Steve Leimberg's Income Tax Planning
Email Newsletter Archive Message #111

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Subject: Ed Morrow, Geoff Germane and David Bowen on the Art of Using Trusts to Avoid Utah Income Tax

"Establishing a non-grantor, non-resident trust can often legitimately avoid state income taxes on traditional portfolio income, capital gains from sales of closely held C corporations, income from pass-through entities to the extent it can be apportioned to out-of-state property or out-of-state businesses, or even capital gains from pure "stock sales" of intangible pass-through entities such as S corps, LLCs, and LPs, regardless of the underlying property held by the entity.

Such is the certainly the case for Utah residents, who will be the focus of this newsletter. Surprisingly, even a Utah resident trust can often achieve the same savings, if it has a qualifying corporate trustee. The use of either completed gift or incomplete gift non-grantor trusts offers significant asset protection, family management, and even federal income tax benefits for Utah taxpayers whose income is anticipated to rise above the highest income tax bracket.

Practitioners in every state, but perhaps even more so in Utah, should consider the effect of trustee choice on state taxation when drafting and choosing trustees for bypass, marital or other continuing trusts post-mortem."

Ed Morrow, **Geoff Germane** and **David Bowen** provide members with their commentary that examines the art of using trusts to avoid Utah income tax. This is part of a series of newsletters to be published by **LISI**, spearheaded by Ed, highlighting trust income tax issues uniquely specific to various states, including source income rules for sales of pass through entities and susceptibility to Constitutional or other challenges. Future newsletters will cover Colorado, Oregon, Idaho, Ohio, New York and California. A few states with strict and Constitutionally-suspect taxing statutes will be amalgamated together

because they share the same fundamental planning hurdle, for example, West Virginia, Virginia, Vermont, Maine and others purport to tax a trust forever based on the settlor's residency at the time of funding.

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Now, here is their commentary:

EXECUTIVE SUMMARY:

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income tax benefits for Utah taxpayers whose income is anticipated to rise above the highest income tax bracket.

Practitioners in every state, but perhaps even more so in Utah, should consider the effect of trustee choice on state taxation when drafting and choosing trustees for bypass, marital or other continuing trusts post-mortem.

COMMENT:

Utah residents are patriotic and willing to pay taxes as a necessary price of living in such a great state, but most would feel just as proud paying half as much. This newsletter will focus on how Utah residents can legitimately avoid Utah income tax using trusts during their lifetime by using either incomplete and/or completed gift non-grantor trusts, and how such trusts can, at the same time, lead to charitable deductions superior to those produced by gifts made outside of trust. Due to sharply increased applicable exclusion amounts and dozens of recent private letter rulings from the IRS, the benefits of these trusts are more appealing than ever.[1] In addition, Utah has unique savings features for resident trusts administered in Utah by an in-state corporate trustee. We will explore when this exemption should be used and when non-resident trusts may still be a better alternative.

First, we will very briefly summarize how trusts are taxed at the federal level before explaining Utah's trust income tax scheme and the importance of being classified as a "resident" or "non-resident" trust. Then, we will address "source income" and situations where Utah may tax even non-residents and non-resident trusts that own Utah-sitused real estate, income, and businesses. More importantly, we'll discuss how this may often be avoided. Once we've determined Utah income tax savings, we'll revisit the two federal tax options available and distinguish between completed gift and incomplete gift options (a.k.a. DING trusts).[2] Lastly, we'll explore when these same trusts may save federal income tax, despite the common wisdom that trusts pay higher rates of income tax.

Federal Trust Income Tax Scheme

Many trusts, including all revocable trusts and even many irrevocable ones, are "grantor trusts" for income tax purposes, meaning they are not

considered separate taxpayers and all gains, income, losses, and deductions in the trust are attributable to the grantor.[3] Utah follows the federal grantor trust scheme.[4]

Trusts and estates have similarities to pass-through entities, but are taxed quite differently from S corporations and partnerships. To sum up a complex subject: usually, capital gains are trapped and taxed to the trust and other income is taxed to the beneficiaries to the extent distributed and to the trust to the extent not distributed.

