New Hampshire Incomplete Gift, Non-Grantor Asset Protection Trusts

Using an "ING" Trust to Avoid State Income Taxes

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1. Introduction.

a. The Idea: State Income Tax Avoidance Some for Non-New Hampshire Resident Settlors. The combination of New Hampshire's adoption in 2008 of the Qualified Dispositions in Trust Act (the "QDTA")[1], and our favorable rules concerning the New Hampshire state income taxation of trusts that do not have New Hampshire resident beneficiaries, provides an opportunity for residents of a few high income tax states (including Massachusetts – see footnote 4) to use a New Hampshire self-settled asset protection trust ("APT") in an effort to avoid state income taxation on capital gains and even interest and dividend income yielded by tangible and intangible personal property held in the APT. Several private letter rulings express the IRS ruling position that under the laws of states with APT statutes, a grantor can create an "ING" trust[2] as a non-grantor APT for federal income tax purposes, fund the APT with contributions that are not considered taxable gifts for federal gift tax purposes, and still retain the eligibility to receive discretionary distributions of income and principal from the APT. New Hampshire does not impose state income tax on non-grantor trusts' income and capital gains distribution.[3] If the grantor and beneficiaries of a carefully-

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[1] The QDTA is codified at RSA Chapter 564-D, which applies to qualified dispositions made on or after January 2, 2009.

[2] "ING" is an acronym for "incomplete gift non-grantor trust".

[3] New Hampshire has no broad-based income tax. It does, however, impose a 5% tax on net interest and dividend income. On June 28, 2012, the New Hampshire General Court significantly changed the interest and dividends tax (the "I&D tax") rules for trusts as part of ongoing efforts to make New Hampshire more attractive for locating trusts. This legislation eliminates the taxation of non-grantor trusts at the trust level, and also eliminates any I&D filing

designed ING trust created under New Hampshire's APT statute reside in a state that does not tax trust based on the residence of the grantor or beneficiaries,[4] it may be possible for the trust to avoid state income taxation altogether.

b. The IRS's Evolving Ruling Position. Seven IRS private letter rulings issued over the six-year period beginning in 2001 and ending in 2007 (sometimes variously referred to herein as the "early rulings" or "pre-2008 rulings") offered some comfort for ING trust creators and their advisors[5]. After issuing the last of these rulings, however, the IRS published News Release IR-2007-127, announcing that it was reconsidering the rulings' conclusions on a critical gift tax issue and soliciting comments from the professional community. That News Release cast some doubt on the correctness of the rulings' conclusions relating to the lack of any gift tax consequences to the members of an ING trust's "Distribution Committee" ("DC") of "adverse parties", the existence of which was critical in supporting the rulings' conclusions on the important federal gift and income tax issues. The IRS issued no PLRs or other guidance on the federal tax treatment of ING trusts for five long years following the Release's issuance.

These developments had a chilling effect on the use of the ING technique – much to the delight of the taxing authorities in the few high income tax jurisdictions whose residents might otherwise employ the strategy. The IRS Chief Counsel's office issued an advisory in 2011 that cast doubt on the other critical ING trust gift tax issues: the ability of an ING trust's creator to make an incomplete gift to an ING trust solely by virtue of the settlor's retention of a

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requirement for non-grantor trusts. New Hampshire resident beneficiaries of non-grantor trusts who receive federal Schedules K-1 will be subject to I&D tax only to the extent that income reflected on the K-1 is taxed federally as interest or dividends. New Hampshire follows the federal rule that the existence of a grantor trust is ignored for New Hampshire I&D tax purposes. New Hampshire Department of Revenue Administration Technical Information Release 2012-002 includes a brief discussion of these important tax changes.

[4] As of June 2014, there are five such states: New Jersey, Kentucky, Massachusetts, Michigan and Missouri. This list also included New York until very recently. On page A-2 of the March 30, 2009 issue of the Wall Street Journal, it was reported that the highest New York income tax bracket was to be increased in 2010 from 6.85% to 7.85% ($300K-$500K of taxable income) and 8.97% (over $500K). This created a powerful incentive for New Yorkers to look at ING trusts created in APT states like Delaware and Nevada for a portion of their portfolio income and capital gains, and capital gains on intangible assets to be sold, as reported by Bloomberg News on December 18, 2013 in Rubin, Wealthy New York Residents Escape Tax with Trusts in Nevada. The New York General Assembly took notice and passed amendments during the 2014 legislative session that treat as a grantor trust for New York income tax purposes any ING trust created by a resident of New York. Governor Cuomo signed the legislation into law on March 31, 2014. Therefore, ING trusts will no longer be useful in avoiding New York state income taxes. See Zeydel, New York State – 2014-2015 Budget Affecting Trusts and Estates, posted on www.netlawreview.com on May 9, 2014.

