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Can Sellers Skip State Taxes With A NING Or DING Trust?

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Can a resident of State A who is selling a company legally avoid State A taxes on the business sale by setting up a trust in State B? This may sound like a silly question. Indeed, when you add NING or DING to the question, it may sound like an eerie reminder of the acronyms from our last big tax-shelter era.

That last tax-shelter era produced such bellwethers as OPIS, BLIPS, BOSS, CARDS and more. It always seemed that at least a small part of the reason those bloated shelters failed was their slick marketing and Madison Avenue nomenclature. Of course, they were also, well, abusive.

NINGs and DINGs are by comparison pretty tame, although not all state tax authorities appear to agree. And to a large extent, the jury is still out on just how well they will stand up to state income tax scrutiny. A NING is a Nevada Incomplete Gift Non-Grantor Trust. A DING is its Delaware sibling.

Then there is the WING, from Wyoming, another no-tax haven. Talk of all such trusts may sound out of place in the context of business sales. Yet sellers of closely held businesses are asking more and more questions about these vehicles.

They are asking what they are, whether they work and how far one can go in pushing the proverbial tax envelope. The focus of client interest and our concern here is solely with state income taxes. But all of the fuss can be traced to the IRS and its seeming largesse. For on March 8, 2013, the IRS issued Private Letter Ruling 201310002.

NING Trust Approved

Taxpayers in high-tax states with large unrealized capital gains have always wanted to find a way to eliminate, or at least to minimize, their state income tax exposure on a sale. Of course, they want to achieve that goal without giving up the economic benefit of the underlying

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assets! The same can be said for taxpayers in high-tax states with a regular stream of ordinary income from an investment portfolio.

Once again, the challenge is to strip away an encroaching tax burden. There are federal tax issues and state ones, and there is a mix of gift and estate tax plus income tax. And yet the real game is relatively simple, a kind of perfect mix, the Arnold Palmer of the tax world.

The main obstacle to creating a trust in this context is that you do not want it to be a grantor trust, taxed to the grantor. Trusts created by people during their lifetimes typically come in two forms, grantor trusts and nongrantor trusts. The income generated by grantor trusts that is not distributed to beneficiaries is typically considered taxable income to the person who put the assets into the trust.

So a grantor in this context does not want a grantor trust. A grantor trust would mean the trust files no tax return and that the grantor would simply include the trust income on his or her personal tax return. The grantor in the high-tax state would still pay the state tax, so there would be no joy there.

Thus, the settlor/grantor of the trust needs to give up just enough control to *avoid* grantor trust status. And yet the grantor/settlor does not want to *actually* part with full control, to truly give the assets away to the kids or to any other beneficiaries. Apart from the obvious fiscal savvy of keeping the assets and not letting anyone else have them, there is the federal gift or estate tax to consider too.

Completed and Incomplete?

After all, a completed gift would mean either paying gift tax or eating into one's lifetime exemption. Currently, that is $5.43 million per person, or $10.86 million per married couple. But that should be saved for later, and it is finite.

It is also not enough if you have already used your lifetime exemption or if you are selling your $20 million business. The emerging answer—at least for the adventurous—is a Nevada or Delaware Incomplete Gift Non-Grantor Trust. Both NING and DING trusts owe something to the marketing efforts of their respective states.

To avoid a completed gift, advisors generally say that you should give the grantor a testamentary nongeneral power of appointment. To avoid grantor trust status, advisors often say you should create a distribution committee that must approve any distribution to the grantor. In short, the grantor cannot just get the property back willy-nilly.

Indeed, one makes sure that the committee members are adverse parties. Under Code Sec. 672(a), that makes the trust *not* a grantor trust. There was a period of uncertainty over these issues from about 2007 to 2013.

But then in 2013, the IRS seemed to resolve the federal tax side of this. In LTR 201310002, and in sister rulings numbered LTRs 201310003, 201310004, 201310005 and 201310006, the IRS approved the notion that a NING trust was a *nongrantor* trust for income tax purposes. And yet, the transfers to the trust were *incomplete* for gift tax purposes.

