

# Estate Tax Reduction with Asset Protection

*By Edward D. Brown*

Edward Brown explains the benefits of planning with two primary goals: asset protection and estate planning. This strategy may help to avoid estate inclusion or a claim of fraudulent transfer by providing a substantive reason for the transfer and avoiding the assertion of an improper planning purpose.

**E**state planning is an important goal for many clients. The focus of this planning is typically on post-death events, such as who will inherit the client's estate after the IRS takes its share. The clients are generally driven by the understandable desire to (1) pay the least amount of estate tax, (2) direct the disposition of assets to family members, and (3) avoid probate. The client wishes to design a planning structure to accomplish these "death-time" goals.

Asset protection is also an important component to many planning structures. The professional planner should endeavor to integrate the above death-time estate planning goals with lifetime asset protection goals. One reason for this second component is that if one fails to adequately protect assets during lifetime, death planning becomes unnecessary.

The estate tax reduction with asset protection (ETRAP) tools discussed in this article are based on the concept of combining estate planning and asset protection planning goals. My goal is to show that an ETRAP is a tool designed to be flexible enough to accomplish and substantially enhance the two independent goals of estate planning and asset protection planning. After reading this article, the reader will come to understand that an ETRAP can most simply be defined either as (1) an asset protection vehicle

for an estate tax reduction motivated client, or (2) an estate tax reduction vehicle for an asset protection motivated client.

## How the ETRAP Approach Enhances Both Estate Planning and Asset Protection Goals

The marriage of estate planning and asset protection goals is ideal for furthering the effectiveness of each. When planning strategies are implemented for the sole purpose of reducing estate taxes, such purpose may be hampered. Likewise, if a client approaches the advisor for the sole purpose of establishing a structure that will protect assets from creditors, such a structure may be more prone to successful challenges from creditors. In these two separate scenarios, the possibility of achieving the desired goal is weakened. The reason for the weakness in the separate strategies is due to the perceived improper motive driving the planning. As an analogy, think of a person acquiring life or casualty (fire) insurance. If that person desires life insurance because he intends to jump off a bridge (without the bungie cord) the next day, will the policy achieve his goal? No. If that individual instead acquires fire insurance on his residence only seconds after a few sparks have ignited in the garage (but well before the house becomes totally engulfed in flames), will that policy provide the desired coverage? The proof required for collection on that policy would be difficult.

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Both policy examples are not effective uses of insurance because the acquisition of the policies is driven by an improper motive. This is how some courts view the establishment of an asset protection trust. The mere asset protection motive for establishing the trust might be viewed as an improper motive of simply attempting to defraud creditors. As such, a court may conclude that the trust is merely an instrument of a fraudulent transfer,<sup>1</sup> allowing the court to unwind the transfers to the trust. In a similar fashion, a terminally ill taxpayer who, in an attempt to reduce estate taxes, makes gifts of value-discounted limited partner interests only weeks or days before succumbing to the fatal illness is sometimes perceived by the IRS as involving an improper motive (*i.e.*, an attempt to disguise death-time transfers as life-time gifts). The very fact that the motive was obviously not one of lifetime generosity, but was motivated solely to reduce estate taxes, provides the basis for allowing the IRS to include the transferred assets in the decedent's taxable estate.

Looking at the facts, it seems that asset protection structures may be more effective for clients who have at least an equally strong desire to achieve estate tax reduction. Likewise, estate planning structures can have a greater likelihood of success when the client has strong asset protection concerns that drive him to set up the plan. This may seem like a contradiction but there does seem to be some evidence that these various planning techniques are more effective given the proper motive of the grantor. Creditors (and judges in debtor-creditor cases) generally view tax-planning as a legitimate and proper basis for trust structures. Likewise, the IRS generally perceives asset protection as a nontax (or legitimate business) purpose, which can avoid categorizing the structure as tax avoidance strategy.

As a practical matter, how is this relevant in an advisor-client context? Is the author suggesting that if a client walks in the door with asset protection motives, the advisor must counsel him to disguise these efforts as estate planning objectives? This is not recommended.

This situation can be best explained by the use of another analogy. Take the example of a client who wants to set up a corporation and wants bylaws to govern the operation of the client's new business that involves him and a few other co-owners. The advisor can simply file the papers of incorporation and draft the bylaws that address the operation of the entity, since that is the goal the client sought to accomplish. And yet, such an advisor would be remiss

in failing to advise the client regarding other related issues that very well may become the larger and more important considerations. For example, is a corporation the best entity to use? What are the tax consequences of withdrawing assets from the corporation that may be avoided if a limited liability company (LLC) had been used instead? The client thought all he wanted was a document to govern how the co-

owners are to operate the business and to establish their respective voting rights. But, as an example, the good advisor quickly points out that many times, the bigger question becomes, "How can I later exit this business without suffering financial harm?" Once the advisor brings these possibilities to light, the client may conclude that these are the new-found more important goals that drive the design.

This is a common development that good advisors typically encounter. In the estate planning and asset protection situations, a client may contact the advisor with a goal to protect assets. Given the fact that asset protection designs often involve the use of trusts, it is the advisor's fiduciary duty to the client to also discuss whether the client has thought through the possibility of having the trust remove assets from his taxable estate in a leveraged capacity that would save him significant estate taxes if these assets remained in his estate at the time of his death. The client may realize that reduction of taxes becomes the desired benefit to be achieved, even more than the initial desire to protect some assets.

The client who arrives with strong desires to reduce estate taxes should likewise be educated by the advisor to also look at other considerations. For example,

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many advisors have interviewed the client who wants an estate plan to provide for the spouse, using the marital deduction, with everything ultimately going to the children at the second spouse's death. The advisor might ask, however, whether the client has considered the possibility that this could result in a 22-year-old inheriting millions of dollars before he is even out of college. The advisor discusses what can happen if the young adult is in the midst of a messy highly emotional divorce at the time he inherits all this cash. The client will most likely immediately see that spendthrift provisions and long-term provisions in the trust are advisable so that the assets stay in trust for that child in a manner that keeps those assets safe from creditors that may arise in that child's life. Asset protection may quickly become the focus that the client finds to be relevant.

