Incomplete Gift Non-Grantor Trusts: How Kaestner Highlights the Importance of Planning for State Income Tax

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In *North Carolina Department of Revenue v. The Kimberley Rice Kaestner 1992 Family Trust*, 139 S. Ct. 2213 (2019), the US Supreme Court held that the in-state residence of trust beneficiaries did not supply the minimum connection with the State of North Carolina required to support the State's imposition of tax on trust income and that the state's tax as applied to the Kaestner trust violated the Due Process Clause of the Fourteenth Amendment to the US Constitution.

In *Kaestner*, a New York resident established a trust for the benefit of his children. The trust was a wholly discretionary trust governed by New York law and had a New York resident trustee. When the grantor established the trust, no beneficiary lived in North Carolina. However, the grantor's daughter moved to North Carolina a few years later. After she moved, the trustee divided the original trust into three subtrusts, with one subtrust being for the benefit of the daughter and her three children. The subtrust was held under the same terms as the original trust, which meant that distributions from the subtrust were made in the trustee's absolute discretion. During the years relevant to the case, no distributions were made from the subtrust to any beneficiary.

For many practitioners, the facts in *Kaestner* sound familiar. Client A and Trustee B establish a trust for the benefit of Child C, Child D, and Child E at a time when all parties live in State O. A few years later, Child C moves to State X, the trustee moves to State Y, and Client A starts discussing retirement in State Z. With grantors, beneficiaries, and trustees living in an increasingly transient society, state income tax traps are lurking—and states, as in *Kaestner*, are staking claim to these sources of revenue. However, with the right facts and careful planning, a trust's state income tax may be eliminated altogether. And because the Tax Cuts and Jobs Act doubled the basic exclusion amount, various clients are shifting their focus and current planning goals towards strategies that may reduce or eliminate state income tax.

Avoiding Minimum Connection

In *Kaestner*, the Court concluded that the residence of trust beneficiaries in North Carolina alone did not supply the minimum connection necessary to sustain the state's tax. The Court also described scenarios where minimum connection has been found and state law withstands the Court's review:

> The Court has already held that a tax on trust income distributed to an in-state resident passes muster under the Due Process Clause... So does a tax based on a trustee's in-state residence… The Court's cases also suggest that a tax based on the site of trust administration is constitutional.

Kaestner, 139 S. Ct. 2213, 2220 (internal citations omitted).

These examples serve as a reminder of the factors to avoid when planning around state income tax with trusts, all of which can be achieved with an Incomplete Gift Non-Grantor Trust (ING).

An ING is a self-settled, irrevocable trust for the benefit of the grantor and other named beneficiaries. The grantor is generally a resident of a high-income tax state, such as California, and the trust is settled in a state with low or no state income tax, such as Nevada. The grantor ensures that the ING is a non-grantor trust for income tax purposes so that trust income is not taxable to the grantor and thus not subject to tax in the grantor's state of domicile. Additionally, the transfer to the ING is an incomplete gift for gift tax purposes so that the grantor preserves his exclusion amount for future transfers (or perhaps has no remaining exclusion at the time of the transfer to the ING). The incomplete gift also ensures that the trust assets are includible in the grantor's estate and receive a step-up in basis upon the grantor's death. Finally, an ING is an asset protection trust formed in a state with favorable asset protection laws and no state income tax or no tax on nonresidents, such as Delaware, Nevada, Ohio, or South Dakota.

Incorporating all of these concepts into the trust instrument requires precise drafting. The drafting attorney should carefully analyze each characteristic to ensure the trust instrument will achieve their clients' desired outcomes. Additionally, clients may be advised to obtain a private letter ruling from the IRS, as several Private Letter Rulings have approved the use of INGs for federal income tax purposes and provide a roadmap for estate planners. *See*, *e.g.*, I.R.S. P.L.R. 201614006 (Apr. 1, 2016), I.R.S. P.L.R. 201510001 (Mar. 6, 2015), I.R.S. P.L.R. 201310002 (Mar. 8, 2013), I.R.S. P.L.R. 200715005 (Apr. 13, 2007), I.R.S. P.L.R. 200729025 (Jul. 20, 2007), I.R.S. P.L.R. 200637025 (Sept. 15, 2006), I.R.S. P.L.R. 200612002 (Mar. 24, 2006); *but see* Rev. Proc. 2020-3, 2020-1 I.R.B. 137 (the IRS recently added certain INGs to its list of areas in which rulings or determination letters will not be issued).

Income Tax Characteristics of INGs

Grantor Trust Rules. Non-grantor trust status is a core characteristic of an ING. The trust must avoid classification as a grantor trust; otherwise the trust's income is taxable to the grantor and subject to taxation in the grantor's state of domicile. Avoiding the application of the grantor trust rules is critical.

