THE NING

NEVADA INCOMPLETE GIFT, NONGRANTOR TRUST

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1. OVERVIEW

1.1 Overview: It is understandable that people living in a state with a state income tax want to avoid paying that tax on their investment income, including capital gain income, especially if they do not need the income and are willing to defer the receipt of the income or allow it to be paid to one or more specified beneficiaries. This is particularly attractive for taxpayers who live in a state with a high tax rate, especially if they have highly appreciated assets with a low basis and/or a significant stream of income that is not presently needed by the taxpayer.

(a) In order to avoid state taxation, one traditional method is to simply gift away income-generation investments to beneficiaries or to a trust for beneficiaries that live in states that do not impose a state income tax or that have relatively low tax rates. This strategy typically involves making gifts that are subject to the federal gift tax or at least using up some of the donor's "applicable exclusion"[2] that is available for federal gift- and estate-tax purposes. If a typical irrevocable trust is involved, the settlor[3] would not be a permissive beneficiary and would have no power to change the beneficiaries.

(b) This memo focuses on another solution, which is to contribute income-producing investments to an "incomplete gift, nongrantor trust". This type of trust is often referred to as an "ING". An ING created under Nevada law is referred to as a "NING". INGs are also created in Delaware (DINGs), South Dakota (SDINGs), and Wyoming (WINGs).

1.2 Executive Summary: A NING is a trust in which income is accumulated or paid out to beneficiaries who live in a state with no income tax or an income tax with lower rates.

(a) To avoid the state income tax, the trust cannot be categorized as a "grantor trust" under the income tax laws of the state in which the settlor resides.

(b) To avoid any federal gift-tax implications, contributions to the trust must not be treated as gifts for federal gift-tax purposes. A transfer that is not a gift is often referred to as an "incomplete gift", usually because the donor retains the right to change the trust's beneficiaries.

(c) For an ING to be effective, the assets must be legally located in a state that has no state income tax, the settlor must not be the only beneficiary, and all distributions

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[1]See https://www.rlklegal.com/attorneys.

[2]Internal Revenue Code § 2010(c) provides for an "applicable exclusion", which is the cumulative amount that can pass free of gift and/or estate tax. The applicable exclusion is $5,340,000 for 2014, $5,430,000 for 2015, and $5,450,000 in 2016. For the applicable exclusion in prior years, see http://rlklegal.info/advintro.html#ae.

[3]"Settlor", "grantor", "trustor", and "trustmaker" are frequently used to reference the creator of a trust. There can be joint settlors, but this memo uses the single term for simplicity.

from the trust must be approved by a "distribution committee"[4] that consists of the settlor and at least two other beneficiaries.[5] The "distribution trustee" must at all times be comprised of enough members to avoid giving any member of the committee, including the settlor, the unilateral power to benefit himself or herself.

1.3 Asset Protection: In addition to saving state income taxes, the NING is also a "spendthrift trust" under Nevada law, which means that its assets are not subject to the claims of any beneficiary's creditors. Because the settlor is a permissive beneficiary, this trust is considered a self-settled spendthrift trust, which is subject to special rules.[6] A self-settled spendthrift trust established under state law is referred to as a Domestic Asset Protection Trust (DAPT), and one established under Nevada law is referred to as a Nevada Asset Protection Trust (NAPT).[7]

1.4 Concerns: A NING does not fit every situation. It is not a trust that avoids all taxes or that allows the settlor to retain control or to receive a guaranteed income. The NING is probably not appropriate: (a) for a person who lives in a state without an income tax or in a state where the state income tax rate is not that high, (b) for a person who will need regular income distributions; or (c) for a person who is not willing to take the chance that state tax law may be changed to trigger an income tax on the income of a NING. In addition, the cost of establishing and administering the NING has to be taken in to consideration in evaluating the NING's benefits.

2. THE NING'S CORE ELEMENTS.

2.1 Investment Location: The investments must be legally located in a state that has no state income tax; otherwise, the state income tax will apply. For example, income-producing real estate in another state will be subject to the income tax in that state even if it is owned by a NING because the source of the income is in the other state. Similarly, income that is generated from business operations that occur in another state will be taxed in that state.

(a) Even so, by using a NING, it may be possible to avoid the state capital tax on the sale of an out-of-state business that is owned by a Nevada LLC owned by a NING if the sale is a sale of the business and not a sale of its assets. Sometimes the savings for the capital gain justifies the expense of using a NING.

