

## **MY IRREVOCABLE TRUST HAS BEEN PAYING STATE INCOME TAX FOREVER. IS THERE ANY WAY TO AVOID STATE INCOME TAX?**

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### **Introduction**

State income taxes can be onerous. New York, New Jersey, California and other states are known for their high state income tax rates. Rates can reach 14%+ and the effects of a high state income tax on trust income over years, or decades for long term trusts, can exact a significant toll on the growth of trust assets. While most of estate planning is focused on grantor trusts, where the settlor creating the trust (and sometimes another person deemed to be the grantor) is charged with paying the income taxes on trust income, many trusts start off as non-grantor or so-called complex trusts that pay their own income taxes. Further, every grantor trust will at some point become a non-grantor trust so that every trust will face the issues of paying state income tax at some point. A trust that might initially be formed as a grantor trust might change into a non-grantor trust by actions taken during the trust term. When the settlor of a grantor trust dies, that trust will be recharacterized as a non-grantor or complex trust.

As with so many areas of planning, addressing the state income tax costs incurred by a non-grantor trust should be addressed in a broad holistic manner. You cannot just focus on avoiding state income taxes in a vacuum as that may have other significant non-tax consequences. Also, it should be addressed in many cases from a wide angle lens as asset protection, impact on beneficiaries, which family bucket pays charitable contributions, etc. may all have bearing on the plan.

Perhaps one of the most important developments in recent years has become the malleability of irrevocable trusts. Not so long ago “irrevocable trusts” were described to those creating the trusts as if they were “carved in stone.” That was the concept of an irrevocable trust. But nowadays even irrevocable trusts might be modified. Not all the time and not in every way, but if the necessary modifications to a trust can be achieved that may facilitate a better state income tax result that years ago may not have been viewed as feasible. For example, a change in trustees, restructuring of trust property, decanting (merging) the existing trust into a new trust with new administrative provisions, changes in a trustee by a resignation and appointment of a new trustee outside of the high tax state, actions of the trust protector, etc., might enable a trust that

had been subject to high state estate tax to minimize or avoid that tax. In some instances, no modification might be necessary, just a change in investments or distributions.

The take home point is that trustees who are paying high state income taxes should explore options to possibly mitigate that tax burden. Even if the decision is made not to make changes that might reduce state income taxes, communicating the reasoning and decision to beneficiaries might deflect a later challenge that the trustees did not properly manage the trust in a tax efficient manner. Documentation of having considered and rejected a course of action, even if not communicated to beneficiaries, may still prove protective of a trustee. The trust's professional advisers should also be alert to this state tax issue. When CPAs prepare trust income tax returns, Forms 1041, they should consider the state income tax implications and at minimum perhaps include a short memorandum or letter to the trustee suggesting that post-tax season a meeting be scheduled to review the state income tax implications of the trust.

This article will explore many different aspects of this planning.

## Table of Contents

I.	When state taxes are implicated and may be minimized or avoided .....	4
A.	Grantor trust income is taxable to the grantor in the jurisdictions where the grantor is taxed.....	4
B.	Generally, source income is taxable to the state where the income was earned or generated. ....	5
C.	“Home” is where the heart is – but what if there is no heart? .....	6
II.	State taxes – what’s the big deal?.....	6
A.	Top marginal tax rates can be very high in some states.....	6
B.	Trusts are subject to the \$10,000 cap on SALT deduction under the Tax Cuts and Jobs Act. 7	
III.	When is worldwide income taxable in your state? .....	7
A.	Trust residence is sometimes based on the residence of the settlor at the time that the trust was originally settled and irrevocable. ....	7
B.	In certain states, multiple factors could lead to the determination that the trust is a resident for income tax purposes. ....	10
C.	The <i>Kaestner</i> case evaluated the propriety of taxing a trust based on the residence of a beneficiary.....	12
IV.	Collaboration between the attorney, wealth advisor, tax preparer and trustee could be essential to ensuring that the trust avoids contacts with problematic jurisdictions. ....	14
A.	All advisors should understand that the nongrantor trust is seeking to avoid taxation in certain jurisdictions.....	14
B.	The trustee should probably reside in a tax-friendly jurisdiction, as this could be essential to avoiding tax in a problematic jurisdiction. ....	14
C.	Consider changing the trustee of a trust. ....	14
D.	For existing trusts, a practitioner should review trust instruments to determine whether there might be any opportunities to achieve resident exempt status. ....	15
E.	Practitioners may wish to structure trusts so that a beneficiary has a power under IRC Section 678 to vest all income sourced to any problematic jurisdiction up to the greater of \$5,000 or 5% of the trust corpus in him/herself. ....	16
F.	Use a Blocker or Second Trust. ....	17

## **I. When state taxes are implicated and may be minimized or avoided**

### **A. Grantor trust income is taxable to the grantor in the jurisdictions where the grantor is taxed.**

For any trust that qualifies as a grantor trust, the income is taxable to the original settlor (the person who created the trust), generally in the jurisdictions where the original settlor is taxed. Most states follow the federal rules on grantor trusts. Thus, the tax preparer would look to the home state of the original settlor and the rules governing taxability of the settlor in any other jurisdiction in order to determine which states might tax the trust income. It is unlikely that a settlor would be able to avoid or minimize income taxes that might be assessed by the settlor's home state on grantor trust income flowing through to the settlor.

