



# Innovative Trust Designs Better Serve Inheritors

Draft trust provisions to carry out an estate planning “wish list” that encapsulates universal client aims.

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**S**killful estate planners can select from many trust blueprints to achieve a wide range of benefits for their clients and clients’ loved ones. This article suggests several new opportunities to enhance trust design by making minimal, but meaningful, adjustments to the trust format. Practitioners can start with traditional trust composition and then recommend to clients these additional compelling design features not normally considered:

1. Expanding the list of potential trust distributees from the primary trust to secondary trusts (i.e., trusts for the benefit of the individual beneficiaries and their family units).
2. Designing income tax basis-bump planning opportunities. Obtaining free basis adjustments may be the most potent income tax shelter device advisors have in their tool box.

3. Nontraditional grantor trust planning; trustees creating trusts a beneficiary can use for the beneficiary’s own estate planning.
4. Using a “use” trust.
5. Every trust should be an ILIT.

The impact of including the expanded format is discussed below, after setting forth the

goals and the authors’ preferred structure.

## The goal

This article is intended to provide forward-thinking advisors with a road-map of enhanced planning opportunities, without a downside risk, to assist their clients. Many clients, and their advisors as well, fail to consider the potential harm that they expose their loved ones to by not passing wealth to them in trust.<sup>1</sup>

Typically, the benefits cited about trusts as wealth sheltering tools are transfer tax avoidance, creditor and divorce protection, and management. The foregoing supplements these basic objectives by adding non-controversial, but extremely powerful, ancillary benefits that expand the virtues of trust planning and that are infrequently considered. They magnify the principle that inheriting wealth in trust is optimal and is always superior

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than inheriting those same assets outright.

### Client's goals

Everyone wants the exact same six items with regard to their property—no more; no less—except that their priorities vary. These items compose this “wish list”:

1. Managerial control.
2. Use and beneficial enjoyment of the wealth and income, if desired.
3. Flexibility and amendment power.
4. Creditor shelter, including protection from a divorcing or dissident spouse.
5. Tax shelter, including income tax and transfer taxes.
6. Avoiding complexity.

Are there any additional components that an advisor or clients would want to be added to the list? Does an advisor or client *not* want any of these features? The authors conclude that no desirable additions are missing from the list, and only rarely would a client not want all of these components.

The prioritizing of the “wish” items differ from client to client. Each item is easily achievable under the same trust format, however, without compromising the other items. The result is that the right trust design can achieve all of the benefits of outright ownership, without the exposures of having legal title. If the desire is to pass wealth outright, all of the foregoing should be given to the inheritor. In addition, the new features being advocated should also be incorporated into the planning. The wish-list shelters—items 4 and 5 on the list—should never be compromised.

Often, advisors eschew the trust wrapper because the estate tax threshold is very high, without adequate consideration of the creditor protection benefits of the trusts

or the income tax savings that are obtainable with trusts. The enhancements will almost always improve the inheritance without ever harming it.

**The right trust achieves all of the benefits of outright ownership, without the exposures of having legal title.**

A beneficiary will never be completely happy without “full control.” Full control is the maximum controls that a person can be given without ceding the protections. Proper trust design can provide control that is essentially the equivalent of owning the wealth outright with the limited exception of life insurance on the life of a trustee insured. For those inheritors who do not have the profile to receive wealth outright, beneficiary controls 1 through 3 can be limited, adjusted, or not given at all.

An “independent trustee” is essential to maximize the desired benefits. Because of the desire for full control, the office of independent trustee is subject to “control” by the primary beneficiary with minimal constraints. The independent trustee increases protections and provides tax economies that are not available without an independent trustee (or if property is transmitted outright).

Because clients often are focused more on income tax savings than on alternative wealth transfer opportunities, basis-bump planning will be a very welcome enhancement to them. Clients also will want to avoid sibling conflicts. Thus, the ability to transfer wealth in trust to one sibling and his or her family units to the exclusion of the others is essential to family unity. Often, proper

advice is that clients should not want assets or controls shared by siblings and their family units.

### Preferred design and distribution format

An expanded list of permissible distributees will be sanctioned. Authorized distributions or the use of trust assets are approved upstream, laterally, and downstream. Distributions to trusts for (all or most) permissible beneficiaries, including both existing and those newly created by the independent trustee (or others) are allowable and even encouraged.

