LEGISLATIVE PROPOSAL C
EXECUTIVE SUMMARY

Title

Taxation of Income from an Incomplete Gift Non-Grantor (ING) Trust

Problem

ING trusts are generally treated as taxable trusts. A California resident grantor is able to establish an ING trust with a nonresident trustee and transfer assets to that trust. By doing so, the taxable income of the ING trust, generally intangible income, is sourced to the commercial domicile of the nonresident trustee for California income tax purposes. (Revenue and Taxation Code (R&TC) sections 17742, 17743, and 17744.) This allows a California resident to transfer assets to an ING trust, with an out-of-state trustee in a jurisdiction that does not have a state income tax, and not pay California state income taxes.

Proposed Solution

Amend Personal Income Tax Laws (PITL) to require that the net income derived from an ING trust's assets, be included in the grantor's gross income and subject to California income tax. This proposal would mitigate a developing tax strategy of shifting income to a state with more favorable tax treatment. New York had a similar issue and resolved the problem by amending their PITL. Our proposal suggests a similar approach. This would eliminate a tax planning strategy while providing consistent and fair treatment of ING net income for similarly situated taxpayers.

Fiscal Impact

This proposal would not significantly impact the department's costs.

Economic Impact

The provisions of this proposal would result in the following revenue gain:

Estimated Revenue Impact of LP C
Assumed Enactment after June 30, 2021

($ in Millions)

Fiscal Year	Revenue
2020-2021	N/A
2021-2022	+$14
2022-2023	+$20
2023-2024	+$17

Title

Taxation of Income from an Incomplete Gift Non-Grantor (ING) Trust

Introduction

This proposal would treat grantors, who transfer assets into an ING trust, in the same manner as grantors of a grantor trust, eliminating the ability to reduce personal income tax by moving income to a state with more favorable tax treatment.

Problem

ING trusts are generally treated as taxable trusts. A California resident grantor is able to establish an ING trust with a nonresident trustee and transfer assets to that trust. By doing so, the taxable income of the ING trust, generally intangible income, is sourced to the commercial domicile of the nonresident trustee for California income tax purposes. (R&TC sections 17742, 17743, and 17744.) This allows a California resident to transfer assets to an ING trust, with an out-of-state trustee in a jurisdiction that does not have a state income tax, and not pay California state income taxes.

Proposed Solution

Amend PITL to require that the net income derived from an ING trust's assets, be included in the grantor's gross income and subject to California income tax. This proposal would mitigate a developing tax strategy of shifting income to a state with more favorable tax treatment. New York had a similar issue and resolved the problem by amending their PITL. Our proposal suggests a similar approach. This would eliminate a tax planning strategy while providing consistent and fair treatment of ING net income for similarly situated taxpayers.

Program History/Background

The Individual and Pass-Through Entity (IPTE) Bureau in the Audit Division identified situations where California grantors establish ING trusts with an out of state trustee, in a state without personal income tax. As discussed in more detail below, in California, grantors of an ING trust are not taxed on the trust income. Instead, the income is sourced to the state of the commercial domicile of the trustee rather than the state of the grantor. As a result, grantors of ING trusts do not pay California state income tax on the trust income.

The volume of impacted taxpayers for the first applicable tax year is estimated to be approximately 1,500 taxpayers, with an annual average of approximately 700 taxpayers thereafter. Without a legislative change, as discussed below, California is unable to require the same tax treatment for grantors with in-state and out of state trustees that retain control over their trusts.

Current Federal Law

Under Internal Revenue Code (IRC) sections 671 through 679, inclusive, there are two general types of trusts – grantor trusts and non-grantor trusts. Grantor trusts are revocable and the grantor retains control over the trust. These trusts are not taxed as separate entities. All of the items of income, deduction and credit flow through to the personal return of the grantor. In addition, distributions from grantor trusts to its beneficiaries are not subject to tax because the trust is essentially disregarded as a taxable entity.

Non-grantor trusts are irrevocable, which generally means that the grantor does not retain control over the trust. These trusts are treated differently. They are taxed on their accumulated income as if they were separate entities. When the trust makes a distribution to a beneficiary, the trust is allowed a distribution deduction, and the trust passes the income along to a beneficiary. The distribution from the non-grantor trust to its beneficiaries is subject to tax. The beneficiary reports the income and pays the tax.

An ING trust is a type of non-grantor trust where the grantor establishes the trust for the benefit of the grantor and other discretionary beneficiaries. The grantor's transfer of assets to the ING trust is treated as an incomplete gift under IRC section 2511, and the regulations thereunder. Because the grantor's gift to the trust is incomplete, the grantor may fund the trust without using the lifetime estate tax exemption or incurring a federal gift tax liability. The trust is considered irrevocable. Within the ING trust structure, the trust maintains control over the assets and any distributions are controlled by the trust distribution committee. This distribution committee approves the distributions that the grantor receives. The result is that the grantor retains sufficient control over the assets to be treated as not having made a completed gift of the assets, while at the same time, being treated as having retained insufficient control over the assets to be considered the owner of the assets for income tax purposes.

There are many private letter rulings that conclude that ING trusts are not grantor trusts for federal income tax purposes under IRC sections 671 through 679. As a result, ING trusts are generally treated as taxable trusts rather than disregarded taxable entities. This means that the net taxable income of the ING trust is subject to federal income tax and taxable regardless of the grantor's state of residency or where the taxable income of the ING trust is sourced for state purposes.

