

Does California's New Law Ending the State Income Tax Benefits Associated with Incomplete Gift Non-Grantor Trusts Violate the U.S. Constitution?



by
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On July 10, 2023, California followed in the footsteps of the State of New York by adding Section 17082 to the California State Tax and Revenue Code (hereafter, “Section 17082”) which establishes that income generated from Incomplete Gift Non-Grantor Trusts (“ING Trust” or “ING Trusts”) created by California taxpayers will be includable in a grantor’s income for California state income tax purposes.¹ ING Trusts are unique tax saving vehicles utilized by individuals residing in states with high income tax rates to eliminate or defer state income tax liabilities on the sale of low-basis, highly-appreciated assets. For federal taxation purposes, an ING Trust is treated as a non-grantor trust, however, the assets contributed to an ING Trust do not count against the grantor’s federal lifetime gift tax exemption because the grantor retains certain powers over the ING Trust to cause the transfer into the ING Trust to be wholly incomplete for federal gift tax purposes.²

To qualify for this favorable tax treatment, an ING Trust must be created in a jurisdiction like Delaware that authorizes self-settled asset protection trusts³ and does not impose state income tax on trust income when none of the trust’s beneficiaries reside in Delaware.⁴ Additionally, the grantor must avoid making a completed gift when funding the ING Trust and the ING Trust must avoid being classified as a grantor trust for federal taxation purposes.⁵ The IRS has issued a series of Private Letter Rulings⁶ establishing that a grantor can accomplish both of these objectives if the following requirements are met: (1) the ING Trust is a self-settled asset protection trust;⁷ (2) the grantor retains a limited power of appointment over the ING Trust’s assets;⁸ (3) the grantor retains the power to consent to distributions directed by a majority of the distribution committee members;⁹ and (4) the ING Trust has a distribution committee that has the discretion to determine whether the grantor is entitled to distributions from the ING Trust’s income and principal.¹⁰

If these requirements are met, upon the sale of the ING Trust's assets, the ING Trust will incur a federal, but not a state income tax liability. Therefore, it is possible for individuals residing in states with high state income tax rates to eliminate their state income tax liability on assets sold by an ING Trust.

Prior to the implementation of Section 17082, the following example demonstrates how California residents were able to use ING Trusts to avoid California state income taxes on the sale of low-basis, highly-appreciated assets.

A is a resident of California that is in the highest federal and state tax bracket. A owns securities with a basis of \$1 million. A believes that the securities are going to appreciate significantly in the future. To reduce state tax liability on the sale of the securities, A forms a Delaware ING Trust and funds the trust with the securities. The trustee later sells the securities for \$10 million. Because the securities were owned by an ING Trust at the time of the sale, the ING Trust will owe federal tax on a \$9 million gain, however, no California state tax will be due as the ING Trust was formed in Delaware where no state income tax is imposed on trust income accumulated for non-resident beneficiaries. Therefore, because A utilized a Delaware ING Trust to sell the securities, A was able to save roughly \$1,197,000 in California state income taxes.¹¹

Given the success that ING Trusts have had in eliminating state income tax, California enacted Section 17082 on July 10, 2023 which states:

For taxable years beginning on or after January 1, 2023, the income of an [ING 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.

Section 17082 has generated controversy among wealth planning practitioners and high-net-worth individuals for two reasons. First, Section 17082 eliminates the tax benefits associated with forming ING Trusts for California residents, as income generated by an ING Trust is now includable in the grantor's income for California state income tax purposes. Second, the statute possesses a retroactive effective date. This means that income generated from ING Trusts formed between January 1, 2023, and July 9, 2023, will be subject to California state income tax even though the law was not enacted until July 10, 2023.

The use of retroactive effective dates for tax legislation is an atypical practice. Traditionally, tax laws utilize what is referred to as a "sunset provision" or a deadline for when the current
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law is set to expire. For example, I.R.C. § 2010(c) states that on January 1, 2026, the federal gift and estate exemption amount will be reduced to \$5,000,000. By having this sunset provision, individuals know they have until December 31, 2025, to make the necessary gifts to take advantage of the current exemption amounts. However, the effective date used by Section 17082 does the opposite, as California residents were not afforded such notice and are now being penalized for engaging in transactions that were recognized as tax-free when they were completed.

