



LIFE INSURANCE

Sales Strategy

Beneficiary Defective Inheritor's Trusts



In the course of wealth transfer planning, estate practitioners consider a number of tools, often including the use of gift tax exemptions, valuation discounts, tax and income shifting approaches, installment note sales and securing protection against creditors. The Beneficiary Defective Inheritor's Trust (BDIT)¹ is an estate planning technique that has recently become popular because it is uniquely designed to combine the benefits of these tools in one planning approach to help minimize a family's wealth transfer costs while maintaining flexibility and control where needed. While this technique is still relatively untested and there exists no formal authority on it, Private Letter Rulings (PLRs)² have been issued by the IRS that appear to support the use of a BDIT. However, PLRs are not precedent and cannot be relied upon by anyone other than the taxpayer for which the ruling was issued.

Simply put, a Beneficiary Defective Inheritor's Trust allows:

- The primary trust beneficiary to pay the trust's income taxes without making a gift in the process;
- The primary trust beneficiary to sell assets to the trust without adverse income tax consequences;
- Trust beneficiaries to use and enjoy the trust assets; and
- The primary trust beneficiary (and after his or her death, subsequent primary beneficiaries) to manage the trust assets.

BDIT BASICS

A BDIT is an irrevocable trust created and funded by a third-party Grantor (e.g., father) that treats the primary beneficiary (e.g., son) as the "owner" of the trust for income tax purposes while keeping the trust assets outside their respective taxable estates for estate tax purposes and creditor protection purposes.

In order for the primary trust beneficiary ("Beneficiary") to be deemed the owner for income tax purposes, the trust must provide the Beneficiary with a withdrawal power over any gift contributed to the trust (as described in the "grantor trust" rules, referenced below) and the Grantor cannot retain any grantor trust powers.³ Moreover, because the BDIT is established and funded by someone other than the Beneficiary, the trust should also not be considered a "self-settled trust" for either tax or creditor protection purposes.⁴

GRANTOR TRUST RULES

The powers that make a trust a grantor trust are described in certain Internal Revenue Code provisions known as the "grantor trust" rules. If these rules apply to a trust, the trust will be disregarded for federal income tax purposes and all items of income, losses, deductions and credits that otherwise would be attributed to the trust are instead attributed to the Grantor of the trust or to a trust beneficiary.

In almost all cases, a trust containing grantor trust powers will be "defective" as to the grantor himself. However, under IRC Section 678 of the grantor trust rules, a person other than the grantor will be treated as the owner of the trust if the person holds the

unilateral power to withdraw all gifts made to the trust *and* the Grantor does not hold any power that otherwise would cause the trust to be treated as a traditional grantor trust.⁵

Consequently, if a beneficiary of the trust holds this specific withdrawal power, the beneficiary should be considered the “owner” of the trust for income taxes purposes. Moreover, the sale of an asset to the BDIT by the Beneficiary can be accomplished without adverse income tax consequences.⁶

