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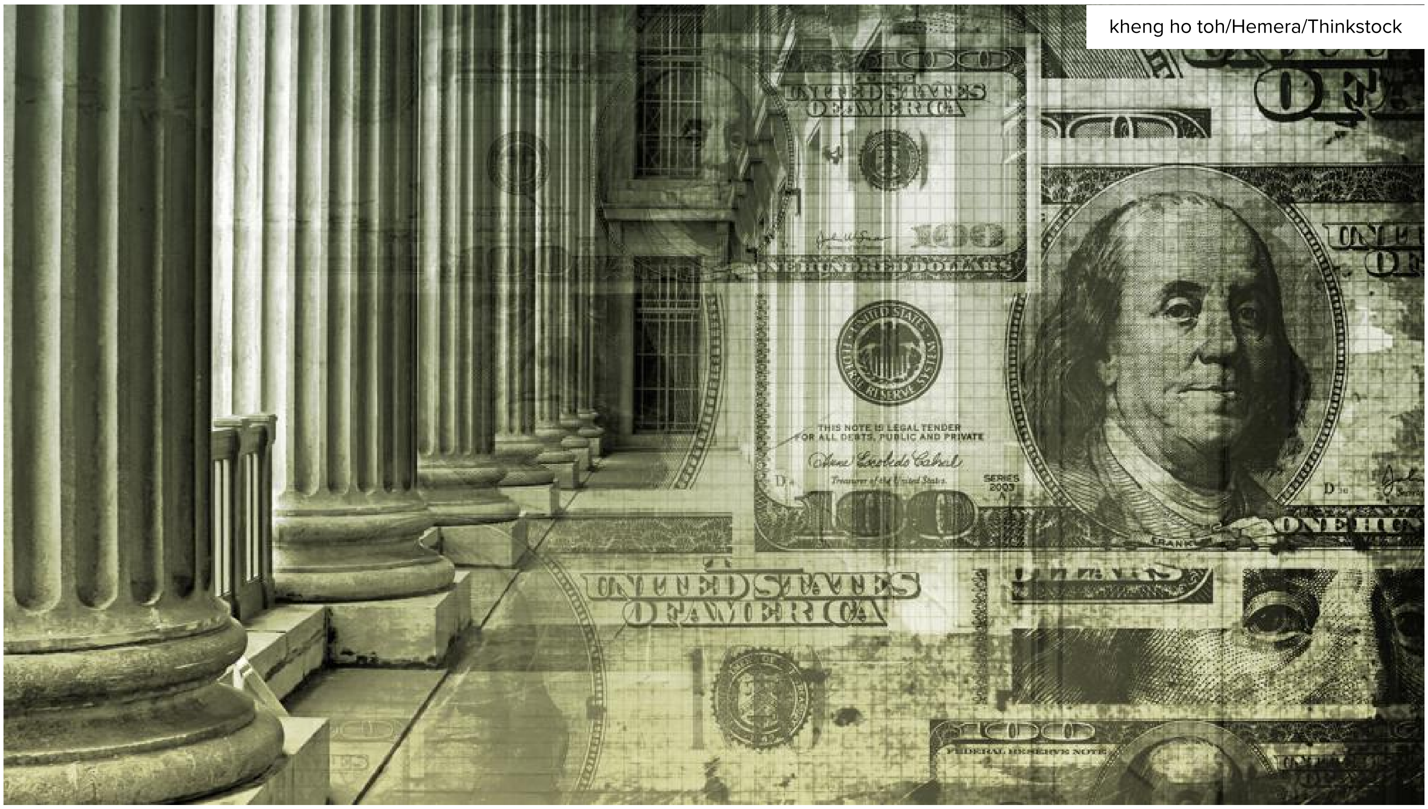

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# The Benefits of Incomplete Non-Grantor Trusts

*A powerful income tax savING strategy.*

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An incomplete non-grantor trust is a powerful planning tool; not just for the super wealthy, but for many people who are looking to save state and/or federal income tax.

