"Incomplete Non-Grantor Trusts ('INGs') are used to transfer wealth not subject to state taxation as 'source income' into trusts that are domiciled in states that permit self-settled spendthrift trusts and do not tax such trusts on undistributed income. After a hiatus of six years, the IRS resumed issuing Private Letter Rulings for such trusts with PLR 201310002. To achieve the desired tax results, a number of state and federal tax hurdles must be overcome, as discussed by the author in LISI Estate Planning Newsletter #2076.

PLR 201550005 is the most recent of the author's PLRs in the field of ING trusts. Novel to this PLR is that it features a transfer of community property to the ING trust and has a ruling that upon the death of the first spouse to die, there will be a full step-up in income tax basis for 100 percent of the trust assets. The ING trust, which is the subject of the PLR, also has some other novel features and includes features that have evolved subsequent to PLR 201310002. In this newsletter, the author, after describing the facts of the current PLR, will point out and highlight differences from the earlier PLRs."

Bill Lipkind provides members with important commentary on a recent development dealing with incomplete non-grantor trusts.

William D. Lipkind, chair of the **Tax Planning & Controversies** practice at **Wilson Elser** and a partner in the firm's New Jersey office, concentrates his practice on the representation of high-net-worth individuals and entrepreneurs. He is especially active in federal, state and international income and estate tax planning, wealth preservation, business transactional matters and asset protection. Bill received degrees from Cornell University (B.A. 1964), Harvard University (J.D. 1967) and New York University (LL.M. in Taxation 1972). He has published numerous articles, been named for inclusion in *Super Lawyers* and as a Top Attorney in New Jersey, lectured extensively before professional and lay organizations, and has been featured on television and quoted in financial and news publications.

Here is his commentary:

EXECUTIVE SUMMARY:

Incomplete Non-Grantor Trusts ("INGs") are used to transfer wealth not subject to state taxation as "source income" into trusts that are domiciled in states that permit self-settled spendthrift trusts and do not tax such trusts on undistributed income. After a hiatus of six years, the IRS resumed issuing Private Letter Rulings for such trusts with PLR 201310002. To achieve the desired tax results, a number of state and federal tax hurdles must be overcome, as discussed by the author in **LISI** Estate Planning Newsletter #2076.

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newsletter, the author, after describing the facts of the current PLR, will point out and highlight differences from the earlier PLRs.

FACTS:

After discussing the facts of the 2015 PLR,[1] this newsletter will contrast it with the 2013 PLR[2] and then focus on substantive and evolutionary differences between the two PLRs, as well as the differences in the holdings of the rulings. No effort will be made to repeat the background information and legal analysis pertaining to incomplete gift, non-grantor trusts, as already discussed in the 2013 Estate Planning Newsletter.[3] Further, no effort shall be made to discuss the IRS analysis and holdings in the 2015 PLR except where there is a difference or evolution from the 2013 PLR.

In the 2015 PLR, California domiciliaries transferred community property to a South Dakota Trust (the "2015 Trust").[4] The beneficiaries of the 2015 Trust include, in addition to the Grantors, their issue, the spouses of their issue and, most interesting, a preexisting California trust for the exclusive benefit of the Grantors' issue of which the Grantors' California accountant was, at the time of the PLR submission and issuance, the sole trustee (the "Investment Trust").

The Power of Appointment Committee (the "PAC") consists of the Grantors' four minor children, the Investment Trust, and the Grantors. The voting power of the minor children on the PAC is exercised, during their minority, by a so-called "Guardian" appointed by the Grantors, acting together, or by the survivor of them.[5]

The PAC operates either by (x) a majority of the PAC members other than the Grantors, with the consent of one of the Grantors, or (y) unanimously by all PAC members other than the Grantors. As long as the PAC consists of two or more members other than the Grantors, the PAC by unanimous consent, including the Grantors, can add a trust beneficiary who is not on the PAC to the PAC.

The PAC ceases to exist upon (x) the death of the surviving Grantor; (y) the membership of the PAC falling to one member other than the Grantors; or (z) the resignation of all PAC members. In the event the PAC ceases to exist, then the trustee has the power to make distributions to the Grantors and the Beneficiaries in its discretion. This power of the trustee causes the trust to become, *ipso facto*, a grantor trust.

Each of the Grantors has a lifetime power, exercisable in a non-fiduciary capacity, to appoint corpus to or for the benefit of any one or more of their issue for their health, maintenance, support and/or education. Pursuant to the Community Property Article of the Trust, an exercise of such power by one of the Grantors is made with the deemed consent of the non-exercising Grantor and the distribution is deemed to carry out equally their community property.

Each of the Grantors also has a broad special testamentary power of appointment with respect to his/her half of the remaining community property. Following the death of the first Grantor, the surviving Grantor's half of the community property remains in the trust subject to the same terms as existed before the death of the first Grantor. To the extent that a Grantor does not exercise his/her testamentary power of appointment in full, his/her share of his/her interest passes 10 percent to the Investment Trust and the balance to the issue *per stirpes* of the Grantors.

