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California Admits Incomplete Gift Non-Grantor Trusts Work...For Now

BY ERIC BARDWELL

In recent years, taxpayers across the country have taken advantage of a planning technique known as an incomplete gift non-grantor trust (ING) (a *NING* in Nevada, *DING* in Delaware, *WING* in Wyoming, etc.). The admiration of INGs stems from their ability to move assets from a high state income tax jurisdiction to a low state income tax jurisdiction without making a completed gift, thus deferring and potentially avoiding state income taxes in the grantor's or beneficiary's state of residence.

On Nov. 10, 2020, a legislative proposal was presented at the California Franchise Tax Board's (FTB) Stakeholders Meeting that directly attacks INGs, and arguably acts as an admission of their current viability. Legislative Proposal C suggests adding new Section 17082 to the Revenue and Tax Code to treat INGs as grantor trusts effective as of Jan. 1, 2022. The result of the proposed legislation would be that an ING established by a California resident, who is still a California resident as of Jan. 1, 2022, would become subject to California income taxation on all of its income after Jan. 1, 2022. The fact that the proposal is seeking to drastically modify current California law seems to suggest that the FTB believes INGs are a valid means of deferring state income tax.

In order to understand why an ING works, a review of how California taxes trusts is necessary. Generally, there are three scenarios that will cause some or all of a non-grantor trust's income to be subject to California income taxation: the trust has California source income, one or more of the fiduciaries is a California resident, or one or more of the non-contingent beneficiaries is a California resident.

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California Taxation of Non-Grantor Trusts

California Source Income

All California source income, regardless of the residence of the fiduciaries and beneficiaries, is subject to California income taxation. Examples of California source income include rental income or any other type of income derived from the ownership, control, or management of real or tangible personal property within California, gains realized from the sale of such property, income from a trade or business conducted within California, and income from certain intangible personal property.

California Resident Fiduciaries

Residency. California taxes the income of a trust based not on the residence of the grantor, but on the residence of the fiduciaries and beneficiaries. Residence, for purposes of a corporate fiduciary of a trust, refers to the place where the corporation transacts the major portion of its administration. Although this definition may seem patently clear, the FTB will consider a myriad of facts and circumstances to make its determination as to whether a corporate fiduciary is a resident of California.

Although not defined under Section 17742 of the California Revenue and Taxation Code, presumably the residence of an individual fiduciary is determined in ac-

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cordance with the rules for determining the residence of an individual taxpayer for California income taxation. If those rules do apply, then any individual who spends, in the aggregate, more than nine months in a given year in California is presumed to be a California resident. In addition, any individual who is in the state for other than a temporary purpose or who is domiciled in the state but who is outside of the state for temporary or transitory purposes is considered to be a resident of California.

Apportionment of Income Taxes Based on Residence of Fiduciaries. In the event of a trust with only one fiduciary who is a California resident, the entire income of the trust, regardless of the residence of any beneficiary, will be subject to California income taxation. If, however, there is more than one fiduciary of a trust, the portion of the trust income subject to California income taxation will be determined based on the number of fiduciaries who are California residents relative to the total number of fiduciaries. Of course, as mentioned previously, the residence of the fiduciaries is only one-half of the equation, as the residence of each non-contingent beneficiary must also be examined.

California Resident Non-Contingent Beneficiaries

Non-Contingent Beneficiaries. The second prong of California's system of trust taxation looks at the residence of every non-contingent beneficiary of the trust. A non-contingent beneficiary is a beneficiary whose interest is not subject to a condition precedent. Although the term ''condition precedent'' is not defined in either the statute or the regulations, the FTB has provided the following definition:

An act or event, other than a lapse of time, that must exist or occur before a duty to perform something promised arises. If the condition does not occur and is not excused, the promised performance need not be rendered. The most common condition contemplated by this phrase is the immediate or unconditional duty to performance by a promisor.

The FTB has determined that, in the case of a fully discretionary trust, a resident beneficiary who receives no distributions during the tax year is a contingent beneficiary. In the event a distribution is made to a resident beneficiary from a fully discretionary trust, the beneficiary becomes a non-contingent beneficiary, but only with respect to the amount so distributed.

