



Asset Protection

Family Wealth Protection And Preservation

The coordination of FLPs and trusts can provide opportunities to create an asset pool that may benefit the creator's descendants into perpetuity

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Family wealth planning has undergone an extensive metamorphosis over the last several years resulting in greater emphasis on multigenerational tax and family planning with significant creditor protection overtones. The focus of tax planning has increased in scope in the transfer tax arena, principally due to the relatively high bracket range in the estate and gift tax area and the imposition of the punitive generation skipping transfer tax (GSTT). Income tax planning, on the other hand, has received reduced attention primarily as a result of the compressed rate schedule and the judicial and legislative reduction of income tax planning opportunities.

Although it always has been a worthwhile consideration, asset protection and liability planning, as part of the business or estate plan, is receiving much more attention than in the past due to the increasing litigious nature of our society and the significantly greater success rate plaintiffs are enjoying. Traditional tax planning arrangements with appropriate modifications work well in this new planning environment and are not only compatible with asset protection techniques, but each enhances and solidifies the benefits of

the other. This article examines two principal traditional wealth transfer tools, trusts and family limited partnerships, and concludes that the integration of protecting wealth from creditors is a logical extension of traditional business planning, income tax planning and estate planning arrangements.

Accomplishing the dual objectives of asset protection and tax planning also is consistent with the added features of permitting enormous flexibility to meet changing circumstances and being able to select the individuals or entities which have control of the family wealth for generations.

During both tax planning and asset protection planning three principles should be kept in mind.¹ First, as a general proposition, tax consequences follow property ownership.² Although this general observation is subject to a variety of exceptions, such as with "defective" or grantor trusts³ and the family limited partnership rules,⁴ creative design and use of certain tax planning techniques can separate the tax consequences from ownership resulting in extremely favorable benefits for the family unit. Second, ownership can be separated from control without disturbing either the tax conse-

quences set forth in the general rule or the property rights vested in the owner of the assets. Third, control held in a fiduciary capacity is not reachable and will not be disturbed by either the fiduciary's personal creditors or the creditors of the beneficiary.

Modern Estate Planning

Sophisticated business and estate planners must ordinarily deal with three principal objectives of their clients when structuring business and estate planning arrangements: control, tax planning and creditor protection.

Control. Typically, for family planning and psychological purposes, it is desirable and essential that control be retained by the senior family members 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

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while shifting the tax consequences from those individuals is usually easily obtainable. For example, managerial control can be given by trusteeship arrangements or by making the desired individual (including the transferor), or an entity which he or she controls, a general partner in a limited partnership. Control over the disposition of the property may be given to a person through a broad special power of appointment in a trust document, typically without adverse tax consequences. The power holder need not even be a beneficiary. Moreover, neither the fiduciary's creditors nor the creditors of power holders can disturb these principles.

Tax savings. Reducing, avoiding and deferring the imposition of tax, primarily income taxes, gift taxes, estate taxes and the GSTT, is an integral part of family wealth planning. One of the key weapons in an estate planner's arsenal is to accomplish these goals by taking advantage of valuation strategies and leveraging opportunities.⁵

At times, an estate planning procedure is 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 are 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 the basis step-up at death. The latter circumstance often involves a delicate balancing of the tax consequences, time-use of money factors and the attitudes of the parties to achieve optimum tax savings consistent with overall family goals.

Asset protection. 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. This undertaking can be accomplished in a manner whereby the appropriate family members will have maximum control and benefits from the property.

To the extent possible, assets should be insulated from creditors.

For example, a spendthrift provision in a trust will accomplish this result. With regard to other assets, such as accumulated wealth owned outright, tax planning will be more difficult and restricted. Moreover, total insulation from creditors may not be possible, and thus strategies which will protect the assets should be considered. For instance, a family limited partnership (FLP) can convert desirable assets into unattractive assets, and perhaps a liability, in the hands of an unfriendly participant such as a creditor.

Divide And Conquer

The proper use, structure and combination of multiple entities is the very essence of modern day family tax and wealth planning to accomplish family security.⁶ Generally, the two most effective techniques to accomplish these goals are trusts and family partnerships and, when properly combined, often form the heart of family wealth planning.

The use of an FLP to fragment interests within the family unit, including trusts for family members, enables the planner to create two values for family wealth, one for the family unit where the value stays intact, and another which is artificially depressed for both wealth transmission and asset protection purposes. This distinction is founded on the supposition that a harmonious family can be expected to act for the benefit of the family unit as a whole. This anticipated unity can be solidified by the judicious selection of control mechanisms such as trusteeships, voting rights, and fiduciary removal rights, which may be customized to comply with the desires of the client. On the other hand, a fragmented portion of the family wealth will be depressed as to third parties, including the IRS (for transfer tax purposes) and potential creditors.

Although the variations of the structures are limited only by the imagination of the architect, this article will concentrate on two of the most formidable variations of these vehicles, the FLP and the Megatrust.^{SM7}

Asset Protection Planning

Many individuals are concerned about the legitimacy of both tax and asset protection planning. The type of restructuring advocated in this ar-

ticle is not tax fraud, nor does it suggest that transfers which would be fraudulent under the bankruptcy law be undertaken. It contemplates only legitimate estate and business planning which should be considered when arranging the structure of any business or estate planning venture.

