BDIT SCHEMATIC

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WEALTH PROTECTION

Solely because assets are placed into an appropriate trust by someone else, and the beneficiary never transfers assets to the trust, except in exchange for full value, as long as they are kept in trust, these assets have benefits that do not, and cannot, exist if the same assets were owned outright (or by a trust funded by the beneficiary).

Properly situated and structured BDITs are forever sheltered:

1. From all estate, gift and GST taxes;
2. From the original and later beneficiary’s creditors (including divorcing or dissident spouses);
3. From probate and incapacity headaches and delays; and
4. From certain income taxes after the death of the original beneficiary.

Beneficiary as Income Tax Owner of the BDIT

Because the original beneficiary is taxed on the trust income, the beneficiary’s estate will be “tax burned,” i.e., depleted by income tax paid on trust income. This, in effect shifts the beneficiary’s personal wealth transfer tax-free into the “BDIT” away from creditors, without gift or GST tax consequences, and with no economic risk because the beneficiary is in control of trust investments.

Insurance Funding

1. Insured beneficiary may not have investment powers over insurance; and
2. Power of appointment cannot extend to insurance on the powerholder.

CONTROL

Without exposing the trust assets to estate taxes and creditors, the trust beneficiary can have substantial controls. The original primary beneficiary and each successive primary beneficiary is in control (at the proper time) subject to amendment by the exercise of the power of appointment by the preceding generation.

Administrative Control:

1. The original primary beneficiary is the Investment Trustee.
2. The Independent Trustee makes all distributions (if any) and makes other tax sensitive decisions.
3. The primary beneficiary can fire and replace the Independent Trustee with another Independent Trustee, with or without cause. Independent does not require a corporate fiduciary, nor a confrontational relationship; it could be a “best friend”.

Beneficiary Control:

1. The right to use the trust-owned assets (rent-free if desired).
2. The primary beneficiary can essentially re-write the trust allowing the primary beneficiary to adjust for changes in tax or trust laws, family dynamics, etc.

These continuing dynastic trusts are protected from creditors, spouses, and the transfer tax system.
AN OUTLINE OF BDIT PLANNING

(1) A BDIT (a Beneficiary Defective Inheritor’s Trust) is a trust created by a parent or other third party who contributes $5,000 in cash to the trust; no other gifts are made to the trust by anyone, especially the beneficiary.

(a) If it is finally determined that a sale to the trust by the beneficiary is partially a gift, the gift would be incomplete (because of his or her limited power of appointment, described below); any such gift would be held in a non-GST exempt share of the trust, under a defined value formula provision.

(2) The trust creator is the grantor of the trust for transfer tax purposes and creditor rights purposes, but not for income tax purposes.

(a) That is, the BDIT is intentionally created as a non-grantor trust from the creator’s point of view.

(3) The trust is irrevocable, fully discretionary, dynastic, and GST exempt (because the creator allocated $5,000 of his or her GST exemption to the only gift to the trust), and the beneficiary has a limited power of appointment over the trust, exercisable during life or at death.

(a) The limited power cannot extend to insurance on the beneficiary’s life.

(4) The beneficiary is given a “Crummey” type power to withdraw the original gift, which right lapses.

(a) While the power of withdrawal is outstanding, the beneficiary is treated as the owner of the trust for income tax purposes under Section 678(a)(1).

(b) After the withdrawal right has lapsed in accordance with Section 678(a)(2), the beneficiary is thereafter treated as the owner of the trust for income tax purposes.

(c) Again, the trust is drafted so that the creator is intentionally not treated as the owner for income tax purposes, so that Section 678(b) doesn’t apply to “trump” the application of Section 678(a) to the beneficiary.

(d) Because the beneficiary’s power to withdraw lapses within the $5,000/5% lapse protection amount for general powers of appointment, the lapse has no gift or estate tax consequences.

(5) As a wholly grantor trust from the beneficiary’s point of view, the beneficiary pays tax on all trust income (with no gift consequences) – the “tax burn”, and transactions between the beneficiary and the trust (such as sales or loans) are ignored for income tax purposes.

