The Inheritor's Trust: The 21st Century Planning Tool

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The Inheritor's Trust™ is a concept that has been taking the legal and tax communities by storm, and it's easy to see why. Incorporating features of the bypass and dynasty trust but more powerful than either, The Inheritor's Trust™ is designed to give the inheritor control and beneficial enjoyment of the trust property, as close to outright ownership as possible, without compromising the ability to avoid transfer taxes at the beneficiary's death as well as the ability to protect the trust assets from creditors.

Despite these advantages to the beneficiary, The Inheritor's Trust™ is not yet as well known in the financial planning community as it should be. That can be expected to change, since The Inheritor's Trust™ offers significant benefits to the planner as well as the client: it opens up a rich new vein for prospecting, allowing leverage of family members' GST tax exemption.

This presentation will discuss:

- Design features and advantages of The Inheritor's Trust™;
- Application of The Inheritor's Trust™ to some classic planning techniques;
- Use of The Inheritor's Trust™ as a prospecting tool.

What is The Inheritor's Trust™

The Inheritor's Trust™ takes advantage of the concept that gifted or inherited property received and retained in trust is much more valuable to the recipient/inheritor then receiving property outright because such wealth is protected from:

- estate and gift taxes, as well as generation-skipping taxes, to the extent the trust is GST "exempt";
- the claims of creditors including those in the hands of a bankruptcy court; and
- divorce awards.

Significant planning opportunities are available by looking "upstream" and having someone, such as a parent, a grandparent, aunt, uncle, or even a spouse create an Inheritor's Trust™, a multigenerational trust for the benefit of your client, to help the client do his or her planning.

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Some Basic Features

The design of The Inheritor's Trust™ generally includes all or most of the following attributes:

1. Beneficiary has full control

It has been our experience that clients are extremely pleased that their descendants and other objects of their bounty (and, if they respond candidly, themselves) can receive protection from creditors and from taxation, 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 he or she is placed in control (or, if the inheritor is not sufficiently mature, if he or she will eventually be placed in control of the trust), and if the inheritor understands the virtues of receiving property in a trust he or she controls. The two vital components of control are managerial control and control of the office of trusteeship.

Management control— generally, the beneficiary will be in "full control" of the trust as trustee, except that an independent (or special) trustee will have tax sensitive powers. Therefore, the beneficiary will have the same investment and management control in his capacity as trustee as he would if he owned the property outright, except for life insurance on his own life. Although the beneficiary can even have the power to make distributions to himself based on an ascertainable standard, such as support, health and education, without considering any other resources that might be available, we recommend against that structure since it compromises some of the tax savings, as well as the creditor protection.

Control of identity of trustees— typically, the inheritor will be (at the appropriate time) the trustee in charge of all non-tax sensitive decisions. At such time as the grantor desires, the beneficiary will generally control the identity of the independent trustee. The ability to fire and replace the trustee need be limited only by the restrictions necessary to preserve the tax status, i.e., the beneficiary cannot appoint a trustee who is a related or subordinate party pursuant to IRC § 672(c) (see Rev. Rul. 95-58, 1995-2 CB 191). There is no requirement that a confrontational relationship exist. The office of independent trustee may be occupied by the beneficiary's best friend.

2. Trust Provisions Are Changeable

Generally, the inheritor will be given broad, special powers of appointment (re-write powers) that allow the inheritor to change the terms of the Inheritor's Trust™ or even to terminate the trust. The re-write power is tax neutral so long as a general power of appointment is not created. Therefore, the inheritor/powerholder may amend the trust exercising the power in favor of anyone other than himself, his estate, his creditors, or the creditors of either, in trust or outright, without transfer tax exposure under IRC §§ 2041(b)(1) and 2514(c). Generally, this amendment power is given to the descendants on a per stirpital basis.

The restrictions necessary to avoid general power of appointment status are, for practical reasons, meaningless.

3. Separate GST Exempt and Non-exempt Subtrusts Are Available

The Inheritor's Trust™ generally provides for separate GST tax-exempt and non-exempt subtrusts with inclusion ratios of either zero or one. This allows more efficient use of the grantor's GST exemption, for example, by allowing the trustee to make distributions to non-skip persons from a nonexempt subtrust, or to pay medical and educational expenses to the provider, a payment which is protected from GST exposure.

