The Inheritor’s Trust: The Art of Property Inheriting Property

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THE INHERITOR’S TRUST™1
The Art of Properly Inheriting Property

by

Richard A. Oshins and Noel C. Ice

Introduction

This article introduces a powerful new concept, which we believe expands the ability of trusts (and the dynastic trust in particular) to protect family wealth. Our mission is to demonstrate the vast opportunities available in structuring "in trust" gifts and inheritances to our clients, even in instances where the visceral reaction is that the transfer is rather de minimis and not deserving of the costs and complexities of setting up the trust, and/or that the client's wealth is so large that generally a potential inheritance is not a compelling concern. Indeed, a small gift in a properly structured dynastic Inheritor's Trust™ by a parent as "seed" money invested in a startup venture that ultimately is economically successful is the ultimate estate planning vehicle. The parent's gift in trust will enable the client to achieve tax savings and a shelter from creditors that the client could not produce for himself.

What is an "Inheritor's Trust™"?

Estate planning is generally viewed as "the process of making the most effective disposition of a client's wealth with the least diminution in value consistent with family goals and values".

Upstream Planning2

When most planners do estate planning they tend to look at structuring their client’s wealth to pass to younger generation beneficiaries. The focus is on using techniques to defund the client's estate. Insufficient attention is given to planning with wealth before it is received by the beneficiary, particularly in suggesting that the client request an "advance" on his or her "inheritance". In many instances, such a gift can have a dramatic effect on the client's ability to plan.

Typically, the only inquiries made about senior generations are (i) do we need to make provisions for older generations' support; or (ii) will our client be receiving an inheritance that we need to take into account in structuring our client's estate plan. A

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virtually untapped segment of the family wealth planning process is advising our clients about how gifts and inheritances that they receive should be structured. We refer to such a receptacle trust, typically drafted from the viewpoint of the donee or Inheritor (hereinafter collectively referred to as the "Inheritor"), as the "Inheritor's Trust™". The Inheritor's Trust™ significantly accentuates the thesis that all gifts and inheritances should be made in and retained in trust because holding assets in a trust controlled by the Inheritor improves the value of the assets to the Inheritor.

After we describe the substantial benefits that property received and retained in trust provide, we then will review the extraordinary untapped opportunities available by having the clients look toward senior (e.g., a parent or grandparent) generations3 to fund a trust for the benefit of, and controlled by, the client.

**The Benefits of an "In Trust" Inheritance**

As advisors we should be sure our clients not only leave property in trust, but also receive property in trust. Although the benefits that can be derived by receiving and keeping gifts and inheritances in trust "...are as unlimited as the imagination of the lawyers..."4 we will focus on those with a more global application in the estate planning process. One of those is sheltering wealth from the claims of the beneficiary's three largest potential claimants: the IRS (taxes), divorcing spouses, and creditors in bankruptcy. This shelter attaches because for transfer tax and property rights purposes the beneficiary "owns" nothing.

**Put in Trust - Keep in Trust**

From a wealth conservation prospective, no other technique offers as much protection from the IRS and other would be claimants as an irrevocable trust, set up and funded by someone other than the Inheritor, and this is true even though the Inheritor has the full use and beneficial enjoyment of the "in trust" property, including virtually "full control" over the property.

A "must read" syllabus on this topic concludes that "[i]nheriting in trust is better than inheriting outright."5 The authors state:

"Many people (including a number of advisors who should know better) overlook trusts in their preference for a “simple” outright inheritance. Tragically, such people do not realize the enormous, unnecessary, and irretrievable loss of assets their families will likely suffer by failing to

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3 An Inheritor's Trust™ can be set up by anyone other than the client himself or herself, even a spouse, and most of the benefits described herein could be obtained. It would be unusual for someone other than an older generation to create such a trust, but it can occur and in our experience has happened.


appreciate the benefits that passing wealth from generation to generation in trust can achieve.  

Despite the large tax bite of the wealth transfer tax system, our increasingly successfully litigious society and the fact that not only do more marriages terminate by divorce than death, but also that the proportion of unsuccessful marriages is increasing, many wealthy families (possibly due to inadequate advice) do not sufficiently incorporate protective measures in their estate planning. The primary failure is the inadequate use of, and under-utilization of trusts. The over-riding concept that unfortunately is not grasped is that assets placed into a trust by someone other than the beneficiary himself are a far more valuable commodity to the Inheritor than those same assets would be if received outright. 

Many important advantages can be obtained solely because assets are received and continue to be held in trust, rather than being received outright either from the transferor or from a trust distribution. Assets received and retained in trust are protected from the substantial unnecessary and irretrievable exposure to the beneficiary's predators - including a divorcing spouse, a creditor or the IRS.

**Transfer Tax Benefits**

The transfer tax benefits of trusts are well known to estate planners. The magnitude of the opportunities were illustrated by Harvard Law School Professor A. James Casner when he told Congress that "in 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." The enactment of the GST tax has eliminated the ability to simply place an unlimited amount of one's assets into a perpetual or dynastic trust. For many, however, the exemption limitation is merely a small bump in the road, because of leveraging techniques employed by knowledgeable estate planning advisors.

**Creditor Rights**

In addition to tax planning, protection against wealth diminishment from lawsuits and failed marriages is an essential ingredient in the modern estate plan. Because of the general litigious nature of our society, the increasing success plaintiffs are enjoying, and the proliferation of divorces, asset protection should be an integral portion of the planning process. It is reasonable to assume that virtually any client faced with the simple inquiry - do you desire that your children's and grandchildren's inherited wealth be sheltered from loss to the IRS, or other creditors, including a disgruntled spouse, would answer in the affirmative. A candid client who is asked if he would like his own assets to be insulated from the same potential claimants would also desire such protection. It would also be a reasonable observation that although there is a general dislike of paying taxes, paying to the federal fisc would be generally more palatable for most than paying a judgment creditor or a divorce settlement.

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6 Keydel and Wallace, supra, footnote 5, p. 1.
7 Keydel and Wallace, supra, footnote 5; Calleton, McBryde and Oshins, supra, footnote 5; Aucutt, supra, footnote 5.
Each of us has met with clients who desire creditor protection and who inquire into the usefulness of either an off-shore or domestic asset protection planning trust. The jury is out on many aspects of those self-settled trusts. For transfers received and retained in a spendthrift trust, even the most avid proponent of the self-settled asset protection trusts would concede that the creditor protection (as well as the tax benefits) afforded by an Inheritor’s Trust™ are superior to that of a self-settled trust. In fact, the trust design that we advocate, a discretionary trust with an independent trustee to make discretionary distributions, is not only the most tax efficient structure, but is also "...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." Even if we assume that the family unit will not do anything to cause liability, we all know that there is a reprehensible, morally bankrupt, segment of our population, including ethically challenged lawyers, who will take advantage of the vagrancies and risks inherent in the judicial system. Why expose the wealth to the wrongful decision of a jury?

Characteristics of the Inheritor's Trust™

Functional Equivalent of Outright Ownership with Predator Protection

The general thesis of this article is that every gift or bequest should be made "in trust" because the fact that the assets are in trust improves their value to the Inheritor. Because the trust entity is the best vehicle for both transfer tax avoidance, as well as creditor and divorce protection, we are suggesting that all (but de minimis) transfers be made in trust. Indeed, in the hands of a capable draftsperson, the perpetual or dynastic trust can be drafted so that "...the intervening generation could be given the equivalent of absolute ownership of trust assets through powers of appointment and trust powers. [Therefore, for the trust beneficiaries]...estate planning is no problem, because the trust is the best built-in estate plan."10

The colonists fought to prevent "taxation without representation"; the Inheritor's Trust™ achieves "representation without taxation" - full control and enjoyment over property outside of the transfer tax system.

The Inheritor's Trust™, as the title suggests, is a trust typically designed from the viewpoint of the Inheritor which gives the Inheritor control and the beneficial enjoyment over the trust property, as close to outright ownership as possible, without compromising the IRS and other predator protection that trusts offer. This trust must be funded by someone other than the Inheritor himself or herself.

By integrating many of the sophisticated wealth shifting strategies estate planners often use into such an Inheritor's Trust™, considerable shelter from the IRS and creditors can be obtained which have previously been ignored. In addition, we have found that most clients are particularly enamored by the ability to have full use and control over the

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10 George Cooper, "A Voluntary Tax?", The Brookings Institute, Washington, D.C., 1979, p. 57
assets until death (sheltered from predators) and not have to "give" the assets away in order to achieve tax savings and creditor protection.