This may even make the client realize that he also has a desire to have those assets protected while he is living to better ensure that an inheritance will be available for his child. The client may discover that asset protection has become a goal that, at a minimum, rivals his initial estate planning concerns.

These are the situations that the author is envisioning as perfect opportunities to introduce an ETRAP design so that the plan to be implemented is driven by the proper motives, and yet has an enhanced ability to also accomplish the client's secondary goal.

## Case Law Examples

In the estate planning case *Bongard Est.*,<sup>2</sup> a taxpayer transferred a LLC interest to another entity (a partnership). However, the taxpayer retained certain controls over the LLC assets in the taxpayer's capacity as a manager of the LLC. Code Sec. 2036<sup>3</sup> causes the LLC assets to be brought back into the taxpayer's taxable estate if the taxpayer retains these manager-type controls over the LLC assets. Code Sec. 2036, however, will not apply if the transfer of the LLC interest was for "full and adequate consideration." In the *Bongard* case, the court considered whether the LLC assets were effectively removed from the taxable estate

by reason of the transfer being made for "full and adequate consideration." The court was aware that the taxpayer did in fact receive an increased capital account in the partnership to which the LLC interest was transferred. The taxpayer was hopeful that this increase in the capital account would establish full consideration for the LLC interest. The court stated however, that because the decedent did not receive any benefit beyond transfer tax savings in contributing the LLC units to the

FLP, the transfer to the FLP was not a *bona fide* sale for adequate and full consideration for purposes of Code Sec. 2036. To establish such a nontax reason, the taxpayer asserted that his transfer of the LLC interest to the partnership was done partly for asset protection purposes. Even though the court found this argument to be unpersuasive<sup>4</sup> because virtually the same asset protection

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was already afforded by the LLC structure prior to the transfer, the holding still leaves open the possibility that asset protection or other nontax reasons can be a legitimate nontax reason for the transfers. Under this interpretation of the case, had asset protection been a substantive factor in making the transfer, the tax result would have been favorable for the taxpayer. If one can show that asset protection is greatly enhanced by a transfer, one can meet the full and adequate consideration test<sup>5</sup> and avoid having the subject assets brought back into the taxable estate. Asset protection motivation is one example of a nontax purpose for a transaction that can enhance the effectiveness of the more secondary estate tax efficiency goal. This opinion is supported by the more recent case of *A. Mirowski, Est.*<sup>6</sup> in which asset protection was recited as a business (nontax) purpose for an LLC. The court concluded that the tax motive was only secondary, and as a result, the LLC assets were not drawn back into the taxpayer's estate.

An example of an asset protection case that involved estate planning motives can be found in the case of *Evseroff*,<sup>7</sup> which involved a debtor who transferred assets to a trust at a time that a large federal tax liability assessment was pending against him. The debtor also had an estranged wife, who (the debtor

feared) might gain access to his estate assets after his death. The debtor admitted that his outstanding tax liability was a factor behind his transfers to the trust, but that his primary motivation for the transfers was to protect his estate at his death from his estranged spouse. The court found that the estate planning considerations (his intended disposition of his estate at death) of the dual goals was an important factor in concluding that the transfers were not fraudulent as to the IRS, and therefore, the assets remained protected. The court stated “when these events occurred, the separation from his wife and need for estate planning based on this separation was much more at the forefront of his life. The now long-running fight with the IRS, while present, was nascent and not as predominate as it later became.”<sup>8</sup> *Evseroff* serves as an example of how an estate planning motivated structure (or even a structure involving properly-balanced estate planning and asset protection goals) can serve well as a defense to an assertion that a person was predominantly motivated by the wrong incentive in a litigated debtor-creditor matter.

Below, we will explore some structures that are especially well-suited for clients that have the proper balance of estate planning and asset protection goals, where the predominant motive proves to be the proper incentive. The professional advisor should document the files with ample support for the properly-balanced estate planning and asset protection goals so that the client can respond to arguments that the prevalent stimulus behind the client’s actions were less than legitimate. Having the estate planning and asset protection goals properly established in the client’s files can be crucial in demonstrating that the assertion of an estate planning purpose in a creditor claim, or an asset protection purpose in an IRS challenge, is not merely a disingenuous afterthought that is being asserted as a lame attempt to cover up an improper motive.

**Transfer of assets using FLPs and LLCs—asset protection as a business purpose.** The IRS has gained momentum in attacking gifts of interests in family limited liability companies (LLCs) and family limited

partnerships (FLPs) when the transferor retains the authority to manage the LLC or FLP assets as a manager or general partner of the entity. Gift and estate tax discounts are commonly intended to be realized through such transfers. The IRS has challenged these transfers when the LLC or FLP has no purpose other than tax reduction. This is when the client’s files that show that a nontax motive played a significant role in the use of these entities is valuable in establishing the right motive for the transfers. The client’s files should go beyond weak general references to charging order protections<sup>9</sup> and transfer restrictions imposed on

family members as being the sole corroboration for the asset protection motives.

If an advisor has previously designed a structure for transferring LLC or FLP interests for a predominantly estate planning motivated client, then the design for the current estate planning and asset protection planning motivated client should not be of the same design. Instead, the design must contain significant asset protection components as well. This does not mean simply including self-serving recitations in the documents as window-dressing for a nontax purpose of the structure. In *D.A. Kimbell*,<sup>10</sup> the court cited the creditor protection aspects of the FLP as a factor in holding that the transferred interests were not included in the transferring taxpayer’s taxable estate.<sup>11</sup> Likewise, in *A. Strangi Est.*,<sup>12</sup> even though the court held that the value of all the FLP’s assets were included in the taxpayer’s taxable estate, the court noted that if there had been a nontax purpose for the creation of the FLP, the FLP’s assets would not have been brought back into the taxpayer’s taxable estate. These cases indicate that significant nontax (e.g., asset protection) motives must be supported by credible, contemporaneous evidence.

