Non-Grantor Trusts, OBBBA, and IRC 643(f)

Take-Away: A lot more planning in the years to come will include the use of non-grantor trusts to save income and capital gain taxes. At the same time, we can expect the IRS to assert more often IRC 643(f) so as to treat multiple non-grantor trusts as a single trust. Let the games begin!

Background: A recent missive summarized how the new provisions of the One Big Beautiful Bill Act (OBBBA) encourage the use of non-grantor trusts. Those perceived opportunities when using a non-grantor trust under OBBBA's provisions include using a non-grantor trust to: (i) shift income to lower marginal income tax brackets; (ii) expand the now enlarged SALT $40,000 income tax deduction; (iii) allow for additional IRC 199A income tax deductions, at 20%, for small business income; (iv) allow 'stacking' of the qualified small business stock (QSBS) [IRC 1202] for C corporations to shelter stock sales proceeds from capital gains taxes; and (v) save state income taxes if the non-grantor trust is located in a state that imposes no income tax. A few examples follow where many of these perceived tax benefits using a non-grantor trust can be doubled, if not tripled.

A Word of Caution- IRC 643(f): While using multiple non-grantor trusts to exploit many of these new tax-savings opportunities, it is important to remember the limitations of IRC 643(f). In 2018 the IRS issued proposed Regulations under IRC 643 to prevent individuals from using multiple non-grantor trusts to create multiple thresholds for the qualified business deduction under IRC 199A. The preamble to those Regulations is not limited to IRC 199A avoidance, however, and it could be extended to these other tax-savings opportunities for the SALT deduction or the IRC 1202 Qualified Small Business Stock (QSBS) exclusion. Separate non-grantor trusts will be respected by the IRS only if they have (i) different primary beneficiaries and (ii) a significant non-tax purpose. Proposed Regulation 1.643(f)(1) provides, in part:

Two or more trusts will be aggregated and treated as a single trust if such trusts have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries, and if a principal purpose for establishing one or more of such trusts or for contributing additional cash or other property to such trusts is the avoidance of Federal income tax.

The proposed Regulations go on to state that a principal purpose of avoidance will be presumed if creating multiple trusts results in a significant income tax benefit unless there is a significant non-tax purpose that could not have been achieved without the creation of separate trusts. Consequently, there must be a sufficient differentiation with respect to the trust beneficiaries and trust terms to avoid aggregation under IRC 643(f).

QBI: The 2017 Tax Act created IRC 199A which created a 20% deduction for noncorporate taxpayers against their qualified business income (QBI.) This includes non-grantor trusts. This deduction is phased out as income increases beyond certain threshold amounts. For a non-grantor trust, the threshold is determined at the trust- level. Thus, dividing business interests among multiple trusts, each with income below the threshold amount can multiply the QBI deduction. For a non-grantor trust, the phaseout begins at $197,300 of trust income.

Example 1: Willa is the sole proprietor of a business that generates $1,000,000 of qualified business income (QBI.) Willa is in the 37% marginal income tax bracket for federal income tax purposes. Willa is in a combined state and federal income tax bracket of 45%. Willa has five children, all of whom are currently in a 20% combined federal and state marginal income tax bracket. Willa transfers a 19.73% interest in her business to a non-grantor trust that is established for the benefit of all 5 of her children.

Income Shifting: All trust income is distributed from the non-grantor trust annually to Willa's children, i.e., $39,460 to each child [$1.0 million x 19.73% = $187,300 divided by 5 children = $39,460 per child.] The distribution from the children's trust will save Willa's family $39,460 in income taxes [$197,300 (trust income) x 45% (Willa's combined income tax rate) less ($197,300 (trust income) x 25% (the children's combined income tax rate)= $38,460 income tax savings.]

SALT Deduction: Willa did not qualify for any SALT deduction due to her high-income level, but her transfer of the business interest to the non-grantor trust creates a SALT deduction. The amount of the SALT deduction will be determined at the non-grantor trust level. That SALT deduction would be for the tax payable by the trust to the state on $197,300 of income.

