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## States Should Follow New York’s Lead and Shut Down Tax-Avoiding “ING Trusts”

By Don Griswold<sup>1</sup> and Michael Mazerov

For well over a decade, tax advisers have promoted a state income tax avoidance strategy called ING<sup>s</sup> — incomplete non-grantor trusts — among their wealthy clients. While ING<sup>s</sup> don’t enable wealthy people to avoid *federal* income taxes, their promoters promise that they can “avoid state income tax altogether” on income and gains from intangible property (financial assets such as stocks, bonds, and passive ownership shares in unincorporated businesses) that are transferred to a properly structured ING.<sup>2</sup> Leaked IRS records reveal that half of the country’s wealthiest people use some type of trust for tax avoidance.<sup>3</sup>

The ability of very wealthy people to leverage this complex tax avoidance scheme likely costs states significant amounts of revenue, especially in more affluent states such as California, Illinois, and Massachusetts. It also violates the principle that everyone who is financially capable of paying taxes should pay their fair share to support public services — especially those who have reaped the most benefit from the opportunities our nation affords. Fortunately, states can address the ING problem through a relatively simple fix to their tax codes, as New York has illustrated.

New York State officials became aware of ING trust abuse relatively soon after it arose and shut it down in 2014 by “decoupling” the state’s tax law from the Internal Revenue Code with respect to the classification of this type of trust. Other states should follow New York’s example promptly and put an end to the ING scheme, which allows very wealthy individuals to shirk their state income tax responsibilities while the rest of us fulfill ours.

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<sup>2</sup> Tara M. Walsh, “NING Trusts: Eliminating State Income Tax and Protecting Your Assets from Creditors,” Stradley Ronan Estate Advisory, August 20, 2019.

<sup>3</sup> Jeff Ernsthausen *et al.*, “More Than Half of America’s Richest People Exploit Special Trusts to Avoid Estate Taxes,” ProPublica, September 28, 2021.

## Background: Grantor Trusts, Non-Grantor Trusts, and INGs

A trust is a legal relationship between three parties: a grantor, a trustee, and one or more beneficiaries. The grantor transfers property “in trust” to a trustee to manage it for the benefit of the beneficiaries. Children or grandchildren of the grantor are often beneficiaries; the grantor, who sets the terms of the trust, often is one as well. The trustee may be a professional service provider or a person the grantor knows and trusts.

Trusts have certain key advantages over outright gifts as a vehicle for transferring assets before death, such as the ability to require that the money be spent on the recipient’s education. They also have advantages over wills as a vehicle for transferring assets after death, such as avoiding the lengthy, costly, court-supervised probate process (which also publicly reveals the size and nature of the assets and who receives them). Some types of trusts can enable the grantor both to direct the transfer of wealth upon their death *and* to retain access to the trust’s assets, or the income they generate (dividends, capital gains, interest, royalties, etc.) while they are still alive, if they turn out to need more money than they had expected when establishing the trust.

For state trust law purposes, a trust typically is not a distinct legal entity like a corporation; it is a legal relationship.<sup>4</sup> For federal and state *income tax* purposes, however, in some cases a trust has its own tax-filing responsibility, just as if it were a legal entity.<sup>5</sup>

There are two broad classifications of ordinary trusts under federal tax law:<sup>6</sup>

- **Grantor trust.** If the grantor retained enough power over the property they transferred to the trust — to manage and dispose of it, even return it to themselves under some circumstances — that they should be treated as continuing to own it, the trust is likely to be classified as a grantor trust.<sup>7</sup> Neither the federal government nor the states treat a grantor trust as a distinct taxable entity. Consequently, all trust income, whether or not it is distributed to beneficiaries, is reported on the *grantor’s* individual income tax return in the year in which it is realized.
- **Non-grantor trust.** If the grantor truly gave up control over the property when transferring it to the trust, the trust is classified as a non-grantor trust, because the grantor is no longer involved in managing the investment or distribution of the assets. Non-grantor trusts are considered *separate, taxable entities* under federal and state income tax laws.

Rules governing this distinction reflect the public policy concern that a grantor should be prevented from “avoiding tax by shifting income to other family members while still retaining an interest in or a power over the property placed in trust.”<sup>8</sup> (See Appendix I for more detail on grantor and non-grantor trusts.)

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<sup>4</sup> Restatement (Third) of Trusts § 2 (2003). The grantor may also be called settlor, creator, trustor, or founder.

<sup>5</sup> Trusts are taxed essentially “in the same manner as in the case of an individual.” IRC Section 641(b).

<sup>6</sup> This discussion concerns ordinary trusts, not business trusts, investment trusts, or liquidating trusts. See Boris I. Bittker and James S. Eustice, *Federal Income Taxation of Corporations and Shareholders*, 7<sup>th</sup> ed., para. 2.03, 2000.

<sup>7</sup> Marvin Chirelstein and Lawrence Zelenak, *Federal Income Taxation*, para. 8.05, 2012.

<sup>8</sup> *Ibid.*, Section 9.01.

The distinction between grantor and non-grantor trusts rests at the crux of a highly complex scheme that enables the wealthiest households to shelter huge sums of money from state taxation. INGs, a specific version of non-grantor trusts, are structured in a way that allows wealthy people to avoid paying state personal income tax on income left in the trust.<sup>9</sup> Indeed, this is “the primary objective” of ING trusts, according to one estate planner.<sup>10</sup>

The essential mechanism of the issue is that a wealthy person transfers cash, stocks, bonds, and other financial assets into an ING formed and administered in *another state* so that the annual earnings these assets generate are no longer taxable on their individual income tax forms. They nearly always locate the trust in a “tax haven” state that completely shields these trusts from taxation, such as Delaware, Nevada, South Dakota, and Wyoming. (See Appendix II for more detail on INGs.) This maneuver diverts large sums of money held by the country’s wealthiest people away from states where it could be taxed — especially more affluent states like California and Massachusetts, where many of these people live. And, as described in Appendix II, careful drafting of the trust agreement can enable the transfer of assets to the trust to be characterized as “incomplete,” achieving the vital aim of avoiding immediate liability for the federal gift tax — which otherwise would apply.

