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Incomplete Gift, Non Grantor Trusts (aka DINGs, NINGs): Not Just for State Income Tax Avoidance

May 1, 2016 / 2016 - May, Advanced Planning, Newsletter

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There is increasingly becoming an important tool in their trust planning arsenal for high income taxpayers—the incomplete gift, non-grantor trust (“ING”). These trusts are often colloquially known as “DINGs” or “NINGs”, short for **D**elaware or **N**evada **I**ncomplete Gift **N**on **G**rantor Trusts, even though other states with similar strong DAPT laws, such as Alaska, South Dakota, Wyoming or Ohio, may also be used. Let’s explain the ING, why it’s used, what state limitations exist and how it can be used beyond state income tax avoidance.



What is an ING? An ING trust has two unique tax characteristics and one unique state law characteristic. Combined, these differentiate an ING from other trusts.

First, as the name implies, the transfer of funds to the trust is an incomplete gift. Warren Buffett could transfer billions to such a trust, with no initial gift or estate tax effect. The trust is designed to be *included* in one’s estate, so it is primarily an income tax and asset protection, rather than estate and GST tax, tool.

Secondly, unlike most irrevocable trusts established during a settlor’s lifetime, it is taxed as a *non-grantor* trust. This means it is considered a separate taxpayer for income tax purposes, filing a Form 1041 fiduciary income tax return. This is in stark contrast to revocable living trusts, GRATs, OPRTs, ILITs or other irrevocable grantor



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Lastly, an ING uses a trustee located in state which allows the trust to use a strong self-settled domestic asset protection trust (DAPT) statute without being subjected to additional state income tax.

So why do most people set up ING's? Trusts that are separate taxpayers (like ING's) can often be established as "non-resident trusts" for state income tax purposes. Thus, the ING design often allows the trust to escape state income tax in the settlor's state of residency. The savings can be tremendous, depending on the state and amount avoided – up to 13.3%. Thus, ING's are trusts that have all of the asset protection characteristics of a typical DAPT, but with the added benefit of being able to avoid state income tax in many situations, and as discussed below, may have federal income tax benefits as well, primarily when the taxpayer and their family are charitably minded or desire to shift income tax burden to beneficiaries who are in lower income tax brackets. Non-grantor trust taxation enables much more advantageous deductions in those areas. Some believe the rationale for upholding the asset protection is even enhanced, since the unique tax characteristics give a strong non-asset protection motive for establishing the trust.

Who are the best candidates for DING's? DING's are not for the average middle class client. Normally, these will best fit clients who will realize at least \$50,000 of state income tax savings from a pending sale of assets and expect to be in the highest income tax bracket anyway, to justify the hassle and expense. Usually, this would be a large income realization event of \$500,000 or more that triggers the initial consideration. Other candidates are those clients who may be substantially charitably minded or would prefer to make substantial gifts to beneficiaries that shift income at the same time.

How does this technique work to avoid state income tax? Avoiding state trust income tax is essentially a two-step process: 1) avoid being labeled a "resident trust" in the state of residency and ensure that the trust does not trigger taxation in any other state and 2) avoid "source income". Let's take the first step.

Avoiding characterization as a resident trust varies greatly state to state. This short article cannot analyze the dozens of jurisdictions, but to generalize, this is usually accomplished by avoiding one or more of the following: the use of an in state trustee



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Minnesota, Nebraska, New York, Oklahoma, Pennsylvania, Vermont, Virginia, Washington, D.C., West Virginia and Wisconsin. There are several recent court cases that have found the broad reach of these statutes to be unconstitutional, but no cases addressed ING's specifically.

Choosing a trustee in a DAPT state that will not tax trust income should be easy – Alaska, Nevada, Delaware, Ohio and South Dakota are all top tier jurisdictions that should qualify. However, people should be careful to evaluate the residency of any co-trustees or other fiduciaries as well.

Understanding State “Source Income” – When Certain State Income Tax Cannot be Avoided

Once we have successfully created a non-resident trust for state income tax purposes, we next need to resolve how and when a state may tax even non-residents and non-resident trusts. The ongoing income of state pass-through entity with ongoing operations or real estate rental income in a state with an income tax is usually taxed to non-resident owners – even if they live in a state with no income tax or even out of the country. However, the sale of the stock (or membership interest) of such entities is not necessarily taxed by a state if the owners are out of state. Thus, stock sales may still present a tax savings opportunity even if underlying company or real estate assets are in state, but each state's statutes should be carefully analyzed on this point.

