The Perfect Modern Trust Including Income Tax Sheltering Opportunities

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Many of the discussion items contain planning thoughts that should always be considered. Alternatively, reasonable advisors may conclude differently with other proposals and approaches.
Is There a Single “Best” Trust Design Strategy?

- Minimal But Meaningful Changes

Structuring Trusts

- The Competent Inheritor
- Others – Immature, Incompetent...

The “Use” Trust – Simpler Than a RT

Modern Trust Design Offers Powerful I/T Shelter Opportunities
OWNING PROPERTY IN TRUST IS ALWAYS BETTER THAN OWNING THAT SAME PROPERTY OUTRIGHT”*

*Provided, that the trust is properly structured
WHY ARE ALMOST ALL TRUSTS?

- Poorly/Inefficiently/Erroneously Designed?
- Take So Long To Draft?
- Or, Not Done at All?
CLIENT’S PRINCIPAL OBJECTIVES

- Reduce or Eliminate Taxes
- Creditor Protection
- Pass Wealth the “Right Way”
“All I Want is a Simple Will”

“My Clients Don’t Want the Complexities of Trusts”*

* Or, Trusts “Impose Too Many Controls”; “Are Only for the Very Wealthy”; “Are Income Tax Inefficient”; “Are Too Expensive”
Was it an Informed Decision?
Then You Need to Try Harder!
Your Clients Will do What You Tell Them to Do!
“The old refrain, “All I want is a simple will,” helps explain why so many people, including many advisors who should know better, so often overlook trusts when planning for the transfer of wealth as an inheritance within the family. In the rush to achieve simplicity, such persons fail to realize the enormous, unnecessary and irretrievable loss of assets (to taxes, divorce, and creditors) that many families will suffer for failing to appreciate the protections that a trust can provide when passing wealth from generation to generation. To quote from an excellent article on the subject, “trusts should be the vehicles of choice for all dispositions to individuals.”

Would You Ever Recommend a Business Entity That Could Be Pierced By Creditors?

Would you Ever Recommend a Business Entity That Would Be Subjected to Unnecessary Taxes?

Why Would a Client Want and/or an Advisor Suggest (or Summarily Accept) Wealth Transfers That Unnecessarily Expose Wealth to Claimants and the Taxing Authorities?
COMMON GOALS

- Business Entity
  - Creditor Protection
  - Tax Avoidance
- Estate Planning
  - Creditor Protection
  - Tax Avoidance
In Business Planning - Advisors Never Would Summarily Accept a Client’s Pushback Regarding the Implementation of an Entity

Why Does a Passive Attitude Occur With Regularity in the Context of Trust Planning?
WHY INHERITING IN TRUST IS ALWAYS BEST

- The “Wish” List Theory
- What Do You Want?
- Everyone Wants the Same Six (6) Things
- Priorities Will Vary
1. Control
2. Use and Enjoyment
3. Flexible/Amendable
4. Creditor/Divorce Protection
5. Save Taxes
6. Avoid Complexity
SHOW “WISH” LIST TO CLIENTS

- “Is There Anything Else You Want?”
- “Is There Anything That You Don’t Want?”
- “Which of These Do You Want (or Not Want)”
  - “For Your Children?”
  - “For Others?”
- Clients Will Always Want Shelters
  - But May Vary Controls
Control Plus Beneficial Enjoyment
Unintended Consequences of Legal Title
IS THERE A “BEST” TRUST DESIGN STRATEGY TO OBTAIN ALL OF THE COMPONENTS OF THE “WISH” LIST?

