Date: 14-Dec-10
From: Steve Leimberg's Estate Planning Newsletter
Subject: **The Beneficiary Defective Inheritor's Trust: Is It Really Defective?**

LISI has never been afraid of a spirited debate, and that's exactly what members get in today's commentary by **Avi Kestenbaum**, **Jeff Galant** and **Eli Akhavan**, on the Beneficiary Defective Inheritor's TrustTM ("BDIT").

The BDIT is no stranger to **LISI** members. In Estate Planning Newsletter #1559, **Jonathan G. Blattmachr** and **Diana S. C. Zeydel** informed members about trusts that are defective with respect to their beneficiaries, and more specifically, and important private ruling by the Service, PLR 200949012. In their commentary, they demonstrated how to create a trust that remains a section 678 trust, even after the power to withdraw all property from the trust lapses, and explained why this produced an important planning option for clients.

By contrast, **Avi Kestenbaum**, **Jeff Galant** and **Eli Akhavan** believe that it would be difficult, if not impossible, to create a comprehensive estate plan utilizing a BDIT in most circumstances. Because they see some estate planners touting the BDIT as a "safe" technique and a "panacea" for all estate plans, they have serious concerns regarding the effectiveness of the BDIT both for gift and estate tax purposes, as well as for creditor protection purposes. The authors believe there are more conservative estate planning techniques, which are similarly effective, but do not carry the risks of the

BDIT.

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Now, here is their commentary:

EXECUTIVE SUMMARY:

Over the last few years, there have been several articles written[i], as well as the issuance of Private Letter Rulings[ii], regarding the potential benefits

and tax consequences of the Beneficiary Defective Inheritor's TrustTM ("BDIT"). Briefly, the BDIT is an irrevocable trust, which is structured to be a "grantor trust" with respect to the beneficiary and not the grantor, yet allows the trust assets to be accessible to the beneficiary in this "best of both worlds" planning approach.

While Private Letter Rulings 200949012 and 201039010 clearly gives credibility to the possibility of creating this trust for income tax purposes, it is the authors' contention that for practical purposes it would be difficult, if not impossible, to create a comprehensive estate plan utilizing a BDIT in most circumstances. Furthermore, some estate planners are touting the BDIT not only as a "safe" technique, but also as the panacea for all estate plans.

The authors have serious concerns regarding the effectiveness of the BDIT both for gift and estate tax purposes, as well as for creditor protection (even if a BDIT is effective for income tax purposes). Finally, the authors believe there are more conservative estate planning techniques, as will be discussed briefly herein, which are similarly effective[iii], but do not carry the risks of the BDIT .

A comprehensive comparison of these other techniques to the BDIT will be the subject of a future **LISI** commentary written by the authors.

Advocating a "one size fits all" planning approach as some BDIT proponents and BDIT materials seem to imply is likely detrimental to both clients and planners.

FACTS:

What is the BDIT: General Structure

The progenitor of the BDIT as a planning technique is the "grantor trust". [iv] A "grantor trust" is a trust which is disregarded for federal income tax purposes and all items of income, losses, deductions, and credits that would be attributed to the trust are instead attributed to the grantor of the trust. Furthermore, gain or loss is not recognized in transactions between the grantor and the grantor trust.[v] The popular estate freeze known as the "Sale to Grantor Trust" or more commonly referred to as the "Installment Sale to the Intentionally Defective Grantor Trust" [vi] is based on this premise.

A similar principle applies to a "non-grantor" beneficiary of a properly structured BDIT. A trust beneficiary, who is not the trust's grantor, will be treated as the trust's owner for income tax purposes if that beneficiary holds the unilateral power to withdraw principal and income from the trust (and the trust is not structured as a "grantor trust" with respect to the grantor). [vii] If the trust is structured as a "grantor trust" with respect to the beneficiary through this withdrawal power, the beneficiary should not recognize gain or loss in transactions with the BDIT, similar to the result with the "Sale to Grantor Trust".

In the typical BDIT structure, the grantor transfers assets to a "non-grantor" trust with respect to the grantor and the BDIT grants the beneficiary the power to alter the disposition of the trust assets through the power of withdrawal over the entire trust corpus. The purpose of this withdrawal power is to ensure that the beneficiary is treated as the owner of the BDIT for income tax purposes.[viii] The BDIT is designed to meet the requirements of Section 678(a)(1) which provides that a person, other than the grantor, is treated as the owner of the trust for income tax purposes if that person has the power to vest the principal or income in himself. Typically, the BDIT will provide a "Crummey"-like power of withdrawal to the beneficiary to confer the Section 678 withdrawal power.

There are, however, complications with this withdrawal power. As a general rule, if the holder of the power allows it to lapse, the lapse may constitute a transfer for gift tax purposes.[ix] An exception to this rule is that the lapse will not constitute a transfer to the extent that the power does not lapse in any given calendar year in an amount greater than $5,000 or 5% of the value of the property over which the power is exercisable.[x] Accordingly, a limitation of the BDIT is that if the beneficiary's power lapses in any calendar year in an amount that is in excess of the greater of $5,000 or 5% of the value, a transfer for gift tax purposes will occur. Furthermore, as will be explained below in Section II(B)(2), the lapse must constitute a "partial release" for the trust to remain a "grantor trust" with respect to the beneficiary. Therefore, the architects of the BDIT advise that the grantor must only contribute $5,000 to the trust to: (1) avoid potential later taxable transfers by the beneficiary; and (2) ensure that the BDIT remains a "grantor trust" with respect to the beneficiary.

