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The Revival of the "DING Trust" — Is it Here to Stay?

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Individuals continue to proactively seek an approach to manage and mitigate potential federal and state income tax exposure, as tax reform over the last several years has produced adverse results, especially for those living in high income tax states generating ordinary income and short-term gains.

Beginning in 2013, the top federal marginal income tax rate is 39.6% for high income taxpayers with earned income and short term gains, which does not include an additional tax rate increase of approximately 1% for the phase out of personal exemptions and itemized deductions. The Medicare tax also adds an additional 3.8% tax on top of the federal tax for investment income generated by the high earners. Those residing in high tax states such as New York and California can count on a combined federal and state marginal income tax rate of up to 56% in certain instances.

The Internal Revenue Service ("IRS") recently resurrected a state income tax planning strategy that been on hold and has not been ruled upon for at least five years, involving what has been known as the "DING Trust" (Delaware Incomplete Non-Grantor trust).

The 2013 private letter rulings, issued by the IRS, indicate a willingness to again issue rulings with respect to this type of trust offering insight into proper structuring. As described below, the DING trust has been subject to rulings issued over five years ago that have been subject to practitioner criticism, and almost suffered extinction with the advent of Internal Revenue Code Section 2511(c) which provided that a transfer to a non-grantor trust would be treated as a completed gift. Fortunately, the American Taxpayer Relief Act of 2012 made the repeal under the 2010 Tax Relief Unemployment Insurance Reauthorization and Job Creation Act permanent.

By utilizing a DING trust, an individual is able to transfer high-income producing assets to a trust without triggering federal or state gift tax (in the case of Connecticut resident) while mitigating state income tax with regard to the assets transferred. The trusts are designed to shift state income tax from the grantor's domicile state to a trust located in a jurisdiction that does not tax trust income, accumulated income and capital gains, with the added benefit of providing asset protection to the grantor and family. Trust jurisdictions used have included Delaware, Nevada, and Alaska.

This type of trust is often appealing to an individual who holds significant income generating portfolios or anticipate a liquidity event of highly appreciated assets, resides in a high tax state that will not tax a non-grantor trust domiciled in such a low or no income state, and is looking for asset protection in the future.

Currently, New York and New Jersey will not tax a trust's income if it has no resident trustees, assets located in the jurisdiction, or state sourced income. An investment portfolio held in a DING trust should be exempt from New York and New Jersey state and local income tax if the trustee is a non-New York resident or non-New Jersey resident, respectively. California will tax trust income if the trust has at least one resident trustee and no non-contingent beneficiary resident in California.

To illustrate the concept, assume a married resident of New York City expecting a $15 million gain from the sale of stock in a closely held business. The individual is considering transferring the stock into a DING trust created in Nevada. All gain will be considered net investment income for purposes of the Medicare tax. Capital gains will be taxed at 20%, a combined New York state and city income tax rate of 12.8%, and Nevada state fiduciary income tax rate of 0%.

	No Trust	With DING Trust
Gain from Sale of stock	15,000,000	15,000,000
Federal Capital Gains Tax (20%)	(3,000,000)	(3,000,000)
Medicare Tax (3.8% over applicable threshold)	(560,500)	(569,546)
Combined New York Taxes (12.8%)	(1,920,000)	0
	9,519,500	11,430,454
Potential Benefit		1,910,954

The funding of the DING trust is designed to be an incomplete gift so the trust assets will be includible in the grantor's estate at death. Other complimentary estate planning strategies should be considered to reduce the grantor's taxable estate, including perhaps setting up an insurance trust to secure life insurance that can be used to fund the estate tax on death.

In considering the design of the trust, it is extremely important to consider the balance of the state income tax savings against the federal income tax resulting from the income being taxed in the trust as opposed to an individual, especially given compressed trust rate brackets and the 3.8% Medicare tax on investment income. Drafting the trust with flexibility enables the trustee to make distributions to those beneficiaries in a lower income tax bracket in the future, thus being able to minimize both federal and state income taxation.

A thorough review of the state trust laws and income tax rules should be undertaken before implementing the plan in order to have the desired state income tax consequences, as many states assert taxation based on a grantor's domicile, the trustee's domicile, location of the assets, place of administration, or a combination of these factors, as mentioned above. Private letter rulings may only be relied upon by those requesting the rulings. Those who execute a strategy using the DING trust may be well advised to obtain their own private letter ruling.

