

# State Income Tax Treatment of Nonresident Trusts: Compliance Challenges and Planning Opportunities

TUESDAY, JULY 24, 2018, 1:00-2:50 pm Eastern

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# State Income Tax Treatment of Nonresident Trusts: Compliance Challenges and Planning Opportunities

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# Notice

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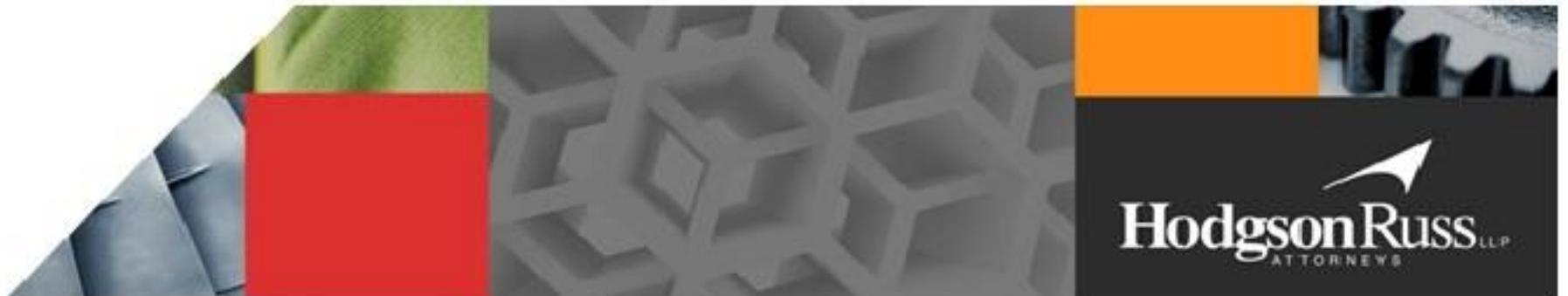
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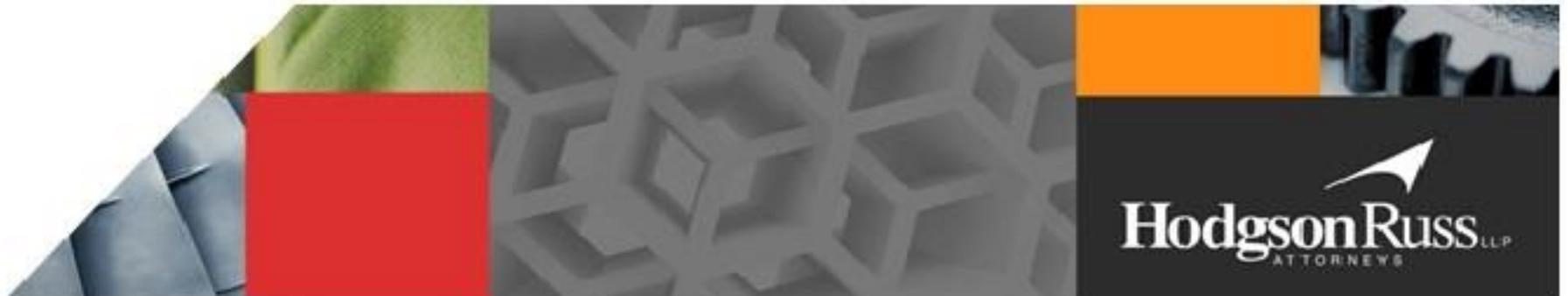
# Section 1

## General Overview: State Taxation of Trusts



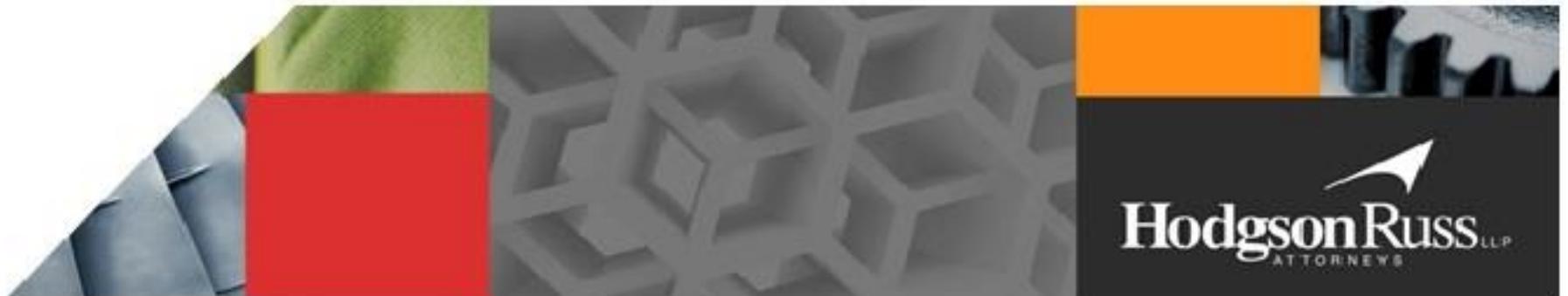
# Grantor Versus Nongrantor Trusts

- Grantor trust – the person who funded the trust pays the tax on all of the trust’s income.
- Non-grantor trust – the trust is no longer tied to trust creator for income tax purposes. The trust pays tax on its own income, or if distributions are made to a beneficiary, all or a portion of the income carries out to the beneficiary, and the beneficiary pays the tax.



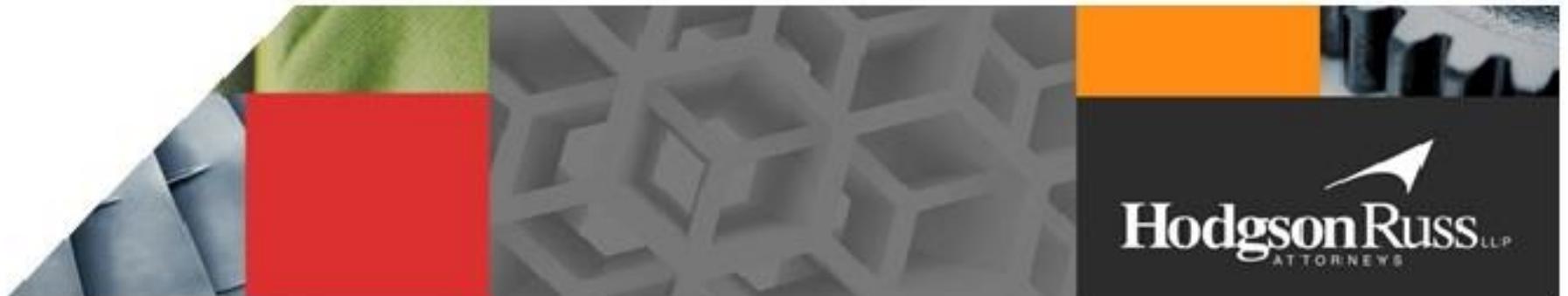
# State Level Grantor Trusts

- Almost all states follow the federal grantor trusts rules
  - Exception: Pennsylvania



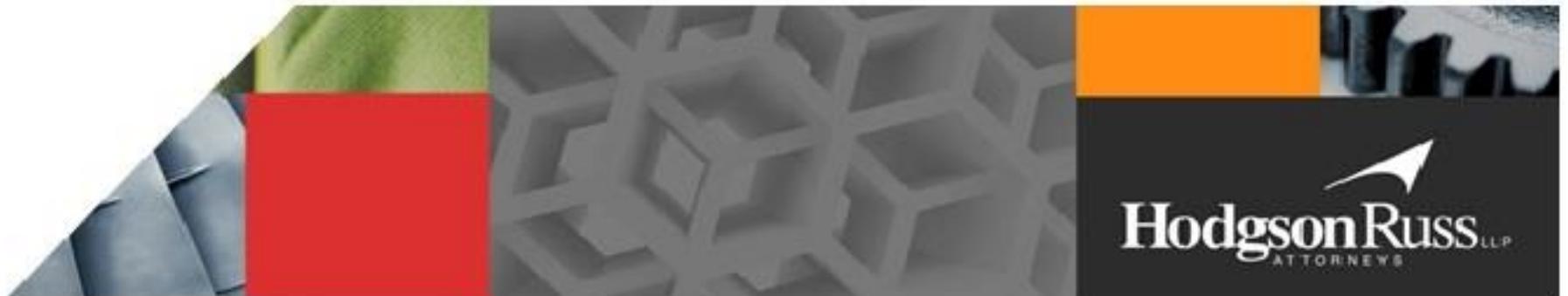
# Which States Don't Tax Trusts?

- Alaska, Florida, Nevada, New Hampshire, South Dakota, Texas, Washington, and Wyoming.



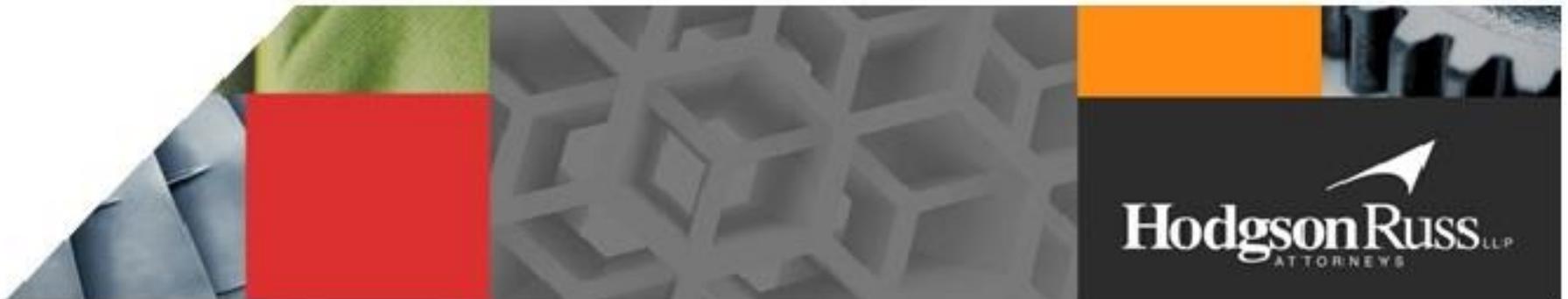
# Different Rationales for Taxing Trusts

- Where did trust creator / decedent live?
  - (Ask, who actually transferred the property to the trust?)
  - NY, NJ, CT
- Where is the Trustee domiciled?
  - CA, OR
- Where is the trust administered?
  - HI, IN
- Where do the beneficiaries live?
  - CA, DE, formerly North Carolina



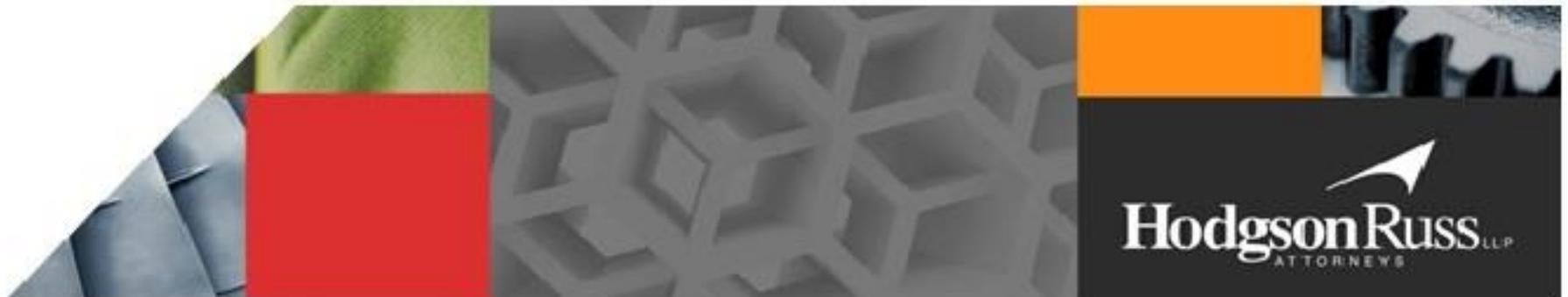
# Resident Versus Nonresident

- Resident trust = all trust income is subject to taxation in that state.
- Nonresident trust = only income sourced to the state is subject to income tax in that state.
- Ex. New York will tax a resident trust on all income. But what if the trust has rental income from real estate in state X? State X will tax the X source income too.
- In some, but not all cases, an offsetting credit is available. More on all this later.



