

**DYNASTY TRUSTS: BENEFICIARY CONTROL,
NON-TAX BENEFITS, LEVERAGE AND
OPPORTUNITY SHIFTING STRATEGIES**

By

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"Sales to Grantor Trusts: Exponential Leverage Using Multiple Installment Sales," ~~Probate & Property~~ (Jan/Feb 1999) [reviewed in the Spring 1999 issue of ~~Conspectus Current~~]

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"The Beneficiary Controlled Dynasty Trust: Leveraging it with Installment Sales, GRAT Remainder Sales and Opportunity Shifting Strategies," Sioux Falls Estate Planning Council (October 19, 2000)

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COMPUTER PROGRAMS DESIGNED:

Sale to "Defective" Trust Megaanalyzersm – a software program that computes the results of using the installment sale to defective trust technique with a dynasty trust (sold to Leimberg & LeClair, Inc. in 1999 for use in "Dynasty" component of NumberCruncher 2000)

DYNASTY TRUSTS: BENEFICIARY CONTROL, NON-TAX BENEFITS, LEVERAGE AND OPPORTUNITY SHIFTING STRATEGIES¹

By

Steven J. Oshins, Esq.

I. Introduction

- A. Most estate planners recognize that there are two tax systems, one for the informed and another for the uninformed.
- B. The same rule is true for those who use creditor protection strategies as compared to those who do not.
- C. The tax, asset protection and divorce protection benefits that can be derived through a well-conceived family wealth plan as compared to an unplanned arrangement are substantial.
- D. With proper planning, a structure can be created for the benefit of one's descendants that can insulate the family wealth from creditors and erode the impact of the transfer taxes on vast wealth, and that can then be enjoyed and controlled by the family into perpetuity.
- E. The integration of a well-structured life insurance program is an important element of this wealth planning process.
 - 1. The most effective wealth shifting devices are often survivorship sensitive, such as GRATs and QPRTs, in that if the grantor does not survive a selected term estate tax inclusion will result. Fortunately, the survivorship risk can be hedged by the acquisition of life insurance. If the transferor survives the term, and the

¹ This outline was originally based on Richard A. Oshins and Steven J. Oshins, "Protecting & Preserving Wealth into the Next Millennium," *Trusts & Estates* (Sept. and Oct. 1998). The authors of that article would like to thank Professors Jerry A. Kasner and Stanley M. Johanson for their valuable guidance and comments in reviewing that article. All additions and modifications to this outline subsequent to that article are the sole responsibility of Steven J. Oshins.

assets transferred produce the economic result anticipated, the transferor wins on the technique. If the transferor does not survive the term, the insurance

exempt from the generation-skipping transfer tax ("GST tax").

4. This will perpetually avoid the imposition of transfer taxes for successive generations.
- D. This outline has as a basic premise the philosophy that any gift or bequest should be made in trust unless the size of the transfer does not justify the expense of setting up a trust.
1. The transfer of a gift or bequest in a trust can confer more benefits upon a beneficiary than the beneficiary would have received if the property had been conveyed outright.
 2. Rather than provide an exhaustive analysis of the myriad uses of trusts, this outline generally addresses the concept that trusts should be the vehicles of choice for all dispositions to individuals, and in most instances should form the centerpiece of the estate plan.
 3. For mature, competent family members who would receive the property outright were it not for the benefits that can be derived through the receipt of property in a trust, the trust would be designed to give the primary beneficiary the functional equivalent of outright ownership, including undisturbed control over the property.
 4. Indeed, many candidates for this type of planning would be unwilling to create such a structure unless the trust benefits are coupled with the ability of the primary beneficiary or beneficiaries to obtain control over the trust property virtually tantamount to outright ownership.
 5. A portion of this outline will focus on such a trust that will be referred to as a "Beneficiary Controlled Trust."
- E. This ability to improve a gift or bequest by arranging that the transfer be made in trust, particularly a flexible Beneficiary Controlled Trust, is too often dismissed without a careful and skilled analysis of the enhanced benefits obtainable through the trust vehicle.
1. Notwithstanding the dual tax and asset protection benefits that trusts can provide, many planners and their clients eschew the opportunity to take full advantage of trusts in the estate planning process.⁴

⁴ See Malcolm A. Moore and Jeffrey N. Pennell, "Survey of the Profession II," U. Miami 30th Inst. on Est. Plan, Ch. 15 (1996).

2. To the knowledgeable, experienced estate planner, it is evident that most clients, and many of their advisors, are not fully aware of how trusts work, nor are they aware that if drafted skillfully, trusts are not the inflexible vehicles that restrict the beneficiary's enjoyment of the property that many perceive.
 3. To the contrary, in the hands of a proficient draftsman, trusts are extremely flexible arrangements that can help the family cope with various problems, both anticipated and unanticipated, that have occurred or may occur in the future.
 4. Customized design of the trust can in almost every instance achieve the client's goals, even where it is desired that virtually all major decisions be lodged in the hands of the trust beneficiaries.
 5. Sophisticated drafting in this instance includes incorporating provisions that are often counterintuitive to most estate planning practitioners.
 - a. This approach often involves, among other things, negating the prudent person rule and expanding the permissible investments to include virtually everything imaginable that the beneficiary/trustee would acquire individually.
 - b. Traditional trust language usually precludes the types of investments that a Beneficiary Controlled Trust encourages.
 - c. For example, a non-controlling interest in a closely held business is often a recommended asset for funding a Beneficiary Controlled Trust, particularly where the installment sale to a defective trust technique is employed.
- F. A surprisingly large number of wealthy estate owners and persons who are otherwise astute in business and finance do not recognize the wealth planning opportunities available to them, nor do they realize the potential diminution of family assets that can be unnecessarily and irretrievably lost through exposure to both the wealth transfer system and the failure to use creditor protection strategies.
1. A properly structured irrevocable trust can avoid this exposure.⁵

⁵ Note, however, that the Mississippi Supreme Court recently ruled in Sligh v. First National Bank of Holmes County, No. 96-CA-00033-SCT, 1997 Westlaw 620799 (Miss. Oct. 9, 1997), that a beneficiary's tort creditors could reach a spendthrift trust for damages arising from gross negligence. Mississippi thus became the only state to recognize a common law exception to the spendthrift trust doctrine, although a few states, such as Louisiana and Georgia, have certain statutory exceptions. See Charles D. Fox IV and Rosalie Murphy, "Are Spendthrift Trusts Vulnerable to a Beneficiary's Tort Creditors?," Trusts & Estates (Feb. 1998). Soon after this case was decided, it was reversed by the enactment of a new state statute.

2. To maximize the goal of keeping wealth within the family unit, the trust should be a dynastic trust, designed, funded and managed in a manner that will enable the trust to grow rapidly and avoid transfer taxes for several generations, preferably into perpetuity.
 3. This philosophy should be followed provided it is consistent with the objective of providing comfortably for the trust beneficiaries.
 4. Under this tax avoidance strategy, the trustee should be encouraged to acquire assets for the "use" of the beneficiaries rather than funding the individuals' personal acquisition of assets.⁶
- G. The trust should be designed in such a way that distributions are permissible, but operationally it is anticipated that they should not be made in the absence of a compelling reason to make them.
1. By retaining property in trust, the assets will not be subject to creditors of the trust beneficiaries or diminishment in a divorce.
 2. The trust corpus can form a "family bank" or "asset pool" for the use of the descendants (and, if desired, the spouse) of the creator.
 3. As a result, the beneficiaries will have the use and enjoyment of the property without transfer tax problems or creditor exposure.
 4. The beneficiaries individually (or by utilization of assets in trusts not protected by the GST tax exemption) should be expected to absorb most family expenditures such as food, schooling and vacations.
 5. Additionally, the exempt funds should generally not be expended on consumable assets, such as clothing, automobiles, etc., since use of protected funds in this manner would be wasteful.
- H. In addition to providing tax savings and creditor and divorce protection, trusts are extremely useful and under-utilized for non-tax purposes as well. It has been stated that, "[i]t is indeed a rare client who should not at least seriously consider the use of a trust for some circumstances, even if only to cover contingencies that ought to be

⁶ See Richard A. Oshins, "Some Viable and Effective Estate Planning Alternatives in a Section 2036(c) Atmosphere, Including The MegatrustSM," Richard A. Oshins and Lawrence Brody, 1989 NYU Institute on Federal Taxation; "MegatrustsSM--Representation Without Taxation," University of Southern California 42nd Institute on Federal Taxation; Richard A. Oshins and Jonathan Blattmachr, "The MegatrustSM: An Ideal Family Wealth Preservation Tool," Trusts & Estates (Nov. 1991).

anticipated."⁷

III. Satisfying the Goals of Estate Planning

A. In examining the desires and goals for most families, there are six primary ingredients that should be incorporated into their family wealth plans: (1) control, (2) tax savings, (3) asset protection, (4) taking advantage of leveraging techniques and exploiting the valuation process to maximize the foregoing, (5) flexibility, and (6) providing for liquidity at death.

1. Control.

For family planning and psychological purposes, the senior family members typically desire to retain control during their lifetimes.

- a. Upon the death of the senior family members, most clients wish to shift control into the hands of the members of the oldest surviving generation and, all other things being equal, enable the oldest surviving generation to be the favored class with respect to enjoying the use and benefits of the transferred property (i.e., children are generally favored over grandchildren).
- b. The goal of preserving control in the hands of senior family members while shifting the tax consequences from those individuals is usually easily obtainable.
- c. For example, managerial control can be secured by trusteeship arrangements whereby the primary beneficiary is the trustee and, if co-trustees are employed, the primary beneficiary has control over the selection of such other trustees.
- d. Control over the disposition of the property may be given to a person through a broad special power of appointment without adverse tax consequences.
- e. These powers and controls would inure to the successor primary beneficiary (typically at the demise of the predecessor primary beneficiary), subject to adjustment by an exercise of a power of appointment if the prior primary beneficiary wishes to alter this arrangement.

⁷ See Edward C. Halbach, Jr., "Trusts in Estate Planning," *The Probate Lawyer*, Summer 1975. Prof. Halbach's contributions to trust planning are consistently insightful and pragmatic, and we recommend any of his writings on the topic for your reading.

- f. The powerholder need not even be a beneficiary.
- g. Moreover, neither the fiduciary's creditors nor the powerholder's creditors can disturb these principles.

2. Tax Savings.

Reducing, avoiding and deferring the imposition of taxes, including income, gift, estate and GST taxes, is an integral part of family wealth planning.

- a. Some estate planning techniques can be beneficial to all taxes. For example, a gift of a partnership interest can shift both income and wealth.
- b. On the other hand, certain transactions may be beneficial under one tax but counterproductive under another tax. For instance, a gift of low basis assets will reduce the transfer tax burden but only at the income tax cost of not receiving a basis step-up at death. This situation often involves a delicate balancing of the tax consequences, time-value-of-money factors (particularly where multi-generational trusts are involved), and the attitudes of the parties, to achieve optimum tax savings consistent with overall family goals.
- c. As a general rule, most clients are motivated to create trusts by the significant transfer tax savings that can be achieved.
- d. This concept was often illustrated prior to the increase in unified credit (now known as the "applicable credit amount" under the Taxpayer Relief Act of 1997) by the example where husband and wife each had an estate worth \$600,000. Under this example, the use of a bypass trust, rather than an outright disposition to the surviving spouse, would save \$235,000 in federal estate taxes, assuming no appreciation or depreciation.
- e. The staggered increases in the unified credit (or applicable credit amount) will result in an increase in the amount that can be sheltered from tax by the use of a bypass trust. In 2006, when the applicable credit amount is fully phased in, \$2 million will be able to be sheltered from tax, resulting in a saving of \$345,800 by using a trust.
- f. The stakes are high since federal unified transfer tax brackets start at 37% for the first dollar taxed and reach 55% (and 60% if the 5% surcharge is applicable) and the GST tax is imposed at the highest estate tax bracket (currently 55%) for each generation skipped for all non-exempt transfers.

- g. The ability to significantly erode the imposition of these somewhat punitive taxes by engaging in sophisticated estate planning maneuvers in conjunction with the trust vehicle is substantial. Thus, from a family wealth planning standpoint, advisors generally focus on avoiding the transfer tax system. The most effective technique to accomplish that result is to use a dynastic trust.
- h. Prior to the imposition of the GST tax, Prof. James Casner, in illustrating the vast potential of generation-skipping trusts to circumvent the transfer tax system, stated to the House Ways and Means Committee, "[i]n fact, we haven't got an estate tax, what we have, you pay an estate tax if you want to; if you don't want to, you don't have to."⁸
- i. These sentiments were echoed by Prof. George Cooper, who opined that, "[t]he perpetual generation-skipping trust may have been the ultimate estate planning scheme for those who had the foresight to establish one."⁹
- j. Under Chapter 13 of the Internal Revenue Code of 1986, each taxpayer may create a trust exempt from the GST tax with \$1 million or, if married, \$2 million. Pursuant to the Taxpayer Relief Act of 1997, the GST tax exemption will increase by inflation each year, rounded down each year to the nearest \$10,000.
- k. The visceral reaction to this relatively modest exemption in planning for large estates is that the statute puts the kibosh on the effectiveness of this arrangement as a means of accumulating massive wealth that would avoid the imposition of the transfer tax system.
- l. The contrary result will accrue for those families who aggressively engage in sophisticated wealth shifting strategies.
- m. Indeed, the effectiveness of the GST tax provisions can be negated using many of the techniques discussed herein and, over time, knowledgeable estate planners can finesse the current tax laws, thus significantly mitigating the intent of the statute.

⁸ Statement of Prof. A. James Casner, Hearings before the House Ways and Means Comm., 94th Cong. 2d Sess. pt. 2, 1335 (1976).

⁹ George Cooper, "A Voluntary Tax? New Perspectives on Sophisticated Estate Tax Avoidance," The Brookings Institute (1979), p. 58.

- n. Although trusts can also save income taxes, these savings have been substantially reduced by the compression of the personal income tax brackets, the enactment of the kiddie tax, the present unfavorable trust income tax brackets and other legislative changes. However, most practitioners are unwilling to assume that the current income tax laws will remain unchanged.
- o. The use of a discretionary trust will enable the trustee to react favorably to any changes in the income tax structure. Furthermore, in many instances, by forum shopping and selecting a state without an income tax, net income tax savings can be achieved despite the unfavorable rate schedule of trust accumulations.

3. Asset Protection Planning.

Although it has always been a worthwhile consideration, asset protection is becoming a more integral part of the business and estate planning processes.