Given the adverse tax consequences that will result from Section 17082's retroactive effective date, one might ask, "is this law even constitutional?" The initial response might be "of course not", as it is a ridiculous notion that a legislature can tax individuals for engaging in transactions that were tax-free at the time they were performed. However, like all areas of law, the answer is not so clear, as the United States Supreme Court has held that a taxpayer's reliance on the current tax law is insufficient to establish a constitutional violation.¹² As such, the remainder of this article will discuss the potential arguments that a taxpayer might raise if Section 17082 were to be challenged on constitutional grounds.

1. Ex-Post Facto Law

The first constitutional argument that might be raised is that the retroactive effective date used by Section 17082 creates an unconstitutional "Ex Post Facto Law." A law is considered an Ex Post Facto Law if a law imposes criminal liability upon an individual for engaging in an act that was legal at the time it was performed.¹³

In regard to Section 17082, it could be argued that the retroactive date used by Section 17082 creates an Ex Post Facto Law because the law imposes tax on a transaction that was exempt from California state income tax prior to Section 17082 being enacted. However, this argument will likely fail, as an Ex Post Facto Law only exists if the law imposes criminal liability for conduct that was legal at the time the act was performed.¹⁴ Additionally, the United States Supreme Court has held that "[t]axation is neither a penalty imposed on the taxpayer nor a liability which he assumes by contract. It is but a way of apportioning the cost of government among those who in some measure are privileged to enjoy its benefits and must bear its burdens."¹⁵ In this case, no criminal liability is being imposed upon California residents that created ING Trusts. Rather, ING Trusts remain legal and Californians using ING Trusts are now required to pay California income tax on income earned by ING Trusts in 2023. Therefore, any argument that the retroactive effective date used by Section 17082 creates an unconstitutional Ex Post Facto Law will likely fail.

2. Due Process

It could also be argued that Section 17082 violates Due Process because Section 17082 imposes tax upon transactions considered tax-free prior to the enactment of Section 17082. The 14th

Amendment's Due Process Clause establishes that no "...State shall deprive a person of life, liberty, or property, without due process of law."¹⁶ In the context of retroactive tax legislation, the United States Supreme Court has consistently found that retroactive tax legislation does not violate Due Process.¹⁷ A reviewing court will find that retroactive tax legislation complies with Due Process if the law is capable of withstanding rational basis review and the period of retroactivity is deemed "modest."¹⁸

Rational basis review is the lowest form of judicial scrutiny that a law can face when being challenged on Due Process grounds. To survive rational basis review, the court must find that the law is rationally related to a legitimate government purpose.¹⁹ A retroactive tax law will fail rational basis review if a court finds that the retroactive law was enacted for illegitimate or arbitrary purposes.²⁰ The United States Supreme Court has found that retroactive tax legislation meets the requirements of rational basis review if the law was enacted to recover or prevent the loss of tax revenue.²¹ In *Carlton*, the United States Supreme Court determined that a retroactive tax law impacting the deductibility of ESOP shares sold by an estate survived rational basis review because the law was implemented to address a mistake in the tax code that could have resulted in significant and unanticipated tax revenue losses. Therefore, if a retroactive tax law was implemented to prevent the loss of tax revenue, the law will overcome rational basis scrutiny.

In addition to satisfying rational basis review, a retroactive tax law will not be found to violate Due Process if a reviewing court determines that the period of retroactivity adopted by the law is considered "modest."²² In previous decisions, the United States Supreme Court found tax legislation possessing a retroactive effective date of slightly more than a year to be considered "modest."²³

In this case, Section 17082 will likely be able to survive any Due Process challenges. Section 17082 satisfies rational basis review because the California legislature estimates that the implementation of Section 17082 will allow the state to recapture an estimated \$17 million of previously lost tax revenue.²⁴ Further, a reviewing court would likely find that Section 17082's retroactive effective date of six months "modest" because the United States Supreme Court has approved retroactive effective dates spanning more than a year. Therefore, a court would likely find that the retroactive effective date used by Section 17082 does not violate Due Process.