BENEFITS OF USING A BDIT

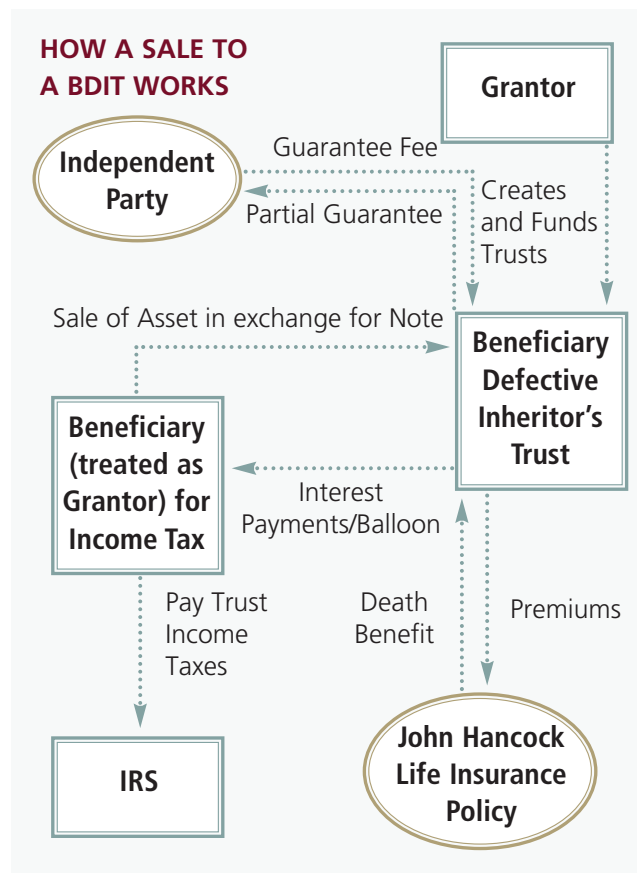
- The Beneficiary enjoys access to trust assets and appreciation of those assets without causing estate tax inclusion.⁷
- The Beneficiary can serve as a trustee and thus can control the investment and management decisions with respect to trust assets.⁸
- The Beneficiary can have the power to change the ultimate beneficiaries of the trust via a special power of appointment without causing estate tax inclusion (excluding insurance on his life).⁹
- The Beneficiary pays the trust income taxes, preserving more of the trust assets for wealth transfer purposes.
- Payment of the trust’s income tax by the Beneficiary is, in effect, a tax-free transfer from the Beneficiary to the trust.¹⁰
- No gain is recognized by the Beneficiary on the sale of assets to the BDIT and the interest payments received on an installment note are not income taxable to the Beneficiary.
- Assets sold by the Beneficiary to the BDIT may be protected from the reach of the Beneficiary’s creditors and can appreciate outside Beneficiary’s taxable estate.

CONSIDERATIONS

- The BDIT must be created and funded by a third-party (e.g., parent, grandparent or generous friend). The Beneficiary cannot provide the funding to the grantor for the trust.¹¹
- Grantor of the BDIT can have no “grantor trust” powers. If Grantor has grantor trust powers,

Grantor will be considered the owner of the trust for income tax purposes.¹²

- It is important that the Beneficiary have no control over decisions with respect to life insurance owned by the BDIT on the Beneficiary’s life, should not serve as the sole trustee, and should not have a power of appointment over the insurance.
- If a sale to the BDIT is contemplated in return for an installment note, the note must be structured properly and qualify as bona fide debt. If fair market value of assets sold to the BDIT by the Beneficiary was undervalued, a portion of the asset’s value may be includible in the Beneficiary’s estate.¹³
- Beneficiary’s access to trust assets could be reached by creditors.



To establish a BDIT that can be used by the Beneficiary for the future sale of assets, consider the steps involved in the transaction:

STEP 1: A third-party Grantor (e.g., parent, grandparent) establishes and funds an irrevocable trust for the primary benefit of Beneficiary.¹⁴ The trust provides a *Crummey* withdrawal power to the Beneficiary over the entire amount contributed to the trust by the Grantor to cause the trust to be a “defective” trust with respect to the Beneficiary.¹⁵ The trust should also include other grantor trust powers in favor of the Beneficiary to ensure continued “grantor trust” status for the Beneficiary of the BDIT.¹⁶

STEP 2: After the trust has been established and funded, the Beneficiary enters into an installment sale agreement with the BDIT in which the trust agrees to purchase assets from the Beneficiary. Ideally, the trust should buy income-producing assets, such as limited partnership interests or S-corporation stock. Valuation discounts on these assets can be taken by appraisers for a variety of reasons, including lack of marketability or minority interests. The transaction should be properly structured so that the sale is not characterized as a disguised gift by the Beneficiary.¹⁷ If the trust has not been sufficiently capitalized or additional capital is desired, a third-party could guarantee the note in return for a fee.¹⁸ The promissory note for the installment sale is generally structured as an interest-only note for a term of years, with the principal balance due at the end of the term. Typically, the interest rate on the note is the AFR at the time of the sale.¹⁹