With respect to the right to tax plan, the following statement by Judge Learned Hand sets forth the legal and moral right to avoid taxes:

We agree with the Board and the taxpayer that a transaction, otherwise within an exception of the tax law, does not lose its immunity, because it is actuated by a desire to avoid ... taxation. Anyone may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes.⁸

To some, asset protection planning has a rather sinister connotation. However, business and estate planning has incorporated asset protection arrangements for many years. Corporations and limited partnerships have as a primary motivating force insulation of the shareholders and limited partners from liability. The increasingly popular limited liability company⁹ also is used for asset protection purposes. Otherwise, a simple partnership will accomplish the same purposes.

In estate planning, the most obvious asset protection technique is the use of trusts and reliance upon spendthrift provisions to inhibit creditors from reaching the trust property prior to its actual distribution.

Family Limited Partnership

"Asset protection planning may be simply described as the process of organizing one's assets and affairs in advance so as to guard them from loss by reason of some future fiscal calamity."¹⁰ Because of the expanding concern for potential future legal liability, creditor protection is now becoming a more integral aspect of a properly designed and integrated business or estate plan. Although creditor protection is a new and evolving area, the predominant approach of protective asset plan-

ning attorneys involves the use of a FLP or a series of FLPs as the primary vehicles to hold assets. One leading expert in asset protection has concluded: "As asset protection tools, the limited partnerships really reign supreme. The single greatest proclamation in recent years to my own estate planning clients, is that the limited partnership is without peer in the asset protection area."¹¹

The concept of a FLP as an asset protection tool is quite simple and straightforward. It is designed to take advantage of Sec. 703 of the Revised Uniform Limited Partnership Act, which provides that a judgment creditor's remedy against the interest of a partner is limited to a charging order against the limited partnership interest. Therefore, the creditor only is entitled to distributions made from the partnership, and not the partnership interest itself. Because the general partner, who is controlled by a family member, determines the amount and timing of the distributions from the partnership, the personal judgment creditor receives an asset of relatively little value. Since the judgment creditor does not become a substitute limited partner,¹² the creditor has no vote or participation in management or right to any information regarding partnership transactions, nor is he or she even entitled to inspect the partnership books. Moreover, the general partner will continue to control the partnership assets and is entitled to receive a reasonable salary for such services.

The ultimate deterrent and negative feature for the judgment creditor, however, is that, for income tax purposes,¹³ obtaining a charging order results in the creditor being treated as the owner of that portion of the partnership interest. Therefore, the judgment creditor must pay tax on the pro rata share of the income earned by the partnership, even though such income is not distributed to him or her. This exposure to tax on phantom income has been appropriately referred to as "KO by the K-1."¹⁴

In light of this problem, in many instances it would be reasonable to conclude that the holder of a charging order may have an interest of perhaps negative value in situations where the partnership interest is held within the confines of a closely-held family situation. Thus, the

practical result of creating a FLP, even if funded in its entirety with freely marketable assets, is the conversion of a desirable asset into one which is unattractive and maybe even undesirable. Creditors and other non-family members often will be best advised not to be involved in such an entity.

The use of multiple FLPs is recommended from both a tax planning perspective and an asset preservation and protection point of view. In the context of tax planning, it makes sense to isolate assets which are more productive for gift giving purposes. For example, assets which are expected to increase significantly in value are generally considered the type of assets one would transfer when embarking on a gift giving program. Assets which generate significant taxable income also are often the subjects of lifetime gifts. Wasting assets, on the other hand, may deserve creditor protection in a FLP vehicle, but are less likely to be the subject of an aggressive gift giving program. Therefore, they should be segregated into a separate FLP.

In the context of protective asset planning, a distinction must be made between "internal" and "external" protection. Lawsuits against the partnership will result in external protection, i.e., the partners are protected. Additionally, the use of multiple FLPs will protect the assets in all partnerships except for judgments against the partnership which has committed the wrongful act. Lawsuits against the partners individually will result in complete internal protection, and the external protection of the partners through the limited charging order remedy.

The distinction between the internal and the external protection is illustrated as follows. Assume A and B are operating a business in the form of a limited partnership with a corporate general partner. If X obtains a judgment against the partnership of \$600,000 and the partnership is worth \$250,000, X can satisfy his or her judgment internally against the net partnership assets of \$250,000. X cannot satisfy the shortfall against the assets owned by A and B individually because a limited partnership shields the external assets held by the individual limited partners from liability. If either A or B individually was a general partner, the personal assets of that general part-

ner would be subject to the internal liabilities of the limited partnership. On the other hand, judgment creditors of either A or B individually would be limited to the charging order remedy against the assets of the limited partnership, and would have no recourse against the partnership assets. In sum, creditors of the partnership itself have only an internal remedy limited to the assets of the partnership, and creditors of the individual partners have the limited remedy of a charging order, subjecting them to the risk of receiving phantom income in accordance with Rev. Rul. 77-137. If A and B have more than one business venture, each should be in a separate limited partnership in order to insulate all unexposed entities from the creditors of the exposed entity.