Federal trust income tax rates hit the higher income tax brackets at much lower levels to the extent that income is trapped in trust and not passed out to beneficiaries on a K-1. The top 39.6% federal income tax bracket is reached at only $12,500 for tax year 2017.[5] The 3.8% net investment income tax is triggered by investment income over this same low threshold.[6]

Utah's Trust Income Tax Scheme: Differentiating Utah Resident and Non-Resident Trusts

Utah follows the lead of the federal scheme of trust taxation: if the trustee has to file a federal trust income tax return, it has to file a Utah trust income tax return.[7] Utah resident beneficiaries must report the income from the trust included in the beneficiary's federal adjusted gross income via K-1 as though the beneficiary received the income directly.[8] The Utah fiduciary income tax has the same top tax rate as the individual income tax (5%).[9] Avoiding Utah trust income tax is essentially a two-step process: either (1) avoid being a resident trust or avoid appointment of disqualifying trustees of a resident trust, and (2) avoid Utah source income.

Let's take the first step. Like most states, Utah tax law differentiates between resident trusts and nonresident trusts.[10] Utah's definition of a resident trust is extremely taxpayer-friendly and much narrower than in many states. Utah statue defines a "Resident Trust" in part as a "trust administered in this state," which in turn means that "the fiduciary transacts a major portion of its administration" in Utah.[11][12]

Thus, unlike many states, the "residency" of a Utah trust is not triggered by the in-state residency of the settlor and/or beneficiaries, the state law that applies under the terms of the trust instrument, or even the location

of trust assets (although the latter may matter for "source income," which is explained later).

Nonresident trusts are simply defined as those that are not resident trusts.[13] Thus, to form a nonresident trust, Utah residents merely need to find an out-of-state trustee who will transact less than a major portion of the trust administration inside of Utah and whose usual place of business is outside Utah. Local trust companies with single purpose out-of-state sister companies, such as KeyBank and Key National Trust Company of Delaware, have an edge because there can still be some local contact and incidental functions and meetings in Utah, while the major part of the trust administration is done out of state.

The taxable income of a resident trust is simply its gross federal income, modified by certain fiduciary adjustments.[14] Utah adjustments that are similar to those of other states include adding back income from municipal bonds issued by other states (unless there is reciprocity) and subtracting U.S. savings bond income.[15] Surprisingly, Utah does *not* start with federal *taxable income* (e.g. after charitable deductions), while most states with a separate trust income tax do. Thus, Utah is one of the least friendly states when it comes to encouraging charitable donations from trusts, not to mention attorney, accountant and tax preparer fees which most states permit as a full deduction, while Utah does not.[16]

There are a few subtractions from income that are truly unique to Utah law. Most notably, income of an irrevocable resident trust is subtracted from federal total income if:

> (i) the income would *not* be treated as state taxable income derived from *Utah sources* under Section 59-10-204 if received by a nonresident trust;
> (ii) *the trust first became a resident trust on or after January 1, 2004*;
> (iii) no assets of the trust were held, at any time after January 1, 2003, in another resident irrevocable trust created by the same settlor or the spouse of the same settlor;
> (iv) *the trustee of the trust is a trust company* as defined in Subsection 7-5-1(1)(d)… (Emphasis added).

This provides a significant tax incentive for Utah residents to either 1) name eligible trust companies as trustees for trusts, including garden-variety “AB” trusts, to enable the generous deduction noted above, or 2) use out-of-state trustees and avoid performing administration in state to avoid being a resident trust in the first place. Although this newsletter primarily discusses inter-vivos planning, the concepts herein also apply to the administration of a testamentary trusts or irrevocable grantor trust after the death of the settlor. Under either scenario (lifetime or post-death trusts), naming a non-qualifying Utah resident individual trustee or co-trustee is the worst of all worlds tax-wise, because it would fail to qualify for either exemption from Utah income tax.

This does not mean just any trust company or out-of-state trustee should be used. You do not want to name a California resident as trustee to simply exchange a 5% tax for a 13.3% tax. However, many states such as Wyoming, Washington, Alaska, Texas, Nevada, and Florida have no income tax. Many other states that are considered leading jurisdictions for trusts, such as Delaware or Ohio, have an income tax for their own residents, but would not impose a state income tax on an out-of-state trust merely because the trust’s choice of law, trustees, advisors, or primary administration is in state.[17]

Understanding Utah Source Income – When Can and Cannot Be Avoided

As noted above, certain Utah “source” income cannot be avoided regardless of whether a nonresident individual taxpayer, nonresident trust or resident trust meeting the corporate trustee exception receives the income.[18]

Utah taxes a nonresident trust in large part in the same manner as if the beneficiary had received the income directly if the income resulted from the ownership or disposition of tangible property (real or personal) in Utah or from the operation of a trade or business in Utah, including pass- through entities taxed as partnerships and S corporations.[19] Proration occurs when portions of a business are outside of state and portions inside of state.

