee to borrow money from the policy and give the loan proceeds to the beneficiary. Since the trust is a grantor trust as to the beneficiary, interest payments made by the beneficiary during his life have no income tax consequences.[44]

A second option is for the trust to borrow from the policy to purchase other assets from the beneficiary. Since the trust is a grantor trust as to the beneficiary, there will be no gain recognized on the sale. The final, and least advantageous, option is a discretionary distribution by the independent trustee to the beneficiary. A distribution will move the assets outside the protective trust wrapper and dilute the inherent transfer tax and creditor protection provided by the BDIT, since the assets distributed will be in the beneficiary's hands. Because a loan must be paid back and a sale requires the BDIT to receive back assets of equal value, the leakage from the trust is avoided.

In addition to accessing the cash value, the life insurance policy itself is a valuable asset that can be used to create liquidity in the event of severe economic hardship. Assuming that there's a market, the independent or insurance trustee can sell the policy or surrender it and use the proceeds for the beneficiary.[45]

## CVLI vs. QRPs

Even though he daily pondered the mysteries of space, time and quantum physics, in the planner's world, Albert Einstein is famous for stating that, "The most powerful force in the universe is compound interest." [46] It's obvious that tax-free compounding is an even greater force. Two of the principal vehicles employed to obtain tax-free compounding are cash value life insurance (CVLI) and qualified retirement plans (QRP).[47]

> Comparing other features, accessibility stands out in favor of the CVLI.

With CVLI, it becomes apparent that a BDIT has many benefits that don't exist in a QRP. In a QRP, even if a Roth conversion is made, someone will be paying income tax at some point and there will be estate tax inclusion. In contrast, the CVLI results in true "tax-free" accumulation. If the policy is purchased and handled properly, there will generally be no income tax recognition at any point in the life of the policy (so long as it's not a modified endowment policy, as defined in IRC Section 7702A).

Comparing other features, accessibility stands out in favor of the CVLI. The cash value in a life insurance policy is accessible with the cooperation of the insurance trustee at any time. On the other hand, withdraw QRP money too soon, too late, too much or too little and there are penalties and income taxes.

When evaluating the investment of funds in a CVLI versus a QRP, consider what happens upon an insured's early death. In a CVLI, the payout of the policy proceeds

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will prove to be a substantial return on investment, whereas, in a QRP, the policy payout is treated as income in respect of a decedent and subject to both income tax and transfer tax. For CVLI inside a BDIT, at death the policy proceeds are paid to the trust free of income tax and outside the transfer tax system.

Looking at the investment from a different perspective, survivorship can be an important element in the decision to use CVLI in a BDIT. Because it takes time for tax-free accumulation to have a meaningful impact, a QRP for a short-term, say three years, makes little sense. A longer term is required before earnings can grow and compound tax-free and become valuable. On the other hand, with CVLI you're actually hedging the bet on the term. If you die early, you win on the mortality bet. If you live for a long period of time, you win on the build-up of tax-free growth.

There are other problems with QRPs that don't exist with CVLIs. A QRP must cover all employees. Not so with CVLI. Also, there's a risk of early investment decline. This is similar to an underwater GRAT (that is, a GRAT in which the property transferred has declined in value to the point where the annuity payments threaten to wipe out the GRAT)—you need to make up the shortfall before you get the benefit of the strategy. With a CVLI, there's a minimum guaranteed crediting, so the tax-free growth and compounding the build-up have legs.

## Business Succession Planning

In many family businesses, the senior generation faces the dilemma of having some children who have chosen to become active in the business and some who haven't. How does the business owner treat them all equitably?

One popular planning option is to reorganize the business into voting and non-voting shares. The active children inherit the controlling shares and the non-active children are given the non-voting shares. This option will often result in family conflict. The active children devote all of their time and efforts into the business and might feel that they are carrying on the heritage of the parent who started the business. They may want to put any earnings back into the business, so it will grow, and may believe that they aren't being appropriately rewarded for the individual sacrifice they're making to carry on the family legacy.

The non-active children might see it much differently. Rather than retaining earnings in the business to fund future business needs and expansion of the business, they want current distributions.

Another planning option is to grant a preferred interest to the non-active children and the common interest to the actively involved children. This strategy opens the door to similar family dynamics issues and may reduce the form of entity options, as two classes of stock will preclude S corporation status.