### Sample dispositive scheme

The distribution provisions of the trust give the independent trustee the broad discretion to distribute (or not distribute), or provide the use of, income, or principal to any of the following:

1. The primary beneficiary.
2. The spouse of the primary beneficiary.
3. Descendants of the primary beneficiary.
4. The living spouse of any descendant who is deceased (provided that such spouse was living with the descendant at the time of the descendant's death or was unable to because of health reasons).
5. Remote inheritors added for basis planning. This will be customized. It can be broad, such as classes of beneficiaries (i.e., parents, grandparents, or in-laws of the foregoing distributees) or narrowly defined, such as a list of names (including friends).
6. Trusts for the primary benefit of any of the foregoing listed in 1 through 5, above. The trusts can be either existing or newly created trusts. Ordinarily, the independent trustee will create a new trust.

**Planning note.** The distribution and use standards can be varied. Very often senior generations will receive preferential treatment, and the benefits for participants under 5, above, are reduced.

### Components of the perfect trust

“A dynastic; discretionary (where distribution power is in the hands of an independent trustee who can be fired and replaced); Beneficiary Controlled Trust (unless (i) controls are undesirable or (ii) impermissible under laws to avoid the taxing authorities and other claimants); where the “use” of trust assets rather than distributions is encouraged (unless beneficiaries are beneficial or desirable); situated in a trust-friendly jurisdiction.”<sup>2</sup>

The trust should have these enumerated characteristics for the reasons that follow.

**Dynastic.** If receiving assets in trust makes sense, why not draft it to continue for as long as the law permits? The trust can be recycled generation after generation, subject to restructuring through special powers of appointment to enable the primary beneficiary and each successor primary beneficiary to re-write it for changes in the law or family dynamics or any other purposes.

**Discretionary.** That feature provides maximum tax and creditor protection.

**Beneficiary controlled.** Control is essential to assure the beneficiary’s happiness. Generally, control is shifted to the beneficiary at the “proper time” (i.e., projected maturity and competency). Controls may be restricted, delayed, or not given at all, based on the profile of the primary inheritor. That decision must be made in any trust. The authors’ thesis is to expand the benefits of the trust wrapper, not to compress them.

**Special features.** Certain features should be included in the trust indenture to best secure the beneficiary’s control status. Some independent trustees might be concerned about the duty of impartiality, in which the trustees generally are required to be impartial in dealing with the various beneficial levels of participation of beneficiaries. That concern is easily overcome through proper trust design. First, the trust should expressly provide that the primary beneficiary is favored, and the other beneficiaries are to receive what is left over. Second, provisions in the trust indenture may indicate that the independent trustee is to give preferential treatment to the primary beneficiary even to the exclusion of others.

Certainly, the controls given to the primary beneficiary clearly are indicative of the transferor’s preferences. Other indicators of the fact that the independent trustee is to give preferential treatment to the primary beneficiary and that the trust was selected as a sheltering vehicle to obtain and preserve “in trust” protections rather than the transferor selecting an outright transfer include:

1. A lifetime special power of appointment allowing removal of a complaining or dissident beneficiary.
2. Broad provisions to fire and replace the independent trustee.
3. Broad discretionary powers on both the distribution trustee’s right to distribute or permit the “use” of trust assets “in the best interest of the beneficiaries, giving preferential treatment to the primary beneficiary during his or her lifetime” using broad standards such as “happiness.”
4. Broad exculpatory clauses, etc.<sup>3</sup>

**Use-trust provisions.** The use-trust concept is based on the thesis that control and beneficial enjoyment are desirable, and legal title is harm-

<sup>1</sup> Keydel and Wallace, “Design Strategies for Dynasty Trusts,” ACTEC Meeting, 3/6/1999, page 49; R. Oshins and S. Oshins, “Protecting & Preserving Wealth Into the Next Millennium,” Parts 1 and 2, *Trusts & Estates* (Sept. and Oct. 1998); Aucutt, “Structuring Trust Arrangement for Flexibility,” 35 *U. Miami Inst. On Est. Plan.*, Ch 9 (2001); Calleton, McBryde, and Oshins, “Building Flexibility and Control Mechanisms Into the Estate Plan—Drafting From the Recipient’s Viewpoint,” *NYU 61st Inst. on Federal Taxation* (2003); Oshins and Siegel, “The Anatomy of the Perfect Modern Trust—Parts 1 and 2,” 43 *ETPL* 3 (January 2016) and 43 *ETPL* 22 (February 2016).

