Incomplete Gift Non-Grantor Trusts: Latest Developments and Private Letter Rulings

Leveraging DINGs Into NINGs for Savings in High State Tax Rate Jurisdictions

WEDNESDAY, JULY 24, 2013

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

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Leveraging DINGs into NINGs for Tax Savings
Nevada Incomplete Gift Non-Grantor Trust

There must be a way to save state income taxes!
The Opportunity #1

- Resident of state with state income tax contributes low basis asset to NING Trust
  - Must not be source income of that state
  - Trustee sells low basis asset
  - Avoids state income tax on the sale
The Opportunity #2

- Resident of state with state income tax contributes investment portfolio to NING Trust
  - Trustee continues to invest portfolio
  - Avoids state income tax on gains
Nevada Incomplete Gift Non-Grantor Trust

Through incredibly good marketing, DING Trusts have become popular in Delaware.

The NING Trust

- Like the DING Trust
- But with the enhanced creditor protection of Nevada
NING Trust Description

NING Trust

- Non-grantor trust for income tax purposes
  - Distribution Committee made up of adverse parties

- Incomplete gift for gift tax purposes
  - Retained testamentary power of appointment
  - Retained non-fiduciary inter vivos power of appointment for HEMS
  - Chief Counsel Advisory 201208026
Private Letter Rulings

The IRS has issued several PLRs approving this strategy:

- PLR 200148028
- PLR 200247013
- PLR 200502014
- PLR 200612002
- PLR 200637025
- PLR 200647001
- PLR 200715005
- PLR 200731019
- PLR 200729025
- PLR 201310002
Numerical Example - Low Basis Asset

Example using round numbers

Assumptions

- Business will be sold for $5,000,000
- Income tax basis is $0
- Federal capital gains rate is 20% plus 3.8% Obamacare
- State capital gains rate is 10%
- Disregard Federal income tax deduction for state income tax paid

Using NING Trust

- $5,000,000 sales proceeds
- $1,190,000 Federal income tax (i.e., $5,000,000 times 23.8% tax)
- No state income tax (would have been $500,000 without the NING)
- $3,810,000 after-tax proceeds (would have been $3,310,000 without the NING)
Four Major Tax Issues

1. State Taxation of Irrevocable Inter Vivos Trusts: Domicile of grantor vs. domicile of trust fiduciary
   - IRC §7701 (a)(6) - acting in a fiduciary capacity
   - NY Advisory Opinion - November 12, 2004
   - Source Income
   - Opinion of Legal Counsel
2. Avoid Grantor Trust status under IRC §671 *et seq.* where Grantor is a beneficiary

- Income of Grantor trust taxed directly to Grantor, §671
- Income for benefit of Grantor and/or spouse, §677
  - Trust irrevocable without reversion
  - Spendthrift
2. Avoid Grantor Trust status under IRC §671 et seq. where Grantor is a beneficiary (cont.)

- Exceptions:
  - Distribution controlled by adverse party, §677(a); §674(a)
    - Adverse party is person with substantial beneficial interest in the trust, §672(a)
  - Power exercisable by Will, §674(b)(3)
  - Power to distribute corpus, §674(b)(5)

- Reversionary Interests and Administrative powers, §673; §675; §676
3. Transfer needs to be incomplete for Federal gift tax purposes

- *Estate v. Sanford*, 308 U.S. 39 (1939); Reservation of power to change beneficial interests

- IRC §2511 and §2514 and Regulations promulgated thereunder
  - Reg. §25.2511-2
  - Reg. §25.2514-3

- CCA 201208026
Four Major Tax Issues (cont.)

4. Avoid Members of Distribution Committee having general powers of appointment and thus making taxable gifts when distributions are made

- IRC §2514 and Regulations promulgated thereunder
  - Completed gift; beneficiary power holder trustee replaced on ceasing to serve
  - Coholder no better off opposing lifetime distribution; not a taker in default
  - Problem if DC member is to be replaced
Distribution Committee. Answers two questions: 1) Why is trust not a grantor trust?

- Directs trustee as to all distributions during lifetime of Grantor; trustee cannot otherwise make any distributions or transfers
- Operates either by majority plus Grantor or unanimously without Grantor; need both prongs, §677.
- Consists of four members all of whom are beneficiaries both during Grantor’s lifetime and, in the event he does not exercise his powers of appointment, following his death
Distribution Committee (cont.) Answers two questions: 2) Why do beneficiary members of DC not have GPA?

- Must always have at least two members; member who predeceases Grantor not replaced unless there would be fewer than two members remaining

- Beneficiary members of DC do not have GPA
  - Holder exercises in conjunction with creator, § 2514(c)(3)(A)
  - Coholder has substantial adverse interest
    - Not taker in default
    - But does succeed to power after death of coholder, Reg §25.2514-3(b)(2)
Retained Powers and Rights of Grantor.

Answer question: Why is Grantor’s gift incomplete?

- Grantor is a member of Distribution Committee
- Grantor is a discretionary beneficiary of trust during his lifetime
  - Beneficiary members of DC do not have substantial adverse interest, Reg. §25.2511-2(e)
  - Beneficiary members of DC not takers in default
  - Beneficiary members of DC do not possess power after Grantor’s death. Reg. §25.2514(3)(b)(2)
Retained Powers and Rights of Grantor.
(cont.) Answer question: Why is Grantor’s gift incomplete?