The BDIT, however, provides an alternative to these two types of traditional business succession planning. The BDIT can own the family business and also purchase life insurance on the business owner. During the earlier years, life insurance will hedge the tax burn. At the death of the insured, the actively involved children will get the business, and the non-active children will get the insurance proceeds. Cash is often the preferable asset for heirs who aren't involved in the business. Additionally, a BDIT provides a ready way to adjust inheritances in a situation in which children active in the business have successfully grown its value through exercise of the SPA.

The BDIT also offers viable options when used in conjunction with a buy-sell agreement. Business partners will often choose a cross-purchase buy-sell so that the acquirer will obtain a basis step-up. The problem is that at the death of the surviving business owner, the acquirer will be exposing the entire value of the business, including appreciation, to the estate tax. The following example provides a better solution:

> Newco is owned equally by Alan and Barry. Alan's parent sets up Alan's BDIT, which buys Alan's entity interest from Alan. Barry's parent sets up Barry's BDIT, which buys Barry's entity interest from Barry. Alan's BDIT buys life insurance on Barry's life, and Barry's BDIT buys life insurance on Alan's life. At Alan's death, Barry's BDIT purchases Alan's interest. Alan's interest has now been transferred to a vehicle outside the reach of the transfer tax system, even though managerial control is in the hands of the surviving owner, Barry.

## The Mid-Range Client

The BDIT isn't just for clients with substantial wealth. For a client who has more moderate wealth, say someone

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with a business valued at $10 million, a valuable home and about $1 million in other assets, the BDIT may be the best option. A client in this position wants to avoid estate tax and exposure to creditors, but isn't in a position to be able to transfer wealth to shelter it from the estate tax. This client needs access to the wealth (often all or most of the income) to maintain his lifestyle, especially during retirement, and generally wants to retain control of the business.

Typical planning options for this type of client such as the GRAT or IDGT invite the risk of having the assets pulled back into the estate under Sections 2036 or 2038, because the client needs to use the assets to live. He will then be stuck without whatever was put into the GRAT or IDGT years before, even if circumstances change and finances become difficult.

Using the BDIT for this client is the solution. Since someone else sets up the trust, the string provisions don't apply. The client can sell the interest in the business to the BDIT in exchange for a note, so the client receives income in the form of non-taxable principal and interest payments on the note, as well as discretionary distributions if needed. And, the client can have an SPA to decide how junior family members are treated.

As described earlier, the client can be a co-trustee with investment and managerial decision-making authority over the assets in the trust. Since this control is held in a fiduciary capacity, it's not attributed to the client for purposes of estate inclusion and there's no exposure to the estate tax. Most importantly, the client will have a broad SPA to use to amend the trust for future beneficiaries. Thus, the client can alter the trust to deal with complaining or otherwise interfering secondary beneficiaries. The only restriction is that the client wouldn't be able to increase his own benefits under a general power of appointment.

## Bottom Line

A small gift in a properly structured and sitused BDIT by a parent or other third party will enable your client to achieve transfer tax savings, control and creditor protection that your client couldn't obtain by directly transferring property in trust. If your client later sells property to the BDIT and receives equal value in exchange, the assets sold to the BDIT won't be exposed to the estate and GST taxes. If the BDIT is sitused in a state with an unlimited perpetuity period, the assets in the BDIT can be sheltered from all estate, gift and GST taxes, forever, as long as they remain in trust. Although a properly structured and administered IDGT can also accomplish these transfer tax objectives, the IDGT can't offer the control advantages and all of the creditor protection advantages that a BDIT can.

What you must communicate to your client is that contrary to the common belief that a gift or bequest in trust is restrictive and an undesirable intrusion on wealth, a properly designed and implemented trust is a substantial improvement over the outright ownership of wealth. Clients generally will be happy if they are placed in reasonable control of a trust, which is typically a design feature of the BDIT. Your client, as the beneficiary of the BDIT, gives up nothing and has protections that outright ownership wouldn't afford.