STEP 3: The assets transferred to the BDIT accumulate inside the trust free of transfer taxes. The Beneficiary will pay the tax due on the trust’s annual income at his or her income tax rate. After the trust pays the interest due on the note (and the guarantee fee, if any), a portion of the remaining trust income can be used by the trustee to fund a life insurance policy on the Beneficiary’s life or anyone else provided there is an insurable interest. Excess funds that accumulate in the trust can be used to fund the balloon repayment at the end of the trust term. The interest payment made to the Beneficiary will not be taxable income since both the Beneficiary and BDIT are considered to be the same taxpayer.

LIFE INSURANCE OPPORTUNITIES

The BDIT can serve as an alternative to a traditional ILIT and own insurance on the Beneficiary or any other person that the trust beneficiaries have an insurable interest. As opposed to a traditional ILIT, the insured Beneficiary of a BDIT can serve as a Trustee of the trust, without causing estate inclusion of the life insurance policy, so long as any decisions regarding the policy are made by an Independent Trustee.²⁰ An advantage of the BDIT (as compared to the ILIT) is that the inside buildup is indirectly accessible for the Beneficiary if the Independent Trustee elects to borrow against the policy²¹ and lend to him or her. The BDIT also should be drafted to prevent the insured Beneficiary from having a power of appointment over the life insurance policy or its proceeds.

PROCEED WITH CAUTION

Although the BDIT is an enticing technique because of the many benefits it can provide the Beneficiary (typically the Client), it is a relatively new planning concept. Currently there is little guidance or authority as to whether a BDIT can truly offer full creditor protection and exclusion of transfer taxes for the Beneficiary while being treated as “defective” for income tax purposes with respect to the Beneficiary.

In particular, the Beneficiary’s withdrawal right over all assets contributed to the trust by the Grantor can open these assets up to claims by the Beneficiary’s creditors because such a withdrawal right is considered a general power of appointment. The general power of appointment over amounts subject to withdrawal also causes inclusion in the Beneficiary’s estate.²² To limit the Beneficiary’s exposure to creditors and potential estate tax inclusion, the Grantor may limit the amount initially contributed to the trust. However, limiting the funding may create the need for a guarantee if the Beneficiary is contemplating a sale of valuable assets to the BDIT and may also open the transaction up to scrutiny by the IRS as a step transaction.²³

In the case of a sale to the BDIT by the Beneficiary, creditor issues and estate tax inclusion could also result if the sale of property is for an amount that is less than “full and adequate consideration” because the Beneficiary will be deemed to have retained an interest in the property sold via his beneficial interest in the

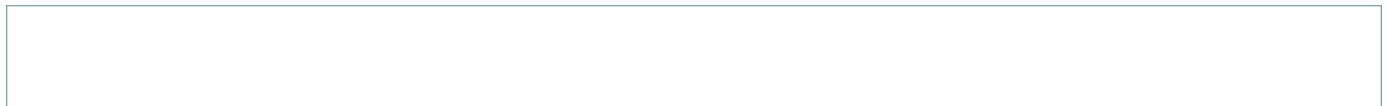
trust. Because of this retained interest, the property (or potentially the entire trust) might be susceptible to the reach of creditors and could result in estate tax inclusion in the Beneficiary's estate.²⁴

Concern has also been raised as to the viability of maintaining grantor trust status once the Beneficiary's right to withdrawal has lapsed or partially lapsed. The language of IRC §678, which is the grantor trust power relied upon to create a BDIT, allows continued grantor trust treatment for a Beneficiary who has previously "partially released or otherwise modified" a power to withdraw corpus or income from the trust. The concern here is whether a "lapse" of a withdrawal right will be treated as a "partial release" under IRC §678. The IRS, however, has determined in multiple Private Letter Rulings that a lapse and a release have the same effect for the purposes of Section 678.²⁵

