Clever Tax Minimization and Wealth Preservation Strategies Utilizing Incomplete-Gift Trusts

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Nicholas Guerra, Esq., LL.M. and Jaime Goldman, Esq. explore creative applications of "incomplete-gift" trusts to minimize income and estate taxes, and to provide creditor protection, in a well-balanced estate plan.

Introduction

Gifting trusts have become a commonplace in estate planning for their role in removing assets from a taxpayer's gross estate for federal estate tax purposes. Such gifting trusts are designed as "completed-gift" trusts so that after assets are transferred to the trust, the gift is complete and the assets are deemed to be owned by the trustee on behalf of the trust, rather than by the individual making the transfer. For estate tax purposes, this generally means that the assets and their future appreciation will no longer be included in the taxable estate of the individual.

On the other hand, trusts can also be designed as "incomplete-gift" trusts for a variety of other benefits. This article highlights tax minimization and wealth protection strategies which may be achieved via incomplete-gift trusts.

General Benefits of Incomplete-Gift Trusts

An incomplete-gift trust can open the door to an array of benefits that a completed-gift trust cannot offer. For example, since a transfer of assets to an incomplete-gift trust is not a completed-gift for transfer tax purposes, there is no requirement to file a gift tax return. The lack of a requirement to file a gift tax return also avoids costly appraisals of the assets transferred.

Another benefit of an incomplete-gift trust is that the assets in the trust would be afforded a step-up in income tax basis to their fair market value at the time of the transferor's death under I.R.C. §1014. For example, assume client has $5 million in stock which was originally purchased for $1 million, and client wishes to transfer the stock to a trust for the benefit of client's daughter. If client transferred the stock to a typical completed-gift trust, upon client's death, the stock in the trust would not receive a step-up in tax basis, and the trust would continue to have a carry-over tax basis of $1 million under I.R.C. §1015. If the $5 million in stock is sold, the trust would recognize $4 million in taxable gain. On the other hand, if the transfer was made to an incomplete-gift trust, upon client's death, the $5 million in stock in the trust would receive a step-up in income tax basis to its fair market value. Immediately after client's death, the trustee could sell the entire $5 million in stock and the trust would not be subject to any income tax on the sale. Thus, incomplete-gift trusts can provide an income tax benefit at the creator's death that completed gift trusts are not afforded.

Incomplete-gift trusts are used in a variety of creative ways due to their ability to obtain a step-up in income tax basis. For example, incomplete-gift trusts can be used in a Medicaid planning context to remove an elderly client's "countable assets" from his or her individual name for Medicaid qualification purposes. Under this strategy, the elderly client transfers assets to a properly structured irrevocable trust, and after a 5-year period, the assets will generally not be counted for his or her qualification. These trusts are commonly designed as incomplete-gift trusts to maintain the step-up in income tax basis over the assets transferred. If the elderly client transferred the assets to a typical gifting trust, his or her heirs would lose the benefit of the step-up in tax basis at his or her death.

What causes a trust to be an "incomplete-gift trust"?

Treasury Regulations Section 25.2511-2 distinguishes between complete gifts (in which a donor parts with dominion and control so as to leave him or her powerless to change its disposition), and incomplete gifts (in which a donor reserves a power to revest beneficial title in himself or herself). A gift is also incomplete if the donor reserves a power to name new beneficiaries or to change the interests of the beneficiaries as between themselves, unless the power is a fiduciary power limited by a fixed or ascertainable standard. Thus, if assets are transferred to a trust and the trust contains a provision granting the donor the power to revest title in himself or herself or the power to appoint the assets to certain individuals, the transfer will constitute an incomplete-gift.

Under Treas. Regs. Section 25.2511-2(f), if the power of the donor to change beneficiaries terminates or is released during his or her life, a completed gift will be triggered. Further, if a beneficiary other than the donor receives income or other enjoyment of the transferred property, this will constitute a gift of such income or of such other enjoyment taxable as of the "calendar period" (as defined in § 25.2502-1(c)(1)) of its receipt. Thus, if under an incomplete-gift trust, the donor retained a power to appoint the assets in favor of any of his or her children, and later appoints a portion of the assets to one of his or her children, a completed gift will result with respect to the assets so appointed.

