InvestmentNews
The Leading Information Source for Financial Advisers

THE TAX-CONSCIOUS ADVISER

Robert N. Gordon

Out-of-state trusts may lose appeal

New York alters rules to stop taxpayers from avoiding state taxes by setting up trusts elsewhere

May 18, 2014 - 12:01 am EST

Over the past few years, we have been asked on numerous occasions about the tax benefits of holding your investments in a trust situated in a state that has no income tax, such as Nevada or Delaware.

This might sound very much like the activity that's causing a lot of bellyaching in Washington about U.S. corporations not paying taxes on the income they make outside the country. Well, it's just like that, but for you and me. At least it was until April Fool's Day 2014.

Since 2001, attorneys have pointed out that trusts set up in a very specific manner could achieve state tax savings by moving the taxable income out of your home state and into the trust's home state. As a report from New York state put it, these incomplete gift trusts “are treated as grantor trusts under federal gift tax law so that the transfer is not subject to gift tax, but as non-grantor trusts for federal income tax purposes so that the trust is a separate taxpayer from the grantor.”

If the state that the trust was in had no income tax, then there would be no state taxes on the income. You would still have to pay taxes on the income at the federal level.

This did not work in all states. I've read that this arrangement was not respected in Connecticut, Ohio or Washington D.C., but could work in others such as New York, New Jersey, Kentucky, Massachusetts, Michigan and Missouri.

The most written about trusts were trusts that went by the acronyms DING — Delaware incomplete non-grantor gift trust — or NING — Nevada incomplete non-grantor gift trust.

This idea gained great momentum last year when the federal government issued a series of rulings (PLRs 201310002 through 201310006, released March 8, 2013) that “condoned” such a trust. There had been doubt in the tax community until then about whether such a trust would be respected.

The other states that were losing out, as you might imagine, have never liked this concept and have at times tried to fight the result in court or in legislation. These efforts have been rebuffed on constitutional grounds.

The New York State Tax Reform and Fairness Commission reported in November 2013 that this proposed change would bring $150 million a year into the state's coffers. At the current New York state tax rate, that means that over $1.5 billion a year in income is earned outside the state by New York residents in these special trusts.

That's not $1.5 billion in assets outside New York, it's $1.5 billion in income that would have been taxed. Who knows what the asset base is that throws off that much taxable income?

Under New York's state budget, which was passed on April 1, New York State will, going forward, treat these incomplete gift trusts as grantor trusts, and thus the income will be taxable to the New York resident as the grantor rather than taxable to the trust itself. This applies to income earned after Jan. 1, 2014.

There is a transition relief rule for trusts liquidated before June 1, two weeks from now. If the trust is liquidated in time, the income that is earned between Jan. 1 and June 1 would be exempt from New York state taxes. If you don't liquidate by then, all of 2014's income will be taxed by New York.

Bottom line: If you are a New York resident and took a giant capital gain this year in one of these trusts, hurry up and liquidate.

For those who went down this path, the good news is that past years are not being looked at for a clawback, so the strategy worked. The bad news is the game is up. Let's see if other states follow suit.

Robert N. Gordon (bob@twenty-first.com) is chief executive of Twenty-First Securities Corp. and an adjunct professor at New York University's Leonard N. Stern School of Business.