How incomplete nongrantor trusts can help avoid state income taxes

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With the federal gift and estate tax exemption at $11.40 million for 2019, people whose estates are below the exemption amount are shifting their focus to income tax reduction. High-income taxpayers — particularly those who live in high-income-tax states — may want to consider incomplete nongrantor trusts, which make it possible to eliminate state taxes on trust income.

Defining an incomplete nongrantor trust

Generally, trusts are classified as either grantor trusts or nongrantor trusts. In a grantor trust, you, as "grantor," establish the trust and retain certain powers over it. You're treated as the trust's owner for income tax purposes and pay taxes on income generated by the trust assets.

In a nongrantor trust, you relinquish certain controls over the trust so that you aren't considered the owner for income tax purposes. Instead, the trust becomes a separate legal entity, with income tax responsibility shifting to the trust itself. By setting up the trust in a no-income-tax state (typically by having it administered by a trust company located in that state), it's possible to avoid state income taxes.

Ordinarily, when you contribute assets to a nongrantor trust you make a taxable gift to the trust beneficiaries. By structuring the trust as an *incomplete* nongrantor trust, you can avoid triggering gift taxes, or tapping your gift and estate tax exemption. This requires relinquishing just enough control to ensure nongrantor status, while retaining enough control so that transfers to the trust aren't considered completed gifts for gift-tax purposes.

Analyzing the benefits

Although the trust will allow you to receive distributions, assets you place in the trust should produce income that you don't need. If you take money out, trust taxable income could follow to you and be taxed in your state of residence.

Incomplete nongrantor trusts aren't right for everyone. It depends on your particular circumstances and the tax laws in your home state.

While this strategy can produce significant state income tax savings, it may increase federal income taxes, depending on your individual tax bracket. Nongrantor trusts pay federal income taxes at the highest marginal rate (currently, 37%) once income reaches $12,700 for 2019, while the 37% rate threshold is $612,350 for married couples filing jointly and $510,300 for singles and heads of households. If you're not in the 37% bracket, the increased federal income taxes the incomplete nongrantor trust would pay might outweigh the state income tax savings.

Also, if federal estate taxes aren't a concern now but could be in the future — such as if your estate could exceed the estate tax exemption when it drops to an inflation-adjusted $5 million in 2026, as currently scheduled — be sure to consider the potential estate tax consequences. Incomplete gifts remain in your estate for estate tax purposes.

Historically, these trusts were structured as incomplete nongrantor trusts so that, as mentioned above, transfers to such a trust would be treated as incomplete gifts, meaning that such transfer that wouldn't trigger a gift tax or use gift tax exemption. In the past, when many of the incomplete nongrantor trust concepts were first developed, the gift tax exemption was much smaller (e.g., $1 million), which very wealthy people already had used. Accordingly, they wanted the transfers to such a trust to be incomplete for gift tax purposes.

Because the current exemption amount will likely sunset in 2026 and decrease from $10 million inflation adjusted to half that, or $5 million inflation adjusted, or perhaps sooner depending on the political situation in Washington, rather than structuring the trust as incomplete, it might be more useful to structure the trust so that transfers to it will be treated as completed gifts, thereby using the existing high gift tax exemption before it decreases. The IRS recently issued proposed regulations suggesting that if the current exemption is used with a completed gift, when the exemption is reduced in the future, there will be no recapture or clawback of the excess exemption used.

Is it right for you?

To determine whether an incomplete nongrantor trust is right for you, weigh the potential state income tax savings against the potential federal estate and income tax costs. Please contact us with any questions.

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