Current State Law

California conforms, with modifications, to the federal treatment of trusts, including the treatment of the ING trust as a separate legal entity and taxpayer. (See R&TC sections 17024.5, 17731, 17734, and 17742.)

Effective/Operative Date of Solution

If enacted in the 2021 legislative session, this proposal would be effective immediately, and specifically operative for taxable years beginning or on after January 1, 2022.

Justification

There has been an increase in tax news articles marketing this as a California tax advantage strategy. This proposal would mitigate a developing tax strategy of shifting income to a state with more favorable tax treatment and eliminate the different treatment of similarly situated taxpayers. Under a grantor trust where the grantor retains control of the trust, the trust is disregarded and the grantor is taxed on the trust income. With an ING trust, the grantor may retain control through the distribution committee, but the trust is not disregarded and is instead taxed as a separate entity. This means that grantors who retain control over their trust are taxed differently based on the trust structure.

Implementation

This proposal would only impact individuals who are grantors or beneficiaries of ING trusts. The adjustment required under this proposal would be a federal to state adjustment on the California Form 540, California Resident Income Tax Return.

Implementing this proposal would require changes to information systems and existing tax form instructions, and taxpayer outreach and education, which would be accomplished during Franchise Tax Board's normal annual update.

Fiscal Impact

This proposal would not significantly impact the department's costs.

Economic Impact

Revenue Estimate

The provisions of this proposal would result in the following revenue gain:

Estimated Revenue Impact of LP C
Assumed Enactment after June 30, 2021

($ in Millions)

Fiscal Year	Revenue
2020-2021	N/A
2021-2022	+$14
2022-2023	+$20
2023-2024	+$17

This analysis does not account for changes in employment, personal income, or gross state product that could result from this bill or for the net final payment method of accrual.

Revenue Discussion

This proposal would make the income of an ING trust, created by a grantor, subject to California state income tax. To calculate the revenue, the number and amount of income for ING trusts must be known. Because it is difficult to predict these amounts, the revenue impact is unknown. However, New York enacted a similar law. Assuming California taxpayers behave in a manner similar to New York taxpayers, it is estimated that ING trusts would report an additional $230 million in income to California for the first applicable tax year. It is assumed that affluent taxpayers would create ING trusts, and as a result, an average tax rate of 10 percent is applied. This results in a $23 million revenue gain for the 2022 taxable year and an estimated $17 million for each year thereafter.

The tax year estimates are converted to fiscal years, and then rounded to arrive at the amounts reflected in the above table.

Policy Considerations

There could be a case where a nonresident grantor transfers assets and establishes an ING trust with a California resident trustee. Without this law, the taxable income of the ING trust would be sourced to the commercial domicile of the California resident trustee. However, this law change would result in the trust income being included in the nonresident grantor's income. The nonresident grantor would only be subject to tax on their California source income.

Other Agency/Industry Impacted

None noted.

Other States

New York

The state of *New York* previously identified this same issue that is being addressed in this proposal. New York resident grantors were effectively moving assets and taxable income outside of the New York state taxing jurisdiction by creating an ING trust with a nonresident trustee in states like, *Delaware, Wyoming, Nevada, South Dakota*, etc., states with no personal income tax. Thus, the taxable income from these New York resident grantor ING trusts was not being taxed by *New York*.

For taxable year beginning on or after January 1, 2014, *New York* enacted legislation eliminating the ING trust problem by taxing this income. *New York* added the net income of an ING trust to the adjusted gross income of the New York resident individual, as if the trust was a grantor trust.

This proposal recommends amending the California PITL in a manner similar to the statute amendments made by the State of *New York*.

Potential Compromises

None noted.

Additional Comments

None noted.

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Franchise Tax Board's Draft Proposed Amendments LP C

Subject: Taxation of Income from an Incomplete Gift Non-Grantor (ING) Trust

Amendment 1

Section 17082 of the Revenue and Taxation Code is added to read:

17082. (a) For taxable years beginning on or after January 1, 2022, the income of an incomplete gift non-grantor trust shall be included in a qualified taxpayer's gross income to the extent the income of the trust would be taken into account in computing the qualified taxpayer's taxable income if the trust in its entirety were treated as a grantor trust under Section 17731.

(b) Notwithstanding subdivision (a), Section 17745 applies to distributions from an incomplete gift non-grantor trust.

(c) For purposes of this section:

(1) "Incomplete gift non-grantor trust" means a trust that meets both of the following conditions:

(A) The trust does not qualify as a grantor trust under Subpart E of Part I of Subchapter J of Chapter 1 of Subtitle A of Title 26 of the Internal Revenue Code, relating to grantors and others treated as substantial owners.

(B) The qualified taxpayer's transfer of assets to the trust is treated as an incomplete gift under Section 2511 of the Internal Revenue Code, relating to transfers in general.

(2) "Qualified taxpayer" means a grantor of an incomplete gift non-grantor trust.

(d) (1) The Franchise Tax Board may prescribe any regulations necessary or appropriate to carry out the purposes of this section.

(2) The Franchise Tax Board may prescribe rules, guidelines, procedures, or other guidance to carry out the purposes of this section. Chapter 3.5 (commencing with Section 11340) of Part 1 of Division 3 of Title 2 of the Government Code shall not apply to any rule, guideline, procedure, or other guidance prescribed by the Franchise Tax Board pursuant to this section.