



# WRMarketplace

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The *WRMarketplace* is created exclusively for AALU Members by the AALU staff and Greenberg Traurig, one of the nation's leading tax and wealth management law firms. The *WRMarketplace* provides deep insight into trends and events impacting the use of life insurance products, including key take-aways, for AALU members, clients and advisors.

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## **TOPIC: The Basics of Beneficiary Defective Income Trusts - BDITs.**

**MARKET TREND:** Since 2012, many clients have exhausted their transfer tax exemptions, making freeze techniques more popular, including beneficiary defective income trusts (“BDITs”).

**SYNOPSIS:** A BDIT is an irrevocable trust often used in the context of business succession planning. Under a properly structured BDIT, a third party donor creates the trust for the benefit of a client. The client-beneficiary is the deemed owner of the trust for income tax purposes (but not for estate, gift or generation-skipping transfer (“GST”) tax purposes (collectively “transfer taxes”). A BDIT, when combined with an installment sale, may provide the client with indirect access to the assets sold and the ability to manage those assets. Life insurance purchased by the BDIT can further enhance this estate planning approach.

**TAKE AWAYS:** BDITs provide a way for clients to: (1) sell assets to a family dynasty trust while also providing trust benefits and creditor protection to the client, (2) preserve a family business or family assets for multiple generations, and (3) facilitate the use of life insurance to provide additional liquidity, if needed.

**PRIOR REPORTS:** *15-31, 15-9, 15-5.*

**MAJOR REFERENCES:** [Internal Revenue Code \(“IRC”\) § 678.](#)

For clients who have appreciating or income-generating assets but are reluctant to engage in planning for fear of parting with those assets, a properly designed and implemented BDIT (also referred to as a beneficiary defective irrevocable trust or a beneficiary defective inheritor's trust) may provide a planning option.

### ***WHAT IS A BDIT?***

A BDIT is an irrevocable trust created by a third party donor (such as a parent or other member of the client's family, the “**donor**”) for the primary benefit of the client. The donor generally funds the trust with a nominal gift (e.g., \$5,000). The donor retains no power or control over the trust that would cause the trust to be treated as a grantor trust with respect to the donor under the so-called “grantor trust rules.” Instead, the trust grants certain rights and powers to the client that

will cause the client (as a trust beneficiary) to be treated as the owner of the trust for income tax purposes under the grantor trust rules.

*Example:* X owns a family business that is expected to grow significantly over the next 10 years. X's father, W, as a donor, creates a trust for X's benefit and gifts \$5,000 to the trust from his own funds. W retains no power or control over the trust that would cause the trust to be a grantor trust with respect to W under the grantor trust rules. X is given the power to withdraw the \$5,000 gift, which power lapses after 60 days. The trustee has the power to distribute income and principal to X for any purpose. X also has other powers over the trust that will cause X to be treated as the deemed owner of the trust under IRC § 678 for income tax purposes but not for transfer tax purposes.

Once the BDIT is established and funded, the trust can purchase assets from the client in exchange for an installment note, much like a typical installment sale to a grantor trust, with similar tax treatment but with the added features of control and creditor protection.

### ***BENEFICIARY AS TRUST OWNER UNDER THE GRANTOR TRUST RULES***

The grantor trust rules, set out in IRC §§ 671-679, describe rights and powers that, if retained by the grantor of a trust, result in the grantor being treated as the owner of the trust's assets for income tax purposes. These include the power (in a non-fiduciary capacity) to reacquire trust assets by substituting other property of equivalent value, the power to borrow from the trust without adequate interest or security and the power to control the beneficial enjoyment of the trust's income and principal. In addition, a grantor will be deemed to be the owner of the trust's assets for income tax purposes if income may be distributed to the grantor or the grantor's spouse in the discretion of the grantor or a non-adverse trustee.

IRC § 678<sup>1</sup>, however, provides that a person other than the grantor (such as a beneficiary) will be treated as the owner of any portion of a trust for income tax purposes where the person (1) has the power, exercisable solely by himself, to vest the corpus or income in himself (such as the power to withdraw gifts to the trust), or (2) having released such power, the person has other powers or control over the trust which would, if held by a grantor, cause the grantor to be the deemed owner of the trust under the grantor trust rules.