The key goal in structuring the DING trust is to avoid the trust being classified as a grantor trust and to avoid a completed gift upon the funding of the trust. The trust is irrevocable and must be domiciled in a state that authorizes self-settled spendthrift trusts; otherwise the grantor's creditors could potentially attach the trust assets creating grantor trust status for federal income tax purposes. Other key areas for consideration include the following:

1. Trust distributions can benefit the trust settlor and other family members during the grantor's life — this is especially helpful if the grantor wants to avoid unforeseen cash flow issues in the future;

2. Trust can create a distribution committee comprised of members of the grantor's family having the authority to make trust distributions to the grantor and to the other beneficiaries including the members of the distribution committee. The grantor cannot be a member of the committee.

3. Trust can provide the grantor with the power to consent to the trust distributions, and the grantor can have a limited testamentary power of appointment over the trust assets.

Over the last decade, the IRS has issued rulings involving the DING trust having similar facts but criticized by practitioners. A particular criticism involved whether the grantor retaining a lifetime power to appoint assets with the consent of a distribution committee would create an incomplete gift and non-grantor trust status. For gift tax purposes, the IRS ruled that a gift was incomplete on the basis that the distribution committee was not adverse to the grantor. But on the same facts, ruled that for income tax purposes the trust is not a grantor trust since the distribution committee members held adverse interests with respect to the settlor.

In the 2013 PLR, the IRS ruled that the funding of an irrevocable trust was an incomplete gift; a gift from the trust should not be treated as a gift from the members of

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the distribution committee, and classified the trust as a non-grantor trust with the following essential provisions:

1. Grantor consent power — Distribute income or principal upon direction of a majority of the distribution committee with consent by the Grantor;

2. Unanimous member power — Distribute income or principal upon direction by all distribution committee members other than the Grantor; and

3. Grantor's sole power — Distribute principal and not income to any of the Grantor's issue upon direction from the Grantor in a non-fiduciary capacity to provide for the health, maintenance, support, and education of his issue.

CONCLUSION

With the rise in federal income tax rates, state income tax planning for those residing in high-tax jurisdictions such as New York, New Jersey, and California is more prevalent. The DING trust, if properly structured, can be used as a tool in a comprehensive financial plan which can be helpful in mitigating income tax for those holding income generating portfolios or anticipating a liquidity event. Individuals considering this strategy should seek counsel especially due to the fluctuations in state law and the specific guidelines set forth by the Internal Revenue Service. These trusts do not provide for federal estate tax savings they work best when combined with a well-thought out estate plan. ■

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Got Cash? How to Get a Higher Yield...Maybe

by Belinda Tsui and Tom Birrittella, CFP, AIF

Got cash? Did you get out of the market after the crash in 2009? Are you too leery to get back into the market, or do you feel it's too late to catch the record highs? Or do you simply have cash sitting for whatever reason that does not seem to be earning much, if anything? It could be quite depressing to open your statement every month to find your cash earning nothing or an even more insulting 0.01%. If you have sufficient funds at one bank, you may hit the next tier to earn a higher rate. If that's not the case, there are still channels for you to safely earn more on your cash, but it will require a little effort.

To earn a higher rate, look around a bit. Local or regional banks and credit unions may be more competitive and offer higher interest rates than large banks. You can simply look at their store front or in your local newspapers. If they have a promotion rate, they certainly will not hide it from you. Local or regional banks are smaller in operations than large banks, but they are still covered by the Federal Deposit Insurance Corporation (FDIC) and protect your money, as outlined below. Credit unions are not banks; however, the funds they hold are still federally insured under the National Credit Union Administration, as described below.

Another place to look is the internet. Online banking is offered by either banks that operate strictly online or banks of any size that simply add online banking to the services they offer. Online banking is really for do-it-yourselfers. Most of the operating of the account is done online or on the phone; service is truly no-frills. Since the customer is doing all the work and does not use much of the bank's resources, the bank is able to use their savings on expenses and offer a better rate.

Certificates of Deposit (CDs) can be issued by credit unions or banks. Look for CDs insured by the FDIC or National Credit Union Share Insurance Fund (NCUSIF). CDs typically offer higher yields than deposit accounts or money markets in return for locking up your money for a stated period of time. You need to be cautious of not buying a CD with too long of a maturity period, as there is a potential opportunity cost if interest rates rise above the rate of your CD before maturity date. Breaking a CD before maturity may cause an interest penalty of associated fees.

