

The Accidentally Perfect Non-grantor Trust

Think about using an APNT when a taxpayer in a state with high income taxes is about to realize a large capital gain, or a client has a large investment portfolio

Much has been written about the intentionally defective grantor trust (IDGT). Transfers to an IDGT are completed gifts for gift tax purposes; and the IDGT is not included in the grantor's estate for estate tax purposes. The IDGT is treated as a grantor trust for income tax purposes; and the grantor's payment of the income tax on the trust's income is not treated as an additional taxable gift by the donor.

But there's a useful technique that is the opposite of the IDGT, one that I call the "Accidentally Perfect Non-grantor Trust" (APNT).² Transfers to an APNT are not treated as completed gifts for gift tax purposes. The APNT is included in the grantor's estate for estate tax purposes. However, the APNT is a separate taxpayer for income tax purposes.

The APNT is most attractive when a taxpayer in a high income tax state is about to realize a large capital gain. The APNT is also good for a client with a large investment portfolio.

APPLICABLE TAX RULES

To create an APNT, the transfer must be incomplete for gift tax purposes, included in the donor's estate for estate tax purposes, and a separate taxpayer for income tax purposes.

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A gift is incomplete if the donor retains the power to name new beneficiaries or to change the interests of the beneficiaries, except as limited by an ascertainable standard.³ Accordingly, the donor can keep the gift from being completed by retaining a special power of appointment. Of course, any distributions other than to the grantor will render the gift completed for gift tax purposes.

Because the grantor retains a power of appointment, the trust assets will be included in the grantor's estate under Internal Revenue Code Section 2036(a)(2).

And, under the grantor trust rules set forth in IRC Sections 671 through 679, the existence of certain powers will cause a trust to be treated as a grantor trust for income tax purposes. The creator of an IDGT must make sure to trigger one or more of these grantor trust provisions. But the creator of an APNT must make sure not to trigger any of the grantor trust provisions. The key is to require the consent of an adverse party for any distributions from the trust.

Under IRC Section 673, a grantor is treated as the owner of a trust in which he has a reversionary interest in either the corpus or the income if, as of the inception of the trust, the value of the reversionary interest exceeds 5 percent of the value of the trust.

Under IRC Section 674, with certain exceptions, a grantor is treated as the owner of a trust if the beneficial enjoyment of the corpus or the income is subject to a power of disposition exercisable by the grantor or a non-adverse party, or both, without the approval or consent of any adverse party. That's why the key is to make sure that distributions require the consent of an adverse party. For this purpose, IRC Section 672(a) defines an adverse party as "any person having a substantial beneficial interest in the trust which would be adversely affected by the exercise or nonexercise of the power which he possesses respecting the trust." To avoid the application of Section 674, practitioners should keep in mind the requirement that the adverse interest held by the person whose approval or consent is required be "substantial."

Under IRC Section 675, certain administrative powers will cause the grantor to be treated as the owner of a trust. IRC Section 675(1) applies if a power exercisable by the grantor or a non-adverse party, or both, without the approval or consent of any adverse party, enables any person to purchase, exchange or otherwise deal with or dispose of the corpus of the income for less than an adequate consideration in money or money's worth. Section 675(2) applies if a power, exercisable by the grantor or a non-adverse party, enables the grantor to borrow the corpus or the income, directly or indirectly, without adequate interest or without adequate security, except where a trustee (other than the grantor) is authorized under a general lending power to make loans to any person without regard to interest or security. IRC Section 675(3) applies under certain circumstances where the grantor has borrowed trust corpus or income. IRC Section 675(4) applies where any person holds certain administrative powers exercisable in a non-fiduciary capacity, without the approval or consent of any person in a fiduciary capacity.

Under IRC Section 676, the grantor is treated as the owner of a trust if the grantor, or a non-adverse party, has the power to revest the title to the trust assets in the grantor.

Under IRC Section 677, the grantor is generally treated as the owner of a trust if the income is, or may be, distributed to the grantor or the grantor's spouse, either currently or in the future. Likewise, the grantor is generally treated as the owner of the trust if the income may be applied to the payment of life insurance premiums on the life of the grantor or the grantor's spouse. However, the grantor will not be treated as the owner of the trust if such distributions require the consent of an adverse party.

In general, under Section 678, a person other than the grantor is treated as the owner of the trust if he or she has the power to vest the corpus or the income in himself or herself.

Section 679 applies to certain foreign trusts with United States beneficiaries.

IRC Section 675(3) only applies under certain circumstances where the grantor has borrowed trust corpus or income.

IRS APPROVES

The Internal Revenue Service has issued several private letter rulings approving the APNT.⁵ In each, the grantor was a beneficiary of the trust. Other beneficiaries included the grantor's current spouse and issue,⁶ the issue of the grantor's parents and any charitable organizations,⁷ and the issue of the grantor's parents and the grantor's spouse.

