FEATURE:
ESTATE PLANNING & TAXATION

ELECTRONICALLY REPRINTED FROM JUNE 2016

TRUSTS & ESTATES

The WealthManagement.com journal for estate-planning professionals

By **William D. Lipkind**

Tax Planning With Self-Settled Non-Grantor Trusts

Help your client achieve a better result

Practitioners are comfortable with and accustomed to drafting inter vivos grantor trusts and using gifts to such trusts to reduce a client's estate tax exposure.[1] But, now that high state income taxes and creditor worries preoccupy many clients, inter vivos non-grantor trusts deserve attention, especially those established in jurisdictions that authorize self-settled spendthrift trusts and impose no state income tax on accumulated income. The primary jurisdictions are Alaska, Delaware, Nevada, South Dakota and Wyoming.

For income tax purposes, all inter vivos trusts are taxed under the Internal Revenue Code, either as a grantor trust or a non-grantor trust. A grantor trust is essentially invisible for income tax purposes, and the trustee doesn't even need to file an income tax return; all of its income and deductions appear on the grantor's personal income tax return.[2] A non-grantor trust is a separate taxpayer, and its trustee files an income tax return for the jurisdiction where the trustee administers the trust.

For estate and gift tax purposes, a transfer to an inter vivos trust, regardless of whether it's a grantor trust or a non-grantor trust, is either a completed gift or an incomplete gift.

After setting out the major tax rules governing the establishment of non-grantor trusts and distinguishing completed gifts from incomplete gifts,[3] I'll turn to examples and illustrations. The uses of non-grantor trusts range from minimizing state income taxes to shifting income tax burdens to low bracket taxpayers to enhanced protection from creditors, including spouses in matrimonial actions.

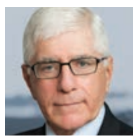
Non-Grantor Trusts

A trust is a non-grantor trust if it's not a grantor trust. An inter vivos trust is a grantor trust if: (1) either the grantor, or his spouse, retains beneficial enjoyment of the income or principal of the trust, or (2) the grantor retains certain controls over the trust assets.

Retention of beneficial enjoyment. IRC Section 677 provides that the grantor is treated as the owner of any portion of a trust the income of which—without the approval or consent of any "adverse party"—is or may be distributed to the grantor or the grantor's spouse, held for future distribution to the grantor or the grantor's spouse or may be applied to the payment of premiums on policies of insurance on the life of the grantor or the grantor's spouse.

"Adverse party" is defined in IRC Section 672(a) as a person who has a "substantial beneficial interest in the trust which would be adversely affected by the exercise or non-exercise of the power which he possesses respecting the trust." IRC Section 672(b) simply defines a "non-adverse party" to be any person who isn't an adverse party.

Unfortunately, it's unclear how much of an interest in a trust a beneficiary needs to be an adverse party. The Treasury regulations provide that an "interest is a substantial interest if its value in relation to the total value of the property subject to the power is not insignificant."[4] The same regulations go on to say that ordinarily, a beneficiary will be an adverse party but that the interest of an ordinary income beneficiary may or may not be adverse with respect to the corpus. Finally, the regulations provide that the interest of a remainderman is adverse with respect to the corpus of the trust but not the income. Case law sheds no light on just how much of an interest



William D. Lipkind is a partner at the Florham Park, N.J. office of Wilson Elser Moskowitz Edelman & Dicker LLP

a beneficiary needs to qualify as being adverse.[5]

Control over assets. A grantor who retains any number of controls over the trust assets will cause the trust to be a grantor trust. If the grantor (directly or through a non-adverse party) retains a reversionary interest, the power to revoke, control over beneficial enjoyment or certain administrative powers, the trust will be a grantor trust.[6]

As reflected by recent private letter rulings,[7] the most common drafting technique for making a trust of which the grantor is a beneficiary a non-grantor trust is to provide that all distributions to the grantor (or the grantor's spouse) shall be made solely at the direction of some, or all, of the trust beneficiaries (other than the grantor or his spouse), commonly referred to as the power of appointment committee (PAC). Typically, the PAC operates either by majority vote with the grantor's consent or unanimously without the grantor's consent.

