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## A Gift From Above: Estate Planning On a Higher Plane

The unique design of a BDIT minimizes—even eliminates—many tax and non-tax problems

Generally, most clients want the same thing: control, use and enjoyment of their assets until death and protection of their assets from potential claimants. They also want these same benefits for their family members after they themselves pass away. Ideally, these goals can be met in a tax efficient manner.

It's a fundamental fact of estate planning that to best accomplish these goals, the assets must be passed on in a generation-skipping trust. The trust can be designed to achieve the desired benefits, generation after generation, even though the trust beneficiaries are given "in trust benefits and controls." This designation makes assets inherited in trust much more valuable and desirable for a beneficiary than receiving the same assets outright. Additionally, a beneficiary will prefer "in trust" receipt of gifts and bequests, provided he's given adequate control and understands the virtues of receiving assets in a continuing trust.

Unfortunately, as estate-planning professionals are aware, many commonly used estate-planning techniques can't simultaneously achieve all of a client's goals. For most clients, those goals are:

1. The ability to maintain investment and managerial control over the transferred assets;
2. Liberal economic access to the income and principal from the transferred assets or the use and enjoyment of the transferred assets;
3. The ability to decide how the income and principal from the transferred assets are to be disposed among junior family members (and other potential inheritors);
4. The protection of the transferred assets from creditors (for both the client and his family); and
5. The transfer of assets from generation to generation with little or no transfer tax.

Looking through the arsenal of typical estate-planning strategies, most advisors realize that if a client is the creator of the trust receiving the transferred assets, at least two, and maybe three, of the above goals can't be satisfied.

If a client transfers assets to a trust that he established with little or no transfer tax exposure, such as a \$5 million taxable gift to a trust for the benefit of a spouse and his descendants, the second and third goals stated above can't be satisfied. Namely, a client's economic access to the income and principal from the transferred assets, or his use and enjoyment of them, will result in the entire value of the transferred assets being included in the client's gross estate upon his death. Likewise, the ability to decide how the income and principal from the transferred assets are to be disposed among family members will result in estate taxation upon a client's death.

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Further, the current best-in-class wealth shifting strategies that use trusts set up by an individual client, such as a grantor retained annuity trust (GRAT), an outright gift in trust or an installment sale to an intentionally defective grantor trust (IDGT) can at most satisfy three of the above five goals.

But there's one strategy that can satisfy all of a client's goals. We call this type of trust a "beneficiary defective inheritor's trust" (BDIT). A BDIT incorporates the virtues of more typical estate-planning strategies, but eliminates their negative features. Because of a BDIT's unique design, we can minimize and potentially eliminate common tax and non-tax obstacles.

No one, including the trust creator, can make additional gift transfers to the BDIT.

The blueprint for a BDIT is designed to minimize transfer taxes and protect trust assets from creditors, yet still provide a client with control over the management and the beneficial enjoyment of the trust property. It allows a client to enjoy more benefits as a beneficiary than the client would enjoy with outright ownership of the property. The key is that someone else "gives" the trust beneficiary powers over a trust that the beneficiary can't "retain" for himself without tax and creditor exposure.

### BDIT Creation

Here are the requisite elements in establishing and preserving a BDIT:

1. The client's parent or other third party (the trust creator) establishes an irrevocable, fully discretionary trust in a jurisdiction that has extended or revoked its perpetuities law, has enacted a "self-settled trust" statute and has other beneficial trust laws;
2. The trust creator contributes \$5,000 in cash<sup>1</sup> (as long as such cash doesn't originate with the beneficiary) to the trust and allocates \$5,000 of generation-skip-

ping transfer (GST) tax exemption to the trust;<sup>2</sup>

3. The trust creator grants a *Crummey* demand power of withdrawal over the \$5,000 to the beneficiary for a limited time, often 30 days, and then the power lapses;
4. The trust creator retains no income tax sensitive powers over the trust that could trigger the operation of the grantor trust rules for income tax purposes with respect to trust creator. For example, the BDIT can't own life insurance on the trust creator or the trust creator's spouse;<sup>3</sup>
5. The trust creator grants full discretion over distributions of trust income and principal to an independent trustee;
6. Subject to usual restrictions, the beneficiary (the client) is granted the power to remove and replace an independent trustee with another independent trustee;<sup>4</sup>
7. The trust creator doesn't grant any power to the beneficiary over trust-owned life insurance on the beneficiary.<sup>5</sup> Instead, an independent trustee is the insurance trustee with respect to insurance on the life of the beneficiary;
8. The trust creator grants a broad special power of appointment (SPA)<sup>6</sup> to the beneficiary, exercisable by the beneficiary during life or at death. This special power can't extend to life insurance on the beneficiary's life because of Internal Revenue Code Section 2042 concerns. This special power is also known as a "rewrite power;" and
9. The beneficiary will be the investment trustee and control all managerial decisions (but not over life insurance on his own life).

### BDIT Mechanisms

Here's how a BDIT operates:

1. No one, including the trust creator, can make additional gift transfers to the BDIT. The beneficiary never transfers assets to the trust unless it's in

exchange for full value;