This newsletter will ignore wages and compensation and focus on sales of intangible personal property (e.g., stock and LLC interests), which is the most likely corpus of a trust, the most likely candidate for large capital gain-triggering events and the most desirable candidate for tax

avoidance. It is also the part of the source income concept that is most difficult to understand.

C corporations are not pass-through entities, so the more complex sourcing rules will not apply.[20] A Florida or Ohio resident (or trust) will not necessarily pay Utah income tax on Huntsman Corporation stock (a C corporation) when it is sold, or pay Utah income tax on dividends received, but any C corporation has its own separate taxes to address. Most closely held businesses (even large ones), however, prefer to avoid the double tax system of C corps, which can be much more onerous overall, especially upon sale, distribution, or termination.

So let's assume for the remainder of this newsletter that we are dealing with a pass-through entity (an LLC, LP, or corporation taxed either as a sole proprietorship, partnership or S corporation). The ongoing income of a Utah pass-through entity with ongoing operations or real estate in Utah is clearly taxed.[21] This is proportionate to its Utah activities—income of a business operated solely in Utah will be taxed 100% in Utah; if half the business were in Idaho, only the 50% sourced to Utah would be taxed in Utah.

But, the sale of the stock (or LLC membership interest) of such entities is not necessarily taxed in Utah if the owners are out of state. Capital gain income from the sale of intangibles is traditionally allocated to the state of the taxpayer's domicile through the doctrine of *mobilia sequuntur personam.*[22] This is generally confirmed through Utah's adoption of the Uniform Division of Income for Tax Purposes Act (UDITPA).[23]

Thus, the sale of S corporation stock, even if the business has real estate or operations in Utah, is not Utah source income, unless the stock itself has acquired a business situs in the state.[24] This might occur if the stock is pledged for indebtedness used to carry on business in state, or if the stock itself is not a mere investment but used to further the business of the owner, or if the owner is in the business of buying and selling such stock. For most individuals or nonresident trusts, the stock is going to be a mere investment, not used to further the business of the owner.[25]

An Example of Possible Savings

Let’s start with a basic example that we will use throughout this newsletter: John Doe makes over $500,000 in annual taxable income (39.6% bracket, plus 3.8% or 0.9% Medicare surtax, a 23.8% capital gains rate, and the 5% Utah tax rate). John is married to Jane and both are Utah residents. He has $11 million in assets that he anticipates selling soon for a capital gain of $10 million. This might be a sale of depreciated real estate, a sale of closely held or publicly traded stock or limited partnership interests, or perhaps even a forced recognition of gain. John would like to explore options that might get around the $500,000 of Utah income tax. Let’s assume that John is not in the business of buying and selling such assets; they are instead held for investment. Can he use a trust to get around Utah income tax if the asset is a pass-through entity? Perhaps. The answer depends on the type of business, the structure of the deal, and whether a §338(h)(10) election is made (described below).

Let’s first examine the nature of the deal and why it matters for source income determination. If the sale will potentially create source income, then an inquiry into the nature of the operations may matter: how much of the property/sales/operations are in Utah? The design of the trust will be discussed in the next section.

Structure of the Sale – Asset Deal v. Stock Deal and §338(h)(10)

The structure of the deal matters—is John selling his stock or LLC interests in a “stock deal,” or is the firm selling in an “asset deal” whereby the buyers are purchasing all the assets of the company? Most buyers prefer to buy the assets of a company rather than stock so they can depreciate assets with a new cost basis and avoid latent liabilities of the selling entity. However, certain contractual obligations and benefits may require a stock deal to properly transfer; the pros and cons vary depending on the nature of the business, contracts, depreciable assets, and whether it is an S or C corp, etc.—many issues beyond the scope of this newsletter. Some buyers may be amenable to structuring a buyout as a stock deal and some may not even consider it, but often it is simply a matter of negotiation.

Let’s bypass that debate and summarize the asset deal for Utah income tax purposes. If all gains pass through to the owner of an LLC/LP/S corp in an asset deal, we are left with the conclusions noted above. That is, all of the gains and income attributable and apportioned to Utah will

pass through and be taxed to the owner, even if the owner is a nonresident individual or nonresident trust. For a small to mid-size business with operations and employees only in Utah, that's 100%. There would typically be no Utah income tax avoided by transferring such assets to a nonresident trust prior to an "asset sale," unless a significant percentage could be apportioned elsewhere, as with a truly interstate business.