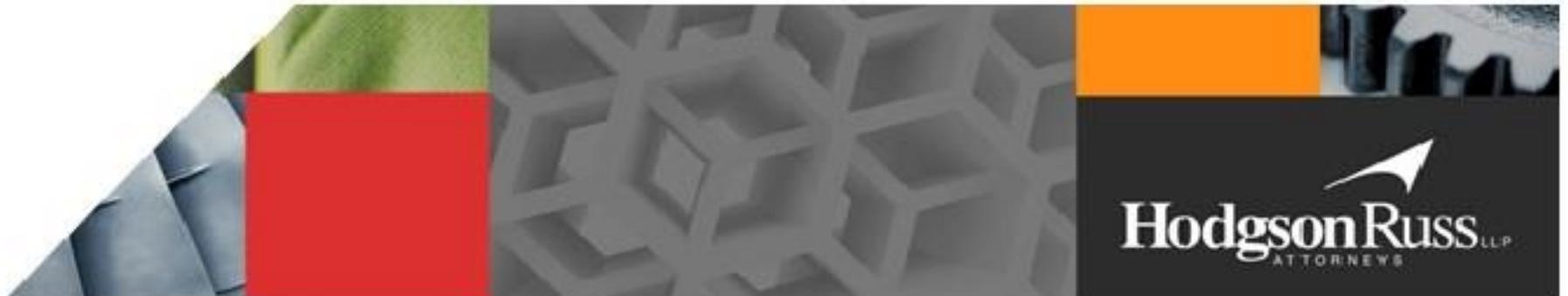
# North Carolina

- North Carolina's statute subjected a trust to NC income tax solely on the basis of the trust having a NC beneficiary.
- In June 2018, the NC Supreme Court struck down the statute, holding that the statute was unconstitutional
- Some type of trust administration, or other connection, is required. Residence of beneficiary is not enough.



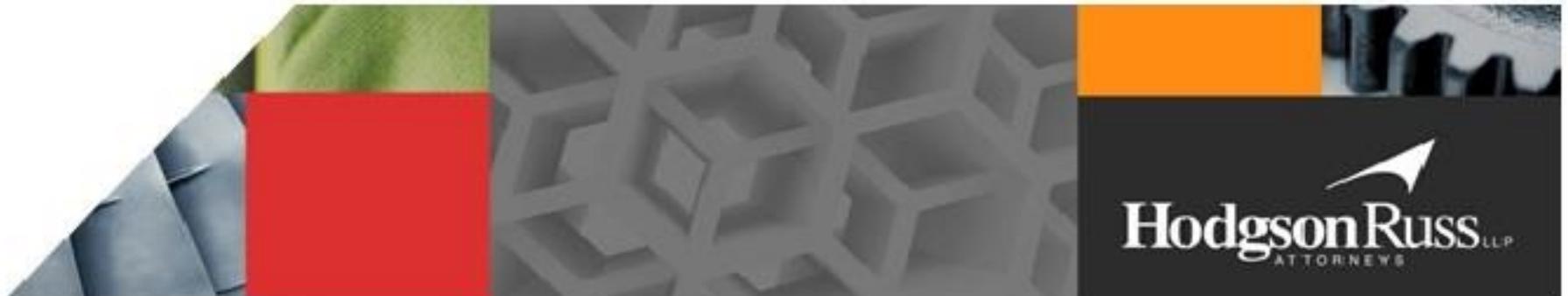
# California

- California basis for taxation:
  - Resident Trustees
  - Resident “noncontingent beneficiaries”
  - Income is apportioned if there is a combination of resident and nonresident trustees, or resident and nonresident noncontingent beneficiaries



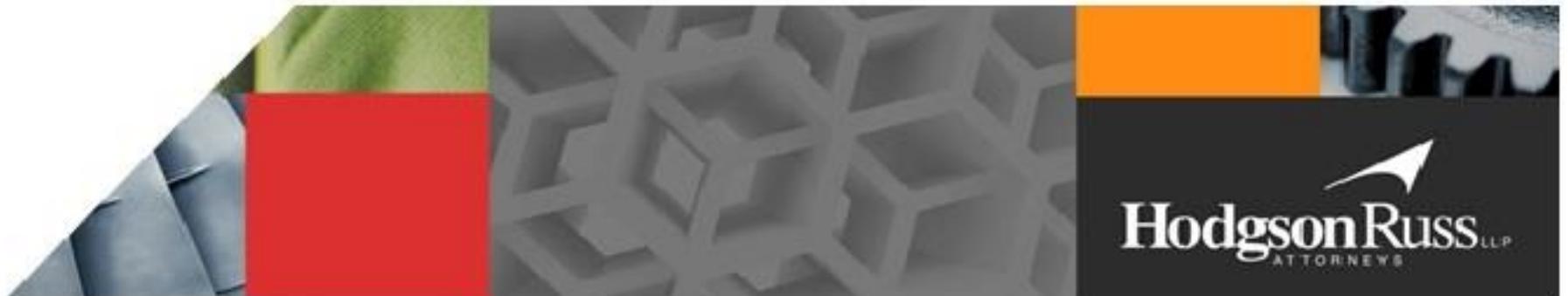
# Connecticut

- Resident trust:
  - Trust funded by the Will of a CT resident decedent
  - Irrevocable trust created by an individual who was a resident of CT at the time of funding
  - Revocable trust, to the extent it is still revocable, and it was created by a CT resident
  - Irrevocable trust, to the extent it was revocable, and the trust creator was a CT resident when trust became revocable



## Connecticut Cont'd

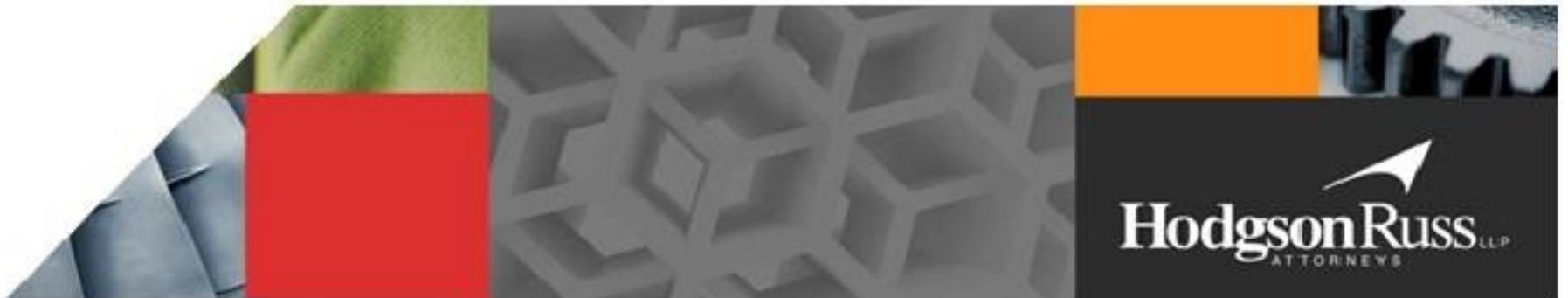
- Exception: If an irrevocable trust (that was not created by a Will) has one or more nonresident noncontingent beneficiaries, the trust is taxed on all of its CT source income, but on only a portion of its non-CT source income.
- This exception does not apply to trusts created under a Will.





# Section 2

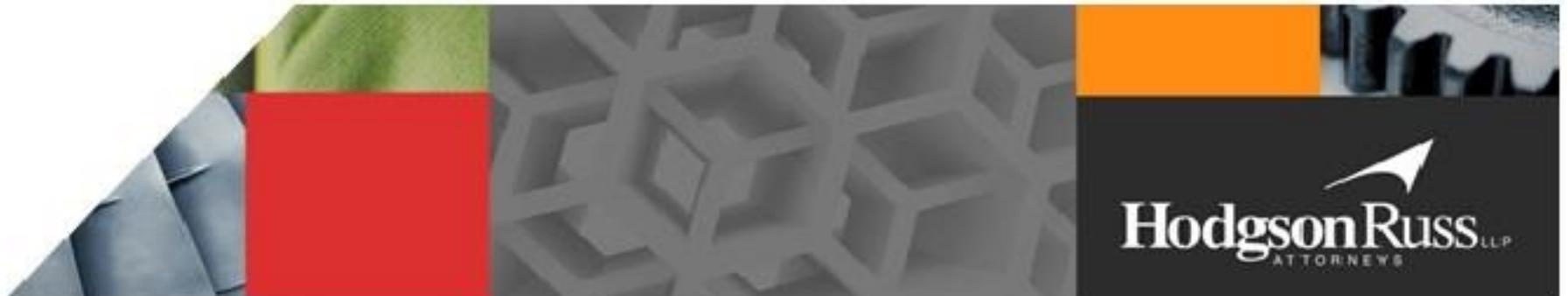
## A Deeper Dive into New York



# New York

Trusts are either:

- Resident,
- Resident exempt, or
- Non-resident



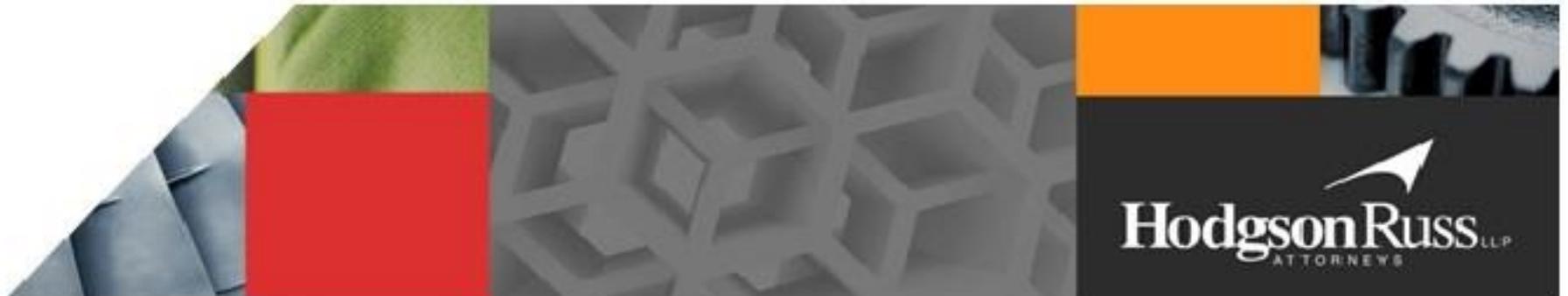
# New York

Trusts are either

(1) resident or (2) non-resident

from day one.