4. The Inheritor's Trust™ Is Intended to be Perpetual

The Inheritor's Trust™ is dynastic, designed to continue for as long as applicable law permits. Clients may also forum shop to obtain a longer perpetuities period than would be otherwise available, by selecting a trust company with offices in a state that has abolished the rule against perpetuities.

5. The Inheritor's Trust™ Offers Flexibility in Deciding Who Will Pay Income Tax.

Separate trusts can 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

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whereby the beneficiary is treated as the owner under IRC § 678; (c) trusts whereby someone (perhaps a child of the beneficiary or other "low-bracket" taxpayer) would be taxed as to the income; and, (d) transfers whereby the trust is taxed as a separate entity under Subchapter J of the Code. It is also important to avoid mixing different income tax results, which can create an accounting nightmare, and create mixed results.

Another aspect to consider is the tax bracket gambit. If a client has a parent (or grandparent) who is in a low income tax bracket, such parent (or grandparent) could fund an Inheritor's Trust™ in a manner to create grantor trust status as to the parent (or grandparent). 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.

An Inheritor's Trust™ can also be designed to be defective as to the beneficiary (via IRC § 678). We call such a trust a Beneficiary Defective Inheritor's Trust™. Beneficiary-grantor trust status can be achieved by funding the trust solely with gifts subject to a power of withdrawal, provided that the grantor is not taxed on the trust income. The powerholder, who is treated as the owner, will have a trust with which he or she can transact business tax-free, including selling property to the trust. The powerholder may also take advantage of the same estate planning opportunities the grantor would have in a trust defective as to the grantor. Moreover, 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 protected against claims of spouses, divorce, and creditors.

6. The Inheritor's Trust™ Secures Creditor Protection

An essential part of estate planning is asset protection. Thus, The Inheritor's Trust™ is designed to protect the trust property against claims of the beneficiary's creditors, including ex-spouses. In light of our increasingly successfully litigious society and the fact that more marriages terminate by divorce than by death, informed clients generally want to incorporate protective measures in their estate planning.

In our experience, most clients 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 or she would like his or her own assets to be insulated from the same potential claimants usually also desires such protection.

Each of us has met clients who desire creditor protection and who inquire into the usefulness of either an offshore or domestic asset protection planning trust. The jury is out on many aspects of those self-settled trusts. Clearly, the creditor protection (as well as the tax benefits) afforded by an Inheritor's Trust™ are superior to that of a self-settled trust. Even if we assume that the family unit will not do anything to cause liability, we all know that there is a reprehensible 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?

The Inheritor's Trust™ in Action

We will now discuss some "classic" strategies that work especially well in conjunction with The Inheritor's Trust™.

1. Opportunity Shifting

One of the best, yet often overlooked, techniques to avoid the transfer tax system is the shifting of an opportunity that will generate wealth from the client to others, including trusts. For planning purposes, it is far simpler, less risky, and more tax efficient to shift an opportunity that will create wealth at the inception of the undertaking than it is to move the wealth once the value has become substantial. For example, when a new business is formed or the family has an investment opportunity, a new entity may be formed and some or all of the equity interests in the new entity can be placed into irrevocable trusts, such as a Beneficiary Controlled Trust. In many instances, the

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"seed" money needed to enable the recipient of the opportunity to acquire a significant interest in a venture that might explode in value is negligible. Obviously, transferring the opportunity while it has a low value ("tiny acorn") can avoid a huge amount of transfer taxes as compared with waiting until the value is very high ("mighty oak tree").

2. Valuation Planning

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 (FLP) and is willing to transfer the limited partnership interests, provided that 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 control block because of the control of the general partner.

Use of The 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 an 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.

3. Personal Retirement Planning

Cash value life insurance is attractive because it provides tax free compounding. The Inheritor's Trust™ can offer a superior vehicle for purchasing life insurance benefits that will not be included in the insured's estate. Estate tax avoidance can be accomplished by appointing an independent trustee over any life insurance in the trust on the inheritor's life and eliminating the inheritor's power of appointment over the life insurance on his own life. The inheritor may be given the power to remove and replace the independent trustee (see IRS Letter Ruling 9832039). Also, the inheritor can be in full control of the trust if the life insurance is on the life of someone other than the inheritor.