In some instances, persons other than the settlor who created the trust might be taxed on trust income. For example, persons given certain powers in the trust document, might be taxed as the "grantor" for federal income tax purposes on trust income. Most states tend to follow the federal regime in these regards. Thus, if someone holds a power to withdraw trust income from the trust (e.g., a so-called 678 power) that person may be taxed on trust income. That might be done intentionally as discussed later in the context of using such a power to avoid any state source income in a particular trust (the "peppercorn" approach). Also, if a beneficiary holds an annual demand power to withdraw the greater of \$5,000 or 5% of trust principal, the trust may in whole or part be taxed as a grantor trust as to that beneficiary.

One notable exception to this general rule is Pennsylvania, which imposes income taxes on all irrevocable trusts, even those which qualify as grantor trusts under federal law.<sup>1</sup> For such trusts, it is necessary to calculate Pennsylvania tax at the trust level and determine whether any beneficiary is required to pay income taxes on the distributable share of income from the trust. In such cases, the tax preparer may have to issue Pennsylvania Schedules K-1 to beneficiaries for the income apportioned to Pennsylvania for state tax purposes even though all of the income is taxable to the settlor for federal income tax purposes.

The quirky Pennsylvania rule illustrates a broader point that should be considered. State income tax rules differ, sometimes considerably from state to state. There are a myriad of nuances of how a particular state's laws may affect trust income taxation. So, generalizations should be made with care. Yes, there are general concepts as to how states tax trust income, and later discussions will address some of those, but be certain to always have a tax professional familiar with a particular state's rules, confirm.

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<sup>1</sup> See the instructions for Pennsylvania Form PA-41.  
<https://www.revenue.pa.gov/FormsandPublications/PAPersonalIncomeTaxGuide/Pages/Estates-Trusts-Decedents.aspx#GrantorTrustsRevocTrusts> (visited 2/25/2023).

**B. Generally, source income is taxable to the state where the income was earned or generated.**

Taxpayers are usually subject to state or local taxes on their worldwide income, based on where they reside during the calendar year, according to the laws and regulations of such state or locality. Part-year residents may be taxable on worldwide income in two or more jurisdictions, based on factors set forth by the rules governing residency by each jurisdiction. This is quite important to consider. Two or even more states may lay claim to tax the same income. Unlike in the international arena where different countries have treaties to avoid double taxation by two or more countries taxing the same income, states do not have such treaties. High income taxpayers often make decisions about when and where to move, at least partially based on potential income tax exposure in any given jurisdiction. Some high income taxpayers also take aggressive positions claiming they are resident in a low or no-tax state when in fact they may not have taken sufficient steps to cement and corroborate that position. This can give rise to costly and complex audits by state tax authorities.

Taxpayers may also be subject to state and local income taxes ("SALT tax") in other jurisdictions where they are not considered to be residents. For example, if you have income generated by a business in a particular state, that state may seek to tax that income regardless of where you reside.

Whether a SALT tax may be assessed against a nonresident generally hinges on the application of the due process clause under the 14<sup>th</sup> Amendment of the U.S. Constitution, which generally requires that the taxpayer have certain minimum contacts or nexus with the jurisdiction seeking to assess the tax, before such tax may be assessed.<sup>2</sup> The concept of nexus generally allows a state or locality to assess a SALT tax on income earned from business activities where the business operations are carried on within the state or on rental income for rental property located in the jurisdiction. Bear in mind that this is a continually evolving area of tax law. Internet commerce remains relatively new and state tax laws are still working out the paradigm shift of how to tax which income based on internet and other virtual concepts that had historically been rooted in clearer constructs like where is the store that sold the merchandise.

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<sup>2</sup> See, generally, *International Shoe v. State of Washington*, 326 U.S. 310 (1945), wherein the Supreme Court laid out the factors that would need to be met in order to establish sufficient minimum contacts. See also *Miller Bros. Co. v. State of Maryland*, 347 U.S. 340 (1954), which at page 345 clarified that the nonresident state would need to establish a "definite link, some minimum connection, between [the] state and the person, property or transaction it seeks to tax." A complete analysis of the Constitutional underpinnings supporting the assessment of nonresident income taxes is beyond the scope of this article.