<sup>2</sup> Oshins and Siegel, *supra* note 1.

<sup>3</sup> Keydel and Wallace, *supra* note 1.

ful.<sup>4</sup> Therefore, operationally, the authors recommend that the assets not be owned outright. The “use” of trust assets is preferred rather than distributions. Retaining title in the trust wrapper avoids both unnecessary liability and taxes. It also provides simplicity, the sixth wish list item. Therefore, force-outs such as pay all income, pay HEMS (i.e., distributions for health, education, maintenance, and support), and 5 or 5 powers (i.e., annual access to the greater of \$5,000 or 5% of the trust’s fair market value) should be avoided.

The beneficiary just uses the trust assets, similarly to using revocable trust assets, but with the safety that the trust wrapper provides. If distributions are preferable or desirable, they should be liberally made. Based on the primary beneficiary’s profile, distributions might be made even if they are simply for happiness, under the theory that the client wanted to pass the wealth outright, but did not do so because of the trust shelter benefits. If distributions are necessary, it is a good thing that the wealth was transferred in trust, because the trust has trust spendthrift protection.

As previously mentioned, the prevailing rule of estate planning should guide the distribution trustee, which is that assets inherited in trust are always more valuable than those same assets would be if they were owned outright. That fundamental thought process is especially true with respect to core assets that, if lost, would be very devastating. Because the primary asset is the “goose” that lays the golden eggs, the trust wrapper is essential to shelter core assets.

**Situs selection.** Situs is very important. The factors with the greatest impact are duration; state income taxes; and creditor protection. Often, preferred state law situs is simply

rented for protection. In that situation, cost is frequently negligible, and trust attributes are meaningful.

**Additional features.** Four additional features will magnify the design. They comport with the four enhancements advocated below:

1. Grantor trust status for income tax purposes. If a primary trust that is not a grantor trust distributes to a secondary trust subject to a power of withdrawal, the beneficiary is the deemed owner of the secondary trust income under Section 678. (See the BDITS discussion, below). There are, however, many positive features of complex trusts that may overcome the normal preference of grantor trust status. These benefits include avoidance of state income tax and bracket shifting. Avoidance of state income tax over a long period often is a very considerable benefit.
2. Income tax basis planning. This is achieved by giving carefully crafted general powers of appointment to predeceasing beneficiaries. The benefits can increase by having the deemed owner for income tax purposes exchange low-basis assets with the beneficiary grantor trust before the inclusion of assets in a remote beneficiary’s estate. The third option is for the beneficiary to exchange high-basis for the trust’s low/negative-basis assets prior to death. An ancillary benefit that should be considered is for the beneficiary to sell assets that have decreased in value to the trust before death to avoid a basis step-down, because Section 1014 cuts both ways.
3. Enabling trust assets to be transferred within a trust wrapper—a “secondary trust.”

4. ILITs. Every trust should permit the purchase of life insurance on all trust beneficiaries, including the primary beneficiary. Life insurance on the life of the primary beneficiary creates the quintessential ILIT.

#### Enhancement #1

*Increase the list of potential distributees to trusts for the benefit of permissible distributees and their family units.*

By expanding the permissible distribution list to include “trusts for any individual trust beneficiaries” (“secondary trusts”), the client is transferring a very valuable potential benefit to inheritors, a “gift” of the opportunity to plan. That confers a benefit that the beneficiary could not create for himself or herself if he or she owned the asset or had a right to the asset.

The predominant use of this variance is for the independent trustee to create a trust for the benefit of one of the downstream trust beneficiaries, such as a child or a grandchild. The transfer to the secondary trust can be either subject to a power of withdrawal or not. With either option, the trust can be a beneficiary controlled trust (or not), and the trust protections normally produced by the trust wrapper are preserved.

