

# Trust Situs Matters: Situsing a Trust for Maximum State Income Tax Savings



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Estate planners are constantly looking for additional ways to save taxes for their clients. One often-overlooked concept is to use trusts to save state income taxes, especially for those clients who reside in a state with a high state income tax. Ironically, income tax savings is generally the most appreciated work we do for our clients given that they can personally enjoy the savings, but yet the planning opportunities are frequently missed.

## Income Taxation of a Trust

An irrevocable trust can have its income either taxed to the settlor, taxed to one or more beneficiaries or taxed to the trust except to the extent the income is distributed to one or more beneficiaries.

A trust which has its income taxed to the settlor is generally called a grantor trust. Such a trust is created by violating one or more of the grantor trust provisions in the tax code. Alternatively, a trust can be taxed to a beneficiary by specifically violating IRC Section 678 of the

tax code. This is often called a beneficiary defective trust. A trust that distributes all of its income to a beneficiary is called a simple trust. However, this article focuses on another income tax

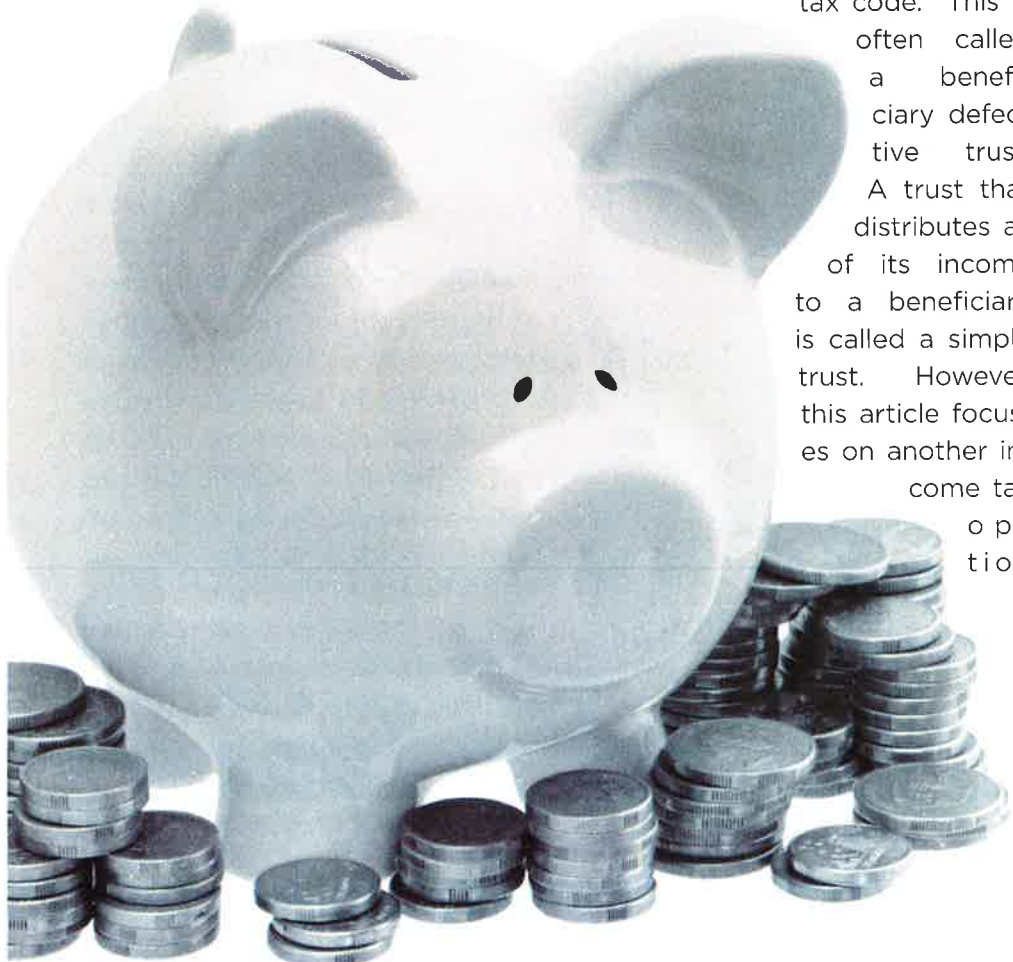
option

called a non-grantor trust or complex trust. A non-grantor trust is an irrevocable trust in which the income is taxed to the trust to the extent it isn't distributed, but to the extent it is distributed it is taxed to the beneficiaries to whom it is distributed.

