

Minimizing or Eliminating New Jersey Income Taxes on Trusts

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New Jersey fiduciaries pay a lot of New Jersey income taxes. Thus, for 2016 (the latest year for which figures have been released), 84,909 fiduciary returns reported owing \$173.2 million of New Jersey tax.¹ This is remarkable because clear rules for avoiding the taxation of trusts have existed for many years. This paper will survey the pertinent authorities and offer planning ideas.

Caselaw

The United States Supreme Court has held that a state may tax all income of a “resident”² but only source income (i.e., income attributable to real property, tangible personal property, and business activity in the state) of a “nonresident.”³ New Jersey classifies a trust created by a New Jersey domiciliary testator or trustor as a “resident trust.”⁴ But, New Jersey caselaw 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),⁵ 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.⁶ The court held:⁷

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.

¹ N.J. Dep’t of the Treasury, Statistics of Income: 2016 Gross Income Tax Returns (Aug. 2019), www.nj.gov/treasury (last visited August 11, 2022).

² Okla. Tax Comm’n v. Chickasaw Nation, 515 U.S. 450, 462-63 (1995). Accord New York ex rel. Cohn v. Graves, 300 U.S. 308, 312–13 (1937); Shaffer v. Carter, 252 U.S. 37, 57 (1920).

³ Chickasaw Nation, 515 U.S. at 463 n.11. Accord Shaffer, 252 U.S. at 57.

⁴ N.J. Stat. Ann. § 54A:1-2(o)(2)–(3).

⁵ Pennoyer v. Tax’n Div. Dir., 5 N.J. Tax 386 (Tax Ct. 1983).

⁶ Id. at 388.

⁷ Id. at 399.

Similarly, in Potter v. Taxation Division Director (1983),⁸ 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.⁹ The court held:¹⁰

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.

More recently, in Residuary Trust A U/W/O Kassner v. Director, Division of Taxation (2015),¹¹ a New Jersey intermediate appellate court held that a trust that qualified as a resident trust was taxable as a nonresident trust. About \$200,000 of taxes, interest, and penalties was involved. The trust was created by the Will of a New Jersey domiciliary who died in 1998 so it met the formal definition of 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:¹²

The square corners doctrine is particularly important in the field of taxation, because trusts, businesses, individuals and others must be

⁸ Potter v. Tax'n Div. Dir., 5 N.J. Tax 399 (Tax Ct. 1983).

⁹ Id. at 401.

¹⁰ Id. at 405 (citation omitted).

¹¹ Residuary Tr. A U/W/O Kassner v. Dir. Div. of Tax'n, 28 N.J. Tax 541 (N.J. Super. Ct. App. Div. 2015), aff'g, 27 N.J. Tax 68 (N.J. Tax Ct. 2013). See Open Weaver Banks, Amy Nogid & Leah Robinson, It's Hip to Be Square in New Jersey, 77 State Tax Notes 925 (Sep. 14, 2015); Richard W. Nenno, Taxpayer Victory in the New Jersey Kassner Case: More Than One Way to Skin a Cat and Save State Income Taxes on Trusts, LISI Est. Plan. Newsl. #2331 (Aug. 11, 2015), www.leimbergservices.com.

¹² Id. at 548 (citations omitted).

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 Taxation 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.¹³ New Jersey treats a trust as a grantor trust if the trust is classified as a grantor trust for federal purposes,¹⁴ and the Garden State permits trustees of nongrantor trusts to take a distribution deduction.¹⁵ In 2021, 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 \$1 million),¹⁶ and the current rate schedule is not scheduled to change.¹⁷

New Jersey defines resident trust as a trust that is created by a New Jersey domiciliary testator or trustor as follows:¹⁸

¹³ Instructions to 2021 Form NJ-1041 at 3. See N.J. Stat. Ann. § 54A:8-3.1(a)(1)(c). For comprehensive guidance, see N.J. Div. of Tax'n, Publ'n GIT-12, Estates and Trusts (Jan. 2022), www.state.nj.us/treasury/taxation.

¹⁴ See N.J. Stat. Ann. § 54A:5-1(h); Instructions to 2021 Form NJ-1041 at 2.

¹⁵ N.J. Stat. Ann. § 54A:5-3; Instructions to 2021 Form NJ-1041 at 2.

¹⁶ N.J. Stat. Ann. § 54A:2-1(b)(7); Instructions to 2021 Form NJ-1041 at 28.

¹⁷ N.J. Stat. Ann. § 54A:2-1(b)(1)–(7).