- a. Indeed, because of the general litigious nature of our society, coupled with the increasing success plaintiffs are enjoying and the proliferation of divorces, creditor protection is often the motivating factor and, from some clients' perspectives, an essential element in the planning process.
- b. Although there is a general dislike of paying taxes, paying the IRS is generally more palatable for most people than paying a judgment creditor or a divorce settlement.
- c. In addition to the traditional estate planning techniques used to pass wealth to the desired persons with a minimum of taxes and costs, the skilled advisor will counsel his or her clients with respect to structuring the family wealth in a manner that will render it undesirable, unattractive and unreachable by creditors, including spouses in the context of divorce.
- d. The planner might consider asking the client - "What have you done to protect your children's and other descendants' inheritances from divorce, creditors or bankruptcy?"
- e. With more marriages in the United States ending in divorce than by death, and with the increased attention being given to asset protection strategies, this query is often a material motivating factor in having the client immediately move forward with the estate planning process.
- f. An irrevocable trust, set up by someone other than the beneficiary, provides the ultimate in creditor protection.

- g. As the asset protection maxim goes - "If you don't own it, nobody can take it away from you."¹⁰
- h. Historically, the general rule has been that the creator of the trust can dictate who may receive the beneficial enjoyment of the property and the extent and circumstances under which this enjoyment may be obtained.
- i. As a result, unless trust property is distributed to a beneficiary, it will be protected from the beneficiary's creditors.
- j. Creditors have made some inroads into that general rule in cases holding that where the beneficiary had certain controls, such as extending the term of the trust¹¹ or the ability to change trustees, the creditor protection may be lost.¹²
- k. If this trend continues, we can expect protective legislation to be enacted and forum shopping to come within the aegis of planning in contemplation of such legislation.
- l. In anticipation of variances in state laws with respect to the rights of creditors to access a trust despite a formidable spendthrift provision, the trust draftsman should incorporate a jurisdiction-skipping clause in the trust indenture enabling the trust to be moved to a more favorable venue.
- m. An example of the protection that can be obtained using a spendthrift trust set up by a third party can be found in Doksansky v. Norwest Bank, N.A.¹³ In this case, the former spouse of a trust beneficiary brought a claim for past due child support against the debtor's interest in a trust set up by the debtor's father. The trust authorized the trustees to make distributions to the debtor and his issue as the trustees determined to be in the best interest of the beneficiaries. The court held that because the debtor could not require the trustees to make

¹⁰ Howard D. Rosen, 810 T.M., Asset Protection Planning, BNA Tax Management Portfolio at A-1.

¹¹ Hatsfield v. Lescher, 721 F.Supp. 1052 (E.D. Ark. 1989).

¹² In re Baldwin, 142 B.R. 210 (Bankr. S.D. Ohio 1992); In re Herzig, 167 B.R. (Bankr. E.D. Va. 1994). Hopefully these cases will prove to be anomalies. Otherwise it could lead to the egregious result that one discretionary beneficiary who goes bankrupt could infect the entire family's wealth.

¹³ Doksansky v. Norwest Bank, N.A., 615 N.W.2d 104 (Neb. 2000).

distributions to satisfy his debt, his interest could not be reached by his former spouse.

4. **Valuation and Leveraging.**

The combination of dynastic trusts with valuation discounts and leveraging techniques creates the cornerstone of the advanced estate plan.

- a. The ability to manipulate value to achieve tax savings within the family unit presents unique opportunities for the tax practitioner to exploit the transfer tax system.
- b. Such a course of action has been referred to as an "Estate Planner's Dream."¹⁴

5. **Flexibility.**

An essential ingredient in formulating an estate plan is to provide flexibility to meet changing family needs and changing laws, particularly tax laws.

- a. The need for a flexible plan increases in scope where the focus of the estate plan is multigenerational in design.
- b. A trust provides far greater flexibility than an estate plan under which property is transferred outright.
- c. For instance, the ability to distribute income directly to a beneficiary in a low income tax bracket is far more flexible and tax efficient than having a high bracket individual receive income, pay tax and then make a taxable gift.

6. **Providing for Liquidity at Death.**

Although nobody relishes the idea of growing old, we all realize that it sure beats the alternative.

- a. Nobody enjoys buying life insurance, but in most instances, it is far superior to the alternative (e.g., illiquid estate, beneficiaries who need economic assistance, etc.).
- b. Life insurance has traditionally been acquired for (i) estate creation and (ii) estate preservation.
- c. However, with new products, such as variable life, and new planning techniques, life insurance also may be arranged to provide lifetime

¹⁴ See Cooper, fn. 9, at p. 47, *supra*.

benefits, such as tax-deferred growth.

- d. With the proliferation of large life insurance policies and the increased attention given by the Service to Crummey powers of withdrawal, planners must be more creative with regard to the funding mechanisms that will achieve transfer tax-free status for the proceeds of these large policies.

IV. Setting the Table

- A. During the embryonic portion of the estate planning process, a procedure that we generally explore with clients is to set forth the ideal estate planning structure that the client might want if it were obtainable.
- B. With the clients' participation, we list the rights that the clients want in their property.
- C. The conclusion generally reached is that most of us, and most of our clients, want to own our wealth whereby we:
 1. Will be able to manage and control our property until our death;
 2. Will have access to the income from our property until our death;
 3. Will have our assets available for our use and enjoyment until our death;
 4. Will be able to decide who will receive our property at our death (or during our lifetime if we were to give it away), and in what form they will receive it;
 5. Will have our property protected from creditors, including our spouses in case of divorce; and
 6. Will save taxes.
- D. It would be reasonable to assume that the foregoing list contains all of the rights in property that anyone would desire.
 1. However, such a structure would indeed be a "pipe dream"¹⁵ if set up for oneself.

¹⁵ Many years ago the fertile mind of John R. Cohan coined the concept of the "Pipe Dream Trust." See *Drafting California Irrevocable Trusts*, John R. Cohan, ed., ¶8.11. The evolution of asset protection as an essential element of family wealth planning has led us to expand John's concept to include that important portion of the plan.

2. The first four elements of the structure are inherent in outright ownership.
 3. On the other hand, it is well recognized that an individual cannot design and fund a vehicle for himself that would enable him to access, enjoy and manage his assets and also obtain the desired creditor protection and tax relief.
 4. If the client were to create such a trust for himself, it would be a grantor trust for both income and estate tax purposes, and the existence of the trust would be ignored by the Service.
 5. From an asset protection perspective, under the laws of most states, creditors of the grantor can reach the maximum amount the trustee can pay from the trust, even though the trustee, in the exercise of his discretion, does not want to pay anything to the grantor/beneficiary, and even though the grantor/beneficiary is unable to compel such a distribution himself.
 6. As a result, creditor protection would not be achieved under the laws of these states.
 7. Alaska, Delaware, Nevada and Rhode Island allow the grantor to set up an asset protection trust with the grantor as a discretionary beneficiary.
- E. Notwithstanding the foregoing, as will be seen later, a trust can be set up by a third party that is classified as a grantor trust as to the beneficiary, thus enabling the beneficiary to move assets into the trust through transactions with the trust. In such instance, the beneficiary will be able to control, use and enjoy trust assets that were formerly the beneficiary's assets, without exposing the formerly owned assets to either transfer tax or the beneficiary's creditors.

V. The Pipe Dream Becomes a Reality

- A. If anyone other than the trust beneficiary were to set up an irrevocable trust, the trust could be structured to provide the beneficiary with all of the six elements of the otherwise proscribed estate plan discussed above.
- B. Accordingly, the estate advisor must plan with the property prior to its transfer to the beneficiary in order to provide the beneficiary with tax and creditor protection benefits, a result that the recipient cannot obtain for himself.

VI. Extending and Leveraging the Benefits

- A. If one accepts the thesis of this outline, that placing property in a well-structured trust will enhance the wealth transfer and result in greater tax and non-tax benefits being obtained with outright ownership, then the natural extension of such philosophy is that in

designing and implementing the trust, the following objectives also should be sought:

1. Extend the duration of the trust for as long as possible. In many cases this can be accomplished through forum shopping by selecting a trustee or co-trustee in a jurisdiction that does not have a rule against perpetuities;
 2. Select a jurisdiction that will not impose state income taxes on the trust earnings;
 3. Take advantage of funding techniques that leverage the \$1 million GST tax exemption; and
 4. Deflect the income tax liability away from the trust so that the trust can grow tax-free. This can be accomplished by causing the grantor or trust beneficiary to be taxed on trust income.
- B. Although the trust design should permit discretionary distributions, operationally the trust should be managed so that distributions are not made unless there are compelling reasons to do so, such as the incurrence of severe adverse income taxes.
- C. The distribution and investment philosophy should be guided by the fact that any distributions from the trust will stunt the growth of the trust and move assets from a tax and asset protected environment into an area that is exposed to both the beneficiary's transfer taxes and creditors.
- D. Trusts domiciled in most states are limited in duration to lives in being at the creation of the trust plus 21 years. This limits the trusts to approximately 90 to 120 years.
- E. The states which either do not have a rule against perpetuities or which allow the trust agreement to opt out of the rule against perpetuities are Alaska, Arizona, Delaware, Idaho, Illinois, Maine, Maryland, New Jersey, Ohio, Rhode Island, South Dakota, Virginia and Wisconsin. Although not a perpetual state, Florida has a 360-year rule against perpetuities.

VII. The Beneficiary Controlled Trust Concept¹⁶

- A. Most of our clients want to leave their property to their loved ones outright, provided that at the time of the gift or bequest the desired recipient is capable of managing the property wisely.

¹⁶ See Frederick R. Keydel, "Trustee Selection, Succession, and Removal: Ways to Blend Expertise with Family Control," 23 U. Miami Inst. on Est. Plan., Ch. 4 (1989).

1. For these clients, trusts, possibly combined with various estate planning maneuvers to increase the size and growth of GST tax exempt trusts, are generally recommended in place of straightforward, outright transfers.
 2. As to those clients who want to pass on their wealth so that the preferred beneficiaries (typically members of the oldest then living generation) obtain the enjoyment of the property in a manner as close to outright ownership as possible, with possible trade-offs in order to increase flexibility, tax and creditor benefits, a Beneficiary Controlled Trust should be considered.
- B. The Beneficiary Controlled Trust is designed to provide the primary beneficiary with all of the rights, benefits and control over the trust property that he would have had if he owned it outright, in addition to tax, creditor and divorce protection benefits that are not obtainable with outright ownership.
- C. The ability to derive more benefits in a trust than one would obtain with outright ownership without giving up control leads one to wonder why trusts are not the vehicle of choice in virtually every estate plan and why Beneficiary Controlled Trusts are not used instead of outright transfers in almost every instance in which the transferor otherwise would be inclined to gift or bequeath the property outright.
- D. The Beneficiary Controlled Trust concept is fairly simple.
1. It is a trust where the primary beneficiary either is the sole trustee or has the ability to fire any co-trustee and select a successor co-trustee.
 2. Typically, control of the trusteeship is coupled with a broad special power of appointment that can have the effect of eliminating any potential interference by remote beneficiaries.
 3. Because the primary beneficiary/trustee possesses the ability to eliminate all participation in the enjoyment of the trust assets by secondary and remote beneficiaries, the latter will not be inclined to interfere because their rights could be eliminated.¹⁷
- E. The use of a Beneficiary Controlled Trust accomplishes or enhances all six of the desired components of the estate plan.
1. From a beneficiary's perspective, the beneficiary can be given more benefits in a

¹⁷ Congress is well aware of the fact that a trust can be designed in such a manner whereby "...the intervening generation could be given the equivalent of absolute ownership of trust assets through powers of appointment and trust powers." Cooper at p. 56, referring to testimony given by Prof. A. James Casner to the Ways and Means Committee.

trust than he could obtain with outright ownership.

2. For the client who would transfer property to the objects of his bounty outright, it is difficult to reconcile not making the transfer to a trust that the primary beneficiary controls, since the primary beneficiary can control the trust virtually without limitation and interference from any secondary beneficiaries and still receive the tax and creditor benefits of the trust vehicle.
 3. As discussed below, a trust designed with control in the hands of the primary beneficiary (and secondary beneficiaries who become primary beneficiaries upon the demise of the primary beneficiary), coupled with a special power of appointment that would enable the primary beneficiary to cut out a complaining secondary beneficiary, should be free of interference and thus is the singularly most important component of the estate plan.
- F. Obviously, not all clients share the foregoing philosophy, and sometimes circumstances preclude or suggest that all power not be lodged in a beneficiary.
1. For such clients, the estate plan should be designed to take into account and reflect the specific variations and desires of the client to accomplish his or her objectives.
 2. Illustrations of circumstances where the client would not select a Beneficiary Controlled Trust include situations where the beneficiary is either legally (e.g., a minor) or practically (e.g., inexperienced, disabled, lacking judgmental skills, etc.) incapable or unable to assume managerial responsibility; where the client wants to limit the beneficiary's enjoyment of the property, enabling others to enjoy and share in the wealth; or where the client wants to limit the beneficiary's power of disposition over the property.
 3. In such instances, a trust, although not a Beneficiary Controlled Trust, should be considered, even for transfers in which tax considerations are not a substantial factor.¹⁸

¹⁸ Interestingly, when queried as to whether or not a trust should be considered for a young couple with a young child or two and few assets which, including life insurance, might total between \$100,000 and \$200,000, most clients and advisors we have asked have responded that a trust is inappropriate. We respectfully submit that the majority answer is incorrect; even here a trust is the best vehicle. The real question is whether the cost of setting up the trust and the remote possibility that the trust would be used justify its creation. Certainly, if the parents were to die prematurely with young children, having a trust in place would be preferable to any other alternative.

VIII. Designing the Beneficiary Controlled Trust

- A. Once it has been decided that a trust should be used, the design of the trust to achieve and maximize the desired results becomes important.
1. In its simplest structure, the trust could be designed whereby the beneficiary would be the sole trustee and have the right to any or all of the income, plus access to principal limited to health, education, support and maintenance, plus a broad special power of appointment during life and/or at death to anyone other than the beneficiary, his creditors, his estate, or the creditors of his estate.
 2. However, in most instances this trust variation is not recommended because greater flexibility, tax benefits and creditor protection can be obtained using a discretionary Beneficiary Controlled Trust with multiple trustees.
 3. By using friendly, independent trustees (or special trustees who could act under appropriate circumstances), certain powers can be woven into the trust agreement that could not exist if there were no independent trustees.
 4. This is so because powers that are rather innocuous in the hands of an independent trustee would cause tax and creditor problems if lodged in the hands of a beneficiary/trustee.
- B. The primary factors that should be considered in designing the Beneficiary Controlled Trust are:
1. **Income.**
Most trust scrivener draft trusts that pay out all of the income.
 - a. This course of action moves the income from a tax and asset protected arena to one that is exposed.
 - b. Distributions from the trust restrict the growth of the protected trust and are counterproductive from both a tax and creditor protection perspective.
 - c. For transfer tax purposes, distributions will increase the beneficiary's estate.
 - d. In addition, the retention of income in the trust will help the trust beneficiaries in accomplishing their own estate planning goals.
 - e. If income is retained in the trust, the trust will grow creating a large accessible fund for the primary beneficiary of the trust.

