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

A Powerful New Wealth Planning Strategy

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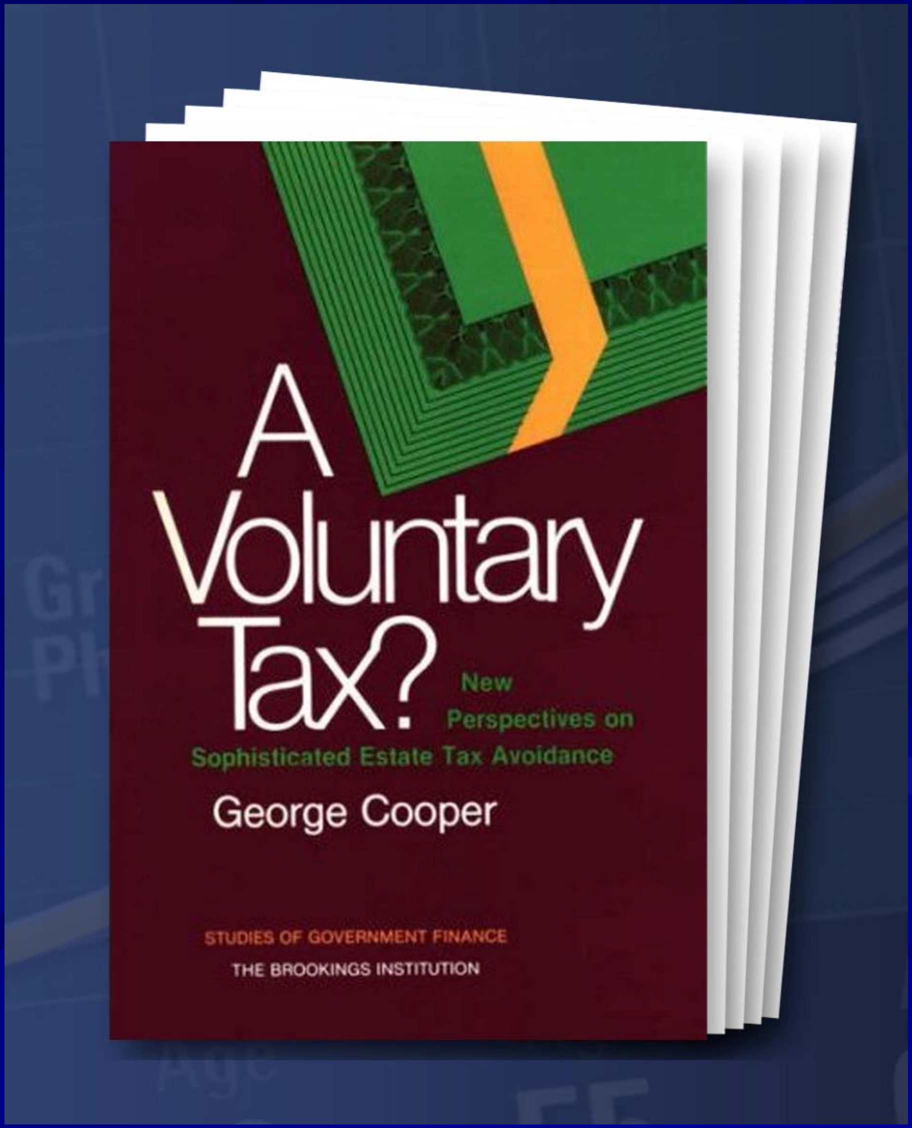
A Voluntary Tax ? [1, 2]



Primary Planning Choices of High-End Wealth Shifting

- Techniques
  - GRATS
  - Installment Sales to IDGTs
- Both Involve Transferring Wealth to Someone Else
- BDIT Alternative

BDIT Creation

- Inheritor's Trust
  - ◊ Mom (or Third Party) Establishes GSTT Exempt Irrevocable Trust

- Beneficiary Defective
  - ◊ Beneficiary is Given a Lapsing Crummey Power of Withdrawal Over the Entire Gift

* *See BDIT Schematic – Exhibit A*

Client's "Wish" List

- Control
- Use and Enjoyment of Their Wealth
- Creditor Protection
- Save Taxes

Four Major Ways Large Amounts of Wealth is Lost in the U.S.

