

State Income Tax Planning for the Nonresident Floridian: The ING Trust

One of the major advantages of Florida domicile and residency is the absence of a Florida state personal income tax. To the Florida estate planning attorney, “state and local taxes” has been the specialty for which he or she “need not apply.” Florida is also a very transient state, as residents come and go from northern states seemingly on a daily basis. This transient nature also flows through to the Florida tax and estate planning bars. To maintain client representation, many East Coast attorneys retain their bar memberships in states such as New York, New Jersey, and Pennsylvania, while many West Coast attorneys retain their bar memberships in states such as Illinois, Ohio, and Michigan.

With the knowledge that many part-time Florida residents choose to remain domiciled “back home,” dual-licensed Florida attorneys must dust off the state income tax books and maintain their skills regarding their “home” state’s income tax planning. This includes awareness of specific techniques to assist with such state income tax planning. For certain clients that 1) reside in states that impose a state income tax (state tax states); 2) have disposable assets they wish to benefit subsequent generations but still retain an interest in the assets “for a rainy day”; and 3) would prefer not to pay state income tax on the income earned from such assets, such a specific planning technique exists that utilizes a self-settled irrevocable trust. These trusts are commonly referred to as “ING trusts,” with “ING” standing for “incomplete (gift) nongrantor” trusts.

The Basics

To follow the logic of the ING trust, three concepts must be understood. First, for state tax states, with respect to grantor trusts, the rules of subchapter J of the Code¹ apply to the particular state income tax.² Second, in certain states, such as Delaware and Nevada, no state personal income taxes are imposed (nontax state) and it may also be possible to create a self-settled irrevocable trust and have those assets be protected from creditors (domestic asset protection trust or DAPT).³ Combining these first two concepts, the question is whether an individual domiciled in a state tax state can create a DAPT and have distributions come back to him or her without the imposition of state income taxes. This is the premise and foundation of the ING trust structure. With that understanding, the third concept of ING trusts is that ING trusts are *not* intended for transfer tax savings. The sole objective of the ING trust is state income tax savings — ING trusts involve incomplete transfers for transfer tax purposes and are anticipated to be included in the grantor’s gross estate.⁴

While most DAPTs are grantor trusts, with the ING trust technique the DAPT is purposefully structured as a *nongrantor* trust and, therefore, becomes its own taxpayer. Since the DAPT is located in a nontax state, the DAPT’s taxable income is taxed in the DAPT state, which means that, at least at the trust level, there is no state income tax. By way of example, suppose that Titus, a Massachusetts resident, creates a nongrantor trust Delaware DAPT at the end of 2013.

In 2014, the DAPT earns \$10,000 of distributable net income (DNI), none of which is distributed (such DNI is also fiduciary accounting income). The DAPT pays the applicable federal income taxes on the DNI. Because Delaware is a nontax state, no state income taxes are assessed on the DNI. The DAPT then provides that any undistributed fiduciary accounting income is to be accumulated by the trustees and added to trust principal. In 2015, the DAPT has \$0 DNI, and, at the end of the year, the trustees effect a discretionary principal distribution to Titus in the amount of \$10,000 (*i.e.*, the same amount of 2014 undistributed DNI). Is that principal distribution taxed to Titus for Massachusetts state income tax purposes? Since the DAPT is a nongrantor trust, the only way that any portion of a distribution can be taxed to a beneficiary is if it consists of DNI, and since the DAPT had no DNI in 2015, it would appear the distribution is not subject to income tax. Titus ultimately received \$10,000 in 2015 for which federal income taxes were paid in 2014, but for which no Massachusetts income tax is due. Thus, the combination of the Subchapter J rules and the DAPT rules allowed Titus to avoid Massachusetts income tax on the 2014 income.

The above is a basic example of the technique — the intervening steps are extremely technical and complicated.

ING Trusts and Subchapter J

The grantor trust rules under subchapter J rely, for the most part, upon powers retained by the grantor when approval is required of the grantor or a nonadverse party.