- f. Based upon the security of the expanded trust fund, the primary beneficiary can establish an aggressive gifting posture and defund his own estate more rapidly and to a greater extent.
- g. In fact, as a result of the assets being beyond the reach of creditors, the trust offers greater comfort and security than outright ownership affords.
- h. From a creditor protection perspective, a trust that provides for a mandatory payout of the income may give creditors the ability to access the right to receive the income.¹⁹
- i. Therefore, although trust corpus is shielded from creditors, some of the asset protection benefits inherent in the trust vehicle will be lost.
- j. In such instance, depending on state law, a court could either direct a sale of such right to income or direct that the income be paid to the creditor until the debt is discharged.²⁰
- k. By eliminating a beneficiary's enforceable rights, his creditor's rights are also eliminated.
- l. Alternatively, for maximum creditor protection, a discretionary trust should be used.²¹
- m. The use of a discretionary trust, where distributions are subject to the absolute discretion of an independent trustee, has been described as "... 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."²²
- n. Many clients will not accept anyone other than the intended beneficiaries as a fiduciary, notwithstanding the benefits and flexibility that a non-beneficiary fiduciary can offer, even if the "stranger" is their best friend.
- o. In such instance, the primary beneficiary should be the sole trustee subject to an ascertainable standard since there is no proscription in the

¹⁹ See *IRS v. Orr*, 84 AFTR2d 99-5390, 1999 WL 486613 (CA-5, 1999).

²⁰ Scott, 2 Trusts 147-147.2 (2d ed. 1956).

²¹ See discussion under Satisfying the Goals of Estate Planning - Asset Protection Planning, *supra*.

²² Keydel, fn. 16, *supra*, at §409.1.

estate tax laws that prevents a Beneficiary Controlled Trust from being designed as a discretionary trust. That route should be selected rather than the alternatives of selecting an outright disposition or a trust that distributes all the income.

- p. Such a trust could authorize the beneficiary/trustee to distribute income and principal to himself based on the ascertainable standard of health, education, support and maintenance without taking into account his other assets.
- q. Under IRC §2041(b)(1)(A), the use of the ascertainable standard would prevent estate tax inclusion as a general power of appointment.
- r. If this option is selected, the draftsman should also include a clause prohibiting the beneficiary/trustee from making distributions that would discharge his legal obligations.
- s. The trust also should include special powers of appointment for maximum flexibility. An inter vivos power would enable the beneficiary/trustee/powerholder to make distributions to secondary beneficiaries by exercise of the power, thus avoiding gifts of his or her interests in the trust.
- t. The income tax consequences of the foregoing arrangement are uncertain. They are governed by IRC §678(a), which provides that a non-grantor beneficiary will "...be treated as the owner...of a trust with respect to which such person has a power exercisable solely by himself to vest the corpus or the income therefrom in himself,..." or has previously released the power and retained a power which, under the principles of the rest of the grantor trust rules, would subject the grantor to treatment as the owner thereof. For inter vivos discretionary trusts, where the trustee/beneficiary is a person described in IRC §672(c) (a trustee who would normally cause the grantor to be taxed), if distributions are limited by an ascertainable standard, the grantor will not be taxed solely because the trustee/beneficiary has the power to allocate income to himself (and others).²³
- u. The effect of IRC §678(a) on a discretionary trust, that is not otherwise taxed to its creator, under which a trustee has the power to make distributions to himself subject to an ascertainable standard is uncertain as between the trust and the beneficiary.

²³ IRC §674(d).

- v. However, the prevailing view appears to be that "... a trustee/beneficiary will not be taxed under Sec. 678 if distribution is made pursuant to an ascertainable standard...(because) (t)he legislative history of that section indicates that it was not intended to apply unless the trustee has an unrestricted right to make distributions to himself or herself."²⁴
- w. Alternatively, there is support for the positions that either the trust beneficiary would be treated as the owner²⁵ or that the beneficiary would not be taxed "...except to the extent that income could have been distributed under that standard (relating to health, education, support and maintenance)."²⁶
- x. To avoid uncertainty as to the income tax consequences, and to increase flexibility and creditor protection, it is generally advisable to use a co-trustee²⁷ if that option is acceptable to the client.
- y. Use of an independent co-trustee is generally acceptable when one realizes that the grantor may have broad removal and replacement powers as long as the replacement trustee is not a "related or subordinate party" as defined in IRC §672(c),²⁸ or, alternatively, such power may be lodged in the hands of the beneficiary.²⁹

2. "Use" concept.

The basic philosophy of this outline is that a transfer of property in trust improves the value of the property to the trust beneficiaries.

- a. The corollary of that thesis is that distributions from the trust, in the absence of a compelling reason to make distributions, such as onerous income tax consequences, should be avoided.

²⁴ Roy M. Adams, "Ask the Expert," Trusts and Estates, (Sept. 1996).

²⁵ Keydel, fn. 16, supra, at §406.3.

²⁶ Howard M. Zaritsky and Norman M. Lane, Federal Income Taxation of Estates and Trusts, 2d Ed. §12.02(1).

²⁷ Keydel, fn. 16, supra, at §404.

²⁸ Rev. Rul. 95-58, 1995-36 I.R.B. 16.

²⁹ LTR 9746007.

- b. The consequence of making distributions would be to move wealth from a tax and creditor protected environment into one that is exposed.
- c. Because of the dynastic nature of the trust, the adverse effect of such leakage would be greatly magnified. See Exhibit A which illustrates the dramatic difference leakage of 1% makes in compounding income over 120 years.
- d. It is anticipated that the investment pattern would be designed to enable the trust to realize and optimize its goal of avoiding transfer taxes and creditor exposure for multiple generations.
- e. The trustee should be encouraged to acquire assets that are expected to appreciate in value for the "use" of the beneficiaries, rather than funding the individual's personal acquisition of the assets.
- f. The right to "use" the trust assets may be for any purpose and need not be limited by an ascertainable standard without coming within the general power of appointment proscription contained in IRC §2041 even though the decision to allow the use is in the hands of a person acting in the dual capacity of beneficiary and trustee. Rather than being a power of appointment, use of the trust assets would be akin to a life estate.
- g. The trust instrument, particularly where a Beneficiary Controlled Trust is the vehicle of choice, should contain specific language that permits investment in assets such as homes, artwork, jewelry, and business and investment opportunities (whether speculative or not), that have significant appreciation potential.
- h. This course of action is generally viewed by purists as being the antithesis of traditional trust investments, but is consistent with the philosophy of the Beneficiary Controlled Trust in that the trust wrapper is employed solely as an enhancement to provide benefits to the trust beneficiary without meaningful restrictions.
- i. Since the beneficiary would have unrestricted investment power had he received the assets outside of the trust, it would be consistent with coming as close to outright ownership as possible to permit broad investment powers inside of the trust.
- j. The beneficiaries individually (or by utilization of assets in trusts not protected by the GST tax exemption) are expected to absorb most family expenditures such as food, schooling and vacations.
- k. Additionally, trust funds should generally not be expended for

consumable assets since use of protected funds in this manner would be wasteful.

- l. If the trust were to acquire and own assets such as the beneficiaries' businesses and homes, it would indeed be rare that an otherwise functional beneficiary could not fund the foregoing family expenditures and consumables with property outside of the trust.
- m. In fact, it is reasonable to conclude that if a beneficiary could not so provide, the trust alternative would be even more desirable as a creditor protection shield.
- n. In order to further protect the beneficiary, rather than making distributions to the beneficiary, the trustee should make secured loans to the beneficiary so that the trust, rather than the beneficiary's creditors, would have priority in case of bankruptcy.

3. Special power of appointment.

A broad special power of appointment is often given to the primary beneficiary of a trust, particularly if it is a Beneficiary Controlled Trust.

- a. A power of appointment is a desirable ingredient in most trusts because it adds flexibility, and permits the trust to be modified in order to deal with changes in the law or family circumstances.
- b. Its importance increases when the trust is dynastic because there is a greater possibility of change in family circumstances, laws, particularly tax laws, etc.
- c. For many clients, the power of appointment is, and should be, an essential ingredient of the plan.
- d. They may not be inclined to proceed with their planning in its absence because of a concern of interference by a complaining beneficiary.
- e. The use of a special power of appointment enhances the objective of using a Beneficiary Controlled Trust in that it provides added control in the hands of the primary beneficiary.
- f. For example, by giving the trustee broad latitude in investing, including high risk/reward opportunities, it can be anticipated that some transactions will fail.
- g. If there were no trust, there would be no accountability to more remote descendants.

- h. By coupling the power of appointment with broad discretionary powers in the hands of the trustee/beneficiary, the result would be that the trustee/beneficiary would have the functional equivalent of no accountability with respect to the trust.
- i. As Professor Ed Halbach has often stated, "[a] power of appointment is also a power of disappointment."
- j. If the creator of the trust desires to provide the beneficiary with rights that are as close to outright ownership as possible, the powerholder can be given the power to appoint the property in favor of anyone, in trust or outright, other than himself, his estate, his creditors or the creditors of his estate³⁰ without causing estate inclusion.
- k. A concern often voiced by dynastic trust candidates and some of their advisors is that they don't want to be irrevocably locked into a trust arrangement forever.
- l. A power of appointment that can be exercised by making outright distributions, thus terminating the trust, can easily finesse that perceived problem.

IX. Opportunity Shifting³¹

- A. One of the best, yet often overlooked, techniques to avoid the transfer tax system is the shifting or deflecting of the opportunity to earn income or generate wealth from the client to others, including trusts.
 - 1. For planning purposes, it is far simpler, less risky and more tax efficient to shift the opportunity to create wealth at the inception of an undertaking than to move wealth once value has matured and has become substantial.
 - 2. The shifting of an opportunity does not involve a transfer and therefore finesses the transfer tax.
 - 3. In its simplest form, if a person were to refer business, customers or clients to another person, or give some gratuitous advice to the other person, no one would think a transfer subject to the gift tax has occurred. Those activities

³⁰ IRC §2041(b)(1).

³¹ See Steven J. Oshins, "Opportunity Shifting: A Life Insurance and Estate Planning Technique," Journal of Financial Service Professionals (May 1999).

happen frequently.

4. Similarly, the shifting of a business or investment opportunity is not an event that gives rise to the imposition of a gift tax, even if the result is detrimental to the referring party.
 5. Thus, when a new business is formed, a new product is being developed, a new location is being considered, or the family has an investment opportunity, a new entity should also be formed, and some or all of the equity interests offered in the new entity should be placed in irrevocable trusts.
 6. In many instances, the "seed" money is negligible to enable the recipient of the opportunity to acquire a significant interest in a venture that can reasonably be predicted to explode in value.
 7. Moreover, a referring family member can determine how much of the opportunity to shift, and can structure the entity accordingly.
 8. Thus, the entity design can include a scenario whereby the opportunity provider obtains complete control of the new venture even though he or she owns only a small sliver of it.³²
 9. For example, control of the general partner of a limited partnership or holder of the only share of voting stock in a corporation or limited liability company will obtain such a result.
 10. A capital structure whereby the opportunity shifter receives control of the entity will subject to the transfer tax system only the interest owned and not the opportunity "transferred."
 11. In addition, at such time as the retained interest is ultimately transferred, it should be taxed at a mere fraction of what the interest really means to its owner.
- B. An often-cited illustration of the opportunity shifting strategy occurred where the senior members of the Lauder family, which owned the Estee Lauder Company, shifted the opportunity to develop the successful Clinique and Aramis products down a generation.³³

³² Cooper, fn. 9, *supra*, at p. 19; Owen G. Fiore, "Ownership Shifting to Realize Family Goals, Including Tax Savings," 37 NYU Inst. on Fed. Tax., Sec. 38 (1979); Owen G. Fiore, "Estate and Value Opportunity Shifting Through Installment Sales, Private Annuities and Interest-Free Loans," U. Miami 13th Inst. on Est. Plan., Ch. 7 (1980).

³³ Cooper, fn. 9, *supra*, at p. 20.

1. Had the senior Lauder family members desired control, the new entity could have been structured whereby the senior Lauders owned a 1% controlling interest in the entity.
 2. Moreover, additional tax and creditor protection benefits could have been obtained had the wealth shifting opportunity been given to trusts for the benefit of their children, Leonard and Ronald, and their descendants rather than to them outright.
- C. The Lauder-type plan is not an isolated instance, but only one illustration of the opportunity shifting concept.
1. Indeed, these planning opportunities occur often.
 2. The problem is that very few of these potential value shifting possibilities are exploited in the real world.
 3. This inaction is probably due to several factors, including that many opportunity shifting situations are not recognized; to a large degree there is indifference on the part of many planners and their clients; and also possibly because the concept is more one of common sense than being a technical legal planning device that would likely be the subject of articles, speeches and other professional training.
 4. Further, since this is a strategy for moving wealth outside the scope of the transfer tax system, it is usually also not the subject of cases or rulings unless an error was made.
 5. The reason little attention is given by the IRS to this type of undertaking is that in most instances where opportunity shifting occurs there is no reporting of the transaction since there is no "transfer" that necessitates the filing of a tax return.
 6. Thus, it is reasonable to assume that much of this planning is not a result of strategizing, but rather is the result of wealthy people just using some common sense without recognizing that their actions have favorable estate planning results.
 7. Hopefully, they will recognize the beneficial implications of such actions and that the recipient of the wealth generating activity should be an irrevocable trust.
- D. There are a number of situations in which this type of tax-free, intrafamily diversion of wealth is often overlooked.
1. For instance, assume that a child wishes to go into the same business as his

parents, just like the Lauder children. Rather than join the parents, irrevocable trusts can be set up to hold a newly formed entity, and the parents can refer some of their companies' business to the trust-owned entity.

2. A striking illustration of this occurs in the situation where both the parents and children are developers, and the parents wish to retire during the next few years and pass the business to their descendants. A direct transfer often has costly tax implications.
 3. With proper advance planning, the tax bite can be mitigated or negated through the process of referrals by the parents to the children's trust-owned entity.
 4. This will have the dual effect of ballooning the value of the trust while concomitantly reducing the value of the parents' entity, perhaps over time even to zero, negating the necessity of selling or gifting the parents' entity to the trust.
- E. An impressive variation of the opportunity shifting strategy exists where the child's trust owns a collateral business to which the parents may refer business.
1. To illustrate, assume that the owner of a retail business wants to shift wealth that would inure to his own benefit if the estate and business planning process is not undertaken.
 2. The business owner could set up trusts for the benefit of his descendants (and perhaps his spouse) that forms an entity to do installation, repairs and warranty work on products sold by the retail business.
 3. The business owner would refer customers to the trust-owned entity for the service work.
 4. Additional sources of collateral fees could be generated by having a trust-owned entity (separate from the installation and repair shop for liability purposes) acquire, own and lease furniture, equipment, or an office building to the business.
- F. The fact patterns under which opportunity shifting strategies can be employed are extensive and are virtually limited only by the imagination of the planner as long as the planner and/or client have been sensitized to the existence of the technique and its effectiveness as a tax avoidance and creditor protection device.
- G. Not only does the use of multiple entities make sense from a tax planning perspective, but it also provides asset protection benefits.³⁴

³⁴ Richard A. Oshins, "Family Wealth Protection and Preservation," Trusts & Estates (February 1993).

