Non-Grantor Trust: A Tool for Estate, Asset Protection and Income Tax Planning

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While there are many forms and types of trust, this article highlights some of the various beneficial structures that encompass the use of non-grantor trusts. The use of non-grantor trusts to achieve estate, asset protection and income tax planning should be customized to address specific facts, assets and needs.

Trusts are a centuries old vehicle originating from England used to allow an individual to transfer assets for the benefit of one or more beneficiaries. The settlor or grantor of the trust transfers the assets to a trustee to be held in trust. The trustee is tasked with managing, preserving and growing the assets based on the intent and instructions of the grantor set out in the trust.

A non-grantor trust can be an irrevocable trust that allows the grantor to transfer assets by gift or sale for the benefit of beneficiaries. This type of trust severs the ownership of the assets from the grantor and potentially excludes them from the grantor’s estate, thereby potentially avoiding estate and inheritance taxes. To achieve exclusion from such taxes and create an effective non-grantor trust, the grantor must not have retained rights, interests or powers over the trust assets.

A trust generally details directions to the trustee as to distribution of income and principal based on facts such as:

- Beneficiary age
- An ascertainable standard relying on the health, education, maintenance and support of the beneficiary
- Or the complete discretion of the trustee.

Properly structured, the limitations and restrictions on distributions are an effective asset protection mechanism that could shield the trust assets from the trust beneficiaries’ creditors and, in some cases, exclude such assets from a marital estate in the event of divorce. In effect and practice, a creditor is not able to force a trustee to distribute assets to him or her when such distribution would be inconsistent with or outside of the scope of the trustee’s enumerated powers.

ADDITIONAL PROTECTION

As additional protection, a non-grantor trust can be settled in state that offers heightened asset protection. Individuals who may have a greater need for aasset protection include those with a substantial estate or those with a profession that exposes them to a heightened risk for liability. States such as Delaware, Nevada, South Dakota, Wyoming, and Alaska have statutes that protect trust assets in trusts set up to benefit the grantor or settlor, sometimes called “self-settled”. To obtain the protection of the statute, there must be appropriate legal nexus, meaning, the trustee of the non-grantor trust must be located in that state and the

administration of the trust assets must likewise occur there. Other requirements for nexus may apply under state law. If the trust has tax nexus to a state that does not have an income tax or does not impose an income tax on the trust's income, establishing nexus there may also afford the trust state income tax savings.

ADDITIONAL INCOME TAX BENEFITS

Having designed a non-grantor trust to achieve one's estate and asset protection planning objectives, a sophisticated tax planner should then consider potential additional income tax benefits. For income tax purposes, a non-grantor trust is treated as a separate taxpayer and the trust's income and losses of the trust do not get included on the grantor's income tax return. While achieving estate and asset planning objectives, the ability to create a trust that is treated as a separate taxpayer provides an opportunity for income tax incentives or deductions that are limited by caps or whose benefit is limited by certain thresholds. It is important to note that the requirements for a non-grantor income tax trust are somewhat different from the estate tax test for a non-grantor trust.

For instance, the current federal income tax deduction for state income and property deduction is limited to $10,000. If, for estate and asset protection planning purposes, a taxpayer transferred ownership of the taxpayer's real estate to a limited liability company ("LLC") and the LLC interests were transferred to a series of non-grantor trusts for the benefit of family members who align with the intended taxpayer's estate plan beneficiaries, each trust would own a portion of the real estate and be responsible for a proportionate part of the property tax. As a non-grantor trust, each trust could separately claim up to the $10,000 state income and property tax deduction and expose more or all of the property tax liability to the state income tax deduction.

Likewise, similar planning could be achieved with business interests that could otherwise benefit from the Internal Revenue Code ("IRC") section 199A deduction. At a high-level, this deduction offers businesses a deduction of 20% of qualified business income. The benefits of this deduction, however, are curtailed or limited for certain businesses if a single or married filing jointly taxpayer's income exceeds $157,500 and $315,000, respectively. If the business interests were strategically held by multiple non-grantor trusts that aligned with the taxpayer's estate plan, it could be possible to expose a greater amount of income to the IRC section 199A deduction.

These examples highlight some potential income tax benefits that can accompany estate and asset protection planning using non-grantor trusts. The added benefit of income tax savings furthers one's estate planning by increasing the value of the assets not only from natural appreciation, but from tax savings. In sum, such planning allows for all such appreciation to be outside of the grantor's estate for estate tax and asset protection purposes.

As with any type of planning, there are many factors that need to be considered. For instance:

- The cost to establish and maintain the trusts must be justified by the economic and intangible benefits of creditor protection
- Realty transfer taxes may be triggered as part of a transfer of real estate assets, especially if the real property is encumbered by a mortgage.

Special care must be taken to meet a series of legal standards and limitations.

Past experience between my law firm and Capaldi Reynolds suggests that synergy between your tax and legal advisors help foment the opportunity for successful, sophisticated planning for your and your family's ultimate benefit. Let us plan for you.

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