MULTISTATE TAX COMMISSION
Maximizing the synergies of multi-state tax cooperation

To: MTC Income and Franchise Tax Subcommittee

From: Lila Disque

Date: July 28, 2014

Subject: Possible scope of a project to explore trust residency and related issues that might benefit from uniform law

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Introduction

At its March, 2014 meeting, the Income and Franchise Tax Subcommittee heard a presentation on the emerging use of trusts by individuals to avoid income taxes. The subcommittee directed MTC staff to prepare a memo on issues that might benefit from uniform state law.

Background

Trust income is generally taxed in one of three ways—either to the trust, if retained by the trust, or to the grantor, if the grantor has retained a sufficient interest, or to a beneficiary who receives a distribution. Trusts have long been used for tax planning by individuals. The most common of the trusts that may be used to avoid state taxes are outlined below. Staff has identified two potential issues for consideration by the Uniformity Committee: 1) whether states should follow federal tax treatment of trusts, which determines how, when and to whom income is taxed, and 2) whether states should have uniform trust residency rules. . As to residency, because states may follow different rules, it is possible for a trust to be a resident of no state or more than one state. .

Types of Trusts and Tax Avoidance/Uniformity Issues

Incomplete-gift non-grantor (DING) trusts.

DING trusts hold the grantor's assets and make distributions to him. It is possible for a DING to be a non-resident trust for purposes of state income tax (so that the trust is not subject to any state's tax) and a non-grantor trust for purposes of income tax and gift tax (so that the income of the trust is also not taxable to the grantor). This is achieved by structuring a trust so it is not subject to tax in the settlor's state or in the state where the trust is located. The trust is irrevocable and must be domiciled in a state that authorizes self-settled spendthrift trusts. The grantor must retain enough control to keep the transfer from being a gift, while surrendering enough control to keep it from being a grantor trust. Un-

der IRC Section 674(a), a trust is a grantor trust if the beneficial enjoyment of the trust property is "subject to a power of disposition exercisable by the grantor or a non-adverse party, or both, without the approval or consent of any adverse party." Therefore, in a DING trust, the grantor retains a special testamentary power of appointment,[1] but any distributions to the grantor must be granted by a distribution committee that includes only persons who are currently eligible to receive distributions.[2]

Because the trust is a non-grantor trust, the tax burden falls on the trust rather than the grantor. However, if the trust is not resident in a jurisdiction that imposes a tax on trusts, it would not end up paying any state tax. This is particularly useful when the grantor puts his interest in an LLC or an LP into the trust. Income from the pass-through entity will go to the trust, which is not taxed on its retained income, rather than going to the grantor and being immediately taxed as income.

DING Trusts: Solutions to Minimize Tax Avoidance

Establish Uniform Residency Rules

Resident trusts are subject to tax on all income retained by the trust, while nonresident trusts are subject tax on income that derives from within the jurisdiction. Most states subject trusts to tax based on one or more of the following activities:

- using the state's law as the governing law of the trust
- administering the trust in the state
- having a resident grantor at the time of death
- having a resident grantor at the time of creation or funding of a trust
- having a resident grantor at the time a trust becomes irrevocable
- having a resident trustee
- having a resident beneficiary
- owning assets located in the state, or
- receiving state-source income.

In order to keep trusts from strategically avoiding state taxation, the states may wish to consider uniform guidelines for determining a resident trust. Some of the factors above are more easily controlled than others after creation of the trust. The governing law, the state where the trust is administered, the location of the trustee, and, arguably, the residence of a beneficiary are relatively easily to manipulate. It may be more difficult to change the location of the trust's fixed assets, its source of trust income. And it is impossible to change the grantor's state of residence at the time of creation of the trust.