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

Taking advantage of the tax-free build-up in a policy that qualifies as a life insurance policy under IRC § 7702 can be preferable to its primary alternatives—pension plans and net income with make up unitrusts (NIMCRUTs). These 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, can be 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.

4. Business Buy-Out

The 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 percent of the entity, and, in the absence of additional planning, the entire business, including all appreciation, will be included in such survivor's taxable estate.

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.

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5. Avoiding or Deferring 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 (or defer) substantial state income taxes. For example, if a New York City domiciliary created a trust with a trustee in a state that did not have income tax, and the trust contained income producing intangible assets, both state and city taxes could be avoided.

6. Step-Up in Basis Opportunities Through Exercise of Powers of Appointment

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. Retaining this power 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 (see IRS Letter 20148028). 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.

Benefits to the Planner

The Inheritor's Trust™ is not just a uniquely flexible and powerful planning device. It allows the financial advisor to plan for families as wholes, not just the individual in front of them. This opens significant new opportunities to engage family members up and down the generational ladder. To illustrate, we'll revisit two situations mentioned earlier from the planner's point of view: cash value life insurance and the GST tax.

The GST and the Generational Ladder

As Harvard Law School Professor A. James Casner told Congress prior to the enactment of the GST tax, "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, but leveraging techniques enable sophisticated planners to compensate.

Suppose you are interviewing a prospective client, B. You've established that B, a successful entrepreneur, has a net worth of about $5 million--$1 million in a qualified retirement plan and the rest in real estate, marketable securities, and liquid assets. B is 45 and can expect to add to his net worth for many years. B has come to you to formulate a plan to minimize estate taxes when his estate passes to his daughter, C. Armed with The Inheritor's Trust™, you are in position to move up the generational ladder.

Your first question to "B" should be: "Are you expecting any gifts or inheritances?" It turns out that B's father, A, has a substantial net worth and intends to transmit the bulk of his estate to B. B hadn't thought about this as it is not part of his current capital base and he doesn't really need the money. This is your opportunity to make clear the full power of GST planning available to the family with The Inheritor's Trust™, using A's GST exemption to you to reduce estate taxes at the B generation level. This means that A has to be brought into the planning process as well. "Your father can leverage his estate and avoid estate and GST taxes for generations to come by setting up an Inheritor's Trust™ for you. But we need to get him in on this."

Once you are in front of A, you can explain GST leverage to him. Such leverage is possible in the first instance because income and capital growth derived from property that is GST tax exempt is also GST tax exempt. To take a simple example using an Inheritor's Trust™ (more accurately, a GST tax–exempt subtrust of an Inheritor's Trust™). Suppose that A were to grant $1 million of marketable securities to the subtrust in 2004. The entire amount (assuming A has $1.0 million GST exemption available) is GST tax exempt. Suppose that the trust assets appreciate to $5 million by B's death. Then A has leveraged $1 million into a $5 million gift to C without the family incurring any GST or estate tax at the B generation level - and all the while B continues to enjoy the benefits of an Inheritor's Trust™ as described above.

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Thus, GST tax leverage using an Inheritor's Trust™ can be a mighty prospecting tool, taking you up and down the generational ladder.

Widows and Other Grantors

It's your first estate planning interview with Barbara, a 45-year-old divorcee whose recent sale of the cosmetics business she founded netted her $5 million. Her planning aim is to provide for herself and her daughter Charlotte, presently a student at Duke. You're not making any headway. She answers all your suggestions with a tart "We've taken care of that." Just before you conclude Barbara doesn't really need your help, you think back to what she told you about her mother, Annette, a widow living in Del Boca Vista, Florida. Annette has a net worth of about $1 million and a "simple" will, because "the attorney said she would not be subject to estate tax."

