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Incomplete Non-Grantor Trusts:
An Invaluable and Overlooked Federal Tax Planning Tool

In recent years, estate planners and tax practitioners have been utilizing incomplete non-grantor trusts, or ING trusts, with increased frequency. The most common use of ING trusts has been to minimize state income taxes, but an often-overlooked aspect of ING trusts is their effectiveness as a tax planning tool at the federal level. ING trusts provide taxpayers and investors a variety of new opportunities that they may have previously disregarded due to their lack of passive income. In a series of articles, we will discuss the utility of ING trusts in facilitating federal tax planning. This article will provide a broad overview of ING trusts and their traditional use as a state tax planning tool, but it will primarily provide a basic illustration on how ING trusts can facilitate tax planning at the federal level.

The Overlooked Utility of an ING Trust: Federal Tax Planning

ING trusts are irrevocable trusts formed in tax-friendly states and have traditionally been used to minimize taxes at the state level. As a non-grantor trust, an ING trust is a separate taxpayer from the trust grantor and is formed in a state that does not impose a state income tax. If properly structured, ING trusts make it possible to avoid state income taxes on the sale of certain assets.[1] While an effective tool in state tax planning, an often-overlooked aspect of ING trusts is their utility as a federal tax planning tool.

Under Code Section 469 and the accompanying regulations and case law, ING trusts are invaluable tax planning tools at the federal level. Taxpayers can use ING trusts to convert active income to passive income, thereby allowing them to absorb passive activity losses they may have, as well as utilize various other tax incentives, such as solar investment tax credits.

ING Trusts Can Help Taxpayers Avoid Limitations Imposed by Passive Activity Loss Rules

ING trusts can facilitate federal tax planning by converting the character of a taxpayer's income from active to passive. Code Section 469 defines passive activity as any activity in which a taxpayer does not materially participate[2], and the Code allows passive activity losses and passive activity credits to be applied only against passive activity income.[3] By converting the character of a taxpayer's income from active to passive, ING trusts allow a taxpayer's otherwise unused passive activity losses to be absorbed and opens the door for the taxpayer to utilize otherwise unusable passive activity tax credits.

[1] Income earned by tangible assets, such as a business or real estate, is sourced to the state in which that asset is located, and state income tax on this income cannot be avoided using an ING trust.
[2] I.R.C. § 469(c)(1)
[3] I.R.C. § 469(d)(1)

How ING Trusts Can Convert the Character of Income

Under Code Section 469 and the accompanying regulations and case law, taxpayers can use ING trusts to convert the character of their income from active to passive. The IRS's position is that income from an ING trust is per se passive,[4] although this interpretation has been rejected by courts in at least two cases.[5] The courts' decisions in those cases allow ING trusts the flexibility of determining the character of their income as passive or active based on the identity and participation of the trustee.

To comply with both the IRS's position and courts' holdings on material participation of trusts, the taxpayer grantor must simply appoint a trustee who is neither an owner nor an employee of the business transferred into trust. Doing so will ensure that income that was active to the individual taxpayer will be passive to the ING trust, allowing formerly unusable passive activity losses and passive activity credits to be absorbed.

Why Use an ING Trust to Convert the Character of Income?

Many tax professionals spend much of their time and effort attempting to convert passive activity losses to active in order to utilize these losses that are limited by the passive activity loss rules. Instead, competent tax professionals taking an active approach in tax mitigation can implement ING trusts to provide a better avenue for their clients to utilize these losses by transforming the character of income from active to passive, unto which passive activity losses can be absorbed. At the same time, using an ING trust to convert income to passive unlocks opportunities to use other tax incentives, such as solar investment tax credits, which generally have only been able to be used by large C corporations or other large entities with passive income.

In addition, some taxpayers may disregard certain investment opportunities, such as solar investments, because they lack the passive income necessary to take full advantage of the tax credits derived from the investment. By utilizing an ING trust, these taxpayers can take advantage of a plethora of investment opportunities that were not previously feasible to them.

Conclusion and Upcoming Articles

In conclusion, incomplete non-grantor trusts have become a popular planning tool to avoid state income tax, but an often-overlooked aspect of ING trusts is their ability to facilitate tax planning at the federal level. ING trusts provide taxpayers with new opportunities to take advantage of various tax incentives and minimize their federal tax liability.

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[4] IRS National Office Technical Advice Memorandum 200733023, issued in response to *Mattie K. Carter Trust v. United States*.

[5] *Mattie K. Carter Trust v. United States*, NO. 4:02-CV-154-A (N.D. Tex. Apr. 11, 2003); *Frank Aragona Trust v. Commissioner*, 142 T.C. No. 9 (U.S.T.C. Mar. 27, 2014).