Tax Consequences

The role of the FLP in family wealth planning has changed significantly over the years from a technique which was principally income tax motivated to an arrangement which is generally designed to effectuate transfer tax savings through the ability to transfer interests, often through annual exclusion gifts,¹⁵ which are subject to valuation discounts. This procedure enables the family to achieve significantly larger transfer tax savings than are available by transferring cash or making similar gifts. In addition, the ability to retain managerial rights by controlling the general partner is another feature which further enhances its desirability. Retention of control in this manner will not cause the transferred property to be included in the transferor's estate.¹⁶ Similarly, Chapter 14 does not apply merely due to the fact that the gifts were non-voting or were minority interests.¹⁷

As a general proposition, transfer taxes are imposed on the "fair market value" of the property transferred. For transfers by gift of property which do not have a readily ascertainable market value, the Treasury Regulations provide that the value "... is the price at which such property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of the relevant facts."¹⁸ Use of this hypothetical formula, when coupled with

the assumption taken in the regulations that the parties are unrelated, can significantly reduce the value of gifts and to a large extent erode much of the impact of the transfer tax system. These discounts reflect the fact that if the interest being valued does not have voting control or a readily available market, prospective buyers would be discouraged from acquiring such interest without a discount, particularly when buying into a family controlled entity. The ability to manipulate value and exploit the valuation uncertainties, even within the family unit, in order to obtain valuation discounts, presents a unique opportunity for the skilled advisor. This situation has been referred to by one commentator as an "estate planner's dream."¹⁹ Another author has summarized the opportunities available to the tax planner to exploit the valuation uncertainties by stating, "Value is what you make it," while initially appearing to be an overstatement, often is an accurate description of the effective use of planning to minimize tax consequences of intrafamily transactions, including gifts ..."²⁰

A transfer of easily valued assets, such as publicly traded securities, into a FLP converts the liquid asset with an easily ascertainable value into a non-liquid asset. Transfers of non-controlling interests in the FLP, even if made within the family unit, subject the transfers to the aforementioned valuation process which assumes a hypothetical sale between unrelated parties. Valuation discounts generally applied to transfers of limited partnership units include:

1. minority interest discounts;
2. discounts for lack of marketability; and,
3. restrictions on disposition of the assets.

These valuation inhibitors can be described as follows:

Minority interest. The minority interest discount concept recognizes the fact that when an interest in a closely-held entity, such as a partnership, is being valued and such interest does not have voting control, buyers may be reluctant to purchase the interest. A minority interest holder is unable to influence investment policy, compel distributions or

force liquidation. Consequently, the minority interest is worth much less than its *pro rata* share of the underlying asset. In fact, in the absence of a minority interest holder having a contractual right to dispose of his or her interest, such interest may be virtually worthless to him.

As we have previously concluded in our discussion on asset protection, such an asset may even have an adverse economic effect. For instance, consider the plight of a non-controlling partner, such as a limited or a minority partner, of a partnership which has taxable income allocated to such partner, but which either makes no distribution or makes distributions insufficient to pay the tax generated by the income. The owner of a non-controlling interest potentially faces the same harsh income tax result as a judgment creditor who obtains a charging order against a partner. The visceral reaction is that the judgment creditor is in a worse position than a non-controlling shareholder since the judgment creditor does not even possess the rights of a partner such as the right to inspect the partnership books, etc., nor is he or she owed a fiduciary duty by the controlling partner or partners. Conversely, the judgment creditor need not enforce the charging order against the partnership. The partner may be locked in without the opportunity to dispose of the asset due to restrictions on disposition, transfer tax exposure, and income tax recapture exposure.

Marketability. The lack of marketability discount concept recognizes the fact that interests in closely-held entities are less attractive and have fewer potential purchasers than similar publicly traded entities. The discount relates to the inherent lack of flexibility in getting in and out of investments with no ready market. The concepts of lack of marketability and minority interest discounts are often confused, used interchangeably and consolidated together to define a situation where in closely-held interests would be difficult to sell at a price that is comparable to that at which publicly held interests are sold.

However, they are two separate and distinct discounts.²¹ The lack of marketability discount is more encompassing, since it is applicable to both minority and majority holdings.

Restrictions on disposition. When

persons form an entity, they often place limitations on the disposition of the interests of the co-owners. They want to be selective and restrictive as to who their associates will be, limiting the successor co-owners to persons with whom they feel they can deal comfortably. This is especially true in a family situation. Therefore, it is extremely reasonable and legitimate to incorporate severe restrictions in the partnership agreement with regard to transfers, particularly as it relates to non-family members. The concept of discounts based upon restrictions on disposition recognizes that such restrictions create a deterrent reducing the ability of the willing buyer and willing seller to strike a deal. Most family held entities are structured whereby transfers to non-family members are restricted. "[T]he natural inclination of a family to restrict ownership interests in their investment or business ventures to parties of their choosing operates to secure a very helpful and significant discount from value for transfer tax purposes."²²

One way to restrict transfers is by giving a right of first refusal to the remaining partners. Since the buyer would have to wait to see if the option will be exercised, the two elements of time and uncertainty would inhibit buyers and, therefore, bear upon the value of the partnership interest. Moreover, the purchaser might reasonably assume that the option would not be exercised only if the arrangement were beneficial to the seller. A prudent buyer would factor into the equation the fact that the existing partners might have information bearing on the value of the entity that a non-participant would not have. Thus, the hypothetical buyer in the valuation process would discount his or her offer. Often partnerships are created whereby the rights of first refusal are designed to be extremely favorable to the remaining partners, thus increasing the significance and magnitude of the valuation reduction.