Typically, when incomplete-gift treatment is desired, the trust will contain a lifetime limited power of appointment (effective during the donor's lifetime) and a testamentary limited power of appointment (effective as of the donor's death). Under each such power of appointment, the power of appointment will be "limited" in that the donor cannot appoint the assets to himself or herself, his or her estate, his or her creditors or the creditors of his or her estate; otherwise, the power of appointment would be characterized as a "general" power, and the assets subject to the power of appointment could be subject to attachment by the donor's creditors. Certain times, the trust will also contain a veto power whereby the donor can veto distributions from the trust during his or her lifetime.

Wealth Preservation Strategies

Domestic Wealth Preservation Trust

A Domestic Wealth Preservation Trust is a trust that is designed to preserve assets within the trust for use by the creator while shielding the assets from his or her creditors. These trusts are designed as incomplete-gift trusts to avoid taxable transfers to the trust and to preserve a step-up in income tax basis over the assets transferred at the time of the creator's death.

Generally, all U.S. jurisdictions hold that trusts created for the benefit of third-party beneficiaries are not reachable by the beneficiaries' creditors. Thus, if structured properly, a grandparent can establish a trust for the benefit of his or her grandchild without worrying that the grandchild's creditors will have access to the trust funds. This type of third-party trust is commonly referred to as a "spendthrift" trust. However, for public policy reasons, "self-settled" spendthrift trusts have traditionally been prohibited. For example, an individual generally cannot set aside assets within a trust for their own benefit and expect the assets to be protected from his or her creditors.

In recent years, this general prohibition has changed for trusts established in select U.S. states, including Nevada, Delaware, Alaska, South Dakota, Utah, and Rhode Island, which have passed laws that make it difficult for a creditor to attach to the assets held in a qualifying trust. Under the legislation in these states, a person may place their own assets into a properly drafted and administered trust and, provided that the transfer of assets to the trust does not violate fraudulent transfer, fraudulent conversion or other applicable laws, the assets in the trust should thereafter be protected from their future creditors.

To achieve such wealth protection, care must be taken to comply with the specific state's requirements in establishing the self-settled spendthrift trust. Generally, the trust would need to be irrevocable, have a spendthrift clause and appoint a trustee that is a resident or trust company of the state where the trust is settled. The creator (the "grantor" or "settlor") of the trust retain limited lifetime and testamentary powers to appoint the assets of the trust to other individuals, receive discretionary income and principal distributions, and may even veto distributions, so long as certain requirements are adhered to.

Domestic Wealth Preservation Trusts may be utilized to protect brokerage accounts, rental property, shares in an S-corporation, interests in a limited partnership or limited liability company, and other assets which would otherwise be owned individually. In general, creditors who come into existence after the creation and funding of the trust cannot attach the assets of the trust unless the action is brought within a certain time period which begins once the trust has been funded.

Premarital Planning

A Domestic Wealth Preservation Trust can also be beneficial in the context of pre-marital planning. Without proper pre-marital planning, the wealthy spouse may find that assets they thought would be protected as their separate property are subjected to equitable distribution upon divorce. This may even include assets the wealthy spouse had inherited that had been commingled prior to the divorce. Traditionally, the wealthy spouse is advised to enter into a premarital agreement; provided, however, even if a premarital agreement is entered into, it may be set aside on several grounds, including situations where (i) both spouses were not independently represented by separate counsel, (ii) the agreement was entered into under duress, namely if there was not a sufficient amount of time between the execution of the agreement and the date of the marriage, (iii) the agreement is argued to be unconscionable, or (iv) adequate disclosures were not made by a spouse. Thus, even with a marital agreement in place, there is a risk of an unexpected division of assets in a divorce.

A Domestic Wealth Preservation Trust can help to avoid a premarital agreement altogether, or it can provide additional protections when established and funded prior to the execution of a premarital agreement. Creating and funding a Domestic Wealth Preservation Trust can also help to avoid providing certain financial disclosures which may be required for a prenuptial agreement. If the Domestic Wealth Preservation Trust is funded with premarital assets prior to entering into the marriage, the assets should no longer be subjected to equitable distribution on divorce. This is because the assets are not the spouse's property, but rather, the assets are the property of the trust. In such case, the spouse has a mere beneficial interest in the assets, subject to the trustee's discretion. As such, establishing a Domestic Wealth Preservation Trust can provide additional protections and clarity as to what will happen to the assets in the event of a divorce. The trust would be structured as an incomplete-gift trust to avoid a taxable gift when the trust is funded, and also to preserve the step-up in income tax basis over the assets transferred upon the creator's death.