Generally, a trust is a grantor trust, and the income therefrom is taxed to the grantor, if:

1. The grantor has a reversionary interest in income or principal that exceeds 5 percent of the total value of the trust at the time of the transfer (*see* I.R.C. § 673(a));
2. The beneficial enjoyment of trust income or principal is subject to a power of disposition, held by the grantor or a nonadverse party, or both, without the approval or consent of an adverse party (*see* I.R.C. § 674(a));
3. The grantor or a nonadverse party has the power to deal with the trust for less than full and adequate consideration or borrow from the trust without adequate interest or security (*see* I.R.C. § 675);
4. The power to revest in the grantor title to any portion of the trust is exercisable by the grantor or a nonadverse party, or both (*see* I.R.C. § 676(a));
5. Income is, or in the discretion of the grantor or a nonadverse party, or both, may be distributed to the grantor or the grantor's spouse, or held or accumulated for future distribution to the grantor or the grantor's spouse, without the approval or consent of any adverse party (*see* I.R.C. § 677(a)).

Additionally, a person other than the grantor is treated as the owner (and the trust income is thus included in such person's gross income) of any portion of a trust with respect to which such person has a power exercisable alone to vest the corpus or the income therefrom in himself or herself. *See* I.R.C. § 678.

There are several exceptions to the grantor trust rules listed above. Specifically, I.R.C. § 674(b)(5) provides that § 674(a) does not apply to a power to distribute corpus to or for a beneficiary, provided that the power is limited by a reasonably definite standard that is set forth in the trust instrument. Additionally, I.R.C. § 674(b)(3) provides that § 674(a) shall not apply to a power exercisable only by will, other than a power in the grantor to appoint by will the income of the trust where the income is accumulated for such disposition by the grantor or may be so accumulated in the discretion of the grantor or a nonadverse party, or both, without the approval or consent of any adverse party.

Distribution Committee. To avoid classification as a grantor trust, distributions from an ING are directed by a distribution committee, sometimes with the consent of the grantor. The distribution committee is controlled by adverse parties acting in a nonfiduciary capacity. An adverse party is any person having a substantial beneficial interest in the trust that would be adversely affected by the exercise or nonexercise of the power he holds with respect to the trust. *See* I.R.C. § 672(a). A nonadverse party is any person who is not an adverse party. *See* I.R.C. § 672(b). In the context of an ING, adverse parties are the beneficiaries to whom distributions can be made, whose interests are adverse to the interest of the grantor. The distribution committee must contain adverse parties because certain powers—critically, a power of disposition over the beneficial enjoyment of corpus or income and a power to distribute income to the grantor—held by the grantor or a nonadverse party will not cause grantor trust status when exercisable only with the approval or consent of an adverse party. *See* I.R.C. § 674(a); I.R.C. § 677(a).

The composition of the distribution committee can vary slightly. For instance, sometimes the grantor is a member of the distribution committee (*see*, *e.g.*, I.R.S. P.L.R. 201310002 (Mar. 3, 2013)); at other times the distribution committee includes only the other beneficiaries and the grantor is specifically excluded (*see*, *e.g.*, I.R.S. P.L.R. 201614006 (Apr. 1, 2016), I.R.S. P.L.R. 200731019 (Aug. 3, 2007), I.R.S. P.L.R. 200729025 (Jul. 20, 2007), I.R.S. P.L.R. 200715005 (Apr. 13, 2007), I.R.S. P.L.R. 200637025 (Sept. 15, 2006), I.R.S. P.L.R. 200612002(Mar. 24, 2006)). Additionally, because the distribution committee must be controlled by adverse parties, the decision regarding who will be designated to serve on the distribution committee is driven by the class of permissible beneficiaries (other than the grantor, in most cases). For instance, if the grantor has no children, he may name siblings, parents, nieces and nephews, or other individuals as beneficiaries. Those individuals then form the class of potential members of the distribution committee. Additionally, if the beneficiaries are minors, the trust instrument will need to permit parents or guardians of permissible beneficiaries to serve on the distribution committee. *See, e.g.,* I.R.S. P.L.R. 201510001 (Mar. 6, 2015); I.R.S. P.L.R. 200612002 (Mar. 24, 2006).

The trust instrument will usually require a minimum number of members on the distribution committee, generally two or three (other than the grantor, if the grantor is permitted to serve on the committee). The trust instrument also will provide that the distribution committee will cease to exist if the committee falls below the minimum required members and, in any event, will cease to exist upon the grantor's death. *See, e.g.,* I.R.S. P.L.R. 201510001 (Mar. 6, 2015).

Gift Tax Characteristics of INGs

The second core characteristic of an ING is that the grantor's transfer to the trust is an incomplete gift for gift tax purposes. The incomplete gift preserves the grantor's remaining exclusion amount (or prevents the payment of gift tax if the grantor has no remaining exclusion amount) and ensures that the assets in the ING are includible in the grantor's estate—and receive a step-up in basis—upon the grantor's death.

