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

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State Income Tax Treatment of Nonresident Trusts

- Introduction
- Resident trusts
- State survey of trust taxation
- Effect of *Kaestner*
- Deeper dive into California taxation of trusts
- Multi-state planning

State Income Tax Treatment of Nonresident Trusts

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Basic Types of Trusts

- Simple vs Complex Trust
- Grantor vs Non-Grantor Trust
- *Inter Vivos* vs Testamentary Trust
- Discretionary vs Formulary Distributions
- Contingent vs Non-Contingent Beneficiaries

Increased Significance of State Taxes

- 2017 Tax Cuts and Jobs Act imposed a $10,000 annual limit on the federal tax deduction for state and local taxes
- Deduction limit applies to nongrantor trusts as well individuals
- Deduction limit and reductions in the federal income tax rates made state and local income taxes more significant

Grantor Trusts

- Trust income is taxed to grantor if he or she retains certain powers over, or interests in, the trust
- Most states (but not all) follow the federal tax rules
- Grantor trusts are effective vehicles to transfer wealth (assets move out of grantor’s estate but future income taxes stay with grantor)
- Three alternative methods of tax reporting of grantor trust income

Non-Grantor Trusts

- Most states tax income accumulated within a non-grantor trust if they consider it a "resident trust"
- What is a "resident trust" is not always defined by statute
- AK, FL, NV, NH, SD, TX, WA, and WY do not tax undistributed income of non-grantor trusts

Factors Considered in the Definitions of "Resident Trust"

- Does the trust specify that the law of the state applies?
- Was the testator of a testamentary trust domiciled in the state at date of death?
- Does the trustor of an *inter vivos* trust reside in the state?
- Is the trust administered in the state?
- Do one or more trustees or fiduciaries reside or do business in the state?
- Do one or more beneficiaries reside in the state?

Trust Specifies that State’s Laws Govern

- A trust (or Will establishing a testamentary trust) may designate the law of another state to govern it and attempt to give the courts of that other state exclusive jurisdiction
- LA taxes a trust if the trust specifically provides that LA law governs, but not if the trust specifies that the law of another state applies
- ID and ND consider the designation of their laws as one factor in determining whether a trust is a resident trust

Trust Created by Will of Domiciled Testator

- CT, DC, IL, LA, ME, MD, MI, MN, NE, OH, OK, PA, VT, VA, WV, and WI all tax testamentary trusts solely based upon the domicile of the testator
- DE, MA, MO, MT, and RI also require at least one resident beneficiary
- ID and IA require more factors such as resident trustees or beneficiaries and in-state assets and/or source income
- CT apportions the tax based on the number of resident and nonresident non-contingent beneficiaries

Domicile vs Residency

- “Domicile” generally means the true, fixed, principal, and permanent home, to which a person intends to return and remain
- “Residency” is defined broader than domicile and typically looks to physical presence (more than 183 days during a 12 month period) plus other contacts
- A person may arguably be a “resident” of more than one state but can only have one domicile

Inter Vivos Trust Created by Resident

- DC, IL, ME, MD, MN, NE, OK, PA, VT, VA, WV, and WI will tax an *inter vivos* trust solely because the trustor resided in-state
- AL, AR, CT, DE, ID, IA, MA, MI, MO, MT, NJ, NY, OH, and RI require one or more additional factors
- Some look for resident trustees or income beneficiaries
- Others consider in-state assets and/or source income

Trust Administered Within the State

- CO, IN, KS, LA, MD, MN, MS, MT, NM, ND, OR, SC, VA, and WI tax the trustee solely because a trust is administered in-state
- HI, ID, IA, and UT tax based upon situs of trust administration if it is combined with other factors, such as
  - trustee does business or manages funds in state
  - trust own property in state
  - resident income beneficiary

One or More Resident Trustees

- AZ, CA, KY, MT, NM, ND, OR, and VA tax a trust solely on the basis that one or more trustees reside in the state
- DE, HI, ID and IA tax trusts on this basis when combined with other factors
- Some states such as CA apportion the trust income if some, but not all, of the trustees are in-state residents

One or More Resident Beneficiaries

- CA, GA, NC, and TN will tax a trust solely on the basis that it has resident beneficiaries but may only tax the income accumulated for the resident beneficiaries
- AL, CT, DE, HI, MA, MI, MO, MT, ND, OH, and RI take into account the residency of beneficiaries as one factor either in determining nexus for taxation and/or the determining amount of income subject to tax