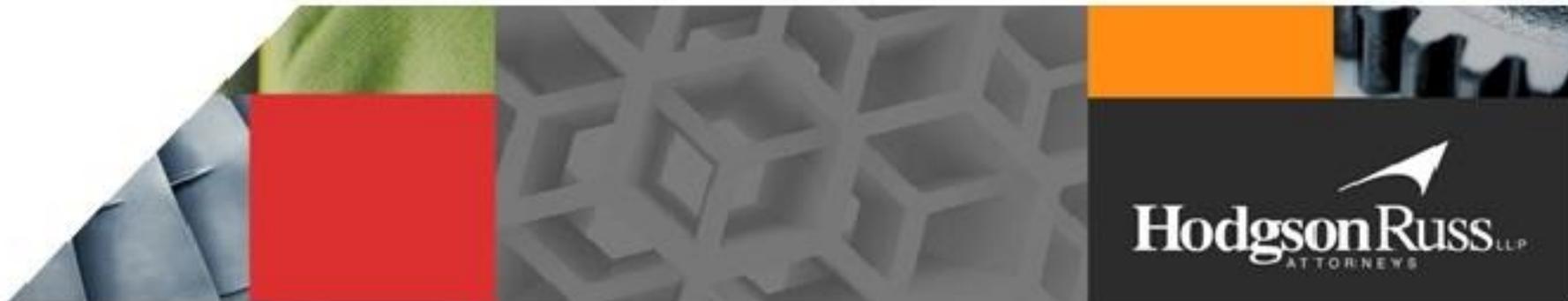
The trust's status will never change.



# NY - Resident Trust

A resident trust is:

- (1) Trust under a Will: a trust, or a portion of a trust, created under Will of person who was domiciled in NY at death (Note: where the Will was probated is not determinative)
- (2) Irrevocable Trust: a trust, or portion of a trust, if the person who transferred the property to the trust was domiciled in NY when the property was transferred to the trust, if the trust was irrevocable at the time of transfer

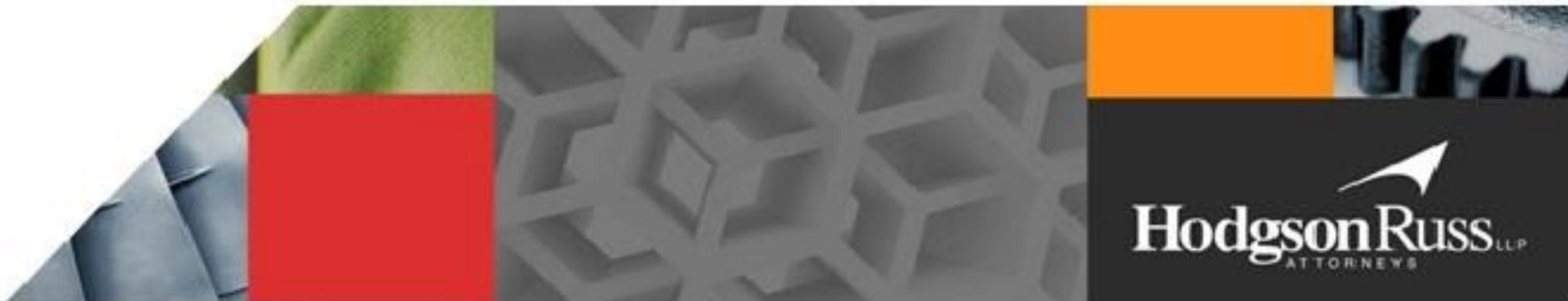


# NY - Resident Trust

A resident trust is:

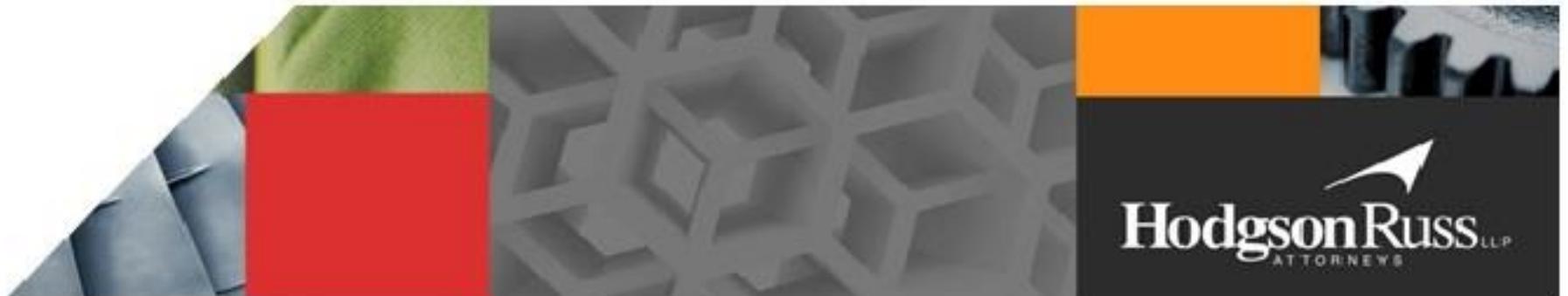
- (3) Revocable Trust that Is Still Revocable: a trust, or portion of a trust, if the person who transferred the property to the trust was domiciled in NY when the property was transferred to the trust, if the trust was then revocable and is still revocable
  
- (4) Revocable Trust that Has Become Irrevocable: a trust, or portion of a trust, if the person who transferred the property to the trust was domiciled in NY when the property was transferred to the trust, if the trust was revocable when property was transferred to the trust but has subsequently become irrevocable

A resident trust is subject to New York income tax on all of its income.



# NY - Non-resident Trust

- A non-resident trust is a trust that is not a resident trust
- A trust can be partially resident and partially non-resident, if the trust creator moves to another state and continues to add property to the trust
- A non-resident trust is subject to New York income tax only on its New York source income

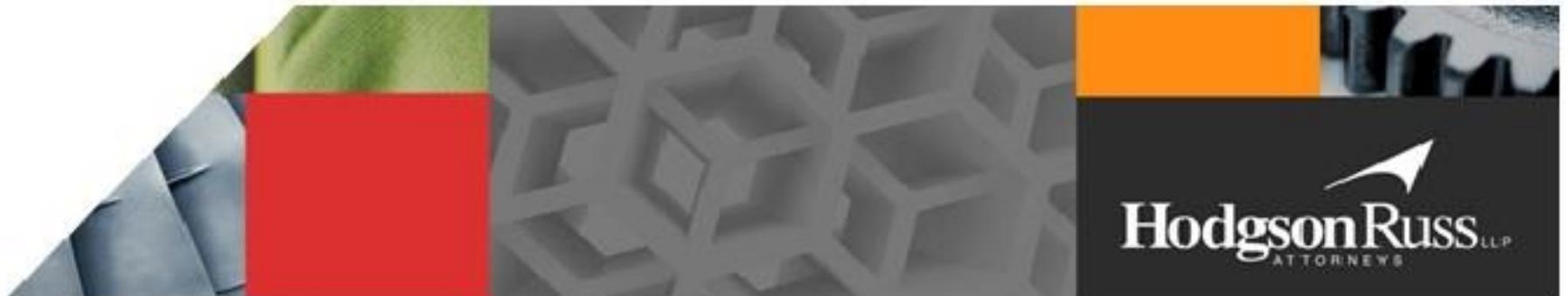


## NY - resident exempt trusts

A resident trust is not subject to New York tax if all of the following conditions are satisfied:

- 1) all the trustees are domiciled in a state other than New York;
- 2) the entire corpus of the trust, including real and tangible property, is located outside New York; and
- 3) all income and gains of the trust are derived from or connected with sources outside New York, determined as if the trust were a non-resident trust.

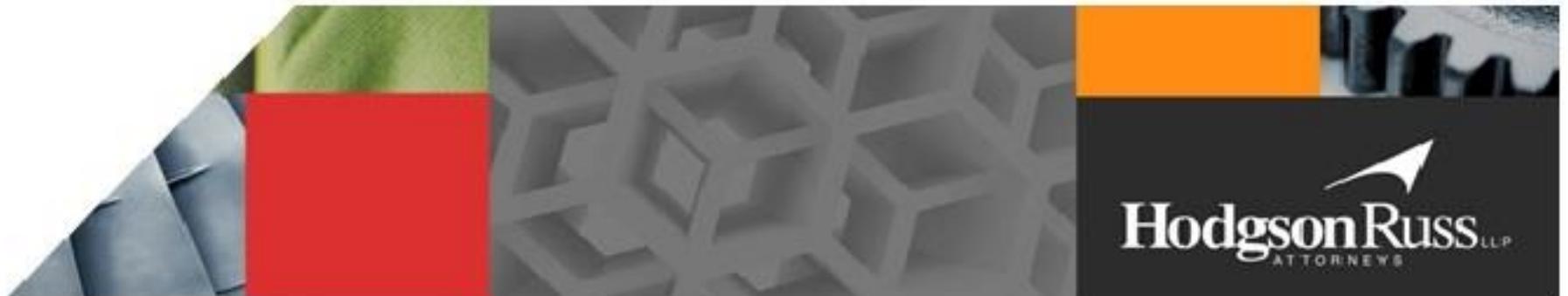
A trust that meets this three prong test is a “resident exempt trust.”



# NY - resident exempt trusts

## Prong #1: No NY Trustees

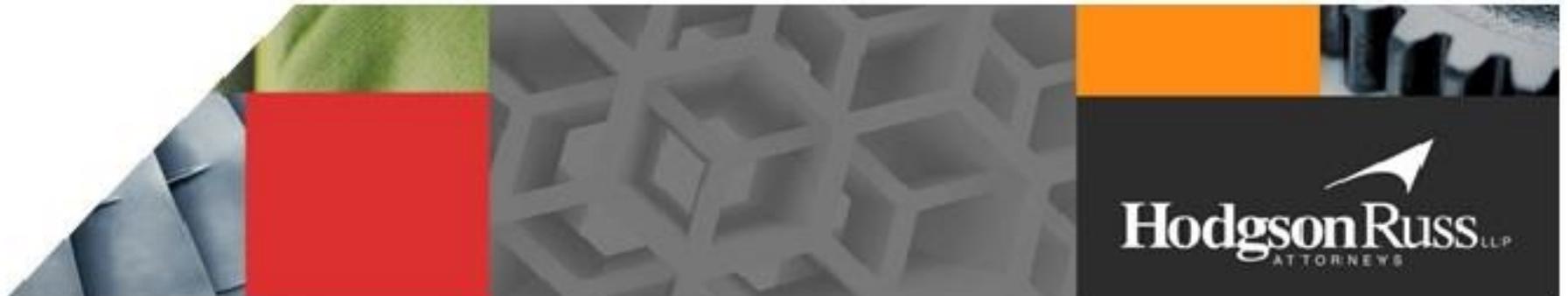
- Beware of quasi-Trustees  
("The Rockefeller opinion")



# NY - resident exempt trusts

Prong #2: No NY situs assets

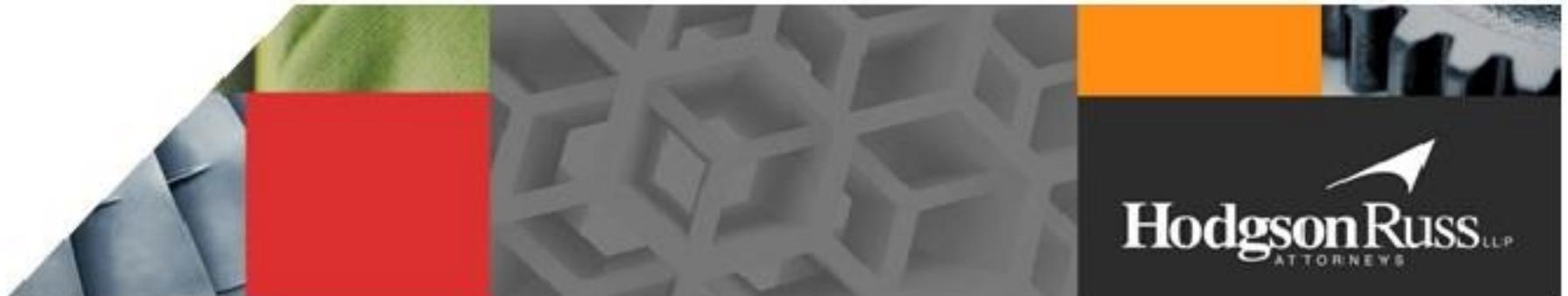
- No real and tangible property located in NY
- Intangible property – such as stocks and bonds – will be deemed to be located in NY only if one or more of the Trustees are domiciled in New York



