

The Beneficiary Defective Inheritor's Trust ("BDIT")

**NAEPC 46th Annual Conference
Amelia Island Plantation
Amelia Island, Florida
November 11-13, 2009**

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Primary Planning Choices of High-End Wealth Shifting

- Techniques
 - ◇ GRATs
 - ◇ Installment Sales to IDGTs
- Both Involve Moving Wealth to Someone Else
- BDIT Alternative

Major Causes of Wealth Erosion

- ❑ Mismanagement
- ❑ Taxes
- ❑ Lawsuits
- ❑ Divorce

Fundamental Fact of Wealth Planning

- ❑ Trusts Enhance Gifts and
Bequests

Inheriting in Trust is Better than Inheriting Outright

- ❑ Trusts offer many significant advantages that cannot exist for assets owned outright
- ❑ Assets received and retained in trust are more valuable to the inheritor than assets received outright

A Trust “Shelters” Inherited Assets From the Beneficiaries

- Taxes

- ◇ Transfer Taxes

- ◇ Income Taxes

- Would Be Claimants

- ◇ Creditors

- ◇ Divorcing Spouses

Ultimate Creditor and Divorce Protection Vehicle

“A 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.” (Emphasis supplied)

Frederick R. Keydel

“Trustee Selection, Succession, and Removal: Ways to Blend Expertise with Family Control,” 23 U. Miami Inst. On Est. Plan., Ch. 4 (1989) at § 409

Overlooked Benefit – Particularly in Today's Volatile Economic World

- ❑ Enables beneficiary to borrow for business or investment purposes without exposing trust-owned assets to risk
- ❑ Lending institution typically requires personal guarantees of business owners and their spouses

Family Business

- ❑ Often most important asset to be protected is family business
- ❑ Goose that lays the Golden Eggs

Query

Can our wealthy client set up a trust for himself and protect his assets from taxes and predators?

The Tax and Creditor Rights Impediments

- ❑ Income Tax – Grantor Trust
- ❑ Estate Tax – Grantor Trust
- ❑ Creditor's Rights – self-settled trust

The BDIT Solution

- Anyone other than the client himself can set up the trust

Key Concepts

- ❑ Must be set up and funded by someone else

- ❑ Beneficiary can not make “gifts” to the trust
 - ◇ Directly, or
 - ◇ Indirectly

Question #1

Can I set up a trust for my descendants which would avoid both their:

- Transfer Taxes, and
- Creditors, including divorcing spouses

Inheritor's Trust

- Set Up and Funded By Someone Else
 - ◇ Generally As An Accommodation

Transfer Tax Consequences

- ❑ Measured by Amount of Contribution
- ❑ Subsequent Growth Irrelevant
- ❑ GST Exempt

Remember Key Concepts

- ❑ Trust Created By Someone Else
- ❑ No Gratuitous Transfers
By Beneficiaries

Question #2

What are the income tax consequences of a gift subject to a Crummey Power of Withdrawal?

Consequences of a Defective Trust Including a Beneficiary Defective Trust

- ❑ Rev. Rul 85-13

- ❑ Tax Burn

“Tax Burn” Concept

- ❑ Estate depletion as a result of paying income tax on trust assets
 - ◇ Less exposed to estate tax
 - ◇ Less exposed to creditors

- ❑ Over time more powerful than discount

- ❑ Trust grows tax-free during “Grantor” trust status

Question #3

What are the gift tax implications if I pay income tax as a result of the grantor trust rules?

Question #4

If I make a sale to a trust that is income tax defective to me, do I realize gain or loss?

Question #5

If I own 100% of an entity and I make a gift of 20% interests to each of my five children, are the gifts each valued as a non-controlling interest?