- Mismanagement
- Taxes
- Lawsuits
- Divorces

Fundamental Fact of Estate Planning

- Assets Received and Retained in Trust Offer Many Significant Advantages That Cannot Exist for Assets Owned Outright [4, 5, 6, 7, 8]

A Trust "Shelters" Inherited Assets From the Beneficiaries [9, 10]

- Taxes
  - Transfer Taxes [11, 12]
  - Income Taxes
- Would Be Claimants [13, 14, 15]
  - Creditors
  - Divorcing Spouses

Technical Rules

The Technical Rules

- IRC §2036
- IRC §2043
- Asset Protection – Fraudulent Transfer Considerations

IRC §2036(a)

General Rule – The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a ***transfer*** ***(except in case of a bona fide sale for an adequate and full consideration in money or money's worth),*** by trust or otherwise, under which he has ***retained***

(1) the possession or enjoyment of, or the right to the income from, the property, or

(2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.

IRC §2043

In General – If any one of the transfers, described in sections 2035 to 2038 and 2041 is made, for a consideration in money or money's worth, but is not a bona fide sale for an adequate and full consideration in money or money's worth, there shall be included in the gross estate only the excess of the fair market value at the time of death of the property otherwise to be included on account of such transaction, over the value of the consideration received therefore by the decedent.

Asset Protection

The key to avoiding a constructive fraud claim is simply to ensure that *reasonably equivalent value* is received in exchange for any transfer. *

* Adkisson and Riser, *Asset Protection, Concepts & Strategies for Protecting Your Wealth,* p 60 (2004)

BDIT – KEY CONCEPTS

- Set Up and Funded by Someone Else
- Beneficiary Can Not Make Gifts to the Trust
    - Directly or Indirectly
    - Sales for Equal Value are OK

BDIT – KEY CONCEPTS

cont'd

- ❑ Transfer Tax Consequences
  - ◊ Measured by the Value of Contribution - Rev. Rul. 93-12
  - ◊ Subsequent Growth Irrelevant
- ❑ Beneficiary Given a Lapsing Power of Withdrawal Over Gift

BDIT

- Mom is Grantor
  - Transfer Tax
  - Creditor Rights
- Client is Grantor
  - Income Tax Purposes [17, 18, 19]

Benefits of Receiving Assets in Trust 20

- Because Mom Set Up the Trust
  - Transfer Tax Protected (Wish List #4)
  - Creditor Protected (Wish List #3)

- Even Though I am Given
  - Use and Enjoyment (Wish List #2)
  - Control (Wish List #1)

Income Tax Consequences of Power of Withdrawal [21, 22]

- Rev. Rul. 85-13 [23]
- Tax Burn

"Tax Burn" Concept

- Client's Wealth Depleted by Tax Paid as a Result of Grantor Trust Status [24]
- Trust Grows Tax-free
- Client's Wealth Shifted Tax-free to Beneficiary Controlled Trust
  - Income Tax-free
  - Transfer Tax-free

Trust Design

"Beneficiary Controlled Trust"

**See Exhibit B*

Traditional Trusts – Typical Characteristics

- Pays Out Income
- Principal May be Invaded for "HESM" – "Support Trust"
- Distributes Assets at Specified Ages
- Beneficiary Not in Control

Modern Trust Design[26, 27]

- Full Discretionary
- Perpetual
- "Use" Concept [28, 29, 30]
- Broad SPAs – "Re-write Power"
- Controlled Trusteeship at Proper Time
  - Family Trustee
  - Independent Trustee

Beneficiary Controlled Trust

- Family Trustee
  - ◊ Controls Investments
  - ◊ Controls Identity of the Independent Trustee

Beneficiary Controlled Trust *cont'd*

- ❑ Independent Trustee
  - ◊ Controls All Tax Sensitive Decisions
  - ◊ Individual or Institution Who Meets the Criteria of IRC §672(c)
- ❑ "Independence" Does Not Require a Confrontational Relationship

Beneficiary Controlled Trust *cont'd*

- Client has Dispositive Controls
  - Right to Use Trust Assets
  - SPA – "Rewrite Power"

Estate Planning Basics

High-End Wealth Shifting

- The "Estate Planner's Dream"
- Combine the Three Most Popular Estate Planning Concepts
  - FLPs, LLCs and "S" Stock
  - Valuation Discounts
  - Trusts

Freeze, Squeeze and Burn [33]

- Three Components of High-End Wealth Shifting
  - Estate Freeze
  - Valuation Discounting [34]
  - "Estate Depletion" as a Result of Grantor Trust Status

Component Comparison

Case Study #1

Existing Business or Investment Facts

- Client Owns a Business Worth $10 Million
- Income/Cash Flow 10%
- Flow Through Entity
- Expected Growth – Double Every 10 Years
- Assumed Discount – 35%