## Endnotes

1. This concept is attributed to Carlyn S. McCaffrey of New York's McDermott, Will & Emery.
2. A trust creator is entitled to use the annual exclusion against the gift because of the *Crummey* power.
3. Under the grantor trust rules, this would cause the trust creator, rather than the beneficiary, to be the grantor for purposes of the income tax. Internal Revenue Code Section 677(a)(3), unless the power required the consent of an adverse party—the trust beneficiary.
4. *See* IRC Section 672(c) and Revenue Ruling 95-58, 1995-2 C.B.72, for restrictions necessary to preserve tax status. There's no requirement that there be an adverse or confrontational relationship. The independent trustee can even be the beneficiary's best friend. Generally, the independent trustee can't be a member of the family or a subordinate.
5. IRC Section 2042. *See* Howard M. Zaritsky and Stephen R. Leimberg, *Tax Planning with Life Insurance* (Warren, Gorman & Lamont, 2d ed.) at par. 5.03(6)(a); and Georgiana J. Slade, 807 T.M., "Personal Life Insurance Trusts" at p. A-25.
6. To avoid inclusion of the beneficiary defective inheritor's trust (BDIT) property in a beneficiary's estate at death under IRC Section 2041, the beneficiary can hold the power to appoint the trust property to anyone other than the beneficiary, the beneficiary's estate or the creditors of either. The only meaningful restriction is that the beneficiary may not increase his benefits. 21 *Willamette L. Rev.* 813 (1985) at p. xx.
7. Carlyn S. McCaffrey, "Formula Valuation—Shield Against Gift Tax Risks or Invitation to Audit," 42nd Annual University of Miami Philip E. Heckerling Institute on Estate Planning, Ch. 11 at Section 1101.2 [B] (2008); *See also* Carlyn S. McCaffrey, "Tax Turning the Estate Plan by Formula," 33rd Annual University of Miami Philip E. Heckerling Institute on Estate Planning, Ch. 4 (1998); Carlyn S.

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McCaffrey and Mildred E. Kalik, "Using Valuation Clauses to Avoid Gift Taxes," *Trusts & Estates* (October 1986) at p. 47; and John Porter, "A Formula for Avoiding Transfer Tax Litigation," *Willamette Law Review* (Autumn 2010), at p. 86.

