

# Minimizing Income Taxation of Trust Income: The Delaware Advantage

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Many tax planners may not be aware that Delaware law can create opportunities for clients to employ Delaware trusts to reduce or eliminate the state income taxes applicable to their trusts. Many states have adopted income taxation systems that tax trusts based on whether the trust is a resident or nonresident trust, as determined by the residence of the grantor and/or trustee. Delaware law takes this approach. However, Delaware law also includes some unique features that can enable grantors in other states to use Delaware trusts to minimize or avoid state income taxes.

## A. Delaware Tax Law

Delaware follows the federal income tax rules for determining whether a trust is a *grantor* or *non-grantor* trust. If a trust is a "grantor trust," then similar to the federal tax system, the trust is disregarded as a separate taxpayer under Delaware law and the income will be taxed to the grantor. Delaware treats "non-grantor trusts" as separate taxpaying entities and further categorizes them as either *resident* or *nonresident* trusts for Delaware state income tax purposes.

A non-grantor trust is a Delaware resident trust if (1) the trust is created by the will of a decedent

who at death was domiciled in Delaware; (2) the trust is created by a person domiciled in Delaware; (3) during more than half of any taxable year, the trust has only one trustee who is either a Delaware resident individual or an entity conducting trust business in an office in Delaware; (4) during more than half of any taxable year, the trust has more than one trustee and one of the trustees is an entity conducting trust business in an office in Delaware; or (5) during more than half of any taxable year, the trust has more than one trustee all of whom are individuals and at least one-half of whom are Delaware residents.<sup>2</sup> Delaware resident trusts are potentially subject to the Delaware income tax imposed upon individuals, however, several deductions may limit or eliminate this potential tax liability. Resident trusts may take an income tax deduction for *both* the amount of their federal distributable net income that is actually distributed<sup>3</sup> and the amount of their federal taxable income (including capital gains), as modified for Delaware purposes, that is set aside for future distribution to nonresident beneficiaries.<sup>4</sup> Consequently, a Delaware non-grantor resident trust will be subject to the Delaware state income tax only on its income that is set aside for future distribution to Delaware resident beneficiaries.

All non-grantor trusts that do not satisfy the definition of a resident trust are nonresident trusts for

Delaware income tax purposes.<sup>5</sup> Nonresident trusts and their nonresident beneficiaries are subject to Delaware income taxation only on the portion of the trust's income taxable to them that is derived from Delaware sources.<sup>6</sup>

## B. Categorizing Other States' Income Taxation of Trusts

The tax laws of states other than Delaware may generally be divided into three categories based on the nature and strength of the connection between a trust and the state that is required in order to impose its income tax on the trust. Many states have laws, similar to Delaware's law described above, that define trusts as either resident or nonresident trusts; such states generally tax all of the taxable income of resident trusts while taxing nonresident trusts only on their income derived from sources within the state. States have adopted various approaches to what type of connection between the state and the trust will classify the trust as a resident trust. In some states, resident trusts include those created by a grantor who was domiciled in the state at the time of his or her death or when the trust became irrevocable. Many of those states purport to impose a tax on all of a resident trust's income throughout its existence, even though the trustee, all of the beneficiaries, and the trust assets may be located outside the

<sup>1</sup> The authors would like to express their appreciation to Christie Di Guglielmo for her contribution to this article.

<sup>2</sup> 30 Del. C. §1136(a).

<sup>3</sup> 30 Del. C. §1137.

<sup>4</sup> 30 Del. C. §1138.

<sup>5</sup> 30 Del. C. §1136(b).

<sup>6</sup> 30 Del. C. §1141.

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state. Other states require a more substantial ongoing link between the trust and the state in order to classify the trust as a resident trust and therefore impose tax on income from sources outside the state. Finally, a few states define a trust's residence based on the domicile of the trustees or beneficiaries.

### 1. States Taxing the Income of Trusts Only When There Remains a Significant Ongoing Link Between the Trust and the State

States with tax laws requiring some significant current link between a trust and the state in order to subject the trust to state income tax include New York, New Jersey, Massachusetts, Michigan and Missouri. New York law will serve as an example of how such states tax trusts. New York generally imposes income tax on all the income of New York resident trusts.<sup>7</sup> Very generally, a New York resident trust is a trust created by the will of a New York decedent or inter vivos trust agreement of a person domiciled in New York at the time the trust was created or became irrevocable. However, in *Mercantile-Safe Deposit & Trust Co. v. Murphy*, 203 N.E.2d 490 (N.Y. 1964), the New York Court of Appeals held that constitutional limitations restrict the state's ability to tax resident trusts with minimal current contacts with the state. In response, New York revised its tax regulations to create a safe harbor for trusts with few New York connections, providing explicitly that New York will not impose a state income tax on a trust if (1) all of the trustees are domiciled

