# The Beneficiary Defective Inheritor's Trust© ("BDIT"): Finessing the Pipe Dream

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## Introduction

The Inheritor's Trust[1] is one of the most powerful estate, tax and asset protection strategies available to planning professionals. Essentially, it is a third-party settled trust designed: (1) to give the client (who is both a trustee and the initial primary beneficiary of the trust) control and beneficial enjoyment of trust property such that the client can use and manage the trust assets without compromising the trust's ability to avoid transfer taxes at the client's death, and (2) to protect the trust assets from the client's creditors. After the demise of the client (the primary beneficiary), control of the trust passes to subsequent primary beneficiaries, often on a *per stirpes* basis, subject to change through the exercise of a non-general power of appointment by the client.[2] In addition to receiving control of the trust, the subsequent primary beneficiaries also receive the benefits of trust-owned property such as: (1) transfer tax avoidance, (2) creditor protection, including protection from a divorcing or separated spouse, and (3) potential income tax savings, including state income tax, by domiciling the trust in a state with preferable income tax rates.

The critical concept empowering the Inheritor's Trust is that assets received from a third party and retained in a properly structured trust are protected from unnecessary exposure to the client's "predators," including the IRS, judgment creditors, a divorcing spouse, disgruntled family members, and/or business partners.

A standard Inheritor's Trust becomes "beneficiary-defective" when it is drafted so that the beneficiary is treated as the owner of the trust for income tax purposes pursuant to the IRC's grantor trust rules (a "Beneficiary-Defective Inheritor's Trust" or "BDIT").[3] This (1) requires the beneficiary to pay the income taxes on the income generated by the trust and (2) also permits the beneficiary to engage in transactions with the trust income-tax-free.[4] Significantly, this also allows trust assets to grow income-tax-free, which compounds the multi-generational accumulation of wealth in the trust.

With respect to the beneficiary, a BDIT combines the benefits of a traditional intentionally-defective grantor trust (IDGT)[5] created for others with the enhanced wealth, transfer tax and asset protection advantages of a trust created and funded by a third party for the benefit of the beneficiary.

Because of the enhanced planning benefits available through a BDIT, particularly the control of the trust property and the access to and enjoyment of the trust property, many clients who otherwise are reluctant to do comprehensive planning or make significant *inter vivos* wealth transfers now can enjoy the benefits of advanced wealth and asset protection planning with minimal personal, financial and tax risk.

## Planning Benefits For The Client/ Beneficiary – The "Inheritor"

The BDIT resolves several major dilemmas for estate planners. First, the strategy provides acceptable, non-threatening planning for clients who may be leery of establishing a comprehensive, lifetime, "wealth-shifting" estate plan that benefits others to the exclusion of themselves. In effect, the trust enables a client to 1) put a protective wrapper around his or her assets, 2) continue to enjoy the management and benefits of the assets transferred to the trust, and 3)

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obtain important transfer tax and creditor protection benefits. In addition, since the client's descendants will be included as beneficiaries of the trust, their use and enjoyment of family wealth can be accelerated, yet controlled by the client.

Second, the strategy provides a risk-free estate plan. Even if family relationships implode in the future, with a BDIT the client never risks losing control and enjoyment of the trust assets or the opportunity to make the decision as to who receives the control and benefits of the wealth after his/her demise. If the client made a traditional estate planning transfer to the client's descendants, but retained the power to alter the disposition of the property transferred, the assets transferred would be subject to estate tax inclusion. Because the power to alter the disposition of the BDIT is given to the client by a third party, if the power is properly limited such that the client cannot exercise the power in favor of himself, his estate, his creditors or the creditors of his estate, the power does not cause inclusion in the client's estate.

Third, even for clients who are willing to consider alternative estate planning techniques, the BDIT appears to offer the maximum wealth and asset protection benefits at the least possible risk. Compared to a grantor retained annuity trust (GRAT), there is no survivorship requirement in order to obtain a wealth shift, and there is no estate tax inclusion period (ETIP) rule to preclude having the transaction exempt from the generation-skipping transfer (GST) tax immediately. Compared with a traditional installment sale to an IDGT, the special power of appointment (SPA) given to the client in the BDIT avoids gift tax exposure.[6] More importantly, the wealth shift does not diminish the client's control and beneficial enjoyment over the property transferred. Indeed, the client's economic security improves because the assets are no longer exposed to potential claimants.

## Finessing The "Pipe Dream"

The estate tax inclusion rules for individuals who make transfers to a trust and retain certain interests in that trust are different from the inclusion rules for beneficiaries of a third-party settled trust. There will be estate tax inclusion under Code Secs. 2036-2038 (the "string" provisions) if a person (1) makes a transfer to a trust for less than fair and adequate consideration and (2) retains a prohibited right or interest in the transferred property.

