

Income Taxation of Estates, Trusts and Their Beneficiaries

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Background

- ▶ In 1997, the Alaska Legislature passed the Alaska Trust Act
 - ▶ This made Alaska the first state in the nation to allow for unique types of planning
 - ▶ Self-Settled Trusts
 - ▶ Allowed for Perpetual Trusts
- ▶ Since 1997, the Legislature has passed a number of additional statutes
 - ▶ Alaska Community Property Trusts
 - ▶ Decanting
 - ▶ Tiered Insurance Premium Tax Structure
- ▶ Overall, this has generated great benefits for the State at no cost
- ▶ Contributes millions of dollars every year to economy
 - ▶ Particularly, through insurance tax - over \$7mm per year

Taxation of Trust Income

- ▶ Usually Taxed in One of Three Ways
 - ▶ To the Grantor (Trust Creator) - If Grantor Retains Sufficient Interest
 - ▶ Due to benefits many trusts are drafted for grantor trust status
 - ▶ To the Beneficiary - To the Extent He or She Receives Distributions (Income)
 - ▶ To the Trust - If Retained by the Trust

Broad Types of Trusts

- ▶ Revocable
 - ▶ Basically a Will Substitute - No Tax Advantages
 - ▶ Disregarded Entity
 - ▶ Taxed to grantor
- ▶ Irrevocable
 - ▶ Creates Separate and Distinct Legal Entity - Can Have Tax Advantages
 - ▶ Taxation Depends On
 - ▶ Resident or Non-Resident Trust For State Tax
 - ▶ Grantor Trust Status
 - ▶ Distributions

Grantor vs. Non-Grantor Trust Status

- ▶ Determines whether income is taxable to trust creator or to trust itself
- ▶ Grantor Trust Triggers - Not Exhaustive List
 - ▶ Grantor is Beneficiary
 - ▶ Grantor's Spouse is Beneficiary
 - ▶ Power to Control Beneficial Enjoyment (Veto Powers)
 - ▶ Reversionary Interests to Grantor
 - ▶ Income for Benefit of Grantor

Trusts - As they Relate to AK State Income Tax

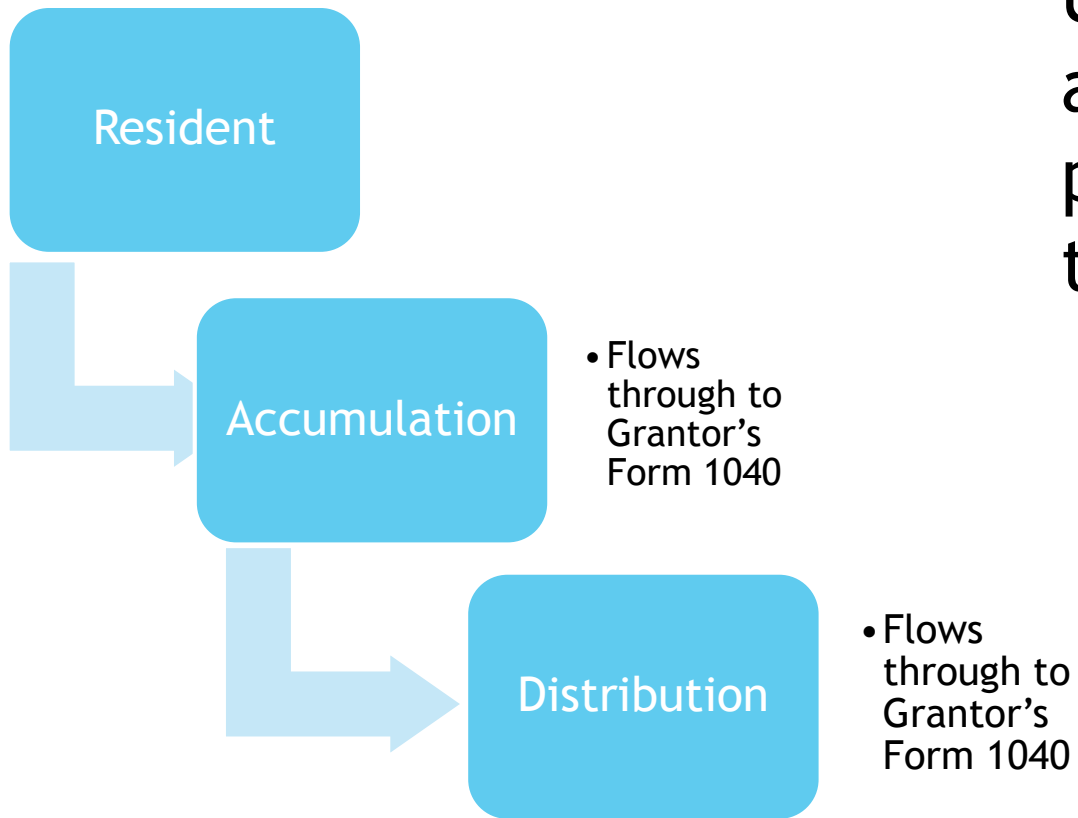
- ▶ Revocable Trusts
 - ▶ Disregarded entities and are taxed at individual level
 - ▶ Can be used for pre-mortem probate
- ▶ Irrevocable Trusts
 - ▶ Grantor
 - ▶ Resident
 - ▶ Non-Resident
 - ▶ Non-Grantor
 - ▶ Resident
 - ▶ Non-Resident
- ▶ HB115 Discussions Centered on Irrevocable Trusts
 - ▶ Particularly, Non-Grantor Resident & Non-Resident Trusts with income accumulation