### **C. “Home” is where the heart is – but what if there is no heart?**

Much like individuals, nongrantor trusts will be taxed in states or localities where they are considered to “reside.” Residency for individuals is a question of intent, specifically, where does the individual intend to reside? As the New York courts have stated: “The test of intent with respect to a purported new domicile has been stated as ‘whether the place of habitation is the permanent home of a person, with the range of sentiment, feeling, and permanent association with it.’”<sup>3</sup> Each state has its own factors, but New York may have set the gold standard for evaluating whether an individual is a resident for income tax purposes. During a New York residency audit, it is typical for the auditor to inquire about all aspects of a taxpayer’s life. A non-exhaustive list of the considerations might include: place of employment, location and extent of business activities, location of routine medical services and bank accounts, the approximate value of abode within and outside of the state, voter registration, drivers license jurisdiction, and religious, social and community involvement.

Of course, many of these factors simply do not apply to a nongrantor trust because, much like the Tinman from the Wizard of Oz, a trust does not have a heart. For this reason, states have had to devise statutory tests to determine whether a trust would be considered a resident which is taxable on worldwide income in that jurisdiction. By understanding these tests, practitioners may be able to minimize exposure to SALT taxes for nongrantor trusts on worldwide income. The question of whether and how much source income a nongrantor trust might have in any particular jurisdiction must also be considered as part of any state income tax analysis.

## **II. State taxes – what’s the big deal?**

### **A. Top marginal tax rates can be very high in some states.**

A survey of various states throughout the country demonstrate that income tax rates can be fairly high in some states and nonexistent in others. The following ten states have particularly high marginal tax rates for nongrantor trust income: California (13.30%), Iowa (8.53%), Minnesota (9.85%), New Jersey (10.75%), New York (10.90%, plus New York City at 3.876%), South Carolina (7.00%), Vermont (8.75%), and Washington, D.C. (10.75%).<sup>4</sup>

Further, the introduction of a so-called “millionaire” tax in some states could increase the top marginal tax rate for high income earning taxpayers. In a ballot measure approved by voters in Massachusetts, the state added a 4% tax to its tax rate of 9% for

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<sup>3</sup> Matter of Bodfish v. Gallman, 50 A.D.2d 457 (N.Y. Sup. Ct., App. Div. 1976). See, generally, Shenkman, Rothenberg, Matak. “Changing Domicile for Tax Benefits and Asset Protection: The TCJA and Recent Court Decision Change the Calculus.” The CPA Journal (New York State Society of CPAs), October 2019.

<sup>4</sup> Please see the 8th Annual Non-Grantor Trust State Income Tax Chart by Steve Oshins of the Law Offices of Oshins & Associates, LLC in Las Vegas, Nevada, [https://sfo2.digitaloceanspaces.com/ultimate-estate-planner/wp-content/uploads/2022/05/06103830/2022-8thAnnualNonGrantorStateIncomeTaxChart\\_SteveOshins.pdf](https://sfo2.digitaloceanspaces.com/ultimate-estate-planner/wp-content/uploads/2022/05/06103830/2022-8thAnnualNonGrantorStateIncomeTaxChart_SteveOshins.pdf) (the Oshins Chart.)

state residents with annual income over \$1 million.<sup>5</sup> Several states appear poised to add similar surcharge taxes to high income earners in their states, “including California, Connecticut, Hawaii, Illinois, Maryland, New York, Oregon, and Washington.”<sup>6</sup> These rules and rates fluctuate frequently with the whims of political change, state financial needs, and voter sentiment. So whatever decision may have been made in terms of state tax impact to plan for, it should be reviewed periodically to determine if the ground rules have changed.

### **B. Trusts are subject to the \$10,000 cap on SALT deduction under the Tax Cuts and Jobs Act.**

The Tax Cuts and Jobs Act or TCJA capped the deduction for state and local income, property and other taxes paid by an individual, married couple or a trust to \$10,000 in any calendar year.<sup>7</sup> In other words, for so long as TCJA is in place, there is no federal tax benefit for a taxpayer who pays state and local taxes that exceed \$10,000, in the aggregate in any given tax year. Since enactment of TCJA, high income taxpayers (including nongrantor trusts) and their advisors focused more intently on the issue of state income taxes and ways to mitigate the expense. While it is also possible to shift a vacation home to a nongrantor trust that may then provide another \$10,000 SALT deduction for property taxes the costs and complexity of that type of planning have limited its use.

## **III. When is worldwide income taxable in your state?**

### **A. Trust residence is sometimes based on the residence of the settlor at the time that the trust was originally settled and irrevocable.**

The following is an excerpt from an article originally published on May 21, 2020 in WealthManagement.com, with revisions as noted:<sup>8</sup>

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<sup>5</sup> See [Fair Share Amendment - Mass. Budget and Policy Center \(massbudget.org\)](https://www.massbudget.org/fair-share-amendment/) for a list of frequently asked questions about the measure. See also <https://itep.org/massachusetts-voters-score-win-for-tax-fairness-with-fair-share-amendment/> (visited 2/25/2023).

