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NING and DING Trusts in Estate Planning: Designing ING Trusts to Avoid State Income Tax and Protect Assets

Effective Drafting of Incomplete Gift Non-Grantor Trusts, Jurisdictional Differences, IRS PLRs

TUESDAY, AUGUST 11, 2015

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

Today's faculty features:

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NING and DING Trusts in Estate Planning: Designing ING Trusts to Avoid State Income Tax and Protect Assets

Presented by:

Robert S. Keebler, CPA/PFS, MST, AEP (Distinguished), CGMA and
Steven J. Oshins, Esq., AEP (Distinguished)

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
  - 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

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

How States Tax Non-Grantor Trusts

- The NING Trust doesn't work if you can't work around the resident's state income tax rules
  - Source income
  - Non-source income
    - Grantor's residency?
    - Administered in state?
    - Resident trustee?
    - Resident beneficiary?

PLR 201310002

- Grantor created irrevocable trust for the benefit of himself and his issue
  - Grantor had four sons
- Sole Trustee = corporate trustee
- Distribution Committee = Grantor and his four sons
  - Must be at least two members or the Distribution Committee ceases to exist
  - Ceases to exist upon Grantor’s death

PLR 201310002 (cont.)

- During Grantor's lifetime, distributions may be made…
  - Grantor's Consent Power: Majority of Distribution Committee Members plus written consent of the Grantor
  - Unanimous Member Power: All of the Distribution Committee Members, other than the Grantor
  - Grantor's Sole Power: Grantor, in a non-fiduciary capacity, may distribute to one or more of Grantor's issue for HEMS

PLR 201310002 (cont.)

- Grantor retained the following powers to avoid a completed gift:
  - Lifetime power of appointment, in a non-fiduciary capacity, to distribute to one or more of Grantor's issue for HEMS
  - Testamentary power of appointment to appoint to anyone other than the Grantor's estate, the Grantor's creditors or the creditors of the Grantor's estate

PLR 201310002 (cont.)

- Requested Rulings
  - Request #1: Rule that the trust is a non-grantor trust for income tax purposes
  - Request #2: Rule that contributions to the trust by the Grantor are not completed gifts for gift tax purposes
  - Request #3: A distribution from the Distribution Committee to the Grantor is not subject to federal gift tax by any member of Distribution Committee
  - Request #4: A distribution from the Distribution Committee to a beneficiary other than the Grantor is not subject to federal gift tax by any member of Distribution Committee

PLR 201310002 (cont.)

- Requested Ruling #1: Rule that the trust is a non-grantor trust for income tax purposes
  - Self-settled asset protection trust jurisdiction
  - Many grantor trust provisions have "adverse party" exception:
    - "person having a substantial beneficial interest in the trust which would be adversely affected by the exercise or nonexercise of the power…"
  - Retained lifetime power of appointment for HEMS in non-fiduciary capacity
    - IRC Sec. 674(b)(5)(A) – "reasonably definite standard"

PLR 201310002 (cont.)

- Requested Ruling #2: Rule that contributions to the trust by the Grantor are not completed gifts for gift tax purposes
  - *Estate of Sanford*, 308 U.S. 39 (1939) - Reservation of power to change beneficial interests
  - Treas. Reg. Sec. 25.2511-2(b)– Transfer of property where donor retains testamentary power of appointment is incomplete gift
    - Remember Chief Counsel Advisory 201208026
  - Treas. Reg. Sec. 25.2511-2(c)– Transfer of property where donor retains power to change interests of the beneficiaries is incomplete gift unless power is a fiduciary power limited by a fixed or ascertainable standard

PLR 201310002 (cont.)

- Requested Ruling #3: A distribution from the Distribution Committee to the Grantor is not subject to federal gift tax by any member of Distribution Committee
  - IR-2007-127 (July 9, 2007) – IRS announced that they were reconsidering whether the Distribution Committee was making gifts
  - According to the PLR, "…any distribution of property by the Distribution Committee from Trust to Grantor is merely a return of Grantor's property."

PLR 201310002 (cont.)