If it is a "stock deal," the analysis is quite different and as noted above, the gain can largely be avoided. Let's say that John and his wife Jane have $11 million of $1 million basis real estate assets in an LLC or S corporation. They transfer the company interests to trusts, and the trusts sell the LLC membership interests (not the assets) to the buyer. The income from January 1 to the date of sale will pass through via K-1, and not avoid any Utah tax. But the $10 million capital gains can, and the savings are approximately $500,000.

There is a hybrid of the two types of deals, however, where the parties elect to treat a stock deal, which might be preferred for state law/contractual reasons, as an asset deal for tax purposes, pursuant to § 338(h)(10) of the Internal Revenue Code. Like an asset deal, this would likely lead to Utah source income. Thus, when we speak of stock deals that can effectively avoid Utah source income categorization, we are speaking more specifically of stock deals wherein the § 338(h)(10) election is not made.

Note that buyers receive a new cost basis for their outside basis in the stock or LLC membership interest, but that may not necessarily change the inside basis of the entity's assets, which is still relevant to ongoing operations. An LLC (or LP, LLP) taxed as a partnership, however, may elect to adjust its basis upwards to more accurately reflect the sale.[26] Most estate planning attorneys are familiar with this election in the context of the death of a partner, but it is also applicable to sales and exchanges.

Special Issues for S Corporations and Non-Grantor Trusts

In addition to the messy Utah tax issues for businesses, transferring an S corporation to a non-grantor trust has the added complications of forcing the trustee to make an Electing Small Business Trust (ESBT) election to ensure continued qualification as an S corporation.[27]

Special Issues for 3.8% Net Investment Income Tax

If a trustee of a non-grantor trust owns a pass-through entity, there are special considerations as regards to the 3.8% net investment income tax (at least, until Congress repeals it). As a general rule, this new surtax does not apply to business income if the investor is sufficiently active in an ongoing active business. By contrast, passive shareholders not involved in the business do pay the 3.8% tax on S corporation income. When and how is a non-grantor trust active or passive?

If the settlor is a passive owner, this may be an opportunity to avoid the surtax. If the trust appoints a co-trustee who is sufficiently active in the business, the 3.8% tax may be avoidable, but if the co-trustee chosen is an individual Utah resident, this may then trigger residency trust status. Whether and when nongrantor trusts and ESBTs can be "active" business investors and avoid the 3.8% surtax on business income is a complicated and still unsettled issue, but there is a high profile recent taxpayer victory in Tax Court.[28] So, while the precedent is promising, the issue is still open to IRS challenge and practitioners should not overpromise in this regard.

Protecting the Trustee from Having to Diversify While Avoiding Residency Status

Typically when corporate trustees hold custody of or manage special assets such as closely held entities, special accommodations must be made. This is because the Prudent Investor Act would otherwise require a trustee to diversify assets and neither the settlor nor the trustee may want the trustee to have to actively manage such assets prior to sale.[29] This requirement can be avoided in a number of ways.

Notably, an investment advisor or committee might be named to direct the trustee to hold or sell the stock, LLC interest, or other asset. Sometimes the settlor or immediate family is the investment advisor, at least for traditional domestic asset protection trusts. But, if the settlor/family were Utah residents fully managing the trust investments, this could lead to a finding that fiduciary decisions are made in Utah, that the advisor is a quasi-trustee, or that the trust is a Utah resident trust.[30] Thus, this design should usually be avoided.

The practitioner should use other methods, such as restricting sale and/or waiving the duty to diversify and gifting non-voting stock or

LLC/LP interests, or ensuring that an out-of-state resident has the role of investment advisor. Using an out-of-state LLC as investment advisor may offer a solution, but remember that LLCs may be "residents" where they do business, and if the managers/members are all in state and make pertinent decisions while in state, residency of the LLC would still be in question. Collectively, a variety of measures can preserve for the settlor the benefits of nonresident trust treatment while still using a Utah corporate trustee.

Structuring the Trust as an Incomplete or Completed Gift Non-Grantor Trust

Revisiting our example, let's say John has assets that would otherwise be able to avoid Utah source income upon sale if he were to change residency or if the assets were owned by a non-grantor, non-Utah resident trust prior to sale.