1. Clients often want to keep things simple and put their business into a single large entity. On the other hand, they often can be more effective using multiple entities.³⁵
2. From an asset protection standpoint, using multiple entities protects the assets of all entities other than the entity where the liability occurred.
3. On the other hand, a single integrated entity subjects all of the entity's assets to any liability.

X. Getting an Advance on Your Inheritance

- A. Estate planners tend to look down generations for planning purposes.
 1. Typically, the only upstream inquiries made as to the economic situation of the parents are (i) whether the client anticipates an inheritance that should be taken into account in planning the client's estate, and (ii) whether the client may need to provide support for a parent in case of an unusual order of deaths.
 2. Planners often overlook inquiring as to whether the client's parent has the ability and inclination to fund a trust for the client's benefit.
 3. Even persons of somewhat modest means can often come up with, and are willing to part with, sufficient seed money for a predictably "hot" investment or business venture, such as a new business entity that will be designed to receive referrals from a present successful business, or another opportunity shifting scenario.
- B. An extraordinary opportunity exists by looking up a generation as part of the planning process.
 1. When the client is about to embark on a new venture or has an investment opportunity with significant potential, consideration should be given to having the client's parent(s) create and fund a trust for the client.
 2. Money placed in a dynastic Beneficiary Controlled Trust funded by the client's parent(s) would provide the "seed" money for any such anticipated business venture or investment.
 3. As long as the client is not the original source of the "seed" money, that course of action would result in the transaction being recast as a trust created by the client under the step transaction or agency theories, the normal rules of taxation

³⁵ Fiore, fn. 32, *supra*; Oshins, fn. 34, *supra*.

should apply and the existence of the trust should be respected for both tax and asset protection purposes.

4. Thus, the client can control the trust by being trustee, and can benefit from the trust assets as the primary beneficiary.
5. An even more potent planning opportunity exists where the senior generation sets up a Beneficiary Defective Trust, a concept discussed later in this outline.

XI. The Defective Trust Concept

- A. A trust that is taxed to the grantor is commonly known as a "grantor trust" or a "defective trust."
 1. A trust that violates one or more of the provisions contained in IRC §§673-679 is a defective trust for income tax purposes.
 2. If a transfer to a trust is not a completed gift, the trust is defective for gift tax purposes.
 3. A trust that is includible in the grantor's estate is defective for estate tax purposes.
- B. Since the grantor trust rules are different for income tax purposes than they are for transfer tax purposes, grantor trust exposure for either income tax purposes or transfer tax purposes or both depends upon which Code sections are being violated.³⁶
 1. Notwithstanding the foregoing, this outline will use the term "defective trust" to refer to trusts that are defective solely for income tax purposes.
 2. Thus, as used herein, a transfer to a trust that has grantor status for income tax purposes will be a completed gift and outside the estate for estate and GST tax purposes.
- C. The fact that the grantor trust rules do not work in pari materia creates some extremely attractive planning opportunities.
 1. In designing a trust to obtain the benefits discussed herein, it is imperative that the "defect" selected to secure grantor trust status for income tax purposes does not result in inclusion in the grantor's estate.

³⁶ Randall D. Roth, "The Intentional Use of Tax-Defective Trusts," U. Miami, 26th Inst. on Est. Plan., Ch. 4 (1992).

2. It is also important that the violation affects both ordinary income and corpus and will infect the entire trust and (not just a portion of the trust) with the result that the grantor (or other person) will be treated as the owner of the entire trust and will be taxed on, and report, all items of income, deductions and credits on his return.³⁷
- D. Just as it is desirable in GST tax planning that trusts be entirely exempt or entirely non-exempt, singular income tax status for a trust is also strongly recommended.
1. If a trust has hybrid tax consequences, in many instances planning is restricted because the consequences of an action may have partially positive results and partially negative results.
 2. Dual tax treatment may also create an accounting nightmare. Consider, for example, Letter Ruling 9034004 which is illustrative of the Service's position on the proper way to compute the income tax consequences with respect to the lapse of a power of withdrawal for a trust that is otherwise not defective.
 - a. The Service ruled that not only is there a pro rata grantor trust exposure to the powerholder as to the amount lapsing, but that such exposure will increase each time a withdrawal power lapses.
 - b. In order to avoid this cascading transition in tax reporting, it is important that separate trusts be created if the funding would otherwise result in different income tax consequences.
 3. It is sometimes also advisable not to have more than one grantor for each trust if the trust is defective. For example, husband and wife should not both be grantors of the same trust. In such instance, on the death of one spouse, grantor trust status will cease to the portion of the trust previously "owned" by the decedent, resulting in hybrid income tax treatment thereafter.
- E. The tax benefits of creating a defective trust are:
1. By paying the tax on the trust income, the grantor is making the functional equivalent of a tax-free addition to the trust for both gift and GST tax purposes.
 - a. This benefit was stated by Prof. Ed Halbach as follows: "[A] settlor sometimes wishes to be taxable on trust income that is nevertheless payable to an adult child whose tax bracket is comparable to that of the settlor. By paying the income tax that would otherwise be charged to the child, the settlor makes what amounts to an additional transfer to the

³⁷ IRC §671.

child each year without having an additional taxable gift.³⁸

- b. Because Ed's article was written two years prior to the enactment of the current GST tax, he did not discuss the beneficial GST tax implications that are even more dramatic than the gift tax benefits because the benefits grow exponentially. To illustrate, consider a trust funded with \$1 million that earns ordinary income of 10% per annum and that both the trust and the grantor (or another person who would be treated as the owner of the trust for income tax purposes) are in the 40% income tax bracket. If the trust paid the tax, the effective growth rate of the trust would be 6% per annum. If, however, the tax were paid outside of the trust, the growth rate would be 10% per annum. After 30 years, the trust would grow to \$5,743,491 if the trust paid the tax, and to \$17,449,402 if the trust were defective. (See also Exhibit A illustrating the enormous difference even 1% makes where there is tax-free compounding over an extended period.)
2. By paying tax on the trust income, the grantor will reduce his own taxable estate by the tax paid. Any potential growth on the "tax" money not paid will inure to the benefit of the trust rather than increase the wealth of the grantor.
 - a. The Service appeared to take the position several years ago in a controversial private letter ruling³⁹ that if the grantor was not reimbursed for tax he paid on account of income earned by the trust, a gift would be made for the taxes paid. In the ruling, reimbursement was required by the trust indenture. Thus, the conclusion reached by the ruling was proper. By not enforcing his right to reimbursement, a gift was made by the grantor.
 - b. The ruling, however, contained some dicta that indicated the Service also felt a gift would have occurred if the trust did not contain a reimbursement provision. In reaction to strong criticism, the Service recanted on that position, issuing a private letter ruling deleting the controversial language.⁴⁰
3. By designing the trust as a grantor trust, it will qualify as a permissible shareholder of an S corporation.⁴¹

³⁸ 63 Or. L. Rev. 381, 384 n. 11 (1984).

³⁹ LTR 944033.

⁴⁰ LTR 9543049.

⁴¹ IRC §1361(c)(2)(A)(i).

4. Transactions between the trust and its "owner" are not recognized for income tax purposes.⁴²
 - a. Thus, techniques such as installment sales of non-controlling interests to the trust work well in this tax environment.
 - b. In addition to the enormous tax planning opportunities available, the ability of the trust owner to deal with the trust itself is a valuable feature. This enables the trust owner to access cash earned by the trust in exchange for individually owned appreciated assets without the imposition of tax on the transaction.
5. A defective trust should be able to acquire a life insurance policy on the life of the owner without subjecting the policy to the "transfer for value" rule that would otherwise expose the policy proceeds to income tax.
 - a. Since for all intents and purposes the existence of the trust will be ignored for income tax purposes, this transaction should fall within one of the exceptions to the transfer for value rule⁴³ and should be treated as a sale to the insured. Moreover, if a third party, such as the insured's spouse, owned the policy, the spouse could sell it to a trust that is defective as to the insured.⁴⁴ By contrast, if the insured's spouse had gifted it to the trust and was a beneficiary of the trust, the transaction would be treated as a transfer with a retained interest, resulting in inclusion in the estate of the insured's spouse.⁴⁵
 - b. The transfer tax results of Crummey powers of withdrawal are quite familiar to estate planners, particularly through experience obtained in working with irrevocable life insurance trusts.
 - c. On the other hand, little thought or attention has been given to the income tax consequences of such powers. Unfortunately, even though Crummey powers have been used for over thirty years, the income tax consequences of these powers in many instances are uncertain. In part, this lack of clarity is as a result of a drafting error in IRC §678(b), and

⁴² Rev. Rul. 85-13, 1985-1 C.B. 184.

⁴³ IRC §101(a)(2)(B).

⁴⁴ Under IRC §1041(a), transactions between spouses are income tax-free.

⁴⁵ IRC §2036.

also in part, from the questionable interpretation given to IRC §678(a)(2) by the Service in its rulings.

- F. Several issues will be discussed in this section, including:
1. The income tax consequences of a trust funded solely with gifts subject to a power of withdrawal where the trust is not a trust that is also taxable to the transferor;
 2. The income tax consequences of a power of withdrawal where the transferor is deemed the owner of the trust under Subchapter J. – Dual grantor status;
 3. The effect of the lapse of a power of withdrawal; and
 4. The effect of the cessation of grantor trust status as to the transferor where the trust is funded with gifts subject to powers of withdrawal.
- G. The Service's ruling position over the last several years has been that where all transfers to a trust are subject to a withdrawal power by the beneficiary, the powerholder is treated as the owner of the trust under IRC §678(a).⁴⁶
- H. For any lapses of the power to withdraw, the Service uses a "withdrawal-recontribution" theory. Thus, according to the Service, for income tax purposes the situation is treated as if the powerholder withdrew the property and then recontributed it to the trust. Therefore, grantor trust status usually continues as to the beneficiary.⁴⁷
- I. If, on the other hand, the trust has dual grantor trust status under IRC §678 and under one or more of the other grantor trust provisions, it is the Service's position that the grantor trust status as to the creator of the trust supersedes the grantor trust status obtained under IRC §678(a) as to the beneficiary.⁴⁸
- J. The Statutory Scheme - General Rule.
1. Section 678(a) sets forth the general rule that a person other than the grantor will be treated as the owner of any portion of a trust for income tax purposes if

⁴⁶ Rev. Rul. 81-6, 1981-1 C.B. 385.

⁴⁷ LTRs 8142061, 8521060, 9034004, 9141027, 9309023, 9311021, 9320018, 9448018, 9625031, 9739026, 9745010, 9809004, 9809005, 9809006, 9809007, 9809008, 9810006, 9810007, 9810008, 9812006, 199935046, 199935047, 200011054, 200011055, 200011056, 200011058, 200022035.

⁴⁸ IRC §678(b); LTRs 7909031, 8103074, 8142061, 8326074, 8308033, 9141027, 9309023, 9321050 and 9448018.

that person has the power exercisable solely by himself to vest the corpus or the income in himself,⁴⁹ or if that person has previously partially released or otherwise modified this power, and after the release or modification retained such control as would, within the principles of the grantor trust rules with respect to the trust creator, subject the grantor of the trust to treatment as the owner.⁵⁰

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

K. Effect of a Lapse.

1. What happens after the power lapses upon its nonexercise? Now the analysis shifts to §678(a)(2).
2. The Service's position is that the powerholder is treated as having partially released the power, and that consequently the powerholder remains the taxpayer after the lapse.⁵¹ The Service's position appears to be technically flawed in that the rulings hold that a "lapse" of the withdrawal power is tantamount to a "release." However, they are not identical. A "release" requires an overt, affirmative act by the powerholder. A "lapse" is the result of a passive nonexercise of the power. For transfer tax purposes, a "lapse" and a "release" are not synonymous. Both §2041(b)(2) and §2514(e) recognize that they are not identical, stating "[t]he lapse of a power...shall be considered a release of a power." The income tax provisions (and more specifically, IRC §678) do not contain a similar provision. It appears that the Service is attempting to use a transfer tax theory, that grantor trust status continues after a power is released, in the context of the income tax. This interpretation of a lapse as being a release in such circumstances is without statutory authority and is dubious at best.
3. The proper "technical" answer, notwithstanding the Service's position to the contrary, appears to be that with regard to a lapsed withdrawal power, IRC §678(a)(1) does not apply after the power has lapsed, and IRC §678(a)(2) should not apply because there was not a partial release (there was a lapse).

⁴⁹ IRC §678(a)(1).

⁵⁰ IRC §678(a)(2).

⁵¹ See fn. 47, *supra*.

4. In many, if not all, cases in which a withdrawal right has lapsed, the beneficiary retains, after the lapse, the right to discretionary distributions from the trust which, had the beneficiary been the trust creator, would have caused him to be treated as the owner under §677(a)(1).⁵² If this is not the case, then to assure that the trust is defective with respect to the powerholder after the lapse, the powerholder should be given another grantor trust power.⁵³

L. Multiple Grantors Having Possible Grantor Trust Status.

1. To muddy up the water even further, IRC §678(b) provides an exception to the general rule that a person other than the grantor will be treated as the owner for income tax purposes. The heading of §678(b) states, "Exception Where Grantor is Taxable." The Service's and most practitioners' belief is that §678(b) overrides the §678(a) general rule with respect to trusts funded with Crummey gifts.
2. The statute, however, provides that the general rule of §678(a) "...shall not apply with respect to a power over income..." (emphasis supplied). A Crummey power is a power over principal, not income. When the statute is read literally, the §678(b) exception should not apply to the general rule of §678(a) that addresses the power to vest both "...the corpus or the income..." (emphasis supplied) in oneself. The problem with this is that the Committee reports make it apparent that the language of §678(b) contains a drafting error and that it was intended to deal with a power over income and corpus, echoing the language contained in §678(a)(1).⁵⁴ This drafting error has been left uncorrected since 1954.
3. Treas. Reg. §1.671-3(b)(3) does, however, define income as taxable income (which includes capital gains) rather than fiduciary accounting income (which does not include capital gains).⁵⁵
4. Therefore, if one respects what the Committee reports and Treasury

⁵² Under IRC §677(a)(1), the grantor is treated as the owner of a trust if the trust income, without the approval or consent of an adverse party is, or in the discretion of the grantor or a non-adverse party, or both, may be distributed to the grantor or the grantor's spouse.

⁵³ See LTR 9311021.

⁵⁴ See H.R. Rep. No. 1337, 83d Cong., 2d Sess. (1954); S. Rep. No. 1622 83d Cong., 2d Sess. (1954).

⁵⁵ See Ferguson, Freeland and Ascher, *Federal Income Taxation of Estates, Trusts and Beneficiaries*, at §8.16.3.

Regulations say (and what Congress appears to have intended), the result would be that the trust should be taxable to the grantor.⁵⁶ If one believes what the statute says, the §678(b) exception should not apply and the Crummey power should be governed by §678(a), thereby resulting in the trust being taxable to the beneficiary for capital gains purposes.