(6) The beneficiary could be the investment trustee, but an independent trustee should be the distribution trustee and must be the insurance trustee with respect to insurance on the life of the beneficiary/trustee.

(a) The beneficiary should have no powers over any trust-owned insurance on his or her life, even as a trustee.

(7) The BDIT can give the beneficiary investment control over the trust (except for insurance on his or her life) and a power of disposition over the trust assets at death (and again, except for insurance on his or her life), but the trust is creditor/predator proof and transfer tax protected from the beneficiary’s point of view.

(8) As a GST-exempt dynastic trust, the BDIT will continue after the beneficiary’s death, subject to his or her special power of appointment, for the beneficiary’s descendants, for life, with the same protections (though not as a grantor trust from their point of view).
BDIT BENEFITS
PROTECTION, USE, CONTROL

➢ CONTROL
  • This does not apply to life insurance on the life of the beneficiary/power holder.

➢ FULL USE AND ENJOYMENT OF TRUST ASSETS
  • Except for Life Insurance on the beneficiary’s life.
  • Life Insurance potentially indirectly accessible through Independent Trustee.

➢ RE-WRITE POWER
  • Special Power of Appointment.
  • Except for Life Insurance on beneficiary’s life.

➢ CREDITOR PROTECTION
  • Including divorcing or dissident spouses.
  • Income taxes paid as a result of grantor trust status depletes original beneficiary’s otherwise exposed estate.

➢ TAX SAVINGS
  • Estate, Gift, and GST Tax Exempt - as long and the assets are kept in trust.
  • Estate Depletion - of initial primary beneficiary’s estate as a result of income tax grantor trust status.
  • Trust Beneficiaries can increase and accelerate their estate planning transfers without economic exposure based upon the security of the controlled trust.
  • Income Tax – after death of initial primary beneficiary.
BDIT CONTROL LIST
PRIMARY BENEFICIARY/TRUSTEE CONTROLS

➢ ADMINISTRATIVE CONTROLS

- Full Management/Investment Control Until Death – as Investment Trustee. This does not apply to life insurance on the life of the beneficiary/trustee.

- Right to Fire and Replace Independent (Distribution) Trustee – Within Constraints of IRC §672 (c) and Rev. Rul. 95-58.

➢ BENEFICIARY CONTROLS

- Full Use and Enjoyment of Trust Owned Assets Until Death – (with or without rent and for any purpose whatsoever). The beneficiary may also use (or determine who uses) the trust owned property and terminate the use of the property. This does not apply to life insurance on the life of the beneficiary.

- Re-Write Power – The ability to essentially revise the trust to adjust for changes in tax laws, trust laws, family dynamics, economics, or for any other reason. This is a Special Power of Appointment and it is permissible as long as the beneficiary does not have the right to exercise this power for him/herself; his/her estate or the creditors of either. This does not apply to life insurance on the life of the beneficiary/power holder.
Investment Trustee:

- Initially Client/Beneficiary
- Full Managerial Control – Except for Life Insurance on the Trustee/Beneficiary’s life. Can create entities and invest in new business and investment opportunities.
- Control of the Identity of the Independent Trustee – Right to fire and replace, with or without cause, subject to IRC §672 (c) and Rev. Rul. 95-58.
- Control Over Who Uses the Trust Assets – Except for life insurance on the Trustee/Beneficiary’s life.

Independent Trustee:

- Makes Tax Sensitive Decisions – Such as distributions.
- Makes all Decisions Pertaining To Life Insurance on Beneficiary/Trustee’s Life
- Makes Decisions Regarding the Purchase or Sale of Hard to Value Assets to or from a Beneficiary – Although not technically required, the independence will add protection.