2. The trust creator continues to be treated as the settlor of the trust for transfer tax purposes and under state law for asset protection purposes, but the trust isn't a grantor trust with respect to the trust creator for federal income tax purposes;
3. While the beneficiary's power of withdrawal is outstanding, the beneficiary is treated as the owner of the trust for income tax purposes under IRC Section 678(a)(1);
4. Once the withdrawal right lapses, the beneficiary continues to be treated as the owner of the trust for income tax purposes under IRC Section 678(a)(2);
5. The lapsed power over the \$5,000 fits squarely within the "5 and 5" exemption of IRC Sections 2041(b)(2) and 2514(e), so minimal estate or gift tax consequences are created for the beneficiary; the maximum estate tax exposure is \$5,000, if the beneficiary dies during the 30-day withdrawal period;
6. Deferred payment sales to the BDIT are made as follows:
  - a. Generally, sales to the BDIT will be structured as a defined value sale (DVS).<sup>7</sup> A qualified appraiser will determine the sales price unless the asset sold has a readily ascertainable value;
  - b. Since the beneficiary is treated as the grantor of the trust for federal income tax purposes, there's no sale for federal income tax purposes and thus no gain nor interest income is reported on any income tax return;
  - c. If a sale to the trust by the beneficiary were later determined to be a partial gift, any gift portion would be shifted pursuant to a defined value formula provision. The gift would be incomplete because of the beneficiary's SPA and no gift tax will be owed;<sup>8</sup>
  - d. If a promissory note satisfies the sales price, then to provide economic substance, the note must be guaranteed by a person or entity in a financial

position to make good on the guarantee. In return, the guarantor should receive a market value guarantee fee for the transaction, which has been set by a qualified appraiser who has also reviewed the guarantor's financial statements.<sup>9</sup> The guarantor should be represented by separate counsel, and the contingent liability must be reflected on the guarantor's financial statements; that is, it must be a "legitimate" guarantee; and

- e. Finally, the beneficiary should timely file a gift tax return reporting the non-gift completed transfer pursuant to Treasury Regulations Section 301.6501(c)-(f)(4), to start the running of the gift tax statute of limitations.<sup>10</sup>

### BDIT Outcomes

Here are the results of a BDIT:

1. As a trust beneficiary holding an SPA, who's also a co-trustee of the BDIT, **the beneficiary has virtually unlimited enjoyment of the economic benefit of the trust property, full managerial control over trust assets, creditor protection (including from an ex-spouse), maximum transfer tax savings and the flexibility, within limitations, to adapt to changing circumstances within the family, tax, legal system or economy by exercising the SPA;**
2. By design, the trust creator is the settlor of the trust for transfer tax and creditor rights purposes, but he isn't taxed on trust income. Instead, the trust is taxed as a grantor trust as to the beneficiary. The trust creator has purposefully avoided retention of any income tax sensitive powers so that IRC Section 678(b) doesn't apply to "trump" the application of IRC Section 678(a) to the beneficiary. This result allows a tax "burn," because it's a grantor trust as to the beneficiary. The beneficiary must pay the income tax on the trust's income from personal funds, thus further depleting the assets remaining in the beneficiary's estate;
3. **As the beneficiary pays the income taxes on all trust income, the assets in the trust grow income tax-free during the beneficiary's lifetime, with no gift tax consequences;**<sup>11</sup>

4. All transactions, such as sales and loans, between the beneficiary and the BDIT are ignored for federal income tax purposes pursuant to the grantor trust rules;<sup>12</sup>
5. From the beneficiary's point of view, the trust is creditor-proof and protected from all transfer taxes;
6. The BDIT continues as a creditor-protected, gift and estate tax-shielded, GST tax-exempt dynastic trust, subject to the beneficiary's SPA (though the BDIT won't be treated as a grantor trust for the beneficiary's spouse or descendants);

When comparing a BDIT to an IDGT, it's crucial to remember that IRC Sections 2036 and 2038 are only applicable to the individual who made closely held gifts to the trust.

7. If the beneficiary sells an asset to the BDIT in exchange for an installment note representing full and adequate consideration, the transaction will be free of the complications of the nefarious "string provisions" of the IRC, which would otherwise trigger inclusion in the grantor's estate at death due to the retention of prohibited powers. This is because the beneficiary isn't the person who created the trust for transfer tax purposes, only for income tax purposes. Accordingly, the beneficiary isn't subject to IRC Sections 2036 through 2038, which would operate to "pull" the fully appreciated date-of-death value of the transferred assets back into the beneficiary's gross estate. Thus, the sale will successfully effect a freeze (shift appreciation out of beneficiary's estate) at the value of the asset sold to the BDIT.

Note that a BDIT accomplishes many signifi-

cant non-tax objectives. Because the typical assets transferred to a BDIT are interests in closely held businesses, representing the "core" family asset, the protection from creditors is meaningful. The potential to retain the family business is much greater within a protective trust wrapper than if the business interests are simply owned outright. Buy-sell agreements with restrictions are much more tax inefficient than transfer restrictions in a trust. Further, restrictions with regard to the design of S corporation stock status can be finessed by proper trust structuring. In addition, the seller has the opportunity to convert a non-marketable asset into a liquid asset via a note sale, which is often desirable as the seller gets older.

#### BDITs vs. IDGTs

Let's look at the difference between a BDIT and an IDGT, a frequently used strategy that can accomplish all but two of the objectives on your client's list of goals. The IDGT takes advantage of provisions in both the income tax and the transfer tax code to accomplish an estate freeze. More importantly, an IDGT allows a grantor to further deplete the estate through the payment of income taxes on all trust income with no gift tax consequences. The income in the trust is left to grow free of the burden of income tax for the ultimate benefit of the trust beneficiaries. In addition, assets sold to an IDGT are very often entitled to a valuation discount. Thus, the IDGT provides the desired freeze, preserves the valuation discount and provides for continued burn.<sup>13</sup>

After the grantor establishes the IDGT, he may sell assets, typically income-producing assets such as a business interest, to the trust and take back an installment note in full satisfaction of the purchase price. The assets sold to the grantor trust are intended to generate enough income to make the note payments to the grantor. Any income in excess of what's necessary to pay the note is left in the trust to grow tax-free for the ultimate benefit of the trust beneficiaries. There's no taxable gain and thus no tax due on the sale or interest income on the note payments.<sup>14</sup>

But there are traps that could befall a client who uses an IDGT—traps that a BDIT can avoid. When the grantor sells assets to an IDGT, the grantor is selling assets to a trust that he established. Since IRC Sections 2036 and 2038 could apply to expose all trusts set up by an individual to estate tax inclusion when

that individual dies, the cautious estate planner will make sure that the grantor doesn't retain any powers that would subject the trust assets to inclusion under the string provisions.<sup>15</sup> If assets are pulled back into the grantor's estate, they will be aggregated with the assets already there; accordingly, estate inclusion of business interests may change the valuation from a non-controlling interest to part of a control block.