# NY - resident exempt trusts

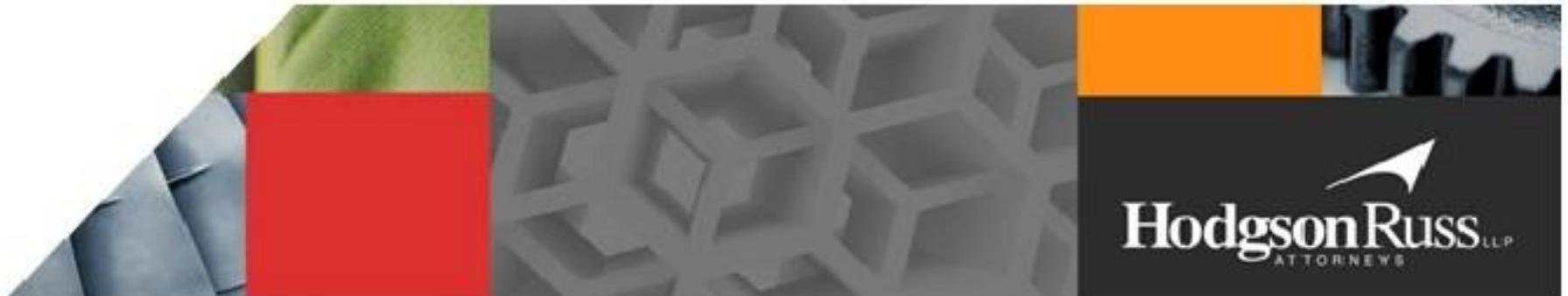
## Prong #3: No NY source income

- Beware of flow through income
  - Especially publicly traded partnerships
- C corporation stock may be a problem if the corporation owns New York real property.
- If a trust receives a K-1 showing \$5 of NY source income, and \$10 of NY source loss, does it have NY source income?



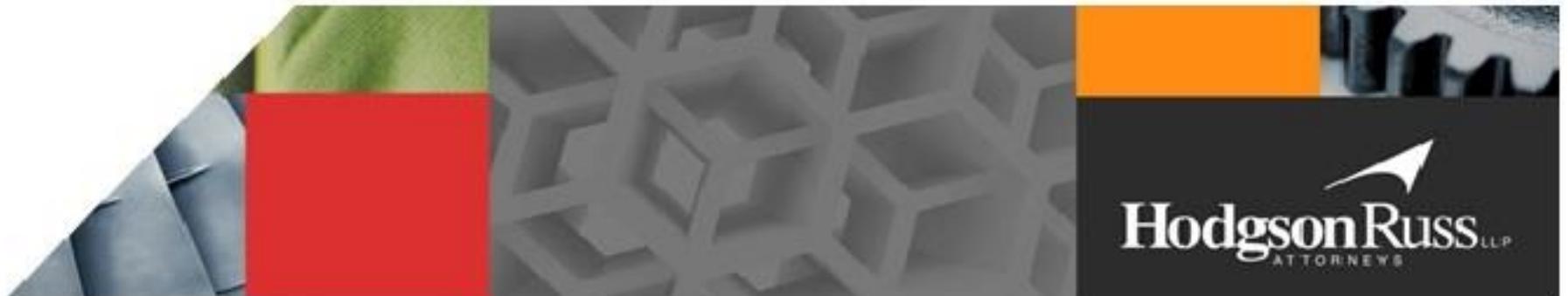
# Case Study #1

- Trust created by NY resident
- Later decanted, assets of trusts distributed to an Alaskan trust
- Still a NY resident trust?
- No NY source income, but are we sure?
- NYS voluntary disclosure



# Becoming a Resident Exempt Trust

- A resident trust can be exempt from day one
  - Ex: Trust created under the Will of a NY domiciliary, with a NJ Trustee, no NY assets, and no NY source income
- Or a resident trust can become exempt after the fact
  - Ex: NY Trustee resigns in favor of a NJ Trustee



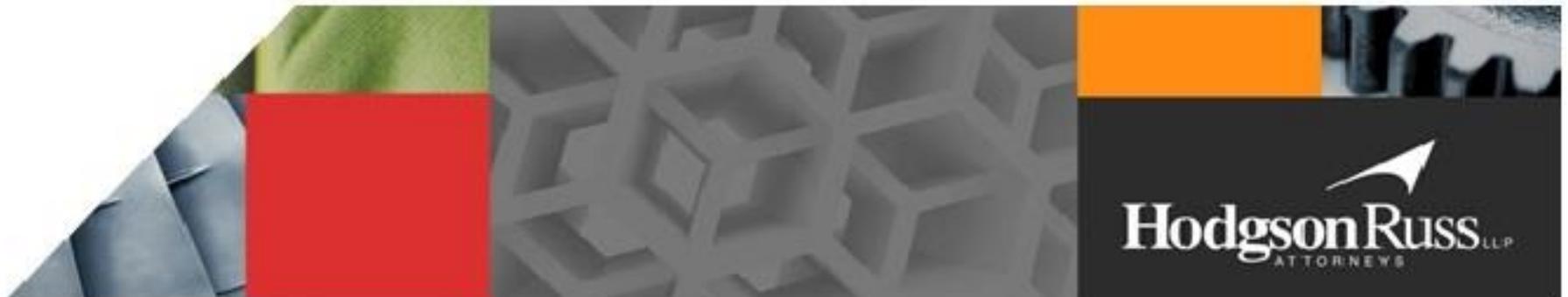
# Mid-year change to a resident exempt trust

New York recognizes:

- Mid-year change of Trustees
- Mid-year disposal of NY situs assets

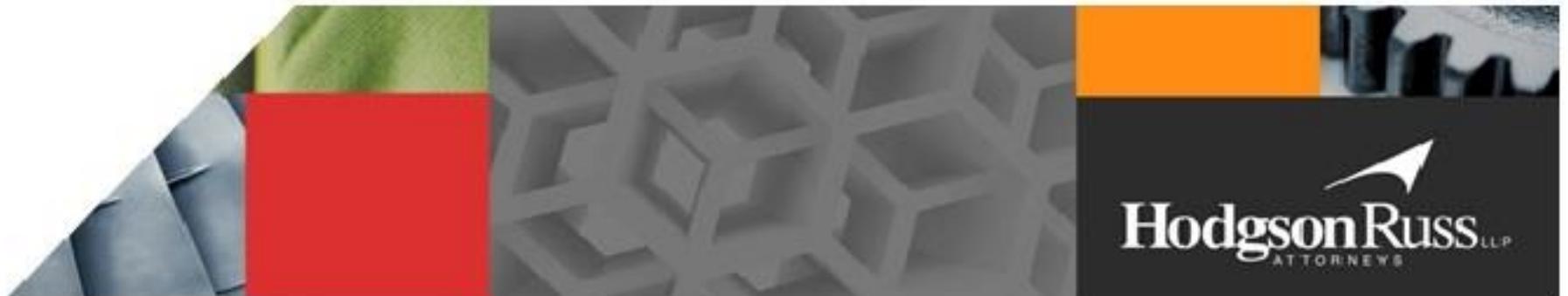
But what about:

- Mid-year disposal of assets with NY source income?



# Reporting requirements for resident exempt trusts

- Starting January 1, 2014, a resident trust claiming to be resident exempt must file a NY tax return and certification that the trust is exempt.
- Failure to file results in a \$150 a month penalty, not to exceed \$1,500 for a given tax year.





Department of Taxation and Finance

# New York State Resident Trust Nontaxable Certification

# IT-205-C

Tax Law – Article 22, Sections 605(b)(3)(D) and 658(f)(2)

To be filed with Form IT-205 when a trust meets the conditions of Tax Law section 605(b)(3)(D); see instructions (Form IT-205-I)

Name of trust	Employer identification number (EIN)
---------------	--------------------------------------

Mark an **X** for all that apply:

- 1 All of the trustees are domiciled in a state other than New York State ..... 1
- 2 The entire corpus of the trust, including real and tangible personal property, is located outside of New York State (it is the Tax Department's position that intangibles located in the state but that are not employed in a business carried on in the state are not located in the state for purposes of this rule) ..... 2
- 3 All income and gains of the trust are derived from, or connected with, sources outside of New York State, determined as if the trust were a nonresident trust (see instructions) ..... 3
- A Is the trust an incomplete gift non-grantor trust? (mark an X in one box; see instructions) ..... Yes  No
- B Did the trust make an accumulation distribution to a New York State resident beneficiary? (mark an X in one box; see instructions) Yes  No

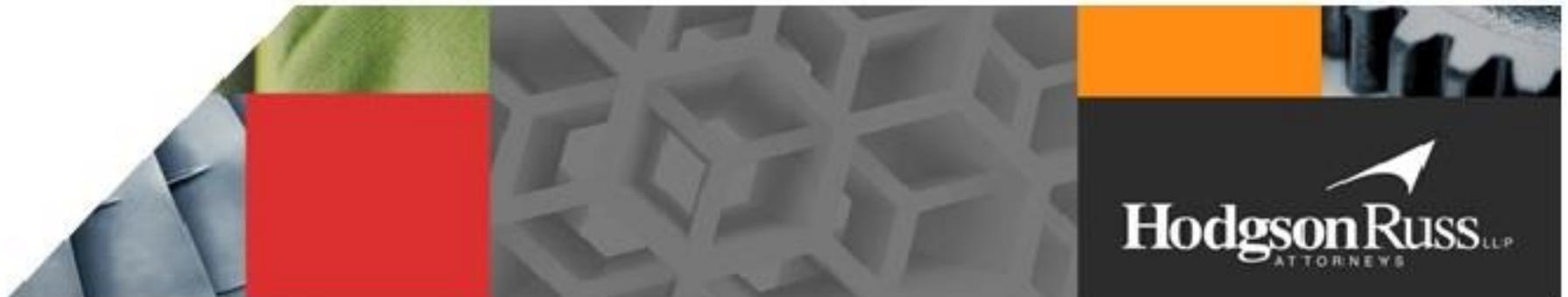
### Trustee identifying information

(Submit additional sheets if necessary. Follow the same format and include the name and EIN of the trust on each sheet.)