## Potential Scale of ING Tax Avoidance

The U.S. has over 700 billionaires,<sup>11</sup> with a combined wealth of almost \$5 trillion.<sup>12</sup> The 1.3 million households who make up the wealthiest 1 percent (with net worth starting at \$11 million apiece) have a combined wealth exceeding \$45 trillion.<sup>13</sup> Very wealthy individuals lower their taxes, in both legal and illegal ways, by accessing a “staggering amount of legal, planning and accounting firepower devoted to wealth defense.”<sup>14</sup>

A great deal of federal tax avoidance by very wealthy individuals is accomplished using trusts established in tax haven states such as Delaware, Nevada, South Dakota, and Wyoming.<sup>15</sup> “[T]he wealth held in the dynasty trusts of ultrarich families stands to reach \$21 trillion between now and 2045,” according to one estimate;<sup>16</sup> another study estimates that the top 1 percent avoid federal taxes on more than one-fifth of their income.<sup>17</sup> Many very wealthy individuals use trusts to avoid *state* income taxes as well. (See text box, “What Makes a State a “Tax Haven” for ING Trusts?”)

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<sup>9</sup> Neil Schoenblum and Jeffrey Schoenblum, “Dings, Nings, and Other Trusts for Reducing and Eliminating State Income Tax,” paper delivered at the 39<sup>th</sup> Annual Notre Dame Tax and Estate Planning Institute, October 18, 2013.

<sup>10</sup> Steven J. Oshins, “NING Trusts for California Residents: ‘Rumors of My Death Have Been Greatly Exaggerated,’” *Ultimate Estate Planner*, June 2, 2021.

<sup>11</sup> Giacomo Tognini, “The Countries with the Most Billionaires 2021,” *Forbes*, April 6, 2021.

<sup>12</sup> Board of Governors of the Federal Reserve, “Distribution of Household Wealth in the U.S. since 1989,” March 18, 2022.

<sup>13</sup> *Ibid.* The U.S. had almost 130 million households in 2021. U.S. Census Bureau, “Households by Type: 1940 to Present,” November 2021.

<sup>14</sup> Chuck Collins, *The Wealth Hoarders*, Polity Press, 2021, p. 58.

<sup>15</sup> Debbie Cenziper, Will Fitzgibbon, and Greg Miller, “Lawmakers Call for Crackdown on Financial ‘Enablers’ After Pandora Papers Revelations,” *Washington Post*, October 6, 2021; Don Griswold, “State Tax Havens in the Pandora Papers,” *Tax Notes State*, January 24, 2020.

<sup>16</sup> Bob Lord, “Dynasty Trusts: Giant Tax Loopholes that Supercharge Wealth Accumulation,” *Americans for Tax Fairness*, February 2022.

<sup>17</sup> John Guyton *et al.*, “Tax Evasion at the Top of the Income Distribution: Theory and Evidence,” National Bureau of Economic Research Working Paper 28542, March 2021, <http://www.nber.org/papers/w28542>.

## What Makes a State a “Tax Haven” for ING Trusts?

What makes a good tax haven state for ING purposes, and why does this paper focus most on Delaware, Nevada, South Dakota, and Wyoming as the location of ING trusts?

The Tax Justice Network defines a tax haven as any country or jurisdiction “whose laws may be used to avoid or evade taxes which may be due in another country under that country’s tax laws.”<sup>a</sup> This can be refined by reference to the Organisation for Economic Cooperation and Development’s 1998 definition (which the Tax Justice Network continues to apply), providing that a tax haven is any jurisdiction where most of the following characteristics are present: “non-residents undertaking activities pay little or no tax; there is no effective exchange of taxation information with other countries; a lack of transparency is legally guaranteed to the organisations based there; [and] there is no requirement that local corporations owned by non-residents carry out any substantial domestic (local) activity.”<sup>b</sup> Tax havens may also exist at the subnational level, including U.S. states.

In the ING Trust abuse context, the following additional elements apply.<sup>c</sup> The state’s laws include provisions that:

- conform to the federal tax income tax distinction between grantor and non-grantor trusts;
- impose no income tax on human persons or trusts; and
- keep up with the latest avoider-friendly trust laws, notably including:
  - No “rule against perpetuities” (thereby allowing trusts to live forever as “dynasty trusts” and keep assets in families for numerous generations); alternatively, a state may extend the life of trusts beyond 100 years but to something less than forever
  - Domestic asset protection trust provisions (preventing the grantor’s creditors from attaching trust assets)
  - Liberal “decanting” provisions (authorizing grantor-friendly trustees to “pour over” assets into a new trust with different terms and beneficiaries)
  - Strong privacy laws
  - Only cursory regulatory oversight of the trust industry (preferring “captured” states like South Dakota, which has a legislative committee that meets every year to develop legislative refinements in an attempt to maintain the state’s reputation as the top destination for trust-related tax and financial abuse)

This paper refers most frequently to four states that satisfy nearly all these criteria (Delaware, Nevada, South Dakota, and Wyoming), but easily could have added Alaska as well. (While, unlike the other four, Delaware does have a personal income tax, it is not imposed on trusts.) Tax avoidance enablers, tax justice advocates, legislators, researchers, and reporters commonly reference these as the top states for trust abuse. For example, following the 2021 Pandora Papers leak of nearly 12 million documents detailing tax evasion including trust abuse, a resolution was submitted to the European Parliament that “condemned the U.S. states of South Dakota, Alaska, Wyoming, Delaware and Nevada as hubs ‘for financial and corporate secrecy’ [and] called on the European Union to consider adding the United States to its list of tax havens.”<sup>d</sup>

<sup>a</sup> Tax Justice Network, “Tax Us If You Can,” second edition, July 2012, p. 61, [https://www.taxjustice.net/cms/upload/pdf/TUIYC\\_2012\\_FINAL.pdf](https://www.taxjustice.net/cms/upload/pdf/TUIYC_2012_FINAL.pdf).

