Protecting & Preserving Wealth Into The Next Millennium

THIS ARTICLE DISCUSSES THE CONCEPT that all significant gifts or bequests should be made in trust because more benefits can be given to beneficiaries if property is conveyed in trust than if wealth is received by gift or bequest outright. It examines how the principal beneficiaries can have the equivalent of outright ownership of the trust assets, including undisturbed control, while still enjoying tax and creditor benefits not available with outright ownership.

Editor's Note: This is the first in a two-part series on protecting and preserving family wealth.

Most estate planners recognize that there are two tax systems, one for the informed and another for the uninformed. The same rule is true for those who use creditor protection strategies as compared to those who do not. 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. 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 then can be enjoyed and controlled by the family into perpetuity.

Unleveling The Playing Field

Under both the transfer tax system and property laws in the United States, properly structured inherited wealth is a far more valuable commodity than wealth earned and saved. Although it is generally true that neither our transfer tax system nor our property law system distinguishes between wealth a transferee taxpayer owns and retransmits and wealth that is earned and subsequently transferred, proper planning can dramatically alter these general rules. The vehicle to achieve and maintain this differential is an irrevocable trust, particularly a dynastic trust. In the typical family setting, the trust is created by a senior family member for the benefit of his or her descendants (and perhaps also for the spouse of the creator). In its most flexible form, the permissible distributees would also encompass spouses of descendants[1] including the surviving spouse of a deceased descendant (who was living with the descendant at the time of his or her death or was unable to do so for health reasons), as well as trusts under which the potential individual recipients are beneficiaries, whether set up by a trustee under the instant trust or by a third party.[2] In order to achieve the maximum transfer tax savings, the trust should be wholly exempt from the generation-skipping transfer tax (GST tax). This will perpetually avoid the imposition of transfer taxes for successive generations.

This article has, as a basic premise, the philosophy that any gift or inheritance should be made in trust unless the size of the transfer does not justify the expense of setting up a trust. The transfer of a gift or inheritance in a trust can confer more benefits upon a beneficiary than the beneficiary would have if the property had been conveyed outright. Rather than provide an exhaustive analysis of the myriad uses of trusts, the article 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. 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, a trust would be designed to give the primary beneficiary the functional equivalent of outright ownership, including undisturbed control over the property. Indeed, many candidates for this type of planning would be unwilling to create such a structure unless the trust benefits are coupled with

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the ability of the primary beneficiary or beneficiaries to obtain control over the trust property virtually tantamount to outright ownership. A portion of this article will focus on such a trust which we will refer to as a "beneficiary controlled trust."

This ability to improve a gift or inheritance 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. 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.[3]

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. 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. 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. Sophisticated drafting in this instance includes incorporating provisions that are often counterintuitive to most estate planning practitioners. This approach often involves, among other things, negating the prudent person rule. Traditional trust language usually precludes the types of investments that a beneficiary controlled trust encourages. 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.

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. Properly structured, an irrevocable trust can avoid this exposure.[4] 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. This philosophy should be followed provided it is consistent with the objective of providing comfortably for the trust beneficiaries. Under this tax avoidance strategy, the trustee would be encouraged to acquire assets for the "use" of the beneficiaries rather than funding the individuals' personal acquisition of assets.[5]

The trust would be designed in such a way that distributions are permissible, but operationally it is anticipated that they would not be made in the absence of a compelling reason to make them. By retaining property in trust, the assets will not be subject to creditors of the trust beneficiaries or diminishment in a divorce. 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. As a result, the beneficiaries will have the use and enjoyment of the property without transfer tax problems or creditor exposure. The beneficiaries individually (or by utilization of trust assets in trusts not protected by the GST tax exemption) will be expected to absorb most family expenditures such as food, schooling and vacations. Additionally, the exempt funds will generally not be expended on consumable assets, such as clothing, automobiles, etc., since use of protected funds in this manner would be wasteful.