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[4]Some practitioners use a "power of appointment committee" to direct distributions. By providing for all distributions to be made under a power of appointment, the power held by members of that committee is not held in a fiduciary capacity, which is vital.

[5]Because the distribution trustee can make distributions by unanimous consent, we recommend that there be a distribution committee of at least three.

[6]A "spendthrift trust" is a trust under which state law exempts the trust's assets from the claims of any creditor of any beneficiary. A "self-settled spendthrift trust" is a spendthrift trust under which the settlor of the trust is a permissive beneficiary. Virtually all states provide for some level of spendthrift trust protection for trusts under which the settlor is not a beneficiary, but only a limited number of states permit self-settled spendthrift trusts. Nevada is one of those states that allow such trusts.

[7]For additional information on asset protection and asset-protection trusts, including a discussion on the limitations and requirements of a Nevada self-settled spendthrift trust, see http://rlklegal.info/pdf/ap.pdf.

(b) Also, when an out-of-state company has a division that does not need to be located in that other state, the company can spin off that division, move its operations to Nevada, and form a new Nevada LLC or corporation to own that division. By doing that, the income from that division would be Nevada-source income, and the company would not have any connection or "nexus" to the other state that would permit the other state to impose a tax on that income.

2.2 Nongrantor Trust: The trust cannot be a "grantor trust" under the income-tax laws of the state in which the settlor resides. In states that apply the federal-law definition of a grantor trust (including the rulings and regulations promulgated by the IRS), it is sufficient if the trust is not a grantor trust under federal law.

(a) A "grantor trust" is a trust that is treated as being owned by the settlor or grantor because of powers retained by the settlor or by "related or subordinate parties" to the settlor. The federal-law definition of "related or subordinate party" excludes anyone who is an "adverse party."

(b) Under federal income-tax law, persons who have competing interests under the terms of a trust are considered "adverse parties". Because a distribution to one beneficiary reduces the amount available for the other beneficiaries of the trust, beneficiaries are, as to each other, adverse parties. When a distribution in favor of the settlor must be approved by persons who are adverse parties, neither the settlor nor a related or subordinate party controls distributions. For this reason alone, the settlor cannot be the sole beneficiary of a NING at any time.

(c) It is also critical that the assets of the trust cannot be reached by the settlor's creditors; otherwise, the trust will be a grantor trust for income-tax purposes. That is why only those states that permit a self-settled spendthrift trust can form a nongrantor trust that allows the settlor to be a permissive beneficiary. Nevada is an ideal jurisdiction for a trust because it does not allow any class of creditors to reach trust assets.[8]

(d) To avoid triggering grantor trust status, the settlor's lifetime power of appointment (discussed in subsection 2.4, below) must be exercisable only for the "health, education, maintenance and support" of the permissive beneficiaries.

2.3 Distribution Committee: All distributions from the trust must be approved by (1) the settlor and a majority of the members of a "distribution committee" or by unanimous consent of the distribution committee members other than the settlor. The distribution committee usually consists of the settlor and other trust beneficiaries.

[8]Some states that permit self-settled spendthrift trusts allow a special class of creditors ("exception creditors") to reach the trust's assets. For example, some allow an ex-spouse to claim the assets of a spendthrift trust to satisfy alimony or child-support payments. Nevada does not.

(a) *Alter Ego.* Care must be taken to make sure that the distribution committee does not operate as the "puppet" or "alter ego" of the settlor. The larger the distribution committee, the less likely this will be a problem.

(b) *Multiple Beneficiaries and Members of Distribution Committee.* To make sure that all distributions must be approved by adverse parties, there must be multiple permissive beneficiaries and multiple members of the distribution committee. It is common to designate as members of the distribution committee all of the settlor's children and grandchildren who are at least 18 years of age who are also beneficiaries of the trust. It is also common to designate agents who can act for minors. For a number of reasons — including the reason explained in paragraph 3.6(d), below — no distribution should be made to the settlor if there are not at least two members of the distribution committee.

(c) *No General Power of Appointment.* To avoid triggering a gift tax when the members of the distribution committee approve a distribution, it is important to avoid giving anyone on the distribution committee a "general power of appointment." As defined under federal tax law, a "general power of appointment" is the power for the person holding the power to direct a distribution to the power holder, the power holder's creditors, the power holder's estate, or the creditors of the power holder's estate. By law, a general power of appointment excludes a power that can only be exercised with the approval of an adverse party.

