



# WRMarketplace

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**TOPIC: The What, Why, Who & How of ING's, DING's and NING's for State Trust Planning.**

**MARKET TREND:** With rising income tax rates and lower market returns, incomplete gift non-grantor ("ING") trusts remain of interest for state trust tax planning as the IRS continues to issue favorable private rulings confirming the federal tax treatment of these trusts.

**SYNOPSIS:** To have an ING Trust, the trust creator ("grantor") must not trigger grantor trust status for federal income tax purposes. In that regard, the IRS has once again released a favorable private letter ruling concerning an ING trust, providing guidance on powers that the grantor and others may hold without invoking federal grantor trust treatment. When this type of non-grantor trust is properly structured and administered, the ING structure conceivably enables a person to transfer high-income producing assets to the trust while potentially managing state (but not federal) income tax expenses and allowing the person to be a discretionary beneficiary.

**TAKE AWAYS:** ING trusts can facilitate state trust and tax planning while allowing the grantor to be a beneficiary and to take part in the trust's administration. Obtaining and maintaining the required federal non-grantor trust status for the ING trust, however,

requires nuanced planning in both trust implementation and operation; otherwise the trust will not achieve its intended goals. Further, ING trusts address state income tax planning only and thus work best as part of a comprehensive legacy plan rather than in isolation.

PRIOR REPORTS: 06-150; 06-59; 13-14; 14-23.

MAJOR REFERENCES: PLR 201628010.

Illustrating the continued interest of both the public and the IRS in so-called incomplete gift non-grantor trusts (“ING trusts”, also referred to as “DINGs” and “NINGs”), the IRS has again released a favorable private letter ruling (“PLR”) on the federal tax treatment of ING trusts, but leaves the door open to invoke grantor trust treatment based on the operation of the trust.

## WHAT ARE ING TRUSTS?

ING trusts refer to any incomplete gift trust established in a state that generally does not subject the income and capital gains of a non-grantor trust to state income tax (an “ING State”, like Delaware (“DING” trust) or Nevada (“NING” Trust)).<sup>1</sup> It is critical to the proper performance of ING trusts that they are created and administered as non-grantor trusts for federal income tax purposes.

## WHY USE ING TRUSTS?

In the right circumstances, ING trusts can facilitate state trust and tax planning. Depending on the laws of the grantor’s residence and the ING trust’s domicile, neither state may tax the ING trust’s income (federal income taxes will apply, however, at rates applicable to non-grantor trusts).<sup>2</sup> In addition, as an incomplete gift trust, no federal gift tax applies to the transfer to the trust,<sup>3</sup> and the grantor may be a trust beneficiary and involved in trust administration during life.

Example: As a simple illustration, assume a single resident of State X expects a \$25 million gain from the sale of a closely-held company. He is considering a transfer of the stock to an ING trust created in an ING State. Also assume: (1) all gain will qualify as net investment income (“NII”) for the 3.8% NII tax, (2) a federal capital gains rate of 20%, (3) a State X income tax rate of 10%, and (4) an ING State fiduciary income tax rate of 0%.

	No ING Trust	ING Trust
Gain from Sale	\$25,000,000	\$25,000,000
Federal Capital Gains Tax (20%)	(\$5,000,000)	(\$5,000,000)
NII Tax (3.8% of gain over threshold) <sup>4</sup>	(\$942,400)	(\$949,529)
X State Taxes (10%)	(\$2,500,000)	\$0
Remaining After-Tax	\$16,557,600	\$19,050,471

## WHO MAY WANT ING TRUSTS?

ING trusts may appeal to an individual who expects a liquidity event or holds high-income producing assets and resides in a state with higher income tax rates that will not tax a non-grantor trust resident in an ING state.<sup>5</sup>

## HOW TO STRUCTURE ING TRUSTS: INSIGHTS FROM PLR 201628010

Newly-issued PLR 201628010 provides further insights into drafting, implementing and administering an ING trust.

**Trust Structure/Distributions.** The grantor creates an irrevocable trust benefiting himself and desired beneficiaries in an ING State. A corporate trustee located in the ING State is the only trustee.<sup>6</sup>

- The trust has a “distribution committee” (“DC”) initially composed of (i) the grantor, (ii) two “Eligible Individuals” (“EIs,” defined as other adult beneficiaries, or the parent/legal guardian of a minor beneficiary or another person who would qualify as an adverse party), and (iii) an unrelated third party. During the grantor’s life, the DC must have at least two EIs. Otherwise, the DC ceases to exist, and distributions to the grantor will not be authorized.
- During the grantor’s lifetime, the trustee is to distribute net income and principal to the grantor and other beneficiaries as follows:
  - As directed by a majority of the DC members, with the grantor’s written consent;
  - As directed by all the DC members unanimously, other than the grantor; and

- o As the grantor may deem advisable, in a nonfiduciary capacity, with regard to trust principal only, for the other beneficiaries' health, maintenance, support, and education.
- At death, the grantor has a testamentary limited power to appoint the remaining trust assets to anyone other than himself, his estate, his creditors, or the creditors of his estate.

