LINE OF
SIGHT

INCOMPLETE NON-GRANTOR TRUSTS: THE BASICS

Trust design for state income tax efficiency and wealth preservation

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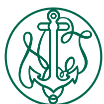
As a result of current tax trends, some individuals face combined federal and state income tax and Medicare contribution tax rates that can exceed 50% or even approach 60%. In the face of these tax trends, there is growing interest in incomplete non-grantor trusts, which may help some clients who reside in high income tax states reduce their state income tax, avoid unwanted federal gift tax consequences and plan for the future transfer of wealth. An incomplete non-grantor trust is designed to be an incomplete gift for gift tax purposes, and as a separate taxpayer resident in a state with favorable trust income tax laws – typically Nevada or Delaware – for state income tax purposes. These trusts can be beneficial when a grantor has fully utilized her federal gift tax exclusion or wants to save the exclusion for future transfers. The trust is included in the grantor's estate and the assets receive a basis adjustment at the grantor's death or the estate tax alternate valuation date, which can help with long-term income tax planning.

Advisors need to help clients structure these trusts carefully to avoid a completed gift and the attendant federal gift tax consequences, and trust ownership by the grantor and consequent imposition of state income tax in the grantor's home state; and to ensure trust residence in a favorable state. This strategy requires making sure the grantor has sufficient control to keep contributions to the trust from being treated as completed gifts, but insufficient control to require that she be treated as the owner of the trust's income. What follows are a number of considerations for designing and implementing the trusts to achieve the goals of incomplete gifting and non-grantor status.[1]

1 See Private Letter Ruling 201310002 for a recent example of an incomplete non-grantor trust design. Private letter rulings may only be relied upon by the taxpayer to whom they are issued and are not legal precedent for other taxpayers.



Northern Trust

When an incomplete non-grantor trust may make sense

Grantor's goals	Advantages of the incomplete non-grantor trust
The grantor desires to establish an irrevocable trust without giving up a basis adjustment for trust assets at death and without using his federal gift tax exclusion or paying gift tax.	Assets held in an incomplete non-grantor trust at death (including appreciation from current value) are included in the grantor's gross estate, and basis is adjusted to date of death or alternate valuation date value. Transfers to the trust are not completed gifts and no applicable exclusion is applied at the time of the transfer to the trust.
The grantor resides in a high income tax rate jurisdiction and is sensitive to state and local income tax burdens.	A trust properly established as a separate taxpayer in Delaware or Nevada is not subject to income taxes in the grantor's home state, provided there is no trust nexus with the home state (such as a resident trustee/advisor) and no state-source income, and the home state does not determine trust residence based on the grantor's domicile.
The grantor has substantial assets outside the trust and wants to preserve a "nest egg" for his family and/or himself.	Trust assets may be protected from creditors of the grantor and beneficiaries as permitted under applicable state and federal law.

Avoiding a Completed Gift

In order to avoid a completed gift and the potential gift tax consequences, i.e., the use of exclusion or payment of gift taxes, it is critical for the grantor to reserve sufficient power over the trust assets. Typically, this is done through the retention of various powers such as limited powers of disposition.

Reserved power. A gift is considered complete if the grantor has given up dominion and control and has not reserved sufficient power to change the disposition of the property.[2] If, however, the grantor reserves a power to direct disposition of the trust's remainder among her descendants, contributions to the trust generally are not completed gifts.[3]

Reserved powers resulting in an incomplete gift include the ability to name new beneficiaries or change the interests among the beneficiaries (unless the power is held by the grantor not individually, but as a fiduciary and is limited in scope).[4] Even if the reserved power can only be exercised in conjunction with another person, as long as that other person does not have a "substantial adverse interest in the disposition of the transferred property or the income therefrom," the gift is still considered incomplete.[5] An incomplete transfer to a trust can later become complete if, for example, a distribution is made from the trust to a person other than the grantor, or the grantor gives up the reserved power or has it terminated during his lifetime.[6]

2 Treas. Reg. Sec. 25.2511-2(b).

3 Id.

4 Treas. Reg. Sec. 25.2511-2(c).

5 Treas. Reg. Sec. 25.2511-2(e). A donor is considered as himself having a power in conjunction with any person not having a substantial adverse interest in the disposition of the transferred property or the income from the transferred property.

6 10 Treas. Reg. Sec. 25.2511-2(f).

Establishing the Trust as a Separate Taxpayer

The goal is for the trust to be viewed a separate taxpayer in the state of choice, rather than the grantor being viewed as the trust owner, since the trust owner can be liable for state income tax in her state of residence. Contrary to the gift tax rules, which expect the grantor to hold onto some control lest the gift be considered complete, the income tax rules require that the grantor relinquish sufficient control, lest she be considered the owner for income tax purposes. Designing the trust to be both an incomplete gift and a non-grantor trust requires careful selection of trustees, committee members and advisors, and precise definition of their powers.

Power of disposition. A trust is treated as owned by the grantor for income tax purposes if the grantor, another person or both together, has a power of disposition over the trust income, assuming the power can be exercised without the approval or consent of an "adverse party." An adverse party is defined as any person who has a substantial beneficial interest in a trust, which would be adversely affected by the exercise or non-exercise of the power he possesses respecting the trust.[7]

Trust income for the benefit of grantor (or grantor's spouse). A grantor can be seen as the owner of the portion of a trust whose income may be distributed, held or accumulated for future distribution to the grantor or grantor's spouse, or applied to the payment of their life insurance premiums, unless the distribution may only be made with the approval of an adverse party.[8] If the grantor's or grantor's spouse's creditors can reach the trust assets, the grantor can be viewed as the trust owner.