There are two basic trust designs that can be used: a trust structured as an incomplete gift, or one structured as a completed gift for federal gift tax purposes. A gratuitous transfer to a completed gift trust would count against the donor's $14,000 annual gift tax exclusion and the $5.49 million lifetime gift tax exclusion. If the value were beyond that, the excess would be subject to a 40% gift tax.[31] Note that if John's wife agrees to "gift split," the above exclusion amounts would be doubled.[32] By contrast, establishing an incomplete gift trust only causes a taxable gift to the extent that later distributions are made to individuals other than the settlor or spouse.

Let's tackle the more complicated first—the *incomplete gift*, non-grantor trust. These types of trusts are colloquially known as DING trusts (Delaware Incomplete Gift Non-Grantor Trusts), based on the original private letter rulings, which used Delaware trusts, and subsequently written articles.[33] PLRs with such structures have also considered Alaska and Nevada law, and there is no reason that the laws of other states such as Ohio or Wyoming might not also be appropriate, though Delaware is still probably the most commonly used.

The design of these trusts is slightly more complicated than most 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 access to the trust as a potential beneficiary. Either goal by itself is rather easy for

any experienced practitioner to accomplish. All three at once requires some agility.

This newsletter will not go through the DING design in depth, but patterned after the dozens of PLRs released in recent years, it is a trust with several unique features to enable the above characteristics.[34]

So how does this DING trust function? The management and reporting work like with any trust, but the distribution provisions are unique. During the settlor's lifetime, a distribution committee uses a jointly held limited power of appointment to appoint cash or property, in lieu of a traditional trustee spray power or direction from the settlor. In addition, the settlor retains a limited power. Together, there is ample flexibility to make distributions – indeed, more flexibility than most trusts.

The settlor and/or spouse or children would only be entitled to funds during the settlor's lifetime as a result of a lifetime limited power of appointment, rather than via the trustee's discretion. This is necessary to prevent grantor trust status.

Thus, Utah income tax can be avoided to the extent income is trapped in trust and distributable net income is not distributed via the power of appointment to Utah resident beneficiaries in the year in which the income is earned. Importantly, Utah does not have throwback rules similar to California and New York that might otherwise try to tax income accumulated and taxed to the trust in prior tax years, nor does it have a specific rule regarding incomplete gift trusts like the one recently passed in New York.[35]

To illustrate the tremendous importance of the lack of a throwback rule, let's say John's trust sold $11 million of assets in 2016 for a $10 million gain. It would incur and pay approximately $2.38 million in federal capital gains tax (23.8%, ignoring exemption, deduction and meager lower brackets), if it makes no further distributions in 2016, and avoids the $500,000 in Utah tax assuming it is not otherwise a Utah resident trust with disqualifying Utah resident fiduciary or administration, as discussed above.[36] In 2017, there is a "clean slate." If the trust makes $30,000 in dividends and interest from January 1 to July 1, 2017, and on that date—to take an extreme and not necessarily recommended case—distributes the entire amount of the trust to Utah resident beneficiaries, the only amount on the K-1 for the beneficiaries subject to Utah tax is the $30,000 of *2017* income.

If large distributions were made in 2016, the same year of the large capital gain, Utah income tax on the gain may be avoided anyway. Recall the general rule discussed above for non-grantor trusts: capital gains are generally trapped in trust, unless one of the three exceptions to the general rule applies.[37] As a result, if in 2016 the trust incurred $10 million of capital gain along with $45,000 of interest, dividends, and rents, and the trustee distributed $2 million, the amount of the beneficiaries' K-1 income may well be limited to $45,000.

In this example, John keeps just enough control via lifetime and testamentary powers of appointment to make the gift incomplete and keep the ultimate beneficiaries in line, but not so much as to cause grantor trust status. Retaining a veto/consent power, lifetime limited powers of appointment, and allowing the children to act without settlor consent only unanimously gives just as much if not more access to the trust as if John and Jane were named beneficiaries. Therefore, with a modicum of creativity, we can use an incomplete gift nongrantor trust (ING) to legitimately avoid Utah taxation of trust income except to the extent a current year's income is part of distributable net income distributed via K-1 to a Utah resident beneficiary or to the extent it is Utah source income.

