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It's Official – I'm An Income Tax Lawyer, Part 1

Potpourri of Income Tax Planning Ideas,
Including State Trust Income Tax Planning
and ING Trust

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2017 Federal Income Taxes

- 39.6% Single (\$418,400+)
- 39.6% Married Filing Jointly (\$470,700)
- 39.6% Married Filing Separately (\$235,350)
- 39.6% Trusts (\$12,500)
- 3.8% Net Investment Income Tax (on interest, dividends, rents, royalties, capital gains, and trade or business income that is a passive activity)
- 20% Long-Term Capital Gains and Qualified Dividends (if in 39.6% bracket)
- Even before imposition of state income taxes, top rates are now effectively 43.4% for ordinary income and 23.8% for long-term capital gains.

State Income Taxes

- State income tax rates range from 0% – 13.3% (page 5)
- California – highest rate (13.3%)
- 7 States with no Income tax: Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming
- Tennessee and New Hampshire only tax dividends and interest. N.H. Admin. Code Rev. § 902.07; Tenn. Code Ann. § 67-2-102.
- States with no estate tax or income tax: Alaska, Florida, Wyoming, and Nevada.

State Income Tax

- Heart of America Region: Arkansas, Kansas, Missouri, Nebraska, & Oklahoma



2016 State Income Tax Rates

California	13.30%	Maine	7.15%	Missouri	6.00%	Utah	5.00%
Oregon	9.90%	South Carolina	7.00%	Tennessee	5.00%	Ohio	4.997%
Minnesota	9.85%	Connecticut	6.99%	Rhode Island	5.99%	New Mexico	4.90%
Iowa	8.98%	Arkansas	6.90%	Maryland	5.75%	Colorado	4.63%
New Jersey	8.97%	Montana	6.90%	North Carolina	5.75%	Kansas	4.60%
District of Columbia	8.95%	Nebraska	6.84%	Virginia	5.75%	Arizona	4.54%
Vermont	8.95%	Delaware	6.60%	Massachusetts	5.10%	Michigan	4.25%
New York	8.82%	West Virginia	6.50%	Alabama	5.00%	Illinois	3.75%
Hawaii	8.25%	Georgia	6.00%	Mississippi	5.00%	Indiana	3.30%
Wisconsin	7.65%	Kentucky	6.00%	New Hampshire	5.00%	Pennsylvania	3.07%
Idaho	7.40%	Louisiana	6.00%	Oklahoma	5.00%	North Dakota	2.90%

Income Tax Planning Techniques to Consider

- Stretch IRAs
- Avoid gifts of highly appreciated property to obtain basis adjustment at death
- Charitable gifts during lifetime instead of death
- Transfer assets to spouse who is likely to die first (using irrevocable trusts to avoid IRC § 1014(e))
 - Use of LLCs to facilitate to the quick transfer of assets to spouse in poor health
- Sell loss property prior to death to realize gain

Income Tax Planning Techniques to Consider

- Utilizing income tax free growth of cash value life insurance
- Roth IRA conversion
- Exercise right to substitute property to move assets with a low basis into taxable estate
- Granting a beneficiary a formula general power of appointment for basis adjustment at death
- Unneeded ILITs, QPRTs, Credit Shelter Trusts, and other Irrevocable Trusts – grant formula power of appointment to achieve basis adjustment but maintain divorce or creditor protection
- Utilizing portability for full basis adjustment at second spouse's death

Income Tax Planning Techniques to Consider

■ Trust Income Tax Planning

- Distributions to beneficiaries
 - Lower rate of beneficiary
 - Avoiding NIIT (2017 Thresholds – Trusts \$12,500; married filing jointly \$250,000; single \$200,000)
 - Allocating Capital Gain to Beneficiary (“Trustees may allocate, within the meaning of Treasury Regulation § 1.643(a)-3(b), to income or principal, or partly to income and partly to principal, all or part of the realized gains from the sale or exchange of trust assets.”)
 - 65-day rule (IRC § 663(b)); made by checking box on Schedule G of Form 1041
- QSST Elections vs. ESBT elections
- Using Grantor Trusts
- Material participation by trustees to avoid NIIT
- INGs (page 28)

642(c) Charitable Income Tax Deduction for Trusts

- Include language in trusts as part of form:
 - Any distribution to a charitable organization shall first be paid with items of gross income, it being my intention that this trust shall be entitled to claim a charitable income tax deduction for such distribution under § 642(c) of the Code.”

