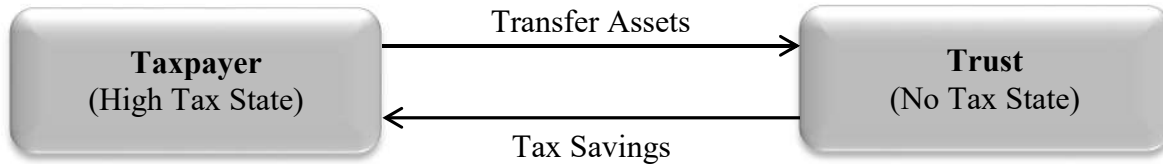


## #15 Incomplete Gift, Non-Grantor (ING) Trusts

Taxpayers in high income tax states should consider transferring assets to a trust in a state that does not tax trust income.



Over time such a trust could produce impressive tax savings.

**Example 1.** Bill Johnson owns a \$3,000,000 investment portfolio that produces \$200,000 of interest, dividends and capital gains per year. Assume that Bill's home state has a 10 percent income tax rate, but would not tax income from a trust created by Bill in another state. By transferring the portfolio to a trust in a state that doesn't tax trust income, and by satisfying certain other requirements, Bill could save \$20,000 per year in state income tax ( $0.1 \times \$200,000$ ). If Bill could reinvest the savings at seven percent, Bill's wealth would increase by \$819,910 over a 20-year period.

Large tax savings might also be achieved by taxpayers holding assets with large capital gains.

**Example 2.** Ellen Smith, a resident of a state taxing long-term capital gains at 10 percent, owns Blackacre with a basis of \$100,000 and FMV of \$1,100,000. If Ellen transferred Blackacre to a trust like the one in Example 1, she could save \$100,000 of state capital gains tax ( $0.1 \times \$1,000,000$  gain). Some commentators have cautioned that in a case like this it might be safer not to make the sale soon after transferring the appreciated asset to the trust.

### Mechanics of the Strategy

To accomplish the desired results, the transaction must be carefully structured to meet all of the following requirements:

- (1) The trust must be created in a state that does not tax trust income;
- (2) The income from the trust must not be taxable by the grantor's home state;
- (3) The trust must allow discretionary distributions to the settlor without making the trust a grantor trust; and
- (4) Transfers to the trust must be incomplete gifts for federal gift tax purposes without making the trust a grantor trust.

### Trust Located in a State that Doesn't Tax Trust Income

The ING trust must be set up in a state that (1) doesn't tax trust income, (2) has a domestic asset protection trust (DAPT) statute, and (3) allows the settlor to retain a lifetime and testamentary non-general power of appointment. Nevada has perhaps become the most popular state for ING trusts. Other states that work include Alaska, Delaware, Ohio, South Dakota and Wyoming.<sup>48</sup>

### Trust Not Subject to Tax in the Settlor's Home State

Locating the trust in one of the states listed above does not necessarily mean that the trust income will not be taxed by the grantor's home state. Most states tax the income of what they refer to as resident trusts. The definition of a resident trust varies from state to state and could include trusts created in other states. For example, Connecticut, the District of Columbia, Illinois, Louisiana, Maine, Maryland, Michigan, Minnesota, Nebraska, Ohio, Oklahoma, Pennsylvania, Utah, Vermont, Virginia, West Virginia and Wisconsin treat trusts as resident trusts if the grantor was a state resident when the trust became irrevocable, regardless of where the trust is located. Other states treat out-of-state trusts as resident trusts based on some combination of the following factors: (1) whether the trust is administered in the state; (2) whether the trustees live in the state; and (3) whether the trust beneficiaries live in the state. Creating a trust in a state that does not tax trust income does not help if the trust income is taxable in the settlor's home state anyway.

### Discretionary Distributions to the Settlor

The trustee must be given the power to make discretionary distributions to the settlor so that the settlor can receive the trust income. However, this must be accomplished without making the trust a grantor trust. If the out-of-state trust is treated as a grantor trust, the settlor will be deemed to be the owner of the trust assets under IRC § 671 and all trust income will be reported on the settlor's Form 1040. This makes the trust income the personal income of the settlor, taxable by the home state just like any other individual income.

Reg. § 1.677(a)-1(d) provides that a trust is treated as a grantor trust if the grantor's creditors can reach the trust assets under applicable state law. In most states, creditors can reach trust assets to the extent a trust allows discretionary payments of income to the settlor. If the trust is structured as a domestic asset protection trust (DAPT), however, allowing discretionary distributions does not make the trust a grantor trust. The states that allow DAPTs and meet the other requirements for an ING trust are listed above.

### Incomplete Gift

Historically, most taxpayers who transferred assets to a state income tax saving trust did not want the transfer to be subject to the gift tax. Thus, they needed to retain enough control over the transferred assets to avoid making a completed gift subject to the federal gift tax and without creating grantor trust status. This was accomplished by (1) giving the settlor a testamentary special power of appointment over the trust assets, and (2) requiring the consent of a distribution committee for any distributions to the settlor. The testamentary special power of appointment made

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<sup>48</sup> Tennessee and a few other states may also qualify.

the transfer to the trust an incomplete gift and the consent requirement allowed the trust to avoid grantor trust status.

However, in CCA 201208026, the IRS took the position that retention of a testamentary special power of appointment makes a transfer in trust incomplete only with respect to the value of the remainder interest, making the value of the lead interest subject to gift tax. Thus, to make the gift incomplete, it is necessary to give the settlor a lifetime special power of appointment as well as a testamentary special power of appointment.

## **Estate Planning**

The sooner wealthy taxpayers can start making lifetime gifts, the more future appreciation they can transfer out of their estates. Until recently, however, there were two factors that discouraged them from doing so. One was a reluctance to pay gift tax or use up the applicable exclusion amount of \$13,610,000 (2024 amount with inflation adjustments). The other was a concern that they might need the assets in the future. The permanent increase in the applicable exclusion amount and the emergence of DAPTs address both concerns. As a result, taxpayers may now wish to make completed transfers to a NING or other DAPT. By doing so, they can remove large amounts from their estates and still have a substantial amount of their applicable exclusion left for future planning. Moreover, if the transfer is made to a DAPT, the trustee can be given discretion to make distributions to the settlor if needed. Such trusts are sometimes referred to as “*rainy day trusts*.”

The 2017 Tax Cuts and Jobs Act enhanced the tax benefit of ING trusts by limiting the federal tax deduction for state and local taxes to \$10,000. The reduced deduction makes avoiding state income tax even more important. Note that ING trusts have been approved in numerous private letter rulings including PLRs 201310002, 201410001, 201440012, 201550005, 201613007, 202006002 and 202007010.

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