PERSPECTIVE

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States Are Fighting Tax Reform

By Robert W. Wood

Federal tax reform passed at year-end, but not everyone is happy. In fact, some states are not taking the changes lying down. There could be lawsuits and various work-arounds by states trying to blunt the impact of some of the federal tax law's provisions. Arguably one of the most distressing changes to taxpayers in California is the cap on state income and property tax deductions.

In California, we are all used to writing off our (high) California taxes on our federal income taxes. That 13.3 percent can hurt, so a write-off with the IRS helps. When those deductions were unlimited, they saved California taxpayers more than $100 billion.

Now, a $10,000 limit doesn't go very far in the Golden State. With this bleak picture, you have to hand it to California for creativity. The pending Protect California Taxpayers Act, if it is passed by legislators in Sacramento, takes a creative spin on tax deductions.

Since the new federal tax law caps deductions for state and local income and property taxes at $10,000, how about making them "charitable contributions"? California's idea is to let Californians make fully tax deductible charitable "donations" to the state instead. The pending bill would provide for that. Whether the IRS would buy it is not yet clear.

After all, wouldn't you expect the IRS to attack taxpayers who try end runs like this? You might think so, but perhaps it will be different if it is state law that provides for this "let's-call-it-something-else" workaround. Yet a fair number of Californians are not waiting around for the state legislature.

Some people are moving out of the state, or at least thinking about it. Tax lawyers in the golden state are used to advising taxpayers who get wanderlust, usually right before some big income event. The wandering taxpayers might be about to sell their company, or take it public. They might be about to settle a big lawsuit or to sell highly appreciated Bitcoin or other cryptocurrency.

Whatever the circumstance, state taxes can play a big part. And remember, unlike federal tax law, California doesn't give you a lower tax rate on long term capital gain. A move done carefully can cut or even eliminate the sting of California's high 13.3 percent state tax.

Aside from physical moves, a related 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? The usual living trust you form for estate planning purposes will not help. Living trusts are great for avoiding probate on death, but they don't help for income tax purposes.

With a living trust, you are still taxed on any income from trust assets on your individual income tax return. But could another type of trust sidestep state taxes? A Nevada or Delaware Incomplete Gift Non-Grantor Trust just might. The donor makes an incomplete gift (with strings attached) to the trust, which has an independent trustee who is not a resident of California.

These NING and DING trusts started with wealthy New Yorkers trying to sidestep New York taxes on certain assets. But New York State changed their state's tax law to make the grantor of such a trust taxable no matter what. California has not done that, but California's Franchise Tax Board has said 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 advisors offer NING and DING trusts 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 by California until it is distributed. At that point, the distributees will hopefully no longer be residing in California. If the NING or DING trust is formed to facilitate a business sale, the proceeds might be long-term capital gain at a federal tax of 20 percent. Adding the 3.8 percent Obamacare tax on net investment income, takes the federal tax rate to 23.8 percent.

California taxes all income at up to 13.3 percent, and there is no lower rate for long term capital gain. If you could avoid it, tax-deferred compounding can yield impressive results. If the NING or DING trust is being used to fund benefits for children and will grow for years, it may make even more sense. 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.

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, where there is no state income tax. For trust investment and distribution committees, committee members should also not be residents of California.

Even if you jump through all the requisite hoops, the NING or DING trust may *still* pay some California tax. For example, if the trust has California source income, it will still be taxable by California. Interest, dividend and gains from stock sales are intangibles, typically not California-sourced. But gain from California rental properties or the sale of California real estate is sourced to California no matter what.

Outside of New York residents, the jury is out on NING and DING trusts. The facts, documents, and details matter. If California tries to push back, it seems more likely to attack these trusts in audits, rather than through the legislature. But if one is careful, willing to bear some risk, and there is sufficient money at stake, the calculated risks may make sense.

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