It is also significant that these rulings concluded that the distribution committee members did not have *general* powers of appointment. Finally, note that the increased applicable exclusion amounts

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currently in effect might make these trusts popular for taxpayers with more modest wealth. In the past, taxpayers using these trusts wanted the transfers to be incomplete gifts to avoid payment of gift tax, or use of applicable exclusion amount.

Selling and Moving

Some sellers, it must be said, hold significant assets and move states before they sell. The high-tax state may have a claim on some of the sales proceeds even assuming that the move is well-timed, *bona fide* and permanent. Indeed, the high-tax state can also dispute the move, arguing that a move in March really was not a move until July.

In some cases, by the time the move is under audit, the taxpayer has moved back to the high-tax state. The mere year or two out of state may be entirely disregarded. It may be argued to be a temporary absence that should not deprive the high-tax state of its share of the sales proceeds.

In many such tax disputes, the details and connections matter a great deal: voting, car registrations, drivers' licenses, social clubs, real estate ownership, local doctors, dentists and other professionals, bank accounts and more. There is often something that is left astray.

Dates and spending habits matter too. The number of days inside and outside the high-tax state may be examined with credit card receipts and other cold, hard facts. Days in the state for *business* reasons could have greater significance than personal visits. It is against this background that NING and DING trusts emerged. Some marketers offer it as an alternative or adjunct to the physical move.

Ring the NING or DING Bell

A resident of a high-tax state hopes to reduce or eliminate his state income taxes. He asks around, and someone says NING or DING. The goal is to have the NING or DING trust accumulate ordinary income and capital gain.

You do not want the NING or DING to be a grantor trust since the grantor is still a resident of the high-tax state. Instead, you want the income and gain in the NING or DING trust not to be taxed until it is distributed. At that point, the distributees will hopefully no longer be in the high-tax state.

One key element, of course, is that the grantor must not be the trustee. Indeed, the chosen trustee must not be a resident of a "bad" state with a high tax. Optimally, the state tax burden can be minimized or eliminated until the assets are distributed.

At that point, the distributed amount will be subject to the high-tax state's income tax only if the beneficiary is a resident of that high-tax state when the distribution is made. Distributions to a beneficiary who has since moved to Nevada or to another no-tax state will then hopefully be free of the high-tax state's income tax. If the beneficiary is in a taxable but not high-tax state, that state gets to tax the distribution.

Yet, even in that event, the tax there may be lower than in the high-tax state. Of course, when comparing tax rates, the difference between ordinary income and capital gain must also be addressed. If the NING or DING trust is formed mostly to facilitate a business sale and the proceeds will be capital gain, there is the federal tax of up to 20 percent.

Then, there is also the 3.8-percent Obamacare tax on net investment income. Combined, they make the current federal tax burden on capital gain up to 23.8 percent. Adding a state capital gain tax may not be too bad. But what if your state taxes capital gain as ordinary income?

California taxes all income at up to 13.3 percent, with no preference for long-term capital gain. It is one reason nearby Nevada has always been alluring for California sellers.

Estate Planning or M&A?

It is worth asking whether the goal of such arrangements is more transactional or estate planning-focused. It may be either or both. Everyone finds the possibility of tax-free growth attractive.

Whether it is a few years or decades, the compounding that avoids any tax can yield impressive results. That is so even if it is only state income tax that is being sidestepped. California's top marginal income tax rate is now 13.3 percent, and as noted, there is no preference for capital gain.

If the NING or DING trust is being used to fund benefits for children and will grow for years, the model may make even more sense. After all, parents frequently fund irrevocable trusts for children. The parents may not expect or want the trust to make distributions for many years to come.

