Beneficiary Deemed Owner Trusts:

BDOT OUTLINE

Prepared by: Avi Z. Kestenbaum
Co-Chair of Trusts & Estates Practice Group

Elliot Dizon
Law Clerk in Trusts & Estates Practice Group

Meltzer, Lippe, Goldstein & Breitstone, LLP
190 Willis Ave, Mineola, NY 11501
460 Park Avenue, New York, NY 10022

What is a BDOT?[1]

- This is a Beneficiary Deemed Owner Trust.
  - The beneficiary will be treated as the owner of the trust for income tax purposes.
  - The beneficiary reports and pays income taxes on all of the trust's income (including capital gains).
  - No right to withdraw trust corpus is needed.

- IRC Section 678: "A person other than the grantor shall be treated as the owner of any portion of a trust with respect to which: (a)(1) such person has a power exercisable solely by himself to vest the corpus or the income therefrom in himself."

- Income definition for IRC Section 678 purposes is taxable income (including income attributed to principal such as capital gains).

- Authority saying beneficiary can be treated owner of income attributed to principal (such as capital gains): Campbell v. Commissioner T.C. Memo 1979-495 affirmed by unpublished court order (8th Cir. Sept. 29, 1980). Also see PLR 2016-33021.

[1] These materials were garnered from *IRC § 678 and the Beneficiary Deemed Owner Trust (BDOT)*: *Exploiting Opportunities to Simplify and Lessen Income Taxation of Trusts and Improve Asset Protection Through the Use of Targeted Powers of Withdrawal that Shift Taxation to Beneficiaries and Away from Fiduciary Income Tax System* by Edwin P. Morrow, III, LISI Estate Planning Newsletter #2587 (Sept 5, 2017), with 2019-2020 updates and *Creative Planning Techniques with Grantor and Non-Grantor Trusts: Planning with Trusts Series* by Austin Bramwell, S. Stacy Eastland, Carlyn S. McCaffrey, and Edwin P. Morrow, III, presented in the 2020 Heckerling Institute.

How do we create a BDOT?

- Give the beneficiary an annual right to withdraw all of the <u>taxable income</u> in the trust. *WARNING: If the beneficiary has the right to withdraw the "net income," the grantor trust rules will apply as to the <u>accounting income</u> only.

- Beneficiary's withdrawal right can be limited to certain sales/income (ex: right to withdraw gain from the sale of X Property), and the beneficiary will only be taxed on that portion of the trust income.
  *WARNING: Limiting the income subject to the beneficiary's withdrawal powers can complicate the accounting and trust administration.

- Withdrawal right is recommended to be exercisable year-round to avoid the argument that the trust only becomes a BDOT at the withdrawal time period.

Estate/Gift/ and GST Taxes

- Using the Section 2514/2041 Lapse rules to avoid estate/gift/GST tax issues:
  - Allow lapse on withdrawal right for taxable income OR 5% of corpus, whichever is greater,
  - Then use a hanging power on any income that exceeds the 5% corpus amount.
  - Alternatively, the beneficiary's spouse can also create a SLAT and fund it with more assets than the BDOT, then give the beneficiary power to withdraw $5,000 per year.
    - This works since Section 2514 <u>aggregates all the withdrawal powers held by the taxpayer, including powers in other trusts.</u>

        - Example: BDOT funded with $5Mil and gain this year is $1Mil. However, beneficiary also has withdrawal powers to a SLAT funded with $16Mil.
        - For purposes of 2514 and 2041, both trusts' assets totaling $21 Mil are considered, and only $1,005,000 of funds are withdrawable, way below the 5% lapse allowed.

Estate and Gift Tax Planning with BDOTs:

- To the extent the beneficiary does not withdraw funds from the trust, such funds may pass free of state/federal estate tax.
  *WARNING: Any income withdrawable at death will be included in the decedent's gross taxable estate.
    * ALL withdrawable income on the year of decedent's death, even if the withdrawable amount is lower than the 5x5 allowable lapse, will be included in the decedent's gross taxable estate. See <u>Estate of Dietz v. Comm'r</u>, 72 T.C.M. (CCH) 1058 (T.C. 1996); Treas. Reg. § 20.2041-3(d)(3)(example).
    * Also, any corpus or principal still subject to the hanging power at death will also be includable in the beneficiary's estate.

- Creating a QTIP-BDOT:
    - Surviving spouse will have withdrawal powers over all taxable income.
    - No need to mandate that all income <u>be paid</u> to the spouse annually.
        - **Treas. Reg. §20.2056(b)-5(f)(8):** In the case of an interest passing in trust, the terms <u>"entitled for life" and "payable</u>

annually or at more frequent intervals," as used in the conditions set forth in paragraph (a)(1) and (2) of this section, require that under the terms of the trust the income referred to must be currently (at least annually; see paragraph (e) of this section) distributable to the spouse or that she must have such command over the income that it is virtually hers. Thus, the conditions in paragraph (a)(1) and (2) of this section are satisfied in this respect if, under the terms of the trust instrument, the spouse has the right exercisable annually (or more frequently) to require distribution to herself of the trust income, and otherwise the trust income is to be accumulated and added to corpus.

