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For Trusted Advisors

Taxation - Income, Estate, and Gift

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

By Eva Stark, JD, LL.M.

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.

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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.

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Preserving your family business.

By Todd Fithian

Preserve the perspective and history of your family business to help the next generation carry your success into the future.

When the time comes to transfer a family business to the next generation, most companies focus on the material aspects of the event. They worry about transfer taxes and whether or not they have the financial resources to survive. But besides the tangible resources of the business, what about all the experience the founding generation takes with them? How do you preserve that?

Experiences accumulated through life create perspective. When someone starts the process of building a business, they experience the challenges firsthand. The ups and downs, the successes and failures, and the fear of scarcity build character in the first generation that helps them manage the reality of having significant wealth. Yet the wisdom, experience, values, attitudes, and preferences a family business is built on usually leave with the founding generations.

For example, if one generation learns how to fish because they're starving, they develop very fine fishing skills. But if they catch so many fish that the next generation doesn't have to catch any, then by the time the fish supply runs out and the third generation comes along, no one will know how to fish. The same trend occurs in family businesses. The first generation works hard and struggles to build the business, the next generation enjoys the wealth, and the third loses everything.

If you can preserve those rich experiences, succeeding generations will have a better understanding of the value system that emerged from them, and, therefore, a better potential to succeed with the resources that are passed on to them.

How can you preserve the experiences that built your family business? Use the following steps to pass the perspective and wisdom down through the generations.

REFLECTION

Most people live life, rather than observe it. Even those who have had rich, rewarding lives sometimes fail to recognize the wisdom in their experiences. They believe that they are no different from anyone else and that their past accomplishments don't matter. But the first step of passing perspective through a family business transfer is to overcome this modesty and reflect on all your experiences.

- Where have you been?
- What mistakes did you make?
- What unique experiences have you had?

Stop, sit down, look back on all your accomplishments, and understand how truly important they are to the future of your business.

DISCERNMENT

Once you've reflected on your experiences, you need to look at what your experiences mean.

- What did you learn from your successes?
- What did you learn from your mistakes?
- What wisdom, insight, and perspective have you gained?

- What have you learned about financial management, decision making, and forging business relationships?

These learning experiences have formed the way you conduct your business, and they can help prevent future generations from making the same mistakes you made.

DOCUMENTATION

Once you see what you have learned through your experiences, document everything.

- For some families, the documentation can be as simple as a letter to the kids or succeeding generation.
- Others use an audio tape or video that talks about their experiences and what's important to them.
- And some produce a documentary on the history of the business.

Regardless of what documentation method you choose, make sure it speaks to the succeeding generation and includes everything you value.

COMMUNICATION

The next step is to communicate all this information and history to the people who need to know it. Again, this can be as elaborate as you want.

You can:

- Gather everyone around the dinner table;
- Plan a special family meeting; or
- Organize a retreat with the purpose of talking through these issues.

Consider a "vision trip" where you create an experience for everyone to do together that will help manifest the family business values. Whether you plan an outdoor adventure that facilitates teamwork or a series of challenges that stimulate learning, a vision trip can be an exciting way to bring everyone together and communicate your values and wisdom.

EVOLUTION

Once you've successfully worked through this process, you must repeat it throughout the lifetime of your business. If the founding generation takes the time to understand and talk about where they have been, the current generation lives in those past experiences. Encourage and inspire future generations to participate in the process as well.

This process should become a living document that builds on each generation, because every family member has unique experiences that impact the business. Therefore, each generation should be encouraged to follow this process and contribute their wisdom to the story.

This continuation creates a framework in which the family considers the stewardship of this story just as crucial a component in their wealth transfer plans as they do the financial resources they have accumulated along the way.

Preserving the Past

The stereotypical three-generation lifespan of a family business is rooted in the loss of perspective that occurs in the transfer from one generation to the next. But your family business can overcome this challenge by preserving its history and creating a context that respects the past while providing liberty to the current generation.

This framework shouldn't bind the current generation to a set of rules, but rather empower them with the lessons learned by previous generations, and show how those past experiences can benefit them. It should inspire future generations to participate and grow the family business, rather than just work there because that's where the money is.

When you use this process to preserve the perspective and history in your transfer plans, future generations will know where the family business came from and all the experiences that made it succeed, which will help them carry the success into the future.

Todd Fithian

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