Beneficiary Defective Inheritance Trusts (BDIT)

A Beneficiary Defective Inheritance Trust ("BDIT") is a unique and powerful estate planning and asset protection tool. BDITs incorporate the "freeze, squeeze, and burn" techniques that are popular components of similar estate planning strategies, with a unique twist. The key difference that makes the BDIT so attractive is that the structure allows for the removal of assets from your estate without surrendering control or the enjoyment of those assets during your lifetime.

Structure

A nominal grantor, often a family member, contributes their own cash or equivalent assets to the trust (typically $5,000), but retains no power or control over the trust that would result in the trust being taxed to them. An independent third-party trustee is commonly used to solidify the fact that discretionary distributions to beneficiaries are controlled by an independent party. The trust provides the beneficiary with a withdrawal right over the initially contributed funds for a short period of time (often only 30-60 days). If the beneficiary allows the withdrawal right to lapse, Section 678 of the internal Revenue Code states that a trust beneficiary is considered a grantor of a trust for federal income tax purposes of any portion of a trust that said beneficiary can independently vest in themselves. Since the beneficiary had the ability to withdraw the entirety of the trust corpus, they will be considered the grantor and owner of the entire trust for income tax purposes even after the right of withdrawal lapses.

Estate Freeze

After the withdrawal right has lapsed, the beneficiary sells an asset (typically one expected to appreciate rapidly, such as an interest in a closely held business) to the trust, thereby becoming the "beneficiary-seller." The sale will be structured as an installment sale with an interest rate no lower than the Applicable Federal Rate (AFR). This sale freezes the value that remains in the beneficiary-seller's estate at the sale price plus the interest required on the note. Any appreciation in the value of the transferred assets in excess of the interest rate on the installment note will accrue outside of the beneficiary-seller's estate.

Asset Squeeze

The transfer price of the asset being sold is "squeezed" by leveraging a valuation discount on the sale to the BDIT. When a non-controlling interest in a closely held business is sold, it is commonly sold at a discount that reflects the lack of control and marketability of that asset. This discount passes tax-free to the BDIT, thereby removing more assets from beneficiary-seller's estate without using any of their estate tax lifetime exemption.

Tax Burn

Because the BDIT is structured as a grantor trust for income tax purposes, the beneficiary-seller as the grantor will be responsible for paying taxes on the trust income. The payment of these taxes is not considered a gift for tax purposes. By paying these taxes from non-BDIT assets, the taxable estate is further reduced while allowing the BDIT to compound its growth outside of the beneficiary-seller's estate. This is what is referred to as "tax burn."

Asset Protection

BDITs can provide a considerable degree of asset protection. Because the seller-beneficiary is not making a gratuitous transfer to the trust, the BDIT is not considered a self-settled trust, and therefor provides bankruptcy protection. Additionally, the transfer to the BDIT is not susceptible to fraudulent transfer claims, which can extend the asset protection to spousal claims situations in divorce proceedings (especially if the trust is established and the assets are sold to the trust prior to the marriage).

Additional Considerations

BDITs are complex legal documents that require experienced legal counsel. One area of concern relates to what is known as the "step transaction doctrine." If the IRS were to determine that the various steps taken to create and implement the strategy were interrelated, the transaction could collapse. It is for this reason that some estate planning attorneys view BDITs as too risky. BDITs are a newer planning strategy. Currently, there is very little guidance or clarity on whether the structure can truly offer all the benefits it's designed to offer.

Conclusion

BDITs can be viewed as a risk/reward tradeoff. With properly drafted trust documents, a BDIT can be an effective estate planning tool that offers significant upside in terms of estate tax mitigation and asset protection. Pairing those benefits with the unique ability to retain control and beneficial enjoyment of the transferred assets potentially makes it an appealing estate planning structure.