State Income Taxation of Trusts

- States tax trusts based on their nexus to the state.
- If the trust is a nongrantor resident trust, then it will be subject to tax on all of the undistributed income.
- States treat a trust as a resident trust based on one or more of the following:
 - If the trust was created by a Will of a resident
 - If person creating trust, or contributing assets to the trust, was a resident of the state
 - If the trust is administered in the state
 - If a Trustee is a resident of the state or does business in the state
 - If a beneficiary lives in the state
- If the trust is a nonresident trust, then only source income will be taxable in the state.

State Taxation of Trusts

- It is possible for a trust to be subject to state income tax in multiple states or a trust may not be subject to state income tax in any state.
- Carefully analyze the state taxation of irrevocable nongrantor trusts.
- Depending on applicable state law, could be beneficial to:
 - Change trustees
 - Appoint additional trustees
 - Divide the trust into separate trusts for each beneficiary

Selected State Resident Trust Definitions

■ Arkansas

■ Arkansas Code § 26-51-201(a) & (b)

- A tax is imposed on the entire income of every trust ... but
- No state income tax shall be due Arkansas from a trust or estate created by a nonresident donor, trustor, or settlor, or by a nonresident testator even though administered by a resident trustee or personal representative except on income derived from [land, tangible personal property, or an unincorporated business located in Arkansas]
- Highest Rate: 6.9%
- If trust was created by an Arkansas resident, will be subject to Arkansas tax forever.

Selected State Resident Trust Definitions

■ Kansas

- Kansas Code §79-32, 109
- “Resident trust” means a trust which is administered in Kansas. A trust shall not be deemed to be administered in Kansas solely because it is subject to the jurisdiction of a district court within this state.
- Highest Rate: 4.6%

Selected State Resident Trust Definitions

■ Missouri

- Mo. Rev. Stat. §143.331

- A “resident estate or trust” means a trust that

(1)

- Was created by Will of a decedent who at his/her death was domiciled in Missouri; and
- Has at least one income beneficiary who, on the last day of the taxable year, was a resident of Missouri; or

(2)

- Was created by, or consisting of property of, a person domiciled in Missouri on the date the trust became irrevocable; and
- Has at least one income beneficiary who, on the last day of the taxable year, was a resident of Missouri.

- Highest Rate: 6.0%

Selected State Resident Trust Definitions

■ Nebraska

- Neb. Rev. Stat. §77-2714.01(6); Reg-23-001
 - A resident trust includes:
 - A trust which consists of property transferred by the Will of a decedent who, at his/her death, was domiciled in Nebraska.
 - A trust which was created by or consists of property of a person domiciled in Nebraska at the time the trust became irrevocable .
 - If the settlor of a trust is domiciled in Nebraska when the trust becomes irrevocable, the trust will be considered a resident trust for the entire life of the trust. Such a trust is a resident trust even though the situs of the trust, property held in trust, or the trustee are located in another state.
- Highest Rate: 6.84%
- If trust was created by Nebraska resident, will be subject to Nebraska tax forever.

Selected State Resident Trust Definitions

■ Oklahoma

- Oklahoma Code § 68-2353.6
 - Resident trust means:
 - A trust consisting of property transferred by Will of a decedent domiciled in Oklahoma at his/her death, or
 - A trust consisting of property of (i) a person domiciled in Oklahoma at the time such property was transferred to the trust if such trust was then irrevocable or (ii) a person domiciled in this state at the time such trust became irrevocable.
- Highest Rate: 5.0%
- If trust was created by Oklahoma resident, will be subject to Oklahoma tax forever.

Selected State Resident Trust Definitions

■ Illinois

- 35 ILCS 5/1501(a)(20)(B), (C), & (D)
 - A “resident” trust:
 - A trust created by a Will of a decedent who at his/her death was domiciled in Illinois, and
 - An irrevocable trust, the grantor of which was domiciled in Illinois at the time such trust became irrevocable. A trust shall be considered irrevocable to the extent that the grantor is not treated as the owner thereof under IRC §§671 through 678.
 - If trust was created by Illinois resident, will be subject to Illinois tax forever – but statute is unconstitutional as applied to certain trusts.
 - Highest Rate: 3.75%

Selected State Resident Trust Definitions

■ Illinois

- Linn v. Dep't of Revenue, 2013 IL App (4th)121055 (2013)
 - Trust created by Illinois resident in 1961.
 - In 2002, the Trustee exercised a power to distribute the trust assets to a new trust to be administered under Texas law (certain provisions of the trust were to be interpreted under Illinois law).
 - The Texas Trust was modified by a Texas court to remove all references to Illinois law, and the trustee then filed the 2006 Illinois return as a nonresident.
 - At that time there was no Illinois Trustee, beneficiary, or trust assets.
 - Court held that Illinois taxation of the trust was unconstitutional.