M. Cessation of Transferor's Grantor Trust Status When Using Crummey.

1. The traditional route in making annual exclusion gifts in trust is to create a single pot trust with multiple powers of withdrawal. Many of these trusts are created to hold life insurance and, according to the Service, are grantor trusts even though Crummey powers of withdrawal are granted.⁵⁷
2. If a trust is funded with gifts subject to a power of withdrawal, but is otherwise defective as to the grantor under IRC §678(b) and one or more of IRC §§673-677, an issue arises as to the proper income tax treatment of the trust after the trust is no longer defective as to the grantor. This issue will arise at the death of the grantor or upon another event, such as a lapse or release of the grantor trust powers.
3. In Letter Ruling 9026036, the beneficiary of the trust was given a power of withdrawal for a period of 30 days. After the lapse of the power, the beneficiary retained a power over the trust that would have caused it to be defective as to him had he been the grantor. The grantor of the trust also retained a power over the trust that caused it to be defective as to her. The Service ruled that upon the death of the grantor, the beneficiary would be treated as the owner of the income and corpus of the trust for income tax purposes. The Service did not give any reasoning for this conclusion. Letter Ruling 9026036 was withdrawn by the Service in 1993 and replaced with Letter Ruling 9321050.
4. Letter Ruling 9321050 revisited the same facts as Letter Ruling 9026036. This time, however, the Service ruled that the beneficiary would not be treated as the owner of the income or the corpus of the trust for income tax purposes. Again, the Service failed to provide any reasoning. The conclusion reached in Letter Ruling 9026036 seems to be more logical and proper than the holding in Letter Ruling 9321050.
5. As a practical matter, the reversal of the Service's position will stop most practitioners from treating the beneficiary as the owner for income tax purposes, unless and until there is judicial resolution to the contrary.

⁵⁶ See LTRs listed in fn. 47, supra.

⁵⁷ See LTRs listed in fn. 48, supra.

- a. Consideration might be given to structuring the trust so that it could accommodate sales if the Service changes its position or the position is rejected by the courts or, preferably, by adopting one of the strategies discussed in the section of this outline relating to Beneficiary Defective Trusts.
- b. Since most Crummey trusts are used for the acquisition of life insurance, separate trusts could be set up for each powerholder and used for installment sales of appreciated assets if after the policy matures, the status of the law is that there is grantor trust treatment as to the beneficiary.

XII. IRC §678(a) - Beneficiary Defective Trusts

- A. A strategy that in many instances can exceed the benefits of the traditional defective trust (i.e., where the donor pays the tax) is a trust arrangement where the donee/beneficiary is treated as the owner of the trust income under IRC §678(a).
 1. The result could be accomplished by funding the trust solely with gifts subject to a power of withdrawal, provided that the trust is not a trust that would be taxed to its creator.
 2. In such instance, the powerholder, who is treated as the owner, will have a trust with which he or she can transact, tax-free, and take advantage of the same estate planning opportunities the grantor would have in a trust defective as to the creator.
 3. Moreover, a trust defective as to the beneficiary may offer superior benefits in that the powerholder/beneficiary may be the trustee and also enjoy the benefits of the trust assets.
- B. Under this scenario, the gifts need not be limited to the annual exclusion in order to obtain IRC §678(a) treatment.
 1. As long as the beneficiary is given a power of withdrawal over the entire contribution, the entire trust would be defective as to the beneficiary.
 2. If the gifts were subject to a hanging power of withdrawal, the beneficiary would have estate tax inclusion only to the extent of the amount hanging at his death.
 3. All lapsed amounts and appreciation would not be includible.
 4. Because the funding will be done with "hot" assets, the lapses should occur

rapidly under the 5% "safe harbor" rule permitted by IRC §2514(e).

- C. This proposed alternative can combine both the advantages of defective trusts and the enhancements that are generally inherent in trusts.
1. For instance, assume that a wealthy client has a business opportunity that he predicts will be successful. The client suggests, and his parent agrees, that the parent set up and fund a trust for the client and his descendants.
 2. The trust is structured as both a Beneficiary Controlled Trust and a Beneficiary Defective Trust. The client can (i) manage and control the trust assets as the trustee; (ii) be the primary beneficiary of the trust; (iii) have a broad power of appointment to give the property to anyone other than himself, his estate, his creditors or the creditors of his estate; and (iv) make income tax-free installment note sales to the trust.⁵⁸
 3. The trust assets would be transfer tax exempt as well as divorce and creditor protected.⁵⁹
- D. Under the right fact pattern, it appears that over time the transfer tax exposure of many wealthy estate owners could be virtually eroded using this strategy.
1. The income earned by a new venture (through opportunity shifting) could be used to acquire wealth presently owned by the estate owner, income tax-free, taking advantage of leveraging techniques such as installment note sales of non-controlling interests.
 2. Both the new venture and the acquired interests can provide cash flow to acquire assets presently owned by the client personally.⁶⁰

⁵⁸ Some states prohibit self-dealing by a trustee. However, forum shopping can resolve any such imbroglio. The trust draftsman should include a waiver of the self-dealing proscriptions which would attach under normal fiduciary standards. It is also advisable to use an independent co-trustee to give the transactions an additional element of independence.

⁵⁹ It is arguable that a beneficiary could be treated as the grantor of the trust for creditor's rights purposes as a result of allowing his power of withdrawal to lapse. However, the better and more logical view is that the beneficiary should not be treated as the grantor unless the beneficiary actually makes a transfer to the trust.

⁶⁰ Care must be taken not to tie the cash flow from the asset sold into the purchase equation so as to trigger the application of IRC §2036(a).

- E. A variation of the facts contained in *R. Crowley*⁶¹ may well offer the ideal estate plan.
1. Mr. Crowley was the CEO of City Federal Savings and Loan Association, which generated ancillary income in the form of appraisal fees, insurance commissions and abstract and title policy commissions.
 2. These collateral business opportunities were shifted to a partnership (later incorporated) comprised of Mr. Crowley's four minor children. Mr. Crowley's oldest son, Robert, while in college and law school, was employed to handle the work and was paid a salary.
 3. The remainder of the income inured to the benefit of the ancillary entity.
 4. The Tax Court held that the income tax burden would be shifted to the children.
 5. Although *Crowley* was an income tax case, presumably it also stands for the proposition that no gift tax would be incurred.
 6. Many estate owners have situations similar to Mr. Crowley's, where a small amount of "seed" money, coupled with referrals, business or investment opportunities, can generate a significant cash flow.
- F. To illustrate the foregoing, assume a savvy businessman has an opportunity to develop a new product, open a new location, create a collateral business, or make a favorable investment that requires a \$200,000 capital contribution.
1. The businessman's parent is able to supply the seed money and sets up a dynastic trust, giving the businessman a hanging power of withdrawal over the entire contribution, but providing that the power will lapse as to the greater of 5% or \$5,000 per annum.
 2. Under IRC §678(a) the beneficiary will be taxed on all of the income.
 3. If the beneficiary dies prior to the full lapse of the power of withdrawal, the amount that could have been withdrawn at the date of death would be includible in the businessman's estate.⁶²
 4. If we assume that the favorable business opportunity grows to a value of \$500,000 in the first year, \$1 million in the second year and \$2.5 million in the third year, the portion of the \$200,000 annually lapsing would be \$25,000,

⁶¹ 34 T.C. 333, CCH Dec. 24, 1998 (1960), acq., 1961-2 CB 4.

⁶² IRC §2041(b).

\$50,000 and \$125,000 respectively based upon 5% of the trust each year, so that the businessman's estate tax exposure would end after three years.

5. Under this arrangement, the beneficiary can aggressively defund his estate based upon the security of the trust since the trust can be designed to give him control and use of the very assets he originally owned.
 6. The result of this arrangement should be transfer tax neutral as long as the client received fair market value for the property sold.⁶³
- G. In structuring Beneficiary Defective Trusts, the following should be kept in mind.
1. The trust should be made defective only as to one beneficiary.
 2. Each trust can have more than one beneficiary, but the power of withdrawal for each trust should be limited to one beneficiary.
 3. If gifts subject to a power of withdrawal are made to more than one beneficiary in a single trust, the trust would be defective as to each beneficiary in proportion to the value of the property subject to that beneficiary's power of withdrawal.
 4. If the trust is not wholly defective as to only one beneficiary, then sales by the beneficiaries to the trust will be partially income tax-free and partially subject to income tax.
 5. In addition, adverse income tax problems can result in a transaction with the trust where the trust would have gain, such as in an instance where the trust makes a payment with an appreciated asset.
 6. Thus, having multiple "owners" of the trust for income tax purposes reduces flexibility and in many instances is incompatible with the sale to a defective trust technique.

XIII. Leveraging the Generation-Skipping Transfer Tax Exemption

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

⁶³ IRC §§2036 and 2038.

- C. In order to further enhance the benefits obtained by using a generation-skipping trust, the term of the trust should be extended for as long as possible.
1. Most states have a rule against perpetuities that limits the duration of trusts. The rule against perpetuities typically states that a trust must vest no later than twenty-one years after the death of all lives in being who are living when the trust becomes irrevocable.
 2. Several states do not limit the term of a trust. In these states, a trust can continue forever. It is not essential that the grantor live in any of these states in order to take advantage of these favorable laws. All that is generally necessary is that at least one trustee resides in the desired state and that there is sufficient activity in that state to give it jurisdiction.
 3. If the client is not inclined to bring one of these states' perpetuities laws into play, careful selection of measuring lives in a well-drafted perpetuities savings clause (e.g., descendants of the grantor's parents, or the grantor's grandparents, alive when the transfer is made) can virtually assure that the vesting for perpetuity purposes will not occur for over 100 years. Since vesting will not result in tax, the transfer tax on the trust assets will be postponed further into the future until the death of the vested beneficiary.
 4. It is difficult to imagine a more superior estate plan than one that gives the primary beneficiary the control over the trust assets at each generational level, without the assets and their accumulated income and growth ever being subject to estate, gift or GST taxes, and which provides creditor and spousal protection forever.
- D. All other things being equal, the trust vehicle can be further enhanced by domiciling the trust in a state with no state income tax.
- E. Many trusts are drafted so that they are defective for income tax purposes.
1. As long as the trust is defective, no immediate income tax benefits will be derived from domiciling the trust in a state with no income tax.
 2. The benefits will be substantial, however, once the trust is no longer defective. At that point, in most instances, the trust will grow state income tax-free, creating a significant difference in the size of the trust as the trust continues to accumulate into perpetuity.⁶⁴ See EXHIBIT A which illustrates the enormous difference 1% makes in compounding over 120 years. Such a differential might

⁶⁴ Some states, such as California, have long-arm statutes that may cause part of the trust to be subject to state income tax.

be solely attributable to state income taxes.

XIV. Installment Sale to a Defective Trust

A. An installment sale to a defective trust in exchange for a promissory note has become an

transactions b

sale transaction, the IRS could argue that the company was worth 100 times the value that was used in the estate planning transaction. The gift tax due could be in the tens of millions of dollars.

- D. Fortunately, there are techniques that can be used whenever the transaction involves a hard-to-value asset.
- E. Formula Gifts and Sales⁶⁹
 - 1. **Value Adjustment Clauses.** A value adjustment clause provides for either an increase in the price of an asset or a return of a portion of the transferred asset if the value of the transferred asset is determined to be greater than anticipated at the time of the transfer. However, this generally does not work because it is against public policy since it is a condition subsequent which would have the effect of undoing a portion of a gift.⁷⁰
 - 2. **Value Definition Clauses.** Unlike a value adjustment clause which attempts to take advantage of a condition subsequent to avoid a transfer in excess of that which is contemplated, a value definition clause defines the value of the gift or sale at the time of the transfer. Therefore, an adjustment on a revaluation by the Service will be upheld and will simply cause an adjustment of the interests allocated between the transferor and transferee.
- F. **“Defined Value” Sale – Residue to Charity.** One technique is to use a “defined value” sale to the defective trust with a residuary amount passing to a charity.
 - 1. For example, the client could assign an X% limited partnership interest to be allocated \$Y worth to the defective dynasty trust and the rest (whatever amount that may be) to a charity.
 - 2. Soon after the assignment to the trust and charity, the trust can purchase the charity’s interest for fair market value in an independent transaction. If the trust purchases the interest, the entire interest will be owned by the trust. This is the preferred result.

⁶⁹ See McCaffrey and Kalik, “Using Valuation Clauses to Avoid Gift Taxes,” 125 *Trusts & Estates* 47 (October 1986); see also McCaffrey, “Some Tips on Tax Tuning Gifts,” 137 *Trusts & Estates* 87 (August 1998). See also the discussion in Sale to a Defective Trust Compared to GRAT, *supra*.

⁷⁰ See *Comm’r v. Proctor*, 142 F.2d 824 (4th Cir. 1944), *cert. denied*, 323 U.S. 756 (1944); *Estate of Gordon McLendon v. Comm’r*, T.C. Memo 1993-459; *Ward v. Comm’r*, 87 T.C. 78 (1986); *Harwood v. Comm’r*, 82 T.C. 239 (1984), *affirmed*, 786 F.2d 1174 (9th Cir. 1986); TAM 9309001; TAM 9246007; TAM 9133001; TAM 8549005; TAM 8531003. But see *King v. United States*, 545 F.2d 700 (10th Cir. 1976) which is the only reported case in which a value adjustment clause was accepted.

3. Call and put rights should be drafted into the partnership agreement to protect all parties involved. The family limited partnership can redeem the interest from the charity or the charity can put the interest to the partnership under these provisions. However, this result is not as favorable as having the trust make the purchase.
 4. The interest should be purchased from the charity after the charity has had sufficient time to do its due diligence.
 5. The IRS doesn't have any incentive to audit the transaction since the residuary amount passes to charity. And since the charity's interest is sold to the trust before the transaction is reported on a tax return, the transaction is fixed at that time, except for the amount of the charitable deduction. If the IRS increases the value of the interest on audit, the client's charitable deduction is increased!
- G. **“Defined Value” Sale – Residue to GRAT.** Another technique is to use a “defined value” sale to the defective trust with a residuary amount passing to a GRAT.
1. For example, the client could assign an X% limited partnership interest to be allocated \$Y worth to the defective dynasty trust and the rest (whatever amount that may be) to a GRAT.
 2. The GRAT would be zeroed-out using a Walton GRAT⁷¹ so that the value of the gift is a small fraction of the value of the asset transferred into the GRAT.
 3. Because of the self-adjusting nature of a GRAT with an annuity payment drafted as a percentage of the initial principal, the potential gift tax liability is minimized. For example, if the value of the transfer is increased by \$100 million on audit, a GRAT which is zeroed-out so that the value of the gift is 1% of the value of the asset would minimize the additional gift to 1% of \$100 million, or \$1 million. The gift tax due on the \$1 million gift is small relative to the otherwise \$55 million gift tax that otherwise could have been due had the GRAT safety net not been used.

