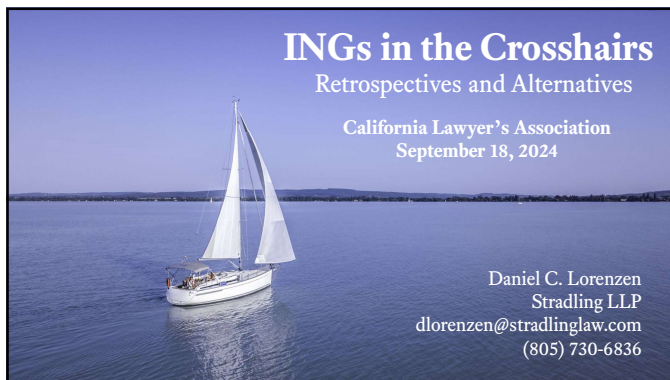


INGs in the Crosshairs

1



2

Revenue Act of 1913

- Trusts were presumed to distribute all income
- So, it was assumed that income beneficiary would remit income taxes
- NY law actually banned accumulation of income in trusts
- But, big exception was trusts with unascertained or minor beneficiaries

3

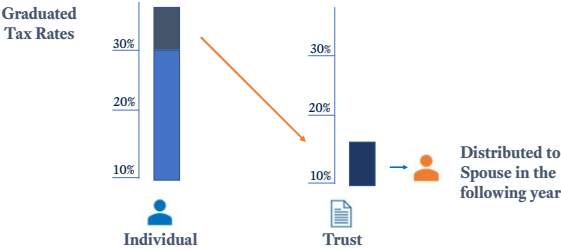
Revenue Acts of 1916-17

- Revenue Acts of 1916 and 1917 clarified that, in the event of accumulations, fiduciaries could file income tax returns
- Planning in the next few decades revolved around forcing trusts to accumulate income
 - By structuring annuity payments that are less than anticipated income
 - By mandating income would be distributed on dates in the following tax year
 - By creating distribution committees of beneficiaries themselves

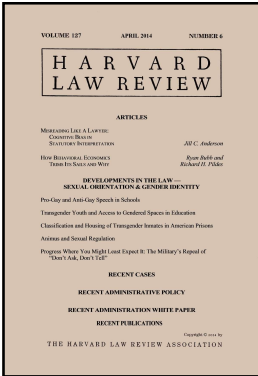
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Pre-war Tax Planning
Dean Trust

Commissioner v. Dean, 102 Fed. 2d 699 (1939)



5



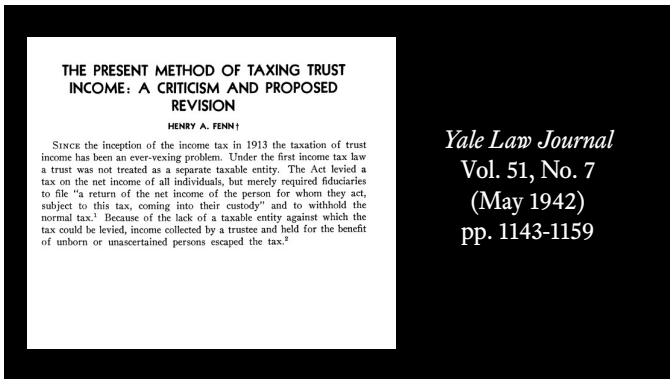
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8



9

Post-war Policy Responses

Coordination with Gift Tax System

Introduction of grantor trust rules
Helvering v. Clifford 1940

Federal accumulations tax § 665-668 (1950s)

Compression of trust income tax rates (1980s)

10

Remaining Benefits of Nongrantor Trusts

Jurisdictional

i.e., zero tax jurisdiction

Statutory

i.e., Section 1202

11

Progressive Trust Laws Come Onshore



- Directed Trusts
- Self-settled Asset Protection
- Privacy
- Extended Perpetuities
- Low/no taxes

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Desired features

- A nongrantor trust sitused in a state that chooses not to tax trust income could pay no state taxes on accumulated income, if there are no other state tax contacts
- A trust structured as an incomplete gift trust would: (i) allow the settlor to retain beneficial interest or control, and (ii) not incur gift taxes no matter how much is contributed to the trust

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Enabling Factors

- Increasingly higher state tax rates
- Stabilized capital gains regime
- Settlor may retain certain powers and the settlor’s creditors may not reach trust assets under state law
- Directed trust statutes

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A trust taxonomy

		Gift	
		Complete	Incomplete
Income	Incomplete	IDGT QTIP GRAT	RLT
	Complete	Completed gift to a nongrantor trust	ING (CRT)

15

Achieving Nongrantor status

- No power triggering grantor trust rules of IRC § 671 – 677, 679
- No administrative rights, no non-adverse party to add or remove beneficiaries, **no income for grantor or spouse**

