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An update from our Trusts & Estates Group

Eliminate a Trust's State Income Tax

A Delaware non-grantor/incomplete gift trust can help you do it. That is, if a client lives in the right state.

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Many advisors are not aware that their clients might use Delaware trusts for state income tax planning. Delaware law can enable individuals residing in many states, such as New York, New Jersey, Kentucky, Massachusetts, Michigan and Missouri, to use Delaware trusts to minimize or even avoid state income taxes. That's because there is no Delaware income tax on Delaware trusts benefiting individuals who reside outside of Delaware. In fact, the states we've just listed don't tax a Delaware trust's income if the trust is a non-grantor trust; it's possible for such trusts to be funded with incomplete gifts. However, advisors must resist any temptation to abuse the Delaware trust option. In fact, such trusts ideally should be funded solely with assets that settlors essentially want to hold for the next generation.

LEGAL UNDERPINNINGS

In general, Delaware treats as a Delaware resident trust any trust that has at least one trustee located in Delaware.[1] Delaware resident trusts may take an income tax deduction both for the amount of their federal distributable net income that is actually distributed[2] and for the amount of their federal taxable income that is set aside for future distribution to nonresident beneficiaries.[3]

The important question then becomes whether a settlor's own state will tax the trust's income. The answer is "yes" in some jurisdictions, such as Connecticut, Ohio and the District of Columbia, and "no" in others, such as New York, New Jersey, Kentucky, Massachusetts, Michigan and Missouri.

Of course, states have many approaches to the taxation of trusts. Some tax all of the income of trusts created by settlors who were domiciled in the state at the time of death or when the trust became irrevocable. Many of these impose a tax on all of a trust's income throughout the trust's existence, even if the trustee, all of the beneficiaries and the trust assets are located outside the state.

Some states require a significant, current connection between a trust and the state to subject it to state income tax.

However, states such as New York require a significant, current connection between a trust and the state in order to subject the trust to state income tax. Although rules vary significantly from state to state, New York is a good example of how these states tax trusts. New York generally imposes income tax on all the income of New York resident trusts.[4] Generally, a New York resident trust is a trust created by the will of a New York decedent or by an *inter vivos* trust agreement of a person domiciled in New York at the time the trust became irrevocable. In the 1964 case of *Mercantile-Safe Deposit & Trust Co. v. Murphy*,[5] the New York Court of Appeals held that constitutional limitations restrict the state's ability to tax resident trusts that have minimal current contacts with the state. In response, New York revised its laws to create a safe harbor for resident trusts with few New York connections. These laws provide that New York will not impose a state income tax on a resident trust if all of the following conditions are met: (i) all of the trustees are domiciled 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.[6]

AVOID INCOME TAX

Clients living in states such as New York can avoid taxes on their trust income simply by moving their trusts to Delaware. In addition, it's generally possible for an individual residing in such a state to create a so-called "self-settled" trust (meaning that the settlor is eligible to receive distributions from the trust) that also won't be subject to income taxation by the settlor's home state. Importantly, such a trust may be designed so that transfers to the trust are not treated as taxable gifts. Until recently, it was unclear whether one could create a self-settled non-grantor trust without adverse gift tax consequences. But in a private letter ruling (PLR) issued on Aug. 27, 2001, to the settlor of a Delaware asset protection trust, and in several subsequent PLRs, the Internal Revenue Service has ruled that it is possible, through careful drafting to create a self-settled non-grantor trust without triggering gift tax.[7]

A Delaware asset protection trust designed as a non-grantor/incomplete gift trust can be a powerful tax and asset protection planning tool for someone who lives in a state that imposes a material income tax on investment income if the state's tax laws allow residents to create trusts of this type that are not subject to the state's income tax.

AVOID GRANTOR TRUSTS

As an initial matter, the trust must avoid grantor trust status. Grantor trusts generally cannot be employed to avoid income taxes imposed by the settlor's home state because settlors usually have to report such trusts' income on their personal state income tax returns.

A trust is a grantor trust if the settlor's creditors can attach the trust's assets.[8] Under the laws of most states, if a trustee has the power, in the exercise of its sole discretion, to distribute trust assets to the settlor, the settlor's creditors may claim all of the trust assets to satisfy the settlor's debts. Thus, self-settled trusts formed under most states' laws cannot be employed to avoid state income taxes in the settlor's home state. But if the settlor's creditors cannot attach the assets of the trust -- as is the case with a Delaware asset protection trust[9] -- the trust would not on that basis be a grantor trust.