Combine Virtues of

1. Ch. 13
2. IRC § 678
3. Rev. Rul. 2004-64
4. Rev. Rul. 85-13
5. Rev. Rul. 93-12

BDIT

- Mom is Grantor
 - ◇ Transfer Tax
 - ◇ Creditor Rights

- Wealthy Client is Grantor
 - ◇ Income Tax Purposes

**BDIT is generally designed
as a Beneficiary Controlled
Trust**

Opportunity Shifting

- ❑ Shifting of a favorable business or investment opportunity is not a gift
- ❑ BDIT is a wonderful recipient of opportunity shift
- ❑ Ancillary benefit-funded ILIT

The BDIT Strategy

- ❑ Client's parent sets up BDIT funding it with \$5,000
- ❑ Client is given power of withdrawal
- ❑ Client sells discountable interests in the entity to trusts for notes

Parent is Settlor

- Client's parent sets up BDIT funding it with \$5,000
 - ❖ Parent uses independent funds
 - ❖ Parent is settlor for transfer tax and creditor right purposes
 - ❖ Sale by beneficiary is for "full and adequate consideration"

Beneficiary Defective Trust

Trust is defective to client for
income tax purposes

- ❖ Power of withdrawal IRC
§ 678(a)
- ❖ Transactions between client and
trust ignored. Rev. Rul. 85-13

Result - Tax

Freeze, Squeeze and Burn

- Estate Freeze
 - ❖ Notes in estate
 - ❖ Post-transfer appreciated shifted

- Estate Thaw
 - ❖ Discount removed from transfer tax system (squeeze)
 - ❖ Tax Burn

Result – Non-Tax

- ❑ Client in control of BCT
- ❑ Hot asset creditor protected for client and family
- ❑ Assets available after “tax burn”
- ❑ Re-write power - Protects against potential family conflicts

“Seeding” the Trust

- ❑ Must come from donor’s funds

- ❑ Economic Validity
 - ❖ Debt-Equity Ratio
 - ❖ Rule of thumb 10% or 9:1

Guarantees

- Guarantees as “seed” money
 - ❖ Must be legitimate
 - ❖ Better than trust assets
 - ❖ Often made by beneficiaries
 - ❖ Need not be for full amount of the note

Is a “gratuitous” guarantee a gift

- Unsettled
 - ❖ Cases seem to say no

- We pay for the guarantee
 - ❖ Get appraisal
 - ❖ Avoids risk of gift to trust by guarantor

Safe Transaction – Valuation Disparity

- Gift Tax/Chapter 14
 - ◇ SPA Protects Against Inadvertant gift
 - ◇ Gift incomplete
Reg § 25.2511-2(b)

- Estate Tax/GSTT
 - ◇ Report the sale

IRS Reporting of Sale to Trust

- Timely File Form 709
 - ◇ Non-completed gift
 - Treas. Reg § 301-6501(c) – 1(f)(4)

- If IRS does not challenge valuation

IRS Reporting of Sale to Trust *cont'd*

- If IRS successfully challenges valuation
 - ◇ Incomplete gift Treas. Reg. § 25-2511-2(b)
 - ◇ Allocation pro-rata between exempt and non-exempt trusts

- Safer than alternative strategies

Life Insurance - ILIT

- BDIT can be a wonderful funded ILIT

- Insurance on beneficiary who is also a trustee
 - ◇ Decisions made by independent trustee
 - ◇ No power of appointment

Life Insurance Correlation with BDIT

- Life insurance two component parts
 - ❖ Death benefit
 - ❖ Inside buildup
 - Asset class
 - QRP and NIMCRUT alternative

Life Insurance Correlation with BDIT *cont'd*

□ Early Death

- ❖ Negligible Tax Burn
- ❖ Win on the Mortality Bet

■ Later Death

- ❖ Greater estate tax depletion
- ❖ Tax-free build-up more dramatic

Primary Retirement Planning Alternatives

- Goal – tax exempt or tax deferred wealth accumulation
- Vehicles
 - ❖ Qualified Retirement Plans (“QRPs”)
 - ❖ NIMCRUTs
 - ❖ Cash Value Life Insurance (“CVLI”)