<sup>7</sup> N.Y. TAX LAW §601(c) (Consol. 2003).

in a state other than New York; (2) the entire corpus of the trust, including real and tangible property, is located outside of New York; and (3) all income and gains of the trust are derived from non-New York sources, determined as if the trust were a nonresident trust.<sup>8</sup>

### 2. States Taxing the Income of Trusts Based on a Minimal Nexus with the State

Some jurisdictions, such as Pennsylvania, Connecticut, Ohio and the District of Columbia, require only a minimal nexus with a trust in order to impose state income tax on the trust. Pennsylvania imposes a tax on all the income of resident trusts and on all the income from Pennsylvania sources of nonresident trusts.<sup>9</sup> A Pennsylvania resident trust is a trust (1) created by the will of a decedent who resided in Pennsylvania at the time of his or her death, or (2) created by or consisting in whole or in part of property transferred to a trust by an individual residing in Pennsylvania.<sup>10</sup> Under Pennsylvania law, the accumulated income of a resident trust will be subject to Pennsylvania tax regardless of whether the trust has any current contacts with Pennsylvania. This is true even if the trust was created under

<sup>8</sup> N.Y. COMP. CODES, R. & REGS. tit. 20, §105.23 (2003).

<sup>9</sup> 72 P.S. §7302 (2002).

<sup>10</sup> *Id.* §7301(s); see also 61 PA. CODE §101.1 (2003) ("The single controlling fact in determining if a trust is a resident trust . . . shall be whether the decedent, the person creating the trust or the person transferring the property was a resident individual or person at the time of death, creation of the trust or the transfer of the property. The residence of the fiduciary and the beneficiaries of the trust shall be immaterial.").

the laws of another state, and all of the trustees, the administration of the trust, and all of the beneficiaries are located outside of Pennsylvania. The tax is imposed simply by virtue of the grantor's residence (or death as a resident) in Pennsylvania at the time of creation of the trust.

Courts in several jurisdictions with tax systems similar to Pennsylvania's have considered and upheld the constitutionality of taxing trusts with such minimal connections to the jurisdiction. In *Chase Manhattan Bank v. Gavin*,<sup>11</sup> the Connecticut Supreme Court upheld the constitutionality of a Connecticut law imposing an income tax on trusts based solely on the fact that the grantors resided in Connecticut at the time the trusts were created. The court reasoned that the trusts were initially created under Connecticut laws and the Connecticut courts were "open and available" for accounting and trust administration. In *District of Columbia v. Chase Manhattan Bank*,<sup>12</sup> the District of Columbia Court of Appeals also upheld the constitutionality of a law that taxed the income of a testamentary trust created by the will of an individual who died while domiciled in the District of Columbia even though the trustee, trust assets, and trust beneficiaries were all located elsewhere. Essential to the court's holding was the fact that D.C. courts had a "continuing supervisory relationship" with respect to the administration of the trust and that even though another state may assert jurisdiction over the trust, the D.C. court may also retain jurisdiction, and the District's power to exercise jurisdiction over a trust is coextensive

<sup>11</sup> 733 A.2d 782 (Conn. 1999).

<sup>12</sup> 689 A.2d 539 (D.C. Cir. 1997).

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with its power to tax it.<sup>13</sup>

The courts in *Gavin* and *Chase Manhattan* essentially based their opinions on the premise that the U.S. Supreme Court's decision in *Quill Corp. v. North Dakota*<sup>14</sup> allowed a state to tax based on very limited contacts with the state. In *Quill*, the U.S. Supreme Court upheld a use tax statute under the Due Process Clause, ruling that a state may tax a taxpayer who has "minimum contacts" with the taxing state – essentially imposing the same test for state taxation under the Due Process Clause as it has traditionally applied to questions of state court jurisdiction over nonresidents.

Several states' courts have reached differing conclusions regarding the constitutionality of income tax statutes that are substantially similar. These inconsistencies have yet to be definitively resolved by the federal courts. Several commentators suggest that *Gavin* and *Chase Manhattan* were clearly erroneous and that the results of their holdings were unconstitutional.<sup>15</sup> It appears those commentators would also view Pennsylvania's statute as unconstitutional.

### 3. States Taxing the Income of Trusts Based on the Residence of the Trustees or Beneficiaries

Some states, such as California and Mississippi, define resident trusts according to the residence of the trustees or beneficiaries, rather than that of the grantor. California imposes state income tax on the entire income of a trust if the trustees or noncontingent beneficiaries are residents of California, without reference to the residence of the settlor.<sup>16</sup> The tax is apportioned according to the number of trustees who reside in the state.<sup>17</sup> Similarly, the residence of the trustees determines

<sup>13</sup> Based on the courts' reasoning in *Gavin* and *Chase Manhattan*, it appears that it may be possible for a trust to avoid Connecticut or District of Columbia income tax if the trustee obtains an order from the appropriate court in Connecticut or the District of Columbia ceding all jurisdiction over the trust to Delaware.