In general, a completed gift results when the grantor has parted with dominion and control over property such that he cannot change its disposition, whether for the grantor's own benefit or for the benefit of another. *See* Treas. Reg. § 25.2511-2(b). If the grantor reserves any power over the disposition of the property, however, the gift may be wholly incomplete or may be partially complete and partially incomplete. *Id*. Additionally, a gift is incomplete "if and to the extent that a reserved power gives the donor the power to name new beneficiaries or to change the interests of the beneficiaries as between themselves unless the power is a fiduciary power limited by a fixed or ascertainable standard." *See* Treas. Reg. § 25.2511-2(c).

The grantor is considered to have a power if it is exercisable by him in conjunction with any person not having a substantial adverse interest in the disposition of the transferred property or the income therefrom. *See* Treas. Reg. § 25.2511-2(e). A co-holder of the power does not have an adverse interest merely because of his joint possession of the power nor merely because he is a permissible appointee under a power. *See* Treas. Reg. § 25.2514-3(b)(2). However, a co-holder of a power is considered as having an adverse interest where he may possess the power after the possessor's death and may exercise it at that time in favor of himself, his estate, his creditors, or the creditors of his estate. *Id*.

Preventing a completed gift, while also preventing grantor trust status, requires the grantor's retention of a power that will be treated as a power of disposition under Treas. Reg. § 25.2511-2(b) and curtailing that power such that it will not be treated as a power of disposition under I.R.C. §§ 674(a) and 677(a).

Drafting the Distribution Provisions

To integrate the income and gift tax characteristics of an ING, the trust instrument should set forth several distinct distribution provisions. The Private Letter Rulings approving INGs describe substantially similar dispositive terms. *See*, *e.g*., I.R.S. P.L.R. 201614006 (Apr. 1, 2016), I.R.S. P.L.R. 201510001 (Mar. 6, 2015), I.R.S. P.L.R. 201310002 (Mar. 8, 2013), I.R.S. P.L.R. 200715005 (Apr. 13, 2007), I.R.S. P.L.R. 200729025 (Jul. 20, 2007), I.R.S. P.L.R. 200637025, I.R.S. P.L.R. 200612002 (Mar. 24, 2006).

Typically, the trust instrument requires that, during the grantor's lifetime, the trustee must distribute the net income and principal of the ING to the grantor and beneficiaries as directed by the distribution committee or the grantor, as follows:

(1) Pursuant to the direction of a *majority* of the distribution committee members, *with the written consent of the grantor*, the trustee shall distribute to the grantor or other beneficiaries such amounts of the net income or principal of the trust as directed by the distribution committee (grantor's consent power) (*see* Treas. Reg. §§ 25.2511-2(e), 25.2514-3(b)(2); I.R.C. § 678);
(2) Pursuant to the direction of all distribution committee members, the trustee shall distribute to the grantor or other beneficiaries such amounts of the net income or principal as directed by the distribution committee (unanimous member power) (see I.R.C. § 678); and
(3) The trustee shall distribute to any of the beneficiaries, other than the grantor, all or any portion of the principal of the trust directly for the health, education, maintenance, or support of the beneficiaries *as directed by the grantor* (grantor's sole power). The grantor's sole power is only exercisable in a nonfiduciary capacity (*see* I.R.C. § 674(b)(5); Treas. Reg. § 25.2511-(c)).

Additionally, the grantor retains a testamentary limited power of appointment over the remainder of the trust exercisable in favor of anyone other than the grantor, the grantor's estate, the grantor's creditors, or the creditors of the grantor's estate. *See* I.R.C. § 674(b)(3); Treas. Reg. § 25.2511-2(b). To be consistent with the regulations, the power of appointment should not be exercisable over accumulated income (at least one Private Letter Ruling did not make this distinction, however (*see* I.R.S. P.L.R. 201310002 (Mar. 3, 2013))).

The grantor's consent power causes the transfer of property to the ING to be wholly incomplete for gift tax purposes. Under Treas. Reg. § 25.2514-3(b)(2), the distribution committee members do not have adverse interests to the grantor; they are only co-holders of the distribution power and their powers terminate upon the grantor's death. Under Treas. Reg. § 25.2511-2(e), therefore, the grantor is considered to have the power to distribute income and principal to any beneficiary and the gift is incomplete. The grantor's sole power causes the transfer of property to the ING to be wholly incomplete under Treas. Reg. § 25.2511-(c), even though the power is limited by an ascertainable standard, because the grantor reserved a *nonfiduciary* power to change the interests of the beneficiaries. Finally, the grantor's testamentary limited power of appointment also causes the transfer of property to the ING to be wholly incomplete under Treas. Reg. § 25.2511-2(b) because it is a retained power of disposition.