[5] PLR 200715005, 200647001, 200637025, 200612002, 200502014, 200247013 and 200148028.

testamentary limited power of appointment. In 2013 the government's thinking on the gift tax issues had finally crystallized to a degree sufficient to allow it to begin again to issue PLRs to ING trust creators. This paper will describe the evolution of the IRS's ruling position, discuss some remaining uncertainties, suggest some drafting techniques to stay on the safe side of all of the critical tax issues, and provide some examples of how a New Hampshire ING trust might be used by Massachusetts residents.

2. The Challenges of Threading the Ever-Shrinking ING Trust Needle.

a. The Natural Tension Between Non-Grantor Trust and Incomplete Gift Status. The ING trust agreement must be drafted to avoid grantor trust status. Best achieving that goal can make it more difficult to achieve the second objective: giving the grantor a sufficient interest in the trust to avoid making a completed gift upon funding the trust. All seven of the pre-2008 rulings used a similar analysis in addressing the tension inherent in achieving both of these objectives. In order to avoid a completed gift, the settlor typically retains a testamentary limited power of appointment ("TLPOA") over all of the trust property remaining at the settlor's death. To avoid grantor trust status, the ING trust agreements that were reviewed in those early rulings provided for a DC (called a "Power of Appointment Committee" in PLR 200612002) consisting of "adverse parties" as to the settlor within the meaning of Code §672(a). The direction of the DC was required for: (i) the settlor or the settlor's spouse to receive discretionary distributions from the trust; or (ii) the trustee to accumulate income in the trust that might be subject to the settlor's retained TLPOA.

b. The Early Rulings, Facts and Analysis.

(1) Addressing the Gift Tax Issues: The Pre-2008 Rulings. A properly designed ING trust agreement will allow the settlor to receive discretionary distributions upon the direction of any one member of the DC, provided that the settlor consents to or does not veto the distribution. Our QDTA expressly permits the grantor to retain certain rights in a New Hampshire APT, including the right to block distributions from the trust. This retained right to receive distributions upon the joint action of the settlor and any member of the DC should constitute a retained lifetime general power of appointment under Code §2514(c)(3)(B), as confirmed by Rev. Rul. 79-63, 1979-1 C.B. 302. The settlor should also retain a TLPOA, which our QDTA also specifically permits.

The retained TLPOA should cause the settlor's gift to the ING trust to be incomplete under Treas. Reg. §25.2511-2(b) based on the applicable legal precedents reviewed in the early rulings. That regulation includes, as an example of a gift of trust income, the donor's transfer of property in trust to pay the income to the donor, or accumulate the income, where the donor retains a testamentary power to appoint the trust remainder among the donor's descendants. Similarly, Treas. Reg. §25.2511-2(c) states that a gift is incomplete if the donor reserves the power to name new beneficiaries or change the interests of the beneficiaries unless the power is exercisable in a fiduciary capacity and is limited by a fixed or ascertainable standard. A TLPOA is the practical equivalent of a power to both change beneficiaries and vary their interests. It stood to reason, therefore, that the grantor's retention of these two rights will guarantee that contributions to the trust are not completed gifts, as the early rulings so held.

(2) Achieving Non-Grantor Trust Status. The early rulings all concluded that the trusts in question successfully achieved non-grantor trust status. The following will provide an overview of the critical features of an ING trust that would likely have avoided grantor trust status based on the trust designs analyzed in the rulings, with a focus on the composition, role and responsibility of the DC, and each pertinent provision of the grantor trust rules of Code §671 et. seq.

(A) Reversionary Interest under Code §673.

i. Defining a Reversionary Interest. A threshold question to determine whether it is possible to create a non-grantor APT: whether the grantor will be deemed to hold a reversionary interest in the trust for purposes of Code §673 by reason of the grantor's eligibility to receive discretionary distributions. Code §673 treats as a grantor trust any trust in which the grantor retains a reversionary interest having a value that exceeds five percent of the value of the trust.

The settlor retains no reversionary interest in a properly drafted APT. The DC's discretionary power to make distributions to the settlor should not be categorized as a "reversionary interest" within the meaning of Code §673.

Code §672 provides definitions for the grantor trust provisions of the Code. Although Code §672 does not provide a definition of a "reversion" for purposes of the grantor trust rules, it seems clear that a reversion under Code §673 exists only when there is a "traditional" reversion. As we know it in property law, a traditional reversion will be found to exist when a person having a vested estate transfers a lesser vested estate to another. The interest left with the transferor after he or she transfers a lesser estate is called a reversion.

