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Converting to Nongrantor Trusts to Minimize Income Tax: Maximizing Increased Exemption Benefits

Switching Off Grantor Trust Features in Existing Trusts, Structuring Multiple Trusts to Preserve Deductions

TUESDAY, FEBRUARY 4, 2020

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Converting to/Using Nongrantor Trusts to Minimize Income Tax

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Introduction – Grantor Trusts

- Recently, the use of grantor trusts has been prevalent for various estate planning and tax planning reasons, such as:
  - Allowing trust assets to grow unencumbered by payment of income taxes
  - Payment of income taxes not considered additional gift to trust beneficiaries
  - Relatively low estate tax exemption
- Sales to grantor trusts

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Toggling Grantor Trust Powers to Turn Off Grantor Trust Status

- Grantor may renounce the Grantor trust powers, such as:
  - Power to reacquire trust assets through substitution
  - Power to borrow without adequate security

- See PLR 200848017, an example of conversion from nongrantor to grantor trust status by modification to include power to reacquire.

- Decanting from Grantor to Nongrantor Trust

- Best to build flexibility for Grantor into trust document. See, Millstein v. Millstein 2018 Ohio 1204. Grantor had no standing to modify grantor trust status over objections by Trustee and beneficiaries.

- Always Consider Tax Implications
  - Use caution with respect to conversion of grantor trust holding negative basis assets to nongrantor status- gain recognition event. If the grantor must recognize gain, the trust's basis in the property of which gain was recognized would increase.
  - The trust property can be deemed to have changed ownership
  - Termination and re-creation of grantor trust status which allowed a grantor to claim certain losses related to options was flagged as a transaction of interest by IRS (Notice 2007-73).

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Using Adverse Parties to Provide Nongrantor Trust Status to Spousal Trusts

- T creates Trust and spouse is a potential beneficiary. Initially, this is a grantor trust

- Another way to toggle off grantor trust status is to use an adverse party when a trust provides for distributions to a spouse (i.e. Non Reciprocal Trusts/SLATs).

- An “adverse party” is a person who has a substantial beneficial interest in the trust which would be adversely affected by the exercise or nonexercise of a power which he possesses respecting the trust, i.e. a discretionary beneficiary who participates in the decision to make a distribution to another discretionary beneficiary. IRC § 1.672(a)-1

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Using Adverse Parties to Provide Nongrantor Trust Status to Spousal Trusts (cont.)

- In trusts where the grantor's spouse is a beneficiary, grantor trust status can be toggled off when an adverse party become trustee (such as one of the grantor's children), such that distributions to the grantor's spouse can only be made with the approval of the adverse party.

- However, it is important the adverse party and the spouse maintain a positive relationship, especially if the trust provides important income to the spouse.

Transferring Assets to a Nongrantor Trust

- Example: Parent creates nongrantor trust for the benefit of her son, her son's spouse, and her son's descendants. Grantor transfers nominal assets to trust. Son transfers assets into the trust by (1) selling the assets to the trust or (2) loaning the assets to the trust.

  - Trust income will not be subject to state income tax.
  - Son has limited power of appointment pursuant to trust terms which will permit him to control disposition to his family members.
  - Son loans or sells assets to the Trust.

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Basic Structure of Incomplete Gift Nongrantor Trust ("INGs")

Example

Client lives in a high income tax state and owns real estate or other assets which produce significant income. Client sets up an ING which is designed to be a separate taxpayer in a state such as Delaware, Nevada, South Dakota or Wyoming. Client establishes ING and transfers income producing asset. Asset escapes state income tax in client's state of domicile. Trust is includable in Grantor's estate, initially.

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Basic Structure of Incomplete Gift Nongrantor Trust ("INGs")

Benefits

- State Income Tax savings can be dramatic
  - Tax advantage of SALT deductions for separate trusts
  - Qualified business income considerations, 199A deductions
  - Potential to shift income to beneficiaries in lower bracket
- Potential creditor protection, depending on state law
- Preservation of step-up in basis in assets transferred to the trust at the client's death
- No estate and gift tax consequences with respect to clients who have already used their entire estate tax exemption
- Clients can apply estate and gift tax exemption to other lifetime transfers

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Examples of Incomplete Gift Non-Grantor Trusts from IRS Private Letter Rulings

- IRS PLR 201925010:
  - The Grantor contributes property to trust for Grantor, parents and siblings, and all are on Trust Committee.
  - Ruled: **no completed gift, not a grantor trust and there was no general power of appointment for members of the Distribution Committee.**

- IRS PLR 201310002, 201310006 & CCA 201208026
  - With respect to maintaining incomplete gift, it is insufficient for Grantor to only retain a testamentary power of appointment.
  - Due to the above rulings, Grantor should also have a lifetime limited power of appointment (limited to an ascertainable standard).

