

Using Delaware Trusts to Reduce New Jersey Income Tax

by
Richard W. Nenno
Senior Trust Counsel
and Managing Director
Wilmington Trust Company



In the fall of 2020, New York commentators observed:¹

The taxation of trusts is an important issue for some states. Trusts are a big and growing business, particularly in the economies of smaller states that have developed legal and tax systems with the goal of attracting trust business. Delaware is one of those states. Less than half a percent of the people in the United States live in Delaware. In 2014, fiduciary income tax returns filed by Delaware trustees reported over three percent of the income shown on the returns of all complex and simple trusts filed throughout the United States. Those returns showed that Delaware fiduciaries collected over three percent of the fiduciary fees collected by all trustees of complex and simple trusts in the United States. The fees of Delaware trustees were nearly half of the trustee fees collected in each of Texas, and New York, states whose populations were at least fourteen times the size of its own.

New Jerseyans are particularly well-positioned to save New Jersey income tax through the use of Delaware trusts. This article explains why.

Case Law

The United States Supreme Court has held that a state may tax all income of a “resident” but only source income (i.e., income attributable to real property, tangible personal property, and business activity in the state) of a “nonresident.” New Jersey classifies a trust created by a New Jersey domiciliary testator or trustor as a “resident trust.”² But, New Jersey case law holds that, in certain circumstances, a trust that meets the formal definition of “resident trust” is nevertheless taxable as a “nonresident trust.” Three cases are instructive.

In *Pennoyer v. Taxation Division Director* (1983),³ the New Jersey Tax Court held that the state could not tax undistributed income of a testamentary trust based primarily on the domicile of the testator—there were no New Jersey trustees, beneficiaries, or assets.⁴ The court held:⁵

I conclude that the creation of the subject trust in New Jersey in 1970, the probate proceeding in a New Jersey court and the jurisdiction and availability of the New Jersey courts are not sufficient contacts with the State of New Jersey to support

taxation of the 1979–1980 undistributed income of the trust, and therefore, N.J.S.A. 54A:1-2(o)(2) may not constitutionally be applied in the subject case.

Similarly, in *Potter v. Taxation Division Director* (1983),⁶ the same court held that the state could not tax undistributed income of an inter vivos trust, which was funded in part during life and in part by a pourover under the decedent's Will, based primarily on the domicile of the trustor. Again, the trust had no New Jersey trustees, beneficiaries, or assets.⁷ The court held:⁸

Any benefit to the trust from the laws of the State of New Jersey relative to the distribution of assets from the estate to the trust can be accounted for in terms of the inheritance tax paid to the State of New Jersey on the assets distributed and transferred to the trust. The facts of this case indicate that the irrevocable inter vivos trust has a situs in New York, not New Jersey. The fact that contingent beneficiaries reside in New Jersey does not alter this conclusion. These beneficiaries are taxable on trust income distributed to them or on undistributed income over which they have control. The state in which a beneficiary is domiciled may tax trust income distributed to the beneficiary. The fact that contingent beneficiaries are domiciled in New Jersey does not constitute a contact sufficient to empower New Jersey to tax undistributed trust income where the contingent beneficiaries have no right to the undistributed trust income.

In *Residuary Trust A U/W/O Kassner v. Director, Division of Taxation* (2015),⁹ a New Jersey intermediate appellate court held that a trust that qualified as a resident trust was not taxable on interest income or income from business activity not attributable to New Jersey. The trust was created by the Will of a New Jersey domiciliary who died in 1998 and therefore was a resident trust for New Jersey tax purposes. But, for all of 2006—the tax year

in question—the sole trustee was domiciled in New York and administered the trust outside New Jersey. The trustee filed a return and paid New Jersey tax on S corporation income attributable to activity in New Jersey but not on interest income or on S corporation income allocated outside New Jersey. On audit, the Director of the Division of Taxation contended that the trustee was taxable on all undistributed income because the trust held assets in New Jersey. Unlike the Tax Court, the appellate court did not find it necessary to apply constitutional principles. Instead, it based its decision on New Jersey's square corners doctrine.¹⁰

The square corners doctrine is particularly important in the field of taxation, because trusts, businesses, individuals and others must be able to reliably engage in tax planning and, to do so, they must know what the rules are. It is fundamentally unfair for the Division to announce in its official publication that, under a certain set of facts a trust's income will not be taxed, and then retroactively apply a different standard years later.