For clients who wish to have maximum protection, clients may consider both (i) the establishment of a Domestic Wealth Preservation Trust to hold a portion of the client's premarital assets, and (ii) the execution of a premarital agreement between the client and his or her fiancé. Ideally, adequate financial disclosures should be made in the execution of the agreement and the fiancé should agree to the prior transfers to the Domestic Wealth Preservation Trust, acknowledging that the transfers being made are of the client's separate property and such property was never held by the client with the expectancy that such property would become marital property or joint property. Finally, the fiancé should be independently represented by separate counsel for purposes of the premarital agreement, with the marriage taking place after a sufficient lapse of time from the execution of such agreement.

Estate Tax Minimization Strategy

There is currently a gift/estate and generation-skipping transfer ("GST") tax exemption of $12.06 million; provided, however, this amount is scheduled to be reduced to $5 million (as indexed for inflation) effective as of January 1, 2026. Any amount beyond the exemption is taxed at a 40% rate. Given this significant tax, clients are seeking effective wealth transfer techniques to take advantage of their existing temporarily high exemptions. Many of these clients are managers of private equity funds holding general partnership interests in such funds. In exchange for the manager's services, a private equity fund typically allocates a percentage of the fund's profits in excess of a minimum return (commonly referred to as a "carried interest") to the general partner. In addition to the carried interest, the managers may also own limited partnership interests in the funds (as do other investors in the fund). If the fund is successful, the carried interest would appreciate at a much greater rate than the limited partnership interests. Therefore, a fund manager would typically prefer to utilize his or her available gift and GST tax exemptions to transfer the carried interest outside of his or her taxable estate, rather than "spending" his or her exemption on transferring the limited partnership interests. Generally speaking, I.R.C. §2701 eliminates this possibility without careful planning.

I.R.C. §2701 generally applies any time an individual transfers an equity interest in a privately held entity to or in trust for the benefit of a younger generation member of the transferor's family if, immediately after such transfer, the transferor holds an equity interest in the entity that is classified as an "applicable retained interest". If I.R.C. §2701 applies, the gift tax value of the transferred interest is determined under the so-called "subtraction method" so that for gift tax purposes, the individual is treated as transferring his entire equity interest in the entity rather than just the equity interest that was actually transferred. As such, if the manager transfers his or her carried interest and retains all or a portion of his or her limited partnership interest, generally, all of his or her limited partnership interest is deemed to have been transferred as a taxable gift utilizing his or her exemptions and/or causing immediate gift tax over the value deemed transferred.

In order to avoid the application of I.R.C. §2701, the manager could consider gifting his or her carried interest (utilizing his or her exemptions) to a completed-gift trust to remove the future appreciation from his or her estate, and at the same time transfer his or her limited partnership interests to an incomplete-gift trust (without requiring the use of his or her exemptions). If the transaction is properly structured and the incomplete-gift trust is designed as a non-grantor trust, the ownership of the limited partnership interests held by the incomplete-gift trust should arguably not be attributed to the manager. As such, I.R.C. §2701 would not be triggered because the manager will not hold an "applicable retained interest" immediately after the transfer. In other words, using an incomplete-gift non-grantor trust (which does not require the use of gift tax exemption) as a holding vehicle for the limited partnership interests can allow the manager to simultaneously gift his or her carried interest to a completed-gift trust to remove the future appreciation from his or her taxable estate without the need to allocate exemption to the value of the limited partnership interests.

Income Tax Minimization Strategies

State Income Tax Minimization

In order to minimize state level income taxes, assets may be transferred to a non-grantor trust. For example, if a Nevada non-grantor trust is established, since Nevada does not impose a state level income tax on a sale of stock, a future stock sale or membership interest sale by such trust will not be subject to state level income tax in Nevada, and if structured properly, will not be subject to state level income tax in the grantor's state of residence.