Thus, the settlor of a trust retains a reversionary interest if a portion of the transferred assets will return to the settlor upon the death of a person (life estate), after a term of years, or upon the settlor's demand. Under this property law definition, if a transferor conveys all of his or her interest in property to a trust, then the transferor has not retained a reversion even if he or she holds a beneficial interest, such as a right to receive distributions in the trustee's discretion. Treas. Reg. §1.673(a)-1(c) provides: "Where the grantor's reversionary interest in a portion of a trust is to take effect in possession or enjoyment by reason of some event other than the expiration of a specific term of years or the death of the income beneficiary, the grantor is treated as the owner of the portion if the event may reasonably be expected to occur within 10 years from the date of transfer of that portion, but he is not treated as the owner under §673 if the event may not reasonably be expected to occur within 10 years from that date." This suggests that reversionary interests, for grantor trust purposes, are consistent with the traditional property law definition.

ii. Applying the 5% Test of Code §673(c). Although Code §673 was originally adopted in 1954, the current §673(c) (which provides that in valuing a reversion, the maximum exercise of discretion in favor of the settlor is assumed) was not adopted until 1988. No case law or administrative interpretations material providing guidance on what is meant by "assuming the maximum exercise of discretion in favor of the grantor" when valuing a reversionary interest. The legislative history of Code §673(c) simply provides that "in determining whether a reversionary interest has a value in excess of five percent of the trust, it will be assumed that any discretionary powers are exercised in such a way as to maximize the value of the reversionary interest." S. REP. NO. 100-445 at 362 (1988) reprinted in 1988 U.S.C.C.A.N. 4515, 4872. There is no other explanation of how this provision affects the reversionary interest rule.

A careful reading of the legislative history, however, demonstrates that Congress intended for Code §673(c) to create a presumption that discretionary powers are exercised in favor of the settlor for the purpose of calculating the proportion of the value of a reversion to the value of the rest of the trust, and not in determining whether the discretionary powers themselves create a reversion.

(B) Power to Control Beneficial Enjoyment under Code §674. Code §672(a) defines an "adverse party" as any person having a substantial beneficial interest in a trust that would be adversely affected by the exercise or non-exercise of a power that he possesses with respect to the trust. Under Code §674(a), a trust is a grantor trust if the beneficial enjoyment of the trust property is subject to a power of disposition exercisable by the settlor or a nonadverse party, or both, without the approval or consent of any adverse party. APTs typically permit discretionary distributions to their settlors (this is why APTs are called "self-settled trusts"). Accordingly, an APT may avoid grantor trust status under Code §674(a) with respect to the trustee's distribution powers with respect to the settlor, his or her spouse and the other APT beneficiaries by providing that no distributions may be made except with the consent of one or more members of a DC populated exclusively by persons who are themselves currently eligible to receive discretionary distributions from the trust. Each Committee member should be an "adverse party" within the meaning of Code §672(a), so long as his or her interest is "substantial".

Whether an adverse party has a "substantial" adverse interest is a question of fact. Any distribution from the trust to the settlor or any other beneficiary will adversely affect the interests of the DC members not receiving the distribution. However, a party with a beneficial interest (present or future) in any given APT is not always an adverse party. What about an ING trust agreement providing that all adult competent beneficiaries who are eligible to receive distributions from the trust must consent in order for the trustee to make a distribution to the settlor or the settlor's spouse? Such a provision should guarantee that the beneficiaries collectively will be deemed to have a "substantial" beneficial interest in the trust adverse to the exercise of the trustee's discretion in favor of the settlor because each distribution actually made to the settlor would reduce the amount that otherwise would be available for distribution to those other beneficiaries. PLR 9016079, and each of the seven pre-2008 rulings, held that each person eligible to receive discretionary distributions had a substantial interest that was adverse (as contemplated in §672(a)) to the exercise of the trustee's discretion in favor of the settlor or the settlor's spouse.

(C) Retained TLPOA under Code §674(b)(3). As indicated earlier, the early rulings confirmed the IRS's initial position that the settlor's possession of TLPOA was sufficient to avoid adverse gift tax treatment to the settlor. The retention of that power should not cause an ING trust to be taxable as a grantor trust. Code §674(a) does not apply to a POA exercisable only by will, other than a power held by the grantor to appoint income accumulated by the grantor or income that may be accumulated in the discretion of the grantor or a nonadverse party, or both, without the approval or consent of any adverse party. The ING trust agreements reviewed in the early rulings provided that no income could be accumulated in the trust without the consent of the DC because the Committee members, who would be adverse parties for the reasons explained above, could, by unanimous action, appoint current and accumulated income among the trust beneficiaries (including the Committee members themselves) eligible to receive current trust distributions. The rulings concluded that this prevented the accumulation of income subject to the settlor's TLPOA.

(D) Power to Revest Property under Code §676. Code §676(a) requires the settlor to be treated as the owner of any portion of a trust over which the settlor or a nonadverse party has the power to revest title to the trust property in the settlor. The existence of a DC of adverse parties prevents the application of Code §676.

(E) Code §677 Distribution Power. Code §677 requires, in general, that the settlor be treated as the owner of any portion of a trust, the income from which may, without the approval of any adverse party, be distributed to the settlor or the settlor's spouse, or accumulated for future distribution to the settlor or the settlor's spouse, or applied to the payment of premiums on insurance on the life of the settlor or the settlor's spouse. In the early rulings, none of these actions could be taken with respect to the income of the ING trusts by anyone other than the members of the DC. Therefore, Code §677 did not cause those ING trusts to be treated as grantor trusts.