Estate Freeze Component

- Concept
  - Freeze the Estate at Current Value
  - Shift Future Appreciation
- $40 Million
  - $10 Million in Estate
  - $30 Million Shifted

35% Discount – Squeeze Component

- Asset Transferred Worth $10 Million
- Receive Back a Note Worth $6.5 Million
- $3.5 Million Disappears From Transfer Tax System

35% Discount – Squeeze Component
cont'd

- Valuation Discounting
  - ◊ Principal Focus of IRS Attack
  - ◊ Larger Discounts Increase Risk of Audit

“Tax Burn” Component

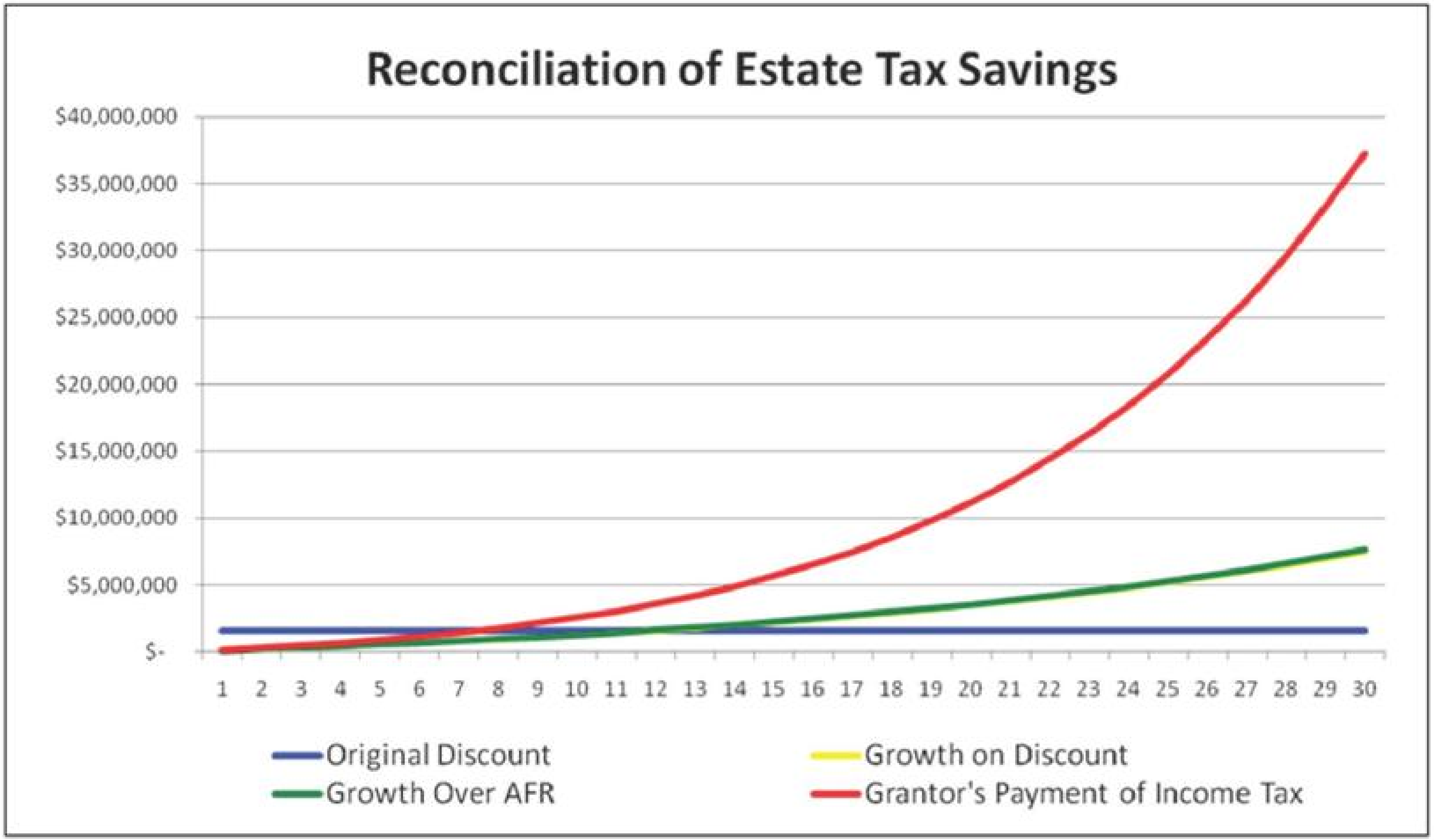
- Estate Depletion as a Result of Grantor Trust Status
  - Inherent in IDGTs, GRATs and BDITs
- Not Audit Sensitive
- Over Time Most Significant Factor