For example, the preamble to §677(a) states as follows:

(a) The grantor shall be treated as the owner of any portion of a trust, whether or not he is treated as such owner under [§]674, whose 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*.⁵

Thus, if distributions or certain powers must be effected with the approval of an *adverse* party, grantor trust status can be avoided. Compare this provision to Delaware law, which requires a Delaware DAPT to have a Delaware-based trustee and also limits the grantor's retained powers, two of which are that the grantor cannot be a trustee and the grantor cannot retain the power to control distributions.⁶ Following those rules, it would seem that, unless a beneficiary who acts as the trustee lives in Delaware, the Delaware trustee would be a nonadverse party that triggers §677(a) and creates a grantor trust. The ING trust structure circumvents §677(a) by creating an intermediary — a “distribution committee” comprised of adverse parties — who direct the trustee as to distributions. The presence of the adverse parties causes §677(a) not to apply, so the ING trust is not a grantor trust. While this may solve the grantor trust issue, practitioners had been concerned about whether having certain powers creates adverse transfer tax consequences as to members of the distribution committee — specifically whether there might be a taxable gift by the members back to the grantor when trust distributions are made to the grantor and/or whether having such powers would be considered a general power of appointment that would cause estate tax inclusion in their respective estates under §2041.

Early Rulings

Between 2005 and 2007, seven different private letter rulings (PLR) — PLRs 200502014, 200612002, 200637025, 200647001, 200715005, 200729025, and 200731019⁷ (early rulings) — were sought seeking approval from the Internal Revenue Service of an ING trust structure that used a “distribution committee” with respect to distributions.

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Under the early rulings, the grantor created a discretionary trust, naming a Delaware corporate trustee as the sole trustee, for the benefit of the grantor and others. The trust granted a “distribution committee,” consisting of two permissible beneficiaries of the trust (PLR 200729025 provided for a three-member distribution committee), the power, acting unanimously, to direct the trustee to distribute trust assets among the permissible beneficiaries. In addition, the grantor and one member of the distribution committee could also direct the trustee to make distributions. If either member of the distribution committee died prior to the grantor, the trust required that member to be replaced with another permissible beneficiary. The grantor retained a broad special testamentary power of appointment over the trust assets.

The early rulings concluded that the grantor had not made a completed gift upon establishing the trust due to the grantor's retention of a broad special testamentary power of appointment. The grantor would be treated as making a completed gift when a trust distribution was made to a beneficiary other than the grantor. The IRS also found that, because the distribution committee members had substantial adverse interests to each other (*i.e.*, they were trust beneficiaries and had the authority to pass distributions to one (or to the grantor) to the detriment of the other), they did not possess gen-

eral powers of appointment over the trust for purposes of §2514. As a result, the trusts were held to be nongrantor trusts and distributions would not be considered taxable gifts by the distribution committee members.

IR-2007-127, Rev. Rul. 76-502, and Rev. Rul. 77-158

Shortly before the issuance of PLR 200729025 and PLR 200731019 (which were likely decided at an earlier date but not released until an internally-specified date), the IRS issued News Release IR-2007-127 (July 9, 2007) in which it announced that it was reconsidering the results in the prior ING trust PLRs with respect to whether the distribution committee members possessed general powers of appointment (which would cause them to be personally subject to transfer taxation as to the distributions). Specifically, the news release highlighted that the conclusions in the PLRs may not be consistent with Revenue Ruling 76-502 and Revenue Ruling 77-158 (76/77 rulings).⁸

In the 76/77 rulings, three siblings, each of whom owned a one-third interest in a family business, contributed their interests to an irrevocable trust for the benefit of their respective descendants. The trust permitted the trustees to distribute property to any beneficiary (including themselves). Each trustee had the power to designate a relative to serve as successor upon his or her death or resignation, and if no successor were designated, his or her oldest living descendant would be appointed.

The 76/77 rulings addressed whether any trust assets were includible in a deceased trustee's gross estate as being subject to a general power of appointment under §2041. The 76/77 rulings focused on the Treasury Regulations under §2041 and highlighted the fact that a successor trustee was appointed on the decedent's death. As a result, the remaining trustees did not receive the entire power of appointment, but instead continued to share the power with the replacement trustee. Based on this fact, the IRS determined that the remaining trustees did not have a substantial adverse interest to the deceased trustee and that one-third

of the value of the trust estate was includible in the deceased trustee's estate as being subject to a general power of appointment under §2041.

Post-News Release

In 2008, the IRS invited public comments to the news release. Many different professional organizations, such as the ABA's Real Property Probate & Trust Law Section, the Delaware Bankers Association with the Delaware Bar Association, the New York City Bar Association, and the New York State Bar Association, submitted comments, all stating that the 76/77 rulings were incorrect.⁹