It is less clear whether a beneficiary of a discretionary support trust, where the fiduciary has the discretion to distribute income and/or principal to a beneficiary for his or her health, maintenance, education, and support, would be considered a contingent beneficiary. The additional limitations imposed by an ascertainable standard coupled with fiduciary discretion should, in theory, render a beneficiary's interest contingent as it places a greater restriction on a fiduciaries ability to make a distribution to a beneficiary. While some commentators have suggested that a beneficiary of such a trust would indeed be considered a contingent beneficiary, others have argued that the use of an ascertainable standard would create an enforceable right in the beneficiary or his or her creditor to compel a distribution, which in turn would cause the beneficiary to be treated as non-contingent.

Apportionment of Income Taxes Based on Residence of Beneficiaries. In the event of a trust with one non-contingent beneficiary who is a California resident, the entire taxable income of the trust would be subject to California income taxation. If, however, there is more than one non-contingent beneficiary of a trust, the portion of the trust income subject to California income taxation will be determined based on the number of non-contingent beneficiaries who are California residents relative to the total number of non-contingent beneficiaries.

Finally, in the event of a trust with California resident and non-resident fiduciaries and California resident and non-resident non-contingent beneficiaries, a two-step calculation is used to determine the portion of trust income subject to California income taxation. First, the total income is multiplied by the number of California resident fiduciaries as it relates to the total number of fiduciaries. This is the first level of income subject to California income taxation. Second, the remaining amount of income not yet subject to California income tax is multiplied by the number of California resident non-contingent beneficiaries as it relates to the total number of non-contingent beneficiaries.

California's Throwback Rules

In the event income is accumulated by a trust in the year it arises but is not subject to California income taxation, such accumulated income may nevertheless become subject to California income taxation upon a later distribution to a California resident beneficiary under one of two rules.

First, if some or all of the trust income was subject to California tax in the year it was earned, due to the residency of the fiduciaries and/or non-contingent beneficiaries, but no tax was actually paid, then the accumulated income is subject to California income taxation when a distribution is made to the California resident beneficiary. If a beneficiary is a non-resident of California, only income distributed to the beneficiary that is California source income will be subject to California income taxation.

Second, and of more importance to those considering establishing an ING, if some or all of the trust income was *not* subject to tax in the year it arose because a California resident beneficiary's interest was contingent, then such income is subject to California income taxation when distributed to him or her. In the event this rule applies, the beneficiary must determine the California income tax due using the accumulation distribution rules (known as the throwback rules). If the period of accumulation by the trust exceeded five years, the beneficiary's tax is equal to the tax that would have been attributable to that income, had it been distributed to the beneficiary ratably over the current year and the five preceding tax years. In the event of accumulation over a period of less than five years, the beneficiary's tax is equal to the tax on the income had it been included in the beneficiary's income over the relevant number of years.

Additional consideration must be given to the residence of the beneficiary both at the time of accumulation and at the time of distribution. If a beneficiary was a California resident both at the time of accumulation and at the time of distribution, the income accumulated will be subject to California income taxation. This is of

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particular importance to the grantor of an ING, as if he or she intends to distribute the assets of the ING to himself or herself, while a California resident the distribution will be subject to California income tax.

If, however, a beneficiary was a California resident at the time of accumulation but is no longer a resident at the time of distribution, the outcome is unclear. If the trust should have paid California income taxation based on the residency of either the fiduciary or the beneficiary but did not, only the accumulated income that is also California source income should be subject to California income taxation. If the beneficiary was a California resident whose interest was contingent at the time of accumulation, it stands to reason that if the individual had been a California resident at any time during the five years preceding the distribution, some portion of the distribution would be subject to California income taxation. Again, the grantor of an ING must carefully consider when and to whom distributions may be made to avoid trust distributions being subject to California income tax.

Finally, if a beneficiary is not a California resident when income is accumulated or distributed, the income distributed to him or her will not be subject to California income taxation, unless the trust itself owes California income tax due to the residence of a fiduciary or the accumulated income distributed contains California source income.

