

Use Trusts to Bypass Limit on State and Local Tax Deduction

The new \$10,000 limit on state and local tax deductions applies per taxpaying entity, so trusts funded with real estate can effectively multiply the deduction limit.

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Many deductions allowed to an individual for federal income tax purposes for certain expenses or costs incurred have been permanently eliminated, or suspended or limited until 2026 by the 2017 Tax Act (“Act”—also commonly known as the Tax Cuts and Jobs Act) for tax years after 2017.¹ The deduction under Section 164 for state and local income, sales, and property taxes² has been limited to \$10,000 annually for individual taxpayers including estates of decedents and non-grantor trusts³ through 2025.⁴

A married couple filing a joint return faces the same \$10,000 limit as do all other individual taxpayers except for a married person filing separately, where the limit is \$5,000 a year. This \$10,000 limit applicable to joint filers is a significant new marriage penalty. Further, the \$10,000 is not indexed for inflation.

The standard deduction for married couples has been increased to \$24,000 and to \$12,000 for other

individual taxpayers (but without any standard deduction for a decedent’s estate or for a non-grantor trust).⁵ A taxpayer who uses the standard deduction may not deduct the expenses and costs still allowed under the Code.⁶

Bunching deductions

Individual taxpayers who otherwise would use the standard deduction can, to a limited degree, “bunch” certain taxes (and other deductible items, such as charita-

ble contributions⁷ and elective medical expenses⁸) into one year and forego the standard deduction for that year.⁹ This can be done by some by incurring sales tax on significant purchases in fewer than all years (and, perhaps, in only one year) from 2018 through 2025.

For example, suppose a married couple intended to acquire new automobiles, expensive jewelry, a pleasure boat, and other items subject to high state and local sales taxes before 2026. They might be better off acquiring them all in the same calendar year. That way, the sales taxes would be bunched and provide a deduction of up to \$10,000 for them. To the extent that the aggregate deductions exceed the new larger standard deduction, additional tax savings would be achieved. Of course, if the couple paid \$10,000 in state and local income taxes, no benefit would be achieved from the bunching of the sales taxes.

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Unfortunately, the timing of payment, for deduction purposes, of state and local real property taxes cannot be so readily manipulated. For instance, property taxes on real estate sold must be apportioned between the seller and buyer according to the number of days in the year that each holds the property.¹⁰ (Pre-paying 2018 state and local real property taxes in 2017 may be tax deductible, but only under certain circumstances.¹¹) The timing of the payment of state and local income taxes can be somewhat controlled by the timing of the recognition of income, such as by the sale of property at a profit, exercising certain stock options, and billing of customers (although accrual-method taxpayers will not have as much flexibility in that regard as will cash-method ones) but only to a limited degree.¹²

In any event, it is not just when the state or local taxes are paid, but how much is paid on account of the \$10,000 annual limit on deductions for such levies.

How trusts may help

The use of non-grantor trusts may assist some individual taxpayers in squeezing more federal income tax benefits from state and local tax payments, despite the limitation on the deduction through 2025. The reasons are that such a trust is a taxpayer, separate and independent of its grantor and beneficiaries, and is entitled to deduct up to \$10,000 annually for state and local taxes.¹³ The trust should also be permitted to deduct the costs of the preparation of the trust income tax return under Section 67(e).¹⁴

Hence, as long as the trust has income equal to the state and local taxes it pays, the trust gets the benefit of a separate up-to-\$10,000 deduction. In contrast, without the trust, the individual grantor or beneficiary may incur more than \$10,000 in state and local taxes and, therefore, lose the income tax deduction benefit for all or part of the state or local taxes paid. For example, if a non-grantor trust

holds an interest in a residence and, therefore, is responsible for real estate taxes, those taxes should be deductible for federal estate tax purposes, of up to \$10,000 a year, if the trust has at least enough income to offset the deduction.

Also note that the shift of passive investment assets into the non-grantor trust beyond those necessary to produce income to pay for, and offset, property taxes due by the trust, may if properly planned avoid state income taxes on that additional income as well.¹⁵

Multiple trust rule

Taxpayers, for decades, have used trusts to divide income. This became so prevalent that the income tax rules were developed under which the income of certain trusts, commonly called grantor trusts, was attributed to their grantors (or in one case to a trust beneficiary)¹⁶ and “throw-back” trust tax rules were enacted.¹⁷ Moreover, the Treasury Department promulgated multiple-trust regula-

¹ The deduction under Section 215 for certain alimony payments is eliminated only after 2018. Although most of the deductions previously allowed to individuals that were disallowed by the Act are restored for tax years after 2025, the deduction for alimony payments made pursuant to any divorce or separation agreement entered after 2018 is not. See section 11051(c) of the Act (PL 115-97). Throughout this article, the term “Section” refers to a section of the Internal Revenue Code of 1986 as amended.

² Reg. 1.164-1(a) lists the taxes that may be deducted.

³ A “grantor trust” is one the income, deductions, and credits against tax of which are imputed to the grantor under Section 671 as though the trust did not exist.

⁴ Section 164(b)(6). Note the limitation does not apply to taxes in carrying on a trade or business or an activity described in Section 212.

⁵ Section 63(c). Although the allowance of personal exemptions has also been suspended through 2025, the personal exemptions allowed under Section 642(b) for an estate or non-grantor trust continue to be permitted.

⁶ The deduction allowed by new Section 199A for a portion of qualified business income is not an itemized deduction, so it apparently would be allowed even if the taxpayer uses the standard deduction. “The conference agreement clarifies that the 20-percent deduction is not allowed in computing adjusted gross income, and instead is allowed as a deduction reducing taxable income. Thus, for exam-

ple, the provision does not affect limitations based on adjusted gross income. Similarly the conference agreement clarifies that the deduction is available to both nonitemizers and itemizers.” Joint Explanation Statement of the Committee of Conference, page 39.

⁷ Section 170(a).

⁸ Section 213(a). Although even non-elective medical expenses also may be deductible, the timing of the payment of those is not as easily controlled as elective ones.

⁹ The deduction for charitable contributions under Section 170 continues to be allowed. The taxpayer will receive no income tax benefit for such contributions if he or she uses the standard deduction and, if not, will receive a tax benefit only to the extent all deductible items exceed the standard deduction otherwise allowed.

¹⁰ Section 164(d).

¹¹ IR-2017-210, 12/27/2017.

¹² A taxpayer can pay and deduct, subject to the \$10,000 limit, state and local income taxes for the year even if part of the taxes may not be due to be paid until the following year.

¹³ A decedent’s estate and a non-grantor trust are taxed as an individual is taxed except to the extent the Code provides otherwise, and thus are entitled to the same deductions as an individual, unless the Code provides otherwise. Section 641(b); Reg. 1.641(b)-1.