Most people associate estate planning—and trusts in particular—with estate planning, which an ING trust can do. For example, an ING trust is invariably formed in a state that permits self-settled trusts so that ING trust assets should not be reachable by the settlor's creditors. Also, an ING arguably isn't a self-settled trust because the trustee has no right to distribute trust assets to the settlor. Rather in the traditional ING trust, the distribution committee has a special power of appointment to direct distributions to the settlor or others specified in the document. According to these interpretations, an ING trust might be safer from claimants than a more typical self-settled domestic asset protection trust. While the traditional ING trust provides no estate tax benefit, a newer variant, a so-called completed gift ING, may be used to safeguard the current high estate tax exemption before it declines. So, INGs can provide both asset protection and estate tax benefits.

But the most valuable application might now be how to use an ING trust to save income tax. This bears significant importance after the Tax Cuts and Jobs Act because of the myriad of different changes that the Act made. There are some potentially great valuable income tax savings that an ING trust can provide and several techniques you can use to tailor the ING as a beneficial planning tool for your clients.

## Why an ING Trust for Income Tax Planning?

ING trusts have traditionally been used for wealthy taxpayers in high tax states seeking to avoid a state income tax on the sale of a highly appreciated intangible asset, for example, stock in a company that might be sold at some future date (or on non-compensation income generated by assets contributed to the trust and which income the owner doesn't currently need to expend). If ownership of the stock is shifted to a non-grantor or complex trust, that trust, not the settlor creating the trust, would be taxable on the gain. If the trust is created in an income tax-friendly state, like Delaware, Nevada or Alaska (called a NING in Nevada or an AKING in Alaska) when the stock is sold, it should avoid being subjected to income tax in the settlor's high tax home state. This technique had become so effective at avoiding state income tax that one state, New York, enacted specific legislation to combat the benefits of the traditional ING. Since, historically, most or all taxpayers using the ING trust technique were wealthy taxpayers who've used their gift/estate tax exemptions, ING trusts were structured to be incomplete gift trusts to avoid triggering any gift tax on funding.

With the changes the Act made to an array of tax benefits, ING trusts might now be used to save federal income taxes as well as state income taxes. Also, because of the restrictions on the deduction of state and local taxes deductions, ING trusts might be more commonly used to shift passive investment income, like your client's stock portfolio, outside of a high tax home state.

**Section 199A Deduction for Qualified Business Income**

Internal Revenue Code Section 199A provides for a 20 percent deduction for qualified business income. One of the challenges clients face seeking to secure this new benefit is the restrictions applicable under IRC Section 199A once the client's taxable income exceeds a certain threshold, amount ($315,000 for married filing a joint return or $157,500 for an individual filer (including a non-grantor trust)). Above these levels, different restrictions apply depending on whether the business is a specified service trade or business, or not. For QBI from SSTBs, the deduction is essentially phased out as taxable income rises from $315,000 to $415,000 (from $157,500 to $207,500 for non-grantor trusts and individuals other than a married couple filing a joint return). For both SSTB and non-SSTB, the client is subject to various phaseouts so that the deduction is the lesser of 20 percent of QBI, 50 percent of W2 wages or 25 percent of W2 wages plus 2.5 percent of tangible property values.

One planning concept shifts some of the equity of that business, in some cases, to a non-grantor trust, so that the trust earned some of the income and qualifies. Its overall taxable income is low enough for the 20 percent deduction: a very valuable benefit. The proposed regulations issued under Section199A take square aim at this planning technique and indicate that if a taxpayer creates any trust to skirt the Section199A taxable income threshold limitations, that trust will be disregarded.

Those proposed regs appear to exceed the scope of the statute, so it isn't certain what will occur. Also, while the proposed regs appear to leave open the possibility of using one non-grantor trust, they also contain general restrictions on tax avoidance planning that the Internal Revenue Service might use to attack. Where does this leave taxpayers? If there are valid non-income tax motives for creating a trust, and especially if the trust might be useful for techniques discussed below, ING trust planning to increase Section 199A benefits might be worth evaluating. But, also consider the new, more restrictive penalty limitations when a Section199A benefit is involved.