Tax Burn Significance

- Over Time – 10% Income; 40% I/T
  - ◊ $10 Million Entity - $400,000
  - ◊ $20 Million Entity - $800,000
  - ◊ $40 Million Entity - $1.6 Million
- Estate Depletion
  - ◊ Payment of Income Tax
  - ◊ Living Expenses

Significance

- Short Term
  - Discount
- Long Term
  - Tax Burn
  - Freeze
  - Discount


Reconciliation of Estate Tax Savings
$40,000,000
$35,000,000
$30,000,000
$25,000,000
$20,000,000
$15,000,000
$10,000,000
$5,000,000
$-
1 2 3 4 5 6 7 8 9 10 11 12 13 14 15 16 17 18 19 20 21 22 23 24 25 26 27 28 29 30
Original Discount
Growth on Discount
Growth Over AFR
Grantor's Payment of Income Tax

Life Insurance Correlation with BDIT

Life Insurance Correlation with BDIT

- Life Insurance-Two Component Parts
  - Death Benefit
  - Inside Buildup
    - > Asset Class
    - > QRP 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

Opportunity Shifting

36, 37, 38, 39, 40, 41

Case Study #2
Opportunity Shifting

- Client Has
  - A New Business or Investment Opportunity
  - Has an Ancillary Business Opportunity
- Typical Planning
  - Limited to Choice of Entity
- BDIT Solution

Estate Planning Implications of Opportunity Shifting in a BDIT

- ❑ Client in Control
- ❑ The Business (or Investment Opportunity) is Never Exposed to:
  - ◊ Transfer Taxes, or
  - ◊ Creditors [42]
- ❑ The Client's Personal Wealth is "Tax Burned"

Installment Note Sales

Case Study #3

Note Sale(s)

- Installment Note Sale of Discountable Income Producing Assets to BDIT(s)
- Multiple BDITs if Own Control

Steps

- Third Party Sets Up and "Seeds" BDIT
- Client is Given Power of Withdrawal
- Client Sells Discountable Interests in the Entity to Trusts for Notes

Sales to BDIT

- Gifts Prohibited
- Sales for Equivalent Value Exception
  - Estate Tax
  - Creditor Rights

Technical Rules We Must Follow

- Estate Tax
  - “Fair and Adequate Consideration” Exception
- Asset Protection
  - “Reasonably Equivalent Value” Exception*

*Adkisson and Riser, *Asset Protection – Concepts & Strategies for Protecting Your Wealth,* p 59-61 (2004)

“Seeding” the Trust

- Must Come From Donor’s Funds
- Economic Substance
  - 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

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

Parent is Sole Settlor

- Parent Settlor
  - Transfer Tax
  - Creditor Rights
- No Gift by Client - Sale by Beneficiary is for "Equal Value"
- No Gift by Guarantor - Adequate Guarantee Fee

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 Appreciation Shifted
- Discount Removed from Transfer Tax System (Squeeze)
- Estate Depletion – Grantor Trust Status

Result – Non-Tax

- Client in Control of BCT
- Key Family Asset Creditor Protected for Client and Family
- Assets Available to Client
- Rewrite Power – Protects Against Potential Family Conflicts

Tax Risks and Tax Protection

Tax Risks
(If Done Incorrectly)

- Income Tax
  - Gain on Sale
  - Possible Loss of "S" Status
  - IRC §§ 672(e); 1041
- Gift Tax [45]
- Chapter 14 – IRC §§ 2701 and 2702

Tax Risks
(If Done Incorrectly) *cont'd*

- ❑ Estate Tax – IRC § 2043
  - ◊ If LI – IRC §2042

- ❑ GST Tax [46]
  - ◊ ETIP – Inability to Allocate GST Exemption – IRC §2642(f)(3)

IRS Reporting of Sale to Trust

- Income Tax
  - ◊ Elect Out of Installment Reporting

- Gift Tax
  - ◊ Timely File Form 709
  - ◊ Non-Gift Transfer
    Treas. Reg § 301-6501(c) - 1(f)(4)

IRS Reporting of Sale to Trust *cont'd*

- If IRS Does Not Challenge Valuation

- If IRS Successfully Challenges Valuation[47]
  - ◊ Incomplete Gift
    Treas. Reg § 25-2511 – 2(b)
  - ◊ Allocation Pro-rata Between Exempt and Non-exempt Trusts