Another popular drafting approach is simply to preclude all transfers to persons outside of the specified class of transferees (except perhaps with the consent of all general partners), which class might include only lineal family members or trusts for their benefits. A provision restricting outsiders from the class of permitted transferees, reflecting the

natural desire to retain the benefits and control of family enterprises within the family unit, when coupled with the valuation reduction opportunities for transfer tax purposes, also enhances the arguments against the creditor who may argue that the partnership arrangement was a sham to defraud creditors.

Family control discount. Many appraisers in computing the discount for a transfer of a non-controlling interest in a partnership will base a great deal of their analysis upon judicially reported conclusions, often using a rather mechanical approach in arriving at their determinations. Such an analysis, in many instances, is flawed, and the client will not receive the appropriate discount to reflect the true "fair market value" of the interest being transferred.

The goal in the valuation process to comply with the federal estate²³ and gift²⁴ tax statutes is to determine the true "value" of the property transferred. Because such determination is susceptible to various analyses, the government has created the arbitrary formula whereby both the Estate Tax and the Gift Tax Regulations employ hypothetical²⁵ and unrelated buyers and sellers in the equation, "... both having reasonable knowledge of relevant facts"²⁶ in an attempt to arrive at the "value" of what is being transferred.

Although the buyer and seller in this transaction are presumed to be hypothetical, the identity and relationship of the other parties, as well as the provisions of the partnership agreement, are not hypothetical. Those facts not only are relevant, but they are information that a reasonable and prudent buyer would be aware of, and take into account in evaluating the economics and risks of the transaction. The Tax Court recognized that the analysis should take into account the identity of the other parties and all other facts when it stated: "... The hypothetical sale should not be construed in a vacuum isolated from the actual facts that affect the value ... in the hands of the decedent."²⁷

There is a significant difference between buying into a family controlled entity and buying into one where the other partners are truly independent and none of whom have either real or effective control. This distinction is important and has a dramatic effect on the value of the

interest. Certainly, it would be an integral factor of a negotiated deal and, accordingly, should be reflected for transfer tax purposes.

The partnership agreement is also extremely meaningful in valuing a non-controlling partnership interest. All of the provisions advocated and used by asset protection lawyers in the structure of FLPs are designed to enhance the asset protection attributes of the partnership and reduce the value in the hands of third parties. For instance, if the partnership agreement has broad discretionary language enabling the managing partner in a family-controlled partnership to withhold distributions, the hypothetical buyer, who is aware that he or she is a stranger to the other partners, would be receiving something of more speculative value than would be received if the partnership agreement provided for annual distributions of all net income. Since the hypothetical buyer is presumed under the applicable regulations to "have reasonable knowledge of the relevant facts," he or she would reduce the purchase price to account for such potential exposure.

Asset protection lawyers have recognized the problems and frustrations which an unfriendly third party intervenor would encounter when faced with a controlled family partnership. It is time that the appraisal community, the IRS and the courts recognize and take into account that the limited rights of a non-family member coupled with the potential phantom income exposure renders such an interest extremely undesirable.

While it is true that the area of protective asset planning is relatively new and there have recently been some inroads in protecting judgment creditors²⁸ under the present environment in the creditors' rights arena, no reasonable and prudent person would buy into a FLP without a substantial price concession, if he or she would buy at all. Even the most cynical advisor (as to the viability of asset protection procedures) should recognize the reduced incentive for a judgment creditor to proceed where the assets are in a FLP setting. At the very least, the purchaser should anticipate the possibility of an expensive and protracted litigation which under current law may not result in his or her receiving anything

of value. The judgment creditor would be less inclined to pay the necessary legal fees for such a risky chance of success. As a result, there is a realistic opportunity for a quick and favorable settlement.

From a planning and drafting point of view, consideration should be given to drafting the FLP where the design limits the rights and access of creditors. Even if the client believes that asset protection is not an important factor, the transfer tax benefits inherent in such a design should result in the inclusion of such protective language in the partnership agreement.

Put Your Money in Trust²⁹

The trust vehicle is the most effective and flexible method of holding property in American jurisprudence. It has been stated, "[i]t is indeed a rare client who should not consider the use of a trust for some circumstances, even if only to cover contingencies that ought to be anticipated."³⁰ Property owned by a well-drafted, customized trust can confer significantly greater benefits to the trust beneficiaries than the beneficiaries would derive from outright ownership of the property.

We have already examined the FLP in relation to the three major goals (control, tax savings and creditor protection) of modern estate planning and have concluded that each goal could be satisfied by that arrangement. With regard to trust planning, the aforementioned three goals are also easily satisfied for all beneficiaries other than a grantor who is also a beneficiary.³¹ A beneficiary is potentially better off receiving property in trust than receiving property outright. The beneficiary may be given the beneficial enjoyment of the trust property virtually tantamount to outright ownership without losing any of the transfer tax or creditor protection benefits. As a result, a skillfully drafted trust can confer greater benefits on the beneficiaries (both tax-wise and for creditor and divorce protection purposes) than is available with outright ownership of the property.