**Structure**

The Inheritor's Trust™ may be designed using a single trust indenture which breaks into separate trusts to accomplish maximum tax efficiency. For instance, there would usually be separate trusts for GST exempt and non-exempt transfers. Trusts which have different income tax consequences would also usually be separate so that a grantor trust would not be co-mingled with a non-grantor trust.

Alternatively, separate trusts can be set up. For example, one trust document might be set up for a trust whereby the donor is treated as the owner, and a separate trust documents that creates a beneficiary defective trust.\(^\text{11}\) Because a trust under which the donor is treated as the owner ceases such status at death of the donor, bequests could be made to that trust. On the other hand, bequests should not be made to beneficiary defective trusts, since this would cause mixed income tax consequences.

The design of the Inheritor's Trust(s)™ will generally include all or most of the following attributes:

1. **Perpetual.** The Inheritor's Trust™ will be dynastic, designed to continue for as long as the applicable law permits. Many clients will forum shop to obtain a longer perpetuities period than would be otherwise available. Often this is accomplished by selecting a trust company with offices in a state which has abolished the rule against perpetuities. Even if transfer taxes were not considered important, the non-tax considerations and benefits inherent in the trust vehicle suggest the use of trusts.\(^\text{12}\) It has been stated that, "It 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 anticipated."\(^\text{13}\)

2. **Separate Exempt and Non-Exempt.** The trust would provide for separate GST exempt and non-exempt trusts with inclusion ratios of either zero or one.

3. **Separate Income Tax.** If a single trust indenture were used, the main trust would provide for separate trusts for separate income tax payers in a manner similar to the segregation of separate trusts for GST purposes. Thus, separate trusts could be set up for (a) gifts where the transferor is treated as the owner (the typical income tax defective trust under IRC §§671-677 or 679); (b) gifts which tax the client/beneficiary as the owner under IRC §678; (c) trusts whereby perhaps a child of the client would be taxed as to income tax owner;\(^\text{14}\) and, (d) transfers which are subject to the general trust income tax

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11 See Beneficiary Defective Inheritor's Trust™ - IRS §678(a), infra.
14 Although the Kiddie Tax has reduced the income shifting ability previously available, there often is a substantial opportunity to shift income after the child attains 14 until the child attains the high bracket of the parent. IRC §1(g).
rules whereby the trust is taxed as a separate entity under Subchapter J. Each Crummey beneficiary would have his own separate trust, if the Crummey beneficiary was treated as the owner of the trust income under IRS §678. The result of mixing different income tax results is an accounting15 and planning nightmare, which should be carefully avoided.16

4. Trustee Can Set Up or Merge Trusts. The trust could provide the Trustee could set up "secondary trusts" or "sub-trusts" and could merge trusts in appropriate situations. For instance, after the death of the grantor, the grantor trust status would end and such a trust could be merged into a trust which was a non-grantor trust without creating income tax complications. Alternatively, the Trustee may carve out a portion of the trust creating a new sub-trust which might purchase a remainder interest in a GRAT (see "Vehicle to Purchase Remainder Interest - A Generation-Skipping GRAT or CRAT", infra).

5. Full Control. It is our experience that clients are extremely pleased that their descendents and other objects of their bounty (and, if they respond candidly, themselves) receive protection from these claimants (to the extent property is received in the form of an Inheritor’s Trust™). In most instances, however, the trust vehicle is desirable to the Inheritor only if the Inheritor is either placed in control, or, if the Inheritor is not sufficiently mature, if he will at the appropriate time be placed in control of the trust. The combination of sheltering family wealth from the claims of predators and the Beneficiary Controlled Trust leads to the "conclusion (that from the perspective of the donee/beneficiary), inheriting in trust is always better, provided the beneficiary has adequate control over his trust!"17

Thus, the client would be in "full control" of the trust as Trustee, except that an Independent (or Special) Trustee would have tax sensitive powers. Therefore, the client would have all investment and management control in his capacity of Trustee just like he would have if the property were owned outright except for life insurance on his own life. There are several variations of this. For example, many of our clients use professional Trustees, such as a Trust Company as the Independent Trustee. Some clients place full investment control in the hands of the primary beneficiary/trustee and some of those clients will hire the Trust Company to manage the assets. Some other clients share the investment responsibilities with the Trust Company and have a veto power over the investments. The variations are virtually unlimited, so long as the tax sensitive powers do not ever become lodged in a beneficiary/trustee’s hands in a manner which would result in adverse tax or creditor exposure. Use of a professional trustee has increased importance in these types of trusts since the enhancements of the “in trust” inheritance are lost only through poor investments or bad record-keeping. The use of an experienced capable trustee often makes sense so that the integrity of the trust vehicle is compromised. Proper record-keeping increases in importance with dynastic trusts. Not

15 See PLR 9034004 which illustrates the computation of the income tax consequences of a lapsing 5% or 5,000 power. The ruling holds that the powerholder has increasing grantor trust exposure every time a power of withdrawal lapses.
16 From a planning perspective there is often both positive and adverse income tax treatment as to transactions by the grantor for income tax purposes with the trust.
17 Keydel and Wallace, supra, footnote 5, page 3
only are the stakes higher but generally there are more trustees and a greater chance of using one without the requisite skill.

The client would have control over the identity of the Independent Trustee. The ability to fire and replace the Trustee would be limited only by the restrictions necessary to preserve the tax status. There is no requirement that a confrontational relationship exist. The office of Independent Trustee may be occupied by the client's best friend.

6. Special Power of Appointment (Re-Write Power). The client would be given the power to literally re-write the trust. The re-write power is tax neutral as long as a general power of appointment is not created. Therefore, the client/powerholder may amend the trust exercising the power in favor of anyone other than himself, his estate or the creditors of either, in trust or outright without transfer tax exposure.

In most dynastic, beneficiary controlled trusts, the primary beneficiary (which in an Inheritor's Trust™ is initially the client) (on a per stirpital basis), is given a re-write power through a broad special power of appointment.

The restrictions which are necessary to avoid general power of appointment status are for practical reasons really meaningless. Although the client cannot exercise the power to benefit his estate, he may exercise it directly to the beneficiaries of his estate or to a trust (designed by the powerholder himself) for the benefit of the beneficiaries. It is almost inconceivable that a powerholder, whose assets are protected by the trust wrapper would desire to exercise the power in favor of his creditors or the creditors of his estate. If the powerholder desires to have the trust amended for his own benefit, the trust could permit a non-beneficiary to hold such a power of amendment. This person could be an Independent Trustee (whose identity could be controlled by the client-powerholder within the restraints of Rev. Rul 95-98) or a "trust protector" whose identity can be determined by the primary beneficiary provided that a successor trust protector must be a permissible person who could be a substitute trustee as described in Rev. Rul. 95-98.

The virtually unrestricted ability to amend the trust adds flexibility to adapt to changes in the law, family circumstances, the attitude of the primary beneficiary, etc. at least equal to outright ownership, and in many instances it gives the trust flexibility in excess of outright ownership. For example the trust, under the direction of the primary beneficiary as Management Trustee could acquire a home for a child's use without adverse tax consequences. If there was not a trust, the parent would have to make gifts to the child and lose control, or alternatively, acquire a home individually, and let the child use it. Unlike the rent-free use of a home owned by a trust, the rent-free use of a home owned by a parent could have adverse gift tax consequences. At death the home will be included in the parent's estate.

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19 One exception, beyond the scope of this article is the Delaware Tax Trap whereby an exercise in trust may not extend the duration of the trust beyond the original perpetuity period. IRC §§2041(a)(3) and 2514(d).
20 IRC §§2041(b)(1); 2514(c).
In addition to its extraordinary flexibility, a broad special power of appointment is integral in placing the client, and successor primary beneficiaries, in "full control" of the trust. Because the client can re-write the trust and exclude secondary and more remote beneficiaries, it is reasonable to assume that there would not be any interference with the client's managerial and other functions by an adverse beneficiary whose participation could be eliminated.

**Why this Works**

An often overlooked point is that the planning must be done in advance. Once a gift or inheritance is received by the Inheritor, it is too late to maximize the predator protection. From a planning viewpoint, it is far easier to avoid the onerous taxes and creditor interference before the receipt of the property than to disgorge existing wealth particularly where the desired benefactor retains an interest. The key here is that the shelter is only available if the trust is created and funded by someone other than the beneficiary and the assets remain in the trust segregated from the recipients' other assets.

