For Trusted Advisors
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Taxation - Income, Estate and Gift

State income tax planning with incomplete gift non-grantor trusts.

With anticipated decreases in federal income tax rates and relatively few taxpayers facing a federal estate tax liability, tax planners are increasingly turning their focus to strategies for reducing state income taxes. Incomplete gift non-grantor trusts, or ING trusts, are becoming an increasingly popular tool. ING trusts may be ideal for residents of states with high income tax rates who own income producing assets or certain types of highly appreciating assets that they plan to liquidate.

Tax Savings Opportunity and Creditor Protection. Let's assume that John Taxpayer lives in a state with a 10% income tax rate. He also falls in the top marginal federal income tax bracket. As a result, his long-term capital gains tax rate is 20% and he is also subject to the 3.8% Medicare tax. He owns an asset with a basis of $3 million that is now worth $13 million. As the table below illustrates, if the asset had been owned by John's ING trust instead of by John outright, $1 million could be saved in state income tax when the asset is liquidated.

	Assets Held By Grantor	Assets Held by ING Trust
Basis	$3 million	$3 million
Current Market Value	$13 million	$13 million
Pre-Tax Gain	$10 million	$10 million
State Income Tax (10%)	$1 million	$0
Federal Income Tax (23.8%)	$2,380,000*	$2,380,000
Total Tax	**$3,380,000**	**$2,380,000**
After-Tax Gain	$13 million	$13 million

*This figure does not account for any deduction for state income tax paid or the impact of the PEP/Pease limitation on itemized deductions.

In addition to the tax savings, assets in an ING trust may also be protected from creditors of the Grantor and the creditors of other beneficiaries as provided by applicable law.

Gift and Estate Tax Treatment. Transfers to ING trusts are considered incomplete gifts and therefore do not trigger gift tax or utilize the donor's lifetime exemption. Since the assets are not considered completed gifts, they remain includible in the Grantor's taxable estate. Assets held by an ING trust generally receive a basis adjustment to their value at the date of death or the alternate valuation date.

Income Tax Treatment. The goal for an ING trust is to be considered a separate taxpayer in a selected jurisdiction (a state other than the Grantor's domicile[1]). It may be set up in a jurisdiction with no state income tax (such as Nevada) or a state with an income tax (such as Delaware) that the trust may avoid if properly structured. Because grantor trust status causes the trust's income to be taxed to the Grantor rather than the trust, the trust must be carefully drafted so that grantor trust status is avoided. Rules governing residence and taxation also differ from state to state, so careful review of applicable state laws is necessary to ensure that an ING trust can achieve its desired tax benefits. A number of states base the residence of a trust for tax purposes exclusively on the residence or domicile of the grantor, which can eliminate the potential state income tax savings benefit of ING trusts altogether. Other states generally consider a combination of factors which may include (i) the residence or domicile of the Grantor at the time the trust became irrevocable, (ii) the residence or domicile of the fiduciaries and the beneficiaries, (iii) the place of administration of the trust and/or (iv) the location of the trust's tangible assets or commercial activities.

Typical ING Trust Structure. The Grantor is generally a beneficiary of his/her ING trust. Where the Grantor is a beneficiary, a Domestic Asset Protection Trust jurisdiction should be selected to avoid grantor trust status and to maintain creditor protection of trust assets. Generally, a corporate trustee serves as sole Trustee. ING trusts additionally feature a "Distributions Committee" that can direct the trustee to make distributions. The Grantor may serve on the Distributions Committee but trust beneficiaries other than the Grantor generally hold a majority.[2] The proper structure and operation of the Distribution Committee can help prevent the occurrence of a completed gift, unintended grantor trust status, as well as other undesirable tax consequences. The Distribution Committee typically ceases to exist upon the Grantor's death. The Grantor also generally holds a special testamentary power of appointment over trust assets to provide additional flexibility.

Conclusion.

ING trusts may be a good option for individuals in certain states who are subject to high state income tax rates and who desire added creditor protection. ING trusts must be carefully structured and operated, but the potential benefits may be well worth the effort for certain taxpayers.

1 Residence and domicile are distinct concepts governed by distinct rules. This article uses the terms interchangeably for simplicity.
2 See e.g. PLR 20168010, PLR 20141001 and PLR201310002. Minor differences exist in the proposed structure of the trusts in the private letter rulings. Private letter rulings may not be relied upon by third parties.

Estate Planning

Confused by the possible repeal of the estate tax and the future direction of estate planning? Don't be.

By Gary V. Post, JD

Tax reform, including elimination of transfer taxes (estate, gift, and generation-skipping transfer taxes), is currently a hot topic in Washington.

The party in control of both houses of Congress and the presidency campaigned on a platform that calls for eliminating the estate tax. Several bills have been introduced this legislative session to do just that.

This leaves the estate planning community in a position of uncertainty. Will the estate tax be repealed and, if so, what will be the fate of the other parts of the transfer tax system? If this transfer tax reformation is to occur, when will the legislation pass and when will it be effective? How do we address our client's estate planning needs in the interim? After the dust settles, what will the estate planning environment look like?