- Requested Ruling #4: A distribution from the Distribution Committee to a beneficiary other than the Grantor is not subject to federal gift tax by any member of Distribution Committee
  - Grantor's Consent Power – IRC Sec. 2514(c)(3)(A) says power of appointment exercisable in conjunction with creator of the power is not a GPOA
  - Unanimous Member Power – IRC Sec. 2514(c)(3)(B) says power of appointment exercisable in conjunction with person having substantial interest in the property which is adverse to the exercise of the power is not a GPOA
    - The PLR gives an example using "X, Y and Z" demonstrating the point

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)

Numerical Example – Portfolio

- Example using round numbers
- Assumptions
  - $3,000,000 stock/bond portfolio
  - 6% annual dividend/capital gains income
  - State dividend/capital gains rate is 10%
- Using NING Trust
  - $180,000 annual dividend/capital gains income
  - No state income tax (would have been $18,000 without the NING)
  - This is just one year –-- the results compound over time!

NRS §166.015.2 - Trustee Requirements

- 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

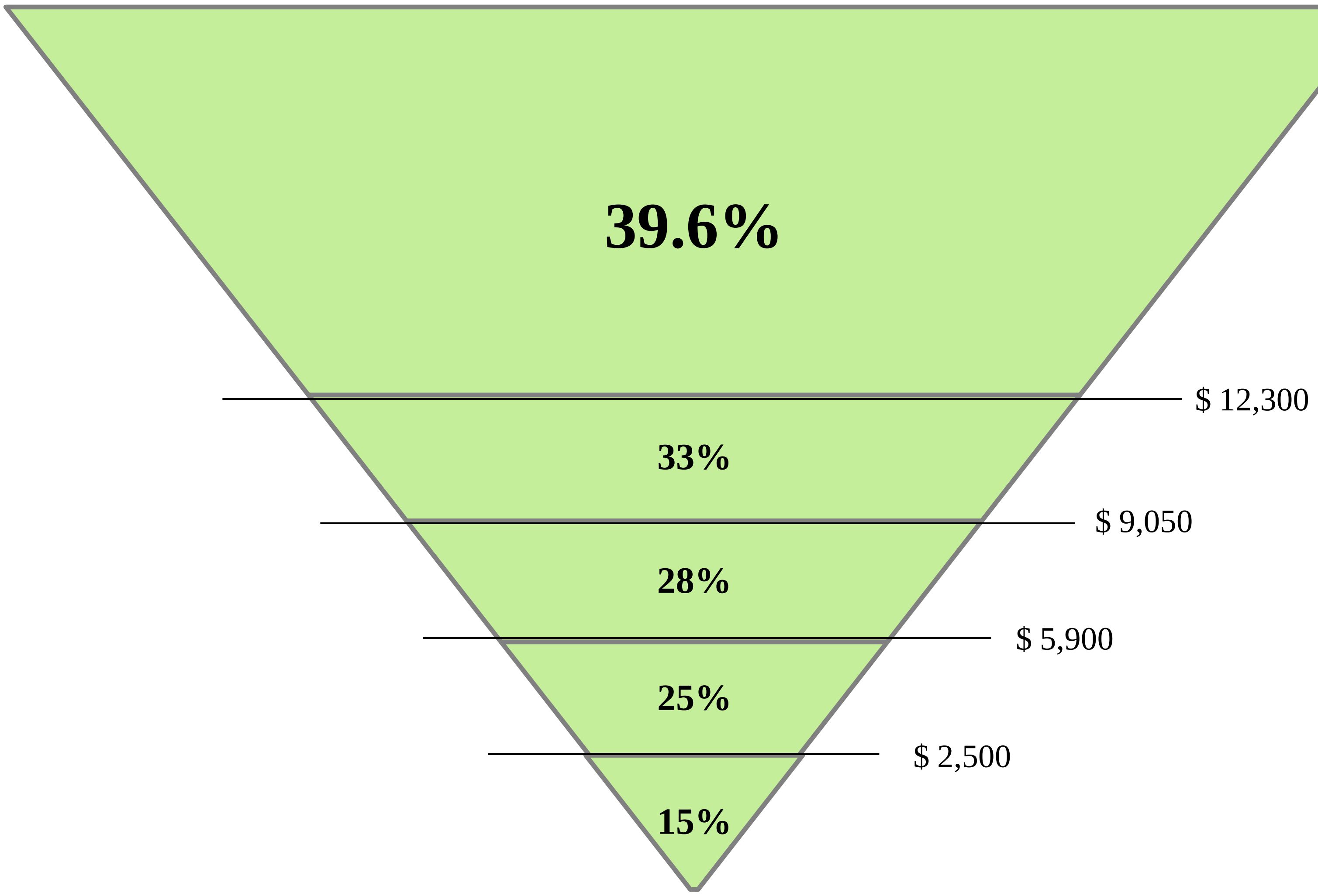
- At least one Nevada trustee must have powers that include
  - maintaining records, and
  - preparing income tax returns for the trust
- All or part of the administration of the trust must be performed in Nevada

