Save State Income Taxes Using a Nevada Incomplete Gift Non-Grantor Trust

Brian Simmons, CFP
Senior Vice President and Trust Officer
Premier Trust
bsimmons@premiertrust.com
www.premiretrust.com

Steve Oshins
Attorney
Law Office of Oshins and Associate, LLC
soshins@oshins.com
www.oshins.com

Private Letter Ruling 201310002 (re leased March 8, 2013) is great news for taxpayers wishing to save a significant amount of state income tax. This Ruling approved the Nevada Incomplete Gift Non-Grantor Trust ("NING Trust") technique, thus opening the door for residents of states with a state income tax to significantly reduce that tax.

Taxpayers in high tax states with large unrealized capital gains or a regular stream of ordinary income from an investment portfolio have always wanted to find a way to eliminate or minimize their state income tax exposure without giving up the economic benefit of the underlying assets. Over time, such a strategy can produce dramatic results.

Suppose, for example, that Taxpayer: (1) has a $5 million investment portfolio that produces $300,000 of interest, dividends and capital gains each year, (2) lives in a state with a ten percent state income tax rate and (3) taxpayer's home state doesn't tax trusts based on the residence of the grantor. Taxpayer could save $30,000 per year (10% x $300,000) by transferring the portfolio to a trust in a state that does not tax trust income. Moreover, if Taxpayer can reinvest the annual tax savings at a six percent after-tax rate of return, the savings would grow to $1,103,568 after 20 years. This amount could be much higher if Taxpayer funds the trust with low basis assets that would later be sold by the trust, although Taxpayer might have to be careful about how soon the assets were sold.

To accomplish these goals, the trust would need to:

1. Be self-settled to give the grantor the ability to receive distributions;
2. Be a non-grantor trust so that the grantor isn't taxed on the trust income at home state tax rates; and
3. Give the grantor a non-general power of appointment to direct disposition of the trust property.
4. In addition, the transfer of the portfolio to the trust would have to be an incomplete gift, includible in the grantor's estate at death.

Successful Rulings

The main obstacle to creating such a trust is giving up enough control to avoid grantor trust status without giving up so much control that a completed gift is made. Prior to 1997, it wasn't possible to do this. Treasury Regulations Section 1.677(a)-1(d) makes a trust a grantor trust if the grantor's creditors can reach the trust assets under applicable state law. Unfortunately, until that time, the law of all states provided that creditors could look to the assets of a self-settled trust for payment of claims against the grantor.

This changed when states began enacting statutes allowing self-settled trusts that couldn't be reached by creditors, commonly referred to as domestic asset protection trusts (DAPTS). Numerous rulings affirmed that these trusts could be used to accomplish all the

goals listed above (See PLRs 200148028 (November 30, 2001), 200247013, (November 22, 2002), 200502014, (November 22, 2002) 200612002 (March 24, 2006), 200637025 (September 15, 2006), 200647001 (November 24, 2006), 200715005 (April 13, 2007) and 200731019 (August 3, 2007)). Although such trusts were possible under the law of any DAPT state and were created in all favorable jurisdictions, the trusts came to be known as Delaware Incomplete Gift Non-Grantor Trusts ("DING Trusts") because of Delaware's substantial marketing efforts.

The rulings all used the same method of making transfers incomplete without creating grantor trust status. To avoid a completed gift they gave the grantor a testamentary non-general power of appointment (Reg. §§25.2511-2(b and (c))). To avoid grantor trust status, they created a distribution committee that had to approve any distribution to the grantor. Because the committee members were adverse parties under IRC § 672(a), the trust wasn't a grantor trust. Significantly, the PLRs also concluded that the powers held by the distribution committee members were not general powers of appointment.

Issues Created by IRS Pronouncements

Two IRS pronouncements made practitioners cautious about creating DING trusts from 2007 to 2013, however. First, in IR 2007-27 the IRS announced that it was re-examining the conclusion that the distribution committee members didn't have general powers of appointment and requested comments. No further action was taken on the issue, however.

Then, in early 2012, Chief Counsel Advisory 201208026 was issued, creating a shock wave through the estate-planning community. The CCA concluded that retaining a testamentary power of appointment makes a transfer in trust incomplete with respect to the remainder interest, but not with respect to the lead income interest. Thus, if this is the official IRS position, a settlor would have to retain an additional power to make the trust a wholly grantor trust for gift tax purposes.

