TAX LAW UPDATE

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TIPS FROM THE PROS

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PRACTICAL PRACTICE SOLUTIONS

Mitigating State Income Taxation of Trusts

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Many clients are interested in mitigating or avoiding state and local taxes (SALT). While income generated by grantor trusts will be taxable to the grantor in the states where the grantor resides, non-grantor trusts will be taxed in states where the trusts are considered to reside. States have had to devise statutory tests to determine whether a trust would be considered a resident, subject to taxes on its worldwide income. By understanding these tests, practitioners may be able to minimize exposure to state taxes for nongrantor trusts.

Practitioners can assess and mitigate exposure to state taxes based on the circumstances that exist at the time the estate plan is devised. Practitioners need to be vigilant for changes that could disrupt the original plan, positively or negatively. Clues that facts have changed might be apparent to advisors in different disciplines at different times, which is why communication among advisors is vital.

Resident-Exempt Trust

Many states,[1] like New York,[2] New Jersey[3] and Illinois,[4] determine residence of a trust based on where the settlor of the trust resided at the time the trust was originally settled (a settlor-resident state). For these states, residence is permanent; no matter where the beneficiaries live, the corpus is located, the trustees are located or the settlors someday move, the trust will remain a resident trust for state income tax purposes. When a client is preparing to move to a settlor-resident state, the planner might want to complete planning and have all irrevocable trusts funded before the client establishes residence.

When a settlor resides in a settlor-resident state, the planner might structure the irrevocable nongrantor trust to satisfy an exemption from state income taxes as permitted under the relevant state law. New York codified a three-prong test to qualify as a resident exempt trust, which is instructive as it closely resembles the rules provided by other settlor-resident states:

(1) All trustees domiciled outside of New York;
(2) All trust property located outside of New York, and
(3) No New York source income.[5]

When a trust is drafted to qualify as exempt from taxes in a specific state, advisors must understand the rules that permit such exemptions, particularly because it may not be clear how the information about changed circumstances might trickle up to the advisory team.

Each advisor should understand the implications of having a resident trustee and alert the drafting attorney and other advisors so they may take steps to remove and replace the transient trustee with a non-resident trustee or perhaps a trust company with its principal place of business outside the state. The trust should be drafted with a mechanism to remove and replace a resident trustee with a non-resident.

The wealth advisor may need to caution trustees about different investment strategies to avoid having any income sourced to the settlor-resident state. Even a very small amount of source income might allow a resident-exempt trust to be taxed on its worldwide income, as was the case in a 2013 New Jersey opinion[6] and a February 2020 advisory opinion issued by the New York Department of Taxation and Finance.[7] The advisors might collaborate to decant or modify the trust so that such investments won't upset the overall planning strategy, perhaps by granting an Internal Revenue Code Section 678 power, which would allow a beneficiary to withdraw all income sourced to a particular state. The beneficiary would then be taxed on all state source income, and the trust would arguably avoid having that proverbial peppercorn of source income that could taint the exemption for the entire trust.

Trustee Residence

California taxes a trust on some or all of its worldwide income to the extent that a trustee resides within its borders.[8] Some states treat a trust as taxable to the extent that there's a resident beneficiary and one or more of the following factors exist: (1) the assets are located within the state, (2) the trustees are residents, (3) the source of the income is in the state, or (4) a state resident created the trust.[9] Other states will impose a tax when a trust is administered within that state.[10]

When a trustee moves into a different state, the advisors need to know so that they might assess whether changing the trustee is required to avoid the trust being treated as a taxable resident of a particular state.

Practitioners might also review existing trusts to identify opportunities to make a change that could have a significant impact on the taxability of the trust. For example, a trust established by a Colorado resident and administered by a New York state fiduciary won't have any tax residence for state income tax purposes, because Colorado bases residence on the state where the trust is administered, and New York is a settlor-residence taxation trust state.

Beneficiary Distributions

In the summer of 2019, much fanfare was made of the *Kaestner* ruling, which struck down a North Carolina statute that taxed a trust solely on the domicile of a beneficiary.[11] However, the U.S. Supreme Court didn't exactly settle the matter of whether a state could tax a trust based on the beneficiary's residence and identified additional factors that informed its decision: the beneficiary had no control over the assets of the trust; couldn't demand any trust income; and didn't actually receive any income from the trust during the years in question.