<sup>4</sup> This philosophy is consistent with an astute observation attributable to John D. Rockefeller, “Control everything. Own nothing.”

<sup>5</sup> Section 678.

<sup>6</sup> Rev. Rul. 85-13, 1985-1 CB 184.

<sup>7</sup> Morrow, “The Optimal Basis Increase and Income Tax Efficiency Trust: Exploiting Opportunities to Maximize Basis, Lessen Income Taxes and Improve Asset Protection for Married Couples after ATRA (Or: Why You’ll Learn to Love the Delaware Tax Trap),” available at SSRN (last revised 2/10/ 2017); and Lee, Brewer, and Harrison, “Venn Diagrams II: Tax Basis and Income Tax Planning for Larger Estates,” 48th Annual Philip E. Heckerling Institute on Estate Planning (2014).

<sup>8</sup> Section 2041.

<sup>9</sup> Section 2041(a)(3). We will discuss the strategy in terms of the GPA in the remainder of the article.

<sup>10</sup> Reg. 20.2041-3(b).

<sup>11</sup> Section 2041(b)(1)(C)(2).

<sup>12</sup> Estate of Freeman, 67 TC 202 (1976).



If a power of withdrawal is used, the trust income will be taxed to the trust beneficiary.<sup>5</sup> The primary additional virtues of that alternative are that the primary beneficiary can transact with the trust income tax-free and the estate depletion of the beneficiary's estate as a result of paying the taxes on the phantom income.<sup>6</sup> The trust will be a beneficiary defective irrevocable trust (BDIT), a beneficiary taxed trust under Section 678.

Alternatively, if the trust is not funded with a power of withdrawal, it will be a complex trust, and the virtues of that design can be enjoyed. Under either alternative, the basis planning discussed below can magnify the benefits of this planning.

A variance of the BDIT theme can be either upstream or laterally. For example, an independent trustee can create a trust for a wealthy parent of the primary beneficiary subject to a power of withdrawal so that the parent is the owner of the trust income under Section 678. This enables the family to tax burn the parent's estate, or enable the parent to engage in transactions with the trust obtaining benefits of tax-free transactions and exchanging high-basis assets for low-basis assets.

This strategy is based on the principle that someone else can "give" a person rights and controls that the person cannot "retain" for himself or herself. Because the trust is not created by the primary beneficiary, and the primary beneficiary never makes a gratuitous transfer to the trust, it is a third-party-created trust. The interest is tested principally under the more liberal Section 2041, rather than the more onerous Sections 2036 and 2038.

The receipt of a "gift" of a planning vehicle and planning opportunities is a very valuable, underused sheltering strategy. It is an advan-

tageous opportunity without a cost and should become a constant in the estate planner's arsenal.

In addition to the transfer tax, income tax, and creditor protection virtues associated with using trusts as recipients of trust distributions, there are inherent family planning advantages of the expanded structure. For example, transfers to a trust for one beneficiary (and his or her family unit) can isolate wealth and controls to the exclusion of others. Prudent family planning dictates that siblings not share certain assets. Simply by adding trusts for the benefit of the individual allowable beneficiaries, many extraordinary value enhancements will inure to clients and their families.

#### **Enhancement #2**

##### *Make use of basis-bump planning.<sup>7</sup>*

To most clients, income tax savings are more compelling than transfer tax or creditor shelter protections. The ability to avoid Section 1031 lock-in, or to receive a free new basis, is very appealing.

Under the Code, if a person dies owning a general power of appointment (GPA), the asset subject to the GPA will be included in the decedent's estate.<sup>8</sup> The same result is obtained by violating the Delaware Tax Trap.<sup>9</sup> Under Section 1014, to the extent that the GPA is given to a beneficiary, the basis will step-up or down to the power-holder's estate tax value. That result provides planners with some extremely beneficial planning opportunities for their clients.

The independent trustee, or a trust protector, would have the power to give, take away, design, restrict, etc. the GPA. Often, the restrictions would include the use of a formula clause to avoid estate taxes and would select asset categories or specific assets so that the basis bump would be most effi-

cient. Thus, usually commercial depreciable real property would be favored over capital gains assets in the ordering of application.