Trustee name			Identifying number (SSN or EIN)	Mark an X in the box if trustee is a nonresident:
Mailing address (number and street or PO Box) Apartment number				<input type="checkbox"/>
City, village, or post office	State	ZIP code		
Trustee name			Identifying number (SSN or EIN)	Mark an X in the box if trustee is a nonresident:
Mailing address (number and street or PO Box) Apartment number				<input type="checkbox"/>
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Mailing address (number and street or PO Box) Apartment number				<input type="checkbox"/>
City, village, or post office	State	ZIP code		

# 2014 New York Law Changes

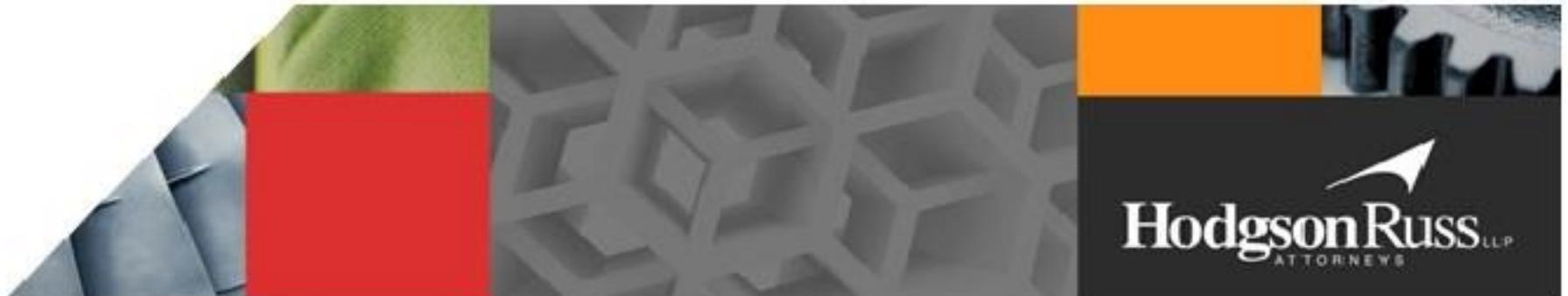
- NY Accumulation Distribution Tax
  - Levies a tax on current distributions from a resident exempt trust to a NY beneficiary, to the extent the income is attributable to prior year undistributed income (but excluding capital gains)
- Undone DINGs
  - Incomplete gift trusts created by a NY resident are now treated as NY grantor trusts
  - “Incoming” incomplete gift trusts still work



# 2014 New York Law Changes

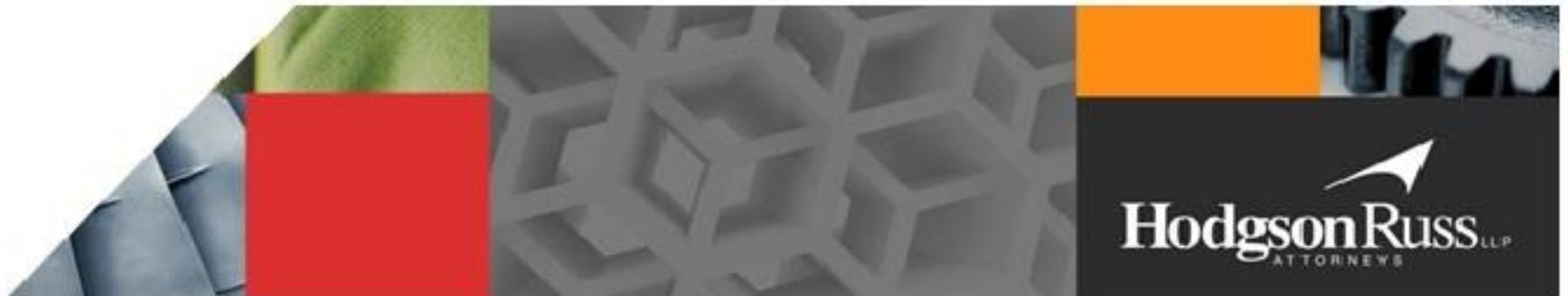
## ■ NY Accumulation Distribution Tax Example

- Tim was a New York domiciliary at the time of his death, and his Will created a trust for the benefit of his 12 adult children, one of whom is a New York resident. From day one, the sole trustee has been domiciled in Florida. No NY source income/assets (i.e., it's an exempt resident trust).
- Year 1: trust earns \$100 of interest income, Trustee accumulates and adds to principal. Year 2, trust earns \$100 of interest income, again accumulates and adds to trust principal. Year 3, trust earns \$10 of interest income. No expenses or deductions in the first three years, and in year 3 it has \$200 of prior year accumulated income.
- Year 3, the New York beneficiary requests a distribution; trustee distributes \$150 to the New York beneficiary.



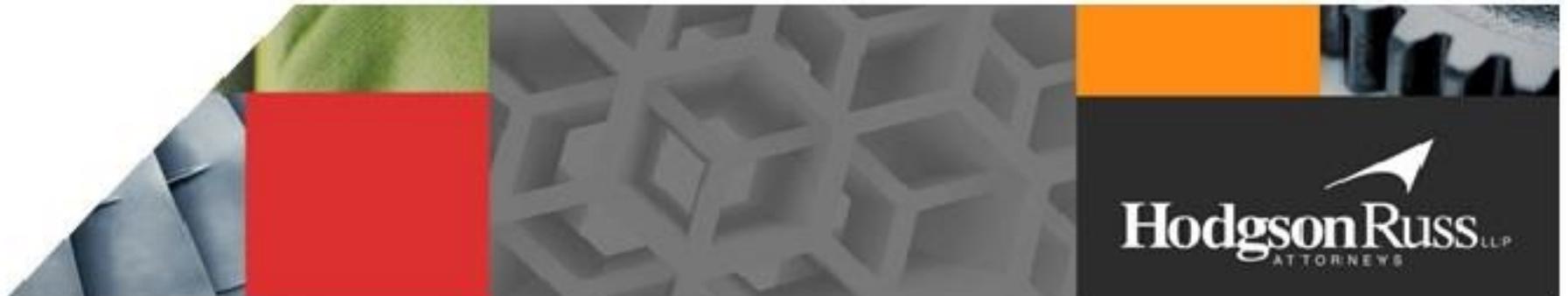
# 2014 New York Law Changes

- NY Accumulation Distribution Tax Example
  - Old Regime: The \$10 of interest income is carried out to the beneficiary on a K-1 and is includible in the beneficiary's gross income. It is also included in the beneficiary's New York adjusted gross income, because the starting point for New York adjusted gross income is federal adjusted gross income
  - New Regime: The entire \$150 is subject to New York income tax in year 3. The first \$10 is included in New York income because it's included in federal gross income, and the next \$140 is treated as a distribution of prior year accumulated income, which is now a required New York addition to federal adjusted gross income.



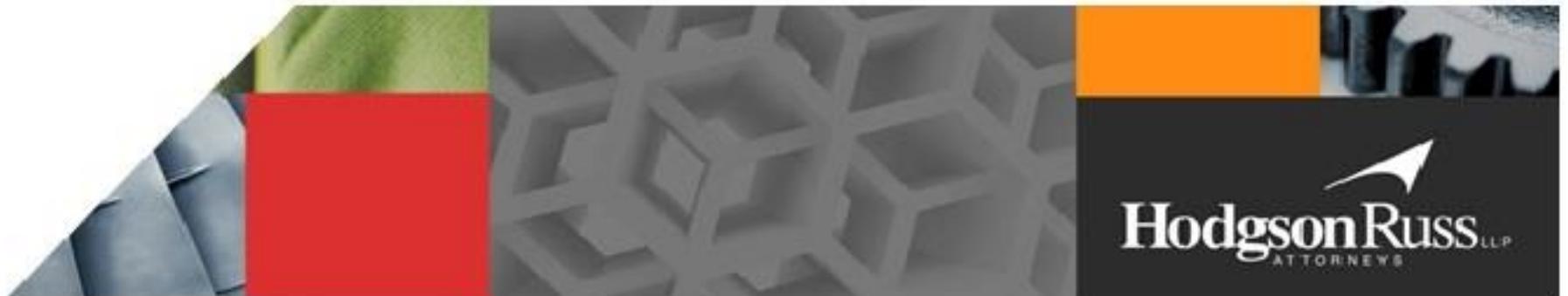
# 2014 New York Law Changes

- Undone DING Example
  - Catherine is a NY resident and does not want to move. But she also doesn't want to pay lots of tax on her investment income.
  - Catherine transfers a bunch of securities into a Delaware trust, but the transfer is an incomplete gift, and it remains a separately-taxable non-grantor trust. The trust qualifies as an exempt resident trust because it has no NY source assets, no NY source income, and a non-NY trustee.



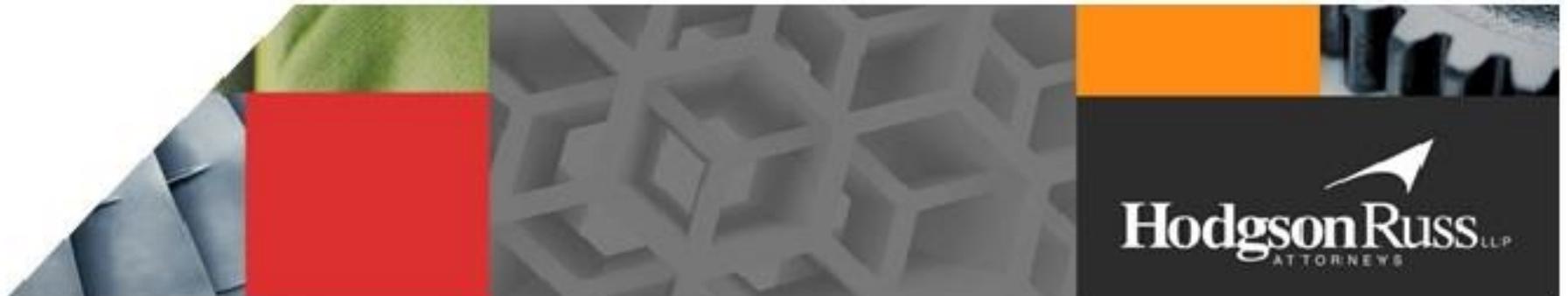
# 2014 New York Law Changes

- Undone DING Example
  - Old Regime: Investment income taxed to the trust. But since trust is taxable as an exempt resident, the trust pays no tax.
  - New Regime: Since Catherine was a NY resident upon formation, her incomplete gift trust is treated, for NY purposes, as a grantor trust. All income gets taxed to Catherine, who is still a NY resident, and thus all the income still gets taxed.



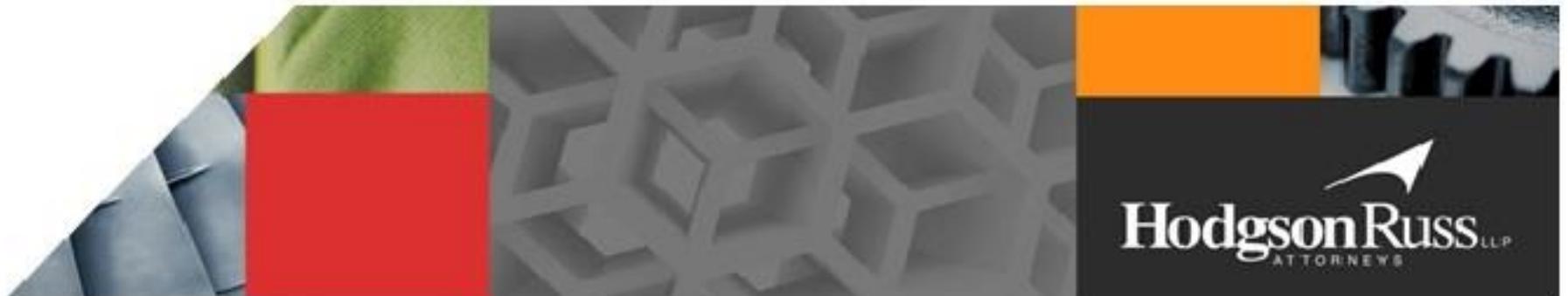
# Other State Cases Around Exempt Resident Trusts