- This allows the surviving spouse to transact tax-free with their QTIP-BDOTs.
- Since QTIP assets are valued separately for estate tax purposes, the surviving spouse can cause or avoid valuation discounts (depending if they have a taxable estate or if they want that step up in basis) by swapping/purchasing/selling assets to the QTIP-BDOT.

- GST-Planning using BDOT concepts:
  - This is for an estate plan with a GST exempt trust and a GST non-exempt trust.
  - The GST exempt trust should provide that the trustee of the non-exempt trust has the right to withdraw all the taxable income of the exempt trust.

        - Treas. Reg. §1.671-2(a)(6) Example 8: a trust can be a deemed owner of another trust under 678(a)(1)
        - Assuming there are no withdrawals, the GST exempt trust grows tax-free. Meanwhile, the GST non-exempt trust is frozen.
    - The GST non-exempt trust will then report and pay taxes on the GST exempt trust income (remember, this can be reduced by administration expenses and distributions to the beneficiaries).
    - Technically, the beneficiary can be given the power to withdraw all the taxable income as to the GST exempt trust, so that it is a regular BDOT. However, this will not suit beneficiaries that actually want to withdraw funds.
        - *WARNING: In using a GST exempt BDOT, any lapsed withdrawal powers in excess of the 5x5 safeguard may be considered a contribution by the beneficiary to the GST exempt trust.
        - Even if the beneficiary/deemed owner is a generation below the original grantor, allowing withdrawal powers above 5x5 to lapse would still complicate accounting and potentially create a fractional exclusion ratio if GST is not allocated.
    - Further, beneficiaries can have power to withdraw all taxable income as to the GST non-exempt trust AND the GST exempt trust, but they have to be careful to withdraw ONLY income from the non-exempt trust, or they will be depleting the exempt trust.

- Using BDOTs to hold IRA payout funds:
    - Make the accumulation trust also a BDOT, allowing the beneficiary to withdraw all taxable income.

        - Withdrawal power will include any IRA distributions taken by the trust.
        - Thus, beneficiary will be deemed owner of the IRA distributions (this is income attributed to the principal) and shall report and pay income taxes on such distribution, even if this stays in the trust.
        - To the extent that the beneficiary does not withdraw the income, the assets will be protected from creditors and federal/state estate taxes.
    - This isn’t very useful if the beneficiary is already in a high-income tax bracket.
    - DON’T USE if there is a special needs beneficiary. IRA funds will be considered a countable resource for such beneficiary.

Income Tax Benefits of BDOTs:

- Section 179 expensing is allowed under the individual beneficiary’s tax return.

- Section 469 deduction for real estate losses will be allowed (beneficiary-deemed owner is a “natural person” that can take this deduction).

- Section 199A deduction for up to 20% of qualified business income is allowed (as if the beneficiary/deemed owner conducted the activities). Also, the calculation of the 199A threshold requirement for BDOTS allows for distribution deductions.

- Section 121 exclusion of $250,000/$500,000 in capital gains on the sale of a personal residence is available.
    - Treas. Reg. § 1.121-1(c)(3)(i) - If a residence is owned by a trust, for the period that a taxpayer is treated under sections 671 through 679 (relating to the treatment of grantors and others as substantial owners) as the owner of the trust or the portion of the trust that includes the residence, the taxpayer will be treated as owning the residence for purposes of satisfying the 2–year ownership requirement of section 121, and the sale or exchange by the trust will be treated as if made by the taxpayer.
    - Note, beneficiary/deemed owner should be able to withdraw all taxable income to claim the full exclusion.

- Charitable deductions follow individual rules under Section 170, rather than trust/estate rules under Section 642.
    - No need to trace donation to gross income.
    - No need to have specific charitable instruction in governing instrument.
    - Unused deductions can carry forward for up to 5 succeeding years.
    - Long term gains on sale of appreciated trust assets can be donated to a charitable remainder trust and be taken as a Section 170 deduction by the beneficiary/deemed owner.

- Unless beneficiary is under a high marginal tax rate ($200K for single / $250K joint), or totally uninvolved in the income-producing business in trust, 3.8% net investment income surtax should not apply to any active business income in the trust.

- Alternative Minimum Tax (AMT) exemption for individuals (married filing jointly) is $111,700 and phasing out at $1,020,600 of income in 2019. Trusts and Estates can only get an AMT exemption of $25,000, phasing out at $83,500 in 2019. See Rev. Proc. 2018-57.

- S-Corporation stock ownership is allowed, even without making a QSST election (although a BDOT may make a protective QSST election).

- For Section 1031 exchanges, the beneficiary/deemed owner can sell the property, and the BDOT can purchase the replacement property, with no consequences under Section 1033. See Rev. Rul. 2004-86; Rev. Rul. 88-103; Rev. Rul. 70-376.

- Using an "Upstream BDOT"
    - For this technique, a child will establish an irrevocable family trust, where a parent has withdrawal rights over all taxable income.
    - Especially useful if parents are well off, do not need to take the withdrawals, and are able to pay the income taxes on the gain.