If the client funded such a trust for the benefit of himself there would be estate tax inclusion.\(^\text{21}\) The so-called "string sections" of the Code include in a decedent's estate transfers for less than adequate consideration where the decedent had retained an interest in such transferred property. Thus, inclusion would be predicated on the fact that there was (i) a gratuitous transfer and (ii) the transferor/decedent retained a right in, interest in or enjoyment of the property. Because the Inheritor's Trust™ is funded by someone other than the trust's beneficiary (which can include a spouse) the "string sections" do not apply and inclusion, if any, would be by under IRC §2041 as a general power of appointment. Certainly, it is easy to draft a trust avoiding such exposure.\(^\text{22}\)

In addition to adverse tax consequences, a self-settled trust in most states\(^\text{23}\) would be accessible by creditors to the maximum amount which could be paid to the beneficiary,\(^\text{24}\) which would be the entire trust.

Thus, it is essential to plan for the expectation before it matures. Once the client has an outright interest in a venture that has turned out to be valuable, the client will be unable to retain an interest while keeping the property out of the client’s estate or out of the hands of the client’s predators, because the client cannot retain an interest in the transferred property and still avoid IRC §2036(a)(1) and creditor exposure.

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21 IRC §§2036 and 2038.
22 Keydel and Wallace, supra, footnote 5; Calleton, McBryde and Oshins, supra, footnote 5; Aucutt, supra, footnote 5.
23 Certain states, Alaska, Delaware, Rhode Island, Nevada and Utah have passed statutes changing this general rule at least for domiciliaries of those states. With regard to domiciliaries of other states who attempt to take advantage of these favorable domestic asset protection jurisdictions, the creditor rights issue, and if the creditor protection is unavailable the property would be includible in the Grantor's estate and any attempted use of the GST exemption would be unsuccessful because of the ETIP rule of IRC §2642(f)(1).
24 Restatement (Second) Trusts §156 (1951).
Dramatic Expansion of Planning Opportunities

An “in trust” gift and inheritance receptacle for transfers from a senior generation substantially expands family wealth protection by shifting it up a generation to the client's level, in that it enables the client to obtain benefits for himself that he could not create for himself. An opportunity generally overlooked in the planning process is that even the affluent client should receive gifts and inheritances from others, virtually irrespective of size, in trust. This course of action creates significant opportunities not otherwise available to the Inheritor to erode the transfer tax system, to shift income taxes and to avoid other claimants in addition to the IRS.

By having an Inheritor's Trust™ in place, or having one set up in conjunction with the planning process of setting up the business or investment opportunity, the estate planning process is simplified, and the client's goal of full control and enjoyment of the property can be achieved. The fact that this course of action is not part of the overall planning process for most clients, after balancing the benefit inherent in ownership by an Inheritor's Trust™, is unsupportable in many instances, particularly where the client's track record of success is proven. When advised of the benefits which are obtainable using the Inheritor's Trust™ concept, we find many clients accelerate the planning implementation to the inception of the undertaking, rather than waiting to engage in the inferior more expensive wealth shifting strategies they would need once the value has matured.

Use a "Beneficiary Controlled Discretionary Trust"

Since wealth received and retained in trust is far superior to wealth received either outright or from trust distributions (because they solve the two most significant concerns of clients seeking wealth planning advice), we wonder why property is so often transferred outright, and why, when placed in trust, the trust is often created with a mandatory pay-out. For those clients who wish to preserve their estates for the family unit (or for charity), rather than expose them to claimants, it is difficult to justify an estate plan that does not follow "a put it and keep it in trust" design.

Most authors, speakers and planners approach the trust design with a view of restricting the access, beneficial enjoyment and control of trust assets. We concede that for many beneficiaries that approach makes sense at least until the attainment of projected maturity. On the other hand, certainly at the time outright distribution is considered, the restrictions should end and the property should remain in trust subject to the control of the intended recipient. Moreover, a large number of our clients believe that children and other Inheritors are mature and responsible. They would be inclined to give the property outright but for the protections available in a trust. These clients should consider the Beneficiary Controlled Inheritor's Trust™, rather than the "traditional trust", i.e., an inflexible mandatory payout trust which that is controlled by someone other than the primary intended beneficiary.

For our clients (many of whom are savvy in business and often so sufficiently affluent that they do not need the inheritance), most of whom are potential inheritors, and often recipients of periodic outright gifts, we suggest the Inheritor's Trust™ as the
recipient of gifts and subsequent bequests rather than the client individually (or as some advisors suggest by passing the client entirely or relying on the use of disclaimers). If you conclude that some (or any) of the many benefits illustrated in this article make sense, consideration should be given to having the client approach the potential transferor and request that gifts and bequests be made in trust, whereby the client/Inheritor would control the design of the trust. Certainly, a transferor who would be inclined to transfer property outright should not object to making the transfer to an "Inheritor's Trust™" which would be designed by the Inheritor with rights and controls that would give the Inheritor enjoyment virtually tantamount to (and as a result of predator protection benefits in excess of) outright ownership. It is our experience that with proper counseling as to how an "in trust" gift or bequest improves the transfer, that almost all potential donor/transferors will cooperate with the advised course of action.

Opportunity Shifting

The Technique

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

In its simplest form, if a person was to refer business, customers or clients to another person, or give some gratuitous advice to the other person, no one would think a transfer subject to the gift tax has occurred. Those activities happen frequently. There is no restriction on the identity of the recipient of a valid shift of opportunity. Thus, the opportunity may be shifted to a trust rather than an individual. In its optimal form for most clients, the quintessential shift would be into an Inheritor's Trust™.

Thus, when a new business is formed, a new product is being developed, a new location is being considered, or the family has an investment opportunity, a new entity should also be formed, and some or all of the equity interests offered in the new entity should be placed in irrevocable trusts. In many instances, the "seed" money is negligible to enable the recipient of the opportunity to acquire a significant interest in a venture that can reasonably be predicted to explode in value.

In the real world, a considerable portion of intra-family diversion of wealth-generating opportunities occur "...even though the parties engaging in it may not be conscious of the substantial estate-planning implications of their actions..." Especially if one is an active businessman or investor, opportunities for bringing one’s prospective heir into a profitable activity occur with regularity.

26 Cooper, supra, footnote 10.
Advisors who counsel their clients at the inception of a new opportunity to set up a structure whereby the fruits of a new venture are shared by the family members are generally viewed as extremely sophisticated particularly where (i) the entity is structured whereby the family has voting control of the entity and the opportunity shift is to a trust rather than outright. In most instances, the client, given a choice, would have the entire entity available to him (as well as other family members) but in his full control.

**Getting an Advance on Your Inheritance**

Planners often overlook inquiring as to whether the client's parent has the ability and inclination to fund a trust for the client's benefit. Even persons of somewhat modest means can often come up with, and are willing to part with, sufficient seed money for a predictably "hot" investment or business venture, such as a new business entity that will be designed to receive referrals from a present successful business, or another opportunity shifting scenario.

If the Inheritor's Trust™ is most advantageously designed the entity may be placed in (i) an income tax defective trust so that the parent or grandparent is taxed; (ii) a beneficiary defective trust so that the client is taxed; (iii) a traditionally taxed trust; or, (iv) interests in the entity may be allocated among the various trusts set forth above in (i) through (iii).

Although opportunity shifting, particularly where the recipient is a trust is an extremely powerful wealth planning technique it is very seldom used. The advisor who does not consider it where a new venture is being set up is not only short-changing the client who is relying on his advice but is forgoing his ability to earn additional fees.

**Look Upstream to "Seed" the Trust**

Many of our clients have the ability to take a small amount of money and create large wealth. An extraordinary opportunity exists by looking up a generation as part of the planning process. When the client is about to embark on a new venture or has an investment opportunity with significant potential, consideration should be given to having the client’s parent(s) or grandparent(s) create and fund a trust for the client. Money placed in a dynastic Beneficiary Controlled Inheritor's Trust™ funded by the client’s parent(s) or grandparent(s) would provide the “seed” money for any such anticipated business venture or investment.

