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Subject: Ed Morrow, Jonathan Blattmachr and Marty Shenkman - Using Decanting and BDOT Provisions to Avoid a Peppercorn of Income Potentially Triggering State Income Tax on a Trust's Entire Income

"Generally, states can only tax the income of non-residents that is sourced to that state, but no more. States can tax all the income of their residents without regard to the source. However, a handful of states look to whether there is source income, or assets located in state, as a crucial factor to determine whether they may levy a tax over a trust's entire income. For these states, avoiding such income or assets in state can be extremely important in order to avoid state income tax on income not sourced to that state.

New York and New Jersey are the two highest profile, high-tax states that look to source income as a crucial factor in determining whether they may tax the entire income of a resident trust. North Dakota also lists source income as a relevant factor in determining whether it has sufficient nexus to tax a trust's entire income.

Other states, including Idaho, Iowa, Michigan, Montana, Pennsylvania and Virginia, look to whether there are assets located in the state as a factor.

Courts in many other states with extremely broad taxing statutes such as Illinois may ultimately view such factors as relevant in judging whether their statues are Constitutional 'as applied' to a taxpayer, even if these factors are not explicitly mentioned in their state statute or other guidance.

In theory, even a small amount of source income or assets, a 'peppercorn,' may be sufficient to create nexus for a state to tax the income of the entire trust, if other factors create a resident trust under that state's law.

Obvious solutions are to simply divest the trust of such assets, but it may be too late to do that in the year the asset is purchased or sold or income allocated. There are less drastic and more nuanced solutions to avoid the in-state taint, such as using beneficiary deemed owner trust (BDOT) provisions, and/or blocker trust solutions, to ensure the source income or asset is segregated from non-source income. Practitioners may consider integrating one of the concepts discussed into a trust plan even if there is

no anticipation of source income, in order to prevent unintended source income from tainting all of a trust's income.

These solutions can save significant state income tax in the above-mentioned states without the need to completely divest of the assets in question. Paying attention to how various states tax trust income may become more important as state governments struggle with the need for additional revenue sources in light of the pandemic. That pressure may well result in other states becoming more aggressive in taxing trusts so that the issue addressed in this article may become more common."

Ed Morrow, Jonathan Blattmachr and Marty Shenkman provide members with commentary that examines important tools and techniques to avoid state income taxes on trusts. Click this link to an extensive 50 state chart with highlighted excerpts and hyperlinks to state statutes, administrative regulations, case law, rulings and articles: **50 State Chart on Residency and Source Income Factors for State Income Taxation of Irrevocable Non-Grantor Trusts**. Members who would like to learn more about this topic should consider watching their upcoming **LISI** Webinar titled "**Leading Tools and Techniques to Avoid State Income Tax on Non-Grantor Trusts after *Kaestner* and *Fielding***" on Thursday September 30th at 1:00 PM EDT - 2:30 PM. Click this link to learn more or to register: **Ed Morrow, Jonathan Blattmachr and Marty Shenkman.**

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Now, here is Ed, Marty and Jonathan's commentary:

EXECUTIVE SUMMARY:

Generally, states can only tax the income of non-residents that is sourced to that state, but no more. States can tax all the income of their residents without regard to the source. However, a handful of states look to whether there is source income, or assets located in state, as a crucial factor to determine whether they may levy a tax over a trust's entire income. For these states, avoiding such income or assets in state can be extremely important in order to avoid state income tax on income not sourced to that state.

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Obvious solutions are to simply divest the trust of such assets, but it may be too late to do that in the year the asset is purchased or sold or income allocated. There are less drastic and more nuanced solutions to avoid the in-state taint, such as using beneficiary deemed owner trust (BDOT) provisions, and/or blocker trust solutions, to ensure the source income or

asset is segregated from non-source income. Practitioners may consider integrating one of the concepts discussed into a trust plan even if there is no anticipation of source income, in order to prevent unintended source income from tainting all of a trust's income.

These solutions can save significant state income tax in the above-mentioned states without the need to completely divest of the assets in question. Paying attention to how various states tax trust income may become more important as state governments struggle with the need for additional revenue sources in light of the pandemic. That pressure may well result in other states becoming more aggressive in taxing trusts so that the issue addressed in this newsletter may become more common.

COMMENT:

Don't Sneeze at Peppercorns

The states and jurisdictions that view source income or the location of some assets in state as a factor that could potentially allow the taxation of all of a trust's income, including non-source income, are as follows (with 2019 top marginal trust income tax rates):

New Jersey (source income and location of assets):	10.75%
New York State (source income and location of assets):	8.82%
New York City (source income and location of assets):	3.876%
North Dakota (source income):	2.9%
Idaho (location of assets – one of 3 out of 5 factors test):	6.925%
Illinois (location of assets, a potential factor in *Linn* case):	4.95%
Iowa (location of assets):	8.98%
Michigan (location of assets):	4.25%
Montana (location of assets):	6.9%
Pennsylvania (location of assets):	3.07%
Virginia (location of assets):	5.75%

Some of these states do not have this as an explicit factor in their statute, but in their administrative code, case law or other guidance (see chart).

Many other states, such as "founder states" may someday add such factors, either proactively, or more likely, as a result of an adverse court decision favorable to taxpayers, such as those occurring years ago in New

Jersey, New York, Michigan, Illinois, and Pennsylvania above.[2] A "founder state" is a state with a broad overreaching statute that purports to tax any trust created by a resident forever, regardless of whether there is a resident fiduciary, administration in state, assets located in state, state source income or even beneficiaries currently residing in the state.

Will Minnesota or North Carolina, fresh off their ignominious defeats in the *Fielding* and *Kaestner* cases, add such factors to their guidance as to when their state may still tax trust income? It would not surprise us if more state tax departments soon argue that source income or location of assets in state may be sufficient *with other statutory factors* to create nexus to tax, even when their own statutes do not list such factors as relevant.[3]

Courts may continue to uphold such statutes where the statutory basis of a state's taxation is found to be unconstitutionally broad as to some taxpayers, but where another factor, such as the receipt of state source income, is present, even though the state statute does not use that as a factor for imposing tax on all of a trust's income. After all, the Supreme Court listed a variety of factors that were not present in deciding that North Carolina could not constitutionally impose its income tax on the trust. Why did the court list these factors when the only factor North Carolina used to impose its tax was the residency of a trust beneficiary? Hence, avoiding state source income may be an important defensive strategy even if source income is not currently considered in the state statute or regulatory guidance as the basis for imposing its income tax.

Georgia, for example, has recently reluctantly admitted that it will follow *Kaestner* (as it must), but warned that any slight deviation from the specific facts present in *Kaestner* would subject the fiduciary to income tax.[4] Presumably this could include having a peppercorn of source income or assets located in Georgia.

Bruce Steiner, in *New York TSB-A-20(2)I: Any New York Source Income Will Destroy a Trust's Exempt Resident Trust Status*, LISI Income Tax Planning Newsletter #202 (July 28, 2020), recently discussed a two page New York State Department of Taxation and Finance opinion from earlier this year concluding that a mere peppercorn of New York source income from a publicly traded partnership is sufficient to trigger state income tax on the entire non-source income of a trust that would otherwise not be taxed by New York at all. This opinion is no surprise to New York practitioners.