Such parents may plan to use nontrust resources to pay for their children's ongoing support and education. They may be funding the trust now in order to remove the future appreciation of the trust assets from their estates for estate tax purposes. A NING or DING trust can benefit a child without a distribution too.

The trust might even purchase a home to be used as a primary residence for an adult child, thereafter holding the home as a trust asset. Because the beneficiary does not own the home, this strategy might carry extra benefits. For example, it could help to protect the asset in the event of divorce. It could also help shield the house from the child's creditors and from estate tax upon the child's death.

Taxing Nexus

Needless to say, the NING or DING trust must be a tax resident of a "good" state, Nevada or Delaware, or at least another good state that does not have an income tax. That usually means having a trustee resident in that good state.

For tax purposes, most trusts are considered taxable where the trustee is situated. For NING and DING trusts, one common answer is an institutional trust company in Delaware or South Dakota.

What about the trust investment committee and distribution committee to direct the trustee on investments and distributions? The committee members also should not be residents of the high-tax state. The beneficiaries who live in the high-tax states must only have contingent interests in the trust.

Usually, that means that the trustee will be given sole discretion on distributions based on the trustee's determination of the best interests of the beneficiaries. The standard language includes reference to the beneficiary's health, education, support and maintenance. That is pretty broad language and leads to surprisingly few disputes.

High-Tax State Income?

Some people are surprised to find that even if they jump through all the requisite hoops, the NING or DING trust may *still* pay some tax to the high-tax state. For example, if the trust has any California-source income, it will still be taxable by California. Although there are certainly disputes about what is California-source, some of the rules are reasonably clear.

For example, generally, investment income such as interest, dividends and gains from stock sales are considered income from intangible assets. That typically means they are not California-source income. Of course, gain from the sale of California real estate is sourced to California no matter what.

The grantor who establishes the trust retains some ability to decide who gets how much money. For income tax purposes, however, the trust is considered a nongrantor trust. The trust is itself taxable and must file a tax return. The trust pays its own taxes on its undistributed income.

Throwback Rules?

One set of trust tax rules that can spoil your NING or DING are the so-called throwback rules. On an intuitive level, the high-tax state is trying to collect retroactive tax on the trust's earnings when it can. The timing and other rules are complex, and they deserve a separate article.

Not in New York

New York City and New York State were the first city and state to say no to the NING-DING craze. A new code section was added, NY Tax Law Section 612(b)(41), that literally calls-out incomplete gift nongrantor trusts by name. For distributions from trusts made on or after June 1, 2014, if a trust is not a grantor trust for federal income tax purposes, and the grantor's transfer of assets to the trust was an incomplete gift for federal gift tax purposes, the trust's income will *still* be taxed as the grantor's income by New York City and State.

Thus, a New York resident who funds a NING or DING trust may have the trust still treated as a nongrantor trust for federal income tax purposes. But for New York City and State taxes, the grantor is still taxed. If the grantor's transfer of assets to the trust was a completed gift for federal gift tax purposes, the grantor will not be taxed on the trust's income, but any beneficiaries that are New York residents will be taxed by New York on distributions of accumulated trust income, even if these distributions are not taxable to them for federal purposes.

Elsewhere, Jury is Out

Outside of New York, are NING and DING trusts guaranteed? They are not guaranteed, as we saw with New York. Are they worth the effort? Whether they are worth the effort can be debated.

The facts, documents and details matter. Moreover, one key variable is emerging state law. Like New York, California generally reacts. California has not yet had a major case or legislative change.

Yet California tax lawyers know that the state rarely takes moves that short California taxes lying down. And state tax fights in California can get extremely messy, being both protracted and expensive. But if one is careful, willing to bear some risk and there is sufficient money at stake, the calculated risks can make sense.

From a state income tax perspective—which is what this is all about—one must make certain that the income tax liability belongs to the trust, not to the grantor who funds it. The trust must be established so that its taxing nexus—usually that means the residence and qualification of the trustee—is not in the bad state. And keeping your fingers crossed and your head down may help too.