<sup>6</sup> Erskine. “Coming Soon to Your State: A Millionaire’s Tax.” WealthManagement.com, February 23, 2023. <https://www.wealthmanagement.com/high-net-worth/coming-soon-your-state-millionaire-s-tax> (visited 2/25/2023).

<sup>7</sup> The title “Tax Cuts and Jobs Act” or “TCJA” is the unofficial title of the “Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018” (Pub. L. 115-97), which is the major tax legislation enacted and signed into law by then-President Trump at the end of December 2017. It became effective on January 1, 2018 and parts of it are set to expire on December 31, 2025 by its own terms, unless Congress passes a bill to make it permanent. For convenience, this legislation will be referred to as TCJA throughout this article.

<sup>8</sup> Matak. “State Income Tax Planning and Opportunities.” Wealth Management, May 21, 2020. <https://www.wealthmanagement.com/estate-planning/state-income-tax-planning-and-opportunities>.

Many states,<sup>9</sup> like New York<sup>10</sup> and Illinois,<sup>11</sup> determine residence of a trust based on where the settlor of the trust resided at the time that the trust was originally settled. For these states, residence is permanent; no matter where the beneficiaries live, the corpus is located, the trustees are located or where the settlors someday move, the trust will remain a resident trust for state income tax purposes. Generally speaking, most of these states have laws – whether by enacted statute or decided by common law – that allow fiduciaries to claim an exemption from state income tax. For example, in 1983, New Jersey determined in two landmark cases that it was unconstitutional for the state to impose an income tax on the undistributed income of trusts when both the fiduciaries and current beneficiaries resided outside of New Jersey and no trust property was located within the state.<sup>12</sup>... [This conclusion by the New Jersey court was upheld more recently in 2013.<sup>13</sup>]

New York's three-prong test for exemption from income taxes is: (1) All trustees domiciled outside of New York; (2) All trust property located outside of New York, and (3) No New York source income.<sup>14</sup> However, New York residents may be subject to an accumulation tax on any distributions received from a New York resident exempt trust to the extent that any distribution received is deemed to have included any undistributed net income earned in a prior year.<sup>15</sup>

\*Additional note: New York has made clear that a de minimus amount of New York source income will require a New York resident exempt trust to be taxed on its worldwide income. Per the facts laid out in a February 2020 Advisory Opinion, the taxpayer trust held two primary intangible investments: New York exempt bond funds and a publicly traded partnership. In the end, only about 1% of the trust's total taxable income was sourced to New York State.<sup>16</sup> Nonetheless, despite the taxpayer's

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<sup>9</sup> See e.g., Alabama, Connecticut, Illinois, Maine, Michigan, Minnesota, Nebraska, New Jersey, New York (includes New York City), Oklahoma, Pennsylvania, Rhode Island, Vermont, Washington, D.C., West Virginia, and Wisconsin. This list is non-exhaustive. State laws are subject to change. Please always check specific state statutes for guidance and do not rely on this listing. See Oshins Chart, *supra* note 4.

<sup>10</sup> NY Tax L. Section 605(b)(3).

<sup>11</sup> 35 ILCS 5 Illinois Income Tax Act Sect. 1501 (a)(20).

<sup>12</sup> NJ Rev Stat Section 54A:1-2(o). See *Pennoyer v. Taxation Div. Dir.*, 5 N.J. Tax 386 (1983) and *Potter v. Taxation Div. Dir.*, 5 N.J. Tax 399 (1983), concluding that imposing state income taxes in such circumstances would violate the due process clause of the constitution of both the United States and state of New Jersey.

<sup>13</sup> See *Residuary Trust A u/w/o Fred E. Kassner v. Director, Div. of Taxation*, 27 N.J. Tax 68 (2013).

<sup>14</sup> See NY Tax L. 612(b)(40).

<sup>15</sup> Note that a distribution from a New York resident exempt trust to a New York resident beneficiary won't be subject to the accumulation tax if one of the following exemptions apply: The trust's income has already been subject to New York tax; the income was earned before Jan. 1, 2014; the income was earned during a period when the beneficiary was not a New York resident; or the income was earned before the beneficiary turned 21. Generally, income for these purposes will include interest and dividends, but not capital gains.

<sup>16</sup> TSB-A-20(2)I. See discussion in: Matak. "Avoiding State Income Tax May Be Harder Than You Think." Wealth Management, August 6, 2020. <https://www.wealthmanagement.com/high-net-worth/avoiding-state-income-tax-may-be-harder-you-think>.

constitutional argument that “imposition of tax on the Trust would violate due process” because the NY-source income was de minimus in comparison with the rest of the taxable income, the state concluded that “all the income, regardless of source, earned by the [ ] Trust is subject to New York income tax as a resident trust.” Ultimately, New York concluded that the trust would be taxed on its worldwide income.