<sup>b</sup> Id.; Organisation for Economic Cooperation and Development, “Harmful Tax Competition: An Emerging Global Issue, 1998, p.25, [https://www.oecd-ilibrary.org/taxation/harmful-tax-competition\\_9789264162945-en](https://www.oecd-ilibrary.org/taxation/harmful-tax-competition_9789264162945-en).

<sup>c</sup> See generally, Steve Oshins, “ING State Ranking Charts,” <https://www.oshins.com/state-rankings-charts>; Don Griswold, “State Tax Havens In the Pandora Papers,” Tax Notes State, January 24, 2022, <https://www.taxnotes.com/tax-notes-state/tax-havens/state-tax-havens-pandora-papers/2022/01/24/7crjw> pp 407-408.

<sup>d</sup> Will Fitzgibbon and Asraa Mustufa, “Another President Under Investigation, U.S. Condemned as Tax Haven by European Parliament as Pandora Papers Fallout Continues,” ICJ, October 22, 2021.

The IRS data that can provide some insight into the potential scale of the use of INGs to avoid state income taxes are only available through tax year 2014. But these data suggest that, even as of

that relatively early date in the evolution of INGs,<sup>18</sup> they were already sheltering a substantial amount of income from state taxes.

As of 2014, more than 30,000 “complex” trusts<sup>19</sup> — that is, trusts that do not distribute all their annual income to beneficiaries but instead accumulate at least some of it — had been established in Delaware, Nevada, South Dakota, and Wyoming combined. (See Table 1.) It is reasonable to assume that all ING trusts would fall into this category; there would be no point in setting up an ING if all the income was going to be paid out to beneficiaries, since the beneficiaries would then owe income tax on their payments in their states of residence. While many of the complex trusts in these four states likely are *not* INGs, the data provide some evidence that many of these trusts are, in fact, INGs being used as state income tax shelters by very rich people:

- For the four states combined, complex trusts reported \$7.4 billion in 2014 income and distributed just 17.3 percent of it to beneficiaries, accumulating the remaining \$6.1 billion. In the country as a whole, in contrast, the average complex trust distributed 54.4 percent of its 2014 income.
- For every 100,000 state residents, 1,162 complex trusts filing federal tax returns were established in Delaware, 714 in South Dakota, 669 in Wyoming, and 339 in Nevada. These figures for the first three states far exceed the nationwide figure of 463 complex trusts per 100,000 residents and provide compelling evidence of widespread use of trusts in these states by non-residents. And while complex trusts in all four states represented only 2.1 percent of such trusts nationally, they reported 8.2 percent of pre-distribution income of complex trusts and almost 15 percent of *undistributed* income.

Other IRS data provide additional evidence that a growing number of taxpayers have taken advantage of the ING tax shelter in these four states in more recent years:

- In 2021, income tax returns filed by trusts and estates combined reported \$3.0 billion in federal income tax liability in Delaware, \$3.1 billion in South Dakota, and \$3.7 billion in Nevada — figures not that different from California (\$3.9 billion) and New York (\$3.5 billion), even though the three trust tax haven states have much smaller populations. (See Table 2.)

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<sup>18</sup> The first IRS private letter ruling (PLR) creating the legal underpinning for the ING strategy appears to be from 2001 and may have set off the first wave of INGs. The IRS issued no PLRs from 2007 through 2012; the sale and creation of new INGs apparently slowed down during that interim period. A series of new PLRs came out in 2013 and 2014, beginning with PLR 201310002 (released on March 8, 2013), which appears to have stimulated the current wave of advocacy and implementation of INGs. The availability of the ING tax shelter is the result of IRS interpretations of federal tax law applied to the factual circumstances of specific taxpayers embodied in these PLRs — not an explicit statutory “blessing.” The IRS rulings have no significant implications for federal revenues because the beneficiaries and/or the trust will pay income taxes as the trust earns income, and the estate tax will eventually be paid when the grantor dies. But the rulings *have* created a costly state income tax shelter.

<sup>19</sup> In addition to complex trusts, the IRS classifies trusts in its statistical compilations as simple trusts, qualified disability trusts, electing small business trusts, and grantor-type trusts.

TABLE 1

### IRS Data Hint that Many Trusts in Recognized Tax Haven States Are INGs

<b>Tax Year 2014</b>	<b>Population 7/1/14</b>	<b># of complex trusts</b>	<b># of trusts per 100k population</b>	<b>Total trust income \$million</b>	<b>Avg income per trust</b>	<b>Income distributed \$million</b>	<b>Share of income distributed</b>	<b>Undistributed income (\$million)</b>
<b>Delaware</b>	932,487	10,840	1,162	\$2,727	\$251,592	\$351	12.9%	
<b>Nevada</b>	2,817,628	9,553	339	\$1,920	\$201,029	\$466	24.3%	
<b>South Dakota</b>	849,129	6,064	714	\$1,972	\$325,173	\$331	16.8%	
<b>Wyoming</b>	582,531	3,896	669	\$761	\$195,326	\$132	17.3%	
<b>4 state subtotal</b>	5,181,775	30,353	586	\$7,381	\$243,156	\$1,280	17.3%	\$6,100
<b>4 state share of U.S.</b>	1.6%	2.1%		8.2%		2.6%		14.8%
<b>California</b>	38,596,972	147,301	382	\$8,410	\$57,096	\$2,817	33.5%	
<b>New York</b>	19,651,049	81,840	416	\$8,253	\$100,846	\$1,631	19.8%	
<b>United states</b>	318,301,008	1,474,651	463	\$90,427	\$61,321	\$49,189	54.4%	\$41,238