Let's look at an example:

A grantor establishes a trust for the benefit of junior family members and gifts asset #1, valued

The ability under a BDIT to change the beneficial enjoyment of existing beneficiaries makes it a preferred strategy compared to its alternatives.

at \$1 million, to the trust. The grantor retains the right to determine how trust assets are to be divided among his children while he's living and by a designation in his will upon his death. The grantor subsequently sells asset #2, valued at \$9 million, to the grantor trust, taking back an interest-only, 20-year installment note with adequate stated interest at the long-term applicable federal rate (AFR) in satisfaction of the entire purchase price. Before the note has matured, the grantor dies. At the date of his death, assets #1 and #2 are valued at \$19 million. Taking into account the trust's \$9 million note obligation, the equity value of the trust is \$10 million. Because of the grantor's limited power to decide how the trust beneficiaries will share in trust assets, the entire equity value of the trust is included in the grantor's gross estate, subject to a consideration offset of the \$9 million installment note.<sup>16</sup> Under IRC Section 2043, the consideration received by the deceased grantor is frozen, while appreciation

in the value of the property transferred will be includible in the estate.

When comparing a BDIT to an IDGT, it's crucial to remember that IRC Sections 2036 and 2038 are only applicable to the individual who made gifts to the trust. The individual who funded the trust can't retain direct or indirect enjoyment of the trust's property, nor any power to affect a beneficiary's right to the trust assets. A BDIT beats out an IDGT on this issue. Because the BDIT is created and funded solely by someone other than the trust beneficiary, the string sections can't apply to the beneficiary.<sup>17</sup> As long as other estate tax inclusion provisions, such as IRC Sections 2041 and 2042, aren't violated, the property won't be pulled back and taxed in the beneficiary's estate. As long as the BDIT beneficiary is only given an SPA, it won't trigger the general power of appointment inclusion under Section 2041. Indeed, "the BDIT is less risky than an installment sale to a grantor trust settled by the grantor because §§2036 and 2038 only apply to someone who has made a gratuitous transfer to a trust."<sup>18</sup>

### Estate Tax Inclusion Period

As noted, when an individual establishes a trust, such as an IDGT, to be used as the vehicle to receive the transfer of his assets, it's possible that the indirect retention of a power may inadvertently cause the trust to be exposed to inclusion under IRC Sections 2036 or 2038. Likewise, the improper management of the assets owned by the trust can cause estate tax inclusion. Inclusion in an individual's estate exposes trust assets to the GST tax because of the estate tax inclusion period (ETIP) rules under IRC Section 2642(f)(3). These rules provide that no GST tax exemption can be allocated to transferred property while the transferor has retained certain rights or interests that would cause the assets to be included in the transferor's estate for estate tax purposes under Sections 2036, 2037, 2038, 2041 and 2042 (but not Section 2035). Application of these provisions can be triggered by the indirect retention of prohibited powers, including through "implied understandings." The ETIP expires only when the trust would no longer be included in the transferor's estate or at the date of the transferor's death.

On the other hand, the string provisions don't apply to a beneficiary of a BDIT (because the only gratuitous



transfer in trust is from a third party). The trust creator applies the GST tax exemption to the initial gift in trust. The GST tax inclusion ratio is 0 percent, and the trust is immediately and forever GST tax-exempt. If the beneficiary of the BDIT later sells an asset in exchange for an installment note at full value, there will be no GST tax due when the beneficiary's descendants receive distributions from the trust, even if the asset continued to appreciate.

### Loss of Control and Enjoyment

Unlike an IDGT, a BDIT also allows the trust beneficiary to have control over the trust and enjoy the trust assets. If an individual who establishes a trust with a gift wants to be treated as the owner of the trust for income tax purposes, the trust agreement must reserve to the trust creator one or more of the powers under the grantor trust rules<sup>19</sup> that will accomplish that result. But, the retained power must be limited so that estate tax exposure under the string provisions won't apply

upon the trust creator's death. Therefore, the trust creator can't retain powers to decide how the trust's income and principal are to be distributed to his descendants. In addition, the trust creator must relinquish most of the power and control over the property to avoid being treated as the owner for estate tax purposes.

To circumvent the possibility of estate inclusion for IDGTs, the trust creator must be divested of almost all powers, such as control over enjoyment of the trust,<sup>20</sup> an SPA, certain administrative powers (such as the power to vote stock in a controlled corporation transferred to the trust)<sup>21</sup> or retention of the income.<sup>22</sup> The trust creator can retain the power in a non-fiduciary capacity to remove trust assets and substitute other assets of equal value without estate tax consequences.<sup>23</sup> But, the issue as to when the trust creator is acting in a non-fiduciary capacity is a question of fact. Other than the power to reacquire the property, the trust creator has no access to the property that was transferred.

A trust creator can't retain any power to alter, amend,



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defer or terminate a beneficiary's interest under the trust. For example, a power that would be an SPA under Section 2041 would constitute a "string" under Sections 2036 and 2038. Since the trust creator can't change what a beneficiary is entitled to receive after the trust is established, there's a reduced ability to influence the conduct of a beneficiary by altering the trust terms. And, the trust creator can't use the trust to control a disident beneficiary.