FDIC COVERAGE

The FDIC is backed by the full faith and credit of the United States government. FDIC insurance is limited to $250,000 per depositor within each ownership category per insured institution. If you have two FDIC-insured accounts titled in the same ownership category, at the same institution, they are insured for an aggregated maximum of $250,000. However, if these same two FDIC-insured accounts are held at different institutions, each account is insured up to a maximum of $250,000. Joint FDIC-insured accounts owned by two or more persons are insured up to a maximum of $250,000 per co-owner.

FDIC defines ownership category of an account by its registration type. There are eight basic types of ownership account categories: single, joint, certain retirement, revocable trusts, irrevocable trusts, employee benefit plans, corporation/partnership/unincorporated associations, and government accounts. FDIC insurance covers an insured bank's deposits, including money market deposit accounts. Money market funds are not FDIC-insured since they are mutual funds, not deposit accounts.

NATIONAL CREDIT UNION SHARE INSURANCE FUND (NCUSIF)

The NCUSIF is administered by the National Credit Union Administration, which is a federal government agency. NCUSIF is the equivalent of FDIC insurance applied to credit unions. NCUSIF insurance coverage is also $250,000 per depositor within each ownership category per insured credit union.

TREASURYDIRECT®

An individual can open an electronic account on the *www.TreasuryDirect.Gov* website. The website is part of the Bureau of the Public Debt under the United States Department of Treasury. This gives the public direct retail access to purchase treasury securities. Within treasury direct, one may want to consider purchasing T-Bills or I Savings Bonds as an alternative to a cash deposit account.

T-Bills are usually issued (purchased) at a discount to their par value. Bills are sold in increments of $100 with maturity terms of 4, 13, 26, or 52 weeks. Interest is paid at maturity and is equal to the difference between the T-Bill's par value and the issue price paid. Interest is federally taxable, but free of local and state tax. If you wish to sell your T-Bill before maturity, you would need to transfer your holdings out of TreasuryDirect to a financial institution that could facilitate the transaction.

I Series Savings Bonds are issued by the U.S. Treasury. I-Bonds accrue interest over the life of the bond and pay at maturity. The interest accrued is based on a combination of a fixed rate stated at issuance and an inflation rate. The inflation rate is adjusted twice a year based on the change in the Consumer Price Index for all Urban Consumers (CPI-U). Interest is federally taxable, but free of local and state tax. I-Bonds earn interest for up to 30 years. After the first 12-month lock-up period, they are redeemable at any point in time. If redeemed after 12 months but before 5 years, there is a penalty equivalent to 3 months worth of interest. After 5 years, there is no penalty. There is an annual purchase limit of $10,000 per account holder's social security number. Interest accrued on I Series Savings Bonds issued after 1989 may be exempt from income tax if the bond holder pays qualified higher education expenses in the same year the bond is redeemed.

There are alternatives with potentially higher yields to holding cash in a deposit account or money market fund. Unfortunately, there is some work involved in finding those solutions for your cash. The potential yield will not keep up with inflation, but is still better than the zero–to-few basis points most money market funds and bank accounts currently yield. And with cash, you have little or low risk compared to stocks or bonds.

SOURCES

www.fdic.gov, www.treasurydirect.gov and *www.ncua.gov* ■

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Consider a 529 Plan for College Savings

Many American families find themselves attempting to balance the three largest financial concerns: housing, retirement and education costs. A 529 plan can help families plan ahead and start savings for a child's future higher education costs. A 529 plan is a savings plan for higher education administered by a state or institution. There are two basic types of 529 plans: a prepaid plan and a savings plan. As the name suggests, a prepaid plan prepays tuition for a beneficiary at a specific educational institution. Prepaid plans are not recommended often since they are not typically portable. A savings plan is a much more flexible option that can be used to attend any qualified institution.

FUNDING AN ACCOUNT

A 529 account can be established for just about anyone: your own children or grandchildren, nieces or nephews, even children of a family friend. Funds added to a 529 plan are considered a gift for tax purposes. In 2013, the annual gift tax exclusion is $14,000 per beneficiary. Current IRS rules allow front loading up to a maximum of five years of gifting in the first year's funding of a 529 account. In 2013, 529 accounts can be funded up to $70,000. You should consult your tax professional when setting up a 529 account as this can create a need to file an informational gift tax return. Depending on the circumstances, you should also consult with your tax professional to see if you have any generation skipping transfer tax issues.