For example, negative-basis commercial real estate could receive a new basis to the fair market value of the power-holder/decedent and could then be re-depreciated or sold without gain. The technique can be used multiple times. Often, this strategy is referred to as "reverse" planning because it is primarily used by expanding the list of permissible discretionary beneficiaries to include "upstream," "lateral," and other beneficiaries.

The mere existence of a GPA results in inclusion. That does not mean that the beneficiaries can actually exercise the GPA. Restrictions can be placed preventing exercise or making it very difficult, including (1) requiring prior notice of exercise;<sup>10</sup> (2) requiring consent of a non-adverse party;<sup>11</sup> or (3) the beneficiary not knowing of the existence of the GPA, even if no notice is given.<sup>12</sup> On the other hand, the authors believe that the power-holders must be real and legitimate, similar to *Crummey* beneficiary qualification. The distribution and use standards often are reduced for remote discretionary distributees (e.g., "need" rather than "happiness"). The benefits can be through distributions or use of the trust titled assets. Contrary to the visceral reaction by many advisors and clients, most clients will want to help needy parents or in-laws, or are doing that anyway. From a value proposition, the help is modest compared to the potential benefits that are achievable.

Most people will die with unused applicable exclusion amounts. The trust's dispositive structure should be expanded to include many secondary distributees, such as parents, in-laws, grandparents, friends, etc. who are expected to

have unused applicable exclusion amount. If the independent trustee gives them a GPA, typically to the extent of their unused applicable exclusion amounts (or less if state death taxes are an issue), the assets subject to the GPA will receive a basis revision to date-of-death values.<sup>13</sup> That is a very valuable commodity. Consider the value of a new fair market basis, or multiple basis bumps, to clients. For most clients, the tax sheltering income tax benefits derived from this process is very meaningful. What is the value of multiple basis bumps without any costs other than fees? This should not be a wasted opportunity for planners to help their clients.

### Enhancement #3

#### *Engage in nontraditional grantor trust planning.*

One of the most popular wealth transfer technique is the use of intentionally defective grantor trusts for sales, gifts, or opportunity shifting. The wealth owner will make a transfer to a trust that is intentionally designed to be treated as a grantor trust for income tax purposes, but not for transfer tax or state law purposes. Often, sales are made to the trust of discountable or appreciating assets to shift post-transfer growth and the discount from the estate. The sale is income tax-free.<sup>14</sup> Because the donor pays the income tax, his or her estate is depleted by the taxes paid—the “tax burn.”

### Enhancement #4

#### *Every trust should be an ILIT permitting the acquisition of life insurance on the primary beneficiary and others.*

Generally, planners and clients are faced with an option as to the ownership of life insurance. They can do either of the following:

- Transfer the policy out of the estate to an ILIT in order to avoid estate tax inclusion. That alternative precludes the retention of the lifetime benefits, such as access of the policy. It also results in the complexities and potential adverse gift tax implications of funding the ILIT.
- Retain ownership of the policy for access, which will result in estate tax inclusion.

Either option often compromises a valuable benefit. In addition, for many clients the payment of premiums to an ILIT results in a forced gift-giving plan that is uncomfortable or has an impact on their lifestyle. Other clients' planning may be compromised because funding their ILITs reduces the amounts that could be used for tax-free transfers of alternative assets. Further, the assets in the trust form a funded ILIT that avoids or compresses the funding complexities and amounts of a naked ILIT.

It is indisputable that owning life insurance on the life of a beneficiary/trustee makes the policy more valuable because it enables indirect access without estate tax inclusion.

### BDITs

Prior to explaining the planning strategy in action, a review of the BDIT concept is useful. A BDIT is an irrevocable trust created and funded by someone other than a trust beneficiary, for the benefit of the primary beneficiary and his or her family unit. There is no prescription to an independent trustee being the trust creator. For transfer tax and state law purposes, because the trust is created by someone else and the trust beneficiaries never make a gratuitous transfer to the trust, the trust is

exempt from the transfer tax system and creditors.

