

Estate Planning Hot Topics: 2016

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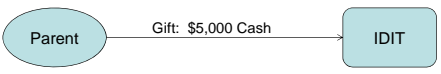
The BDIT (Beneficiary Defective Inheritor's Trust)

The BDIT

- Is a version of the [Intentionally Defective Grantor Trust](#)
 - IDIT – Grantor (Parent):
 - (a) creates trust fbo next generation and
 - (b) Grantor/Parent sells interest in closely held entity to IDIT in exchange for a promissory note.
 - BDIT – Grantor (Parent):
 - (a) creates trust fbo next generation and
 - (b) [Beneficiary](#) sells interest in closely held entity to IDIT in exchange for a promissory note.

The BDT

- Intentionally Defective Grantor Trust
 - Grantor (Parent) creates trust for benefit of Child/Grandchildren

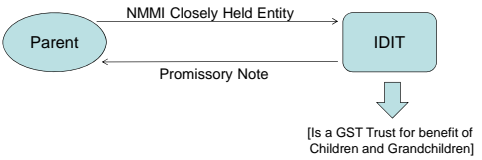


Parent → Gift: \$5,000 Cash → IDIT

- Parent retains power over trust (power to substitute assets)
- Causing IDIT to be a "Grantor Trust" as to Parent

The BDT

- Intentionally Defective Grantor Trust
 - Parent sells interest in closely held entity to IDIT in exchange for a promissory note.



Parent → NMMI Closely Held Entity → IDIT

← Promissory Note

↓
[Is a GST Trust for benefit of Children and Grandchildren]

The BDT

- Benefits of IDIT:
 - Estate Freeze.
 - "Grantor Trust" for Income Tax Purposes –
 - Parent is the grantor under grantor trust provisions.
 - Trust income is taxed to Parent.
 - Generation Skipping Trust.
 - Creditor Protected.

The BDIT

- Beneficiary Defective Inheritor's Trust
 - Grantor (Parent) creates trust for benefit of Child/Grandchildren

```
graph LR; Parent((Parent)) -- "Gift: $5,000 Cash" --> IDIT[IDIT];
```

- Parent does not retain power to substitute assets.
- Is not a "Grantor Trust" as to Parent.
- Parent gives Child a limited power of appointment.

The BDIT

- Beneficiary Defective Inheritor's Trust
 - Child sells interest in closely held entity to BDIT in exchange for a promissory note.

```
graph LR; Child((Child)) -- "NMMI Closely Held Entity" --> IDIT[IDIT]; IDIT -- "Promissory Note" --> Child; IDIT --> Note["[Is a GST Trust for benefit of Children and Grandchildren]"]; style Note fill:none,stroke:none;
```

The BDIT

- BDIT Key Concepts:
 - BDIT must be created/funded by third party (i.e., Parent):

```
graph LR; Parent((Parent)) -- "Gift: $5,000 Cash" --> IDIT[IDIT];
```

The BDIT

- BDIT Key Concepts:
BDIT beneficiary (Child) cannot make gifts to the Trust:

```
graph LR; Child((Child)) -- "Gift: $5,000 Cash" --> IDIT[IDIT];
```

The BDIT

- BDIT Key Concepts:
BDIT Trustee:
 - Need independent trustee for purposes of making discretionary distributions.
 - Beneficiary (Child) can be investment trustee.

```
graph LR; Trustee((Trustee)) <--> IDIT[IDIT];
```

The BDIT

- BDIT Key Concepts:
The BDIT is a "Grantor Trust" as to Child under IRC (§ 678(a)(2)) :

```
graph LR; Parent((Parent)) -- "Gift: $5,000 Cash" --> IDIT[IDIT];
```

- Parent gives Child a 5/5 power of withdrawal.
- Child does not exercise withdrawal right.
- The "lapse" of the withdrawal right causes the trust to be a "Grantor Trust" as to Child (§ 678(a)(2)).
- The lapse is not a transfer for estate/gift tax purposes (§ 2514(e)).

The BDT

- BDIT Key Concepts:

Child sells interest in closely held entity to BDT in exchange for a promissory note.

```
graph LR; Child((Child)) -- "NMMI Closely Held Entity" --> BDT[BDT]; BDT -- "Promissory Note" --> Child;
```

- Use defined formula valuation clause.
- If re-valued on audit – excess value (gift) allocated to Non-GST Subtrust.
- Incomplete gift as Child retained power to control beneficial enjoyment (via LPA).
- Non-GST Subtrust is included in Child's estate (§ 2036).

The BDT

- Benefits of BDT:

- Estate Freeze.
- "Grantor Trust" for Income Tax Purposes –
 - Child is the grantor under grantor trust provisions.
 - Trust income is taxed to Child.
- Generation Skipping Trust.
- Creditor Protected.

