

State Income Tax On Trusts: How to improve the trust's total return.



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Introduction

Most states impose an income tax on trusts.

The tax ranges from 3% to over 12%.

With planning the tax may be reduced or avoided, conversely without planning a trust may be subject to tax in more than one state.

The Benefit to the Client

Elimination of the state income tax can improve a trust's real investment performance by over 100 basis points a year simply by eliminating the drag from state taxes.

Seven States have no income taxes, including Florida.

Bases for Taxation of Trusts

The 44 states that tax trusts on income do so on based upon the following:

- Trust created by Will of resident decedent
- If settlor of *inter vivos* trust lived in the state
- If the trust is administered in the state
- If one or more trustees live or do business in the state
- If one or more beneficiaries live in the state

Tax on Testamentary Trust of Resident

- Connecticut
- DC
- Illinois
- Louisiana
- Maine
- Maryland
- Michigan
- Minnesota
- Nebraska
- Ohio
- Oklahoma
- Pennsylvania
- Utah
- Vermont
- Virginia
- West Virginia
- Wisconsin

Tax on *Inter Vivos* Trust of Resident

- DC
- Maine
- Illinois
- Maine
- Maryland
- Minnesota
- Nebraska
- Oklahoma
- Pennsylvania
- Vermont
- Virginia
- West Virginia
- Wisconsin

Tax on Trust Administered in State

- Colorado
- Georgia
- Indiana
- Kansas
- Louisiana (unless specifies law of another state)
- Maryland
- Minnesota
- Mississippi
- New Mexico
- North Dakota
- Oregon
- South Carolina
- Utah (inter vivos only)
- Virginia
- Wisconsin

Tax Because Trustee in State

- Arizona
- California (apportioned by the number of trustees)
- Georgia
- Kentucky
- New Mexico
- North Dakota
- Oregon
- Virginia
- Idaho
- Iowa
- Montana

Some states have qualifiers such as in state beneficiaries, corporate trustees, etc.

Once Taxed – Always Taxed

Historically, in many states, a trust is taxed virtually forever if it was established by the Will or Revocable Trust of a resident.

Even if all the parties to the trust (the trustees and beneficiaries) have moved away.

But, the law is changing.

State Trust Income Tax Unconstitutional

State Court Rulings

- Connecticut
- Michigan
- New York
- Illinois
- New Jersey
- Pennsylvania
- Missouri

Connecticut Law

Chase Manhattan Bank v. Gavin, 733 A.2d 782 (Conn. 1999)

HELD: Conn. Supreme Court upholds taxing a trust based solely upon the fact that the grantors lived in Connecticut when the trusts were funded based upon the reasoning that the courts were “open and available” for accounting and trust administration.

Michigan Law

***Blue v. Department of Treasury*, 462 N.W.2d 762 (Mich. Ct. App. 1990)**

HELD: Michigan may not tax trust income if all trustees, beneficiaries and the trust administration is outside of the State of Michigan even if there is Michigan (non-income producing) real property.

New York Law

***Mercantile-Safe Deposit & Trust Co. v. Murphy*, 242 N.Y.S.2d 26 (N.Y. App. Div. 1963), aff'd, 15 N.Y.S. 2d 579 (1964)**

HELD: New York may not tax an *inter vivos* trust that has no ties to New York other than that the trust was created by a resident and has a resident contingent beneficiary.

Illinois Law

Linn v. Department of Revenue

The trust was established in 1961 by A.N. Pritzker, an Illinois resident. The trust was initially administered by Illinois trustees pursuant to Illinois law. By 2006 the trust had been modified and relocated to Texas and had no trustee, beneficiary or asset in the state of Illinois.

The Illinois Department of Revenue (“IDR”) determined that the trust was a resident trust and was subject to Illinois income tax. The trustee argued that imposing Illinois tax under these circumstances was unconstitutional.

New Jersey Law

***Pennoyer v. Tax Div. Director*, 5 N.J. Tax 386 (1983) and
Potter v. Tax Div. Director, 5 N.J. Tax 399 (1983)**

HELD: A New Jersey testamentary trust cannot be taxed on income if trustees and trust assets are outside of the state and there is no New Jersey source income

Pennsylvania Law

***McNeil Trusts v. Commonwealth of Pennsylvania*, 2013 Pa. Commw. LEXIS 168 (PA Commonwealth, May 24, 2013)**

HELD: In the opinion of the Court, neither the Trust creator's residency nor the residency of the beneficiaries provides the requisite presence in Pennsylvania to establish a substantial nexus. The imposition of tax is not reasonably related to the benefits Pennsylvania provides to the Trust. Thus, the tax cannot be imposed without violating the Commerce Clause.

Missouri Law

***In re Swift*, 727 S.W.2d 880 (Mo. 1987)**

Supreme Court of Missouri examined whether the state could tax a testamentary trust.

Six points of contact: (i) settlor's domicile; (ii) state in which created; (iii) location of trust property; (iv) domicile of beneficiaries; (v) domicile of trustees; (vi) location of administration.