Source: IRS data available at  
<https://www.irs.gov/statistics/soi-tax-stats-fiduciary-income-and-deductions-by-state-and-entity-type-filing-year-2014>,  
<https://www.irs.gov/pub/irs-soi/14fd02.xlsx>,  
<https://www.irs.gov/statistics/soi-tax-stats-income-from-estates-and-trusts-statistics>

TABLE 1

### Income Tax Liability Reported on Federal Income Tax Returns for Trusts and Estates, 2009 and 2021

		2009	2021	% change
<b>Delaware</b>	# federal estate/trust income tax returns	31,548	39,316	24.6%
	net federal tax reported on estate/trust income tax returns (\$million)	\$463	\$3,046	558.3%
	federal income tax reported per return	\$14,668	\$77,479	428.2%
<b>Nevada</b>	# federal estate/trust income tax returns	21,319	51,152	139.9%
	net federal tax reported on estate/trust income tax returns (\$million)	\$167	\$3,665	2088.6%
	federal income tax reported per return	\$7,856	\$71,658	812.1%
<b>South Dakota</b>	# federal estate/trust income tax returns	12,956	21,093	62.8%
	net federal tax reported on estate/trust income tax returns (\$million)	\$578	\$3,110	437.9%
	federal income tax reported per return	\$44,630	\$147,463	230.4%
<b>Wyoming</b>	# federal estate/trust income tax returns	8,554	12,552	46.7%
	net federal tax reported on estate/trust income tax returns (\$million)	\$45	\$557	1130.4%
	federal income tax reported per return	\$5,296	\$44,410	738.5%
<b>California</b>	# federal estate/trust income tax returns	396,540	402,921	1.6%
	net federal tax reported on estate/trust income tax returns (\$million)	\$653	\$3,914	499.1%
	federal income tax reported per return	\$1,648	\$9,714	489.6%
<b>New York</b>	# federal estate/trust income tax returns	311,800	340,352	9.2%
	net federal tax reported on estate/trust income tax returns (\$million)	\$757	\$3,450	355.5%
	federal income tax reported per return	\$2,429	\$10,138	317.3%
<b>United States</b>	# federal estate/trust income tax returns	3,685,064	3,885,048	5.4%
	net federal tax reported on estate/trust income tax returns (\$million)	\$11,493	\$49,942	334.6%
	federal income tax reported per return	\$3,119	\$12,855	312.2%

Source: <https://www.irs.gov/statistics/soi-tax-stats-state-data-by-year>

- Between 2009 (the first year for which these data are available) and 2021, the amount of federal income tax liability reported on estate and trust income tax returns rose by 438 percent in South Dakota, 558 percent in Delaware, 1,130 percent in Wyoming, and a whopping 2,089 percent in Nevada — well above the national increase of 335 percent.

## The New York Solution

To date, the only state to end this indefensible and inequitable ING trust abuse is New York, which has 135 billionaires and a very large share of the nation’s highest-income 1 percent.<sup>20</sup> In 2012, then-governor Andrew Cuomo established the New York State Tax Reform and Fairness Commission “to examine the equity aspect” of the state’s tax structure.<sup>21</sup> The Commission asked tax law experts with the New York State Bar Association<sup>22</sup> to analyze the ING issue and make policy recommendations.

The NY Bar’s report confirmed the problem with INGs: “We agree with the Commission’s view that DING Trusts [ING trusts established in Delaware] created by New York State grantors should be subject to New York State income tax, given that DING Trusts appear to be primarily established to avoid state income taxation.”<sup>23</sup> The report explained that:

- INGs “allow for the gift-tax-free transfer of unlimited amounts of property to trusts that are treated as taxpayers separate from the grantor for Federal income tax purposes.”
- An ING’s “state income tax [avoidance] benefits are achieved only if the trust is a non-grantor trust for tax purposes.”
- A “significant amount of income” is sheltered in these tax avoidance vehicles, based on data collected by New York’s tax department.<sup>24</sup>

The report also addressed an even “more aggressive” use of INGs, which could be called the “stash-and-sell” scheme. Consider an individual who owns property (such as stock) that has appreciated in value and who intends to sell it at a very large gain. Unlike individuals selling more modest appreciated property, who must pay tax on their capital gain in the year it is realized, someone with access to ING planning could transfer their stock to their ING and, after a relatively short delay (aimed at fending off a possible challenge from the IRS under its “step transaction

<sup>20</sup> Jemima McEvoy, “The Richest Billionaire in Every State 2022,” *Forbes*, April 5, 2022.

<sup>21</sup> Rahul Pathak *et al.*, “State Tax Reform Efforts: 2010-2015,” Georgia State University Center for State and Local Finance, January 26, 2016. See also Liz Malm, “New York Governor’s Tax Commission Releases Reform Recommendations,” Tax Foundation, November 18, 2013.

<sup>22</sup> Hereinafter “the NY Bar.”

<sup>23</sup> Joseph Septimus *et al.*, “Report on Certain New York State Resident Trusts,” New York State Bar Association Tax Section, Rep. No. 1293, November 18, 2013. The report notes that INGs “appear to have first been utilized in Delaware” but states that its analysis and recommendations apply equally to the INGs of any tax haven state.

<sup>24</sup> This reference is to data collected by the New York State Department of Taxation and Finance pursuant to an information gathering project: “Filing Requirement for Resident Trusts Not Subject to a Tax,” TSB-M-10(5)(I), July 23, 2010.



doctrine”),<sup>25</sup> informally direct the ING’s trustee to sell the stock. With a cleverly structured ING, they would owe no federal gift tax on the transfer, and the ING trust would owe no New York income tax on the capital gain.