Review of Taxation

- ▶ Grantor Trusts
 - ▶ Taxed to Grantor
- ▶ Non-Grantor Trusts
 - ▶ Taxed to recipient/beneficiary when distributed
 - ▶ Taxed to trust when income is retained
- ▶ All Competitive States Attempt to Tax Resident Trusts, but Not Non-Resident Trusts
 - ▶ Definition is extremely important
 - ▶ Where State will lose business from both residents and non-residents, if not done properly
- ▶ Review of Below Scenarios Assumes No AK Source Income

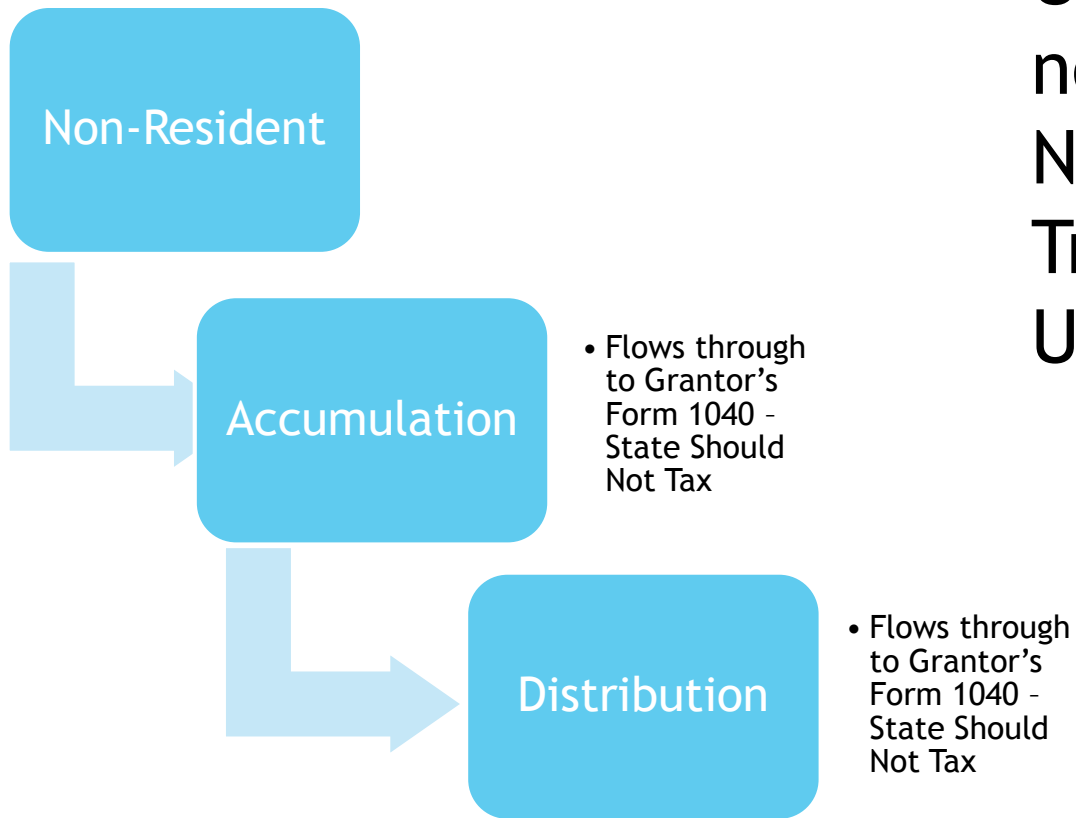
Grantor Trusts - Resident

Ultimately, the State always collects the proper tax regardless of taxation on trusts.



