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NOT YOUR ORDINARY TRUSTS: WHAT YOU NEED TO KNOW ABOUT SLANTS, BDITS AND OTHER NONCONVENTIONAL ESTATE PLANNING TECHNIQUES

SOUTHERN ARIZONA ESTATE PLANNING COUNCIL

October 16, 2024

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*Special thanks to David Allen, Stephanie Ross and Jack Bradley of Katten Muchin Rosenman LLP for assistance with these materials

AGENDA

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2. Spousal Lifetime Access Non-Grantor Trusts
3. Beneficiary Defective Inheritor's Trusts
4. Beneficiary Deemed Owner Trusts
5. Incomplete Gift Non-Grantor Trusts
6. Finishing Thoughts and Questions

SPOUSAL LIFETIME ACCESS NON-GRANTOR TRUSTS ("SLANTS")

Introduction to SLANTs

The estate planner's everyday trust (not the topic of this presentation) is the Spousal Lifetime Access Trust ("SLAT"). A SLAT allows client to make a completed gift into trust during life and still indirectly access the gifted property by spouse taking a distribution if necessary. The beneficiaries of the SLAT are client's spouse or spouse and descendants/other beneficiaries.

SLANTs are Spousal Lifetime Access Nongrantor Trusts— so SLATs structured as non-grantor trusts.

- Unlike SLATs, where the grantor remains liable for income taxation for the trust, a SLANT is a non-grantor trust and is a distinct taxpaying entity that pays its own income tax.
- A SLANT is a tricky because the grantor trust provisions of the Internal Revenue Code ("IRC") provide that if the grantor or the grantor's spouse retain sufficient control and/or use over the property, the trust will be a grantor trust.
- SLANTs live in the exceptions to the IRC and the Regulations.

SPOUSAL LIFETIME ACCESS NON-GRANTOR TRUSTS ("SLANTS")

Introduction to SLANTs

SLANTs are irrevocable and held for the benefit of the grantor's spouse and descendants or other beneficiaries.

Trust assets contributed to a SLANT, and their appreciation in value, are not included in the grantor's gross estate.

- If assets are gifted to a SLANT, the grantor's lifetime gift exemption is allocated to the gift.
- If assets are sold to a SLANT, the sale is a taxable sale— an income tax realization event. Grantor is liable for income tax on gain triggered in the sale and the promissory note interest payments.

SPOUSAL LIFETIME ACCESS NON-GRANTOR TRUSTS ("SLANTS")

Fine Line In the IRC

IRC §§ 671-679 outline the rules of the road to be deemed a non-grantor trust.

If a grantor retains certain powers or interests in the trust, then all or a portion of the trust will be deemed a grantor trust. Those retained powers include:

- A reversionary interest in trust corpus or income which is worth more than 5% of the initial value of the corpus or income. IRC § 673.
- A power affecting beneficial enjoyment of trust corpus or income. IRC § 674.
- Certain administrative powers affecting the disposition, borrowing, or investment of trust property. IRC § 675.
- A power to revoke the trust. IRC § 676.
- A right to receive current or future distributions of trust income. IRC § 677.
- The trust can be deemed a "grantor trust" with respect to someone other than the grantor, if that person has the power to withdraw property from the trust. IRC § 678.

See appendix A for checklist for non-grantor trust status (not specific to SLANTs)

SPOUSAL LIFETIME ACCESS NON-GRANTOR TRUSTS ("SLANTS")

Fine Line In the IRC

SLANTs allow for distributions to the grantor's spouse, while maintaining non-grantor trust status by requiring consent of "adverse parties" for distributions to the grantor's spouse.

Adverse Party: Any person with a substantial beneficial interest in the trust that would be adversely affected by the exercise or nonexercise of the power held. Underlying assumption is that the adverse party is likely to act in his or her own best interest when making decisions related to trust property rather than acting on the grantor's behalf.