For the next four years, no official rulings or public comment was made as to ING trusts. Then, on February 24, 2012, the IRS released Chief Counsel Advice 201208026 (CCA). The purpose of the CCA was to clarify the IRS's position as to what is an "incomplete gift" for gift tax purposes and to comment on certain withdrawal rights. Up until this time, the prevailing belief was that the retention of a limited power of appointment over the remainder interest in a trust was sufficient to cause a transfer to the trust to be deemed to be "incomplete." The CCA changed this assumption by stating that such retention was insufficient for the stated purpose. One of the collateral effects of this CCA was the impact on ING trust planning. Recall that one of the objectives of an ING trust is that the transfer to the ING trust be an incomplete gift for federal gift tax purposes. Several commentators concluded that a grantor would have to possess an additional power to allow transfers to the trust to be deemed to be incomplete gifts for the ING trust structure to work. Such commentators suggested that the grantor should retain a limited lifetime power of appointment over distributions for health, education maintenance, and support, as this would deem the gift of the income interest also to be incomplete for transfer tax purposes.¹⁰

2013 Private Letter Rulings

On March 8, 2013, the IRS issued PLR's 201310002 through 201310006 (2013 PLR's). The 2013 PLR's all

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involved ING trusts similar to the basic fact pattern described above with the additional element that the grantor also retained the power, in a nonfiduciary capacity, to direct the distribution of principal to any one or more of his issue for their health, education, maintenance or support.

The 2013 PLR's ultimately held that the grantor would not be deemed to be the owner of any portion of the trust under the grantor trust rules, that the transfer of property by the grantor would not be a completed gift, and that distributions by the distribution committee to the grantor and the other beneficiaries would not be considered completed gifts by the members of the committee. The 2013 PLR's did not, however, answer the issues raised by the news release as to whether a deceased distribution committee member may be treated as having a general power of appointment under §2041.

PLRs 201410001 through 201410010 — The Response to IR-2007-127¹¹

One year later, on March 7, 2014, the IRS issued PLRs 201410001 through 201410010 (2014 PLR's),¹² which finally resolved the open issues on ING trusts.

The basic fact pattern of the 2014 PLRs involved the creation of an irrevocable trust by a grantor for the benefit of herself, her stepchildren,

her children, and issue of her stepchildren and children. A corporate trustee was the sole trustee of the trust. The distribution committee consisted of the grantor, the grantor's children (through appointed guardians acting on their behalf until majority), and the grantor's stepchildren. During the grantor's lifetime, the trustee was required to distribute trust income and principal pursuant to the direction of a majority of the distribution committee members and with the written consent of the grantor. The trustee was also directed to distribute income and principal at the direction of all distribution committee members other than the grantor. At all times, the grantor, in a nonfiduciary capacity, could, but was not required to, direct a distribution to the other beneficiaries as the grantor deemed advisable for a beneficiary's health, maintenance, support, and education. At all times the distribution committee had to have at least two members acting other than the grantor, and if a vacancy occurred, it would be filled by the eldest of the grantor's adult issue, or if none, then the eldest issue of the grantor's stepchildren. If at any time this requirement was not met, the distribution committee would be deemed not to exist, and in any event, it was to cease to exist on the grantor's death. Finally, in addition to its distribution authority, the distribution committee could direct the trustee to distribute income and principal to any one or more qualified trusts (*i.e.*, trusts created under a document other than the trust agreement at hand).

On the grantor's death, the trustee was to distribute the balance of the trust assets to or for the benefit of any person or entity, other than the grantor's estate, creditors, or creditors of the grantor's estate, as the grantor appointed by will (the power). If not effectively appointed, the trust assets were to be distributed in further trust to the issue of the grantor's spouse.

The IRS issued six specific rulings as to ING trusts. First, there were no circumstances present that would cause the grantor to be treated as the owner of any portion of the trust under Subchapter J. Second, because none of the other distribution commit-

tee members had a power exercisable solely by him or her to vest the trust income or principal in himself/herself, none of the distribution committee members would be treated as the owner of any part of the trust. Third, there were no circumstances that would cause administrative controls to be considered exercisable primarily for the benefit of the grantor under §675 (ultimately, though, that this was a question of fact that must be deferred until the federal income tax returns of the parties had been examined). Fourth, the grantor's retained powers (including, but not limited to, the power) all caused the transfer of property to be *wholly* incomplete for federal gift tax purposes. Fifth, any distribution from the trust to the grantor would be considered to be a return of the grantor's property, which would not be a completed gift by any member of the distribution committee. Lastly, the distribution committee members did not possess general powers of appointment and when distributions were made to other beneficiaries of the trust, would not be personally deemed to have made completed gifts. Any distribution of property from the trust to a beneficiary other than the grantor would, however, be a completed gift by the grantor.

To summarize the various holdings, each trust was a nongrantor trust, no completed gift was made by the grantor when transferring property to the trust, and the distribution committee was not making a taxable gift upon the issuance of directions to the trustee.