*Planning Idea:* In forming the FLP or LLC for clients who are motivated by both estate planning and asset protection concerns, the files should be well documented reflecting each goal. Correspondence to the client supporting those motives should be made clear, and proper steps should be taken, all to establish that the tax benefits are an important moti-

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vation, but that asset protection is also an important factor behind the main purposes for the planning. On the asset protection side, for example, the files and correspondence should make it clear that the domestic or foreign jurisdiction in which the FLP or LLC is formed was chosen for its strong charging order protections under the applicable statutes. Using a Nevis situated LLC, for example,<sup>13</sup> would be a strong indication that the LLC is designed for asset protection (due to the provisions in the Nevis LLC Ordinance 1995, as amended, that makes a charging order the creditor's sole remedy). This asset protection aspect can be further enhanced by having an independent Nevis entity serve as the LLC's manager. Such a manager with no U.S. branches may be in the position of being beyond the reach of a U.S. creditor. Such a manager can also have control over distributions from the LLC. The asset protection design can be further corroborated by having the LLC invest in assets that are not held in U.S. financial institutions or otherwise located within the United States. These are just a few examples of facts that go well beyond a weak attempt to assert the more general asset protection features of any common domestic LLC. This is not to say that domestic LLCs should never be used. In using domestic LLCs, selecting state law for the formation of the LLC, such as Arizona, Wyoming or Nevada where a charging order is also the exclusive remedy, should be part of such an ETRAP design, at the very least.<sup>®</sup>

The governing documents for the LLC or FLP, whether domestic or offshore, should also be well drafted, with extensive provisions regarding what occurs when a member or partner becomes party to a divorce action, or becomes subject to an involuntary bankruptcy. As examples, consideration can be given to having provisions that require a redemption of entity interests of a member or partner in certain creditor-triggering events in which the redemption purchase price is payable over an extended period of time pursuant to an installment obligation. The valuation of the redeemed interest can be required in the governing documents to take into account any appropriate discounting that reflects the minority status or lack of marketability of the redeemed interests. The terms of the installment obligation can be designed to be more favorable for the entity as opposed to the redeemed member. Consideration might also be given to having the governing documents contain a provision that precludes the use of

any Code Sec. 754 election, so that any acquirer of an interest in the entity cannot benefit from any desired step-up in basis in the underlying assets. Making the governing instrument an "executory" contract in the bankruptcy sense can also support the asset protection design. Generally, although beyond the scope of this article, bankruptcy law allows creditors to disregard the asset protective provisions of an LLC agreement unless the LLC agreement constitutes an executory contract. In order to be an executory contract, the debtor-partner must have continuing obligations under the LLC agreement (e.g., to make further capital contributions), where the failure to do so would be a substantial breach.

Although many provisions in a governing document for asset protection reasons can equally serve as a basis for further discounting of the value of the entity interests for estate planning purposes, it may be wise to document which provisions were designed with asset protection in mind, and which were designed with estate planning (*i.e.*, the valuation discounting provisions) in mind. This way, one cannot counter-argue that the asset protection provisions were actually designed for estate planning reasons (or *vice versa*).

It is important to note that transfers of LLC or FLP interests, as well as all other transfers, should be made only at a time that such transfers will not cause the transferor to become (or leave the transferor) insolvent. Otherwise, a creditor may be able to unwind such transfers as being "fraudulent transfers," notwithstanding a plethora of estate planning motivated factors and components.

## **Transfer of Assets—In General**

Under typical state law regarding fraudulent transfers, a creditor can rely on certain "badges of fraud" to establish that transfers of assets were made for the purpose of hindering a creditor, even if no actual intent can be proven.

If estate planning incentives are strongly documented as a significant motivational force behind the transfers, then a good case can be made for rebutting any presumption that the badges of fraud constitute constructive intent to hinder a creditor. This is not to suggest that one can gift away assets for estate planning purposes when such transfers cause the taxpayer to become insolvent (or to become more insolvent) with regard to creditor claims pending at the time of such transfers.<sup>14</sup>

## The Use of ETRAP Trusts

Below are four examples of trust structures that display a healthy mix of both estate planning and asset protection design features, particularly well suited for ETRAP usage.

### *Inter Vivos* QTIP Trust—Where Is the Asset Protection in That?

One example of an ETRAP trust is one created for a spouse that qualifies for the unlimited marital gift tax deduction. Some refer to this type of trust as an *inter vivos* QTIP<sup>15</sup> trust. So long as the spouse is a U.S. citizen, the QTIP trust can be funded with an unlimited amount without incurring any gift tax to the donor. The QTIP trust provides benefits to the spouse for her lifetime, after which the trust benefits those designated in the QTIP trust instrument. Such a trust allows the client to ensure that in the event of his spouse's death or in the event of divorce, the assets he gifted to the spouse will not wind up belonging to persons unacceptable to the client.

This clearly has an estate-tax benefit in that it removes assets from the donor's taxable estate. Also, such a structure is fairly benign in the arena of "tax-abusive" structures that are more the focus of IRS scrutiny. Given that fact, creating a record to support any asset protection motivations for such a structure is most likely not as necessary.

The fact that this structure is so clearly estate planning motivated, however, enhances the asset protection effectiveness of the structure, in true-ETRAP fashion. For example, the trust will most likely contain a spendthrift provision that protects the trust assets from the spouse's creditors. The client can also retain some control over the trust assets by serving as trustee until the spouse dies.

This is a strategy in which the assets are protected, and yet the client retains a number of controls and potential benefits from the trust. During the client's life, he can benefit in the distributions the spouse receives. The spouse is free to gift any distributions she receives from the trust back to the client, or the client can share in activities in which such distributions are used.

But, let's explore how this *inter vivos* QTIP can achieve a strong asset protection effect for the client, specifically. The *inter vivos* QTIP design can in fact be a tool to allow the client to self-settle a nonself-settled trust for his own benefit. Nonself-settled trusts generally have much greater asset protection potential than self-settled designs.