**State Income Tax Benefits**

In the past, your client may not have qualified for state income tax deductions either, because of the alternative minimum tax. Unfortunately, the newest restriction on SALT deductions included in the Act is more severe. The Act limits SALT deductions to $10,000 annually. This is the same cap for individuals and for married couples filing a joint income tax return. Further, the amount isn't inflation-adjusted in future years. What can be done to address this new restriction? How might ING trusts help in that planning? Solutions for savings include shifting passive non-source income (such as your client's stock and bond portfolio) into a non-grantor trust, such as an ING trust, and located in a no-tax state. This planning can save or at least defer all state income tax on that income (except, perhaps, New York). While this type of planning might not seem feasible for a retiree who might need distributions for living expenses, it may still be in part feasible, depending on the required minimum distributions the client must withdraw from a retirement plan relative to client's living expenses.

**Charitable Contribution Deductions**

The Act also changed the calculus of charitable contribution deductions. Because of the SALT cap, many clients will be hard-pressed to obtain any benefit from a deduction for charitable contributions. This is because taxpayers with moderate wealth or income may not have deductions, including contributions, that exceed the new standard deduction, which is about double what it had been; $24,000 for married filing a joint return.

A planning option to salvage contribution deductions might be the use a non-grantor trust to make charitable contributions. The non-grantor trust may be able to qualify for the entire charitable contribution deductions, without losing any of it to meet the standard deduction threshold. This is because trusts don't have a standard deduction as do individual taxpayers.

There are a few nuances to this planning. The contributions must meet the requirements of IRC Section 642(c) and be paid from gross income.

### Net Investment Income Tax

There's a net investment income tax, including business interests and naming a person who's actively involved in the business as trustee may afford the opportunity to avoid the tax, among other benefits. Building several potentially valuable income tax benefits through structuring an ING trust and funding it with the appropriate assets may be an appropriate goal for the client.

### Adverse Parties on Distribution Committee

Another common characteristic of the ING trust is to have a distribution committee (often called the "power of appointment" committee). So, if you set up the trust in one of these jurisdictions, your client and perhaps one or two adverse parties, such as beneficiaries of the trust, would be on this committee and make distribution decisions, which included the client, "Adverse" means a trust that names the client and all their descendants. If a child is a descendant and a beneficiary, that child is adverse to your client because, if the child approves or directs, $100,000, for example, to your client; that's $100,000 less for the child, making the child your client's adverse party. The distribution committee is a hallmark of the ING trust. Therefore, be prudent when structuring a non-grantor trust to ensure that none of the trust provisions will taint or characterize the trust as a grantor trust and lose all the income tax planning benefits discussed here.

### Traditional Incomplete Gift ING

Historically, ING trusts were typically created in states like Delaware and Nevada and referred to as DING (Delaware ING) and NING (Nevada ING). Historically, they were developed as incomplete gifts, that is, transfer that wouldn't trigger a gift tax or use gift tax exemption. Under current law, the gift tax exemption in 2018 is $11.18 million. In the past, when many of the ING trust concepts were developed, the gift tax exemption was only $1 million, which very wealthy people already had used. Inasmuch, they wanted the transfers to assets to an ING trust to be incomplete for gift tax purposes. This is very important because the Act created a temporary much larger exemption. The exemption, however, is scheduled to be reduced by half in 2026. No one can foresee what may happen in Washington, but the amount of the exemption will likely sunset or decline from $10 million inflation adjusted to half that, or $5 million inflation adjusted, which might be reduced at an earlier stage.

So, using that exemption might suggest that instead of a traditional ING (unless your client is very wealthy), you might want to restructure the ING trust to be used to convert the traditional ING to a completed gift variation. Again, different from the historic approach, but perhaps more useful in the current tax environment. The Treasury recently issued proposed regulations suggesting that if the current exemption is used with a completed gift ING trust and when the exemption is reduced in the future, there will be no recapture or clawback of the excess exemption used.

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