While there are dozens of DING PLRs on the books now, some practitioners may be nervous about drafting such trusts. After all, if the tax laws were obvious, some would argue, there would not be so many people seeking PLRs! While many attorneys are comfortable drafting such trusts based on the reasoning and statutes/regulations cited in the PLRs, some may not be. Are there other options?

Completed Gift, Non-Grantor Trusts

With $5.49 million of gift tax applicable exclusion, potentially $10.98 million for married couples (adjusting annually for inflation), some clients may not care about using up some of their estate/gift exclusion. Using completed gift trusts may have the double benefit of leveraging estate tax exclusion, removing growth from the federal estate tax base, and potentially saving state estate tax if the assets comprising trust corpus are located in a state with a separate estate tax (e.g., a Utah resident has a vacation home in Oregon or Maine).

To create a completed gift non-grantor trust, you simply use a DING without the features that make the gift incomplete (or alternatively,

remove or add the provisions in your standard irrevocable grantor trust that make it a grantor trust). This would mean removing settlor limited powers of appointment and veto powers, and keeping the adverse party distribution structure for any distributions to the settlor and/or spouse to avoid grantor trust status.

Some practitioners may feel more comfortable with such trusts being less "cutting edge" or susceptible to adverse ruling. And they would certainly provide additional estate tax benefits in some cases. However, completed gifts trusts would potentially be wasteful of estate/gift exclusion to the extent funds were eventually returned to the settlor's/spouse's estate tax base, and funding by gift would of course be limited to the amount of exclusion available. There are ways to leverage such amounts, but that discussion is beyond the scope of this newsletter. Suffice it to say that the incomplete gift trust is more palatable for wealthier clients, but the completed gift trust may also be part of the solution, or potentially the only solution needed for those with estates well under $10.98 million.

Practitioners should be cautious about the income tax effect of *Crummey* powers. A *Crummey* power is a withdrawal right that typically lapses after 30-60 days.[38] If a settlor gifts to what would otherwise be a non-grantor trust, but the trust contains *Crummey* powers, the trust will be either a fully or partially beneficiary-deemed owner trust (aka beneficiary-grantor trust), pursuant to the grantor trust rules.[39] To the extent it is a beneficiary-deemed owner trust, this would trigger state income tax based on the residency of the various beneficiaries whether they took any money or not, similar to a pass-through corporate entity.[40] This structure could be much more complicated, and lead to problematic phantom income to the beneficiaries if the trust does not distribute enough to pay the beneficiary's tax.

When Non-Grantor Trusts Are More Efficient for Federal Income Tax Regardless of State Income Tax Treatment

Although trusts reach the highest 39.6% bracket and 3.8% surtax bracket at only $12,500, if settlors are otherwise in that same bracket, there are features that make non-grantor trust taxation more attractive. Despite the Supreme Court's decision in *Knight,*[41] the opportunity still exists for trusts to claim better above-the-line deductions than individuals.[42]

For those charitably minded, the benefit is even more pronounced. Deductions to charity from a trust's gross income are not limited to U.S. domestic charities, are not subject to any AGI limitation, and are not subject to "Pease" limitations.[43] Furthermore, they are eligible for a one-year lookback.[44] Imagine if we could make a donation in December 2017 and make it count against our 2016 income! Furthermore, trust provisions can enable deductions to offset categories of income subject to higher income tax rates, provided the provision has an economic effect on the amount the charity could receive.

More importantly, there is a far superior opportunity to shift income to beneficiaries in lower tax brackets (e.g., if a distribution is made that carries out capital gains or qualified dividends to a beneficiary in one of the lower tax brackets, their federal tax rate on this income is 0%). This threshold is higher than many people think. For a married beneficiary filing jointly, this bracket is up to $75,900 of taxable income (which is after deductions, so this may be a much higher AGI or gross income). Thus, if the trust makes distributions of $28,000 to three children in such lower brackets, the $84,000 passes free of gift tax, due to the annual exclusion (assuming the settlor and spouse gift split), and shifts $84,000 to children in a 0% tax bracket. In practical effect, this generates an income tax deduction for annual exclusion gifts to the kids.