¹⁸ N.J. Stat. Ann. § 54A:1-2(o)(2)–(3). See Instructions to 2021 Form NJ-1041 at 2. 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. For New Jersey income-tax purposes, an individual is a “resident,” with certain exceptions, if the individual is domiciled in New Jersey or if the individual maintains a permanent place of abode and spends more than 183 days in the state during the taxable year (N.J. Stat. Ann. §54A:1-2(m)). Given that taxation is based on the testator's or trustor's domicile, the second test in the foregoing definition does not come into play. For the meaning of “domicile” for New Jersey income-tax purposes, see Instructions to 2021 Form NJ-1041 at 3. See also Robert Kantowitz, A Tale of Two States, 98 Tax Notes State 161 (Oct. 12, 2020). Guidance for individual taxpayers is provided by N.J. Div. of Tax'n, Publ'n GIT-4, Filing Status (Jan. 2022), www.state.nj.us/treasury/taxation; N.J. Div. of Tax'n, Publ'n GIT-5, Nontaxable Investment Income (Jan. 2022), www.state.nj.us/treasury/taxation; N.J. Div. of Tax'n, Publ'n GIT-6, Part-Year Residents and Nonresidents (Jan. 2022), www.state.nj.us/treasury/taxation; N.J. Div. of Tax'n, Publ'n GIT-8, Estimating Income Taxes (Jan. 2022), www.state.nj.us/treasury/taxation; N.J. Div. of Tax'n, Publ'n GIT-9P, Partnership Income (Jan. 2022), www.state.nj.us/treasury/taxation; N.J. Div. of Tax'n, Publ'n GIT-9S, Income From S Corporations (Jan. 2022), www.state.nj.us/treasury/taxation; N.J. Div. of Tax'n, Publ'n GIT-11, New Jersey Resident Return Examples (Jan. 2022), www.state.nj.us/treasury/taxation.

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 revert 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.¹⁹

New Jersey taxes all New Jersey gross income of resident trusts²⁰ but only New Jersey-source gross income of nonresident trusts.²¹ In New Jersey, trustees must make estimated tax payments for trusts.²²

¹⁹ N.J. Stat. Ann. § 54A:1-2(p); Instructions to 2021 Form NJ-1041 at 3.

²⁰ N.J. Stat. Ann. § 54A:5-1.

²¹ N.J. Stat. Ann. §§ 54A:2-1.1, 54A:5-7; Instructions to 2021 Form NJ-1041 at 3. See Tina Schiller Tr. for Benefit of Siegelbaum v. Dir., Dep't of Treasury, Div. of Tax'n 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 Tax'n, 29 N.J. Tax 318 (N.J. Super. Ct. App. Div. 2016) (Pennsylvania residents taxed on New Jersey source income distributed to them from New Jersey resident trust); Xylem Dewatering Solutions Inc. v. Dir. Div. of Tax', 30 N.J. Tax 41, 41 (2017), aff'd sub nom. John M. Paz v. Dir. Div. of Tax'n, 31 N.J. Tax 76 (N.J. Super. Ct. App. Div. 2019) (“[G]ain from the deemed sale of assets of a New Jersey S corporation under Internal Revenue Code § 338(h)(10) is sourced to New Jersey on the non-resident shareholders’ New Jersey Non-Resident Gross Income Tax Returns” based “with reference to the Corporation Business Tax statutes”). See Andrea Muse, Appellate Court Affirms Sourcing of Gain to State, 91 State Tax Notes 522 (Feb. 11, 2019); Robert Willens, New Jersey Uses the ‘McKesson’ Decision to Its Advantage, Daily Tax Rep., May 24, 2017, at J-1; Eric Yauch, Deemed Asset Sale Gain Sourced to State New Jersey Court Rules, 84 State Tax Notes 243 (Apr. 17, 2017).

²² N.J. Stat. Ann. § 54A:8-4(m); Instructions to 2021 Form NJ-1041 at 11.

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.

Note: Because it is unclear whether advisers, protectors, and committees are encompassed within “trustee,” the safe course is not to appoint New Jersey domiciliaries to participate in New Jersey trusts.

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

²³ Instructions to 2021 Form NJ-1041 at 2 (emphasis in original).

²⁴ N.J. Div. Tax’n 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 I.R.C. § 664(b).

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 a state, 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.

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 2021 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 current \$10,000 per year limitation on the deduction of state taxes²⁷ and might be enhanced if, as some speculate, a Democrat administration will eliminate the stepped-up income-tax basis at death.