It is basic estate planning that a beneficiary of a trust may be given substantial rights in that trust without causing estate tax inclusion. These rights include: (1) the right to income; (2) the right to withdraw property from the trust based upon an ascertainable standard;[7] (3) the unlimited (no standard) authorization to have an independent trustee distribute trust property to him/her; (4) the right to appoint (give) property to anyone other than him/herself, his/her estate or the creditors of either; (5) the right to "use" trust property for virtually any purpose (a life estate); and (6) the right to manage the property. Thus, a trust beneficiary may be given rights and benefits that a gratuitous transferor could not retain for him/herself.

Although the Inheritor may be given the rights enumerated above, in order to maximize the tax and creditor protection benefits of the Inheritor's Trust its most efficient design would restrict these rights and be structured as follows: (1) the trust would be a fully discretionary trust in which the distribution decisions are lodged solely in the hands of an independent trustee; and (2) the Inheritor would be given a special power of appointment (re-write power) and managerial control over the trust. Importantly, none of these rights cause exposure to the IRS or other would-be claimants.[8]

Even though a person cannot establish a trust arrangement for him/herself without a multitude of adverse tax and creditor protection consequences, when a trust is properly established and funded by someone other than the Inheritor, the elements of what appears to be a "pipe dream trust"[9] might be the quintessential estate planning arrangement, providing both transfer tax and creditor protection not otherwise obtainable by our clients.

Fortunately, there are several counter-intuitive tax and asset protection planning concepts which enable the Inheritor to obtain these benefits, including the following:

> (1) The estate tax inclusion provisions of Code Secs. 2036-2038 apply to transfers with a retained interest only if the *Inheritor* makes a <u>gift</u> to a trust . If the Inheritor has not made a gratuitous transfer to the trust, the Inheritor can enjoy the benefits of trust-owned property without exposure to the IRS, creditors, divorce or disgruntled family members, regardless of how large the trust grows and even if the trust explodes in value due to the astute management of the Inheritor as trustee.

(2) Unlike transfers by a settlor to a traditional IDGT for less than fair and adequate consideration (which can result in immediate gift tax exposure to the settlor or estate tax inclusion of the trust assets in the settlor's estate under Code Secs. 2036-2038), if assets are transferred by an Inheritor to a BDIT for less than fair and adequate consideration, there will be no immediate gift and only the portion of the trust attributable to the transfer for less than fair and adequate consideration by the Inheritor should be includible in the Inheritor's estate.[10]

(3) The valuation process presumes a hypothetical, arm's-length, fair market value transaction between strangers.[11]

(4) The BDIT concept enables the Inheritor (the client/beneficiary) to enter into transactions with the trust income-tax-free.[12] Likewise, the Inheritor's spouse may enter into transactions with the trust income-tax-free.[13]

(5) The "tax burn" (estate depletion) effect of grantor trust income tax status disgorges wealth from the Inheritor in his/her individual capacity in favor of a trust in which the Inheritor both controls and enjoys the benefits of the trust assets. The "tax burn" results from the Inheritor's personal liability to pay the income tax on the trust income. Essentially this enables the Inheritor to move additional assets out of his/her estate into an asset-protected dynastic trust in which he/she is also the beneficiary, all without tax consequences. This result is the functional equivalent of a tax-free gift to the trust and not a gift transfer with a retained interest.[14] In addition, because the Inheritor is also the beneficiary of the BDIT, the "tax-burn" will enable him/her to pay taxes, spend money, or otherwise disgorge assets in his/her estate without concern for his/her security because he/she has ready access to the trust-owned property.

(6) The "use" concept allows the Inheritor to use trust assets rent-free without exposing them to the transfer tax system or to creditors. In effect, the full use and enjoyment of trust-owned property is similar to a life estate, which does not result in estate inclusion.



## Designing And Operating The Beneficiary Defective Inheritor's Trust

**The Creator/Settlor of the BDIT.** A third party such as a parent or grandparent (the settlor) establishes and funds a Beneficiary Controlled Trust for the benefit of the Inheritor (the primary beneficiary of the trust). The Inheritor's descendants, and, generally, their spouses, are included as permissible discretionary distributees. Because the BDIT is established and seeded through gifts made to the trust solely by someone other than the Inheritor him/herself, the trust is not a "self-settled trust" for either tax or creditor rights purposes. Therefore, in regard to trust owned property, the Inheritor is not exposed to either the transfer tax system or creditors. Obviously tremendous benefits can be derived from this strategy. Keep in mind it is essential that the settlor uses his/her independent funds for the contribution to the trust. If the Inheritor gives the settlor the funds, the Inheritor will be treated as the creator of the trust for both tax and creditor rights purposes.