Other states' tax departments might take a similar position that the minimal value of the assets is irrelevant and assume their statutes are Constitutional, though at least one state appellate court has found that *non-income producing* assets in state are insufficient by themselves to grant jurisdiction and nexus to tax a trust as a resident trust.[5]

Location of Assets v. Source Income

The location of assets in a state often overlaps with the concept of source income generated in state, but there are differences. Owing rental real estate in state could trigger both criteria. But a plot of land, vacation home or work of art located in state may generate no income whatsoever.

The mere location of assets may be a factor in determining whether a trust resides in New Jersey, New York State and New York City, Idaho, Illinois, Iowa, Michigan, Montana, Pennsylvania and Virginia.

By contrast, a trust might have source income that would cause an issue in New York, New York City, North Dakota and New Jersey without owning any assets located in the state. A pass-through entity, for example, may rent property or have employees working in that state or significant sales in that state, any of which may cause some apportionment of income to that state which is attributed to the company's owners, yet the company may not *own* any assets there.[6]

A company with more expenses than revenue may actually generate a source "loss" rather than source "income". Would this be sufficient for a state to tax a trust? The authors could find no authority on this topic and this was not discussed in the recent New York state tax department ruling, but it's quite likely that a state tax department viewing Forms K-1 that generate losses would even see a source "loss" as a relevant factor – it's possible that not even a mere peppercorn is needed under such an interpretation.

If a pass-through entity does own assets in state, however, is a trust deemed to own a portion of a pass-through entity's assets located in a particular state solely due to owning a portion of the pass-through entity? Like source income, this could happen quite inadvertently, without the knowledge of the trustee.

The answer to this may depend on the form of entity. Generally, a shareholder is *not* deemed to own a fractional portion of a corporation's assets. Thus, a trust owning shares in an S corporation that happens to own property in a particular state should not be deemed to own such property or have any direct property rights to it, other than through the corporation.

Owning an interest in a general partnership, however, is much less certain. Some states view a general partner as having property rights in the partnership's assets and view the sale of a general partnership interest as a sale of the underlying assets for nexus purposes. In such a case, the trust may be deemed to own property located in a state solely by virtue of its interest in the general partnership that owns such property. This, in turn, may cause all of the trust income to be taxed.

In an era of cheap and easy LLC formations, however, most trusts will likely own any partnerships in an LLC (or an LP or LLP variant), or at least they should. These entities are closer to corporations than general partnerships for many state law property principles and the general rule is that someone is not deemed to own any portion of or have specific property rights in an LLC's assets directly merely by virtue of owning a membership interest in the LLC.[7]

Constitutionality of a State Using the Location of Assets or Source Income as a Factor in Determining Trust Residency

It is debatable whether a state may use either of these two factors as an appropriate and relevant factor in determining whether a trust is a resident of a particular state, enabling the state to tax **all** of the trust's income, especially if their state statute does not even consider location of assets or source income as relevant factors. It may be decades before we know for sure. The Supreme Court in *Kaestner,* while it was a unanimous taxpayer victory, side-stepped these issues and issued an extremely narrow opinion that did not touch on whether such factors would be permissible to consider in determining nexus to tax all of a trust's income as a resident trust:

> Today's decision does not address state laws that consider the in-state residency of a beneficiary as one of a combination of factors, that turn on the residency of a settlor, or that rely only on the residency of noncontingent beneficiaries, see, e.g., Cal. Rev. & Tax.

Code Ann. §17742(a). We express no opinion on the validity of such taxes.[8]

There are excellent arguments that one or even both of these factors should be irrelevant and are impermissible factors in determining trust residency enabling the state to tax all non-source income – especially if the state statute does not even reference it. These arguments are beyond the scope of this newsletter. As a practical matter, few trustees or beneficiaries want to expend the time, hassle and cost of fighting a decade-long Constitutional battle against a state unless there is a very significant amount of tax at stake, and no easier options to simply avoid it. At the administrative hearing level, state taxing statutes are presumed to be Constitutionally valid, so it would often be years before a state court would even entertain the argument and multiple appeals would likely extend this further.

Why “Stock Deals v. Asset Deals” Matter When Selling Pass-Through

Before analyzing the solutions to avoid peppercorns of source income, remember that on the sale of a business structured as a pass through entity such as an LLC/LP taxed as a partnership or an S corporation, the *form* of the transaction can make a tremendous difference in how it is taxed for state income tax purposes.[9] For example, if a business is primarily in New Jersey or New York and the business is sold in an asset deal, or a stock deal treated as an asset deal for income tax purposes,[10] the owners will pay state income tax on most of the gain on sale whether the owner lives in Florida or Texas or the owner is a trust that might otherwise avoid state income tax on non-source income. It will be considered source income.

By contrast, most states follow the *mobilia sequuntur personam* “doctrine” that sources the capital gain from the sale of an intangible such as an LLC interest or stock to the residency of the owner.

This may not be true, however, if a general partnership interest is sold. Some states may even analogize and treat a member-managed LLC or general partnership interest in an LP as similar to the sale of a general partnership.[11]

Solution #1: Selling the Asset

The simplest solution to having assets located in or producing source income in a particular state is to sell the asset. Of course, sometimes there are very good reasons not to sell an asset – it may have restrictions on sale or take some time to sell, it may be a great investment or there may be significant capital gains that would trigger state and federal income tax, or a combination of these. In some cases the trustee may not realize that the state source asset, or the asset producing the peppercorn of state source income even existed until it is raised on a later state tax audit. That would make it impossible to even know to sell the asset.

Even if the asset is identified and then sold, however, it does not solve the state nexus issue for the year of sale or years before the sale, but it would certainly solve the issue for future tax years.

Solution #2: Placing an Asset Located in State into LLC/S Corp

Another solution that may be helpful in some cases is to contribute the offending asset to a closely held entity such as an LLC or corporation (likely taxed as an S corporation) in exchange for an LLC membership interest or stock. This may be sufficient under state law to convert the asset into intangible personal property whose nexus is tied to the owner's residency rather than where the underlying assets are located. Be aware, however, that some states look through single-member LLCs in other taxing contexts. Thus, using a single member LLC, while perhaps simple, may not provide the desired certainty of state tax avoidance. That negative result could occur even if a multi-member LLC or S corporation would clearly avoid state income taxation. LLCs taxed as partnerships would ordinarily be preferred over S corporations due to the inability to distribute appreciated assets or liquidate the S corporation without triggering gain.

This may not help remove the state source income taint which is so important in New York State, New York City, New Jersey and North Dakota However, it may be helpful in the states whose statutes or guidance look to the location of assets, such as Idaho, Iowa, Michigan, Montana and Pennsylvania. It may eliminate a potential argument and factor that founder states with broad taxing statutes may someday use to rebut that their statutes are not unconstitutional "as applied" to those trusts with assets or source income tied to the state.[12]

That said, with the budgetary issues states are experiencing due to the COVID-19 pandemic and economic downturn, some states may

increasingly try to look through single member LLCs or even other pass through entities for certain purposes, potentially including the nexus to tax. Maine and Connecticut, for example, are trying to impose a state estate tax on real estate sitused in state even if it is owned in an LLC considered as intangible personal property of a non-resident decedent.[13] Is that Constitutional? It's hard to say for certain and may depend on various factors.[14] For purposes of this article, this trend simply highlights that putting assets into a pass-through entity such as a single member LLC may not necessarily be enough to erase the nexus with a state even if the state only purports to look to the location of real or tangible assets in state. Thus, it may better to use some of the other methods discussed later in this article in conjunction with that the single member LLC technique.