From a beneficiary's perspective, it is difficult to envision any rights in property that cannot also be provided in a trust. For instance, in a "maximum benefit trust" the beneficiary can be given (1) the right to

the income from, and the use of, the trust property, (2) the power to withdraw property for the beneficiary's health, education, support and maintenance, (3) the right to give property to any other person, in trust or outright, other than him/herself, his or her estate, his or her creditors or the creditors of his or her estate (a broad special power of appointment) and, (4) as trustee, the ability to manage the trust property, without the property being includible in his or her estate. The beneficiary also can be given an annual, non-cumulative power of withdrawal of up to the greater of 5 percent or \$5,000; however, to the extent that the beneficiary has the power of withdrawal at death, that portion will be includible in his or her estate.

A concern often voiced during the planning process is the possibility that a remote beneficiary might sue a trustee-beneficiary. The trust architect could solve that problem by giving the preferred beneficiary a broad special power of appointment which could be exercised to deprive the complaining secondary beneficiary of any interest in the trust property. As one of the foremost authorities in trust planning, Professor Ed Halbach³² has often stated, "A power of appointment is also a power of disappointment."

Additional Benefits

Additional tax and creditor protection benefits may be derived by using a discretionary trust, rather than a maximum benefit trust, with an independent trustee possessing the tax sensitive powers, particularly the decision to distribute or retain income (and principal) in the trust. Not only is this approach more tax efficient from an income tax point of view, but significant transfer tax savings can also be realized. The trust income, if retained in a trust protected from the GSTT and not distributed, will not be subject to transfer taxes for the duration of the trust. The use of a discretionary trust with an independent trustee, whose sole duties are limited to tax sensitive decisions, will not meaningfully reduce the control of the family trustee, particularly if a "friendly trust protector" is used who can remove the independent trustee. The primary non-tax sensitive power is managerial control over investments. Such power may be lodged in the hands

of a trustee, who is also a beneficiary, without disturbing the tax consequences.³³

The beneficiaries can enhance the estate tax avoidance program further by consuming their personal assets, thereby reducing their taxable estates, since they will have the security of the trust assets as a cushion. Because the discretionary trust will be managed so that it retains income, rather than distributing it, the trust can be expected to grow more rapidly than a maximum benefit trust. Therefore, its use as an emergency source of funds will enable the beneficiaries to defund their estates more aggressively due to the increased security available to the beneficiaries in the enlarged trust.

Creditor protection. In addition to the tax benefits inherent in the more flexible discretionary trust arrangement, such a trust provides greater creditor protection than a trust which has the beneficiary as its sole trustee, or a trust that provides for fixed distributions rather than discretionary distributions. As a general rule, the more discretionary the trustee's power, the more creditor-proof the trust will be. 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 him/herself has no enforceable rights against the trust."³⁴ By eliminating the beneficiary's enforceable rights, his or her creditors' rights are also curtailed.

MegatrusterSM concept. One form of trust which is designed to maximize both the tax and creditor protection benefits of the trust vehicle is called a Megatruster. Under the Megatruster concept, the creator of the trust places property into a trust, electing to allocate a sufficient amount of his or her GST exemption against the transfer so that the trust is wholly exempt from the GSTT. The term of the trust is structured to extend as long as possible, subject only to the constraints of the rule against perpetuities. The trust will be managed with the avoidance of wealth transfer taxes, a primary consideration, insofar as consistent with the objective of providing comfortably for the trust beneficiaries.

Distributions are permissible, but

not encouraged since distributions would be considered as "leakage" from a transfer tax perspective and would remove the shield from creditors to the extent made. The trustee should take into account all tax considerations and creditor protection issues prior to making any distributions and should be encouraged to provide the "use" of trust assets rather than to make distributions, in the absence of a compelling reason (e.g., adverse income tax consequences) to deviate from this policy. The trust beneficiaries will be expected to pay for their own consumables. Thus, the Megatruster will form an "asset pool" providing multigenerational benefits through the "use" of the trust assets for the descendants (and perhaps the spouse³⁵) of its creator.

The philosophy of the Megatruster can be illustrated by assuming a client creates a MegainsurancetrusterSM for the benefit of his or her son. The trust owns a \$1 million life insurance policy on the grantor and is funded by annual exclusion gifts subject to the son's Crummey³⁶ withdrawal powers. Traditional trust structuring would provide that if the son wished to acquire a house, a business or other asset that the trustee approves of, the trustee would finance the acquisition by making distributions to the son (or directly to the vendor) who in turn would acquire the asset in his own name. In addition, most trusts provide for termination during the child's lifetime, perhaps at staggered ages (e.g., one-half at age 25 and the remainder at age 30), at which time the child will have the funds or the acquired assets enabling the child to purchase assets in his or her own name. Assets acquired by the child in his or her own name would be subject to death taxes and creditors of the child, including spouses in the context of a divorce.

On the other hand, if a Megatruster is used and it acquires the assets, such assets would continue to be owned by the trust and, thus, be protected from taxes and creditors of the beneficiary. The beneficiary would have the use and enjoyment of the trust property without the risks and detrimental tax results. For those clients who desire that their descendants come as close to outright ownership as possible, without the negative features of outright

ownership, the child can also be the managing trustee of the trust and can make the investment decisions to acquire such properties for his or her "use."³⁷ As this is not a tax sensitive issue, an independent trustee need not be involved in this decision making process. The trust beneficiaries would be expected to use their personal money to acquire depreciables, such as automobiles, and to individually fund current expenses such as food, schooling, vacations, etc., since the use of protected funds expended on those items would be wasteful.