Beneficiary powers. Limiting the extent of beneficiary powers, such as powers the beneficiary might have as the member of a distribution or other committee, is also important so that a beneficiary will not be treated as the owner. This can happen, for example, if she is given powers that the IRS considers the equivalent of direct ownership of trust property, such as the ability to withdraw trust assets. If the power is exercisable by the beneficiary alone and for her benefit,[9] the beneficiary can be viewed – and taxed – as the owner.

Trust Residence for State Tax Benefits

In addition to establishing the trust as a separate taxpayer from the grantor, to benefit from the favorable state income tax in a chosen state, it's critical that the trust be considered a resident of that state, rather than the grantor's home state.

Delaware and Nevada are two particularly "tax favored" states for trusts. A Delaware resident trust is not required to file a Delaware income tax return if it has no Delaware resident beneficiaries and no Delaware source income, and Delaware allows a deduction for income accumulated for non-resident beneficiaries.[10] Nevada has no income tax and a constitutional prohibition against a personal income tax.[11]

7 Code Sec. 672(a).

8 Code Sec. 677(a).

9 Code Sec. 678.

10 30 Del. C. Secs. 1635(a); 1636(a).

11 Constitution of the State of Nevada, Article 10, Section 1, Subsection 9.

Certain elements of state law and trust design can affect whether or not the trust is considered a resident of a state with favorable income tax treatment of trusts, or alternately, a resident of a state with unfavorable treatment.[12] The residence rules differ from state to state, but considerations include the residence or domicile of the grantor at the time the trust became irrevocable; and/or the residence or domicile of trustees, fiduciaries or advisors, and beneficiaries. Also, the place of administration of the trust and/or the presence of tangible assets or commercial activity in the state can affect trust residence for state tax purposes.

For example, grantors who live in high income tax states that base the residence of a trust exclusively on the residence or domicile of the grantor may not receive a state tax benefit from incomplete non-grantor trusts, since the trust will be treated as a resident of the high income tax state where the grantor resides even if it is also treated as resident in another state.[13] Also, some states, such as California, tax certain accumulations in out-of-state trusts upon distribution to in-state beneficiaries.

Understanding the numbers

Facts	Grantor Holds Assets	Trust Holds Assets
▪ $10,000,000 assets with $1,000,000 basis ▪ Grantor resident of state with 10% income tax rate ▪ Federal long-term capital gain and Medicare contribution tax 23.8%. ▪ Non-grantor trust established in state with no income tax	▪ Generally $2,142,000 federal tax upon sale ▪ Generally $900,000 state tax upon sale ▪ Generally $6,958,000 after-tax assets remaining for continued investment.	▪ Generally $2,142,000 federal tax upon sale ▪ Generally $0 state tax upon sale ▪ Generally $7,858,000 after-tax assets remaining for continued investment

Red flags for state tax authorities

State taxing authorities may challenge abusive transactions that are designed primarily to avoid incurring state income tax on a particular transaction, such as the disposition of a block of highly appreciated stock. State taxing authorities may be on the lookout for issues including:

- Funding a trust with assets that are certain or even highly likely to be sold shortly after the creation of the trust;
- Funding a trust with assets the grantor may require to sustain his standard of living;
- Selling a trust's principal asset, then distributing all or a substantial portion of the proceeds back to the grantor.

12 State tax residence may be based upon "residence" and/or "domicile." For purposes of this discussion the terms are used interchangeably, although the technical definitions vary. Careful review of the applicable laws of the states in question in a particular circumstance is recommended.

13 Connecticut, the District of Columbia, Illinois, Michigan, Minnesota, Ohio, Pennsylvania, Virginia and Wisconsin are examples of grantor's domicile or so called "residence by birth" states.

10 considerations to address in trust design and implementation

Trust design for tax efficiency is unique to each grantor and trust circumstance. It's important to address a number of considerations, including:

1. The current and future residence of the grantor;
2. The family and financial circumstances of the grantor;
3. The applicable federal and state tax laws;
4. The potential that state taxing authorities may challenge the validity of the trust and the willingness to assume that risk (note, for example, that the State of New York has solicited and received recommendations from New York State Bar Association regarding how to implement taxation of incomplete non-grantor trust);
5. The type of assets to be held in the trust;
6. The selection of the trustee and the scope of the trustee's powers;
7. The selection of committee members and the scope of committee members' powers;
8. The identity of the beneficiaries of the trust and their residence;
9. The identity and residence of advisors and trust protectors; and
10. The ability to grant advisors and committee members powers of direction under state law.

Conclusion

Incomplete non-grantor trusts can be an effective planning strategy under certain circumstances, but this depends on the details of the client's situation, as well as careful trust design and implementation to address issues of control and ownership to ensure the trust is established as an incomplete gift, a separate taxpayer from the grantor, and a taxpayer that is resident in a state of choice. Keep in mind that tax laws change frequently, so it is essential to stay current on the applicable tax laws.

Interested in reading further about incomplete non-grantor trusts? Read our recent *Line of Sight* paper, written by Suzanne L. Shier, director of Wealth Planning and Tax Strategy and Laura G. Mandel, president of The Northern Trust Company of Delaware.

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