Solution #3: Dividing the Trust or Decanting the Asset to Another Trust

Another solution would be to bifurcate the trust between the assets creating the taint and all the other assets. This might be done using a power appearing in many trust instruments and in the Uniform Trust Code permitting a trustee to divide a trust into multiple trusts (a power of division).[15]

If that route is not feasible, a simple decanting of the existing trust into two separate trusts may achieve the desired result. Decanting, similar to pouring a liquid, such as wine, from one container to another, describes the act of a trustee who is authorized and does invade the principal of a trust by paying it over to another trust for one, some or all of the beneficiaries of the original trust. There can be tax and non-tax consequences of decanting.[16] The vast majority of states have now adopted decanting statutes[17] and a trustee's decanting authority may exist under common law.[18] In any case, a trustee with such authority could transfer the "offensive" assets to a separate trust including one, if authorized in the statute, created by the trustee.

The IRS has issued several private letter rulings essentially respecting decanting, although in IRS Notice 2011-101, it asked for comments about the tax effects of doing so. Many comments were submitted to the IRS but the Service has failed to issue any additional guidance.[19]

In any event, a distribution by a trustee, who is authorized to do so, under the terms of the governing instrument or state law, presumably has the same tax effect of shifting the ownership and distributable net income (DNI) to the "new" trust. Hence, distributing the offensive assets (e.g., assets that produce state source income) to the "other" trust, should then prevent the original trust from thereafter having the adverse source income. How to ensure the prior year source income carries out to the new trust is discussed in the next section.

When a decanting occurs so there are two trusts rather than one, the multiple trust rule of Section 643(f), which causes two or more trusts to be treated as one for federal income tax purposes, should not apply. The multiple trust rule applies only "if a principal purpose for establishing one or more of such trusts or for contributing additional cash or other property to such trusts is the avoidance of ***federal*** income tax."[20] Dividing or decanting a trust to isolate source income for state tax purposes would be to limit overpayment of ***state*** income tax and could not constitute federal tax avoidance. May a state interpret IRC §643(f) as also applying to trust divisions and decantings done to avoid *state* income tax, without modifying their law that typically incorporates and starts with federal tax determinations of income? The authors do not know of any such case, but wary practitioners may wish to warn clients of such a possibility and consider this in evaluating the different solutions proposed in this article.

Further, the decanting could create one or more new trusts for just one or some but not all of the beneficiaries of the trust that is decanted. For example, the trustee may decide to send New York source income to New York resident beneficiaries since the state income tax would be paid regardless, and send other income to beneficiaries residing in other states who would not otherwise pay any New York income tax. Thus, the multiple trust rule may be also avoided if the beneficiaries of the two resulting trusts are different.

Solution #4: Using a Second Trust so that One Trust Soaks up the Taint and Permits the Other Trust to be Free of Source Income or Assets (the so-called "Blocker Trust" or "Mother/Daughter Trust" Combination)

Similar to bifurcating a trust and distributing the offending asset through division or decanting discussed above, the parties may use a second trust to divide the *income* rather than the assets. The concept of pre-

establishing a second trust as beneficiary of the first trust to receive only capital gains as a distribution from the main trust was previously discussed in *Ed Morrow on the Use of Non-Grantor Trusts for Income Tax Planning in New York in Light of Tax Reform,* LISI Income Tax Planning Newsletter #140 (April 25, 2018). This has more application for the sale of an interest in a multi-state pass through entity business with some assets, sales or payroll creating source income in New Jersey, New York (and potentially North Dakota).

The goal would be to avoid the source income taint by ensuring all the source income remains in one trust (that would pay state income tax on that income), while permitting the other trust to enjoy the benefits of only the non-source income (i.e. not taxed by NYS, NYC, NJ or ND or potentially other states where source income may otherwise taint all the income of the trust). This could be done either by sending the source income to another trust, or sending the non-source income to another trust.

In the latter instance, you might look at the first trust as *blocking* or soaking up the offending source income to allow a second trust to receive the remaining non-tainted income, similar to how a blocker corporation is used to keep income taxed inside of a corporation rather than passing that income through to the owners. In the second instance the approach is to simply pass all the source income out of the trust to another trust, which we'll refer to as a mother/daughter trust relationship.

Both of these techniques rely on understanding the allocation of income rules regarding trust distributions and how the *character* of income passes through to beneficiaries via distributions. Moreover, if it is preferable for capital gains to be distributed, one must understand how and when capital gains may be considered as part of distributable net income (DNI).

It helps to understand how the default rules work. First, the default rule is that capital gains are not part of distributable net income (DNI) and therefore distributions from the trust would not pass out capital gains.[21] However, capital gains are included in DNI if allocated to income or "paid, credited, or required to be distributed to any beneficiary during the taxable year". Regulations provide more detail on this and other exceptions to the default rule with several methods to have capital gains included as part of DNI.[22] If the trust instrument and trustee comply with these regulations, the capital gains may be taxed to beneficiaries (which may include another trust) to the extent of distributions up to DNI.

Secondly, the default rules require pro rata allocation of the various classes of income. For example, assume a trust has $1 million of capital gain and $500,000 of pass through entity income ($100,000 of which we will assume is source income) and $500,000 of interest and dividend income. $2 million total income but only $1 million DNI ($500,000 of pass through income plus $500,000 of interest and dividend income), ignoring other deductions. If a beneficiary (which may be another trust) receives $500,000, the pass through entity income (including the source income) and interest and dividend income would be pro-rated accordingly and 50% of each of those items of income would be allocated – including the source income.[23] Ordinarily, the trustee cannot simply decide to report only the pass through entity income or only the dividends and interest income as distributed to the beneficiary. The same would hold true if capital gains were part of DNI but not specifically allocated – a pro rata portion of the capital gains would pass out to the beneficiary.

This default rule is a problem in any attempts to segregate the peppercorn of source income, because a portion of the source income taint in the "mother trust" would follow any distribution of even a nominal amount to the "daughter trust."

However, like the default rule for capital gains being excluded from DNI, this general default rule also has a broad exception: if there are specific provisions in the governing instrument for the allocation, distribution or accumulation of different classes of income to different beneficiaries, such allocations must be followed.[24] Thus, capital gains could be specifically allocated to another trust as beneficiary and the pass through entity income (including or even limited to the source income) could be specifically allocated to other beneficiaries and/or walled off from distribution to other beneficiaries.

This allows the trustee to make distributions of only certain income (either the source income, or other income) to another trust, so that only one trust is now reporting any source income, and the non-tainted income is being reported to another trust.

Thus, with the proper language in the trust and mandated distributions by the trustee, one trust might report only the capital gains from the sale of an entity (which is not source income), but not the ordinary income attributable to the entity (which may have some source income to the extent some sales, payroll or property are in state), which would be taxed in the other

trust. Distributing source income out to another trust rather than distributing non-source income to another trust should lead to the same result, if specific allocations of income are made in the trust. The provisions of the first trust that owns the asset must specifically allocate the source income to the second trust, leaving only non-source income in the first trust. If sufficient distributions are made to the second trust to carry out all of that source income included in DNI to the second trust, this would leave only the capital gains which is typically non-source income in the first trust. Ideally, this distribution of the source income is mandatory rather than at the trustee's discretion. As noted in the regulations cited in endnote 21, the second trust as beneficiary of those assets will be deemed to have received all of that state source income directly.