- *Gavin* in Connecticut
- *Kassner* in NJ
- *McNeil* in PA
- *Linn* in IL



# Potential Trustee Liability for Getting it Wrong

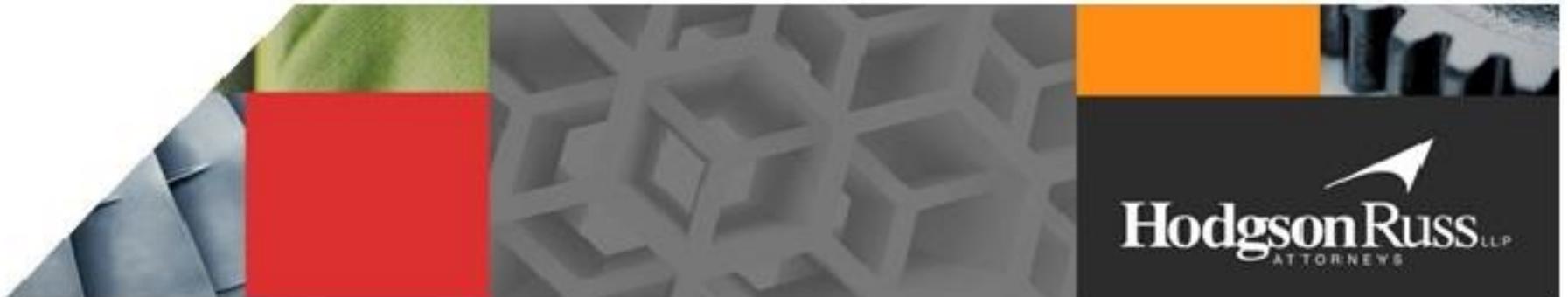
- Mobile Beneficiaries
  - When it's a large pool of beneficiaries, how does a Trustee keep track of a beneficiary's change of residence?
- Assessing accountant's acumen at multi-state trust taxation
  - Will a NJ accountant preparing a return for a trust created under the Will of a NY resident know that the existence of a CA Trustee requires a CA return?





# Section 3

## Key Issues for Nonresident Trusts

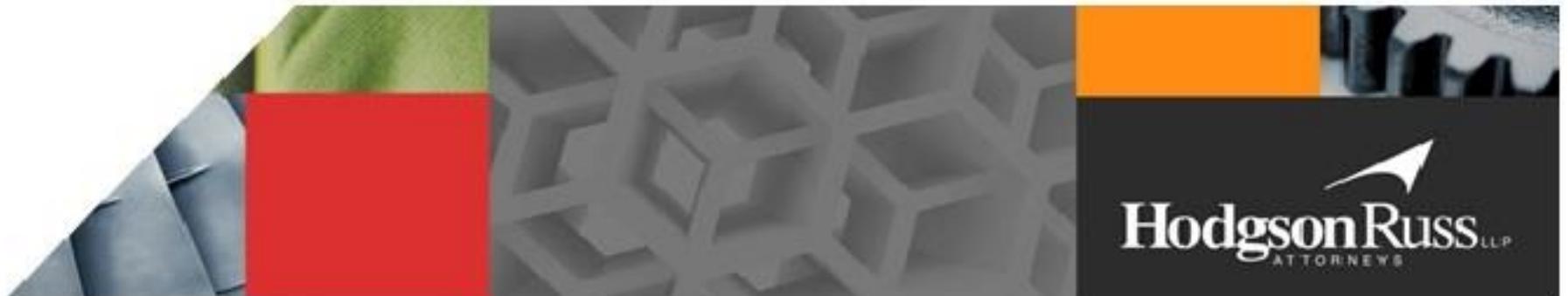


# Issue #1: Allocation of State-Sourced Income Between Trusts and Beneficiaries

- Assume a Florida trust has income sourced to NY, IL, and NJ. A nonresident return must be filed in each of those states to report the income.
- Assume also that the trust distributes 50% of its income to an OH resident. The income passes out to the OH resident on a federal K-1.
- At the state level, which income passes out to the beneficiary on the K-1? All of the NY income? Half of the NY income?

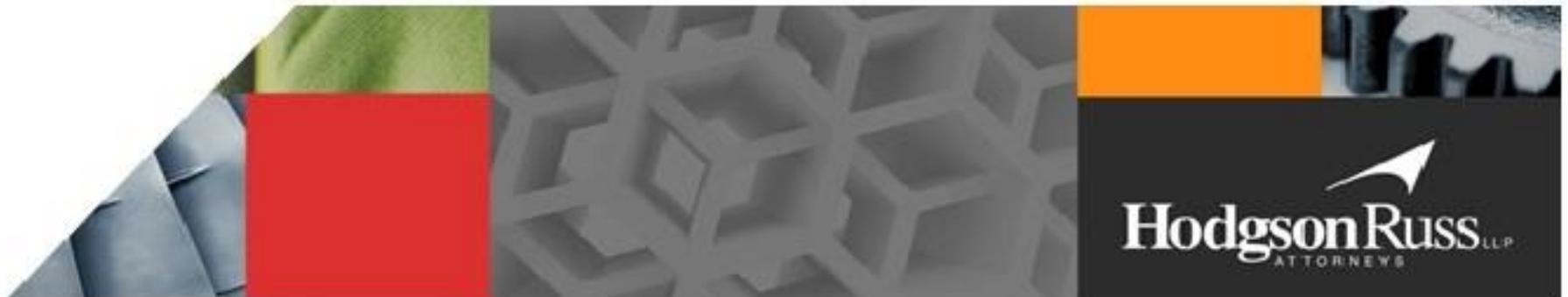
# Issue #1 Cont'd: Allocation of State-Sourced Income Between Trusts and Beneficiaries Cont'd

- In most states, there is little guidance. The accountant must come up with a defensible method.
- New York does offer some guidance:
  - Generally, NY source income is allocated based on the percentage of DNI distributed to the beneficiary versus what remains with the trust.
  - If no federal DNI, NY source income is based on percentage of income distributed (as income is determined under local law)
  - Alternative methods may also be used, if the above method results in a substantial inequity



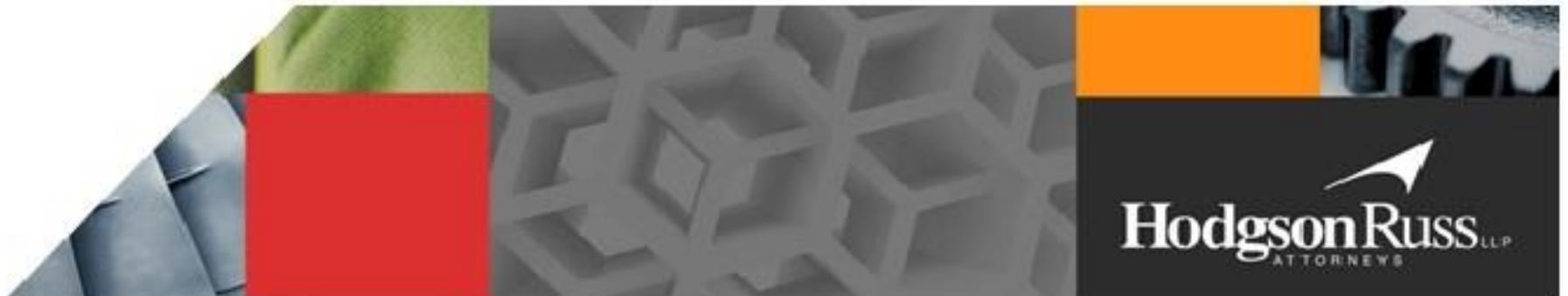
# Issue #2: Determining Income From State Sources

- **Categories of State-Sourced Income**
  - Real or tangible personal property located in the state
  - Some states include certain gains or losses from the sale or exchange of an interest in an entity that owns real property in the state
  - A business, trade, profession, or occupation carried on in the state



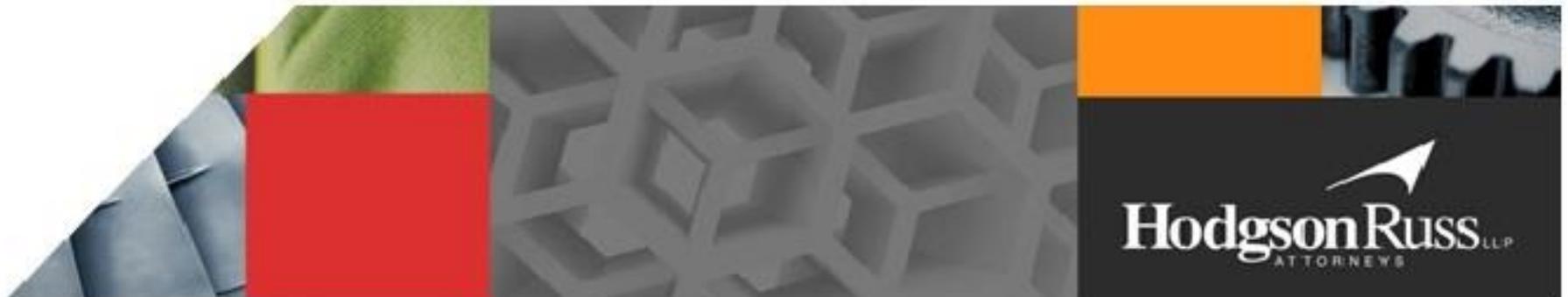
## Issue #2: Determining Income From State Sources Cont'd

- A taxpayer's distributive share of New York State partnership income or gain.
  - Be wary of different apportionment regimes
  - Ex: three-factor apportionment for partnerships vs. single-factor apportionment for S corps;
  - Market-based vs. cost-of-performance
- New rules on source income from sales of partnership interests



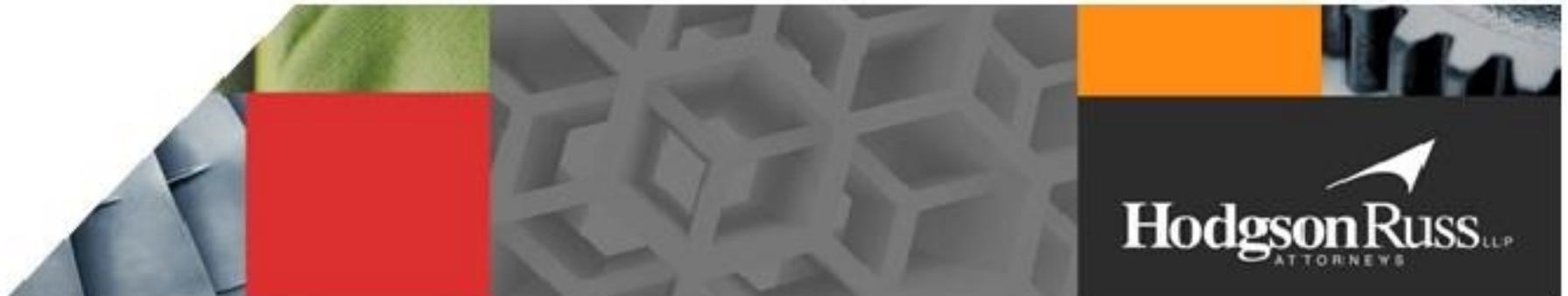
## Case Study #2

- Mark is a CT resident but also may be a NYC “statutory” resident
- He owns 100% of an S corp, low allocation in both NY and CT. But flow-through income is double-taxed because of dual residency.
- Solution: transfer shares to ESBT, incomplete gift.