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 anticipated."[6]

Satisfying The Goals Of Estate Planning

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. 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).

The goal of preserving control in the hands of senior family members while shifting the tax consequences from those individuals is usually easily obtainable. 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. Control over the disposition of the property may be given to a person through a broad special power of appointment without adverse tax consequences. 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. The powerholder need not even be a beneficiary. 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. Some estate planning techniques can be beneficial to all taxes. For example, a gift of a partnership interest can shift both income and wealth. 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. The latter circumstance 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.

As a general rule, most clients are motivated to create trusts by the significant transfer tax savings that can be achieved. 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. 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 is fully phased in, $2 million will be able to be sheltered from tax, resulting in a savings of $345,800 by using a trust.

Since federal unified transfer tax brackets start at 37 percent for the first dollar taxed and reach 55 percent (and 60 percent if the five percent surcharge is applicable) and the GST tax is imposed at the highest estate tax bracket (currently 55 percent) for each generation skipped for all non-exempt transfers, the stakes are high. 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 a dynastic trust.

Prior to the imposition of the GST tax, Prof. A. 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."[7] 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."[8]

Under Chapter 13 of the Internal Revenue Code (IRC) of 1986, each taxpayer may create a trust exempt from the GST tax with $1 million or, if married, $2 million. 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. The contrary result will accrue for those families who aggressively engage in sophisticated wealth shifting strategies. 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.

Although trusts can also save income taxes, these savings have been substantially reduced during the last several years 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. 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 and liability planning is becoming a more integral part of the business and estate planning processes. 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. Although there is a general dislike of paying taxes, paying to the federal fisc is generally more palatable for most people than paying a judgment creditor or a divorce settlement.

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.

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?" 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.

An irrevocable trust, set up by someone other than the beneficiary, provides the ultimate in creditor protection. As the asset protection maxim goes — "If you don't own it, nobody can take it away from you."[9] 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. As a result, unless trust property is distributed to a beneficiary, it will be protected from the beneficiary's creditors. 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 trust[10] or the ability to change trustees, the creditor protection may be lost.[11] 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. 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.

4. Valuation and Leveraging. The combination of dynastic trusts with valuation discounts and leveraging techniques creates the cornerstone of the advanced estate plan. 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. Such a course of action has been referred to as an "estate planner's dream."[12]

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. The need for a flexible plan increases in scope where the focus of the estate plan is multi-generational in design. A trust provides far greater flexibility than an estate plan under which property is transferred outright. 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 taxes and then make a taxable gift.

6. Providing for Liquidity at Death. Just like the fact that none of us relishes the idea of growing old, we all realize that it sure beats the alternative. 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.). Life insurance has traditionally been acquired for (i) estate creation and (ii) estate preservation. However, with new products, such as variable life, and new planning techniques, life insurance also may be arranged to provide lifetime benefits, such as tax-deferred growth. 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.

Setting The Table

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. With the clients' participation, we list the rights that the clients want in their property.

The conclusion generally reached is that most of us, and most of our clients, want to own our wealth whereby we:

(i) will have access to the income from our property until our death;

(ii) will have our assets available for our use and enjoyment until our death;

(iii) 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;

(iv) will be able to manage and control our property until our death;

(v) will have our property protected from creditors, including our spouses in case of divorce; and

(vi) will save taxes.

It would be reasonable to assume that the foregoing contains all of the rights in property that anyone would desire. However, such a structure would indeed be a "pipe dream"[13] if set up for oneself. The first four elements of the structure are inherent in outright ownership. 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. 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.

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. As a result, creditor protection would not be achieved.

Notwithstanding the foregoing, as will be seen later, a trust can be set up by a third party that is classified 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.

The Pipe Dream Becomes A Reality

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 six elements of the otherwise proscribed estate plan discussed in the preceding section. 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.