If the nexus issue is the location of assets in state, rather than source income, then the first "blocker trust" solution of distributing only non-source income and out-of-state assets to the second trust would be preferred over the "mother/daughter" solution, because there is no way to avoid the taint of the first trust having owned the asset. For example, if the trust were established by a Pennsylvania resident or one of the other states noted above that looks to the location of assets in state and the trust owns a piece of real estate in that state, it would not help to distribute only source income to another trust, because the first trust would still own the offending in-state asset. The better practice would be to distribute all the *non-source* income to another trust that does not own an asset in that state. If the asset were non-income producing, this may even be all the income.

States do not necessarily have to follow federal tax law on all points, but they typically start with federal adjusted gross income and make any minor adjustments from there, rather than create their own special allocations and tax scheme.[25] Thus, states will generally follow special allocations, distribution deductions and the division of income among the trust, its beneficiaries, or even the grantor, unless it has enacted an entirely different scheme of taxation, such as the anti-ING statute in New York, or the modified throwback rules in New York and California, or Pennsylvania's differing treatment of irrevocable grantor trusts.[26]

Solution #5: Using Beneficiary Deemed Owner Trust (BDOT) or Partial Grantor Trust Provisions to Deem Beneficiaries or Grantors as the Direct Owner of Source Income or of In-State Assets to Remove the Taint from the Non-Grantor Trust as Separate Taxpayer

Rather than separate source and non-source income between two different trusts as separate taxpayers, it is also possible to divide income between the trust as a separate taxpayer and a grantor or beneficiary. Trusts can be part-grantor, part-non-grantor trusts. Provided that state income tax rules follow the federal rules with respect to grantor (or beneficiary deemed owner) trusts ("BDOTs") under IRC 671-679, this permits an additional way to avoid state income tax attributed to the trust itself.

Beneficiary deemed owner trusts (BDOTs) were discussed much more extensively in two prior LISI newsletters, which should be consulted for more detail.[27] Here is a quick primer how such provisions work. IRC §678 provides that:

> a) General rule
>
> A person other than the grantor **shall be treated as the owner** of any portion of a trust with respect to which:
>
> 1) such person **has a power exercisable solely by himself to vest** the corpus **or the income** therefrom in himself, or

A power to withdraw trust assets clearly implicates this, but this is usually anathema from the perspectives of restricted beneficiary control over assets, asset protection, and estate tax planning. This power may also apply to the power to vest "income", however. Treasury regulations and cases are clear that "income" in §678(a)(1) above refers to income as defined for federal income tax purposes, and not fiduciary *accounting* income (FAI). Thus the applicable definition would include capital gains or other income attributed to principal, provided the withdrawal power so provides.[28]

Importantly, whether the beneficiary actually withdraws the asset or the income (or how much is withdrawn) is completely irrelevant.[29] We refer to any trust in which the beneficiary must be taxed on all the taxable income, yet does not necessarily have any power over the corpus beyond this, as a beneficiary deemed owner trust, or "BDOT". In some circumstances involving state income tax, however, it may be beneficial to become a part-grantor trust (or part-BDOT) as to certain assets/income, and part non-grantor trust as to other assets/income.

Targeting Source Income to be Taxed Directly to the Grantor or to Beneficiaries and Away from the Trust

What if the trust instrument grants a beneficiary or beneficiaries (which may include another trust) the power to withdraw all state source income or any income derived from any assets located in state? Let's take the latter question first, as it is an easier question to answer.

Example #1: Trust has $10 million of total assets, with a small rental property worth $200,000 located in one of the offending states noted above such as New York or New Jersey that would in some cases tax all the trust's income solely because of this additional factor. If the trust grants one or more beneficiaries the right to withdraw all of the income attributed to this asset (e.g., rents, or capital gains upon sale), the beneficiaries are deemed to be the *owners* of the asset for income tax purposes, and all income, deductions and credits attributable to that asset must be attributed to them accordingly. The trust as a separate taxpayer would not be deemed to own the asset or its income for income tax purposes.

Current beneficiaries can split the right to withdraw income from an asset, but if the right to withdraw income is parsed so that some beneficiaries have differing rights (e.g. a New York resident beneficiary has the right to withdraw New York source income but a Connecticut resident beneficiary does not), the non-tax ramifications should be considered. If the potential is significant for large amounts of source income that might go beyond what the settlor would want the beneficiary to currently enjoy, the withdraw right over source income might be given to another trust for that beneficiary instead.

Example #2: Same as above. The small rental apartment is located in New York City and a planned concert celebrating a successful Covid vaccine is planned. Every major celebrity will be performing. The apartment has a bird's eye view of the park where the concern will occur and is rented out for the week of the concert for $20,000. That windfall passes to the same beneficiary who get the offending New York source income. How will the other beneficiaries feel? Practitioners need to be mindful that there can be real economic consequences to the planning that clients may not appreciate.

Example #3: Same as above, but the trust instrument grants the trustee the power to distribute such income (and *only* such income) to the grantor's

spouse. This would cause that income to be attributed to the grantor under IRC §677(a)(1). This may be quite important for any NY/NJ/ND resident seeking to use a spousal lifetime access non-grantor trust (SLANT) who would not want to taint the entire trust income, which may be quite important in the sale of a closely held partnership (LLC) or S corporation that may have a peppercorn of source income.

The trust as a separate taxpayer must report only the remaining income in the above examples under Subchapter J, parts A-D non-grantor trust rules.[30] There are several options for reporting the trust income attributed to the grantor or beneficiary.[31] For income tax purposes only, the asset is deemed to be owned by the beneficiaries (or the grantor in the third example), not the trust. The beneficiaries (or the grantor) are deemed to have received the income or paid the expenses generating any deductions or credits ***directly***, not through the trust.[32] Thus, the non-grantor trust as a separate taxpayer would never have any source income, nor be deemed to own the offending asset for income tax purposes.

The "portion" rules of Treas. Reg. §1.671-3(a) require dividing the deductions and credits as well as the income, so the non-grantor trust as a separate taxpayer can take no deductions or credits attributable to the portion deemed to be owned by grantor or beneficiary:

> (2) If the portion treated as owned consists of specific trust property and its income, all items directly related to that property are attributable to the portion. Items directly related to trust property not included in the portion treated as owned by the grantor or other person are governed by the provisions of subparts A through D (section 641 and following), part I, subchapter J, chapter 1 of the Code. Items that relate both to the portion treated as owned by the grantor and to the balance of the trust must be apportioned in a manner that is reasonable in the light of all the circumstances of each case, including the terms of the governing instrument, local law, and the practice of the trustee if it is reasonable and consistent.[33]

Thus, for example, a property management fee for the real estate in our first example above would be a deduction for the beneficiaries entitled to the income from the rent, not the trust, and an accountant's fee for Form 1041 tax preparation would have to be apportioned between the trust and the beneficiaries.

This treatment is clearly helpful when there is one asset only generating in-state source income, but what if there is a pass-through entity, which may even include a publicly traded partnership, that has significant income but only a small portion of it is sourced to that state? This was, after all, the situation in New York Tax Department's most recent state tax guidance on this issue.[34] Treasury regulations are clear that grantor trust rules (not just IRC §678) might apply to a specific asset and all its income, but what about *only* certain state source income from a particular asset? This is a trickier issue.