Structure of an ING

Assuming a taxpayer is interested in implementing an ING prior to the effective date of the proposal (if, for example, he or she wanted to shelter a gain in 2021 and believed the accumulated income in the ING would continue to benefit from deferral after 2021), an ING must accomplish four fundamental tasks:

1. The transfer to the trust must be complete for income tax purposes (i.e., the trust must not be considered a grantor trust);
2. The transfer to the trust must be incomplete for gift tax purposes;
3. The direction by the distribution committee to make a distribution to the grantor must not be considered a completed gift by the committee members, but merely a return of the grantor's property; and,
4. The direction by the committee to make a distribution to individuals other than the grantor must not be considered a completed gift by the committee members, but instead a completed gift by the grantor.

An ING is an irrevocable trust created by the grantor for the benefit of the grantor and certain other beneficiaries (often the grantor's spouse, descendants, and other family members). The ING often has a corporate trustee in the low state income tax jurisdiction, as well as a distribution committee comprised of the grantor and other beneficiaries. The distribution committee must include at least two members other than the grantor at all times. In the event of a grantor with only minor beneficiaries, an appointed guardian for each such minor child will be required to serve on the distribution committee to represent the minor beneficiary's interest until the child reaches the age of majority.

During the grantor's lifetime, distributions may be made from the ING, as follows:

1. The trustee, pursuant to the direction of a majority of the distribution committee members other than the grantor, with the consent of the grantor, shall distribute to a beneficiary such amounts of the net income or principal as directed by the distribution committee (grantor's consent power);
2. The trustee, pursuant to the direction of all of the distribution committee members, other than the grantor, shall distribute to a beneficiary such amounts of the net income or principal as directed by the distribution committee (unanimous member power); and,
3. The grantor may direct the trustee to distribute to any one or more of the beneficiaries (other than the grantor) such amounts of the principal (including the whole thereof) as the grantor deems advisable to provide for the health, maintenance, support, and/or education of such individuals (grantor's sole power'').

The grantor also holds a testamentary limited power of appointment over the assets of the ING.

The Trust is a Non-grantor Trust

In order for the ING to avoid state income taxation in the grantor's state of residence, the ING must be a non-grantor trust. Internal Revenue Code Sections 673 through 677 specify circumstances where the grantor will be treated as the owner of a trust for income tax purposes. Generally, those provisions provide for grantor trust treatment under the following circumstances:

1. The grantor has a reversionary interest in the principal or income of the trust, the value of which exceeds 5% of the value of the trust.
2. The beneficial enjoyment of the principal or income of the trust is subject to a power of disposition, exercisable by the grantor or a nonadverse party, or both, without the approval or consent of any adverse party.
3. Under the terms of the trust agreement or circumstances attendant to its operation, administrative control is exercisable primarily for the benefit of the grantor rather than the beneficiaries of the trust.
4. Where at any time the power to revest trust property in the grantor is exercisable by the grantor or a nonadverse party, or both.
5. The income without the approval or consent of any adverse party is, or in the discretion of the grantor or a nonadverse party (or both) may be, distributed to the grantor or the grantor's spouse; held or accumulated for future distribution to the grantor or the grantor's spouse; or applied to the payment of premiums on policies of insurance on the life of the grantor or the grantor's spouse.
6. A person other than the grantor shall be treated as the owner of any portion of a trust with respect to which: such person has a power exercisable solely by himself to vest the principal or the income therefrom in himself, or 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 671-677 subject a grantor of a trust to treatment as the owner thereof.

In Private Letter Ruling 201410002, which requested rulings with respect to an ING, the IRS concluded that as none of the non-grantor distribution committee members had a power exercisable solely by him or herself to vest trust income or principal in him or herself, the non-grantor distribution committee members were not treated as the owners of any portion of the ING un-

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der IRC Section 678. Further, the IRS concluded that the ING did not contain any provisions which would cause it to be treated as a grantor trust under IRC Sections 673, 674, 676, or 677.

The IRS further noted that none of the circumstances that would cause administrative controls to be considered exercisable primarily for the benefit of the grantor under IRC Section 675 were present in the trust, but that the circumstances attendant to the operation of the ING would ultimately determine whether the grantor will be treated as the owner of any portion of the ING under that section. As the application of Section 675 is a facts and circumstances test, caution should be given to avoid the application of that section during the administration of an ING.