**Avoid Step Transition**

As long as the client is not the original source of the “seed” money, (which course of action would result in the transaction being recast as a trust created by the client under the step transaction or agency theories), the normal rules of taxation should apply and the existence of the trust should be respected for both tax and asset protection purposes. Thus, the client can control the trust by being trustee, and can benefit from the trust assets as the primary beneficiary.

**Benefits of Inheritor's Trust™/Opportunity Shifting**
Even though the more traditional planning would permit the opportunity provider to obtain complete control of the entity even though he owns only a small portion of it by being a controlling general partner of a limited partnership, manager of an LLC, or holder of the only voting stock in a corporation, clients would be better served by having control of the entity (and preferably the entire entity) in a Beneficiary Controlled Trust. Certainly the risk is greater if a dissident donee sues for breach of fiduciary duty in the capacity of general partner, manager or director than if the complaining family member sued the trustee of a discretionary trust where the client/trustee/beneficiary had a broad special power of appointment which would permit him to cut out the complainer.

A second (and perhaps a primary) benefit of having full control of, and access to the entire wealth through the Inheritor's Trust™ is that many clients would not shift the wealth during their lifetimes. By shifting the opportunity to a trust controlled by the client himself and structuring the trust with full enjoyment of the property during lifetime and a "re-write power" (a special power of appointment) the client has the ultimate estate planning structure.

A third benefit of having full control and access to the matured wealth inside of the Inheritor's Trust™ is that the client can more comfortably defund his personal estate as a result of the accessible (and protected) wealth in the Inheritor's Trust™.

**Illustration.** An estate owner decides to acquire an automobile dealership. Typically, the entire business is conducted under the umbrella of a single entity. The better route is to use multiple entities in structuring the transaction. From an asset protection perspective, if a single entity were used, liability exposure from any separate unit would expose the entire business to creditors. The use of multiple entities would insulate all but the entity where the liability occurred from creditors. From a tax planning standpoint, the use of multiple entities makes a great deal of sense. For example, the parent of the family patriarch can set up Inheritor's Trust™ for the benefit of the client and his descendents (and perhaps their spouses) that would own the shop doing repairs and warranty work on automobiles sold by the sales entity. The parent would create the trust electing GST exemption on the gift. The trust owned property and all assets acquired from the income derived from the business would be outside the transfer tax system for multiple generations.

**Income Tax Sheltering Inheritor's Trust™**

By far the most popular use of the defective trust gambit is structured whereby a wealthy taxpayer intentionally violates the grantor trust rules so that by being treated as the owner of the trust income he is able to reduce his estate by the tax paid, enable the trust to grow income tax free and to enable him to transact with the trust without income taxes to himself, his spouse or the trust.\(^2^7\)

A fantastic income tax strategy can be used whereby a client who has a parent (or grandparent) who is not working and is in a low bracket funds an Inheritor's Trust™ in a manner so that grantor trust status as to the parent (or grandparent) is obtained.

\(^2^7\) Rev. Rule 85-13; IRC §1041(a)(1)
If the trust corpus is invested in a favorable business opportunity which throws off income, that income would be taxed to the parent (or grandparent), taking advantage of the bracket differential.

Because the parent's (or grandparent's) income tax exposure will increase, fairness would dictate that the parent's (or grandparent's) income tax exposure be protected assuming they are unable to comfortably absorb the deficiency. One way to protect the situation would be to permit the trust to reimburse the parent (or grandparent) for tax liability incurred as a result of the grantor trust status.

If the trust reimburses the parent the growth of the trust will be adversely affected. Because most Inheritor's Trusts™ will be generation skipping, the adverse impact of such "leakage" will be accentuated. An alternative would be for the client to make annual exclusion gifts as well as make medical payments directly to the provider, up to the amount of the shortfall. If there is an excess of income tax obligations the differential can be made up by the trust, through loans to the parent or by reimbursement.

Additional benefits might be obtained with this structure. If the business or investment opportunity matured as anticipated the parent (or grandparent) could exchange higher basis property of equal value (even cash or a note) with the low-basis investment with the result being that there would be a basis step-up at the death of the parent (or grandparent) for the property originally owned by the trust.

Alternatively, the parent (or grandparent) could retain a power, such as a power of appointment, which would cause estate inclusion at the parent's death which could result in estate tax inclusion, and a step-up in basis, but would not result in any estate tax because it would be protected by the unified credit.

Variation

A variation of the use of income shifting through drafting and funding alternatives is to give a person such as a grandchild a power of withdrawal so that the grandchild would be taxed on the trust income in the grandchild's low bracket. Although the "Kiddie Tax" might have some adverse implications until the beneficiary attains 14 years of age, the gap between 14 and the grandchild's real earning years in most instances is considerable and may enable the family unit to save significant taxes.

Beneficiary Defective Inheritor's Trust™ - IRS §678(a)

An Inheritor's Trust™ that is designed to be defective as to the beneficiary (via IRC §678) rather than to the creator, is an extremely attractive variation of the income tax grantor trust. We call such a trust a Beneficiary Defective Inheritor's Trust. For many clients, if properly implemented, such a design strategy can avoid the transfer tax system for massive amounts of wealth and protect those assets from creditors of the powerholder while the clients can enjoy the benefits and use of that property.
Beneficiary-Grantor trust status could be achieved 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. 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 that person has the power exercisable solely by himself to vest the corpus or the income in himself, 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.

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.

What happens after the power lapses upon its nonexercise? Now the analysis shifts to §678(a)(2). For any lapses of the power to withdraw, the IRS 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 to the beneficiary.

The Beneficiary Defective Inheritor’s Trust™ can achieve a result whereby the powerholder, who is treated as the owner, will have a trust with which he or she can transact business, including selling property to the trust, tax-free, and take advantage of the same estate planning opportunities the grantor would have in a trust defective as to the creator. Moreover, a trust defective as to the beneficiary may offer superior benefits in that the powerholder/beneficiary may be the trustee and also, as beneficiary, enjoy the benefits of the trust assets. The trust assets would be transfer tax exempt as well as divorce and creditor protected. Although assets could be transferred from the trust beneficiary to the trust in a manner that would result in taxable sale or exchange treatment if the trust were not a grantor trust under §678, they would not be subject to income tax recognition, nor would they be subject to estate tax inclusion if the sale were for full and adequate consideration provided that there is no gratuitous transfer. The "...adequate and full consideration..." exceptions to IRC §§2036-2038 protect against inclusion.

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28 IRS §678(a)(1)
29 IRC §678(a)(2)
30 IRC §678(b); 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 and 200147044 [hereinafter Sections].
31 Rev Rul 85-13
32 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. Any other interpretation would result in estate tax inclusion for the powerholder under IRC §2041(b)(1) and render the five percent or $5,000 exception of IRC §§2041(b)(2) and 2514(e) meaningless.
33 IRC §§2036(a); 2037(a); and 2038(a)(1).

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Under this scenario, the gifts to the trust by someone other than the beneficiary need not be limited to the annual exclusion in order to obtain IRC §678(a) treatment. As long as the beneficiary is given a power of withdrawal over the entire contribution, the entire trust would be defective as to the beneficiary. If the gifts were subject to a hanging power of withdrawal, the beneficiary would have estate tax inclusion only to the extent of the amount hanging at his death. All lapsed amounts and appreciation would not be includible. Because the funding would be done with "hot" assets, the lapses should occur rapidly under the 5% "safe harbor" rule of IRC §2514(e).

ILLUSTRATION.

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.\(^{34}\) The businessman’s parent is able and willing to supply the seed money, and sets up an Inheritor's Trust\(^{\text{TM}}\), 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.

If the trust is a Beneficiary Defective Inheritor's Trust, then IRC § 678(a) should operate to cause the beneficiary to be taxed on all of the income. This is a good result, since the beneficiary will not be treated as having made a gift to the trust simply because the law requires that the beneficiary owes and pays the tax with the beneficiary’s own funds. 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 his estate.\(^{35}\) If we assume that the favorable business opportunity grows to a value of $500,000 in the first year, $1 million in the second year and $2.5 million in the third year, the portion of the $200,000 annually lapsing would be $25,000, $50,000 and $125,000 respectively based upon 5% of the trust each year, so that his estate tax exposure would end after three years.