Qualified Business Income: Willa's transfer of the business interest to the non-grantor trust will also increase the IRC 199A deduction. For Willa, this tax deduction would have been completely phased out, but by transferring the business ownership interest to the non-grantor trust, Willa's family could claim at QBI deduction of $39,460 [20% (QBI income tax deduction) x $197,300 (trust's income) = $39,460 tax savings.]

State Income Tax: Willa established her non-grantor trust in a state that does not impose trust income taxes, e.g., Nevada. Willa's family could add state income tax savings to the federal income tax benefits, but only with respect to income that is not sourced to the state with a state income tax.

Example 2: Ralph and Alice, married, own several commercial real properties, having acquired them in the 1970's through 1990's. The commercial real estate owned by them is managed by a third-party under contract; accordingly, Ralph and Alice pay no wages for the commercial properties' management. The qualified business income (QBI) from their real estate holdings is about $1.9 million a year, and Ralph and Alice's total taxable income for the year is $2.2 million. The original income tax basis of the improvements to the real estate fully depreciated now, so Ralph and Alice have a minimal amount of qualified property, i.e., around $750,000. Based on these facts, Ralph and Alice gift interests in the entities that own the commercial real property to 15 trusts, established for each of their four children and their 11 grandchildren. The QBI and taxable income for each of these non-grantor trusts is about $126,667 [$1,900,000 QBI divided by 15 non-grantor trusts = $126,667 QBI per trust.]

As noted above, the IRC 199A deduction is phased out as income increases beyond certain threshold amounts and for trusts in 2025 that phaseout begins at $197,300 of trust income. $126,667 is less that the threshold amount of $197,300, and therefore the limitation does not apply to any of the 15 trusts. The QBI deduction is the lesser of: (i) 20% of net business income- $126,667 x 20% = $25,333; or (ii) 20% of taxable income- $126, 667 x 20% = $25,333. This planning with multiple non-grantor trusts will also allow for increased SALT deductions along with shifting income to family members at much lower marginal income tax brackets.

Stacking Trusts: OBBBA reduced the required holding period to claim an IRC 1202 exclusion amount. It also increased the amount of that exclusion. The holding period is phased in with a 50% exclusion after 3 years, a 75% exclusion after 4 years, and a 100% exclusion after 5 years. The exclusion amount is also increased from the greater of $10 million- or 10-times basis to the greater of $15 million- or 10-times basis. This IRC 1202 gain exclusion can be effectively *stacked* using non-grantor trusts.

Example 3: Warren created a C-corporation to develop unique AI concepts with a nominal capital investment. Five years later Warren's stock has ballooned to $20 million in value. Warren is made an 'offer that he cannot refuse' and he agrees to sell his C-stock for $20 million. If Warren sells his C-stock, he can exclude the first $10 million from tax using IRC 1202. That reduces Warren's taxable gain on the sale of his stock to $10 million. The tax that Warran will have to pay on the sale of his C-stock goes from $4,760,000 to $2,380,000. [This is an effective 23.8% tax rate, i.e., the tax of 20% regular capital gains plus the 3.8% net investment tax (NIIT.)]

Example 4: Suppose instead that immediately after creating his C corporation, Warren gave 50% of his C- stock in his corporation to a non-grantor trust created for his daughter Beth. Five years later, Warren and the trust that he created for Beth each sell their C-stock for $10 million. Both Warren and Beth's non-grantor trust receive a $10 million exclusion under IRC 1202. No tax is paid by either Warren or Beth's trust. Note, that creating a non-grantor trust for Beth is not the only way to *stack* the available QSBS exclusion. Warren could have transferred the C-stock to an LLC or to a family limited partnership, or outright to Beth, and in each instance the IRC 1202 exclusion could be claimed by Warren and who or whatever else held the C-stock.

Conclusion: Clearly there are a lot of new tax planning opportunities under OBBBA using non-grantor trusts. Thus, it would not be a surprise to see a lot more non-grantor trusts created as part of estate plans, in reliance on these new 'incentives.' That said, it would also not surprise me if the IRS revisited it's Proposed Regulations on IRC 643(f) to add several more examples when using these new Tax Code deductions and exclusions, of when they will be deemed to be primarily used for 'tax avoidance purposes.'

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