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Examples of Incomplete Gift Non-Grantor Trusts from IRS Private Letter Rulings (cont.)

- IRS PLR 200612002:
  - "Power of Appointment Committee" was the Grantor's sibling and another beneficiary of the trust. Power of Appointment Committee could distribute income or principal to the Grantor and the Grantor's issue. Power of Appointment Committee acted in a non-fiduciary capacity, and had the authority to act unanimously or with the Grantor and one Committee member.
  - Ruled: **no completed gift, not a grantor trust and there was no general power of appointment for members of the Committee with respect to distributions made to the Grantor.**

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Drafting INGs

Practitioners must ensure that Grantor of ING retains enough control over the trust's assets such that the transfer will not be considered a completed gift, while at the same time ensuring that none of the Grantor trust rules have been triggered.

- Transfer to the ING should be structured as **incomplete gift**, i.e. Grantor, acting in a non-fiduciary capacity may change beneficiaries interests. See, Treas. Reg. §25.2511-2
  - See, PLR 201744006- "Grantor's Consent Power" and "Grantor's Sole Power" caused the transfer of property to a trust to be incomplete for federal gift tax purposes but a distribution from the trust to a beneficiary (other than the Grantor) was deemed to be a completed gift at the time of the distribution. A distribution of property by the Committee to the Grantor was deemed to be a return of property, not a completed gift.
- Trust must maintain **nongrantor status**. See IRC § 641 et. seq.
  - Grantor maintains some elements of control but trust require "adverse party" consent (See, IRC §672(a))
  - Use of "Distribution Committee" in conjunction with Directed Trustee for distributions of income and principal
  - Grantor, spouse and descendants may be discretionary beneficiaries

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State Income Tax Treatment of Nongrantor Trusts – Delaware, Nevada, South Dakota and Wyoming

- Most common states for INGs are states with no state income tax and have favorable treatment for domestic asset protection trusts
- Pursuant to state law, grantor trust status could be triggered if creditors are permitted to reach trust's assets

  - Alaska – no income tax
  - Delaware – no income tax on trusts administered in state of Delaware (income tax treatment varies if trust was created by a resident of Delaware or has a resident Trustee if the Trust has a resident beneficiary)
  - Nevada – no income tax
  - South Dakota – no income tax
  - Wyoming – no income tax

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ING Example

- Grantor held an asset which was going to be sold and produced substantial taxable gain. The value of the asset was above the federal gift tax exemption. Grantor was a resident of a state with an income tax. Grantor transferred the asset to a South Dakota ING, shielding the income from the asset from tax, while not immediately paying gift tax on the transfer of the asset (though still paid federal tax)
  - South Dakota Trust Company as Trustee
  - Beneficiaries are Grantor, children and relatives
  - Relatives are Distribution Committee
  - Distribution Committee may direct Trustee to distribute income and/ or principal to Grantor and descendants by unaniumous consent with Grantor's consent
  - Grantor has lifetime limited power of appointment, ascertainable standard
  - Grantor also has testamentary power of appointment

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Grantor's Domicile

- We must be mindful of residency issues for Grantor's state of domicile and evaluate all relevant contacts with the state
  - Fielding v. Comm'r of Revenue 916 N.W. 2d 323 (2018) MN residents established irrevocable trusts funded with stock in MN corporation. Upon sale of stock, MN sought to tax gains based upon Grantor's residency at the time trusts became irrevocable. There were very limited contacts with state of MN other than Grantor's domicile. Tax Court held taxation was violation of due process, MN Supreme Court Agreed.
  - North Carolina Dep't of Revenue v. The Kimberley Rice Kaestner 1992 Family Trust 139 S.Ct. 2213 (2019) New York resident creates New York trust for his children. All administration of trust assets occurred in NY. NC sought to tax based upon a discretionary beneficiary's state of domicile. Supreme Court ruled residence of the discretionary trust beneficiaries alone cannot support minimum contacts.