**Inheritor's Spouse as Settlor.** Although we generally do not recommend that the Inheritor's spouse be the settlor of the trust, there are a variety of circumstances where having the spouse as settlor makes sense. If there is no other person willing and able to establish the trust, the Inheritor's spouse could set it up, but should do so only after both parties understand that generally the spouse/settlor will be taxed on the trust income even after death of the Inheritor or divorce,[15] and, as the trust settlor, the spouse cannot be named as a beneficiary of the trust. Because the spouse is treated as the grantor of the trust for income tax purposes, transactions between the trust and the settlor's spouse will be ignored.[16] Therefore, so long as the settlor is alive, a sale by the settlor's spouse to the trust will be an income-tax-free event.

**Selecting the Trustees of the BDIT.** The trust is designed so that the Inheritor will be in full control of the trust to the extent permitted under law without exposing the trust assets to transfer tax or creditor's rights. In its most desirable structure, the trust agreement creates two trustee positions: 1) a Family Trustee who initially is the Inheritor, and 2) an Independent Trustee consisting of one or more third-party trustees.

The Family Trustee/Inheritor controls trust investment and management decisions and also controls who will hold the office of Independent Trustee, subject to a few constraints.[17] The investment and management powers create essentially the same scenario as if the property were owned outright by the Inheritor. Although the Family Trustee/Inheritor will generally be primarily responsible for the investments and management of the trust assets, it is strongly recommended that the Family Trustee/Inheritor not represent the trust in non-arm's-length transactions (i.e., purchases of hard-to-value assets) with him/herself, or with his/her family members. Additionally, the Family Trustee/Inheritor cannot have control over decisions with respect to life insurance owned by the BDIT on the Inheritor's life and should not hold any "tax sensitive" powers that could cause tax or creditor problems for the Inheritor him/herself. These tax sensitive and non-arm's-length powers will generally be given to the Independent Trustee.

The Independent Trustee should be independent as to the settlor or else grantor trust status will shift to the trust settlor.[18] The Independent Trustee (or alternatively a special trustee or trust protector) will make all tax sensitive decisions, represent the trust in non-arm's-length transactions and those involving hard-to-value assets, make decisions regarding life insurance on the life of the Inheritor, and exercise powers which otherwise could cause tax or creditor problems. Ideally, the Independent Trustee making decisions with respect to hard-to-value assets would be an institutional trustee which would not be controlled by the Inheritor and would have fiduciary responsibilities it must honor. The Inheritor controls the identity of the Independent Trustee because the Inheritor can have the power to remove and replace the Independent Trustee without adverse tax consequences.[19] Some advisors place the power to remove and/or replace a trustee in the hands of a trust protector who is selected by the Inheritor; however, there is no requirement to do so.

**Domicile and Dynasty Trust Considerations.** Typically the BDIT is designed as a dynastic trust which will continue for as long as possible under applicable state law. Flexibility in trust design will allow the Inheritor to make decisions with respect to the state of trust situs and administration in order to obtain longer perpetuity periods than otherwise might be available in the domicile of the settlor or the Inheritor. An ideal candidate to act as Independent Trustee is a trust company with offices in a state that has abolished the rule against perpetuities and which has favorable state income tax and asset protection laws.

**Special Power of Appointment (SPA).** In order to provide flexibility in the design of the trust, enable the Inheritor to react to changed circumstances in the future and avoid certain transfer tax issues, the Inheritor (as the primary beneficiary of the trust) usually will be given a broad special power of appointment, which essentially is the power to "rewrite" the trust. This allows flexibility in family wealth planning so that the Inheritor and succeeding primary beneficiaries may re-write the trust as circumstances, family dynamics or laws change. Usually, the SPA is given to trust descendants at such times as they become the primary beneficiaries on a *per stirpes* basis, subject to alteration by a prior powerholder. Properly drafted, the SPA does not result in adverse transfer tax consequences under Code Secs. 2041(b)(1) or 2514.

As an additional trust enhancement, a non-beneficiary can be given a power to amend the trust. This would allow an Independent Trustee or a trust protector appointed by the primary beneficiary to amend the trust even for the benefit of the primary beneficiary.[20]

A broad SPA will protect the Inheritor against interference with his/her administration of the trust by subordinate beneficiaries. Obviously, if the Inheritor has a broad re-write power over the trust it is extremely unlikely that subordinate beneficiaries will interfere with the Inheritor's management or enjoyment of the trust property because an adverse beneficiary's interest in the trust could be eliminated through the Inheritor's exercise of the SPA.