¹⁴ It should not be eliminated by new Section 67(g). See note 59, *infra*.

¹⁵ See Nenno, note 27 *infra*.

¹⁶ See, generally, Akers, Blattmachr, and Boyle,

“Creating Intentional Grantor Trusts,” 44 Real Property, Trust and Estate Law J. 207 (Summer 2009).

¹⁷ See Sections 665 through 668.

¹⁸ Reg. 1.641(a)-0(c).

¹⁹ Stephenson Trust, 81 TC 283 (1984).

²⁰ See SIIH Partners LLLP, 150 TC No. 3 (2018), also reported as TCM 2016-333, dealing primarily with the treatment of controlled foreign corporations (CFCs) under Section 956(d) (which provides, in part, that a CFC “shall, under regulations prescribed by the Secretary, be considered as holding an obligation of a United States person if * * * [the CFC] is a pledgor or guarantor of such obligation”) states, in part, “Petitioner [taxpayer] contends, and respondent [Commissioner of the IRS] does not dispute, that section 956(d) is not self-executing and that the applicability of section 951(a)(1)(B) and the amount of the income inclusions at issue can be determined only by reference to regulations promulgated by the Department of the Treasury...” (emphasis added). See also, discussions in 15 West 17th Street LLC, 147 TC No. 19 (2016); Gall, “Phantom Tax Regulations: The Curse of Spurned Delegations,” 56 Tax Lawyer 413 (2003); Grewal, “Mixing Management Fee Waivers with Mayo,” 16 Fla. Tax Review 1 (2014).

²¹ Section 7701(o)(5)(B).

²² See Steiner and Shenkman, “Beware of the Reciprocal Trust Doctrine,” 151 Trusts & Estates 14 (April 2012).

tions¹⁸ as part of the throwback regulations themselves. But these multiple-trust regulations were struck down as invalid.¹⁹ Nonetheless, the Code was amended to add Section 643(f) which provides:

For purposes of this subchapter, under regulations prescribed by the Secretary, 2 or more trusts shall be treated as 1 trust if—(1) such trusts have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries, and (2) a principal purpose of such trusts is the avoidance of the tax imposed by this chapter. For purposes of the preceding sentence, a husband and wife shall be treated as 1 person. [Emphasis added.]

Although the section was enacted in 1984, it has never been applied and even today may not be effective because it is premised as applying apparently only under regulations prescribed by the Treasury, and no such regulations have been issued. Whether a section, premised on the issuance of regulations, applies in the absence of any such regulation is at least somewhat uncertain. A reasonable conclusion may be that at least some taxpayer-friendly regulations are self-executing but taxpayer-unfriendly ones are not.²⁰

Even if Section 643(f) cannot be applied (in the absence of regulations), the IRS might be able to apply one of the “mystical” tax doctrines, such as substance over form, to cause multiple trusts to be treated as one. Or the Service might attempt to apply the statutory economic-substance doctrine under Section 7701(o) but that section applies “only to transactions entered into in connection with a trade or business or an activity engaged in for the production of income.”²¹ Hence, the statutory economic substance doctrine does not seem to apply.

Avoiding application of a multiple-trust rule

Despite the apparently strong argument that Section 643(f) has no cur-

rent application, it may be best to avoid having the same beneficiary or beneficiaries in each trust, so no multiple-trust rule should apply. In the absence of regulations, one cannot be certain, but it seems that if a different family member is the primary beneficiary of each separate trust, the separate trusts should not be treated as one. So, if the taxpayer has four descendants, he or she should be able to create at least four trusts that would not fall under any multiple-trust rule that would treat all or some of them as one.

It is common for a taxpayer to create a separate trust for the primary benefit of each child or other descendant but with other descendants (and, perhaps, for asset protection reasons, also for spouses of the descendants) also as discretionary beneficiaries with no entitlement by any one of them to distributions from the trust. If spouses create non-reciprocal, non-grantor, spousal lifetime access trusts, it would seem quite difficult for the IRS to challenge such trusts under any conception of the multiple-trust doctrine as those trusts would by definition embody significant differences between them.²²

And there is now another compelling reason, in addition to salvaging property tax deductions and saving state income taxes because of the state and local tax deduction limitation, to create such trusts. This motivation is similar to that which existed in 2012: the legislative sunset of part of the gift, estate, and GST tax exemptions. Under the Act, the new higher exemptions are scheduled to sunset from around \$11.2 million per donor today to around \$5.6 million after 2025 (as further adjusted by an inflation factor after 2017), making it a “use it or lose it” tax benefit. More than a few practitioners have also expressed concern that the exemptions may be lowered before



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Using the exemption to reduce the family's overall income tax burden likely also will make good sense. The challenge for practitioners is to create a different type of trust to reconcile post-Act client goals that may include minimizing state income taxes, expanding property tax deductions, permitting access to trust assets (because of the quantum of transfers possible with the new exemptions), and making the trust a completed gift to use the sunseting exemptions.

For the past 30 years or so, many taxpayers who made lifetime transfers made them to grantor trusts which, among other things, allow the trusts to grow free of income tax, one of the most powerful arrangements for estate planning.²³ Indeed, one study, using a Monte Carlo simulation²⁴ comparing direct lifetime gifts to grantor trusts, grantor retained annuity trusts (GRATs) described in Reg. 25.2702-3(b)(1), and installment sales of property to grantor trusts, indicates that the most significant factor in reducing overall wealth taxes (i.e., gift, estate, and generation-skipping transfer (GST) taxes) is using grantor trusts.²⁵ The default to grantor trust status remains useful for some clients, but for fewer of them. For ultra-high net worth clients, some moderate wealth clients in low-tax states, and for certain types of assets (e.g., life insurance and active business interests whose income would be taxed in the high-tax state regardless of whether transferred to a non-grantor trust), use of grantor trusts may remain preferable.

With wealth transfer tax exemptions through 2025 of over \$11 million for each taxpayer and over \$22 million for a married couple, however, reducing wealth transfer tax is no longer important for most Americans. In fact, once the exemp-

tions reached \$5 million, income tax planning for almost all families took priority over estate and GST tax planning.²⁶ Thus, practitioners need to grapple with a broad range of income tax planning implications, not merely maximization of income tax basis on death.