8. Treasury Regulations Section 25.2511-2(b) and Private Letter Ruling 95-35-008 (9-1-95).
9. A. James Casner and Jeffrey N. Pennell, "Shifting Opportunities," *Estate Planning* (6th ed.) at Section 6.3.3.6; *See also* Milford Hatcher, "Planning for Existing FLPs," 35th Annual University of Miami Philip E. Heckerling Institute on Estate Planning (2001), Ch. 3 at Section 302.2.
10. McCaffrey, "Formula Valuation," *supra* note 7 at Section 1101.2[B].
11. Rev. Rul. 2004-64, 2004-2 C.B. 7.
12. Rev. Rul. 85-13, 1985-1 C.B. 184.
13. The "freeze" is an estate freeze. The client will receive a note in exchange for an asset expected to grow in value. The note's interest rate will be less than the income earned by the asset purchased. The post-transfer growth will be shifted to the purchaser rather than increase the seller's estate. By selling discounted assets (generally, non-controlling interests in entities that don't have a viable market), the amount of the discount is passed transfer tax-free into the trust. The "burn" refers to the estate depletion (that is, the "tax burn") resulting when the grantor pays the income taxes on taxable income earned by the trust.
14. *See supra* note 12.
15. The "string provisions" include IRC Sections 2036, 2037 and 2038. They operate to pull property back into a decedent's estate for purposes of the estate tax if the property was transferred in trust by the grantor during life under certain conditions. Generally, the string sections are triggered if the transfer was made with a retained right to receive income or designate the income beneficiary; if the possession or enjoyment of the property could be obtained only by surviving the decedent and the decedent retained a reversionary interest that exceeds 5 percent of the value of the property; or, if the transfer was made with a retained interest over the income, or with the power to alter, amend or revoke or terminate the interest of any beneficiary.
16. IRC Section 2043.
17. IRC Sections 2036 and 2038 only apply if the settlor of the trust has certain powers. Sections 2036 and 2038 can't apply if a beneficiary has these same powers unless it's a general power of appointment under Section 2041.
18. Jerome M. Hesch and David A. Handler, "Evaluating the Sometimes Surprising Impact of Grantor Trusts on Competing Strategies to Transfer Wealth," New York University 68th Institute on Federal Taxation Ch. 19, at pp. 19-43.
19. Pursuant to Proposed Regulation 20.2036-2(a) flush language, Section 2036(b) only applies if the settlor of the trust transfers voting shares in trust and retains the power to vote the voting stock now owned by the trust. Section 2036(b) doesn't apply if the settlor transfers only non-voting shares to the trust and retains the ownership of the voting shares. This regulation was proposed in 1983, but has yet to be adopted.
20. IRC Sections 671-677.
21. IRC Sections 674, 2036 and 2038.
22. IRC Sections 675 and 2036(b).
23 IRC Sections 677 and 2036(a).
24. This power isn't a string under IRC Sections 2036 or 2038 because it's for "adequate consideration." Rev. Rul. 2008-22, 2008-16 I.R.B. 796. Note the omission of reference to Section 2042.
25. Hesch and Handler, *supra* note 18 at pp. 19-4 and 19-6.
26 *Ibid. at* p. 19-42.
27. This could be an "oral understanding."
28. Hesch and. Handler, *supra* note 18 at pp. 19-43.
29. *McCord v. U.S.,* 461 F.3d 614 (5th Cir. 2006), *rev'g* 120 T.C. 358 (2003); *Estate of Petter v. Comm'r; Estate of Christiansen v. Comm'r,* John H. Hendrix, T.C. Memo. 2011-133; *See also supra* note 7.
30. McCaffrey, "Formula Valuation," *supra note* 7 at Section 1104.
31. Treas. Regs. Section 25.2511-2(b) and PLR 9535008 (Sept. 1, 1995).
32. *Linton vs. U.S.*, 630 F.3d 1211 (9th Cir. 2011).
33. *Linton vs. U.S.*, 130 T.C. 170 (2008).
34. *Holman Jr. v. Comm'r*, 601 F.3d 763 (8th Cir. 2010).
35. *Suzanne J. Pierre v. Comm'r*, 99 T.C.M. (CCH) (2010).
36 Nevada Revised Statutes Section 166.170.
37. Alaska Stat. Section 34.40.110(d), Del. Code Ann. tit. 12, Section 3572(b)(2) and R.I. Gen. Laws Section 18-9.2-4.
38. Frederick Keydel, "Trustee Selection, Succession, and Removal Ways to Bland Expertise with Family Control," 33rd Annual University of Miami Philip E. Heckerling Institute on Estate Planning, Ch. 4 (1989) at Section 409.1.
39. Treas. Regs. Section 25.2511-2(b). *See* PLRs 2002-7-013 (Nov. 22, 2002); 200148028 (Nov. 30, 2001); and 200502014 (Jan. 14, 2005).
40 Hesch and Handler, *supra* note 18 at pp. 19-43.
41. The beneficiary can only have a special power of appointment, not a general power of appointment.
42. *See* IRC Section 672 and Rev. Rul. 95-58 1995-2C.B.72, for restrictions necessary to preserve tax status.
43. IRC Sections 2035(d) and 2042.
44. IRC Section 2036(a); *see also* IRC Sections 2038 and 2041 (if reachable by creditors.)
45. But there may be income to report if the policy is sold or terminated or if more than basis is withdrawn.
46. Alice Calaprice, *The New Quotable Einstein* (Princeton University Press 2005). at pp. 294-295.
47. Charitable remainder trusts provide another option.

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

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

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## 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 –

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

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[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).

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.[1]

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."[2]

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.

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[1] 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.

[2] 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. Incapacity and probate avoidance benefits.

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. Inherited wealth often benefits from the respect shown by its segregation.

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.

1. 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. Conclusion-Inheriting in trust is *always* better, ***provided the beneficiary has adequate control over his trust*!**

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) The importance of control to a donee-beneficiary's peace of mind.**

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) Nevertheless, in some cases a donee-beneficiary may not have control.**

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"[3]

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;

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

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

- 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. <u>How a BCT differs from traditional trusts.</u>**

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. <u>"Independence" does not require a confrontational relationship.</u>

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. BCTs keep inherited assets in trust over mulitple lifetimes.

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. Most traditional trusts distribute outright at certain ages.

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. A BCT instead gives the beneficiary control over the trust's assets.

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

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**

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[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.

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 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. Trust Design – "Totally Discretionary"

### A. The "totally discretionary" distribution pattern should be the design of choice.

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) Offers the greatest flexibility**

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). Insulates the trustee from litigation**

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) Equals outright ownership if/when beneficiary gains "full control"**

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) Requires an IRC section 672(c)(2) Independent trustee**

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

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

lifetime. This will permit the primary beneficiary (as the holder of the power), within the specified limits, to:

(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. Administrative and investment controls

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) Traditional trusts

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 recommendations, 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).