COMMENT:

Material Differences from 2013 Trust

The primary difference is that the 2015 Trust was settled by a couple domiciled in a community-property state. Some leading practitioners have questioned whether community property can retain its character as community property when transferred to an irrevocable trust. There is also the question of whether a trust domiciled in a state that does not expressly provide for an irrevocable community property trust can hold property characterized as community property. Finally, some practitioners have argued that if a trust contains community property, then by the very definition of community property the entire corpus must be available to the present and future creditors of the trust settlors and thus the trust cannot be a non-grantor trust. In the case of the 2015 Trust and PLR, applicable and appropriate opinions of counsel were obtained: (1) from leading tax and trust counsel in the domicile state of the settlors that the property, subject to the restrictions set forth in the 2015 Trust, retained its character as community property and (2) from prominent trust counsel in the domicile state of the trust that the property retained its character as community property and was not generally available, subject to a fraudulent conveyancing exception, to the creditors of the Grantors.[6]

Another interesting feature of the 2015 PLR is that the Investment Trust, a preexisting trust of which the grantors' accountant was the sole trustee, was a beneficiary and member of the PAC and thus, obviously, also an "adverse party" within the meaning of IRC §672. Absent that factor, the only members of the PAC other than the Grantors would have been their children. In structuring membership of the PAC, one must always be sensitive to the fact that the PAC, acting unanimously, has the power to distribute the entire trust corpus to the beneficiaries, leaving the Grantors with no beneficial interest in the trust and with a large gift tax liability to the IRS.

The Investment Advisor provisions are similar in text in the 2013 Trust and the 2015 Trust but differ materially in substance. In the 2015 Trust, the Investment Advisor is a South Dakota special-purpose entity, specially authorized by the laws of South Dakota[7] to serve as a fiduciary for a single family in South Dakota trusts. These entities are inexpensive to form, have minimal capitalization requirements, and invoke minimal review and supervision by South Dakota. By using this unique feature of South Dakota law, all of the trust fiduciaries for the 2015 Trust are licensed and domiciled in South Dakota. This is in contrast to the 2013 Trust wherein there was a Nevada Administrative Trustee and Distribution Trustee, but the Investment Advisor, serving in a fiduciary capacity, was not domiciled in Nevada. It is conceivable that the taxing authority in the domicile state of the settlors might attack the choice of law provision in the trust,[8] arguing that the proper law of the trust was the law of the domicile state, which law does not respect self-settled trusts and that therefore the trust was a grantor trust because its assets were fully available to the creditors of the settlors. It is submitted that the structure of the 2015 Trust, wherein all trust fiduciaries were domiciled in South Dakota, increases the contacts between South Dakota and the trust assets and therefore enhances the argument that the law of the trust chosen by the settlors should be respected.[9]

In PLRs issued subsequent to the 2013 PLR, the IRS approved features included in the 2015 Trust but not the 2013 Trust. These included the power of the PAC, acting by unanimous consent, to make a "Beneficiary" who is not a member of the PAC into a member of the PAC[10] and the use of grantor-appointed "Guardians" to vote on the PAC for minor members of the PAC.[11] The IRS has also confirmed that the members of the PAC do not possess general powers of appointment so that the trust property is not includible in their gross estates under IRC § 2041.[12] Finally, the IRS did not object to the trust becoming a grantor trust by its terms if and when the PAC ceases to exist.[13]

Differences in Rulings between 2013 PLR and 2015 PLR

The most noticeable difference is that the 2015 PLR has a ruling on the 100 percent step-up in income tax basis upon the death of the first spouse. Although novel to the PLRs, the ruling does appear to be a perfunctory application of the IRC based on the representations made in the PLR request with respect to the laws of the grantors' domicile state and the laws of the trust domicile state.

Not so obvious is the fact that, notwithstanding the 2007 News Release, the 2015 Trust does not terminate the PAC until it falls to a single member, other than the Grantors,[14] and the 2015 PLR continues to provide that a distribution by the PAC to a Beneficiary is a gift by the Grantor(s) and not the exercise of a general power of appointment by any members of the PAC.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Bill Lipkind

CITE AS:

CITATIONS:

[1] PLR 201550005

[2] PLR 201310002

[3] Lipkind, "DING Redux," LISI Estate Planning Newsletter, #2076 (March 12, 2013); Blattmachr and Lipkind, "Fundamentals of DING Type Trusts: No Gift Not a Grantor Trust," Probate Practice Reporter (April 2014)

[4] The trust in the 2013 PLR was domiciled in Nevada (the "2013 Trust").

[5] The "Guardian" is simply appointed by the Grantors and is not a court-appointed guardian.

[6] Alaska has a Community Property Trust statute, but some commentators have questioned certain aspects of the statute. The author has been advised that a bill has been introduced to the Alaska Legislature to make clear that the concerns of the aforementioned commentators are inapplicable. The author also has been advised that at least two other states will consider enacting community property trust statutes in 2016, modeled on the Alaska statute.

[7] S.D.C.L. §51A-6A-66

[8] See, for example, *In re Huber*, 493 B.R. 798 (Bankr. W.D. Wash. 2013).

[9] Consider the criteria in Restatement (Second) of Conflict of Laws, §6, §270.

[10] PLR 201510001

[11] PLR 201410001

[12] PLR 201510001

[13] PLR 201510001

[14] This provision was first introduced in PLR 20151001. The 2013 Trust provided that the Committee would cease to exist when its membership fell to two members.