PERSPECTIVE

Los Angeles | Daily Journal

FRIDAY, JUNE 28, 2019

Cutting California Taxes Armed With Supreme Court's Trust Ruling?

By Robert W. Wood

In *North Carolina Department of Revenue v. Kimberley Rice Kaestner 1992 Family Trust*, 2019 DJDAR 5507 (June 21, 2019), the U.S. Supreme Court unanimously ruled that a state could not tax an out of state resident on trust income without minimum contacts. If you live in a high tax state (in California, rates top out at 13.3%!) you may already be slapping an out-of-state trust together to stockpile income and assets in Nevada, Delaware or some other state. But will it work?

You could avoid California taxes by moving, of course, as many Californians try to do shortly before a major income event. You might be selling a company, settling a lawsuit, or about to sell a mountain of bitcoin. Done carefully and with the right kind of income, a tax-motivated move can cut the sting of high state taxes. Of course, even *moving* to avoid state taxes can be tough to orchestrate, and states can audit and push back.

A newer and still largely untested approach 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," in Wyoming. The usual grantor trust for estate planning doesn't help, since the grantor must include the trust income on his own tax return.

With a Nevada or Delaware Incomplete Gift Non-Grantor Trusts, the donor makes an incomplete gift to the trust, and the trust has an independent trustee. The idea is to keep the grantor involved but not as the owner. New York State changed its law to make the grantor taxable no matter what, but the jury is still out on these trusts in California and other states. Some marketers of NING and DING trusts offer them as alternatives or adjuncts to a physical move.

The idea is for the income and gain in the NING or DING trust not to be taxed until distributed, when the distributees will hopefully no longer be in the high tax state. The trustee must not be a resident of the high tax state. Tax-deferred compounding can yield impressive results, even if only state tax is being sidestepped. Parents frequently fund irrevocable trusts for children, and may not want the trust to make distributions for years, removing future appreciation from parent's estates.

Most trusts are considered taxable where the trustee is situated. For NING and DING trusts, a common answer is an institutional trust company located in a desirable place. Trust investment and distribution committees should also not be California residents. The facts, documents and details matter, and states like California may well push back. However, doesn't the Supreme Court's recent *North Carolina* case help?

The Supreme Court ruled that North Carolina's tax statute asserting jurisdiction on a foreign trust based *solely* on the residence of a beneficiary was too broad. But it is still constitutional for a state to tax based on the residence of the trustee or cite of trust administration. Plus, who forms the trust matters. In the *North Carolina* case, the trust was formed by the taxpayer's *father*, and he was a resident of New York. The taxpayer in the case was the daughter, and she was not the trustee, nor did she have any control over the trust.

In fact, she didn't even receive *any* distributions from the trust in the years involved in the case. That made her an appealing plaintiff to express outrage that North Carolina was taxing her. And it was a compelling situation for the Supreme Court to tell North Carolina it couldn't tax her.

In contrast, many NING/DING trusts are formed by the person in the high-tax state trying to avoid state tax, a person in California, for example. And then there's the distribution question, as some NING/DING trusts do anticipate that the settlor might receive distributions. The administration can be touchy too, as some NING/DING trusts include the settlor/beneficiary as a member of a distribution committee that exercises control over trust distributions.

Depending on the facts of the NING/DING trust, therefore, the Supreme Court's ruling seems pretty limited. In fact, the case is limited to the handful of states that use beneficiary residence as the *sole* factor for determining the state's taxing jurisdiction. The court says its ruling should not impact states that consider beneficiary residence as only one of several factors for determining their jurisdiction to tax. Interestingly, California is one of five states identified in the case that establishes jurisdiction based entirely on the beneficiary's residence.

Even here, though, the opinion carves out California's tax statute as an issue to resolve at a later date. California law only allows the state to assert jurisdiction based solely on the beneficiary residence when the beneficiary's interest is *not* contingent (such as not subject to the discretion of a trustee). The *North Carolina* case involved a trustee who had discretion to control distributions, or to not make distributions at all. Thus, the court saved for later the question whether a beneficiary's residence alone is sufficient when a beneficiary's interest is not contingent.

In that sense, the true holding of the *North Carolina* case seems pretty narrow. It says that a state cannot assert jurisdiction over a trust based solely on the residency of the beneficiaries, when the beneficiaries have contingent interests. Thus, will your NING/DING trust work to shield you and your beneficiaries from state tax?

Whether it will work is likely to depend on the details, and the level of connections the trust has with California. The more divorced from California it is, the better it looks. Of course, California's Franchise Tax Board could still attack NING and DING trusts. But some of them seem likely to survive just fine. And even though the case was very narrowly decided, the Supreme Court's recent trust decision might help.

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