2.4 Incomplete Gift: To avoid having contributions to the trust being treated as a completed gift for federal gift-tax purposes, the settlor has a nongeneral power of appointment that can be exercised to change the trust's beneficiaries. Nevada law permits both a lifetime power and a post-death power, and it is important for the settlor to have both powers to make contributions to the trust fully incomplete.[9] The IRS has considered a number of elements that make the gift incomplete.[10]

2.5 The Trustee: The trust must be managed by one or more trustees.

(a) *Alter Ego.* No matter who is selected, care must be taken to make sure that the trustee does not operate as the "puppet" or "alter ego" of the settlor. This is not a problem as to decisions that require the consent of an independent trustee.

(b) *Nevada Trustee.* Nevada spendthrift trust law requires at least one trustee that is a bank or trust company or who is an individual who is a Nevada resident. At a minimum, the Nevada trustee must have the power to maintain trust records and to prepare

[9] See Chief Counsel Advisory 201208026 and PLR 201310002.

[10] (1) Because distributions are made by joint consent of the settlor and a majority of the members of the distribution committee, Reg. §§ 25.2511-2(e) and 25.2514-3(b) apply to make the gift incomplete; (2) the settlor's power to add beneficiaries or modify beneficiaries' interests triggers Reg. §25.2511-2(c) to make the gift incomplete; (3) the post-death or "testamentary" power of appointment triggers Reg. §25.2511-2(b) to make the gift incomplete; and (4) in its 2013 PLRs, cited in footnote 19, the IRS ruled that the ability of the distribution committee to act by unanimous consent to approve a distribution did not trigger a completed gift.

income tax returns for the trust, but we recommend that the Nevada trustee's involvement be much more significant than that. One does not want to risk having the trust's connection (or "nexus") to Nevada being challenged as being illusory.[11]

(c) *Independent Trustee.* To avoid some tax pitfalls, some decisions will require an "independent trustee." An independent trustee is a bank or trust company or an individual who is not a "related or subordinate party" as to the settlor or any beneficiary. The independent trustee and the Nevada trustee can – and often should – be the same person or entity. For some decisions, the independent trustee can work as a co-trustee with a family member, but no more than half of the co-trustees can be a related or subordinate party to the settlors or any beneficiary. ("Related or subordinate party" does not include a beneficiary with an "adverse" interest.)

(d) *Non-Nevada Trustees.* Many states impose an income tax on accumulated trust income when the trustee or when one or more of the co-trustees are residences of that state. For that reason, no trustee or co-trustee of a NING should be a resident of a state that imposes a state income tax.

2.6 Other Advisors: It is common, but not required, to designate additional advisors to the trustee.

(a) *Trust Protector.* We normally recommend that the settlor designate a person that has powers that should not be exercised by the settlor and/or the trustee of the trust. Nevada law does not specifically define the role of a trust protector, and so the trust protector's powers must be specifically stated in the trust agreement. The trust protector might have one or more of these powers:

(1) The power to remove and replace a trustee;

(2) The power to appoint a special trustee;

(3) The power to veto the removal or designation of a trustee that is made by a beneficiary or a group of beneficiaries;

(4) The power to employee a CPA at trust expense to audit the trustee's records and account; and/or

(5) The power to petition a court to enforce the provisions of the trust.

(b) *Investment Advisor.* Some people do not want the trustee to make trust investment decisions or do not want them to make such decisions without advice from a trusted advisor.

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[11] NRS 164.045(4) provides some guidance as to the required "nexus" for state law to apply.

(1) If the trustee is required to follow the investment direction of an investment advisor, Nevada law classifies the trustee as a "directed fiduciary", and the trustee is not liable for bad investments. Unless the investment advisor is acting as a fiduciary, the investment advisor is usually not liable either. Because that puts the beneficiaries without recourse as to bad investments, one should choose the investment advisor wisely.

(2) In the alternative, if the trustee is permitted but not required to follow the investment suggestions of the investment advisor, the trustee remains ultimately liable to invest prudently, regardless of the investment advisor's counsel.

(c) *Special Trustee*. A special trustee might be needed to act when the acting trustee has a conflict of interest or when special expertise for specific decisions is required. In most trusts, a special trustee is not named at the beginning, but is designated when needed by the current trustee or a majority of the co-trustees. In some situations – such as the sale of a business or the sale of a major investment holding – the settlor of a trust may wish to designate a special trustee for that.

3. LIMITATIONS OF A NING

3.1 Accumulation or Distribution of Income: The NING is not the appropriate tool if there is no desire to accumulate income or to allow it to go to beneficiaries who Federal tax law will apply to trust income. The trustee will pay the income tax on accumulated income at the rates applicable to trusts, and the beneficiaries who receive income distributions will pay tax on the income received at their own rates. If a beneficiary – including the settlor – lives in a state that has a state income tax, that state's tax will apply to the income received.

