WRMarketplace

An AALU Washington Report

The *WRMarketplace* is created exclusively for AALU members by experts at Greenberg Traurig and the AALU staff, led by **Jonathan M. Forster, Steven B. Lapidus, Martin Kalb, Richard A. Sirus, and Rebecca Manicone.** *WR Marketplace* 17-05 was written by Greenberg Traurig Shareholder Jonathan M. Forster

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TOPIC: ING Trust Update: The IRS Giveth & the IRS Taketh Away.

MARKET TREND: If lower federal income tax rates are coming, the appeal of incomplete gift, non-grantor ("ING") trusts will only increase as individuals focus their planning on state income taxes.

SYNOPSIS: As discussed in *WRMarketplace No. 16-36,* to create an ING trust, the trust creator ("grantor") must avoid both grantor trust status for federal income tax purposes and making a completed gift to the trust. The IRS has issued several private letter rulings ("PLRs") in this area providing guidance on powers that the grantor and others may hold when creating an ING trust. Recently-issued PLRs again confirm the basic requirements for obtaining ING trust status, including for married grantors in community property states.

The IRS, however, revoked part of an earlier PLR that had previously conferred non-grantor trust status on an ING trust that, in specified circumstances, could terminate and return all trust assets to the grantor during the grantor's lifetime.

TAKE AWAYS: Continued favorable PLRs in this area, although generally non-binding, further solidify the roadmap for ING trust creation. PLRs addressing the treatment of "community property" ING trusts also may open up new planning opportunities for married couples in community property states. Continued attention to these PLRs is crucial to creating an ING trust that allows a person to manage state (but not federal) income taxes and benefit from the trust as a discretionary beneficiary. The toll charge for these benefits is inclusion of the ING trust assets in a client's estate at passing, which can be managed through complementary life insurance planning.

PRIOR REPORTS: 13-14; 14-23; 16-36.

MAJOR REFERENCES: PLRs 201636027-201636032; PLR 201642019; PLR 201650005; and PLRs 201653001-201653009.

As a sign of the increasing popularity of so-called incomplete gift non-grantor trusts ("**ING trusts**"), the IRS continues to issue favorable private letter ruling ("**PLRs**") on the federal tax treatment of these trusts, with one notable revocation of a prior ruling regarding non-grantor trust status.

ING TRUSTS: A REFRESHER

Below is a brief overview of ING trusts. For a more complete discussion of their operation and taxation, see *WRMarketplace No. 16-36*.

<u>What Are They</u>? 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**").[1] To work as intended, ING trusts must be ***created and administered as non-grantor trusts for federal income tax purposes***.

<u>Why Use</u>? 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, however, ***will apply***).[2]

Further, as an incomplete gift trust, no federal gift tax applies to the transfer to the trust,[3] and the grantor may be a trust beneficiary and involved in trust administration during life. The ING trust assets, however, will be includible in the grantor's taxable estate.

Who May Want Them? ING trusts may appeal to individuals who expect liquidity events or hold high-income producing assets. For example, a single individual who expects $25 million of capital gain upon the sale of a closely-held company and transfers the stock to an ING trust could save almost $2.5 million in state income taxes, assuming a 10% state income tax rate.[4]

Important Structural Components. Based on prior PLRs,[5] the grantor creates an irrevocable trust benefiting himself and desired beneficiaries in an ING State, with a corporate trustee located in the ING State as the only trustee.[6] The trust terms include, among other requirements, that:

- The trust has a distribution committee ("**DC**") initially composed of: (1) the grantor and (2) at least two "eligible individuals" ("**EIs**"), who are other trust beneficiaries or another person who would qualify as an adverse party.[7] The DC ceases to exist upon the earlier of the grantor's death or the date the DC has only one EI apart from the grantor, and distributions to the grantor will no longer be authorized.

- During the grantor's lifetime, the trustee is authorized 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
  - 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.

RECENT PLRs: WHAT'S NEW?