- Simplicity
- Shelters
- Controls
PRIMARY TRUST DESIGN STRATEGIES

- Maximum Benefit Trust
  - Entitlements
  - Force-outs
- Fully Discretionary Trust
  - Distribution Control
  - Requires an “Independent Trustee”
- Professional Trustee
Pay Income Annually or More Frequently
HEMS
Power to Withdraw Greater of 5% or $5,000
Staggered Distributions
Beneficiary Can Be Sole Trustee
TRADITIONAL “MAXIMUM BENEFIT TRUST” PLANNING PROCESS

- Give Menu of Available Options
- Client (With Guidance) Selects Options
- Law of Unintended Consequences

  ◊ More is Not Always Better
  ◊ Does Client Really Understand Full Impact of Choices?
DISCRETIONARY TRUST COMPONENTS

- Fully Discretionary
- Dynastic
- Beneficiary-Controlled (at Proper Time(s))
- “Use” Concept
- Amendable - Broad SPAs – “Re-Write Powers”
- Favorable Situs
- Requires an Independent Trustee
“PERFECT TRUST” DESIGN PROCESS
REVERSE ENGINEERING

- Start With the “Wish” List
  ◊ How Do We Obtain All Components
- Trust Design Always Preserves Protections and Simplicity
- Make Minimal, But Meaningful Alterations
  ◊ Adjust Controls
  ◊ Adjust Guidance
MAXIMUM BENEFIT TRUST
TAX AND CREDITOR
SHELTER INEFFICIENCIES
AND FLAWS

Violates “Wish” List
Force-outs Terminate “In-Trust” Shelters

◊ Transfer Tax Inefficient – Leakage
◊ Income Tax Inefficient
◊ Creditor Exposed
ASCENTABLE STANDAR
“HEMS”* 

“Support Trust” Issue**
Relies on Spendthrift Trust Provision
Exception Creditors
◊ Statutorily Created – See Restatement 2\textsuperscript{nd} 
◊ Judicially Created – Bacardi v. White, 463 So. 2d 218 (Fla. 1985); Garretson v. Garretson (306 A. 2d 737 (Dela. 1973))

* Some State Statutes Protect HEMS Trusts; Will That Be Respected By Judges In Other Jurisdictions If There Is No Other Contacts With The Governing Law States?

**Steven J. Oshins, Asset Protection Other Than Self-Settled Trusts: Beneficiary Controlled Trusts, FLPs, LLCs, Retirement Plans and Other Creditor Protection Strategies; The 39\textsuperscript{th} Annual Heckerling Institute on Estate Planning, University of Miami School of Law, June 2005.
LAPSING POWER TO WITHDRAW “5% OR $5,000” ANNUALLY

- Estate Tax Exposure
- Creditor Protection Adversely Impacted
- Income Tax Inefficient PLR 9034004
- Administrative Nightmare

◊ Expense
◊ Added Complexities
Ed Morrow often asks business owners (and sometimes attorneys) “At what age do you have your LLC/corporation expire?”
THE ANATOMY OF THE PERFECT TRUST

Component Analysis

1. Fred Keydel and Harvey Wallace; Design Strategies for Dynasty Trusts; ACTEC March 6, 1999
THE PERFECT TRUST PHILOSOPHY

- “Own Nothing; But Control Everything”*
- Satisfies All Components of the “Wish” List
- Legal Title Creates Exposure to Predators and the Taxing Authorities

*Quote attributable to John D. Rockefeller
Dynastic; Discretionary (with distribution discretion in the hands of an Independent Party who can be fired and replaced); Beneficiary Controlled Trust (unless (i) controls are undesirable or (ii) impermissible under law to avoid the taxing authorities and other claimants); where the use of trust assets rather than distributions are encouraged (unless distributions are beneficial or desirable); sitused in a trust-friendly jurisdiction.
MORE IS NOT ALWAYS BETTER
COMMON COMPONENTS

Do These Help?
- Pay Out Income at Least Annually
- Ascertainable Standard ("HEMS")
- Lapsing "5 or 5" Power

If They Do Not Improve the Trust Then Why Use Them?
Beneficiary v. Third Party Controlled Trust
   ◊ Investment Committee
   ◊ Distribution Committee

Do They Add Anything to a BCT?

