BDIT lets you give away property without losing control

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By temporarily doubling the gift and estate tax exemption, the Tax Cuts and Jobs Act ("TCJA") opened a window of opportunity for affluent families to transfer assets tax-free. To take advantage of the higher exemption amount, many families that own businesses or other assets worth more than the pre-TCJA exemption amount are planning substantial gifts to their children before 2026.

Traditionally, parents use trust-based gifting strategies to transfer assets to their children. Even though these strategies offer significant tax-planning benefits, they also have a major drawback: They require you to relinquish much of your control over the assets, including the right to direct the ultimate disposition of the trust assets. One strategy for avoiding this drawback is to use a beneficiary defective inheritor's trust ("BDIT").

It's better to receive than to give

The Internal Revenue Code prevents you from transferring assets in trust to your children or other beneficiaries on a tax-advantaged basis if you retain the right to use or control those assets. But similar restrictions don't apply to assets you *receive* as beneficiary of a third-party trust. This distinction is what makes a BDIT work. The strategy is best illustrated with an example:

Let's say John owns a business valued at $12 million (just over the current exemption amount of $11.4 million) and it's organized as a limited liability company ("LLC"). He'd like to take advantage of the exemption by transferring ownership of the business to his three children. But he's not ready to relinquish control over the business. John arranges for his parents to establish three BDITs, each naming him as primary beneficiary and one of his children as contingent beneficiaries. He then sells a one-third interest in the LLC to each trust for $3 million. The sale price of each interest reflects a 25% minority interest discount.

As a result, John:

- Removes the value of the business and all future appreciation from his estate without triggering gift tax liability;
- Provides the trust assets with some protection against creditors' claims;
- Retains the right as beneficiary to manage the trust assets, to receive trust income, to withdraw trust principal for his "health, education, maintenance or support," and to receive additional distributions at the independent trustee's discretion;
- Retains the right to remove and replace the trustee; and
- Enjoys a special power of appointment to distribute the trust assets (so long as it's not for his benefit).

For this strategy to pass muster with the IRS, a couple of things must happen. First, to ensure that the BDITs have economic substance, John's parents should "seed" each trust with cash — typically at least 10% of the purchase price, in this case $300,000 per trust.

Second, to avoid negative tax consequences for John's parents, the trusts must be "beneficiary defective," ensuring that John is treated as grantor for income tax purposes. Typically, this is accomplished by granting John lapsing powers to withdraw funds from the trust.

Implementing this strategy is complex, but it can offer significant estate tax benefits. Please contact us before taking action.

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