North Carolina Taxation of Irrevocable Trusts

BY WILLIAM R. CULP JR. AND MARK L. RICHARDSON

Background

Irrevocable trusts are often the foundation of estate plans for high net worth clients. Irrevocable trusts offer protection from creditors and marital discord claims and can be used to reduce and eliminate estate taxes. Many North Carolina estate planners use irrevocable trusts which are sitused in states other than North Carolina. Trusts sitused in jurisdictions other than North Carolina may be used to avoid the rule against perpetuities (South Dakota), offer creditor protection for self-settled trusts (Nevada and Delaware) and in certain specific situations avoid state income tax on trust income (Delaware, Florida, Nevada and South Dakota). For this article, we wanted to review the state income taxation of irrevocable trusts with a focus on accumulated intangible income. We will review the state income tax regime for irrevocable trusts in North Carolina and contrast the regime in North Carolina with that of South Carolina.

The Stakes—Federal vs. North Carolina Tax Burden

North Carolina trust income is taxed at rates that reach 8.25%. North Carolina does not provide a favored rate for capital gains. Because the federal tax rates for long-term capital gains and qualified dividend income currently reach only 15%, the North Carolina tax burden for dividend and capital gain income comprises a substantial percentage of a trust's total tax burden. For qualified dividend and capital gain income, the highest North Carolina income tax rate is currently 55% of the highest federal tax rate. The ability to reduce or eliminate the state income tax burden for a trust's intangible income can yield significant tax savings.

State Taxation of Irrevocable Trusts

The state taxation of accumulated intangible income of irrevocable trusts offers a planning opportunity because different states tax irrevocable trusts in different ways. This lack of uniformity among the states can be a trap for the unwary (if a trust is subject to tax in multiple states) or an opportunity for the informed (if a trust can avoid state income tax on intangible income).

As an overview, most states will only tax the intangible income of an irrevocable trust if the trust is classified as a "resident trust." An irrevocable trust is classified as a resident trust (as opposed to a non-resident trust) based on whether one or more of the following factors are present:

- The trust was formed (either at death or during lifetime) by a resident of the state
- The trust is administered in the state (typically the place where the investment and distribution decisions are made)
- One or more trustees live or do business in the state
- One or more beneficiaries live in the state

In general, a recitation in a trust agreement that a certain state's law will apply will not be a factor in determining whether a state's income tax law will apply to the trust.[1]

Some states tax trusts based on the existence of one of the above factors. Other states tax trusts if a combination of more than one of the above factors is present. A single trust may be subject to state tax in multiple states or it may completely avoid state income tax.

The distinction between a resident and non-resident trust is significant for state income tax purposes. Generally, a state that taxes resident trusts will tax a resident trust on all of its income, both from sources inside the state (source income —generally income from real property, in-state business income and tangible personal property) and outside the state (non-source intangible income, out-of-state real property, and out-of-state business income).[2] In contrast, a non-resident trust will be taxed only on source income, but not on non-source including intangible income. Thus, if a trust can be structured to avoid classification as a resident trust in a state with an income tax, the trust may be able to avoid income tax on its non-source intangible income.

The ability to choose the residency of an irrevocable trust for state tax purposes will depend on the residency of the parties involved (grantor, trustee and beneficiaries), the place of administration and the relevant law in each state in which the grantor, trustee and beneficiaries reside and in which the trust is administered. In addition, the ability to move the situs of a trust for state income tax purposes will depend on a similar analysis. For example, in South Carolina, as discussed below, the place of administration determines whether a trust is a resident or non-resident trust. It would seem that the place of administration could be both initially determined and moved, if it is desirable for tax purposes, by choosing a trustee in the desired jurisdiction. In North Carolina, as discussed below, it appears that some portion of the accumulated intangible income of a trust will be taxed if a beneficiary of the trust is a resident of North Carolina, even if the trust is a resident trust of another state. Thus, in North Carolina it would appear more difficult to avoid state taxation of non-source income of a trust, whatever the residency of the trust if the trust has a North Carolina beneficiary.