For income tax purposes, all transfers to the trust are subject to a lapsing power of withdrawal. If the trust is funded by a person, the donor cannot be an income tax grantor of the trust.<sup>15</sup> If distributions from a current trust are allowable into a trust and the independent trustee funds the secondary trust from an existing primary trust, the primary trust cannot be an income tax grantor trust, or the primary trust will be deemed to be the grantor of the secondary trust.<sup>16</sup>

Under U.S. law, anyone else can set up a trust with all of the wish list characteristics for another individual's benefit, but an individual cannot do the same thing for oneself. Typically, but not always, a BDIT is created for a person as an accommodation so that the beneficiary can do his or her estate planning outside of the proscriptions of self-settled trusts. The person who owns the property, or has the right to the property, has extremely restricted planning options for his or her own benefit. Because the BDIT is a third-party trust funded by a lapsing power of withdrawal, it is transfer tax protected, creditor sheltered if situated correctly, and a beneficiary grantor trust for income tax purposes. The beneficiary-owned income tax status has two very significant benefits. It permits the beneficiary to transact income tax-free with the trust and because the trust is a grantor trust, the owner of the income will incur the income tax burn.

<sup>13</sup> Section 1014(b)(9).

<sup>14</sup> Rev. Rul. 85-13, *supra* note 6.

<sup>15</sup> Section 678(b).

<sup>16</sup> See Reg. 1.671-2(e)(6), Example 8; Ltr. Rul. 201633021.

<sup>17</sup> Section 678(a).

<sup>18</sup> Rev. Rul. 85-13, *supra* note 6.

### Illustration #1A and #1B

*Opportunity shifting for Spencer and a sale of Katie's existing business to BDITs.*

Illustrations #1A and #1B have a similar theme. Spencer and Katie are two siblings and remote beneficiaries of a primary trust that is a fully discretionary and permits trusts for the beneficiaries. For income tax purposes the primary trust is a complex trust.

Both children are very competent and responsible individuals who could and should be in control of their own trusts. Spencer has a favorable business or investment opportunity. Alternatively, someone else has an advantageous opportunity that he or she would like to shift to Spencer. Katie owns a successful business.

From a family-unity perspective, it would neither be fair nor sensible for the children to have shared ownership, shared controls, shared distribution patterns (which leads to inefficient income tax planning), the same advisors, or sibling scrutiny or involvement. Sharing would be particularly unjust where a child was or would be investing sweat equity in the business or investment. The suggested planning process isolates assets that siblings should not share.

**Planning for Spencer's new business or investment opportunity—#1A.** One of the simplest, most effective estate planning strategies is "opportunity shifting," taking advantage of the fact that the shifting of a favorable business or investment opportunity is not a taxable gift because nothing tangible or intangible is being transferred, but, rather a mere nontaxable hope. By shifting the opportunity into the BDIT, Spencer will have received a "gift" of all of the components of

the wish list: full control, all protections, and simplicity.

The independent trustee would set up a newly created trust (secondary trust) with a transfer to the trust subject to Spencer's lapsing power of withdrawal. Spencer would be treated as the "owner" of the trust for income tax purposes.<sup>17</sup> Therefore, he can transact with the trust income tax-free<sup>18</sup> and, by paying income tax on any phantom income, Spencer can deplete his other wealth.

**Planning note.** If the gift was not subject to a power of withdrawal, all "in trust" benefits would still apply. The trust would be a complex trust able to obtain other income tax economies, such as the avoidance of state income taxes.

**Katie's existing business—#1B.** The planning process for Katie incorporates one additional step. Katie would sell her existing business to her BDIT, the secondary trust created for her benefit. She would receive back a note for the value of the business at the time of the sale. The sale would be designed as a defined value transaction. Because Katie owns the trust income, the sale is income tax-free. Over time, the expectation is that the note will be paid off and tax burned.

The power of the BDIT concept, all wish list components, plus beneficiary grantor status, is dramatically accentuated by using "cascading BDITs." These are trusts set up by the independent trustee, recycled generation after generation, amendable through broad special powers of appointment to adjust for changes in family dynamics or changes in the law, for as long as the governing law allows.

**Ancillary benefits for Katie and Spencer.** The BDITs would:

- Be funded ILITs where the independent trustee can acquire life insurance on the life of the child.
- Could become similar to a pre-nuptial agreement.
- Allow for basis-bump planning.
- Be recycled to future generations subject to revision by a special power of appointment.
- Avoid the risk inherent in intentionally defective grantor trusts where the tax burn could produce harmful economic consequences. Although grantor trust status could be turned off, the timing could be problematic and be tax inefficient.

