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$10K State Tax Deduction Cap Prompts Bold Moves To Skirt California Taxes

Federal tax reform passed at year-end, but not everyone is happy. There could be lawsuits and work-arounds by states trying to blunt the impact of some of the provisions. One of the most distressing changes to taxpayers in high tax states is the cap on state income and property tax deductions. In California, we are used to writing off high California taxes. When you pay 13.3%, a write-off with the IRS helps. A $10,000 limit doesn't go very far in the Golden State, but you have to hand it to California for creativity. If passed, the pending Protect California Taxpayers Act will take a creative spin on tax deductions. The federal tax law caps deductions at $10,000, so how about making them "charitable contributions?"

The pending bill tries that work-around, although whether the IRS would buy it is not yet clear. After all, wouldn't you expect the IRS and FTB to attack taxpayers that try an end run like this? You might think so, but perhaps it will be different if state law provides a call-it-something-else workaround. It's a curious turn of events, with California sounding a little like a tax-dodger.

Some Californians are not waiting around for the state legislature. Some are moving out of the state, or at least thinking about it, even if New Yorker Millionaires love NYC too much to leave if taxes go up.

For Californians, this is not a new phenomenon. For decades, tax lawyers in the golden state meet clients with wanderlust, often right before a big income event. Wandering taxpayers might be about to sell or take a company public or settle a big lawsuit. They might be about to sell highly appreciated Bitcoin. Whatever the circumstance, state taxes can play a big part. Moving doesn't always work, if it isn't done soon enough or done properly. And moving won't help if you are selling something that is inherently always taxed by California, such as a sale of California real estate.

But for many, a move done carefully, and with the right kind of income, can cut the sting of California's high 13.3% state tax. Apart from physical moves, another approach—that will probably be considered by more people in 2018—involves setting up a new type of trust in Nevada or Delaware. A 'NING' is a Nevada Incomplete Gift Non-Grantor Trust. A 'DING' is its Delaware sibling. There is even a 'WING,' from Wyoming. Let's say you can't move, so you wonder if a trust in another state might sidestep California taxes.

Living trusts are great for avoiding probate on death, but they don't help for income tax purposes. You are still taxed on income from trust assets on your individual income tax return. With a Nevada or Delaware Incomplete Gift Non-Grantor Trust, the donor makes an incomplete gift—with strings attached—to the trust. The trustee must not be a resident of California. NING and DING trusts started with wealthy New Yorkers trying to sidestep New York taxes on certain assets. But New York changed the law to make the grantor taxable no matter what. California has not done that, but California's Franchise Tax Board says it is studying the issue. It is possible that California tax authorities will pursue these trusts in audits and tax controversies.

But some people are giving it the old college try. Some marketers of NING and DING trusts offer them as alternatives or adjuncts to a physical move. The idea is for income and gain in the NING or DING trust not to be taxed by California until it is distributed. At that point, the distributees will hopefully no longer be residing in California. California taxes all income at up to 13.3%, and there is no lower rate for long term capital gain. Tax-deferred compounding can yield impressive results, even if only state income tax is being sidestepped.

Parents frequently fund irrevocable trusts for children, and may not want the trust to make distributions for many years. The parents might also remove future appreciation of trust assets from their estates. Since most trusts are taxable where the trustee is situated, one common answer is an institutional trust company in Delaware or South Dakota, where there is no state income tax. For trust investment and distribution committees, committee members should also not be residents of California. Outside of New York, the jury is still out on NING and DING trusts. The facts, documents, and details matter. But if one is careful, willing to bear some risk, and there is sufficient money at stake, the calculated risks may make sense.

For alerts to future tax articles, email me at Wood@WoodLLP.com. This discussion is not legal advice.