For now, the answers to these tax questions are left to the politicians, with the substance and effective date of such legislation being impacted by a multitude of competing interests and pressures. While it is too early to know what the end result will be, it can be helpful to clear the air by looking at the options that are being considered for transfer tax reform.

From the view of what can we expect, there are proposals to repeal all three of the transfer taxes, estate, gift, and generation-skipping transfer. However, there are many options that repeal the estate and generation-skipping transfer taxes, but retain the gift tax.

It is possible that assets will still be entitled to a basis step-up upon the death of the owner. Alternatively, the repeal of the estate tax could be coupled with a carryover basis system wherein the built-in gains at death would be retained and passed on to the next generation by having them assume the same income tax basis (i.e., the same built-in gains) as the decedent.

Another option calls for combining estate tax repeal with the recognition of all income on assets upon the death of an individual as if those assets had been sold the day before the individual died. This would substitute an income tax at death for the estate tax.

As to how and when, the present plan is to package tax reform with other legislation in a budget reconciliation bill that can be passed with a simple majority in the Senate. Otherwise, a standalone tax bill that went before the Senate would require 60 votes for passage. Interestingly, this is the process that was used to pass the 2001 Tax Act.

An important factor that came into play in 2001 was the "Byrd rule." Under that rule, a Senator can remove a tax provision (i.e., estate tax repeal) from legislation if it would add to the deficit after the budget reconciliation window (typically ten years). For this purpose, the provision would be removed unless 60 Senators voted to retain it or if it was paid for by another provision. To avoid the Byrd rule in 2001, estate tax repeal was sunsetted so that it came back into the law after ten years (in 2011).

The dynamics that were present in 2001 are present today, including a small majority in the Senate and the tremendous size of the overall tax cut under consideration, so there is the possibility that any estate tax repeal will be sunsetted with the tax set to return after ten years.

Thus, we are in a position where we do not know if a tax reform bill will be passed, whether that bill will include any repeal and/or reformation of the transfer tax system, and, if so, what those reforms will look like and will the tax be set to return. Are we confused? Only if we fail to see the forest for the trees. Focus, and remember that estate planning is the process of transferring wealth from one generation to the next in a manner that accomplishes the family's objectives. Every family is different and every family's objectives are different. For some, transfer tax planning is a key component of the overall plan, while for others it is not present or, if so, it is not the most important need. With or without transfer taxes, families will still need to address asset protection, income tax minimization, probate, retirement planning, life insurance planning, incapacity and spendthrift protection, charitable planning, and, for large estates, the fact that even with smart investment and estate tax planning, family wealth can be dissipated during the lives of the second generation and gone during the lives of the third generation. Transfer tax planning does not solve the problem of an heir who is disabled, is in a bad marriage, or has substance abuse, creditor or spendthrift problems. Transfer tax planning does not alleviate, and sometimes can exacerbate, the potential for income taxes to decimate a family estate.

Both in today's environment, and whatever environment we are in after the dust settles on tax reform, the estate planner's role is to, first, identify the needs and objectives of the family with respect to the ownership and transfer of family wealth and, then, know, access, and implement all of the tools necessary to accomplish those objectives. Those tools may include the use of a Dynasty Trust that will last for the child's lifetime and continue in trust for the parents' descendants from generation to generation. This tool will allow family assets to be protected from the descendants' creditors, from loss upon a divorce, and from mismanagement or spendthrift tendencies of the heirs. In addition, the Dynasty Trust can assure that the trust assets are held only for the benefit of descendants and do not pass outside of the family.

The needs and objectives of families, and thus the estate planning practice, has evolved over the past few decades in many ways that do not involve taxes. Due to a relatively high divorce and remarriage rate, blended families have brought new issues and needs to the estate planning environment. High net worth families are recognizing that smart investments, well-structured wills and trusts, and estate tax planning are not sufficient to prepare the heirs to receive, manage, and sustain the family wealth.

One aspect of life insurance planning is to provide for a source of funds for the payment of federal estate taxes, but that is just one spoke of a broad planning wheel.

A blended family's needs may be met by transferring one spouse's "family" assets to his or her children from a prior marriage and then create wealth to place in trust for the surviving spouse. The best plan for a family business owner may be to transfer the business to an active child and create wealth to equalize that gift for the inactive children. Clients that are active owners with unrelated parties in a closely held business want to assure that, upon their death, their family will receive a fair market value payment for their interest in the ongoing business. Knowledgeable life insurance planning is a key part of delivering these clients a comprehensive estate plan.

> Will the estate tax be repealed and, if so, what will be the fate of the other parts of the transfer tax system?

Estate planning is the process of working with families to successfully transfer wealth (no matter how much) to subsequent generations. Smart transfer tax planning is but one part of a large and evolving puzzle.

Gary V. Post, JD

Gary Post is a Partner with The Blum Firm, P.C., a boutique estate planning firm with offices in Fort Worth, Dallas, Austin, and Houston. Gary's practice is focused on estate planning and trust matters for traditional and blended families, including: planning and implementing testamentary estate plans to accomplish estate and generation-skipping transfer tax savings, non-tax family objectives, and charitable planning objectives; asset protection planning; gift and generation-skipping transfer tax planning, including gifts and sales to intentionally defective grantor trusts; administration and planning with respect to existing trusts, including exercise of trust protector powers and trust modification; and, administration of estates and continuing living trusts. Gary writes and speaks frequently on various estate planning topics and is a Fellow of The American College of Trust and Estate Counsel. In addition, he has served as a director for many not-for-profit and Bar-related organizations.