Extending And Leveraging The Benefits

If one accepts the thesis of this article, that placing property in a well-structured trust will enhance the wealth transfer and result in greater tax and non-tax benefits being obtained than owning the property outright, then the natural extension of such philosophy is that in designing and implementing the trust, the following four objectives also should be sought:

(i) 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;

(ii) select a jurisdiction that will not impose state income taxes on the trust earnings;

(iii) take advantage of funding techniques that leverage the $1 million GST tax exemption; and

(iv) 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.

Further, 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. 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 the beneficiary's transfer taxes and creditors.

The Beneficiary Controlled Trust Concept[14]

It has been our experience that high on many clients' wish lists would be 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. 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.[15] 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.

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. 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.

The beneficiary controlled trust concept is fairly simple. 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. Typically, control of the trusteeship is coupled with a power of appointment that can have the effect of eliminating any potential interference by remote beneficiaries. 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 bring a lawsuit because their rights could be eliminated.[16]

The use of a beneficiary controlled trust accomplishes or enhances all six of the desired components of the estate plan. From a beneficiary's perspective, the beneficiary can be given more benefits in a trust than he could obtain with outright ownership. 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. 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.

Obviously, not all clients share the foregoing philosophy, and sometimes circumstances preclude or suggest that all power not be lodged in a beneficiary. 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. Illustrations of circumstances where the client would not select a beneficiary controlled trust would include situations where the beneficiary is either legally (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. 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.[17]

Designing The Beneficiary Controlled Trust

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. 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. 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. 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. 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. The primary factors that should be considered in designing the beneficiary controlled trust are:

1. Income. Most trust scriveners draft trusts that pay out all of the income. This course of action moves the income from a tax and asset protected arena to one which is exposed. Distributions from the trust restrict the growth of the protected trust and are counterproductive from both a tax and creditor protection perspective. For transfer tax purposes, distributions will increase the beneficiary's estate. In addition, the retention of income in the trust will help the trust beneficiaries in accomplishing their own estate planning goals. If income is retained in the trust, the trust will grow creating a large accessible fund for the primary beneficiary of the trust. 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. 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.

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. Therefore, although trust corpus is shielded from creditors, some of the asset protection benefits inherent in the trust vehicle will be lost. 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.[18] By eliminating a beneficiary's enforceable rights, his creditor's rights are also eliminated.

Alternatively, for maximum creditor protection, a discretionary trust should be used.[19] 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."[20]

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. In such instance, since there is no proscription in the 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. Such a trust could authorize the beneficiary/trustee to distribute income and principal to himself based on the ascertainable standards of health, education, support and maintenance without taking into account his other assets. The use of the ascertainable standard would prevent estate tax inclusion as a general power of appointment under IRC Sec. 2041. 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. 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.

The income tax consequences of the foregoing arrangement are uncertain. They are governed by IRC Sec. 678(a), which provides that a non-grantor beneficiary will "...be treated as the owner...of a trust with respect to that 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 Sec. 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

Exhibit A

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

Annual After-Tax Growth	Value of Dynastic Trust After 120 Years	Value of Property If No Trust*
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.

to himself (and others).[21]

The effect of IRC Sec. 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. 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."[22] Alternatively, there is support for the positions that either the trust beneficiary would be treated as the owner[23] 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)."[24]

To avoid uncertainty as to the income tax consequences, and to increase flexibility and creditor protection, it is generally advisable to use a co-trustee[25] if that option is acceptable to the client. Use of an independent co-trustee is generally acceptable when one realizes that the grantor may have broad removal and replacement power as long as the replacement trustee is not a "related or subordinate party" as defined in IRC Sec. 672(c),[26] or, alternatively, such power may be lodged in the hands of the beneficiary.[27]

2. "Use" concept. The basic philosophy of this article is that a transfer of property in trust improves the value of the property to the trust beneficiaries. 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. The consequence of making distributions would be to move wealth from a tax and creditor protected environment into one that is exposed. 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 one percent makes in compounding income over 120 years. (This exhibit is in Parts 1 and 2 of this document).

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. The trustee is 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. 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 Sec. 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.