The benefits achieved from this planning are:

- Simplicity.
- A funded ILIT where they can be beneficiaries (unlike most ILITs).
- Protection of their essential core asset.
- Segregation of assets that should not be comingled with siblings or others.
- An effective prenuptial substitute.
- A "tax burn" of their other assets through application of the grantor trust rules, which could, if desired, eliminate their other assets.

They would in effect have the perfect estate plan.

### Illustration #2

*The power of basis-bump planning.*

John is a successful married physician who owns his office building personally. As a physician, he has reduced opportunities to shelter income and to pass wealth in a leveraged transaction. Retirement planning has many restrictions and complexities, including having to cover employees. Both John's parents and in-laws are living. John's grandmother passed away recently,

leaving wealth in a discretionary trust providing for descendants and trusts for their benefit.

The independent trustee will create a BDIT with John as the primary beneficiary. In addition to the typical discretionary design, John's wife, John's parents, and John's in-laws are discretionary beneficiaries of the trust. It is a beneficiary-controlled trust, so John makes all investment decisions and has the power to determine the identity of the independent trustee.

**Every trust should permit the purchase of life insurance on all trust beneficiaries, including the primary beneficiary.**

John will sell his office building to the BDIT for a fair market value note. The cash flow from the lease of the building to the entity will fund the note. Because it is a BDIT, John will be entitled to the depreciation shelter. John may also consider selling to, or acquiring office equipment in, the BDIT.

Over time, both parents, both in-laws, and John's wife predecease John. All five were given carefully crafted GPAs over the trust assets. As a result, the building will receive a new fair market value basis at each decedent's death, providing John with new depreciation deductions. Prior to John's death, he exchanged his high-basis assets and cash for the office building. That exchange resulted in a sixth basis bump at his death.

Conversely, high-basis assets (i.e., fair market value is less than the basis) transferred to the BDIT in exchange for the low-basis assets will preserve the high basis and

avoid the reduction to date-of-death values because Section 1014 works both ways (i.e., it can provide a step-up in basis or a step-down in basis).

Two ancillary benefits were obtained. As a physician, John was very concerned about potential malpractice liability. Because the BDIT is a third-party-created trust created in a trust-favored jurisdiction, John has substantial creditor protection. By paying the income tax on trust income, John's exposed estate was compressed further. Moreover, rather than establishing a retirement plan that included employees, John's BDIT acquired some cash value life insurance to provide tax-free accumulation for his retirement.

### Illustration #3

#### *The quintessential ILIT.*

Life insurance is an asset that estate owners frequently purchase. It is acquired for a variety of reasons. Three popular reasons are:

1. Estate creation.
2. To pay taxes and expenses as a result of death.
3. As a safe alternative investment asset backed by a powerful financial institution and benefited by the income tax-free build up.

None of these features are mutually exclusive, and the acquirer of life insurance may desire to obtain more than one of the benefits. Frequently estate owners are, however, forced into elections that have adverse consequences irrespective of which path is selected.

Life insurance (other than term insurance) has two components; the lifetime benefit and the death benefit. Frequently, the planner and the client are faced with the options of:

1. Transferring the policy out of the estate in order to avoid estate tax inclusion, which

precludes the retention of the living benefits, such as access to the policy through loans.

2. Retaining ownership of the policy for assets, which results in estate tax inclusion.

Either option compromises a valuable benefit. Funding a policy in a traditional ILIT has costs and complexities. It involves transferring wealth to someone else and surrendering access to both the gifted wealth and the policy itself. Contrarily, a funded trust set up by another person provides substantial funding benefits irrespective of the income tax consequences, although this strategy is most often used where the beneficiary is both the insured and the income tax payer in a BDIT.

For many clients, the payment of premiums to an ILIT to benefit others causes mental or economic stress for the insured/donor. Essentially, it is viewed by some as a forced gift, or reduction of monies that could better be used elsewhere or retained. For some, it reduces the amount available for annual gift giving. Irrespective of the reason, it is easily concluded that the client would prefer to have access than not to.

