Formation of Trusts for Asset Protection and Reduction of State Tax Burden

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Trusts in the News

Purpose

- As designed, trusts have many valid uses:
  - Promote charitable giving
  - Protect privacy
  - Limit liability
  - Maximize an asset on behalf of someone else
  - Protect beneficiaries against their own inability to handle money

Abusive Trusts

- Abusive trust arrangements generally offer tax benefits with no meaningful change in the taxpayer's control over or benefit from the taxpayer's income or assets. They typically are promoted by the promise of such benefits as:
  - Reduction or elimination of income subject to tax.
  - A stepped-up basis for property transferred to the trust.
  - The reduction or elimination of gift and estate taxes.

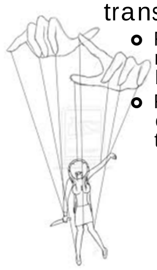
Source: IRS

Terminology

- A valid **trust** is a legal arrangement creating a separate legal entity
- To create a trust, legal title to property is conveyed to a **trustee**, who must use that property for the benefit of another person, called the **beneficiary**, who has all the benefits of ownership except for bare legal title.
- An **inter vivos trust** (the type addressed in this presentation) is one that is created during the lifetime of the grantor.

Terminology

- Incomplete transfer = grantor retains "dominion and control" over the assets as laid out in IRC §§ 671-677
  - Creates a **grantor trust**
  - Is an incomplete transfer if grantor:
    - Retains power to name new trust beneficiaries
    - Retains power to change the interest of trust beneficiaries



- Complete transfer = grantor relinquishes control of the transferred property and retains no power to change the disposition of the gifted property.
  - Creates a **non-grantor trust**
  - Grantor gives up the right to regain ownership of the property or to receive income from it

Taxation of Trusts

- Generally, a trust is considered a stand-alone entity and is therefore subject to federal and state income tax laws.
- **Grantor trusts**: Ordinary income earned and capital gains realized are generally taxed to the grantor.
- **Non-grantor trusts**: Ordinary income earned and capital gains realized are generally taxed to the recipient of the distributions
  - If the trust does not distribute gains, it is taxed as a separate taxable entity

Exploitable State Differences in Taxation

- States have different standards for resident/nonresident trust
  - Timing
    - determine trust residency at the moment the trust is created? When it becomes irrevocable?
  - By beneficiary/trustee/state law applied
    - using the state's law as the governing law of the trust,
    - administering the trust in the state,
    - having a grantor that is a resident of the state,
    - having a trustee that is a resident of the state,
    - having a beneficiary that is a resident of the state,
    - owning assets located in the state, or
    - receiving state-source income.

	State's law governs the trust	Trust administered	Resident grantor	Resident trustee	Resident noncontingent beneficiary	Assets located in state	State-source income
Alabama			X	X		X	X
Alaska							
Arkansas				X		X	X
Colorado		X				X	X
DC			X		X	X	X
Hawaii		X	X	X	X	X	X
Idaho	X	X	X	X		X	X
Kansas		X	X	X		X	X
Michigan			X			X	X
Missouri	X		X		X		X
Montana		X		X		X	X
New Mexico	X	X	X	X		X	X
North Dakota	X	X	X	X	X	X	X
Oregon	X	X		X		X	
Texas							
Utah	X	X	X	X		X	X
Washington							
New York			X				X

Source: BNA

Note some states require a trust to meet more than one condition before it is considered a resident trust.

Trusts and Nexus

- Multiple taxation/nontaxation
  - Trusts can be structured in a manner parallel to that of corporations, are similarly vulnerable to multiple taxation but can exploit state laws to avoid state income taxation

	State's law governs the trust	Trust administered	Resident grantor	Resident trustee	Resident beneficiary	Assets located in state	State-source income
Oregon	x	x		x		x	
Michigan			x			x	x
Missouri	x		x		x		x

Trusts and Nexus

- Trust must have nexus with the state under Commerce Clause/Due Process Clause analysis in order to be subject to taxation by the state
  - **Due Process Clause "minimum contact"**
    - Undistributed income of *inter vivos* trust was taxable in Connecticut based on the facts the trust's grantor was a Connecticut resident when he established the trust and the trust's beneficiary was a Connecticut resident. The beneficiary's rights to the accumulated income were protected by Connecticut law. *Chase Manhattan Bank v. Gavin*, 733 A.2d 782 (Conn. 1999)
    - Trust property distributed to a new *inter vivos* trust after the Illinois grantor's death could not be subject to income tax in Illinois. *Linn v. Department of Revenue*, 2013 WL 6662888 (Ill. Ct. App. 2013.)
  - **Commerce Clause "substantial nexus"**
    - Under *Quill*, Connecticut court found that the risks associated with subjecting trusts to income tax imposed by multiple states on intangibles were too remote and speculative to constitute a violation of the Commerce Clause. *Chase Manhattan Bank v. Gavin*, 733 A.2d 782 (Conn. 1999)