IRS Reporting of Sale to Trust *cont'd*

- Estate Tax
- GST Tax
- Safer Than Alternative Strategies
- Finality

Funded

ILIT

Case Study #4

Funded ILIT

- BDIT Can be a Wonderful ILIT
  - ◊ Cash Flow From Assets Can Pay Premiums
  - ◊ No Crummey Limitations or Complications
- During Start-up Period
  - ◊ Can Use Split Dollar or Premium Financing
  - ◊ Exit Strategy

Funded ILIT

cont'd

- BDIT Can Own LI on Client's Life
- Two Adjustments
  - Independent Trustee
  - No Power of Appointment
- Accessing Inside Buildup

Retirement Plan Alternatives

** See Exhibit C*

Case Study #5

BDIT as a Retirement Planning Vehicle

- "Private Pension Plan" Concept
  - Really an Over-funded LI Policy
  - Estate Tax Inclusion

Planning With Life Insurance Investment Component

- One of the Most Important Concepts in Wealth Planning is Tax-free or Tax Deferred Growth
- "The Most Powerful Force in the Universe is Compound Interest" Albert Einstein

Primary Retirement Planning Alternatives

- Goal – Tax Exempt or Tax Deferred Wealth Accumulation

- Vehicles
  - ◊ Qualified Retirement Plans (“QRPs”)
  - ◊ Cash Value Life Insurance (“CVLI”)

BDIT (with CVLI) vs. QRP

- Tax-free Growth
- Temporary Access
- IRD
- CVLI in BDIT – No Taxes

BDIT (with CVLI) vs. QRP *cont'd.*

- Employee Coverage
- Risk of Early Valuation Decline
- Survivorship Feature

Buy-Sell Planning

Case Study #6

Buy-Sell Planning

- Newco is Owned 50/50 by A and B
- A’s Parent Sets Up A’s BDIT Which Buys A’s Entity Interest from A
- B’s Parent Sets Up B’s BDIT Which Buys B’s Entity Interest from B

Buy-Sell Planning *cont'd*

A's BDIT	B's BDIT
Owns A's Interest Buys Life Insurance on B's Life	Owns B's Interest Buys Life Insurance on A's Life

Broad Client Profile

Case Study #7

Query

"Why Wouldn't Everyone do a BDIT?"

- Misperception – Only for Ultra Affluent
  - Planning Alternatives Involve Giving to Someone Else
  - BDIT Contains Virtues of Alternative Estate Planning Techniques
  - BDIT Benefits – Substantial and Forever

Planning for the Mid-Range Client

- The Client with a
  - $10 Million Business
  - $1 Million Home
  - $1 Million Other Assets
- The Dilemma
  - Tax and Creditor Exposure
  - Can Not Afford to Give Wealth Away

Mid – Range Client

- GRAT and IDGT
  - Prohibition Against Transfers with Retained Rights
- BDIT
  - "Fair and Adequate Consideration" Exception
- Really the "Only" Option

BDIT vs. Other Strategies

BDIT vs. Note Sale to IDGTs

- Wealth Shifting Benefits [49, 50]
  - Retained interest often creates continued Sec. 2036 exposure
  - No Need to Retain Anything
- Control
- No Economic Risk
  - Managerial
  - Use and Enjoyment
  - Rewrite Power
  - Tax Burn [51]

BDIT vs. Note Sale to IDGTs

cont'd

- Safety
  - Gift Tax
  - Step Transaction
  - Pierre v. Comm'r

BDIT vs. APTs

- Greater Creditor Protection
  - Not a Self-Settled Trust
- Transfer Tax Savings
- Control
- Use and Enjoyment Determined by Client
- APTs Continuing Costs

BDIT vs. FLPs

- Historical Purpose of FLPs
  - Control
  - Valuation Discounts
- IRC § 2036 Exposure
  - There is no IRC §2536
- Substantial Non-Tax Purpose

BDIT vs. ILITs

- ❑ Built-in Funded ILIT
- ❑ No Crummey Complexities and Limitations
- ❑ Living Benefits of LI
  - ◊ Access to “Inside Build-Up”

BDIT and Other Estate Planning Vehicles

- Revocable Trusts
- Gifting
- Charitable Planning
- Business Succession Planning

BDIT and Other Estate Planning Vehicles *cont'd*

- Pre-Nuptial
- Unmarried Partners
  - Traditional
  - Non-Traditional
- Planning for Physicians
- Planning for Athletes and Entertainers