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Creditor access to trust

- If the trust income can be used to satisfy obligations of the grantor, then the trust will likely be a grantor trust, IRC § 677
- So, it is vital that the state law of the trust's situs allow the settlor to settle and remain a possible beneficiary of the trust, and retain certain powers over the trust, and the grantor's creditors may not access the trust income

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California Source Income

- Rev. & Tax Code 17951 – the gross income of nonresident taxpayers includes only the gross income from sources within this state
- For an individual or trust, the sale of stocks and bonds, for example, has a source in the state where the individual resides
- However, income from a business, trade or profession carried on within California will have at least some California source

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California Taxation of Trusts

- Rev. & Tax Code 17743 – income is apportioned among the numbers of resident versus nonresident trustees
- Rev. & Tax Code 17744 – income is apportioned among the numbers of resident versus nonresident noncontingent beneficiaries
- * Thesis – INGs do not present any unique or interesting differences to the CA taxation picture

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Achieving an Incomplete Gift

“A gift is also 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 between themselves unless the power is a fiduciary power limited by a fixed or ascertainable standard.”
Treas. Regs. 25.2511-2(c).

Various Rulings – a gift may be separately complete or incomplete over the remainder versus an income interest in a trust, or as to the income or principal interests

20

PLRs

Usually, the worst-case federal tax consequences of an ING trust are far worse than the state tax benefits are beneficial (40% vs. 13.3%)

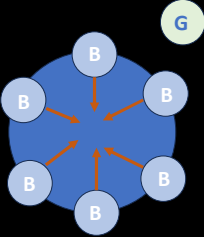
PLRs frequently covered:

- That the transfer is an incomplete gift
- That the DC members do not exercise a POA or make a gift
- That the trust is a nongrantor trust
- That a distribution to any beneficiary who is not the settlor is a completed gift deemed to have been made by the settlor

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Key mechanism

Distribution Committee
or
Power of Appointment
Committee



22

ING features

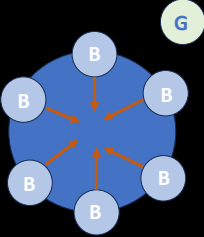
-  Grantor's Sole Power
-  Grantor's Consent Power
-  Grantor's Testamentary Power
-  Members' Unanimous Power

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Key mechanism revisited

This structure is

Incomplete for gift purposes
and
Complete for income purposes



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Downsides & Risks (structural)

- Settlor has given control of distributions to other beneficiaries, and has only retained the ability to appoint principal among Settlor's own issue
- Other beneficiaries should not reside in California to avoid income apportionment
- Although settlor is a potential beneficiary, distributions received while a California resident will be subject to the California accumulations tax

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Downsides & Risks (legal)

- There is no good reason for the disparate income and gift treatment of the same structure to exist (rational)
- Federal tax implications (i.e., a completed gift in excess of exemption, or the deemed exercise of a general power by the Distribution Committee members) are far worse than the California tax savings are a benefit
- No cases or rulings supporting the strategy overall
- Purpose other than tax avoidance?

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A trust taxonomy

		Gift	
		Complete	Incomplete
Income	Incomplete	IDGT QTIP GRAT	RLT
	Complete	Completed gift to a nongrantor trust	ING (CRT)

27

First PLRs
IRS CCA & pause
2013 PLRs
NY Law
VA Tax Review
IRS no ruling
FTB legislative
2023 CA budget

The first PLRs were issued starting in around 2001, before a pause in rulings in 2007.
-> issue was whether a vacancy could be filled in the distribution committee membership

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First PLRs
IRS CCA & pause
2013 PLRs
NY Law
VA Tax Review
IRS no ruling
FTB legislative
2023 CA budget

CCA 201208026 questioned whether the retention of a limited testamentary power of appointment alone is enough to make the entire gift incomplete, as the gift consists of severable term and remainder interests

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First PLRs
IRS CCA & pause
2013 PLRs
NY Law
VA Tax Review
IRS no ruling
FTB legislative
2023 CA budget

Private Letter Rulings obtained from 2013 onward addressed the CCA concern by including one or both of the Grantor Consent Powers and Grantor Sole Powers

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First PLRs

IRS CCA & pause

2013 PLRs

NY Law

VA Tax Review

IRS no ruling

FTB legislative

2023 CA budget

Effective January 1, 2014, New York added legislation to add the net income of an ING trust to the income of the trust's grantor, effectively treating an ING as a grantor trust for state law purposes.