Specifically, the asset protection benefit is derived by the client designing the QTIP trust to provide, if the client outlives the spouse, for income to be payable to the client annually, commencing at the spouse's death. The achieved asset protection in that situation is a trust that is considered for tax purposes as created by a third party (the spouse) for the client, which provides an argument that the trust is not self-settled,<sup>16</sup> and therefore the principal of such trust is not reachable by the client's creditors (beyond his right to the income, and even then, only to the extent the trust generates any income). The position supporting the nonself-settled trust status is that the client previously gave the assets to his spouse. Under federal tax law, the QTIP nature of the trust requires the trust assets to be treated as belonging to the spouse at her death. Under the same Federal tax law, when that spouse dies, the resulting trust, deemed to be settled by the spouse, pays all its income to the client, and is eligible for an unlimited marital tax deduction in the spouse's estate. Therefore, it is not a tax burden on her estate. The terms of the resulting trust can also provide that the client be able to appoint the trust assets at the client's death (again, assuming he survived the spouse) to the client's children.

Another design variable would be to have the trust mandate that an independent trustee be appointed to the trust if the client is to be able to receive principal distributions from the trust (but purely in the discretion of the independent trustee). This allows further flexibility for the trust to benefit the client. Since the trust is not self-settled, the client's creditors would not have access to the undistributed principal.

Even though the estate planning side of the estate planning asset protection dual goal clearly overshadows the incidental asset protection motivations (which, again in true ETRAP fashion, is a good thing in protecting against any fraudulent transfer motive arguments), the advisor should still advise the client that there is always the possibility that if the QTIP trust eventually reverts back to a trust for the client's benefit, his creditors could attempt to convince a court that the trust is truly self-settled in nature since the client was the initial donor who also designed the trust for his own eventual benefit. As such, the then-deemed self-settled trust loses its asset protection component. The advisor should, therefore, as an advocate for his client, educate the client as to the option of creating the QTIP trust in one of the 10 (or 11) states<sup>17</sup> (referred to as the domestic asset protection trust states or DAPT states) that allows self-settled

trusts to avoid creditor attachment, or to create the trust in a foreign jurisdiction that is more protective than any of the ten or eleven DAPT states.

If a foreign QTIP is used, the file should still be documented for the non-asset protection reasons for using a foreign jurisdiction, if such reasons are legitimate. For example, perhaps the client desires a foreign trust to allow it to invest in certain funds that may not be available to U.S. investors. Having these non-asset protection factors documented may be helpful in vindicating the client from any fraudulent conveyance scheme accusations.

## Nonmarital Trust

The same individual that sets up the *inter vivos* QTIP trust can also craft that trust to become both a marital trust for the client after his wife's death, and (to the extent of his wife's available applicable exclusion amount<sup>18</sup>) create a "bypass" trust for the client and his children (or any other persons) (referred to as the donee beneficiaries), allowing for distributions to the donee beneficiaries in the trustee's discretion. This is denoted as a bypass trust because it not only escapes estate tax in the donor individual's (here, the wife) estate, it also avoids estate tax in the donee beneficiaries' estates.<sup>19</sup> The bypass trust can be funded with the wife's entire available applicable exclusion amount (currently \$2M, but scheduled to increase to \$3.5M in 2009) without being subject to estate tax in either her or the client's estate.

To further enhance the estate tax-savings another strategy includes making the bypass trust a grantor trust<sup>20</sup> with respect to the client (again, assuming the client outlives his spouse) so that the client (in lieu of the trust) will be obligated to pay income taxes on any taxable earnings of the bypass trust. Even though for estate tax purposes, the spouse will be treated as the settlor<sup>21</sup> of this bypass trust, the grantor trust tax laws<sup>22</sup> will treat the client as the settlor (*i.e.*, the "grantor" of the grantor trust). The bypass trust must, however, be designed to ensure the client holds certain grantor trust powers. The client paying the income taxes arising as a result of the bypass trust's earnings may, on the surface, appear as an added burden, but is in fact a way for the assets in the bypass trust to eventually benefit the client's children without the trust being depleted to pay income taxes. The payment of income taxes is a further gift that benefits the trust beneficiaries, since the trust is relieved of that tax obligation. As a result, the bypass trust is allowed to grow well beyond the applicable exclusion amount, and yet

still bypass estate taxation that would otherwise occur in the client's (and even the children and further descendants, if so designed) estate. Furthermore, the payment of the income taxes by the client is not deemed a gift that would otherwise be taxed or utilize gift exemption amounts.<sup>23</sup>

For the same reasons discussed above in the QTIP scenario, the strong estate planning design of the above discussed ETRAP-style marital and bypass trusts most likely negates any appearance of an asset protection motive in creating the trusts. Yet, the client shares in the enjoyment of the benefits of the trust since he is a beneficiary. Very effective in the AP context.

If the above described *inter vivos* QTIP trust that later converts to a marital and bypass trust combo for the client is created as a domestic trust in a non-DAPT state, there is that downside risk on the asset protection side that the aforementioned bypass trust created ultimately for the client may be viewed as self-settled, which makes the trust includible in his taxable estate (under the view that since his creditors can access the trust, it is as if the client had a general power of appointment over the trust assets, which pulls the assets into his estate).<sup>24</sup> The cautious advisor may therefore suggest, at the inception of this planning, the use of a foreign bypass trust so that the possible self-settled nature of the trust will avoid this general power of appointment risk.<sup>25</sup> As with all ETRAPs, the estate planning motive to make the bypass trust a foreign trust makes the trust much more creditor-proof.