Perception (and Reality)
   ◊ Too Complex
   ◊ Too Controlling
OBTAINING “WISH” LIST COMPONENTS
3.1.1 Discretionary Distributions of Income and/or Principal. The Independent Trustee, in its sole, absolute and unreviewable discretion, shall have the power, the exercise of which shall be absolutely binding on all persons interested now or in the future in this trust, to distribute to or apply for the benefit, enjoyment or use of any one or more of the following permissible distributes:

A. The primary beneficiary,
B. The spouse of the primary beneficiary,
C. The descendants of the primary beneficiary who are then living (even though not now living),
D. Any then living spouse of any such descendant who is then deceased (provided such spouse was living with such descendant at the time of such descendant’s death or was unable to do so for reasons of health), and/or
E. Any trust for the primary benefit of any one or more of the above-described permissible distributees (even one created by the Independent Trustee hereunder), whether now existing or hereafter created, except...

so much of the income or principal, or both, of the trust estate, in equal or unequal proportions, and at such time or times as such Independent Trustees shall deem appropriate for such beneficiaries’ benefit, care, comfort, enjoyment or for any other purposes, after taking into consideration their income or other resources...
SIMPLICITY

THE “USE” TRUST

SIMPLER THAN A REVOCABLE TRUST
“USE” TRUST KEY CONCEPTS*

- Keep “Legal Title” In Trust Wrapper
- Just “Use” Trust Assets
- Available to All Beneficiaries
  ◊ To Primary Beneficiary on a Preferential Basis

* See Richard A. Oshins, Megatrusts™; Representation Without Taxation; NYU 48th Inst. On Federal Taxation, Ch 19 (1990); §19.02
RESULT
ALL COMPONENTS OF “WISH” LIST

- Full
  - Control
  - Use and Enjoyment
- Full
  - Shelter
- Minimal Complexity
“USE” TRUST EQUALS SIMPLICITY

- Similar to a Revocable Trust
- Except
  - No Gratuitous Transfers
  - Income Tax Return for Non-Grantor Trust
HOW SIMPLE IS THE “USE” TRUST?

- Simpler than Outright
  - Long Term
- What is Complex?
DISTRIBUTIONS ARE PERMISSIBLE, BUT DISCOURAGED

- Unless there is a Compelling Reason to Make Them
  - Needed
  - Wanted
  - Makes Sense
- Consider “F/B/O”
- Separate the Fruit From the Tree
WISH LIST #5 – Transfer Taxes

A VOLUNTARY TAX?

A Voluntary Tax?
New Perspectives on Sophisticated Estate Tax Avoidance
George Cooper

STUDIES OF GOVERNMENT FINANCE
THE BROOKINGS INSTITUTION
“In fact, we haven’t got an estate tax, what we have is, you pay an estate tax if you want to; if you don’t want to, you don’t have to.”

– Professor A. James Casner
TRUSTS AS THE QUINTESSENTIAL INCOME TAX SHELTER
TRUSTS OFFER SUBSTANTIAL INCOME TAX PLANNING OPPORTUNITIES NOT AVAILABLE WITH OUTRIGHT TRANSFERS

- Rethinking Trusts as an Income Tax Sheltering Strategy
  - Misperception – Because of Compressed Trust Income Tax Brackets Trusts Are Inefficient

- Virtues
  - Sprinkling to Low Brackets
  - State Income Tax Avoidance Opportunities
  - Basis Planning
BASICS

- Sprinkling
  - Bracket Leveling
  - 65-Day Rule
- State Income Taxes
  - Compounding – The 8th Wonder of the World*

*Power of Compounding Attributed to Albert Einstein
Impact of State Income Tax on Dynasty Trusts

This model compares the impact of state income tax for a dynasty trust over the period of 120 years. The hypothetical trust has one group of stock that pays annual dividends at a constant rate (x% of principal). The stock’s value grows by y% per year. We assume that all dividends, after tax, are reinvested in the same stock. All income is in the form of dividends, so it is taxed as ordinary income. We compare the ultimate impact of the state income tax by comparing the value of the trust assets depending on whether the trust is situated in New York (outside New York City and within New York City), California, Massachusetts, or in a state that does not impose an income tax. The income tax rates are based on 2014 state rates, updated for 2015 when available, and 2015 Federal income tax rates.