To form a BDIT, the first element of IRC § 678 is generally satisfied by giving the client the exclusive power to withdraw the donor's contributions to the trust. The withdrawal power makes the client the owner of the trust assets for income tax purposes during the withdrawal period. The withdrawal right generally lapses after a specified period of time (and is treated as a release for purposes of IRC § 678).<sup>2</sup>

To continue grantor trust treatment as to assets for which the withdrawal right has lapsed, the BDIT generally satisfies the second element of IRC § 678 by granting the client a combination of powers, any one of which would trigger grantor trust status if held by the donor. For example, the BDIT could grant the following powers to the client:

- The right to receive discretionary or mandatory distributions of income in the discretion of a non-adverse trustee.
- The right to withdraw assets as needed for the client's health, education, maintenance and support.

- A special power of appointment that can be exercised by the client during life and/or upon the client's death.
- The power to acquire trust assets by substituting other property of equivalent value.

It is important to note that to qualify as a BDIT, the trust cannot provide the donor with powers or otherwise contain provisions that would cause grantor trust treatment with regard to the donor. Such treatment would trump any powers granted to the client and make the trust a grantor trust as to the donor, not the client.<sup>3</sup>

### ***WHY USE AN INSTALLMENT SALE TO A BDIT***

An installment sale to a BDIT has many similarities to a sale to a traditional grantor trust – the sale is a disregarded transaction for income tax purposes, valuation discounts may apply to the assets sold, the client will not make a gift to the trust if the fair market value of the note equals the value of the assets sold, and the assets and future appreciation thereon are not included in the client's estate (although the value of note is included if the client dies during note term). BDITs, however, may offer other features not readily achieved through a sale to a grantor trust:

- The client may be a trust beneficiary, which allows the client to benefit from the trust assets through distributions or use of trust property.
- The BDIT can provide creditor protection to the client. In a properly structured BDIT, the client will neither create the trust nor make a gratuitous transfer to the trust. Accordingly, the trust's assets will generally be protected from the client's creditors – even in those states that do not authorize self-settled asset protection trusts.
- The client can change the trust and the ultimate beneficiaries through a limited power of appointment granted to him or her exercisable during life or at death without causing estate tax inclusion.

Further, although the client should not serve as a trustee with authority to make discretionary distributions of income and principal (a "distribution trustee"), the client can manage the assets as an "investment trustee."<sup>4</sup> The client also can have the power to remove and replace trustees (provided that any replacement for the distribution trustee should be a person who is not related or subordinate to the client).

### ***BDITs AND LIFE INSURANCE***

A BDIT can serve as an alternative to a traditional life insurance trust, particularly if the BDIT has income producing assets that can support the payment of insurance premiums (in addition to payments required under any installment note). The trustee of the BDIT can access the cash value build-up within the policy through withdrawals of basis or policy loans, which can be used to support distributions to trust beneficiaries, if needed.

Life insurance also can hedge against unexpected tax liabilities or liquidity needs at the client's death. In addition, if the BDIT is part of a family business succession plan and only part of the client's family is actively involved in the business, the life insurance proceeds could be used to equalize among family members, with the trustee allocating cash to the inactive beneficiaries and setting aside the business interests for those involved in the business.

Care must be taken, however, when structuring a BDIT that will acquire policies insuring the client's life to ensure the client does not have any "incidents of ownership" over the policies. For example, if the client serves as the investment trustee, he should be specifically excluded from exercising any power or control over the insurance policy (such power and control should be given to an independent trustee). In addition, any power of appointment granted to the client should exclude the right to appoint any policies insuring the client's life.

### ***ADDITIONAL CONSIDERATIONS***

BDITs and installment sales to BDITs are advanced planning alternatives that require proper planning, implementation and on-going administration. Careful consideration should be given to a number of competing factors.