## IV. <u>FLEXIBILITY IS ESSENTIAL</u>

In the case of any perpetual or dynastic trust, (i) the extended duration of the trust arrangement and (ii) the likelihood that its component trusts will ultimately benefit six or

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[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.

more generations (some of which as yet have no living members) magnify the arrangement's exposure to the vicissitudes of time, society, and family evolution. Practically speaking, this means having to deal with:

A. Changes in the tax laws, in investment practices, in state trust laws, and so on, as well as

B. Changes in the family's makeup, including changes in the needs, character, and circumstances of the many present and future trust beneficiaries.

Thus, flexibility is needed to respond to such changes (and to be able to do so without having to undertake a court action for trust reformation every time the need for such a revision in the governing trust document arises). Achieving that kind of flexibility means including in the trust document certain provisions that:

- Permit each separate trust's primary beneficiary to make such changes in the plan as are called for from time to time and

- Empower the trustees to appropriately respond to new and different circumstances.

With long-term trusts, there is always a significant risk that rigidity will produce unintended and inappropriate results in the future – making flexibility essential. However, in the process of developing any mechanisms for making needed changes in the plan, a balance must be struck between providing for maximum flexibility and carrying out the settlor's specific wealth transfer plan in the manner he believed to be most appropriate for his children and their descendants.

## A. Powers to make changes held by trust beneficiaries.

A trust beneficiary (usually meaning the primary beneficiary of a separate trust) is normally given three important tools that can be used to adjust the plan for changing circumstances. These are:

1.Special powers of appointment, both exercisable testamentary and inter vivos.
2.Planned for disclaimers, and
3.Powers and rights as to trustee selection- as to both appointment and removal

### 1. Special powers of appointment-a "rewrite power"

One of the best ways to deal with the prospect of changing circumstances is to give the primary beneficiary of each trust a special power to appoint the trust assets to or among certain individuals, either outright or in a new trust.

**a. Necessary restrictions**

In order to avoid creating an inadvertent general power of appointment (with consequent loss of the shelter benefits otherwise afforded an inheritance in trust), every special power of appointment should be restricted so that it cannot be exercised in favor of the holder of the power, his or her estate, or the creditors either.

**b. Scope of power may be further restricted**

The creator of the trust (that is, the settlor or testator, as the case may be) will often wish to further narrow the permissible objects of appointment. For instance –

(1) In many trusts, the beneficiary's power to appoint will be exercisable only in favor of the settlor's descendants and the spouses of such descendants- and often, if spouses of descendents are permissible appointees, any appointment to a spouse is required to be made to a trust.

(2) In other trusts, however, the beneficiary's power of appointment will instead be a "broad" special power (that is, a power exercisable in favor of any person or persons except the holder, his or her estate, and the creditors of either).

(3) Sometimes clients will feel more comfortable if the power to appoint, particularly a broad power, is exercisable by the beneficiary only with a trustee's prior written approval (as a protection against hasty or rash action and to provide a "reality check" on a proposed exercise). However, such a condition is not consistent with giving full control and the beneficial enjoyment virtually tantamount to outright ownership.

Since the exercise of a special power can always be conditioned on prior trustee (or third party) approval, it would seem that there are very few trust arrangements that should not include at least some kind of special power of appointment – thereby allowing the plan to be rewritten (within specified limits if necessary) effective as of the beneficiary power holder's death.

## B. Powers to make changes held by trustees

A disinterested trustee may be given virtually unlimited discretion to modify most trust provisions without disturbing the tax objectives of the dynastic trust arrangement. With proper protections to assure that the settlor's dispositive goals will not be modified, an independent trustee may be given powers to cope with tax and/or circumstantial

changes and to take advantage of new trust drafting approaches. These powers are of two kinds.

### 1. **Changing trust provisions by exercise of independent trustee's totally discretionary power to make distributions**

In totally discretionary trusts, the independent trustee's discretion (amounting to a special power of appointment held by the independent trustee in a fiduciary capacity) introduces tremendous flexibility. It permits the independent trustee, by transferring all of the trust assets to a new trust created by that trustee, to, in effect, rewrite the entire trust (as long as it benefits no one other than one or more of the original trust's beneficiaries and permissible distributees).[19]

#### a. **Limitations on naming new beneficiaries**

The grant of distribution discretion normally limits the making of distributions to a group of permissible distributees identified in the trust document. Thus, the trustee is prohibited from creating a trust which allows a person who is not a listed permissible distributee to benefit. In other words, only a present beneficiary or potential future beneficiary of the trust thus being changed is eligible to be a beneficiary of the new trust to be created by the trustee's discretionary distribution.