Connecticut also determines whether a trust is a resident for income tax purposes based on the residence of the settlor at the time that the trust became irrevocable.<sup>17</sup> However, whereas other states allow exemptions from state income taxes for both inter vivos and testamentary trusts based on various factors, Connecticut treats testamentary trusts differently from inter vivos trusts. Specifically, in *Gavin*, the Connecticut Supreme Court concluded that testamentary trusts established on the death of a Connecticut resident will remain taxable in Connecticut regardless of whether the trust has any other nexus with Connecticut.<sup>18</sup> Pointing to the fact that the Connecticut probate courts were required to approve the original trustees and their successors and otherwise assure the continued existence of testamentary trusts established as part of the probate process, the court opined that the minimum contacts with the state required to satisfy due process were met by the benefits and opportunities afforded the trusts by the Connecticut courts and legal system. The state's laws determined the validity of the trusts and assured their continued existence.

The Illinois appellate court in *Linn* found it compelling that the *Gavin* court distinguished testamentary trusts from inter vivos trusts.<sup>19</sup> The Illinois court pointed out that the connection between an inter vivos trust created by a resident settlor and the state was “more attenuated than a testamentary trust” because the inter vivos trust “does not owe its existence to the laws and courts of the state of the grantor in the same way a testamentary trust does and thus does not have the same permanent tie.”<sup>20</sup>

For both Connecticut and Illinois, an inter vivos trust established by a resident may avoid state income taxes so long as: (1) neither the trustee nor any current beneficiaries reside within the state; and (2) the trust doesn't own any assets located within the state.

Additionally, Connecticut clarifies that the taxable income of a resident trust does not include income allocable to a “nonresident noncontingent beneficiary” whose interest is

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<sup>17</sup> See CT Gen Stat. Section 12-701(a)(4)(C)-(D) (2018).

<sup>18</sup> See *Chase Manhattan Bank v. Gavin*, 249 Conn. 172, 733 A.2d 782, cert. denied, 528 U.S. 965 (1999).

<sup>19</sup> *Linn v. Dept. of Rev.*, 2013 Ill App (4<sup>th</sup>) 121055, at para. 25. Pursuant to CT Gen Stat. Section 12-701(a)(4) (2018), when an inter vivos trust “... has one or more nonresident noncontingent beneficiaries, the Connecticut taxable income of the trust” is determined by multiplying all non-Connecticut source income by “a fraction the numerator of which is the number of resident noncontingent beneficiaries and the denominator of which is the total number of noncontingent beneficiaries” and adding the product to all Connecticut source income. Additional modifications are required under the statute to determine the alternative minimum taxable income of the trust, based on the ratio of noncontingent nonresident beneficiaries to all noncontingent beneficiaries.

<sup>20</sup> *Linn*, *ibid.*, at para. 28.

not subject to a condition precedent.<sup>21</sup> A noncontingent beneficiary includes every individual to whom a trustee of a nontestamentary trust during the taxable year (i) is required to distribute currently income or corpus (or both) or (ii) properly pays or credits income or corpus (or both) or (iii) may, in the trustee's discretion, distribute income or corpus (or both).

**B. In certain states, multiple factors could lead to the determination that the trust is a resident for income tax purposes.**

1. For some states, "administering" a trust within the state will be sufficient to cause taxation in that state.<sup>22</sup> Determining where administration occurs is often unclear. Where does a trust company actually have its operations? If an out of state trustee merely has a meeting in the state with a beneficiary is that sufficient? What if the meetings are all via web meetings? Give the growing reliance on outsourcing what actual activities must occur in state? See the discussion of the Kaestner decision below.
2. In some states, a trust will be taxable to the extent that there's a resident beneficiary and other factors such as assets located within the state, resident trustees, source income and/or creation of the trust by a state resident.<sup>23</sup> See the comments near the end of this article concerning how states may view the newer trust functions, like "directors," or "advisers" in terms of being the equivalent of a trustee or not for nexus purposes.

As a recent example, effective July 1, 2019, Virginia changed its definition of a "residence trust" effective July 1, 2019 so that it may tax the worldwide income of a trust whose original settlor was a resident at the time the trust was created or tax any trust that is administered within the Commonwealth of Virginia.

3. California determines residence of a trust based on the residence of either the trustees or the noncontingent beneficiaries.

In Information Letter 2015-02, the California Franchise Tax Board explained that one or more of the following three separate elements must exist in order for California to tax the income of a trust:

- a) The trust has income from California sources.

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<sup>21</sup> CT Gen Stat. Section 12-701(a)(9)-1.

<sup>22</sup> *E.g.*, Arizona, Colorado, Indiana, Kansas, Kentucky, Mississippi, Montana, New Mexico, Oregon, South Carolina, Utah and Virginia. See Oshins Chart, *supra* note 4.

<sup>23</sup> See, *e.g.* Delaware, Hawaii, Idaho, Iowa, Massachusetts, Missouri, North Dakota, Ohio and Rhode Island. See Oshins Chart, *supra* note 4.