Selected State Resident Trust Definitions

■ North Carolina

- N.C. General Statute §105-160.2. Effective for taxable years beginning on or after January 1, 2014.
- The tax is computed on the amount of the taxable income of the trust that is for the benefit of a resident of this state.

Selected State Resident Trust Definitions

■ North Carolina

- Kaestner 1992 Family Trust v. North Carolina Department of Revenue, 12 CVS 8740 (N.C. 2015)
- The beneficiary's residence, standing alone, was not a sufficient contact to support treating the trust as a resident trust.
- New York resident created trust for his descendants with a New York trustee. In 1997 one of the beneficiaries moved to North Carolina.
- The trust had no connection or activity in North Carolina.
- To determine nexus, court analyzed the activities of the Trust through the actions of the trustee (beneficiaries contacts with North Carolina are irrelevant).
- Court held that North Carolina income taxation of trust was unconstitutional.

Selected State Resident Trust Definitions

■ Pennsylvania

- 72 P.S. §7301(s)
 - Resident trust means:
 - A trust created by the Will of a decedent who at the time of his/her death was a resident individual; and
 - A trust created by, or consisting in whole or in part of property transferred to a trust by, a person who at the time of such creation or transfer was a resident of Pennsylvania.
- Highest Rate: 3.07%
- If trust was created by Pennsylvania resident, will be subject to Pennsylvania tax forever.

Selected State Resident Trust Definitions

■ Pennsylvania

- McNeil v. Commonwealth, 651 F.R. 2010, 173 F.R. 2011 (May 24, 2013)
 - Trusts created by Pennsylvania resident with Pennsylvania discretionary beneficiaries. Trustees were not required to make distributions of income or principal; beneficiaries had no current or future right to the Trusts' income or assets.
 - Trusts were governed by Delaware law and administered in Delaware by a Delaware corporate Trustee (Wilmington Trust Company) who had no offices, and conducted no affairs in Pennsylvania.
 - Was no source income to Pennsylvania.
 - Court found that imposition of Pennsylvania income tax was unconstitutional.

Cases on Constitutionality of State Resident Trust Statutes

- **Caselaw in Connecticut, Illinois, Michigan, Missouri, New Jersey, New York, and Pennsylvania.**
- Cases finding taxation of trust constitutional under state definition of resident trust:
 - District of Columbia v. Chase Manhattan Bank, 689 A.2d. 539 (D.C. App. 1997).
 - Chase Manhattan Bank v. Gavin, 733 A. 2d. 782 (Conn. 1999).
 - Westfall v. Director of Revenue, 812 S.W.2d 513 (Mo. 1991).

Cases on Constitutionality of State Resident Trust Statutes

- Cases Finding State Resident Trust Definition Unconstitutional under State Definition of Resident Trust:
 - Mercantile-Safe Deposit & Trust Co. v. Murphy, 242 N.Y.S.2d 26 (N.Y. App. Div. 1963), aff'd, 15 N.Y.S. 2d 579 (1964).
 - Pennoyer. v. Tax Div. Director, 5 N.J. Tax 386 (1983).
 - Potter v. Tax Div. Director, 5 N.J. Tax 399 (1983).
 - In re Swift, 727 S.W.2d 880 (Mo. 1987).

Cases on Constitutionality of State Resident Trust Statutes

- Blue v. Department of Treasury, 462 N.W.2d 762 (Mich. Ct. App. 1990).
- Linn v. Dep't of Revenue, 2013 IL App (4th)121055 (2013).
- McNeil v. Commonwealth of Pennsylvania, 651 F.R. 2010, 173 F.R. 2011 (PA Commonwealth, May 24, 2013).
- Kaestner 1992 Family Trust v. North Carolina Department of Revenue, 12 CVS 8740 (N.C. 2015).