1 The position of Independent Trustee can be fragmented into:
   ○ A Distribution Trustee – Someone who is an Independent Trustee as provided in IRC §672 (c) and Rev. Rul. 95-58. This does not have to be a confrontational relation – It can be the client/beneficiary’s best friend; and
   ○ An Administrative Trustee – A person, but most often an entity who/which enables the client to obtain favorable jurisdiction. Caveat – the Administrative Trustee must perform sufficient services to access the superior state laws.
BDIT Flowchart #1

Attached Flowchart of a Sale of Business or Investment Assets to a Beneficiary Defective Inheritor’s Trust (a “BDIT”) on an Installment Basis

CIRCULAR 230 DISCLOSURE

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The attached flowchart depicts a simplified version of the series of steps that would be taken to: 1) have a third party create a BDIT, and 2) have the trust beneficiary sell business or investment assets to the BDIT, on an installment basis.
CREATION OF BDIT
FOR SALE OF BUSINESS OR INVESTMENT ASSETS

Parent of Beneficiary or Other Third Party

Gift of $5,000 cash to create and fund a BDIT\(^1\) (GST exemption allocated, assuming the BDIT is a Dynasty Trust)

BDIT \(^2\)

Beneficiary is given right to withdraw the entire gift \(^3\)

\(^1\) Neither the beneficiary (nor anyone else) can make a gift to the trust after the initial funding

\(^2\) Beneficiary is granted a special power of appointment over the trust

\(^3\) That withdrawal right will make the trust a “grantor trust” from the point of view of the beneficiary, since the creator will retain no income tax sensitive powers over the trust. Because the right lapses within the $5,000/5% lapse protection amount, it is not treated as the release of a general power of appointment.
SALE OF BUSINESS OR INVESTMENT ASSETS  

4/ The sale would take place after the beneficiary’s withdrawal right had lapsed; the sale will be of a defined value and a gift tax return would be filed reporting the transaction as a non-gift

5/ May be an existing irrevocable trust, beneficiary’s spouse, the creator of the trust, or any other party who or which has sufficient assets to satisfy the guarantee, if necessary

6/ If the value of assets sold is adjusted by IRS resulting in an unintentional gift, then the beneficiary’s testamentary power of appointment would avoid treating that excess as a completed gift; any excess would be allocated under a formula in the trust to a non-GST exempt share
ANNUAL ADMINISTRATION OF SALE OF BUSINESS OR INVESTMENT ASSETS

Beneficiary

Promissory Note

Annual interest (and any principal prepayment) on promissory note
(Disregarded for income tax purposes)

Income on trust assets taxed to Beneficiary

7/ Payment of income tax by the beneficiary on trust income is not a gift for gift tax purposes

Guarantor(s)

BDIT

Guaranty Fee

Initial Gift

Business or investment assets

Income
COMPLETION OF SALE OF BUSINESS OR INVESTMENT ASSETS AFTER NOTE TERM

Beneficiary

- Repayment of outstanding principal of promissory note and any accrued interest – paid in cash or in kind
  (Disregarded for income tax purposes)
- Satisfaction of promissory note ("Paid in Full")

BDIT

- Initial Gift
- Remaining business or invest. assets

Principal and interest payments
FOLLOWING COMPLETION OF SALE OF ASSETS

Income on trust assets continues to be taxed to Beneficiary for life

Beneficiary

Principal and interest

BDIT

Initial Gift

Remaining business or invest. assets
FOLLOWING DEATH OF BENEFICIARY

Beneficiary’s Estate

Principal and interest

BDIT

Separate Trusts for Descendants for Life ⁸/, then Recycled Down for Future Generations ⁹/

⁸/ Protected from their creditors, spouses, and the transfer tax system

⁹/ Unless modified by the exercise of a limited power of appointment
BDIT Flowchart #2

Flowchart of a Sale of Business or Investment Assets to a Beneficiary Defective Inheritor’s Trust (a “BDIT”) on an Installment Basis and Purchase of a Life Insurance Policy on the Life of the Beneficiary