With the 2014 PLRs, the IRS has now issued another series of rulings that essentially approves the ING trust structure and its validity under certain circumstances. One important highlight from these rulings is that the IRS has now addressed the issue that it raised in the news release, specifically finding that distribution committee members will not be treated as having a general power of appointment (and thereby rejecting the link to the 76/77 Rulings as suggested by the news release).

State Tax States Fight Back — Combating the ING Trust

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may not be pleased to know that the IRS has approved a roadmap that would allow trust income to escape state income taxation. While ING trusts are intended to be effective in those states that track the grantor trust rules, recent legislation in some of these states, however, has made it so that an ING trust will either not avoid state income taxation or have difficulty achieving the stated objective of avoiding state income taxation.

For example, in an effort to eliminate the advantages posed by ING trusts, New York enacted statutory changes in 2014 that other states may be inclined to follow. Prior to June 1, 2014, ING trusts worked in New York. However, effective as of June 1, 2014, New York modified N.Y. Tax Law §612(b) by adding new subsection (41), which provides the following inclusion to a New York resident individual's New York adjusted gross income:

(41) In the case of a taxpayer who transferred property to an incomplete gift nongrantor trust, *the income of the trust, less any deductions of the trust, to the extent such income and deductions of such trust would be taken into account in computing the taxpayer's federal taxable income if such trust in its entirety were treated as a grantor trust for federal tax purposes.* For purposes of this paragraph, an "incomplete gift nongrantor trust" means a resident trust that meets the following conditions: (i) the trust does not qualify as a grantor trust under [§§671–679 of the Code], and (2) the grantor's transfer of assets to the trust is treated as an incomplete gift under [§2511 of the Code], and the regulations thereunder.

Translated, if a New York taxpayer transferred property to a trust intended to be an ING trust, the income generated from such trust will be taxed as if such trust were a grantor trust. As to a New York domiciled grantor, the income is reported on the grantor's New York income tax return even though the trust is a nongrantor trust for federal income tax purposes.

Another way to combat the ING trust is to model legislation after California, which has adopted a "throwback rules" concept for dealing with ING trust structures.

Under California Cal. Rev. & Tax. Code §17742, the tax status is determined by residence of fiduciary or beneficiary (other than a beneficiary whose interest in such trust is contingent), regardless of the residence of the grantor. The key under California law is Cal. Rev. & Tax. Code §17745, which provides guidance for unpaid taxes due on distributions.

Subsection (a) of this section provides that if, for any reason, the taxes imposed on income of a trust that is subject to California income taxation are not paid when due and remain unpaid when that income is distributable to the beneficiary, such income shall be taxable to the beneficiary when it is actually distributed to the beneficiary.

Next, subsection (b) provides that if no taxes have been paid on the current or accumulated income of the trust because the California beneficiary's interest in the trust was "contingent" (explained below), such income shall be taxable to the beneficiary when it is actually distributed to him or her.

What about income accumulations that are directed to be added to principal? Subsection (c) clarifies that income accumulated by a trust continues to be taxable income even if the trust provides that the accumulated income is to be added to principal. Thus, this is a throwback concept intended to trap deferred distributions.

The tax, then, is calculated and paid under subsection (d), which states that the tax attributable to the inclusion of that income in the

gross income of that beneficiary for the year that income is distributed or distributable shall be the aggregate of the taxes, which *would have been attributable to that income* had it been included in the gross income of that beneficiary ratably for the year of distribution and the five preceding taxable years, or for the period that the trust accumulated or acquired income for that contingent beneficiary, whichever is shorter.

The effect of California law is that, if an out-of-state irrevocable trust created by a California resident is structured as a nongrantor trust, the trust should avoid the immediate imposition of California income tax if the interests of California residents are “contingent.” The California Code of Regulations, in Cal. Code Regs., tit. 18, §17742(b), specifies that a noncontingent beneficiary is “one whose interest is not subject to a condition precedent.” A further explanation was provided by the California Franchise Tax Board when, in Cal. FTB TAM No. 2006-2 (2/17/16), it stated that as to a beneficiary with a contingent interest, once the trustee decides to distribute income in a specified amount, the beneficiary has a noncontingent, vested interest in the trust, but only for that amount, and that the beneficiary continues to have a contingent interest in the remaining corpus of the trust.

In other words, even though the income initially avoids California taxation, once the income is distributed to a California resident, the income becomes taxable, regardless of whether such distribution occurs in a future year — this is a result of the “throwback” rules of Cal. Rev. & Tax Code §17445(c). The only way, then, for the ING trust to work technically to avoid California income taxation is if the distributions are made to non-California residents; if the income comes back into California, the California statutory tax mechanism will trigger the tax upon reentry.

