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Retaining Power in Estate Planning

From Self-Settled Trusts to Self-Directed IRAs

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Aside from sharing the word "self," what do self-settled trusts and self-directed IRAs have in common? Self determination. In other words, control (but not too much control).

Control is one of those elemental issues of life itself that drives mankind, shapes cultures, causes warfare, and alters the course of history. Control over assets is the ultimate power struggle over who shall leave their mark upon the sands of time…and who shall watch their wealth vanish like so much sand in the wind.

Extremes of Wealth

Control is also the key to understanding financial matters, but the context has a broad range across the spectrum of wealth.

Presented With Our Compliments

At one extreme of the wealth spectrum, there are those with few assets. They desperately wish to control their last vestige of wealth and resort to self-settled trusts when faced with bankruptcy, divorce, liability, or eligibility requirements for Medicaid.

At the other extreme, there are those who have vast wealth and seek to part with control, perhaps by creating a grantor trust or a family limited partnership as a means of devaluing assets for tax purposes.

And somewhere in between these extremes there is everyone else, trying to make a living and looking at the self-directed IRA as a way of having more control over how his or her retirement assets will be invested.

In each of these diverse instances the real trick is having a trust provide just the right amount of control. Enough so that people are in charge of assets to some degree, but not so much as to allow creditors or tax authorities to gain a foothold.

Let's use this inquiry as an excuse to review the rules and limits of "power" over assets in many different contexts.

A Power Trip

The rules of control are undergoing significant changes in many contexts:

States have cracked down on fraudulent "Pure Trust" scams.

Bankruptcy and Medicaid rules now have longer "look back" periods for transferred assets.

Self-directed retirement accounts have arrived and self-directed Social Security accounts have been proposed.

Even a donor's retained powers over a charitable gift are drawing attention.

Collectively, these and other diverse areas, provide a glimpse at the very boundaries of power. Let's take a look at all these "trees" and then determine what kind of forest we can see.

Scams Revealed

Trusts have been effective mechanisms for preserving assets for hundreds of years. Fictitious legal entities that keep assets safe have been found extremely useful. Long story short, there are many popular and effective trust arrangements that have well-known rules and guidelines that make them stand up to legal scrutiny and function smoothly.

Yet, conversely, there are always those who, perhaps endowed with an adventurous spirit or who find existing trust rules too confining, venture into the unknown and experiment with risky new arrangements. Encouraging this process has been a steady stream of unscrupulous promoters who dupe people into using arrangements that inevitably prove to be too good to be true.

Quatloos, a website sponsored by Financial & Tax Fraud Education Associates, Inc., a California not-for-profit company, identifies the following aliases for bogus trusts:

> Pure Trusts — Patriot Trusts — Contract Trusts — Freedom Trusts — Business Trust — Unincorporated Business Trust — Equipment Trust — Service Trust — Final Trust — Common Law Trust Organizations (COLATOS) — Foreign Common Law Trust Organizations (FORCOLATOS) — GPG Trust — Complex Trust System.

Let's be very clear. Despite their names, these are not bona fide trust arrangements. The Quatloos website notes the successful IRS track record against these arrangements (the Service is apparently undefeated). Sometimes sham trusts are also used to limit liability to creditors.

However, the "Pure Trust" and similar arrangements reportedly have zero victories against any creditor in any state court, making such shams unreliable to say the least.

The flawed mechanism of these sham arrangements varies. Some are based on the contracts clause of the U.S. Constitution, which has no bearing on the taxation or access of creditors to assets. The arrangements also assert that no taxes need to be paid by such "trusts." This is misleading; the arrangement pays no taxes because it doesn't legally exist. Therefore, all of the transactions conducting by and income generated by or through the sham arrangement is treated as though the assets are held directly by the taxpayer or debtor.

In most states, these arrangements are treated as self-settled spendthrift trusts which are explicitly invalidated under state laws. As a general rule, you can't avoid creditors by transferring your money to yourself with instructions to limit your spending. In most jurisdictions, this maneuver is also treated as a form of fraud against known creditors.

Incidents of Ownership

Life insurance has several properties or attributes that make it an ideal planning device. One feature is that insurance naming a beneficiary other than the insured's estate will not be included in the insured's estate. But if the insured retains too much control over the policy, the proceeds will be included in the estate. "Incidents of ownership" is the operative term of art and includes the following:

- The power to surrender, cancel, or assign the policy.
- The power to change the beneficiary.
- The power to revoke an assignment.
- The power to pledge the policy for a loan against its surrender value.
- Control of the trust's terms or the payout of income to the beneficiaries in a fiduciary capacity.
- Ownership of a corporation that is the policy's beneficiary.

Self-Directed Retirement Accounts

IRAs with an independent administrator allow you to self-direct your money to any investment allowed by law. Not only are you allowed to invest in all of the products offered by the traditional administrator, you are now allowed to invest in leveraged or unleveraged real estate, trust deeds, unsecured notes, improved or unimproved real estate, limited partnerships (public and private) and more.[1]

Self-Directed Social Security Accounts

There have been proposals to expand the concept of allowing an individual to have control over retirement funds to Social Security funds by means of privatized accounts. However, a 2005 study conducted by Diversified Investment Advisors found that 64% of retirement plan experts do not believe such self-directed Social Security accounts would become reality before the end of the decade.

Bankruptcy Reform

Bankruptcy laws now impose a longer "look back" period for transferred assets.

President Bush signed the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 in April and the new provisions took effect on October 17, 2005, making it harder to wipe away all debts with a Chapter 7 filing and instead requiring the use of Chapter 13 filings with scheduled repayment plans.