There is no limit on the number of 529 accounts an individual may establish. You are limited by how much you can fund for each beneficiary before there is a reportable tax event. Many plan administrators typically have a limit on cumulative contributions per beneficiary. Most plans' limits are generally between $200,000 and $400,000. When the account balance reaches the administrator's stated limit, the plan will stop accepting contributions. The cumulative limit per beneficiary is typically an aggregate of all accounts for that listed beneficiary.

SUFFICIENT SAVINGS

The average annual cost for a four-year undergraduate degree was about $22,000 in school year 2010-11. The cost of a public institution was about $16,000 vs. almost $33,000 for a private institution. These costs include tuition, room and board for full time students[i]. Costs have been rising, on average, about 6% annually[ii].

If you were to start saving every month for your child as soon as they were born, you would need to set aside more than $850 per month for the next 18 years. This assumes you pay for four years of higher education at today's cost of $33,000 annually, education costs continue to inflate at 6% per year, and your 529 savings plan averages an annual return of 7%.

In a different scenario, you and your spouse could open one account and front load a contribution of $70,000 at the beginning of year one. With the compounding effect of front loading, you and your spouse would only need to contribute less than $290 per month through your child's last year of college. This assumes you pay for four years of higher education in the scenario noted above.

If a grandparent is the 529 account owner, the account value does not impact the student's eligibility for federal financial aid. Up to 5.6% of a 529 account's balance is included in the calculation for federal financial aid eligibility for 529 accounts owned by a parent. Rules for financial aid provided by colleges can vary from the federal calculation.

GIFTING AND ESTATE PLANNING BENEFITS

Gifting to a 529 plan helps to reduce your taxable estate since a 529 plan is excluded from the donor's gross estate (as long as the listed beneficiary is other than the donor). An interesting fact is, even though you have completed a gift for tax purposes and it is excluded from your estate, you as the owner of the account still have control of the account's assets. This includes the ability to change the beneficiary and management of the assets (within the investment choices provided by the specific 529 plan). If, as the account owner, you front load contributions in year one and subsequently pass away before the front load time period ends, part of the contributions can be added back to your gross estate.

CHOOSING A SPECIFIC PLAN

You are not limited to choosing the 529 plan administered by your state of residency, although in some cases this may be beneficial for tax purposes if your home state offers a state tax deduction for contributions. Many states have 529 plans that are available to non-state residents. There is no federal tax deduction or credit for contributions to a 529 plan.

Plans typically have a prepopulated list of mutual funds from which you can select (similar in this respect to most 401(k) retirement accounts). You should consider a 529 plan that offers index-based mutual funds. These funds will usually have the lowest expense ratios. In addition to the funds' expense ratios it is important to look for plans with low administrative fees for your account. Lower administrative fees and expense ratios will maximize the performance of the account and the amount of savings available for the beneficiary.

TAX-DEFERRED OR TAX-FREE GROWTH

Assets held in a 529 account grow tax deferred. Distributions are tax-free if used for qualified education expenses as defined by the IRS. Qualified education expenses for the 529 beneficiary includes higher education's tuition, required fees, books and supplies. Room and board may also be qualified expenses for the beneficiary attending a qualified institution if he or she is at least a half-time student. If a distribution is not used for a qualified expense, there is a 10% penalty in addition to ordinary income tax due on the earnings portion of the distribution.

MANAGING A 529 ACCOUNT

Most plan administrators give account holders the choice among self-managing their account's investments using a pre-chosen list of funds or using automatic investment options. The automatic investment options could be ideal if you have limited investment experience or prefer to spend the least amount of time managing the account. These are usually asset allocation models based on risk tolerance and the beneficiaries' age. During younger years, the account will be invested more aggressively. Over time as the beneficiary nears college age, the account will automatically change to a more conservative allocation.

A 529 plan gives individuals a great way to save for higher education expenses. With college costs rising on average at a faster rate than normal inflation, the tax-free compounded growth of a 529 account is critical to maximizing savings for the beneficiary. When choosing a 529 plan, pay attention to the plan's stated administrative fees and underlying funds' expense ratios. A plan employing index funds can offer lower expense ratios, potentially increasing the future savings for the beneficiary. If considering a 529 plan, you should consult with your tax advisor or financial planner to make sure any potential gift tax issues or generation skipping transfer tax issues are thoroughly reviewed before the account is funded.

SOURCES

www.irs.gov, www.savingforcollege.com, www.bankrate.com and *www.nces.ed.gov* ■

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[i] *National Center for Education Statistics (www.nces.ed.gov)*
[ii] *www.bankrate.com*

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