(F) Avoiding Creditors' Rights. Treas. Reg. §1.677(a)-1(d) provides that a trust is a grantor trust if under applicable state law the settlor's creditors may recover from the trust amounts owed to them by the grantor. Virtually all of the states that have not adopted APT legislation[6] retain the self-settled trust doctrine: if the settlor is eligible to receive discretionary distribution from the trust, the settlor's creditors may look to the trust to satisfy the settlor's obligations owed to them. A self-settled incomplete gift non-grantor trust therefore can be created only under our QDTA or similar legislation in the other states that have enacted similar APT acts.

[6] As of June 2014, sixteen states have exacted APT legislation.

c. Avoiding Adverse Gift Tax Consequences to DC Members and Achieving Incomplete Gift Status: Dealing with the Implications of IR-2007-127, the IRS's 2011 Chief Counsel's Advisory Opinion and the Recent PLRs.

(1) Context. A brief recap of the recent critical features of the ING trusts reviewed in the early rulings is necessary to understand the context in which the 2007 IR, the 2011 CCA and the 2013 PLRs were issued.

The early PLRs were issued by the Office of the Associate Chief Counsel, Passthroughs and Special Industries. In each of those rulings, the settlor creates a discretionary trust for the benefit of the settlor and others (the "permissible beneficiaries"). A Delaware corporate trustee is appointed as sole trustee. The DC consists of two of the permissible beneficiaries of the trust. The DC members have the power, by their unanimous consent, to direct the trustee to distribute trust assets among the permissible beneficiaries. In addition, the settlor and one member of the DC may by their agreement direct the trustee to make distributions. If a member of the DC resigns or otherwise ceases to serve, a permissible beneficiary (other than the settlor or the settlor's spouse) is appointed as a successor DC member. The settlor retains a TLPOA over the trust assets. The TLPOA provision allows the settlor to appoint the remaining trust assets to any person or organization other than the objects of a general power of appointment defined in Code §2041(b)(1): the settlor, the settlor's estate, the settlor's creditors or the creditors of the settlor's estate.

The early rulings conclude that the settlor has not made a completed gift upon the funding of the ING trust due to the settlor's retained TLPOA. However, the settlor will be treated as making a taxable gift if and when a trust distribution is made to someone other than the settlor him or herself. Each early ruling also concluded that the DC members have substantial adverse interests to each other DC member's interests under Code §2514. Therefore no DC member has a general power of appointment over the trust assets, and distributions from the trust will not be considered to be gifts by the DC members.

(2) The 2007 IR.

(A) The Proffered Basis for Reconsideration. IR-2007-127 states that the IRS was reconsidering the early rulings' conclusions with respect to the gift tax consequences to the DC members. The basis that the IRS offers for its reconsideration is its apparent belief that those conclusions may not be consistent with the reasoning and results in

Revenue Ruling 76-503 and Revenue Ruling 77-158 (the "Revenue Rulings"), each of which involved substantially identical facts.

In the Revenue Rulings, three siblings, A, B and C, owned equal one-third interests in their family business. Each contributed his or her respective interests in the business to an irrevocable trust established for the benefit of the siblings' descendants. The trust agreement permitted the trustees to distribute trust property to whomever they select, including themselves, in such proportions and at such times as they determine in their absolute discretion. Each trustee had the power to designate one of the trustee's relatives to serve as successor trustee upon the trustee's death or resignation. The oldest adult living descendant of the deceased or resigned trustee was to fill the vacancy as successor trustee if the deceased or resigning trustee could or would not appoint his or her successor.

The Rulings involved the question of whether all or a portion of the trusts' assets should be included in the estate of the decedent, "D". Before D's death, sibling A selected D to be one of the three original trustees. D served in this position until his death. The Revenue Rulings address whether any of the trust assets are includible in D's gross estate under Code §2041: did D possess a general power of appointment ("GPOA") over the trust assets held jointly with the other two co-trustees? The Rulings conclude that D held a GPOA over one-third of the value of the trust as of the date of D's death. Therefore, one-third of the date-of-death value of the trust principal was held to be includible in D's gross estate under §2041.

The Rulings based this holding on the flush language of Code §2041(b)(1)(C)(ii), which states that a power that is not exercisable by the decedent except in conjunction with a person having a substantial adverse interest in the property subject to the power is not a GPOA. The §2041(b)(1)(C)(ii) safe harbor did not apply to D because the remaining co-trustees did not have a substantial adverse interest as to D. The terms of the trust provided that upon D's death a successor trustee was to be appointed in D's place. The remaining co-trustees did not receive the entire power of appointment upon D's death. Rather, the surviving co-trustees continued to share the power with D's replacement. The Rulings conclude that this did not put the surviving co-trustees in a better economic position after D's death then they enjoyed before D's death. Therefore, their interest was not substantially adverse to D. If the trust had been drafted so that upon D's death the POA would vest solely in the remaining co-trustees, the co-trustees' interest would have been substantially adverse to D's interest, and D would not have a GPOA.