Note that even if a trust is a resident trust under some of the above qualifications, it may be deemed not to have a minimum connection with the state for purposes of the commerce clause and/or the due

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[1] "Special testamentary power of appointment" is a provision in the trust reserving the grantor's right to name in his will those people who will receive the balance of the trust upon his death.
[2] For an example of how this works, see Private Letter Rulings 201310002-201310006; the committee may consist of family members who themselves receive periodic distributions.

process clause.[3] This is a potential pitfall to hinging residency of the trust on an immovable factor like the grantor's state of residence at the time of creation of the trust: although it cannot be changed, it is likely to have the most distant connection to the state. With this in mind, it would be best to base residency on several factors. Uniform residency rules would ensure that a trust is a resident somewhere. This would reduce the opportunity for strategic tax planning; however, in order to avoid double taxation the states would need to develop a uniform method of apportionment or credits. According to Bradley Fogel in *State Income Taxation of Trusts*:

> In many states, the credit is limited to tax paid to another state on income derived from that state. See, e.g., Mo. Rev. Stat. § 143.081(1); Conn. Gen. Stat. § 12-704(a). Thus, for example, the credit would be available to offset income tax paid by a resident to another state based on income derived from real property located in that other state. The credit would not be available, however, to offset state tax imposed on income from intangibles, such as stocks.
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> In addition, in some states the credit is available only if the other state's tax is imposed "irrespective of the residence or domicile" of the taxpayer. *39 Haw. Rev. Stat. § 235-55(a); see also, e.g., Mont. Code Ann. § 15-30-124(c)(2). This limitation would prevent a trust deemed a resident of more than one state from using the credit because the tax is imposed based on the trust's residence in both states.In essence, the problem with the credits is that they are intended for the situation in which a single state taxes the taxpayer as a resident, but the taxpayer pays tax as a nonresident to a different state only on its source income.
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> In such a case, the state of residence would typically give the taxpayer a credit for the tax paid to the other state. In that kind of case, the credit greatly alleviates double taxation. For a trust that is deemed a resident of more than one state, however, the credits may not apply, and the problem of double taxation will continue without relief."

19-AUG Prob. & Prop. 36, 38-39:

In this respect, uniform residency rules might present a secondary challenge.

Disregard Federal Status

New York's 2014-2015 budget, signed into law as Chapter 59, made a number of changes to state tax laws, including the taxation of resident trusts. New York's law will now treat DING trusts created by a New York resident as grantor trusts for New York income tax purposes:

> There shall be added to federal adjusted gross income:
> …

[3] *See, e.g.,* Linn v. Dep't of Revenue, 2013 IL App (4th) 121055. Although it is unclear to me that the due process clause and commerce clause *should* apply, since a trust is arguably not engaged in interstate commerce, state courts generally apply an analysis similar to that of corporate income tax cases.

> (41) In the case of a taxpayer who transferred property to an incomplete gift non-grantor trust, the income of the trust, less any deductions of the trust, to the extent such income and deductions of such trust would be taken into account in computing the taxpayer's federal taxable income if such trust in its entirety were treated as a grantor trust for federal tax purposes. For purposes of this paragraph, an "incomplete gift non-grantor trust" means a resident trust that meets the following conditions: (i) the trust does not qualify as a grantor trust under section six hundred seventy-one through six hundred seventy-nine of the internal revenue code, and (2) the grantor's transfer of assets to the trust is treated as an incomplete gift under section twenty-five hundred eleven of the internal revenue code, and the regulations thereunder.
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> N.Y. Tax Law § 612(b)(41) (McKinney)

Under this new rule, a DING trust structure is disregarded, and the income from the trust is added back to the grantor's state return. The legislation does not affect the trust's classification for Federal income tax purposes, so a DING trust will be treated as a separate taxpayer for Federal purposes, but as a grantor trust for New York State purposes.

Offer Election to Subject Trust to State Tax

Another proposal in the New York budget process was to permit the trustee of the DING Trust to affirmatively elect to subject the trust to state income tax. If the trustee makes this election, the trust would be subject to state income tax while the grantor would not be subject to tax on the trust's income. This is administratively simpler for the trustee than having to treat the trust as a grantor trust for state income tax purposes and a non-grantor trust for federal income tax purposes. If the trustee did not make the election, the trust would be treated as a grantor trust for state income tax purposes, and the trust itself would not be subject to state income tax.