A person can be adverse with respect to a portion of a trust only. A trust can be a grantor trust with respect to income and not principal, so beware an accidental part grantor trust.

SPOUSAL LIFETIME ACCESS NON-GRANTOR TRUSTS ("SLANTS")

When to use a SLANT

- SLANTs offer similar asset protection and estate planning benefits as SLATs.
- SLANTs remove trust assets from the grantor's taxable estate, while keeping trust assets indirectly accessible to the grantor's spouse.
- Some states, including NY and CA, have passed legislation against incomplete gift non-grantor trusts (INGs). For those seeking the state income tax benefits, SLANTs become a viable alternative in these states. Not an opportunity in IL.



SPOUSAL LIFETIME ACCESS NON-GRANTOR TRUSTS ("SLANTS")

When to use a SLANT

- SLANTs can also be used in complicated marital situations:
 - To comply with a pre or post nuptial agreement
 - To fix the IRC 672(e) divorce trap
 - In blended family situations, to separate what spouse might receive vs what children from prior marriage might receive and siphon income tax liability
- If you are crazy (in the author's opinion) and searching for more capped deductions or in 199A planning. The "SALT-y SLANT"



SPOUSAL LIFETIME ACCESS NON-GRANTOR TRUSTS ("SLANTS")



Qualified Small Business Stock ("QSBS") and "Stacking"

- Every qualified shareholder is limited to one \$10 million exemption for gain on the sale of QSBS under §1202 of the Code. The \$10 million exemption is granted to each qualifying taxpayer.
- By gifting QSBS to a nongrantor trust, there will be a new \$10 million exemption. Multiple nongrantor trusts could be created including SLANTs created by each spouse for the benefit of the other (commonly referred to as "stacking").
- Since the trust must be a separate taxpayer, a grantor trust will not provide another exemption.

SPOUSAL LIFETIME ACCESS NON-GRANTOR TRUSTS ("SLANTS")

Qualified Small Business Stock ("QSBS") and "Stacking"



- Beware the multiple trust rules. § 1.643(f)-1. For purposes of fiduciary income tax rules under Subchapter J, two or more trusts will be aggregated and treated as a single trust if such trusts have substantially the same grantor/grantors, substantially the same primary beneficiary /beneficiaries and a principal purpose for establishing one or more of such trusts or contributing additional assets to the trust is the avoidance of federal income tax. For purposes of applying this rule, spouses are treated as one person.
- Act early
 - Gifting shares early when they are relatively low in value enables huge amounts of wealth to be gifted while using up little lifetime gift exemption.
 - The growth of trust assets in a SLANT is not includable in the grantor's taxable estate for estate tax purposes.

SPOUSAL LIFETIME ACCESS NON-GRANTOR TRUSTS (“SLANTS”)

Qualified Small Business Stock (“QSBS”) and “Stacking”

- Example: John and Jane have three children. Jane creates 3 SLANTS—one for the benefit of each of her three children with John included as a beneficiary of each. Jane gifts \$1 million of qualified stock to each trust (only using \$3 million of her lifetime gift exemption). The assets transferred to the trusts grow over time to \$30 million. John and Jane are able to create an additional \$30 million in QSBS exemption by “stacking” additional \$10 million exemptions.

	Not Stacking	Stacking
Total Qualified Stock	\$100 million	\$100 million
QSBS Exemption	\$10 million*	\$40 million*
Federal Estate and Gift Tax Exemption	\$27.22 million (for married couple)	\$27.22 million (for married couple)
Federal Tax Bill	\$25.875 million	\$17.25 million

*= the law is unclear on whether spouses have 1 \$10 million exemption or 2. These illustrations assume 1 exemption total

SPOUSAL LIFETIME ACCESS NON-GRANTOR TRUSTS ("SLANTS")