(B) Criticisms of the IRS's Reasoning. Was the IRS misguided with its concern expressed in IR-2007-127 that the Revenue Rulings might have some bearing on members of the DC serving under the typical ING trust? Many commentators think so, based on a comparison of the facts of the Revenue Rulings to those of the pre-2008 rulings.

The pre-2008 rulings involved trusts that provided that upon the resignation of any DC member, a permissible beneficiary was to be appointed as a successor DC member to succeed the resigning member. In that respect, the facts of the pre-2008 rulings are similar to those of the Revenue Rulings: The distribution power does not vest in the remaining DC members, but instead must be shared with the successor DC member. This does not enhance the remaining DC members' economic position after the resignation of one of their counterparts.

There is an important fact, however, distinguishing the two sets of facts. The pre-2008 ING trust rulings conclude that: (i) the transfer to each ING trust by the settlor would be an incomplete gift; and (ii) a distribution from the ING trust to any person other than the settlor would be a completed gift by the settlor. In the Revenue Rulings, by irrevocably transferring their interests in the family business to the trust upon its creation, A, B and C made a taxable gift to the trust. Accordingly, distributions from the trust to the beneficiaries would not be considered taxable gifts by A, B or C.

If the rationale of the Revenue Rulings were properly applied to the facts presented in the early rulings, distributions from the trusts reviewed in the early rulings would constitute completed gifts by the DC members. There is no statutory common law or regulatory authority to support that result. If this theory were taken to its logical conclusion, a distribution from an ING trust to the settlor would constitute a taxable gift made to the settlor of property which, for federal wealth transfer tax purposes, the settlor is already treated as owning. Moreover, a distribution to any other person besides the settlor would constitute a taxable gift of the same property to the same person at the same time by both the settlor and the DC members.

Obviously, this makes no sense: A person cannot be treated as holding a GPOA over property, which for transfer tax purposes, is considered owned by another until the owner has made a completed gift of such property. The only possible authority that the IRS might cite to refute this logic is Revenue Ruling 67-370.

In that ruling, a settlor established a revocable trust that provided that upon the settlor's death the decedent or his estate was to receive the remaining trust assets. The settlor reserved the right to modify, alter or revoke the trust during her lifetime. The decedent predeceased the settlor. Revenue Ruling 67-370 holds that the decedent's interest in the trust is includible in the decedent's estate for federal estate tax purposes under Code §2033 because the decedent's interest was descendible, devisable and alienable under the governing local (New York) law.

Revenue Ruling 67-370 does not involve powers of appointment. It does, however, conclude that property owned by one taxpayer who has never made a completed gift of that property may simultaneously be includible in the gross estate of another taxpayer. This rather curious, counter-intuitive ruling appears to be the only authority that supports the proposition that the same property can be simultaneously includible in the gross estates of two different taxpayers prior to the time either of them has made a completed gift. Many commentators believe that Revenue Ruling 67-370 was simply wrongly decided, and that its rationale and holding would not pass judicial muster if it were challenged.

It is important to note that IR-2007-127 was only a News Release indicating that the Service was *considering* a change in the position it took on only one aspect of the early rulings. In response to the Service's invitation, the AICPA and the Tax Sections of the ABA and the New York Bar Association and weighed-in with letters and legal memoranda cogently asserting that the IRS's contemplated change in position would not be supported by any precedent and would be inconsistent with fundamental wealth transfer tax principles.

(3) <u>The 2011 CCA, the 2012 CCM and Treatment of a Settlor's Retained Testamentary Limited Power of Appointment</u>. On September 28, 2011, Chief Counsel to the IRS released CCA 201208026 (the "<u>CCA</u>") Without referring to ING trusts, and without discussing the gift tax issues raised in the 2007 IR, the CCA contradicted the incomplete gift conclusions of the early rulings.

Under the facts of the CCA, settlors A and B transfer property to an irrevocable trust. The trustee, Child A, has discretion to make distributions for the settlors' children, other descendants, their spouses, and charity. The settlors are not eligible to receive trust distributions, thus the trust was not a self-settled APT. They did, however, retain a TLPOA.

After citing the relevant gift tax regulations, the CCA refers to a 1907 Supreme Court case and states:

> Though it predates the enactment of the gift tax, the [Supreme Court] opinion supports the proposition that a testamentary power of appointment relates to the remainder of a trust, not the preceding beneficial term interests. The testamentary power does not (and cannot) affect the trust beneficiaries' rights and interests in the property during the trust term. Rather, a trustee with complete discretion to distribute income and principal to the term beneficiaries may, in exercising his discretion, distribute some or all of the trust property during the trust term. The holder of a testamentary power has no authority to control or alter these distributions because his power relates only to the remainder.