The BDIT is often structured with two trustees: the primary beneficiary as the investment trustee; and an independent trustee such as a corporate fiduciary, as the distribution trustee (though, depending upon applicable state debtor-creditor law, the primary beneficiary may be given the power to hire or fire the distribution trustee). As will be discussed below, the beneficiary is also provided a testamentary limited power of appointment, so that if the beneficiary's transaction with the trust is later deemed to be for less than full and adequate consideration, an incomplete gift has occurred and no gift tax is due. Based on PLR 200949012, some commentators have suggested that the BDIT provisions should provide the beneficiary with the unilateral right to withdraw contributions made to the trust for: (1) any reason at all (which power lapses, as discussed above); and (2) the beneficiary's health, education, maintenance and support so that the trust remains a grantor trust, as will be discussed below in Section II(B)(2). [xi]

The grantor's contribution of $5,000 to the BDIT will qualify for the gift tax annual exclusion. However, a gratuitous transfer by the beneficiary to

the trust will likely be considered a gift of a future interest (except to the extent of the present value of the beneficiary's interest) and therefore will not qualify for the gift tax annual exclusion. A gift will have occurred to the extent that the beneficiary engages in a transaction with the BDIT for less than full and adequate consideration (once again, the proponents of the BDIT advocate providing the beneficiary with a testamentary limited power of appointment to render the transfer incomplete for gift tax purposes). For estate tax purposes, the proponents of the BDIT assert that the value of trust assets should not be includible in the grantor's estate nor in the beneficiary's estate (though, as will be discussed below, to avoid estate inclusion in the beneficiary's estate on a potential incomplete gift, it is recommended that the BDIT be set up in jurisdiction that protects self-settled trusts).

BDIT advocates maintain that the BDIT provides asset protection from the beneficiary's creditors for a variety of related reasons. First, the trust is irrevocable and created and funded by the grantor. Second, while the beneficiary has the potential use and beneficial enjoyment of the trust property upon distribution by the trustee, his powers are sufficiently limited so that creditors cannot reach the trust assets. (Yet, as will be explored in Section II(D) below, the BDIT must always strike the complex balance between: (1) sufficient power so that the beneficiary is considered the "owner" of the trust for income tax purposes; and (2) limited control so that the beneficiary's creditors cannot reach the trust assets.)

Incredibly, unlike the traditional Sale to the Grantor Trust, which does not allow the "seller grantor" to benefit from the appreciation in value of the trust assets since the note is frozen at the time of sale, the BDIT is structured to allow the "seller beneficiary" to benefit from the appreciation in value of the trust assets since the seller is the beneficiary of the trust. The authors acknowledge that in the right, but limited circumstances, the BDIT might provide excellent planning opportunities (though as discussed below, even in these limited situations, there might be better alternatives, and to be safe, counsel must determine whether a Private Letter Ruling should be sought each time before the BDIT is implemented).

Capitalizing the BDIT

As previously mentioned, the BDIT is specifically designed to allow for the later purchase of assets by the trust from the beneficiary for an installment note. For a successful transaction, the BDIT should be sufficiently capitalized to make such purchase. As a practical matter, if the debt-to-equity ratio in the installment sale is too high (thinly capitalized), the IRS may recharacterize the sale to the BDIT as a disguised gift with a retained income interest, thereby subjecting the sale to possible gift taxation as a failed GRAT and causing the assets to be included in the beneficiary's estate.[xii] For the proper level of capitalization, many practitioners rely on

the 10% rule of thumb (i.e., generally seeding the trust with 10% of the purchase price). For example, the BDIT should be seeded by the grantor with approximately $1 million in order to substantiate a purchase of assets valued at $9 million dollars from the beneficiary. The 10% rule of thumb is based on Private Letter Ruling 9535026 in which it was agreed that at least 10% of the purchase price would be contributed as part of the trust equity, as well as guided by general debt/equity principles that cautious practitioners utilize.[xiii] The BDIT advocates dismiss the 10% requirement and suggest that a proper guarantee by the beneficiary or unrelated third party will obviate the necessity for the 10% requirement. (See the discussion on the guarantee in Section II (B)1 below.)

COMMENT:

Concerns with the BDIT: Step Transaction[xiv]

The common law step transaction doctrine is sometimes effectively used by the government to deny a taxpayer the tax benefits of a particular transaction, which involves several inter-related steps that independently may not create any tax issues. In applying the step transaction doctrine, the IRS or a court will not treat the various steps as independent thus collapsing the steps into a single transaction.

In determining whether the steps in a particular transaction should be collapsed, one or all of the following related tests may apply:

- The binding commitment test;
- The end result test; and
- The mutual interdependence test.

The binding commitment test applies when the parties to a transaction "commit" themselves to reach a specific result from the outset of the transaction. The end result test considers whether the steps to a particular transaction would have excluded all other results. The mutual interdependence test examines whether the different steps in a transaction are so interdependent that individually, the steps would be "fruitless" without the completion of a series of transactions. In the estate planning context, the IRS and the courts have applied the step transaction doctrine in some recent cases involving family limited partnerships ("FLPs") cases (e.g., Linton v. United States[xv], Heckerman v. United States[xvi], and Pierre II[xvii]) to support the contention that taxable gifts were made.