The NY Bar report offered an elegant solution to the ING problem. Noting that “the ING Trust would not achieve the desired state income tax avoidance if it were characterized as a grantor trust,” it proposed to characterize INGs as grantor trusts for state purposes — even though they are treated as non-grantor trusts for federal purposes — simply by “decoupling from the Internal Revenue Code with respect to this specific issue.”<sup>26</sup>

State legislative decoupling is easy and common, so it is unsurprising that the New York State legislature adopted this approach. States generally follow the federal Internal Revenue Code except when they choose to decouple from specific federal rules they prefer to address in their own way. Section 612(a) of the New York tax law establishes that New York personal income tax generally follows federal law; Section 612(b) then provides a long list of New York-specific decoupling “modifications.” In 2014, acting on the NY Bar’s report, the legislature added a new sub-subsection (41) to Section 612(b) that shuts down ING-based tax avoidance:

**Sec. 612(b) Modifications increasing federal adjusted gross income.** There shall be added to federal adjusted gross income:

. . . (41) In the case of a taxpayer who transferred property to an incomplete gift non-grantor trust, the income of the trust, less any deductions of the trust, to the extent such income and deductions of such trust would be taken into account in computing the taxpayer’s federal taxable income if such trust in its entirety were treated as a grantor trust for federal tax purposes.<sup>27</sup>

In other words, the income of the ING trust is attributed to the New York resident grantor, not the trust.

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<sup>25</sup> Analytically, any business transaction might be viewed as an organic whole or as a series of “steps” that were necessary to complete the transaction. The tax consequences of the transaction may differ markedly, depending upon which viewpoint governs, so taxpayers and revenue authorities frequently haggle in court over which analytical approach applies in any given case. See Bittker & Eustice, *op. cit.*, at para. 1.05[2][d].

<sup>26</sup> As the report stated, the state should treat “the DING Trust as a grantor trust, and therefore tax the grantor.” A follow-up report from the Bar in 2022 summarized the ING problem and its solution:

- 1) “An ING’s non-grantor status effectively permits the grantor to shift income from one taxpayer — namely, the grantor — to another — namely, the ING.”
- 2) “By treating an ING as a grantor trust, the income of the ING is attributed to the resident grantor, thereby effectively preventing a New York resident individual from avoiding New York State income tax by shifting income-producing assets to an ING.”

Austin Bramwell and Alan Halperin, “Report on New York State Tax Law Section 612(b)(41),” New York State Bar Association Tax Section, Rep. No. 1455, January 12, 2022.

<sup>27</sup> NY Tax Law Section 601(b)(41). The new rule defines an “incomplete gift non-grantor trust” as: (a) a trust that wouldn’t otherwise qualify as a grantor trust under Section 671 of the New York tax law; and where (b) Section 2511 of the Internal Revenue Code treats the grantor’s transfer of property to that ING as an incomplete gift not subject to federal gift tax.

## Replicating the New York Solution

With the simple addition of INGs to its long list of statutory decoupling “modifications,” New York solved its ING problem in 2014. In the eight years since then, however, no other state has followed its lead. Other states — particularly those with larger numbers of people in the top 1 percent and progressive tax codes — also should end personal income tax avoidance among very wealthy individuals by terminating ING trust abuse.

### California’s Unfinished Business

Some 186 billionaires currently live in California, more than any other state,<sup>28</sup> and the wealth of the state’s 30 wealthiest people as of October 2021 exceeded \$1 trillion.<sup>29</sup> California’s top personal income tax rate of 13.3 percent is the highest in the country, and neighboring Nevada is one of the top tax havens for locating an ING trust.<sup>30</sup> All this adds up to serious vulnerability to ING trust abuse.

In 2020 the California Franchise Tax Board (FTB) explained at a public stakeholder meeting that California had the same tax problem that New York had before decoupling.<sup>31</sup> As in New York, California’s vulnerability to ING trust abuse reflects the fact that California “conforms, with modification” to the federal tax treatment of trusts, “including the treatment of the ING trust as a separate legal entity and taxpayer.”<sup>32</sup>

Also like New York, California could eliminate ING trust abuse simply by decoupling from the federal treatment, explained the FTB. “New York had a similar issue” and “enacted legislation eliminating the ING trust problem by ... add[ing] the net income of an ING trust to the adjusted gross income of the New York resident [grantor], as if the trust was a grantor trust.” That is, New York “[s]evered the connection between the federal and state rules” governing ING trusts. “Our proposal suggests a similar approach,” explained the FTB.<sup>33</sup> In January 2023, California Governor Gavin Newsom included in his proposed fiscal year 2024 budget package a fix for the ING trust problem modeled on the New York approach.<sup>34</sup> Legislators would be wise to adopt it without delay.

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<sup>28</sup> Rachel Sandler, “Golden State Billionaires: California Home to the Most Billionaires in the U.S.,” *Forbes*, April 5, 2022.

<sup>29</sup> Bob Lord, “10-15-21 Billionaires Data,” <https://docs.google.com/spreadsheets/d/1tjwAN-HA0ZEj39OZz2bnfslxCf4YewjSv8eJH71T-X4/edit#gid=1259834744>, in “U.S. Billionaires Wealth Surged by 70%, or \$2.1 Trillion, During Pandemic; They Are Now Worth A Combined \$5 Trillion,” Americans for Tax Fairness and Institute for Policy Studies, October 18, 2021. This piece analyzes data from *Forbes*, “The World’s Real-Time Billionaires: Today’s Winners and Losers,” accessed October 15, 2021.

<sup>30</sup> John Nuckolls *et al.*, “Incomplete Non-Grantor Trusts: An Effective Tax Planning Strategy,” BDO, August 2020.

<sup>31</sup> Elaine Segarra Warneke, Tiffany Christiansen, and Annette Kunze, “Legislative Proposal C – Taxation of Income from an Incomplete Gift Non-Grantor (ING) Trust,” California Franchise Tax Board, 2020. See also Eric Bardwell, “California Admits Incomplete Gift Non-Grantor Trusts Work...for Now,” *Bloomberg Tax*, December 3, 2020.