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. 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 providing benefits to the trust beneficiary without meaningful restrictions. 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.

The beneficiaries individually (or by utilization of assets in trusts not protected by the GST tax exemption) will be expected to absorb most family expenditures such as food, schooling and vacations. Additionally, trust funds will generally not be expended for consumable assets since use of protected funds in this manner would be wasteful. 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. 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. 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 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. Its importance increases when the trust is dynastic because there is a greater possibility of change in family circumstances, laws, particularly tax laws, etc. For many clients, the power of appointment is, and should be, an essential ingredient of the plan. They may not be inclined to proceed with their planning in its absence because of a concern of interference by a complaining beneficiary.

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. For example, by giving the trustee broad latitude in investing, including high risk/reward opportunities, it can be anticipated that some transactions will fail. If there were no trust, there would be no accountability to more remote descendants. 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. As Professor Ed Halbach has often stated, "[a] power of appointment is also a power of disappointment."

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 estate[28] without causing estate inclusion. 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. A power of appointment that can be exercised by making outright distributions, thus terminating the trust, can easily finesse that perceived problem. ◆

End Notes

1. For example, if a descendant was being sued or going through bankruptcy, a distribution to the descendant's spouse could finesse attachment by the descendant's present or potential creditors, yet still provide indirect benefits to the descendant.
2. See Malcolm A. Moore, "New Horizons in the Grant and Exercise of Discretionary Powers," 15 U. Miami Inst. on Est. Plan., Ch. 6 (1981).
3. See Malcolm A. Moore and Jeffrey N. Pennell, "Survey of the Profession II," U. Miami 30th Inst. on Est. Plan., Ch. 15 (1996).
4. 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) (Petition for rehearing pending), 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).
5. See Richard A. Oshins, "Some Viable and Effective Estate Planning Alternatives in a Sec. 2036(c) Atmosphere, Including The Megatrust[sm]," Richard A. Oshins and Lawrence Brody, 1989 NYU Institute on Federal Taxation; "Megatrust[sm]—Representation Without Taxation," University of Southern California 42nd Institute on Federal Taxation; Richard A. Oshins and Jonathan Blattmachr, "The Megatrust[sm]: An Ideal Family Wealth Preservation Tool," *Trusts & Estates* (Nov. 1991).
6. 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.
7. Statement of Prof. A. James Casner, Hearings before the House Ways and Means Comm., 94th Cong. 2d Sess. pt. 2, 1335 (1976).
8. George Cooper, "A Voluntary Tax? New Perspectives on Sophisticated Estate Tax Avoidance," The Brookings Institute (1979), p. 58.
9. Howard D. Rosen, 810 T.M., Asset Protection Planning, BNA Tax Management Portfolio at A-1.
10. *Hatsfield v. Lescher*, 721 F.Supp. 1052 (E.D. Ark. 1989).
11. *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.
12. See Cooper, fn. 9, at p. 47, *supra*.
13. 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.
14. 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).
15. The more controls a beneficiary has, the greater the possibility that creditors can launch a successful attack and negate the trust's spendthrift protection.
16. 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.
17. 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.
18. Scott, 2 Trusts 147-147.2 (2d ed. 1956).
19. See discussion under Satisfying the Goals of Estate Planning - Asset Protection Planning, *supra*.
20. Keydel, fn. 15, *supra*, at Sec. 409.1.
21. IRC Sec. 674(d).
22. Roy M. Adams, "Ask the Expert," *Trusts and Estates*, (Sept. 1996).
23. Keydel, fn. 15, *supra*, at Sec. 406.3.
24. Howard M. Zaritsky and Norman M. Lane, *Federal Income Taxation of Estates and Trusts*, 2d Ed. Sec. 12.02(1).
25. Keydel, fn. 15, *supra*, at Sec. 404.
26. Rev. Rul. 95-58, 1995-36 I.R.B. 16.
27. LTR 9746007.
28. IRC Sec. 2041(b)(1).