U.S. Supreme Court *Kaestner* Decision

- In a 2019 decision, the court held that the presence of in-state beneficiaries alone did not allow the state of NC to tax accumulated income in a trust where:
  - trustee had "absolute discretion" to decide when, whether, and to whom to make distributions,
  - trustee was explicitly authorized to distribute funds to one beneficiary to the exclusion of others,
  - trustee and not the beneficiaries was authorized to make investment decisions regarding trust property, and
  - beneficiaries were prohibited from assigning to another person any right they might have to the trust property.

States Potentially Impacted by *Kaestner*

- GA, TN, and, of course, NC are all directly impacted by *Kaestner*
- CA which limits the taxation of trust income that is based on the residency of the beneficiary to “non-contingent beneficiaries” is less vulnerable
- AL, CT, DE, HI, MA, MI, MO, MT, ND, OH, and RI, all of which take into account the residency of a beneficiary as one factor, may also be impacted by *Kaestner*

Cert. Denied in *Fielding* Case

- Also in 2019, the US Supreme Court denied Cert in the Fielding case letting stand a MN Sup Court ruling the residency of the grantor was not by itself sufficient to tax a trust in MN
- The MN Sup Court looked also for these other factors:
  - Domicile of the trustee
  - Location of the trustee's decision-making
  - Location of the trusts' administration
  - Location of the trusts' records, and
  - Inter vivos trust versus testamentary trust using MN probate court

States Potentially Impacted by *Fielding*

- DC, IL, ME, MD, MN, NE, OK, PA, VT, VA, WV, and WI, all which will tax an *inter vivos* trust based solely upon the residency of the grantor or trustor, are directly impacted by *Fielding*
- AL, AR, CT, DE, ID, IA, MA, MI, MO, MT, NJ, NY, OH, and RI, all of which take into account the residency of the trustor as one factor, may also be impacted by *Fielding*

Examples of Basic State Income Tax Planning

- Move trust administration to a state that does not tax trusts (may not work if moving from a state taxing based upon residency or domicile of the grantor or testator)
- Modify the trust to remove provisions causing taxation (judicial or non-judicial with beneficiary consent)
- Decant the assets to a new trust in a state that does not tax trusts (statutory authority for decanting exists in at least 30 states)

Example of Complex State Income Tax Planning

- If nongrantor trust will be making significant distributions consider taking the following steps :
  - contribute all assets to an S corporation,
  - elect to for the trust be taxed as a small business trust ("ESBT"), and
  - locate both trust and S corporation in a state that does not impose income taxes
- Result: income generated by the trust will not be subject to state income taxes whether or not it's distributed to beneficiaries

California Income Taxation of Trusts
Multi-state Planning

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Taxation of Revocable and Other Grantor Trusts

- California treats property of grantor trusts as owned by and taxable to its grantor (settlor) for income tax purposes.
- The income, deductions and credits generally are included in computing the tax liability of the grantor and the *trust is disregarded* for both federal and California income tax purposes.

Taxation of Irrevocable, Non-grantor Trusts

- California-source income of a trust is subject to tax
- Other income is subject to tax based on the <u>residence</u> of the:
  - Fiduciaries
  - Beneficiaries with a non-contingent interest
- Facts not considered:
  - Residence of the settlor
  - Governing law

California Source Income is Always Taxable

- California imposes tax on 100% of California source income
  - For example, rent from California real property

- Taxpayer in *Paula Trust* made an argument based on the statutory structure that source income should be subject to apportionment, just like all other income, based on the number of California fiduciaries.
- Taxpayer lost on appeal.
- California Supreme Court denied cert.
  - *Steuer v. Franchise Tax Board*, 51 Cal.App.5th 417 (2020), review denied (Oct. 14, 2020) [

Other Trust Income Subject to California Tax

- **Resident Fiduciaries**
  - California imposes income tax on a trust if one or more fiduciaries are California residents.
  - If there is a combination of resident and non-resident fiduciaries, the income is apportioned.
- **Resident “non-contingent beneficiaries”**
  - California imposes income tax on a trust if one or more “non-contingent beneficiaries” are California residents.
  - If there is a combination of resident and non-resident beneficiaries, the income is apportioned.