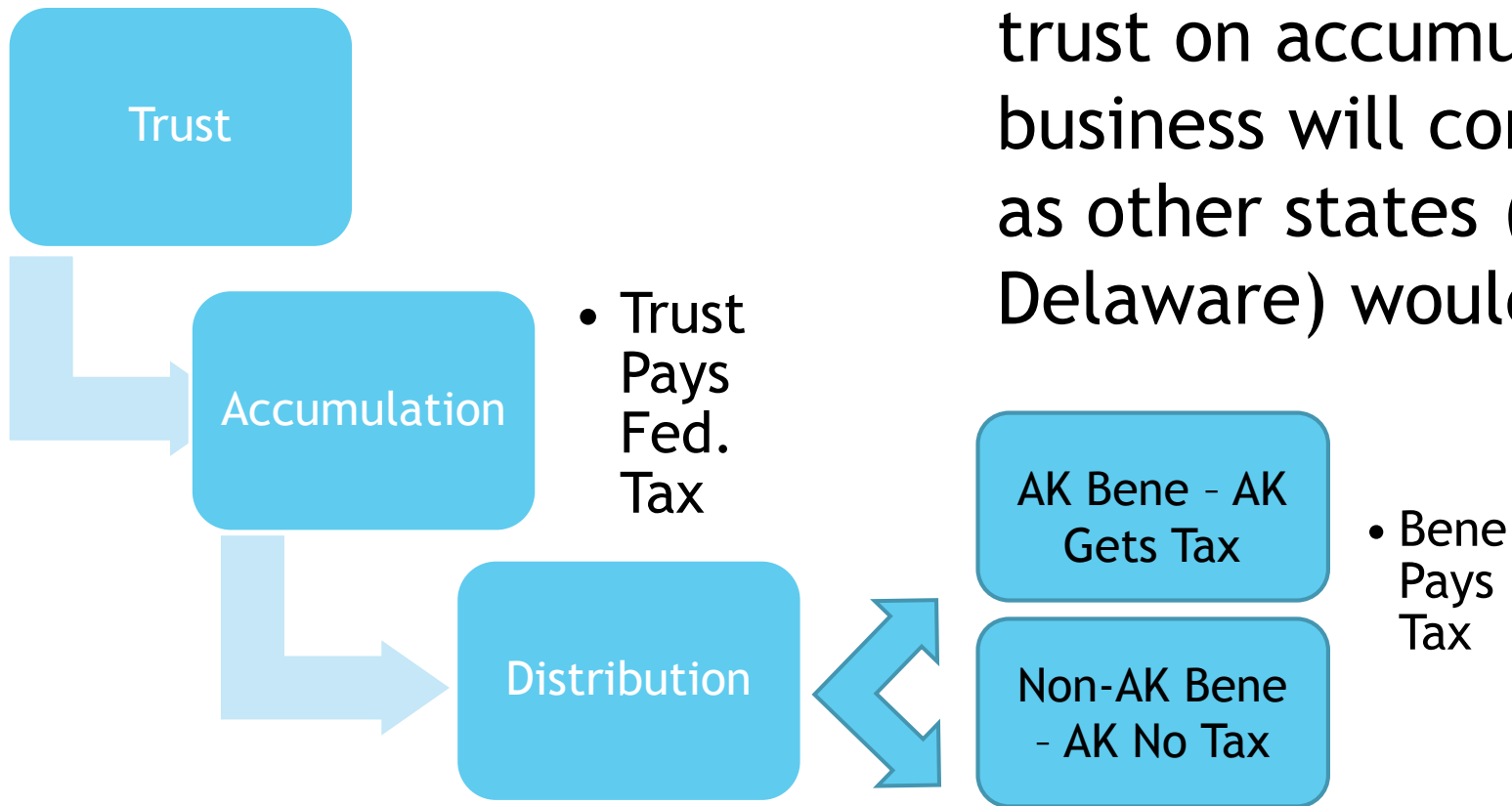
Grantor Trusts - Non-Resident

Ultimately, State should not collect the tax on Non-Resident, Grantor