Finally, the existence of the SPA will eliminate significant gift tax issues with respect to the operation of the BDIT. The SPA prevents the IRS from determining that there is a completed gift from the primary beneficiary to the trust in situations where it is determined that assets sold by the beneficiary to the trust are undervalued.[21] If this occurs, in the absence of the SPA the IRS will assess tax and penalties that were not contemplated with respect to the transaction. The existence of the SPA will make the gift an incomplete gift and, thus, offer protection against inadvertent gift taxes, which is superior to the protection of a "defined value" clause that often is used in the more traditional installment note sale. Indeed, this protection from the gift tax makes this transaction almost a "no-brainer" for someone who would not otherwise be doing alternate transfers.

**Obtaining "Beneficiary-Defective Trust" Status.** If the transaction is properly structured, the Inheritor of the BDIT will be considered the "owner" of trust for income taxes purposes pursuant to the grantor trust rules.[22] This is the feature which "super-charges" the Inheritor's Trust. Code Sec. 678(a) provides the general rule that a person other than the settlor is treated as the owner of trust income if that person has the power to withdraw corpus or income. A *Crummey* power of withdrawal is a power to withdraw principal, and therefore, is such a power.

***Powers of Withdrawal.*** It is critical to the proper design of a BDIT that *Crummey* powers of withdrawal are granted to the Inheritor over the *entire amount* contributed by the creator/settlor to the trust, including amounts in excess of the gift tax annual exclusion, so that the trust will be entirely defective as to the Inheritor. Also, the power of withdrawal must be held exclusively by the Inheritor (and no other beneficiaries) so that the trust is *entirely "owned"* by him/her under the grantor trust rules. The purpose of the withdrawal power is to obtain grantor trust status for income tax purposes for the entire trust, not necessarily to obtain annual exclusions for gift tax purposes, although the latter occurs to the extent the contributions and the withdrawal powers are within the limitations of the annual exclusion.[23]

With a properly structured *Crummey* power, pursuant to Code Sec. 678 the Inheritor will be treated as the owner of all trust income. If more than one trust is used for the Inheritor (for example, to obtain minority discounts), the Inheritor will have the right to withdraw all contributions to all trusts. A "sine que non" of the BDIT strategy is that no trust beneficiaries other than the Inheritor will be given withdrawal powers. "If the beneficiary's demand power applies to all contributions to the trust, and if all the trust funds are held for possible future distribution to the beneficiary, as is often the case, the beneficiary would own the entire trust at all times. The beneficiary would own the portion of the trust attributable to the addition during the pendency of the demand power under Code Sec. 678(a)(1), and he would own the balance of the trust under Code Sec. 678(a)(2), because it would be held for future distribution to the beneficiary."[24] In planning for beneficiary-defective trust status, the settlor may not retain a power or operate the trust in a manner that would make him/her the owner of trust income. For example, the BDIT may not acquire life insurance on the life of the settlor or the settlor's spouse.

Code Sec. 678(a)(1) deals with powers of withdrawal while the power is existing. Code Sec. 678(a)(2) deals with powers of withdrawal that have been "…released or otherwise modified…". A potential tax problem is whether a "lapse" is a "release" under Code Sec. 678(a)(2). If it is, beneficiary-defective trust status is safe; if it is not, there is a mixed income tax result which is harmful to BDIT planning.

As a general rule, a design feature of a properly crafted Crummey withdrawal power is a built-in lapse within the "5 or 5" exception of Code Secs. 2514(e) and 2041(a)(2). If the power is "released" rather than permitted to "lapse" there are adverse transfer tax consequences. A "release" requires an affirmative act by the powerholder, whereas a "lapse" occurs as a result of a passive non-exercise of the power over time. The estate and gift tax statutes make a distinction between lapses and releases.

Read literally, a lapse would not be within the protection of Code Sec. 678(a)(2). Since it is no longer a withdrawable amount due to its lapse, the beneficiary is not an "owner" for income tax purposes under Code Sec. 678(a)(1). Therefore, some practitioners are concerned that the powerholder is not taxed on the income of a trust after a lapse of a withdrawal power. On the other hand, the IRS' consistent ruling policy is that for purposes of Code Sec. 678, a lapse and a release have the same effect, and the beneficiary remains taxed as the owner of the trust under Code Sec. 678(a)(2) subsequent to the lapse. All of the rulings which have addressed the issue have been private letter rulings (PLRs) and PLRs are effective only as to the taxpayer who obtained the ruling. However, the many PLRs issued with respect to this issue clearly indicate an IRS policy of treating a lapse as a release for purposes of income taxation. Also, most of the respected treatises recognize this issue, and conclude that a "lapse" should be treated as a "release" for purposes of Code Sec. 678(a)(2).[25]

