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Estate Planning

Move to Florida! But if You Can't, Use Non-Grantor Trusts to Avoid State Income Tax

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With New Jersey and New York being two of the higher income tax states (New Jersey's top marginal rate is 10.75% and New York City residents face a top combined rate approaching 13%), an easy recommendation is for clients to go south. Florida (among other states) does not impose a state income tax. The income tax differential between Florida and New Jersey (or New York) was not as pronounced prior to the effective repeal of the federal State and Local Income Tax (SALT) deduction. That's because the SALT deduction reduced the effective state income tax by up to 39.6% (in 2017). However, as of 2018, the SALT deduction is limited to $10,000. As a result, many wealthy northerners experienced a significant income tax increase. So, as an estate planning attorney, I advised clients to move to a state with no income tax (like Florida) and use SPF 50.

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But alas, many of my clients can't move, or don't want to move. They have local business interests or family up north. Proximity to grandchildren is an unbelievably motivating force. Some simply like all the amenities that the New York/New Jersey metro region has to offer. Others simply cringe at the thought of moving to God's waiting room. Luckily, some clients can use non-grantor trusts to provide a partial solution to their state income tax problem.

A non-grantor trust is deemed a separate income tax entity—the trust pays its own income tax on income it earns and retains from the assets it owns in any year. It's a creature of federal tax law. States like New Jersey and New York (with certain caveats) follow the federal law in treating the trust as a separate taxpayer apart from the person who created it, commonly known as the trust's "grantor."

In order to create a non-grantor trust, a tax lawyer must ensure that the trust is devoid of any provisions that would compromise its separate taxable entity status. If one mistake is made (among a myriad that are possible), the trust will be treated as a "grantor trust," and all income earned by the trust will be deemed earned by the grantor of the trust and reportable on the grantor's personal income tax return. The grantor trust rules, contained in Internal Revenue Code (IRC) Section 673, et. seq., are tricky.

But if the trust qualifies as a non-grantor trust, then another concept can be incorporated into the design that allows for state income tax planning. Just as an individual can be a resident of a state with no income tax, a non-grantor trust can qualify as a resident of a state with no income tax. Thus, income earned on assets owned by the non-grantor trust, while subject to federal income tax, may avoid state income taxation on its income. For example, a non-grantor trust can be designed to be a resident of Alaska (or another state with no state income tax). Achieving that result, however, is not a day at the Florida beach.

The first step in the process is attempting to thread the needle between two areas of federal tax law with seemingly incompatible rules. In order to qualify as a non-grantor trust, the grantor of the trust must not retain any powers and rights that would otherwise tax the income earned by the trust to the grantor directly. In order to make these trusts worth the cost of establishing and administering them as separate taxable entities in another state's jurisdiction, the state income tax savings

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must be worthwhile. Usually that takes a transfer of several million dollars in assets, such as an investment portfolio of publicly traded securities that could generate income and/or capital gains of at least $250,000 annually, or a potentially large one-time capital gain in the many millions of dollars.

Conversely, if a client transfers assets worth several million dollars to a non-grantor trust, such a transfer raises federal gift tax issues. The client is transferring assets and receiving nothing in return, which is a gratuitous transfer. Often, the client establishes a non-grantor trust for state income tax savings (and not estate planning), with the intent to maintain access to the assets in the trust. The client must retain a certain level of control over the trust to maintain access and to avoid transfers to the trust being treated as taxable gifts (thereby avoiding federal gift taxation).

And therein lies the conflict—the client must relinquish enough control under the federal income tax law to qualify the trust as a separate income tax entity (i.e., a non-grantor trust), yet retain enough control so that the transfer to it is not deemed a taxable gift for federal gift tax purposes. That specific trust structure is called an "incomplete gift non-grantor trust" or "ING." It can be done, but it is tricky.

The IRS has issued several Private Letter Rulings (PLRs) that provide a road map to structuring INGs. Note that PLRs cannot be used as legal authority but provide an indication of the IRS's position. The IRS issued a string of PLRs approving INGs beginning in 2001 until 2007. Then from 2007 to 2012, the IRS seemed to change its position on the feasibility of INGs. Beginning in 2013 through 2018, the IRS issued several more PLRs that refined and approved the design. PLR 201742006 is a great example. In Rev. Proc. 2020-3, the IRS listed a number of "bad factors" that appear to compromise an ING's non-grantor status and indicated that, if any such bad factors are present, it will no longer rule on the non-grantor aspect of the ING structure.

Once non-grantor, incomplete gift status is achieved, the trust must be established in a state that does not impose an income tax. There are several. Alaska, Nevada, South Dakota and Delaware are frequently used, primarily because these states have also promoted a corporate trustee business climate that allows residents from states such as New Jersey to easily establish trusts under their laws and thus obtain the income tax-free (and other) benefits of those states.

Many states with high income tax rates have tax law structures that allow their residents to circumvent state income tax by using INGs. Moreover, federal constitutional issues surrounding a state's ability to tax "nonresident" trusts may limit a state's ability to curtail the use of INGs.

There is a key limiting factor in creating INGs for New Jersey (and other) clients: state source income. For example, Florida residents who have New Jersey source income must pay tax to New Jersey on that New Jersey source income. Two important categories of state source income are income generated from the rental or sale of real property located in the state, and active business income generated by operations in the state (or the sale of such a business). States can be aggressive in taxing source income. In fact, in Tax Topic Bulletin GIT-12, Estate and Trusts, Understanding Income Tax (at page 3), the New Jersey Division of Taxation has implied that a non-grantor trust created by a New Jersey resident (regardless of the state under which the trust is created) could be subject to New Jersey tax on all its income simply by having just one dollar of New Jersey source income.

If New Jersey can tax an Alaska ING on New Jersey source income, then what types of income are not New Jersey source income for such an ING? The most important types are capital gains, dividend income, and interest income from publicly traded securities. These are all considered source income of the state in which the taxpayer resides. In the case of an ING established in a non-tax state, that means all interest, dividends and capital gains from its brokerage account can escape New Jersey income taxation. If that account generates $250,000 per year in such income over 10 years, that can translate into a New Jersey income tax savings of up to $268,750. There are many other instances where INGs can save millions of dollars in New Jersey tax. Moreover, an ING's investment assets can remain in a local brokerage in New Jersey.

At last count, 41 out of the 44 states that impose an income tax have adopted the federal grantor trust rules, including New Jersey. New York has adopted modified federal grantor trust rules—if the trust is designed to be an incomplete gift trust, it by definition is a grantor trust for New York income tax purposes. That modification effectively disallows the "ING" structure for New York clients. However, there are still techniques using non-grantor trusts wherein New York residents can avoid New York income taxes on non-New York source income. One method is to structure the transfer as a completed gift to a non-grantor trust situated in, for example, Alaska. With the federal gift tax exemption currently at $11.58 million per person, a non-grantor trust of that size can generate significant annual state income tax savings. Other, more creative techniques for even larger transfers to non-grantor trusts that avoid gift characterization are also possible for New York (and other) clients.

If your client can't move to Florida, consider the non-grantor trust as an alternative to avoid state income taxation, and skip the SPF. ■