Taxation - Income, Estate and Gift

Planning issues and considerations for non-U.S. citizens.

Many U.S. businesses utilize H1B, L-1A and other visa programs to fill needs for specialty occupations. As such, more and more people, as well as their spouses, children and other close family members (such as a parent who accompanies the nuclear family), are not U.S. citizens. Planning for non-U.S. citizens is more complicated than planning for U.S. citizens. This provides a competitive advantage to the financial professional who becomes educated on estate planning for non-U.S. citizens.

Consider residency and situs

Resident aliens, persons who are foreign nationals residing in the United States (including the vast majority of green card holders), are taxed on their world-wide assets for estate and gift tax purposes, just like U.S. citizens. Non-resident aliens, persons who are foreign nationals residing outside of the United States, are only taxed on their U.S.-situs assets. There are certain assets that are not considered to be U.S.-situs assets, including bank accounts, certificates of deposits, municipal bonds, and stock of foreign (non-U.S.) corporations. A life insurance policy, where owner and insured is the same non-resident alien, is not considered a U.S.-situs asset and as such, is not subject to U.S. estate tax.

Different gift and estate tax treatment

A U.S. citizen and a resident alien are treated the same for both federal estate and gift tax (as well as the generation-skipping transfer tax), with the applicable exemption amount being $5,490,000 per person ($10,980,000 per married couple) in 2017. This amount is adjusted for inflation annually, with an estate tax rate of 40% on assets in excess. A non-resident alien (a person who is not domiciled in the United States at the time of death or gift), however, may transfer only $60,000 of assets free of estate and gift tax. This $60,000 exclusion amount was set in 1988, and has not been adjusted for inflation since that year. The exclusion amount for a non-resident alien may be greater than $60,000 (but not more than $5,490,000) if the non-resident alien is a domiciliary of a country that has negotiated a separate or combined estate and gift tax treaty with the United States.[1] Some nations that lack an estate tax, such as Canada and Israel, have estate tax provisions within their U.S. income tax treaty. Each treaty is distinct with nuances that can surprise planners.

Planning strategies

If a non-resident alien is from a country without an estate and/or gift tax treaty with the United States, then that person will most likely need life insurance to pay estate tax on all U.S.-situs assets where the aggregate value exceeds $60,000.

With married couples, planning can be even more complex. Where a spouse is not a U.S. citizen, no marital deduction is available for estate tax purposes for transfers made either directly to, or in trust for, the non-U.S. citizen surviving spouse. If the decedent spouse's estate exceeds the applicable exemption amount, there is likely to be an estate tax that cannot be deferred until the death of the surviving spouse. However, the Internal Revenue Code (IRC) provides for a Qualified Domestic Trust (QDOT) that enables deferral of federal estate tax on property passing into the QDOT for the non-U.S. citizen spouse at the U.S. citizen spouse's death. The use of a QDOT merely delays imposition of the estate tax, it does not eliminate it. The income paid from the QDOT, however, escapes estate tax (though it is still subject to income tax).

With regard to gifts from a U.S. citizen spouse to a non-U.S. citizen spouse, the IRC provides what many planners call a "super-annual exclusion." Annual gifts to a non-U.S. citizen spouse that otherwise qualify for the annual gift tax exclusion can be made in amounts of up to $149,000 in 2017 (subject to annual adjustment for inflation). This super-annual exclusion may be leveraged using a popular technique. The U.S. citizen spouse makes gifts to the non-U.S. citizen spouse each year of an amount up to the super-annual exclusion amount. The non-U.S. citizen spouse then leverages this super-annual exclusion gift by purchasing insurance on the life of the U.S. citizen spouse using most or all of the gift amount. Ultimately, the death benefit proceeds would provide financial security to the non-U.S. citizen that would be free from the U.S. citizen spouse's creditors. Such proceeds also could be used to purchase assets from the estate of the U.S. citizen spouse in order to obtain a "stepped-up" basis for those assets.

Additionally, an opportunity exists to utilize more than the super-annual exclusion amount if, in addition to the super-annual exclusion gift itself, the U.S. spouse also makes an interest-free loan to the non-U.S. citizen spouse, which is then used for the purchase of life insurance. Such a below-market interest rate loan is possible as, under the IRC, a husband and wife are treated as one person, and a person cannot make a loan to him or herself.

There is, of course, much more to know where a U.S. citizen or resident alien owns property outside the United States, or where a non-resident alien owns property within the United States, so clients should consult with an estate planning attorney with experience in planning for non-U.S. citizens.

1 The estate tax treaty nations include Australia, Austria, Denmark, France, Germany, Japan, Sweden, and United Kingdom. The gift tax treaty nations include Australia, Austria, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Japan, Netherlands, Norway, South Africa, Sweden, Switzerland and United Kingdom.