Valuation Planning

Under the wealth transfer tax system a tax is imposed on of the gratuitous disposition of property. For estate tax purposes, the tax is levied on the fair market value of all property the decedent owned (or is deemed to have owned\(^{36}\)) at death. In many instances the client is willing to part with an interest in property, but desires to retain control over the property. A classic example of this is where the client forms a family limited partnership and is willing to transfer limited partnership interests, provided the client can control the partnership through the retention of the general partnership interest. The property transferred will receive a significant valuation reduction for gift tax purposes by virtue of being a non-controlling interest; however, if the client has retained liquidation control, the value of the underlying assets held by the limited partnership interests retained at death will very likely be included and aggregated as part of the

\(^{34}\) Alternatively, the parent can make a part gift, part loan. The loan would be paid with the cash flow of the business.

\(^{35}\) IRC § 2041(b).

\(^{36}\) Certain types of interests or entitlements are includible even though the decedent did not own them in the classic sense, such as certain transfers within three years of death, revocable transfers, retained life estates, transfers that take effect at death, powers of appointment, etc.
control block—because of the control of the general partner. Thus, for example, assume a family limited partnership has a 1% general partnership interest and a 99% limited partnership interest, and that the client owns the 1% general partnership interest and a 39% limited partner interest. In that case, the client would probably be deemed by the IRS to own the 40% as part of a control block. A viable argument that could be successful is that the 40% interest should be entitled to a significant valuation deduction because a "buyer" of that interest would be receiving only an "assignee" interest and would not receive control.37

The use of an Inheritor's Trust™ can resolve this problem. The Inheritor's Trust™ can be the General Partner of the client's FLP. Even if the client is the Trustee of the Inheritor's Trust™, and as a result, controls the FLP in that capacity, the fiduciary control will not be imputed to him at death for estate tax purposes. Control held in a fiduciary capacity is not attributed to the decedent in his individual capacity.38 Thus, all the decedent owned and transferred at death would be non-controlling interests, which would reduce the transfer tax significantly.

The same result would be obtained if other entities were used. For instance, if the Inheritor's Trust™ owned the one share of voting stock of a corporation and the 99% non-voting stock was owned outright by the client, the estate tax would be imposed upon only the fair market value of the non-voting shares, irrespective of the fact that the decedent had full control of the corporation as Trustee.

Asset Protection Planning

A common asset protection strategy involves the creation of an FLP, in which the client creator is the one-percent general partner, and a foreign asset protection trust ("FAPT") is the 99% limited partner. The client as the general partner of the FLP has managerial control over the limited partnership interests in the FAPT. However, there is a weakness in this strategy. In the event that an enhanced level of asset protection is desired, the FLP often is dissolved, but the one-percent general partnership interest would be exposed to creditors and the managerial control mechanism would be lost.

On the other hand, if even a relatively small amount of assets were gifted or bequeathed to an Inheritor's Trust™ from someone other than the client (e.g., a parent, grandparent, or spouse), that trust could then invest in the FLP by purchasing all, or at least, a controlling interest in the general partnership interest in the FLP. The trust's spendthrift clause would shield the interest from creditors and control over the limited partnership interests owned by the FLP would continue, because the general partnership interest is protected by a trust created by a third party. If there is a concern that a U.S. court could determine that the high degree of control given the Beneficiary Controlled Trust beneficiary

37 John W. Porter, Current Valuation Issues Regarding Closely-Held Entities and Fractional Interests, p. 6-7.

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is tantamount to ownership, additional protection might be obtained if the Inheritor's Trust™ is structured as a foreign situs trust.  

The Inheritor's Trust™ Personal Retirement Plan Scenario

The Inheritor's Trust™ offers other benefits that can not otherwise be achieved. A long standing concept that has been receiving significant attention in the wealth planning community is the use of cash value life insurance. This vehicle takes advantage of the single most important concept of financial and estate planning – tax free compounding.

The Inheritor’s Trust™ offers a ready made vehicle for purchasing life insurance benefits that will not be included in the insured’s estate. In many instances it might be the quintessential irrevocable life insurance trust avoiding funding issues and the Inheritor can be in full control of the trust if the life insurance is on the life of someone other than the Inheritor. Estate tax avoidance can be accomplished by appointing an independent trustee over any life insurance in the trust on the Inheritor’s life and elimination of the Inheritor power of appointment on the life insurance on his own life. The Inheritor may be given the power to remove and replace the insurance trustee.  

In the wealth transfer area, Professors A. James Casner and George Cooper, during the mid 1970s, both opined that the transfer tax free, multi-generational trust was the most important concept for the avoidance or possible erosion of the transfer tax system because of its transfer tax free compounding. Although not advanced by Professors Casner and Cooper, the perpetual trust is also the best vehicle to avoid family wealth diminution from creditors.

Adding another enhancement, a tax-free capital accumulation component, will significantly increase the ability to accumulate wealth provided that the “cost” to obtain that type of treatment is not too severe. One vehicle that offers that opportunity is cash value life insurance. For many estate owners, the cost to purchase “the insurance wrapper” is negligible relative to the benefits obtained, principally the ability to grow the investment component income tax free. Because tax-free compounding is somewhat exponential, time is necessary to achieve magnified results. The death benefit feature of the life insurance policy creates a hedge and windfall against an unanticipated premature death of the insured. In addition, the death component offers the traditional benefit of the insurance product.

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39 The source of this foreign situs Beneficiary Controlled Trust idea is David Lockwood, an attorney in Denver, Colorado.
40 PLR 9832039.
41 Prof. Casner stated, "in 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." Hearings Before the House Ways and Means Comm., 94th Cong., 2nd Sess., Pt 2 1335 (1976).

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Taking advantage of the tax-free build-up in a policy that qualifies as a life insurance policy under IRC § 7702 is not a new idea, and should be considered as an accumulation vehicle, which has many preferable attributes when compared to its primary alternatives - pension plans and NIMCRUTs. In fact, the latter two techniques are tax deferral (as distinguished from tax-free) strategies where a tax will be due when the fund is accessed. The life insurance alternative, on the other hand, is far superior since the internal buildup is available tax free by loans or partial withdrawals during the life of the insured provided that the policy is not a modified endowment contract (“MEC”). At death the potential income tax exposure disappears. Thus, except in the most unusual of circumstances, cash value life insurance is a true tax exempt rather than tax deferral device.

Two popular cash value accumulation products, rather than mortality driven products, created in the 1980s and early 1990s were the single premium whole life (“SPWL”) and the product marketed by the insurance fraternity as a retirement plan substitute under the name “Private Pension Plan.” Both of these were, in reality, over-funded life insurance policies designed to take advantage of the tax-free build-up of the investment component of the policy. Today’s more sophisticated approaches include variable life insurance and the theoretically ultimate vehicle for high-end consumers, Private Placement Life Insurance (“PPLI”).

The accessible tax-free buildup inherent in a non-MEC life insurance product is far superior to the two other primary tax deferral strategies, the pension plan and the NIMCRUT. When placed inside of a dynastic trust as a combined tax-free wealth accumulation and tax-free wealth transfer plan, the growth pattern can lead to dramatically favorable results.

At death, both the insurance and the investment component, cured of basis problems, are paid to the trust free of income tax, in addition to being outside of the transfer tax system. Because the benefits of tax-free compounding grow exponentially over time, in the short run, the tax-exempt feature is far less dramatic, a trait that is shared with tax-deferred devices. Thus, survivorship is an important element of cash value insurance as to the capital accumulation component of the product. The other component of the policy, the pure insurance feature, is a built-in hedge against the retardation of the investment due to early death. Therefore, with a shortened life, the economics result in the life insurance death benefit being a productive return on investment, and with a long life the lower return of the death benefit compared to investments is offset by the multiplier effect of the investment component. As a result, the consumer either wins on time (the death bet) or wins on the technique.

The usual alternatives to the life insurance product, NIMCRUTs and qualified retirement plans (“QRPs), have severe repercussions upon a premature demise of the estate owner. QRPs are IRD, subject to both the income tax and transfer tax and with a NIMCRUT the entire property passes to the charitable remainder beneficiary and not the family.

43 If access to the internal build-up is unimportant to the Inheritor a MEC policy might be preferable because it permits a larger front end funding thus an earlier tax free accumulation period.
Costs of Moving Into An Income Tax Free Accumulation Vehicle

As a general proposition there are significant costs associated with obtaining tax-free growth. With municipal bonds the cost is a lower yield than can be obtained by taxable investments of equal quality, and the growth possibility is severely restricted, and more apparent over time. With QRPs, the statutory restrictions and IRD tax issue severely reduces the family’s beneficial enjoyment; and with a CRT, the fact that the property goes to charity, although often a desired result, ultimately reduces the wealth of the family unit.