Making the gift incomplete. To make a transfer to a non-grantor trust an incomplete gift, the draftsman has to walk a narrow line. According to the U.S. Supreme Court and the Treasury regulations,[8] a gift to a trust is incomplete if the grantor retains any power to alter the beneficial enjoyment of the income or principal. A grantor who retains only a testamentary power of appointment (POA) has made a gift of the corpus incomplete, but hasn't made the gift of the income interest incomplete.[9]

Over the past few years, I've received a number of PLRs that demonstrate two discrete ways to achieve incomplete gift status. One is for the grantor to retain in a non-fiduciary capacity a lifetime power to distribute corpus to or for a beneficiary, which power is limited by a reasonably definite standard; the other is for a POA to be given to a beneficiary, the exercise of which requires the consent of the grantor.[10]

A completed gift trust is very different. For example, distributions to beneficiaries, other than the grantor or his spouse, may be made by a trust fiduciary who isn't an adverse party. This eliminates the risk that the beneficiaries could give away any portion of the trust to anyone, including themselves, and leave the trust with no assets that could benefit the grantor. Secondly, in some cases, a distribution to the grantor or his spouse requires only the consent of a single adverse party, not a whole committee. Of course, in a completed gift trust, the grantor can't retain either lifetime or testamentary POAs.

Drafting Pitfalls

In drafting a trust, there's a plethora of tax traps for the unwary. Failure to seek them out may well convert a non-grantor trust into a grantor trust. For example, many trust documents and state trust statutes have decanting provisions whereby the assets of a trust may be transferred to a different trust, usually for the same beneficiaries. In such situations, the trustee must be precluded from decanting into a trust for the benefit of the grantor and/or his spouse without the consent of an adverse party.

> Incomplete gift trusts are generally used when the donor wishes to transfer a sum substantially in excess of his remaining gift tax credits.

Further, counsel must review both the applicable state trust statute and the boilerplate of the trust to make sure that the trustee isn't provided with powers that make the trust a grantor trust. For example, many state trust statutes, and the boilerplate provisions of many trusts, permit a trustee to make loans to a grantor that don't require adequate security. That power alone would make a trust a grantor trust.[11]

In the case of an incomplete gift, if the draftsman wishes to provide the grantor with a testamentary POA[12] and still have a non-grantor trust, it was necessary in the

recent PLRs to allow the beneficiaries to appoint everything to all beneficiaries, including themselves, without the grantor's consent.[13] If the beneficiaries exercise this power, not only will they strip the trust of its assets to the detriment of the grantor, but also, the incomplete gift becomes completed, and the grantor will incur a federal gift tax on the entire amount appointed by the beneficiaries.

Care also must be taken that the trust doesn't name a person as a trust fiduciary who's domiciled either in the grantor's home state[14] or in a state that taxes trusts just because a trust fiduciary is domiciled in that state.[15]

It may be desirable to convert a non-grantor trust into a grantor trust or vice versa. This result can be achieved by providing in the non-grantor trust that if the PAC ceases to exist (when all members resign), the trustee will have traditional discretionary powers to make distributions to the grantor.[16] In the alternative, the non-grantor trust could be decanted with the consent of an adverse party to a trust for the same beneficiaries and become a grantor trust.[17] Similarly, a grantor trust can be decanted to a non-grantor trust.

> Consider using a completed gift non-grantor trust instead of an intentionally defective grantor trust, when the grantor can foresee both an explosion in the value of the assets transferred to the trust and a liquidity event.

Finally, in some asset protection strategies, when the grantor isn't named as a beneficiary, someone such as a protector is given a power, exercisable in a non-fiduciary capacity, either to make the grantor a beneficiary or to appoint funds to the grantor or his spouse. Putting to one side whether such provisions jeopardize the exclusion of the trust assets from the grantor's estate on his death, they surely make the trust a grantor trust.

Uses of Incomplete Gift Trusts

Incomplete gift trusts are generally used when the donor wishes to transfer a sum substantially in excess of his remaining gift tax credits.

A primary use is for an individual domiciled in a high income tax state to transfer assets to a non-grantor trust domiciled in a no-income tax state. Inasmuch as the trust, not the grantor, is taxed on the trust income, the strategy is intended to eliminate state taxation on income that's accumulated, at least with respect to income that isn't source income.

This strategy doesn't work for all persons domiciled in all high income tax states. Some states take the position that if one of its citizens establishes an inter vivos trust, the state will tax the accumulated income of the trust regardless of other facts and circumstances.[18] Such statutes have been held unconstitutional by the highest court in a number of states. Nonetheless, many high income tax states don't have such statutes,[19] but in those that do, there have been intermediate court decisions striking down certain applications.[20]

Non-Grantor Trust Examples

The following three examples demonstrate some uses of a non-grantor trust.