That's why the ability under a BDIT to change the beneficial enjoyment of existing beneficiaries makes it a preferred strategy compared to its alternatives. And, a BDIT doesn't need any reorganization into voting and non-voting interests, because the desired control can be given to a beneficiary in the form of an SPA under the trust agreement.

Another attractive feature of a BDIT is that the beneficiary who sold an asset to the BDIT for an installment note is still a beneficiary of the BDIT. Therefore, an independent trustee can be permitted to make discretionary distributions of income and principal to that beneficiary. Receiving a discretionary distribution authorized by the independent trustee of a third-party created trust doesn't expose the trust to estate taxation as part of the beneficiary's estate, so long as there's no evidence of a pre-arrangement to make distributions so as to constitute a general power of appointment.

A BDIT is also attractive for creditor protection purposes, as the beneficiary has no retained right in trust assets. Since the independent trustee has the exclusive power to make any distributions to the beneficiary, the beneficiary isn't exposed to Sections 2036 and 2038.

### Wealth Depletion

A downside to an IDGT is that the strategy can be, economically, too successful!

An IDGT is designed to require the trust creator to report all grantor trust income and pay the income taxes on that income. Thus, the grantor trust can grow in value for succeeding generations at no additional transfer tax cost. Eventually, the grantor/transferor may face the possibility that his remaining estate will be depleted far too much if grantor trust status continues, especially after the installment note has been fully paid. If trust income is higher than expected, the grantor's obligation to pay the income taxes on trust income will increase. If the grantor, the trustee or a trust

protector has the power to cancel the grantor trust status or has the right to "toggle off" or release that power, the exercise of the right may create cancellation of indebtedness income for the grantor.<sup>24</sup>

This isn't the result in a BDIT. If the trust is a grantor trust with respect to the beneficiary and if grantor trust status results in an excessive reduction in the grantor-beneficiary's remaining assets, the independent trustee can authorize discretionary distributions to the beneficiary (the client) to protect against economic exposure. Thus, a BDIT provides a financial safety net if the client needs additional funds. This is a significant safeguard against the risk of too much depletion.<sup>25</sup> Although a discretionary income tax reimbursement provision can be included in an IDGT, it's a complicated clause both to compute and to administer—in essence, an accountant's nightmare. And not all tax reimbursement clauses are sheltered from the string provisions. For example, Revenue Ruling 2004-64 specifies that if a trustee's discretion can be combined with any of the following facts, Section 2036 might apply: (1) there was a prearranged or pre-existing agreement regarding the trustee's use of discretion;<sup>26</sup> (2) the grantor retained the power to remove the trustee and name a successor; or (3) local law subjects the trust assets to any of the grantor's creditors. Since the beneficiary of a BDIT can receive trust distributions, in the discretion of the independent trustee, there's no need to use tax reimbursement clauses.

The clear advantage of a BDIT over an IDGT is that a BDIT is less risky, because Sections 2036 and 2038 can only apply to the individual who established the trust.<sup>27</sup>

### Gift Tax Risk

A gift tax risk arises if the IRS challenges the value placed on property sold to an IDGT. If the note given in satisfaction of the purchase price is less than the higher value determined by the IRS, the IRS may recast the transaction as part sale, part gift. Based on recent case law, most advisors believe that a defined value clause (DVC) (that is, a clause that limits the quantity of assets gifted or sold until there's a final determination of the asset's value) should be effective to eliminate the gift.<sup>28</sup> Even so, is there a way for the client to secure closure on the matter? First, he should start the statute of limitations running by reporting the installment sale on a timely filed gift tax return as a "non-gift completed transfer" under Treas. Regs. Section 301.6501(c)-1(f)(4).<sup>29</sup> If the IRS doesn't

challenge the valuation, the three-year statute of limitation will expire and the transaction should be fine.

For those advisors who are still concerned about DVCs, a BDIT will provide an additional layer of comfort. With a BDIT, if the IRS successfully challenges the valuation of the asset the beneficiary sold to the BDIT, the BDIT beneficiary won't incur a taxable gift of the excess value of the asset over the value of the note transfer—because of the SPA, the transfer can't be a completed gift.<sup>30</sup>

### Step Transaction Doctrine

The unique structure of a BDIT safeguards against the IRS successfully applying the step transaction doctrine (that is, when the IRS combines a series of separate transactions and treats them as one taxable event). With an IDGT, it's crucial that your client spaces out his transfers and adheres to transfer formalities. Several court opinions address the step transaction doctrine. In *Linton v. U.S.*,<sup>31</sup> the appellate court overturned a lower court's summary judgment in favor of the IRS and held for the taxpayers. The appellate court held that the sequencing of the transactions was critical to its determination of whether to apply the step transaction doctrine and remanded the case back to the trial court for the taxpayers to substantiate that there was a meaningful lapse of time between the transactions. The lower court in *Linton*<sup>32</sup> had based its analysis, in part, on *Holman v. Commissioner*,<sup>33</sup> one of the first gift tax cases to address the step transaction doctrine with respect to the transfer of assets to an entity and later gifts of interests in that equity. The *Holman* court refused to extend step transaction treatment to collapse a series of transfers that occurred just six days apart, even though the family limited partnership (FLP) held only marketable securities.

In a case that didn't go well for the taxpayer, *Suzanne J. Pierre v. Comm'r*,<sup>34</sup> the IRS was able to successfully collapse four transactions—two 9.5 percent gifts and two 40.5 percent installment note sales. The note amounts were based on an appraised value of a 40.5 percent non-managing interest in a limited liability company, discounted for lack of control and lack of marketability. Because the transactions were collapsed, the valuations applied to two 50 percent interests rather than to minority interests, so the assets sold were undervalued.

