Exploiting Beneficiary Deemed Owner Trust (BDOT)

Apology: I apologize in advance for all the acronyms used in this missive.

Background: In the past we have touched on the creative planning that can arise using a *beneficiary deemed owner trust,* or BDOT. This missive will address how such a classification might be used in conjunction with a qualified terminable interest property trust, or QTIP Trust. With a successful BDOT the primary beneficiary of the Trust is the owner of the Trust's assets for federal income tax purposes. [IRC 678.] The beneficiary, or other Trusts considered to be owned by the trust beneficiary, and the BDOT can enter arm's-length transactions with each other without causing the imposition of income tax on the transactions, and without having to pay income tax on interest or other payments made to the deemed owner/beneficiary from the other party to the deemed owner. Assets that are sold by the BDOT will normally be viewed as appreciating faster than the interest rate that is paid on the note or notes given to the BDOT in exchange for its asset. The promissory note, or notes that are given in exchange for assets sold, will usually be at the applicable federal rate (AFR.) Consequently, the sold assets will be expected to grow at a rate that exceeds the interest rate paid on the note(s) that the BDOT receives in exchange for its assets.

QTIP Trust and IRC 2519: We have covered the IRC 2519 *trap* in the past, which can cause all the assets held in a QTIP Trust to be treated as being gifted by the surviving spouse if any interest in the QTIP Trust, however small, is transferred to a third party, e.g., a gift of a 1% income interest, with the surviving spouse retaining the remaining 99% income interest, still is treated as a taxable gift by the surviving spouse of *all* of the QTIP Trust's assets. However, if the QTIP Trust is classified as a *beneficiary deemed owned trust* then the only beneficiary deriving economic benefit from the sale of assets is the surviving spouse beneficiary. Treasury Regulations treat the surviving spouse's right to withdraw income as being the equivalent to continuing to require all income to be distributed to the surviving spouse beneficiary. [Regulation 20.2056(b)-5(f)(8).] Note that this *right* to withdraw all taxable income of the Trust will qualify the Trust as a BDOT regardless of whether the surviving spouse exercises the right or not.

QTIP Trust as BDOT: How a QTIP Trust might be drafted to become a BDOT to reduce future exposure to federal estate taxes follows.

Fact Pattern: For discussion purposes, assume a wealthy couple. The husband has died. The deceased husband's estate plan provides that a credit shelter trust is funded first, and the balance of his assets then pass to fund a QTIP Trust established for his wife's lifetime benefit. Given the nature of the husband's estate assets, a substantial amount of appreciating commercial real estate is transferred to the QTIP Trust. The wife has a taxable estate in her own name, even without the QTIP Trust assets being included in her own gross estate, such that the appreciating real estate transferred to the QTIP Trust of which she is the lifetime beneficiary will simply cause more estate taxes to be paid on the wife's subsequent death. As noted in prior missives, if the spouse-beneficiary of a QTIP Trust attempts to transfer any interest in the QTIP Trust that will result in a deemed gift of *all* the QTIP Trust's assets. [IRC 2019.] If the QTIP Trust could be drafted as a BDOT, then it could 'sell' its appreciating assets to another Trust created by the wife, also a *grantor* Trust, which could then be used to purchase the appreciating commercial real estate in exchange for a promissory note, thus *freezing* the value of the QTIP Trust's assets (it holds only promissory notes at AFR rates) that will be included in the wife's taxable estate at her death.

All Taxable Income: Previously it was reported that to qualify as a QTIP Trust the spouse-beneficiary must receive all *trust accounting* income, but it does not have to all taxable income that is distributed to meet the definition of an eligible QTIP Trust. [IRC 2056(b)(7).] However, for the QTIP Trust to be classified as a BDOT, the QTIP Trust must pay all taxable income from the Trust, including capital gains income. This broader definition of trust taxable income will cause IRC 678 to apply to the QTIP Trust so that the QTIP Trust will be treated as owned by the surviving spouse for income tax purposes. Accordingly, the QTIP Trust can then engage in income tax-free arms-length exchanges either with the surviving spouse or with another irrevocable *grantor* Trust that the surviving spouse creates, outside of the estate of the surviving spouse for federal estate tax purposes.