Example 1. Donald Huston lives in New Jersey and is contemplating selling his company, Hoboken Manufacturing, for $55 million and has only a $5 million income tax basis in the stock. Hoboken is a Delaware C corporation. If Don does nothing, he'll pay New Jersey an 8.97 percent gross income tax on the $50 million sales price ($4.5 million). Therefore, Don establishes an incomplete gift non-grantor trust in South Dakota and makes sure that he doesn't name as a trust fiduciary anyone living in New Jersey. The beneficiaries of the trust are Don, his wife and their four adult children. On the sale of the company, the trustee files applicable fiduciary tax returns and pays from the trust the full federal income tax on the sale proceeds. But, because the trust isn't subject to New Jersey tax and is selling stock of a Delaware company, no New Jersey income tax is owed, and Don has just saved $4.5 million.

Example 2. Following the sale in Example 1 and the investment of the sale proceeds, the trustee of Don's trust undertakes a program of distributing income from

the trust to Don's children, all of whom are in income tax brackets lower than those of Don or the trust. In making the distributions, the trust deducts the income so distributed, and the children report the income on their own tax returns.

Example 3. Fred established a grantor trust for the benefit of his children. Years later, when Fred divorced his wife, the matrimonial judge treated the income of the trust, none of which could ever be distributed to Fred, as his income because he included the income on his personal income tax return. Had Fred instead created a non-grantor trust, the conclusion of the matrimonial judge would have been different.

Finally, non-grantor trusts are often used to enhance asset protection. In states that don't permit self-settled spendthrift trusts, the legal effect of such a trust is that a successful creditor can apply to a court to invade the trust to satisfy the creditor's claim to the maximum amount that the trustee could invade the trust for the benefit of the grantor. However, in the case of a non-grantor trust, the trustee has no power to make any distributions to the grantor without the consent of an adverse party and, arguably, the trust therefore isn't self-settled. Regardless of whether the argument succeeds, the grantor is certainly in a better position than he would be with a traditional domestic asset protection trust in which the trustee has the discretion to make distributions to the grantor.

Uses of Completed Gift Trusts

Clearly, a completed gift non-grantor trust can be used to achieve all of the objectives of an incomplete gift non-grantor trust and exclude the trust assets from the federal gross estate of the grantor.

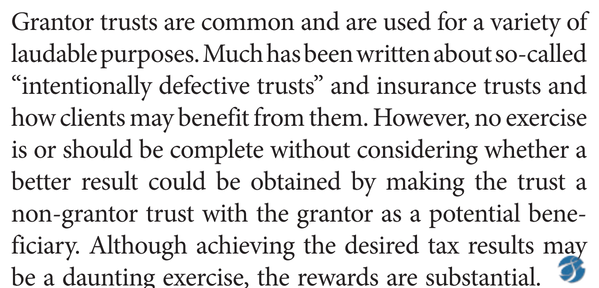
Consider using a completed gift non-grantor trust instead of an intentionally defective grantor trust, when the grantor can foresee both an explosion in the value of the assets transferred to the trust (thus achieving a significant gift and estate tax result) and a liquidity event (thus achieving a state income tax result).

New York recently changed its income tax statutes to make any trust that's an incomplete gift for federal gift tax purposes a "New York grantor trust."[21] Thus, rather than endeavor to tax the income of such trusts (when New York courts have found constitutional restrictions), New York will tax the grantor. But, if the gift is to a completed gift non-grantor trust, New York won't tax either the trust or the grantor on the undistributed non-source income of the trust. To plug that gap, New York imposed a throwback rule for distributions from completed gift non-grantor trusts.[22] This throwback rule, however, applies solely to distributable net income (DNI), and because most completed gift non-grantor trusts don't allocate capital gains to DNI, a completed gift non-grantor trust will shelter a New York domiciliary from New York taxes, both on the sale of his business (without having to move to Florida) and on his portfolio income, without fear of a throwback.

Taxpayers who wish to acquire private placement variable life insurance but don't wish to have the funds invested in insurance-dedicated funds are rightfully concerned about the IRS attributing the income of the life insurance policy to them under the so-called "owner control" theory.[23] If the policy is acquired by a non-grantor completed gift trust and not a traditional irrevocable life insurance trust, the ability of the IRS to assert the owner control doctrine will be substantially curtailed, if not altogether eliminated.