Using non-grantor trust to reduce taxes

Many taxpayers will benefit from creating non-grantor trusts even if (or in many instances, especially if) transfers to them are completed gifts. Implementing this strategy will avoid state and local income taxes as trusts almost always can be formed, even by a person domiciled in a jurisdiction with a state (or state and local) income tax, to avoid state and local income taxes.²⁷

ING trusts. In fact, the IRS has consistently ruled that a taxpayer may create what is commonly called an "ING" trust (i.e., an incomplete gift non-grantor trust), which would not be a grantor trust but transfers to it would not be completed gifts.²⁸ Although the high exemptions render avoiding making completed gifts unimportant for almost all taxpayers, avoiding state income tax has become even

more important for almost all. The reason is that the limitation of \$10,000 a year for the deduction for state and local taxes has made them more expensive for many. If one who pays a 5% effective state (or state and local) income tax may deduct the tax for federal income tax purposes and is in a 40% effective federal income tax bracket, the state and local income tax cost drops to 3% (that is, $(1 - .4 \text{ federal bracket}) \times 5\% \text{ state bracket}$).

Keeping the grantor as a trust beneficiary. Although a non-grantor trust may avoid state and local income taxes, many have not structured trusts to do so. That has occurred because it is generally perceived that neither the individual taxpayer who creates the trust nor his or her spouse may be a trust beneficiary. This is based on a widely held belief that, if either is a trust beneficiary, the trust will be a grantor trust. Grantor trust status would mean that the income would be attributed back to the individual taxpayer and, therefore, be subject to the state and local income taxes, under the laws of most states, that would be imposed on the taxpayer as if he or she had directly earned the income. That is because almost

²³ See, generally, Gans, Heilborn, and Blattmachr, "Some Good News About Grantor Trusts: Rev. Rul. 2004-64," 31 ETPL 467 (October 2004).

²⁴ "Monte Carlo simulation furnishes the decision-maker with a range of possible outcomes and the probabilities [that] will occur for any choice of action. It shows the extreme possibilities—the outcomes of going for broke and for the most conservative decision—along with all possible consequences for middle-of-the-road decisions." www.palisade.com/risk/monte_carlo_simulation.asp.

²⁵ Blattmachr and Zeydel, "GRATs vs. Installment Sales to IDGTs: Which Is the Panacea or Are They Both Pandemics?" 41st Annual Heckerling Institute on Estate Planning (2007).

²⁶ See, generally, Blattmachr and Rivlin, "Searching for Basis in Estate Planning: Less Tax for Heirs," 41 ETPL 3 (August 2014).

²⁷ See discussion in Nenko, "Long-Term Trusts," 66th Annual Tulane Tax Institute (12/1/2017) at 114 et seq.

²⁸ See Blattmachr and Lipkind, "Fundamentals of DING Type Trusts: No Gift Not a Grantor

Trust," 26 Probate Practice Reporter 1 (April 2014).

²⁹ See, e.g., Section 677.

³⁰ 1985-1 CB 184.

³¹ Section 121 provides for the exclusion of \$250,000 (\$500,000 for a married couple) of gain recognized upon the sale of a taxpayer's residence if it has been owned and used by the taxpayer(s) as the principal residence for at least two of the five years before the sale.

³² Section 121(d)(11).

³³ Converting a non-grantor trust to a grantor trust should not have any adverse income tax consequence. CCA 200923024 (no gain on conversion, although it might be argued that gain should be recognized where an encumbering liability exceeds basis such as described in Rev. Rul. 77-402, 1977-2 CB 222).

³⁴ See TAM 9515003 (not precedent) (refusing to permit estate to argue for estate tax inclusion under Section 2036(a)(1) on the basis of an implied understanding).

³⁵ Rev. Rul. 85-13, *supra* note 30.

³⁶ Section 671.

all state and local jurisdictions impose their income taxes based essentially, but subject to exceptions and special rules, on the taxpayer's federal income. Consequently, income attributed to the grantor under the grantor trust rules would continue to be subject to the same state and local taxes as would all other income reportable by the grantor.²⁹

By excluding the grantor and the grantor's spouse as beneficiaries, a non-grantor trust may readily be created. Many taxpayers, however, do not want to lose access to the property transferred to a trust as well as the income the property thereafter produces. This is particularly the case after the Act because of the large wealth transfer tax exemptions.

How to create non-grantor trusts

While the use of a grantor trust can be effective in permitting the trust to grow free of income tax and allowing certain transaction between the grantor and the trust to occur free of income tax effects pursuant to Rev. Rul. 85-13,³⁰ it can also produce disadvantages, such as precluding the deduction of additional property taxes, as discussed above. But, while a non-grantor trust can, in contrast, provide for this deduction and other benefits, it has drawbacks as well. For example, a sale of the residence owned by a non-grantor trust would not qualify for the gain exclusion under Section 121³¹ given that the trust, not the grantor, is treated as the owner.

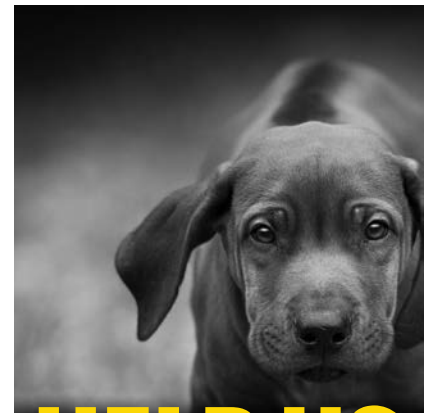
While a decedent's estate and revocable trust may qualify for the home-sale exclusion,³² that benefit does not extend to a non-grantor trust or to a trust beneficiary who has used the property as his or her principal residence. This disadvantage can, however, be ameliorated by toggling on grantor trust status

in anticipation of the sale.³³ Once that occurs, the grantor would again be treated as the owner, qualifying any gain for the exclusion after the expiration of two years.

Another potential disadvantage concerns the basis of the residence after the death of the grantor. While it would appear likely that Section 2036(a)(1) would result in inclusion of the residence in the grantor's gross estate given the grantor's rent-free use of the residence after the creation of the trust, it is not clear that this would trigger an adjustment in basis under Section 1014.³⁴ This disadvantage could also be ameliorated by converting it to a grantor trust before the grantor's death if the grantor repurchased the residence from the trust before death—which could be accomplished on a tax-free basis if the repurchase is made after the conversion to grantor-trust status.³⁵ The IRS, if advancing a contention that the residence is included in the grantor's estate under Section 2036(a)(1) by reason of its use by the grantor while held in trust, might also contend that the use of income generated by trust assets that is used to pay for property taxes on a home used by the grantor causes those trust assets to be included in the grantor's gross estate.

One issue that taxpayers must face is how they will create non-grantor trusts. A grantor trust will not accomplish anything in salvaging the benefit of deductions for expenses and costs incurred by the trust because the income, deductions, and credits against tax of the trust will be imputed to the grantor as though the trust did not exist,³⁶ foiling any benefit that may be derived by having trusts that are separate taxpayers.

