**Incomplete Non-Grantor Trusts: Unlocking Passive Activity Losses**

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 discuss in detail how ING trusts can minimize a taxpayer's federal tax liability by allowing the deduction of passive activity losses.

**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 facilitators of tax planning 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.

**Passive Activity Loss Rules**

The passive activity loss rules provided in Code Section 469 disallow the deduction of passive activity losses.[4] A passive activity is any activity that involves the conduct of a trade or business in which the taxpayer does not materially participate.[2] To be deemed to materially participate in an activity, a taxpayer must participate in the trade or business on a regular, continuous, and substantial basis.[5] More succinctly, income and losses derived from an activity in which the taxpayer materially participates are considered active income and active losses, while the income

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[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)
[4] I.R.C. § 469(a)(1)
[5] I.R.C. § 469(h)(1)

and losses from an activity in which the taxpayer does not materially participate are considered passive income and passive losses.

The passive activity loss rules provide that a taxpayer's passive losses may only be claimed against and only to the extent of the taxpayer's passive income.[6] If a taxpayer has no passive income in the taxable year, no deduction for any passive activity losses will be allowed, and the passive loss will be carried forward indefinitely until such year that the taxpayer has passive income unto which it can be applied.[7] Under these rules, taxpayers with active income and passive losses in a taxable year could suffer an economic loss yet nonetheless be subject to a tax liability because the losses could not be deducted from income. An ING trust can remedy this problem by converting the taxpayer's active income to passive income, thereby allowing the passive losses to be deducted, resulting in a lower tax liability.

**Converting the Character of Income Using ING Trusts**

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.

Through administrative publications and judicial holdings, the IRS and courts have provided guidance to follow to ensure the ING trust is not deemed to materially participate in the business transferred into trust. The IRS's position is that income from an ING trust is per se passive,[8] although this interpretation has been rejected by courts in at least two cases.[9] In these cases, the IRS argued that the actions of a trust's employees, whether trustees or not, should not be considered in determining whether the trust materially participated in an activity. The courts disagreed with the IRS in both cases, holding that the actions of the trustees and employees of a trust should be considered when determining if a trust materially participated in an activity.

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, allowing previously disallowed passive activity losses to be absorbed therefrom.

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[6] I.R.C. § 469(d)(1)

[7] I.R.C. § 469(b)

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

[9] *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).

## Conclusion

ING trusts provide multiple tax planning opportunities at the federal level, including minimizing tax liability by allowing the deduction of previously disallowed passive activity losses. ING trusts accomplish the feat by transforming the character of a taxpayer's active income into passive income. To take advantage of this opportunity, a taxpayer who actively participates in a business should transfer the business into an ING trust that is properly structured, as is illustrated in our previously published article. For federal tax purposes specifically, the grantor must appoint a trustee who is neither an owner nor an employee of the business. Doing so will ensure the trust does not materially participate under Section 469 and will thus produce passive income unto which the taxpayer's passive losses may be applied.