A nontax attack by states on ING trusts could also arise through the application of the Uniform Voidable Transaction Act (UVTA). Adopted by the Uniform Law Committee in

2014 to replace the current Uniform Fraudulent Transactions Act (which has been adopted by almost every state), the UVTA has, as one of its stated goals, to render as voidable (presumably as to creditors) any DAPT created by a nonresident of the DAPT state.¹³ Consider whether a state income tax authority is a “creditor” for this purpose; if so, and if the grantor’s state of residence adopts the UVTA, that could perhaps allow the said taxing authority to proceed as a creditor against the grantor and invalidate the trust as a “voidable transfer.” This would have the effect of returning the assets back to the grantor and allow the state to tax the income.

Conclusion

Under the proper circumstances, an ING trust may be created to avoid state income taxes. The ING trust is not, however, the panacea for complete avoidance of state income taxes. If applicable state law does not prohibit or hamper the taxability of an ING trust’s assets, various PLRs should give the roadmap for the creation of a successful ING trust. As with all aggressive tax techniques, the client should consult with his or her estate planning attorney and apply for his or her own PLR for verification of the federal tax consequences. The planner should, however, be sensitive to all applicable laws, even those that may not directly impact the taxability of the trust. □

¹ Unless otherwise specifically stated all references to the code shall be to the Internal Revenue Code of 1986, as amended, and any section references shall refer to sections under the code. “Subchapter J” shall refer to subchapter J of the code, and the term “grantor trust” is used to denote a trust that is taxed under subchapter J with all of its income and deductions attributed to the grantor.

² See, e.g., MASS. GEN. L. Ch. 62, §10(e).

³ The pros and cons of the DAPT are beyond the scope of this article.

⁴ References to “gross estate” shall be to the gross estate as finally determined for federal estate tax purposes.

⁵ Emphasis added.

⁶ See, generally, 12 DEL. CODE ANN. §§3570(11)(a)-(c), 3570(8), and 3571.

⁷ PLR 200502014 (Jan. 14, 2005); PLR 200612002 (Mar. 24, 2006);

PLR 200637025 (Sept. 15, 2006); PLR 200647001 (Nov. 24, 2006); PLR 200715005 (Apr. 13, 2007); PLR 200729025 (July 20, 2007); and PLR 200731019 (Aug. 3, 2007).

⁸ Rev. Rul. 76-503, 1976-2 C.B. 275; Rev. Rul. 77-158, 1977-1 C.B. 285.

⁹ See, e.g., ABA Section of Real Property Trusts & Estates Letter to the Internal Revenue Service as signed by Kathleen M. Martin, section chair (Sept. 26, 2007); Delaware Bankers Association and Delaware Bar Association Joint Letter to the Internal Revenue Service as signed by Anne L. Stallman, chair, Trust & Estates Division of the Delaware Bar Association and David G. Bakarian, president and CEO of the Delaware Bankers Association (Oct. 1, 2007); New York City Bar Association Letter to IRS chief counsel signed by Michael I. Frankel, chair, Estate and Gift Tax Committee (Oct. 3, 2007); and New York State Bar Association Letter to Eric Solomon, assistant secretary (tax policy), Department of the Treasury, and Linda E. Siff, acting commissioner, Internal Revenue Service, signed by Patrick C. Gallagher, chair (Oct. 11, 2007).

¹⁰ See Richard Nenno, *Planning and Defending Domestic Asset-Protection Trusts*, ABA SECTION OF TAXATION, 2014 MID-YEAR MEETING, ESTATE AND GIFT TAX COMMITTEE PRESENTATION, PHOENIX, ARIZONA §VI.C (Jan. 24, 2014).

¹¹ All issued on Mar. 7, 2014. This section is derived from George D. Karibjanian and Hannah W. Mensch, *Current Developments In Federal Transfer Taxes*, ABA SECTION OF TAXATION, MAY 2014 MEETING, ESTATE AND GIFT TAXES COMMITTEE PRESENTATION, WASHINGTON, D.C. (May 9, 2014).

¹² Mar. 7, 2014.

¹³ UNIFORM VOIDABLE TRANSACTIONS ACT §4, comments 2 and 8, as adopted by the National Conference on Commissioners on Uniform State Laws (Oct. 13, 2014).

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This article is submitted on behalf of the Tax Law Section, James Herbert Barrett, chair, and Michael D. Miller and Benjamin Jablow, editors.