Creating a trust that is not a grantor trust is "as easy as pie" or, using another food analogy, "a piece of cake," although the



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actual administration of a trust may cause it to become a grantor trust.³⁷

When the grantor wants to be a beneficiary. Complications arise, however, when the grantor wishes to be a beneficiary of the trust or for his or her spouse to be one. Grantor trust status arises when income or corpus may be distributed to the grantor or the grantor's spouse without the consent of an adverse party (i.e., someone with an adverse interest).³⁸

Finding an adverse party. The question of adverse interest is essentially one of fact, to be determined by considering in each case the particular interest created by the trust instrument and the relative size of the interest. Section 672 defines a nonadverse party as any person who does not have "a substantial beneficial interest in the trust which would be adversely affected by the exercise or nonexercise of the power which he possesses respecting the trust."³⁹

The private letter rulings holding that the trusts were not grantor trusts (and transfers to them not completed gifts) may be particularly helpful. These are generically known as ING trusts often with the first letter of the state in which they are formed. So, one created in Delaware is a DING, in Nevada a NING, in Alaska AKING (which is uses the postal abbreviation of Alaska). Although in each of the letter rulings, the grantor or the grantor and spouse were beneficiaries, the trusts were found not to be grantor trusts because other beneficiaries, who comprised what is called the Distribution (or Power of Appointment) Committee, had adverse interests on account of their interests in the trusts.

Structure of ING trusts. All of the trusts that were the subject of the ING rulings are similar. Each such

trust was irrevocable, and the trustee had no authority to make distributions to any beneficiary during the grantor's lifetime except at the direction of a group of individuals, who were beneficiaries in addition to the grantor and called the Distribution Committee, either by their unanimous direction or by the direction of the grantor and at least one member of the Distribution Committee. The grantor also retained a testamentary special (non-general) power of appointment and, in default of its effectual exercise, the trust remainder would pass to the grantor's descendants or, if none, to alternate remainder beneficiaries (e.g., charitable organizations).

Under this structure, the IRS has consistently held that, and the trusts were not grantor trusts. The IRS has also held that the transfers to the trusts were not completed gifts.

State law and ING's. It is important to note that the ING trusts were formed under the laws of a state (e.g., Alaska, Delaware, Wyoming, South Dakota, and Nevada) that allow individuals to create trusts of which they are discretionary beneficiaries (that is, may receive distributions only with the consent of someone other than himself or herself) without subjecting the trust assets to the claims of creditors of the grantor. A trust will be a grantor trust if the grantor's creditors may attach trust assets in satisfaction of the grantor's obligations.⁴⁰

ING's in New York. ING trusts created by New York income tax residents do not "work" to avoid New York income taxation because New York Tax Law § 612(b)(41) provides that, when a transfer to a non-grantor trust is incomplete for gift tax purposes, the trust nonetheless will be characterized as a grantor trust for state income tax purpose

even though it is not a grantor trust for federal income tax purposes. Thus, the income earned by the trust would be attributed to the trust as a separate taxpayer (as opposed to the grantor) for federal (although not New York state) purposes.

Thus, the trust would have its own income and its own deduction for federal purposes but those items would be attributed to the New York income tax resident for New York income tax purposes. That would likely have the effect of limiting the deduction for the real estate taxes to \$10,000 for New York purposes (which would not be deductible at all if the grantor paid at least \$10,000 of state and local income or other taxes). Hence, even in New York, an ING trust could be beneficial for federal income tax purposes but not as beneficial for New York income tax purposes. But New York Tax Law § 612(b)(41) could be avoided if the transfers to the ING-type trust are completed gifts.

Completed gift ING's. A gift is rendered incomplete where the grantor retains the power to modify or revoke unilaterally or in conjunction with a non-adverse person. Thus, in the ING rulings, where incomplete-gift status was of course critical, the grantor had retained such powers. But if completed-gift status is sought, the grantor should not retain such powers. In addition, the trust should be located in a

³⁷ See, e.g., Section 675(3). See, generally, Akers, Blattmachr, and Boyle, *supra* note 16.

³⁸ See Sections 676 and 677.

³⁹ See Blattmachr and Boyle, *Income Taxation of Estates and Trusts*, 14th ed., PLI, at section 3:3.1 for a more complete discussion and summary of cases about adverse interests for grantor trust purposes.

⁴⁰ See Rev. Rul. 54-516, 1954-2 CB 54.

⁴¹ See Rev. Rul. 76-103, 1976-1 CB 293.

⁴² See Rev. Rul. 2004-64, 2004-27 IRB 7.

⁴³ *Id.*

⁴⁴ *Cf.* Du Pont Testamentary Trust, 574 F.2d 1332, 42 AFTR2d 78-5259 (CA-5, 1978), and Plant, 76 F.2d 8, 15 AFTR 376 (CA-2, 1935).

jurisdiction whose laws would prevent creditors from accessing trust assets. For if under state law the grantor's creditors can access the trust's assets, the gift is incomplete on the rationale that the grantor in effect retains a revocation power, i.e., the ability to relegate creditors to the trust's assets.⁴¹ Any of the approximately 18 jurisdictions permitting self-settled domestic asset protection trusts should qualify as appropriate situs for a completed-gift ING.

Specifically, to make the transfers completed gifts, the grantor would not retain certain powers the grantors retained in the ING rulings—that is, the grantor would not retain any special power of appointment exercisable by will (falling under the Section 674(b)(3) grantor trust exception) or any lifetime power (falling under the Section 674(b)(5) grantor trust exception), held in a non-fiduciary capacity, to distribute corpus pursuant to a health, education, maintenance, or support (HEMS) standard, as the retention of any of these powers would prevent the gifts to the trusts from being complete. These powers also would have caused the trust to be included in the grantor's gross

estate under Sections 2036(a)(2) and 2038 but there should be no inclusion without them unless the trust is created in a jurisdiction where the grantor's creditors could attach trust property, or the IRS can establish there was an understanding that distributions would be made to the grantor by the trustee.⁴² Moreover, if distributions may be made only to persons other than the grantor, there should be no finding of an understanding that the grantor would benefit from the trust even if the grantor's spouse (as opposed to the grantor himself or herself) is a beneficiary and receives distributions.

Hence, a taxpayer may create an ING type trust but, by not retaining certain powers included in the standard or traditional ING trust, render the transfers to this new variant of the ING trust as being completed for gift tax purposes. Although some might view that the estate tax benefits of completed gifts to a trust are eroded to the extent trust property is returned to the grantor or spouse, the high exemptions may make that unimportant for the vast majority of taxpayers. Also, in many if not most such planning scenarios, the intent

will not be to make distributions to the spouse. Rather the objective will be to assure the client access to funds in the trust if necessary in order to give the client the confidence to make the transfer.

In no situation should a client ever transfer too large a proportion of his or her assets to this or other structures, as such an excessive transfer might be a fraudulent conveyance. Thus, clients creating completed gift INGs should have sufficient resources outside the structure.