3.2 No Guaranteed Distributions: Because all distributions require approval of the distribution committee, the settlor has no power to demand a distribution. Even though the settlor has the power to change beneficiaries, that power cannot be exercised in favor of the settlor, the settlor's creditors, the settlor's estate, or the creditor of the settlor's estate.[12]

3.3 Federal Gift Tax: Although contributions to the trust are not completed gifts, any distribution from the trust to a beneficiary other than the settlor will be a completed gift. Unless a gift-tax exclusion fully covers the gift,[13] a gift tax return (IRS Form 709) will need to be filed.

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[12] Even after the need for income-tax savings has passed or after the settlor's death, the trust can continue as a generation-skipping spendthrift trust. Of course, the best creditor protection comes when there are no separate shares for individual beneficiaries and all distributions are made with the approval of the distribution committee or in the discretion of an independent trustee.

[13] During each calendar year, each taxpayer can exclude certain gifts from the imposition of the gift tax. There is an "annual exclusion" applicable to gifts made to each donee (recipient) during each calendar year. This amount is $14,000 for gifts in 2013 through 2016 and is subject to cost of living increases. Other exclusions that have no dollar limitation include: (1) tuition you pay directly to the educational institution for someone else; (2) medical expenses you pay directly to the health-care institution for someone else; (3) gifts to your spouse; and (4) gifts to a charitable organization for its use.

3.4 Federal Estate Tax: Because contributions to the trust are not completed gifts, the assets of the trust will be subject to the federal estate tax when the settlor dies. (On the other hand, for persons whose estates are not large enough to trigger an estate tax, this is not a problem, and inclusion in the taxable estate will trigger a stepped-up income tax basis on appreciating assets.)

3.5 State Income-Tax Law Issues: Creating a NING can be a bit of a gamble, and Nevada law is not the issue.

(a) A NING works where the state law is the same as federal law for the rules on grantor trusts, but there is no guarantee that state law will not change. New York, for example, changed its laws in 2014 so that INGs are treated as grantor trusts under New York law even though they are not treated as grantor trusts under federal law, and there was no "grandfathering" of trusts created prior to the effective date.[14]

(b) Some states apply "throwback rules" that trigger taxes on delayed income as if it had been distributed when earned. Tax advice from a competent accountant or attorney who is experienced in state income-tax law is essential to avoid this possible trap.

3.6 IRS Rulings: In a state that has income tax laws that define "grantor trusts" based on federal income-tax law, the rulings of the Internal Revenue serve are binding.

(a) The creation of INGs has been evolutionary. The first rulings from the IRS on incomplete-gift, nongrantor trusts were in 2001 and 2002, many of which were established in Alaska.[15] In 2006, the IRS issued a number of favorable private letter rulings including rulings relating to DINGs (created under Delaware law).[16]

(b) In 2007, the IRS expressed concerns that those early rulings were inconsistent with some of its subsequent Revenue Rulings.[17] The IRS subsequently asserted that DING under which the settlor held only a testamentary power of appointment would not be fully recognized as a grantor trust.[18]

The "applicable exclusion" that is available for taxable transfers during life and at death will not be affected except as to gifts that exceed these exclusions. Gifts that exceed the annual exclusions and the lifetime "applicable exclusion" will trigger a gift tax.

[14]See Carmela Montesano, "New York Enacts Significant Changes to its Estate, Gift, GST and Trust Income Tax Laws," 39 *Tax Mgmt. Est., Gifts & Tr. J.* 165 (July/Aug. 2014) and N.Y. Tax Law §612(b)(41).

[15]For example, PLR 200148028, PLR 200247013, and PLR 200247014.

[16]For example, PLR 200612002 and PLR 200729025.

[17]See IRS Release 2007-127.

[18]Chief Counsel Advisory 201208026.

(c) In 2013, the IRS issued favorable rulings for Nevada-based NINGs.[19] A number of additional favorable rulings have followed.