#### b. **Power to distribute to an entity**

The trustee can also be given the power to create any other entity, such as a general or limited partnership, limited liability company, or corporation, provided that such entity is owned and controlled by no one other than such trust and/or one or more of its permissible distributees.

### 2. **Disinterested trustees' power to amend or restate the entire trust agreement**

Many of our trusts provide that the trustees of each trust that may come into existence under the document, other than any person:

- Who could be financially affected by the amendment involved or

- .Who could be considered to be a donor of any of that trust's assets,

are always given a limited power to amend or restate the entire trust document as it applies to that particular trust (and to all trusts that may arise out of that particular

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[19] For an excellent discussion of possibilities which are opened by the grant of a trustee discretion to make distributions to existing or new trusts, see Malcolm A. Moore's 1981 paper at this institute, "New Horizons in the Grant and Exercise of Discretionary Powers" [15 *U Miami Inst on Est Plan,* Ch 6 (1981).]

trust).[20] On the other hand, other clients are uncomfortable permitting a "stranger" to virtually rewrite to trust.

**a. <u>Examples of amendment powers typically given to trustees</u>**

Illustrative of the kinds of amendment powers routinely given to trustees are the following:

(1) The power to grant or eliminate general powers of appointment – this power can be useful in responding to changes that may be made in applicable transfer taxes, specifically the GST tax.

(2) The power to conform the provisions of any marital deduction trust contained in the trust document to those that are currently required in order to qualify for the marital deduction under the then circumstances – this power is virtually a necessity in the context of a dynasty trust arrangement since it is impossible at the outset to know whether or not some future descendant will be survived by a non citizen spouse.

(3) The power to divide a trust into two or more separate trusts (or subtrusts) – this power can be useful for GST and qualified retirement benefits planning – and also for segregating into a QSST[21] or ESBT[22] shares of an S corporation which may be held in or acquired by any trust contained in the governing trust document.

**b. <u>Restrictions on the exercise of the amendment powers</u>**

The trustee's power to amend and restate the trust agreement must be restricted for tax purposes so as not to:

(i) Violate the rule against perpetuities,

(ii) Impair any beneficiary's enforceable right to receive income,

(iii) Reduce the restrictions on the grantor's and trustee's actions as set forth in the trust agreement,

(iv) Give a trustee any powers or discretions that would result in adverse transfer tax consequences, or

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[20] See Early, "The Irrevocable Trust That Can Be Amended." 18 *U Miami Inst on Est Plan*, Ch 17 (1984).
[21] A QSST is defined in IRC section 1361 (d).
[22] An EBST is defined in IRC section 1361 (e).

(v) Disqualify any trust which currently qualifies for a deduction, credit, exclusion, or other tax benefit, and,

from a non tax point of view, the power to amend and restate can also be further restricted so that no change can:

(i) Result in any direct or indirect financial benefit (or grant any power of appointment) to any individual who is not at the time of such amendment both a member of the settlors' family (as defined) and already a present or potential future beneficiary,

(ii) Discriminate in any significant financial way in favor of one or more siblings (where siblings are to be treated in s substantially equal fashion), or

(iii) Change any trustee removal provisions, eliminate any requirement that a bank or trust company serve as trustee, lower the age specified in any attainment of a specified age provision, or modify in any way the definition of children, descendants, etc.

**c. <u>Trustee exculpation</u>**

Since the trustee's exercise of this limited power of amendment or restatement of trust agreement may upset one or more beneficiaries, it is important to include a broad exoneration and indemnification clause.

**Exhibit A**

# The Power of Compound Growth

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- **Assumptions - $1 Million; Trust Lasts 120 Years and Earns 8%; 50% Transfer Tax Every 30 Years**
  - No Trust - $ 640,812,059
  - Dynastic Trust - $ 10,252,992,943

| Annual Tax Growth | Value of Trust After 120 Years | Value of Property If No Trust |
|---|---|---|
| 6% | $1,088,187,748 | $68,011,734 |
| 7% | $3,357,788,383 | $209,861,774 |
| 8% | $10,252,992,943 | $640,812,059 |
| 9% | $30,987,015,749 | $1,936,688,484 |
| 10% | $92,709,068,818 | $5,794,316,801 |