**Note:** Although PLR 201628010 may only be relied upon by the taxpayer requesting the ruling, this PLR and prior PLRs<sup>7</sup> provide additional confidence that ING trusts that include these features can attain the intended federal tax treatment (i.e., non-grantor trust status and an incomplete gift to the trust).

**Ensuring Non-Grantor Trust Status.** Grantor trust status causes a trust's income and gain to be taxed to the grantor rather than the trust. As noted, a key feature of an ING trust is that it will not be taxed as a grantor trust at the federal level (the trust will pay its own federal tax) and that neither the trust nor the grantor will be subject income tax at the state level. Since most states have adopted the federal grantor trust rules to determine grantor trust status, a successful ING trust must take steps to ensure its treatment as a federal non-grantor trust, which means avoiding rights and powers that trigger grantor trust status. The following reviews various powers and indicates when they will and will not trigger grantor trust status:

Right/Power	Grantor Trust	Non-Grantor Trust
<b>Powers over Income</b>		
(1) Income may be: (a) distributed to grantor or grantor's spouse, (b) held or accumulated for future distribution to grantor or grantor's spouse, or (c) used to pay premiums on life insurance premiums on grantor and/or grantor's spouse, <sup>8</sup> without the consent of adverse party (e.g., a trust beneficiary). <sup>9</sup>	✓	
(2) Same powers as in (1) but require the consent of an adverse party.		✓
<b>Powers over Beneficial Enjoyment</b>		
(3) Grantor or non-adverse party can control the beneficial enjoyment of trust income or principal: (a) without the	✓	

consent of an adverse party, (b) without being limited to a “reasonably definite standard” (e.g., for health, maintenance, and support), <u>and</u> (c) during the grantor’s life. <sup>10</sup>		
(4) Same powers as in (3) but: (a) require the consent of an adverse party, (b) limit to a “reasonably definite standard,” <sup>11</sup> <u>or</u> (c) allow the grantor the power to appoint, but only exercisable by will. <sup>12</sup>		✓
Administrative Powers <sup>13</sup>		
(5) Grantor or non-adverse party can exercise certain administrative powers, such as a power to borrow from the trust without adequate interest or security or a power to reacquire trust assets by substituting other property of equivalent value.	✓	
(6) Same powers as in (5) except designed to fall under exception (i.e., for borrowing power, trustee may make loans <u>to any person</u> without regard to interest or security under a general lending power or, for substitution power, a person in a fiduciary capacity must approve or consent to the substitution).		✓

An ING trust will be carefully drafted to ensure that the trust powers fall under the non-grantor trust column. For example, ING trusts often take advantage of the “adverse party” exception to the grantor trust rules through the creation of a DC, which is designed to include other trust beneficiaries who would be “adverse parties” on the committee and to provide them with the ability to block distributions to the grantor and the grantor’s spouse. If the composition of the DC should change and the adverse parties are out-numbered, however, the trust would become a grantor trust.

Example: X creates an ING trust for the benefit of himself and his descendants. The DC is initially comprised of X, his friend (an uninterested third party) and X’s two adult children. Distributions must be approved by a majority of the members. If a fifth member is added to the DC who is not an adverse party, distributions would no longer require the consent or approval of an adverse party and grantor trust status would be invoked.

## THE OPEN DOOR: ING TRUST OPERATION

The grantor trust rules treat the grantor as the owner of a trust if, under the terms of the trust instrument or circumstances attendant on its operation, administrative control is exercisable primarily for the benefit of the grantor rather than the beneficiaries of the trust.<sup>14</sup>

In PLR 201628010, the IRS concluded that the actual operation of the trust will determine whether the grantor will be treated as the owner for grantor trust purposes, leaving the door open to an examination of how the trust actually operates to determine whether grantor trust treatment is warranted. Accordingly, even if all of the other controls are in place, to avoid grantor trust treatment, the operation of the trust is critical. If facts indicate the trust is operated primarily for the benefit of the grantor, grantor trust status could still be triggered. Consequently, for an ING trust to be successful, care must be taken in trust operation.