In any case, the trust could acquire assets (such as residences or works of art) for the use by the grantor or spouse without, it seems, causing estate tax inclusion unless a finding is made that there was an understanding that the trustee would do so for the benefit of the grantor.⁴³ It seems relatively certain that the rent-free use of property is not a distribution of distributable net income (DNI) from the trust to the beneficiary which would cause such income of the trust to be shifted to the beneficiary under Section 662.⁴⁴

No gift by distribution committee members. The ING rulings also have held that the individual beneficiaries who were members of the



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Distribution Committee and who held the power, in a non-fiduciary capacity, to require the trustee to make distributions would not be treated as making a gift for federal gift tax purposes by directing the trustee to make distributions to the grantor but further held that distributions to beneficiaries other than the grantor would be completed gifts by the grantor and not by members of the Distribution Committee.⁴⁵ The reasoning used in the private rulings indicates that neither the grantor nor any member of the Distribution Committee would be deemed to have made gifts if the Distribution Committee directs the trustee to transfer trust property either to the grantor or to another member of the Distribution Committee even if the original transfers by the grantor to the trust are completed gifts.

The grantor could not be deemed to have made a gift (as long as his or her creditors could not attach the trust assets) because the grantor would no longer own the trust assets. The members of the Distribution Committee would not be deemed to make any gift because none would be deemed to hold a general power of appointment, under Reg. 25.2514-3 joint powers provision, as explained in detail in the rulings. However, it is possible the IRS could contend that the members of the Distribution Committee have made a gift of their property interests in the trust, if the original transfer to it was a completed gift.⁴⁶

Back to New York and its anti-ING rule. As indicated, an incomplete ING trust created by a New Yorker will be treated as a grantor trust for New York income tax purposes. That means that the income and deductions of the trust will be attributed to the grantor for New York income tax purposes, causing the

grantor to lose the benefit of having income and the deduction to be treated as being received and incurred by the non-grantor trust (so the income earned by the trust can be offset by up to a \$10,000 deduction for state and local taxes) for New York income tax purposes. Again, that will not prevent the trust from claiming an additional \$10,000 in property tax deductions on the trust's United States Fiduciary (trust) Income Tax Return, Form 1041.

However, the New York State Senate recently passed a bill that would decouple state tax law from the federal changes that were made as part of the Act which passed in December. The bill, S06974A, essentially says that any reference to the laws of the U.S. mentioned in the state tax law means the provisions contained in the Internal Revenue Code and any amendments to it made prior to 12/1/2017.⁴⁷ The bill also removes language referring to the federal government with regard to itemizing deductions. Currently, New Yorkers can itemize deductions on their personal income tax only if they also itemize on their federal returns. The bill would allow them to itemize their New York taxes even if they cannot do so for their federal taxes.

The bill also replaces language saying individuals whose federal exemption amount is zero get a \$7,500 standard New York deduction. Under the legislation, this would apply, instead, to those who are claimed as dependents by another New York state taxpayer.

The Empire Center, an Albany-based fiscally conservative think tank, said that the recent executive budget, curiously, did not have language decoupling state and federal tax law. It said that lacking such a change would amount to a roughly \$1.5 billion tax increase on New Yorkers, who would no longer be able to itemize. The blog post, writ-

ten on January 18, proposes the exact solution taken in the bill: simply draw a line at 2017, before the new federal tax law went into effect.

Hence, it seems that the Senate bill would allow the New York grantor of an incomplete gift ING to deduct for state income tax purposes all real estate taxes (without limit) paid regardless of whether the grantor has taken the standard deduction for federal income tax purposes.

Completed gift trusts for grantor and spouse

Perhaps, a simpler approach compared to an ING trust (whether the transfers to it are complete or not for gift tax purposes) is simply to create an irrevocable trust for the grantor, the grantor's spouse, or both (and, perhaps, others) but permit distributions to or for the grantor or spouse only with the consent of an adverse party. Although, as explained above, a trust is a grantor trust to the extent distributions may or must be made to the grantor or spouse, such a trust is not "automatically" a grantor trust if the distributions may be made only with the consent of an adverse party.⁴⁸

⁴⁵ See, e.g., Ltr. Rul. 201410001.

⁴⁶ See note 51, *infra*.

⁴⁷ Here is a link to the bill: https://nam01.safelinks.protection.outlook.com/?url=http%3A%2F%2Fassembly.state.ny.us%2Fleg%2F%3Fdefault_fld%3D%26leg_video%3D%26bn%3DS06974%26term%3D%26Summary%3DY%26Actions%3DY%26Text%3DY&data=02%7C01%7C%7C3b8bf6732416421b759d08d56450179e%7C84df9e7fe9f640afb435aaaaaaa%7C1%7C0%7C636525217523359153&sdata=SKqEi6lOa2fprfOCtQ1geGptnX5xJfAxLgMAAI7hzDU%3D&reserved=0.

⁴⁸ Even if neither the grantor nor spouse is a beneficiary, the trust may be a grantor trust for other reasons. See Akers, Blaittmacher, and Boyle, *supra* note 16.

⁴⁹ See, e.g., Regester, 83 TC 1 (1984). In Rev. Rul. 79-327, 1979-2 CB 342, the IRS stated it disagreed with Self, 142 F. Supp. 939, 49 AFTR 1913 (1956), which seems contrary to Regester.

⁵⁰ See, e.g., Ltr. Rul. 9811004, Ltr. Rul. 8824025, Ltr. Rul. 8905035, Ltr. Rul. 9451049, Ltr. Rul. 199908060, Ltr. Rul. 200243026, Ltr. Rul. 200745015, Ltr. Rul. 200745016, Ltr. Rul. 201122007, and Ltr. Rul. 201342001.

⁵¹ Cf. Section 7477.

Finding an adverse party. As explained above, the determination of whether someone is adverse is a factual one. However, some guidance indicates that one will almost certainly be found to be adverse in certain circumstances. As also explained above, the IRS has consistently so ruled in the ING rulings. The regulations under Section 2514 provide other definite examples at least for purposes of adversity for general power of appointment purposes. Example 1 under Reg. 25.2514-3(b) provides:

The taxpayer and R are trustees of a trust under which the income is to be paid to the taxpayer for life and then to M for life, and R is remainderman. The trustees have power to distribute corpus to the taxpayer. Since R's interest is substantially adverse to an exercise of the power in favor of the taxpayer, the latter does not have a general power of appointment. If M and the taxpayer were trustees, M's interest would likewise be adverse.