Substantial Rewards

Grantor trusts are common and are used for a variety of laudable purposes. Much has been written about so-called "intentionally defective trusts" and insurance trusts and how clients may benefit from them. However, no exercise is or should be complete without considering whether a better result could be obtained by making the trust a non-grantor trust with the grantor as a potential beneficiary. Although achieving the desired tax results may be a daunting exercise, the rewards are substantial.



Endnotes

1. These trusts are known by a variety of names, including intentionally defective insurance trusts (IDITs), irrevocable life insurance trusts (ILITs), spousal lifetime access trusts (SLATs) and domestic asset protection trusts (DAPTs). *See* Alan E. Rabunski, "Intentionally Defective Grantor Trusts," *The CPA Journal*, Vol. 69, No. 2 (February 1999); Bradley E.S. Fogel, "Life Insurance and Life Insurance Trusts: Basics and Beyond," *Probate and Property* (January/February 2002); Darsi Newman Sirknen, "Domestic Asset Protection Trusts: What's the Big Deal?" 8 *Tenn. J. of Bus. Law* 133 (2006).
2. Treasury Regulations Section 1.671-2(a); Revenue Ruling 2004-64.
3. For a more technical discussion of the tax aspects in this article, *see* William D. Lipkind, "DING Redux," *LISI Estate Planning Newsletter*, #2076 (March 12, 2013); William D. Lipkind, "2016 ING Update," *LISI Estate Planning Newsletter*, #2373 (Jan. 8, 2016); Jonathan G. Blattmachr and William D. Lipkind, "Fundamentals

of DING Type Trusts: No Gift Not a Grantor Trust," *Probate Practice Reporter* (April 2014).

4. Treas. Regs. Section 1.672(a)-1(a).
5. *But see* Private Letter Ruling 201310002 (Nov. 7, 2012), which I obtained.
6. Internal Revenue Code Sections 673 through 676.
7. *Supra* note 5; PLR 201550005 (Aug. 7, 2015).
8. *Estate of Sanford v. Commissioner*, 308 U.S. 39 (1939); Treas. Regs. Section 25.2511-2.
9. Treas. Regs. Section 1.674(b)-1(b)(3); News Release IR-2007-127 (July 9, 2007).
10. *Supra* note 5; PLR 201410001 (Oct. 21, 2013); PLR 201510001 (Oct. 10, 2014); Treas. Regs. Section 25.2514-3(b)(2).
11. IRC Section 675(2).
12. This will enable the grantor to obtain a marital deduction without having a trustee accumulate income for the benefit of the grantor's spouse, which would create a grantor trust under IRC Section 677.
13. *Supra* notes 5 and 10.
14. For example, New Jersey will subject any trust established by a New Jersey domiciliary that appoints a New Jersey resident fiduciary to New Jersey state income taxation (N.J.S.A. Section 54A:1-2(o)(3) and instructions to Form NJ-1041).
15. For example, Arizona (Ariz. Rev. Stat. Section 43-1301(5)).
16. PLR 201510001 (Oct. 10, 2014).
17. Note that the Internal Revenue Service won't rule on any issue relating to a distribution from one irrevocable trust to another irrevocable trust (decanting) (Revenue Procedure 2015-3).
18. For example, Connecticut (Conn. Gen. Stat. Section 12-701(a)(4)) and Virginia (Va. Code Ann. Section 58.1-302).
19. This includes California, New Jersey and New York.
20. There have been successful court challenges to state statutes in Illinois (*Linn v. Department of Revenue*, 2013 IL App. (4th) 121055 (Ill. App. Ct. 4th Dist. 2013)), North Carolina (*Kaestner v. Department of Revenue*, 2015 NCBC 36 (N.C. Super. Ct. 2015)) and Pennsylvania (*McNeil v. Commonwealth*, 67 A.3d 185 (Pa. Comm. Ct. 2013)).
21. NY CLS Tax Section 612(b)(41).
22. NY CLS Tax Section 612(b)(40).
23. William D. Lipkind and Jonathan G. Blattmachr, "Income Tax Aspects of Variable Life Insurance Policies," *Journal of Taxation* (February 2015); *Webber v. Comm'r*, 144 T.C. No. 17 (T.C. June 30, 2015).

Copyright © 2016 by Penton Media, Inc.
For more information on use of this content, contact Wright's Media at 877-652-5295.