Although Section 17082's retroactive effective date is punitive and penalizes Californians for utilizing ING Trusts to minimize their state income tax liability, any claims that the law is unconstitutional on the basis that the retroactive effective date creates an Ex Post Facto Law, or violates Due Process, will likely fail. However, given the unpredictable and ever-changing nature of constitutional jurisprudence, it is not unrealistic that a court could strike down Section 17082 as unconstitutional if the correct facts were to present themselves.



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Notes:

- 1- In 2014, New York eliminated the state income tax savings benefits associated with ING Trusts by adding § 612(b)(41) to the Consolidated Laws of New York which states that income from ING Trusts will be treated as if it were derived from a grantor trust and therefore includable in a grantor's income for New York state income tax purposes.
- 2- See, PLR 200612002; PLR 200502014; PLR 200247013; PLR 200148028.
- 3- See, 12 Del. C. § 3572.
- 4- See, 30 Del. C. § 1636.
- 5- For a more detailed discussion of the structuring requirements for ING Trusts see, Michael Gordon, *Use of Delaware Incomplete Gift Non-Grantor Trusts in Light of IR-2007-127* (2011), available at <https://www.gfmlaw.com/sites/default/files/pdfs/Use%20of%20Delaware%20Non-Grantor%20Incomplete%20Trusts%20%2800304860%29.pdf>
- 6- See, PLR 200715005; PLR 200647001; PLR 200637025; PLR 200612002; PLR 200502014.
- 7- Treas. Reg. § 1.677(a)-1(d) (if creditors are able to reach a trust's assets, the trust will be considered a grantor trust for federal taxation purposes).

- 8- See, 26 CFR § 25.2511-2(b) (a gift may be incomplete if the donor reserves any power over its disposition).
- 9- PLR 200247013.
- 10- I.R.C. § 677(a) (a grantor will be considered the owner of any portion of a trust if the income can be distributed to the grantor without the approval of an "adverse party").
- 11- This is assuming that the California tax rate applicable to this transaction is 13.3%.
- 12- See, *U.S. v. Carlton*, 512 U.S. 26, 33 (1994); *Welch v. Henry*, 305 U.S. 134, 146 (1938).
- 13- *Calder v. Bull*, 3 U.S. 386, 390-91 (1798).
- 14- See, *Kentucky Union Co. v. Commonwealth of Kentucky*, 219 U.S. 140, 155 (1911) (Kentucky statute authorizing retroactive tax was not an Ex Post Facto Law because the law did not impose criminal liability upon taxpayers).
- 15- *Welch*, 305 U.S. at 146.
- 16- U.S. Const. amend. XIV, § 1.
- 17- See, *United States v. Hemme*, 476 U.S. 558 (1986); *United States v. Darusmont*, 449 U.S. 292 (1981); *Welch*, 305 U.S. at 134; *United States v. Hudson*, 299 U.S. 498 (1937); *Milliken v. United States*, 283 U.S. 15 (1931); *Cooper v. United States*, 280 U.S. 409 (1930).
- 18- *Carlton*, 512 U.S. at 30-31.
- 19- *Id.*
- 20- *Id.* at 32.
- 21- *Id.*
- 22- *Id.*
- 23- *Id.* at 32-35 (United States Supreme Court determined that the retroactive effective period of fourteen months was "modest" and did not violate Due Process); *Welch*, 305 U.S. at 150-51 (United States Supreme Court found that state tax law enacted in 1935 that was retroactive back to transactions conducted in 1933 did not violate Due Process); *Milliken*, 283 U.S. at 23-24 (United States Supreme Court found that retroactive period of two years did not violate Due Process).
- 24- See, Legislation Proposal C Executive Summary, Taxation of Income from an Incomplete Gift Non-Grantor (ING) Trust, available at <https://www.ftb.ca.gov/tax-pros/law/regulatory-activity/lp-c.pdf>



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