Example #4: a trust that is otherwise a non-grantor trust owns 1% membership interest of an LLC (taxed as a partnership). The LLC itself has $10 million of income, with $100,000 sourced to New York, and the Form K-1 to the trust shows its 1% share as $100,000 of income, only $1,000 of which sourced to New York. Can the trust permit the beneficiaries to withdraw *only the $1,000 sourced to New York* such that this only income is taxed to the beneficiaries and the other $99,000 is taxed to the trust as a separate taxpayer?

Similarly, if someone establishes an irrevocable trust for his or her children (and avoids all other grantor trust triggers making it a non-grantor trust) with the same asset as above, but grants the independent trustee the power to distribute *only* New York source income to their spouse (making such income taxable to the grantor under IRC §677), would this cause partial grantor trust status as to *only* the New York source income distributable to the spouse?

The answer should be *yes* to both scenarios. They both have a substantial independent economic effect of limiting the beneficiary's rights to only the source income. This allows the removal of the source income taint to the non-grantor trust by attributing the source income back to the grantor and permitting the trust to continue as an exempt resident trust never tainted by the source income. Should such a clause be required for any non-grantor SLAT (sometimes called a "SALT-y SLAT" or "SLANT") established as a non-grantor non-resident (exempt resident) trust that could otherwise escape state income tax but for the potential for source income (e.g., in NY, NJ, ND, but potentially other states, depending on future litigation)?

The wording of the withdrawal right may be quite important (or, in our second example, the trustee's discretion to distribute certain income). If

the trust instrument only grants the beneficiary the right to withdraw New York state source income (or the trustee the discretion to only distribute such income in the second example), arguably the grantor trust rules only apply to the $1,000 of New York state source income. Courts have split taxable income between ordinary income and capital gains and allocated different income between the grantor and non-grantor trust in prior cases.[35] That concept is well established in Treas. Reg. §1.671-3, but there is no discussion on parsing such income into further components. However, this conclusion seems to follow from the grantor trust principles enunciated in Treas. Reg. §1.671-3(a)(2) quoted above. In other contexts, Treasury regulations do seem to permit parsing between foreign income and non-foreign income, so such powers should be able to apply to different income that is capable of being calculated separately from a particular asset.[36]

The concept of targeting certain income is not exactly intuitive, but it does have parallels in the non-grantor trust rules, as discussed in Solution #4 above and the discussion of how Treasury Regulations permit specific allocations of different classes of income. Income received as cash is fungible, but the code and regulations adopt a fiction that certain income tax characteristics can be traced and attributed to certain beneficiaries or kept as taxable to the trust. Generally, outside of IRC §642(c) and certain foreign trusts, subchapter J does not require the *actual* tracing of income.

Going back to our Example #1 above, there is nothing in IRC §678 that requires any tracing, since the power to withdraw need not even be exercised in order to have the exact same tax effect.

Going back to our Example #2 above, where IRC §677 would apply to the New York source income distributable to the spouse, recall that IRC §677 applies regardless of whether any income is *actually* distributed, only that it "may be distributed." Thus, the tracing of this income should be irrelevant in that example as well, provided the trustee is tracking the *amount* of source income distributable.

An additional uncertainty related to this issue may be the prospect of "phantom income". Phantom income occurs when a pass-through entity distributes less than the income attributed on the Form K-1 or there is substantial debt relief on a sale such that the proceeds received are less than the income.[37] Building on our example #4 above, this would be if the Form K-1 showed $100,000 of income, $1,000 of which is sourced to New

York, but the LLC only distributed $60,000 to the trust (without any indication, of course, of whether this cash was sourced to New York). If this $60,000 were the only income received by the trust, the trust's fiduciary accounting income (FAI) would only be $60,000, not $100,000.

In Subpart E of Subchapter J of the Code, such as IRC §677 and §678 discussed above, whether income is fiduciary accounting income seems largely irrelevant, however.[38] The question is whether the beneficiary may vest $100,000 (not *the* actual $100,000, since tracing is irrelevant, but $100,000 in general) in our first example, or whether the trustee may distribute $100,000 (not *the* actual $100,000, since tracing is irrelevant, but $100,000 in general) to the spouse for IRC §677(a)(1) to apply in our second example. If the trustee has the abilityto actually distribute $100,000 (and must do so if actually requested), the beneficiary's access to this is not illusory at all, despite the receipt of phantom income, provided the trust agreement adequately addresses this issue and permits the trustee to satisfy the obligation other assets.

Thus, it is uncertain whether tax income imputed to but not physically received by the trust is imputed under section 678 to a beneficiary who has the power to 'vest' the income in himself or herself. However, it would seem that as long as the beneficiary can demand and receive cash equal to such imputed income, such income should be treated as vested in the beneficiary under section 678.[39]

QSSTs, which are essentially deemed to be BDOTs under §678(a) (at least until the sale of the S corporation stock or all its assets),[40] pass through phantom income all the time. In some cases, QSSTs could be used in place of a BDOT provision.[41]

Comparing Multiple Trust v. Part-Grantor/Part-BDOT Solutions

Using two or three trusts as noted above may effectively parse and allocate source income away from one trust and into another, but it does require additional fiduciary income tax preparation and attention to administration that may add to costs and complexity. This may be several thousand dollars more annually.

By contrast, if one trust is used, but part of the trust's income is attributed to a grantor or beneficiary, this may be reported on a Form 1041 using special

reporting as a “grantor trust”, or reported directly to the grantor or beneficiary as the deemed owner of the income, which some may prefer.[42] Unlike any income distribution deduction which, unless mandatory, relies on distributions being fully and timely made (and therefore careful attention paid to both distributions and 65-day elections), a grantor trust or BDOT provision such as discussed above must apply regardless of whether any portion of the income is actually distributed/withdrawn.

BDOT provisions are also preferred where there the trust owns S corporation stock and there is an electing small business trust (ESBT) election in place. An ESBT does not receive an income distribution deduction as to its S corporation income, so it is not possible to divide this income among multiple trusts and separate the source income from other non-source income.[43] When an ESBT is partly or wholly deemed to be owned by another taxpayer (a.k.a. grantor or beneficiary deemed owner trust), however, the trust is still eligible to make the ESBT election,[44] and the deemed ownership rules trump the ESBT/non-grantor trust rules as to the grantor/deemed owner portion.[45]

In addition, there is the slim risk discussed above of a state attempting to broaden its incorporation of IRC §643(f) concepts into state income tax enforcement where multiple trusts as separate taxpayers are used that have substantially similar grantors and beneficiaries. IRC §643(f) would not apply to part-grantor (part-BDOT) trusts, since the whole point of the statute is to avoid the abuse of using multiple trusts as separate taxpayers.

Conclusions – Solutions for Source Income and In-State Assets

Sometimes simply selling an asset, distributing it, contributing it to an LLC or decanting it to another trust may be the simplest solution in the long term to avoiding the potential taint of source income or assets located in a particular state. However, this may not help in a given year when an asset might be inadvertently transferred into the trust or source income is unexpectedly attributed to the trust without any recourse to undo the taint through such methods until the next tax year or later.

