

## “NING” Tax Planning Nevada Incomplete Gift Non-Grantor Trust

The benefits of a NING include asset protection coupled with the deferral and the possible elimination of state income taxes associated with intangible property. If the beneficiaries have settled in different states by the time distributions are made, then the distributions will not be subject to California income tax even for beneficiaries who are lifelong California residents. The distributions may however, be subject to tax in the state where the beneficiary is a resident.

Income from investments such as interest, dividends and gains from sale of stock are considered investment income from intangible assets and therefore not considered California source income. Conversely, the gain from the sale of real estate located in California would be subject to California tax even if the trust is treated as a nonresident trust.

The NING trust in order to receive its favorable state-income-tax-shifting treatment must be taxed as a “non-grantor” trust. By operating as such, the NING trust is treated as a separate and distinct entity for income tax purposes, such that even if the person who funded the trust (the settlor/grantor) lives in a high-income-tax-rate state (e.g., California), the assets held inside the trust are taxed separately based solely to what state the trust is based (e.g., Nevada).

The fact that the gift is not completed means transferring property into the NING does not trigger the filing of a Form 709 gift tax return. Drafting of the trust properly provides the settlor/grantor of a NING trust with the income tax benefits, without triggering unfavorable gift or estate tax treatment.

Notably, the fact that the transfer of assets to a NING is an incomplete gift also always means the investments inside the NING trust will be included in the settlor’s estate, providing for a step-up in basis on those investments at death.

The tax consequences generally flow through from the trust to the underlying beneficiary. The trust claims a distributable net income (DNI) deduction, and sends a Form K-1 to the beneficiary to report the taxable income on his/her return instead. As a result, this means that as beneficiaries receive distributions, state income taxes may be due to the beneficiary that year.

There are caveats in considering if a NING would be viable. For a non-grantor trust for Federal tax purposes, the top 39.6% tax bracket as well as the 3.8% Medicare surtax on investment income begins at only \$12,400 of income in 2016, while the top tax bracket doesn’t begin until \$464,850 for a married couple (with a threshold of \$250,000 of AGI for the 3.8% Medicare surtax). If the NING settlor/grantor is not already at or near the top federal tax brackets, even beyond the income generated by the assets being contributed to the NING, there is a danger that any state income tax savings would be more than offset by higher federal taxes.

In addition, under Revenue Procedure 2015-1, seeking a Private Letter Ruling (“PLR”) to ensure the trust will be honored as desired for Federal tax purposes entails a cost of \$28,300. Coupled with the legal cost of drafting the trust, along with trustee fees and annual tax and accounting costs, careful analysis should be done to ensure that the tax benefits are significantly positive.

The NING Trust can use its accumulated funds to benefit a child without a distribution being made, and thus without subjecting the accumulated income and capital gain to California tax. For example, the NING Trust can purchase a home as a primary residence for an adult child and continue to hold the home as a trust asset. Because the beneficiary does not own the home, this strategy has the added benefit of protecting the asset from divorce, from creditors of the child, and from estate tax in the child’s estate.

Accordingly, the ideal NING candidate has three key characteristics. First, has exposure to significant taxable income from existing intangible assets; Secondly, is already near or at top Federal tax rates, even after the intangible assets are transferred; and, Thirdly, resides in a state with high tax rates.