The 13.3% Solution: of DINGs, NINGs, WINGs and Other ThINGs

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Wealthy taxpayers have now experienced the impact of higher federal and state income tax rates for a full year.[1] Many have created or would like to create trusts for their children and grandchildren, which also could be subject to extraordinarily high income tax rates. In California, for example, trust taxable income is subject to state income tax at a rate as high as 13.3%.[2] How can a California resident avoid such exorbitant taxes on a trust's income? The solution is to create a trust beyond the scope of California income tax in one of several income tax friendly states - such as Nevada, Delaware, Wyoming and others.[3] The wealth accumulation advantage of avoiding California state income tax on trust income over time is dramatic.

How Does California Tax Trust Income?

First, if a trust is a "grantor trust" for federal income tax purposes,[4] California and other states will tax all trust income directly to a grantor that only resides in that state. Therefore, this article considers "non-grantor" trusts for this strategy.

Second, a trust's "California source income" will always be subject to income tax in California. This includes income from real property, tangible personal property or business property located in California.[5]

Third, a trust's non-California source income will be subject to income tax in California if there are *either* California resident trustees or California resident, non-contingent beneficiaries.[6] If there are both resident and non-resident trustees or beneficiaries, California will tax a portion of the trust income based on the ratio of California resident trustees to total trustees and/or resident beneficiaries to total beneficiaries.[7] Obviously, when trust income is actually distributed to a California beneficiary it will then be subject to California income tax to that beneficiary.[8]

Properly structured non-grantor trusts created by a California resident may be able to avoid California income tax on interest, dividends, capital gains and other non-California source income. For example, assume a California resident establishes a properly structured trust and contributes a $20 million stock portfolio that produces 8% taxable income per year. Over a period of 10 years, the California income tax saved could be $2,500,000. Over 20 years, the compounded savings from not paying California income tax could be $8,500,000.

Residency of the grantor in California does not cause the trust's income to be subject to tax in California, and is not even a factor in that determination. Many states treat the grantor's residency differently.[9]

California Non-Contingent Beneficiaries

Who can be a potential beneficiary of a trust designed to avoid California state income tax? In California Franchise Tax Board Technical Advice Memorandum 2006-0002 (2/17/06), the California Franchise Tax Board ("FTB") stated that if a non-California trustee could make distributions in the trustee's discretion to a California beneficiary, the undistributed income of such trust should not be subject to California tax. The FTB reasoned that a California beneficiary has a non-contingent interest only as of the time, and to the extent of the amount of income, that the trustee actually decides to distribute or is required to distribute to that beneficiary. Thus, when distributions are not being made or required to be made, there is no resident beneficiary in this situation, and the trust is not a resident trust.[10] However, closer scrutiny of the FTB ruling states:[11]

> "A resident beneficiary whose interest in a trust is subject to the *sole and absolute discretion* of the trustee holds a contingent interest in the trust. The

exercise of the trustee's discretionary power is a condition precedent that must occur before the beneficiary obtains a vested interest in the trust.

This technical advice memorandum presumes the trustee has complete, unfettered discretion whether and when to make a distribution. However, the trust document should be reviewed in each case to determine any limitations on the trustee's discretion to accumulate income rather than to distribute it to the beneficiary. [emphasis added]"

Thus, to fall *squarely* within the FTB ruling, the trustee's power to distribute to California beneficiaries must be in the "sole and absolute discretion" of the trustee. A discretionary power to distribute for a beneficiary's "health, support, maintenance and education," which is contained in many trusts, arguably makes such beneficiaries non-contingent,[12] and, therefore, subjects the trust to California income tax at least in part. An optimal plan might consist of two trusts, one sitused outside California giving the trustee "sole and absolute" discretion to make distributions to beneficiaries, and the other trust sitused in California with more limited trustee discretion over distributions. As is frequently done when an estate plan creates exempt and non-exempt GST trusts, or a credit shelter and marital trust at the first spouse's death, such trusts should be invested and distributed taking into account their particular tax attributes.[13]

Gift Tax Issues - "Incomplete Gifts"

