The Financial and Estate Planning Council of Metropolitan Detroit, Inc.

January 2012

30600 Northwestern Hwy., Suite 208, Farmington Hills, MI 48334 • (248) 538-7654 • FAX: (248) 538-7656

President's Message

Our first meeting of 2012 is fast approaching with a great spouse's night venue and program planned. Paula Marks Bolton, a very energetic Holocaust Survivor, will be presenting her captivating personal story at the Holocaust Memorial Center in Farmington Hills on February 7, 2012. The Center will be open for our group with docents present at 4:30pm. Please RSVP by mail or on the website.

I would like to personally recognize and thank our outgoing president, Andy Dincolo, CPA, for a job well done in 2011 as our leader. I'm sure Andy will be an active Immediate Past President. Also leaving the board is Steve Moore who served as Immediate Past President. Steve, thanks for the many years of service to the Council. You will be missed!!!

We have the privilege of adding four new board members for 2012. They are: Marilyn Capelli Dimitroff, CFP®, Marita Grobbel, JD, CFP®, John Burpee, LUTCF and David Thoms, JD. We look forward to the contribution these members will bring to the board and the Council as a whole.

Thank you to those who attended our last meeting held at the beautiful Gem Theatre in downtown Detroit. We had about 80 members take advantage of the afternoon continuing education and evening program presented by Michael Halloran, CLU, ChFC, CFP® as he enlightened us on Beneficiary Defective Inheritor's Trusts and Charitable Remainder Trusts. Mike is the Immediate Past President of the National Association of Estate Planners & Councils. He follows a long list of quality speakers we bring to our membership meetings. Speaking of meetings, please mark your calendars for our upcoming meetings: May 21, 2012 is our annual charity golf outing … September 25, 2012 will bring speaker David Diamond and a presentation on Delaware Trusts … and the November 8, 2012 meeting featuring speaker, Hugh McGill, is being sponsored and hosted by Northern Trust.

Sponsorships are a vital part of our being able to bring to you quality speakers, top notch venues and low meeting prices. I ask you to please consider having your firm sponsor an upcoming event. Details may be found on the website or ask any one of the board members.

I wish all of you a very healthy, prosperous and happy New Year. See you February 7th for Spouse's Night.

Brad M Kreiner CFP®, AEP®

WELCOME TO OUR NEW MEMBERS

Jeffrey S. Bonk
Citizens Bank Wealth Management
Sponsors: Molly Wilson and Benson Barr

William R. Carson
PNC Bank, Wealth Management
Sponsors: Kevin Granger and Matt Zeigler

The Beneficiary Defective Trust: A New and Important Refinement to An Old Friend

Alan J. Mittelman, J.D., CLU

Over the last decade, one of the most powerful estate planning tools for business owners has been a sale to a grantor trust. There are a number of names for this technique. Some planners call it a sale to a defective trust (a "SDT"). Others refer to the technique as a sale to an intentionally defective grantor trust. Whatever its name, this planning tool continues to be a very effective method of transferring wealth to the next generation and beyond.

The technique involves a number of components. First, there has to be something to sell. Typically, the property being sold is a business, but it could just as easily be an investment portfolio or real estate. The seller needs to be a high net worth person. There is no minimum net worth required but the seller should probably have a net worth of at least $20 Million. Otherwise, this planning tool may be too complex and expensive to justify.

The buyer must be a trust and the trust must be irrevocable. In the traditional form of this SDT, the seller is the person who created the trust – the "settlor." The settlor is not a beneficiary of the trust.

If the trust is set up correctly, the assets of the trust will not be included in the taxable estate of the beneficiaries for as long as the trust exists (The trust can be set up in perpetuity if this makes sense for the family.). The assets of the trust can be protected from the beneficiaries' creditors since the trust is not a self-settled trust. These two features alone are among the most powerful reasons for using this type of trust in estate planning.