Transfer Tax Planning with Cash Value Life Insurance

Most advisors, as well as their clients, are familiar with estate planning using mortality driven life insurance, recognizing that the ILIT is generally the preferred vehicle. Where accumulation products are involved, there are two features that must be addressed. First, in its embryonic stage, SPWL and the Private Pension Plan were sold with little or no thought as to how the estate tax could be avoided without foregoing the more compelling aspect of the policy, its use as an accessible tax free accumulation vehicle, often designed as a retirement substitute. In most instances, estate tax inclusion was generally conceded at the point of sale by having the insured own the policy. If the experience we’ve had with QRPs and the desire to dribble out the money as slowly as possible retaining the rest in the tax advantaged vehicle, are indicative of the projected experience with the internal build-up in policies, the accumulated wealth will not be needed at retirement. In the latter instance, transfer tax exposure would be harmful and unnecessary.

The second problem is moving the life insurance into a vehicle, outside of the transfer tax system and accessible by the client. Because we are over-funding the policy, premiums will be larger than what would be required to fund for traditional death benefit structured insurance. That feature will often require more imaginative trust packing techniques than where the funding of pure prototypical insurance is owned by the trust.

Because the Internal Revenue Code treats life insurance differently from all other assets, we need to focus on planning for cash value life insurance for the estate owner where the transfer tax exposure is eliminated without giving up the beneficial enjoyment of, and access to, the investment component.

Solving the Dilemma – Access Without Estate Tax

The dilemma often faced with cash value life insurance used for retirement planning is that the estate owner wants both access to the internal build-up and also desires to keep the death benefits outside of the estate tax system. The estate tax exposure can be finessed by using an Inheritor's Trust™ because the trust must be created by someone other than the client.

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44 IRC §§2035(d) and 2042.

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The Inheritor’s Trust™ can be designed as a Beneficiary Controlled Trust but if the insurance is on the beneficiary’s life, the beneficiary may not be a trustee who makes decisions with regard to the insurance nor have a power of appointment as to the insurance portion of the corpus without estate tax exposure under IRC § 2042. Therefore, if life insurance on the beneficiary/trustee’s life is an asset of the trust, the strategy is to use a special or independent trustee who would be the trustee as to the life insurance, and the beneficiary/trustee would not be given, or if given in the original trust, would release, the power to appoint the life insurance. The insured/beneficiary can be the Trustee as to the rest of the trust and have a power of appointment over the non-insurance assets. The beneficiary can also have the right to fire and replace the special trustee provided that the replacement power must be limited to permissibles under IRC §672. If the life insurance is on another person the foregoing restrictions would not apply. Thus, life insurance can be acquired on a child or grandchild, which could be used as a tax-exempt accumulation vehicle without restriction on account of IRC § 2042. From an economic perspective, if the parent doesn’t need or desire the death component, the purchase of life insurance on a younger person is preferable because of the cheaper mortality costs as well as the anticipated longer tax-free growth due to a longer life expectancy.

If the prospective Inheritor needs the death component, the insurance becomes far more valuable to him if the death benefit is outside the estate but the investment or cash value portion is obtainable through a friendly co-trustee who could be fired and replaced by the insured/beneficiary.

**Accessing the Cash Value By The Beneficiary**

We have concluded that, without exception, a trust may be designed giving the trustee/beneficiary full control of the trust. If insurance is to be acquired by the trust, the minimal alteration in trust design would require a separate trustee to handle the insurance on an insured trustee, as well as the insurance not being subject to a power of appointment by the insured/beneficiary.

If it were desirable for the beneficiary to access the cash value, the process would be done in two steps. First, the trustee, (other than a trustee who is also the insured) would borrow the money from the policy. The second step has the following three options:

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45 See Zaritsky and Leimberg, Tax Planning with Life Insurance, WARREN GORMAN & LAMONT, 2nd Ed. at paragraph 5.03(6)(a) and Slade, 807 T.M., Personal Life Insurance Trusts at pA-25.

46 A variation of this strategy which has been promoted by some is “The WRAP Trust,” Proponents of the technique believe that access to the cash value buildup can be available to the grantor of the trust by providing in the trust indenture the right to borrow funds from the trust provided that the grantor pays market interest and provides adequate security. Blasé, The Wrap Trust, Journal of the Amer. Soc. of CLU & CHFC at 120 (Sept. 1997); O’Sullivan and Thiessen, Avoiding Estate Tax Problems Unique to Life Insurance, Journal of Financial Service Professionals at 68 and 83, which cites the Blasé article (November 2001). Contra, Calleton, Grantor Trusts, 18, UCLA- C.E.B. Estate Planning Institute at 57 (1996). We believe that this analysis is incorrect and such a retained right will result in inclusion under IRC §2036(a). Inclusion under that section occurs where the decedent made (i) a transfer (ii) for less than adequate and full consideration and (iii) retained the enjoyment of the property. In The Wrap Trust, the decedent retains the right to borrow, (i.e.; the enjoyment of the property) without paying for it. On the other hand, with the Inheritor's Trust™, the beneficiary has not made a gratuitous transfer to the trust and, therefore, can not have retained a right in property he transferred to the trust.
(i) Loan money to the beneficiary. If the loan is from a trust that is a grantor trust as to the beneficiary, interest payments made by the beneficiary or his spouse during the beneficiary's lifetime do not have income tax consequences. The visceral reaction is use a low loan rate. The opposite approach is more beneficial from a planning view since it will enable the beneficiary to move greater wealth into the trust outside of the transfer tax system subject to the caveat that excessive interest could be recast as a contribution to the trust by the beneficiary. That course of action would also create estate tax exposure.47 Any unpaid amount at death would be deductible as a debt of the estate. Any unpaid interest would be taxable when paid, since grantor trust status would have ceased.

(ii) Purchase other assets from the beneficiary. If the trust is a beneficiary defective trust assets can be sold to it (and from it) without gain. Assuming that the beneficiary spends the cash, the assets exchanged for the cash will be owned by the trust, useable by the beneficiary, resulting in an estate reduction. If the beneficiary desired to invest the cash, the probable desired strategy would be to make the investment inside of the trust so that its growth will inure to the benefit of the trust. If the investment was in a wasting asset, such as an automobile, a loan or sale followed externally by the asset purchase is recommended. The beneficiary may also access the cash without estate tax exposure after it is borrowed from the policy if he has a swap out power.48

(iii) Distribution: The worst option is a distribution, since it moves the assets from a protected arena to a non-protected one thereby diluting the transfer tax and creditor protection advantages inherent in trusts. It would generally not be anticipated that a distribution would be made unless dictated by the otherwise adverse income tax consequences.

Vehicle to Purchase Remainder Interest – A Generation-Skipping GRAT or CLAT

Because of the taxpayer victory in Walton v. Commission, where the Tax Court unanimously blessed a “zeroed-out” GRAT, the current low interest rates and the ability to avoid valuation controversy and risk of gift tax the GRAT (and CLAT) have become increasingly popular. Many planners when faced with the “ETIP” provisions under IRC §2642(f)(1) (and IRC §2642(e)(1) for CLATs), which prevent the Grantor from leveraging the transfer for GST tax purposes prohibiting him from allocating his GST exemption until after the front-end annuity interest terminated, simply believed that leveraging the generation-skipping exemption could not be achieved with proper planning, we believe that generation-skipping can be obtained.

Although the ETIP rules prohibit the allocation of GST exemption until there would

47 IRC § 2036(a) and possibly IRC §§ 2038 and 2041 (reachable by creditors).
be no inclusion in the transferor’s estate, many practitioners believe that the inability to use generation-skipping leveraging techniques with the GRAT and CLAT can be finessed by having the remainder beneficiary either gift or sell his remainder interest to a dynastic trust. Because the remainder beneficiary would transfer his entire interest and not retain anything, the ETIP rules should not apply since, after the transfer, the property would not be subject to inclusion in the remaindermen/transferor’s estate.

Upon the end of the annuity term, the property then belonging to the original trust would pass to the dynastic trust, thereby protecting the property from the transfer tax system and providing creditor protection perpetually. As a result, the leveraging benefits of the GRAT technique will be available for GSTT purposes.