What is a "Fiduciary"?

- R&T 17006 defines fiduciary to mean guardian, trustee, executor, administrator… or "any person…acting in any fiduciary capacity for any person, estate or trust"
- Anyone who owes a duty to the beneficiaries of the trust and can be sued by them for breach of that duty
  - Trustee
  - Investment direction adviser
  - Distribution direction adviser
  - Trust protector
  - Person who holds powers in a "non-fiduciary capacity"?

California Residency Requirements for Individuals

- A California "resident" includes an individual who is:
  1. In California for other than a temporary or transitory purpose; or
  2. <u>Domiciled</u> in California and outside the state for a temporary or transitory purpose.
- Presumed California resident if present for more than 9 months

California Residency Requirements for Corporate Entities

- “The residence of a corporate fiduciary of a trust means the place where the corporation transacts the <u>major portion</u> of its administration of the trust.”
  - Cal. Rev. & Tax. Code Sec. 17742(b)

- “Major portion” of trust administration depends on the facts and circumstances.

- Facts not considered:
  - State in which entity is incorporated
  - Location of entity headquarters

Multiple Fiduciaries: Apportion

- Trustee:
  - Joe Smith, resident of Santa Cruz, CA
- Investment direction advisor:
  - Jane Roberts, resident of Salt Lake City, UT
- Trust Protector:
  - Aunt Molly, resident of Tuscon, AZ

- 1 of 3 fiduciaries is in California
  - 1/3 or 33% of trust income is taxable in California

Resident Beneficiaries

- California taxes trust income if the beneficiaries
  - are California residents, and
  - have non-contingent interests

- What is a "non-contingent interest"?
  - Not defined, but likely means:
    - Vested interest
    - Beneficiary has an <u>absolute right</u> to receive the trust income at some future point
  - For example:
    - A beneficiary of a post-death administrative trust who will receive the entire trust property outright at the end of the administration has a <u>non-contingent</u> interest.

Discretionary Trust = Contingent Beneficiary

- A California resident beneficiary's interest in a discretionary trust is <u>contingent</u> when
  - the terms of the trust instrument give
  - the trustee <u>absolute discretion</u> to determine
  - whether to make distributions to a beneficiary
    - *Steuer, et al. v. Franchise Tax Bd.*, No. A154691, 2020 Cal. App. LEXIS 592 at *23 (June 29, 2020), aff'g in part and rev'g in part *Paula Trust, et al. v. Cal. Franchise Tax Bd.*, No. CGC-16-556126, 2018 Cal. Super. LEXIS 644 (Cal. Super. Ct. Feb. 6, 2018)

Case Study: Facts

- Trustee: Delaware
- Investment adviser: New York
- Distribution adviser & Trust protector: California
- Beneficiaries: California
- Distribution standard: Absolute discretion
- Trust income: Interest, dividends, and rent from a commercial property in Los Angeles.

Case Study: Facts

1 • Trustee: Delaware

2 • Investment adviser: New York

3 • Distribution adviser & Trust protector: California

• Beneficiaries: California

• Distribution standard: Absolute discretion

Contingent interest

Case Study: Analysis

- Trust’s income:
  - $20 from rent from the Los Angeles building
  - $90 from interest and dividends

- California taxable income:
  - $20 California source income
  - <u>$30 apportioned income (1/3 X $90)</u>
  - $50 total California taxable income

Case Study: Recommendations

- Avoid California fiduciaries.
- Beware of the trust protector.
- Do not forget about the throwback tax….

Throwback tax

- Trust income that is not taxable by California currently may be subject to “throwback tax” when later distributed to a California beneficiary

- California and a few other states impose a throwback tax
  - New York
  - Pennsylvania

California Throwback Tax

- Throwback tax applies to income that was not subject to tax in California when it was earned because beneficiary had a contingent interest.
  - Cal. Rev. & Tax Code § 17745

- Throwback tax applies to the <u>beneficiary,</u> *IF*
    - Beneficiary was a resident of California when income earned <u>and</u>
    - Beneficiary is a resident of California in the year when the income is distributed.