There are several planning approaches that can be taken to solve the lapse "problem":

1. Lapse the power within the "5% or $5,000" exception to Code Secs. 2514(e) and 2041(a)(2) in accordance with the IRS rulings and the interpretation of the preponderance of the estate planning treatises. Because the power would be expected to lapse prior to the death of the powerholder, this option is superior from a transfer tax perspective. Interestingly, although the power of withdrawal is given to the beneficiary over the entire contribution and the income tax consequences will apply as to the entire trust (including post-transfer appreciation), the portion exposed to estate tax inclusion in the beneficiary's estate is only the amount that is withdrawable at death. The effect of the growth of the trust is to increase the "pot" against which the lapse is applied, pos-

sibly accelerating the lapse. The growth of the trust will not be exposed to estate tax inclusion in the beneficiary's estate.

2. Obtain a PLR confirming that the income of the BDIT will be taxed to the Inheritor.
3. Use a power of withdrawal that does not lapse until the death of the powerholder. Because the power of withdrawal continues to be in existence until death and because powers that are in existence are safe under Code Sec. 678(a)(1), the potential lapse/release issue is finessed. The amount subject to the power will be includable at death in the powerholder's estate as a general power of appointment under Code Sec. 2041. The amount exposed to tax in the Inheritor's estate will be relatively negligible, and generally will be substantially offset by the discount on the sale as well as the "tax burn." The inclusion is limited by the dollar amount that is withdrawable at death and not a percentage of the trust. The powerholder's representative should allocate GSTT Exemption to the amount subject to inclusion so that the trust will continue to be 100% exempt from the GST Tax. Alternatively, the power of withdrawal (a) could be designed to be exercisable by will at death; (b) could be paid to the powerholder's estate at death and be handled as part of the residue of the powerholder's estate; or (c) could be allocated to the non-exempt portion of the trust.[26] The power could "hang" until the earlier of the death of the powerholder or 30 days after a specified event such as a Revenue Ruling confirming the IRS' present position or notice by the Independent Trustee that the power will begin to lapse.

***Structuring Transactions Between the Inheritor and the BDIT.*** If the trust is a BDIT, sales and other transactions between the trust and the Inheritor are income tax-free pursuant to Rev. Rul. 85-13. The Inheritor can engage in sales of discountable, income-producing assets to the trust and also can sell "hot" assets to the trust, both on an income tax-free basis. Because it is essential that these transactions are structured as arm's-length sales for "fair market value," prudence dictates that with transactions involving assets with no readily ascertainable value, the Inheritor should not act as both the buyer (as Trustee) and the seller (individually). The more independent the trustee appears to be, the better the chance of success. An independent financial institution such as a trust company is an ideal trustee. Also, it is critical that both valuation and interest rate issues with respect to these transactions are documented by qualified, independent appraisers and other experts. Finally, each party to these transactions should be represented by separate, independent counsel.[27]

***Interest Rates.*** If the Inheritor transacts with the BDIT through an installment note sale or loan, interest rates with respect to the transaction should be at current market rates rather than the current applicable federal rate (AFR) if it is lower. Although use of the AFR safe harbor may prevent exposure with respect to gift tax issues, using an interest rate that is less than the current market rate risks exposure under creditor rights laws, as a transfer that is not for fair market value, which could cause estate tax inclusion as a general power of appointment.[28]

***Funding the BDIT With Seed Money.*** As explained previously, the trust is established and "seeded" by a third-party settlor, someone other than the Inheritor or the Inheritor's spouse. Seeding the trust gives it the economic and tax substance necessary to successfully complete the other steps involved in this planning technique. Fortunately, the BDIT concept does not require a significant amount of seed money on the part of the creator/settlor in order to provide the Inheritor with significant wealth transfer and asset protection benefits. If additional seed money is necessary or desirable to ensure the economic and tax viability of the transactions, legitimate, commercially viable guarantees can form part of the seed money. Often the guarantees are made by a trust beneficiary; however, other parties might make a guarantee as well.

Because it is uncertain whether a gratuitous guarantee is a gift and because it is essential that all gifts to the trust are subject to a power of withdrawal, if guarantees are used to provide seed money the guarantors should receive reasonable payment for the guarantees in order to avoid gift tax issues. The guarantee fees should be determined by an independent appraiser and should be at prevailing market rates for similar guarantees unless the guarantor is independent and has no reason to use a favorable rate. A guarantee fee received by a spouse (or an irrevocable trust taxable to the Inheritor or the Inheritor's spouse) who is paid for the guarantee is income tax-free.[29] Finally, the guarantor should be represented by separate counsel.

