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LEGAL UPDATES

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Understanding the Unique Benefits of Beneficiary Intentionally Defective Irrevocable Trusts (BIDITs)

A Beneficiary Intentionally Defective Irrevocable Trust (BIDIT) provides a unique planning opportunity because it allows a beneficiary to continue to benefit from his or her own assets while maintaining some level of control and also protecting such assets from estate taxes, creditor, and divorce claims.

What is a BIDIT and how does it work?

A third-party individual, generally a parent or family member (the grantor), creates the BIDIT for the beneficiary. Certain provisions are included so that the trust qualifies as a “grantor trust,” and the beneficiary is deemed to be the owner of the trust assets for income tax purposes. A BIDIT is designed to borrow funds from a beneficiary and make investments on the beneficiary’s behalf. A beneficiary may also sell assets to the BIDIT. Assets of the BIDIT should appreciate outside of the beneficiary’s taxable estate.

What are the benefits of a BIDIT?

A BIDIT has similar benefits to a traditional irrevocable trust in that the assets should not be included in the beneficiary’s estate or subject to creditor and divorce claims. Additionally, by paying the income taxes and transferring appreciating assets to the BIDIT, the beneficiary reduces estate and transfer taxes both for the beneficiary and for future generations. Finally, the BIDIT provides the added benefit that the beneficiary may still enjoy and maintain a certain level of control over the assets transferred to the trust.

Income tax burn

Because the beneficiary is deemed to be the owner of the BIDIT assets for income tax purposes, the beneficiary’s payment of the income tax will act to

“burn off” assets in the beneficiary’s estate that might otherwise be subject to federal or state estate tax. Payment of the income taxes should not cause the assets owned by the BIDIT to be included in the beneficiary’s estate, nor is the payment considered to be a gift for gift tax purposes. Furthermore, the beneficiary may sell assets to the trust without incurring capital gains taxes. Finally, if the income tax burden becomes too heavy, the BIDIT may be amended in the future to provide that the trust, rather than the beneficiary, is responsible for the payment of income taxes.

Control

The beneficiary may retain a certain degree of control over the trust assets by serving as trustee of the BIDIT. Moreover, the beneficiary may be given the power, effective at his or her death, to direct and re-allocate the remaining trust assets among future beneficiaries.

Shift future appreciation out of the beneficiary’s estate

A beneficiary may sell appreciating assets to the BIDIT that would otherwise be included in the beneficiary’s estate and subject to federal and state estate tax. Appreciation on the BIDIT assets should grow estate tax free and generation-skipping transfer tax free.

What are the risks of a BIDIT?

There are several risks to be aware of when considering a BIDIT.

Administrative burden

Technical rules must be followed in funding and administering the BIDIT. In addition, to avoid self-dealing in connection with the transfer of assets to a BIDIT, a transaction trustee should be named to act as the trustee for the purposes of any transaction between the beneficiary and the BIDIT.

Lack of clear guidance

The IRS has not issued definitive guidance in this area and could challenge the use of a BIDIT. There is little Internal Revenue Service authority dealing with BIDITs; however, the structure of a BIDIT relies on statutory provisions in the Internal Revenue Code.

Asset performance

To benefit from a BIDIT, the trust assets must appreciate to an amount greater than the transaction costs of the BIDIT. Further, assets owned by the BIDIT may not receive a basis adjustment upon the death of the grantor or the beneficiary.

Conclusion

BIDITs are an effective estate planning tool for individuals who wish to continue to benefit from their assets and maintain some level of control. Creating and administering a BIDIT involves complex financial, legal, tax, and other considerations. You should consult with your tax and legal counsel before proceeding.

Contact us

If you have questions or would like to discuss how this strategy or others can be used to help meet your planning goals, please contact a member of the Husch Blackwell Private Wealth team or your Husch Blackwell attorney.