The trust will almost always be a grantor trust for income tax purposes. This means that the income of the trust is taxed to the settlor, because the trust will have one or more provisions that cause this result under §§672-677 of the Internal Revenue Code. Sometimes a grantor trust is referred to as a defective trust because of this income tax result. However, trusts created as grantor trusts for this type of sale are intentionally made grantor trusts precisely so that the income can be taxed to the settlor. As discussed below, using a grantor trust in a sale makes the technique very powerful and permits the transfer of significant wealth free of gift taxes.

When a settlor sells an asset, there ordinarily is a capital gain. The capital gain may be long term or short term depending upon the length of time the settlor owned the asset being sold. However, when the settlor sells an asset to a grantor trust created by the settlor, no gain is recognized. This is because a grantor trust is treated as the alter ego of the settlor. No gain or loss is recognized on sales between the settlor and the grantor trust.

Originally, this concept was designed to prevent the settlor from selling an asset to himself or his family and recognizing a loss. The IRS did not want the settlor to recognize a loss on a transaction that did not have substance. However, the flip side of the doctrine produced this powerful wealth shifting tool. With the grantor trust, the settlor can sell an appreciated asset to the trust and no gain or loss is recognized on the sale, even if the purchase price is paid on a deferred basis. The trust can use the cash flow from the asset being purchased to pay the seller/settlor, and the settlor recognizes all of the annual income produced by the asset sold to the trust. This means that the trust can use 100% of the cash flow to make annual payments on an installment note instead of the net after tax cost. As a result, the grantor trust permits much more leverage in a buyout for this purpose.

In a typical leveraged buyout, the purchaser first must pay income taxes on the net annual income produced by the asset. The net remaining cash flow can then be used to pay the seller. Also, the seller has a capital gain to recognize if the asset sold is an appreciated asset. In effect, there is double taxation on the sale. However, with a sale to a grantor trust, there is only one level of taxation. The trust does not pay income taxes, there is no capital gain tax for the seller, and the seller recognizes all of the income that the trust ordinarily would have to recognize.

At first blush, this does not look so good for the seller. Instead of paying the long-term capital gain rate, the seller has to pay ordinary income taxes on the income earned by the trust each year. However, this is part of the beauty of the arrangement. First, if the seller had not sold the asset, he/she would have had to recognize this income, anyway, and pay the same income tax. Second, the seller under an installment sale may receive annual payments that approximate the income he/she earned from the asset prior to the sale. Third, by paying the income taxes each year for the trust, the seller is diminishing his/her own estate while the wealth of

FINANCIAL AND ESTATE PLANNING COUNCIL OF METROPOLITAN DETROIT

Presents

"Spouse's Night"

PAULA MARKS BOLTON

Holocaust Survivor

Paula Marks Bolton was 13 years old when the Nazis stormed into her town in Poland and deported her family to the Aucshwitz death camp. We will meet Paula, a survivor of Auschwitz, Ravensbruck, Muhlhausen and Bergen-Belsen concentration camps. She will speak to us of her own personal story of survival.

It is the goal of the Holocaust Memorial Center and the survivors who share their experiences of making the Center a place where people can come to be inspired, educated, and to walk away feeling a sense of hope for the next generation.

"Our obligation is to give meaning to life and in doing so to overcome the passive, indifferent life." Elie Wiesel

TUESDAY, FEBRUARY 7, 2012

Holocaust Memorial Center

28123 Orchard Lake Road
Farmington Hills, MI 48334

Mission Statement: It is the mission of the Holocaust Memorial Center Zekelman Family Campus to remember those who perished and survived the Holocaust and, in a world increasingly faced with sectarian strife and intolerance, to set forth the lessons of the Holocaust as a model for teaching ethical conduct and responsible decision-making. By highlighting those individuals who, in the midst of evil, stood for the best rather than the worst of human nature, the Holocaust Memorial Center seeks to contribute to maintaining an open, free society.