Risks and Drawbacks

- Any distribution to the grantor's spouse must be approved by an adverse party to avoid the SLANT being treated as a grantor trust.
- SLANTs are irrevocable so the grantor must be comfortable relinquishing control of the trust assets.
- SLANTs usually do not qualify for the unlimited marital deduction so gifts to SLANTs use the grantor's lifetime gift tax exemption. Theoretically possible to structure as QTIP, but tricky.
- Must "walk the walk"
 - Even with proper drafting, the trust must be administered correctly or it may be later characterized as a grantor trust.
- Non-grantor status is not always better than grantor status
 - Grantor trusts allow for the grantor to effectively give free gifts to their descendants in the form of paying taxes on trust income, which provides additional estate/gift tax savings. The estate/gift tax is higher than the income tax, so an overall net tax savings analysis is important.
- Despite a SLANT being treated as a separate taxpayer, trusts reach the highest income tax bracket much quicker than individuals.
- If not drafted properly, upon divorce, the grantor's ex-spouse can still benefit from the SLANT and the donor spouse may lose indirect access.

BENEFICIARY DEFECTIVE INHERITOR'S TRUSTS ("BDITS")

Overview of Beneficiary Owned Trusts

Typical grantor trusts are taxable from an income tax perspective to the grantor of the trust under §§ 671-679.

Under §678, the trust can be taxed from an income tax perspective to the beneficiary:

(a) General Rule. A person other than the grantor shall be treated as the owner of any portion of a trust with respect to which:

(1) such person has a power exercisable solely by himself to vest the corpus or the income therefrom in himself, or

(2) such person has previously partially released or otherwise modified such a power and after the release or modification retains such control as would, within the principles of Sections 671 to 677, inclusive, subject a grantor of a trust to treatment as the owner thereof.

(b) Exception Where Grantor Is Taxable. Subsection (a) shall not apply with respect to a power over income, as originally granted or thereafter modified, if the grantor of the trust or a transferor (to whom Section 679 applies) is otherwise treated as the owner under the provisions of this subpart other than this Section.

We will discuss two types of beneficiary-owned trusts:

- BDIT: Beneficiary Defective Inheritor's Trust
- BDOT: Beneficiary Deemed Owner Trust

BENEFICIARY DEFECTIVE INHERITOR'S TRUSTS ("BDITS")

The Basic Technique

Third party creates a Trust for benefit of Beneficiary and funds it with \$5,000.

Beneficiary is given power to withdraw all contributions without a lapse of the right constituting a gift from the Beneficiary to the Trust.

Beneficiary becomes the deemed owner of the Trust from an income tax perspective under §678(a)(1) while the withdrawal power exists and under §678(a)(2) after it lapses.

Beneficiary then sells assets to the Trust in exchange for a promissory note without gain recognition.

BENEFICIARY DEFECTIVE INHERITOR'S TRUSTS ("BDITS")

Potential Benefits BDITs

- Appreciation of assets sold to Trust grow estate tax-free.
- Beneficiary pays Trust income tax liability with individual assets allowing Trust value to grow faster.
- Beneficiary may be in a lower tax bracket than the Trust.
- May be able to avoid overlapping state fiduciary income taxes since grantor trust.
- Beneficiary may be able to take advantage of income tax rules that apply to individuals vs nongrantor trusts.
- Beneficiary is able to transact with the Trust without gain recognition.
- Beneficiary can retain beneficial enjoyment of Trust property and control over the Trust—as a fiduciary, holder of the power to designate fiduciaries and via special limited power of appointment.
- Beneficiary retains cash flow from the promissory note.
- Creditor protection on Trust assets.

BENEFICIARY DEFECTIVE INHERITOR'S TRUSTS ("BDITS")

Considerations of BDITs

IRS "No Ruling" Policy

- Rev. Proc. 2013-3 § 4.01(43) – IRS won't rule on transactions in which a person other than a grantor is treated as a substantial owner if "the value of the assets with which the trust was funded by the grantor is nominal compared to the value of the property purchased."

Capitalization and Leverage Mismatch

- \$5,000 seed capital may be viewed as inadequate to substantiate sale of much more valuable asset to the Trust.