If a parent, grandparent or some other third person were to set up an Inheritor’s Trust™ for a client, the client could set up a Walton GRAT which would sell the GRAT remainder interest to the Inheritor’s Trust™ for fair and adequate consideration. At the end of the GRAT term the property remaining in the GRAT would be transferred to the client’s Inheritor’s Trust™. This should not be subject to the transfer tax system since it was not a gratuitous transfer (one of the requirements for inclusion).

LTR 200107015

The IRS announced its position on the transfer of a remainder interest in LTR 200107015 in the context of a transfer of a remainder interest in a CLAT. The question answered in the ruling for our planning purposes was whether there was a change in transferor from the original creator of a CLAT or GRAT to a new transferor, the remainderman for GST tax purposes, so that the new transferor can allocate his own GST tax exemption to the transfer to keep it outside the scope of the GST tax.

The Service ruled that there would be two transferors as of the date of the assignment, the remainderman with respect to the portion of the trust equal to the present value of his remainder interest and the creator of the original trust as to the balance. Thus, upon the end of the annuity term, the original transferor’s interest, which generally would represent the bulk of the assets, would be subject to the GST tax.

The Service’s position is based on policy, that the purpose of IRC §2642(e) and (f) is to prevent the use of these types of leveraging transactions to circumvent the application of the GST tax. We, as well as other practitioners, believe that the Service’s position is technically flawed and will not withstand judicial scrutiny.

49 IRC §2642(e)(1) create a similar proscription for a CLTA prohibiting election of GST tax exempt status until the expiration of the annuity period.
50 Steven J. Oshins and David A. Handler, “GRAT Remainder Sale to a Dynasty Trust,” Trusts & Estates (December 1999) and “The GRAT Remainder Sale,” Trusts & Estates (December 2003); Adams, Roy M., Proprietary Approaches for Planning with Individuals and Their Businesses, TELECONFERENCE SERVICES at 13, (March 27, 2001).
51 Byrle M. Abbin, [S]he Loves Me, [S]he Loves Me Not – Responding to Succession Planning Needs through a Three-Dimensional Analysis of Consideration to be Applied in Selecting from the Cafeteria of Techniques, 31 U. of Miami Inst. On Est. Plan. At Ch. 13 (1997) who commented: “Informally, IRS has indicated that the trust should have assets equal to 10 percent of the purchase price to provide adequate security for payment of the acquisition obligation.” Gopman, Steinberg and S. Oshins, Ruling on
Protective Planning

Although we believe that the IRS position lacks merit, prudent advisors might protect against the downside risk if the IRS did prevail. For example, deferral of the imposition of the GST tax could be achieved by transferring the remainder interest to an Inheritor's Trust™ drafted in a manner to include all the GRAT grantor's children and perhaps their spouses have present discretionary interests. The GST tax would be postponed until the death of the last to survive of the persons interested in the trust assigned to the generation just below that of the grantor of the GRAT. If a child of the grantor of the GRAT is deceased leaving a surviving child or children, the child or children will be assigned to the preceding generation, thereby enabling a taxable termination to be postponed until the death of such grandchild or grandchildren.

Sale and Leaseback

A popular estate freezing technique is a gift or sale (generally of appreciated property) to younger family members (or trusts) with the property being leased back by the transferor. One advantage of this tactic is that the transferor can continue to use the property without estate tax inclusion. Assets that work well in this arrangement include land, office buildings, furnishing and equipment. Often business owners inadvisably acquire or transfer these assets into the operating entity. That course of action will expose the assets to creditors of the operating entity as well as limit the tax planning possibilities and can preclude a basis step up if the entity is a corporation. On the other hand, owning the operating assets outright will expose the assets to personal creditors as well as the transfer tax system. An Inheritor's Trust™ may resolve that.

Illustration – Assume that four physicians wish to acquire some medical equipment for $1,000,000. Although they are extremely competent doctors, they are concerned about malpractice lawsuits. They are also interested in tax planning.

If the equipment was acquired in their professional entity, it would be exposed to lawsuits arising out of the medical practice. Instead, it is suggested that they acquire the equipment in an LLC. If a physician has his parent set up a Beneficiary Defective Inheritor's Trust that acquires his 25 percent interest and that interest received a 40 percent valuation discount, the value of the transferred interest would be $150,000. The LLC would then lease the equipment to the operating entity. If we determined that this type of equipment is normally leased for 20 percent of its cost, the proportionate cash flow for the transferred interest would be $50,000.

Assignment of Vested Remainder Interest Nay Have Reached Wrong Conclusion, Tax Management; Estates, Gifts and Trusts Journal, (September/October 2001); Richard A. Oshins and Arthur D. Sederbaum, "Generation-Skipping and the GRAT: Sale or Gift of the Remainder", Estate Planning Magazine, June 2003; See also Jerry A. Kasner, Hot Tax Topics for Estate Planners, Outline at 71 (April 12, 2001), where Jerry states, “The IRS can’t have it both ways, if the child is deemed to have made a gift, the child would now be the transferor, and the father cannot also be the transferor – the rule is the last transferor for gift or estate tax purposes is the transferor for GST purposes.

52 IRC §2613(a)
53 IRC §2651(e)
54 Because the trust would be defective as to the doctor the sale would be income tax free.

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Planning Note. The transfer of the interest should precede the lease because if the lease is in place when the transfer is made, the value of the underlying entity would be enhanced. With the medical malpractice problem being of such a great concern to physicians, it is shocking how little this planning technique is used.

Business Buy-Out

An Inheritor’s Trust™ can open up some considerable planning alternatives when used in conjunction with a buy-sell agreement. In most instances a cross-purchase is the method of choice because the acquirer will obtain a basis step-up. A problem often occurs because the last surviving purchaser will own 100% of the entity and in the absence of additional planning the entire business, including all appreciation, will expose his estate to unnecessary estate taxes.

Rather than have the interest acquired by the surviving owner, the planner should consider structuring the transaction whereby the purchase is made by an Inheritor's Trust™. Where the buyout is insurance funded, the life insurance on the other owners would be acquired by the Inheritor's Trust™. Upon the death of a co-owner the decedent’s interest would be transferred to a vehicle outside the reach of the transfer tax system even though the control is in the hands of the surviving owner.

Illustration – Assume that three business owners wish to fund a buy-out agreement. An Inheritor's Trust™ might be set up for the benefit of an owner that has a cash flow from either an opportunity shift or a sale and leaseback. Thus, if the clients had segregated the “hard” assets from the operation into a leasing company and the operating company could be accomplished.

Can extend to the operating entity as well.

Under this alternative, the Inheritor's Trust™ would acquire insurance on the lives of the other owners of the leasing company, using the cash flow from the leasing company to pay the premiums. For example, assume A, B and C each own a one-third interest in a business and leasing company (collectively, “the business interest”) with a combined value of $6 million. In the normal cross-purchase buyout arrangement, if A died, B and C would purchase A’s shares for $1 million each and would each then own one-half of a $6 million business. If B then died, C would acquire B’s interest for $3 million and would own the entire entity worth $6 million. Under this scenario, $11 million would be exposed to the transfer tax system. If the purchase was funded with life insurance, each party would need $2 million of life insurance initially ($1 million on each of the other owners); $3 million at the death of the first to die (to acquire the interest of the non-deceased co-owner); and using round numbers (assuming a 50% estate tax), $3 million to pay the estate tax at their own death.

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**Variation**

Assume that A and B each own 50% of an entity. A's parent sets up an Inheritor's Trust™ for the benefit of A and his family which acquires life insurance on the life of B to fund a buy-out. B dies and the Inheritor's Trust™ acquires B's 50% interest. A could then redeem his interest and have full control of the entity as trustee of the Inheritor's Trust™ without any inclusion of the entity for estate tax purposes. At the very least, A should consider redeeming one share or unit of the entity so that he has inclusion of less than 50% of the entity.