What design features cause the unique tax character for ING's?

The design of DING's is slightly more complicated than most trusts due to the conflicting goals of 1) making the gift incomplete; 2) making the trust a non-grantor trust and 3) enabling the settlor to have some nominal access and/or control of the trust. Either goal by itself is rather easy for any experienced practitioner – accomplishing all three at once requires some agility.

Based on the dozens of PLRs released in the last three years, an ING is a trust with several unique features to enable the above characteristics. [1] The first three below refer to the how distributions are made.



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trust. Lifetime distributions to appointees are limited to a standard such as health education, maintenance and support to prevent grantor trust status.

- More importantly, there is a distribution committee comprised of adverse parties (beneficiaries) who control distributions. The trustee would not control distributions at all during the settlor's lifetime. This is necessary to enable distributions back to the settlor and/or spouse without triggering grantor trust treatment. The committee structure is necessary to prevent adverse estate/gift tax effects to the power holders or grantor trust status as to the power holders.
- There is a settlor veto/consent power, unless the distribution committee unanimously overrules the settlor – this is designed to make the gift incomplete.
- The trust is established in a state that permits self-settled DAPTs and would not otherwise tax the trust or beneficiaries. This helps ensure asset protection for the settlor and power holders, but less obviously, it is also designed to prevent grantor trust status.

How does this trust function as a practical matter? The management and reporting is like any trust, but the distribution provisions are what make it truly unique. The trustee has no role during the settlor's lifetime. The distribution committee uses a jointly held limited power of appointment to appoint cash or property during the settlor's lifetime, or the settlor uses his or her sole power unilaterally, though this must be limited by ascertainable standards. Together, there is ample flexibility to make distributions – indeed, more than most trusts. Many settlors are nervous to entrust such wide discretion to a corporate trustee.

Beyond state income tax advantages – avoiding net investment income tax, shifting federal tax burdens and other more creative income tax planning

If a taxpayer anticipates the sale of a closely held business, and is not sufficiently active in the business such that the sale would cause a 3.8% net investment income tax, the owner might use a DING and appoint a co-trustee who is sufficiently active in the business to cause the trust to be able to avoid the 3.8% surtax on the sale.

Non-grantor trust rules also allow a remarkable amount of tax shifting which is much more efficient than ordinary gifting. Imagine you'd like to shift the taxation of your 3% dividend on your stock worth \$1 million to your children. Normally, to shift that



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shifted via K-1 to the presumably lower bracket beneficiaries (remember, many taxpayers in the 15% bracket pay 0% tax on qualified dividend income).

There are even greater advantages that may be had using a charity, non-profit or charitable remainder trust as an appointee of trust distributions. Unlike individuals, trusts are permitted to reduce their net investment income for the 3.8% surtax by charitable donations under Section 642(c), and the Pease limitations do not apply to trusts.

Conclusion

To summarize, establishing an ING trust can often legitimately avoid state income taxes on capital gains, often including sales of closely held C corps, S corp or LLC/LP interests, even if the underlying assets are in state.

INGs have significant asset protection and even federal income tax benefits for taxpayers with income anticipated to be above the highest income tax bracket.

For the upcoming seminar with the Ultimate Estate Planner, we'll explore the design features in more depth, along with the various state residency and sourcing rules, administration issues, and federal income tax planning with non-grantor trusts.

RESOURCES

[1] Recent PLRs include: PLRs 2013-10002 to 2014-10006, PLRs 2014-10001 to 2014-10010, PLRs 2014-26014, PLR 2014-27008; PLRs 2014-27010 to 2014-27015, PLRs 2014-30003 to 2014-30007; PLRs 2014-36008 to 2014-36012, PLR 2014-38010 to 2014-38014 * (not an ING, but had a similar distribution committee), PLRs 2014-40008 to 2014-40012, PLR 2015-10001 – 2015-10008 (guardians for minors on committee), PLR 2015-50005 (funded with community property), PLR 2016-13007

RELATED EDUCATION

To find out more about DINGs and NINGs, join us for a special 2-part teleconference on Tuesday, May 24, 2016 and Wednesday, May 25, 2016 each at 9am Pacific Time

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