- Grantor has lifetime non-fiduciary power to appoint to beneficiaries (other than himself) limited to an ascertainable standard
- Grantor has testamentary power to appoint to anyone other than his estate, his creditors or the creditors of his estate
- Grantor may appoint and fire investment advisors for the Trust, a directed trust
- Grantor may appoint and fire trustees
PLR 201310002 - The Road Map (cont.)

**Beneficiaries**

- All members of Distribution Committee
- Anyone else the Grantor desires other than his wife

**Nevada**

- PLR 201310002 could not have been accomplished in Delaware, Alaska or South Dakota
- Alaska statute amended
Issues With Settlor’s Domicile State

- Different states, different laws. New York, California, Connecticut, Hawaii, Pennsylvania
  - Taxation of Trust based on domicile of settlor vs. residence of fiduciary

- What is a “fiduciary”?
  - State of New York Advisory Opinion, November 12, 2004

- Notwithstanding federal law, is Trust a Grantor Trust?
  - In re Huber, 2013 Bankr. LEXIS 2038, May 17, 2013
  - Dahl v. Dahl, Fourth Judicial District Court, Utah County, State of Utah, Civil No. 090402989, November 1, 2011
Issues With Settlor’s Domicile State (cont.)

- Restatement of Conflicts 2\textsuperscript{nd}
  - § 273
  - § 6

- State Law
  - New York: NY CLS EPTL § 7-3.1
  - New Jersey: NJSA § 3B:11-1
  - California: Cal Prob Code § 15304 and § 24

- Avoiding state grantor trust status
  - Impact of having a PLR
  - State grantor trust statutes
  - Argument: NING not a self-settled trust and does not offend public policy of non-DAPT state
Drafting Issues

- Minors as beneficiaries and on Committee
- Distribution Committee vs. Power of Appointment Committee
- Beneficiary Members of Committee performing additional functions
- Seek Committee Members not domiciled in Grantor’s domicile
- What to do when number of Beneficiary Members falls to two?
- Who should be residuary remaindermen?
- Structure of Investment LLC
Investment of Trust Assets

- Trustee invests; trust Appointer can fire and hire trustees subject to certain modest restrictions

Directed Trusts:

- Appointer appoints Trust Investment Advisor who directs trustee
- Trust establishes Limited Liability Company and Trust Investment Advisor serves as Manager
- Trust establishes Limited Liability Company and Grantor serves as Investment Manager
Decanting

- Potential solution to problems that may arise
- State statutes
- Internal Trust provisions
- Uncertainty because IRS will not rule, Notice 2011-101, 2011-2 C.B. 932
Protection of Tax Status

- Private Letter Ruling
- Tax Opinion from Counsel without Private Letter Ruling
- No Tax Opinion from Counsel and no Private Letter Ruling
- State is not bound by Private Letter Ruling
Additional Factors to Consider

- Distribution during lifetime of Grantor to Grantor is gift tax free
- Distribution during lifetime of Grantor to any beneficiary other than Grantor is subject to gift taxes
- Distribution during lifetime of Grantor carries out current income of trust and recipient pays the income taxes; trust gets corresponding income tax deduction
- No income tax on distribution of accumulated income except in California (assuming California Grantor)
- Corpus in estate of Grantor upon his death
- Distribution Committee falls to two members
  - Collapse Trust and return all to Grantor?
  - Terminate Distribution Committee and let trust become grantor trust?
  - Decant?
In re Huber

In re Huber, 2013 Bankr. LEXIS 2038, May 17, 2013

Donald Huber was a real estate investor.

The real estate market was crashing and Huber had numerous personal guarantees.

He set up an Alaska DAPT and transferred in $10,000, a 99% LLC interest (holding more than 25 different LLC interests), and other assets, thereby leaving himself insolvent.

Trust assets were not protected.

Blatant fraudulent conveyance.

Filed for bankruptcy: 10-year clawback per Sec. 548(e).

Choice of law issue: Washington resident (bad WA statute/Mastro case was WA resident).
Dahl v. Dahl

Dahl v. Dahl, Fourth Judicial District Court, Utah County, State of Utah, Civil No. 090402989, November 1, 2011

- Charles and Kim Dahl were Utah residents
- Charles set up a Nevada DAPT and transferred his residence (with Kim jointly transferring the residence) and a 97% LLC membership interest (holding brokerage assets) to the DAPT
- Charles and Kim divorced

Trust assets were protected

- Charles won on Summary Judgment
- “As noted by the Court in Innerlight v. Matrix Group, LLC, 2009 UT 31, choice of law and choice of forum provisions contained in contracts and legal documents are enforceable.” [Emphasis added.]
At least one trustee of a spendthrift trust must be:
(a) A natural person who resides and has his or her domicile in this State;
(b) A trust company that:
   (1) Is organized under federal law or under the laws of this State or another state; and
   (2) Maintains an office in this State for the transaction of business; or
(c) A bank that:
   (1) Is organized under federal law or under the laws of this State or another state;
   (2) Maintains an office in this State for the transaction of business; and
   (3) Possesses and exercises trust powers.
NRS §166.015.1(d) - Other Requirements

At least one Nevada trustee must have powers that include

- maintaining records, and
- preparing income tax returns for the trust

All or part of the administration of the trust must be performed in Nevada
Thank You For Attending Today’s Seminar

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