The Basics of BDITs

A Beneficiary Defective Inheritance Trust ("BDIT") is an irrevocable trust that freezes the value of assets for gift and estate tax purposes when such assets are sold to the trust by a beneficiary ("beneficiary-seller"), who has the added benefit of being eligible to receive future discretionary distributions from the trust. Other benefits of a BDIT are that the beneficiary-seller will enjoy asset protection with respect to the assets in the trust, and perhaps even leverage the value of assets for gift and estate tax purposes, while having no impact on the beneficiary-seller's unified credit.

How Does It Work?

Structure. The nominal grantor of the trust, typically a family member of the beneficiary-seller, contributes his or her own cash (usually $5,000) or other equivalent property to the trust, but retains no powers or strings of control over the trust that would cause the trust to be taxed to him or her. The trust is structured so as to not cause the assets to be included in the estate of either the nominal grantor or the beneficiary-seller, and typically names an independent third-party as trustee such as Commonwealth Trust Company (which places control of discretionary distributions in the hands of an independent party). The trust instrument will provide the beneficiary-seller with a withdrawal right over the initially contributed funds, typically for a fairly short window (30-60 days) which the beneficiary-seller will allow to lapse without exercising his or her withdrawal right. Section 678 of the Internal Revenue Code provides that a beneficiary of a trust will be considered the owner (that is, the grantor) for federal income tax purposes of any portion of the trust that such beneficiary can independently vest in himself or herself. Because the beneficiary-seller had the ability to withdraw the entire trust corpus, the beneficiary-seller will continue to be considered the grantor of the entire trust for federal income tax purposes even after his or her withdrawal right has lapsed.

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Estate Freezing Transfer. At this point, the beneficiary-seller will sell a considerable amount of assets to the trust – preferably assets that are expected to appreciate significantly in value, such as interests in a closely held business. The sale will be in exchange for a promissory note with an interest rate equal to at least the AFR (about 2.75% for a long-term promissory note in July, 2015). This transaction locks in the value of the transferred assets at their transferred value plus the interest rate required by the note. Any appreciation in the value of the transferred assets in excess of that rate will occur outside the estate of the beneficiary-seller, instead accruing to the benefit of the trust. In practice, the transaction can even generate an up-front financial benefit, if the transferred assets are minority interests and/or subject to transfer or other restrictions, for which a valuation discount might reasonably be applied, freezing the value of the asset to the beneficiary-seller at the discounted value plus the applicable interest rate.

Other Benefits

Control and Access. The beneficiary-seller can serve as an investment advisor of the trust and/or in a managerial position with the business in which the interests were sold to the trust, thus maintaining a considerable degree of control over the economic fate of the assets. The trust instrument will also include provisions permitting the beneficiary-seller and perhaps other family members to receive discretionary income or principal distributions, so if a change in circumstance would require access to some, or even all, of the assets in the trust, they would be available to the beneficiary-seller and his or her family. Unlike another popular estate freeze technique (the intentionally defective grantor trust), the beneficiary of a BDIT can even maintain a right to receive mandatory income distributions without adverse estate tax consequences.

Asset Protection. In addition, the BDIT can provide a significant degree of asset protection. Since the beneficiary-seller does not make any gratuitous transfers to the trust, the BDIT would not be considered self-settled for bankruptcy (and most state law) purposes. Second, a transfer to a BDIT should not be vulnerable to fraudulent transfer claims, and the same is true with respect to spousal claims in a divorce or similar proceeding, particularly if the trust is established and the assets sold to the BDIT prior to the marriage.

Tax Burn. Because the BDIT is a grantor trust to the beneficiary-seller for federal income tax purposes, neither gain on the sale itself, nor the interest paid on the note, generates any taxable income. Moreover, any income of the BDIT is taxed to the beneficiary-seller, resulting in a further reduction in the beneficiary-seller's potentially taxable estate and allowing the (thus undiminished) trust assets to grow at an incrementally faster rate.

No Impact on Unified Credit. Because the transaction with the beneficiary-seller (if it is properly structured) does not involve any gratuitous transfer by the beneficiary-seller, no allocation of his or her unified credit is required, and the BDIT is therefore particularly appealing to a person whose unified credit has been consumed by prior gifts or other planning transactions.

Complications

BDITs are, in practice, extremely complex, and require sophisticated legal advice. There are many issues which must be addressed, and sometimes there are considerations unique to the specific contemplated BDIT. For example, if the trust is funded with only $5,000, and then the beneficiary sells property worth $10,000,000 to the trust in exchange for a $10,000,000 promissory note bearing interest at the AFR, the IRS could reasonably attempt to characterize that exchange as a gift. In that situation, the IRS might assert that the trust is too thinly capitalized to support the payments due under the promissory note. The IRS's reasoning would be that no third-party seller would accept that promissory note without insisting on adequate collateral and/or guarantees, a significantly higher interest rate on the note, or similar assurances.

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With respect to asset protection, state law will have a significant impact on the degree to which the BDIT can be effective as an asset protection vehicle since each jurisdiction has its own transfer periods, special rules and exceptions.

Also, experienced counsel will be crucial in drafting the trust instrument and the documents related to the sale, as great care must be taken to avoid inadvertent grantor status for the creator of the trust, inclusion of the trust assets in the estate of any involved party, and to carefully navigate subtle pitfalls with respect to Section 678, the application of discounts to transferred assets, and the myriad issues surrounding guarantees which may be required to support the validity of the sale.

Conclusion

While there is great complexity involved in a BDIT, the structure has vast upside potential. When properly structured by an experienced counsel, and properly administered with an experienced trustee, like Commonwealth Trust Company, the BDIT has been successfully used by many as a powerful estate freezing and asset protection vehicle, particularly among persons with little to no available unified credit.

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