Planning Alternatives to Reduce the Burden of State Income Taxes

Depending on the residency of the grantor, trustee, and beneficiaries and the place of administration, it may be possible for the accumulated intangible income of a trust to avoid state income tax. Some common planning alternatives are as follows:

1. Situs Trust in State with No Income Tax. Most planners have clients who have moved to another state (such as Florida) to reduce or eliminate their personal state income tax burden. Instead of moving to another state, it may be possible for an individual to transfer his or her intangible assets to an irrevocable trust which is sitused in a state with no income tax, and thereby avoid state income tax on the accumulated intangible income of the trust. There have been several recent IRS private letter rulings ("PLRs") that appear to allow taxpayers to avoid grantor trust status on self-settled trusts.[3] The trusts subject to the PLRs have several key features. The trusts are self-settled, thereby allowing the grantor to remain as a beneficiary of the trust. The trusts are drafted so that gifts made by the grantor are incomplete for federal gift tax purposes. This is accomplished by ensuring that the grantor retains a testamentary power of appointment. Despite the fact that the

See **TRUSTS** *page 8*

trusts are self-settled trusts, the PLRs hold that the trusts are non-grantor trusts for income tax purposes. Presumably, because the trusts are non-grantor trusts for income tax purposes, the income would not be taxed to the grantor for purposes of the state income tax. The authors are aware of several trust companies located in jurisdictions with no state income tax that have been actively promoting the formation of such self-settled trusts for state income tax purposes.

In addition to self-settled trusts, a third party can form and fund (either by gift, sale or as an inheritance) a trust for the benefit of an individual and the trust can be sitused in a jurisdiction that does not tax trust income.

2. Avoid Classification as Resident Trust. It should also be possible for a trust to avoid state income tax on accumulated intangible income by avoiding classification as a resident trust in any one state. A recent article in *The Wall Street Journal*[4] describes this alternative:

> In some cases, it can make sense to situate your trust in a state that's not known as a tax haven. That's because each state has different rules that define whether the trust's income is taxable. For New York state to tax an irrevocable trust, for example, the trust must be created by someone who lives in the state. "If you live in New Jersey, you can create a trust in New York with no New York or New Jersey income tax," says Gail Cohen, senior vice president and general trust counsel for Fiduciary Trust Co. International.

North Carolina Taxation of Intangible Income

North Carolina is aligned with the minority of states that impose a tax on trusts if a beneficiary is a resident of the state.[5] N.C.G.S. Section 105-160.2, which deals with the tax on estate and trusts, states in relevant part that "[t]he tax shall be computed *on the amount of the taxable income of the estate or trust that is for the benefit of a resident of this State,* or for the benefit of a nonresident to the extent that the income (i) is derived from North Carolina sources and is attributable to the ownership of any interest in real or tangible personal property in this State or (ii) is derived from a business, trade, profession, or occupation carried on in this State" (emphasis added).[6]

The scope and application of this statute seem unclear, in part due a recent amendment of the North Carolina Administrative Code. Title 17, Section 6B.3724 of the North Carolina Administrative Code titled "Allocation of Income Attributable to Nonresidents" formerly stated in part that: "[t]he taxable income of an estate or trust located outside North Carolina, does not include any intangible income or any other income derived from sources outside of North Carolina."

The Regulation recognized that a trust located outside of North Carolina would not owe North Carolina tax on intangible income. This sentence was deleted from the North Carolina Administrative Code (the deletion appears to have been effective Feb. 1, 2005).[7] Although beyond the scope of this article, it is relevant to question whether a change in the long-standing interpretation and application of a North Carolina statute can (and should) be made by the deletion of a sentence in the Administrative Code.

Title 17, Section 6B.3724(b) of the North Carolina Administrative Code states that "[t]he determination of the amount of undistributed income from intangible property which is for the benefit of a resident is based on the beneficiary's state of residence on the last day of the taxable year of the trust. In the case of both resident and nonresident beneficiaries, the determination of the amount of undistributed income from intangible property which is for the benefit of a resident is made on the basis that the resident beneficiary's interest for the taxable year relates to the interest of both resident and nonresident income beneficiaries for the taxable year."

The question of when taxable income of a trust is "for the benefit of a resident" and how the taxable income is apportioned between resident and non-resident income beneficiaries can sometimes be unclear and difficult to apply. The following examples illustrate several different interpretation issues. A trust could state that it is an accumulation trust and it is for the benefit of the grantor's unborn grandchildren. The unborn grandchildren are obviously not yet North Carolina residents, even if their parents are North Carolina residents. Alternatively, the trust could provide that the trust is a discretionary trust for the issue of the grantor but the terms of the trust could provide that no distributions of income could be made to a North Carolina resident. In the case of a charitably inclined grantor, it may be desirable to include multiple non-North Carolina charities as permissible income beneficiaries of a trust with North Carolina beneficiaries and make distributions to the charities when desirable.