## Straightforward Self-Settled Trusts

Many clients like the concept whereby a trust can be created for the benefit of family members, but also have the flexibility of receiving distributions back from the trust (*i.e.*, self-settled). All but the aforementioned DAPT states treat most self-settled trusts as being void as to the client's creditors. However, in the DAPT states, such a self-settled trust can be created without exposing the trust assets to the client's creditors. As a result of the trust assets not being reachable by the client's creditors, the client is able to make "completed" gifts to such a trust. The impact of such a completed gift is (with some exceptions) that the trust assets are effectively removed from the client's taxable estate. This is a good example of where such a domestic asset protection trust is motivated primarily by estate planning concerns. The IRS ruled in a private letter ruling<sup>26</sup> that gifts made to a self-settled trust do-

miciled in one of the DAPT states (Alaska) qualified for such completed gift treatment. As such, the use of asset protective trusts in these states has a strong estate planning oriented inducement, which provides the desirable fact pattern conducive for supporting the client's estate and asset protection goals.

### The Third-Party Trust

A common feature of asset protection driven trusts is that the client is able to retain a beneficial interest in the trust assets. Another ETRAP design can accomplish this when the client and one of his parents are both clients, and that parent desires to create a third-party trust (TPT). Generally, this design involves having the third party (e.g., the client's parent) be the settlor of, and the only transferor (by way of a gratuitous transfer) of assets, to the TPT, and hence the name "third-party trust." This is necessary to avoid having the primary beneficiary (i.e., the client) settle the trust. If the client were the settlor, the trust would be a self-settled trust, and therefore may not be respected (except in the jurisdictions noted above) as an asset-protective structure.

The client can serve as a co-trustee with powers limited to the management and investment of the trust assets. Also, there is an "independent" cotrustee who holds the discretionary power to make distributions to the client, which prevents a creditor from being able to compel the client to demand a distribution. As long as the client does not contribute assets to the TPT by way of a gratuitous transfer, Code Sec. 2036<sup>27</sup> will not apply. The client's only contributions, if any, to the TPT by way of a sale for full consideration (e.g., an installment note).

The TPT agreement can be drafted to cause it to be a grantor trust with respect to the client.<sup>28</sup> In accordance with Rev. Rul. 85-13, 1985-1 CB 184, this allows any later sale by the client to the TPT to be treated as a sale from the client to himself for income tax purposes, and thus not treated as a taxable event.

In order to have the TPT treated as a grantor trust to the client, the client (who is also typically the primary beneficiary of the TPT) must hold a temporary withdrawal power (known as a "Crummey" power) over the settlor's contributions. The withdrawal power eventually lapses, with the client/beneficiary then having, for example, some or all of the following grantor trust powers:<sup>29</sup> (1) the right, in a nonfiduciary capacity, to substitute trust property for equal value [see Code Sec. 675(4)(C)]<sup>30</sup>; (2) the right to dispose of trust income or principal to other beneficiaries [see

Code Sec. 674(a)]; and (3) the right to potentially receive income at the discretion of a nonadverse party, such as the independent trustee [see Code Sec. 677(a)(1)].

The client may not want to have the necessary Crummey power because of the concern that the withdrawal power makes the trust assets analogous to a self-settled trust<sup>31</sup> or exposes assets to creditors during the withdrawal period. By now, the reader can probably guess this is where the author will again raise the concept of using a DAPT state or foreign domiciled trust design to avoid the resulting EP risk of using self-settled trusts (with the attendant asset protection enhancement that follows in standard ETRAP fashion).

**Recaps.** To recap the EP design variables, recall that this tool allows for the client's parent who wants to gift assets to the client (via an advancement on the client's inheritance or as seed money to allow the client to engage in business ventures that can grow estate tax-free) can do so in a way that removes assets from the parent's estate. Also, the child of the parent is gaining a tool through which he can invest the trust assets in appreciating ventures and opportunities outside his taxable estate, and yet receive financial benefits from the trust. Furthermore, the child of the parent has a vehicle to which he can sell assets with high upside growth potential to the TPT income tax free. This also provides an ideal estate freeze opportunity for that client (or even estate tax reduction for that client if he sells discounted LLC or FLP interests to the TPT). The estate planning motives are plentiful and serve two individuals' (the child and parent) estate planning needs with one trust.

To summarize the asset protection design components, the TPT can be an offshore or DAPT trust, but for estate planning driven reasons. As noted above, the DAPT or offshore approach avoids the asset protection risk of the lapsing of the client's Crummey withdrawal powers being deemed to be client contributions to the TPT, making it a self-settled trust that makes the trust includible in his taxable estate (under the view that since his creditors can access the trust, it is as if the client had a general power of appointment over the trust assets, which pulls the assets into his estate). Using the foreign or DAPT TPT avoids having the possible self-settled nature of the trust create a *defacto* general power of appointment. As with all ETRAPs, the motive to make the TPT a foreign trust makes the trust much more creditor-proof because the reason for doing so is clearly estate planning driven.

## Trusts Used to Manage the FLPs and LLCs—The “No Strangi’s Attached” Approach

If the client has concerns of Code Sec. 2036 issues<sup>32</sup> with gifting LLC/FLP interests as first discussed above, an ETRAP-designed trust can hold the Manager or general partner interest in such entity. The trustee can be an independent person whom the client trusts in exercising trustee discretion over trust assets. This adds an estate planning component to a trust that the advisor might have otherwise had concerns of such trust being overly asset protection motivated in its formation. Clients are well served not only by taking the opportunity to fully implement both estate planning and asset protection dual goals in the client’s planning structure, but are also provided cost-efficient legal representation by the attorney by being able to create a single trust to accomplish both the estate planning and asset protection goals simultaneously (while also enhancing the estate planning and asset protection effectiveness through the ETRAP strategies espoused in this article).

## The “Discounting” S Corporation

Clients that own substantial assets in S corporations may have strong income, gift and estate tax motives to sell the stock to an intentionally defective irrevocable trust (IDIT)<sup>33</sup> in exchange for a private annuity or installment note. With such a multitude of income, gift and estate tax reasons for such a transfer, any asset protection benefits are better insulated against fraudulent transfer arguments. This is desirable because the client may also have significant reasons to want to reposition his assets in a way that makes those assets lesser in value and less attractive to potential future creditors. The ETRAP design below accomplishes all these goals, while also supporting the fact that the design is not driven predominantly by either motive.