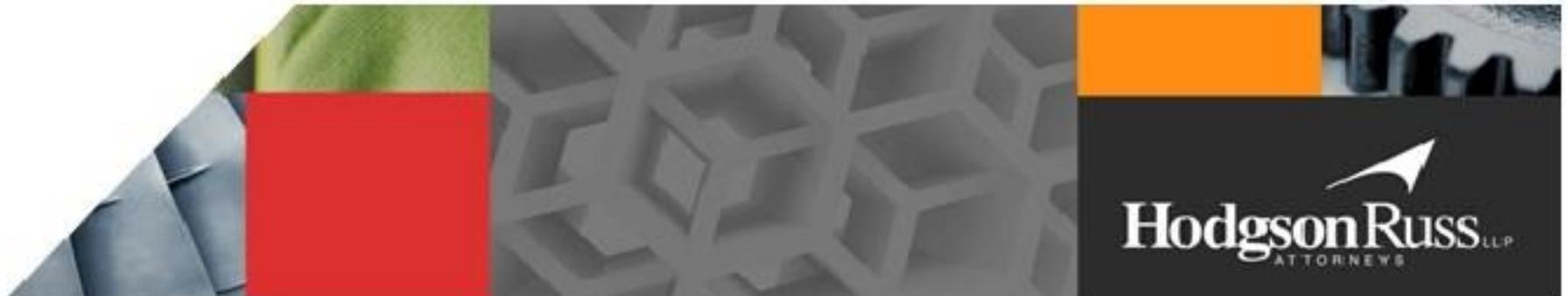
## Case Study #2

- ESBT will be nonresident NY trust, paying tax on source income in NY only.
- ESBT is resident trust for CT purposes
  - Trust will pay all tax on CT source income. But trust only pays portion of tax on non-CT source income, to the extent there are CT beneficiaries.
  - Mark decides to create a trust with many family member beneficiaries, who all live outside of CT.
- No special incomplete gift rules in CT.



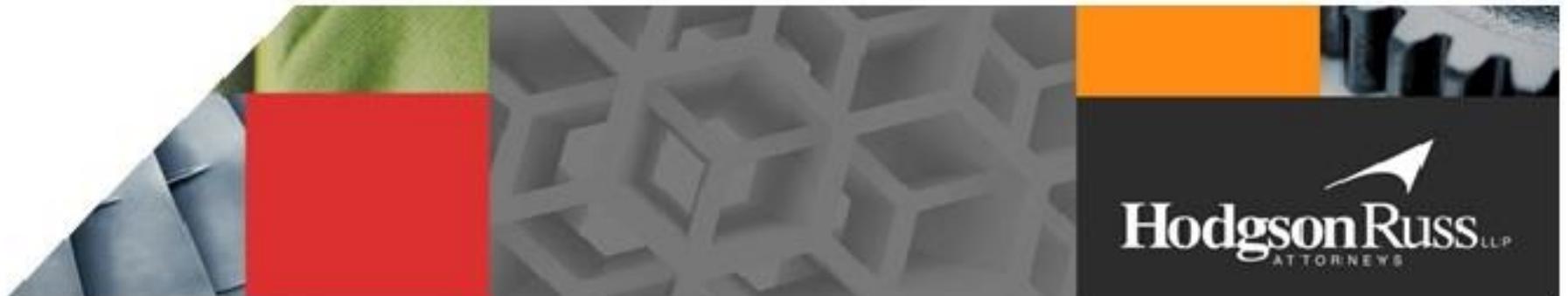
## Case Study #3

- Tax Law § 639(g); special rules for beneficiary when residency status changes. Prorate income or direct accounting?
- Madeline is beneficiary of UK trust; in July 2016, the trust sells UK property for \$10M, and immediately distributes to Madeline.
- Additional complication: UK trust fiscal-year ended in 2017, so income not reported for federal (and state) tax purposes until 2017.



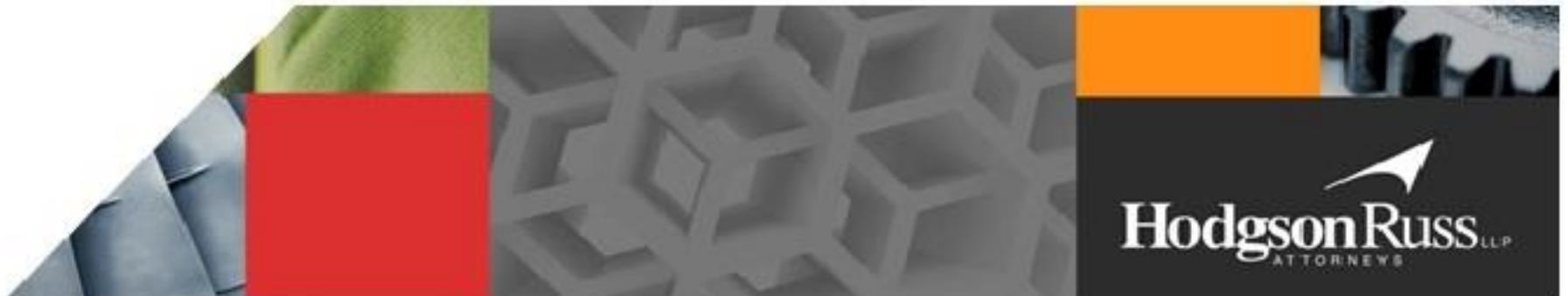
## Case Study #3

- Madeline moves to NY in October 2016. So Madeline was a part-year NY resident in 2016, and a full-year resident in 2017.
- What portion of the gain is taxed?



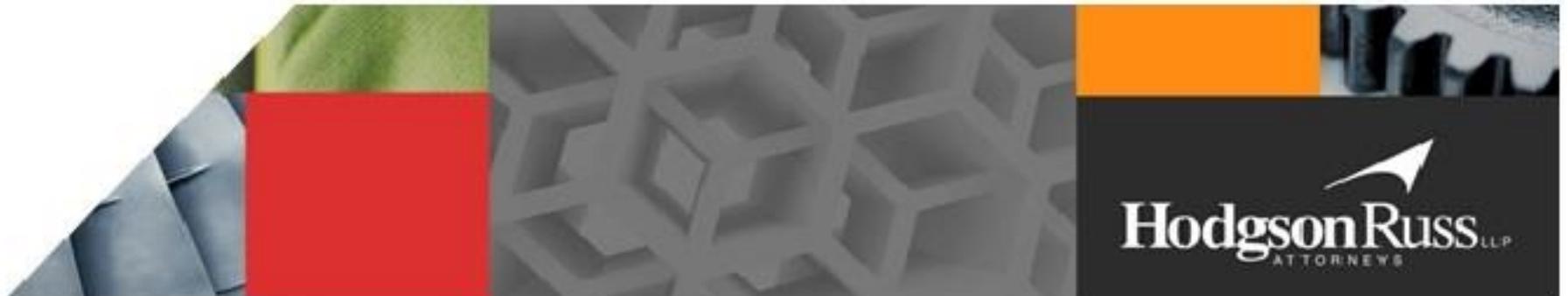
## Issue #3: Grantor Trusts

- Assume a NY resident creates an irrevocable trust, which is a grantor trust federally, and in NY. All income is reportable on the NY trust creator's return. The trust makes no distributions in a given year.
- The trust has PA source income.



## Issue #3: Grantor Trusts Cont'd

- Because PA does not recognize grantor trusts, and because no income was distributed from the trust, the trust must file a PA return and pay tax on the PA source income.
- Two separate tax payers at the state level – the individual in NY, and the trust in PA. What about a credit?

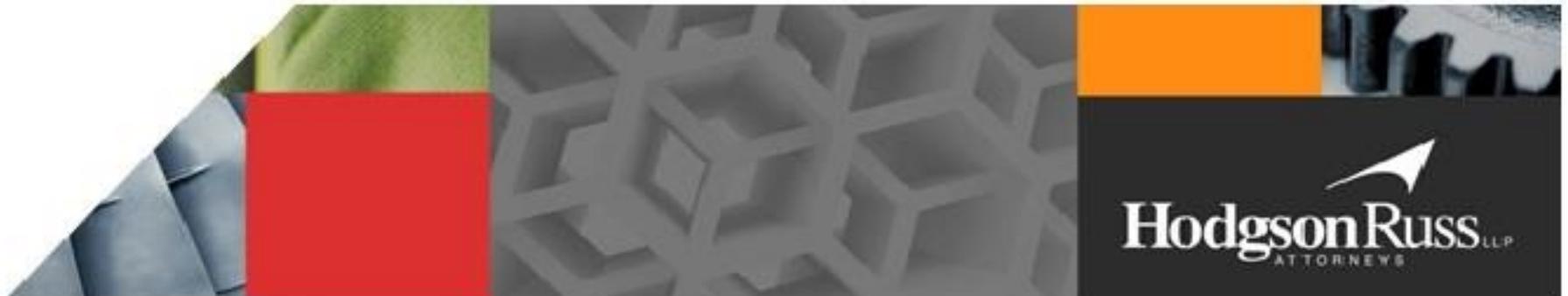


## Issue #4: Estimated Tax Payments and Withholding Requirements

- Assume a NY resident trust has PA source income. The Trustee pays estimated taxes in NY and in PA. Late in the year, the Trustee decides to make a distribution to a beneficiary living in NJ, which carries out the PA source income. The beneficiary will not have made an estimated tax payments in PA, and may be subject to penalties.

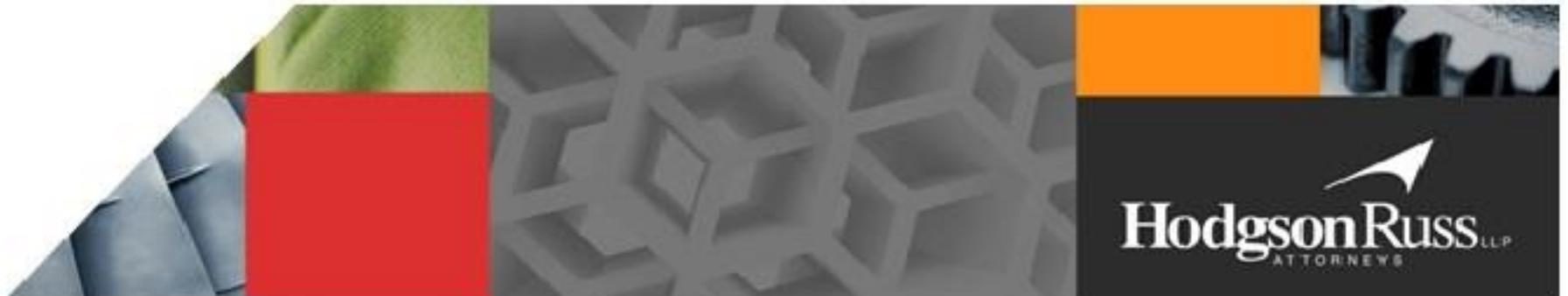
## Issue #4: Estimated Tax Payments and Withholding Requirements (Cont'd)

- Only a few states allow the trust's estimated tax payment to be credited to the nonresident beneficiary.
- Some states require withholding on distributions of source income to nonresident beneficiaries.