A BDOT provision permitting the asset and its income to be attributed to the beneficiaries or another trust may not save the source income from that asset from state taxation, but it may prevent the source income or asset from being attributed to the non-grantor trust over which the state may try to tax all of its other income.

The above planning concept may be taken a step further. No one may realize that an investment made by the trust in a partnership might inadvertently generate that peppercorn of tainted income. The existence of that peppercorn may not become apparent until an audit years later when an aggressive state income tax auditor assesses tax, interest and penalties on years of prior trust income tainted by the newly discovered peppercorn. Perhaps practitioners might consider including in such trusts a BDOT provision as a protective measure even if no source income is anticipated. Should that nettlesome peppercorn be discovered years later on an audit, the peppercorn of source income would be taxable to the beneficiary who was granted a withdrawal right over state source income, and the trust could not thereby be tainted.

Moreover, splitting the trust in two, either at the outset, or as a result of a trust division or a decanting, should also be able to segregate the offending state asset or income from the rest of the trust, provided that careful attention is paid to the provisions and regulations surrounding changing the default scheme of allocations of different types of income to different beneficiaries. Like the BDOT provision, this technique does not avoid the state being able to tax state income, it only avoids the state taxing all the *non-source* income.

We only listed a handful of states that we know will look to location of assets or source income. However, based on the trend of several court cases in various states, and the financial pressures on state and local governments from Covid, it may only a matter of time before courts in other states deem these two factors to be relevant in deciding whether their own overly broad state statutes may still be Constitutional as applied in a particular case, even where the state statute does not list it as a factor.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Ed Morrow

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[1] For a list of "founder" states and their broad taxing statutes, administrative code, rulings, cases and articles concerning them, see the 50-state chart linked to previously. The most egregious of these that purport to tax a trust indefinitely based on settlor residency alone include: Illinois (see discussion of *Linn* case below), Maine, Maryland (although the way the statute reads it may only apply while the settlor is living), Michigan (see discussion of *Blue* case in footnote 3), Minnesota (though it is now severely limited by its state supreme court decision in *Fielding v. Commissioner of Revenue*, Minn. Tax, May 31, 2017, aff'd MN 2018, 2018 WL 3447690, *cert. denied*, U.S. June 28, 2019 (No. 18-664)), Nebraska, New Jersey (limited by case law and other guidance), New York (limited by case law and other guidance), Oklahoma, Pennsylvania (see *McNeil v. Commw.*, 67 A.3d 185 (Pa. Commw. Ct. 2013), Vermont, Virginia (though limited

through state guidance), Washington, D.C., West Virginia and Wisconsin. These founder state statutes are so broad that if interpreted in some cases, are very likely to be unconstitutional *as applied*, but are likely to be held up in other cases as constitutional *if* sufficient other facts create nexus. A handful of other states such as Montana, Missouri, Ohio and Rhode Island also look to the residence of a settlor as a perpetual factor, but also require a resident beneficiary, which of course as a *sole* factor has been deemed unconstitutional by the Supreme Court in *Kaestner* (provided the beneficiary is contingent, that is, not actually receiving or required to receive assets in a given year). As an example of how a state court may view such statutes, which if anything is much more likely now after the *Kaestner* and *Fielding* cases, consider this reasoning the Illinois appellate court in *Linn v. Department of Revenue*, 2013 IL App (4th) 121055 used in denying the state the ability to tax a trust even though it clearly met the definition of a "resident trust" under state statute:

> Moreover, the Autonomy Trust 3 meets none of the following factors that would give Illinois personal jurisdiction over the trust in a litigation: "the provisions of the trust instrument, the residence of the trustees, the residence of its beneficiaries, the location of the trust assets, and the location where the business of the trust is to be conducted." Sullivan v. Kodsi, 359 Ill. App. 3d 1005, 1011, 836 N.E.2d 125, 131 (2005) (citing People v. First National Bank of Chicago, 364 Ill. 262, 268, 4 N.E.2d 378, 380 (1936)). Accordingly, we find insufficient contacts exist between Illinois and the Autonomy Trust 3 to satisfy the due process clause, and thus the income tax imposed on the Autonomy Trust 3 for the tax year 2006 was unconstitutional.

[2] *Potter v. Taxation Div. Director*, 5 N.J.Tax 399 (Tax Ct.1983), *Mercantile-Safe Deposit & Trust Co. v. Murphy*, 19 A.D.2d 765, 242 N.Y.S.2d 26, 28 (App Div, 3d Dept 1963), [2] *Blue v Michigan Department of Treasury*, 185 Mich App 406; 462 NW2d 762 (1990), *Linn v. Department of Revenue*, 2013 IL App (4th) 121055, *McNeil v. Commonwealth*, 67 A.3d 185, Pa. Comm. Court, Nos. 651 F.R. 2010, 173 F.R. 2011 (2013).

[3] Consider, for example, the Ohio Supreme Court decision of *T. Ryan Legg Irrevocable Trust v. Testa*, 149 Ohio St.3d 376 (Ohio 2016), in which the court held that a Delaware trust was a non-resident trust pursuant to Ohio statute, but that there was still sufficient nexus to tax the sale of an LLC

interest that would not have been taxed had the owner been a non-resident individual. See, *If A Non-Resident Business Owner is Trying to Avoid Ohio Income Tax on the Sale of an Ohio Business, Does she have a Legg to Stand on?* By Brian Layman and Edwin Morrow, Probate Law Journal of Ohio, Nov/Dec 2018, Vol. 29, Issue 2.

[4] Georgia Department of Revenue Policy Bulletin IT-2019-02 *Taxation of Nonresident Trust Fiduciaries – Effect of Kaestner Decision*

[5] *Blue v Michigan Department of Treasury*, 185 Mich App 406; 462 NW2d 762 (1990), in which the trust established by a Michigan resident decedent owned a non-income producing parcel of real estate in Michigan, but this was insufficient to create nexus for Michigan to tax the income of the trust where the trustee, administration and beneficiaries were in Florida. It is unclear from the decision whether the court would have permitted taxation of all the non-source income as a resident trust had the Michigan real estate produced taxable income. Note that the Michigan Department of Treasury only acquiesced in part to this decision and while it has recognized some Constitutional limits on its ability to tax, it will still look to whether a trust has assets in Michigan as a factor in creating nexus, despite the *Blue* case. Michigan Department of Treasury Revenue Administrative Bulletin 2015-15 states that:

> In addition, a trust that meets the definition of a resident trust may nonetheless become a nonresident trust if all the following are true: the trustee is not a Michigan resident; *the trust assets are not held, located or administered in Michigan*, and; all of the beneficiaries are nonresidents.

[6] For general principles that many states use in dividing income of a multi-state business operation among the various states involved, usually based on factors involving property, payroll and sales, see the Uniform Division of Income for Tax Purposes Act and the Multistate Tax Compact.

[7] E.g., "A membership interest in the limited liability company is personal property. A member has no interest in specific property of the limited liability company." N.Y. Ltd. Liab. Co. Law § 601.

[8] *North Carolina Department of Revenue v. Kimberley Rice Kaestner 1992 Family Trust*, 588 U. S. ____ (June 21, 2019).

[9] This was explored in more depth in *Ed Morrow on Corrigan v. Testa: Avoiding State Income Tax on Source Income*, LISI Income Tax Planning Newsletter #93 (May 25, 2016). Citations to state income tax rules regarding source income rules for the sale of LP/LLCs/S corporations are also hyperlinked and summarized in the 50 state chart.