XVI. Income Tax Consequences at Death of “Owner.”

- A. Upon the death of the person who is treated as the “owner” for income tax purposes, if the promissory note is still outstanding there is an issue as to whether the owner must recognize gain.
- B. The issue arises as a result of the conversion of the defective trust to a non-defective

⁷¹ See discussion under Walton GRAT, *supra*.

trust.

- C. The commentators who believe that gain must be recognized⁷² do so under the rationale of Treas. Reg. §1.1001-2(c), Ex. (5), Madorin⁷³ and Rev. Rul. 77-402.⁷⁴
1. Under each of these authorities, the grantor creates a trust in which the grantor is treated as the owner for income tax purposes. Each year, the grantor uses the deductions attributable to the trust assets to offset income on the grantor's personal tax return. When the defective trust is going to begin producing income that will be reported on the grantor's return, the trustee renounces the powers over the trust that caused it to be defective so that it becomes non-defective. Under each of these authorities, at the time the trust becomes non-defective, the grantor must realize gain (or loss) to the extent the liabilities exceed the adjusted basis.
 2. These authorities are not directly on point, however. Since the possible income tax triggering event in the sale to a defective trust transaction is death, authorities providing an analysis with respect to other triggering events do not necessarily apply.
 3. TAMs 200010010 and 200010011 had similar holdings under a different fact pattern. In these TAMs, two-year GRATs borrowed from other trusts to make the annuity payments. The GRATs terminated after the two-year term. The Service, citing Treas. Reg. §1.1001-2(c), Ex. (5), noted that the grantor was discharged of the liability as a result of the termination of the GRATs. They ruled that the amount of debt incurred by the trust will be included in the grantor's amount realized when the trust terminates.
- D. The other view is that death has no income tax consequences and that the aforementioned authorities should not apply.⁷⁵
1. A concept that Prof. Jerry Kasner has suggested is that the transaction can be structured so that income tax can be avoided by having the seller elect out of installment reporting.⁷⁶

⁷² See, e.g., Covey, Practical Drafting, pp. 4365-4367.

⁷³ Madorin v. Comm'r., 84 T.C. 667 (1985).

⁷⁴ Rev. Rul. 77-402, 1977-2 C.B. 222.

⁷⁵ See H. Allan Shore and Craig T. McClung, "Beyond the Basic SUPERFREEZE - An Update and Additional Planning Opportunities," Taxes (January 1997).

⁷⁶ IRC §453(d); Jerry A. Kasner, "Maybe the Cup is Half Empty - Planning for Premature Death,"

2. The taxpayer would report the transaction on his return, explain that under Rev. Rul. 85-13 the gain would not be recognized, that there would be carryover of basis and that the taxpayer elected to opt out of installment reporting.
 3. In the normal transaction, for example a sale to a non-defective trust, if the taxpayer elects not to use the installment method, the entire gain would be reported in the year of sale.
 4. Nothing further would be reported at death.
 5. Because the gain is not recognized by the trust, being a grantor trust, why would future years be affected?
 6. It would be reasonable to conclude that each successive year would stand on its own and if an estate owner were to die in year 10, for instance, we would not look back to year 1 to see if gain was recognized in determining the treatment for year 10.
- E. This issue of whether there are income taxes at the seller's death may be avoided by having the defective trust pay off the entire note prior to the seller's death.
1. Where practicable, it is advisable that the note should be paid off with appreciated assets so that the assets obtain a new income tax basis in the seller's estate.⁷⁷
 2. Payment by the trust with appreciated assets is an income tax-free event.⁷⁸
 3. Unfortunately, the time of death is often unpredictable.
- F. There is a better solution to avoid the income tax issue at death. The technique that will avoid this issue is to change the transaction into a low interest loan, as opposed to an installment sale, by taking a few extra steps. Rather than structuring the transaction as a gift followed by an installment sale, the identical result can be achieved (without the income tax at death issue) by taking the following steps:
1. Make a "seed money" gift to the defective trust.
 2. Borrow money on margin, by credit line, from a bank or otherwise. The money

Outline (1998).

⁷⁷ IRC §1014.

⁷⁸ Rev. Rul. 85-13, 1985-1 C.B. 184.

can be paid back within a week, so interest should be insignificant.

3. Loan the money to the defective trust for a promissory note with interest payable at the AFR.
4. Sell the limited partnership interests or other assets to the defective trust for cash (i.e., not for a promissory note).
5. Use the money to pay back the brokerage, bank or other lender.

XVII. Avoiding IRC §2036 in Structuring the Sale.

- A. One concern in structuring the sale is that IRC §2036(a)(1) may apply.
 1. Under IRC §2036(a)(1), property transferred in which the transferor retains an interest is included in the transferor's taxable estate.
 2. This code section should not apply if the transaction is carefully structured and the advisor makes sure the facts surrounding the transaction indicate that it is a bona fide sale.
 3. Preferably, the funds to pay the note would be generated by another asset.⁷⁹
 4. Certainly the payment schedule should not follow the income stream earned by the trust.
 5. Where the transferred asset is the source of payment of the note, the safest route is to pay off the note prior to death.
- B. Most practitioners believe that, in order to avoid form over substance or sham arguments that the Service might use, the defective trust should be independently funded with some seed money.
 1. It appears that 10% has been the rule of thumb that most practitioners have used as a threshold amount.⁸⁰

⁷⁹ See, however, Hesch, *supra*, at p. 116 where the author states that the promissory note sale is outside the scope of IRC §2036(a). The outline draws an interesting analogy to *Comm'r. v. Clay Brown*, where the sole source of funding for a sale-leaseback with a charity was the property sold and the U.S. Supreme Court ruled that the bootstrap sale would be valid. Thus, he concludes that by analogy such sale should also be valid for transfer tax purposes.

⁸⁰ See, however, Hesch, *supra*, at p. 118 for a more aggressive approach. Jerry takes the position that independent seed money is not required. He states: "Commentators suggest that the independent funding

2. It also appears that this amount will be administratively acceptable.⁸¹
- C. Some practitioners have suggested that you may be able to avoid the 10% rule by having the beneficiaries of the trust personally guarantee the amount owed to the seller.⁸²
1. Under Private Letter Ruling 9113009, a beneficiary guarantee would be a taxable gift from the beneficiary both at the time the guarantee is made and at the time the beneficiary pays the seller the guaranteed amount.
 2. The Service withdrew a portion of Private Letter Ruling 9113009 in Private Letter Ruling 9409018. However, the withdrawn portion only dealt with an unrelated marital deduction issue. Thus, the position that the guarantee is a taxable gift is still presumably the Service's position.
 3. A taxable gift to a trust in which the guarantor is a beneficiary may have adverse tax results for income tax purposes,⁸³ gift tax purposes,

and generation-skipping transfer tax purposes.⁸⁶

4. If the trustee of the trust pays the guarantor fair market value each year for guaranteeing the note, then the tax issues above will no longer exist. However, it is nearly impossible to determine the fair market value. Presumably, the parties could use the price that a bank would charge. However, this still may not be accurate.
5. Note that this still would not comply with the IRS's informal position that the trust should have assets worth 10% of the purchase price.
6. If the trust does not have sufficient independent funding, then the Service may conclude that the entire trust, including all appreciation, is included in the grantor's estate as a disguised transfer with a retained interest under IRC Section 2036(a)(1).
7. If the trust is included in the grantor's estate, then an attempted early generation-skipping transfer tax exemption allocation will be ineffective. because of the ETIP rules.⁸⁷
8. Thus, for these numerous reasons most practitioners have chosen to avoid using beneficiary guarantees and have instead chosen to follow the IRS's informal position that the trust should have 10% independent funding.

XVIII. Walton GRAT

- A. A GRAT is an irrevocable trust in which the grantor retains the right to receive an annuity for a fixed term, at which time the remaining trust assets pass to the remaindermen, or to trusts for their benefit, without any further gift tax implications.⁸⁸
 1. The annuity payments are qualified interests pursuant to IRC Sec. 2702(b) so that the value of the gift is reduced by the present value of those payments.
 2. For maximum leverage, the GRAT is usually structured so that the value of the gift is as close to zero as possible. This is referred to as a zeroed-out GRAT.

⁸⁶ The estate tax inclusion rules under IRC Section 2642(f) would preclude the guarantor/beneficiary from effectively allocating generation-skipping transfer tax exemption to the portion of the trust over which he is treated as the grantor until his death. Thus, the time value benefits of an early allocation are lost.

⁸⁷ IRC §2642(f).

⁸⁸ IRC §§2702(a)(2)(B), 2702(b).

3. Under Treasury Regulations Section 25.2702-3(e), Example 5, a completely zeroed-out GRAT is not possible since Example 5 says that a GRUT (or GRAT) payable to the grantor or the grantor's estate (i.e., a "term" GRAT or GRUT) is valued as a "shorter of term or life" GRAT or GRUT. Example 5 states as follows:

"A transfers property to an irrevocable trust, retaining the right to receive 5 percent of the net fair market value of the trust property, valued annually, for 10 years. If A dies within the 10-year term, the unitrust amount is to be paid to A's estate for the balance of the term. A's interest is a qualified unitrust interest to the extent of the right to receive the unitrust payment for 10 years or until A's prior death."

4. However, in a case filed December 22, 2000, the Tax Court in Walton v. Comm'r⁸⁹ declared Example 5 invalid. Thus, a term GRAT can now be zeroed-out.
5. Note, however, that the GRAT should never be completely zeroed-out since the Service may use a public policy argument to claim that the attempted gift is invalid. The planner should also factor in possible rounding by the software program used to calculate the gift. Thus, don't aim for a gift of \$1.00.

B. The facts of the Walton case were as follows:

1. On April 7, 1993, Audrey Walton (the ex-wife of Sam Walton's brother) established two substantially identical GRATs, each of which had a term of two years and each of which was funded with 3,611,739 shares of Wal-Mart stock.
2. The fair market value of the stock on that date was \$27.6875 per share. Therefore, the fair market value of the stock transferred to each GRAT was \$100,000,023.56.
3. According to the provisions of each GRAT, Ms. Walton was to receive an annuity amount equal to 49.35% of the initial trust value for the first 12-month period of the trust term and 59.22 percent of such initial value for the second 12-month period. In the event that she died before the end of the two-year period, the remaining annuity amounts were to be paid to her estate.
4. This assets of each GRAT were exhausted upon the final payment since all income and principal had been distributed to Ms. Walton pursuant to the scheduled annuity payments. In fact, each GRAT had a shortfall of \$14,465,475.01. Thus, there were no assets left for the remainder beneficiary.

⁸⁹ Walton v. Comm'r, 115 T.C. 41 (2000).

5. Ms. Walton filed a gift tax return reporting each gift at a value of zero. The Commissioner of Internal Revenue issued a notice of deficiency determining that Ms. Walton made a taxable gift to each GRAT of \$3,821,522.12. Ms. Walton now concedes on brief that the gift to each GRAT should be \$6,195.10.
6. The exact value of the gifts is still being argued. However, since Example 5 was declared invalid, the gifts should be valued at some figure equal to or close to the value claimed by Ms. Walton.

XIX. Sale to a Defective Trust Compared to GRAT.

- A. The installment sale to a defective trust technique resembles a grantor retained annuity trust ("GRAT").
- B. A GRAT is an irrevocable trust in which the grantor retains the right to receive an annuity for a fixed term, at which time the remaining trust assets pass to the remaindermen, or to trusts for their benefit, without any further gift tax implications.⁹⁰
- C. In most respects, the installment sale to a defective trust technique is superior to the GRAT technique.
 1. In contrast to the sale technique, one shortfall of the GRAT is that GST tax exemption may not be allocated until the end of the initial term of the trust, thus precluding leveraging of the GST tax.
 - a. Under IRC §2642(f), the GST tax exemption may not be allocated during the estate tax inclusion period ("ETIP"), which is any period in which the trust would be included in the grantor's estate if the grantor were to die, other than by reason of the three-year rule under IRC §2035.
 - b. Conversely, the sale technique does not have an ETIP problem since no interest in the trust is retained that would make the trust defective for estate tax purposes.
 2. A second disadvantage of the GRAT, as compared to the sale, is that the grantor must survive the initial term for the transaction to be successful.⁹¹

⁹⁰ IRC §§2702(a)(2)(B), 2702(b).

⁹¹ See David A. Handler and Deborah V. Dunn, "Guaranteed GRATs: GRATs Without Mortality Risk," Trusts and Estates (Dec. 1999) for a possible solution.

- a. If the grantor does not survive the term, it is the position of the Service that the entire trust, including post-transfer appreciation, is includible in the grantor's estate.⁹²
 - b. The sale to a defective trust technique works even if the grantor dies immediately after entering into the sales agreement, since discounted assets are removed from the grantor's estate and replaced by a promissory note with a face value equal to the discounted fair market value of the assets transferred.
 - c. Further, in many instances, the tax exposure of failing to survive the GRAT term will be far more significant than the foregoing. This occurs where the estate owner makes a transfer to the GRAT of a minority interest that was part of a control block in the estate owner's hands, but was subject to a minority discount for gift tax purposes when transferred to the GRAT. If the interest is includible in and returned to the estate due to premature death, it will be valued for estate tax purposes as part of a reconstituted control block. It does not appear that the Tax Court's rejection of the Service's aggregation theory in *Mellinger* (112 T.C. 26 (1999)), *Nowell* (T.C. Memo 1999-15 (1999)) and *Lopes* (T.C. Memo 1999-225 (1999)) all of which valued separately interests includible under IRC §2044 and another code section would be extended to valuing separately interest includible under IRC §§ 2033 and 2036.
 - d. Because of the differential in operation between the estate tax and the gift tax, inclusion will result in the transfer being a tax-inclusive transfer rather than a tax-exclusive transfer, making the result of a premature death even more onerous.
3. A third reason the note sale is superior to the GRAT technique is that each year's annuity payment from the GRAT may not exceed 120% of the amount paid in the preceding year, and the payment schedule must be set up at the inception of the undertaking.⁹³
 - a. Conversely, the installment sale can be endloaded by structuring it as an interest-only note with a balloon payment at the end of the term.

⁹² LTR 9451056. It is arguable, however, that the inclusion should be limited to the amount required to produce the unpaid annuity. Most commentators on this issue believe that since inclusion is under IRC §2039 rather than IRC §2036, the Service's position is misplaced. For support of this proposition, see Rev. Rul. 82-105, 1982-1 C.B. 133.

⁹³ Treas. Reg. §25.2702-3(b)(1)(ii).

