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Steve Leimberg's Income Tax Planning Email Newsletter - Archive Message #96

Date: 05-Jul-16
From: Steve Leimberg's Income Tax Planning Newsletter
Subject: Steve Oshins Releases 2nd Annual Non-Grantor Trust State Income Tax Chart

"Advisors should be taking advantage of the opportunity to avoid the tax drag inherent in many trusts that accumulate income that is subject to state income tax even if not sourced to that state. In fact, it is somewhat shocking that this concept isn't the most talked about concept among the financial planners whose assets under management are ratably affected by this tax drag.

This planning is imperative for attorneys, accountants, financial planners, trust officers and anybody else who advises clients on taxes and trust planning. The 2nd Annual Non-Grantor Trust State Income Tax Chart is an easy-to-use summary that should open up opportunities for practitioners to save state income tax for their clients by moving and fixing any existing trusts that are needlessly paying state income tax and therefore dragging down the trust's asset base."

Frequent **LISI** contributor **Steve Oshins, Esq., AEP (Distinguished)** authors three different annual state rankings charts and one state income tax chart:

- The Annual Domestic Asset Protection Trust State Rankings Chart
- The Annual Dynasty Trust State Rankings Chart
- The Annual Trust Decanting State Rankings Chart
- The Annual Non-Grantor Trust State Income Tax Chart

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Before we get to Steve's commentary, members should note that two **60 Second Planners** were recently posted to the **LISI** homepage:

- In the first podcast, **Bob Keebler** reports on PLR 201625022, where the IRS denied a taxpayer's application for waiver of the 60-day rollover period with respect to an IRA distribution based on the particular facts of the ruling request. The text of the ruling can be found at https://www.irs.gov/pub/irs-wd/201625022.pdf , and members should click this link to listen to Bob's podcast.

- In the second podcast, **Steve Oshins** reports on Colorado's enactment of the Uniform Trust Decanting Act, which will take effect August 10, 2016. Click on this link to listen to Steve's podcast.

Now, here is Steve Oshins' commentary:

EXECUTIVE SUMMARY:

It is wasteful to accumulate income in a non-grantor trust that is subject to state income tax on income that is not sourced to a state with a state income tax. Different states have different rules as to what creates a "resident trust" that is subject to taxation in that state.

Some states tax a testamentary trust that is set up in the Will of the resident testator. Some states tax an inter vivos trust set up by a resident of that state. Some states tax a trust that is being administered in that state. Some states tax a trust if there is a resident trustee. Some states tax a trust if there is a beneficiary who is a resident of that state. Some states tax a trust based on a combination of these factors.

COMMENT:

I. The Tax Drag

The "tax drag" is the amount by which investment returns are reduced due to taxes. The opportunity to move a non-grantor trust to a jurisdiction where state income tax can be avoided often makes a substantial impact on the value of the trust's underlying assets. By avoiding the tax drag inherent in a trust that is subject to state income tax, the trust grows in value much faster.

This planning opportunity is very well-known to many advisors, but yet it appears to be underused by most and should be considered whenever any trust is being planned and created and whenever an advisor is reviewing an existing trust to look for opportunities to help the client.

No trust should ever be created without the advisor knowing the residency of the settlor, the proposed trustees and the beneficiaries. This information is invaluable in the planning process since it can have a substantial influence on the decision points.

Thus, each advisor should have a handy resource to use to quickly access the different state rules in order to be able to properly plan for their clients.

II. The 2nd Annual Non-Grantor Trust State Income Tax Chart

The 2nd Annual Non-Grantor Trust State Income Tax Chart is a two-page summary of the non-grantor trust state income tax rules in all states and Washington, D.C. The states are listed in alphabetical order. [If your computer still shows the 1st Annual Chart at this link, clear your computer's cashe in order for it to be updated, or simply email Steve Oshins at soshins@oshins.com and request the chart by email.]

- Column 1 lists the name of the state.

- Column 2 lists the statute or other taxing authority showing what it takes to be treated as a resident trust. For those who access the online version, the statute or taxing authority is linked so that the end-user can easily access that authority in order to read the rules carefully. This feature will help those who were unsure how to spot the opportunity to very easily go directly to the source.

- Column 3 lists the highest tax rate for 2016 in that jurisdiction.

- Column 4 answers the question, "Under What Condition does the State Tax a Non-Grantor Trust?" It answers it in a very short summary fashion so the reader can quickly understand the gist of the statute or other taxing authority. There is a warning towards the bottom of each of the two pages not to rely on the short summary and to always read the statute.

III. The 2016 Tax Rate Changes

A number of states changed their highest state income tax rate for 2016. These changes are summarized as follows:

1. Arkansas reduced its top income tax rate from 7.00% to 6.90%.

2. Hawaii's temporary tax increase expired, thus reducing its top income tax rate from 11.00% to 8.25%.

3. Maine reduced its top income tax rate from 7.95% to 7.15%.

4. Massachusetts reduced its top income tax rate from 5.15% to 5.10%.

5. Ohio reduced its top income tax rate from 5.333% to 4.997%.

Despite there being so many reductions in tax rate from 2015 to 2016, there are a number of states that currently have proposed legislation in place to raise future rates. So the reader should not get the false impression that the trend is to reduce rates.

IV. How to Fix the State Income Tax Problem

It is often relatively simple to fix the state income tax problem.

<u>Removal/Resignation:</u> It might be as simple as having the trustees who are in a state that causes the trust to be taxed to resign or, if the trust agreement allows for it, to remove and replace them.

<u>Decanting:</u> Another way to potentially modify the trust to avoid state income tax is to have the distribution trustee decant the trust either by using that state's decanting statute, if there is such a statute, or, if the trust agreement has decanting language, by using the decanting language in the trust agreement. If neither exists, then if the trust has a change of situs provision, the trustee or trust protector can change the situs to a state with a flexible decanting statute and then decant it.

<u>Nonjudicial Settlement Agreement:</u> Yet another way to potentially modify the trust to avoid state income tax is to utilize any statutory authority in that state,

such as a nonjudicial transfer of trust situs to change situs and modify the trust by following the statutory rules.

Court Petition: Finally, if all else fails, the trustee can petition the local court for authority.

V. States Taxing a Trust Solely Based upon Residency of the Settlor/Testator

Modifying the ongoing state income tax might be next-to-impossible if the state taxes a trust solely based on the residency of the settlor or testator. This might require a court challenge to the constitutionality of the taxing statute. This has been successfully done in some of these states, but generally is only done for families with substantial assets who can afford to pay for such a challenge.

VI. Suggestions to Improve the Chart

This Chart required a lot of research and planning. However, we are all human, so any errors or suggestions should be reported to soshins@oshins.com.

Any suggestions that would add words to the Chart should be balanced against the fact that the Chart takes up nearly every part of two pages and therefore has very minimal capacity for additions! [There is not enough room to list the court cases where a successful constitutional challenge has been made.]

VII. Conclusion

Advisors should be taking advantage of the opportunity to avoid the tax drag inherent in many trusts that accumulate income that is subject to state income tax even if not sourced to that state. In fact, it is somewhat shocking that this concept isn't the most talked about concept among the financial planners whose assets under management are ratably affected by this tax drag.

This planning is imperative for attorneys, accountants, financial planners, trust officers and anybody else who advises clients on taxes and trust planning. The 2nd Annual Non-Grantor Trust State Income Tax Chart is an easy-to-use summary that should open up opportunities for practitioners to save state income tax for their clients by moving and fixing any existing trusts that are needlessly paying state income tax and therefore dragging down the trust's asset base.

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

Steve Oshins

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