<table>
<thead>
<tr>
<th>Trust Principal</th>
<th>$1,000,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Annual Dividends</td>
<td>6%</td>
</tr>
<tr>
<td>Annual Appreciation of Principal</td>
<td>0%</td>
</tr>
</tbody>
</table>
ADVANCED PLANNING USING TRUSTS
ESPECIALLY GRANTOR TRUSTS

- Basis Bump Planning – Upstream and Lateral
- Monitoring Grantor Trusts
- Downstream Planning

* Edwin P. Morrow III, Basis Bump Planning - For Two Outstanding Discussions on this topic, please see: “The Optimal Basis Increase and Income Tax Efficiency Trust”; Paul S. Lee, Paradigm Shift: “Permanent” Changes in Perspective
REVERSE AND LATERAL PLANNING
USING GPAs* - RULES

- IRC §2041 Inclusion
- IRC §1014 Basis of Property Acquired From a Descendent
- Previously Transferred Assets
  ◊ Carryover Basis

*Or, Delaware Tax Trap
Many People Will Die With Unused AEA

Expand List of Permissible Distributees of Trusts
  ◊ E.g., Parents, G/Ps; In-laws; Siblings...

Most Clients Will Want to Help Needy Parents/In-laws

Distribution Standards Can Vary
  ◊ Preferential Beneficiaries – Happiness
  ◊ Secondary - Need
INDEPENDENT TRUSTEE OR TRUST PROTECTOR CAN GIVE, TAKE AWAY AND DESIGN GPAs

- Formula GPA
- Ordering of Best Assets – e.g., -
  - Low Basis/Negative Basis Depreciable Commercial Real Estate
  - Capital Gain Assets
- Ordering of Specific Assets
PREVENTING EXERCISE OF GPAs

- Can Require Prior Notice of Exercise – Treas. Reg. §20.2041-3(b)
- Can Require Consent of a Non-Adverse Party – IRC §2041(b)(1)(c)(2)
- Beneficiary Does Not Have to Know of Existence of the Power – *Estate of James C. Freeman*
Client Doctor/Business Owner Owns Office Building
Beneficiary Grantor Trust – IRC §678
FMV $5 Million – Basis $1 Million
Parents, In-laws, Spouse Are Also Beneficiaries of Trust
All (5) Pre-decease Client

Query- What is the Value of the Multiple Basis Step-ups?
EXCHANGES WITH GRANTOR TRUSTS
BY OWNER OF TRUST

- Rev. Rul. 85-13
- Trust Owns Low/Negative Basis Assets
- Client Owns Assets – FMV Less Than Basis
- Exchange
  - Step-up For Decedent
  - Preservation of Basis Transferred to Trust
GIFT OF “OPPORTUNITY TO PLAN”
CASCADING BDITs
3.1.1 Discretionary Distributions of Income and/or Principal. The Independent Trustee, in its sole, absolute and unreviewable discretion, shall have the power, the exercise of which shall be absolutely binding on all persons interested now or in the future in this trust, to distribute to or apply for the benefit, enjoyment or use of any one or more of the following permissible distributes:

A. The primary beneficiary,
B. The spouse of the primary beneficiary,
C. The descendants of the primary beneficiary who are then living (even though not now living),
D. Any then living spouse of any such descendant who is then deceased (provided such spouse was living with such descendant at the time of such descendant’s death or was unable to do so for reasons of health), and/or
E. Any trust for the primary benefit of any one or more of the above-described permissible distributees (even one created by the Independent Trustee hereunder), whether now existing or hereafter created, except...