There are several ancillary benefits to the approach taken in the example which have received little, if any, commentary, but can prove to be extremely meaningful in the future. From an income tax standpoint, the IRS has held that the holder of a Crummey power will be treated as if he or she had withdrawn the property and then recontributed it to the trust and, thus, would be treated as the grantor.³⁸ Since the beneficiary will be paying income tax, which will be attributable to trust earnings, the dual effect will be to avoid any leakage of assets protected from the transfer tax, and a transfer tax free diminishment of the beneficiary's estate.

In the example above, there is only one child and, therefore, the trust is a wholly grantor trust with respect to the child. The fact that the child is treated as the sole grantor for income tax purposes creates an additional planning opportunity in that the beneficiary-grantor is able to buy and sell assets from the trust without income tax consequences.³⁹ Therefore, the beneficiary who owns assets (such as a home, business, stock, land, partnership interests, etc.) may sell these assets to the trust for cash, and then have the cash to pay for his or her own expenses. The sale of a minority interest in a partnership or corporation to a trust offers some exceedingly productive transfer tax benefits to the beneficiary. This procedure also is consistent with the creditor protection goals of the family unit in that assets which are sold by the beneficiary of the trust will come within the shield of the trust's creditor protection provisions and, therefore, permit the beneficiary the use of these assets without creditor intervention.

Historically, the most popular

structure of a life insurance trust was a single "pot" trust for the descendants with multiple powers of withdrawal. In light of the foregoing analysis, in order to enable the descendants to take advantage of the suggested techniques, consideration might be given to creating separate trusts at the inception for each child (and his or her descendants) where only one beneficiary (the child) has a power of withdrawal so that the trust would be a wholly grantor trust for that beneficiary. The insurance, in such instance, would be either fragmented (with or without the necessity of physical segregation) or held in a partnership arrangement.

Income Tax Planning⁴⁰

Trusts offer some valuable income tax planning opportunities. Often these income tax planning opportunities will also translate into significant transfer tax savings.⁴¹ The design, funding and operation of the trust can result in the grantor being taxed, the beneficiary being taxed or the trust being taxed. In addition, under certain circumstances, capital gains may be taxed to a different entity or person than is taxed for ordinary income tax purposes.⁴²

A discretionary trust funded by using the unified credit or other taxable gifts will usually be taxed under the general rule whereby the trust is taxed on the income, except that the beneficiaries will be taxed to the extent the income is distributed to them. The trust, however, could be designed as a "grantor trust" for income tax purposes so that the income is taxed to the grantor. Such a result would occur because of the violation of the income tax grantor trust rules set forth in IRC Secs. 671 through 679. Significant transfer tax benefits can be achieved under the defective trust approach since the grantor's payment of taxes attributable to assets owned by the trust will result in the diminishment of the grantor's estate and the enhancement of the value of the trust. In addition, if the grantor is treated as the owner of the trust, he or she will be able to buy and sell assets from the trust, resulting in enormous flexibility to obtain substantial tax benefits. For instance, if a grantor acquires highly appreciated assets from a trust that is defective as to the income tax, but not the transfer tax system, the purchase

of the low basis asset will be neutral with respect to transfer tax, but will enable the grantor (decedent to be) to acquire an asset and hold it until death so that the basis can be stepped up. From a transfer tax perspective, consideration might be given to selling minority interests to the trust, enabling the seller to defund his or her estate without any income or transfer tax consequences.

Trusts funded using annual exclusion gifts under current IRS ruling policy would result in the power holders being taxed as grantors, and the planning opportunities discussed in the previous section by the creation of separate Crummey trusts would be available to them.

Estate Planning Benefits

The enormous potential of the dynastic trust vehicle was acknowledged by the late Professor James Casner, when in testimony before Congress he stated, "In fact, we haven't got an estate tax, what we have, you pay an estate tax if you want to; if you don't want to, you don't have to."⁴³ Congressional recognition of this multigenerational tax avoidance opportunity resulted in the enactment of the GSTT, which under present law places a \$1 million per transferor ceiling on generation skipping transfers in excess of certain annual exclusion gifts.⁴⁴

The transfer tax benefits for trusts such as the Megatrast, which is designed to leverage the \$1 million GSTT exemption by providing the use of assets for multiple generations, however, can still lead to some extraordinary results. A contribution of \$1 million into a Megatrast that will last for 120 years and grow at 8 percent per annum, will result in a trust value of more than \$10.25 billion in that 120 years. A 9 percent growth during that same period of time expands that benefit to almost \$31 billion. The 1 percent differential might occur because the trust might be located in a jurisdiction which has no estate income tax, rather than a jurisdiction which subjects the income to tax. The state income tax avoidance might be accomplished by forum shopping through the selection of a trustee in a favorable jurisdiction. Additional leveraging might occur through a trust being a grantor trust either as to the beneficiary or the grantor himself or herself.