Gift and Estate Tax Considerations

- Adequate disclosure on non-gift transactions;
- Identity of transferor for estate tax purposes;
- Potential for estate tax inclusion if Beneficiary's creditors can reach BDIT assets; and
- Potential Trustee estate tax liability.

Income Tax Considerations

- Complex issues and competing views as to how/whether grantor status is achieved.

Step Transaction Concerns

Reputational Risk for Independent Fiduciaries

BENEFICIARY DEEMED OWNER TRUSTS (“BDOTS”)

The Basic Technique

- Third party creates a Trust, during life or on death, for benefit of Beneficiary and funds it with adequate seed capital (not limited to \$5,000).
- Beneficiary is given an annual right to withdraw all net taxable income of the trust, including income attributable to corpus such as capital gain.
- Beneficiary becomes the deemed owner of the Trust from an income tax perspective under §678(a)(1) due to the income withdrawal right.
 - “A person other than the grantor shall be treated as the owner of any portion of a trust with respect to which: (1) such person has a power exercisable solely by himself to vest the corpus or the income therefrom in himself...”
- Beneficiary then sells assets to the trust in exchange for a promissory note without gain recognition.

BENEFICIARY DEEMED OWNER TRUSTS (“BDOTS”)

Potential Benefits of BDOTs

- Because the Beneficiary holds a withdrawal power over taxable income each year rather than the entire contribution to the Trust, gifts of any size could be made to the Trust because there is no concern with keeping the entire contribution within the “5 or 5” power amount. This minimizes the aforementioned IRS “No Ruling” Policy, capitalization and leverage mismatch, gift and estate tax and step transaction concerns associated with BDIT planning.
- BDOT created at grantor’s death avoids potential of grantor being treated as owner of the trust for income tax purposes.
- Appreciation of assets sold to Trust grow estate tax-free.
- Beneficiary pays Trust income tax liability with individual assets allowing Trust value to grow faster.
- Beneficiary may be in a lower tax bracket than the Trust.
- May be able to avoid overlapping state fiduciary income taxes since grantor trust.
- Beneficiary may be able to take advantage of income tax rules that apply to individuals vs complex trusts.
- Beneficiary is able to transact with the Trust without gain recognition.
- Beneficiary can retain beneficial enjoyment of Trust property and control over the Trust—as a fiduciary, holder of the power to designate fiduciaries and via special limited power of appointment.
- Beneficiary retains cash flow from the promissory note.
- Creditor protection on Trust assets.

BENEFICIARY DEEMED OWNER TRUSTS (“BDOTs”)

Considerations of BDOTs

Income Tax Considerations

- Complex issues and competing views as to how/whether grantor status is achieved.

Drafting Considerations for Withdrawal Rights

Gift and Estate Tax Considerations

- Uncertainty in calculating the lapse amount;
- Accounting for net taxable income exceeding the greater of \$5,000 or 5% lapse protection;
- Adequate disclosure on non-gift transactions;
- Identity of transferor for estate tax purposes;
- Potential for estate tax inclusion if Beneficiary’s creditors can reach BDIT assets; and
- Potential Trustee estate tax liability.

Creditor Protection Issues

INCOMPLETE GIFT NON-GRANTOR TRUSTS ("INGS")

Introduction to INGs

INGS:

- are irrevocable trusts; but are incomplete transfers for gift/estate tax purposes so not out of grantor's estate and no use of exemption amounts
- allow the grantor to control the ultimate distribution of trust assets
- are non-grantor trusts for federal income tax purposes; thus separate taxpayers for federal *and most state* income tax purposes causing the ING to pay its own taxes and possibly escape state income tax depending on the resident trust rules of the various states with a connection to the trust.
- The ING must be created in a state with asset protection trust laws because a trust will be treated as a grantor trust if the grantor's creditors can reach the trust's assets. §1.677(a)-1(d)

Approx. 19 States allow a client to create a domestic asset protection trust, i.e., an irrevocable self-settled trust that generally is effective against claims by creditors: Alaska, Connecticut, Delaware, Hawaii, Indiana, Michigan, Mississippi, Missouri, Nevada, New Hampshire, Ohio, Oklahoma, Rhode Island, South Dakota, Tennessee, Utah, Virginia, West Virginia, and Wyoming.