A BDIT provides a safer haven than an IDGT and can backstop a step transaction attack. For example,

assume that an IDGT is set up and funded with a \$1 million gift and, shortly thereafter, the trust creator sells property worth \$9 million to the IDGT for an installment note, intending to use the income from the trust to pay the note. If the IRS successfully argues that the “seed” money gift and the sale were part of an integrated transaction, the seller will have transferred \$10 million to the trust and received less than adequate and full consideration: the note, for only \$9 million in return. As previously mentioned, to have inclusion under Section 2036, three things must occur: a transfer; with a retained interest; and for less than adequate and full consideration. Having failed the adequate

Properly drafted, a BDIT will allow the maximum control permitted without exposing the trust assets to taxes and creditors.

and full consideration test, the trust might be exposed to Section 2036; there could be estate tax inclusion of the property at the fully appreciated date-of-death value.

Under the BDIT structure, however, a third party (not the beneficiary) is the only party making a gratuitous transfer to the trust. Thus, the DVS would protect the BDIT from estate tax inclusion. The beneficiary would have received a note back for the full value of what was sold to the trust, satisfying the adequate and full consideration test. The “seed” money wouldn't be aggregated with the asset sold.

### Asset Protection Trusts

Asset protection is, or should be, as much a part of estate planning as transfer tax savings. The rise in popularity of the self-settled trust as an asset protection trust (APT) is one testament to this fact. So situs your client's BDIT in a state that allows asset protection for self-settled trusts.

A BDIT has a major advantage over transfers to APTs—there's no waiting period! Typical APTs have a waiting period before assets transferred to a trust



can be protected from the transferor's creditors. The shortest waiting period is two years.<sup>35</sup> However, the waiting period is four years in most other self-settled trust jurisdictions.<sup>36</sup>

A BDIT, however, isn't a self-settled trust. It's established by a third party. A third-party settled discretionary trust with "... the distribution discretion held by an independent trustee ... is the ultimate in creditor and divorce claims protection—even in a state that restricts so called 'spendthrift' trusts—since the beneficiary himself has no enforceable rights against the trust."<sup>37</sup>

It's possible for an individual to transfer property to an APT during life and exclude the property from his estate. To do this, an individual's transfer must be structured as a completed gift.<sup>38</sup> This transfer requires substantial restrictions on the use and control of the property to achieve creditor protection under appreciable state statutes or to obtain estate tax avoidance. The transferor can't retain any powers that would constitute a retained interest under Sections 2036 and 2038. In contrast, the beneficiary of a BDIT would avoid these restrictions because the beneficiary didn't set up the trust for his own benefit—a third party did. Thus, with a BDIT, the beneficiary can have control of the use and enjoyment of the property in the BDIT and still protect the property in the trust from being subject to estate tax.

There's a substantial concern with respect to the theory that property transferred to an APT as a completed gift will in fact be outside the transfer tax system. The apparent exposure is a result of situations in which there's an implied understanding that the transferor will be able to access the assets transferred to the trust. This can easily occur when the trust creator transfers the bulk of his assets to an APT and is then unable to maintain the same standard of living without the use of those assets or has been receiving continuing periodic distributions from the APT.

## FLPs

Initially, most FLPs were designed to obtain valuation discounts and shift future appreciation of the limited partnership interests, while allowing the transferor to retain control through retention of a general partnership interest.

Over the years, the IRS has successfully launched attacks in two principal areas: 1) on discounts; and

2) on entities such as FLPs, which are used to obtain such discounts. The IRS' success has resulted in reducing discounts, or ignoring the entity itself, under the theory that such entities needed to show a substantial non-tax purpose under Section 2036.

A BDIT, however, doesn't have the retained interest problem that an FLP suffers from, because Sections 2036 and 2038 only apply to the settlor of a trust.<sup>39</sup> A BDIT, by design, is settled by someone other than the beneficiary. Because the beneficiary never makes a gift transfer to the BDIT, the BDIT is tested under Section 2041 which, as noted above, enables the beneficiary to have rights and controls that he can't have under the string sections.

Just as an FLP is designed to afford control to the transferor, a BDIT is designed to afford control to the beneficiary, who will enjoy control over the BDIT trust property as a management trustee without the inclusion risk under Section 2036. Properly drafted, a BDIT will allow the maximum control permitted without exposing the trust assets to taxes and creditors. Such control includes administrative and managerial decision-making power and a dispositive power (that is, a broad SPA).<sup>40</sup> A broad SPA will give the power holder control over how the other trust beneficiaries receive trust distributions or the ability to remove them entirely.

The ability to indirectly control distributions during life is obtained in a BDIT through the independent trustee whose identity is controlled by the beneficiary. Such control in an FLP, however, would expose the FLP to estate tax inclusion under Sections 2036 (implied understanding) and 2038 ("in conjunction with any other person").

Another weapon the IRS uses against FLPs is the "substantial business purpose" requirement. Any good FLP checklist will assure that there must be legitimate, non-tax reasons for its formation. Because the cases on this issue are fact-sensitive, there should be several non-tax reasons for creating an FLP. The transferor of an FLP must document his non-tax reasons for the FLP's formation, and the actual operation of the FLP must be consistent with those reasons. However, there's no substantial business or non-tax purpose requirement for a BDIT. Consider advising those clients who have existing FLPs to avoid a potential audit risk by selling any retained interest in the FLP to a BDIT for fair market value. Another suggestion

is to terminate a successful FLP in which the wealth shift has already been accomplished, to eliminate Section 2036 exposure.