The general BDIT structure appears to have many of the elements necessary to apply the step transaction doctrine. From the outset, the grantor (generally a parent) enters into an implicit agreement with the beneficiary (generally a child) to engage in a contrived series of transactions, namely the creation of a very specially designed trust, followed by the funding of exactly $5,000, and sale by the beneficiary to the trust, to achieve tax benefits (implicating the binding commitment and end result tests). Each step of the transaction appears to have been specifically designed to avoid

taxes (with limited economic purpose) and may not have independent significance (implicating the mutual interdependence test).

Some may argue that the BDIT structure is similar to the standard Sale to the Grantor Trust, which the IRS has not attacked under the step transaction doctrine. However, the Sale to Grantor Trust is different from the BDIT in two significant ways.

First, a properly structured Sale to a Grantor Trust attempts to mimic an arms-length sale between unrelated parties. The "grantor seller" is neither a trustee nor a beneficiary of the trust. Under the typical BDIT structure, practically speaking the seller (beneficiary) and the buyer (trust) are economically the same person since the trust is for the benefit of the beneficiary and the beneficiary may also be a trustee.

Second, for the BDIT structure to be viable, even according to its proponents, there must always be a $5,000 or less initial contribution by the grantor to the trust and the designed 5 x 5 lapse (with a carefully and similarly worded trust document each time to deal with: (1) the lapse; (2) the retention of grantor trust status with respect to the beneficiary; and (3) an incomplete gift if the transaction between the beneficiary and the trust is determined to be for less than full and adequate consideration) for every single BDIT.[xviii]

Accordingly, it is the authors' concern that the contrived nature of the BDIT may expose it to the risk of being collapsed under the step transaction doctrine as a disguised self-settled trust. The BDIT trademark, as well as the BDIT planning materials presented to the client and other advisors from the outset of the planning, is also not helpful.

Issues with Capitalization: Mismatch of Trust Funding and Asset Purchase

As previously mentioned, BDIT proponents believe that the BDIT should only be funded with $5,000 because of the lapse issues. For illustration purposes, let's suppose that the BDIT will purchase assets from the beneficiary with a value of $20 million, but the BDIT only has $5,000 in funds. BDIT advocates suggest that a third party with financial wherewithal guarantee the note (or a portion of the note)[xix] and a reasonable guaranty fee should be paid by the trust to the guarantor since a gratuitous guarantee might constitute a gift.[xx] Note the guarantee fee is taxable to the guarantor but probably not deductible by the beneficiary, which is a drawback.

Even if the guarantee is a viable possibility, would the sale of $20 million in assets to a trust with $5,000 be respected for tax and creditor protection purposes? The BDIT certainly does not appear to always be a "safe" technique as its advocates have suggested.[xxi] The BDIT is severely limited in its effectiveness as it seems it should only be used in purchases of assets of insubstantial value that will likely significantly increase in value

over time.
Furthermore, if that is the case, there seems to be more conservative, less complicated and less costly, but similarly effective alternative techniques to implement, such as the creation of a trust by a spouse for the benefit of the other spouse and issue, intra-family and intra-trust loans, freeze partnership, and Family Limited Liability Company (or FLP) with carefully drafted "waterfall provisions", as will be discussed below in Section III and which will also be the subject of a future LISI Newsletter comparing and contrasting to the BDIT . Additionally, even if the BDIT is implemented in situations involving asset purchases from the beneficiary of insubstantial value, there are other serious concerns as mentioned above and as follow below.

Loss of Beneficiary's Tax "Owner" Status
A fundamental complication arises from fact that the beneficiary's power of withdrawal is limited to the 5 x 5 lapse each year. This gradual limitation may cause the beneficiary to stop being treated as the owner of the BDIT for income tax purposes, which could jeopardize the entire BDIT structure. Section 678(a)(2) provides that a trust remains a beneficiary-owned trust for income tax purposes if: (1) a power is partially released or otherwise modified by the beneficiary; and (2) the trust would be a grantor trust with respect to the grantor if the grantor had retained an interest or power described in any of Sections 671-677.
Accordingly, if the beneficiary partially released or otherwise modified the power, and if any of the conditions in sections 673-677 are present, the trust remains a Section 678 trust. The issue is whether a complete lapse of the 5 x 5 power can be considered a partial release for purposes of Section 678(a)(2) or is it a complete release?[xxii] If it is a complete release, the first prong of Section 678(a)(2) is arguably not satisfied and there is significant risk that the beneficiary will not be treated as the BDIT's owner for tax purposes after the lapse.
Some commentators have suggested giving the beneficiary a unilateral (and not lapsing) power to withdraw for health, education, maintenance and support ("HEMS") to avoid the complete release.[xxiii] Query, however, will this HEMS power subject the BDIT assets to the beneficiary's creditors (depending on the state where the beneficiary resides)? This is a real concern, as will also be discussed in Section II(D) below. Note the IRS did not require that the BDIT provide HEMS to remain as a grantor trust with respect to the beneficiary in PLR 201039010. (In that PLR, the independent trustee had the right to distribute to the beneficiary.) In any event, due to all of this uncertainty, the cautious practitioner should determine whether to request a PLR before each BDIT is implemented to confirm that the BDIT remains as a grantor trust with respect to the beneficiary.

State Income Taxes

The BDIT advocates and materials seem to recommend the BDIT in almost every circumstance. Today, perhaps more than ever with rising income tax rates, state income tax planning is an important component of estate planning.