INCOMPLETE GIFT NON-GRANTOR TRUSTS ("INGS")

Introduction to INGs

Grantor does not have to live in one of these 19 states, but trust must be governed by one of these state's laws and/or have a qualified trustee in one of these states.

INGS are generally not subject to income tax in the grantor's home state if:

- (1) no state-source income or assets in the grantor's home state; and
- (2) grantor's home state does not determine trust residence based on the grantor's residence.
- (3) Connections with grantor's home state AND state fiduciary income tax rules defining residence must be carefully analyzed.

INCOMPLETE GIFT NON-GRANTOR TRUSTS ("INGS")

Introduction to INGs

States where fiduciary income tax laws and definition of "Resident Trust" can provide a state income tax savings opportunity by using an ING:

- Nonresident trust if no resident trustee and no administration in the state: Arizona, California (although INGs separately banned), Colorado, Hawaii, Indiana, Iowa, Kansas, Kentucky, Mississippi, Montana, New Mexico, New Jersey, North Dakota, Oregon, South Carolina, and Utah.
- Same as above but must also not use the state law as governing law: Louisiana.
- Same as above but also no real or tangible personal property in the state: Idaho.
- Nonresident trust if no beneficiary is a resident: Delaware, Georgia, New Hampshire, North Carolina, Rhode Island, and Tennessee.
- But remember how fiduciary income tax works. If distributions are made, trust income can be carried out to trust beneficiary receiving the distribution.

Arizona position: So long as no Arizona resident holds fiduciary or fiduciary like powers, the ING should be recognized as a non-resident trust.

INCOMPLETE GIFT NON-GRANTOR TRUSTS ("INGS")

Legal Underpinning of INGs

The grantor must toe the line between maintaining sufficient control to avoid asset transfers being classified as gifts, but also insufficient control to avoid the grantor being treated as the owner of the ING's income. §25.2511-2(b).

- The grantor completely parting with "dominion and control" of the assets will mean a gift has been completed. Also, Grantor retains too much control and the trust will be a grantor trust.
- In dozens of private letter rulings issued since 2013, the IRS has ruled that INGs that followed the approach described in this presentation qualified as nongrantor trusts.
- Transfer of ING cannot be a made to evade a known creditor otherwise it may be deemed a fraudulent transfer. Generally, placing too substantial a portion of the client's assets in the ING will be seen as a mechanism to evade creditors and a constructive fraudulent transfer.

INCOMPLETE GIFT NON-GRANTOR TRUSTS ("INGS")

Typical Structure of INGs

Mechanics:

- Generally, there is a “distribution committee” of three or more beneficiaries (if the grantor is on the committee two if not) who have an adverse interest in making distributions to the grantor. Basically, the adverse parties (see important definition on prior slide) have to outvote the grantor/grantor’s spouse on making distributions to the grantor and the other beneficiaries.

- Distributions to beneficiaries other than grantor then become a taxable gift.

- To prevent a completed gift from being made, the grantor retains both:
 - (1) an *inter vivos* lifetime power of appointment and/or a power to veto distributions; and
 - (2) a limited testamentary power of appointment.

INCOMPLETE GIFT NON-GRANTOR TRUSTS ("INGS")

Benefits of using an ING

- Provides attractive asset protection
- Potential state income tax savings
- Provides additional \$10 million exemption for QSBS (see prior slides for full explanation)
- Assets receive a step-up in basis at the grantor's death
- Transferring assets to INGs does not use gift tax exemption because transfers are incomplete gifts
 - But note that the gift will be complete when the ING makes distributions to non-grantor beneficiaries

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