Sponsorship Opportunities Available

AGENDA:	**4:30 p.m.**	**Holocaust Memorial Center Museum Available for Viewing (docents will be available for questions)**
	5:30 p.m.	**Complimentary Cocktails / Museum Viewing may continue**
	6:30 p.m.	**Presentation**
	7:30 p.m.	**Dinner**

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NEW FEATURE: Log onto our website by January 30, to make your reservation and pay with VISA or Master Card.
www.metrodetroitfepc.org

OR PLEASE MAIL YOUR RESERVATION AND CHECK BY JANUARY 30 TO:
FEPCMD ● 30600 Northwestern Hwy-#208 ● Farmington Hills, MI 48334
Phone: (248) 538-7654 ● Fax: (248) 538-7656

COST: $60.00 PER PERSON
$75.00 after January 30

MEMBER NAME: ______________________ **GUEST NAME:** ______________________

TOTAL ENCLOSED: ______________________
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the trust beneficiaries grows. Fourth, since recognition by the grantor of the trust income is required under §§672-677 of the Internal Revenue Code, paying the taxes on income earned by the trust is not a taxable gift to the beneficiaries. Therefore, a seller who is the parent or grandparent of the trust beneficiaries can make a substantial gift to his/her family members each year without paying a gift tax. This is the true power of the technique.

In certain SDT's, the asset being sold is real estate or a business interest. If the interest being sold is a partial interest (e.g., a non-voting limited partner interest or a tenant-in-common interest in real estate), then there may be a discount on the value of the asset being sold. This makes the result even better. However, it is the grantor trust tax rules that are the most important component in making an SDT work.

The payment method with a SDT often is an installment note. Other methods are a private annuity and a self-canceling installment note. Any of these methods can have annual payments of principal and interest or can be interest only with a balloon payment in a later year. The latter alternative provides even more leverage for the purchaser.

For a variety of reasons, not everyone likes to use a SDT. For example, a parent may not want to give up ownership or control of a valuable asset. Many people do not like the idea of paying the trust's income taxes. Even though this is a fabulous wealth shifting device, they just do not like the idea. Also, when making a sale to a trust, the IRS is very concerned about the trust's ability to pay the obligation as it comes due. Therefore, the beneficiaries may be asked to provide financial guarantees or the settlor may need to make a substantial cash gift to the trust (typically thought to be 5% to 10% of the purchase price although there is no statutory requirement). And there always is the risk that the IRS will challenge the valuation of the asset sold, claiming that the settlor did not receive full and adequate consideration for the sale.

The Beneficiary Defective Trust

Over the years, a number of estate planners have examined IRC §678 trying to ascertain its meaning and significance. Section 678 is part of the grantor trust section of the Internal Revenue Code, but it has the opposite effect of §§672-677. These latter sections require that the grantor recognize all of the income of a grantor trust, as described above. However, §678 requires a beneficiary to recognize the income of a trust if the provisions of this section apply to the beneficiary. The key sections of I.R.C. §678 are as follows:

SEC. 678. PERSON OTHER THAN GRANTOR TREATED AS SUBSTANTIAL OWNER.

678(a) GENERAL RULE. —A person other than the grantor shall be treated as the owner of any portion of a trust with respect to which:

678(a)(1) such person has a power exercisable solely by himself to vest the corpus or the income therefrom in himself, or

678(a)(2) such person has previously partially released or otherwise modified such a power and after the release or modification retains such control as would, within the principles of sections 671 to 677, inclusive, subject a grantor of a trust to treatment as the owner thereof.

678(b) EXCEPTION WHERE GRANTOR IS TAXABLE. —Subsection (a) shall not apply with respect to a power over income, as originally granted or thereafter modified, if the grantor of the trust or a transferor (to whom section 679 applies) is otherwise treated as the owner under the provisions of this subpart other than this section.