Creating non-grantor trusts that avoid California income tax requires careful planning to avoid adverse gift tax consequences. Transferring assets to a non-grantor trust for the benefit of children and/or grandchildren will create a taxable gift (and possible generation-skipping tax consequences), unless the gift is deemed "incomplete."[14] There have been several recent Internal Revenue Service private letter rulings that provide guidance on creating a non-grantor trust in which the gift to fund the trust is deemed incomplete.[15] The most recent rulings issued in 2013 lifted a pall that had existed over such planning for several years.[16] Trusts of the type described in these rulings are commonly referred to as DINGs (Delaware Incomplete Non-Grantor Trusts), NINGs (Nevada Incomplete Non-Grantor Trusts), WINGs (Wyoming Incomplete Non-Grantor Trusts), and other INGs. These states and others have laws that are favorable to establishing trusts to avoid state income tax.[17]

A review of PLRs 201310002 - 201310006 is useful in designing a trust structure to thread the needle between California trust income tax and Federal gift tax.[18] The rulings all involve identical fact situations. Grantor created an irrevocable trust of which grantor and his issue were discretionary beneficiaries. There was a corporate trustee in the tax friendly state that was required to distribute income or principal at the discretion of a distribution committee or principal upon direction from the grantor. The distribution committee consisted of the grantor and each of his four sons. There must always be at least two "eligible individuals" serving as distribution committee members. Three alternative methods were provided for distribution directions: (1) *Grantor consent power* - distribute income or principal upon direction of a majority of the distribution committee members with the written consent of grantor; (2) *Unanimous member power* - distribute income or principal upon direction by all distribution committee members other than grantor; and (3) *Grantor's sole power* - distribute principal (not income) to any of grantor's issue, but not grantor, upon direction from grantor as grantor deems advisable in a non-fiduciary capacity to provide for the health, maintenance, support and education of his issue. Distributions can be directed in an unequal manner among potential beneficiaries.

The IRS gave four favorable rulings: (1) the trust is not a grantor trust; (2) the transfer to the trust is an incomplete gift by grantor; (3) a direction by distribution committee members to make distributions to grantor is not a completed gift by the committee members, because it is merely treated as a return of grantor's property; and (4) a direction by distribution committee members to make distributions to persons other than grantor is not a completed gift by the committee members, because the distribution power is held jointly by persons having interests that are adverse to each other.

There are obviously many planning options related to these rulings and each client and their advisors should consider seeking a private letter ruling addressing their specific facts.

A significant feature of these rulings is that the grantor may be a beneficiary of the trust, if distributions are solely within the control of a distribution committee whose financial interests are adverse to those of the grantor. That is, if the distribution committee makes a distribution to the grantor, the amount such committee members could receive as beneficiaries is reduced. Many authors believe such a structure creates a trust that, subject to appropriate state law limitations, also may avoid the reach of creditors of the grantor. Discussion of such asset protection features is beyond the scope of this article.[19]

Planning Considerations for Non-California INGTs

A trust designed to avoid California state income tax (an incomplete non-grantor trust, or "INGT") has both near-term and long-term benefits. For individuals planning a liquidity event in the near-term involving assets that would not be deemed California source income, use of an INGT can avoid California income tax on the liquidity event for some portion of those assets. For example, shares of a company about to "go public" could be transferred pre-IPO into a non-California INGT.[20] The INGT is one of many pre-liquidity event tax planning strategies that should be considered.

For accumulated wealth, developing strategies to diversify the tools available to a family over multiple generations should include those having a variety of different tax attributes. Certain trusts will take advantage of lifetime gift and estate tax exemptions.[21] Others will be structured to avoid transfer taxes at multiple generations through the generation-skipping tax exemption,[22] and the choice of state law permitting dynasty trusts of long duration.[23] Trusts will also be designed to tax advantage of the grantor trust rules to maximize income tax planning between generations.[24] Discount planning will continue to be a central feature of many such trusts, although its future in family tax and estate planning is in doubt.[25] Alongside these tools, California residents with substantial wealth should also consider the INGT as a complement to their other planning. This is especially true given the currently favorable treatment accorded to California residents who establish non-California trusts.

Given the perpetual desperation of California for tax revenue, this may be one of the tools with a limited life. The 13.3% solution is there for the taking now.[26]

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[1] The maximum Federal income tax rate increased to 39.6% in 2013. Capital gains are taxed at 20%. The Obamacare tax of 3.8% on net investment income. California state income tax of up to 13.3% on taxable income in excess of $1,000,000.

[2] Cal. Rev & Tax Code §§ 17041, 17043.

[3] Surveys of state income taxation of trusts appear in Nenno, 869 T.M., *State Income Taxation of Trusts* at B-101, hereinafter "Nenno", and Bloomberg BNA Special Report - *2013 Trust Nexus Survey: Analysis of Key Factors Driving State Taxation of Trusts* (Vol. 2013, No. 34), hereinafter "Bloomberg Report."