The Original Domestic Tax Shelter: Domestic Asset Protection Trusts

- Before 1997, a trust could not make distributions to the grantor without being considered a grantor trust
  - If the trustee had the power to make either mandatory or discretionary distributions to the grantor, creditors could reach the asset too
- In 1997, Alaska enacted a statute providing creditor protection for self-settled spendthrift trusts, which are called domestic asset protection trusts (DAPTs)

The Original Domestic Tax Shelter: Domestic Asset Protection Trusts

- The DAPT assigns an independent trustee who has absolute discretion to make distributions to a class of beneficiaries that usually includes the grantor
- The intent of the DAPT is to shelter assets from the claims of the grantor's future creditors
- BUT the secondary effect is that under most authorizing statutes the asset and its future appreciation are removed from the grantor's estate

The Original Domestic Tax Shelter: Domestic Asset Protection Trusts

As of May 2013, DAPTs could be created in the following 15 states:	
Alaska	New Hampshire
Colorado	Rhode Island
Delaware	South Dakota
Hawaii	Tennessee
Missouri	Utah
Nevada	Virginia
Ohio	Wyoming
Oklahoma	

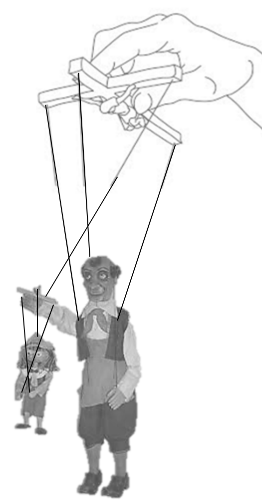
The Original Domestic Tax Shelter: Domestic Asset Protection Trusts

- "When I drafted the first DAPT statute (for Alaska) and participated in the drafting of the second (for Delaware)," explains Jonathan Blattmachr, "my motive was to allow more efficient estate tax planning. One of the major reasons, in my experience, why individuals will not do estate tax planning is because they usually lose all potential benefit from the property used in the plan. By creating a self-settled trust in a DAPT jurisdiction, the taxpayer can make a completed transfer for estate and gift tax purposes but remain a discretionary beneficiary of the trust used in the arrangement. That, I think, continues to be the major advantage of DAPT legislation."

-- Robert L. Moshman, "Return of the DING Trusts"

Avoiding State Income Tax: "Delaware Incomplete Non-Grantor" (DING) trusts

- DING trusts hold the grantor's assets and make distributions to him while remaining a non-resident trust for purposes of state income tax and a non-grantor trust for purposes of income tax and gift tax.
  - But the assets *are* includible in grantor's estate (PLR 201310002)



Avoiding State Income Tax: DING Trusts

Strategy: Step 1

- Set up trust residency so income is not subject to income tax in the state where the trust is located

a. Seven states (Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming) do not tax trust income at all. The remaining states tax resident trusts (see chart). For reasons covered in the next slides, Nevada and Alaska are the most favored states for an DING trust.

Avoiding State Income Tax: DING Trusts

Strategy: Step 2

- Set up grantor residency so trust is not subject to income tax in the grantor's home state.
  - Under the residency test, a trust is a resident trust for state income tax purposes if the grantor was a state resident when the trust became irrevocable.
  - States using this criterion include Connecticut, the District of Columbia, Illinois, Louisiana, Maine, Maryland, Michigan, Minnesota, Nebraska, Ohio, Oklahoma, Pennsylvania, Utah, Vermont, Virginia, West Virginia, and Wisconsin (more on residency later).

Avoiding State Income Tax: DING Trusts

Strategy: Step 3

- Leave grantor sufficient power over the transferred assets to avoid a completed gift that could trigger a gift tax
  - CCA 201208026: retaining a testamentary power of appointment (POA) makes a transfer in trust incomplete with respect to the remainder interest, but not with respect to the lead income interest.
  - PLR 201310002 implied that an incomplete gift is established if the grantor retains a lifetime special POA.
  - Nevada and Alaska are the only DAPT states that have statutes allowing the grantor to retain a lifetime POA without subjecting the trust assets to the claims of creditors.

Avoiding State Income Tax: DING Trusts

Strategy: Step 4

- Allow distributions to the grantor, while maintaining the trust's status as a non-grantor trust
  - require approval of any distributions to the grantor by a distribution committee that included only persons currently eligible to receive distributions themselves.
    - This makes the committee members adverse parties under Section 672(a), so the trust is not a grantor trust (this was confirmed in PLR 201310002.