Therefore, if the remainder beneficiary of a trust must consent to a distribution to the grantor or spouse, the remainder beneficiary certainly seems to be adverse. Although Reg. 25.2514-3(b) deals with the meaning of adversity for general power of appointment pur-

poses and not necessarily for purposes of Sections 676 and 677, it seems likely the remainder beneficiary should be deemed adverse for those sections as well and, therefore, the trusts should not be deemed to be grantor trusts but separate taxpayers.

Gift by adverse party. If, however, the beneficiary having the adverse interest consents to distributions to the grantor or spouse, the beneficiary may be deemed to have made a gift, not by exercising a general power of appointment in favor of another, but by transferring his or her property interest in the trust. It seems relatively certain that a beneficiary entitled to income from a trust makes a gift by exercising a lifetime special power of appointment in favor of another.⁴⁹

The IRS has ruled (privately) that a beneficiary makes a gift when giving up an interest in a trust even if the beneficiary is not entitled to any distribution or benefit from the trust such as where the beneficiary is entitled only to distributions made by a trustee in the exercise of sole and absolute discretion and even if, apparently, someone (such as the current beneficiary to whom

distributions are made with the consent of the remainder beneficiary) holds a special power of appointment to divert the trust assets away from the remainder beneficiary.⁵⁰ However, as some of the private letter rulings indicate, the value of any such gift may be *de minimis* so any such gift would be extremely small and possibly qualify for the gift tax annual exclusion under Section 2503(b).

Although the IRS might take the position that a gift has been made, and that the value of that gift is more than nominal, it seems doubtful it would aggressively pursue the matter if the taxpayer had significant lifetime exemption.⁵¹

Where to create the completed gift trust. The trust could be located anywhere, provided the location and trust administration will not trigger state income tax. For example, a New Yorker could create a trust in New Jersey, and if it has no New York trustee, no New York situs property, and no New York source income, neither New York nor New Jersey will tax the income of the trust (except New Jersey would impose its tax on New Jersey-source income). However, if a

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trust created by a New York income tax resident holds an interest in New York real estate, then the trust would be subject to New York income tax.⁵² Of course, if the trust has no taxable income (income fully offset by, for example, a deduction for real estate taxes the trust pays), no New York tax would be due.

The problem, however, is that under the law of most states, trust assets are subject to the claims of the grantor's creditors. As mentioned above, this causes the trust to be a grantor trust if the grantor is a beneficiary, and causes the assets to be included in the grantor's gross estate for federal estate tax purposes.⁵³ As also mentioned above, those consequences can be avoided by creating the trust under the law of a state that does not automatically subject the assets to the claims of creditors of the grantor.⁵⁴ Moreover, if the grantor, in fact, uses the home, the IRS likely would contend the home is included in the grantor's gross estate under Section 2036(a)(1).⁵⁵

Trust only for spouse. As an alternative, a non-grantor trust could be created only for the grantor's spouse, as long as distributions to the spouse may be made only with the consent of an adverse party, and vitiating any concern about inclusion of the trust in the grantor's gross

estate for federal estate tax purposes. Therefore, if the trust for the spouse is created and administered so as not to be subject to state income tax, state income tax should be avoided. (Some states impose their income taxes merely because a person or entity resident there is a trustee.⁵⁶) It is beyond the scope of this article to discuss the matter in detail, but it seems that, if the spouse is granted a special power of appointment which is exercised at his or her death to continue the trust for the grantor, there should be no grantor trust status, if distributions for the grantor also may be made only with the consent of an adverse party, nor estate tax inclusion.⁵⁷

Setting up and administering the trust

To successfully obtain the benefit of a complete income tax deduction for nonbusiness real estate taxes, the trust must pay no more than \$10,000 of such taxes and have income at least equal to the taxes.⁵⁸ For example, if the trust pays each year \$10,000 of real estate taxes and has \$10,000 of income (reduced by any other deductions such as for trustee's fees⁵⁹), the trust essentially would have no taxable income.

An individual taxpayer who owns non-trade or business real estate (e.g., the taxpayer's residence) and who

cannot deduct the real estate taxes paid on it on account of using the standard deduction or absorbing all (or at least part) of the deduction under Section 164 for other state and local taxes (perhaps, state income taxes), could give the real estate to a non-grantor trust for one or more family members together with assets that are expected to produce income equal to the amount of real estate taxes, anticipated to be not more than \$10,000 a year. Because the income will be offset by the real estate tax deduction, the trust should owe no income tax and, in effect, the family will have received the benefit of a full deduction for the real estate taxes.

If the real estate taxes exceed \$10,000 a year, the taxpayer could create a sufficient number of non-grantor trusts for family members so each would pay no more than \$10,000 annually. For instance, if the real estate taxes on the residence is \$40,000 a year, the taxpayer could create four non-grantor trusts (e.g., one for the taxpayer's two children and two grandchildren⁶⁰) and transfer 25% of the property to each together with sufficient assets to produce for each trust at least \$10,000 of taxable income, which should be offset by the \$10,000 real estate tax deduction.

This could be accomplished by transferring undivided interests in

⁵² New York Tax Law § 605(b)(3)(D).

⁵³ Rev. Rul. 54-516, *supra* note 40, and Rev. Rul. 2004-64, *supra* note 42.

⁵⁴ See, e.g., Ltr. Rul. 200944002 (Alaska law).

⁵⁵ See, e.g., Rev. Rul. 78-409, 1978-2 CB 234.

⁵⁶ As discussed in detail in Nenzo, *supra*, note 27.

⁵⁷ *Cf.* Rev. Rul. 84-179, 1984-2 CB 195.

⁵⁸ Clearly, it will be more efficient, all other things being equal, for the trust to generate ordinary income rather than income (such as qualified dividends) that is taxed at less than the top income tax rates.

⁵⁹ Although some have questioned whether expenses and deductions described in Section 67(e) ("costs which are paid or incurred in connection with the administration of the trust or estate and which would not have been incurred if the property were not held in such trust or estate" and the deductions allowable

under Sections 642(b) (the personal exemption), 651, and 661 (the latter two for distributions of DNI to a beneficiary) continue to be deductible or are disallowed until after 2025 on account of the disallowance of miscellaneous itemized deduction under Section 67(g), the Conference Report to the Act states in part, "The ... amendment suspends all miscellaneous itemized deductions that are subject to the two-percent floor under present law." Joint Explanatory Statement of the Committee Conference, page 94. Those described above may be itemized deductions because they are not, by reason of Section 67(e), subject to the 2% floor. Hence, it seems that those deductions are not disallowed by Section 67(g). This conclusion seems reinforced by Reg. 1.67-4 and Knight, 552 U.S. 181, 101 AFTR2d 2008-544 (2008).

⁶⁰ A separate trust could be created for children-in-law. See discussion in Blattmachr and Graham, "Extra Crummy Trust(ssm): Maybe

the Best Annual Exclusion Vehicle Around," 22 Probate & Property 46 (July/August 2008).