***The BDIT is Less Risky Than an IDGT.*** For transfer tax purposes, the BDIT is superior to the traditional note sale by a settlor to an IDGT because there is less risk with respect to both the estate tax issues (Code Sec. 2036—full estate tax inclusion to the transferor) and the gift tax issues (undervaluation and Code Secs. 2701 and 2702—the entire amount will be a taxable gift). These estate and gift tax provisions are more punitive than inclusion under the "string" provision sections of Code Secs. 2036-2038 involving transfers from a beneficiary to a third-party settled trust. Although practitioners sometimes draft "defined value clauses" to protect gifts and sales to a trust, these types of transactions are uncertain. The decision in *C. McCord Jr.*[30] is helpful, but questions regarding defined value sales still exist and the IRS does not look favorably upon the use of defined value clauses.

Additionally, giving the Inheritor a SPA in the BDIT avoids an immediate gift tax if the asset is revalued. Instead, if the asset is successfully revalued, the value of the asset at the Inheritor's death minus the consideration paid to the Inheritor by the trust would be includible in the Inheritor's estate under Code Sec. 2043. This potential estate tax exposure is more palatable than paying a gift tax immediately because the exposure can be finessed. If the Inheritor adequately discloses the sale on a timely filed gift tax return, after the statute of limitations period has run for the audit of the return, the valuation issue should not be challengeable on an estate tax audit. If the service audits the gift tax return and challenges the valuation of the asset sold to the BDIT, the portion of underpayment would be allocated to a separate non-GST exempt trust under the BDIT.[31] This separate non-GST exempt trust under the BDIT can be depleted during the Inheritor's lifetime in a variety of manners so that the estate tax exposure is further reduced upon the Inheritor's death. The SPA also avoids exposure to Code Sec. 2702 inclusion because there is no completed gift.[32] The traditional note sale has been attacked as a Code Sec. 2702 transfer.[33]

## Planning Opportunities with the BDIT

***The BDIT is the Perfect Recipient of Gifts and Inheritances.*** Properly drafted and funded, the BDIT provides dramatic planning and investment opportunities for clients/beneficiaries and their families. For instance, well-advised clients/beneficiaries would elect to receive gifts and inheritances from third parties through the BDIT rather than individually. Client/beneficiaries should discuss these benefits with parents, grandparents, and other persons who potentially may be making gifts and bequests to the beneficiary and request that these persons make the transfers directly to the BDIT. By properly coordinating such planning, an Inheritor can control the design of the BDIT and obtain the financial benefits of the gift or inheritance as well as the enhanced wealth, tax and asset protection of the BDIT discussed in this article.

***BDIT Business and Investment Opportunities.*** The BDIT can hold or receive favorable business and investment opportunities and trust assets can explode in value with the ancillary benefit of the "tax burn" soaking up the Inheritor's estate. In addition to installment note sales of discountable and/or hot assets, "opportunity shifting" planning should be considered. In situations where the Inheritor is about to enter into a new business venture or has an investment opportunity with significant potential for growth, a BDIT created and funded by the Inheritor's parents or grandparents can have dramatic effects. The intra-family diversion of wealth through opportunity shifting is not a "transfer" for gift tax purposes.

Although beyond the scope of this article, for all of the reasons herein discussed, a BDIT may be the quintessential planning tool to implement and fund buy-sell arrangements and to structure business succession planning. Once the business is owned by the BDIT, it is perpetually protected from the transfer tax system and would-be claimants. A buy-sell arrangement with the BDIT as the buyer is a very powerful planning device. Often the BDIT will own life insurance on the lives of other owners of the entity as part of the buy-sell process.

***Life Insurance Planning with the BDIT.*** The use of a BDIT in combination with life insurance is quite compelling. For example, a BDIT can serve as a funded life insurance trust that can own life insurance on the life of any beneficiary, including the Inheritor, provided that (1) a trustee other than one who is also the insured holds all rights and powers with respect to the life insurance, and (2) the insured beneficiary does not have a power of appointment over the life insurance or its proceeds. However, through the non-insured Trustee, the insured indirectly has access to the tax-free inside build-up of the life insurance while the life insurance proceeds will be outside of the estate tax system. This might be compared to a qualified retirement plan (QRP) without the QRP's inherent problems of coverage, IRD, complexity and estate tax inclusion. In essence, the transaction can function as a private pension plan. This transaction also might be compared to a "net income with makeup" charitable remainder unitrust (NIMCRUT) without its disadvantages such as loss of the trust property to charity at death, restricted access to trust property, income tax realization under the four-tier rule, and the NIMCRUT's attendant complexity and costs. Finally, note that if life insurance policies on the Inheritor's life are sold to the trust by the Inheritor, the transfer-for-value rules are not violated because the sale is treated as a sale to the insured.[34]

