NEW JERSEY INCOME TAX PLANNING OPPORTUNITY: DELAWARE TRUSTS

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A significant benefit of using trusts is the ability to minimize state level income taxes. The availability of this strategy depends on the residence of the trust creator (the "settlor"); the residence of the trustee; the residence of the trust beneficiaries; the type of assets owned by the trust; and the type of income earned by the trust. When all of the factors align correctly, the trust settlor can minimize, or even eliminate, state level income tax on the trust assets.

Often these trusts are structured as "DING trusts" (aka Delaware Incomplete Gift, Non-Grantor trusts). This strategy is particularly attractive for New Jersey residents, who can essentially eliminate state level income tax while still retaining access to the trust assets.

How does the DING trust work? It is essential that the trust is structured as a "non-grantor" trust for federal and state income tax purpose. As a non-grantor trust, the DING trust will be a separate taxpayer for income tax purposes. At the same time, transfers made to the DING trust by the settlor are not completed gifts. This means the settlor does not have to file a gift tax return, and the settlor does not use any of his or her federal estate and gift tax exemption on the transfer (which is currently $11.4 million per person).

In order for the strategy to work, the settlor must appoint a trustee located in Delaware (or another state that authorizes so-called "domestic asset protection trusts," such as Nevada or South Dakota). If the trust does not have a New Jersey trustee, does not have New Jersey assets, and does not receive any New Jersey source income, then the trust will not owe income tax in New Jersey. And because Delaware does not impose income tax on these types of trusts, there is no state level income tax in Delaware either. If the trust is established and administered correctly, no state will have the ability to tax the trust (note, the trust will still be subject to federal income tax). If and when the trust makes distributions, the state where the beneficiary lives may be able to tax the trust's current year income, which carries out to the beneficiary, depending on the laws of that particular state.

A Delaware individual can be the trustee of the DING, but if the settlor does not have a trusted friend or family member in Delaware, the settlor can hire a corporate trustee for a fee.

Suppose a New Jersey resident has a $15 million stock portfolio. Dividends and interest generated on the portfolio may be subject to New Jersey income at a tax rate of up to 8.97%. This state level income tax can be eliminated if the stock portfolio is instead transferred to the DING trust.

Furthermore, low basis property that may be sold in the future is particularly ideal property to fund a DING trust. Assume the $15 million stock portfolio has an income tax basis of $5 million and is liquidated. New Jersey would impose state level income tax on the sale at up to 8.97% - that's up to $897,000 of state income tax on the recognized capital gain. If low basis property is instead sold when it is in a DING trust, that entire state level tax on the capital gain can be eliminated.

Not all assets are suitable for this structure. In order for the trust to save income taxes, the trust cannot receive any New Jersey source income. If the trust owns an interest in a partnership or S corporation that throws off New Jersey source income (such as income from a New Jersey business or rent from New Jersey real estate), the trust will be subject to New Jersey income tax.

The Delaware trustee can serve in merely an administrative role – typically the role is reduced to a trust officer located in Delaware who generates periodic account statements and communicates with the trust's settlor and beneficiaries from an office in Delaware. The settlor appoints an "investment adviser" for the DING trust, who has the power to direct and control the trust's investments. The settlor also appoints a "distribution committee" for the DING trust, which has the power to direct distributions from the trust to the trust beneficiaries. The Delaware trustee must take directions from the investment adviser and the distribution committee; the trustee cannot exercise its own independent judgment on these decisions. Essentially, the corporate trustee can be used to get a foothold in Delaware, while all significant decision making authority can be given to the settlor's trusted friends, family members, and advisers.

Typically, the distribution committee is comprised of three or more beneficiaries other than the settlor. Often the distribution committee members will be the settlor's spouse and/or children. The distribution committee controls when and if the settlor receives a distribution – but the settlor also retains the power to veto distributions to other beneficiaries.

Ideally, assets will sit in the DING trust for years or decades, eliminating state level tax on the trust's income. However, distributions can be made back to the settlor or his or her spouse if needed.

New York State has passed legislation that essentially eliminates the DING trust opportunity for individuals who create the trust when they are New York residents. But if a New Jersey settlor creates a DING trust before moving to New York, the technique should continue to work, making the trust a viable option for individuals who are thinking about a change of residence.

If you have any comments or questions, please contact any of the attorneys listed below:

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