DING summary

- Non-grantor trust = no state income tax on grantor
- Non-resident trust = no state income tax on trust
- Incomplete gift = no gift tax
- Asset remains part of grantor's estate

Avoiding Capital Gains Tax: Charitable Remainder Unitrust

- Commonly used for appreciated assets w/low basis
- Owner puts the appreciated asset into a charitable trust, which can (as a tax-exempt entity) sell it without owing any federal capital gains tax itself
- The CRUT's charitable contribution requirement provides for an immediate income tax charitable deduction reflecting the present value of the future gift to charity

Avoiding Capital Gains Tax: Charitable Remainder Unitrust

- IRC § 664(d)(1) sets the federal income tax requirements for a CRUT
  - The charity must be an organization described in § 170(c):
    - *organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals*

Avoiding Capital Gains Tax: Charitable Remainder Unitrust

- The assets contributed to the CRUT are no longer part of the taxable estate
  - Trust pays the former owner of the asset a fixed percentage of the principal as revalued each year; taxes are imposed on the payments, but are not necessarily regular income taxes
    - Taxes are based on how the CRUT earned the income; regular income and capital gains are taxed accordingly and distributions of trust principal are tax-free.

Avoiding Capital Gains Tax: Charitable Remainder Unitrust

- Payments continue either for a set number of years or for one or more lives, and the remainder goes to charity.
- *At least 10% of the original amount must go to charity – otherwise does not qualify as a CRUT*

Avoiding Capital Gains Tax: Charitable Remainder Unitrust

- This works to minimize federal taxes, but doesn't work in all states:
  - Only exclusively charitable trusts qualify for income tax exemption under the New Jersey Gross Income Tax Act. A Charitable Remainder Trust, in contrast to a charitable trust, has "noncharitable" beneficiaries and does not operate exclusively for charitable purposes. Accordingly, a Charitable Remainder Trust is not an exclusively "charitable trust" exempt from New Jersey income tax under N.J.S.A. 54A:2-1 and income that is not distributed and which is not deemed to be permanently and irrevocably set aside or credited to a charitable beneficiary is taxable income to the trust. -- New Jersey Division of Taxation Regulatory Services Branch TB-64
  - Under Pennsylvania statute, a charitable trust is a trust operated exclusively for religious, charitable, scientific, literary, or educational purposes. A trust is a charitable trust only if all net earnings for the tax year and remaining life of the trust are for distribution for such purposes – PA Code 101.9

CRUT summary

- Charitable trust = no capital gains tax, charitable deduction, lifetime annuity
- Completed gift = not in grantor's estate
- Some states have more stringent rules that preclude CRUTs

Minimize Transfer Taxes: Grantor Retained Annuity Trust

- Before the enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), Pub. L. No. 107-16, 115 Stat. 38, most states imposed an estate tax equal to the federal state death tax credit laid out in § 2011 of the Internal Revenue Code.
- After EGTRRA replaced the state death tax credit with a deduction for state death taxes, many states decoupled from the federal estate tax.

Minimize Transfer Taxes: Grantor Retained Annuity Trust

- Modified pick up states impose a state estate tax based on the state death tax credit under IRC § 2011 as it would have been in effect on a certain date (usually before EGTRRA) and assuming certain threshold amounts

Modified pick up states	2014 Exemption	2014 Top Tax Rate
Delaware	$5,340,000	16%
District of Columbia	$1,000,000	16%
Hawaii	$5,340,000	16%
Illinois	$4,000,000	16%
Maine	$2,000,000	12%
Massachusetts	$1,000,000	16%
Minnesota	$1,000,000	16%
New York	$1,000,000	16%
Rhode Island	$921,655	16%
Vermont	$2,750,000	16%
Tennessee (repealed effective for deaths after December 31, 2015)	$2,000,000	9.5%

Minimize Transfer Taxes: Grantor Retained Annuity Trust

- Some states created their own estate tax with their own definitions of taxable estate, estate tax rates, and exclusion/threshold amounts.

State-specific Estate Tax	2014 Exemption	2014 Top Tax Rate
Connecticut	$2,000,000	12%
Oregon	$1,000,000	16%
Washington	$2,012,000	20%

Minimize Transfer Taxes: Grantor Retained Annuity Trust

- Other states impose an inheritance tax, which is imposed on the person who inherits property from another (unlike an estate tax, which is imposed on the decedent's estate)

Inheritance Tax	2014 Exemption	2014 Top Tax Rate
Iowa	$25,000	15%
Pennsylvania	$3,500	15%
Kentucky	Up to $1,000	16%
Nebraska	Up to $40,000	18%

GRATs: minimize transfer taxes

- Maryland and New Jersey have both estate and inheritance taxes*

Estate and Inheritance Tax States	2014 Estate Exemption	2014 Top Estate Tax Rate	2014 Inheritance Exemption	2014 Top Inheritance Tax Rate
Maryland	$1,000,000,	16%,	$0	10%
New Jersey	$675,000	16%	Up to $25,000	16%