The CCA concludes: "Accordingly, for gift tax purposes, the Donors' transfers to the trust constituted a completed gift of the beneficial term interests. The Donors' testamentary limited powers of appointment relate only to the trust remainder." Citing Code §2702, the CCA states: "the Donors' retained testamentary powers are interests, and the value of their retained interests is zero. Therefore, the value of the Donors' gift is the full value of the transferred property."

All of the pre-2008 rulings concluded there was an incomplete gift due to the settlor's retained TLPOA. The CCA's reasoning, if applied to the facts of these rulings, would treat the transfers as completed gifts.

A Chief Counsel Advisory is addressed to IRS Area Counsel. It was possibly written in contemplation of litigation (or at least in serious pursuit of audit issues). It recites that it "may contain privileged information", and for all those reasons it may not tell the full story on the IRS's position on the effect of a retained POA in an ING trust of which the donor is a current sprinkle beneficiary. The CCA is, therefore, probably an unreliable indication of the IRS's current thinking on these issues.

In any event, the office of Chief Counsel confirmed its position on the facts presented in the 2011 CCA in a more formal Chief Counsel Memorandum ("<u>CCM</u>")

released on February 24, 2012. Despite the uncertainties as to the implications of the CCA's reasoning for ING trusts, cautious drafters will not rely exclusively on a retained TLPOA to secure incomplete gift status.

(4) The 2013 and 2014 Private Letter Rulings. Against this backdrop, and with the last PLR having been issued in 2007, the IRS issued PLR 201310002 dated November 7, 2012 and released on March 8, 2013.[7] Like the early rulings, the 2013 ruling was favorable for the taxpayer. However, the rationale for some of its conclusions is different and is questionable in several respects.

The facts of the 2013 PLR are similar to those in the early rulings, though with some significant modifications that appear designed to address the implications of the CCA that a TLPOA alone may not be sufficient to render a gift incomplete.

The trust was irrevocable; distributions of income or principal could be made to the grantor or the grantor's issue, with the consent of the grantor, but only at direction of a DC consisting of the grantor and his sons (the "Grantor's Consent Power"); distributions of income or principal could be made to the grantor or issue at direction of all DC members other than the grantor (the "Unanimous Member Power"); distributions were also permissible as the grantor, in a nonfiduciary capacity, directs among the grantor's issue for health, education, maintenance and support (the "Grantor's Sole Power"); and the grantor retained a TLPOA (the "Grantor's Testamentary Power").

With regard to the incomplete gift issue, there are separate rulings for each of the grantor's retained powers.

(A) Grantor's Consent Power. "The Distribution Committee members do not have interests adverse to Grantor under section 25.2514-3(b)(2) and for purposes of section 25.2511-2(e). Therefore, Grantor is considered as possessing the power to distribute income and principal to any beneficiary himself because he retained the Grantor's Consent Power. The retention of this power causes the transfer of property to be wholly incomplete for federal give tax purposes". (emphasis added)

(B) Grantor's Sole Power. "Under Section 25.2511-

[7] On the same date, four identical PLRs also were issued for each of the ING trust's Grantor's sons. These are PLRs 201310003, 201310004, 201310005 and 201310006. The IRS also issued PLRs 201410001-201410010 on March 7, 2014, that reached conclusions similar to those reached in the 2013 PLRs. Therefore, only the first of the 2013 PLRs will be analyzed.

2(c), 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. In this case, Grantor's Sole Power gives Grantor the power to change the interests of the beneficiaries. Accordingly, the retention of the Grantor's Sole Power causes the transfer of property to Trust to be wholly incomplete for federal gift tax purposes". (emphasis added)

(C) Grantor's Testamentary Power. "Under section 25.2511-2(b) the retention of a testamentary power to appoint the remainder of a trust is considered a retention of dominion and control over the remainder. Accordingly, the retention of this power causes the transfer of property to Trust to be incomplete with respect to the remainder in Trust for federal gift tax purposes". (emphasis added)

Regarding the grantor trust issue, the ruling concluded: "An examination of Trust reveals none of the circumstances that would cause Grantor to be treated as the owner of any portion of Trust under sections 673, 674, 676, or 677". Although not expressly stated, it appears that this conclusion is based on a determination that the Distribution Committee members are adverse parties under Code §672(a).

It seems reasonable to conclude that the drafters of the ING trust reviewed in the 2013 PLR tweaked the trust's provisions to avoid the issues raised in the 2011 CCA in that the Grantor retained both a TLPOA and lifetime powers. In fact, with respect to the testamentary power, the ruling clearly states that this retention only causes the transfer to be incomplete with respect to the remainder. This is a significant change from the facts of the early rulings. Commentators have questioned the rationale that the IRS offered to support its conclusions in the 2013 PLR. Specifically, the ruling that the Grantor's Consent Power resulted in an incomplete gift is premised on the Distribution Committee members not having interests adverse to the grantor. However, the non-grantor trust ruling is unclear on those same members' status as adverse parties. Apparently the IRS interprets the phrase "adversely affected" differently for gift and income tax purposes. It is also noteworthy that since the Grantor's Sole Power relates only to principal and not income, it is not clear if this alone should make the transfer wholly incomplete for gift tax purposes. Although the incomplete gift analysis of the pre-2008 PLRs has been called into question by the CCA opinion, the 2013 PLR offers some guidance as to how to structure ING trusts to avoid the broad implications of the 2011 CCA.