Kaestner distinguished the North Carolina statute it was overturning from a similar rule in California[12] that taxes a nongrantor trust on "all net income . . . from all other sources which eventually is to be distributed to the non-contingent beneficiaries who are residents of this State."[13] Conversely, when the interest of a California beneficiary is subject to the discretion of a non-resident trustee, the undistributed income of such trust isn't subject to a California tax.[14]

Both California and New York impose a throwback tax on distributions deemed to have included any undistributed net income earned in a prior year.[15] In California, income that's accumulated in the trust is taxable on distribution to a beneficiary who then resides in California. New York imposes a throwback tax on beneficiaries of resident exempt trusts, with some exceptions based on the age and residence of the beneficiary when the income was earned.[16]

Advisors should be generally aware of the rules governing distributions from the trust to beneficiaries located in different states and then keep each other informed if any such distributions are contemplated. There might be a better option than making a distribution that would subject the trust to unplanned SALT, particularly in high tax jurisdictions.

State-by-State Matrix

The nongrantor trust may have been established for the purpose of avoiding taxation in certain states. When circumstances for our clients change, it may not be certain which advisor will first learn about it.

Perhaps as part of the estate-planning process, advisors might create a matrix identifying problematic states where the trust might one day be taxed and listing the elements that could result in SALT. Such a matrix might prompt the client to provide essential information important to SALT mitigation strategies, particularly as their lives and circumstances change. Advisors might use the matrix as a tool to ensure that communication among them flows freely to maintain the integrity of the plan.

Endnotes

1. *See, e.g.,* Alabama, Connecticut, Illinois, Maine, Michigan, Minnesota, Nebraska, New Jersey, New York (includes New York City), Oklahoma, Pennsylvania, Rhode Island, Vermont, Washington, D.C., West Virginia and Wisconsin. This list is non-exhaustive. State laws are subject to change. Please see the "8th Annual Non-Grantor Trust State Income Tax Chart" by Steve Oshins of the Law Offices of Oshins & Associates, LLC in Las Vegas, *https://sfo2.digitaloceanspaces.com/ultimate-estate-planner/wp-content/uploads/2022/05/06103830/2022-8thAnnualNonGrantorStateIncomeTaxChart_SteveOshins.pdf* (the Oshins Chart).
2. N.Y. Tax L. Section 605(b)(3).
3. N.J .Rev Stat Section 54A:1-2(o). *See Pennoyer v. Taxation Div. Dir.*, 5 N.J. Tax 386 (1983) and *Potter v. Taxation Div. Dir.*, 5 N.J. Tax 399 (1983), concluding that imposing state income taxes in such circumstances would violate the due process clause of the constitution of both the United States and New Jersey.
4. 35 ILCS 5 Illinois Income Tax Act Section 1501(a)(20).
5. *See* N.Y. Tax L. Section 612(b)(40).
6. *See Residuary Trust A u/w/o Fred E. Kassner* v. *Director, Div. of Taxation*, 27 N.J. Tax 68 (2013).
7. TSB-A-20(2)I. *See* Joy Matak, "Avoiding State Income Tax May Be Harder Than You Think," (Aug. 6, 2020), *www.wealthmanagement.com/high-net-worth/avoiding-state-income-tax-may-be-harder-you-think.*
8. California Revenue and Taxation Code Section 17742.
9. *See, e.g.*, Delaware, Hawaii, Idaho, Iowa, Massachusetts, Missouri, North Dakota, Ohio and Rhode Island. *See* Oshins Chart, *supra* note 1.
10. *E.g.,* Arizona, Colorado, Indiana, Kansas, Kentucky, Mississippi, Montana, New Mexico, Oregon, South Carolina, Utah and Virginia. *See* Oshins Chart, *supra* note 1.
11. *North Carolina Department of Revenue v. Kimberley Rice Kaestner 1992 Family Trust*, 588 U.S. ___ (2019). An in-depth evaluation of the *Kaestner* case is beyond the scope of this article.
12. *Kaestner, ibid.*, at footnote 12, *citing* Cal. Rev. & Tax. Code Ann. Section 17742(a).
13. 18 Cal. Code Regs. Section 17744.
14. Technical Advice Memorandum 2006-0002.
15. *See* California Revenue & Taxation Code Section 17745 and N.Y. Tax Law Section 612(b)(40).
16. New York accumulation tax won't apply to income earned before Jan. 1, 2014, during a period when the beneficiary wasn't a New York resident or before the beneficiary turned age 21.