### Irrevocable Life Insurance Trusts

Clients have come to recognize life insurance as a separate asset class in its own right, similar to a municipal bond, and in these risky economic times, clients often view life insurance as safer and better. A BDIT can be used as a funded life insurance trust. It can purchase life insurance for anyone in whom the trust has an insurable interest and, generally, that would be on the life of one or more of the trust beneficiaries (but caution: without

Comparing other features, accessibility stands out in favor of the CVLI.

proper planning, a BDIT shouldn't buy insurance on the life of the third-party creator or the creator's spouse, as that destroys the objective of having the beneficiary treated as the grantor for income tax purposes because of Section 677(a)(3)). If a BDIT acquires a policy on the life of a beneficiary, then the independent trustee or a separate insurance trustee must handle any decisions regarding that policy. In addition, the insurance can't be subject to the beneficiary's SPA. Both of these safeguards must be put in place to avoid running afoul of IRC Section 2042, which would result in estate inclusion of the policy proceeds for the beneficiary. If the beneficiary is the insured, he may hold the power to remove and replace the independent or insurance trustee with certain constraints.<sup>41</sup>

Until there's adequate cash flow to pay premiums (and fund the interest on any installment note), the strategy will often either involve using a donor/donee split-dollar arrangement (if the policy is a survivorship policy) or a premium financing transaction, with either the insured or a third-party lender loaning money to the trust to provide a source of premium payment. Because the trust creator shouldn't make any additional transfers to the trust after the initial contribu-

tion, the trust creator won't be making gift transfers to pay premiums. Instead, clients must use assets owned by the BDIT for cash flow.

Importantly, the IRC treats life insurance differently from all other assets.<sup>42</sup> The dilemma often faced with cash value life insurance (CVLI) used for retirement planning is that the estate owner wants both access to the internal build-up and to keep the death benefits not includible for estate tax purposes. A BDIT finesses this problem because the trust is created by someone other than the beneficiary. If the BDIT owns life insurance, and the beneficiary needs to access the cash value, there are several ways he can accomplish this.

One way is for the insurance trustee to borrow money from the policy and lend the loan proceeds to the beneficiary. Since the trust is a grantor trust as to the beneficiary, interest payments made by the beneficiary during his life have no income tax consequences.<sup>43</sup>

A second option is for the trust to borrow from the policy to purchase other assets from the beneficiary. Since the trust is a grantor trust as to the beneficiary, there will be no gain recognized on the sale.

The final, and least advantageous, option is a discretionary distribution by the independent trustee to the beneficiary. A distribution will move the assets outside the protective trust wrapper and dilute the inherent transfer tax and creditor protection provided by the BDIT, since the assets distributed will be in the beneficiary's hands. Because a loan must be paid back and a sale requires the BDIT to receive back assets of equal value, the leakage from the trust is avoided.

In addition to accessing the cash value, the life insurance policy itself is a valuable asset that can be used to create liquidity in the event of severe economic hardship. Assuming that there's a market, the independent or insurance trustee can sell the policy or surrender it and use the proceeds for the beneficiary.<sup>44</sup>

### CVLI vs. QRPs

Even though he daily pondered the mysteries of space, time and quantum physics, in the planner's world, Albert Einstein is famous for stating that, "The most powerful force in the universe is compound interest."<sup>45</sup> It's obvious that tax-free compounding is an even greater force. Two of the principal vehicles employed to obtain tax-free compounding are CVLI and qualified retirement plans (QRP).<sup>46</sup>

With CVLI, it becomes apparent that a BDIT has many benefits that don't exist in a QRP.<sup>47</sup> In a QRP, even if a Roth individual retirement account conversion is made, someone will be paying income tax at some point, and there will be estate tax inclusion. In contrast, CVLI results in true "tax-free" accumulation. If the policy is purchased and handled properly, there generally will be no income tax recognition at any point in the life of the policy (so long as it's not a modified endowment policy, as defined in IRC Section 7702A).

Comparing other features, accessibility stands out in favor of CVLI. The cash value in a life insurance policy is accessible with the cooperation of the insurance trustee at any time. On the other hand, withdraw QRP money too soon, too late, too much or too little, and there are penalties and income taxes.

When evaluating the investment of funds in a CVLI versus a QRP, consider what happens upon an insured's early death. In CVLI, the payout of the policy proceeds will prove to be a substantial return on investment, whereas, in a QRP, the policy payout is treated as income in respect of a decedent and subject to both income tax and transfer tax. For CVLI inside a BDIT, at death, the policy proceeds are paid to the trust free of income tax and outside the transfer tax system.

Looking at the investment from a different perspective, survivorship can be an important element in the decision to use CVLI in a BDIT. Because it takes time for tax-free accumulation to have a meaningful impact, a QRP for a short term, say three years, makes little sense. A longer term is required before earnings can grow, compound tax-free and become valuable. On the other hand, with CVLI you're actually hedging the bet on the term. If you die early, you win on the mortality bet. If you live for a long period of time, you win on the build-up of tax-free growth.

There are other problems with QRPs that don't exist with CVLIs. A QRP must cover all employees. Not so with CVLI. Also, there's a risk of early investment decline. This is similar to an underwater GRAT (that is, a GRAT in which the property transferred has declined in value to the point where the annuity payments threaten to wipe out the GRAT)—you need to make up the shortfall before you get the benefit of the strategy. With CVLI, there's a minimum guaranteed crediting, so tax-free growth and compounding the build-up have legs.

## Business Succession Planning

In many family businesses, the senior generation faces the dilemma of having some children who have chosen to become active in the business and some who haven't. How does the business owner treat them all equitably?

One popular planning option is to reorganize the business into voting and non-voting shares. The active children inherit the controlling shares and the non-active children are given the non-voting shares. This option will often result in family conflict. The active children devote all of their time and effort into the business and might feel that they are carrying on the heritage of the parent who started the business. They may want to put any earnings back into the business, so it will grow, and may believe that they aren't being appropriately rewarded for the individual sacrifice they're making to carry on the family legacy.

The non-active children might see it much differently. Rather than retaining earnings in the business to fund future business needs and expansion of the business, they want current distributions.