Current Rules for Taxations of Trusts

In New Jersey, a trustee of a resident trust must file a return if the trust has more than \$10,000 of gross income; a trustee of a nonresident trust must file a return if the trust has New Jersey source income and more than \$10,000 of gross income from all sources.¹¹ New Jersey treats a trust as a grantor trust if the trust is classified as a grantor trust for federal purposes,¹² and the Garden State permits trustees of nongrantor trusts to take a distribution deduction.¹³ In 2019, New Jersey taxed the New Jersey taxable income (including accumulated ordinary income and capital gains) of nongrantor trusts at rates up to 10.75% (the 10.75% rate applied starting with such income over \$5 million),¹⁴ and the current rate schedule is not scheduled to change,¹⁵ except that the threshold for the 10.75% rate has been lowered to \$1 million for 2020 and later years.¹⁶

(continued on p. 24)

GF&M GORDON, FOURNARIS & MAMMARELLA, P.A.

Attorneys concentrating in Delaware Trust Law, Fiduciary Litigation, Taxation, Estate Planning, Estate Administration, Business Law and Counseling, Entity Formation, Succession Planning, Mergers and Acquisitions, Commercial Litigation, Real Estate, Zoning, Land Development and Alternative Dispute Resolution

Peter S. Gordon
Thomas Mammarella
Emmanuel G. Fournaris
Michael M. Gordon

William M. Kelleher
Neil R. Lapinski
Norris P. Wright
Daniel F. Hayward
Charles P. O'Brien
Robert V.A. Harra III
Kimberly Gill McKinnon
Shannon L. Post
Joseph Bosik IV

Phillip A. Giordano
Mark P. Gordon
Patrick J. Rohrbach
Danielle R. Dell
Christopher P. Clemson
Constantine E. Fournaris



Special Counsel

Grover C. Brown
E. Norman Veasey

1925 Lovering Avenue
Wilmington, DE 19806
(302) 652-2900 Phone
(302) 652-1142 Fax
www.gfmlaw.com

Follow us on Twitter: @GFandMLaw

Tax Planning

(continued from p. 23)

New Jersey defines resident trust as a trust that is created by a New Jersey domiciliary testator or trustor as follows:¹⁷

A resident . . . trust means: . . .

(2) A trust, or a portion of a trust, consisting of property transferred by will of a decedent who at his death was domiciled in this State, or

(3) A trust, or portion of a trust, consisting of the property of:

(a) A person domiciled in this State at the time such property was transferred to the trust, if such trust or portion of a trust was then irrevocable, or if it was then revocable and has not subsequently become irrevocable; or

(b) A person domiciled in this State at the time such trust, or portion of a trust, became irrevocable, if it was revocable when such property was transferred to the trust but has subsequently become irrevocable.

For the purposes of the foregoing, a trust or portion of a trust is revocable if it is subject to a power, exercisable immediately or at any future time, to revest title in the person whose property constitutes such trust or portion of a trust, and a trust or portion of a trust becomes irrevocable when the possibility that such power may be exercised has been terminated.

A nonresident trust is a trust that is not a resident trust.¹⁸

New Jersey taxes all New Jersey gross income of resident trusts¹⁹ but only New Jersey-source gross income of nonresident trusts.²⁰

In New Jersey, trustees must make estimated tax payments for trusts.²¹ In 2016 (the latest year for which figures are available), 84,909 fiduciary returns reported owing \$173.2 million of New Jersey tax.²²

The New Jersey taxing authorities honor the *Pennoyer-Potter* rule. Hence, a resident trust does not have to pay any New Jersey tax if it has no New Jersey trustee, asset, or source income and files an informational return as follows:²³

A resident . . . trust is not subject to New Jersey tax if it:

- Does not have any tangible assets in New Jersey;
- Does not have any income from New Jersey sources; and
- Does not have any trustees . . . in New Jersey.

However, the fiduciary must file Form NJ-1041 for such . . . trust, enclose a statement certifying that the . . . trust is not subject to tax, and check the box on Line 26.

Adverse Treatment of CRTs

In 2009, the New Jersey Division of Taxation announced that a charitable-remainder trust (“CRT”) is taxed at the trust level for the following reason:²⁴

Only *exclusively* charitable trusts qualify for income tax exemption under the New Jersey Gross Income Tax Act. A Charitable Remainder Trust, in contrast to a charitable trust, has “noncharitable” beneficiaries and does not operate exclusively for charitable purposes. Accordingly, a Charitable Remainder Trust is not an exclusively “charitable trust” exempt from New Jersey income tax under N.J.S.A. 54A:2-1 and income that is not distributed and which is not deemed to be permanently and irrevocably set aside or credited to a charitable beneficiary is taxable income to the trust.