The growth potential also is enhanced by the fact that assets which pass outside of a trust will probably be reduced not only by the tax, but also by:

1. divorce settlements;
2. creditor problems; and,
3. the fact that assets are less likely to be dissipated in a trust than if held outright, even if the invasion rights in the trust are extremely broad and generous.

These results may be further leveraged by the use of several funding techniques. Certainly, if the Megatruster is funded with partnership interests, the valuation discount will enable significantly more family wealth to be passed on.

One technique which can produce some extraordinary leveraging benefits is to fund a defective Megatruster with limited partnership interests which have a large income stream. The income stream can then be used to acquire life insurance which is generally considered to be a leveraged type of investment. Consideration also might be given to using a split-dollar arrangement to acquire life insurance in the Megatruster. The value of the gift, particularly where second-to-die life insurance is being acquired, is extremely low relative to the anticipated return.

Integration Of Goals

The goals of tax reduction and protection against creditors can be best accomplished by the skillful coordination of the two common planning vehicles discussed above. Techniques to accomplish either goal significantly enhance the benefits of the others.

We have previously illustrated the fact that the use of asset protection techniques enhances the tax planning opportunities, particularly in the transfer tax arena.

From an asset protection perspective, the tax and estate planning benefits are also critical. Catherine G. Henkel, in her outline on "Asset Protection Techniques,"⁴⁵ states: "In this regard, if the planner participates in or advises any type of transaction that has no beneficial tax effect, the planner should satisfy him/herself that some purpose other than hindering, delaying, or defrauding creditors is served by the transaction."

Another leading authority in the asset protection area, Larry W. Gibbs, of San Antonio, echoes the foregoing caveat, stating: "Avoid any procedure, no matter how innocent, which might imply that the client's predominant motive is to asset protect."⁴⁶ Non-compliance with this admonishment may result in disciplinary action to the advisor,⁴⁷ damages to the creditors,⁴⁸ fines and criminal penalties.⁴⁹

In light of the foregoing, it is important that the techniques used to asset protect plan incorporate significant income and estate planning benefits in order to pass the "smell" test. Clearly, the various strategies used in structuring the FLP to take advantage of the valuation inhibitors for estate planning purposes also enhance the legitimacy of the FLP from an asset protection perspective.

Conclusion

The skilled coordination of FLPs and trusts can provide unique opportunities to create a "family asset pool" which may benefit the creator's descendants into perpetuity. It is perhaps the ultimate opportunity to protect and preserve family wealth on a multigenerational basis without disturbing the enjoyment of the transferred property. The inherent flexibility necessary to meet the changing needs and circumstances of the beneficiaries, and to select those persons who will control or determine control of the family wealth, strongly suggests that the use of the FLP in conjunction with trust planning should receive careful consideration when evaluating any business or estate planning undertaking. ◇

FOOTNOTES

1. Cooper, *A Voluntary Tax? New Perspectives on Sophisticated Estate Tax Avoidance*, 77 Columbia Law Rev. 13 (March 1977), and Fiore, *Ownership Shifting to Realize Family Goals, Including Tax Savings*, NYU 37th Ann. Inst. Fed. Tax., Ch. 38 (1979). These outstanding articles deal with intrafamily tax planning techniques and are recommended reading even though some of the techniques discussed have been changed or eliminated by subsequent law changes.
2. *Lucas v. Earl*, 281 U.S. 111 (1930); *Helvering v. Horst*, 311 U.S. 112 (1940).
3. IRC Secs. 671-679.
4. IRC Sec. 704(e).
5. Many of the leveraging techniques such as GRITs, GRATs and GRUTs are beyond the scope of this article.
6. See Fiore, fn. 2.
7. See Oshins, "MegatrustersSM, Representation Without Taxation," NYU 48th Institute on Federal Taxation, 1990; Oshins and Brody, "Representation Without Taxation, Megatrusters and

Megainurance trusts,SM USC 42nd Institute on Federal Taxation, January 1990; Oshins and Blattmachr, "Megatrusters and Megainurance trusts," *Jour. of Amer. Soc. of CLU & ChFC*, 3/91; and Oshins and Blattmachr, "The Megatruster: An Ideal Family Wealth Preservation Tool," *TRUSTS & ESTATES*, 11/91. The Megatruster is a servicemark held by Richard A. Oshins and Jonathan G. Blattmachr and licensed to Alfred J. Olsen and Susan K. Smith.

8. *Gregory v. Helvering*, 69 F.2d 809 (1934).

9. This article concentrates on the use of FLPs. The relatively new vehicle, a limited liability company, appears to offer the same benefits as the FLP, but does not have the long term history of FLPs nor is it available in all states. The advisor should consider its use either in conjunction with, or in lieu of, an FLP.

10. Engel, "Asset Protection Planning: A Critical Part of Any Estate Plan," *Financial & Estate Planning*, Sec. 30,001.

11. Mitton, "Asset Protection Guidebook," p. 12 (1987).

12. RULPA Sec. 702.

13. Rev. Rul. 77-137, 1977-1 CB 178.

14. Mitton, fn. 12.

15. The Service ruled in TAM 9131006 (4/30/91) that gifts of limited partnership interests constituted gifts of present interests.

16. *Ibid.*, The retention of management authority in the capacity of general partners will not result in inclusion because the managerial control was held in a fiduciary capacity.