3. Under the holdings of Proctor⁹⁷ and McLendon,⁹⁸ a revaluation clause in a sales agreement most likely would be ignored. In both Proctor and McLendon, the courts held that a revaluation savings clause was ineffective in avoiding a taxable gift, ruling that such a provision was against public policy.
4. This risk may be mitigated in a variety of ways. First, and foremost, the appraisal must be top-notch and able to withstand scrutiny. Some lawyers frame the property transferred in a fixed dollar amount to be satisfied by assets in kind, such as "\$X worth of partnership units" or as a fraction of the asset being transferred.⁹⁹ Alternatively, some planners use a fixed amount with any excess going to charity or a foundation, the theory being that there is no incentive for the Service to audit the transaction since there is no additional tax - only a larger portion reverting to charity.¹⁰⁰ If the trust, in an independent arm's length transaction, were to purchase "the charity's interest" for fair market value down the road, the entire interest would end up in the trust.
5. The foregoing approaches are distinguishable from Proctor¹⁰¹ in that they use a "definition clause" rather than an "adjustment clause." The differential has been explained as follows:

"The IRS does not seem to have focused on valuation definition clauses to the same extent as it has focused on adjustment clauses. To the extent it has dealt with them, it has not indicated an opposition to their use. These kinds of clauses, to which we now turn our attention, may be more effective as a means of reducing the gift tax risk associated with the transfer of hard to value assets than are adjustment clauses.

"A valuation definition clause functions by leaving open the determination of how much property has been transferred to the purchaser or donee until value has been determined. It may be distinguished from adjustment clauses because it does not require a price adjustment or an adjustment in the amount of

⁹⁷ Comm'r. v. Proctor, 44-1 USTC ¶10, 110, 142 F.2d 824 (CA-4), cert. denied 323 U.S. 756 (1944).

⁹⁸ Estate of McLendon v. Comm'r., 66 T.C.M. 946 (1993).

⁹⁹ See Malcolm A. Moore, "Attempting to Achieve Finality in Potentially 'Open' Transactions," 29 U. Miami Inst. on Est. Plan., Ch. 13 at 1301.4 (1995).

¹⁰⁰ See various writings by Stacy Eastland.

¹⁰¹ Comm'r. v. Proctor, fn. 97.

property transferred. The transaction is complete, but the extent of the property sold or given is not fully known.¹⁰²

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

XX. Sale of GRAT Remainder Interest to a Dynastic Trust¹⁰³

- A. As previously mentioned, a GRAT is a popular wealth transferring strategy.
1. Although in most instances the installment sale is preferable to the GRAT, many advisors and their clients prefer the GRAT alternative, even where multigenerational planning is a viable consideration.
 2. The rationale for the GRAT selection under those circumstances would probably be that there is authority for the GRAT, both statutorily¹⁰⁴ and administratively and, if properly drafted, there is little valuation risk in setting up a GRAT.
 3. Additionally, the installment sale to a defective trust is generally considered to be a riskier transaction to structure and implement.
- B. The inability to take advantage of generation-skipping leveraging with the GRAT technique can be finessed by having the remainder beneficiary sell the remainder interest to a dynastic trust.
1. In order to avoid a gift by the GRAT remaindermen to the dynasty trust, the purchase price paid by the dynastic trust should be the fair market value of the remainder, as determined under IRC Sec. 7520.

¹⁰² See Carlyn S. McCaffrey and Mildred E. Kalik, "Using Valuation Clauses to Avoid Gift Taxes," Trusts & Estates (Oct. 1986).

¹⁰³ See David A. Handler and Steven J. Oshins, "GRAT Remainder Sale to a Dynasty Trust," Trusts & Estates (Dec. 1999) and Steven J. Oshins and Julie M. Wickett, "Installment Sale to a Defective Trust vs. GRAT Remainder Sale: An Economic Comparison," Trusts & Estates (June 2000).

¹⁰⁴ IRC §2702.

2. One alternative structure for the transaction is to make the remainder payable to a remainder trust for the benefit of the children. The remainder trust could be one already established by the client, or a new one that is nominally funded (e.g., with \$100). The trustee of the remainder trust would own a vested remainder in the GRAT that it would be able to sell to the dynastic trust. If the remainder trust and the dynastic trust are both defective trusts as to the grantor of the GRAT, the sale of the remainder will be a non-event for income tax purposes.
3. Another alternative structure is to make the remainder payable to the child outright. The child would have a vested interest that could be sold income tax-free to a dynastic trust that is defective as to the child.
4. Using either alternative structure, because the remainderman transfers its entire interest and does not retain anything, the ETIP rules will not apply.
5. It is best to have established the dynasty trust far in advance of the remainder sale to reduce the chance that the Service could successfully argue substance

4. Since the assets in a defective trust accumulate income tax-free, it is usually easy to produce such a return.
 5. This differential would inure to the benefit of the trust.
- B. A low interest loan can be used to help fund a life insurance trust.
1. The IRS has ruled that loans by a grantor to an irrevocable trust to enable the trust to pay life insurance premiums would not cause inclusion of the insurance proceeds in the grantor's gross estate.¹⁰⁸
 2. Since insurance on the life of the grantor has more potential for estate inclusion than other assets, it is important that the loan arrangement be properly designed so as not to cause estate tax inclusion of the trust assets.

XXII. Charitable Lead Trust

- A. A charitable lead trust ("CLT") is another method of leveraging the amount being transferred.
1. The value of the transfer is determined by subtracting the value of the front-end charitable interest from the value of the property transferred.
 2. For multigenerational planning, the charitable lead unitrust ("CLUT") is generally selected because GST tax exemption may be allocated immediately.
 3. Conversely, GST tax exemption may only be allocated to a charitable lead annuity trust ("CLAT") upon expiration of the charitable lead period.¹⁰⁹
- B. For the same reason that GRATs are favored over GRUTs, planners prefer to use the annuity version of the CLT rather than the unitrust alternative because more value can be allocated to the annuity interest than to the unitrust interest, even to the extent of zeroing out the gift.
1. Thus, it appears that the planner is faced with balancing the option in doing multigenerational planning, of (i) doing a CLUT and having a long front-end charitable term and making a gift, as compared to (ii) doing a CLAT and being able to compress the term of the charitable interest and zero-out the gift at a cost of restricting the transfer to the generation below the transferor.
 2. This problem may be finessed, since there appears to be no proscription in

¹⁰⁸ LTR 9809032.

¹⁰⁹ IRC §2642(e); TAMRA §1014(g)(3)(A).

creating a CLAT with very low transfer tax value, and having the remaindermen sell or gift his interest to a dynastic trust.¹¹⁰

3. The transaction is similar to the previously discussed sale of a remainder interest in a GRAT.
4. If this alternative is contemplated, the spendthrift provision in the trust should be drafted so that it does not preclude the transfer.

XXIII. Split-Dollar Life Insurance

- A. Virtually everybody familiar with estate planning knows the benefits of irrevocable life insurance trusts. Life insurance is generally regarded as a leveraged asset, and thus, a popular choice in dynastic trust planning.
- B. With the proliferation of large policies requiring large premiums, the alternative of using straightforward gifts of the premiums to fund the policy often will not result in the most favorable transfer tax result. In addition, gifts of the entire premium will use more GST tax exemption than some of the alternative funding devices.
- C. Split-dollar is a popular solution to this funding problem. By utilizing a split-dollar arrangement, the gift and GST tax exemption used will be measured by the economic benefit - the lower of the P.S. 58 (or for survivorship policies, P.S. 38) tables or one-year term cost. As a result of this gift being much lower than the cost of the insurance, the trust can acquire, and protect from transfer taxes, significantly more life insurance than could be purchased if a split-dollar arrangement was not used.¹¹¹

XXIV. Insurance Funding Opportunities Other than Split-Dollar

- A. Insurance professionals and other estate planners who work in the upscale marketplace are often faced with the problem of funding large life insurance policies within the annual exclusion limitations.

¹¹⁰ See, however, Michael D. Mulligan, "Allocating a Client's GST Exemption Most Effectively," Estate Planning (May 1997), p. 154, which takes the position that for purposes of Chapter 13 "[i]t is a trust's status as a CLAT that precludes allocation of GST exemption, not the question of whether the trust is includible in the transferor's estate. Status of a trust as a CLAT prevents allocation under Section 2642(e) by any party, whether the original transferor or a subsequent transferor of a remainder interest in the trust."

¹¹¹ Howard M. Zaritsky and Stephan R. Leimberg, Tax planning With Life Insurance, Warren Gorham and Lamont, §5.03(7)(e) at 55-37.

1. Despite taxpayer victories in cases such as Cristofani,¹¹² it is well recognized that the use of naked powers of withdrawal should be rejected as too risky.
 2. For many practitioners, the solution is to make taxable gifts.
 3. Nobody likes paying insurance premiums, but it certainly is much more tolerable than paying gift tax on the premiums.
 4. The forward-looking advisor will seek alternatives to resolve this problem.
- B. In addition to the gift tax issue, for those who wish to do dynastic planning, all transfers in trust, including a multi-generational insurance trust, have generation-skipping implications.
1. Prior to April 1, 1988, annual exclusion gifts to grandchildren also avoided the GST tax.
 2. For transfers subsequent to March 31, 1988, annual exclusion gifts in trust are not so protected unless made in a trust for a single beneficiary and includible in the beneficiary's gross estate.¹¹³
 3. As a result, but for the limited exception, all gifts to trusts have a "cost" for GST tax purposes, and those in excess of the annual exclusion will have a "cost" for estate and gift tax purposes.
 4. Further, many larger policies require premiums that can be projected to exceed the GST limitation.
 5. Although the use of a split-dollar agreement is often a viable solution, that approach has its own problems, particularly with regard to the rollout.¹¹⁴
- C. Two techniques discussed earlier in this outline, opportunity shifting and the installment note sale, will often produce better results than the split-dollar arrangement, or are extremely comparable with split-dollar. These approaches, as well as integrating some of the various strategies this outline has covered, show that the variations are only limited by the imagination of the advisor.
- D. Opportunity Shifting.

¹¹² Estate of Cristofani v. Comm'r., 97 T.C. 74.

¹¹³ IRC §2642(c).

¹¹⁴ TAM 9604001.

1. To illustrate, assume an estate owner has the opportunity to create a new product, move into a new location, start a collateral business, etc.
2. By shifting the opportunity to a dynastic trust, the trust could fund the policy with earnings from the new venture.
3. If the estate owner desires control, a limited partnership or limited liability company could be set up where the client would own the controlling interest and the trust could own the remaining interest, and such interest could be the bulk of the entity, but not the controlling interest.
4. If the insurance is on the life of the estate owner and/or his spouse, and the trust is entirely defective as to the grantor, the trust income would be taxed to the estate owner, and all earnings, undiminished by income tax, would be available to pay premiums.
5. If the insurance policy is on the life of someone other than the insured or insured's spouse, for example on the client's parent(s) or client's child, a Beneficiary Defective Trust could be created. In such instance, the life insurance proceeds could be used to acquire assets income tax-free from the insured's estate, due to a step up in basis,¹¹⁵ as well as from the "owner" of the trust as a result of IRC §678(a).
6. During the embryonic stage of the business venture where earnings often are not be sufficient to fund the premiums, the policy could be split-dollar.
7. The inherent problem of terminating split-dollar arrangements, in addition to problems such as those income tax problems discussed in TAM 9604001, and the concomitant gift and GST tax problems, can be avoided by using funds earned by the trust outside of the policy rather than by the policy through the internal cash buildup.

E. Installment Sale to Defective Trust.¹¹⁶

1. Assume that an estate owner with three children has a business valued at \$10 million dollars that has a cash flow after expenses of 10% or \$1 million; that the

¹¹⁵ IRC §1014.

¹¹⁶ See Steven J. Oshins, Al King, III and Pierce McDowell, III, "Sale to a Defective Trust: A Life Insurance Technique," Trusts and Estates (April 1998) and Steven J. Oshins, "Creative Life Insurance Funding Techniques for the Large Policy," CCH - Estate Planning Review (Sept. 20, 1999) for more information on the life insurance opportunities available using the sale to a defective trust technique.

value of a 33% interest after valuation adjustments is \$2 million; and that the interest rate under IRC §1274 is 6.5%.

2. Assume further that the business is operated either as a limited partnership or an LLC, or was placed in one of these entities prior to the note sale portion of the planning process.
3. The estate owner could set up defective trusts for the benefit of each of his children.
4. Each trust could include as a beneficiary the estate owner's spouse.
5. In an independent transaction, the estate owner could sell each of the three trusts a 33% interest in the entity for installment notes with face values of \$2 million, and interest payments of \$130,000 a year.
6. If the entity distributes its net cash flow, each trust would have \$200,000 available annually to pay premiums (\$330,000 pro rata cash flow less \$130,000 allocable to interest on the promissory note).

XXV. Conclusion

- A. Receiving property in trust is a superior alternative to outright ownership. For those who desire that control be lodged in the hands of a specific beneficiary or beneficiaries, rather than making distributions to the beneficiary upon reaching the age at which the donor believes the beneficiary will be able to manage the property, the Beneficiary Controlled Trust should be used. The beneficiary should become the controlling trustee upon attaining the specified age. This alternative is preferred over outright ownership because it offers the beneficiary estate tax, creditor and divorce protection.
- B. If the Beneficiary Controlled Trust concept is the preferred trust design for one generation, then it logically follows that the same trust design should be considered for successive generations. In fact, the trust should be drafted to continue for as long as state law permits. A limited number of jurisdictions do not have a limit on the duration of a trust. A co-trustee domiciled in one of those states can be used in order to establish the necessary contacts with the chosen state to use its favorable laws. The Beneficiary Controlled Trust can give the primary beneficiary the power to remove and replace the co-trustee.
- C. The trust can be drafted so that it is defective for income tax purposes. By having either the grantor or the beneficiary pay the income taxes, the trust grows income tax-free while at the same time reducing the grantor's or the beneficiary's estate. Since the "owner" of the defective trust can transact with the trust without any income tax ramifications, the "owner" can leverage the amount of assets in the trust by selling discounted assets to the trust for an installment note. Although the sale to a defective

trust is the primary leveraging technique, other leveraging techniques are also available. Practitioners should be more sensitive to opportunity shifting into a defective, dynastic trust and possibly combining that technique with installment sales or other leveraging strategies. Despite the fact that the GST tax only permits a \$1 million exemption (indexed for inflation), proper utilization of creative funding and leveraging designs can revitalize the dynastic trust as the ultimate family wealth tool and, indeed, for many families, virtually erode their tax and creditor exposure into perpetuity.

- D. Benjamin Franklin stated, "...nothing in this world is certain but death and taxes."¹¹⁷ Prof. Erwin N. Griswold distinguished the two stating: "We have long had death and taxes as the two standards of inevitability. But there are those who believe that death is the preferable of the two. 'At least,' as one man said, 'there's one advantage about death; it does not get worse every time Congress meets.'"¹¹⁸
- E. There is another differential. Despite all of the efforts of medical science, there is still no way to avoid death. However, this outline shows that while taxes cannot be completely avoided, through proper planning they can be reduced to more palatable levels.
- F. Many taxes are voluntary¹¹⁹ and are paid by persons who fail to engage in sophisticated tax planning.
- G. The ability of the knowledgeable insurance advisor to work effectively in the upscale wealth planning arena will produce many benefits for his or her clients as well as enhance his or her own productivity. Wealthy clients talk to each other and it would be reasonable to conclude that this word of mouth exposure will result in significant increased business.
- H. Moreover, the ability to find premium money as well as the fact that most of the superior wealth shifting strategies have survivorship features will result in a significant competitive advantage for insurance professionals who employ these techniques.

