WRMarketplace
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The *WRMarketplace* is created exclusively for AALU Members by the AALU staff and Greenberg Traurig, one of the nation's leading tax and wealth management law firms. The *WRMarketplace* provides deep insight into trends and events impacting the use of life insurance products, including key take-aways, for AALU members, clients and advisors.

TOPIC: "ING" Trusts & Income Tax Planning – Good News & Bad News.

MARKET TREND: Higher overall income tax rates have incentivized many clients to focus on income tax planning, including reductions in anticipated state income tax liabilities, potentially through the use of so-called incomplete gift non-grantor ("ING") trusts. While recent IRS guidance has created more certainty regarding the federal tax treatment of these trusts, state scrutiny of these trusts may be on the rise.

SYNOPSIS: The IRS has again released a series of favorable private letter rulings ("PLRs") regarding ING trusts (created in Nevada), finding that the trust structure outlined in these rulings resulted in (1) a non-grantor trust for federal income tax purposes, and (2) wholly incomplete gifts to the trust for federal gift tax purposes. Properly implemented, these trusts conceivably allow a person to transfer high-income producing or appreciating assets to a trust without triggering federal gift tax while also limiting their state income tax obligations with regard to those assets. Despite renewed federal clarity, however, some states, like New York, are attempting to eliminate these trusts' potential state income tax planning benefits.

TAKE AWAYS: Although PLRs may only be relied upon by the taxpayers requesting the rulings, the recent PLRs essentially clarify how to create an ING trust that should attain the desired federal income and gift tax treatment. At the same time, ING trust taxation has become a target for revenue hungry states, like California and New York (as discussed herein), which may limit or eliminate ING trust planning benefits. For clients who can take advantage of ING trust planning, the approach will work best when combined with complementary estate tax planning, such as life insurance to cover the client's potential estate tax exposure, since ING trusts do not provide transfer tax protection.

PRIOR REPORTS: *06-150; 06-59; 13-14; 14-17.*

MAJOR REFERENCES: *PLRs 201410001 through PLR 201410010.*

The IRS has again released a series of favorable private letter rulings ("**PLRs**") on the federal tax treatment of ING trusts. For the right clients, these trusts may offer a way to manage their state

income tax exposure, although some states are attempting to eliminate these trusts' potential state income tax benefits.

OVERVIEW

Trust Structure. As discussed in *WRMarketplace No. 13-14*, an ING trust generally involves an individual resident of a high-income tax state who transfers income-generating or appreciating assets to an irrevocable, non-grantor trust created in a state that will not subject the trust's income or capital gains to state income tax (a "no-tax trust state", *e.g.*, Delaware ("DING" trust), Nevada ("NING" trust), etc.).[1] The typical ING trust allows the grantor to benefit from the trust during life and to retain some control over the trust assets to ensure the transfer to the trust is an incomplete gift for federal gift tax purposes. A properly implemented ING trust conceivably allows a person to transfer high-income producing assets to a trust while retaining economic benefits and reducing the state income tax obligations associated with those assets, all without triggering federal gift tax.

State Income Taxation. The income of a properly structured ING trust should not incur state income tax in either the grantor's state or the trust's state of residence. Thus, ING trusts likely will appeal to clients who (1) hold significant income generating portfolios or may encounter a liquidity event with regard to highly-appreciated assets and (2) reside in a high-tax state that will not tax a non-grantor trust that is resident in a no-tax trust state.

> *Example:* For illustration purposes only, assume a single resident of a high-tax state may generate $15 million from the sale of stock in a closely-held corporation, with $10 million representing gain. He's considering a transfer of the stock to a NING trust. Assuming proper implementation and application of a top state income tax rate of 13% to the gain, the potential state income tax savings of the NING trust could be up to $1.3 million.

Federal Income Taxation. As a non-grantor trust, the trust's income will be taxed to the trust (and not the individual grantor) for federal income tax purposes. Accordingly, clients must compare the potential state income tax benefits relative to the higher federal income tax rates and the 3.8% net investment income tax ("**NII tax**") that will apply at lower thresholds to the undistributed income of non-grantor trusts (*e.g.*, for single filers, the top 39.6% federal ordinary income tax rate applies at $400,000 of taxable income and the NII tax at $200,000 of modified adjusted gross income, while for non-grantor trusts, the thresholds are only $12,150).

> *Example:* Using the above example, assume the $10 million gain is the only income earned and it all qualifies as net investment income. For the individual, the potential NII tax is $372,400 (3.8% of ($10,000,000 - $200,000)). For the NING trust, the potential NII tax increases to $379,538 (3.8% of $10,000,000 - $12,150)).

Estate & Gift Taxation. ING trusts are primarily a state income tax planning tool and ***do not eliminate the grantor's gift or estate tax exposure with regard to the trust assets.*** Trust assets distributed to a beneficiary other than the grantor will constitute a completed gift subject to gift tax, and the trust assets also will be includible in the grantor's estate for estate tax purposes. ***Accordingly, clients should combine ING trusts with complementary estate tax planning, such as obtaining life insurance in a separate irrevocable life insurance trust ("ILIT") to cover the potential estate tax exposure.***

Example: Using the first example, even if the individual transfers the stock to a NING trust, he will face a top federal estate tax rate of 40% on the $15 million of stock/sale proceeds, ***with a potential federal estate tax of up to $6 million***. Acquiring a life insurance policy with a commensurate death benefit through an ILIT can help offset this significant exposure.