[10] There are special tax elections under IRC 338(h)(10) and IRC §336(e) to treat a purchase and sale of stock as a sale of the company's assets for income tax purposes. Further explanation is beyond the scope of this newsletter.

[11] See, e.g., Oregon source income rules in the 50 state chart.

[12] E.g., *Linn v. Department of Revenue*, 2013 IL App (4th) 121055, *Blue v Michigan Department of Treasury*, 185 Mich App 406; 462 NW2d 762 (1990), both discussed elsewhere herein, but also see *Pennoyer v. Taxation Div. Dir*., 5 N.J. Tax 386 (1983) and *Potter v. Taxation Div. Dir*., 5 N.J. Tax 399 (1983), *Residuary Trust A u/w/o Fred E. Kassner v. Director, Div. of Taxation*, 27 N.J. Tax 68 (2013)

[13] 36 M.R.S. § 4104, discussed in Maine Revenue Services' Estate Tax FAQ #9. Connecticut General Statues 12-391(e)(2)(B).

[14] In *First National Bank v. Maine*, 284 U.S. 312, 52 S. Ct. 174, 76 L. Ed. 313 (U.S. 1932), the Supreme Court denied Maine the ability to levy an estate tax on a Massachusetts resident decedent who had owned stock in a Maine corporation that owned assets in Maine, under the due process clause of the Fourteenth Amendment to the Constitution. This case was overruled by *State Tax Comm'n of Utah v. Aldrich*, 316 U.S. 174 (1942), where the Court found that the state of incorporation also had enough nexus to levy an estate tax on the stock of a non-resident decedent who had owned stock in a corporation incorporated there (Utah). The Court's rationale for overruling *First National Bank v. Maine* completely focused on the laws of the state of incorporation (Utah in the latter case) creating the existence of the corporation, the nature and extent of the rights of the corporation and its shareholders and the legal protections Utah afforded as the state of incorporation – where the corporation owned property was not even mentioned, not even in the concurring opinion. Thus, following Aldrich, if someone places Maine or Connecticut real estate or other tangible property in an entity incorporated in the same state, those states could Constitutionally levy an estate tax at the shareholder/member's death. This begs the question – can Maine and Connecticut (or any other

state with an estate tax) Constitutionally tax a non-resident decedent owning an LP/LLC/corporation that in turn owns property there, but that is NOT incorporated in that state (unlike *Aldrich*), without violating due process jurisprudence? Probably not, but it may in turn depend on whether the entity is required to register, or has registered, as a foreign entity, which states often require for entities that transact business in state (even if this rule may often be ignored). See e.g., Uniform Limited Liability Company Act, §902, §905. The Court in *Aldrich* stated that a state that "has extended benefits or protection, or*** can demonstrate "the practical fact of its power" or sovereignty as respects the shares, may likewise constitutionally make its exaction [i.e. estate tax]." An out-of-state LLC owning a vacation home would typically not be "transacting business" and therefore not be required to register as a foreign entity, but an LLC owning property used in business would be, and an LLC owning investment property could be, depending on the level of activity. Id at §905(10) and comments. Wouldn't it be wise, considering the above two cases, for anyone with a potentially taxable estate owning vacation or passive investment property in a different state with an estate tax such as Maine or Connecticut, to own the property through an entity incorporated in a state without an estate tax?

[15] See, Uniform Trust Code §417: "COMBINATION AND DIVISION OF TRUSTS. After notice to the qualified beneficiaries, a trustee may combine two or more trusts into a single trust or divide a trust into two or more separate trusts, if the result does not impair rights of any beneficiary or adversely affect achievement of the purposes of the trust."

[16] See, generally, Blattmachr, Horn & Zeydel, "*An Analysis of the Tax Effects of Decanting*" Real Property, Trust and Estate Law Journal, Volume 47, Number 1, Spring 2015, and Zeydel & Blattmachr, "*Tax Effects of Decanting - Obtaining and Preserving the Benefits*," Journal of Taxation, Vol. 111, p. 288 (November 2009).

[17] *Phipps v. Palm Beach Trust Co*., 192 So. 299 (1940).

[18] Culler, State Decanting Statutes Passed or Proposed as of Jan. 14, 2020, available at https://www.actec.org/assets/1/6/Culler-Decanting-Statutes-Passed-or-Proposed.pdf.

[19] See, e.g., ACTEC Comments on Transfers by a Trustee from an Irrevocable Trust to Another Irrevocable Trust available at

https://www.actec.org/resources/comments-on-transfers-by-a-trustee/. The IRS has been "studying" decanting for nearly a decade now and has placed decantings that change beneficial interests of the beneficiaries on its "no ruling" list, but the decantings discussed in this article would not rise to that level. See Rev. Proc. 2020-3, § 5.

> AREAS UNDER STUDY IN WHICH RULINGS OR DETERMINATION LETTERS WILL NOT BE ISSUED UNTIL THE SERVICE RESOLVES THE ISSUE THROUGH PUBLICATION OF A REVENUE RULING, A REVENUE PROCEDURE, REGULATIONS, OR OTHERWISE"***
>
> (13) Section 2501.—Imposition of Tax.—Whether the distribution of property by a trustee from an irrevocable trust to another irrevocable trust (sometimes referred to as a "decanting") resulting in a change in beneficial interests is a gift under § 2501.
>
> (14) Sections 2601 and 2663.—Tax Imposed; Regulations.—Whether the distribution of property by a trustee from an irrevocable generation-skipping transfer tax (GST) exempt trust to another irrevocable trust (sometimes referred to as a "decanting") resulting in a change in beneficial interests is the loss of GST exempt status or constitutes a taxable termination or taxable distribution under § 2612.

[20] Treas. Reg. §1.643(f)-1(a).

[21] IRC § 643(a)(3).

[22] Treas. Reg. §1.643(a)-3(b)

[23] IRC §661(b), IRC §662(b); Treas. Reg. § 1.661(b)-1.

[24] IRC §661(b), IRC §662(b); Treas. Reg. § 1.661(b)-1, Treas. Reg. § 1.662(b)-1: "In determining the amount includible in the gross income of a beneficiary, the amounts which are determined under section 662(a) and §§ 1.662(a)-1 through 1.662(a)-4 shall have the same character in the hands of the beneficiary as in the hands of the estate or trust. The amounts are treated as consisting of the same proportion of each class of items entering into the computation of distributable net income as the total of each class bears to the total distributable net income of the estate or trust ***unless the terms of the governing instrument specifically allocate different classes of income to different beneficiaries…***". Further,

Treas. Reg. §1.651(b)-2(a) provides, in part, "if the terms of the trust specifically allocate different classes of income to different beneficiaries, entirely or in part,..., each beneficiary will be deemed to have received those items of income specifically allocated to him." [**emphasis** added]

[25] E.g., NY CLS Tax § 612.

[26] NY CLS Tax § 612(b)(41).

[27] *IRC §678 and the Beneficiary Deemed Owner Trust (BDOT)*, LISI Estate Planning Newsletter #2577 (September 5, 2017) and *Using BDOTs for Optimal Asset Protection and Income Tax Minimization After Passage of the Secure Act, LISI Income Tax Planning Newsletter #192* (February 18, 2020). The 2017 article has been extensively updated and is available to download free online from SSRN at: https://ssrn.com/abstract=3165592.