**Avoiding State Income Taxes**

Do state income taxes apply to an Inheritor's Trust™, and if so, can anything be done about it? The answer to the question is largely a matter of state law. Thus, an Inheritor's Trust™ with a trustee in a state with no income taxes, can be used to escape substantial state income taxes. For example, if a New York City domiciliary created a trust with a trustee in a state which did not have income tax, and the trust contained income producing intangible assets, both state and city taxes could be avoided.56

Alternatively, if the trust situs is in a state that taxes trusts, whether as a result of a change of law or otherwise, the problem may still be fixable. A properly drafted Inheritor's Trust™ should contain powers to change the trust situs, in addition to the power to create subtrusts. It may therefore be beneficial and possible to change the trust situs to a jurisdiction that does not tax trusts. Since it may be necessary to change the trustee as well, in order to obtain these benefits (as in the New York example above), the client may want to create a subtrust with the assets that would otherwise be subject to state income tax, and to transfer those assets to another jurisdiction, perhaps appointing another trustee, but retaining a local trustee (e.g., the beneficiary) for other assets not likely to generate taxable income. One way or another, a properly drafted Inheritor's Trust™ ought to be flexible enough to solve the state income tax problem, if there is one. With the Inheritor's Trust™, flexibility is the key, and this is just one example of how flexible trustee appointment provisions and subtrust creation provisions can be used to solve a problem.

**Step-Up in Basis Opportunities Through Exercise of Powers of Appointment**

Under IRC §1041, as it presently exists, property in a decedent’s estate, generally gets a free step-up in income tax basis. In the case of a community property, both halves get stepped-up (to the consternation of many estate planners in states that do not have community property). Since the estate tax is higher than the capital gains tax, the step-up in basis is nice, but the net result is still a tax deficit for those whose estates are subject to the estate tax. However, not everyone has a taxable estate, and as the unified credit is increased over time, the number of people benefited by the step-up, without simultaneously being subject to estate tax, is likely to increase.

**Retained Power**


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If the grantor has a relatively small estate and is expected to have unused unified credit, the grantor might consider retaining a special power of appointment over the property in the trust, which would cause the trust to be taxable in the grantor’s estate under IRC §2038, resulting in a basis step-up. If the dispositive provisions of the Inheritor's Trust™ prohibit distributions without the consent of an adverse party, the trust would not be a grantor trust for income tax purposes. So, just as it is possible to have a grantor trust that is not in the grantor’s estate, it is possible to have a non-grantor trust that is in the grantor’s estate.

**Variation**

But what if the grantor did not retain a power that would place the property in the grantor’s estate? In most cases a grantor would take pains not to retain such a power. However, with the unified credit increasing yearly, that initial decision may not have been the best one. Further, it may be that there are family members other than the grantor whose estates are not taxable, and for whom a step-up in basis at death could be beneficial. A possible variation of the original technique would be for the beneficiary of the Inheritor's Trust™ to transfer the property back up the line, with the expectation of inheriting it later, and thus getting the step-up in basis. However, there are two hurdles to overcome. One is the gift tax. The other is §1014(e). It may be that the Inheritor's Trust™ can solve both problems.

In the past, it was not unheard of for a child to transfer low-basis assets to an elderly parent (whose estate was not large enough to attract an estate tax), with the expectation that the child/donor would inherit the assets with a step-up in basis at some point in the future. This would only be practical if the child was not in a high gift tax bracket either. That loop-hole was closed by the passage of 1014(e), which provides that if “appreciated property was acquired by the decedent by gift during the 1-year period ending on the date of the decedent’s death, and” if “such property is acquired from the decedent by (or passes from the decedent to) the donor of such property (or the spouse of such donor)”, then “the basis of such property in the hands of such donor (or spouse) shall be the adjusted basis of such property in the hands of the decedent immediately before the death of the decedent.”

However, what if the decedent, instead of leaving the property back to the original donor, leaves the property to a trust for the donor. As a technical matter, that ought to work, since it does not literally fall within the §1014(e) proscription. However, PLR 200101021 and TAM 9308002 held that the spirit of 1014(e) was violated, and that the technique did not work, in the case of a joint revocable trust set up by a husband and wife, where the first spouse to die was given a general power of appointment over the entire trust, and where the surviving spouse owned and held the power to revoke up to the moment of death of the first spouse. We believe that if the property were given to the decedent, and the decedent independently and without prior arrangement left it to an Inheritor’s Trust™ for the original donor, that PLR 200101021 and TAM 9308002 ought

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57 PLR 200148028.
not to apply, since the beneficiary did not hold on to the trust property up to the moment of the donor’s death.

The argument that neither PLR 200101021, TAM 9308002 nor §1014(e) apply is even stronger if the “donor” was not an individual but an Inheritor's Trust™. The deceased recipient of the property could have received it in one of two ways: either as a discretionary distribution from an Inheritor's Trust™, or possibly as the result of the exercise of an inter-vivos power of appointment under a trust. (There is some risk that the exercise of this power could be considered a gift if the power-holder was also a beneficiary of the trust, for example, if the power holder had a nondiscretionary right to the income.) If the decedent then leaves the property to another Inheritor's Trust™. We believe that a step-up in basis can be obtained tax-free, even if the power-holder, or better yet, an Inheritor's Trust™ for the power holder, receives the property in question after the decedent’s death.

The issue boils down to the question of who is the “donor” if the property is transferred pursuant to a discretionary distribution power or even pursuant to a power of appointment by someone who has never technically owned the property, someone who cannot properly be said to be or ever have been the donor of it (e.g., the beneficiary of an Inheritor’s Trust™ for which someone else was the “donor”). In sum, we believe that it is probable that §1014(e) will not apply in that case, even if the property is inherited within a year of transfer.

CONCLUSION: The Inheritor's Trust™, in all its Varieties and with all its Uses, Should be the Centerpiece of the 21st Century Estate Planner’s Tool Box.

As previously discussed in some detail, the Inheritor's Trust™ is a very flexible concept that can assume an unlimited number of forms. Nevertheless, there are several characteristics that one would commonly expect to find in an Inheritor's Trust™. First, and primary, the trust would be “beneficiary controlled” for all practical purposes (functional equivalent of outright ownership), by use of broad distribution and investment standards. In virtually every case, the trust would be “Dynastic,” designed to last as long as the law permits. This perpetuity provision would, in addition, virtually always be coupled with a power in the client to change who eventually receives the trust property, and under what conditions and in what form. This would be achieved through the use of liberal and creative powers of appointment (“re-write powers”), something central to the concept of an Inheritor's Trust™. In most cases the beneficiary would also have some form of power to remove and replace the independent trustee. In addition, the Independent Trustee (whose identity is controlled by the beneficiary) will usually be given a power to merge or terminate the trust, including the power to create subtrusts, perhaps with separate trustees and separate tax and investment objectives.

Despite its protean nature, and that fact that the Inheritor's Trust™ is virtually unlimited in the forms it can take on, it is most likely to be found in several especially useful varieties, or in a combination thereof. Each form can be used separately to accomplish a specific objective, and taken in combination can solve just about any estate planning problem that the Internal Revenue Service has so far attempted to create for families who are trying to preserve wealth without losing investment and distribution.
flexibility. Some of the more popular varieties of the Inheritor's Trust™, the ones treated at length in this article include:

(a) The GST Exempt Variety.
(b) The GST Non-Exempt Variety.
(c) The “Intentionally Defective” Donor Grantor Trust Variety under IRC §§671-677 or 679, with a power to turn off Grantor income taxation.
(d) The Beneficiary Defective Inheritor's Trust™ under IRS §678(a) (Perhaps the Most Important), possibly with a power to turn off Grantor income taxation.
(e) The Intentionally Non-Grantor Tax Paying Trust Variety.

What does, or can, the Inheritor's Trust™ achieve: (a) estate tax savings; (b) generation skipping tax savings; (c) ordinary income tax savings by shifting the ordinary income to the individual or the trust that produces the lowest rate (with low capital gains and dividend rates, it may be that even if income taxes are paid at trust tax rates, this will not be of any importance, and may even result in alternative minimum tax savings); (d) state income tax savings, by shifting the trust domicile to a state that does not tax trusts; (e) provisions that cause capital gains to be either unrealized, or stepped up to fair market value without recognition at all; (f) creditor/predator protection; and (g) last, but perhaps just as important, the beneficiary of the Inheritor's Trust™ can use the trust to achieve virtually all of his or her personal non-tax estate planning objectives and needs through use of pervasive powers of appointment. The Inheritor's Trust™ does all of this, and more, while simultaneously reposing in the beneficiary virtually total flexibility and control. Because of its flexibility in the face of changing tax laws, changing family structures, a more hostile climate for litigation victims, and a rapidly changing investment climate, the Inheritor's Trust™ is a concept particularly well suited for the 21st Century estate plan. Finally, and not to be overlooked, while the Inheritor's Trust™ is, of course, especially beneficial in the case of the super-wealthy, it is obviously of great benefit to persons of moderate wealth as well, and to their families.