In effect, if §678 applies to a beneficiary, the trust will now be defective as to that beneficiary. But, as we will see, it is not defective at all. In fact, the beneficiary defective trust ("BDT") may be even more powerful than a traditional SDT. Here is why.

With the BDT concept, the person who will be making the sale to the trust is the beneficiary, not the settlor. It is not intuitive at all how this is beneficial. Let me explain.

First, the trust still will be created by a parent or grandparent (the settlor) for the benefit of one or more family members. The settlor will make a gift of $5,000 to the trust for the beneficiary. The gift will be subject to a Crummey withdrawal power. The trust will be irrevocable but will not have grantor trust powers and therefore will not be treated as a grantor trust for the settlor.

Second, the beneficiary will let the Crummey power lapse and in accordance with §678, the trust will become a wholly-grantor trust for the beneficiary. The trust also can have one of the commonly used grantor trust provisions found under §675. And, it always will have the §675(4) power which permits the beneficiary to exchange trust assets in a non-fiduciary capacity for assets of equivalent value. These two features combined make the BDT even more powerful that the traditional SDT.

Since the trust was created by someone other than the beneficiary, it can be structured to be outside of the beneficiary's taxable estate and exempt from the beneficiary's creditors due to the spendthrift provision of the trust.

Now, the beneficiary can sell a highly appreciated asset (e.g., a business) to the trust without having to recognize a capital gain since the trust is a grantor trust to the beneficiary. The trust can agree to pay the beneficiary by any of the deferred payment methods available under the traditional SDT – installment note, private annuity or self-canceling installment note.

The beneficiary's personal wealth should diminish over time as the beneficiary pays all of the trust's income taxes. This does not effect the beneficiary since the value of the trust should be increasing, and the trust wealth is not part of the beneficiary's taxable estate. Theoretically, the beneficiary could die without any assets as all of the beneficiary's wealth is shifted tax free into the trust.

Each year, the trustee can distribute income or principal to the beneficiary. This can be done via use of discretionary distribution powers of the trustee. The trustee can be the beneficiary, but an independent trustee probably is a good idea, too. Therefore, if the asset continues to grow in value, the potential for significant distributions increases even though all of the assets are outside of the beneficiary's estate.

If at some time in the future, the beneficiary desires to get the asset back from the trust, he/she can exchange it for assets of equivalent value without any income tax consequence. This is because of the general principle of grantor trusts – there is no income or loss recognition on transactions between the trust and the person who is treated as the owner of the trust income under §672-678.

With this technique, there is not as much incentive to obtain large discounts on the valuation of the asset being sold. The reason is that the beneficiary is both seller and beneficiary. There is no reason to minimize the purchase price. Therefore, there is less risk of audit by the IRS.

In a typical SDT, the seller is often a senior citizen looking for a method of reducing his or her taxable estate, and to retire from a business. With the BDT, the seller may be a young person who wants to reduce or eliminate estate taxes and obtain creditor protection for a valuable asset, but may still want to control the business. The beneficiary can still control the business if he/she is named as trustee. Even if there is an independent co-trustee, the beneficiary may be given powers to manage the trust assets in a state that permits such bifurcation of trustee powers.

In short, the BDT offers the opportunity to significantly reduce or eliminate a large taxable estate, retain control of the asset being sold, avoid income taxes on the sale of the asset, protect one's assets from creditors, and even get the asset back someday if the beneficiary desires. This is truly a great estate planning tool.

Alan J. Mittelman, J.D., CLU is a member of Spector Gadon & Rosen, P.C. and Chairman of the Wealth Preservation Department. Alan practices law in Pennsylvania and Florida and currently is President of the Philadelphia Estate Planning Council.

For more information on the beneficiary defective trust, see Oshins, Brody and McBride, The BDIT: A Powerful Wealth Planning Strategy When Properly Designed and Implement, Steve Leimberg's Estate Planning Email Newsletter – Archive Message #1824 (June 22, 2011).

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