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Trust Situs Selection—Tax Havens or Illusory Strategy?

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Statutory recapture, i.e., a state income taxation scheme relative to a settlor, a trustee, or a beneficiary that, in whole or in part, nullifies any tax benefits derived from the chosen situs of the trust in question, is too often overlooked.

Choosing the situs for a trust generally involves many factors, including the charging order laws of the situs state for asset protection purposes, applicable estate and trust taxation rates and schemes, the costs of administration and litigation in the situs state (if necessary), the level of control that is retained over trust assets, and other factors.

Of all the applicable factors, one primary factor looms large for most settlors whose focus is to maximize their plan's asset protection component while minimizing the tax liabilities resulting from use of a trust as a wealth preservation and tax mitigation tool. That factor is:

Does the preferred situs tax the income of the trust being used?

The most commonly known trust tax havens are: Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming. Additionally, Florida, New Hampshire, Tennessee, the District of Columbia, and Louisiana have limited forms of taxation on various forms of income generated by a non-grantor trust. However, many states, despite not being the situs of the trust, will tax one or more of these various forms of trust income.

Of the states that do tax non-resident trusts, there are five common criterion for imposition of the taxation scheme:

1. The domicile status of a decedent (as of the date of death) who created a trust via testamentary provisions.

2. The domicile status of a settlor who created an *inter vivos* trust.

3. The fact that the trust in question is administered within the taxing state.

4. The domicile of one or more of the fiduciaries of the trust, and/or minimal business contacts within the taxing state by the fiduciaries.

5. The domicile of one or more of the beneficiaries within the taxing state.

Other factors that impact whether the taxing state may impose its taxation scheme on the trust income are: (1) Whether or not the controlling instrument designates the taxing state's laws as the choice of law pertaining to the administration of the trust; (2) the domicile of the trust when it became irrevocable; and/or (3) other statutory or common law factors as may be applicable within the jurisdiction.

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Once it has been determined that the taxing state may impose its taxation scheme on part or all of the trust income, it must then be determined if such tax liability is constitutional under the Due Process and/or the Commerce Clauses of the U.S. Constitution.

While the existing case law varies in content and scope of authority, binding authority within the jurisdiction will determine if the exercise of the jurisdiction is appropriate and lawful. In some states that do tax trust income, they do so throughout the trust's existence even when all fiduciaries, beneficiaries, and trust assets are located in foreign domiciles.

Essentially, there is a two-step analysis that must be undertaken with respect to each applicable criteria as it is possible that more than one of these criteria may apply in any given situation. For example, it is possible for one person to be both a fiduciary and a beneficiary, and if both criteria are used to justify lawful imposition of the taxing state's authority to tax, then this analysis must be undertaken with respect to each attribute of the person in question.

The primary inquiries are:

1. Does the state in question have jurisdiction over the trust for purposes of taxation?

2. Is the exercise of the claimed jurisdictional authority constitutional?

It should be noted that the primary means of securing taxing authority over a particular non-resident trust is to re-characterize the trust as a "resident" trust for taxation purposes. While the jurisdictionally specific details as to how this is accomplished are beyond the scope of this article, some general points are worth noting:

- As a general rule, a revocable trust established via non-testamentary means whose situs is in a state other than the taxing state will have a lower probability of being subject to the taxing state's authority.

- All interested parties should consider constitutional challenges if a taxing state attempts to impose its authority over trust income based on state statutes. This is especially true when there is minimal binding case law within the jurisdiction and/or where applicable statutes and regulations are vague or ambiguous.

- In some cases, undistributed income and capital gains may be subject to taxation prior to distribution.

- The domicile, business activities, and powers given to fiduciaries should be carefully considered given the potential impact of these factors relative to taxation.

- The relationship between the extent of the benefits and protections provided by a state for any particular trust, its fiduciaries or beneficiaries, and its scope of taxing authority based on these benefits and protections should be carefully examined.

- Choice of law provisions in the controlling instrument may have a profound impact on the lawfulness of the imposition of a taxing state's authority.

- When in doubt due to statutory or common law ambiguities or vagueness, a ruling from the taxing state's authorities should be sought prior to execution of the trust agreement.

- The impact of any applicable source income taxation schemes (i.e., those that apply to income generated from assets found within the taxing state) should be considered prior to making a situs choice for the trust.

- The IRS has determined that some self-settled trusts are non-grantor trusts for purposes of federal taxation under certain circumstances. Thus, if the facts are similar, these historical rulings may impact the classification of the particular trust by any given state.

- Any position taken by legal or financial counsel relative to the applicability of such taxation schemes should be made in good faith based on existing law and clients should be fully informed as to the risks and potential outcomes of the position taken.

In summary, the income tax planning strategies for, and consequences of establishing a non-grantor trust are many and varied. It should serve as sufficient warning that negative and unintended consequences have and continue to be the result when all applicable factors are NOT given appropriate weight in deciding upon the trust form and its situs selection relative to all interested parties.

About the Authors:
The Holt Law Group, P.C, is a small firm that specializes in comprehensive wealth preservation and asset protection planning, as well as generally in the field of wills, trusts, and estates. The firm specializes in planning for high net worth persons such as physicians, entrepreneurs, business executives and owners. The sister firm of the law group is Holt Capital Management Group and this firm specializes in financial advising, asset management and investments. The firm's personnel consist of attorneys, certified financial planners, registered investment advisors, licensed insurance representatives, and certified wealth preservation and asset protection planners.

The practice also offers CME and CPE training for medical and dental professionals, as well as for certified public accountants and enrolled agents. The firm has over 25 years of experience and is located in Glendale, Arizona.

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