Other Use – Sprinkling Income

- Many of our clients make annual exclusion gifts (and sometimes exemption gifts) each year
- Rather than making a gift out of their pocket, consider:
  - Distribution from NING Trust of $14,000 per year (or $28,000 per year if Grantor is married) to each intended beneficiary
  - Most of our clients’ children, grandchildren and other intended beneficiaries are in lower income tax brackets

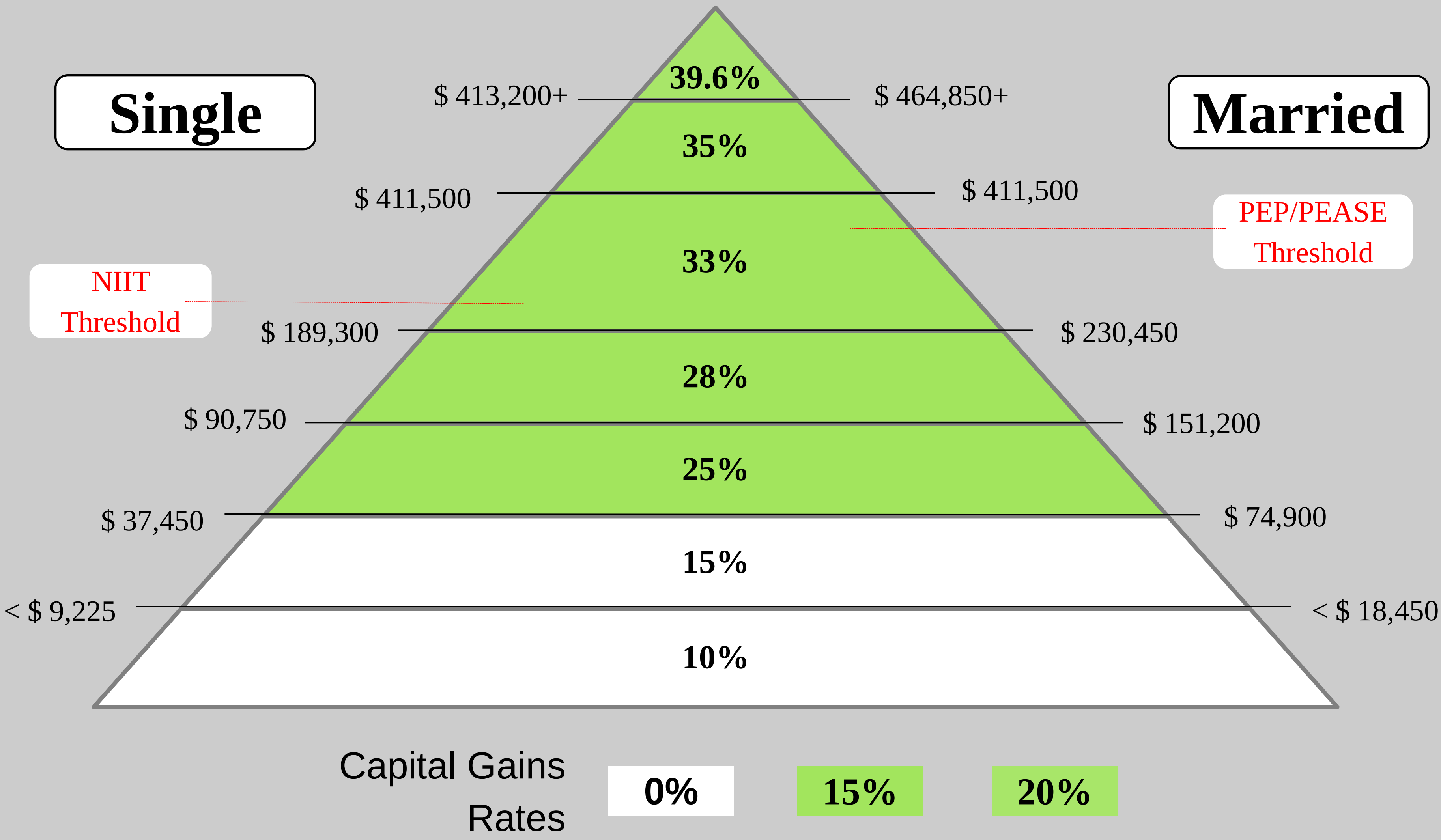
Other Use – Sprinkling Income

2015 Ordinary Income Tax Rates for Estates & Trusts



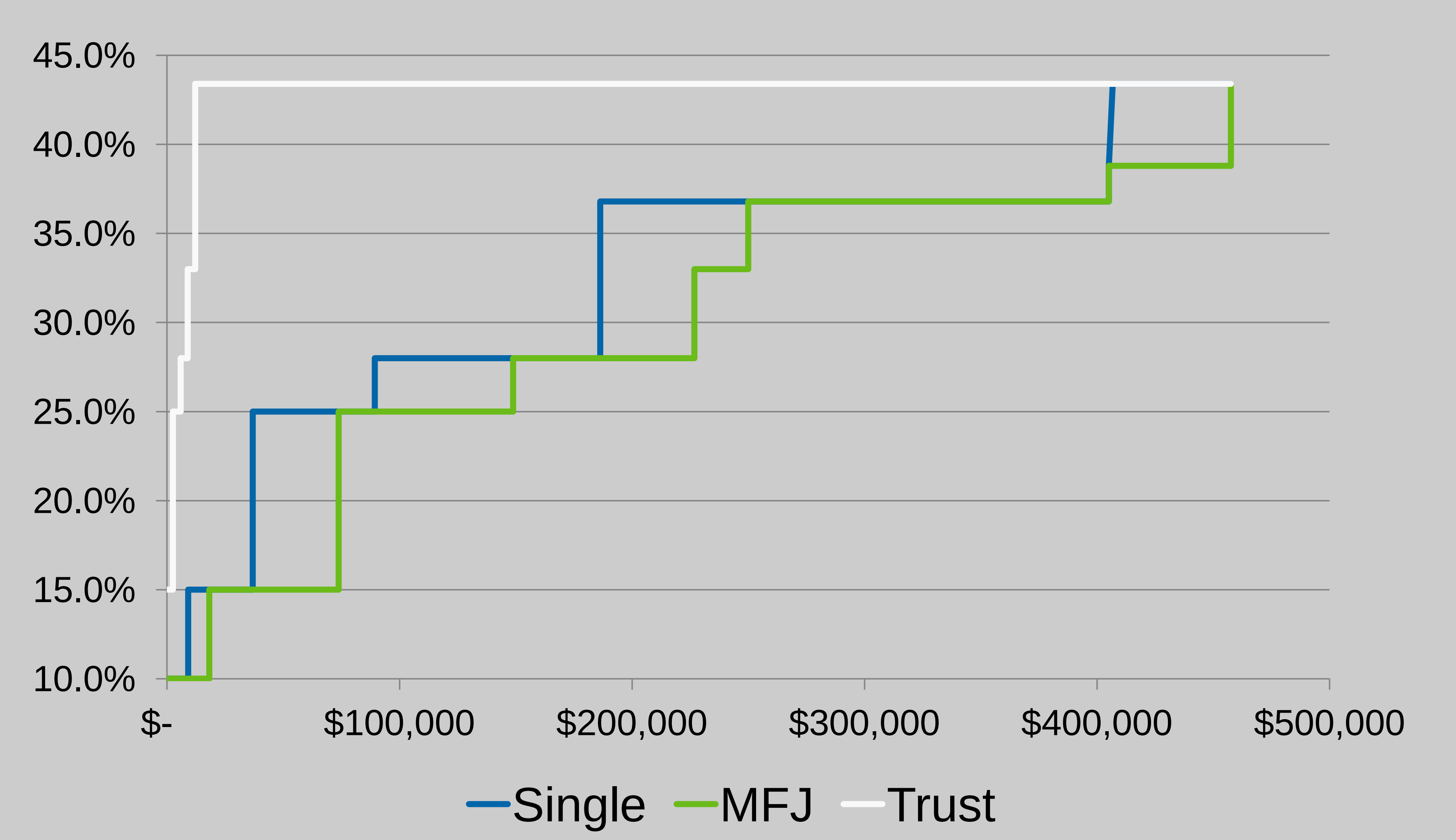
Other Use – Sprinkling Income

2015 Ordinary Income & Capital Gain Rates for Individuals



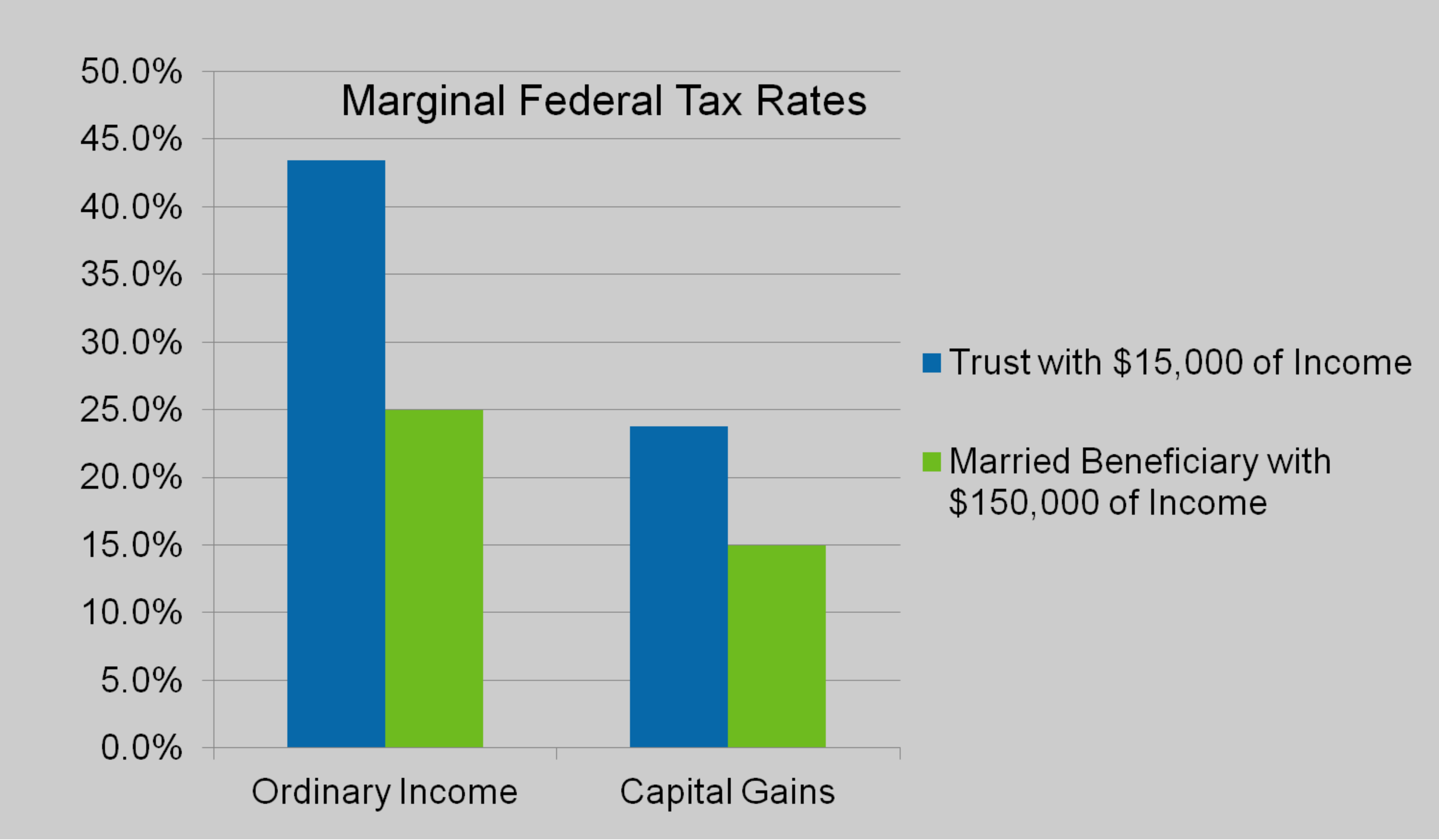
Other Use – Sprinkling Income