What of the other rules for affixing the "grantor trust" label to a trust? Internal Revenue Code Section 673 provides that a trust is a grantor trust if the settlor retains any material reversionary interest. But eligibility to receive discretionary distributions doesn't seem to constitute a reversionary interest as the term is commonly understood. The IRS has agreed in its Aug. 27, 2001, PLR and three subsequent letter rulings. It is critical, however, that the drafter of any trust agreement intended to avoid grantor trust treatment ensure that no portion of the trust will ever revert to the settlor or the settlor's spouse.

IRC Section 674 generally provides that a trust is a grantor trust if the beneficial enjoyment of the trust property is subject to a power of disposition exercisable by the settlor or a non-adverse party or both, without the approval or consent of any adverse party. But the settlor will not be taxed as the owner of any portion of the trust pursuant to IRC Section 674 if both of the following conditions are met:

- the trust income and principal may be distributed or accumulated in the trust only with the consent of the members of a "distribution committee," each of whom is an adverse party within the meaning of IRC Section 672(a); and
- the settlor's only power to control beneficial enjoyment is a testamentary limited power of appointment.

To avoid classification of the trust as a grantor trust pursuant to IRC Sections 676 or 677, the trust agreement should provide that during the settlor's life, the trustee has no power to make any distribution of net income or principal to or for the benefit of the settlor or the settlor's spouse unless the distribution is made at the direction of a distribution committee.

In the form of trust agreement on which the IRS ruled, the initial members of the distribution committee were the two eldest adult and competent individuals (other than the settlor or the settlor's spouse) initially eligible to receive distributions out of the trust estate.

One way for a trust to be a grantor trust: the settlor retains a material reversionary interest.

It should be possible to configure the distribution committee in other ways, provided that each member of the committee is then eligible to receive distributions out of the trust estate. Each member of the distribution committee should have the power, acting in a non-fiduciary capacity, to participate in deliberations concerning, and to vote in favor of, distributions to, or for the benefit of, such distribution committee members personally. Members of such a distribution committee then would be "adverse persons" with respect to the settlor and the settlor's spouse for purposes of the grantor trust rules.

Also in the form of trust agreement on which the IRS ruled, all rights and powers conferred on the distribution committee were exercisable only by unanimous action of all members of the committee except that any member of the committee acting alone could direct the trustee to make one or more distributions upon obtaining the settlor's prior written consent to each such distribution. Here too it should be possible to achieve the same goal with a different design, providing the non-grantor trust with other mechanisms for distribution committee action.

Beware: although the settlor's spouse may be a discretionary distributee during the lifetime of the settlor, a Delaware non-grantor/incomplete gift trust should not provide the surviving spouse with a qualified terminable interest property (QTIP) trust or any other beneficial interest. That's because under IRC Section 672(e), the settlor is treated as holding any power or interest held by the settlor's spouse. A QTIP trust, for example, would likely cause the settler to be deemed to possess a reversionary interest that would cause the trust to be a grantor trust under IRC Section 673. All is not lost for the settlor's spouse, however, because the settlor may retain and exercise a testamentary limited power of appointment in favor of the spouse either outright or in favor of a QTIP trust or in some other type of trust in which the spouse holds an interest. In fact, if the settlor desires to integrate the Delaware trust with his estate plan and provide for the trust assets to be held in a QTIP trust following the settlor's death, the settlor could execute a codicil to his will when the Delaware trust is formed, exercising the settlor's testamentary limited power of appointment in a fashion that provides for the surviving spouse.

AVOID COMPLETED GIFTS

If the trust agreement provides the settlor with a testamentary limited power of appointment over all of the trust property, then contributions by the settlor to the trust would not be completed gifts for federal gift tax purposes. That's because the settlor would retain the power to change the beneficial interests of the beneficiaries of the trust. Treasury Regulations Section 25.2511-2(c) provides that a gift in trust is incomplete if, and to the extent that, a reserved power gives the settlor the power to name new beneficiaries or to change the interests of the beneficiaries as between themselves, unless the power is a fiduciary power limited by a fixed or ascertainable standard.

A taxable gift will occur when the settlor's power to change the trust interests is released or extinguished. As soon as the settlor relinquishes or otherwise loses the power to alter the interests of the beneficiaries, there will be a completed gift. Thus the gift will be complete (and hence taxable) upon the occurrence of any action by the distribution committee that would effectively terminate the settlor's power of appointment with respect to any part of the trust property, including the distribution of income or principal to anyone other than the settlor.