ALTERNATIVES

Although the use of a BDIT offers many advantages, the technique is still relatively new. Because some concerns have been raised by practitioners in the field regarding the legitimacy of this planning technique, advisors might consider alternative planning techniques that may provide some of the same benefits afforded by the BDIT. These techniques include:

- Structuring a Sale to a Grantor Trust as a Private Annuity
- Intra-family loans to a Grantor Trust
- Sale to a Spousal Access Trust



1. Trusts should be drafted by an attorney familiar with such matters in order to take into account income and estate tax laws (including generation-skipping transfer tax). Failure to do so could result in adverse tax treatment of trust proceeds.
2. See e.g., PLRs 200840025, 200949012, 201039010.
3. See IRC Sections 671-678.
4. If the Beneficiary contributes property to the trust for less than full and adequate consideration, the trust will be considered self-settled trust to the extent consideration was not received. Depending on the situs of the trust, such a contribution by the Beneficiary could have adverse gift and estate tax consequences and open the trust up to the claims of creditors.
5. If the Beneficiary's right of withdrawal lapses, the Beneficiary will still be considered the "owner" of trust assets for income tax purposes if the Beneficiary retains certain powers that would subject a grantor to income tax under §§671-677. IRC §678(a)(2). Any amount over which the Beneficiary has a right to withdrawal will be subject to the reach of the Beneficiary's creditors.
6. Revenue Ruling 85-13. The IRS ruled that a grantor trust is disregarded for income tax purposes and that transactions between the grantor and trust have no income tax consequences.
7. So long as the Beneficiary has not made any gifts to the trust or transferred assets for less than fair and adequate consideration, trust assets should not be included in Beneficiary's taxable estate.
8. It is important that the Beneficiary have no control over decisions with respect to life insurance owned by the BDIT on the Beneficiary's life and should not serve as sole trustee. It is recommended that the Beneficiary serve as co-Trustee along with an Independent Trustee. The Beneficiary-Trustee could control investment and management decisions while giving all other duties and power to the Independent Trustee.
9. Because Beneficiary is not the grantor of the trust, the special power of appointment given to the Beneficiary should not cause estate tax inclusion. See IRC 2041.
10. Revenue Ruling 2004-64. In this Ruling, the IRS determined that a grantor can pay income tax on trust income and it will not be considered a gift to the trust.
11. If Beneficiary gives grantor funds to establish trust, Beneficiary will be treated as the creator of the trust for tax and creditor protection purposes.
12. IRC 678(b). The trust should prohibit life insurance to be purchased on the Grantor or Grantor's spouse.
13. See IRC §2043. As compared to a traditional sale to a grantor trust, if the IRS determines that the sale price was undervalued, the Beneficiary's special power of appointment should prevent gift tax exposure and limit potential estate tax to only a portion of the trust. See Treas. Reg. 25.2511-2(b) and Treas. Reg. 20.2036-1(a). Proponents of the BDIT advise that certain additional measures can be taken to eliminate estate tax exposure including obtaining an appraisal, disclosing the sale on Form 709 (gift tax return), and using a defined value sale.
14. Initial contribution by the Grantor will be considered a gift to the trust that may or may not be covered by the annual exclusion. The Beneficiary should never make a gift to the trust. Beneficiary's spouse and lineal descendants may be included as permissible discretionary beneficiaries as well.