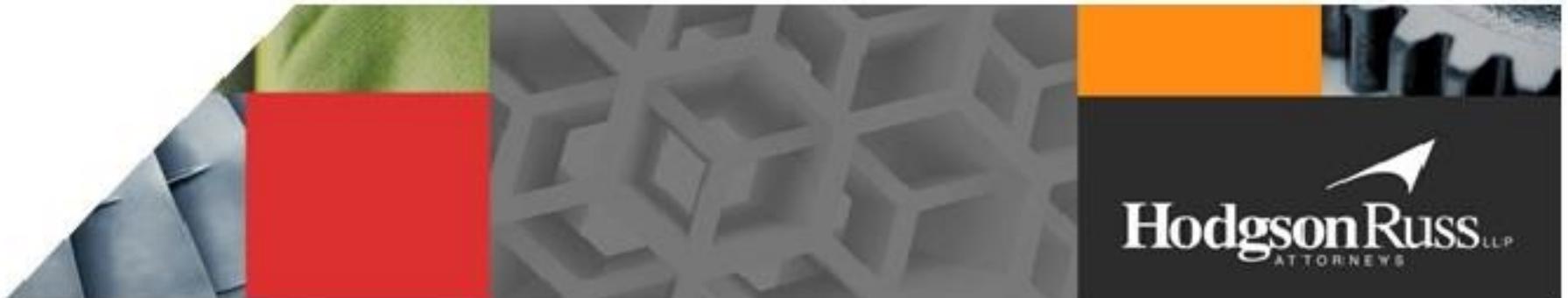
# Issue #5: Credits for Taxes Paid to Other States

- The issue: resident trust pays tax on ALL income and also on income sourced in other states.
- Double taxation?
- Resident credits available to alleviate double taxation
- But.....it's not always so simple



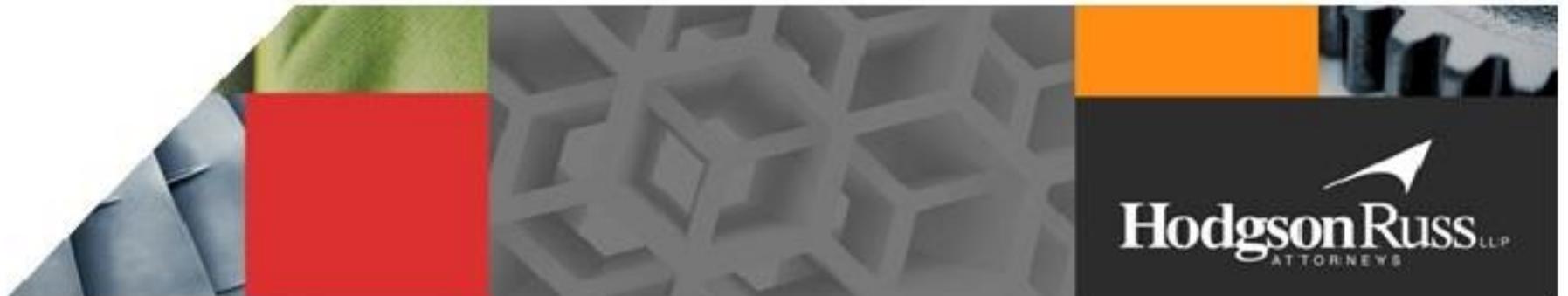
# Issue #5: Credits for Taxes Paid to Other States

- State income tax add-back issues
- Who paid the tax?
- Different sourcing rules
- Problems in dual resident situations



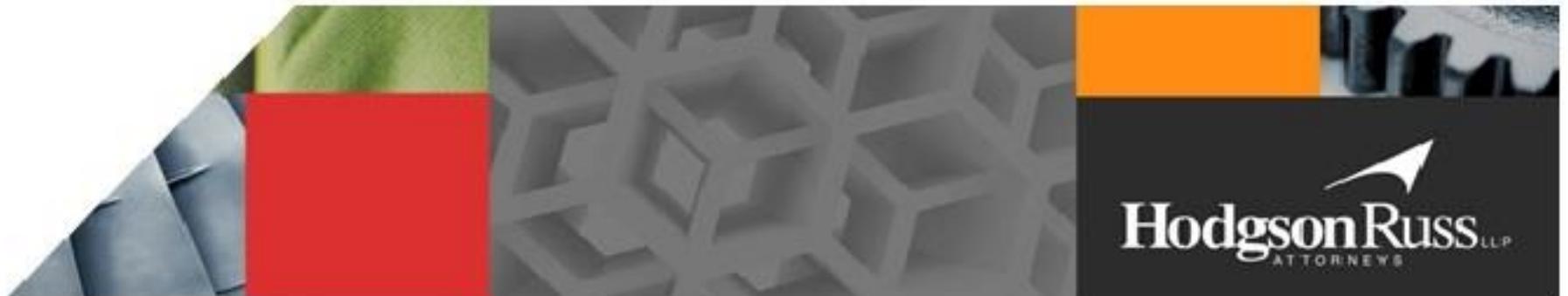
# Section 4

## Planning Ideas



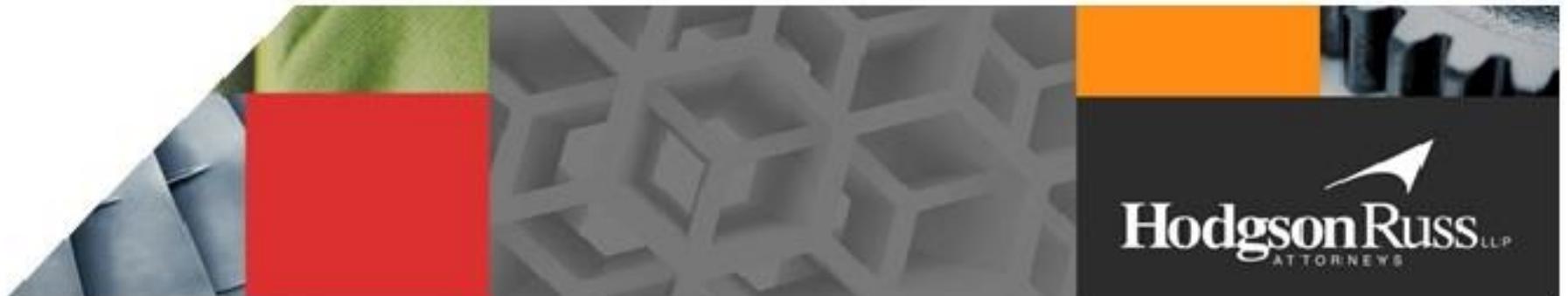
# Planning Ideas

- Use multiple trusts:
  - Discourage individuals living in different states from making gifts to the same trust
  - If trust creator moves, consider creating a second inter vivos gifting trust



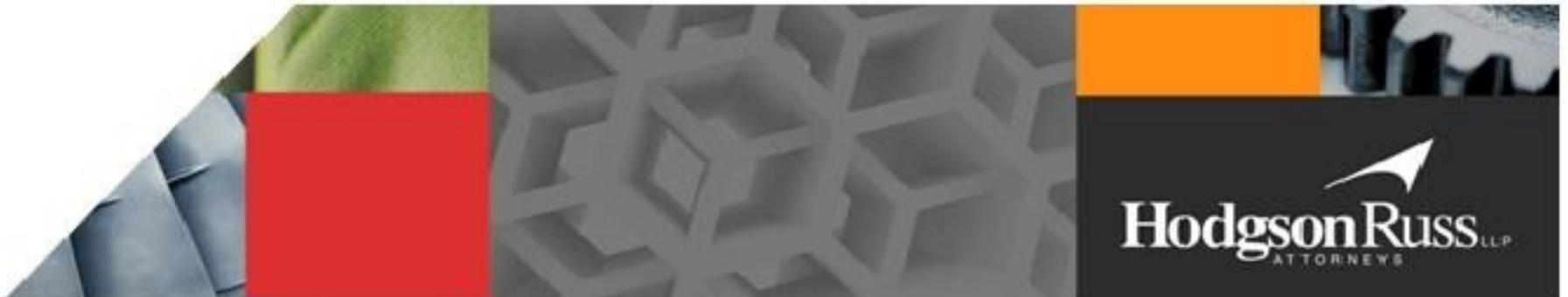
# Planning Ideas Cont'd

- Trust severance:
  - Consider severing a trust to segregate source income from different states into different buckets
  - Consider severing a trust where beneficiaries live in different states



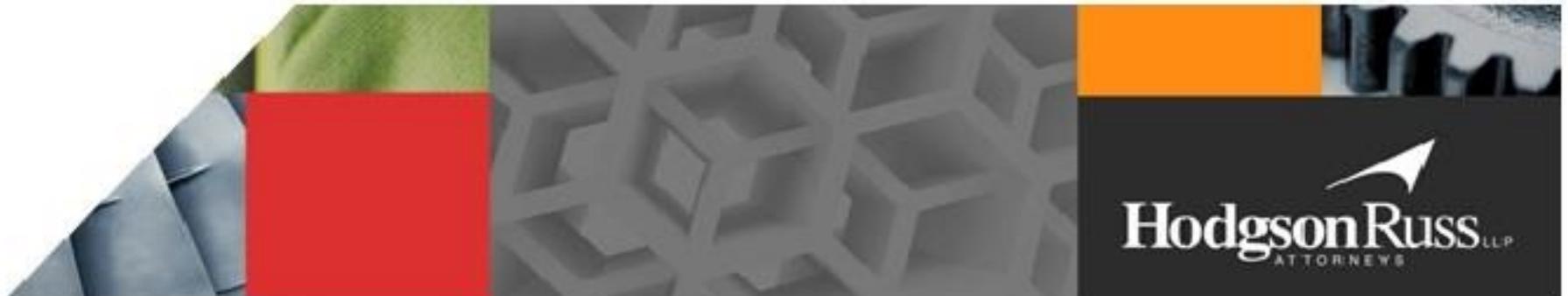
# Section 5

## Impact of the TCJA



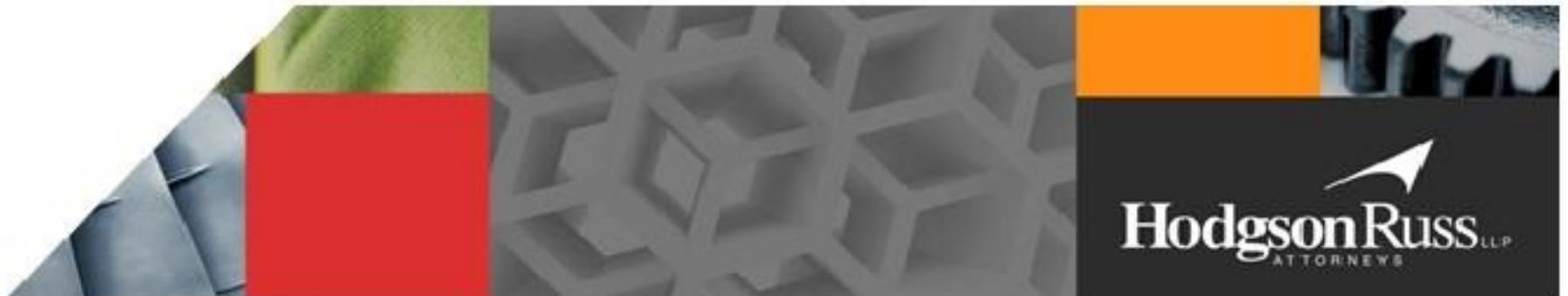
# TCJA's Impact on Resident and Non-resident Trusts

- Loss of SALT deduction = more clients want to move assets into states without income tax
  - Increased appeal of DINGs
  - Will more states stymie the effectiveness of DINGs, like NY did in 2014?
- Increased estate tax exemption means larger completed gifts can be made to out-of-state trusts
  - Will states attempt to rewrite rules for taxation of irrevocable trusts where trust creator is still alive?



# TCJA's Impact on Resident and Non-resident Trusts

- Using trusts to spread out the \$10K limitation?
- Impact on state residency issues and domicile changes generally



## Case Study #4

- Post TCJA, Mildred is considering moving from CT to FL because she is furious over the loss of her SALT deduction. But she doesn't like the hot summers.
- Mildred decides to create a DING and funds the trust with a substantial brokerage account. All of the income is treated as non-CT source.
- 80% of the trust beneficiaries lives outside of CT, so only 20% of the income from the brokerage account is subject to CT tax.

**QUESTIONS?**