**Tax benefits.** The tax benefits include the fact that the sale of stock to the IDIT is income-tax free. Also, no gift taxes occur because the taxpayer is receiving full value for the sale.

There should also be an estate tax benefit in that a client chooses to sell an asset that he believes will appreciate in value. In return for the sold asset, he receives a nonappreciating (or even depreciating) asset (the note or annuity), thereby removing the appreciation component or more from the reach of estate taxation.<sup>34</sup> In fact, the estate tax reduction can be

further enhanced if the sale involves a “discounting” LLC or FLP much like the ones discussed above.

A foreign IDIT (a FIDIT)<sup>35</sup> could be used instead of a domestic IDIT. A FIDIT of course gives an appearance of going above and beyond what is needed to accomplish the sought-after estate tax benefits, thereby raising the specter of a future creditor allegation that the client must be engaging in some sort of fraudulent creditor-hindering scheme. A seasoned advisor may, however, still advise the use of a FIDIT as a precautionary measure to avoid any successful argument by the IRS that the note or annuity payments received by the client are somehow a retained beneficial interest in the trust, which makes the client a *defacto* beneficiary of the trust, which then makes the trust self-settled, which then makes the trust under local applicable law available to his creditors. As such, that makes the trust includible in the client’s taxable estate since the client can effectively get the assets back simply by accumulating unpaid debts. Therefore, the use of a FIDIT in a foreign jurisdiction that precludes even a deemed self-settled trust from being subject to the client’s creditors may be an effective barrier to such creditors. This significant (to be documented in the files and correspondence) estate planning motivated design for the FIDIT should be helpful in thwarting possible future creditor arguments to a court that the FIDIT was designed with that creditor in mind.

**Asset protection benefits.** If the S corporation stock is first placed into an LLC wholly owned by the client, the client is then able to sell a large percentage of the LLC to the IDIT or FIDIT while taking advantage of valuation discounts, which serves the asset protection side in that the client’s asset (the note or annuity) is worth less than the assets held in the S corporation. The fact that the IDIT or FIDIT is a grantor trust allows the S corporation stock inside the LLC to still be considered as if it were wholly owned directly by the client (and therefore does not run afoul of the prohibition of two or more member LLCs taxed as partnerships owning the stock).<sup>36</sup>

An incidental benefit of this ETRAP structure is that the LLC is disregarded for income tax purposes, and therefore, negates the need for an added tax return filing.

## The Toggling FIDIT<sup>37</sup>

The use of FIDITs (foreign intentionally defective irrevocable trust) offer much in the way of asset protection, due to the protective foreign laws that apply. Therefore, some advisors may be wary of implementing these due to concern over a court viewing the

foreign nature of the trust as *prima facie* evidence of a fraudulent conveyance. Before this tool is removed, however, from an advisor's arsenal of ETRAP tools, thought should be given to a significant estate planning reason supporting the use of a FIDIT.

The estate planning reason relates, once again, to the leveraging of value attributed to the FIDIT by reason of the grantor-trust rules. Specifically, the FIDIT can be designed to be foreign for income tax purposes. As such, it becomes a grantor trust under Code Sec. 679 (provided the settlor and some beneficiaries are U.S. persons). As mentioned above, this serves the common estate planning goal of allowing the settlor to pay the income taxes on the FIDIT's earnings (thereby effectively making further gift-tax free gifts to the beneficiaries of the FIDIT).

A problem can arise later, however, if the tax burden has grown so high that the settlor no longer desires or is no longer able to pay those taxes. The problem with a domestic IDIT is that once you have turned on a grantor-trust feature, it may be problematic to turn it back off. This problem has been met by drafting the IDIT so that the settlor can release the power (or powers) that cause the trust to be a grantor trust. This would result in the IDIT now being classified as a nongrantor trust, and it would be responsible for its own tax under subchapter J of the Code. However, what happens if after turning off the grantor-trust status of the trust, the client's taxable estate grows too large, and it becomes advantageous to turn back on the grantor-trust income tax classification. It would be ideal if the grantor-trust nature of the IDIT could be turned on and off like a spigot. If the client and the trustee had the ability to control the timing of when the trust was classified as a grantor trust, they also would have more control over the dollar amount removed from the client's estate.

A common way to provide grantor trust status is to grant the settlor the power to substitute assets of equal value for assets in the trust. Later, if the settlor wants to discontinue (at least for awhile) the grantor-trust feature, he can release that power. In order to later turn the grantor-trust spigot back on, the trustee must be given the power to regrant to the settlor the power to substitute property of equivalent value. Once the trustee has regrant this power, the trustee has in effect toggled the switch and turned on the grantor-trust status. Later, the grantor may again wish to turn off the grantor-trust toggle by releasing the power again. Also, later the trustee may wish to regrant the power again. The question that arises is how many times may the settlor and trustee work in harmony releasing

and regrating the power before there is an estate tax inclusion issue? If the settlor and trustee are viewed as working in harmony, then one must ask whether this harmonious interaction would give rise to an argument that the trustee is acting solely as the grantor's agent or that there is an implied agreement that the trustee will follow the grantor's wishes. If there is an implied agreement or agency relationship, the trust property may be included in his estate under Code Sec. 2036(a)(2) or 2038, since the settlor is controlling the trustee.

Not only are there estate tax inclusion issues associated with the traditional toggle switches proposed by many planners, but some estate planners have voiced concern that there could be a substance over form argument, and the IRS may assert and planners have also said, that the IDIT should be classified as a perpetual grantor trust.

## **An Alternative to Having the Trustee and Settlor Work in Harmony**

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As noted above, there are two primary issues with multiple releasing and regrating of grantor trust powers: (1) the property may be included in the settlor's estate, or (2) the IDIT may be permanently classified as a grantor trust. The problem with both of the aforementioned methods of toggling the switch is that the settlor and the trustee are working in harmony: one party releases, one party regrants. In fact, it is highly questionable whether the trustee would regrant the power to substitute property of equivalent value unless the settlor specifically asked the trustee to do so. Therefore, the IRS may assert that the only reason the trustee's power to regrant the power to substitute property of equivalent value was included in the trust was for the avoidance of tax. So the question becomes, is there another way to make the spigot work without including language that appears to only have a tax motive and without giving the appearance that the settlor and the trustee are working in harmony?