The Initial Contribution to the ING is an Incomplete Gift

The second hurdle in creating an ING is ensuring that the contribution to the ING is not a completed gift. In the typical ING structure, the grantor retains the grantor's consent power over the income and principal of the ING. The concern here is whether the distribution committee is considered as having a substantial adverse interest in the ING. As a coholder of a power is only considered as having an adverse interest where he may possess the power after the possessor's death—and the distribution committee ceases to exist upon the grantor's death—the distribution committee members do not have interests adverse to the grantor. Therefore, the grantor is considered as possessing the power to distribute income and principal to any beneficiary himself, because he retained the Grantor's Consent Power. The retention of this power causes the transfer of property to the ING to be wholly incomplete for federal gift tax purposes.

Further, a gift is incomplete if and to the extent that a reserved power gives the donor the power to name new beneficiaries, or to change the interests of the beneficiaries. As the Grantor's Sole Power gives the grantor the power to change the interests of the beneficiaries, the retention of this power causes the transfer of property to the ING to be wholly incomplete for federal gift tax purposes.

Finally, the retention of a testamentary power to appoint the remainder of a trust is considered a retention of dominion and control over the remainder. Accordingly, the retention of the grantor's testamentary limited power to appoint the property also causes the transfer of property to the ING to be incomplete with respect to the remainder interest for federal gift tax purposes.

The Distribution to the Grantor by the Distribution Committee is Not a Completed Gift

Although the distribution committee possess the unanimous member power, this power is not considered a condition precedent to the grantor's sole power. Therefore, the grantor retains dominion and control over the income and principal of the ING until the distribution committee exercises its unanimous member power, rendering any distribution to the grantor a mere return of the grantor's property.

Distributions to Beneficiaries Other Than Grantor Are Not Gifts by the Distribution Committee

The powers held by the distribution committee are either exercisable only with the consent of the creator (i.e., the grantor's consent power) or by individuals with substantial adverse interests (i.e., the unanimous member power), thus the distribution committee does not hold general powers of appointment, and any distribution to a beneficiary other than the grantor is deemed to be a gift from the grantor, not the distribution committee.

Legislative Proposal C

As justification for the Legislative Proposal C, it is stated that there has been an increase in marketing INGs as a ''California tax advantage strategy'' and the change would mitigate a developing strategy of shifting income to a more tax friendly state and ''eliminate the different treatment of similarly situated taxpayers.'' The logic for this last statement is that in the case of a grantor trust where the grantor retains control of the trust, the trust is disregarded and the grantor is taxed on trust income—while in an ING the grantor may retain control through the distribution committee, but the trust is not disregarded and instead is treated as a separate entity. According to the proposal, this ''means that grantors who retain control over their trust are taxed differently based on the trust structure.'' The proposal suggests that roughly 1,500 taxpayers would be impacted by the change in 2022, dropping to 700 annually thereafter. The proposal further predicts that this change would result in an increase in revenue to the state of $23 million in 2022 and an estimated $17 million annually thereafter.

On March 31, 2014, New York enacted legislation intended to close the loopholes exploited by INGs. Specifically, the state provided that an ING (defined in the statute as a trust created by a New York resident, the funding of which is considered an incomplete gift, but which is not taxable to the grantor) will be treated as a grantor trust for state income tax purposes. The proposal cites this New York law change as an effective way to curtail this type of planning and is largely modeled after New York's law.

If California were to enact the proposal during the 2021 legislative session, it would defeat one of the most attractive benefits of INGs and possibly cause taxpayers with existing INGs to question their continued effectiveness. It is unclear whether the accumulated income in an existing ING would continue to benefit from a state income tax deferral, but as the proposal doesn't mention any impact on the accumulation distribution rules under Section 17745 of the Revenue and Tax Code, it seems that is the likely outcome. If the proposal is seen as an admission by the FTB that INGs work to defer California income tax, at least for now, it may actually increase the number of INGs that are created in advance of large capital transactions. In any event, taxpayers considering an ING should carefully consider the long term effectiveness of the structure, given the FTB's current interest in it.

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