New Jerseyans might want to create and fund revocable trusts outside New Jersey 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

²⁶ See Colo. Rev. Stat. §§ 15-5-505, 15-5-818; Del. Code Ann. tit. 12, § 3344; Fla. Stat. Ann. § 736.08145; N.H. Rev. Stat. § 564-B:8-816(c); N.Y. Est. Powers & Trusts Law § 7-1.11.

²⁷ See I.R.C. §§ 164(b)(6)(B), 641(b).

²⁸ See N.Y. TSB-A-20(2)I.

²⁹ See Residuary Tr. A U/W/O Kassner v. Dir. Div. of Tax'n, 28 N.J. Tax 541 (N.J. Super. Ct. App. Div. 2015).

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 non-New Jersey 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 federal 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 in 2021 was at least \$40,099.

Domiciliaries of other states might consider establishing trusts in New Jersey because it does not tax trusts created by nondomiciliaries except on source income.

The ING Trust Option

New Jerseyans might use a type of domestic asset-protection trust (“APT”) known as the incomplete-gift nongrantor trust (“ING 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 Internal Revenue Service (“I.R.S.”) ruled that domestic APTs that followed the ING-Trust approach qualified as incomplete gifts and as nongrantor trusts.³² Most—if not all—of the early rulings involved Nevada law in large part because, at the time, Nevada was the only domestic APT state that allowed a trustor to keep a nongeneral lifetime power of appointment. Alaska, Delaware, and South Dakota now offer that option as well.³³ The trustor of an ING Trust might be able to receive tax-free distributions of the untaxed income in later years.³⁴

³⁰ Potter v. Tax’n Div. Dir., 5 N.J. Tax 399, 405 (Tax Ct. 1983).

³¹ N.J. Stat. Ann. § 3B:31-8(b).

³² See, e.g., I.R.S. Priv. Ltr. Ruls. 202017018 (Nov. 29, 2019); 202014001–202014005 (Aug. 26, 2019); 202007010 (Sep. 18, 2019); 202006002–202006006 (Sep. 18, 2019).

³³ Alaska Stat. § 34.40.110(b)(2); Del. Code Ann. tit. 12, § 3570(11)(b)(2); Nev. Rev. Stat. § 166.040(2)(b); S.D. Codified Laws § 55-16-2(2)(b).

³⁴ See Charles A. Redd, “ING” Trusts Aren’t For Everyone, 160 Tr. & Est. 13 (Mar. 2021); Eric R. Bardwell, California Admits Incomplete Gift Non-Grantor Trusts Work...For Now, 46 Tax Mgmt. Est., Gifts & Tr. J. 24, 26–28 (Jan. 7, 2021); Lindsay R. DeMoss D’Andrea, Incomplete Gift Non-Grantor Trusts: How Kaestner Highlights the Importance of Planning for State Income Tax, 34 Prob. & Prop. 42 (May/June 2020).

The author of a 2015 article concluded:³⁵

Few advisers are likely to say that the NING or DING trust is guaranteed to provide the desired results. A better question is: Are they worth the effort? This can be debated, but in some cases they will be.

With every i dotted and t crossed, the informed and non-risk-averse client may go from the certainty of paying significant state income tax to the reporting position of paying little. Of course, the facts, documents, and details matter. The entire exercise can also be a helpful push into the related and often uncomfortable topic of estate planning.

The days of the ING Trust might be numbered for two reasons. First, Professor McCouch of the University of Florida Levin College of Law published an article early in 2020 in which he questioned several tax aspects of the vehicle.³⁶ Second, in January of 2021, the I.R.S. announced that it will not issue Private Letter Rulings on the income-, estate-, and gift-tax implications of ING Trusts until it issues pertinent guidance.³⁷ The I.R.S. reconfirmed this no-ruling position in January 2022.³⁸

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³⁵ Robert W. Wood, Sellers and Settling Litigants Lured by Tax Savings of NING and DING Trusts, 77 State Tax Notes 565, 568 (Aug. 10, 2015).

³⁶ Grayson M.P. McCouch, Adversity, Inconsistency, and the Incomplete Nongrantor Trust, 39 Va. Tax Rev. 419 (Spring 2020).

³⁷ Rev. Proc. 2021-3 §§ 5.01(9), (10), (15), (17) (Jan. 4, 2021).

³⁸ Rev. Proc. 2022-2 §§ 5.01(9), (10), (15), (18) (Jan. 3, 2022).