⁶¹ Section 761(a).

⁶² Section 761(a); Reg. 1.761-2(a)(1).

⁶³ Hager, 76 TC 759 (1981).

⁶⁴ Reg. 1.761-2(a)(2).

⁶⁵ Reg. 1.761-2(b); 1.6031-1(e).

⁶⁶ Reg. 1.761-2(b)(2)(i).

⁶⁷ *Cf.* Bollinger, 435 U.S. 340, 61 AFTR2d 88-793 (1988); Temp. Reg. 1.6031(c)-1T.

⁶⁸ New Jersey does not tax the income of a trust created by its income tax residents if the trust has no New Jersey trustee, source income, or tangible asset located there (www.state.nj.us/treasury/taxation/pdf/pubs/tgi-ee/git12.pdf). Of course, a home in New Jersey would be a tangible asset located there—but if the home were owned by a non-disregarded LLC, it would seem not to be a tangible asset in that state.

the real estate to the trusts as tenants in common. Alternatively, the real estate (and income-producing assets) could be transferred to a limited liability company (LLC) which would be taxed as a partnership under Reg. 301.7701-3 membership interests in which would be transferred to the appropriate number of non-grantor trusts. That way, only one check would need to be sent in to pay the real estate taxes (or other costs of owning and administering the property). Although not well known, a partnership (such as an LLC taxed as one) can opt not to file a separate partnership income tax return and have the tax attributes attributed directly on the partners' returns (in this case, the non-grantor trusts that are the partners).

In order to elect out of partnership treatment, requirements must be met. An organization, used for investment purposes only and not for the active conduct of a business may, on the consent of all its partners, elect to be excluded from Subchapter K (partnership tax rules) even though it is otherwise a partnership.⁶¹ An organization formed for the joint production, extraction, or use of property, or certain security dealers, may also elect out. Thus, a group of persons joined for the joint purchase, retention, sale, or exchange of investment property may elect out.

The partners (or members in the case of an LLC taxed as a partnership) must be able to individually calculate their income without the need to compute partnership taxable income.⁶² The partners must own the partnership property as co-owners. This is likely an issue governed by state law and may suggest that a contractual arrangement confirming this be created in the application of this approach by members of an LLC. The partners must reserve the right to separately take or dispose of their

shares of any property acquired or retained. If the parties do not reserve the right to separately take their shares of the property, the election out is not valid.⁶³ Again, this latter requirement might be addressed in the governing instrument for the LLC opting out.

The partners cannot irrevocably authorize a person acting in a representative capacity to purchase, sell, or exchange such investment property. However, each partner may delegate the authority to purchase, sell, or exchange his or her share of any such investment property for his or her account, but not for longer than one year.⁶⁴ The election out available under Section 761(a) must not be made later than the time for filing the tax return for the partnership for the first tax year the exclusion is desired.⁶⁵


The partnership income tax return, Form 1065, on which the election out is made must include certain information as required by the regulations:⁶⁶ the members' names, addresses and tax identification numbers; the location of the partnership (or operating agreement if it is determined that members of an LLC can meet the requirements to elect out in this instance under state law); a statement that the organization quali-

fies for making the election to be excluded from Subchapter K, and that all of the members elect out.

Alternatively, the LLC could simply be made nominee⁶⁷ owner of each trust's share of the property held by the trust.

Although a separate United States Fiduciary Income Tax Return (Form 1041) would need to be filed for each non-grantor trust, that likely would not be very bothersome as they should be relatively simple returns and nearly identical for each trust. Presumably, no state (or local) income tax return would be filed for any trust as the trust presumably would be "located" in a jurisdiction that would not require such a return (e.g., no New York return if the non-grantor trust was created by someone domiciled in New Jersey⁶⁸).

Although separate and independent shares of a trust are considered separate trusts under Section 663(c) for purposes of determining the trust's DNI, it does not seem that each separate share would be entitled to a separate \$10,000 deduction for state and local taxes. Rather, it seems that the trust would have one such deduction that would be allocated by the shares.

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Use of the residence. Each co-tenant, in general, is entitled to use commonly owned property. If the trusts own the property as co-tenants (either directly or through the LLC as mere nominee for them⁶⁹), each trust could allow its beneficiaries to use the property and, as indicated above, no income should be imputed to either the trust or its beneficiaries.⁷⁰ In fact, no trust presumably will have any DNI as it will have no taxable income.⁷¹

If the real estate is a residence and the taxpayer (who would be the grantor of the trust) or the taxpayer's spouse wants to be able to continue to occupy the property, either the grantor (or spouse) could continue to hold some interest as property as a co-tenant or be a beneficiary of one of the trusts that is a co-owner.⁷² As explained above, to avoid grantor trust status where either the grantor or the spouse is a beneficiary, distributions must be made to either only with the consent of an adverse party.

As mentioned above, an adverse party who consents to a distribution to another could possibly be treated as making a gift (although the ING structure should prevent any such gift being deemed made). Moreover, it is the distribution to the grantor or grantor's spouse that must be made subject to the consent of an adverse party—the mere use does not seem to be a distribution.⁷³

In any case, requiring consent of an adverse party even to allowing the grantor or grantor's spouse to use such property might not be a gift at all by the adverse party and likely would qualify for the annual exclusion. Hence, if, for example, there were four trusts each of which had its adverse party consent to allow the grantor or spouse to use the property, no taxable gift would be made by any of four adverse parties as long as the annual use was less than \$60,000 a year (except to the extent

an adverse party made other gifts to the grantor or spouse using the annual exclusion). If the grantor and spouse do not retain any equity interest in the residence, and the trust requires an adverse party to approve a distribution to the spouse who is a beneficiary, it might be advisable to have the adverse party corroborate his or her consent to the use of the residence in writing.

Summary on trust structure with a residence. If the real estate taxes are not in excess of \$10,000 a year on the taxpayer's home, the taxpayer could transfer the home and sufficient income-producing assets to pay for the taxes to a non-grantor trust of which the taxpayer or spouse would be a beneficiary who could receive distributions (or be permitted to use the property) only with the consent of an adverse person, such as a child named as remainder beneficiary of the trust.

If real estate taxes are in excess of \$10,000, the taxpayer could create a disregarded LLC that would act as nominee for the separate non-grantor trusts (at least one of which would permit distributions to the grantor or spouse with the consent of an adverse party) the taxpayer would create and to which the taxpayer would transfer a portion of the residence (together with suffi-

cient income-producing assets to pay for each trust's proportionate share of the taxes).