In order to minimize state level income taxes in the client's home state, the trust would need to be designed as a "non-grantor" trust, meaning that it will be treated as a separate taxpaying entity and will pay income tax at the trust level on any taxable income retained by the trust. If the trust is treated as a "grantor trust," then all of the income will be taxed to the creator and state income tax will not be avoided. Instead, the trust would be structured to be a non-grantor trust so that the income in the trust is not taxed to a beneficiary until it is distributed. If the income is accumulated or is distributed to a beneficiary residing in a state without high income taxes, then overall income taxes can effectively be minimized. Alternatively, if a distribution is made to a beneficiary who resides in a high-tax state, the distribution will be subject to such state's income taxes to the extent of the trust's distributable net income.

Many times, clients will want to minimize state level income taxes, but for a variety of reasons they do not wish to make a completed gift. The client may not wish to part with the beneficial interest in the assets transferred, or he or she may not wish to use his or her gift and GST tax exemptions (or may have exceeded his or her exemptions and wishes to avoid triggering a gift tax). The client may also wish to maintain a step-up in income tax basis over the assets transferred at the time of his or her death. In such cases, the client could consider utilizing an incomplete-gift version of a non-grantor trust to minimize state level income taxes.

Note that since 2014, this strategy is not available for residents of New York because New York law provides that an incomplete-gift non-grantor trust is treated as a grantor trust (ie, taxed to the creator) for New York income tax purposes. This means that the income and deductions of the trust will be reported on the creator's individual New York income tax return and subject to New York income taxes. New York residents are confined to utilizing completed-gift non-grantor trusts for these purposes.

Planning for Qualified Small Business Stock

In addition to minimizing state level income taxes, incomplete-gift non-grantor trusts can be used to minimize federal income taxes for "Qualified Small Business Stock" or "QSBS" of a C corporation. This term applies to a section of the Internal Revenue Code – I.R.C. §1202 – that allows founders of startup companies or other investors in C corporations to avoid tax on a future sale of QSBS. If certain requirements are met, each stockholder can generally exclude the greater of $10 million or 10 times the stockholder's income tax basis from a future taxable sales transaction. For stock to qualify as QSBS, among other requirements, (i) the business must be organized as a C corporation, (ii) the stockholder must acquire the QSBS from the issuing corporation in exchange for cash or other property or for services rendered to the corporation, (iii) the stockholder must hold the QSBS for at least five years, and (iv) the business must be a qualified small business, meaning the issuing corporation's aggregate gross assets cannot exceed $50 million in value when the QSBS is issued to the stockholder. Additionally, if a gift of the QSBS is made, pursuant to I.R.C. §1202(h), the transferee will generally be treated as having acquired the QSBS in the same manner as the transferor and having held the QSBS for the same length of time that the QSBS was held by the transferor.

If the stock qualifies as QSBS, then substantial income tax benefits can be achieved on sale, and potentially even greater tax benefits can be derived through the use of an incomplete-gift non-grantor trust. For example, assume a client purchased QSBS for $500,000 which is now worth $20 million. If client were to sell the stock, he or she would recognize income taxes on a $9.5 million taxable gain ($20 million amount realized, less $500,000 tax basis = $19.5 million gain less $10 million QSBS exclusion = $9.5 million taxable gain). In such case, client could consider transferring $10 million in QSBS to an incomplete-gift non-grantor trust prior to the sale. In such case, each of client and the trust should arguably be afforded a $10 million exclusion, and there would be no taxable gain.

Even when the taxable gain is not expected to exceed $10 million, an incomplete-gift non-grantor trust may be helpful to minimize state level income taxes for QSBS because many states do not follow the federal exclusion amount for QSBS purposes. If the client is a resident of such a state, he or she could consider transferring the QSBS to an incomplete-gift non-grantor trust not subject to taxation in the client's state of residence. In such case, the trust would receive the federal exemption amount and state level income taxes could be eliminated.

Conclusion

Incomplete-gift trusts should not be overlooked when developing a comprehensive estate plan. These trusts can help to minimize income taxes and estate taxes, and they can assist in wealth preservation. This article has been written merely to illustrate the potential benefits of incomplete gift trusts; when implementing any of the strategies discussed herein, care should be taken to address any risks and restrictions under such a strategy, and each client's unique facts and circumstances should be analyzed to ensure that the trust structure will accomplish his or her intended goals.