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The attached flowchart depicts a simplified version of the series of steps that would be taken to: 1) have a third party create a BDIT, 2) have the trust beneficiary sell business or investment assets to the BDIT, on an installment basis and 3) have the BDIT acquire a life insurance policy on the life of the beneficiary.
CREATION OF BDIT
FOR SALE OF BUSINESS OR INVESTMENT ASSETS AND
PURCHASE OF INSURANCE

Parent of Beneficiary or Other Third Party

Gift of $5,000 cash to create and fund a BDIT ¹/
(GST exemption allocated, assuming the BDIT is a Dynasty Trust)

BDIT ²/

Beneficiary is given right to withdraw the entire gift ³/

¹/ Neither the beneficiary (nor anyone else) can make a gift to the trust after the initial funding
²/ Beneficiary is granted a special power of appointment over the trust
³/ That withdrawal right will make the trust a “grantor trust” from the point of view of the beneficiary, since the creator will retain no income tax sensitive powers over the trust. Because the right lapses within the $5,000/5% lapse protection amount, it is not treated as the release of a general power of appointment.
SALE OF BUSINESS OR INVESTMENT ASSETS 4/

Secured Promissory Note with interest paid or accrued at AFR (Disregarded for income tax purposes)

Beneficiary

Partial Guaranty

Guarantor(s) 5/

Guaranty Fee

BDIT

Sale of Business or Investment Assets 6/

Promissory Note

Initial Gift

Business or investment assets

4/ The sale would take place after the beneficiary’s withdrawal right had lapsed; the sale will be of a defined value and a gift tax return would be filed reporting the transaction as a non-gift

5/ May be an existing irrevocable trust, beneficiary’s spouse, the creator of the trust, or any other party who or which has sufficient assets to satisfy the guarantee, if necessary

6/ If the value of assets sold is adjusted by IRS resulting in an unintentional gift, then the beneficiary’s testamentary power of appointment would avoid treating that excess as a completed gift; any excess would be allocated under a formula in the trust to a non-GST exempt share
PURCHASE OF INSURANCE

Life Insurance Company

Policy

Initial Premium

BDIT

Policy

Business or Investment Assets

Initial Gift

7/ If the BDIT did not generate enough cash flow to pay premiums, the beneficiary would enter into a private premium financing split-dollar arrangement with the BDIT

8/ Beneficiary cannot hold Trustee powers over the insurance on his or her life, and his or her power of appointment can’t extend to that insurance
ANNUAL ADMINISTRATION OF TRUST

Life Insurance Company

Guarantor(s)

Premiums

Guaranty Fee

BDIT

Beneficiary

Promissory Note

Annual interest (and any principal prepayment) on promissory note (Disregarded for income tax purposes)

Income on trust assets taxed to Beneficiary

Initial Gift

Business or investment assets

Policy

9/ Payment of income tax by the beneficiary on trust income is not a gift for gift tax purposes
COMPLETION OF SALE OF BUSINESS OR INVESTMENT ASSETS AFTER NOTE TERM

Beneficiary

Life Insurance Company

BDIT

Satisfaction of promissory note ("Paid in Full")

Repayment of outstanding principal of promissory note and any accrued interest – paid in cash or in kind (Disregarded for income tax purposes)

Principal and interest payments

Initial Gift

Remaining business or invest. assets

Policy

Premiums
FOLLOWING COMPLETION OF SALE OF ASSETS

**Beneficiary**

- Principal and interest

**BDIT**

- Life Insurance Company
  - Premiums
  - Initial Gift
  - Remaining business or invest. assets
  - Policy

*Income on trust assets continues to be taxed to Beneficiary for life*
FOLLOWING DEATH OF BENEFICIARY

Beneficiary’s Estate

Principal and interest

Life Insurance Company

BDIT

Separate Trusts for Descendants for Life ¹⁰/
(funded with remaining trust assets and death proceeds), then Recycled Down for Future Generations ¹¹/

¹⁰/ Protected from their creditors, spouses, and the transfer tax system

¹¹/ Unless modified by the exercise of a limited power of appointment