<sup>14</sup> 505 U.S. 298 (1992).

<sup>15</sup> For examples of this perspective on the constitutionality of taxation schemes requiring a minimal nexus in order to tax trusts, see Bradley E. S. Fogel, What Have You Done For Me Lately? Constitutional Limitations on State Taxation of Trusts, 32 U. Rich. L. Rev. 165 (1998); M. Read Moore & Amy L. Silliman, State Income Taxation of Trusts: New Case Creates Uncertainty, 24 Est. PLAN. 200 (1997).

<sup>16</sup> CAL. REV. & TAX. CODE §17742 (Deering 2003).

<sup>17</sup> CAL. REV. & TAX. CODE §17743. The U.S. Supreme Court has upheld states' proportional taxation of a trust based on the residence of a trustee. See *Greenough v. Tax Assessors*, 331 U.S. 486, 498 (1947) ("[T]he resident trustee was the possessor of an interest in the intangible [property], sufficient . . . to support a proportional tax . . . by Rhode Island.").

whether a trust will incur income tax under Mississippi law.<sup>18</sup>

### C. Tax Planning Strategies Using Delaware Trusts

There are several strategies involving Delaware trusts which may be useful in minimizing state income taxes applicable to trusts. The utility of the strategies described below will differ depending on which type of taxation system a grantor's home state has adopted, and the vigor with which the state taxing authorities administer and enforce the tax statutes. The strategies involve issues of local law and their viability should be considered by counsel in those jurisdictions.

#### 1. How a Delaware Trust May Help Grantors Avoid Income Taxation by States Requiring a Significant Ongoing Connection with the State

Establishing a Delaware non-grantor resident trust, or moving an existing trust to Delaware, can provide significant state income tax advantages for settlors in states such as New York, New Jersey, Missouri, Michigan and Massachusetts, which require a trust to have a significant ongoing connection with the state in order to subject the trust to tax. For example, through careful drafting, it is possible for a New York resident settlor to create a Delaware trust in which he or she retains an interest and which is a non-grantor trust for income tax purposes, but the transfers to which are not treated as completed gifts.<sup>19</sup> If all of the trust's income is either set

<sup>18</sup> See *Fogel*, at 179 & n. 70 (analogizing California's and Mississippi's taxation of trusts).

<sup>19</sup> See Priv. Ltr. Rul. 200148028 and Priv. Ltr. Rul. 200247013.

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aside for nonresident beneficiaries or distributed, the trust will not be subject to Delaware state income tax and New York will not impose a tax, despite its creation by a settlor residing in New York, as long as it satisfies the requirements of New York's safe harbor. Additionally, the beneficiaries and trustee(s) of an existing New York trust might reduce or eliminate all state income tax imposed on the trust by eliminating the New York trustee and replacing it with a Delaware trustee, thus moving the trust from New York to Delaware, if none of the beneficiaries reside in New York and the trust otherwise satisfies the New York tax regulations.

### 2. Suggested Strategies for Using a Delaware Trust to Avoid Income Taxation by States Taxing Trusts Based on a Minimal Nexus with the State

#### a. Limited Power of Appointment

One strategy in states such as Pennsylvania may be to create a trust in which a nonresident of Pennsylvania has a limited power to appoint all or a portion of the trust assets in favor of a new trust.<sup>20</sup> Upon exercise of such powers, the terms of the new trust may be substantially the same as the original trust. Arguably, the appointment of the trust assets to a new Delaware resident trust by the nonresident Pennsylvania powerholder would not

<sup>20</sup> Generally, an existing trust may be reformed to add such a limited power, if none currently exists, through an uncontested proceeding in Delaware Chancery Court.

constitute a transfer by a Pennsylvania resident, and therefore the new trust would not be a resident trust under Pennsylvania law. It seems that if the powerholder can appoint the assets in favor of anyone he or she chooses, either outright or in trust, it is possible that the resulting Delaware trust would not fall within the definition of a Pennsylvania resident trust. The trustee of the original trust would identify the resident Pennsylvania trust's income tax return in the year of the appointment as the final return, and the new Delaware resident trust would no longer report Pennsylvania taxable income.