Where the only basis for taxing a trust is that the trust has California source income, only that source income will be taxable in California.

b) A trustee of the trust is a resident of California.

A corporate fiduciary will be deemed to be a resident of the state where it administers the trust. Residence for an individual fiduciary is not defined under the relevant statute but generally, an individual should refer to the rules governing the residence of individuals as a matter of California state law.<sup>24</sup>

c) A non-contingent beneficiary of a trust is a resident of California.

California defines a non-contingent beneficiary as one whose interest is not subject to a condition precedent.<sup>25</sup> The determination of whether a beneficiary is contingent or non-contingent will depend primarily on the distribution standards and rights of the beneficiary under the trust agreement and the trustee's exercise of discretion in administering the trust subject to such standards. Under regulations adopted by the California Franchise Tax Board (the "FTB"), a nongrantor trust will be taxable on its California source income and on the proportion of "all net income... from all other sources which eventually is to be distributed to the non-contingent beneficiaries who are residents of this State."<sup>26</sup>

The FTB explains that if the interest of a California beneficiary is subject to the discretion of a non-resident trustee, the undistributed income of such trust should not be subject to a California tax.<sup>27</sup> Specifically, the FTB ruling states:

A resident beneficiary whose interest in a trust is subject to the sole and absolute discretion of the trustee holds a contingent interest in the trust. The exercise of the trustee's discretionary power is a condition precedent that must occur before the beneficiary obtains a vested interest in the trust. ... However, the trust document should be reviewed in each case to determine any limitations on the trustee's discretion to accumulate income rather than to distribute it to the beneficiary.<sup>28</sup>

The statute does not provide for apportioning of the trust's income based on the extent to which the beneficiary's interest is non-contingent.<sup>29</sup> As a result, if a resident beneficiary is entitled to, for example, one-third of the trust income, the entire trust, not one-third of the trust, will be subject to California income tax. If the non-contingent beneficiary is both the sole beneficiary and a resident of California, the trust must then report all its income and gains for California income tax purposes.

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<sup>24</sup> California Revenue and Taxation Code §17742.

<sup>25</sup> California Revenue and Taxation Code §17742(b).

<sup>26</sup> 18 Cal. Code Regs. § 17744.

<sup>27</sup> Technical Advice Memorandum 2006-0002.

<sup>28</sup> Id.

<sup>29</sup> California Revenue & Tax Code §17742(a).

- d) California will apportion income based on the residency of the fiduciaries and the beneficiaries.

Where a nongrantor trust has both resident and non-resident fiduciaries, California will apportion the worldwide income of the trust based on the number of resident fiduciaries over the total fiduciaries then serving. California will further apportion income based on the number of non-contingent resident beneficiaries over the total number of beneficiaries.

- e) California has a throwback taxing regime.

In California, income that is accumulated in the trust would be taxable upon distribution to a beneficiary who then resided in California.<sup>30</sup> California imposes a throwback tax upon the beneficiary, effectively levying a tax against the beneficiary at the beneficiary's highest tax rate for the year in which the income was earned by the trust. The throwback period is 5 years from date of any distribution.

### **C. The *Kaestner* case evaluated the propriety of taxing a trust based on the residence of a beneficiary.**

In the summer of 2019, the U.S. Supreme Court struck down a North Carolina statute which taxed a trust solely on the domicile of a beneficiary.<sup>31</sup> Specifically, the Court noted: "... the presence of in-state beneficiaries alone does not empower a State to tax trust income that has not been distributed to the beneficiaries where the beneficiaries have no right to demand that income and are uncertain ever to receive it." In the case, the Court was concerned about three factors: 1. the beneficiaries did not actually receive income from the trust; 2. the beneficiaries had no right to demand trust income or otherwise control, possess, or enjoy the trust assets; and 3. it was not certain that the beneficiaries would ever receive income from the trust.

Georgia and Tennessee had similar statutes but, since the Supreme Court made clear that its decision in *Kaestner* was specifically limited to the facts and circumstances of that case, the Georgia Department of Revenue determined that unless the facts of a case were exactly like those in *Kaestner*, Georgia would continue to tax a trust if a beneficiary were a domiciliary of the state.<sup>32</sup> Specifically, in the wake of *Kaestner*, Georgia clarified that a nongrantor trust would not be subject to tax where the beneficiary was not receiving distributions, could not demand distributions and had no expectations of receiving distributions in the future.

Instead of settling the matter of whether it is acceptable for a state to tax a non-grantor trust based on the residency of the beneficiary, the Court merely identified facts that would not allow a state to tax a trust based *solely* on the beneficiary's residency. Specifically, the *Kaestner* Court was particularly persuaded that the beneficiary had no

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<sup>30</sup> California Revenue & Taxation Code §17745.