THE GOOD NEWS – CLARITY FOR FEDERAL TAX TREATMENT

Key Objectives. For federal tax purposes, the key objectives in structuring an ING trust are: (1) to avoid grantor trust status for federal income tax purposes, (2) to avoid completed gifts to the trust for federal gift tax purposes, and (3) to avoid adverse federal gift tax consequences for other trust beneficiaries serving as members of a trust "distribution committee" (a "**DC**") (potentially arising from their participation in trust distribution decisions).

Repeat of Favorable PLRs. In 2007, the IRS created some uncertainty on ING trust planning when it issued IR-2007-127, stating that it was re-considering prior favorable PLRs regarding certain federal gift tax issues associated with ING trusts. As reported in *WRMarketplace No. 13-14*, however, in 2013, the IRS released several favorable PLRs ("**2013 PLRs**"),[2] ruling that:

- The ING trusts in those PLRs would be ***non-grantor trusts*** for federal income tax purposes,
- Transfers to these trusts would be ***wholly incomplete gifts*** for federal gift tax purposes,
- Trust distributions to the grantor would ***not be deemed gifts to the grantor by DC members***, and
- Trust distributions to a beneficiary other than the grantor ***would be deemed completed gifts from the grantor***.

Now, the IRS has reiterated the above rulings in another recent series of PLRs ("**2014 PLRs**"), based on ING trusts with structures almost identical to those in the 2013 PLRs.

Roadmap. Given the similarities in both sets of PLRs, clients and their advisors should consider these ***PLRs as a roadmap for drafting and implementing an ING trust***. Although PLRs may only be relied upon by the taxpayers requesting the rulings, the 2014 PLRs should provide additional confidence that ING trusts structured to include the following attributes can attain the desired federal tax treatment:

- The grantor creates an irrevocable trust benefiting himself and desired beneficiaries in a no-tax trust state.[3] A corporate trustee located in that state is sole trustee.
- The trust has a DC initially composed of the grantor and other beneficiaries. During the grantor's life, the DC must consist of at least two beneficiaries other than the grantor.[4]
  - Otherwise, the DC ceases to exist (and also will cease to exist at the grantor's death).
- During the grantor's lifetime, the trustee must 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.[5]

- At death, the grantor has a testamentary limited power to appoint the remaining trust assets to anyone other than his estate, his creditors, or the creditors of his estate.

THE BAD NEWS – STATES SCRUTINIZING ING TRUSTS

The recent PLRs have brought some attention to ING trust planning, for better or worse. While clarification of the federal tax issues facilitates the implementation of ING trusts, the heightened awareness may provide an easy target for states looking to generate needed revenue without direct tax increases. Some states, like California and New York, have already enacted or changed certain state tax laws, which may limit or eliminate the potential state income tax benefits of ING trusts.

With California residents, ING trust planning may still be possible. For purposes of state trust taxation, however, California tax laws apply very broad definitions for the concepts of (1) California-source income, (2) California residency and domicile, and (3) California resident fiduciaries (*e.g.*, to include trust advisors, trust protectors, or any other person with power to direct or control trust property or trustee actions). Without precise planning and careful monitoring, implementation and administration of an ING trust, it is easy to run afoul of these rules, resulting in California income taxation.

As discussed in *WR Marketplace No. 14-17*, New York recently enacted trust tax law changes that go even farther, effectively ***eliminating the ability of New York residents to avoid New York income tax by transferring assets to an ING trust.*** Under the new state laws, New York treats ING trusts created by New York residents as grantor trusts for New York income tax purposes, essentially "decoupling" New York's income tax treatment of ING trusts from the federal income tax treatment. ***As of January 1, 2014***, a New York grantor of an ING trust ***must*** include all items of the trust's income, gain and loss in his New York gross income, as if he directly owned the trust assets (although this ***rule will not apply to an ING trust that was liquidated before June 1, 2014***).

Although we may see constitutional challenges to these state tax laws, there is no way to predict when and how those challenges will work their way through the legal system. In the interim, other states seeking to raise revenue may look to model new state tax legislation based on the California and/or New York trust tax laws, further limiting opportunities for ING trust planning. Thus, those who wish to utilize ING trust planning may want to do so sooner rather than later.

TAKE-AWAYS

- Although PLRs may only be relied upon by the taxpayers requesting the rulings, the recent PLRs essentially clarify how to create an ING trust that should attain the desired federal income and gift tax treatment.

- At the same time, ING trust taxation has become a target for revenue hungry states, like California and New York, which may limit or eliminate ING trust planning benefits.

- For clients who can take advantage of ING trust planning, the approach will work best when combined with complementary estate tax planning, such as life insurance to cover the client's potential estate tax exposure, since ING trusts do not provide transfer tax protection.

NOTES

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[1] There are numerous considerations in creating an ING trust and the selection of an ING trust jurisdiction, which are impacted by the client's state of residence, particular circumstances, and intended trust terms and beneficiaries. A full review of these considerations is beyond the scope of this report.

[2] *See* PLRs 201310002 through 201310006.

[3] Although none of the 2014 PLRs specify the trust's jurisdiction, it appears the trusts are likely NING trusts.

[4] Although the order of succession can be tailored (*e.g.*, descendants before siblings or other beneficiaries).

[5] Note that this power may not be required to make the gift entirely incomplete (*i.e.*, as to both the income and remainder interest) for federal gift tax purposes. All the PLRs rule that the grantor's consent power over trust distributions of income and principal makes the transfer to the trust a wholly incomplete gift. Avoiding this power may be necessary to achieve ING trust status with regard to certain states. For example, creating an ING trust with regard to California will require the trust to have only "contingent" beneficiaries. A trust that includes a discretionary power to distribute for a beneficiary's "health, support, maintenance and education," may make such beneficiary non-contingent and potentially taxable by California.

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