- ***per Rev Proc 2020-3, IRB 131, the IRS will no longer issue Private Letter Rulings on income taxation of nongrantor incomplete gift trusts.**

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Q&A

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Converting to Nongrantor Trusts to Minimize Income Tax

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Income Tax Impact: Complete vs Incomplete Gifts

Complete vs Incomplete Gifts

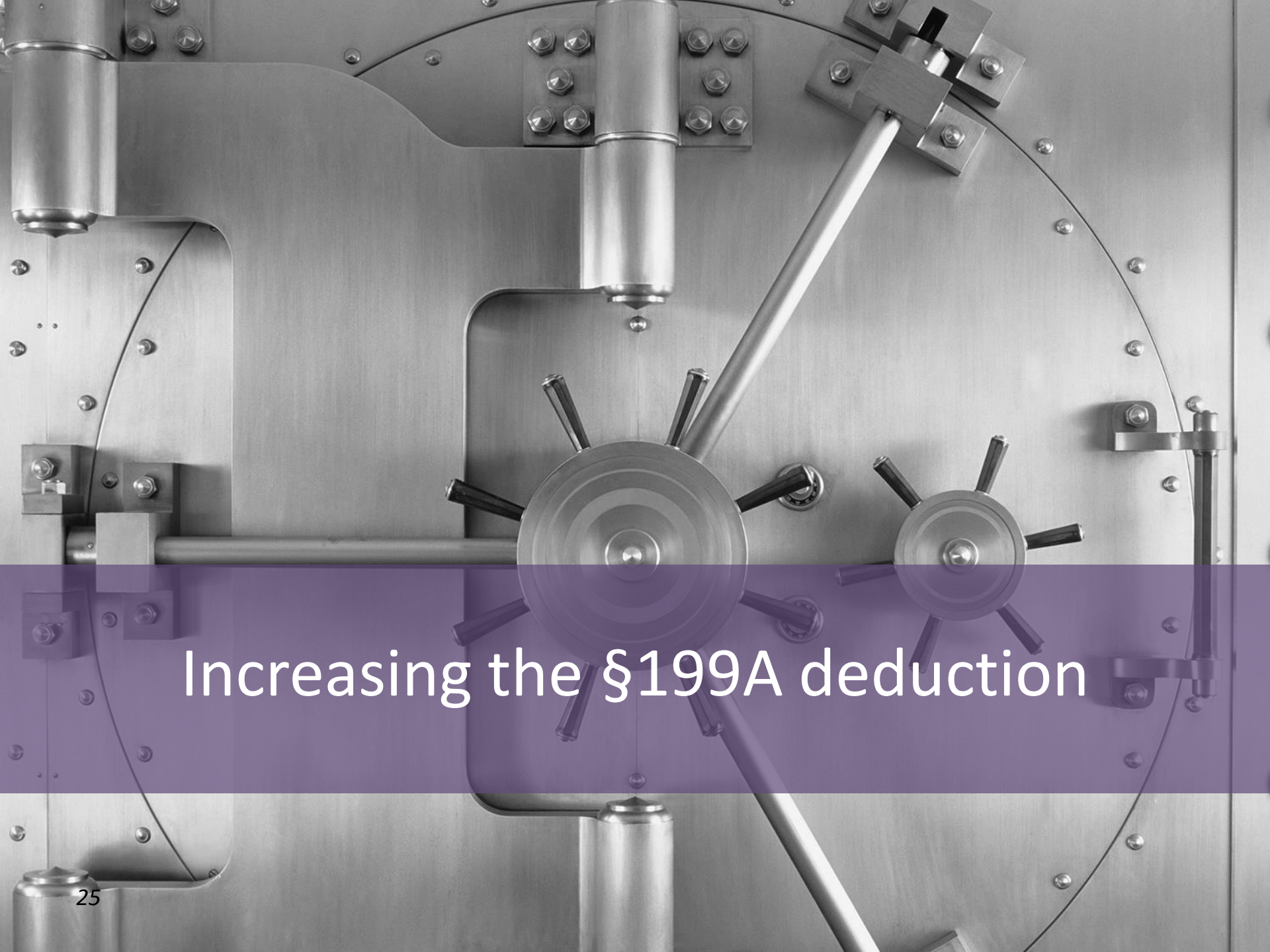
Tax impact:

- Completed Gifts
  - Donor relinquishes all dominion and control over the property transferred
  - Taxable, but asset is removed from estate
  - Retention of only fiduciary powers limited by an ascertainable standard results in a completed gift
  - Gift tax statute of limitations begins to run after filing with adequate disclosure

Complete vs Incomplete Gifts

Tax impact:

- Incomplete Gifts
  - Donor retains the power to modify or revoke
  - Not taxable, but asset is included in estate
  - Gift tax statute of limitations does not begin to run until gift is considered completed.
  - Used often with nongrantor trusts (INGs) to plan around state income tax



Increasing the §199A deduction

Increasing the §199A Deduction

- TCJA of 2017 enacted §199A, which created a deduction for pass-through entities of up to 20% of their "qualified business income"
- "Qualified business income" is the net amount of income, gain, loss and deduction from an eligible trade or business
  - Does not include capital gain and loss, certain dividends from real estate investment trusts, cooperatives and publicly-traded partnerships.
- If and how much of the §199A is actually deductible is a function of the taxpayer's taxable income.

Increasing the §199A Deduction

- Full 20% deduction reduces effective rate from 37% to 29.6%

- Applies to owners of:
  - Partnerships
  - S Corporations
  - Sole proprietorships (Sch C of Form 1040)
  - Rental real estate (Sch E of Form 1040)

- Trusts and estate eligible for the deduction

Increasing the §199A Deduction

- Type of Business
  - Specified Service Trade or Business (SSTB)
    - Health, Law, Accounting, etc.
    - Trade or business where principal asset is the reputation or skill of employees or owners
  - Other (Non-Service)
    - All others

Increasing the §199A Deduction

- If the taxable income threshold is exceeded, the deduction is the lesser of:
  - 20% of QBI, or
  - Greater of:
    - 50% of W-2 wages or
    - The sum of 25% of wages plus 2.5% of unadjusted basis of property

	SSTB	Non-service
Income less than $321,400 (MFJ) or $160,700 (other)	20% Deduction	20% Deduction
Income between $321,400 – 421,400 (MFJ) or $160,700 – 210,700 (other)	Deduction phase out	Limitation Phase in
Income greater than $421,400 (MFJ) or $210,700 (other)	No Deduction	W-2 wages and property basis limitation