The characteristics discussed previously can be combined into the perfect planning device, illustrated by the following facts. Assume an existing trust has the features recommended in this article. The distribution trustee will create a beneficiary-controlled secondary trust for a discretionary primary trust beneficiary, such as Katie, Spencer, or John. The secondary trust would be funded by a gift subject to a lapsing power of withdrawal. The trust would be designed with an expanded number of beneficiaries, such as in-laws, parents, grandparents, and the spouse of the primary beneficiary.



Assume that the beneficiary has some depreciable real property that he or she uses in a business. The trust is a BDIT. It is a third-party-created trust for both state law and transfer tax purposes. The income is deemed owned, thus taxed, to the beneficiary under Section 678.

- The primary beneficiary will sell the real property to the trust for a note of equal value. The note will be paid by lease payments from the business. The sale is transfer-tax neutral because it is for equivalent value and ignored for income tax purposes because of the grantor trust status.
- Excess cash flow may be used to acquire life insurance on the life of the primary beneficiary, therefore, avoiding the funding problems. All decisions as to the life insurance on the life of the primary beneficiary must be made by the independent trustee, and the policy or its proceeds cannot be subject to a power of appointment. The beneficiary will have the lifetime advantages of a cash value life insurance policy with access provided by the independent trustee without estate tax inclusion. Policies on the life of anyone else are not subjected to the control, direct access, or power of appointment restrictions. The cash value life insurance may provide a retirement fund that can enable the primary beneficiary to avoid the installation of a business retirement plan. This advantage is especially powerful for physicians or other inheritors with similar profiles.

The life insurance increases in value to the inheritor because he or she receives (1) access; (2) estate tax avoidance; (3) simplified and efficient funding; and (4) avoidance of a continuing commitment to transferring continued funds earmarked for premiums. Moreover, as a result of the basis-bump planning, the money used to pay premiums can be viewed as being income tax-sheltered funds.

- Because the primary beneficiary did not create the trust, the trust assets are creditor-protected, and tax sheltered even though the beneficiary has controls, except for those proscribed for life insurance on his or her life.
- If both parents, both in-laws, and the spouse are trust beneficiaries who die with proper basis-bump planning, there will be five opportunities to bump the basis on assets funding the cash value life insurance to fair market value. The commercial real estate can be transferred without needing Section 1031 lock-in protection, or re-depreciated five times. That is a very powerful benefit.
- Assume that, prior to death, the primary beneficiary sells the high-basis assets to the trust for the low-basis property. That would be a sixth basis bump.
- The independent trustee of the next generation will have the death benefits and can set up cascading BDITs for others.

### Conclusion

The simple addition of trusts as potential discretionary distributees can provide families with many powerful planning opportunities. This structure can enable the primary trust to do planning for loved

ones that they could not do for themselves. Many advisors take advantage of the virtues of generation-skipping trust planning. That generally is advised as a transfer tax avoidance strategy. Because of the GST tax, “the generation-skipping trust is one of the most powerful estate planning techniques in the estate planner’s arsenal.”<sup>19</sup> The GST tax exemption is a very valuable commodity, and capable advisors use strategies to leverage that exemption, such as installment note sales to grantor trusts.

The expansion of permissible beneficiaries extends the ability for superior planning. It can provide (1) transfer tax avoidance, (2) income tax sheltering; (3) creditor protection (including protection from a dissident or divorcing spouse or ex-spouse); (4) avoidance of conflicts through the segregation of assets that should not be shared with siblings and others; (5) an ILIT in which the insured can be a beneficiary, and (6) basis-bump planning.

If the trust is designed as a beneficiary taxed trust, the virtues also will include (1) the tax-burn benefits for both estate tax and asset protection; (2) the ability to transact income tax-free with the BDIT to shift “hot” assets to the trust; and (3) the ability to basis plan by selling low-basis assets for cash or high-basis assets before death. Basis planning further increases the value of the suggested trust design. The value derived by obtaining reusable depreciation for many clients is massive.

Because there is no downside risk in expanding the beneficiary list, the trust draftsman should consider using the strategy. ■

<sup>19</sup> See, e.g., Cooper, “A Voluntary Tax? New Perspectives on Sophisticated Estate Tax Avoidance,” 77 Columbia L. Rev. 161 (March 1977).