



New Strategies, 2004

By Robert L. Moshman

As the same-sex marriage issue heats up, partners thinking of changing their legal status will have a number of estate-planning issues. Meanwhile, increasing scrutiny of Family Limited Partnerships has prompted some planners to explore alternatives such as the restricted management account (RMA).

And finally, with the fate of the transfer tax system in total chaos, and trillions of assets on the verge of being inherited, estate-planning professionals face the challenge of having a long-term estate plan get off to a good start and then have enough flexibility to stay on track. These circumstances make the arrival of the "Inheritor's TrustTM" most timely.

Same-Sex Unions

It is the dawn of a revolution. Barring a constitutional amendment preventing same-sex marriage (as proposed by President Bush), or the complete opposite approach of a Federal law allowing same-sex marriages and preempting state laws, the United States may have 50 separate state approaches. This presents a potential "taxa sutra" of possible scenarios.¹

Same-sex marriage may end up being permitted in some states, outlawed in other states, and permitted with restrictions in certain other states. And with same-sex marriages or civil partnerships taking place in the Netherlands, Canada, California, Vermont, etc., states and nations around the world are forced to decide which marriages they will recognize. This is accelerating the process dramatically and could trigger waves of changes over the next few years.

For professional planning purposes, the questions that arise go well beyond the existence of a same-sex marriage. What tax and inheritance consequences will each state attach to such marriages? What about joint ownership, insurance, and adoption? How will the union affect divorce, litigation, or bankruptcy? Will these areas be treated differently in every jurisdiction? Which marriages from other jurisdictions will be recognized? Consider a legal conundrum:

Example: Ed and Ned are wed. It is a valid ceremony in State A. Ned then marries Nell in State B, which allows the marriage because it does not recognize Ned's prior marriage. Then, bad news, Ned is dead. He's left real estate and surviving spouses in both jurisdictions. Ed, the surviving spouse in State A, claims the entire estate because State A doesn't recognize Ned's subsequent marriage to Nell. And in State B, Nell is claiming Ned's entire estate because State B doesn't recognize Ned's prior marriage in State A.

There are already marriages of convenience that people use to alter their legal status for tax, inheritance, or insurance purposes. With same-sex partnerships available, the opportunities for such strategies are expanded. It is conceivable that someone would have same-sex partnerships, marriages, or other unions of convenience for tax purposes in multiple jurisdictions.

Steering clear of the social issues involved, professional planners need to protect the assets and interests of the clients they represent. That shifts the issue from whether a couple is officially "married," to whether a couple's legal or tax status will be satisfactory during the foreseeable future. That means identifying the applicable local, state, federal, and international laws should the couple break up, adopt children, purchase property, and so forth.



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Care must be taken to clearly indicate whether survivorship rights are intended when property is owned jointly. Some practitioners recommend a controlling document, akin to a conventional prenuptial agreement, to resolve some of the critical issues on property distribution. A will or separate contract could confirm that beneficiary designations on life insurance policies and retirement plans are intentional. Such a document could also resolve time-consuming questions such as what constitutes termination of the relationship, who will be obligated to make property tax and mortgage payments, child custody and visitation rights, which state laws apply, will mandatory arbitration apply, and how will estate taxes be apportioned.²

An FLP Alternative

Say it isn't so! Only a few years ago, the family limited partnership (FLP) appeared on the verge of invincibility. Assets transferred to FLPs only weeks prior to death were being devalued by 20% to 60% and the IRS seemed helpless to prevent it. But the IRS got a second chance in Strangi, and has chipped away at FLPs. At this point, courts are looking closer at dramatic discounts of assets. While the FLP remains in the forefront of planning alternatives right now, it is not unreasonable to be concerned that legislation will one day clip the wings of FLPs for good.³

Can FLP objectives be obtained in other ways? Certainly. There may soon be some new initials on the block. Say hello to the Restricted Management Account (RMA). It's extremely simple (a good thing). It involves far less paperwork than an FLP (another plus). The fact that it is relatively new and has not been the subject of any definitive cases or rulings is a valid concern. But RMAs are growing in popularity and appear to be on solid ground.