- The initial trust must be created by the donor (preferably by the donor's own attorney). The client cannot gift assets to the trust either directly or indirectly. The donor's gift to the trust must be made from his or her own funds. If the client gives the donor the funds to transfer to the trust, or if the client later reimburses the donor for the gift, the client will be deemed to have funded the trust, causing the client to be the grantor and resulting in transfer taxes as to the client and the likely loss of creditor protection for the client.<sup>5</sup>
- The BDIT must be drafted so that it is not a grantor trust as to the donor – otherwise the donor, and not the client, will be the deemed owner of the trust under the grantor trust rules.
- The donor should file a gift tax return to report the gift to the BDIT and allocate part of his or her GST tax exemption to the gift.
- The client should not have any power as a trustee to distribute trust income or principal (although the client can be granted the power to withdraw income and principal for his or her own health, education, maintenance and support). Preferably, such distributions would be made by a trustee who is not related or subordinate to the donor, the client, or any other beneficiary of the trust.
- Care must be taken to ensure the client's sale of assets to the trust is for full and adequate consideration. An incorrect asset valuation could result in a deemed gift from the client to the trust, with the attendant transfer tax and creditor protection concerns discussed above.
- Like installment sales to grantor trusts, the sale must be bona fide and adequately capitalized. Otherwise, the transaction could be re-characterized as a transfer to the trust by the client with a retained interest, which could pull the assets back into the client's estate for transfer tax purposes. For BDITs that are nominally funded, the use of personal guarantees may be an option.
  - Any guarantees should be made by persons other than the client, such as other current beneficiaries (if any) or the remainder beneficiaries. A guarantee issued by the client indicates the client is aware the trust is not adequately funded for the purchase.
  - The individuals issuing guarantees should have sufficient assets to assure repayment of the debt in the event the BDIT defaults on the note.
  - The individuals issuing the guarantees should be paid a fee determined by a qualified appraiser. The fee should be paid by the BDIT and not the client.
- The installment note needs to be respected as bona fide indebtedness:

- The debt should be evidenced by a written installment note.
  - At a minimum, the note should require the payment of interest annually with a balloon payment at the end of the term.
  - The BDIT should actually pay interest on the note at least annually.
  - There should be (1) a fixed repayment schedule, (2) adequate security (see above), and (3) a reasonable expectation that the note can and will be repaid.
  - The seller (the client) and purchaser (the BDIT) should behave as if there is a true creditor-debtor relationship.
  - The principal on the note should be paid when due.
- The client should file a gift tax return to disclose the sale and start the limitations period running.

### ***THE FUTURE OF BDITS***

BDITs are a relatively new and somewhat less familiar estate planning concept as compared to traditional installment sales to grantor trusts. Accordingly, clients and advisors should keep in mind the following: Other than PLRs<sup>6</sup> (which can only be relied on by the requesting taxpayer) and commentary by practitioners, there is little guidance on the use of BDITs and how they work. The IRS has signaled its concerns regarding installment sales to BDITs by including the transaction on its no-ruling list.<sup>7</sup> Recent Tax Court cases and IRS internal guidance also indicate renewed IRS interest in installment sales to grantor trusts.<sup>8</sup> In addition, for the last several years the President's budget proposals have advocated changes to the treatment of installment sales to grantor trusts (including BDITs) which would curb the use of sales to such trusts.

### ***TAKE AWAY***

BDITs provide a way for clients to: (1) sell assets to a family dynasty trust while also providing trust benefits and creditor protection to the client, (2) preserve a family business or family assets for multiple generations, and (3) facilitate the use of life insurance to provide additional liquidity, if needed.

### **NOTES**

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<sup>1</sup> IRC § 678(a) provides:

“A person other than the grantor shall be treated as the owner of any portion of a trust with respect to which:

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

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

<sup>2</sup> See, PLRs 201039010, 200011058 and 9812006. In cases where the BDIT is funded with more than \$5,000, the client would be granted a “hanging withdrawal right” that would lapse as to the greater of \$5,000 or 5% of the trust estate each year. Note that the client's creditors would be able to reach assets over which the client has a continuing withdrawal power. In addition, if the client dies prior to the entire withdrawal right lapsing, the portion of the trust the client could withdraw will be included in the client's estate.

<sup>3</sup> IRC § 678(b).

<sup>4</sup> Although the client, as investment trustee, should not have powers over any life insurance policy owned by the BDIT insuring the life of the client – see discussion herein under “BDITs and Life Insurance.”

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<sup>5</sup> Unless, however, the BDIT is established in a state that recognizes self-settled asset protection trusts, such as Alaska, Delaware, Nevada, South Dakota, Wyoming or another state that has enacted such legislation.

<sup>6</sup> See for example, PLRs 200949012, 201039010, 201216034.

<sup>7</sup> See, Rev. Proc. 2015-3, 2015-1 I.R.B. 138 § 4.01 (39).

<sup>8</sup> See, *Estate of Marion Woelbing v. Commissioner*, T.C. No. 30260-13, *Estate of Donald Woelbing v. Commissioner*, T.C. No. 30261-13, *Estate of Davidson v. Commissioner*, T.C. No. 013748-13 (July 6, 2015), and CCA 201330033, as discussed in *WRMarketplace No. 15-31* and *Washington Report No. 14-13*.

## **DISCLAIMER**

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