Control and Asset Protection Benefits of BDOTs:

- No need to give power to beneficiary to withdraw corpus (good for estate tax purposes as to the beneficiary too).

- Unlike a QSST, lots of actions can be done with a BDOT without losing ability to hold S-Corp stock:
    - Decanting/amendment of trust
    - Keeping accounting income in trust if beneficiary does not exercise right to withdraw that year
    - Using forfeiture clauses

- For BDOTs with forfeiture clauses, if that clause is triggered, the BDOT simply turns into an ordinary discretionary spendthrift non-grantor trust.

- For BDOTs with forfeiture clauses, the withdrawal power may even be added back to the trust by a trust protector.

State Tax Benefits of BDOTs:

- Depending on the state law, non-grantor trusts may be subject to multiple states' income taxation. Fortunately, most states follow federal grantor trust rules and status, so the BDOT income will only be subject to state income tax in the state of the beneficiary/deemed owner.

- In certain states, there are "throwback taxes" on distributions made to beneficiaries (residing in the throwback tax state) from non-grantor trusts administered/ settled in other states.
    - However, throwback taxes (at least in CA and NY) do not apply to distributions from grantor trusts. Thus, any income withdrawn by the

beneficiary/deemed owner will not be subject to the state throwback tax.

- Since the BDOT will just check the box as a grantor trust in its 1041, all of the trust income, even if it is NY source, will only be reported on the beneficiary's return.
    - Can also clean out specific state source income and tax it to the beneficiary.

Limits to BDOT Structure:

- When a beneficiary/deemed owner of a BDOT is claiming a large loss, it is possible that the beneficiary will not be deemed owner of the trust, since the only benefit they possess is vesting a negative income (loss) on themselves.
    - Ed Morrow suggests that the trustee should just distribute the loss property in kind to the beneficiary. Beneficiary gets same basis as donor anyway.
    - If a non-grantor trust is being converted to a BDOT, careful if the trust is holding on to any losses. Consider triggering gains before converting into a BDOT.

- Prior to triggering a conversion from BDOT/grantor trust to non-grantor trust status, or vice versa, clean up any installment sales or "negative basis" property that might trigger a taxable event.

- Some question as to whether Rev. Rul. 85-13 will apply to the BDOT.

- A BDOT can function as an ILIT and hold life insurance funds. However, the life insurance proceeds may be included in the beneficiary's gross taxable estate, as the withdrawal power over taxable income could be an incident of ownership (since the policy can theoretically be sold or surrendered and generate taxable income). See Section 2042.

- A Special Needs Trust is incompatible with the BDOT.
    - The income withdrawable by the SNT beneficiary will be considered a countable resource for them.

- For an inter-vivos BDOT, careful that the real grantor does not have any explicit grantor trust powers. See IRC 678(b).
    - **Powers that trigger settlor-grantor trust rules under Sections 671-77 override Section 678(a), such as:**
        - The settlor's power to add charitable beneficiaries
        - The settlor's powers of substitution
        - Certain trust language on distributions and/or transactions with the settlor or the settlor's spouse
        - Crummey powers given to anyone other than the BDOT deemed owner

- If property is decanted into a BDOT, the withdrawal powers may be considered a material change in the beneficial interest of the beneficiaries and trigger a gift, income, or GST transfer tax.

- Mortgage interest deduction is allowed to the extent it is paid by the beneficiary only. Deduction will not be allowed to the extent that the BDOT pays for the mortgage interest.
    - Treas. Reg. §1.163-1(b): Interest paid by the taxpayer on a mortgage upon real estate of which he is the legal or equitable owner, even though the taxpayer is not directly liable upon the bond or note secured by such mortgage, may be deducted as interest on his indebtedness. Pursuant to the provisions of Section 163(c), any annual or periodic rental payment made by a taxpayer on or after January 1, 1962, under a redeemable ground rent…. is required to be treated as interest on an indebtedness secured by a mortgage and, accordingly, may be deducted by the taxpayer as interest on his indebtedness.

- Caution on the Beneficiary's Sales to the BDOT:
    - There is more pressure on a sale to a trust in which the seller is also a beneficiary of the trust.
    - If there is a sale made with inadequate consideration, the full value of the sold asset minus the value of note at the time of the sale may be included in beneficiary's gross taxable estate. Sections 2036 & 2043.
    - Further, for credit protection purposes, even if the sale is for adequate and full consideration for gift tax purposes, the IRS (or a creditor) could take the position that:
        - (1) the sale is not adequate for creditor protection purposes under the relevant state law or

        - (2) even if the sale is adequate for state law purposes, the beneficiary could still create a future creditor relationship that could access the trust.
        - Still, note that most states have creditor protection up to lapsed withdrawal amounts less than 5% of the corpus.
    - In order to avoid the consequences of a sale for inadequate consideration, strong consideration should be given to using a defined valuation clause.

- Turning grantor trust status on and off could lead the IRS to argue that there was no business purpose and question the validity for tax purposes.

- Too many decantings could cause the IRS to question control over the trust assets and cause an estate tax exclusion.

- Additionally, the above actions might also give a creditor an argument against the asset-protection benefits of the trust.