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First PLRs

IRS CCA & pause

2013 PLRs

NY Law

VA Tax Review

IRS no ruling

FTB legislative

2023 CA budget

ADVERSITY, INCONSISTENCY, AND THE INCOMPLETE NONGRANTOR TRUST

Grayson M.P. McCouch *

1. INTRODUCTION

Federal tax considerations have traditionally played a prominent role in the planning and drafting of family trusts. State taxes, by comparison, have received far less attention. Since 2001, however, sophisticated estate planners have developed a specialized form of trust, known as an "incomplete nongrantor" (ING) trust, which purports to avoid state fiduciary income taxes on accumulated trust income. Unlike most tax-driven trusts, the ING trust is

Grayson M. P. McCouch, Adversity, Inconsistency, and the Incomplete Nongrantor Trust, 39 VA. TAX REV. 419 (2020)

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First PLRs

IRS CCA & pause

2013 PLRs

NY Law

VA Tax Review

IRS no ruling

FTB legislative

2023 CA budget

IRS added ING's to the no ruling list in 2021, Rev. Proc. 2021-3

33

First PLRs
IRS CCA & pause
2013 PLRs
NY Law
VA Tax Review
IRS no ruling
FTB legislative
2023 CA budget

In Legislative Proposal C in 2021, the California Franchise Tax Board publicly proposed legislation to render ING trusts ineffective in California, citing that “a California resident [may] not pay California state income taxes” using an ING trust.

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First PLRs
IRS CCA & pause
2013 PLRs
NY Law
VA Tax Review
IRS no ruling
FTB legislative
2023 CA budget

The Governor’s budget for 2023 included a number of tax provisions to raise revenue. One of these provisions was styled on the prior New York anti-ING legislation. Because it was part of the budget, it received an up or down vote in the California legislature with no debate or committee review. This provision is now Rev. & Tax Code Section 17082.

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New § 17802

- Effective January 1, 2023
- The income from an ING trust will be added to the grantor’s gross income as if the trust in its entirety were treated as a grantor trust
- Creates a definition of a resident non-grantor trust, mainly to handle a strange exception

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Subsection (c)

- Provides that for certain incomplete gift nongrantor trusts, the income is not imputed to the grantor if 90% or more of the distributable net income of the trust is distributed or distributable to a charitable organization.
- Appears to allow the charitable deduction in these circumstances to be taken under § 642 (more generous) instead of under § 170(c) (more limited), but the state equivalents of those.

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CRUTS & IRAs

- It is conceivable that each of these is a form of a nongrantor trust, and the transfers thereto are incomplete gifts
- This issue was raised and resolved in New York
- The CA FTB issued a statement, in an obscure publication, clarifying that it would not include CRUTs or IRAs in the new legislation
- However, a legislative fix is desired

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Existing ING Trusts

- Treated, for CA purposes only, as grantor trusts, since 2023
- Federal law still treats them, presumably, as completed gift, nongrantor trusts

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Options for Existing ING Trusts

- Turn some or all of trust property into a completed gift
 - Through exercise of a power of appointment (i.e., grantor sole power)
 - Through a distribution by the Distribution Committee
 - Completed gift may be an ongoing nongrantor trust
 - Through a decanting?
- Maintain the ING Trust
- Distribution Committee may distribute property back to the grantor, but subject to CA accumulations tax

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Personal Residency (Chief Alternative)

- Effect of California multi-factor test
- Need to sever CA connections and build connections in another state
- Temporary or transitory
- Day count is important, but not dispositive
- Cannot leave California for nowhere in particular
- Time consuming and planning intensive

G Guidelines for Determining Residency

The underlying theory of residency is that you are a resident of the place where you have the closest connections. The following list shows some of the factors you can use to help determine your residency status. Since your residence is usually the place where you have the closest ties, you should compare your ties to California with your ties elsewhere. In using these factors, it is the strength of your ties, not just the number of ties, that determines your residence. This is only a partial list of the factors to consider. No one factor is determinative. Consider all the facts of your particular situation to determine your residency status.

Factors to consider are as follows:

- Amount of time you spend in California versus amount of time you spend outside California.
- Location of your spouse/POA and children.
- Location of your principal residence.
- State that issued your driver's license.
- State where your vehicles are registered.
- State where you maintain your professional licenses.
- State where you are registered to vote.
- Location of the banks where you maintain accounts.
- The origination point of your financial transactions.
- Location of your medical professionals and other healthcare providers (doctors, dentists etc.), accountants, and attorneys.

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Insurance

- Private Placement Life Insurance has a long history, and is guarded by some of the most well-settled tax exemptions in the Code
- Taxpayer attempts to control or manipulate the life insurance investments will continue to be an area of push and pull with the government, but the basic foundations are well-settled

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Completed Gift to a Nongrantor Trust

- “Safe and sane” tried and true strategy
- Limited by remaining amount of gift tax exemption
- Assets are given away in trust, and there is no retention of benefit by the grantor
- Some advisor confusion?

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Section 678 Trust Structure

- Trust No. 1 is an incomplete gift, grantor trust
- Trust No. 2 is a completed gift nongrantor trust
- Trust No. 2 is the grantor of Trust No. 1 by virtue of holding a power to withdraw the income of Trust No. 1
- Old idea pre-dating INGs
- Many questions:
 - Mismatch of income received to place where tax liability resides
 - Do the trusts have the same beneficiaries such that no gifts are made?

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