Let's go back to our example with John and Jane with the $11 million trust incurring a $10 million gain. Let's say the family trust distribution committee decides to contribute $1 million of this income to their church or favorite charity or even to a donor advised fund to dole out among several charities. In addition, John and Jane have three children and seven grandchildren. The distribution committee decides to contribute $28,000 to each of the ten descendants. The $1 million reduces the trust's income. Unlike for individuals, it even reduces income for the 3.8% Medicare net investment income tax (a.k.a. Obamacare surtax), and it is not reduced for any "Pease" limitations. The $280,000 is distributed free of gift tax (provided other gifts are not made) and carries out income to the beneficiaries payable at *their* tax rate. If one or more of the children is in the top tax bracket, there are still tax savings since the grandchildren's income under the "kiddie tax" is still not subject to the 3.8% surtax. These two features of non-grantor trust taxation can offer significant savings even aside from the Utah income tax savings.

By contrast, had our hypothetical sale occurred outside of the trust and been taxed to John and Jane, their charitable deduction would be severely curtailed for both federal and Utah state income tax purposes, and would not save a dollar of 3.8% Medicare surtax. Moreover, their gift to the children and grandchildren would not reduce John's and Jane's income at all, nor cause any of the income to be taxed at the younger family members' lower rates.

Conclusion

To summarize, establishing a non-grantor, non-resident trust can legitimately avoid the 5% Utah income taxes on traditional portfolio income, including capital gains from sales of closely held C corps, income from pass-through entities to the extent it can be apportioned to out-of-state property or out-of-state businesses, or capital gains from pure "stock sales" of intangible pass-through entity assets such as S corps, LLCs, and LPs. These savings can also be realized even with a Utah resident trust if it has a qualifying corporate trustee, and in some cases this may be preferred.

The use of either completed or incomplete gift non-grantor trusts discussed above offers significant asset protection, family management, and even federal income tax benefits. Utah taxpayers for whom such a strategy is most useful are those who anticipate future income to be well over the highest income tax bracket, but it may also be useful for those intending to make large charitable contributions or who desire to shift income tax through gifts to beneficiaries.

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

Ed Morrow

Geoff Germane

David Bowen

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[1] Federal tax rules for trusts are primarily found in Subchapter J of the Internal Revenue Code, IRC §§ 641-692. As of 2013 the top federal income tax bracket of 39.6% (20% for long-term capital gains and qualified dividends) start at $400,000 taxable income for singles, $450,000 married filing jointly, which annually adjust upwards for inflation, in 2015 these start at $413,201 and $464,851 respectively. The additional Medicare surtax on net investment income of 3.8%, which acts in many ways like an income tax, starts at $200,000 and $250,000 modified AGI respectively.

[2] Incomplete Gift, Non-Grantor Trusts are commonly known as "DING" trusts, for Delaware Incomplete Non-Grantor Trust, though other states such as Ohio, Nevada, South Dakota, Alaska might be used, and the list of these seems to increase nearly every year.

[3] See IRC §§ 671-679, especially § 671 for general rules.

[4] Utah Code Ann. § 59-10-103(1)(a), (w); § 59-10-104(1).

[5] IRC § 1; For inflation adjusted brackets, see Rev. Proc. 2014-61 at http://www.irs.gov/pub/irs-drop/rp-14-61.pdf.

[6] IRC § 1411(a)(2).

[7] Utah Code Ann. § 59-10-504.

[8] Instructions Form TC-41 at page 3.

[9] Utah Code Ann. § 59-10-201(1), referencing § 59-10-104(2)(b).

[10] *See* UT Form TC-41, available at http://tax.utah.gov/forms/current/tc-41inst.pdf.

[11] For purposes of this provision, the term "fiduciary" means "trustee" or "any person acting in any fiduciary capacity" for the trust. See Utah Code Ann. §59-10-103(1)(g) and §75-1-201(16). See also instructions to 2014 UT Form TC-41 at page 2.

[12] Utah Code Ann. § 75-7-103(1)(iii). *See* Instructions to 2014 UT Form TC-41 at 3.

[13] Instructions to 2014 UT Form TC-41 at page 3.

[14] Utah Code Ann. § 59-10-201.1.

[15] Utah Code Ann. § 59-10-202(1), (2).

[16] There is a provision for a deduction for non-grantor charitable lead trusts in Utah Code Ann. § 59-10-202(2)(g), but this provision oddly ignores other non-grantor trusts that may have charitable provisions, which are generally honored in most other states.

[17] For example, see Ohio Department of Taxation Information Release TRUST 2003-02 - Trust Residency — February 2003 http://www.tax.ohio.gov/ohio_individual/individual/information_releases/trust200302.aspx.

[18] See definition in Utah Code Ann. §59-10-117.

[19] *Id.*

[20] *Id.* § 59-10-117(2)(a).