<sup>31</sup> *North Carolina Department of Revenue v. Kimberley Rice Kaestner 1992 Family Trust*, 588 U.S. \_\_\_\_ (2019). An in-depth evaluation of the *Kaestner* case is beyond the scope of this article.

<sup>32</sup> Georgia Department of Revenue Policy Bulletin IT-2019-02.

control over the assets of the trust, could not demand any trust income, and did not actually receive any income from the trust during the years in question.

The Kaestner Court also note that the trustee resided out of State, trust administration was split between New York (where the Trust's records were kept) and Massachusetts (where the custodians of its assets were located), and the trustee made no direct investments in North Carolina. Do these statements mean that if some trust administration occurred in North Carolina and/or there had been a direct investment there that the state could impose its income tax on the trust's undistributed income? The court mentions in footnote 3 that there were only two meetings between the beneficiaries and the trustee in the tax years in question, both of which took place in New York. Does this suggest that if there had been several meetings with the beneficiary that took place in North Carolina that its decision would have been different? The court also mentions that the trustee also gave the beneficiary accountings of trust assets and legal advice concerning the trust. Perhaps, the Kaestner Court was saying that states cannot add those factors (e.g., giving accountings and legal advice to the beneficiaries) to other factors to permit the state lawfully to impose its income tax.

The Kaestner Court also noted that the settlor did not reside in North Carolina. Many states use the settlor's domicile the factor or a factor in imposing its tax on undistributed trust income although it seems appropriate to note that many state courts have held that the settlor's domicile alone cannot provide the premise for taxation of the trust.

The court held "that the presence of in-state beneficiaries alone does not empower a State to tax trust income that has not been distributed to the beneficiaries where the beneficiaries have no right to demand that income and are uncertain ever to receive it," but the court adds "we do not imply approval or disapproval of trust taxes that are premised on the residence of beneficiaries whose relationship to trust assets differs from that of the beneficiaries here."<sup>33</sup>

Further, the Supreme Court in *Kaestner* differentiated the taxing scheme in California, pointing out that the California statute "applies its tax on the basis of beneficiary residency only where the beneficiary is not contingent" unlike the North Carolina statute at issue.<sup>34</sup>

Another or alternative factor a state might use is if a resident is a de facto trustee or holds powers similar to a trustee. In TSB-A-04(7)I , New York ruled that members of the trust committee were trustees for New York income tax state because they had responsibilities and powers of a trustee. That opinion, not official precedent even in

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<sup>33</sup> Blattmachr and Shenkman, "State Income Taxation of Trusts: Some Lessons of Kaestner," Estate Planning, October 2019, Vol. 46/No. 10.

<sup>34</sup> Kaestner at footnote 12, supra note 31, citing Cal. Rev. & Tax. Code Ann. §17742(a).

New York, suggests that a trust protector or other (e.g., a so-called “director”) who can direct the trustee in carrying out fiduciary duties may also be treated as a trustee for New York income tax purposes. Perhaps, if the residence of a trustee is a sufficient ground under Kaestner for a state to tax the trust, then it seems somewhat likely that the residence of a director or trust protector with such or similar authority also would be sufficient.

#### **IV. Collaboration between the attorney, wealth advisor, tax preparer and trustee could be essential to ensuring that the trust avoids contacts with problematic jurisdictions.**

##### **A. All advisors should understand that the nongrantor trust is seeking to avoid taxation in certain jurisdictions.**

It is probably advisable for the drafting attorney to collaborate with the tax preparer and wealth advisor. The practitioners should identify problematic jurisdictions and discuss the elements that would likely cause taxation of the trust in that jurisdiction. By way of example, if a New York resident establishes an irrevocable, non-grantor trust, it may be advisable for all advisors to understand that the trust should not own assets located in New York, should not earn New York source income and should not have a New York resident trustee. With all advisors working toward the same goal of avoiding New York state tax, the goal is more likely to be achieved.

##### **B. The trustee should probably reside in a tax-friendly jurisdiction, as this could be essential to avoiding tax in a problematic jurisdiction.**

Several states don’t impose income taxes on trusts.<sup>35</sup> When mitigating state income tax is a factor, it would be preferable for the trust to have a trustee who conducts all trust administration in the same tax-friendly jurisdiction where such trustee resides.

Clients should consider using professional trustees in tax-friendly jurisdictions. Even though professional trustees charge fees for their services, if mitigating state income tax is a factor, it may be that the cost of the professional trustee is far exceeded by the tax benefits of reducing or eliminating state income taxes. The use of a professional, independent institutional trustee may also help backstop many other aspects of the client’s tax and asset protection plan thereby providing further justification for the costs incurred.