[4] The Federal income tax rules pertaining to grantor trusts are contained in Internal Revenue Code §§671-678 (hereinafter "IRC").

[5] Cal. Rev. & Tax Code § 17951; Cal. Code Regs. titl. 18, §§17951-3.

[6] Cal. Rev. & Tax Code § 17742.

[7] Cal. Rev. & Tax Code §§ 17743, 17744.

[8] Cal. Rev. & Tax Code § 17745.

[9] Bloomberg Report, supra n.3; Nenno, supra n.3 at A-6.

[10] Charles A. Redd, "State Income Tax Issues with Trusts," Cannon Financial Institute (The 2011 Estate Planning Teleconference, January 25, 2011), at 5 (hereinafter "Redd").

[11] Cal. Franchise Tax Bd. TAM 2006-0002 (Feb. 17, 2006).

[12] The power to distribute trust income for the beneficiary's health, support, maintenance and education is not within sole and absolute discretion of trustee. Such distribution language is deemed to create an "ascertainable standard" for Federal income and transfer tax purposes (IRC Sections 674(b)(5) and 2041(b)(1)(A); Treas. Reg. Section 25.2511-2(g)), and may create an enforceable right in the beneficiary or the beneficiary's creditor to compel distributions. See *U.S. v. Taylor*, 254 F.Supp. 752(N.D. Cal. 1966).

[13] *See* Scott Bieber and David R. Hodgman, "Trust Severances and Other Planning Under the New Final and Prop. GST Regs," Estate Planning (January 2008).

[14] Treas. Reg. Section 25.2511-2(c); *Sanford Est v. Commr.*, 308 U.S. 39 (1939).

[15] PLR 200148028, 200247013, 200502014, 200612002, 200637025, 200647001, 200715005. See also CCA 201208026 - incomplete gift applies only to remainder interest if grantor is not a potential beneficiary.

[16] No IRS rulings had been issued for five years following the IRS announcement in IR - 2007-127 (July 9, 2007) that it was reconsidering certain positions taken by it in previous rulings. Steve R. Akers, *Musings on Current Events*, www.actec.org/public/Akers_Favorable_DING_Trust_PLRs_Musings.asp.

[17] Bloomberg Report, supra n.3.

[18] PLRs are not precedent. IRC Section 6110(k)(3).

[19] For a comprehensive discussion of self-settled asset protection trusts, see Richard W. Nenno, "Planning and Defending Domestic Asset-Protection Trusts," ABA Section of Real Property, Trust and Estate Law (Nov. 1, 2011).

[20] This should be considered in conjunction with other techniques also employed to take advantage of the substantial appreciation in value of such stock as the company transitions from a private company to a public company.

[21] Pursuant to Rev. Proc. 2013-35, 2013-47 I.R.B. 543, the Federal lifetime exclusion for gift and estate tax purposes as of 2014 is $5,340,000 per person.

[22] *Id.*

[23] Many states have modified the Rule Against Perpetuities, either by abolishing it entirely (e.g., South Dakota, Alaska and Idaho) or by substantially extending its duration (e.g., Nevada (365 years), Wyoming (1,000 years), and Arizona (500 years)). GST exempt trusts may grow in such states without transfer tax for many more years than in states like California that limit trust duration to 90 years or lives in being plus 21 years. Cal. Prob. Code §21205. The Obama administration has proposed limiting the duration of a trust's exemption from transfer taxes to 90 years. *See* Treasury Department's General Explanations of the Administration's Fiscal Year 2014 Revenue Proposals (commonly referred to as the "2013 Greenbook") at 143.

[24] Typical transactions include gifts to a Grantor Retained Annuity Trust (GRAT), and sales and gifts to intentionally defective grantor trusts (IDGTs). The Obama administration has proposed limiting the use of GRATs by requiring a minimum ten-year term. *See* 2013 Greenbook at 142.

[25] *See* Gordon A. Schaller and Scott Harshman, *The "Death Knell" for Family Discounts*, LISI Estate Planning Newsletter No. 2093 (April 29, 2013), http://www.leimbergservices.com, and recent articles on the expected increase in the use of executive orders and regulatory power for the duration of the Obama presidency. *See* "Estate Planning: New Hazards," Wall Street Journal (April 27, 2013).

[26] Taxpayers should consult their own tax and legal advisors and consider the cost to implement and maintain such a trust.