¹¹⁷ Jeffrey L. Yablon, "As Certain as Death - Quotations About Taxes," Tax Notes, Dec. 29, 1997 at 1485.

¹¹⁸ *Id.*

¹¹⁹ Cooper, fn. 9, *supra*.

ECONOMICS

**ASSUMPTIONS: \$1 Million; Trust Lasts 120 Years
And Earns 8%; 55% Transfer Tax Every 30 Years**

- **No Trust — \$420,436,792**

- **Dynastic Trust — \$10,252,992,943**

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

*Note that it is reasonable to assume that this amount will be further diminished by divorce and lawsuits.

LTR 9436006

This is in response to your February 8, 1994 letter and prior correspondence in which you requested rulings up sections 2701 and 2702 of the Internal Revenue Code.

On December 28, 1992, Taxpayer created Trust for the benefit of his descendants and their spouses. Under the terms of the trust agreement, Taxpayer cannot be a beneficiary or a trustee of Trust. Taxpayer funded Trust with publicly-traded stock valued at \$1,200,000.

Taxpayer intends to sell personal property consisting of additional publicly-traded stock and closely-held partnership units to Trust. In payment for the property, Trust will give Taxpayer a 25-year term note. The face value of the note will be the sale price of the property, which will be determined on the date of the sale. The note will bear interest at the Long Term Applicable Federal rate determined under section 1274 in effect at the time of the sale. The note will be negotiable and will provide for quarterly payments of interest with principal payable at the end of the term.

Section 2501(a)(1) provides that a tax is imposed for each calendar year on the transfer of property by gift during the calendar year by any individual.

Section 2511(a) provides that the tax imposed by section 2501 shall apply whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible.

Section 2701(a) provides that, solely for purposes of determining whether a transfer of an interest in a corporation or partnership to (or for the benefit of) a member of the transferor's family is a gift (and the value of the transfer), the value of any right--(A) that is described in section 2701(b)(1) and (B) that is with respect to any applicable retained interest that is held by the transferor or an applicable family member immediately after the transfer shall be determined under section 2702(a)(3).

Section 2701(b)(1) provides that the term applicable retained interest means any interest in an entity with respect to which there is--(A) a distribution right, but only if, immediately before the transfer described in section 2701(a)(1), the transfer and applicable family members hold control of the entity or (B) a liquidation, put, call, or conversion right.

Section 2701(b)(2)(B) provides that, for purposes of section 2701(b)(1) the term control for a partnership means--(i) the holding of at least 50 percent of the capital or profits interests in the partnership, or (ii) in the case of a limited partnership, the holding of any interest as a general partner.

Section 25.2701-2(b)(3) of the Gift Tax Regulations provides that a distribution right is the right to receive distributions with respect to an equity interest.

Section 2702(a) provides that, for purposes of determining whether a transfer of an interest in trust to (or for the benefit of) a family member of the transferor's family is a gift (and the value of the transfer), the value of any interest in the trust retained by the transferor or any applicable family member (as defined in section 2702(e)(2)) shall be determined as provided in section 2702(a)(2).

Section 2702(c)(3) provides that the term "term interest" means--(A) a life interest in property, or (B) an interest in property for a term of years.

Section 25.2702-2(a)(3) provides that the term "retained" means held by the same individual both before and after the transfer in trust. In the case of the creation of a term interest, any interest in the property held by the transferor immediately after the transfer is treated as held both before and after the transfer.

In this case, Taxpayer intends to sell units in a closely-held partnership to Trust and, immediately afterwards, will hold debt. Debt is not an interest that is subject to the provisions of section 2701. Therefore, we conclude that section 2701 does not apply to this transaction.

Also, Taxpayer intends to sell publicly-traded stock to Trust. In exchange, taxpayer will hold debt that is not a "term interest" within the meaning of section 2702(c)(3). Therefore, we conclude that the valuation rules provided in section 2702 do not apply to this transaction.

Except as we have specifically ruled herein, we express no opinion about the proposed transaction under the cited provisions of the Code or any other provisions of the Code.

This ruling is directed only to the taxpayers who requested it. Section 6110(j)(3) provides that it may not be used or cited as precedent.

Sincerely,

Assistant Chief Counsel
(Passthroughs and Special
Industries)

By _____
Richard Grosgebauer
Chief, Branch 4

LTR 9535026

This is in response to your letter dated April 20, 1995, and prior correspondence in which you requested rulings under sections 671, 2036(a), 2512, 2701, and 2702 of the Internal Revenue Code.

In 1992, A established an irrevocable trust ("Trust") for the benefit of his three children. Trust provided for a separate share for the benefit of each of three children, B, C, and D. Under the terms of the Trust, the beneficiaries of each separate share include the named child, his or her spouse or unmarried surviving spouse, descendants, spouses and unmarried surviving spouses of descendants. A's wife and a bank are named trustees. The Trust establishes a "Protector" to review the performance of the trustees. A and his children can not serve as trustees or Protector.

A transferred assets to the three separate shares of Trust. Each child has also made transfers to his or her respective share. Pursuant to authority conferred upon the Trustees under Item Six of Trust, the trustees divided each share into two portions: one to hold assets transferred by A and one to hold assets transferred by the respective child. With respect to the second portion, the trustees have created a separate trust. Thus, each separate trust estate, consists solely of assets contributed by the respective child.

Each child proposes to sell Stock to his or her respective separate trust (RST). In return for the stock, each child will receive a promissory note from the RST. The trustees of the RST will pay interest for 20 years to each child. A balloon payment of principal will be paid at the end of 20 years. The notes will bear sufficient interest such that the loan will not be characterized as a below market loan under section 7872. The notes provide that payments of interest and principal may be paid in cash or property, but in no event shall any payments be made by promissory notes. The note issued by the RST will be secured by the stock transferred to the RST.

The trusts provide that the Trustees shall distribute to such of the beneficiaries of any such separate share thereof, as the Trustees shall designate, living on any distribution date, all or such amount or amounts of the net income and principal of such separate share as the Trustees shall from time to time determine to be appropriate for any reason whatsoever.

You have requested the following rulings on behalf of B, C, and D.

1. The RST will be considered a grantor trust under sections 675 and 677. Accordingly, the sale of stock to the RST by the child will not be recognized for income tax purposes by virtue of section 671. Therefore, all items of RST income, deduction and credit will be included in the child's individual income tax returns. No capital gain arising from the sale will be recognized by the child. The trust will assume the child's basis in the Stock. The RST will not be entitled to a deduction for interest paid to the child and the child will not be required to include interest income from the notes in taxable income.

2. The fair market value of the notes issued in consideration for the purchase of stock by each RST will be for purposes of Chapter 12 of the Internal Revenue Code, the face amount of the notes. The sale will not be considered a gift to the extent the fair market value of stock transferred to the RST in exchange for the note does not exceed the face amount of the note.

3. The note issued by the RST to the child will not constitute applicable retained interests under section 2701.

4. Section 2702 is not applicable to the proposed transaction.

RULING REQUEST 1

Section 671 of the Code provides that where the grantor or another person shall be treated as the owner of any portion of a trust, there shall then be included in computing the taxable income and credits of the grantor or the other person those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust to the extent that such items would be taken into account under Chapter 1 of the Code in computing taxable income or credits against the tax of an individual.

Sections 673 through 677 of the Code specify the circumstances under which a grantor is treated as the owner of a portion of a trust.

Section 677(a) of the Code provides in part that a grantor shall be treated as the owner of any portion of a trust, whether or not he is treated as such under section 674, whose income without the approval or consent of any adverse party is, or, in the discretion of the grantor or a nonadverse party, or both, may be distributed to the grantor or the grantor's spouse or held or accumulated for future distribution to the grantor or the grantor's spouse.

Rev. Rul. 85-13, 1985-1 C.B. 184, holds that, if a grantor is treated as the owner of an entire trust, the grantor is the owner of the trust's assets for federal income tax purposes. Therefore, a transfer of assets to the trust by the grantor who owns the entire trust is not recognized as a sale for federal income tax purposes.

In the present case, each child will sell stock solely to his or her wholly owned trust (RST). Under section 677(a) of the Code, each child is the owner of the RST of which he or she is the grantor. Each child will be considered the owner of his or her respective RST for purposes of section 671 and shall include in computing his or her taxable income those items of income, deductions, and credits against tax which are attributable to his or her RST.

In accordance with the holding set forth in Rev. Rul. 85-13, we conclude that none of the children nor their RST will recognize any gain or loss as a result of the transfers of stock to their RST. Each RST will assume its respective child's basis in the stock transferred. Each RST will not be entitled to a deduction for interest paid to the respective child, and each child will not include interest income

from the notes in his or her taxable income.

RULING REQUEST 2

Section 2501(a)(1) provides for the imposition of a gift tax on the transfer of property by gift. Section 2511(a) provides that the gift tax applies to a transfer by way of gift whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible.

Section 2512(a) provides that, if a gift is made in property, the value thereof at the date of the gift shall be considered the amount of the gift.

Section 25.2512-5A(d)(1)(i)(A) provides that, where a donor transfers property in trust or otherwise and retains an interest therein, the value of the gift is the value of the property transferred less the value of the donor's retained interest.

Section 1274(d)(1) provides that the applicable federal rate for a debt instrument with a term of over nine years is-

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In *Frazer v. Commissioner*, 98 T.C. 554 (1992), the Tax Court addressed the issue of whether, for gift tax purposes, the fair market value of a promissory note issued by children to their parents in exchange for real property must be determined by use of a discount rate prescribed under section 7872, or the safe-harbor rate provided under section 483(e). The court also considered the application of the rates prescribed under section 1274. The court concluded that section 7872 applied in determining the gift tax treatment of below-market loans regardless of whether the transaction involved a sale of property or a cash loan. The court reaffirmed its earlier position in *Krabbenhoft v. Commissioner*, 94 T.C. 887 (1990), *aff'd* 939 F.2d 529 (8th Cir. 1991), that section 483 does not apply for gift tax purposes. In concluding that section 1274 was not applicable in valuing the note for gift tax purposes, the court stated that section 1274 characterizes installment payments as principal or interest and, where stated interest is inadequate, it imputes interest. On the other hand, the court noted section 7872 was enacted specifically to address the gift tax treatment of below-market loans. Thus, the court concluded that the application of section 7872 is not limited to loans of cash. Rather, the term "loan" under section 7872 is broadly interpreted to include any extension of credit.

As noted above, for term loans, in determining whether a loan is a below-market loan, section 7872(f)(1) and (2) requires use of a discount rate equal to the applicable federal rate in effect under section 1274(d) on the date the loan was executed. Section 1274(d)(1)(A) uses the applicable federal long-term rate for debt instruments with a term of over nine years. Thus, in general, under section 7872, a promissory note for a term longer than nine years is not treated as a below-market loan if the interest rate on the note is equal to or higher than the applicable federal long-term rate, compounded semiannually.

In the present case, the stated interest rate on the notes will equal the rate prescribed by section 7872. Thus, we conclude that, if the fair market value of the stock transferred to the RST equals the principal amount of the note, the sale of stock to the RST will not result in a gift subject to gift tax. This ruling is conditioned on satisfaction of both of the following assumptions: (i) No facts are presented that would indicate that the notes will not be paid according to their terms; and (ii) the RST's ability to pay the notes is not otherwise in doubt.

RULING REQUESTS 3 & 4

Section 2701(a) provides that, solely for purposes of determining whether a transfer of an interest in a corporation or partnership to (or for the benefit of) a member of the transferor's family is a gift (and the value of the transfer), the value of any right -- (A) that is described in section 2701(b)(1)(A) or (B); and (B) that is with respect to any "applicable retained interest" that is held by the transferor or an applicable family member immediately after the transfer, shall be determined under section 2701(a)(3).

Section 2701(b)(1) provides that the term "applicable retained interest" means any interest in an entity with respect to which there is -- (A) a distribution right, but only if, immediately before the transfer described in section 2701(a)(1), the transferor and applicable family members hold control of the entity or (B) a liquidation, put, call, or conversion right.

Section 25.2701-2(b)(1) of the Gift Tax Regulations provides that an applicable retained interest is an equity interest in a corporation or partnership that is either an extraordinary payment right or a distribution right.

Section 25.2701-2(b)(3) provides that a distribution right is the right to receive distributions with respect to an equity interest.

Section 2702(a) provides that, for purposes of determining whether a transfer of an interest in trust to (or for the benefit of) a family member of the transferor's family is a gift (and the value of the transfer), the value of any interest in the trust retained by the transferor or any applicable family member (as defined in section 2702(e)(2)) shall be determined as provided in section 2702(a)(2).

Under section 2702(c)(1), the transfer of an interest in property with respect to which there is 1 or more "term interests" shall be treated as a transfer of an interest in trust.

Section 2702(c)(3) provides that the term "term interest" means -- (A) a life interest in property, or (B) an interest in property for a term of years. See also, section 25.2702-4(a).

Section 25.2702-2(a)(3) provides that the term "retained" means held by the same individual both before and after the transfer in trust. In the case of the creation of a term interest, any interest in the property held by the transferor immediately after the transfer is treated as held both before and after the transfer.

In this case, B, C, and D will sell Stock to their RST, and immediately afterwards, will hold debt. A debt instrument is not an applicable retained interest that is subject to the provisions of section 2701. Therefore, we conclude that section 2701 does not apply to these transactions.

In this case, B, C, and D will sell Stock to their RST. In exchange, they will receive debt. Under the facts presented here, the debt instrument involved is not a "term interest" within the meaning of section 2702(c)(3) and the applicable regulations. Therefore we conclude that the valuation rules provided in section 2702 do not apply to these transactions.

The above rulings (2-4) will be considered void if the promissory notes are subsequently determined to be equity or not debt. We express no opinion about whether the notes are debt or equity because that determination is primarily one of fact (section 4.02(1) of Rev. Proc. 95-3, 1995-1 I.R.B. 85 (94)). Nor do we express any opinion as to the collectibility of the notes.

Except as we have specifically ruled herein, we express no opinion about the federal tax consequences of the transaction under the cited provisions or under any other provisions of the Code. Specifically, we are expressing no opinion regarding the application of sections 2511 or 2702 to any other transfers to the RSTs. See, e.g. Rev. Rul. 77-378, 1977-2 C.B. 348. Additionally, we are expressing no opinion regarding the application of section 2036 to the transaction.

This ruling is directed only to the taxpayers who requested it. Section 6110(j)(3) provides that it

may not be used or cited as precedent.

Sincerely,

Assistant Chief Counsel
(Passthroughs and Special
Industries)

By _____
George Masnik
Chief, Branch 4