## Illustration of BDIT Transaction

Mom gifts a total of $60,000 to separate trusts for her son (the "Inheritor") and descendants. The Inheritor has three children; therefore, three (3) trusts of $20,000 each are set up—one each for the Inheritor and a different grandchild. The Inheritor is given a power of withdrawal over the entire $60,000, making him the "owner" of each trust for income tax purposes. Mom is the settlor of each trust for transfer tax and creditor's rights purposes.

Each separate trust is fully discretionary as to the Inheritor, the Inheritor's spouse, and a grandchild plus said grandchild's descendants. The Inheritor is the Family Trustee and controls the identity of the Independent Trustee.

Assume that the Inheritor owns 100 percent of a pass-through entity such as an LLC. The Inheritor would be able to sell a one-third (1/3) interest in the LLC to each trust in return for a note or a series of notes using market interest rates. Each sale is for the FMV of the LLC interest being sold, taking into account appropriate valuation discounts because the interest being sold is a non-controlling interest in a closely-held entity. The notes are paid through the cash flow generated by the entity.

If the notes owed by each trust would cause the trust's debt:equity ratio to exceed 9:1, the Inheritor's spouse, if he/she has the economic wherewithal, may guarantee each sale in order to give the sale economic substance for transfer tax purposes. Ideally, the spouse will guarantee at least ten percent (10%) of the value of note owed by each trust. The spouse will be paid fair market value for providing the guarantees, which enables the "wealth shift" to occur without gift tax. Payment of the guarantee fees is income tax neutral so long as the Inheritor is living because transactions between the trust and the Inheritor's spouse are treated as a transaction between spouses for income tax purposes.

The following are the results of this transaction: (1) the entity (LLC) is removed from the Inheritor's estate on a discounted basis; (2) the transaction results in a leveraged estate freeze for the Inheritor; (3) there is no income tax on the sales or the guarantees; (4) all of the assets in the trusts are still available to and controlled by the Inheritor; (5) the Inheritor has a SPA (re-write power); (6) the taxable estate of the Inheritor is depleted by valuation discounts as well as payment of income taxes on the trust income (the "tax burn") ; (7) the BDIT has both GSTT and estate tax exemption into perpetuity; (8) the Inheritor and his/her family have creditor and divorce protection into perpetuity; (9) the SPA prevents a gift tax on transactions with the trust; and (10) otherwise resistant clients will move forward with planning. The Inheritor will not lose anything to anyone during his or her life and will obtain creditor and transfer tax benefits for himself or herself and his or her children. Finally, other beneficiaries can benefit from the property and receive distributions right away without gift tax implications.

## Conclusion

The BDIT should be one of the most important tools in the forward-thinking estate planner's tool box. From a wealth transfer and asset protection perspective, no other planning technique offers as much opportunity, flexibility and protection from taxes and creditors as a BDIT. The BDIT allows the Inheritor to:

- control the investment and management decisions with respect to the trust;
- remove and replace an Independent Trustee;
- rewrite the trust without adverse tax or creditor exposure pursuant to a special power of appointment;
- control and enjoy the trust assets[35] in a manner that is the functional equivalent to outright ownership of the trust property;
- obtain the income tax, wealth transfer tax and asset protection benefits of a traditional dynastic intentionally defective grantor trust (IDGT);
- structure gifts, loans, life insurance, business and investment opportunities through the trust all by means of a relatively risk-free, highly leveraged income and wealth transfer tax transaction.

## Endnotes

* The authors wish to thank Bruno Graziano, J.D., M.S.A., for his review of this article.

1 Richard A. Oshins and Noel C. Ice, "The Inheritor's Trust™: The Art of Properly Inheriting Property," *Estate Planning,* September 2002, 419. Richard A. Oshins and Gerald E. Lunn, Jr., "Trust Planning for the 21st Century: An Introduction to the Inheritor's trust," CCH: Practitioner's Strategies, 2004. The planning techniques discussed in this article are an enhancement of the planning techniques set forth in these articles.

2 Control to subsequent primary beneficiaries after the death of the client (initial primary beneficiary) is generally at the time of projected maturity of the subsequent primary beneficiaries, often the time at which many advisors and clients would be inclined to make outright distributions to the subsequent primary beneficiaries, but for the protections that the trust offers.