Opportunities: Trusts that accumulate income

- Irrevocable Non-Grantor Trusts
- Reverse Defective Grantor Trusts
- Asset Protection Trusts
- Moving Trusts to non-tax States
- Planning for the Future- the mobile society

Planning For the Future

- Grant beneficiaries a power of appointment (non resident then appoints to a new trust)
- Set up a “trapping trust” in another state to receive income distributions
- Give trustees the power to change trust situs
- Don't name a trustee in a state that taxes trusts due to trustee location
- Avoid double taxation

Opportunity: Reverse Grantor Trust

IRS finds that an irrevocable trust can avoid state income tax in a living grantor's home state.

We all know about Intentionally Defective Grantor Trusts that tax income to a grantor, but remove the trust assets from his taxable.

Now comes the reverse: A technique that pushes the income tax to a trust instead of a living grantor, but keeps the assets inside the taxable estate.

Opportunity: Reverse Grantor Trust

In PLR 201310002 the IRS agreed that the trust provisions and the applicable state law also meant that the accumulated trust income would no longer belong (be taxed to) the grantor.

This means that a grantor living in the state of New York can avoid the 12% plus state income tax.

Disappearing Opportunity?

New York

Governor Cuomo's budget bill, released last week, includes significant changes to New York State's estate tax system. If these provisions in the bill pass, many of the changes will become effective nearly immediately

New York State Proposal

- Increased exemption to match the federal unified credit by April 1, 2017.
- Top estate tax rate gradually reduced from 16% to 10%.
- New York State gift tax “loophole” will be closed.
- Residents taxed on certain types of trust income currently exempt.

Steps to take Now: Stop Paying Tax

- Review state taxation: Review connections to the taxing state and consider whether actions could be taken to fall within the purview of these cases.
- File return with no tax due: Consider filing a return referencing applicable case law and reporting no tax due. For each tax year, a tax return must be filed in order to commence the running of the statute of limitations. An appellate court decision that supports the taxpayer's position ordinarily provides a basis for the abatement of tax penalties.
- Amend prior tax returns: The trustee could consider filing amended tax returns for prior years. A trustee that has timely filed prior year tax returns may file an amended tax return at any time prior to the third anniversary of the due date of the tax return, including extensions.

Steps To Take Now: Move The Trust

Consider whether a trust can be moved from a State that taxes due to location of trustee

- Determine if current trustee will resign or can be removed;
- Locate a trustee in a different state;
- Co-ordinate the change of trustee.

Steps to Take Now: Move the Trust

Analysis of:

- Rules and procedures in existing state and the prospective state;
- The terms of the trust;
- The location of the trustees and beneficiaries;
- The nature of the trust assets.

In almost every state the governing law stated in the trust document is irrelevant for purposes of a “Resident Trust” determination.

Opportunity: Choosing Different State

Some states require significant nexus; if not present - relocate trust.

- New York
- New Jersey
- Missouri
- Michigan
- Massachusetts

Example: New York Law

The statutes state specifically when trust is not taxed. If all met then no tax:

- All trustees domiciled other than NY;
- All principal (including real & TPP) outside of NY;
- All income and gains are non NY source.
- NY Tax Law § 605(b)(3)(D)

Designation of Florida law as Governing

Although settlors/testators are generally free to designate which state's governing law applies, in the absence of a designation in the trust instrument, "situs" for governing law purposes will generally depend on whether the issue involves:

- 1) validity;
- 2) construction; or
- 3) administration.

Designation of Florida law as Governing

736.0107 Governing law.--The meaning and effect of the terms of a trust are determined by:

(1) The law of the jurisdiction designated in the terms of the trust, provided there is a sufficient nexus to the designated jurisdiction at the time of the creation of the trust or during the trust administration, including, but not limited to, the location of real property held by the trust or the residence or location of an office of the settlor, trustee, or any beneficiary; or

Designation of Governing Law

The Uniform Trust Code, which has been enacted in modified form in 21 states (including Florida), provides that in the absence of a designation in the trust, the “meaning and effect” of the terms of the trust will be determined by the laws of the jurisdiction “having the most significant relationship to the matter at issue.”

Common law, which varies from state to state, relies on location of real estate, domicile of the testator, and place of administration in determining in which states governing law applies.

Florida as Place of Administration

The principal place of administration of a trust is the trustee's usual place of business where the records pertaining to the trust are kept or, if he or she has no place of business, the trustee's residence.

Fla.Stat. §736.0108

See statute for requirements if moving place of administration to Florida.

Additional Options to Move Trust

- Decanting
- Modification
- Merger



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Janet Bandera is a nationally recognized attorney, author, lecturer and teacher. Janet has been engaged in the practice of law working with clients on estate and business planning for 18 years. She is an adjunct professor at Washington University School of Law and has been designated as AV Preeminent[®], a designation given to less than 5% of women lawyers, and a 5 Star Wealth Manager[®].

Janet was the Chair of the inaugural University of Missouri-St. Louis Planned Giving Committee and a member of AAUW. She is a past Board Member of Gilda's Club, AMC Cancer Research Center, the American Cancer Society Heritage Board and the Ronald McDonald House and Missouri Humane Society Planned Giving Committees.

She authored a bi-monthly column on charitable giving techniques for *The Journal of Practical Estate Planning*, published by CCH, for 7 years. In 2008 she was appointed to the Missouri Women's Council by the Governor.

Janet works with clients in Florida, Illinois and Missouri.

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