Non-Grantor Trusts May Sneak Services Into Passthrough Deduction

Posted on Apr. 30, 2018

By Jonathan Curry

The exclusion of several professional service fields from the benefits of the new passthrough deduction left many professionals dismayed, but non-grantor trusts could help bypass that obstacle.

Grantor trusts have been the entity of choice for most estate planners for years, but the Tax Cuts and Jobs Act (P.L. 115-97) seems to have inadvertently raised the value of non-grantor trusts — which have traditionally been less widely used — for a variety of federal and state income tax purposes, Gregory V. Gadarian of Gadarian & Cacy PLLC said April 27 at an American Law Institute Continuing Legal Education conference in Austin, Texas.

One of those purposes could be to help a taxpayer who resides in a high-tax state to bypass the new $10,000 limitation on state and local tax deductions by shifting ownership of a residence into multiple non-grantor trusts, Gadarian said. Another technique, he continued, may be to use incomplete gift non-grantor trusts to reduce a taxpayer's taxable income below the section 199A 20 percent passthrough deduction's income thresholds, and thus avoid the "specified service trade or business" exclusion.

Under the new law, a passthrough business's qualified business income is eligible for the 199A deduction unless that income is derived from a specified service trade or business, which includes services in the fields of law, accounting, consulting, and athletics, among others. However, the specified trade or business exclusion does not apply if a taxpayer's taxable income does not exceed $315,000 for joint filers, or $157,500 for individuals and trusts.

The benefit of using a non-grantor trust is that it is treated as a separate taxpayer, Gadarian explained. By shifting qualified business income into multiple non-grantor trusts, a taxpayer whose business field would ordinarily be excluded from eligibility might be able to spread their income across multiple non-grantor trusts such that the income falls below the section 199A income threshold in each trust.

The potential tax benefits of using a non-grantor trust extend beyond just maximizing section 199A and the state and local tax deduction. Gadarian's presentation materials show that by situating a non-grantor trust in a state with little or no income tax on trusts, non-grantor trust status "can generate substantial state income tax savings on the trust's undistributed ordinary income and capital gains."

And using incomplete gift non-grantor trusts has the added bonus of asset protection, according to Gadarian. "We didn't create this trust for purposes of lawsuit protection, that's just a side benefit of it being an irrevocable trust," he said.

Toggle Time

The newly realized tax benefits of non-grantor trusts might encourage taxpayers to switch or “toggle” their existing grantor trusts to non-grantor trusts, and Gadarian said that in many cases they ought to be able to do so easily.

Often, all that’s required is that the grantor relinquish the power that causes the trust to be treated as a grantor trust, Gadarian said, such as a power to reacquire the trust’s estate by substituting property. Even in those cases a trust protector can be given authority to later reinstate the power to substitute assets, he said.

Gadarian also observed that there are typically no tax consequences for toggling from grantor to non-grantor trust status, except in situations in which there’s a lot of debt tied to a property and the property’s basis is less than that debt.

Back to 199A

Larry Katzenstein of Thompson Coburn LLP said there is one way in which section 199A may be relevant for charitable planning. “What if you have a qualified business as defined in [section] 199A in a charitable remainder trust? Can the charitable remainder trust somehow take advantage of that deduction?” Katzenstein asked. “I don’t know the answer to that, but I have some ideas.”

The deduction probably will not reduce income within the section 664(b) tiers, Katzenstein said. Another open question is if the deduction applies at the beneficiary level, he said, adding that the situation may be analogous to the section 664 treatment of foreign tax credits in LTR 9313018.

LTR 9313018 treated a trust’s foreign income as distributed and the taxes paid by the trust on that income as paid by the beneficiaries.

Katzenstein did have an idea of what types of qualified business income might not be unrelated business income. He suggested that rental income, royalties, dividends from real estate investment trusts, and income from publicly traded partnerships all might fall into that category.

Nathan J. Richman contributed to this article.

Correction, April 28, 2018: The service trade income exclusion threshold applies to taxable income, not passthrough income.

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