<u>The IRS Giveth</u>:

- ***Renewed Confirmation of ING Trusts: PLRs 201636027-201636032 and 201650005.*** Once again, these PLRs ruled, in pertinent part, that for trusts including the key structural components above:
  - The trusts would be ***non-grantor trusts*** for federal income tax purposes as long as the DC remained in existence and administrative control of the trust was ***not*** exercisable primarily for the grantor's benefit, whether pursuant to the terms of the trust or its operation,[8] and
  - Transfers to these trusts would be ***wholly incomplete gifts*** for federal gift tax purposes.
- ***Approval of Community Property ING Trusts: PLRs 201653001 – 201653009***. In two sets of PLRs, the IRS addressed ING trusts created by married grantors residing in community property states and funded with community property. In addition to ruling that these trusts would be treated as ING trusts, these PLRs ruled that the income tax basis of all community property held in the ING trusts would receive a basis step up to the fair market value of such property at the passing of the first grantor (as if the grantors held the property outright).

<u>The IRS Taketh Away</u>

- ***Partial Revocation of PLR 201426014*.** In PLR 201426014, the trust's DC was made up of the grantor's two children and six other individuals, who all were trust beneficiaries. In addition to the key provisions noted above, the trust provided that, if at any point during the grantor's life, the grantor's two children were no longer serving as DC members, or if there were less than two DC members, the trustee would distribute all trust property back to the grantor and terminate the trust. ***PLR 201426014 originally ruled that this trust was a non-grantor trust, but the IRS revoked this ruling in PLR 201642019,*** holding that termination of the trust and return of the trust property to the grantor in these circumstances constituted a reversion under IRC §673 of the grantor trust rules, making the trust a grantor trust.[9]

USING PLRs AS ROADMAP

Clients and advisors should consider these PLRs as a roadmap for drafting and implementing ING trusts. Although PLRs may only be relied upon by the taxpayers requesting the rulings, the similarities among the several sets of PLRs issued over the past few years should provide some confidence that ING trusts structured in compliance with these PLRs can achieve the intended federal tax treatment (i.e., non-grantor trust status and an incomplete gift to the trust). The PLRs on community property ING trusts also may open new planning options for married couples resident in community property states (*e.g.*, California, Arizona, Texas, etc.).

COMPLEMENTING WITH LIFE INSURANCE

As the transfer of assets to an ING trust remains an incomplete gift until the grantor's death, the trust assets will be includible in the grantor's taxable estate. Accordingly, ING trusts will work best when combined with complementary estate planning, such as obtaining life insurance in a separate irrevocable trust to cover the potential federal and state estate tax exposure.

TAKE AWAYS

Continued favorable PLRs in this area, although generally non-binding, further solidify the roadmap for ING trust creation. PLRs addressing the treatment of "community property" ING trusts also may open up new planning opportunities for married couples in community property states. Continued attention to these PLRs is crucial to creating an ING trust that allows a person to manage state (but not federal) income taxes and benefit from the trust as a discretionary beneficiary. The toll charge for these benefits is inclusion of the ING trust assets in a client's estate at passing, which can be managed through complementary life insurance planning.

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NOTES

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[1] Potential ING States include Alaska ("AING" trust), Delaware ("DING" trust), Nevada ("NING" trust), and Wyoming ("WING" trust). 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.
[2] These taxes will apply at rates applicable to non-grantor trusts. Thus, 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.
[3] Any distribution from the trust to a beneficiary other than the grantor, however, will be deemed a completed, taxable gift.
[4] 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 *WRMarketplace No. 16-36*.
[5] For other PLRs ruling similarly regarding ING trusts, see e.g., PLRs 201310002 through 201310006 and PLRs 201410001 through PLR 201410010.
[6] 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.
[7] If the trust beneficiaries are minors, their parent/legal guardian/personal representatives may serve on the DC. Note that, in some case, an unrelated third party may also serve on the DC. The ING trust, however, must 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. For example, assume 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.
[8] *See* Treas. Regs. §1.675-1(a). As in other PLRs, the IRS notes 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 for a later examination of a trust's operation to determine grantor trust status. Thus, proper administration is crucial to maintaining non-grantor trust status.
[9] IRC §673 provides that the grantor shall be treated as the owner of any portion of a trust in which the grantor has a reversionary interest in either the corpus or the income therefrom, if, as of the inception of that portion of the trust, the value of such interest exceeds 5% of the value of such portion.