There is one grantor trust power that does not depend on powers exercised back and forth between the settlor and trustee. This is found in Code Sec. 679. Under Code Sec. 679, there are only the following three requirements that must be met for a trust to be classified as a grantor trust:

- U.S. person transfers property,
- To a foreign trust, and
- There is any U.S. beneficiary.

What if the trustee alone exercises the powers that result in the trust being classified as a foreign trust or not? There are two simple methods where this may be accomplished. The first method vests the power in the trustee to add an additional trustee so that the new trustee is a foreign trustee. If the foreign trustee is involved in making substantial decisions on behalf of the trust, the trust will fail the control test,<sup>38</sup> and the trust will be classified as a foreign trust for tax purposes (enter the FIDIT). Since a U.S. person is now deemed to have transferred property to a foreign trust with U.S. beneficiaries, the trust is classified as a grantor trust under Code Sec. 679.

Another method to change the tax classification of the domestic trust to a foreign trust is to vest in the trustee the power to change the applicable law of the trust to a foreign jurisdiction. Upon the change of the applicable law, the trust fails the court test,<sup>39</sup> and the trust is then classified as a foreign trust. Since all other elements are present, the trust is classified as a grantor trust under Code Sec. 679. The result under both approaches is that that the trustees can be designated as the only persons who hold the power to toggle the trust between nongrantor-trust and grantor-trust status. Further, one of keys to the success for the IRS's possible argument of either inclusion in the settlor's estate or a perpetual grantor-trust status is that the traditional spigot (*i.e.*, the settlor/trustee interplay) appears to have no purpose other than a tax motive. There is no business or investment purpose for the regranting and releasing of a power to substitute property of equivalent value.<sup>40</sup> On the other hand, with the ETRAP designed FIDIT, there may be one of several investment or business (*i.e.*, asset protection) reasons for having the foreign-trust classification.

First, the asset protection side of the FIDIT structure is evidenced by the use of one of the various nations<sup>41</sup> that have adopted very specific asset pro-

tection legislation that allows for the protection of a beneficiary's interest in a trust. While the DAPT states have also adopted asset protection legislation, there is some question regarding how effective these state statutes will be.<sup>42</sup> For this reason, there may well be a fiduciary (and ETRAP) purpose (*i.e.*, to protect the trust's assets) for the trustee to designate foreign law as the applicable law of the trust. A second reason the IDIT may preferably be a FIDIT is to open up certain investment opportunities that are not available to U.S. investors. Another nontax reason for using foreign law is that some planners believe that the foreign jurisdiction's laws are less likely to be repealed or revised as frequently as many U.S. laws. Therefore, one can see how FIDITs provide advantages, including the ability to toggle between grantor- and nongrantor-trust status for income tax purposes. With proper planning, this spigot provides the estate planner with a much greater estate planning related flexibility.

## Conclusion

The best of both worlds may be to have a fairly equal balance of estate planning and asset-protection motives for setting up a planning structure. In this way, there is substantial support for arguing that the asset-protection motives are a significant factor if the IRS claims that tax avoidance was the primary goal. In contrast, if a creditor claims the structure of and transfers to the planning vehicle were all designed primarily to defraud that creditor, one can honestly and strongly argue the genesis of the structure was due to estate planning goals, and that the structure was primarily designed for that purpose, which is documented by the files, allowing a court to view such estate-planning motives as negating any significant intent that could give rise to a fraudulent transfer.

## ENDNOTES

- <sup>1</sup> A "fraudulent transfer" is a transfer made with an intent to defraud, frustrate or hinder an existing or anticipated creditor. The remedy available to such creditors is the reversal of the transfer, placing the assets back in the debtor's hands.
- <sup>2</sup> *W.C. Bongard*, 124 TC 95, Dec. 55,955 (2005).
- <sup>3</sup> See *infra* note 5 below.
- <sup>4</sup> See *Kimbell* case *infra* in note 10 below where the court found asset protection to be a persuasive factor in the court's decision that the assets were *not* included in the taxpayer's estate.
- <sup>5</sup> Code Sec. 2036 is used as the legal authority

to include such assets in the client's estate, due to the client retaining benefits from the assets or retaining the ability to affect the beneficial enjoyment of such assets by others. The IRS view is that when a taxpayer transfers an interest in an LLC or family limited partnership (FLP), and yet continues to serve as manager or general partner, the taxpayer has the ability to receive benefits (*e.g.*, distributions) and/or affect others' beneficial enjoyment (*e.g.*, affect timing of distributions to other owners of the entity's interests). Code Sec. 2036, however, states specifically that if the transfer of the interest is made in the form of a bona fide sale for "full and adequate consideration," then the

estate tax inclusion provisions of Code Sec. 2036 will not apply.

<sup>6</sup> *A. Mirowski Est.*, 95 TCM 1277, Dec. 57,379(M), TC Memo. 2008-74.

<sup>7</sup> *Evseroff*, 2007-1 USTC ¶ 50,222.

<sup>8</sup> See *supra* note 7.