Another planning option is to grant a preferred interest to the non-active children and common interest to the actively involved children. This strategy opens the door to similar family dynamics issues and may reduce the form of entity options, as two classes of stock will preclude S corporation status.

A BDIT, however, provides an alternative to these two types of traditional business succession planning options. A BDIT can own the family business and also purchase life insurance on the business owner. During the earlier years, life insurance will hedge the tax burn. At the death of the insured, the actively involved children will get the business, and the non-active children will get the insurance proceeds. Cash is often the preferable asset for heirs who aren't involved in the business. Additionally, a BDIT provides a ready way to adjust inheritances in a situation in which children active in the business have successfully grown its value through exercise of the SPA.

A BDIT also offers viable options when used in conjunction with a buy-sell agreement. Business partners will often choose a cross-purchase buy-sell so that the acquirer will obtain a basis step-up. The problem is that at the death of the surviving business owner, the acquirer will be exposing the entire value of the business,

including appreciation, to the estate tax. The following example provides a better solution:

Newco is owned equally by Alan and Barry. Alan's parent sets up Alan's BDIT, which buys Alan's entity interest from Alan. Barry's parent sets up Barry's BDIT, which buys Barry's entity interest from Barry. Alan's BDIT buys life insurance on Barry's life, and Barry's BDIT buys life insurance on Alan's life. At Alan's death, Barry's BDIT purchases Alan's interest. Alan's interest has now been transferred to a vehicle outside the reach of the transfer tax system, even though managerial control is in the hands of the surviving owner, Barry.

### The Mid-Range Client

A BDIT isn't just for clients with substantial wealth. For a client who has more moderate wealth, say someone with a business valued at \$10 million, a valuable home and about \$1 million in other assets, a BDIT may be the best option. A client in this position wants to avoid estate tax and exposure to creditors, but isn't in a position to transfer wealth to shelter it from the estate tax. This client needs access to the wealth (often all or most of the income) to maintain his lifestyle, especially during retirement, and generally wants to retain control of the business.

Typical planning options for this type of client, such as a GRAT or IDGT, invite the risk of having the assets pulled back into the estate under Sections 2036 or 2038 if there's an understanding that the business and income will be accessible to him, because the client needs to use the assets to live. He will then be stuck without whatever was put into the GRAT or IDGT years before (or the income therefrom), even if circumstances change and finances become difficult.


Using a BDIT for this client is the solution. Since someone else sets up the trust, the string provisions don't apply. The client can sell the interest in the business to the BDIT in exchange for a note, so the client receives income in the form of non-taxable principal and interest payments on the note, as well as discretionary trust distributions if needed. And, the client can have an SPA to decide how junior family members are treated.

As described earlier, the client can be a co-trustee with investment and managerial decision-making authority

over the assets in the trust. Since this control is held in a fiduciary capacity, it's not attributed to the client for purposes of estate inclusion and there's no exposure to the estate tax. Most importantly, the client will have a broad SPA to use to amend the trust for future beneficiaries. Thus, the client can alter the trust to deal with complaining or otherwise interfering secondary beneficiaries. The only restriction is that the client wouldn't be able to increase his own benefits under a general power of appointment.

### Bottom Line

A small gift in a properly structured and situated BDIT by a parent or other third party will enable your client to achieve transfer tax savings, control and creditor protection that your client couldn't obtain by directly transferring property in trust. If your client later sells property to the BDIT and receives equal value in exchange, the assets sold to the BDIT won't be exposed to estate and GST taxes. If the BDIT is situated in a state with an unlimited perpetuity period, the assets in the BDIT can be sheltered from all estate, gift and GST taxes, forever, as long as they remain in trust. Although a properly structured and administered IDGT can also accomplish these transfer tax objectives, an IDGT can't offer the control advantages and all of the creditor protection advantages that a BDIT can.

Communicate to your client that contrary to the common belief that a gift or bequest in trust is restrictive and an undesirable intrusion on wealth, a properly designed and implemented trust is a substantial improvement over the outright ownership of wealth. Clients generally will be happy if they are placed in reasonable control of a trust, which is typically a design feature of a BDIT. Your client, as the beneficiary of a BDIT, gives up nothing and has protections that outright ownership wouldn't afford. 

### Endnotes

1. This concept is attributed to Carlyn S. McCaffrey of New York's McDermott, Will & Emery.
2. A trust creator is entitled to use the annual exclusion against the gift because of the *Crummey* power.
3. Under the grantor trust rules, this would cause the trust creator, rather than the beneficiary, to be the grantor for purposes of the income tax. Internal Revenue Code Section 677(a)(3), unless the power required the consent of an adverse party—the trust beneficiary.
4. See IRC Section 672(c) and Revenue Ruling 95-58, 1995-2 C.B.72, for