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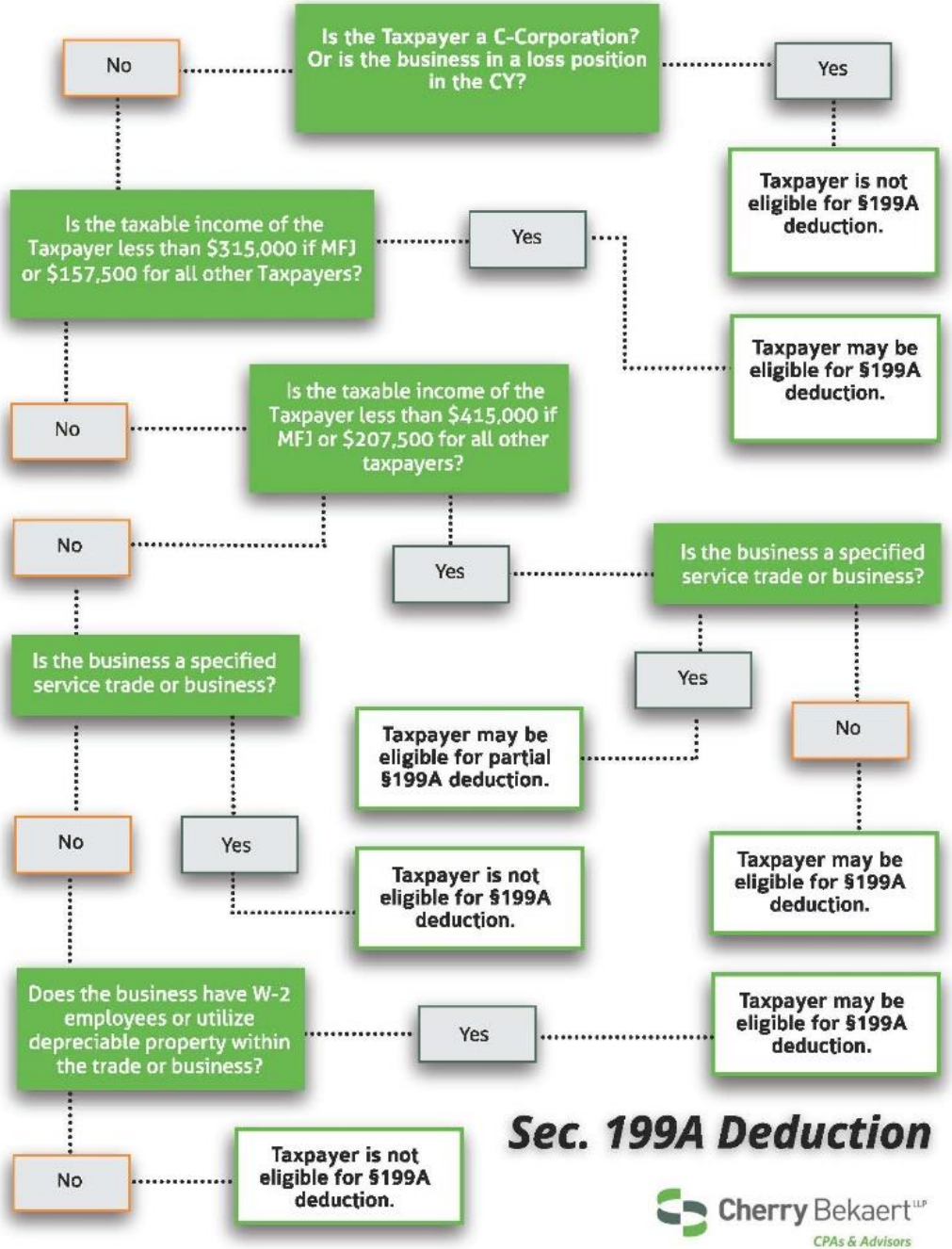

Sec. 199A Deduction

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Increasing the §199A Deduction

- Very board summary:
  - Taxpayers subject to the lowest four tax rates can claim the §199A deduction without limitation
  - Taxpayers in the three remaining higher tax brackets are subject to limitations and a phaseout of the deduction
  - Phase out range:
    - Single $160,700 – $210,700
    - MFJ $321,400 – $421,400

Increasing the §199A Deduction

- Summary continued:
  - Limitations depend on:
    - Nature of the business
      - If the business is deemed to be a specified service trade or business, no deduction after the phaseout is allowed.
    - The amount of W-2 wages paid by the business and
    - The aggregate unadjusted bases of all tangible depreciable property used in the business at the end of the taxable year.

Increasing the §199A Deduction

- Trusts and estates are subject to the same thresholds applicable to individuals
  - $160,700 – $210,700
- Each trust can claim its own QBI deduction
- Shortly after TCJA, creative advisers and taxpayers wanted to leverage this model - transfer partial ownership of the business to multiple trusts in order to maximize §199A deduction.

Increasing the §199A Deduction

- Example:

Andy operates a business that generates $600,000 in qualified business income, but Andy's §199A deduction is limited as a result of his higher income. Andy creates three separate non-grantor trusts, all with his son Opie as the beneficiary. Andy then gives 25% of the business to each trust, keeping 25% interest for himself. Each trust would recognize $150,000 of income (25% x $600,000) which is less than the $160,700 limitation threshold for trusts. Thus, each trust can claim the full 20% §199A deduction without any applicable limitations or phaseouts.

Increasing the §199A Deduction

- Proposed regulations in 2018, which were finalized in early 2019 specifically and effectively denounced this approach.

- Section 643(f): Two or more trusts treated as one if:
  - Substantially the same grantor(s) AND
  - Substanitially the same beneficiary (ies) AND
  - Principal purpose of trust is to avoid income tax

Increasing the §199A Deduction

- Proposed Regs: Presumption that tax avoidance is a principal purpose for use of multiple trusts
  - Removed from final regs.