so much of the income or principal, or both, of the trust estate, in equal or unequal proportions, and at such time or times as such Independent Trustees shall deem appropriate for such beneficiaries’ benefit, care, comfort, enjoyment or for any other purposes, after taking into consideration their income or other resources...
Independent Trustee Sets Up BDITs
- For Spencer’s New Business
- For Katie’s Existing Business

Sharing Not Desirable
- Controls
- Fruits of Sweat Equity
INCOME TAX VARIATIONS

- Beneficiary Grantor Trust ("BDIT")
  - Beneficiary Has Lapsing Power of Withdrawal
  - Basis and Burn

- Complex Trust
  - Basis
RESULT – BENEFICIARY HAS

- Full Control
- Beneficial Enjoyment of Trust Owned Assets
- Creditor / Divorce Protection
- Transfer Tax Shelter
- “Tax Burn” of Personal Wealth
CREDITOR PROTECTION IS AS MUCH A PART OF ESTATE PLANNING AS TAX PLANNING*

- Asset Protection Maximum
- Legal Title Harmful

*Attributable to Skip Fox “Current Financial and Estate Planning Trends”, CCH Financial and Estate Planning, (Nov 26, 2007), “… I would argue that there may very well be an affirmative duty to talk to your clients about (an asset protection trust).” at p. 83 and, "...it could be any advisor." at p. 84.
“A discretionary trust with “... the distribution discretion held by an independent trustee... is 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.” (Emphasis supplied)

Frederick R. Keydel


Caveat - Under Current Law, I Would Add, “provided that the trust is sitused in a trust friendly jurisdiction”.
REASONABLE CONTROLS, USE AND BENEFICIAL ENJOYMENT DO NOT SACRIFICE SHELTERS

- **Controls**
  - Managerial Control Not Impactful
  - Independent Trustee Has Tax and Creditor Sensitive Powers

- **Situs**
  - Rent Protective Situs
  - No Exception Creditors
IMPORTANCE OF SITUS
“My Client’s Want to Stay Local!”

◊ Did You Ask the Client?
◊ Really?
◊ Then You Did Not Explain the State Disparities Correctly

◊ Can Rent Situs Cheaply
PRIMARY FACTORS IN SELECTING JURISDICTION

- RAP
- Creditor Protection Laws
  - No “Exception Creditors”
- No State Income Taxes
- Cost of Renting Jurisdiction
- Cooperation of Situs Trustee
And so on, all Subject to Amendment through a Power of Appointment by the Senior Generations.
CONTROLS

“OWN NOTHING, BUT CONTROL EVERYTHING”*

*Quote attributable to John D. Rockefeller
Primary Beneficiary Controls
   ◊ Investments
   ◊ Identity of Independent Trustee

Independent (Distribution) Trustee
   ◊ Controls All “Tax Sensitive” Decisions

Situs Trustee – Can Be One of the Foregoing
   ◊ Distribution and Situs Trustee Often the Same
AMENDABLE/FLEXIBLE
“RE-WRITE” POWERS

- Special Power of Appointment ("SPA")
- Deal With Changing Laws, Family Dynamics and Needs
- Deal With Dissident Subordinate Beneficiaries
ALL TRUSTS SHOULD HAVE LIFE INSURANCE PROVISIONS IN THEM UNLESS IMPERMISSIBLE AS A MATTER OF LAW
COMPONENTS OF LI POLICY

- Inside Build-up
- Death Benefit
LIFE INSURANCE OWNED BY A THIRD PARTY TRUST MAKES THE POLICY MORE VALUABLE

- Indirect Access to a Conservative Asset Backed by a Powerful, Regulated Financial Institution
- Death Benefit Out of Estate
- Funding Complexities and Limitations Avoided