As previously indicated, BDIT commentators suggest setting up the BDIT in a self-settled trust jurisdiction such as South Dakota, Delaware, Alaska or Nevada, to name a few, where self-settled trusts if set up properly are not subject to claims of the beneficiary's creditors. However, this strategy would eviscerate one of the primary advantages of setting up a trust in these self-settled trust jurisdictions, which is the avoidance of state income taxes. Only the non-grantor trust will potentially avoid state income taxes.

The BDIT is a "grantor trust" with respect to the beneficiary, and the beneficiary will not save on state income taxes unless he is a resident in one of these jurisdictions. While, the standard Sale to Grantor Trust is similarly ineffective for state income tax avoidance, the "grantor trust" might not always be the correct trust to utilize and every planning situation is unique. Many times a "non-grantor" trust will be a more effective alternative (especially if saving state income taxes is important, and other techniques like the "freeze partnership" allow for the non-grantor trust, to benefit from, and pay the income tax, on the assets' growth). Furthermore, the typical BDIT example seems to involve a parent who is the grantor of the trust, and the wealthy child who is the beneficiary of the trust that sells assets to the trust, and if that is the case, the child is probably still fairly young with some time to deal with estate taxes (the BDIT would decrease the child's estate every year the child is responsible for and pays the income taxes) and saving immediate state income taxes might be more important to the child. Every client and planning situation is unique and recommending a "one size fits all" planning approach is likely detrimental to both clients and planners.

Reach of Creditors and Valuation

A principal reason for contributing property to an irrevocable trust is to keep the property beyond the reach of both the contributor's future creditors and the beneficiary's present and future creditors. Success depends upon compliance with the applicable jurisdiction's laws concerning self-settled trusts, as well as its debtor-creditor statutes. Success also has a two-fold meaning: (1) the property should be shielded from creditors; and (2) the property should not be subject to estate tax in either the contributor's estate or the beneficiary's estate. If the property can be reached by the creditors of the contributor or the beneficiary, it will be subject to estate tax.[xxiv]

As an example, under New York's Estates, Powers and Trusts Law, Section 7-3.1, a creditor can reach trust property to the extent that the contributor has retained a beneficial interest in the property.[xxv] Article 10 of New

York's Debtor and Creditor Law provides that a creditor can reach the property if the transfer to the trust constituted a fraudulent conveyance.[xxvi] Generally, there is a fraudulent conveyance when the contributor either: (i) failed to receive a "fair consideration" in return for the transfer, when the contributor was not solvent enough to satisfy his current and expected debts and obligations; or (ii) transferred the property to the trust with the actual intent to hinder, delay or defraud present or future creditors.[xxvii]

In order for a sale of assets by the grantor or a beneficiary to a trust for an installment note to be respected for debtor-creditor purposes, there are several important factors that must be considered, including the appropriate: (i) funding of the trust; (ii) purchase price; (iii) interest rate; (iv) down payment; (v) maturity date; and (vi) security interest, as well as other factors necessary to construct a transaction that reflects, to the extent possible, the terms of a sale between unrelated parties dealing at arms-length. The sale to the trust must be for "full and adequate consideration", generally considered to be fair market value.[xxviii] The sale should also not raise creditor issues if the grantor or the beneficiary has not otherwise retained a beneficial interest in the property.

The concern in the case of a sale by the beneficiary to the BDIT is that the beneficiary by definition also has a beneficial interest in the trust, and, further, would be considered to have retained a beneficial interest in the property if the sale is for an amount that is less than full and adequate consideration. Certainly, with respect to a bargain sale in any jurisdiction that does not protect self-settled trusts, such as New York, the property could be reached by creditors resulting in estate tax inclusion in accordance with Section 2036, 2038 and 2041.

For example, by virtue of New York's EPTL Section 7-3.1, the beneficiary would be considered to have "retained" a beneficial interest in the transferred property, at least to the extent of the bargain element in the case of an undervaluation. Furthermore, since the beneficiary already has a beneficial interest in the trust, if creditors are able to reach beyond the bargain element, the entire trust may be exposed to estate tax under Section 2041. The situation, of course, would be exacerbated if a fraudulent conveyance had occurred.

The BDIT advocates suggest always utilizing a self-settled trust jurisdiction to avoid this issue. The fact remains, however, that the "Full Faith and Credit" clause of the U.S. Constitution will likely require the recognition by any such jurisdiction of the judgments of other states that have strong public policies against protecting self-settled trusts.[xxix] The key difference when the seller of the trust is the grantor versus when the seller of the trust is the beneficiary is that a beneficiary has greater vulnerability to creditors.

First, in the case of an undervaluation or bargain sale, a sale by a grantor to a non-self settled trust does not implicate the retained interest in Section 2036. On the other hand, a sale by the beneficiary implicates Section 2036 since the beneficiary has "retained" an interest in the trust. Attempts to draft around the problem by providing the beneficiary with a limited power of appointment may be effective for gift tax purposes, but it is difficult to imagine that a court would deny access to the beneficiary's creditors in a bargain sale transaction regardless of whether it is a fraudulent conveyance and irrespective of the jurisdiction's wont to protect self-settled trusts.[xxx] Second, for the beneficiary to be considered the trust owner for income tax purposes, the withdrawal power will have to be present, which may provide creditors with the opportunity to reach the trust property.[xxxi] Certainly, to the extent the power is "hanging", the trust assets are vulnerable to the beneficiary's creditors. Determining the appropriate amount required to fund the trust is the third issue. In the BDIT scenario, its proponents suggest avoiding the lapse issue by having the grantor fund the trust with no more than $5,000.[xxxii] The question remains whether the principal of a "thinly capitalized" trust is reachable by creditors of the beneficiary (either by considering the beneficiary to be the actual grantor of the trust or by ignoring the trust's promissory note in favor of the beneficiary), just as creditors of a thinly capitalized corporation can sometimes reach its shareholders.