(5) Drafting Around the Issues Raised after the Issuance of the Early Rulings.

(A) Avoiding Gift Tax Consequences to the DC Members under the Rationale of the 2007 IR. We must be cautious when establishing New Hampshire ING trusts requiring that a DC member be replaced by a successor member upon the predecessor's resignation. There are a few drafting strategies that may avoid these issues:

- The trust agreement provides for multiple DC members who are not replaced by a successor DC member upon death or resignation. The Revenue Rulings cited in the IR reason that if a successor DC member is not to be appointed upon the resignation of a DC member, the distribution power would vest in the remaining DC members giving them substantially adverse interests in the trust property.
- Another option: provide that distributions among the sprinkle beneficiaries may only be made pursuant to an ascertainable standard. Under Code §2014(c)(1), the power to distribute only for the health, education, support or maintenance of the permissible beneficiaries is not a general power of appointment. (This would, however, restrict the purposes for which distributions could be made and may be too constraining for your settlor. As a practical matter, this may not be a problem if, as we recommend, the settlor commits only a nest egg to the trust, and is able to live off his or her other assets indefinitely.)

(B) Completed Gift Status in Light of the 2011 CCA and Subsequent Rulings.

One option is to conclude that the CCA's completed gift conclusion is unsupported by the law or precedent, and that, in any event, the facts of the CCA are distinguishable from those involved in the pre-2008 rulings in that the CCA did not involve a self-settled trust created under an APT statute. An optimistic draftsperson who takes this view may continue to rely exclusively on the retained TLPOA to secure incomplete gift status without torturing the document with unnatural governance provisions of the type reflected in the ING trust reviewed in the 2013 ruling.

But the stakes of being wrong on this issue will be prohibitive for most settlors and their careful counsel: a wasteful consumption of gift tax exclusion for assets that ultimately will be subject to estate taxation, or worse: the imposition of a 40% gift tax, plus interest and penalties, after an expensive gift or estate tax return audit.

One way to achieve certainty on the completed gift issue (and non-grantor trust status, as well) is to convince your client to spend over $20,000 to get his or her own PLR. But many clients will refuse to do so. While you can't guarantee that proceeding without a PLR will be without risks, you can tell your client that you have done your best to draft the ING trust document to give him or her the best chance to defend it in the event of an IRS challenge.

Fortunately, New Hampshire's APT statute allows for less unnatural governance structures than those employed in the 2013 PLR for those looking for a belt for their New Hampshire ING trusts to complement the TLPOA suspenders.

First, retaining a veto power over the DC's exercise of its power to distribute to beneficiaries other than the settlor should render incomplete the gift of what the 2011 CCA refers to as the "term interest" on the theory that a veto power is the equivalent of the settlor consent power discussed in the 2013 ruling. Our QDTA, specifically RSA 564-D:2.II(a) and 564-D:5, allows a QDT settlor to retain that power as a trust advisor.

Second, although our QDTA does not permit it as of this writing, amendments to RSA 564-D:2, II that are pending[8] that would provide that a QDT's settlor may retain an <u>inter</u> <u>vivos</u> limited power of appointment over the QDT's assets. The settlor's retention of a power to direct the QDT's trustee to distribute trust property among its beneficiaries (other than the settlor, the settlor's creditors or estate, and the creditors of the settlor's estate) certainly would avoid a finding of a completed gift.

3. <u>Examples of When an ING Trust May Be Used Successfully</u>.

a. <u>Transfers in Anticipation of a "Liquidity Event"</u>.

(1) <u>Closely-Held Business Interests and Publicly-Traded Securities</u>. Tom, a business owner residing in Massachusetts, is considering selling his closely-held stock to a strategic buyer. His investment banker tells him that he thinks he can successfully shop the stock for a price of $10M, net of the banker's fees. Tom's basis in the stock is $1M. His $9M capital gain would be taxed at the Massachusetts income tax rate of 5.25%, yielding a state tax of $472,500, if he sells the stock while he is a resident of Massachusetts. He can have a very good chance to reduce the tax if, well before the sale, he transfers a portion of his stock to a New

[8] As of June 4, 2014, the amendments had passed both the houses of the New Hampshire legislature, and were headed to the governor for signature.

Hampshire ING and, at some later point, the trustee of the ING sells the stock. Caveat: be sure that the transfer occurs as early as possible after Tom decides to sell, and that he funds the ING trust before he has signed a P&S committing him to close the sale. This will make it less likely that the Massachusetts taxing authorities will successfully "collapse" the transaction and impute the gain to Tom under the step transaction, substance over form, or assignment of income doctrines.