##### **C. Consider changing the trustee of a trust.**

Changing the trustee of an existing trust may enable the trust to avoid being treated as a taxable resident of any state. For example, a trust established by a Colorado resident and administered by a New York state fiduciary won’t have any tax residence for state income tax purposes, because Colorado bases residence on the state where the trust is

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<sup>35</sup> E.g. Alaska, Florida, Nevada, New Hampshire, South Dakota, Texas, Washington and Wyoming. See Oshins Chart, supra note 4.

administered, and New York is a settlor-residence taxation trust state. Practitioners should review existing trusts for opportunities to make a change that could have a significant impact on the taxability of the trust.

There could be several options for effectuating the change in trustees depending on the terms of the governing trust instrument. The trustee may be given authority to name a successor and could do so as the last act before resigning. A trust protector may have authority to remove and replace a trustee. The Settlor might have reserved the power to remove and replace a trustee subject to not appointing anyone who is related or subordinate. A decanting under the terms of the trust instrument or applicable state law may be used to effectuate the desired change. A non-judicial modification may be feasible as well.

**D. For existing trusts, a practitioner should review trust instruments to determine whether there might be any opportunities to achieve resident exempt status.**

1. The trust should avoid owning any tangible property in the taxing state.

Practitioners should confirm how the taxing jurisdiction determines whether an asset is considered tangible such that it will create a sufficient nexus to allow for resident trust treatment. Perhaps a tangible asset can be physically moved to custodians who are physically located in tax-friendly states.

Obviously, assets such as real estate cannot be moved. Perhaps these assets should be dropped into a limited liability company (LLC). States such as New Jersey and New York view LLC membership interests as intangibles. For these states, LLC interests holding tangible property located within the state would nevertheless be considered a non-situs asset.

Another alternative is to divide the trust into two trusts with one holding all of the assets that have situs in, or generate source income attributable to, the high tax state, and the other trust owning no such assets. 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?<sup>36</sup>

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<sup>36</sup> 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," Steve Leimberg's Income Tax Planning Email Newsletter - Archive Message #205, Sep. 15, 2020.

2. Avoid having trusts make distributions to resident beneficiaries. To the extent that a settlor wishes to benefit an individual who resides in a beneficiary-residence trust taxation state, consider creating a separate trust for that resident beneficiary.
3. Avoid trust source income in any high tax jurisdiction. Assets could be segregated among different trusts to limit the taxability of non-source income.

**E. Practitioners may wish to structure trusts so that a beneficiary has a power under IRC Section 678 to vest all income sourced to any problematic jurisdiction up to the greater of \$5,000 or 5% of the trust corpus in him/herself.**

Some 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 all of that 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.<sup>37</sup> Thus, an insignificant amount of income within such a state, the proverbial peppercorn, could trigger taxation of all income by that state. This can be a particularly nettlesome issue if the trust invests in a diversified portfolio that may include private equity funds that may hold even small investments in pass through entities in that particular state.

Using a limited application of a grantor trust power may mitigate this issue. Granting a Section 678 power to a beneficiary would effectively bifurcate the trust into two pieces:

1. Grantor trust with respect to the problematic-source income only pursuant to IRC Sect. 678. Specifically, the designated person would be granted the power to withdraw any state source income of that trust. With this power in the trust, regardless of whether that income is withdrawn, that say New York sourced income would be taxed to the powerholder and the non-grantor trust would be left with no source income in that particular state.
2. Non-grantor trust with respect to all other income, including capital gains.

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<sup>37</sup> For a more detailed discussion of this planning concept see *Id.*

The IRC Section 678 power should be carefully structured so that the beneficiary is not deemed to have made a gift to the trust. Specifically, the power should be limited to an amount that is equal to or less than the greater of \$5,000 or Five (5%) Percent of the trust.

Prior to drafting a trust that creates a partial grantor trust, the practitioner should confirm that:

1. The relevant state statutes permit grantor trust treatment. As previously noted, Pennsylvania does not allow for grantor trust treatment.
2. The trust does not expect to have substantial source income in the problematic jurisdiction in any year in the trust. Use of a Section 678 power is intended to be a prophylactic measure in case any (hedge fund or similar) investment has source activity in any given year.
3. This option will work best where the value of the assets owned by the trust is quite substantial such that allowing a beneficiary to withdraw 5% of the corpus would cover all of the problematic source income, thereby substantially mitigating the risk that the entire trust would be taxable in the problematic jurisdiction.
4. The beneficiary with the power under IRC Section 678 should not be the grantor's spouse.

The drafting attorney should collaborate with the tax preparer to ensure that the income is reported to the appropriate taxpayers.

#### **F. Use a Blocker or Second Trust.**

Another approach is to create a second or "blocker" trust. Some refer to this structure as a "mother/daughter" trust structure. Similar to dividing a trust and distributing the state-tainted asset through division or decanting, a second trust might be used to divide the income rather than the assets. This planning might entail establishing a second trust as beneficiary of the first trust to receive only capital gains as a distribution from the main trust. This may have beneficial 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 intent is 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.<sup>38</sup>

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<sup>38</sup> 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).