Charitable Remainder Unitrust (CRUT)

A CRUT is a trust structure commonly used for appreciated assets with a low basis that are likely to generate significant taxable gain. Rather than selling the appreciated asset, the grantor donates it to an irrevocable charitable trust, which can (as a tax-exempt entity) sell the asset without owing any federal capital gains tax itself. The CRUT must pay out a fixed percentage to the grantor, which is taxable to the grantor when distributed. This allows the grantor to receive some benefit from the sale of the asset, while deferring the tax on the gain. The grantor may also take a charitable contribution deduction based on the present value of the remainder interest (based on complex calculations involving the grantor's life expectancy and the fixed pay-out, as well as other factors). The charitable beneficiary must be an organization described in IRC Section 170(c): "organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals." The present value of the charitable remainder interest must be at least 10 percent of the net fair market value of such property transferred in trust on the date of transfer

There are obvious policy reasons for encouraging the use of CRUTs; however, states may want to make an independent assessment of whether the policy reasons justify the foregone tax. A CRUT can be set up to pay out the lesser of the fixed percentage payment or the trust's net income (other than capital gains) for the year, with the difference to be "made up" in a future year. A trust that incorporates this "net income with make-up" option is known as a NIMCRUT. This can be exploited when the trust invests in high-growth assets that produce little or no income. At a later date trust investments are shifted to income-producing assets. The income beneficiaries then receive the fixed percentage payment plus payments from earlier years that were deferred by virtue of the trust's "net income with make-up" feature. This was intended to give some wriggle room to trustees to avoid having to invade the corpus of the trust in low-performing years. But in effect it allows for a tax-free buildup of income, with a payout when the non-charitable beneficiary is in a lower tax bracket (usually after retirement). The IRS views this with disapproval. Given clever methods of maximizing the non-charitable beneficiary's benefit, it may be worthwhile to advocate for charities in other ways.

Taxation of CRUTs is unique to each state. Some states (such as Pennsylvania and New Jersey) do not exempt the CRUT from taxation. Many states exempt CRUTS from taxation; other states (such as Indiana) exempt them from taxation, but require that a copy of the IRS Form 5227 be filed with the state taxing authority.

CRUTs: Solutions to Minimize Tax Avoidance

Under Pennsylvania statute, a charitable trust is a trust operated exclusively for religious, charitable, scientific, literary, or educational purposes. A trust is a charitable trust only if all net earnings for the tax year and remaining life of the trust are for distribution for such purposes. No part of the earnings of a charitable trust may benefit any private individual.[4]

A charitable trust for New Jersey gross income tax purposes is a trust operated exclusively for religious, charitable, scientific, literary, or educational purposes. A trust cannot be deemed to be a charitable trust unless it is operated exclusively, during all of the tax years in question, for religious, charitable, scientific, literary, or educational purposes; serves a public interest as opposed to a private interest; and, under the governing instrument, there is no possibility that a non-charitable beneficiary will receive gains or income.[5] Under these definitions, a CRUT is unlike a charitable trust in that it has non-charitable beneficiaries and does not operate exclusively for charitable purposes. It is therefore not qualified for the favorable tax treatment enjoyed by CRUTs in other states.

Conclusion and Recommendations

It is unclear how much revenue the states may be losing due to the use of trusts in tax planning. The New York Department of Taxation and Finance sent out informational returns and estimated that the new rules will ultimately generate $150 million a year, or about a 0.4 percent increase in personal in-

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[4] Pa Code 101.9 Trusts Pennsylvania.
[5] *See* Technical Bulletin 64, New Jersey Division of Taxation, June 29, 2009 (Doc 2009-14966 or 2009 STT 128-14).