- Connecticut and Minnesota are the only states that impose true gift taxes

Gift Tax States	2014 Gift Tax Exemption	2014 Top Gift Tax Rate
Connecticut	$2,000,000	12%
Minnesota	$1,000,000	10%

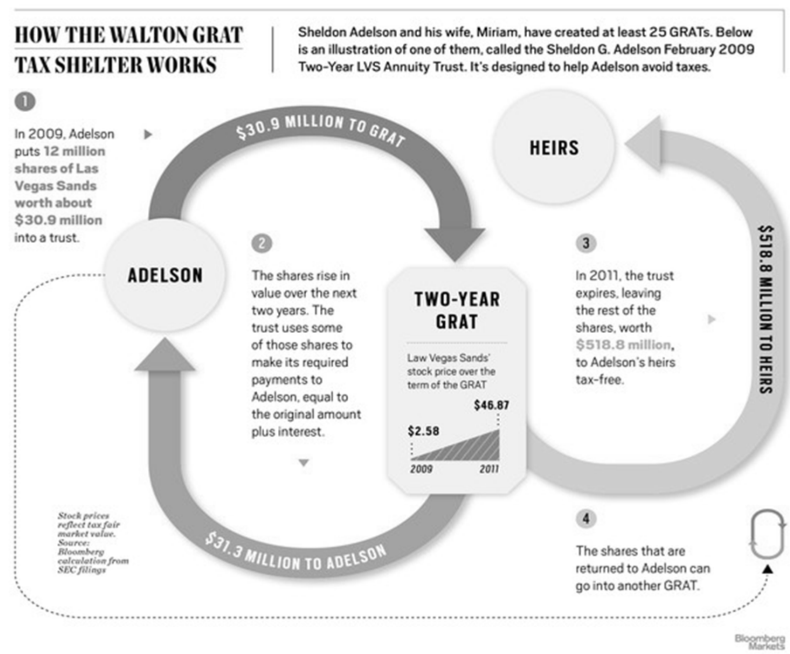
* Any inheritance tax paid is credited against the estate tax.

Minimize Transfer Taxes: Grantor Retained Annuity Trust

- GRATs offer a chance to transfer the growth potential of assets while minimizing gift and estate taxes.
- In 2000, *Walton v. Commissioner* paved the way for a class of SuperGRATs. This technique pushed the envelope of planning by "zeroing out" a GRAT—adjusting the duration and rate of return so that the Grantor's retained interest has the same value as the transferred assets, offsetting the transfer entirely so that there are zero gift taxes

Minimize Transfer Taxes: Grantor Retained Annuity Trust

- Structure of GRAT
  - Grantor makes a completed gift of assets to an irrevocable grantor trust
  - Grantor retains the right to receive annuity payments for the term of the GRAT
  - Grantor pays tax on income attributable to the property in the GRAT
  - The annuity paid to the grantor should be valued using the rates in IRC § 7520 so that the value of the annuity is equal to the value of the assets transferred to the GRAT.
  - The excess appreciation of the assets over the amount of the annuity passes to the remainder beneficiaries gift tax free thus reducing the size of the taxpayer's estate.



Minimize Transfer Taxes: Grantor Retained Annuity Trust

- Domicile of Taxpayer
  - Establishing domicile in a state with no income tax will allow a taxpayer to use a GRAT to remove value from the estate free of all tax.
    - Elements of Domicile
      - Vehicle registration
      - Home ownership
      - Church membership
      - Driver's license
- There have been efforts in Congress to impose a 10-year minimum annuity period, but so far no progress

GRAT summary

- Revenue Ruling 2004-64: grantor's payment of the GRAT's income taxes is not an additional gift for gift tax purposes.
- Few states have a gift tax, so more applicable for federal purposes
- Death during annuity period puts trust back in the estate

Uniformity Issues

- In November of 2013, a New York state tax commission recommended laws to limit the use of out-of-state trusts.
- The New York Dep't of Taxation and Finance estimates that the proposed change would generate $150 million a year, or about a 0.4 percent increase in personal income tax collections.
  - Those figures suggest annual income in out-of-state trusts of more than $1 billion and assets much bigger than that.

Source: http://www.bloomberg.com/news/2013-12-18/wealthy-n-y-residents-escape-tax-with-trusts-in-nevada.html

Uniformity Issues

- New York recommendation:
  - Close the resident trust loophole by decoupling from the federal treatment of Delaware Incomplete Gift Trusts and treating these trusts as grantor trusts for New York State income tax purposes. This would result in trust income being taxed to the grantor of the trust.
  - Note there is some concern that this will inadvertently affect trusts other than DING trusts

Uniformity Issues

- Throwback?
- Subject the trusts themselves to state tax?
- Treat DING trusts as grantor trusts?

…"You scratch your head and say, 'Why pay if we don't have to?'"

-- William Lipkind, a New Jersey lawyer