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The *WRMarketplace* is created exclusively for AALU Members by the AALU staff and Greenberg Traurig, one of the nation's leading tax and wealth management law firms. The *WRMarketplace* provides deep insight into trends and events impacting the use of life insurance products, including key take-aways, for AALU members, clients and advisors.

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## TOPIC: Non-Grantor Trusts Can be Taxing – Part II: State Income Tax Considerations.

**MARKET TREND:** With income tax rates now exceeding transfer tax rates, trustees are becoming more proactive in understanding the state income tax exposure of non-grantor trusts.

**SYNOPSIS:** A non-grantor trust will be subject to state income tax if the trust is deemed to be a resident of the state. State income tax rates can vary greatly from 0% to over 13%. The determination of a trust's residency varies from state to state but generally occurs because the trust has some connection with the state, such as the residency of the settlor, a trustee, or a beneficiary. This connection can make the trust a deemed resident in more than one state, which makes determination of the trust's state residency critical to understanding its overall state income tax exposure. Trustees have a fiduciary duty to consider the potential tax consequences of their trust administrative and distributions decisions, and moving the administration of the trust to a state with different tax rates or rules, changing trustees, decanting, or dividing a large trust into separate trusts can be useful tools when making these decisions.

**TAKE AWAYS:** State income tax on undistributed income can be a significant draw on trust resources, depending on the state or states in which the trust is a deemed resident for tax purposes. The migration of the trust's settlor, beneficiaries and trustees can unexpectedly expose the trust to new state income tax systems. Monitoring a trust's state income taxes requires advisors to be proactive and knowledgeable about potentially applicable state income tax rates.

***PRIOR REPORTS: 15-36; 14-23; 13-14.***

*WRMarketplace No. 15-36* discussed the federal income tax rules applicable to non-grantor trusts. In most cases, states also will tax the undistributed income of a non-grantor trust. As discussed in the prior report, trustees have a fiduciary duty to consider the potential tax consequences of their trust administrative and distributions decisions. Complex, conflicting, and often confusing state tax systems, however, can make navigating state taxes particularly challenging for both trustees and their advisors.

Careful planning during the implementation phase and ongoing evaluation during administration can help in monitoring the impact of state income taxes on non-grantor trusts.

### *STATE INCOME TAX RATES*

State income tax rates applicable to non-grantor trusts vary significantly from state to state. For example, Alaska, Florida, Nevada, New Hampshire, South Dakota, Texas, Washington, and Wyoming do not have a state income tax at the state planning level for non-grantor trusts. On the other hand, as illustrated in the sample of states identified below, other states' tax rates can run from a low of 3.07% to a high of 13.3%.

| State | Income Tax Rate |
|---|---|
| Pennsylvania | 3.07% |
| North Dakota | 3.22% |
| Indiana | 3.40% |
| Illinois | 3.75% |
| Arizona | 4.54% |
| Massachusetts | 5.15% |
| North Carolina | 5.75% |
| New York | 8.82% |
| Washington, D.C. | 8.95% |
| New Jersey | 8.97% |
| Minnesota | 9.85% |
| Oregon | 9.90% |
| California | 13.3% |

States that tax trust income typically tax all of the trust's income if the trust is deemed to be a "resident" of the state. For a "non-resident" trust, states usually tax only income generated from sources within the state (such as income from rental property or a business located in the state). Thus, evaluating a non-grantor trust's state "residency," including whether it is a resident of more than one state for tax purposes, becomes key to assessing the trust's state income taxes.

## ***BASIS FOR IMPOSING STATE TAX – STATE RESIDENCY***

The residence of a trust for state income tax purposes is determined by each state based on its own set of statutes, regulations, and case law. A provision in the trust instrument that the trust is governed by the laws of a particular state is not dispositive for purposes of determining the trust's residency for state income tax purposes.

Federal constitutional considerations require that a trust have a connection or "nexus" with the state in order for the state to have a basis for imposing taxes. Each state has developed its own criteria regarding what constitutes a nexus with the state that will cause a trust to be a tax resident. These criteria generally fall within one or more of the following categories:

| Basis for Trust Tax Residency |
|---|
| • **Trust Creator**:<br>o The settlor of an *inter vivos* trust was living in the state when the trust was created, funded, and/or became irrevocable.<br>o The trust was created under the will of a testator who lived in the state at the time of his or her death. |
| • **Trustee**: A trustee is a resident of the state. |
| • **Beneficiary**: A beneficiary is a resident of the state. |
| • **Trust Administration**: The trust is administered in the state. |

The determination of whether a trust falls within the tax system of a particular state is further complicated by varying nuances and definitions given to each criterion by the different states. For example, one state will deem a trust to be a tax resident if the settlor was a resident when the trust became irrevocable, while another state will deem a trust to be a tax resident based on the settlor's residence in the state when the trust was funded. Further, while some states base residency on only one factor (thereby decreasing the chances that the trust will be pulled into that state's tax system), other states have multiple factors to determine residency, any one of which could make the trust a state tax resident.

Adding even more complexity to the analysis, trust protectors, distribution advisors, investment committee members, and other fiduciaries could be deemed to be co-trustees by the state in which any of these persons resides, also bringing the trust into the tax system of that state.