[28] Treas. Reg. §1.671-2(b):

> (b) Since the principle underlying subpart E (section 671 and following), part I, subchapter J, chapter 1 of the Code, is in general that income of a trust over which the grantor or another person has retained substantial dominion or control should be taxed to the grantor or other person rather than to the trust which receives the income or to the beneficiary to whom the income may be distributed, *it is ordinarily immaterial whether the income involved constitutes income or corpus for trust accounting purposes. Accordingly, when it is stated in the regulations under subpart E that "income" is attributed to the grantor or another person, the reference, unless specifically limited, is to income determined for tax purposes and not to income for trust accounting purposes*. [*emphasis* added]

When Congress decided to refer to income in the accounting or fiduciary income sense, it specifically stated so only for code sections involving non-grantor trusts (governed by subparts A-D in subchapter J) in IRC § 643(b) and specifically excluded such application from *subpart E* (IRC §671-679 grantor trust rules):

> (b)Income
>
> For purposes of this subpart and subparts B, C, and D, the term "income", when not preceded by the words "taxable", "distributable net", "undistributed net", or "gross", means the amount of income of

> the estate or trust for the taxable year determined under the terms of the governing instrument and applicable local law. Items of gross income constituting extraordinary dividends or taxable stock dividends which the fiduciary, acting in good faith, determines to be allocable to corpus under the terms of the governing instrument and applicable local law shall not be considered income.

This distinction is also noted in Treas. Reg. §1.677(a)-1(g) Example 2, which clearly assumes that "income" for purposes of subpart E grantor trust rules includes capital gains. See also, *Campbell v. Commissioner*, T.C. Memo 1979-495, PLR 2016-33021.

[29] See, e.g., *Campbell v. Commissioner*, T.C. Memo 1979-495, PLR 2016-33021, *Mallinckrodt v. Nunan*, 146 F.2d 1 (8th Cir. 1945)

[30] IRC §671:

> Where it is specified in this subpart that the grantor or another person shall be treated as the owner of any portion of a trust, there shall then be included in computing the taxable income and credits of the grantor or the other person those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust to the extent that such items would be taken into account under this chapter in computing taxable income or credits against the tax of an individual. Any remaining portion of the trust shall be subject to subparts A through D.

[31] Treas. Reg. §1.671-4.

[32] Treas. Reg. §1.671-2(c).

[33] Treas. Reg. §1.671-3(a)(2).

[34] New York State Tax Department Advisory Opinion TSB-A-20(2)I.

[35] E.g., in Glenn E. Edgar v. Comm., 56 TC 717, 07/08/1971, where the grantor was taxed only on ordinary income, but not on capital gains and losses.

[36] Treas. Reg. §1.671-2(c) "An item of income, deduction, or credit included in computing the taxable income and credits of a grantor or another person under section 671 is **treated as if it had been received or paid directly**

by the grantor or **other person (whether or not an individual)**. For example, a charitable contribution made by a trust which is attributed to the grantor (an individual) under sections 671 through 677 will be aggregated with his other charitable contributions to determine their deductibility under the limitations of section 170(b)(1). Likewise, **dividends received by a trust from sources in a particular foreign country which are attributed to a grantor or another person** under subpart E will be aggregated with his other income from sources within that country to determine whether the taxpayer is subject to the limitations of section 904 with respect to credit for the tax paid to that country." [**emphasis** added]

[37] This is sometimes referred to as *Crane* gain, after the Supreme Court case of *Crane v. Comm*., 331 U.S. 1 (1947). The relief of the debt is still included in amount realized even if non-recourse and can cause a realized gain, even if the taxpayer receives nothing, or much less than the gain, on sale.

[38] Treas. Reg. §1.671-2(b).

[39] Cf., however, *Sid Richardson Foundation v. United States*, 430 F.2d 710 (5th Cir. 1970), where it was held that income imputed from an S corporation to an estate which was bequeathed in its entirety to charity could not be treated as set aside for charity under Section 642(c). Section 642(c) require tracing, however.

What does it mean to *vest the income* under IRC §678? Does it only apply to the exact dollars coming in or does it just mean that the powerholder has an economic right to an amount equal to the income? It is more logical to conclude the latter, so long as the document makes it clear that that amount is still accessible, otherwise it would lead to absurd results that none of the logic of the decades of case law that Section 678 was patterned on would have followed. For example, if the trustee spent or reinvested some of the income during the year, a tracing rule would mean the beneficiary can't be taxed on that income any longer, even though they can access the exact same economic benefit as if the trustee had not spent or reinvested it. A trust could simply state "beneficiary, you can withdraw an amount of corpus equal to taxable income, but only so long as it is not traceable to actual taxable income" and the beneficiary would magically avoid taxation on most of the income even though they have clear access to the exact same economic benefit. That would be absurd and contrary to the principles established in the *Mallinckrodt* case, that when an individual

can freely access the benefits of the income, that individual should be taxed on it. The fact that taxation occurs under IRC §678 regardless of whether the powerholder actually withdraws anything simply reinforces the conclusion that tracing is not required.

[40] IRC §1361(d)(1):

> In general In the case of a qualified subchapter S trust [QSST] with respect to which a beneficiary makes an election under paragraph (2)—
> (A) such trust shall be treated as a trust described in subsection (c)(2)(A)(i), [i.e. grantor trust or BDOT, "(i) A trust all of which is treated (under subpart E of part I of subchapter J of this chapter) as owned by an individual who is a citizen or resident of the United States."]
> **(B) for purposes of section 678(a), the beneficiary of such trust shall be treated as the owner of that portion of the trust which consists of stock in an S corporation** with respect to which the election under paragraph (2) is made. [**emphasis** added]

A QSST is treated as the owner of the trust's S corporation taxable income, like a BDOT, even though § 678(a) would ordinarily require the beneficiary to have the ability to withdraw all taxable income rather than simply accounting income, otherwise it would be only a part-grantor trust.

[41] Since a QSST is basically a BDOT until the stock is sold, you could accomplish the exact same result as we propose (at least for individual source income producing assets such as a rental property in state), by placing the asset in an S corporation and having the beneficiary make a QSST election (provided it qualifies). The income would be attributed directly to the beneficiary and not to the non-grantor trust portion. While both can deem income to be attributed directly to beneficiaries, there are some advantages to the QSST and some to the BDOT – a QSST can shift taxation to the beneficiary regardless of distributions and permit the S corporation owner (which may be the trustee) to control distributions without giving the beneficiary access, which is very helpful in the Medicaid and government benefits arena regarding special needs trusts (see *The SECURE Act, Trusts, Corporations and CRTs*, by Jonathan G. Blattmachr, F. Ladson Boyle, Mitchell M. Gans & Diana S.C. Zeydel, July 2020 Issue of Estate Planning magazine). By contrast, an S corporation adds another

layer of complexity - it is difficult to distribute appreciated assets out of an S corporation without triggering taxation, and if the asset is included in one's estate, only the outside rather than the inside basis receives an adjustment to date of death value.

[42] Treas. Reg. §1.671-4

[43] IRC §641(c).

[44] Treas. Reg. §1.1361-1(m)(8)(iii) and (m)(2)(v).

[45] Treas. Reg. §1.641(c)-1(c).