3 Code Sec. 678

4 Rev. Rul. 85-13, 1985-CB 184

5 The benefits of an IDGT include: leveraged freezes, income tax-free transactions and "tax burn."

6 Reg. §25.2511-2(b) and Code Sec. 2702(a)(3)(A)(i)

7 The typical health, education, support and maintenance standard authorized by Code Sec. 2041 (b)(1)(A).

8 Keydel "Trustee Selection, Succession, and Removal: Way to Blend Expertise with Family Control," 23 U. Miami Inst. On Est. Plan. Ch 4 (1989) at Sec. 403; Keydel and Wallace, "Design Strategies For Dynasty Trusts," ACTEC Meeting, March 6, 1999; Fred Keydel, "Trustee Selection, Succession, and removal – Ways to Blend Expertise with Family Control," 23 Miami Inst. On Est. Plan, Ch 4 (1989); Howard D. Rosen, 810 T.M. Asset Protection Planning, BNA Tax Management Portfolio at A-1; George Cooper, "A Voluntary Tax? – New Prospective on Sophisticated Estate Tax Avoidance," The Brookings Institute, Washington, D.C., 1979; and Howard M. Zaritsky, "Tax Planning for Family Wealth Transfers," Sec. 11.07

9 "Drafting California Irrevocable Trusts," Secs. 8.11 and 8.12, John Cohan, Editor

10 The tainted transfer - Code Sec. 2043(a) and Reg. §20.2043-1(a). The punitive result of Code Sec. 2043(a) and the applicable Treasury Regulations as it applies to transfers by a beneficiary to a BDIT may be avoided if the beneficiary/Inheritor adequately discloses the transfer on a timely filed gift tax return.

11 Reg. §20.2031-1(b)

12 Rev. Rul. 85-13, 1985-CB 184

13 Code Sec. 1041(a)

14 Rev. Rul. 2004-64, 2004-2 CB 7

15 Code Sec. 677(a)(1)

16 Code Sec. 1041

17 Rev. Rul. 95-58, 1995-2 CB 191, which restricts the identity of the Independent Trustee by excluding parents, children, siblings, a spouse or a subordinate employee of the client.

18 Code Sec. 678(b)

19 Code Sec. 672(c) and Rev. Rul. 95-58, 1995-2 CB 191

20 Note that the Independent Trustee or trust protector designated by the Inheritor must be a non-related, non-subordinate person who could be a substitute trustee as provided in Rev. Rul. 95-58.

21 Reg. §§25.2511.2(b), 25.2512, and 25.2701-2704

22 Code Secs. 671-679

23 Code Sec. 2503(b)

24 Howard M. Zaritsky and Norman M. Lane, "Federal Income Taxation of Estates and Trusts," WGL at ¶ 12.03(3)(a)

25 Byrle M. Abbin, "Income Taxation of Fiduciaries and Beneficiaries," CCH (2006) at Section 1404.1; Ferguson, Freeland and Ascher, "Federal Income Taxation of Estates, Trusts & Beneficiaries," at Section 10.16; Howard M. Zaritsky and Norman M. Lane, "Federal Income Taxation of Estates and Trusts," WGL, at Section 12.03(3)(a); and A. James Casner and Jeffrey N. Pennell, "Estate Planning," Sixth Ed., CCH at Sections 5.11.1-5.11.7.

26 Our firms often pour-over a decedent's estate into an otherwise exempt trust and allocate unused GSTT exemption to the exempt portion of the trust and the remainder to the non-exempt portion.

27 *See* C. Rector Est., 94 TCM 567, CCH Dec. 57,201 (M), T.C. Memo. 2007-367 (December 13, 2007) and see also R. Stone, DC-CA, 2007-1 USTC ¶ 60,540 (May 25, 2007). Both of these cases refer to separate counsel in a partnership context.

28 Code Sec. 2041

29 Code Sec. 1041

30 *C. McCord Jr.*, CA-5, 2006-2 USTC ¶ 60,530, 461 F 3rd, 614; Rev' g. 120 T.C. 358, CCH Dec. 55, 149

31 Carlyn S. McCaffrey, "Formula Valuation—Shield Against Gift Tax Risk or Invitation to Audit," 42 U. Miami Inst. On Est. Plan. Ch 11 (2008).

32 Code Sec. 2702 (a) (3) (A) (i) and Reg. §25.2511-2(b)

33 Sharon Karmazin, TC Docket No. 2003-7941. (Case settled)

34 Rev. Rul. 2007-13, IRB 2007-11, 684

35 The Inheritor will not hold any powers over life insurance owned by the BDIT insuring the Inheritor's life.