The BDT

- Benefits of BDT:

- Estate Freeze.
- "Grantor Trust" for Income Tax Purposes –
 - Child is the grantor under grantor trust provisions.
 - Trust income is taxed to Child.
- Generation Skipping Trust.
- Creditor Protected.
- Child:
 - Can retain managerial control (can be investment trustee).
 - Can retain control over ultimate disposition of the trust property (through the limited power of appointment).
 - Continues to have discretionary access (through independent trustee).

The § 2704 proposed regulations.

The § 2704 Proposed Regulations.

- § 2704 (a) – deals with lapses, and provides that where:
 - a voting or liquidation right lapses and
 - the family controls the partnership or corporation both before and after the lapse,then the lapse is deemed a taxable transfer.

Value of transfer:

- The value of the interests held by the transferor before the lapse (treating rights as non-lapsing), over
- The value of such interests after the lapse.

The § 2704 Proposed Regulations.

Example:

- Father forms Limited Partnership.
- Father owns 100% of General Partner Units.
- At Father's death, General Partner Units convert to Limited Partner Units.
- The lapse of the voting rights associated with being a General Partner is a taxable transfer.

The § 2704 Proposed Regulations.

- Exception: No lapse occurs if the interest given has all the rights in the donee's hands that it had in the donor's hands. (Treas. Reg. § 25.2704-1(c)(1)).
- Treas. Reg. 25. § 2704-1 (f), Example 4:
 - If Parent has 84% of the vote and gives 42% away in equal shares to each of his children, the reduction from majority controlling shareholder to minority shareholder is not a lapse of a voting right or liquidation right contemplated by § 2704 because the voting rights have not been eliminated.
- Since the voting stock did not become non-voting, no taxable lapse occurred.

The § 2704 Proposed Regulations.

- § 2704(b) – deals with restrictions on liquidation, and provides that if there is:
 - a transfer of an interest in a corporation or a partnership,
 - to a member of the transferor's family, and
 - the transferor and members of the transferor's family hold, immediately before the transfer, control of the entity,then, any "applicable restriction" is disregarded in valuing the transferred interest.

The § 2704 Proposed Regulations.

- § 2704(b)(2) defines "applicable restriction" as any restriction that:
 - limits the ability of the corporation or partnership to liquidate, and
 - either:
 - the restriction lapses after the transfer, or
 - the transferor and members of the transferor's family, alone or collectively, have the right after the transfer to remove the restriction.

The § 2704 Proposed Regulations.

- A restriction imposed or required to be imposed under Federal or State law is not an "applicable restriction" (§ 2704(b)(3)).
- Treas. Reg. § 25.2704-2(b) further provides that a limitation on the ability to liquidate an entity that is more restrictive than the limitations that would apply under State law is an applicable restriction.
- Default State law has become the standard for measuring whether a particular restriction was imposed or required to be imposed by State law.

The § 2704 Proposed Regulations.

- Example:
- Operating Agreement provides that unanimous consent of the partners is required to liquidate the partnership.
 - Would be an applicable restriction and disregarded in valuing the gifted/transferred ownership interest.
- However, State law was changed to provide a default rule that unanimous consent of the partners is required to liquidate the partnership, so
 - Is not an applicable restriction, so the restriction on liquidation is considered in valuing the gifted transferred interest.

The § 2704 Proposed Regulations.

- Most Signification Concepts under Proposed Regulations:
 - Creates "Death Bed Transfer" analysis on lapse of control, imposing 3-year Rule. (Prop. Reg. § 25.2704-1).
 - Changes the State law exception to applicable restrictions, from default State law to mandatory State law. (Prop. Reg. § 25.2704-2).
 - Creates a new class of restrictions ("disregarded restrictions") that would be disregarded in valuing the transferred interest. (Prop. Reg. § 25.2704-3).
 - Effective Date: Not before 30 days after the proposed regulations become final.

The § 2704 Proposed Regulations.

- Creates "Death Bed Transfer" analysis on lapse of control, imposing 3-year Rule. (Prop. Reg. § 25.2704-1).
 - The lapse of a voting or liquidation right as a result of the transfer of an interest within three years of the transferor's death is treated as a lapse occurring on the transferor's date of death, includible in the gross estate § 2704(a).

The § 2704 Proposed Regulations.

Modifies Treas. Reg. 25. § 2704-1(f), Example 4 by adding the italicized language:

- If Parent has 84% of the vote and gives 42% away in equal shares to each of his children, the reduction from majority controlling shareholder to minority shareholder (and thus giving up the right to liquidate) is not a lapse of a voting right or liquidation right contemplated by § 2704 *because the voting rights have not been eliminated, and the transfer occurs more than three years before Parent's death. However, had the transfers occurred within three years of Parent's death, the transfers would have been treated as the lapse of Parent's liquidation right occurring at Parent's death.*

The § 2704 Proposed Regulations.