- restrictions necessary to preserve tax status. There's no requirement that there be an adverse or confrontational relationship. The independent trustee can even be the beneficiary's best friend. Generally, the independent trustee can't be a member of the family or a subordinate.
5. IRC Section 2042. See Howard M. Zaritsky and Stephen R. Leimberg, *Tax Planning with Life Insurance* (Warren, Gorman & Lamont, 2d ed.) at par. 5.03(6)(a); and Georgiana J. Slade, 807 T.M., "Personal Life Insurance Trusts" at p. A-25.
  6. To avoid inclusion of the beneficiary defective inheritor's trust (BDIT) property in a beneficiary's estate at death under IRC Section 2041, the beneficiary can hold the power to appoint the trust property to anyone other than the beneficiary, the beneficiary's estate or the creditors of either.
  7. Carlyn S. McCaffrey, "Formula Valuation—Shield Against Gift Tax Risks or Invitation to Audit," 42nd Annual University of Miami Philip E. Heckerling Institute on Estate Planning, Ch. 11 at Section 1101.2[B] (2008); See also Carlyn S. McCaffrey, "Tax Turning the Estate Plan by Formula," 33rd Annual University of Miami Philip E. Heckerling Institute on Estate Planning, Ch. 4 (1998); Carlyn S. McCaffrey and Mildred E. Kalik, "Using Valuation Clauses to Avoid Gift Taxes," *Trusts & Estates* (October 1986) at p. 47; and John Porter, "A Formula for Avoiding Transfer Tax Litigation," *Willamette Law Review* (Autumn 2010), at p. 86.
  8. Treasury Regulations Section 25.2511-2(b) and Private Letter Ruling 9535008 (Sept. 1, 1995).
  9. A. James Casner and Jeffrey N. Pennell, "Shifting Opportunities," *Estate Planning* (6th ed.) at Section 6.3.3.6; See also Milford Hatcher, "Planning for Existing FLPs," 35th Annual University of Miami Philip E. Heckerling Institute on Estate Planning, Ch. 3 at Section 302.2 (2001).
  10. McCaffrey, "Formula Valuation," *supra* note 7 at Section 1101.2[B].
  11. Rev. Rul. 2004-64, 2004-2 C.B. 7.
  12. Rev. Rul. 85-13, 1985-1 C.B. 184.
  13. The "freeze" is an estate freeze. The client will receive a note in exchange for an asset expected to grow in value. The note's interest rate will be less than the income earned by the asset purchased. The post-transfer growth will be shifted to the purchaser rather than increase the seller's estate. By selling discounted assets (generally, non-controlling interests in entities that don't have a viable market), the amount of the discount is passed transfer tax-free into the trust. The "burn" refers to the estate depletion (that is, the "tax burn") resulting when the grantor pays the income taxes on taxable income earned by the trust.
  14. See *supra* note 12.
  15. The "string provisions" include IRC Sections 2036, 2037 and 2038. They operate to pull property back into a decedent's estate for estate tax purposes if the property was transferred in trust by the grantor during life under certain conditions. Generally, the string sections are triggered if the transfer was made with a retained right to receive income or designate the income beneficiary; if the possession or enjoyment of the property could be obtained only by surviving the decedent and the decedent retained a reversionary interest that exceeds 5 percent of the value of the property; or, if the transfer was made with a retained interest over the income or with the power to alter, amend or revoke or terminate the interest of any beneficiary.
  16. IRC Section 2043.
  17. IRC Sections 2036 and 2038 only apply if the settlor of the trust has certain powers. Sections 2036 and 2038 can't apply if a beneficiary has these same powers unless it's a general power of appointment under Section 2041.
  18. Jerome M. Hesch and David A. Handler, "Evaluating the Sometimes Surprising Impact of Grantor Trusts on Competing Strategies to Transfer Wealth," New York University 68th Institute on Federal Taxation, Ch. 19, at pp. 19-43.
  19. IRC Sections 671-677.
  20. IRC Sections 674, 2036 and 2038.
  21. IRC Sections 675 and 2036(b).
  22. IRC Sections 677 and 2036(a).
  23. This power isn't a string under IRC Sections 2036 or 2038 because it's for "adequate consideration." Rev. Rul. 2008-22, 2008-16 I.R.B. 796. Note the omission of reference to Section 2042.
  24. Hesch and Handler, *supra* note 18 at pp. 19-4 and 19-6.
  25. *Ibid.* at pp. 19-42.
  26. This could be an "oral understanding."
  27. Hesch and Handler, *supra* note 18 at pp. 19-43.
  28. *McCord v. U.S.*, 461 F.3d 614 (5th Cir. 2006), *rev'g* 120 T.C. 358 (2003); *Estate of Petter v. Comm'r*; *Estate of Christiansen v. Comm'r*, John H. Hendrix, T.C. Memo. 2011-133; See also *supra* note 7.
  29. McCaffrey, "Formula Valuation," *supra* note 7 at Section 1104.
  30. See *supra* note 8.
  31. *Linton v. U.S.*, 630 F.3d 1211 (9th Cir. 2011).
  32. *Linton v. U.S.*, 130 T.C. 170 (2008).
  33. *Holman Jr. v. Comm'r*, 601 F.3d 763 (8th Cir. 2010).
  34. *Suzanne J. Pierre v. Comm'r*, 99 T.C.M. (CCH) (2010).
  35. See Nevada Revised Statutes Section 166.170.
  36. Alaska Stat. Section 34.40.110(d), Del. Code Ann. tit. 12, Section 3572(b)(2) and R.I. Gen. Laws Section 18-9.2-4.
  37. Frederick Keydel, "Trustee Selection, Succession, and Removal Ways to Bland Expertise with Family Control," 33rd Annual University of Miami Philip E. Heckerling Institute on Estate Planning, Ch. 4 at Section 409.1 (1989).
  38. Treas. Regs. Section 25.2511-2(b). See PLRs 2002-7-013 (Nov. 22, 2002); 200148028 (Nov. 30, 2001); and 200502014 (Jan. 14, 2005).
  39. Hesch and Handler, *supra* note 18 at pp. 19-43.
  40. The beneficiary can only have a special power of appointment, not a general power of appointment.
  41. See IRC Section 672 and Rev. Rul. 95-58 1995-2C.B.72, for restrictions necessary to preserve tax status.
  42. IRC Sections 2035(d) and 2042.
  43. IRC Section 2036(a); see also IRC Sections 2038 and 2041 (if reachable by creditors).
  44. But there may be income to report if the policy is sold or terminated or if more than basis is withdrawn.
  45. Alice Calaprice, *The New Quotable Einstein* (Princeton University Press 2005) at pp. 294-295.
  46. Charitable remainder trusts provide another option.
  47. Intentionally defective grantor trusts also have the same benefits.