Federal Marginal Rate Comparison



Other Use – Sprinkling Income

Federal Tax Savings of Shifting Income



Other Use – Sprinkling Income

General Tax Rules

- Income taxed to either the trust or the beneficiary
  - If income is accumulated, then the income is taxed to the trust
  - If income is distributed, then the trust receives an income tax deduction and beneficiaries report taxable income

Other Use – Sprinkling Income

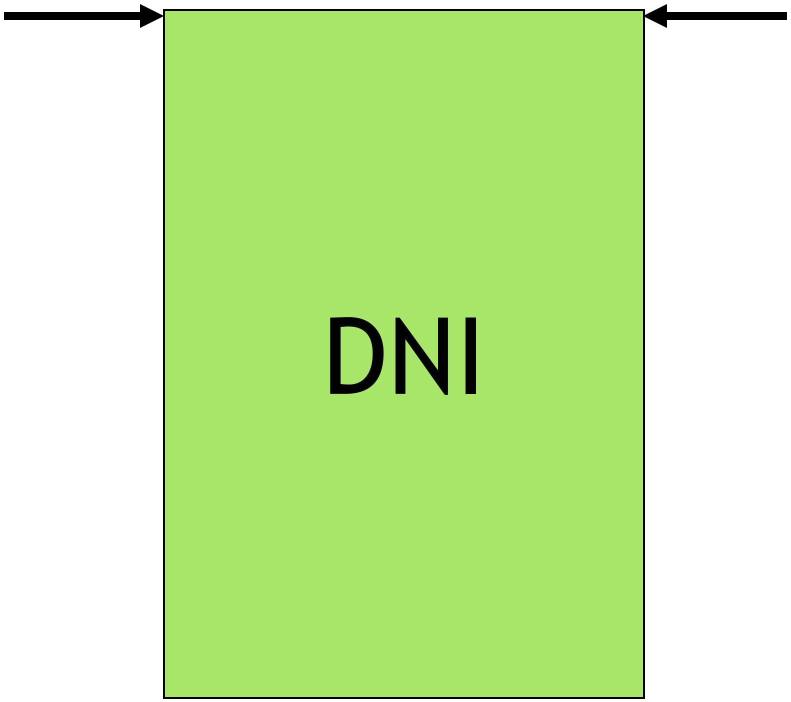
Distributable Net Income (DNI)

- Determines the amount of the trust's or estate's income distribution deduction.
- Determines how much the beneficiaries must report as income on their tax returns.
- Determines the character (e.g. interest, dividends, etc.) of the taxable income in beneficiaries' hands.

