Incomplete Non-Grantor Trusts: Structure and Uses

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. This article will take an in-depth dive into the structural requirements an ING trust must fulfill to be effective in facilitating both state and federal tax planning.

The Overlooked Utility of an ING Trust: Federal Tax Planning

ING trusts are invaluable tax planning tools at the federal level under Code Section 469 and the associated regulations and case law. 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. To effectively utilize an ING trust in this manner, taxpayers must make sure the trust meets certain structural requirements.

The Basic Characteristics of an ING Trust

An ING trust is an irrevocable non-grantor trust that is a separate taxpayer from the trust grantor, with undistributed income produced by trust assets being taxed to the trust itself. An ING trust is designed to be an incomplete gift for federal gift tax purposes and a resident of a state with favorable trust income tax laws. This structure allows taxpayers to avoid the gift tax consequences that accompany a completed gift, and by establishing the trust in a state with no state income tax, allows taxpayers to minimize their state tax liability.

The fact that an ING trust is treated as a separate taxpayer from the grantor is important when considering federal tax consequences as well. If an individual taxpayer materially participates in a business, the income derived therefrom will be active income to that taxpayer. If, however, the same taxpayer transfers the business into an ING trust, a distinct and separate taxpayer, the income derived therefrom will be passive income to the trust, providing that the trust is so structured that it will not be deemed to materially participate in the business. This conversion of income character unlocks multiple opportunities to reduce tax liability at the federal level. As discussed below, every ING trust, regardless of its use, must satisfy certain structural requirements, but an additional requirement must be met when using an ING trust in federal tax planning.

The General Structural Requirements of ING Trusts

ING trusts provide multiple tax planning opportunities, but to take advantage of these opportunities, they must be properly structured. First, ING trusts must be established in a state with favorable trust income tax laws. Second, to avoid federal gift tax consequences, the grantor must retain a limited power of appointment over the trust assets. Third, for the trust to maintain its non-grantor status, the trust instrument must establish a distribution committee comprised of trust beneficiaries other than the grantor.

To realize any state tax benefits, ING trusts must be established in a state with favorable trust income tax laws. Specifically, ING trusts must be formed in a state that has no fiduciary state income tax as well as Domestic Asset Protection Trust statutes. Together, these two requirements exclude the option to establish an ING trust in most states. For this reason, almost all ING trusts are formed in either Nevada or Delaware.

Transfers to an ING trust are intended to be incomplete gifts for federal gift tax purposes. To avoid a completed gift and the potential gift tax consequences that accompany it, the grantor must retain sufficient power over the trust assets. A gift is considered complete when the grantor has so parted with dominion and control that he has no power to change its disposition.[1] The grantor may therefore ensure the gift is considered incomplete and avoid any of the associated federal gift tax consequences by retaining a limited power of appointment over the trust assets.

Contrary to the above requirement that the grantor retain sufficient control over the trust assets for gift tax purposes, the grantor must also relinquish a certain amount of control over the trust assets to ensure the trust remains a non-grantor trust that is a separate taxpayer from the grantor. A grantor is considered the owner of any portion of a trust in which the beneficial enjoyment of the principal or the income is subject to a power of disposition, exercisable by the grantor or a nonadverse party, without the consent of any adverse party.[2] To ensure the grantor is not deemed an owner of any portion of the trust and the trust remains an entirely separate taxpayer, the ING trust instrument must establish a distribution committee comprised of the trust beneficiaries other than the grantor. This committee makes distributions decisions by either unanimous vote or majority vote plus the vote of the grantor. The distribution committee is an adverse party under Code Section 672(a) and will therefore ensure the ING trust remains a non-grantor trust that is a separate taxpayer from the grantor.

Additional Requirement for ING Trusts Used in Federal Tax Planning

Described in more detail in other articles of this series, ING trusts facilitate federal tax planning by essentially converting the character of a taxpayer's active income to passive income. For an ING trust to produce passive income, the trust may not materially participate in the income-producing activity. To ensure an ING trust is not deemed to materially participate in an activity, an additional requirement for ING trusts used in federal tax planning is that the appointed trustee(s) may be neither an owner nor an employee of the business transferred into trust.

The Internal Revenue Code and treasury regulations provide little guidance on how to determine if a trust materially participates in an activity, but through administrative publications and court holdings, the IRS and courts have laid a clear foundation for taxpayers to follow to ensure that the ING trust is not deemed to materially participate in an activity and thus produces passive income.

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[1] 26 CFR § 25.2511-2(b)
[2] I.R.C. § 674(a)

The IRS's position is that income from an ING trust is per se passive,[3] although this interpretation has been rejected by courts in at least two cases.[4] In both cases, the IRS argued that only the activities of the trustees should be considered in determining material participation, and the activities of a trust's employees should be disregarded when determining if the trust materially participated in an activity. The IRS further argued that the activities of trustees who are also employees of the trust should be disregarded because it is impossible to differentiate between activities performed as an employee and those performed as trustee.

The courts disagreed with the IRS in both cases. In *Mattie K. Carter Trust*, the District Court held that the activities of both the trustee and the trust's employees are to be considered in determining whether the trust materially participated in an activity. Similarly, in *Frank Argona Trust*, the U.S. Tax Court found that trustees' activities as employees should be considered when determining material participation of a trust in an activity. Despite the courts' rulings in these cases, the IRS has not changed its position that income from an ING trust is per se passive.[3]

The courts' decisions in these 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 grantor of an ING trust 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, unlocking multiple opportunities for tax planning at the federal level.

Conclusion

ING trusts provide multiple tax planning opportunities at both the state and federal level, but to be effective, they must be properly structured. ING trusts must be established in a state with no Domestic Asset Protection Trust statues and no state income tax, with Nevada being the state of choice for most ING trusts. For gift tax purposes, the grantor must retain a limited power of appointment over the trust assets to avoid the gift tax consequences that accompany a completed gift. In addition, the trust instrument must establish a distribution committee consisting of beneficiaries other than the grantor to ensure the ING trust retains its non-grantor status and is a separate taxpayer from the grantor. Lastly, for federal tax planning purposes, the grantor must appoint a trustee who is neither an owner nor an employee of the business transferred into trust to ensure the trust produces passive income.

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

[4] *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).