Many clients also assume that a non-grantor trust will be tax resident in only one state, which is not the case. Application of each state's rules can result in the trust being deemed a tax resident of multiple states. Trusts with multiple beneficiaries or trustees are especially vulnerable to multi-state taxation.

*Example*: X, a resident of Illinois, dies in Illinois creating a testamentary trust under his will. X names Y, a resident of Arizona, as trustee of the trust and Z, a resident of California, as a distribution advisor (deemed to be a co-trustee under California law). The three beneficiaries of the trust, A, B and C, live in North Carolina, California, and Tennessee, respectively. The testamentary trust will be deemed to be an income tax resident in each of the five different states as follows:

| | |
|---|---|
| **Illinois:** | Under Illinois law, the trust is a resident because it is created under the will of an Illinois resident. |
| **Arizona:** | Under Arizona law, the trust is a resident because there is at least one Arizona trustee. |
| **Californi a:** | Under California law, two factors exist, each of which would qualify the trust as a resident:<br>• There is at least one California trustee<br>• There is a non-contingent California beneficiary<br>Note: If there are multiple trustees and/or multiple beneficiaries who are not California residents, income is apportioned. |
| **North Carolina:** | Under North Carolina law, the trust is a resident because there is at least one North Carolina beneficiary. |
| **Tenness ee:** | Under Tennessee law, the trust is a resident because there is at least one Tennessee beneficiary. |

To properly advise clients regarding their trusts' state income tax obligations, advisors need to be aware of the criteria used by the various states to determine when a non-grantor trust will be a tax resident.

### *PLANNING CONSIDERATIONS*

Although several of the standards for the imposition of state income taxes may be difficult to plan for (such as the residency, or a subsequent change in residency, of the settlor or the beneficiaries), it may be possible, through proper planning both during the initial formation phase and during the ongoing administration of the non-grantor trust, to account for other factors that impact the determination of a trust's residency for state tax purposes.

***Carefully Select the State of Trust Creation***. When creating a non-grantor trust, a preliminary question will be where to establish the trust. Selecting a state with low state tax rates (such as North Dakota, Indiana or Pennsylvania) or with no state tax (such as Alaska, Florida, Nevada, Texas or Wyoming) may help the trust deal with future state tax obligations on undistributed income. This typically will require the appointment of a trustee who resides in the desired state. Note that if the settlor or a beneficiary lives in a state that determines a trust's residence based on their individual residency, establishing the trust in a state with low or no state income taxes may have less effect.

***Change the Place of Administration by Amendment***. For an existing trust that is deemed resident in a state based on its place of administration, the trust instrument may allow the trustee to amend the trust to move the place of administration without the need for court proceedings.

***Decanting***. Decanting is another option for changing the place of a trust's administration, which also allows the trust to be updated or restructured (for example, to grant beneficiaries powers of appointment or to convert a non-grantor trust into a grantor trust).

***Change Trustees***. If the non-grantor trust is deemed to be a resident of a particular state based upon the residency of the trustee or the place of administration, changing trustees (and thus the place of administration) may change the tax residency of the trust.

***Name Additional Trustees***. If the trust's state residency is based on the residency of the trustees, adding trustees may be relevant. For example, one criterion used by California to determine whether a non-grantor trust is a resident is the presence of at least one of the trustees in that state. However, if only one of three co-trustees resides in California, only one-third of the trust's undistributed (non-California source) income will be subject to tax in California (assuming no non-contingent beneficiaries also reside in California).

***Divide a Pot Trust into Separate Trusts***. If a beneficiary of a "pot trust" (a single trust held for multiple beneficiaries) lives in a state that determines residency based on a beneficiary's residence in that state, dividing the trust into separate trusts, or segregating a portion of the pot trust into a separate trust for that beneficiary, may remove trust beneficiaries who are not residents from the impact of that state's taxes.

***Change the Situs of the Trust's Assets***. Nearly all states that tax trust income will impose tax on income having its source in that state, even if the trust is not a resident. Thus, the trustee may consider changing the situs of those assets, where possible, to a different state.

***Update Estate Planning Documents***. A few states will deem a revocable *inter vivos* trust to be a resident of the state if it is created by a resident or funded while the settlor lived in the state. This tax residency can continue even if the settlor moves to another state and dies while a resident of the new state. In such cases, terminating the old revocable trust and creating a new revocable trust can be beneficial. In this increasingly mobile society, it is important that clients have their documents reviewed by local counsel whenever they move to a new state.

***Life Insurance***. Life insurance also may be useful for trustees evaluating their trust's state income tax obligations. Growth that remains within the policy is not subject to current income or capital gains under appropriate and long-standing tax laws and principles. Further, if the policy is not a modified endowment contract, a trust can access cash value up to its basis in the policy without current state income tax.

***Federal Income Tax Considerations***. The federal income tax considerations discussed in *WRMarketplace No. 15-36*, including making income distributions and

managing investment portfolios, also apply to trusts when dealing with state income taxes.

### *TAKE AWAYS*

- State income tax on undistributed income can be a significant draw on trust resources, depending on the state or states in which the trust is a deemed resident for tax purposes.
- The migration of the trust's settlor, beneficiaries and trustees can unexpectedly expose the trust to new state income tax systems.
- Monitoring a trust's state income taxes requires advisors to be proactive and knowledgeable about potentially applicable state income tax rates.

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