In each of these rulings, distributions could not be made without the consent of an adverse party, so IRC Sections 674 and 677 did not apply; and no one had any other power that would make the trust a grantor-trust.

Practitioners should review these PLRs when creating an APNT.

WHY DO AN APNT?

It would therefore appear at first glance that an APNT could not possibly provide any income tax benefit. The income tax brackets for trusts are highly compressed. In 2005, trusts reach the 35 percent federal income tax bracket on taxable income in excess of \$9,750.⁸

Also, under the Jobs and Growth Tax Relief Reconciliation Act of 2003, the top federal income tax rate on dividends and capital gains is generally reduced to 15 percent (or 22 percent if the alternative minimum tax (AMT) exemption phase-out applies).⁹ Thus, in most cases, the trust tax rates will not be a problem with respect to dividends and capital gains. Indeed, by shifting the dividends and capital gains to a trust, it may be possible to avoid the AMT exemption phase-out.

In addition, if the trust is its own taxpayer, it will avoid the cutback of most itemized deductions by 3 percent of taxable income in excess of \$145,950 (\$72,975 in the case of a married person filing separately) for 2005.¹⁰

But even if there is no federal tax benefit, an APNT may provide a substantial state income tax benefit, especially for taxpayers in high

income tax states. Different states have different ways of determining the residence of a trust, and when a trust is taxable. Some, such as New York and New Jersey, determine the residence of a trust based upon the grantor's residence.¹¹ Others determine the residence of a trust based upon the trustees' residence. Among those that determine the residence of a trust based upon the grantor's residence, some will not tax the trust if there are no in-state trustees, no real or tangible property in the state, and no income from the state of a type on which a non-resident would be taxable.¹²

Thus, for example, if a New York resident creates an APNT with no trustees in New York, no assets in New York and no New York source income, the trust will not be subject to New York income tax. If none of the trustees reside in a state that taxes a trust based upon the residence or place of administration of the trust, the trust may not be subject to income tax in any state. With the top income tax rate for a New York City resident being about 12 percent, using an APNT can cut the total federal, state and local income tax on the trust's qualified dividends and capital gains by nearly half.

Thus, the APNT is likely to be most attractive for a taxpayer in a high income tax state who is about to realize a large capital gain—particularly if the asset being sold consists of shares of a C corporation, as distributions out of a C corporation's earnings and profits are generally treated as dividends (and thus intangible income) regardless of the source of the corporation's income.¹³

A similar opportunity may be available with respect to shares of an S corporation or an interest in a limited liability company (LLC) if the S corporation or LLC does not have any income source in the taxpayer's home state.

Even if the S corporation or LLC earns income from sources in the

taxpayer's home state, a taxpayer residing in a state that determines the residence of a trust based upon the trustees' residence rather than the grantor's, still may be able to use an APNT to avoid capital gains tax on the sale of the trust's S corporation shares or LLC interest, even though the S corporation's or LLC's income, sourced in that state, may be taxable in that state. In this regard, in *Tina Schiller Trusts v. Director*, the New Jersey courts held that gain from the sale or exchange of intangible assets is generally not taxable to a non-resident trust.¹⁴

Accordingly, the APNT can be a useful tool in the right circumstances. ■

Endnotes

1. Rev. Rul. 2004-64, 2004-27 I.R.B. 7.
2. The APNT is, of course, no more accidental than the IDGT is defective. The appellation "accidentally perfect non-grantor trust" illustrates that the APNT is the opposite of the IDGT.
3. Treas. Reg. Section 25.2511-2(c).
4. Treas. Reg. Section 25.2511-2(f).
5. PLRs 200502014, 200247013 and 200148028.
6. PLR 200502014.
7. PLR 200247013.
8. PLR 200148028.
9. IRC Section 1(e).
10. IRC Section 1(h) and 55(d).
11. IRC Section 68.
12. N.Y. Tax Law Section 605(b)(3); N.J.S.A. Section 54A:1-2(o).
13. N.Y. Tax Law Section 605(b)(3)(D); N.Y. Reg. Section 105.23; *Mercantile Safe Deposit & Trust Co. v. Murphy*, 242 N.Y.S.2d 26 (3d Dept. 1963); *aff'd*, 255 N.Y.S.2d 96 (1964); *Penoyer v. Director*, 5 N.J. Tax 386 (1983); *Potter v. Director*, 5 N.J. Tax 399 (1983); Instructions to New Jersey fiduciary income tax return (Form NJ-1041); *contra*, *District of Columbia v. Chase Manhattan Bank*, 684 A.2d 539 (D.C. App. 1997).
14. IRC Sections 301(c)(1) and 316(a).
15. 14 N.J. Tax 173 (App. Div. 1994).

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