New Jersey taxation at the trust level is undesirable when, as often is the case, a client wants to use a CRT to diversify a portfolio of low-basis securities without being taxed immediately on all capital gains.²⁵

Planning

Grantor Trusts

New Jerseyans who create grantor trusts often must pay all federal and New Jersey income taxes attributable to such trusts even though they do not have access to the trusts’ assets. Unless a trust gives the trustee discretion to reimburse the grantor for income taxes, grantors of such trusts have the all-or-nothing choice either to pay such taxes, which might become burdensome over time, or to release the powers that trigger grantor-trust treatment and thereby cause the trust funds to be depleted to pay them. New Jerseyans might consider establishing new trusts in or moving existing trusts to Delaware, where a statute gives trustees of grantor trusts discretion to reimburse the trustor for federal and state income taxes unless prohibited by the governing instrument.²⁶ Using this statutory power, the trustee might reimburse the trustor for some taxes one year, for no taxes in a second year, and for all taxes in a third year.

Practical Planning in an Unprecedented Financial Landscape

TRUST AND HIGH NET WORTH TEAM

CONTACT US
302.737.6200 | SANTORACPAGROUP.COM

Nongrantor Trusts

New Jersey testators and trustors should structure their nongrantor trusts (including their CRTs) to qualify for the safe harbor quoted above. That's because the potential tax savings are substantial. For example, the potential tax reduction for the trustee of a New Jersey resident trust on a \$1 million long-term capital gain incurred in 2019 was at least \$74,484. Not only will this planning satisfy the trustee's duty to minimize trust expenses, but it also will improve the trustee's investment performance by eliminating the state-income-tax drag. This planning is all the more important given the recently enacted \$10,000 per year limitation on the deduction of state taxes²⁷ and might be enhanced if, as some speculate, a Democratic administration will eliminate the stepped-up income-tax basis at death.

New Jerseyans might want to create and fund Delaware revocable trusts during life to escape the New Jersey income tax that otherwise would be payable by their probate estates.

Under the above safe harbor, a New Jersey resident trust is taxed as a nonresident trust if the trust has no New Jersey tangible asset, source income, or trustee. It should be noted, however, that, unlike New York,²⁸ New Jersey appears to tax a resident trust that has no New Jersey tangible asset or trustee but does have New Jersey source income only on the source income.²⁹ Nevertheless, out of an abundance of caution, practitioners who fear that New Jersey might move to the New York approach, might advise clients to create two trusts, one to hold assets that generate New Jersey source income and one to hold assets that do not generate such income.

Similarly, although *Potter* held that “[t]he fact that contingent beneficiaries are domiciled in New Jersey does not constitute a contact sufficient to empower New Jersey to tax undistributed trust income where the contingent beneficiaries have no right to the undistributed trust income”³⁰ and although the above safe harbor does not require that a trust have no New Jersey beneficiaries, some practitioners might be concerned that New Jersey will assert that trusts with New Jersey beneficiaries do not qualify. Consequently, cautious practitioners might again advise clients to create two trusts, one for New Jersey beneficiaries and one for non-New Jersey beneficiaries.

Trustees and beneficiaries of trusts that are paying New Jersey income tax should take steps to reduce or eliminate that tax. In this regard, New Jersey law stipulates that “[a] trustee is under a continuing duty to administer the trust at a place appropriate to its purposes, its administration, and the interests of the beneficiaries.”³¹ A change from a New Jersey trustee to a Delaware trustee might do the trick.

Given that trusts get to the top federal income-tax rate so much more quickly than individuals, some trustees are considering including capital gains in distributions to beneficiaries in order to take advantage of the beneficiaries' lower tax brackets. This might be a really bad idea for New Jerseyans thanks to the New Jersey Gross Income Tax. For example, the net tax cost of including \$1 million of long-term capital gain in DNI for a New Jersey resident individual rather than taxing the gain to a New Jersey resident trust that is structured to escape tax is \$40,881.

(continued on p. 26)

MCCOLLOM D'EMILIO SMITH UEBLER LLC

ATTORNEYS AT LAW

TRUSTS AND ESTATES

TRUST ADVISORY

BUSINESS TRANSACTIONS

LITIGATION

McCollom D'Emilio Smith Uebler LLC is a Delaware law firm focusing on trusts, estates, and tax; business transactions, and litigation.