Planning Alternatives

The BDIT structure, except if implemented in a jurisdiction that protects self-settled trusts, is not for the faint of heart. Even in a self-settled trust jurisdiction, the concerns outlined in this article would appear to provide second and third thoughts to planners and clients before they recommend or implement the BDIT. Furthermore, there are excellent alternatives to accomplish freezing asset values for gift and estate tax purposes and trust income being taxable to the client, yet still giving the client the upside to enjoy the future growth in value of the trust assets in the "best of both worlds" planning approach. Once again, the following is only a brief discussion of the planning alternatives and a follow-up LISI Newsletter by the authors will provide a comprehensive analysis and comparison to the BDIT.

Structuring the standard Sale to the Grantor Trust with supercharged provisions may outperform the BDIT. A good example of this is structuring the Sale to Grantor Trust as a Private Annuity.[xxxiii] The theoretical economic advantages of the BDIT can be mimicked or surpassed under the right circumstances by allowing the client to receive substantial payments over his life expectancy, yet effectively eliminate estate taxes at death.[xxxiv] The Sale to the Grantor Trust for the Private Annuity works especially well with the current historically low 7520 rates. Further

examples of providing the client with more upside to future growth include: adding carefully drafted and properly valued, arms length options to repurchase, "waterfall" provisions, and appropriate management fees and provisions in LLC and FLP documents keying into contingent and extraordinary asset growth.[xxxv]

An intra-family loan to a grantor trust is another fine, yet conservative alternative. Due to historically low interest rates there is a great opportunity to pass on wealth to the next generation with neither adverse transfer taxes nor adverse income tax consequences. For example, the December 2010 annual mid-term rate is 1.53%, which applies to loans with a term of more than 3 years but not more than 9 years.[xxxvi] As a result, all income and appreciation in excess of 1.53% will accrue free of transfer taxes. The loans may also be structured in "reverse" so the grantor would be permitted to borrow monies from the grantor trust with adequate interest paid.

Since the BDIT seems to work best when assets of nominal value are purchased by the trust from the beneficiary due to the $5,000 funding, if the client has a living spouse, why not have the spouse simply create a trust for the benefit of the client and the client's issue, and that trust will purchase the assets from the client's spouse? The trust can be created as a grantor trust because the spouse is the grantor.[xxxvii] The sale will be ignored for income tax purposes and, unlike the BDIT, the seeding of the trust will not be inhibited by the $5000 funding issue, nor will there be the same concerns regarding continuing grantor trust status.[xxxviii]

The "freeze partnership" is an entity typically set up as a LLC, which consists of a (frozen) preferred interest and a common (growth) interest. Generally, it is structured so that the client contributes assets (e.g., interests in another partnership or LLC) to the freeze partnership in exchange for the preferred interest and a trust contributes assets to the freeze partnership in exchange for the growth interest.

Typically, to comply with the Chapter 14 valuation rules, the client contributes assets valued at 90% of the freeze partnership's total value for the preferred interest, and the trust contributes 10% for the growth interest.[xxxix] While a complete explanation of this structure is beyond the scope of this article,[xl] the trust that owns the growth interest could be created for the benefit of the client, if another person, such as the parent or spouse of the client, is the grantor.

Thus, the "best of both worlds" is achieved since the client could still benefit from the growth of the partnership assets as a permissible beneficiary of the trust (for income tax purposes, the trust could be structured as a grantor trust or a non-grantor trust). Freeze partnerships also work especially well with real estate and other low-basis assets since a partial step-up in basis might still be achieved upon the death of the preferred interest holder, which might not be the case, and is subject to

debate among practitioners, with the BDIT or Sale to Grantor Trust.[xli]

Conclusion

While the BDIT has facial appeal, it appears that it should only be implemented, if at all, in situations when the assets sold to the trust are of insubstantial value and in a self-settled trust jurisdiction. Additionally, there are still creditor concerns if the beneficiary resides in a state, which does not respect self-settled trusts.

Furthermore, due to the concerns whether the BDIT remains as a grantor trust after the lapse of the 5 x 5 power, counsel should consider whether a Private Letter Ruling should be requested each time before a BDIT is utilized. Finally, the seemingly contrived nature in which the BDIT is implemented for most clients (from the trademark, to the materials, to the same funding amount and similarly worded document provisions, and beneficiary on both sides of the same transaction) leads to concerns of a step-transaction and disguised self-settled trust, and in most situations, there are more conservative estate planning techniques available that can achieve similar results without unnecessary risks and costly legal and set-up fees. In fact, in this age of added scrutiny by the IRS and increased estate litigation, one of the authors has been trying to raise national awareness that estate planners must be "big picture" thinkers and understand that each client and situation is unique.[xlii] Instead of squeezing the client into a particular planning technique, each client and his or her personal, economic, psychological, income and gift and estate tax, business succession, and other attributes much be examined and understood very carefully to create a comprehensive and complete estate plan to meet the client's goals and objectives.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFFERENCE!