<sup>32</sup> *Ibid.*

<sup>33</sup> *Ibid.*

<sup>34</sup> Governor Gavin Newsom, “Governor’s Budget Summary, 2023-24,” January 20, 2023, p. 135.

## Other States Should Also Act

Vulnerability to ING trust abuse extends beyond California to include nearly every state that has not turned itself into a tax haven.

Illinois, home to 26 billionaires whose combined wealth exceeds \$100 billion, would benefit from adopting the New York solution. So would Massachusetts and Nebraska, each of which hosts billionaire wealth of more than \$100 billion. Resident billionaires enjoy more than \$50 billion of combined wealth in each of six other states — Connecticut, Michigan, Oregon, Pennsylvania, Virginia, and Wisconsin — which are also highly vulnerable to ING abuse. Hawai'i, New Jersey, and North Carolina each host a billionaire class controlling more than \$20 billion.<sup>35</sup> And, of course, INGs are also attractive tax shelters for wealthy families with assets below \$1 billion.

Moreover, the estimates above may be far too low. The true amount of wealth concentrated among very wealthy individuals is hard to determine because their trust arrangements are often entirely secret, with no way for regulators or tax authorities to trace who owns what and how much it is worth.<sup>36</sup> On rare occasions, some information becomes public when a whistleblower leaks documents from firms in the “wealth defense” industry. This happened in the Pandora Papers leak, which showed that many wealthy people hide money in offshore accounts to avoid taxation.<sup>37</sup> These leaks, however, present only partial pictures.

Currently there is no way to accurately estimate states' revenue losses due to ING trust abuse, but the data that are available, including estimates of the size of billionaire fortunes and of the large proportion of very wealthy individuals who engage in tax avoidance, suggest that those losses are considerable. ING trusts enable this group to dodge their state personal income tax obligations, but states can shut down this abuse by applying the New York solution.

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<sup>35</sup> *Forbes*, “The World’s Real-Time Billionaires.”

<sup>36</sup> See, for example, Debbie Cenziper and Will Fitzgibbon, “The ‘Cowboy Cocktail’: How Wyoming Became One of the World’s Top Tax Havens,” *Washington Post*, December 20, 2021. “The cocktail and variations of it — consisting of a Wyoming trust and layers of private companies with concealed ownership — allow the world’s wealthy to move and spend money in extraordinary secrecy, protected by some of the strongest privacy laws in the country and, in some cases, without even the cursory oversight performed by regulators in other states.” See also Will Fitzgibbon and Debbie Cenziper, “American lawmakers denounce South Dakota, other US States as hubs for financial secrecy,” *International Consortium of Investigative Journalists*, December 8, 2021.

<sup>37</sup> *International Consortium of Investigative Journalists*, “Pandora Papers: The largest investigation in journalism history exposes a shadow financial system that benefits the world’s most rich and powerful,” October 3, 2021.

## Appendix I: Grantor and Non-Grantor Trusts

A grantor trust is not a taxable legal entity; the trust property, though “transferred” by the grantor, is treated as still owned by the grantor. Consequently, all trust income — regardless of whether it is distributed to beneficiaries — is reported on the grantor’s individual income tax return in the year in which it is realized.

A non-grantor trust, in contrast, is a trust over which the grantor no longer has meaningful control — for example, to revoke the trust arrangement, require distributions to the grantor, or change beneficiaries. As a consequence of that complete gift of property, the non-grantor trust is treated for tax purposes as if it were a legal entity independent of the grantor, as the owner of the trust property, and as a taxpayer in its own right. The trust agreement may direct the trustee to distribute the income flowing from that property to beneficiaries, direct the trustee to let the income accumulate in the trust, or leave that decision up to the trustee’s discretion. But if the trust accumulates income in a given year, it must pay tax on that income, and if it distributes income to beneficiaries, they are taxed on that income. (The trust then gets a deduction so there is no double taxation.)<sup>38</sup>

State income tax laws generally follow federal tax law. For the taxation of trust income, as for the taxation of corporate and individual income, most states take as their starting point the Internal Revenue Code and related regulations, rulings, and court decisions. If a trust is a non-grantor trust for federal tax purposes, almost all states deem it a non-grantor trust, too.<sup>39</sup> However, each state can decouple by statute from a variety of specific federal rules and substitute its own. This decoupling concept is central to the New York solution to the ING problem.

An individual, corporation, or trust is subject to a state’s income tax only if there is a sufficient “nexus” (connection) between it and the state to satisfy jurisdictional standards that limit state power to impose tax on that entity. In-state residency is the connection that matters in the context of grantor trusts. If the grantor of a grantor trust is resident in the state, every year they must include on their individual tax return all their income from whatever geographic source, including any trust income attributable to them.

Non-grantor trusts are also treated as having a “residence” for tax purposes, but because they are legal entities and not human beings, determining the state of residence is less straightforward.<sup>40</sup> State rules for determining a non-grantor trust’s state of residency vary widely;<sup>41</sup> relevant factors include whether: (1) the trustee is an in-state resident; (2) the beneficiary is an in-state resident; (3) the grantor is an in-state resident (or was when it became a non-grantor trust);<sup>42</sup> (4) the trust is

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<sup>38</sup> IRC sections 641, 651, 661. See Janet Rae Montgomery, “Income Taxation of Trusts and Estates,” Stetson Law 2021 National Conference, October 13, 2021.

<sup>39</sup> Mitchell M. Gans, “Kaestner Fails: The Way Forward,” *William and Mary Business Law Review*, Vol. 11, No. 3, April 2020.

<sup>40</sup> Of course, people can own more than one home or live in more than one place in a given tax year, and many disputes also arise over their residency status for state income tax purposes.