What is simple here is your chance to move up the generational ladder and secure both Annette and Barbara as clients. If Annette were to die in 2004, it's true that because the estate tax exemption for 2004 is $1.5 million, her estate would incur no tax. But Barbara doesn't need that money. She doesn't need to augment her estate only to have to reduce it again. If, instead of a "simple" will, Annette were to pass her estate to (a GST tax–exempt subtrust of) The Inheritor's Trust™, with discretionary distributions of principal and income to Barbara for life and remainder to Charlotte, then the $1.0 million grows free of estate tax in the trust and whatever its value at Barbara's death will not be includable in Barbara's estate. Barbara can still enjoy trust income and principal and indeed, as explained above, even act as trustee, as long she has no tax-sensitive powers.

Planners who aren't attuned to the possibilities of the Inheritor's Trust™ for GST leverage miss this solution. Fixed on the individual in front of them, they fail to see the need to view him or her in the context of the whole family, as one rung on the generational ladder. Focusing on the GST tax brings more of the ladder into view, because alone among transfer tax exemptions, whether or not to take the GST exemption depends not on your own net worth but on that of the next generation. Combined with an Inheritor's Trust™, the effect is synergistic.

The other lesson of our trip to Del Boca Vista is that even the affluent client should receive gifts and inheritances from others, virtually irrespective of size, in trust. 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 can be simplified, and the client's goal of full control and enjoyment of the property can be achieved. For our clients (many of whom, like Barbara, are savvy in business and 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). The GST issues and prospecting benefits alone make the move worthwhile.

Life Insurance and the Inheritor's Trust™: Prospecting with the Ultimate Leverage

We've already discussed the massive leveraging advantages of using The Inheritor's Trust™ as an irrevocable life insurance trust. In both of the cases above, for example, maximum leverage would be achieved by using the transferor's assets, so far as possible, to purchase a life insurance policy. Suppose that Annette could either 1) transfer her $1 million estate into Barbara's Inheritor's Trust™ in, say, marketable securities, or 2) cause the trust to purchase a life policy with a $5 million death benefit. (Having the trust purchase the policy is meant to avoid the three-year rule of IRC § 2035.) And suppose that the trust's investment portfolio has an annual return of 10%. Then it would take nearly 16 years for Annette's $1 million to appreciate to $5 million. By contrast, under the life insurance policy alternative, the full leverage obtains from the moment of the transfer.

The prospecting advantage arises from this fact plus the unique tax treatment of life insurance, which makes it the only vehicle that can guarantee success in wealth transfer

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planning. Nobody can guarantee that if Annette transferred the investment portfolio to her irrevocable trust today, she would live until 2020, the 16 years necessary for the portfolio to appreciate to $5 million. Yet a $1 million life policy would guarantee a $5 million death benefit from the moment it became effective. Annette could die the next day knowing for sure that she had eliminated estate and GST taxes on a highly leveraged transfer. Life insurance is the only asset that can offer this guarantee because it is the only asset whose leverage is effective as soon as it comes into being.

CONCLUSION: The Inheritor's Trust™—Sharpest Tool in the 21st Century Estate Planner's Tool Box

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) (or any other person, including a spouse) 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. 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 that was 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.

Due to its protean nature, The Inheritor's Trust™ can be designed to solve just about any estate planning problem for families who are trying to preserve wealth without losing control and flexibility.

The Inheritor's Trust™ can achieve: (1) estate tax savings; (2) GST tax savings; (3) ordinary income tax savings by shifting the ordinary income to the individual or the trust that produces the lowest rate; (4) state income tax deferral or savings, by shifting the trust domicile to a state that does not tax trusts; (5) tax savings through provisions that cause capital gains to be either unrealized or stepped up to fair market value without recognition at all; (6) creditor/predator protection; and (7) last, but perhaps just as important, the beneficiary of an Inheritor's Trust™ can use the trust to achieve virtually all of his or her personal non-tax estate planning objectives and needs by accessing trust funds through loans or rent-free use of trust property and through use of pervasive powers of appointment. The Inheritor's Trust™ can provide all of this, and more, while simultaneously reposing in the beneficiary virtually total control. Finally, and not to be overlooked, while The Inheritor's Trust™ is especially beneficial for the super-wealthy, it is also a worthwhile option for clients of moderate wealth, and their families.

(Footnotes)

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