#### b. Distribution in Further Trust

Alternatively, the trustee might exercise a discretionary power to distribute all of the trust assets to a new Delaware resident trust for the benefit of the beneficiaries of the original trust upon substantially the same terms and conditions as the original trust.<sup>21</sup> The trustee's exercise of such a power could be characterized as a distribution of all of the trust assets which results in the termination of the original trust. Following distribution of all of the original trust's assets, the trustee would identify the trust's Pennsylvania tax return as the final return in the year of the distribution, and the new Delaware trust would no longer report Pennsylvania taxable income.

#### c. Trapping Trust

A final strategy may be to create a companion Delaware resident trust to which an annual distribution of all of the undistributed income of the Pennsylvania resident trust could

<sup>21</sup> Here, too, if the trustee does not possess such a power, the Delaware Chancery Court may issue an order in an uncontested proceeding, granting the trustee the power.

be made. Under this strategy only the income would be distributed to a new trust, and the original trust would continue to exist as a Pennsylvania resident trust. The original trust will distribute all of its income annually and, consequently, will not have any Pennsylvania taxable income. The second trust, called a "trapping trust", would be a Pennsylvania nonresident trust and would trap and eliminate state income tax. This strategy might also minimize or eliminate state income tax on trust net income that is actually distributed to beneficiaries by making the distributions to the trapping trust and delaying the distributions to beneficiaries from the trapping trust until a year when the trapping trust has little or no distributable net income.

For example, the trustee of a Pennsylvania resident trust could make a distribution of all of the undistributed trust income to a Delaware resident trust held for the benefit of the same individual beneficiaries. Amounts distributed by the first trust to the trapping trust would enter the trapping trust in a year in which the trapping trust makes no distributions to the beneficiaries and would be accumulated and added to principal. The income of the first trust would be carried out as a deduction for distributed income when it is distributed to the trapping trust; consequently, the Pennsylvania resident trust would have no income subject to the Pennsylvania income tax. The income or capital gains accumulated in the trapping trust would not be subject to Delaware income tax if none of the beneficiaries resides in Delaware and may not be subject to Pennsylvania income tax on income from non-Pennsylvania sources, because it would be created by the Delaware

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# The Family Investment Partnership: Complexities Abound

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Many articles have been written recently regarding family investment partnerships. Some proponents of the family investment partnership contend such an entity can solve all of a family's investment concerns. In theory, the family investment partnership makes a lot of sense. A large extended family with substantial net worth consolidates its investable assets in a single family partnership. The partnership then hires one or more investment managers to manage the family's consolidated portfolio. The structure offers many advantages, primary of which are centralized investment management and increased pricing leverage for the members of the family. However, the family investment partnership, while simple in concept, can be anything

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trustee or some third person who does not reside in Pennsylvania.

### D. Conclusion

This article has provided a necessarily brief sketch of states' various approaches to income taxation of trusts. As summarily explained, Delaware law may allow tax planners to employ a number of strategies involving Delaware trusts to reduce or eliminate the state income tax liability of trusts.

but simple in operation. Complexities abound both from a tax standpoint and from a risk management perspective. That is to say nothing of the issues an investment family partnership can present from a family planning aspect.

### An Illustration of the Family Investment Partnership

The issues involved in creating and maintaining a family investment partnership can be best illustrated with a simple example. Assume your firm has represented a family client for years. Your firm's client was initially the matriarch and patriarch of the family, both of whom have died during your involvement in the representation of the family. The matriarch and patriarch died leaving six children who vary in ages from their mid-forties to late-fifties. All but one of the six children have children of their own and two of the children also have grandchildren. On a combined basis, the family investment portfolio totals \$65 million. This article will address just some of the many issues that you, as the family's advisor, will need to consider and work through, should your clients desire to create a family investment partnership.

### Family Planning Issues

It would be neat and clean conceptually if each of your client's children retained an equal amount of their respective inheritances from their parents' aggregate estate, but that is rarely the case. Annual gifting

disparities, estate planning at the children's generation, spending habits and lifestyle choices likely will have resulted in wide disparities in investable assets of each child. Each child has investable assets to contribute to the family investment partnership, but the disparity in value owned by each child in relation to his or her siblings will result in disproportionate limited partnership interests for each child if the family members contribute all the family's wealth to the partnership.

Disproportionate partnership interests may not pose a problem from a tax standpoint but could very well create issues in the family dynamic among the siblings. These issues are likely to be magnified by the limitations usually placed on the ability of a limited partner to withdraw from a limited partnership. From a gift and estate tax planning standpoint, the restrictions on transferability of limited partnership interests and the prohibitions against withdrawal of a limited partner are desirous, in that they form the foundation upon which most valuation discounts are derived. Furthermore, limiting withdrawal rights simplifies partnership accounting.

A family that is considering a family investment partnership should be counseled on the possibility of contributing some, but not all, of the family's investable assets to the partnership. This may make it possible for each sibling to

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