Avi Kestenbaum
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Technical Editor's Comments by Steve Gorin

The authors raise some serious concerns about a structure that has been promoted as safe and viewed as a panacea by some financial services providers. A beneficiary grantor trust (my term for an irrevocable trust in which the primary beneficiary is the deemed owner for income but not for

estate or gift tax purposes) can be an effective part of an estate plan. For example, when a business expands to a new location, the initial gift to a beneficiary grantor trust could be used to form a limited liability company (LLC) to hold the real estate, and a bank might be willing to loan the real estate purchase price to the LLC based on the strength of the lease from the business. As the lease payments reduce the mortgage, the LLC and therefore the trust increases its net worth. The trust might later participate in LLCs for other locations or buy-sell agreements or perhaps even might buy an interest in the business itself. In a conversation with me, the authors agree that such a transaction works.

The authors' true objection is promoting, as safe, a package where the trust was set up for only the special purpose of a thinly-capitalized purchase from the beneficiary. I note, however, that the lawyer who drafted the first sale-to-an-irrevocable-grantor-trust approved by a Letter Ruling readily uses thinly capitalized trusts with beneficiary guarantees and claims a stellar track record in defending audits. The 20% equity component (funded by loan guarantees) in the sale to a beneficiary grantor trust, together with fair market value loan guaranty fees, looks a lot more arm's length than the apparently accepted sales to irrevocable grantor trusts with smaller equity and smaller guaranty fees.

Quite frankly, nobody really knows how the authors' "Full-Faith-and-Credit" argument will turn out, but one must concede that the doubt that it casts causes one to view it not as a panacea but rather as one of a number of strategies that one might consider. States that have adopted the Uniform Trust Code and a few other states provide that the lapse of a Crummey power does not treat the beneficiary as a settlor; however, one might still be concerned if the beneficiary moves to a state without this favorable rule.

The structure in Letter Ruling 200949012 troubles me, as the number of states that protect from creditors the holder of a power of appointment exercisable in favor of the holder is extremely limited. The structure of Letter Ruling 201039010 appears to be more appropriate as far as creditor protection is concerned; however, a pattern of distributions by the independent trustee could create creditor and (therefore) estate tax risks. I prefer authorizing the beneficiary to be a trustee and distribute for his or her own support and only rarely rely on an independent trustee to make distributions beyond support; however, some practitioners would view the beneficiary serving as trustee as being too risky, the level of risk being determined by applicable state law and the beneficiary's conduct.

As far as the beneficiary's deemed ownership for income tax purposes is concerned, the only structure that complies with Code § 678(a)(2) (the provision under which the beneficiary is deemed the owner for income tax purposes) in a very literal way is Letter Ruling 200949012, about which the authors and I have expressed concern for other reasons. However,

traditionally the IRS has issued private rulings approving beneficiary deemed-owner status so that the trust could hold stock in an S corporation. Whether to obtain a ruling or risk a change in the IRS' view on this issue is a matter that should be expressly discussed with, and decided by, the client. I look forward to the authors' comparison with other structures they noted, which might or might not be good alternatives to sales to beneficiary grantor trusts. Meanwhile, **LISI** members, please note: taxpayers consistently defeated IRS attempts against family limited partnerships until the Tax Court got disgusted by a slick sales presentation, told the IRS how to attack them, and then invented a rule that sustained IRS attacks.
If you want to use a sale to a beneficiary grantor trust, please be careful how you present it and even whether you present it at all initially – your client might be better off gradually building equity in a beneficiary grantor trust as an entity in its own right before you even discuss making a sale to it.

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CITES:

Internal Revenue Code Sections 671-679, 1014, 2036, 2038, 2041(a)(2), 2041(b)(2), 2514(b), 2514(e), 2701, 2702; Revenue Rulings Rev. Rul. 85-13, Rev. Rul. 2010-26; Private Letter Rulings PLR 9535026, PLR 200949012, PLR 201039010; Irwin Union Bank & Trust Co. v. Long, 312 N.E.2d 908 (Ind.App. 1st Dis. 1974); Linton v. United States, 638 F. Supp. 2d 1277 (W.D. Wash. 2009); Heckerman v. United States, 2009 WL 2240326 (W.D. Wash. July 27, 2009); Pierre II,

99 TCM (CCH) 1436 (2010); Estate of Petter v. Comm'r, T.C. Memo 2009-280; State Statutes: Section 272 of New York Debtor and Creditor Law; Section 5205(c)(1) of the New York Civil Practice Law and Rules. Sections 7-3.1, 10-7.1, 10-7.2 and 10-10.1 of the New York EPTL. RSMo Section 456.5-505.5 (Missouri); Jonathan G. Blattmachr, Diana S. C. Zeydel, PLR 200949012 – Beneficiary Defective Trust(sm) Private Letter Ruling, LISI Estate Planning Newsletter #1559 (December 10, 2009), at http://www.leimbergservices.com.; Richard A. Oshins, Robert Alexander, Kristen Simmons, The Beneficiary Defective Inheritor's Trust© ("BDIT"): Finessing the Pipe Dream, CCH Practitioner's Strategies (November 2008); Richard A. Oshins, Noel Ice, The Inheritor's TrustTM Preserves Wealth as Well as Flexibility, 30 Est. Plan. 475 (October 2003); Richard A. Oshins, Noel Ice, The Inheritor's TrustTM: The Art of Properly Inheriting Property, 30 Est. Plan. 419 (September 2003); Jonathan G. Blattmachr, Mitchell M Gans, Alvina H. Lo, A Beneficiary as Trust Owner: Decoding Section 678, 35 ACTEC Journal 106 (Fall 2009); Richard A. Oshins, Robert Alexander, The Beneficiary Defective Inheritor's Trust, Creating the Ideal Wealth Transfer and Asset Protection Plan, (2009); Donald P. DiCarlo, Jr., What Estate Planners Need to Know about the Step Transaction Doctrine, Real Property, Trust and Estate Law Journal, Summer 2010; Susanna C. Brennan, Changes in Climate: The Movement of Asset Protection Trusts from International to Domestic Shores and Its Effect on Creditors' Rights, Oregon Law Review, 79 Or. L. Rev. 755 (2000); Victoria Hasseler, Trustee-Beneficiaries, Creditors, and New York's EPTL: The Surprises That Result and how the UTC Solves Them, 69 Albany Law Review 1169 (2006); Laura Blasberg, Freeze Partnerships – an Alternative to Installment Sales to Grantor Trusts, Journal of Real Estate Taxation (3rd Quarter, 2010); Avi Z. Kestenbaum, Risk Assessment, Trusts and Estates (April 2010); Avi Z. Kestenbaum, A Practitioner's Risk Assessment Checklist, **LISI** Estate Planning Newsletter #1636 (May 5, 2010), at http://www.leimbergservices.com.

