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The Washington Report

Wealth Transfer Edition

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California Amends Tax Code Affecting Incomplete Gift Non-Grantor Trusts

MARKET TREND: In July 2023 California amended its tax code to ensure that income earned by an incomplete gift non-grantor trust ("ING trust") settled by a California resident will be deemed income earned by that California resident, not the trust, and, therefore, will be subject to California income tax.

SYNOPSIS: An ING trust enables an individual residing in a high income tax state to shift income to a low or no income tax state and thereby reduce his or her state income tax liability. This wealth preservation strategy is not available to residents in all states, but where available, it is highly effective. By joining New York in foreclosing this strategy, California may encourage other states to do the same, especially as states look for more revenue to close their budget gaps.

TAKEAWAYS: Taxpayers should exercise caution in implementing ING trusts, particularly in light of California's new law, which is effective retroactively. While the ING trust remains a viable wealth preservation strategy in many states, it is unclear how long this will continue. Taxpayers who implement this strategy are well advised to craft an exit strategy as well.

MAJOR REFERENCES: California Revenue and Taxation Code Section 17082.

Background

An ING trust is irrevocable and attempts to leverage federal and state tax law to enable an individual residing in a high income tax state to shift income to a low or no income tax state, typically, Delaware, Nevada, or Wyoming.

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As the name suggests, an ING trust is defined by two federal tax characteristics: (1) a transfer of assets to an ING trust is an incomplete gift for federal gift tax purposes; and (2) an ING trust is a non-grantor trust for federal income tax purposes. These characteristics are important because:

- Incomplete gifts are not subject to federal gift tax; and
- A non-grantor trust is a separate taxpayer from its settlor for federal income tax purposes. (In contrast, a grantor trust is disregarded for federal income tax purposes so that the trust's settlor/creator reports, and pays tax on, the trust's income.)

For the most part, states follow federal tax law with respect to the grantor trust, non-grantor trust distinction. Thus, if a trust is a grantor trust (or non-grantor trust) for federal income tax purposes, it will in most cases be a grantor trust (or non-grantor trust, as applicable) for state income tax purposes. The new California law is a departure from this construction.

Individuals are typically subject to tax in their state of residence on all of their income, regardless of its source (subject to credits for taxes paid in other states). To manage their state tax liability, an individual who resides in a high income tax state generally can transfer assets to a non-grantor trust formed in a low or no income tax state. Because the trust will be a separate taxpayer from the settlor, it can avoid paying tax in the settlor's state of residence provided that the settlor's state of residence does not treat the trust as a resident trust and that the trust assets do not produce income that is sourced to the individual's state. In addition, because the transfer of assets to the trust will be an incomplete gift, the settlor will not have to allocate gift tax exemption to the transfer to avoid paying federal gift tax, which tax would otherwise offset the state income tax savings.

In some cases, state residency rules for trusts prevent taxpayers from implementing this strategy. For example, the District of Columbia, Illinois, Maine, Michigan, Minnesota, Nebraska, Oklahoma, Pennsylvania, Vermont, Virginia, West Virginia, and Wisconsin treat a non-grantor trust as a resident trust if at the time the settlor created the trust the settlor was a resident of the state. Because in these cases the trust has the same residency as the settlor, the income from the assets transferred to the trust will be subject to income tax in the settlor's state of residence, notwithstanding that the trust is a separate taxpayer from the settlor.

Example – Who Might Consider Using an ING Trust?

An ING trust is most effective when the settlor lives in a high income tax state, and owns income-producing assets and/or intends to sell an asset with significant built-in gain. Assume that Claire plans to sell her business for $70 million. Claire started the business 30 years ago and has no income tax basis to offset the built-in gain. If Claire sells the business without prior tax planning, she will owe approximately $23.31 million in federal and state income taxes.[1]

[1] Based on a 20% federal long-term capital gains tax rate plus a 13.3% California tax rate.

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Now assume that, prior to the sale, Claire consults her advisors who recommend that she form an ING trust in Nevada (a no income tax state) and that she fund the trust with a $30 million interest in the business. This will not trigger federal gift tax on the transfer to the trust because the transfer is an incomplete gift. Upon the sale of the business, Claire will owe approximately $13.32 million in tax,[2] and the trust will owe approximately $7.14 million in tax,[3] for a total tax liability of approximately $20.46 million. By implementing the ING trust strategy, Claire will save almost $3 million in state income tax.

California's New Law – How Does It Prevent State Income Tax Planning?

Until recently, the ING trust strategy was available to California residents. Pursuant to Sections 17742-17744 of California's Revenue and Taxation Code ("RTC"), California taxes a non-grantor trust's income based on the residence of the trustees and beneficiaries, not the residence of the settlor. On July 10, 2023, however, Governor Gavin Newsom signed into law Senate Bill 131, thereby creating a new Section 17082 of the RTC.

In a highly unusual turn of events, Section 17082 is effective retroactively to January 1, 2023, and decouples federal and state tax law for purposes of determining the state income tax treatment of an ING trust. It provides instead that California will tax an ING trust as though the trust were a grantor trust notwithstanding the trust's treatment under federal tax law. This solution is essentially the same as the solution enacted by New York in 2014.

Observations and Solutions

California's decision that Section 17082 should apply retroactively likely reflects concerns regarding the state's finances. Governor Newsom first proposed taxing ING trusts in his initial 2023-2024 Budget Report, in which he also projected a $22.5 billion budget gap for the fiscal year. Other states may follow the New York/California example and enact legislation combatting tax leakage from ING trusts. Taxpayers who decide to create ING trusts, and taxpayers in California with ING trusts already in place, may want to consider one of the following exit strategies.

- Transfer the ING trust assets to a completed gift non-grantor trust ("CNG trust") formed in a no income tax state. Provided the settlor has sufficient gift tax exemption available, the settlor would not owe federal gift tax on the transfer, and the transfer would both (1) remove the assets from the grantor's taxable estate and (2) continue to protect the assets from state income tax. A very positive outcome.

- Sell the ING trust assets to a CNG trust formed in a no income tax state and structure the sale as a so-called Internal Revenue Code Section 453 installment sale. Essentially, the ING trust would sell the trust assets to the CNG trust in exchange for an interest-only installment note. Provided that the CNG trust did not dispose of the assets for at least

[2] See footnote 1.
[3] Based on a 20% federal long-term capital gains tax rate plus the 3.8% federal net investment income tax.

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two years after the sale, during the payment period, the ING trust would pay income tax in the settlor's state of residence only on the interest payments, thus deferring tax on the principal until the end of the payment period. Meanwhile, all income earned by the CNG trust, to the extent not used to pay interest to the ING trust and to the extent not sourced to the settlor's state of residence, would escape taxation in the settlor's state of residence. Further, all asset appreciation in the CNG trust would escape income taxation in the settlor's state of residence.

- Adjust the ING trust's investments so that the trust invests primarily in a low turnover portfolio of growth assets and/or invests in nontaxable assets, such as a high cash value life insurance product.

Takeaways

Taxpayers should exercise caution in implementing ING trusts, particularly in light of California's new law, which is effective retroactively. While the ING trust remains a viable wealth preservation strategy in many states, it is unclear how long this will continue. Taxpayers who implement this strategy are well advised to craft an exit strategy with their advisors.

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