Avoiding State Taxation of An Individual's Income

- Two Options:
 - Move to a state with no income tax
 - or
 - Create ING Trust (only works in certain states)

Incomplete Gift, Non-Grantor Trusts (INGs)

1. Must create the trust in a state with no income tax and a domestic asset protection trust statute (now 16 DAPT states)
 - Options: Alaska, Nevada, New Hampshire (has income tax but not applicable if nonresident beneficiaries), South Dakota, Wyoming, and Delaware (has income tax but trusts receive a deduction for income accumulated for a nonresident beneficiary)
 - If creditor of grantor could recover from the trust, then it is a grantor trust. Treas. Reg. § 1.677(a)-1(d)

INGs

2. Client (grantor of trust) must live in a state with the “right” kind of resident trust definition.
 - Where INGs may work (states where resident trust status is based on having an in-state Trustee or trust administration): Arizona, California, Colorado, Hawaii, Idaho, Indiana, Kansas, Kentucky, Louisiana, Massachusetts, Mississippi, Montana, New Jersey (Instructions to 2016 Form NJ-1041 at 1), New Mexico, Oregon, South Carolina, Utah ...
 - New York: No longer works in New York due to a throw back tax enacted in 2014. NY Tax Law § 612(b)(41). Income generated by ING Trust created by NY resident will be taxed to NY resident as if it was a grantor trust.
 - Nenno, 869 T.M., State Income Taxation of Trusts (excellent resource on state income taxes)

INGs

3. ING Trust must be structured to avoid resident trust status in grantor's state of residence by naming a Trustee in the ING Trust state and administering the trust in the ING Trust state (thereby avoiding nexus to grantor's resident state).
4. This only works with intangible property. Source income (real estate income, tangible property income, in-state business income) is taxed to a state even if not a resident.
5. Only works for accumulated income – distributions to a beneficiary of ordinary income that carry out DNI will usually be taxed in the beneficiary's resident state.

INGs

6. Transfers to the trust by the grantor/beneficiary must be treated as an incomplete gift.
 - Grantor retains:
 - A testamentary power of appointment and
 - CCA 201208026 calls into question Treas. Reg. § 25.2511-2(b) – no longer safe to rely only on testamentary power of appointment. Transfer to trust is an incomplete gift only as to the remainder if anyone other than the grantor is a current beneficiary.
 - An inter vivos power of appointment.
7. The trust cannot be treated as a grantor trust under IRC § 671-679.
 - Distributions can only be made with the consent of an adverse party (beneficiaries of the trust other than the Grantor). IRC § 677(a).
8. When do INGs make sense:
 - Expecting a large liquidity event
 - Substantial state income tax liability on a regular basis

ING PLRs

- PLRs blessing ING Trusts:

- Early rulings (prior to IR-2007-127 where IRS stated they were reconsidering their gift tax position): 200148028, 200247013, 200502014, 200612002, 200637025, 200647001, 200715005, 200729025, 200731019
- 201310002 to 201310006
- 201410001 to 201410010 , 201427008, 201427010 to 201427015, 201430003 to 201430007,
- 201436008 to 201436014, 201436018, 201436024 to 201436032, 201440008 to 201440012
- 201510001 to 201510008 (guardians for minors on committee)
- 201613007, 201636027 to 201636032, 20165005, 201653001 to 201653009.
- 201642019 revokes 201426014. Distribution committee consisting of beneficiaries – if grantor’s children ceased to be committee members or if there were ever less than two committee members, then trust terminated and all property was to be distributed to the grantor.
 - 201642019 determines this to be a reversion under IRC § 673.
- Community property ING Trusts: 201550005, 201653001 to 201653009

PLR Rulings

- Non-grantor trust
- Incomplete gift by grantor
- Distributions to grantor are not a completed gift
- Distribution committee members do not make gifts upon making distributions to a beneficiary other than the grantor (i.e., committee members do not have general powers of appointment)

States That Present Planning Opportunities

■ If a Trust is paying state income taxes in one of these states, you may be able to avoid it with the right planning:

- Arizona
- California
- Colorado
- Hawaii
- Idaho
- Indiana
- Kansas
- Kentucky
- Louisiana
- Massachusetts
- Mississippi
- Montana
- New Jersey
- New Mexico
- Oregon
- South Carolina
- Utah

Do INGs Work?