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[i] Jonathan G. Blattmachr, Diana S. C. Zeydel, PLR 200949012 – Beneficiary Defective Trust(sm) Private Letter Ruling, *LISI Estate Planning Newsletter #1559* (December 10, 2009), at http://www.leimbergservices.com; Richard A. Oshins, Robert Alexander, Kristen Simmons, *The Beneficiary Defective Inheritor's Trust© ("BDIT"): Finessing the Pipe Dream,* CCH Practitioner's Strategies (November 2008); Richard A. Oshins, Noel Ice, *The Inheritor's Trust™ Preserves Wealth as Well as Flexibility*, 30 Est. Plan. 475 (October 2003); Richard A. Oshins, Noel Ice, *The Inheritor's Trust™: The Art of Properly Inheriting Property,* 30 Est. Plan. 419 (September 2003). *See also generally,* Jonathan G. Blattmachr, Mitchell M Gans, Alvina H. Lo, A Beneficiary as Trust Owner: Decoding Section 678, 35 ACTEC Journal 106 (Fall 2009).

[ii] Priv. Ltr. Rulings 200949012 and 201039010.

[iii] Other techniques discussed briefly herein include: freeze partnership, sale to grantor trust, private annuity, intra-family and intra-trust loans, creation of trust by spouse for other spouse and issue, and options, waterfall and management provisions.

[iv] See Sections 671-679 of the Internal Revenue Code of 1986, as amended ("Code"). All statutory references herein are to the Code unless otherwise stated.
[v] See Rev. Rul. 85-13, 1985-1 CB 184.
[vi] Though, the Grantor Trust is not really "defective" and "intent" is irrelevant.
[vii] Section 678(a)(1). See also Priv. Ltr. Rul. 200949012.
[viii] Section 678.
[ix] Sections 2514(b), (e) and 2041(a)(2), (b)(2)).
[x] Sections 2514(e) and 2041(b)(2).
[xi] *See* Blattmachr, *LISI Estate Planning Newsletter #1559*. To qualify under Section 678, the beneficiary requires the complete withdrawal power. Once it lapses, in order to satisfy the partial lapse requirement under Section 678, the beneficiary needs to have the HEMS power. Also, once the lapse occurs, having just the HEMS power will not cause estate tax inclusion under Section 2041. However, the HEMS power may not be necessary. See, e.g., Priv. Ltr. Rul. 201039010.
[xii] Section 2036 and Section 2702.
[xiii] *See also Estate of Petter v. Comm'r,* T.C. Memo 2009-280, a recent example of the 10% rule of thumb utilized in practice.
[xiv] For a more thorough explanation of the application of the step transaction doctrine in the estate planning context, *see* Donald P. DiCarlo, Jr., What Estate Planners Need to Know about the Step Transaction Doctrine, *Real Property, Trust and Estate Law Journal*, Summer 2010.
[xv] 638 F. Supp. 2d 1277 (W.D. Wash. 2009).
[xvi] 2009 WL 2240326 (W.D. Wash. July 27, 2009).
[xvii] 99 TCM (CCH) 1436 (2010).
[xviii] Note the BDIT proponents might be correct with respect to the income tax status of the trust. In Priv. Ltr. Rul. 201039010, the IRS held that the beneficiary would be considered the "owner" as long as the contribution did not exceed $5,000.
[xix] Some commentators advocate a guarantee for 20% of the Note, but there is no real authority in this area. Note than on a $20 million transaction, a 20% guarantee could result in a fee of $120,000 (3% of $4 million).
[xx] Query whether the guarantee fee is actually required. An "economic benefit" is clearly provided, but this may not be a gift. The guarantee fee might create more problems than it solves and the authors (and/or Technical Advisor) might raise and discuss this issue in a future article.
[xxi] *See* Richard A. Oshins. Robert G. Alexander, The Beneficiary Defective Inheritor's Trust, *Creating the Ideal Wealth Transfer and Asset Protection Plan*, (2009).
[xxii] The terms "release" and "lapse" are distinct. However, the IRS, in numerous private letter rulings has suggested that a "lapsed" power is equivalent to a "partial release" for purposes of Section 678(a)(2). For a more comprehensive treatment see Blattmachr, et. al., A Beneficiary as Trust Owner: Decoding Section 678, 35 ACTEC Journal 106 (Fall 2009).
[xxiii] See Blattmachr, et. al., A Beneficiary as Trust Owner: Decoding Section 678, 35 ACTEC Journal 106 (Fall 2009).
[xxiv] Section 2036 (contributor has retained beneficial interest if creditors can reach property) or section 2041 (beneficiary has general power of appointment if creditors can reach property, e.g., where the beneficiary has the power of withdrawal). Section 2038 (dealing with "retained" powers) may also be relevant.
[xxv] A small number of states protect trust assets from creditors where the lapse is limited to the $5000/5% standard. *See e.g.,* RSMo Section 456.5-505.5 (Missouri) and *Irwin Union Bank & Trust Co. v. Long*, 312 N.E.2d 908 (Ind.App. 1st Dis. 1974) (Indiana).
[xxvi] The New York law is based on the Uniform Fraudulent Conveyance Act, which had been adopted by many states. More recently, various states have adopted the Uniform Fraudulent Transfer Act, a broader statute that maintains the underlying purposes of the original act.
[xxvii] "Fair consideration" exists when "such property ... is received in good faith to secure a present advance or antecedent debt in amount not disproportionately small as compared with the value of the property, or obligation obtained." See, section 272 of New York Debtor and Creditor Law.
[xxviii] Query the meaning of "adequate consideration" and "fair consideration". The standard for gift and estate tax purposes is "fair market value" which allows for discounts for, *inter alia*, minority interest and lack of marketability. For debtor-creditor statute purposes, is the amount that constitutes "fair market value" for transfer tax purposes the equivalent of "fair consideration" or "adequate consideration" or "reasonably equivalent value" as provided in such statutes? For example, if the "applicable federal rate" for the month of the transaction is less than the prevailing market interest rate, is the sale for less than "adequate consideration" or "fair consideration"?
[xxix] *See* Susanna C. Brennan, *Changes in Climate: The Movement of Asset Protection Trusts from International to Domestic Shores and Its Effect on Creditors' Rights*, Oregon Law Review, 79 Or. L. Rev. 755 (2000): "Once a court has determined which law applies to the matter and issues a judgment, the Full Faith and