PLR 201310002

The most straightforward solution to the CCA 201208026 issue would be to give the settlor a lifetime special POA. This power would make the gift incomplete with respect to the lead interest as well as the remainder interest. Of the leading DAPT jurisdictions, however, only Nevada and Alaska have statutes allowing the settlor to retain a lifetime POA that would satisfy the Regulations without subjecting the trust assets to the claims of creditors. Since one exception to the grantor trust rules is to retain a lifetime power of appointment for health, education, maintenance and support
("HEMS") in a non-fiduciary capacity, Nevada and Alaska seem to be the best jurisdictions for getting around the CCA 101208026 concern. Since Nevada is the only DAPT jurisdiction that has no state income tax and doesn't allow any class of creditors to pierce through the trust, Nevada has a distinct advantage over other DAPT jurisdictions and therefore is often the jurisdiction of choice.
A Nevada Incomplete Gift Non-Grantor Trust ("NING Trust"), using a lifetime non-general power of appointment with a HEMS standard, did indeed pass muster with the IRS in PLR 201310002 (and its sister PLRs, 201310003, 201310004, 201310005 and 201310006). The IRS ruled that the trusts were non-grantor trusts for income tax purposes and that the transfers were incomplete for gift tax purposes. Perhaps equally important, the PLR held that the distribution committee members don't have general powers of appointment.

Planning Implications

The PLR should make practitioners much more comfortable about using incomplete gift non-grantor trusts to avoid state income tax, evidently indicating that the IRS has dropped the issue it raised in IR 2007-127. It also suggests that Nevada and Alaska are the preferred jurisdictions for setting up such a trust. While there may be other methods of making a transfer incomplete with respect to both the remainder interest and the lead interest without triggering grantor trust status, these methods are untested in the context of irrevocable gift non-grantor trusts. Other DAPT jurisdictions could change their laws if taxpayers are unsuccessful in obtaining favorable PLRs under their self-settled trust statutes, but even if they do, valuable time will be lost in waiting for the changes. Finally, note that the increased applicable exclusion amounts currently in effect might make these trusts popular for taxpayers with more modest wealth. In the past, taxpayers using these trusts wanted the transfers to be incomplete gifts to avoid payment of gift tax or use of applicable exclusion amount. Now, taxpayers who don't expect to have a taxable estate may want gifts to be incomplete so they can obtain a basis step-up on the assets at death.

Nevada Trustee Requirement

For the trust to qualify as a Nevada trust for legal and tax situs purposes under Chapter 166 of the Nevada Revised Statutes, at least one trustee must be a natural person residing in Nevada, a trust company that maintains an office in Nevada, or a bank that possesses trust powers and that maintains an office in Nevada. Individuals wishing to set up a NING Trust who may not have any individual contacts in Nevada generally use a trust company based in Nevada to serve in that capacity.

Portions of this article come from a previously-published article co-authored by Steven J. Oshins, Esq., AEP (Distinguished) and Peter Melcher, CPA

Steven J. Oshins, Esq., AEP (Distinguished) is an attorney at the Law Offices of Oshins & Associates, LLC in Las Vegas, Nevada, with clients throughout the United States. He is listed in The Best Lawyers in America®. He was inducted into the NAEPC Estate Planning Hall of Fame® in 2011 and was named one of the 24 Elite Estate Planning Attorneys in America by the Trust Advisor. He has authored many of the most valuable estate planning and asset protection laws that have been enacted in Nevada. He can be reached at 702-341-6000, ext. 2, at soshins@oshins.com or at his firm's website, www.oshins.com.

Brian J. Simmons, CFP has over seven years experience in the Financial Services industry as an independent financial advisor and life insurance agent. His expertise includes working with high net worth clients developing and implementing their financial, investment, estate and insurance plans. Before joining Premier, he worked with a local Registered Investment Advisory firm. His professional accreditations include Series 7, 66 and 24 securities licenses, various state insurance licenses, and membership in the Southern Nevada Estate Planning Council. Contact Brian at: bsimmons@premiertrust.com