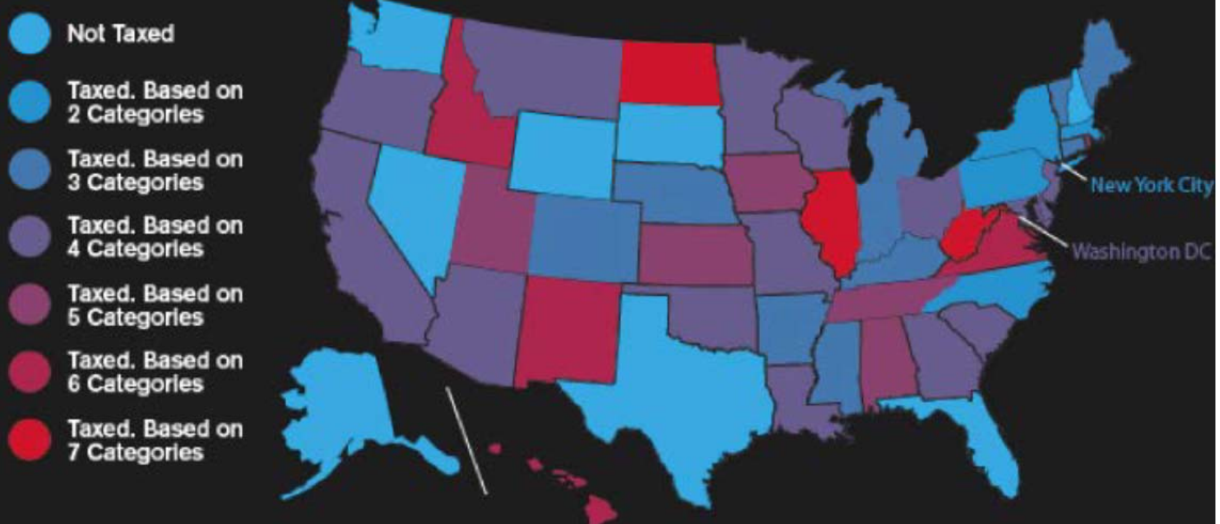
come tax collections.[6] Ultimately, tax planners will always rely on the several states that do not impose an income tax on trusts. But even with careful planning, not all of the aspects of a trust can be controlled (residence of a beneficiary, for example). Before embarking on a project, the subcommittee should consider using informational returns similar to the ones issued by New York to assess the effect of non-grantor trusts in the state.

The general goal of the uniformity committee is to address issues in which the MTC has particular expertise—corporate income and franchise taxes, allocation and apportionment of income, and sales and use taxes—and for which the best solution appears to be a uniform rule. While the taxes at issue with respect to trusts are typically individual income taxes, not corporate or business taxes, there does seem to be at least one issue for which the best solution is a uniform rule: the issue of trust residency. Without a uniform rule, there is a possibility that a trust could be resident nowhere or in more than one state. States are generally unable to address this problem without doing so as part of a collective approach. There is another issue which may be susceptible to a uniform approach, at least in part, and that involves whether states should de-couple from federal treatment in some cases. To the extent there is a "best practice" in doing so, states may be served by adopting that uniform approach. It is unclear how much of a state tax issue trusts will present; if the subcommittee decides to prioritize other projects, it may nevertheless wish to request an informational paper for the use of the appropriate tax administrator.

[6] Richard Rubin, *Wealthy N.Y. Residents Escape Tax With Trusts in Nevada*, Bloomberg, Dec 18, 2013, *available at* http://www.bloomberg.com/news/2013-12-18/wealthy-n-y-residents-escape-tax-with-trusts-in-nevada.html (last visited July 22, 2014).

WHERE IS MY TRUST MOST LIKELY TO BE TAXED

Trusts in 42 of 50 states, the District of Columbia and New York City may be subject to income tax based on a number of factors.



This map compares the likelihood that trust will be taxed in a particular state by identifying a number of broadly categorized actions triggering income tax of trusts. Categories include state's law governs the trust, adminstering the trust in the state, having a trustor or trustee or beneficiary that is a resident of the state, owning assets in the state, and receiving state-source income.

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