Credit Clause requires other states to recognize the judgment upholding validity of the domestic asset protection trust, even though the trust's provisions strongly conflict with the laws of those other states. Conversely, the Full Faith and Credit Clause would also compel courts in Alaska and Delaware to recognize judgments of other states invalidating a domestic asset protection trust because it violates one or more of that state's fundamental trust laws. Since very few exceptions exist in which a state may not be required to enforce a sister state's judgment, states will usually have to recognize the judgments of other states regarding the validity or invalidity of a domestic asset protection trust."

[xxx] Curiously, and perhaps unintended, New York law in non self-settled situations appears to shield a trustee/beneficiary's unlimited withdrawal power from creditors since for New York purposes the power is not considered a power of appointment. See section 5205(c)(1) of the New York Civil Practice Law and Rules, and sections 10-7.1, 10-7.2 and 10-10.1 of the New York EPTL. For a complete explanation of New York's protected trusts see Victoria Hasseler, *Trustee-Beneficiaries, Creditors, and New York's EPTL: The Surprises That Result and how the UTC Solves Them,* 69 Albany Law Review 1169 (2006).

[xxxi] See footnote 7.
[xxxii] In fact, in order to assure that the beneficiary is treated as the "owner" of the BDIT where the beneficiary's withdrawal power is limited by the 5 x 5 power, it appears that the current IRS ruling position requires that on an annual basis the first year's contribution not exceed $5,000. See Priv. Ltr. Rul. 201039010.
[xxxiii] A private annuity is an unsecured promise to pay an annuity by anyone other than a commercial insurance company, to any person (the "annuitant") in exchange for adequate consideration. In effect, the annuity results in spreading the payment for the property exchanged for the annuity over the life expectancy of the seller. However, the obligation to pay the annuity ceases upon the death of the annuitant, whenever death occurs, even if the full price for the property has not been paid. For estate tax purposes, since the annuity ceases upon the annuitant's death there is no value to include in the annuitant's estate for such tax purposes. Of course, to the extent the annuitant has saved prior annuity payments, such amounts will be subject to estate tax.
[xxxiv] Note the Private Annuity must be structured properly to avoid 2036 inclusion and 2702 issues and is also not for every situation.
[xxxv] With proper respect paid to Section 2701.
[xxxvi] See Revenue Ruling 2010-26.
[xxxvii] Section 677.
[xxxviii] Creditor concerns should also not be as pronounced as with the BDIT if the sale is arms length with proper valuations and no commingling of assets.
[xxxix] See Section 2701. Note that some commentators suggest a 15% to 20% contribution for the common interest, but this is clearly not required under Chapter 14 and valuation experts do not mandate it.
[xl] *See, e.g.*, Laura Blasberg, *Freeze Partnerships – an Alternative to Installment Sales to Grantor Trusts*, Journal of Real Estate Taxation (3rd Quarter, 2010).
[xli] See Section 1014.
[xlii] *See* Avi Z. Kestenbaum, Risk Assessment, *Trusts and Estates* (April 2010); Avi Z. Kestenbaum , A Practitioner's Risk Assessment Checklist, *LISI Estate Planning Newsletter #1636* (May 5, 2010), at http://www.leimbergservices.com.