- Changes the State law exception to applicable restrictions, from default State law to mandatory State law. (Prop. Reg. § 25.2704-2).
 - an applicable restriction does not include a restriction imposed or required to be imposed by federal or state law (as per IRC § 2704-2(b)(3)), but only if the restrictions imposed under federal or state law are mandatory (as opposed to no more restrictive than would apply under the State's default rules.)
 - Requiring unanimous consent to liquidate is not an applicable restriction, only if State law requires unanimous consent to liquidate – rather than State law setting that as the default rule.

The § 2704 Proposed Regulations.

- Creates a new class of restrictions ("disregarded restrictions") that would be disregarded in valuing the transferred interest. (Prop. Reg. § 25.2704-3).
 - A "disregarded restriction" is a restriction that is:
 - a limitation on the ability to redeem or liquidate an interest in an entity,
 - that is described in items (i) – (iv) below, and
 - the restriction in whole or in part either:
 - lapses after the transfer or
 - can be removed by the transferor or any member of the transferor's family, either alone or collectively.

The § 2704 Proposed Regulations.

- Creates a new class of restrictions ("disregarded restrictions") that would be disregarded in valuing the transferred interest. (Prop. Reg. § 25.2704-3).
 - Disregarded restrictions: restrictions that limit the transferee's ability to:
 - (i) sell (liquidate or redeem) the interest;
 - (ii) sell for less than minimum value (net fmv of the interest – liquidation value);
 - (iii) receive full payment within 6 months (the "6 month put"); or
 - (iv) receive cash/property for interest (and for certain active businesses, notes).

The § 2704 Proposed Regulations.

- Reactions:
 - Bills in both House and Senate have been introduced to nullify the proposed regulations:
 - H.R. 6042 states that:
 - The proposed regulations "shall have no force or effect."
 - And further states that "any substantially similar regulations hereafter promulgated, shall have no force or effect."
 - Per Treasury Officials – the proposed regulations are not intended to, and do not, eliminate minority or marketability discounts. Rather are intended to ignore certain restrictions. Will need further regulatory clarification.

The "Null and Void" QTIP Election.

The "Null and Void" QTIP Election.

- Is a QTIP election effective if the QTIP election is not needed to reduce or eliminate estate taxes?
- Many planners now use the combination of the QTIP election and the Portability election to preserve the step-up in basis at the surviving spouse's death.

The "Null and Void" QTIP Election.

- With the basic exclusion amount now equal to \$5,450,000, subject to a COLA;
- And with portability;
- Most clients won't have an estate tax.
- As a result, estate planning now focuses on methods to cause property to be included in a decedent's estate in order to allow a basis adjustment.

The "Null and Void" QTIP Election.

- IRC § 1014 -- property acquired from a decedent receives a step-up (or step-down) in basis equal to the fair market value of the property on the decedent's date of death.
- IRC § 1014(b)(10) -- "property acquired from a decedent" includes property included in the gross estate of the decedent under IRC § 2044 (property for which a marital deduction was previously allowed).

The "Null and Void" QTIP Election.

- Disclaimer Trust:


```

            graph TD
            A[Smith Family Trust] -- "1st Death" --> B[Marital Trust (Revocable)]
            B -- "Survivor's Death" --> C([Survivor's Gross Estate])
            B -.-> D["(Portability Election)"]
            C -.-> E["(100% Step-Up)"]
            
```

| | |
|----------------|--------|
| Survivor's EE: | \$5.45 |
| DSUE: | \$5.45 |

The "Null and Void" QTIP Election.

- Disclaimer Trust:


```

            graph TD
            A[Smith Family Trust] -- "1st Death" --> B[Marital Trust (Irrevocable)]
            B -- "Survivor's Death" --> C([Survivor's Gross Estate])
            B -.-> D["(QTIP Election & Portability Election)"]
            C -.-> E["(100% Step-Up under § 2044)"]
            F["No ET, GE under EE"] -.-> B
            
```

| | |
|----------------|--------|
| Survivor's EE: | \$5.45 |
| DSUE: | \$5.45 |

The "Null and Void" QTIP Election.

- IRS has issued private letter rulings and technical advice memorandum that contain as "dicta" a reference that a QTIP election can only be made if the effect of the election is to reduce estate tax.
- IRC § 2056(b)(7), authorizing the QTIP election, does not contain a requirement that the election must decrease the estate tax.

The "Null and Void" QTIP Election.

- Rev. Proc. 2016-49, IRB 2016-42, modifies/supersedes procedures to disregard as null and void for transfer tax purposes a QTIP election where the QTIP election wasn't necessary to reduce the estate tax liability to zero, where:
 - The estate's federal estate tax liability was \$0 regardless of the QTIP election, thus making the QTIP election unnecessary to reduce the federal estate tax liability; and
 - The executor did not make a portability election.

Stated alternatively – if executor made a portability election, a QTIP election will be respected even if it is not necessary to reduce the estate tax.