EXAMPLE

A simple example illustrates the power of a Delaware non-grantor/incomplete gift trust. Let's say a couple residing in New York City has a sizeable portfolio of marketable securities and other intangible assets. These two are concerned about liability to potential future creditors. They are in the highest federal income tax bracket and pay combined state and city income tax at an 11 percent rate. They don't want to make a completed gift because they don't want to pay gift tax or use any of their gift tax exclusion amount. Within their portfolio of securities, they have $2 million of assets that they essentially hold for the benefit of their children because they don't foresee any circumstance (other than a catastrophic lawsuit or similar financial setback) in which they would expend that money during their lifetimes given the magnitude of their other assets.

A Delaware non-grantor/incomplete gift trust could be a powerful planning tool for this couple. As settlors of such a trust, they could retain the right to receive discretionary distributions of income and principal from the trust (subject to the consent or direction of a distribution committee comprised of their children who are also potential discretionary beneficiaries). This would provide the couple with a safety net against the possibility of a major financial setback. The trust also will provide creditor protection for the trust assets. At the same time, the trust's income will not be subject to New York state or city income taxation. The federal income tax imposed on the trust's assets would be about the same in the trust as it would be if the couple owned the assets outright.

Had the couple retained this $2 million in their own names and achieved an enviable 10 percent annual rate of return before taxes, the $2 million would grow to about $8.6 million in 20 years, assuming the earnings are comprised entirely of qualified dividends and realized capital gains. The effective rate of tax on these investment assets would be 24.35 percent (15 percent federal rate on capital gains and dividends; 11 percent New York state and city tax on all income; New York taxes deducted in computing federal taxes). By contrast, contributing the $2 million to a Delaware non-grantor/incomplete gift trust means the effective rate of tax is reduced to 15 percent, and the trust grows to about $10.225 million in the same time with the same rate of return. Thus, merely by creating the trust, the couple would obtain asset protection for the trust property during the entire 20-year trust period and, at the end, the value of the property would be $1.6 million greater.

AVOID ABUSE

It's possible that state taxing authorities in various states will attack obviously abusive transactions using Delaware non-grantor/incomplete gift trusts that are designed primarily to avoid the imposition of state income tax on a particular transaction, such as the disposition of a block of highly appreciated stock. Consequently, advisors should avoid funding such trusts with assets likely to be sold shortly after the creation of the trust. Such a trust could be even more vulnerable to attack if the sale were followed by the distribution of all, or a large portion, of the trust assets back to the settlor. The settlor's home-state taxing authority could view such a transaction as a "sham" and might attack it on the basis of substance over form, assignment of income, or some similar theory.

In addition to risks under state tax laws, such a transaction could jeopardize the trust's creditor protection if there is evidence that the settlor had a prearranged agreement with the distribution committee to distribute assets back to the settlor at a particular time. And, as we've seen, without the creditor protection, the trust would be a grantor trust and its income would be subject to income taxation by the settlor's home state.

The best course is to create the trust with the intent to continue it at least for the lifetime of the settlor. Clients should avoid transferring a proportion of their assets to such a trust that is so large that they will need routine distributions from the trust to pay for their living expenses. Optimally, for creditor protection reasons as well as sound tax planning, advisors should generally recommend that their clients fund such trusts only with those assets that the client likely will never need to expend, absent extraordinary events.

The Delaware non-grantor/incomplete gift trust is a unique opportunity, but it does require a long-term commitment to take proper advantage of it.

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1. 30 Delaware Code Section 1601(8).
2. *Ibid.,* Section 1635.
3. *Ibid.,* Section 1636.
4. N.Y. Tax Law Section 601(c) (Consol. 2003).
5. *Mercantile-Safe Deposit & Trust Co. v. Murphy,* 230 N.E.2d 490 (N.Y. 1964).
6. N.Y. Tax Law Section 605(b)(3)(D) (Consol. 2003), N.Y. Comp. Codes, Rules and Regulations, title 20, Section 105.23 (2003)
7. *See* Private Letter Ruling 200148028; *see also* PLRs 200502014; 200247013; and 200612002. It's actually possible to create four types of Delaware asset protection trusts: (1) non-grantor/incomplete gift, (2) non-grantor/completed gift, (3) grantor/incomplete gift, and (4) grantor/completed gift. Each variation can have very beneficial attributes to settlors with specific planning needs.
8. Treasury Regulations Section 1.677(a)-1(d).
9. The requirements for creation of a Delaware asset protection trust are beyond the scope of this article but may be found at 12 Del. C. Section 3570, *et seq.*