Case Study: Throwback

Year	DNI	CA Source Income	CA Accumulated Income
2018	$110	$20	$90
2019	$110	$20	$90
2020	$125	$20	$105
2021	$135	$25	$110
2022	$135	$25	$110
2023	$145	$30	$115
Total	**$760**	**$140**	**$620**

Case Study: Throwback

Year	DNI	CA Source Income	Distribution	CA Accumulated Income
2018	$110	$20	$0	$90
2019	$110	$20	$0	$90
2020	$125	$20	$0	$105
2021	$135	$25	$0	$110
2022	$135	$25	$0	$110
2023	$145	$30	$100	$45
Total	**$760**	**$140**	**$100**	**$550**

Case Study: Throwback

Year	DNI	CA Source Income	Distribution	CA Accumulated Income
2018	$110	$20	$0	$90
2019	$110	$20	$0	$90
2023	$145	$30	$100	$45
2024	$145	$30	$300	-$155
Total	**$905**	**$170**	**$400**	**$395**

Throwback distribution subject to tax

Case Study: Throwback

Year	DNI	CA Source Income	Distribution	CA Accumulated Income
2018	$110	$20	$0	~~$90~~
2019	$110	$20	$0	$25 ~~$90~~
2023	$145	$30	$100	$45
2024	$145	$30	$300	-$155
Total	**$905**	**$170**	**$400**	**$395**

Case Study: Throwback

Year	DNI	CA Source Income	Distribution	CA Accumulated Income
2023	$145	$30	$100	$45
2024	$145	$30	$300	-$155
2025	$150	$30	$300	-$150
Total	**$1,055**	**$200**	**$700**	**$245**

Throwback distribution subject to tax

Case Study: Throwback

Year	DNI	CA Source Income	Distribution	CA Accumulated Income
2019	$110	$20	$0	~~$25~~ $90
2020	$125	$20	$0	~~$105~~
2021	$135	$25	$0	$90 ~~$110~~
2025	$150	$30	$300	-$150
Total	**$905**	**$170**	**$400**	**$395**

Planning for California Tax on Trusts

- Establishing a trust outside of California allows one to avoid California state income tax currently, if
  - the <u>fiduciaries</u> are not California residents, <u>and</u>
  - The beneficiaries' interests are contingent

- Considerations/Pitfalls:
  - Maintenance of fiduciaries outside California
  - Throwback tax at time of distribution

Best Practices When Creating New Trusts

- Consider current and potential future residences of trustees and fiduciaries
- Avoid mandatory income and principal distribution provisions
- Provide flexibility to change situs or to decant without court involvement
- Allow for trustee, protector, investment advisor ability to appoint successor
- Consider administration location and using trust companies in domestic asset protection jurisdiction (AK, DE, NV, SD, WY)

Best Practices When Creating New Trusts – CA specific

- For directed non-CA trusts, avoid assigning fiduciary roles to CA residents
- Specifically define protector as a non-fiduciary (DE and SD allow)
- Consider creating separate subtrusts for CA and non-CA source income
- Be careful with granting testamentary general powers of appointment to CA resident beneficiary

Multi-state Planning

- What is the objective of the trust being settled – dynastic planning or vanilla estate planning?
- What are the assets being planned for – source or non-source income?
- Are separate trusts for separate buckets of assets practical?
- Planning with directed trusts.

Common Pitfalls & Issues

- Trustees are liable for accurate and complete multi-state reporting
  - Must keep track of multiple beneficiaries' locations
  - Must hire accountants with the expertise to handle multi-state issues
    - Minnesota accountant working on a trust return for a testamentary trust created by a Wisconsin decedent with a California resident trustee. Does this accountant know to file and pay tax in California?

Issue: Allocation of Income

- Allocation of state-sourced income between trusts and beneficiaries – it's complicated
- Assume SD trust that owns rental property in NY and CA and an investment portfolio.
  - Income and gains from CA/NY properties taxable to trust in each state, respectively. Trust has to file nonresident return in each state
  - Income and gains from portfolio not taxed to trust by any state.
  - If distribution is made to a beneficiary, CA source income and NY source income is allocated based on the percentage of DNI distributed to the beneficiary

Issue: ING Trusts

- A self-settled trust established in a non-tax state and intended to be treated as a non-grantor trust
- Purpose: Avoid state income tax on trust income
- NY has disallowed by statute
- CA has proposed a statute to disallow