17. IRC Sec. 2701. The Conference Report states that "[t]hese rules do not affect minority discounts or other discounts available under present law." Conf. Rep. at 1137.

18. Treas. Reg. Sec. 25.2512-1

19. Cooper, fn. 2, p. 197.

20. Fiore, fn. 2.

21. *Northern Trust Co. Transferee v. Comm'r*, 87 T.C. 349 (1986); *Estate of Andrews v. Comm'r*, 79 T.C. 938 (1982).

22. Wallace, "Now You See It, Now You Don't — Valuation Conundrums in Estate Planning," 1991 Miami Est. Plan. Inst., Ch. 8 at Sec. 803.6.

23. IRC Sec. 2031.

24. IRC Sec. 2512(a).

25. The IRS's attempt to deviate from a "hypothetical" buyer and seller to the persons who most likely undertook the transaction was rejected as being contrary to case law and the Regulations in *Estate of Andrews v. Comm'r*, fn. 22. The Court stated, "We must assume these hypothetical parties exist even though the reality of the situation may be that the stock will most probably be sold to a particular party or type of person." 79 T.C. 938, 956.

26. Treas. Regs. Secs. 20.2031-1(b) and 25.2512-1.

27. *Estate of Andrews v. Comm'r*, fn. 22, at 956.

28. See *Centurion Corp. v. Crocker Natl. Bank*, 255 Cal. Rptr. 794 (1989) where the California court ruled that the rights of the creditors were not limited to a charging order and permitted the creditor to attach and sell the partnership interest.

29. Oliver Wendell Holmes, "The Autocrat of the Breakfast-Table," (1858).

30. Halbach, "Trusts and Estate Planning," *The Probate Lawyer*, Summer 1975.

31. Restatement (Second of Trusts) 156, provides that where the grantor of a trust is also a beneficiary, a creditor may reach the maximum amount that the trustee can distribute to the grantor even if the trust is discretionary and the trustee is independent. This would also result in grantor trust status for both transfer tax and income tax purposes. Additional discussion of tax and creditor rights results for a grantor-beneficiary is beyond the scope of this article.

32. Professor Halbach's contributions to the trust planning field are consistently insightful and pragmatic, and I would recommend any of his writings on the topic for your reading.

33. See Keydel, "Trustee Selection, Succession and Removal: Ways to Blend Expertise With Family Control," 23 Miami Est. Plan. Inst., Ch. 23.

34. Keydel, "Trustee Selection, Succession, and Removal: Way to Blend Expertise With Family Control," 23 U. Miami Inst. On Est. Plan., Chap. 4 at Sec. 409.1(1989). The MegatrustSM has been referred to as "... perhaps the greatest asset protection tool that a client can establish..." Olsen-Smith, Ltd., *Tax Planning Update*, Vol. 89-8.

35. The spouse of the creator may be included among the beneficiaries, but careful attention must be given to the income tax consequences, since the trust will be a grantor trust unless distributions may only be made to the spouse with the consent of an adverse party. See, for example, *Homer Charles Wilson*, Bkry., N.D. Tex., Adv. No. 591-5031, where the trust assets were protected from the IRS by virtue of a spendthrift clause.

36. *Crummey v. Comm'r.*, 397 F.2d 82 (9th Cir. 1968).

37. This "use" should not result in inclusion in the beneficiary's estate since it will be similar to a life estate.

38. P.L.R. 9034004.

39. Rev. Rul. 85-13, 1985-1 C.B. 184.

40. See generally, Roth, "The Intentional Use of Tax-Defective Trusts" 26 Inst. on Est. Plan., Chap. 4 (1992).

41. See for example, *Id.*, Appendix A and B.

42. P.L.R. 9211026 (Dec. 13, 1991).

43. Statement of Prof. James Casner, Hearing before the House Ways & Means Committee, 94th Cong., 2nd Sess., Pt. 2, 1335 (1976).

44. See IRC Sec. 2642(c)(2) with regard to the GSTT result as to transfers in trust which qualify for the gift tax annual exclusion.

45. Henkel "Asset Protection Techniques," American Bar Assn., Sec. of Taxation, Estate & Gift Tax Com., Aug. 9, 1991, p. 1.

46. Larry Gibbs is a well respected attorney from San Antonio who specializes in estate planning and asset protection. The quote is from an article to be published by Larry, which the author had the privilege of reviewing.

47. *Id.*, fn. 46, citing *Townsend v. State Bar*, 32 Cal. 2d 592, 197 Pac. 2d 326 (1948).

48. *Id.*, fn. 46, citing *McElhanon v. Hing*, 151 Ariz. 386, 728 P.2d 256, 264 (Ariz. App. 1984), *aff'd in part and vacated in part on other grounds*, 151 Ariz. 403, 728 P.2d 273 (1986), *cert. den.*, 481 U.S. 1030 (1987).

49. *Id.*, fn. 46, at p. 5, stating "Criminal Penalties". Any person who, in contemplation of a case under title 11 of the United States Code (bankruptcy), or with intent to defeat the provisions of title 11, knowingly and fraudulently transfers or conceals any of his property will be fined not more than \$5,000 or imprisoned not more than 5 years, or both. 18 U.S.C.A. Sec. 152 (Supp. 1991).

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