<sup>41</sup> See Jeffrey Schoenblum, “Strange Bedfellows: The Federal Constitution, Out-of-State Non-grantor Accumulation Trusts, and the Complete Avoidance of State Income Taxation,” *Vanderbilt Law Review*, Vol. 67, No. 6, November 2014; Gans.

<sup>42</sup> Recurring legal challenges to the constitutionality of factors 2 and 3 may be problematic for some states. Taxpayers seeking to avoid tax argue that neither an in-state grantor nor an in-state beneficiary, standing alone or together, creates a sufficient connection to give the state jurisdiction to tax the trust itself. Some judicial decisions, including a recent one from the U.S.

administered in state; (5) the trust owns real estate or other tangible property in state; and (6) the trust agreement says it's governed by the state's law.

Residence rules are an essential ingredient of many schemes to avoid state personal income tax. A handful of states do not impose any individual or trust-level income tax on their residents; these states function as tax havens for ING trusts.<sup>43</sup>

## Appendix II: The ING Trust Problem

Most states impose personal income tax on their residents' investment income (like dividends and interest) earned during the year on their intangible assets (like stocks and bonds). But an ING provides very wealthy individuals with a vehicle to escape their state personal income tax obligations on this income when they leave it in the trust.<sup>44</sup> Indeed, state personal income tax avoidance is “the primary objective” of ING trusts, according to one estate planner.<sup>45</sup>

### How INGs Work

INGs manipulate three fundamental elements of state personal income taxation: (1) the identity of the taxpayer; (2) the state's taxing jurisdiction over that taxpayer (nexus); and (3) the taxpayer's ownership of the income (the tax base).

First, for the scheme to work, the ING — not the grantor — must be the taxpayer. A non-grantor trust is treated as a taxable entity separate from its grantor, and relinquishing control is central to qualification as a non-grantor trust. If the grantor does not make a complete gift of their property to the ING, then the ING is a grantor trust, and the grantor remains the taxpayer and is liable for tax on the trust's income.

Second, the ING must be subject to the taxing power of a tax haven state, not the grantor's home state. That way, when the ING earns and retains<sup>46</sup> income from its intangible property,<sup>47</sup> this income

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Supreme Court, have favored the plaintiffs. See *North Carolina v. Kaestner Family Trust*, 139 S. Ct. 2213, 2019. The constitutionality of these two trust residency factors is not relevant to New York's solution to the ING problem.

<sup>43</sup> Alaska, Florida, South Dakota, Tennessee, Texas, and Wyoming impose no individual income or trust taxes, and Nevada does not tax income unrelated to employment, like dividends, interest, and royalties — the very types of income that ING trusts earn on their property. Despite levying an income tax on non-grantor trusts, Delaware has also become an attractive location for the formation of INGs because it exempts from the tax any income accumulated for beneficiaries who are not Delaware residents. See Janelle Cammenga and Jared Walczak, “2022 State Business Tax Climate Index,” Tax Foundation, December 16, 2021; Steven J. Oshins, “8th Annual Non-Grantor Trust State Income Chart,” Ultimate Estate Tax Planner, 2022. Washington recently imposed an excise tax on a trust's capital gains (the only tax that the state imposes on trusts); a recent court decision ruling it unconstitutional will be appealed. *Quinn/Clayton v. Washington*, No. 21-2-0075-09; 21-2-00087-09, WA Superior Ct., March 1, 2022.

<sup>44</sup> Schoenblum and Schoenblum.

<sup>45</sup> Oshins, “NING Trusts for California Residents.”

<sup>46</sup> Recall that if the non-grantor trust distributes that income to a beneficiary, it will be taxed as income to the beneficiary by the beneficiary's state of residence.

<sup>47</sup> The ING strategy does not shelter income from tangible investments (like real estate rents and racehorse stud fees) because such income can be traced to a source in a particular state: the physical location of the tangible assets. The in-state presence of a non-resident trust's tangible property gives the state jurisdiction to tax the trust on that income.

Despite this limitation, estate planners could still find ways to convert those tangible assets into intangibles — perhaps contributing racehorses, for example, to a limited liability company (LLC) and gifting the LLC stock to the ING. In that event, the income may not be “sourced” to any particular state. See Schoenblum and Schoenblum.

will not be subject to state personal income tax. A trust's nexus with a state is determined by its residence, which a skilled attorney, accountant, or trust company officer can easily manipulate. If the trustee (an individual or service firm) is resident in a state with no income tax on trusts or no income tax at all; if the trustee administers trust operations in that state; and if the trust is governed by that state's laws, then the ING is a resident taxpayer in the tax haven.<sup>48</sup>

Third, the grantor's tax base must be shifted to the ING. The tax base is the accumulated (that is, undistributed) income produced by the grantor's intangible property. The grantor transfers that property to the ING as part of the process of qualifying it as a non-grantor trust.

### **Federal Gift Tax Poses Obstacle but Can Be Overcome**

There is one significant disincentive to pursuing the ING strategy: the federal gift tax, which levies its top 40 percent rate on most of the assets a grantor would wish to transfer to their ING.

The gift tax is imposed on the value of all gifts an individual makes during their life,<sup>49</sup> and transfers of property to a non-grantor trust typically count as gifts as soon as they are made. The Internal Revenue Code provides a lifetime exemption amount that can be given away tax free (the current amounts are roughly \$12 million for individuals and \$24 million for couples), but most very wealthy gift-givers will far surpass their exemption. This 40 percent tax would more than offset the state personal income tax advantages of an ING unless the grantor can avoid the federal gift tax consequences of transferring assets to the ING.<sup>50</sup>

The problem appears unresolvable initially, since the legal requirement for obtaining non-grantor trust status (namely, that the property transfer must be "complete") conflicts with the requirement for escaping the federal gift tax (that the property transfer must be "incomplete" and thus not really a gift after all).

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<sup>48</sup> Recall that if a home state's assertion of trust residency is grounded solely on in-state presence of the grantor or a beneficiary, the state may face a constitutional challenge brought by the trust.