A possible application of the North Carolina statute may be illustrated with the following example:

Example. Nevada has no income tax. A Nevada resident formed and funded an irrevocable trust. The sole trustee is a Nevada resident and the trust is administered in Nevada. The beneficiary (both as to income and principal) of the irrevocable trust is a North Carolina resident. The assets of the trust consist of $1,000,000 in marketable securities, which generate intangible income (interest and dividends). There are no distributions to the beneficiary and all income is accumulated.

Based on the position of the North Carolina Department of Revenue, it appears that the intangible income will be subject to North Carolina income tax. If the position of the North Carolina Department of Revenue is correct, a North Carolina resident, as a beneficiary of a trust sitused in another jurisdiction, will be taxed in North Carolina.

South Carolina Taxation of Intangible Income

In contrast to North Carolina, South Carolina taxes a trust based on whether the trust is administered in South Carolina. A trust is a "resident trust" if it is being administered in South Carolina.[8] South Carolina Form 1041 (the fiduciary income tax return) states that "[a] resident trust is any trust which is administered in South Carolina. A trust being administered outside of South Carolina shall not be considered a resident trust merely because the governing instrument or a law requires that the laws of South Carolina be followed with respect to interpretation or administration of the trust. All other trusts are nonresident trusts."[9] The residence of a beneficiary of a trust is not a basis for taxation in South Carolina.

The instructions to South Carolina Form 1041 confirm that "[f]or a nonresident estate or trust, income from the following is not considered to be derived from South Carolina sources: annuities, interest, dividends or gain from the sale or exchange of intangible personal property, unless it is part of the income from a business, trade, profession or occupation carried on within South Carolina."[10]

The application of the South Carolina statute may be illustrated with the following example:

Example. Nevada has no income tax. A Nevada resident formed and funded an irrevocable trust. The sole trustee is a Nevada resident and the trust is administered in Nevada. The beneficiary (both as to income and principal) of the irrev-

ocable trust is a South Carolina resident. The assets of the trust consist of $1,000,000 in marketable securities, which generate intangible income (interest and dividends). There are no distributions to the beneficiary and all income is accumulated.

Based on this example, it appears that the trust will avoid state income tax on all accumulated intangible income. South Carolina taxes a trust based on its state of administration and the trust is administered in Nevada. It appears that a trust could be sitused in a jurisdiction other than South Carolina and avoid the tax on intangible income in South Carolina.

Operation of Different Taxing Regimes

Because North Carolina and South Carolina use different regimes to tax irrevocable trusts, there may be an opportunity for the informed planner.

Example. A North Carolina resident formed and funded an irrevocable trust. The sole trustee is a North Carolina resident and the trust is administered in North Carolina. The only beneficiary of the irrevocable trust is a South Carolina resident. The assets of the trust consist of $1,000,000 in marketable securities, which generate intangible income (interest and dividends).

Based on this example, it appears that the intangible income will avoid state income tax in both North Carolina and South Carolina. First, the trust should avoid tax in South Carolina because the trust is not administered in South Carolina and is therefore not a South Carolina resident trust. Second, the trust should avoid tax in North Carolina because the trust does not have a North Carolina beneficiary. The same result should occur if a South Carolina resident formed and funded the trust.

However, because the taxing regimes in North Carolina and South Carolina are different, the formation of an irrevocable trust can be a trap for the unwary.

Example. A South Carolina resident formed and funded an irrevocable trust. The sole trustee is a South Carolina resident and the trust is administered in South Carolina. The only beneficiary of the irrevocable trust is a North Carolina resident. The assets of the trust consist of $1,000,000 in marketable securities, which generate intangible income (interest and dividends).

Based on this example, it appears that the intangible income will be subject to state income tax in North Carolina and South Carolina. The trust is administered in South Carolina and therefore should be considered a resident trust and subject to South Carolina state income tax. The trust has a North Carolina beneficiary and therefore should be subject to North Carolina income tax.

