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Beneficiary Defective Inheritance Trust ("BDIT")

A Beneficiary Defective Inheritance Trust ("BDIT" or "Section 678 Trust") 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, who has the added benefit of being eligible to receive future discretionary distributions from the trust.

The Basics

The BDIT is created by an independent person as grantor (essentially anyone other than any beneficiary of the BDIT) and a person (or trust company) is named as trustee. (The beneficiary of the trust can be the trustee.). The grantor executes the trust agreement and gives the trust a check for $5,000. The grantor retains zero benefit, control, or power over the trust.

The person with the estate tax issue is the beneficiary of the trust and has the right to move the $5,000 from the trust. The trust instrument will provide the beneficiary with a withdrawal right over the initially contributed funds, typically for a fairly short window (30-60 days) which the beneficiary will allow to lapse without exercising her withdrawal right. Section 678 of the Internal Revenue Code provides that a beneficiary of a trust will be considered the owner *for <u>federal</u> <u>income</u> <u>tax</u> purposes* of any portion of the trust that such beneficiary can independently vest in herself. Because the beneficiary had the ability to withdraw the entire trust corpus, the beneficiary will continue to be considered the owner of the entire trust for federal income tax purposes (*but not <u>federal</u> <u>estate</u> <u>tax</u> purposes!)* even after her withdrawal right has lapsed. The beneficiary reports all income on her individual 1040 tax return.

Because the BDIT is a grantor trust to the beneficiary 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, resulting in a further reduction in the beneficiary's taxable estate and allowing the (thus undiminished) trust assets to grow at an incrementally faster rate.

The BDIT allows the beneficiary as much control as she can have without including the assets in her estate, including the ability to reacquire trust property, substitute assets, direct investments, or serve in a management position in a business owned by the BDIT.

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The beneficiary then sells assets—oftentimes stocks or units of highly appreciating closely held businesses—in exchange for a promissory note with an interest rate equal to at least the AFR. (The assets must be professionally appraised after the sale.) Thus, the BDIT owns the securities and/or the closely held business going forward. The BDIT then receives distributions from the business and in return, makes payments to the beneficiary on the promissory note.

Any appreciation in the value of the transferred assets in excess of that rate will occur outside the estate of the beneficiary, instead accruing to the benefit of the BDIT. In practice, the transaction can 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 at the discounted value plus the applicable interest rate.

The beneficiary continues to receive payments on the promissory note until the note is paid off. The promissory note is included in the beneficiary's estate at death to the extent it has not been paid off.

The BDIT also provides that the beneficiary is to receive income and principal for health, education, maintenance and support, so when the note is paid off, the individual still receives these payments from the BDIT.

On the death of the beneficiary, the contingent beneficiary might be the beneficiary's descendants. The assets in the BDIT are never included in anyone's taxable estate.

Other benefits of a BDIT are that the beneficiary 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's unified credit….meaning the beneficiary is not burning any part of her estate tax exemption by utilizing the BDIT.

The typical BDIT transaction will involve the following entities/documents:

- Family Limited Partnership (FLP) (or other asset to be sold to the BDIT)
- Assignment of FLP interest
- BDIT document
- Certified appraisal
- Promissory note
- Secured interest agreement
- Guarantor agreement
- EIN for the BDIT

Complications

There are many issues which must be addressed, and sometimes there are considerations unique to the specific contemplated BDIT. Here's one example: If the trust is funded with only with the $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.

One way to protect against this issue is to have a third party guarantee the note for at least 20% of the value of the purchase price and pay that guarantor a fee annually equal to 1% of the amount of the guarantee. The third party should have a net worth big enough to actually make it a *real* guarantee. In other words, one would not want to pick a sibling or a child (or someone else they don't mind the 1% fee going to) to be guarantor if that person does not have enough assets to actually deliver on the guarantee if ever needed.

Conclusion

While there is great complexity involved in a BDIT (not many attorneys "go there"), the structure has vast upside potential. When properly structured and properly administered by the trustee, the BDIT can be successfully used by many as a powerful estate freezing and asset protection vehicle, particularly among persons with little to no available unified credit.