15. The Crummey withdrawal power must be limited to the Beneficiary exclusively so that the entire trust is considered "owned" by the Beneficiary under IRC §678(a). Proponents of the BDIT recommend that the initial amount contributed by the Grantor and the amount subject to the Crummey withdrawal right be limited to the 5% or \$5,000 exception of 2514(e) and 2041(a)(2) to avoid unwanted gift and estate tax consequences to the Beneficiary. Alternatively, if an amount exceeding the 5x5 power is contributed to the trust, a "hanging" withdrawal power may be employed. If the withdrawal amount "hangs" until the death of the Beneficiary, the outstanding withdrawal amount will be includible in the Beneficiary's estate as a general power of appointment and the executor of estate should allocate GSTT exemption to the amount subject to estate inclusion to keep trust 100% exempt from GST tax.
16. See IRC §678(a)(2) and PLRs 200949012 and 201039010.
17. IRC Section 2036 and 2702. Many practitioners rely on a 10% rule of thumb (i.e., seeding the trust with 10% of the purchase price of the asset being sold). If Grantor did not fund trust with sufficient capital for the sale, a guarantee provided by a trust beneficiary (other than the primary Beneficiary) or another third-party may be considered. A guarantee fee, determined by an independent appraiser at prevailing market rates, should be paid to avoid adverse consequences that may be associated with gratuitous transfers to the trust.
18. Often guarantees are made by a trust beneficiary, but other parties may make a guarantee as well. It is important that the grantor must have the wherewithal to pay the guarantee if it is called. The guarantee fee should be determined by an independent appraiser and should be at prevailing market rates for similar guarantees.
19. IRC 1274(d). The IRS publishes the AFR on a monthly basis.
20. An Independent Trustee must be a non-related, non-subordinate person.
21. Loans will reduce the death benefit, cash surrender value, and may cause the policy to lapse. Lapse or surrender of a policy with a loan may cause the recognition of taxable income. Policies classified as modified endowment contracts may be subject to tax when a loan is made and a federal tax penalty of 10% may also apply if the loan is taken prior to age 59½. Cash value available for loans may be more or less than originally invested.
22. IRC §2041. The withdrawal right over the entire amount contributed by the grantor in any given year is necessary for the Beneficiary to be considered the owner for income tax purposes. See IRC §678(a). To avoid adverse gift or estate tax consequences to the Beneficiary, this withdrawal right should not lapse except to the extent that is allowed to lapse under §2514 (e.g., \$5,000 or 5%).
23. The step-transaction doctrine treats separate distinct steps that are integrated parts of a single scheme as a single transaction. The step transaction has been used by the government to collapse a transaction and deny the taxpayer the tax benefits of the particular transaction.
24. See IRC §§2036, 2038, and 2041. Proponents of the BDIT recommend that a BDIT should be sited in a jurisdiction that has enacted asset protection statutes for self-settled trusts to avoid creditor protection issues.
25. See e.g., PLRs 201039010, 200011058, and 9812006.

Listen to our JHAM Radio broadcast with Richard Oshins, JD of Oshins & Associates, an expert on the Beneficiary Defective Inheritor's Trust (BDIT). To see all of the JHAM Radio shows, go to www.jhsalesnet.com and click on "Advanced Markets Group" and then "JHAM Radio."

This material does not constitute tax, legal or accounting advice, and neither John Hancock nor any of its agents, employees or registered representatives are in the business of offering such advice. It cannot be used by any taxpayer for the purpose of avoiding any IRS penalty. It was written to support the marketing of the transactions or topics it addresses. Comments on taxation are based on John Hancock's understanding of current tax law, which is subject to change. Anyone interested in these transactions or topics should seek advice based on his or her particular circumstances from independent professional advisors.

Insurance policies and/or associated riders and features may not be available in all states.

Insurance products are issued by: John Hancock Life Insurance Company (U.S.A.), Boston, MA 02116 (not licensed in New York) and John Hancock Life Insurance Company of New York, Valhalla, NY 10595.

© 2011 John Hancock. All rights reserved.

IM6085 09/11 MLINY09071115481



INSURANCE PRODUCTS:		
Not FDIC Insured	Not Bank Guaranteed	May Lose Value
Not a Deposit	Not Insured by Any Government Agency	