The grantor's sole power prevents grantor trust status under I.R.C. § 674(b)(5) because it is subject to a reasonably definite standard that is set forth in the trust instrument. Additionally, the grantor's testamentary limited power of appointment also prevents grantor trust status under I.R.C. § 674(b)(3) because the power is exercisable only by will. Finally, the grantor's consent power and the unanimous member power also prevent grantor trust status under I.R.C. § 678 because neither the grantor nor any member of the distribution committee has the sole power to vest trust corpus or income in himself.

State Law Characteristics

An ING must be valid under state law and be resident in a state that permits self-settled domestic asset protection trusts (DAPTs). The creditor protection afforded by DAPT statutes helps to ensure that the ING is a non-grantor trust (if the grantor's or the grantor's spouse's creditors can reach the assets of the ING, the grantor may be deemed to be an owner under the grantor trust rules (*see*, *e.g.*, Treas. Reg. § 1.677(a)-1). Additionally, because one of the purposes of an ING is to reduce or eliminate state income tax, the grantor should choose a jurisdiction that will not impose a tax on the trust's income. The grantor would typically select the trust's residence by appointing a trustee in the desired jurisdiction and ensuring that the trust administration is done there.

There are several jurisdictions especially known for their favorable DAPT statutes and preferred tax laws. For instance, Nevada and South Dakota are widely known for having the combination of strong asset protection laws and no state income tax. Ohio also has a strong DAPT statute (with a shorter statute of limitations—just 18 months—than any other jurisdiction (*see* Ohio Rev. Code Ann. § 5816.07)) and imposes an income tax only on the income of nonresident individuals that is earned or received in Ohio. *See* Ohio Rev. Code Ann. § 5747.05(A). Other popular jurisdictions include Alaska and Wyoming, which have no income tax at all, and Delaware, which would impose an income tax only on the Delaware source income of a nonresident. *See* Del. Code Ann. tit. 30, § 1121. Many other states would also tax nonresidents only on income sourced in that jurisdiction.

There is some concern that INGs must be formed in a jurisdiction whose DAPT statute does not permit exception creditors (like claims for child support or alimony), such as Nevada or Utah, under the theory that if a state's statutes permit exception creditors to reach the assets of a DAPT, then the trust could be characterized as a grantor trust. *See*, *e.g.*, Treas. Reg. § 1.677(a)-1(d). However, numerous Private Letter Rulings confirm that INGs are permissible in DAPT jurisdictions that permit some exception creditors, such as Delaware.

Ultimately, the grantor's choice of jurisdiction will depend on his goals and potential contacts with their selected jurisdiction. For many grantors, naming a corporate trustee in their selected jurisdiction will be the best option. For others, there may be advantages to naming an individual in that jurisdiction who can serve as trustee, such as reduced trustee commissions. The grantor must also be aware that many jurisdictions will impose tax on income sourced in that state, so total elimination of state income tax may be difficult (especially where tangible or real property is involved).

Additional Considerations

Unfortunately, not everyone will benefit immediately from an ING. For instance, Maryland would characterize an ING as having a "resident fiduciary" if the grantor is a current resident of Maryland. *See* Md. Code Ann., Tax-Gen. § 10-101(k)(1)(iii). Even if a Maryland resident settles the trust in Nevada, names a Nevada corporate trustee, and all trust administration is conducted in Nevada, Maryland will impose its income tax on the trust for so long as the grantor is a Maryland resident. A similar jurisdiction is Connecticut, which characterizes an irrevocable trust as one created by a Connecticut resident when the grantor was a resident at the time of the transfer. *See* Conn. Agencies Regs. § 12-701(a)(4)-1(a)(4). A careful review of the tax laws of the client's state of domicile may help determine whether establishing an ING may be a worthwhile effort, understanding that state tax laws are subject to change.

One final consideration is that an ING should be viewed as a "rainy-day fund" for the grantor because many of the benefits of an ING are lost when distributions are made. For instance, any income or principal distributed to the grantor will be subject to taxation in the grantor's state of domicile. Additionally, any assets distributed to other beneficiaries will be regarded as completed gifts for gift tax purposes and subject those assets to income tax in the beneficiary's state of domicile. Therefore, the client must be prepared to "set it and forget it" with respect to assets placed in the ING so that the trust achieves its primary purposes.

Conclusion

INGs can be powerful tools for achieving various estate planning goals and for reducing or eliminating state income tax. Careful drafting and deliberate selection of beneficiaries and distribution powers will ensure that the trust is a non-grantor trust and that the grantor's transfer to the trust is not a completed gift. The grantor must also be deliberate when selecting the most appropriate jurisdiction to use and weigh various factors such as applicable DAPT statutes and income tax rules. Finally, an ING should not be viewed as a current resource to the grantor, because the benefits of the ING are maximized when the transferred assets remain in trust.