(d) On October 14, 2016, the IRS released PLR 201642019, in which it negated "Ruling 1" of PLR 201426014.[20] Contrary to its 2014 ruling, the IRS concluded that the trust involved in that ruling was a grantor trust because "*the provision in Trust that provides that in the event that both the children are no longer serving as members of the Distribution Committee or if there are fewer than two serving members, the trust property will be distributed to the grantor and the trust shall terminate constitutes a reversionary interest under § 673*." Some commentators have indicated that this is a bad sign for future INGs, but the 2016 ruling was based on unique trust provisions that are not going to be included in a NING. Because a NING has to qualify as a self-settled spendthrift trust, a Nevada attorney drafting such a trust would provide for the trust to terminate and revert to the settlor. The solution is to make sure that, during the settlor's lifetime, the distribution committee must consist of at least two members and, during any period during which the distribution committee has fewer than two members, no distributions to the settlor may be made until the distribution committee is properly reconstituted.[21]

3.7 Private Letter Ruling: This memo has cited "private letter rulings" from the IRS, which were issued when the settlor involved applied for a binding ruling from the IRS that their trust would not be classified as a grantor trust. A private letter ruling (or "PLR") is only binding on the IRS as to the person who applied for it, but PLRs do give an idea of what the IRS' position is. If you want your own private letter ruling, you will need to go through the lengthy and expensive process of applying for one. Our office does not initiate PLRs because we believe this is best done by a larger firm with more resources than we have; however, we are happy to review the application and provide feedback if requested.

4. CONCLUSION

If you decide to create a NING:

4.1 Advisory Team: We recommend that you design it with a team of advisors.

[19] PLRs 201310002, 201310003 , 201310004 , 201310005 , and 201310006.

[20] PLR 201426014 is cited by the IRS as PLR-140408-13.

[21] In an article titled "ING Trusts Remain Alive and Well Despite New PLR", Jonathan Blattmachr and Vanessa L. Kanaga explain that the 2014 ruling is distinguishable from the 2013 rulings and conclude, "*Hence, if a trust follows the structure set forth in all the other favorable rulings issued since 2013 (e.g., PLR 201310002), it appears that the trust would not be a grantor trust*." They go on to state, "*Although the new ruling may indicate that this technique will receive additional scrutiny by the IRS in the future, it appears that the trust at issue in the newly released ruling is distinguishable from other trusts that were the subject of favorable rulings in this area*." (The article was distributed via e-mail link to a page on https://interactivelegal.com/ and can be downloaded from http://r4th.us/ING-Blattmachr.)

(a) The first member of your advisory team should be a certified public accountant who is familiar with both federal tax law and the state tax law in which you reside.

(b) The second member of your advisory team should be an attorney who is familiar with your current estate plan and the applicable law in the state in which you reside. This attorney or his firm should review the draft of the NING and provide a second opinion as to its provisions.[22]

(c) The third member of your advisory team would be an attorney licensed in Nevada who is familiar with NINGs.

4.2 Trustees and Advisors: You need to decide on the trustee or trustees, the beneficiaries, the distribution committee, and, if one is desired the trust protector. As mentioned in paragraph 2.6(b), above, you may also want to designate an investment advisor[23] and determine whether or not the advisor can direct investments or merely recommend them.

4.3 Distributions Before and After Death: Distributions of the trust are usually made either as directed by the distribution committee acting unanimously, by you with approval of a current beneficiary, or in the trustee's discretion to someone other than you. Your trust needs to explain how distributions are made after your death.[24] You can provide for discretionary distributions from a pooled trust to continue, you can provide for a division of the trust with specific shares for specific beneficiaries, or you can provide for any other type of distribution normally done under the terms of a trust that does not include you as a beneficiary. If your total estate may trigger the federal estate tax, one or more qualified charities or charitable trusts might be included as beneficiaries of the NING.

[22] For one thing, the attorney practicing in the law of the state where the settlor resides should confirm either (1) that applicable state income-tax law follows the federal law as it pertains to the classification of a trust as a grantor trust and that it is appropriate to rely on the rulings and regulations promulgated by the IRS or (2) that the trust is not a grantor trust under applicable state income-tax law even though that law differs from the federal law.

[23] To avoid entanglements with non-Nevada law, you may be advised to transfer assets into one or more investment accounts or business entities created in Nevada.

[24] Your death will trigger the estate tax. If, during your lifetime, you want to convert the trust into a completed gift, you can irrevocably renounce any power or right to receive future distributions and any right to exercise any further powers that caused transfers to be incomplete gifts. Since the gifts would now be complete, the gift tax would be triggered. After that, trust distributions could be made as if you were deceased.

4.4 Better than Doing Nothing? To be candid, there is no guarantee that a NING will work in your state, and, if it works now, there is no guarantee that it will work forever. The good news is that even if the state income-tax savings are not realized, the trust can continue as an asset-protection trust, and it can be a good vehicle for protecting assets for many generations.

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