<sup>9</sup> Charging order law provides under most state LLC or FLP laws that in situations where a creditor is pursuing the assets of an individual who owns an interest in an LLC or FLP, that creditor's remedy against the assets held in the LLC or FLP is limited to a "charging order" against the LLC. As a result, the creditor is only entitled to receive distributions from the LLC or FLP, if and when such distributions are declared

- by the manager of the LLC or general partner of the FLP. The creditor is not able to compel any distributions. Furthermore, the charging order does not result in the creditor obtaining any rights of a member such as the ability to vote with regard to LLC or FLP matters or to exercise any other rights that are typically provided to members of an LLC or FLP.
- <sup>10</sup> *D.A. Kimbell*, CA-5, 2004-1 USTC ¶60,486, 371 F3d 257.
- <sup>11</sup> However, another strong factor in the taxpayer's favor was that the FLP held some "business" assets (oil and gas interests), and this appears to have been the predominant factor that the court weighed in favor of the taxpayer. Nevertheless, the asset protection motive appeared as an additional component that was factored into the Court's decision.
- <sup>12</sup> *A. Strangi Est.* 85 TCM 1331, Dec. 55,160(M), TC Memo. 2003-145 (*Strangi III*); *R. Gulig*, CA-5, 2002-2 USTC ¶60,441, 293 F3d 279, (*Strangi II*); *A. Strangi Est.*, 115 TC 478, Dec. 54,135 (*Strangi I*).
- <sup>13</sup> Also consider Cook Islands LLC established under the recently enacted Cook Islands LLC statutes.
- <sup>14</sup> See the *Everoff* case, *supra* note 7.
- <sup>15</sup> "QTIP" stands for "qualified terminable interest property."
- <sup>16</sup> "Self-settled" trusts are considered, in most states, as vulnerable to the client's creditors due to the widespread view in the United States that creditors of a settlor (*i.e.*, the creator of the trust) can access the assets that the settlor placed into a trust that names the settlor as a primary beneficiary. In most states, any spendthrift provision in such a trust would be ineffective as to the settlor's creditors. Also, the trustee of such a trust can be compelled to distribute the maximum amount allowable under the trust terms to the settlor.
- <sup>17</sup> The laws of Alaska, Delaware, Nevada, Rhode Island, Utah, Missouri, South Dakota, Tennessee, Wyoming, Oklahoma (and to a lesser extent, Colorado) contain exceptions to the general rule against self-settled spendthrift trusts.
- <sup>18</sup> Currently, \$2M.
- <sup>19</sup> It effectively bypasses estate taxes until the trust assets are ultimately distributed outright to the final beneficiaries of the bypass trust.
- <sup>20</sup> A grantor trust results in the beneficiary being the one obligated to pay the income taxes on the trust's annual earnings. See Code Sec. 671, *et. seq.*
- <sup>21</sup> As intimated in note 16 above, the term "settlor" means the person who creates (*i.e.*, settles) and funds the trust by way of gifts.
- <sup>22</sup> Reg. §1.671-2(e)(5).
- <sup>23</sup> See Rev. Rul. 2004-64, 2004-2 CB 7.
- <sup>24</sup> See *M.M. Outwin*, 76 TC 153, Dec. 37,645, 1981-2 CB 2.
- <sup>25</sup> If applicable law does not allow creditors to access the trust assets, then there is no estate tax inclusion risk from the deemed general power of appointment. See *E.E. German Est.*, CtCl, 85-1 USTC ¶13,610, 7 Ct.Cl, 641.
- <sup>26</sup> LTR 9837007 (June 10, 1998).
- <sup>27</sup> See *supra* note 5 above.
- <sup>28</sup> See Code Sec. 678, which discusses when a trust will be treated as a grantor trust with respect to a person other than the settlor.
- <sup>29</sup> These postlapse grantor trust powers are required under Code Sec. 678(a)(2) to allow the TPT to be a grantor trust with respect to the client.
- <sup>30</sup> The IRS has also ruled that holding such a power does not cause the assets to be included in the powerholder's estate. See Rev. Rul. 2008-22, IRB 2008-16.
- <sup>31</sup> The fact that the client could have withdrawn the assets, but instead lets the assets remain (lapse) in the TPT, raises the risk of such lapse is an effective contribution/gift of those assets to the TPT by the client.
- <sup>32</sup> See *supra* note 5 above.
- <sup>33</sup> An intentionally defective trust is one that is purposely designed as a grantor trust, meaning that the earnings of the trust are not taxable to the trust, but are instead directly taxable to the settlor.
- <sup>34</sup> With the use of a private annuity, the estate tax inclusion can be effectively reduced to zero with respect that asset.
- <sup>35</sup> A FIDIT can take advantage of the foreign jurisdiction's asset protective laws while still being designed as a domestic grantor trust for federal income tax purposes, allowing the FIDIT to be an eligible shareholder of S corporation stock.
- <sup>36</sup> One should note here that the FIDIT must be designed to be a domestic trust for income tax purposes (although the asset-protective law still applies for creditor-right purposes) in order to be eligible to indirectly hold S corporation stock. Also, incidentally, if the client is looking for further tax benefits, see *J.F. Jelke Est.*, 2007-2 USTC ¶60,552, 507 F3d 1317, in which the taxpayer achieved a reduction in the valuation of the stock to reflect the entire unrealized built-in capital gains tax liability. This planning tool also assumes that the LLC is not "disregarded" for discount valuation purposes.
- <sup>37</sup> The author described this concept previously in *The Integrated Offshore Intentionally Defective Grantor Trust*, by Merric and Brown, JOURNAL OF TAXATION, Nov. 2001.
- <sup>38</sup> Code Sec. 7701(a)(30)(E)(ii).
- <sup>39</sup> Code Sec. 7701(a)(30)(E)(i).
- <sup>40</sup> The author acknowledges that the business or investment purpose is generally applied in tax avoidance cases or in corporate business reorganizations. Further, the author is aware that many times a trustee will be vested with powers to grant a general power appointment to create a nonexempt trust for generation skipping transfer tax purposes. However, the author also points out that the underlying tone of most implied agreement cases and tax avoidance cases is that there is no business purpose to the action taken (or the structure) other than a tax motive.
- <sup>41</sup> For example, Cook Islands and Nevis.
- <sup>42</sup> Giordani and Osborne, *Stateside Asset Protection Trusts: Will They Work*, ESTATE & PERSONAL FINANCIAL PLANNING, Nov. 1997; See, Rothschild, Rubin, & Blattmachr, *Self-Settled Spendthrift Trusts: Should a Few Bad Apples Spoil the Bunch*, 32 VANDERBILT JOURNAL OF TRANSNATIONAL LAW 3, May 1999, at 763-778.

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