Here's how it works. The investor places assets in the RMA with an investment manager. He agrees to leave this arrangement intact for a term of years, such as five years. The investment manager will therefore have the exclusive control over the assets during that term. The investor may not withdraw the funds nor direct how they will be invested. In the typical RMA, the investor retains the right to transfer the account to a family member. He cannot, however, transfer the account to a third party without the investment manager's consent.

This simple arrangement accomplishes two things. First, it gives an investment manager an opportunity to implement an effective, long-term plan. This arrangement avoids having to sacrifice significant long-term growth just to produce short-term results. Second, it imposes a restriction on the assets that limit values for transfer tax purposes. The investor has given up both control and transferability. That normally means a valuation discount. Note that it is also possible to place an IRA in an RMA and thereby reduce its value for purposes of the required minimum distributions.⁴

Inheritor's TrustSM

Here's where we are right now. The estate tax is repealed. Only the repeal hasn't taken effect yet. And then, after being repealed for one year, the tax may come back to life. Or maybe not.

It doesn't take an LLM in taxation to determine how uncertain transfer taxation has become these days...and just on the eve of trillions of dollars being inherited by the baby boom generation. Any hope of long-term planning depends squarely on the positioning of this bulge of inherited wealth in the system and on remaining flexible for many years into the future.



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With these goals in mind, the Inheritor's Trust™ is just in time and may end up becoming the paradigm of 21st century planning. Until now, dynasty-style planning has looked, prospectively, as far into the future as possible to exploit the explosive growth of assets that are unfettered by transfer taxation over many years.

The Inheritor's Trust™ takes a step back in time. It looks "upstream" to take better advantage of assets that the client has not yet inherited. Intercepting an inheritance and directing it into a separate trust before the assets can be received by the client's estate is critical. Such a trust improves so many of the existing strategies in the modern estate planner's toolbox. Consider the benefits:

- ◻ Even if the inherited assets are relatively small, they can have a major role if they remain in a separate trust that can continue for many years and remain out of the reach of creditors.
- ◻ Having a separate pool of assets to use as "seed money" in several contexts. Wealth-earning opportunities can be shifted to the trust at their inception so that future earnings are kept out of the client's estate.
- ◻ A separately funded trust can also purchase life insurance, the benefits of which will not be included in the client's gross estate.
- ◻ The Inheritor's Trust™ can become the 1% general partner of an FLP. A relatively small amount of assets is needed, and if the funds are derived from a separate source, i.e., anyone other than the client, the trust will retain the controlling interest. The client could retain control over the FLP in a fiduciary capacity on behalf of the trust, yet his estate would only possess non-controlling interests in the FLP.
- ◻ The trust can be designed to be "intentionally defective," i.e., in violation of grantor trust rules. Trust income is paid to beneficiaries, yet is taxed to the grantor, allowing him to further reduce his estate while his beneficiaries prosper.

Positioning a client as an "inheritor" and setting up a trust that keeps inheritable assets separate is a strategy with potential benefits for any estate. It can be coordinated with a generation-skipping GRAT, a buy-sell arrangement for buying out a business, state-income tax strategies, and many other techniques in an array of useful variations. A trust for an inheritor/client certainly gets a long-term estate plan off to an excellent start. It is dynastic in its durability, yet practical enough to benefit a moderately sized estate.⁵



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Recent Decisions

A Marital Trust's Fatal Flaw

Submitted for your approval. An estate of vast wealth. An estate plan that reduced estate tax to zero. A success story for the annals of estate planning literature. It was all going so well...until an extra \$40 million turned up and spoiled everything. The estate tax return for Robert Lurie's estate reported a gross estate of \$91.71 million, which included a revocable trust worth \$88.66 million. The trust was to provide for the surviving spouse in a manner that reduced estate tax to zero. The estate tax return claimed a marital deduction of \$91.68 million and a taxable estate of zero.