Credit Shelter Trust: The husband's credit shelter trust could also be drafted as a BDOT, or *beneficiary owner grantor* Trust. As noted above, for the surviving spouse to be the deemed owner of the credit shelter she must be given the right to withdraw all income, including capital gains, not just fiduciary accounting income. Thus, a surviving spouse who does not have enough assets in her own name to justify creating and funding a *grantor* Trust using her own assets, might engage in similar tax-free exchanges with the credit shelter trust if it too is classified as a BDOT. The credit shelter trust would then be able to purchase assets from the QTIP Trust for an AFR interest promissory note to shift value from the QTIP Trust to the credit shelter trust, if the credit shelter trust assets grow in value at a rate higher than the AFR that is used with the promissory note the credit shelter trust gives to the QTIP Trust. The growth of the credit shelter trust assets would also be without reduction for income taxes because of the surviving spouse being responsible for the income taxes of the credit shelter trust. Perhaps, too, the promissory note given by the credit shelter trust to the QTIP Trust could be converted later for a self-cancelling installment note (SCIN) with a higher interest rate premium used with the note. With that type of promissory note, it would disappear on the surviving spouse's death with no value attached to the QTIP Trust for the survivor's estate tax exposure.

Creditor Risk: The risk associated with a BDOT is the spouse-beneficiary's right to withdraw all income from the Trust. Because of this *right* to withdraw held by the spouse, his/her creditors will also have access to the Trust's income.

Example: Rex died in 2022 leaving $12.0 million to a credit shelter trust that will benefit Rex's wife, Rosie, for her lifetime. The credit shelter trust will not be taxed on Rosie's death nor included in her estate for estate tax purposes. Rosie is the beneficiary of the credit shelter trust. None of the credit shelter trust assets will be included in Rosie's estate at her death. A QTIP Trust was also funded on Rex's death with $20 million. Both the QTIP Trust and the credit shelter trust are structured as BDOTs, with Rosie possessing the right to withdraw all taxable income generated by the Trusts. Assume that both these Trusts are invested primarily with equities and are expected to grow at 8% a year. Assume, further, that the QTIP Trust will distribute 1.5% of its assets to Rosie each year as income and is spent by her on her living expenses. Assume, further, that no distributions are made from the credit shelter trust to Rosie. In 20 years the QTIP Trust will be worth about $68.9 million. The credit shelter trust will be worth about $41.3 million. On Rosie's death the full $68.9 million will be taxed in her estate.

BDOT Sale: Assume that the QTIP Trust sells its $20 million in assets to the credit shelter trust in exchange for a 15-year promissory note that bears interest at 4.5% a year, which is the long-term AFR in effect at the time of the sale. The credit shelter trust will pay to the QTIP Trust $900,000 a year which is income that is disregarded for federal income tax purposes since Rosie is the deemed income tax owner for both Trusts; there is no interest income nor interest expense due to the *grantor* trust rules. This amount can be used by Rosie to pay her income tax liability.

Estimated Tax Savings Results: If the credit shelter trust grows at the rate of 8% a year, being about $2,560,00 on the credit shelter's trust corpus of $32,000,000 [initial funding of $12.0 million plus $20.0 million or purchased assets] and it then pays 4.5% of the $20,000,000 note ($900,000 a year) to the QTIP Trust, the difference (8% - 4.5% = 3.5%] will be growth in the credit shelter trust. After 10 years the credit shelter trust will have roughly $46.9 million in gross assets, and $26,900,000 in assets net of the $20.0 million promissory note that it owes to the QTIP Trust. After 20 years, assuming the note to the QTIP Trust was repaid after 15 years, the credit shelter trust will be worth about $50.150 million in assets. The QTIP Trust would have about $29.4 million in assets compared to the $68.9 million had there been no sale of its assets to the credit shelter trust. In sum, about $15.7 million is saved in federal estate taxes with the transaction between the two BDOTs. Note, too, that the value of the note given to the QTIP Trust may also be subject to valuation discounts that may apply on an unsecured below-market interest only promissory note.

Conclusion: Admittedly this is an aggressive estate planning strategy using the BDOT rules. There are also risks when the IRS sees the *grantor* trust rules exploited in an estate plan to effect an estate *freeze,* akin to its hostility to the installment sale of appreciated assets to an intentionally *defective* grantor trust (IDGT.) That said, the example demonstrates how structuring both the QTIP Trust and the credit shelter trust to give the spouse-beneficiary the *right* to withdraw all taxable income from the Trusts can enable the movement of assets between the two Trusts without incurring any capital gain, and thus monitor the size of the QTIP Trust's assets and its exposure to federal estate taxes on the spouse-beneficiary's death.

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