We represent corporate and individual clients in a range of transactional and litigation matters with a commitment to strategic thinking, responsiveness, and efficiency.

Little Falls Centre Two
2751 Centerville Road, Suite 401
Wilmington, DE 19808

(302) 468-5960

mdsulaw.com

Tax Planning

(continued from p. 25)

Note that nongrantor trusts created by New Jersey domiciliaries will not have to pay Delaware income tax or file a Delaware return as long as there are no Delaware resident beneficiaries.³²

The DING Trust Option

New Jerseyans might use a type of Delaware asset-protection trust (“APT”) known as the Delaware incomplete-gift nongrantor trust (“DING Trust”) to defer or eliminate New Jersey income tax on undistributed ordinary income and capital gains if they are willing to subject distributions to themselves to the control of adverse parties. In dozens of private letter rulings issued since 2013 (some of which involved trusts created by New Jersey domiciliaries), the IRS ruled that domestic APTs that followed the DING-Trust approach qualified as incomplete gifts and as nongrantor trusts.³³ The trustor of a DING Trust might be able to receive tax-free distributions of the untaxed income in later years.



Richard W. Nenno, Esquire, is a Senior Trust Counsel and Managing Director with Wilmington Trust Company, Wilmington, Delaware. He is a nationally known speaker and author on estate-planning topics, including Delaware trust law, the state income taxation of trusts, directed trusts, trust jurisdiction selection, and domestic asset-protection trusts.

This article, with commentary, is for informational purposes only and is not intended as an offer or solicitation for the sale of any financial product or service. It is not designed or intended to provide financial, tax, legal, accounting, or other professional advice since such advice always requires consideration of individual circumstances. If professional advice is needed, the services of a professional advisor should be sought.

Wilmington Trust is a registered service mark used in connection with various fiduciary and non-fiduciary services offered by certain subsidiaries of M&T Bank Corporation including, but not limited to, Manufacturers & Traders Trust Company (M&T Bank), Wilmington Trust Company (WTC) operating in Delaware only, Wilmington Trust, N.A. (WTNA), Wilmington Trust Investment Advisors, Inc. (WTIA), Wilmington Funds Management Corporation (WFMC), and Wilmington Trust Investment Management, LLC (WTIM). Such services include trustee, custodial, agency, investment management, and other services. International corporate and institutional services are offered through M&T Bank Corporation's international subsidiaries.

Loans, credit cards, retail and business deposits, and other business and personal banking services and products are offered by M&T Bank, member FDIC.



WeinerBenefits GROUP

we work for your benefit

Since 1938

A Heritage of Trust & Experience

OUR SERVICES

- ◆ Employee Benefits
- ◆ Voluntary Benefits
- ◆ Life Insurance
- ◆ Disability Insurance
- ◆ Alternative Healthcare Funding Options
- ◆ Strategic Planning
- ◆ Personalized Service
- ◆ HR Systems & Services
- ◆ Industry Compliance

RETIREMENT PLANS*

- ◆ Holistic approach to financial well-being
- ◆ Plan participant education and engagement
- ◆ Investment menu and plan design
- ◆ Fiduciary oversight and governance
- ◆ Fee analysis and benchmarking
- ◆ Compliance and administration



Louis D. Memmolo, AIF, GBA Michael D. Reckner, GBA, GBDS, VBS Debra S. Shears, CEBS, GBDS

2961 Centerville Road, Suite 300, Wilmington, DE 19808 | 302-658-0218 | www.weinerbenefitsgroup.com

Wilmington Trust Company operates offices in Delaware only. Note that a few states, including Delaware, have special trust advantages that may not be available under the laws of your state of residence, including asset protection trusts and directed trusts.

©2020 M&T Bank Corporation and its subsidiaries. All rights reserved.