Trusts. Potentially Unconstitutional.



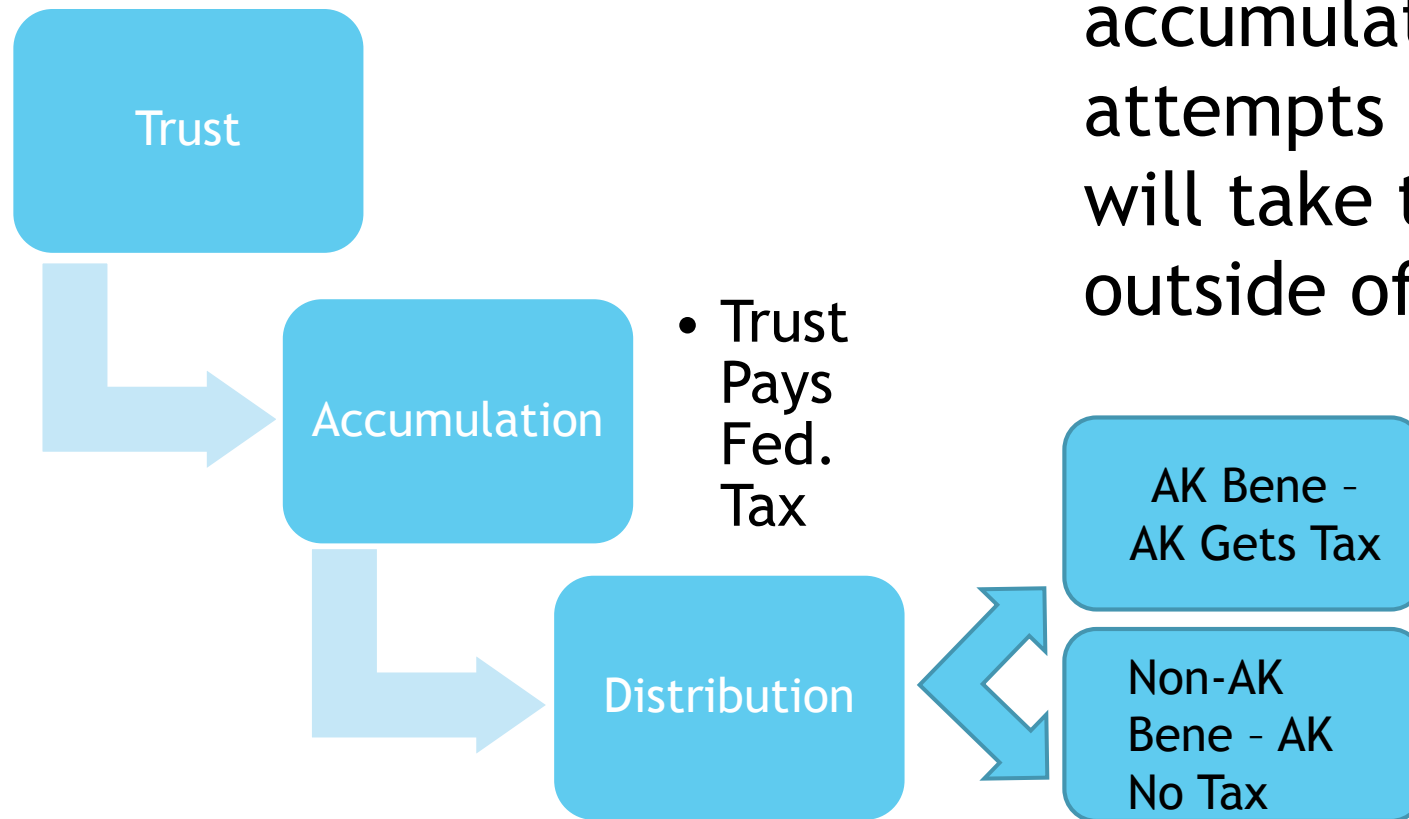
Non-Grantor Trusts - Non-Residents - Most Important