(2) "Collectible" Tangible Personal Property. Bill, an art collector residing in Massachusetts, is considering selling one of his paintings that recently was appraised at $2 million. He purchased the painting for $25,000 twenty years ago before the artist became famous. Bill creates a New Hampshire ING trust and transfers the painting to the trust's New Hampshire resident trustee. Six months later the trustee contracts with an auction house to sell the painting. It sells at auction six months later (a year after the transfer to the trust) for $2.025 million. The $2 million capital gain escapes the 12% Massachusetts income tax that Bill would have paid had he sold the painting himself, saving $240,000 in taxes.[9]

b. Marketable Securities Portfolio. John and Mary, residing in Boston, have a $10M portfolio of marketable securities. John and Mary are both practicing surgeons, but they have no pending or threatened malpractice claims. They are concerned about liability to potential future creditors. They are in the highest federal income tax bracket, and pay Massachusetts income taxes at a 5.25% rate. They wish to avoid making a completed gift of their stocks and bonds because they do not want to pay gift tax or use any of their $5.34 million federal gift tax exclusion amount. John's and Mary's portfolio holds $3 million of assets – other than non-taxable municipal bonds – that they consider to be holding for the benefit of their children, because they do not foresee any circumstance under which they would need to monitize those securities to generate needed liquidity during their lifetimes.

As settlors of a New Hampshire ING trust, John and Mary transfer that $3M to the trust in 2014, and they can retain the right to receive discretionary distributions of income and principal from the trust, subject to the consent or direction of a Distribution

[9] M.G.L. Chapter 62, Section 2(b) divides Massachusetts gross income into three parts. "Part A" gross income includes interest, dividends and certain capital gains income. Section 4 provides that Part A capital gains income is taxed at a rate of 12%, whereas Part A interest and dividend income is taxed at 5.25%. The Massachusetts Department of Revenue website indicates that capital gains from the sale of "collectibles" are reported on Schedule B of Form 1, the Massachusetts income tax return, and that the gain realized by a Massachusetts resident's sale of a collectible is taxed at the 12% rate. A "collectible" is any capital asset as defined in Code §408(m), which includes works of art, antiques, gems, alcoholic beverages and certain coins.

Committee composed of their four adult children, who also are potential discretionary beneficiaries. This would give the couple a fall-back fund to protect them against the possibility of a major financial reversal or a catastrophic malpractice judgment above any available insurance coverage. The $3M, and any accumulated income and gains held in the New Hampshire trust, will be creditor-safe. The trust's income should not be subject to Massachusetts income taxation – assuming the trust avoids Massachusetts source income and contacts with Massachusetts that would give the Commonwealth's taxing authorities the power to tax the trust under the statutory definition of "resident trusts" and state and federal constitutional "nexus" principles. The federal income tax on the trust's assets would be roughly the same as it would be if John and Mary continued to own the assets outright.

4. <u>The Pigs May Save State and Local Taxes, While the Hogs Will Almost Certainly Get Slaughtered</u>. State and local taxing authorities across the county are stepping-up their "nexus" audits in response to their state fiscal crises. Massachusetts tax collectors have been particularly aggressive lately. How can the state revenue commissioner in the ING trust settlor's state attack an abusive use of the ING strategy?

There are several theories available to revenue-hungry tax collectors, especially if you give them reason to assert that the transaction was designed primarily to avoid state income tax. There is also the chance that the widespread use of abusive ING trusts by residents of high tax states will encourage their legislatures to change their statutory definitions of resident trusts and grantor trusts to include these arrangements (as New York has recently done). If this happens, it is highly unlikely that existing ING trusts will be grandfathered (they were not in New York).

To address these issues, counsel your ING-inclined clients to avoid funding an ING trust with assets likely to be sold shortly after the creation of the trust (recall the timing-related caveat above in the discussion of John, our Massachusetts closely-held shareholder). Such a trust would be doubly vulnerable to attack if the sale were followed by the distribution of all, or a large portion, of the trust assets back to the settlor. The settlor's home-state taxing authority could view such a transaction as a "sham" and might attack it on the basis of substance over form, assignment of income, or some similarly elastic common law theory that the courts often allow the revenue commissioners to use whenever a strategy that appears to overreach is characterized as satisfying the letter, but not the spirit, of the tax laws.

In addition to risks under state tax laws, a pattern of regular distributions from an ING trust to the settlor could jeopardize the trust's creditor protection if there is evidence that the settlor had a prearranged agreement with the DC to distribute assets back to the settlor at a particular time. Optimally, an ING trust should be created only with the intent to continue the trust at least for the lifetime of the settlor. Settlors should be encouraged to refrain from transferring to the trust assets that the settlor will for living expenses. For creditor protection reasons, as well as prudent tax planning, advisors should caution that their clients that they should fund an ING trust only with "surplus" assets that the client likely will never need to tap, absent extraordinary events.