Bankruptcy trustees will be able to utilize a two-year look-back rule to void transfers made within two years of filing for bankruptcy in general (doubling the previous one-year rule). In determining the domicile of the bankruptcy, the six-month look-back period is being extended to a two-year look-back.

Homesteads: A related provision prevents newly acquired homes from gaining homestead exemption status; homestead protection is limited to $125,000 for debtors who have lived in a house and previous homesteads less than 40 months.

In addition, a 10-year look-back provision precludes a debtor from converting non-exempt property to a homestead with the intent of defrauding a creditor.

Medicaid Look-Back Rules, Revised

Medicaid eligibility is changing even as this is being written with "look back" periods increasing from three years for five years for transfers to individuals. Transfers to trusts were already subject to a five-year look-back rule.[2]

In addition, the new rules postpone the onset of the period of ineligibility, which can range from 5 to 20 months, depending on the applicable state laws. Thus, a period of 20 months would, under the old rules, start to run as soon as the disqualifying transfer was made. Under the new rules, the individual must pay down assets to qualify for Medicaid…and THEN the 20 months of ineligibility begins to runs.

Note: This establishes the perfect set up for many senior citizens to fall into an extended gap between the end of their spend down and the beginning of Medicaid eligibility. Hardship exceptions will alleviate some of these situations.

"5&5" Powers

How much money or value can a beneficiary withdraw from a trust without being considered the owner of the trust for estate and gift tax purposes? The standard limits on the beneficiary are "five and five" powers. That is, the right of the beneficiary to withdraw the greater of five percent or $5,000 of the trust principal, annually.

QTIP Powers

When the unlimited marital deduction arrived in 1981, testators with children from a previous marriage were caught between the need to qualify for the marital deduction and the need to retain sufficient control over the disposition of assets to protect the

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inheritance rights of the children. In response, Congress carved out an exception to the terminable interest rule.[3]

The qualified terminable interest rule under §2056(b)(7) enabled the estate to claim the marital deduction for assets transferred to a QTIP for the surviving spouse. Assets would ultimately go to the testator's designated heirs…yet would be taxed in the estate of the surviving spouse. However, to meet the QTIP standards, the surviving spouse had to be given certain rights.

The surviving spouse has a qualifying income interest for life if he or she "is entitled to all the income from the property, payable annually or at more frequent intervals," and "no person has a power to appoint any part of the property to any person other than the surviving spouse."

Modern Arrangements

Power and control over Grantor Trusts have been raised to a fine art or science in recent years as more practitioners have become aware of income tax consequences of trusts. By intentionally making such trusts "defective" by retaining certain powers, a grantor can cause income tax consequences to apply to his or her own income instead of the beneficiary.

Giving up power over assets placed in Family Limited Partnerships has been used in recent years to devalue assets just prior to death. For example, a $100-million asset that is placed into an FLP just prior to death can dramatically reduce the value by $20 million, $30 million, or more, simply because the assets are now subject to the control of partners.

The fine line of control over a family limited partnership has been taking shape in a series of cases over the past six years.

In, *Strangi* (part IV), the Fifth Circuit Court of Appeals agreed with the Tax Court's conclusion that §2036(a)(1) applied because of an "implicit understanding" among the parties that Dr. Strangi would continue to have access to his assets.

Charitable Gifts….With Strings

Although a donor may have donated $10 million to a hospital, that use of that money may be "controlled" by terms on how the money is used…and even the size of the donor's name over the front doorway.

Writing on the "Thinking Peace" website, Arianna Huffington proposes a compassion index for valuing charitable gifts. This approach discounts self-aggrandizing gifts while giving extra credit for gifts that are meaningful. Thus, a gift to help soup kitchens would be valued higher than one that patronizes the arts or other pastimes of the wealthy.

In 2000, Ms. Huffington applied her approach to the *Slate* list of 60 top charitable donors: "The biggest hit was taken by William Porter, founder of the Internet brokerage E*Trade, and his wife, Joan. Their $25-million gift to MIT had placed them in a tie for the twenty-seventh spot on the original *Slate 60*, but they dropped thirty spots for donating a) to a building at b) an already well-endowed institution that c) is related to Mr. Porter's business and d) was named after himself."[4]

Conclusions

Can a connection or global trend be discerned? One reasonable hypothesis is that there is a modern trend of empowering beneficiaries by providing direct input into the investment of assets. But there is another trend that has arrived almost as a counterpoint. If you have power over assets and attempt to divest yourself of such power illegitimately, or while still retaining control, you will be held accountable.[5]

But there is an unanswered question: Why are people constantly exposing assets to so much liability out of their desire to stay in charge of assets when the means to control assets already exists without any risks?

As opposed to newly devised arrangements that fall victim to their own success when their increasing popularity draws the attention of the Internal Revenue Service, there exist tried and true trust techniques that can be utilized quite effectively.

Technical References

1. Greene, "You Did What With an IRA?" *The Wall Street Journal* (Oct. 15, 2005).
2. The Deficit Reduction Act of 2005 (DRA), which contains the new Medicaid rules, is to be voted upon by Congress in February 2006.
3. *Estate of Arthur M. Clayton v. Commr.*, provides a historical context to explain the advent of the QTIP requirements.
4. Michael Kinsley, then editor of *Slate*, called this revised list "The *Slate* 60 Huffington Virtue Remix."
5. Self-settled trusts http://www.financial-planning.com/pubs/fp/20050601030.html