Other Use – Sprinkling Income

Distributable Net Income (DNI)

<u>Trust/Estate</u>
DNI acts as a ceiling for purposes of the allowable deduction



<u>Beneficiary</u>
DNI acts as a ceiling for the total amount of income the beneficiary must report on his/her tax return

Other Use – Sprinkling Income

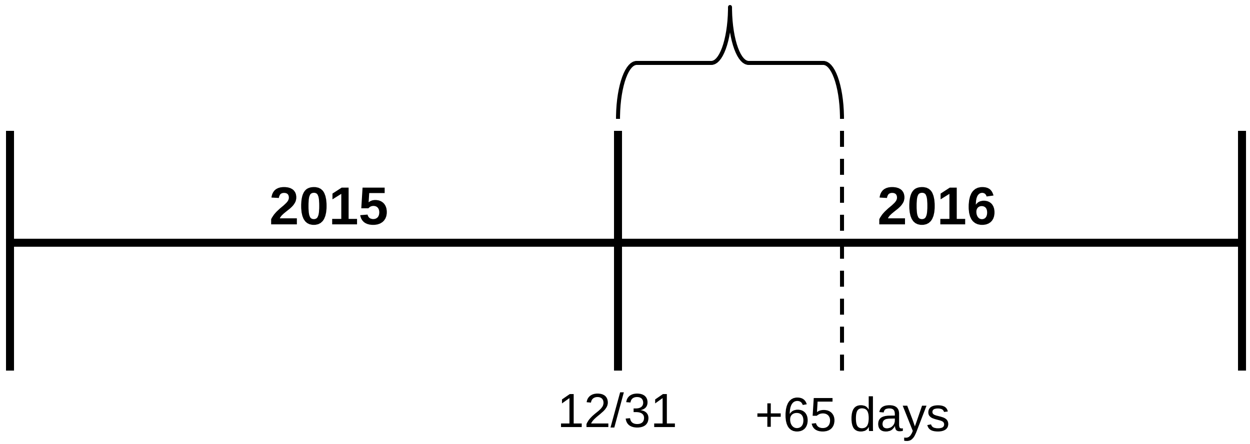
"65-Day" Rule – IRC 663(b)

- Applies to estates and complex trusts
- Allows fiduciary to treat distributions made within 65 days after year-end to be treated as if they were made as of December 31st of the prior year
  - Limited to DNI (reduced by distributions made during the prior year)
- Election must be made by the due date of the tax return
  - Election is irrevocable
  - Annual election

Other Use – Sprinkling Income

"65-Day" Rule – IRC 663(b)

Distributions for the 2015 tax year made during this period will be treated as have been made as of 12/31/2015 (if a timely election is made)



Other Use – Reducing the Itemized Deduction Phase-out

- IRC §68 (named after Congressman Pease) limits the use of itemized deductions.
- It reduces certain itemized deductions of individuals by 3% of the amount by which AGI exceeds a threshold, up to a maximum reduction of 80% of the affected deductions.
- The 2015 thresholds are as follows:
  - Single $ 258,250
  - Head of Household $ 284,050
  - Married Filing Jointly $ 309,900

Other Use – Reducing the Itemized Deduction Phase-out

Example

- Consider a single taxpayer with an AGI of $3,000,000 and itemized deductions of $100,000.
- This taxpayer's income exceeds the threshold by $2,741,750 [$3,000,000 - $258,250].
- Itemized deductions are reduced by the maximum amount of $80,000 [$100,000 x 80%] because this amount is less than the $82,253 [$2,741,750 x 3%] calculated using the 3% phaseout.

Other Use – Reducing the Itemized Deduction Phase-out

Example (cont)

- Therefore the taxpayer can only claim $20,000 in itemized deductions [$100,000 - $80,000].
- Assuming the lost deductions of $80,000 would have offset ordinary income and the NIIT applies, the taxpayer will incur $34,720 [$80,000 x 43.4%] in additional tax.

Other Use – Reducing the Itemized Deduction Phase-out

Example (cont)

- However, consider if the taxpayer shifts income producing investments into trust and reduces AGI to $500,000.
- In that case, the $100,000 in itemized deductions are only reduced by $7,253 [($500,000 - $258,250) x 3%] and the tax savings are $31,572 [$34,720 – ($7253 x 43.4%)].

Thank You For Attending Today's Seminar

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