Other expenses of the residence. Real estate taxes are not the only costs of maintaining a residence. Heat, insurance, electricity, and yard maintenance costs are also incurred as a general rule. The payment of these non-real estate tax expenses by the trust beneficiary permitted to use the residence should not result in income to the trust that owns the property.⁷⁴ Alternatively, the trust could be funded with sufficient income-producing assets to generate income to pay for the real estate taxes and other expenses of the residence. These additional expenses may not be deductible.⁷⁵ So the trust could have taxable income and pay income tax. Hence, it might be preferable and simpler to have these household expenses paid by the beneficiary who is permitted to use the home.

Mortgage payments. Many pieces of real estate, whether or not a home, are subject to debt. Complications always arise when property subject to debt is transferred. One is that the transfer may accelerate the debt. Hence, it usually is necessary to obtain the consent of the debt holder to the transfer (that is, so the payment of the debt will

⁶⁹ If the LLC is a partnership for federal income tax purposes of which the trusts are partners as opposed to merely being a nominee for them, it is possible the IRS could contend that the use of the property by the trusts (or their beneficiaries) somehow results in income being imputed from the LLC. Cf. Dean, 187 F.2d 1019, 40 AFTR 352 (CA-3, 1951); Rodgers Dairy Co., 14 TC 66 (1950); Dean, 9 TC 256 (1947). While the trust presumably will have no taxable income so no income could be imputed from the LLC, it may be preferable merely to make the LLC a nominee for the trusts.

⁷⁰ See Du Pont Testamentary Trust, *supra* note 44.

⁷¹ See Section 643(a).

⁷² "In a [tenancy in common], the shares in the property may be of unequal size, and can be freely transferred to other owners both during the owner's lifetime and via a will. Even if owners own unequal shares, all owners still have the right to occupy and use all of the property." www.law.cornell.edu/wex/tenancy_in_common.

⁷³ Cf. Du Pont Testamentary Trust, *supra* note 44.

⁷⁴ *Id.*

⁷⁵ See Plant, *supra* note 44. The trust may also incur expenses such as for the preparation of its income tax return. As indicated above, these expenses likely are fully deductible, so if the trust's income is not in excess of the deductible real estate taxes and expenses described in Section 67(e), the trust should have no taxable income.

⁷⁶ Section 163(h)(2). Cf. Ungerman Trust, 89 TC 1131 (1987) (interest, paid to the IRS under Section 6166 extension to pay estate tax, considered an administration expense, and, therefore, not subject to alternative income tax).

⁷⁷ Section 163(h)(4)(D).

⁷⁸ See Reg. 1.671-3 for the grantor trust portions rules.

⁷⁹ Reg. 1.121-1(c)(3)(i).

⁸⁰ Gifts to one's spouse are generally not subject to gift tax. Section 2523.

not be accelerated). Given the restrictions the Act has placed on mortgage interest deductions, if a taxpayer has a grandfathered pre-Act mortgage he or she will likely not wish to jeopardize that.

In any case, the amount of the transfer for gift tax purposes may be net of the debt if the property remains subject to the debt when the property is transferred. However, if the transferor guarantees to be personally responsible for the debt (and to reimburse the transferee if the debt in fact is charged against the property), the gift tax value may be the gross value of the property. Of course, if the transfer is made to an ING trust, there will be no gift, so valuation is irrelevant.

Perhaps, most important is that if the grantor is personally liable on the debt and the debt essentially offsets the grantor's liability, the trust that holds the property may well be a grantor trust. Therefore, it is important to structure the transfer so the grantor cannot be benefitted by the trust satisfying debt for which the grantor is personally liable.

Section 163(h) disallows any deduction for personal interest for all taxpayers other than corporations. Nevertheless, qualified personal residence interest is not disallowed. Qualified personal residence interest is interest on debt secured by the principal or second residence of the taxpayer, but subject to the \$1 million (\$750,000 for debt occurred after 12/15/2017 and before 2026) loan limit.⁷⁶ Any residence held by an estate or trust is treated as a qualified residence for interest deduction purposes if the estate or trust establishes that the residence is a qualified residence of a beneficiary who has a present interest in the estate or trust or an interest in the residue of the estate or trust.⁷⁷ Hence, to be able to deduct

such interest, the grantor or spouse should have a present interest in the trust assuming the grantor or spouse uses it as his or her principal residence. However, to that degree it almost certainly will be a grantor trust although if the grantor or spouse's present interest or residuary interest is only a fractional share of the trust, it may be a grantor trust only to that extent.⁷⁸

Exclusion of gain from sale of principal residence. Under Section 121, a taxpayer may exclude up to \$250,000 (\$500,000 for a married couple) of gain on the sale of the taxpayer's residence if owned and used as his or her principal residence in two of the past five years. The taxpayer will be treated as owning the residence if it is a grantor trust with respect to the taxpayer.⁷⁹

Hence, if the taxpayer intends to sell the residence and avoid gain pursuant to Section 121 prior to 2026, the taxpayer probably should not have interests in the residence held by a non-grantor trust (or any other entity that is not disregarded as to the taxpayer) within two years of the expected time of sale. In such instances, either the transfer should not be consummated or the trust might be converted to a grantor trust with adequate time before the sale.

Terminating the trusts. Unless the law is changed, the allowance of a full deduction for state and local taxes (including real estate taxes) will re-arise after 2025. If that does happen, the need to use the structures discussed above will then end. At that time, returning the residence or other real estate to the grantor (or spouse) may be desired. That could be done by means of the adverse party's consent. As explained above, that might be treated as a gift by the adverse party. However, it seems relatively certain

that an ING trust could be used and without concern of a gift if the property is returned to the grantor (or the grantor's spouse⁸⁰).

The "downside" of the ING trust is that the trust should be located in one of the approximately 18 domestic asset protection trust (DAPT) jurisdictions (such as Alaska, Michigan, or Ohio) that permit the creation of a trust for oneself but not automatically making the assets subject to claims of the grantor's creditors (and any real estate involved first placed into an entity such as an LLC if the property is situated in non-DAPT state). On the other hand, if the grantor is not a beneficiary but only his or her spouse is, then no particular jurisdiction need be used as long as the jurisdiction will not impose an income tax on the trust income and not deny a deduction for real estate taxes paid.

Conclusion

Starting in 2018, the federal income tax deduction for state and local taxes is limited to \$10,000. Many taxpayers will not benefit from the deduction at all because they use the standard deduction. Others who itemize will not benefit from the payment of real estate taxes because the \$10,000 deduction limit will be absorbed by other taxes, such as state and local income taxes. A non-grantor trust that has at least \$10,000 of income should be able to deduct up to \$10,000 of real estate taxes paid on property it owns.

For some taxpayers, transferring non-business real estate will help preserve or enhance the deduction for real estate taxes. Complications arise when the taxes exceed \$10,000 and where the real estate is encumbered by debt. ■