Notes:

- 1- Carlyn S. McCaffrey, John C. McCaffrey & Toni Ann Kruse, *Rationalizing the State Income Taxation of Trusts: Chasing Quill Feathers in the Wind*, 45 Est., Gifts & Tr. J. 298, 300 (Sept. 10, 2020) (footnotes omitted).
- 2- NJSA § 54A:1-2(o)(2)–(3).
- 3- *Pennoyer v. Taxation Div. Dir.*, 5 N.J. Tax 386 (Tax Ct. 1983).
- 4- *Id.* at 388.
- 5- *Id.* at 399.
- 6- *Potter v. Taxation Div. Dir.*, 5 N.J. Tax 399 (Tax Ct. 1983).
- 7- *Id.* at 401.
- 8- *Id.* at 405 (citation omitted).
- 9- *Residuary Trust A U/W/O Kassner v. Dir. Div. of Taxation*, 28 N.J. Tax 541 (Super. Ct. App. Div. 2015), *aff'g*, 27 N.J. Tax 68 (N.J. Tax Ct. 2013).
- 10- *Id.* at 548 (citations omitted).
- 11- Instructions to 2019 Form NJ-1041 at 1. See NJSA § 54A:8-3.1(a)(1)(c). See also N.J. Div. Tax'n GIT-12, *Estates and Trusts: Understanding Income Tax* (Dec. 2019), www.state.nj.us/treasury.
- 12- See NJSA § 54A:5-1(h); instructions to 2019 Form NJ-1041 at 1.
- 13- NJSA § 54A:5-3; instructions to 2019 Form NJ-1041 at 1.
- 14- NJSA § 54A:2-1(b)(6); instructions to 2019 Form NJ-1041 at 24.
- 15- NJSA § 54A:2-1(b)(1)–(7).
- 16- NJSA § 54A:2-1(b)(7).
- 17- NJSA § 54A:1-2(o)(2)–(3). See instructions to 2019 Form NJ-1041 at 1. For the meaning of “domicile” for New Jersey income-tax purposes, see instructions to 2019 Form NJ-1041 at 1. In a Letter Ruling, which will not be released for publication, the N.J. Division of Taxation determined that a trust created by a Delaware trustee via the exercise of a decanting power over three New Jersey

resident trusts at the direction of a non-New Jersey adviser would be considered to be a nonresident trust for New Jersey tax purposes where the new trust did not meet the definition of resident trust.

- 18- NJSA § 54A:1-2(p); instructions to 2019 Form NJ-1041 at 1.
- 19- NJSA § 54A:5-1.
- 20- NJSA §§ 54A:2-1.1, 54A:5-7; instructions to 2019 Form NJ-1041 at 1–2. See *Tina Schiller Trust for Benefit Siegelbaum v. Dir., Dep't of Treasury, Div. of Taxation for State of N.J.*, 14 N.J. Tax 173, 181 (N.J. Super. Ct. App. Div. 1994) (“The disposition of the corporate stock here constitutes the nontaxable sale of the intangible asset”). See also *Hill v. Dir., State Div. of Taxation*, 2016 WL 3351959, at *5 (N.J. Super. Ct. App. Div. June 2, 2016) (Pennsylvania residents taxed on New Jersey source income distributed to them from New Jersey resident trust).
- 21- NJSA § 54A:8-4(m); instructions to 2019 Form NJ-1041 at 3.
- 22- N.J. Dep't of the Treasury, *Statistics of Income: 2016 Gross Income Tax Returns* (Aug. 2019), www.nj.gov/treasury (last visited Oct. 8, 2020).
- 23- Instructions to 2019 Form NJ-1041 at 1 (emphasis in original).
- 24- N.J. Div. Taxation Tech. Bull. 64, *Charitable Remainder Trusts*, 2009 N.J. Tax Tech. Bull. Lexis 34 (N.J. Div. Tax. June 29, 2009) (emphasis in original), www.state.nj.us/treasury.
- 25- See IRC § 664(b).
- 26- See 12 Del. C. § 3344.
- 27- See IRC §§ 164(b)(6)(B), 641(b).
- 28- See N.Y. TSB-A-20(2)I.
- 29- See *Residuary Trust A U/W/O Kassner v. Dir. Div. of Taxation*, 28 N.J. Tax 541 (Super. Ct. App. Div. 2015).
- 30- *Potter v. Taxation Div. Dir.*, 5 N.J. Tax 399, 405 (Tax Ct. 1983).
- 31- NJSA § 3B:31-8(b).
- 32- See 30 Del. C. § 1636.
- 33- See, e.g., PLR 202017018 (Nov. 29, 2019).



Get the skills to
build your business.

WilmU works.



WILMINGTON
UNIVERSITY™

WilmU is a registered trademark of Wilmington University.
All rights reserved. © Wilmington University 2020

WilmU graduate programs include:

- Master of Business Administration (MBA)
- Master of Science in Management (MSM)
- Doctor of Business Administration (DBA)

Learn more at wilmu.edu/BusinessDegrees