<sup>49</sup> IRC Section 2503 *et seq.*

<sup>50</sup> It might be asked why the grantor would care about the immediate gift tax liability given that the transfer of the assets to any beneficiary at death would presumably be subject to an equivalent 40 percent federal *estate* tax. There are three principal answers.

First is the time value of money. If gift tax applies, only 60 percent of the grantor's transferred assets will continue earning returns, possibly for many years, until the estate tax would have been due.

Second, if the trust can retain its grantor status for gift and estate tax purposes (that is, not become subject to an immediate gift tax), the assets will be eligible for a "stepped-up basis" at the time of the grantor's death — meaning that any appreciation in their value between the time the grantor acquired them and the grantor's death would permanently avoid federal and state income taxation. This "angel of death loophole" creates a significant distributional inequity problem. See Urban-Brookings Tax Policy Center, "Briefing Book: A citizen's guide to the fascinating (though often complex) elements of the federal tax system," 2022. It is beyond the scope of this paper to consider the reasons states might justifiably decide to cease conforming to this federal tax rule.

Third, loopholes in federal estate tax laws often allow the "dynasty trust" laws enacted by South Dakota and other states to serve as "perpetual estate-tax-avoidance machine[s]." A discussion of those loopholes is beyond the scope of this paper; see Bob Lord, "Dynasty Trusts: Giant Tax Loopholes that Supercharge Wealth Accumulation," Americans for Tax Fairness, February 1, 2022.

In sum, although ING-based state income tax avoidance can be significant, it pales in comparison with the asset growth and federal income tax avoidance opportunities that would be forgone by the grantor due to the 40 percent up-front reduction of trust asset value, should the federal gift tax apply. In other words, the cost of having to pay gift tax would far exceed the gain from ING-derived state income tax avoidance. Therefore, it is essential that the federal gift tax be avoided, which the "incomplete" element of the "incomplete non-grantor trust" achieves.

The solution is for the grantor to tell the IRS that the property transfer is both “complete” and “incomplete,”<sup>51</sup> using carefully drafted trust provisions that skirt close to faking the facts.<sup>52</sup> A common way to walk this tightrope when drafting the trust agreement is, first, to give the grantor ongoing “strings of control” — like the power to make payouts to beneficiaries for their health and education. This makes the grantor’s gift to the trust “incomplete” for gift tax purposes, and thus not a taxable gift. Second, the agreement should condition this grantor payout power on approval by a “distribution committee” composed of some of the beneficiaries and sometimes even the grantor. This retains the trust’s non-grantor status, since it means the grantor’s power over the trust is not unlimited.<sup>53</sup>

### INGs Can Also Enable Very Wealthy Individuals to Avoid Creditors

“[T]ax havens aren’t primarily for tax avoidance. They offer something even more appealing and dangerous, which is law avoidance in general,” writes Brooke Harrington.<sup>54</sup> She continues: “What high-net-worth individuals buy in this system is the right to pick and choose the laws that govern them.”<sup>55</sup> ING trusts are one example, since they can enable very rich individuals to escape the laws that require everyone else to pay their debts.

Creditor avoidance is easy for wealthy people with ING; indeed, it is a *required element* under federal law for creating ING. Under federal tax rules, “the possibility that trust assets can be accessed to cover claims of creditors of the [grantor] makes the trust a ‘grantor trust’” — not an ING.<sup>56</sup> That’s because the IRS treats creditor access to trust property as an economic benefit for the grantor, as it would be for a grantor who desired to control enough property in the trust to satisfy their debts. Retaining that benefit constitutes retention of “control” by the grantor.

With creditor avoidance a necessary element for qualifying a trust as an ING, tax havens stand ready to oblige. Led by Nevada and South Dakota, more than a dozen states have enacted legislation authorizing “domestic asset protection trusts” (DAPTs) that enable tax dodgers to evade their creditors as well.<sup>57</sup>

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<sup>51</sup> As early as 2001, the IRS began issuing private letter rulings that described transfers to an ING as both “incomplete” enough to escape gift tax and “complete” enough to escape grantor trust status. See PLR 200148028 (November 30, 2001). See also Gans and Schoenblum and Schoenblum, discussing unpublished rulings reflecting the IRS’s changing attitude toward ING over nearly 20 years.

<sup>52</sup> Schoenblum and Schoenblum write: “Indeed, a properly crafted NING is something of a sleight of hand.”

<sup>53</sup> Under the Internal Revenue Code, other beneficiaries are considered “adverse parties” because their interest in having the trust income distributed to them is contrary to the potential interest of the grantor in retaining the ability to receive the money. Sections 674(a) and 677(a) of the IRC provide that “a power to distribute income to the grantor . . . will not cause grantor trust status when exercisable only with the approval or consent of an adverse party.” See Lindsay R. DeMoss D’Andrea, “Incomplete Gift Non-Grantor Trusts: How *Kaestner* Highlights the Importance of Planning for State Income Tax,” *Probate & Property*, May/June 2020. But as Schoenblum and Schoenblum note: “[I]n reality, the [grantor] retains practical control in many of these situations because adverse parties, especially younger family members, are likely to comply with the perceived or stated wishes” of the grantor.

<sup>54</sup> Brooke Harrington, *Capital Without Borders: Wealth Management and the One Percent*, Harvard University Press, 2016.

<sup>55</sup> Brooke Harrington, “Offshore accounts aren’t for evading taxes. They’re for evading laws altogether,” *Washington Post*, October 6, 2021.

<sup>56</sup> Schoenblum and Schoenblum.

<sup>57</sup> Steven J. Oshins, “The 11th Annual DAPT State Rankings Chart Released!” *Ultimate Estate Planner*, May 1, 2020. See also “Fear Factor: Protecting Assets by Getting into the Creditor’s Head and Controlling His Mind,” an online training program in which Oshins discusses “DAPTs, Hybrid DAPTs” and more.