If State attempts to tax trust on accumulation, no business will come to AK as other states (Nevada, Delaware) would not tax.



Non-Grantor Trusts - Residents

Most states try to tax accumulation. If State attempts to tax, Alaskans will take their business outside of Alaska.



Federal Trust Tax Rates

- ▶ Discourage income retention, encourage trust distributions
- ▶ Compressed Tax Brackets
 - ▶ Same rates as individuals, but with compressed brackets
 - ▶ For example, individuals reach max. tax bracket (43.4%, including Medicare surtax) at \$415,050 for single filers and \$466,950 for married filing jointly. Trust reach this rate at \$12,400 of income.
- ▶ Therefore, income is usually only retained in trust if there is compelling reason to do so
 - ▶ Beneficiary has substance abuse problems
 - ▶ Funds are used for “special needs” and not all income is consumed

Recap

- ▶ Up to this point, AK collects proper tax without a tax on trusts
- ▶ What is missing?
 - ▶ Only accumulated income in a Resident, Non-Grantor Trust
 - ▶ Accumulation Not Likely
 - ▶ Federal tax rates encourage trust distributions - almost immediate 43.4% tax rate
 - ▶ Tax could only be avoided for non-source income
 - ▶ Already have “anti-DING” rule in HB115
 - ▶ If State attempts to tax, residents would plan outside of AK

Recap Continued

- ▶ Without a Tax On Trusts
 - ▶ State Will Always Collect Proper Tax When
 - ▶ Resident Grantor Trusts Either Accumulates or Distributes Income
 - ▶ Non-Resident Grantor Trusts Distributed to AK Resident
 - ▶ Resident or Non-Resident, Non-Grantor Trust Distributed to AK Resident
 - ▶ Any trust distributes to AK Resident
 - ▶ State Would Not Collect Tax
 - ▶ Non-Resident Grantor or Non-Grantor Trust Either Accumulates or Distributes to Non-AK Resident - Unconstitutional
 - ▶ **Resident Non-Grantor Trust Either Accumulates or Distributes to Non-AK Resident**

Suggested Amendments to HB115

- ▶ Individuals receive \$10,300 exemption, trusts do not.
 - ▶ Why? To punish those who plan? To deter planning?
- ▶ Section 43.22.020 (c) should make affirmative statement that non-resident trust and estate are not subject to AK income tax.
- ▶ Section 43.22.040 (a) references section 26 U.S.C 661 of the Internal Revenue Code, should also include 651.
- ▶ Section 43.22.150 (1) provides definition of domicile and (l) includes location of dental and medical personnel that provides services to individuals.
 - ▶ Will this discourage nonresidents to find other providers?
- ▶ Section 43.22.150 (19) defines a resident trust. This should include a definition as to when a transfer to a trust is deemed to have been made.
- ▶ Section 43.22.150 (19) should make affirmative statement that if a nonresident transfers property to an AK trust, it is deemed nonresident.

Suggested Amendments to HB115

- ▶ Definition of resident trust
 - ▶ Discourages AK residents from planning in AK
 - ▶ For example, AK residents creates trust for children who reside in Montana and Texas. Trust would be subject to AK tax on accumulated income. AK resident would create trust in other state.

Thank you for you consideration.