## Income Tax Savings

In the 2014 tax year, a trust reaches the highest Federal income tax bracket of 39.6% at only \$12,150 of taxable income. At that point, certain types of income are also subject to the 3.8% net investment income surtax. Therefore, at least from a pure federal perspective, since most beneficiaries are in a lower income tax bracket there is a significant advantage in distributing the income from the trust to the beneficiaries who are in lower tax brackets.

However, with many state income tax rates as high as they are even for trust beneficiaries who are in a lower federal income tax bracket, there are often substantial state income tax advantages that can be obtained by leaving income inside a trust. In addition to looking at this from the trust beneficiaries' perspectives, there are also plenty of high-net-worth individuals who reside in a state with a high state income tax and can easily afford to transfer substantial wealth into a non-grantor trust for the ben-



efit of that person's descendants and other intended beneficiaries without worrying about the loss of cash flow. Those assets often can be gifted to a trust that saves significant state income tax.

## What Causes a State Income Tax?

Each state that has a state income tax has different rules that apply to determine whether the trust is subject to a state income tax in that state. Some states tax an inter vivos trust that is established by a resident of that state. Some states tax a trust that was established under the will of a resident of that state. Some states tax a trust that is being administered in the state. Some states tax a trust if it has a trustee who resides in that state. Some states tax a trust based on whether beneficiaries of the trust reside in that state. Therefore, each individual situation must be analyzed in designing the trust and choosing appropriate trustees to manage the trust.

## Simpler Than You May Think

Many estate planners fail to consider using a trust jurisdiction that is different than the client's home jurisdiction either because of a fear

that it is overly complicated or a fear that it will be too expensive. It is very easy to appoint a co-trustee in a jurisdiction that doesn't tax a trust. That co-trustee is often a trust company or bank. This co-trustee need not have all trustee powers and can even serve principally as a jurisdictional trustee with a more limited role while other co-trustees can have the investment and distribution powers. And since many of the trust companies and banks frequently serve in this more limited trustee capacity, they generally have a low flat-fee that should not be a cause for concern, especially when compared to the much more substantial income tax savings that the family is achieving by using this strategy.

## Moving an Existing Trust to Save State Income Taxes

In addition to planning for a newly-created irrevocable trust, there are a number of existing trusts that can be moved to a new jurisdiction to achieve the state income tax savings described in this article. The trustee or trust protector might have the power under the trust agreement to move the trust to another jurisdiction. This is done in writing with a new co-trustee in the new jurisdiction accepting the co-trusteeship.

If there is no provision allowing the trustee or trust protector to move the trust to another jurisdiction, then the trustee might be able to "decant" the trust by distributing the trust assets into a second trust that is established in the new jurisdiction. Decanting has become extremely popular and can often be used to fix inflexible trusts.

Yet another option would be for the trustee to petition the local court for approval to move the trust or for approval to modify the trust to allow the trustee or trust protector to move the trust.

## Summary

Selecting an appropriate trust situs in order to save state income taxes is an underutilized strategy. This article is intended to position this strategy as one that should be considered by the estate planner whenever a new irrevocable trust is being formed and also to give the estate planner some opportunities to move existing irrevocable trusts to jurisdictions with no state income tax. Estate planners who take advantage of these opportunities should find themselves busy with more work than they can handle given the number of trusts that are likely currently domiciled in jurisdictions with a state income tax.

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