- Careful planning around Section 643(f) may still allow for multiple trusts to claim deductions

Potential benefits under IRC Section 1202

Potential benefits under IRC 1202

- Section 1202 was enacted in 1993 as an incentive for taxpayers to invest in small businesses. Incentive was US federal capital gain exclusion on the sale of qualified small business stock (QSBS) under Sec. 1202
- A "qualified small business" under 1202 is generally a C corporation with gross assets under $50M
- Stock must have been acquired at original issue in exchange for either money, other property, or services
  - Not in exchange for stock
- Stock must have been held for five years

Potential benefits under IRC 1202

- Section 1202 allows an investor to exclude up to 100% of the gain realized from the sale or exchange of QSBS
  - 50% of gain excluded if QSBS was acquired before 2/18/2009
  - 75% of gain excluded if QSBS was acquired after 2/17/2009 but before 9/28/2010
  - All gain excluded if QSBS was acquired after 9/27/2010
- Investors allowed to exclude the *greater of* $10 million or 10 times the taxpayer's adjusted tax basis
- Gift exceptions
  - Acquired by gift or inheritance: A transferee is treated as having acquired the stock in the same way and at the same time as the transferor.

Potential benefits under IRC 1202

- Rollover (The Sec.1031 of QSBS)
  - Rollover of gain on sale or exchange of QSBS available to trusts if held for more than six months
    - Five year holding period under §1202 exclusion rules not applicable
  - Trust must purchase other QSBS stock within 60 days of sale
    - Basis of new QSBS is purchase price less unrecognized gain from sale of original QSBS
    - Holding period from original QSBS is used for new QSBS
    - Recongizes gain on sales proceeds in excess of the cost of the replacement stock
  - Allows taxpayer to spread risk over QSBS in multiple small corps.

Potential benefits under IRC 1202

- "Stacking up" QSBS exclusions
  - Grantor owning QSBS gifts to irrevocable nongrantor trust which is a separate taxpayer
    - Can a nongrantor trust claim its own $10M QSBS gain exclusion separate from the grantor's $10M exclusion?
    - Can more than one nongrantor trust receive QSBS stock and claim its own $10M exclusion?
  - Each trust should have different beneficiaries
    - Some advisors cautious – reciprocal trust doctrine, etc.
  - Advisors should model QSBS exclusion benefits over taxpayer's lifetime to determine overall best tax strategy

Potential benefits under IRC 1202

- Pitfalls
  - Most common is transferring QSBS and losing QSBS status
    - Transfer to FLP/LLC, etc.
- Best practices
  - Document the purchase
  - Request certification of QSBS from company
  - Track the holding period
  - Compotent estate planning counsel, accountant, corporate counsel

How to increase the SALT deduction by $10,000 per trust

Increasing the SALT Deduction

- TCJA caps individual deduction of state and local taxes at $10,000
- Trend immerging to transfer real property into an LLC along with income-producing assets. LLC interests are then transferred to one or more nongrantor trusts.
- Ideally, the income allocated to each trust equals $10,000, which is offset by the nongrantor trust's own $10,000 SALT deduction
- Salvages otherwise lost SALT deductions, removes income from 1040

Increasing the SALT Deduction

- Considerations:
  - Reciprocal trust doctrine (Sec 643(f))
  - Income tax resulting from the sale of residences
  - Need to transfer income-producing assets out of estate
  - Potential issues transferring mortgaged property to LLC
  - Loss of step-up in basis at death

Increasing the SALT Deduction

- Example:
  - Gomer owns two residences, each of which requires that he pay $20,000 annually in property taxes. Gomer transfers the two residences to a limited liability company, along with other investment assets that generate roughly $40,000 in annual income. Gomer then gives 25-percent interests in the LLC to four separate nongrantor trusts.
  - The result is each trust has around $10,000 in annual income, offset by its $10,000 share of the property tax deduction. The entire property tax deduction amount of $40,000 is salvaged each year, and Gomer can still deduct another $10,000 in personal state and local tax on his 1040. Additionally, the tax liability of $40,000 of investment income has been removed from his 1040.

Summary

- Many/most existing irrevocable trusts drafted as grantor trusts when estate tax savings was main objective
- Income tax savings
  - State income tax savings
  - Federal income tax savings
  - Multiple non-grantor trusts
    - $10,000 SALT deduction per trust
    - 20% QBI deduction per trust
    - Section 1202 opportunity

Q & A