[21] Utah Code Ann. § 59-10-117(2)(d),(f), and (g).

[22] Latin for "movables follow the person"

[23] Utah Code Ann. §59-10-118. See also Uniform Division of Income Tax Purposes Act (UDITPA) at http://www.uniformlaws.org/shared/docs/uditpa/uditpa66.pdf

[24] *See* Utah Code Ann. § 59-10-118(1)-(3) for some explanation of business versus nonbusiness income and commercial domicile.

[25] That is, for most individuals, the sale of an LLC or S corporation would be non-business income per Utah Code Ann. §59-10-118(1)

[26] *See* IRC § 743(b) and IRC §754.

[27] IRC §1361(e).

[28] *Frank Aragona Trust v. Comm., 142 T.C. 9* available at http://www.ustaxcourt.gov/InOpHistoric/FrankAragonaTrustDiv.Morrison.TC.WPD.pdf. See also *Mattie K. Carter Trust v. United States,* 256 F. Supp.2d 536 (N.D. Tex. 2003). Both were taxpayer victories, but the IRS does not like the idea, see Technical Advice Memorandum 2013-17010.

[29] Utah's Uniform Prudent Investor Act, at Utah Code Ann. § 75-7-901, et seq., specifically §75-7-903 for diversification.

[30] *See* instructions to 2014 UT Form TC-41 at 3.

[31] The available exclusion amount accounts for prior taxable gifts, adjusts annually for inflation, and could be increased up to double with the Deceased Spousal Unused Exclusion (DSUE), gifts split with a spouse, or a trust jointly settled with a spouse.

[32] Great caution must be used with gift splitting—and indeed may not be available—when the spouse is also a beneficiary. See, e.g., Rev. Rul. 56-439 and *Robertson v. Commissioner*, 26 T.C. 246 (1956).

[33] *See e.g.,* early PLRs 2001-48028, 2002-47013, 2005-02014, 2006-12002, 2006-37025, 2006-47001, 2007-15005, 2007-29025, 2007-31019.

[34] See various presentations by author on this subject for more detail, such as those available at www.ultimateestateplanner.com. 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 2014-36032; PLRs 2014-40008 to 2014-40012, PLR 2015-10001 – 2015-10008, PLR 2015-50005, PLR 2016-13007, PLRs 2016-36027 to 2016-36032. General design features of an ING are:

1) The settlor retains a lifetime and testamentary limited power of appointment solely exercisable by him/herself. It is designed to help make the gift incomplete yet be curtailed enough so as not to trigger grantor trust status. Lifetime distributions to appointees are limited to a standard such as health education, maintenance and support to prevent grantor trust status.

2) There is a distribution committee comprised of adverse parties (beneficiaries) – 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 tax effects to the powerholders or grantor trust status as to powerholders.

3) There is a veto/consent power unless the distribution committee unanimously overrules the settlor – this is necessary to make the gift incomplete.

4) The trust is established in a state that permits self-settled trusts (aka domestic asset protection trust) – this is designed to prevent grantor trust status via indirect settlor access and ensure asset protection for both settlor and power holders.

[35] N.Y. Tax Law §612(b)(41).

[36] This is assuming there is not an alternative Utah "source" trigger.

[37] *See* IRC § 643 and Treas. Reg. §1.643(a)-3. For extensive discussion of how the trustee and family can manipulate this, or use beneficiary grantor trust status to alternatively shift, trap or toggle income between trusts and beneficiaries, *see* The Optimal Basis Increase and Income Tax Efficiency Trust, a white paper that incorporates several published articles, available at http://ssrn.com/abstract=2436964, or by contacting Ed Morrow at edwin.morrow3@gmail.com or edwin_p_morrow@keybank.com.

[38] For an article discussing the concept and history as applied in the most recent tax court case, see *Ed Morrow and Alan Gassman on Mikel v.*

Commissioner: Tax Court Approves the Mother of All Crummey Trusts with 60 Beneficiaries, LISI Estate Planning Newsletter #2309 (May 14, 2015).

[39] IRC §678(a) and (b).

[40] See IRC §671 for general rules.

[41] *Knight v. Commissioner,* 552 U.S. 181 (2008).

[42] E.g. IRC § 67(e).

[43] Pease limitations do not apply to non-grantor trusts and estates. IRC § 68(e).

[44] See Treas. Reg. § 1.642(c)-1.