It should be noted that most states provide credits for taxes paid to other states. However, in many cases the credits are based on tax arising from source income from other states and not on intangible income or non-source income. The authors of a leading treatise on state income taxation describe the problem of multiple state taxation of intangible income:

> Whereas individual taxpayers almost invariably are considered to be resident in only one state at any given time, trusts frequently are considered to be resident in several states simultaneously. As we observed earlier, they may be considered to be resident where the decedent or settlor resides, where the trustee resides, where the beneficiaries reside, where the trust is administered, or where a combination of these factors applies. Each of these states' claims may be substantial and none of them, in the words of the Connecticut Supreme Court, "trumps the other." Moreover, because each of these states will be taxing the trust's income on a "residence" basis, they will subject the trust's undistributed investment income to tax regardless of its source. And they will provide no credit for other states' taxes on such income: the income (being investment income from intangibles) was not "derived from sources" within these states.[11]

The authors of the treatise also describe a scenario in which a testamentary trust is taxed on its accumulated investment income in Connecticut (the decedent was a Connecticut resident), Arizona (the trustee was a resident of Arizona), Virginia (the trust was administered in Virginia), and California (the beneficiaries were residents of California). Despite the trust being taxed in each state, none of the states would provide a credit for the taxes on the investment income paid to the other states.

North Carolina provides for a credit for income taxes paid by trusts to other states.[12] It appears that the North Carolina statute would provide a credit on taxes paid from income sourced in another state, but possibly not on intangible income not sourced in another state.

Conclusion

The lack of uniformity among states as to the taxation of irrevocable trusts may lead to opportunities for the informed or traps for the unwary. For new trusts, the planner should review the grantor, the trustees, the beneficiaries and the place of administration prior to formation to make sure the state income tax burden for intangible income is minimized or eliminated. The planner should be careful selecting a grantor, trustees, and beneficiaries in different states because this will tend to increase the likelihood that the trust will be subject to tax in multiple states. In North Carolina, the planner should consider the residency of the beneficiaries of the trust. For existing trusts, it is possible that a change of a trustee or the place of administration can yield state income tax savings. North Carolina appears to be a favorable state for the administration of a trust with beneficiaries who do not reside in North Carolina. ❐

CULP AND RICHARDSON ARE PARTNERS WITH CULP ELLIOTT & CARPENTER, PLLC IN CHARLOTTE, WHICH FOCUSES ITS PRACTICE ON TAX LAW. A GRADUATE OF UNC CHAPEL HILL, WHERE HE ALSO EARNED HIS LAW DEGREE, CULP RECEIVED A MASTER'S IN TAXATION FROM NEW YORK UNIVERSITY. HE IS THE CO-AUTHOR OF *VALUATION PRACTICE IN ESTATE PLANNING AND LITIGATION*. A GRADUATE OF THE UNIVERSITY OF VIRGINIA, RICHARDSON RECEIVED HIS LAW DEGREE FROM THE UNIVERSITY OF SOUTH CAROLINA AND HIS MASTER'S IN TAXATION FROM THE UNIVERSITY OF FLORIDA. RICHARDSON IS LICENSED IN NORTH CAROLINA AND SOUTH CAROLINA. BOTH CULP AND RICHARDSON ARE BOARD CERTIFIED SPECIALISTS IN ESTATE PLANNING AND PROBATE LAW.

Endnotes

1. Richard W. Nenno, "Selecting the Situs of a Trust: State Fiduciary Income Tax Implications," ABA CLE, Feb. 8, 2006.
2. South Carolina does not tax out-of-state real property income or out-of-state business income. See S.C. Code Ann. Section 12-6-610 and Instructions for South Carolina Form 1041, page 2.
3. See PLRs 200612002, 200502014, 200247013, and 200148028.
4. Ruth Simon and Rachel Emma Silverman, "The Tax Shelter Next Door," *The Wall Street Journal*, Feb. 20, 2003.
5. See Footnote #1. In addition to North Carolina, California, Georgia, Kentucky, Tennessee and North Dakota impose state tax on trust income if the trust has a resident beneficiary.
6. According to the North Carolina Department of Revenue's Web site, "North Carolina's trust and estate tax is based on the state of residence of the trust's *income* beneficiaries and not on the situs of the trust's trustees or where the trust is created" (emphasis added). See *http://www.dor.state.nc.us/* for Web site.
7. See Title 17, Section 6B.3724 of the North Carolina Administrative Code.
8. S.C. Code Ann. Section 12-6-30(5).
9. See Instructions for South Carolina Form 1041, page 1.
10. See also S.C. Code Ann. Section 12-6-1720.
11. James R. Hellerstein & Walter Hellerstein, State Taxation, Paragraph 20.09[2][b].
12. N.C.G.S. Section 105-160.4.