- PLRs on federal tax consequences, but ...
- State income tax authority?
 - State tax authorities could apply step transaction or substance over form doctrine
 - Avoid funding ING trusts with assets likely to be sold shortly after creation of trust
 - Fund with excess assets not likely to be needed
- For resident trust statutes, when will a trust protector or advisor be considered a “Trustee”

Future of INGs

- On January 24, 2017 S.B. 205 was introduced in the Senate, which includes a provision to add back IRC § 2511:
 - (c) TREATMENT OF CERTAIN TRANSFERS IN TRUST – Notwithstanding any other provision of this section and except as provided in regulations, a transfer in trust shall be treated as a taxable gift under § 2503, unless the trust is treated as wholly owned by the donor or the donor's spouse under subpart E of part I of subchapter J of chapter 1.
- Identical to the original EGTTRA (2001) provision.

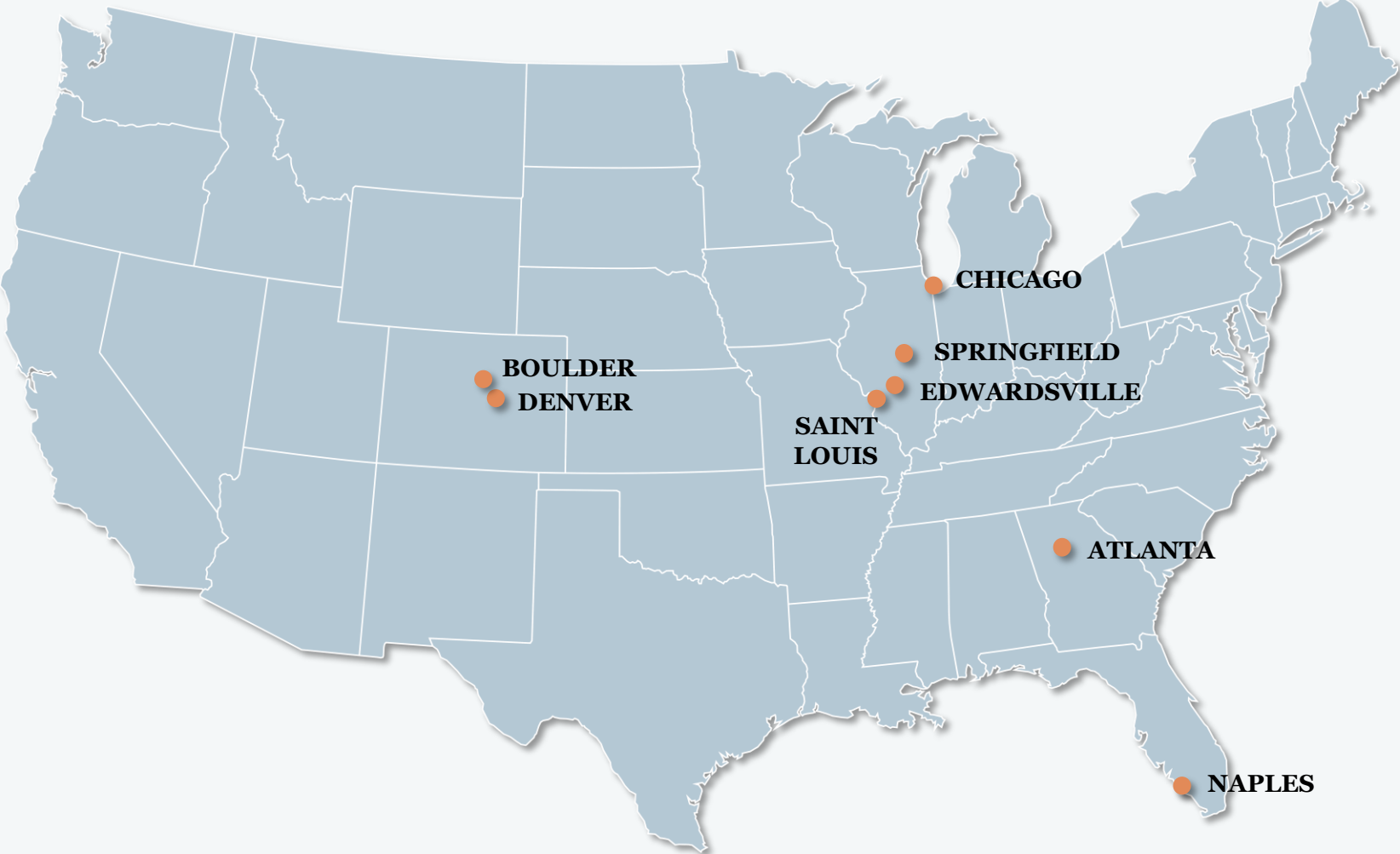
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Questions?

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