## STATES HAVE THE LAST WORD

While PLR 201628010 is the most recent of several favorable ING trust PLRs, states will have the final say on the availability of ING trust planning, particularly as many of them look to change their tax laws to generate additional tax revenue (See WRMarketplace No.14-17 for changes in New York state laws impacting ING trusts).

## TAKE AWAYS

ING trusts can facilitate state trust and tax planning while allowing the grantor to be a beneficiary and take part in the trust's administration. Obtaining and maintaining the required federal non-grantor trust status for the ING trust, however, requires nuanced planning in both trust implementation and operation; otherwise the trust will not achieve its intended goals. Further, ING trusts address state income tax planning only and thus work best as part of a comprehensive legacy plan rather than in isolation.

## NOTES

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<sup>1</sup> Note that whether a state does or does not impose tax on a particular trust will depend on the circumstance of the grantor and the trust, as well as applicable state law. For example, Delaware resident trusts are potentially subject to the Delaware income tax. Due to certain available state income tax deductions, however, practically, these trusts may not pay Delaware income tax (or file Delaware income tax returns) if (1) none of the living beneficiaries are Delaware residents; and (2) none of the beneficiaries are identified based on their relationship to a Delaware resident.

<sup>2</sup> Clients will need to review the potential state income tax consequences of an ING trust against the higher federal income tax rates and the net investment income tax that will apply to the undistributed income of non-grantor trusts, which take effect at lower thresholds than if the income were taxed to an individual due to grantor trust status (e.g.,

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the top federal income tax rate of 39.6% applies at \$415,050 of taxable income for a single filer and at \$12,400 for a non-grantor trust).

<sup>3</sup> However, since the transfer to the ING trust is and remains an incomplete gift until the grantor's death, the trust assets will be includible in the grantor's estate for federal estate tax purposes. Accordingly, ING trusts likely will work best when combined with complementary estate tax planning, such as obtaining life insurance in a separate irrevocable trust to cover the client's potential federal and state estate taxes.

<sup>4</sup> The NII Tax thresholds are \$200,000 of modified adjusted gross income for a single filer and \$12,400 of adjusted gross income for a non-grantor trust.

<sup>5</sup> Note that a multitude of factors may affect the final state tax analysis, including the domicile of the grantor at the trust's creation or when it became irrevocable, whether the trust is an *inter vivos* or testamentary trust, the residence of trust beneficiaries, the location of the administration or property of the trust, etc. See, e.g., Richard W. Nenno, "Planning to Minimize or Avoid State Income Tax on Trusts," 34 ACTEC J 131 (2008) and Richard W. Nenno & Howard Zaritsky, "State Income Taxation of Trusts Based Solely on Residence of the Testator/Settlor," LISI Estate Planning Newsletter #1646 (May 26, 2010) at <http://www.leimbergservices.com>. As the analysis is highly state specific, local counsel both in the grantor's state and in the contemplated ING State should be consulted to review the potential state income tax consequences prior to implementation of any ING trust.

<sup>6</sup> The PLR does not specify the trust's jurisdiction. However, to help ensure non-grantor trust status, the trust should be placed in a jurisdiction that allows self-settled asset protection trusts to protect the assets from the grantor's creditors.

<sup>7</sup> The proposed structure of the trust in this PLR differs only slightly from the trusts in prior PLRs. See e.g., PLRs 201410001 through 201410010 and PLRs 201310002 through 201310006.

<sup>8</sup> IRC §677. Note that merely the possibility that income will be distributed to or accumulated for the grantor or the grantor's spouse is sufficient to cause grantor trust treatment – actual distributions are not required.

<sup>9</sup> An adverse party for grantor trust purposes means any person having a substantial beneficial interest in the trust that would be adversely affected by the exercise or non-exercise of the power which he possesses respecting the trust. Other beneficiaries of a trust generally would be adverse parties. IRC §672(a).

<sup>10</sup> IRC §674(a).

<sup>11</sup> IRC §674(b)(5).

<sup>12</sup> IRC §674(b)(3). Along with non-grantor trust status, ING trusts require incomplete gifts. Gifts to a trust are generally incomplete if the grantor has a testamentary limited power of appointment over the assets. Powers of appointment that are exercisable by will are another exception to the grantor trust rules and will not trigger grantor trust status.

<sup>13</sup> Internal Revenue Code ("Code") §§673 – 677.

<sup>14</sup> Treas. Regs. §1.675-1(a).

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## DISCLAIMER

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