But the revocable trust's terms required it to pay all estate taxes and administration expenses to the extent that the probate estate assets were insufficient. Since the probate estate only contained \$760,000, it was insufficient to pay the tax on \$40 million that turned up and was included in the gross estate. Payment of these unexpected estate tax liabilities from the marital trust caused a \$47 million reduction in the available marital deduction.

This unexpected plot twist arose because Lurie had exercised powers of appointment in 1983 over 20 trusts which had been established in the 1960s and 1970s. Shouldn't these trusts have paid their own share of estate tax? The estate's arguments for equitable apportionment of the tax as required by Illinois law were rejected based on the Lurie's intent as made clear by the directions in the marital trust to pay estate tax liabilities. Under Illinois law, legal expenses were administration costs which, under the terms of the trust, were paid by the trust. This further reduced the marital deduction.

One must ask how an estate plan sophisticated enough to steer \$91.71 million past the estate tax would overlook \$40 million and massive tax liabilities. In any event, the marital deduction that was the whole point of these arrangements has utterly failed...something the testator, were he in a position to comment, would undoubtedly object to. Estate of Lurie v. Comm'r., T.C. Memo. 2004-19.

Permanent Repeal

The President's 2005 budget calls for the permanent extension of the estate and generation-skipping transfer tax repeals and of the gift tax modifications made by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). These tax changes would otherwise expire on December 31, 2010. The cost of such extension is approximately \$180 billion over 10 years.

Tax Lien Outmaneuvered

Decedent owned 286 shares, or 78%, of a Cadillac dealership. Decedent's will left his shares to Decedent's son, who already owned the remaining 22% of shares. At Decedent's death, his estate paid \$331,000 of estate tax and elected to defer \$249,000 under §6166. In return, the executors agreed to a lien on Decedent's 286 shares under §6324A. Three years later, the son sold the company's assets and filed for bankruptcy. The IRS asserted a secured claim against the bankruptcy estate. But the bankruptcy court ruled that the claim was not secured by the gross estate (as it would be with a general lien under §6324). This was a special lien against 286 shares. Therefore, the corporate assets could be sold and the 286 shares are now worthless. Did equity require the lien to attach to the corporate assets? No. The court refused to extend a statutory creation, a lien, beyond the strict statutory limits based on a theory of equity. In re Roth v. IRS, U.S. Bankruptcy Court, W.D. Pa. (Oct., 2003).



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TECHNICAL REFERENCES

¹With the 50 states addressing a dozen areas of law, there is a veritable "Taxa Sutra" of possibilities. The *Kama Sutra* (Sanskrit for "Aphorisms of Love") is a lengthy 4th century, A.D. treatise written by Mallanaga Vatsyayana that illustrates the multitude of variations that can be fueled by an active imagination.

²Levitan and Berkowitz, "Unmarried But Protected", 142 *Trusts & Estates*, 9, p. 28 (Sept., 2003).

³"It may be only a matter of time before either the IRS successfully identifies a fatal weakness in the FLP structure or Congress simply legislates their demise." Handler and Sennett, "Avoid FLPs", 142 *Trust & Estates* 5, p. 30 (May, 2003).

⁴"The RMA should be treated at least as favorably as an FLP." Handler and Sennett, "Avoid FLPs", 142 *Trust & Estates* 5, p. 30 (May, 2003).

⁵Oshins and Ice, "The Inheritor's TrustTM: The Art of Properly Inheriting Property", 30 *Estate Planning* 9, p. 419 (Sept., 2003) and "The Inheritor's TrustTM: Preserves Wealth as Well as Flexibility", 30 *Estate Planning* 9, p. 475 (Oct., 2003). This 17-page, 51-footnote, two-part work incorporates the best of modern estate- and asset-protection planning into a comprehensive vision. Editor's Note: The Inheritor's TrustTM is a trademark of Richard A. Oshins, Steven J. Oshins, and Noel C. Ice. This publication is not endorsing any product or attorney but is merely making readers aware of a potentially useful strategy.

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