Beneficiary Income Tax Planning

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SOME CLIENTS GET CONFUSED among the various taxes that apply to their estate plans. While many are concerned about the federal (and state) estate tax, **it's the income tax that more commonly affects the inheritances of your loved ones**. The gift tax is a tax on the transfer of assets during your life, and the estate tax is a transfer tax on the value of your assets at the time of your death. The federal gift/estate tax exemption in 2022 exceeds $12 million. The amount of taxable gifts are deducted from your exemption. Few estates exceed the decedent's available exemption amount at the time of his or her death.

This whitepaper focuses, instead, on income taxes, and more specifically, state income taxes. Nearly every estate has income tax consequences to its beneficiaries. Consequently, income tax planning is oftentimes more important than estate tax planning, yet many plans don't contain strategies designed to minimize income taxes for loved ones.

A healthy percentage of our clients that have come to us from a northern state have an estate plan that needlessly focuses on estate tax planning, and doesn't contain much, if any, income tax planning strategies.

Worse, without knowing how each state taxes income, one may unwittingly cause their loved ones to fall into a tax trap, depending upon where they reside.

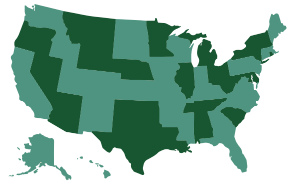
INCOME TAX PLANNING

To implement income tax planning strategies, the estate plan needs to create continuing trusts for the beneficiaries. Outright distributions leave no planning options. Therefore, many of our clients' plans direct that the inheritances they leave their loved ones continue in a testamentary (after the grantor's death) trust.

Primary reasons to create ongoing trusts for our loved ones include protecting the assets from divorce, lawsuits, and bankruptcy, in addition to implementing income tax planning strategies. When so considering income tax planning strategies, both federal and state income tax laws must be addressed.

To illustrate, suppose that Irene's estate plan creates, on her death, separate trust shares for her two children, Robert, and Lynn. After Irene's death, each child may become the trustee of his or her own trust share. Robert controls the investment and distribution decisions of his trust share. Lynn, likewise, controls the investment and distribution decisions of her trust share. Each can do as they please.

Let's examine how income tax planning strategies may affect the amount of income tax that is remitted each year following Irene's death:



POTENTIAL INCOME TAX SAVINGS

The potential for income tax savings centers on what Robert and Lynn decide to do with the income generated by each of their trust shares. Suppose, for example, that after Irene's death the share that her estate plan creates for Robert allows him, as trustee, to:

1. Accumulate the income inside of the trust and have the trust pay the income tax
2. Accumulate the income inside of the trust share and have Robert pay the income tax
3. Distribute the income to himself
4. Distribute the income to one or more of his children

It should be noted that if the inherited trust is the taxpayer, (rather than the beneficiary,) the trust quickly ascends to the highest federal marginal income tax bracket of 37% under current law. In 2022 trusts that accumulate income and pay federal tax will pay a 37% rate when it earns as little as $13,451 of income.

Let's assume that for Robert's inherited trust, the income consists of interest and dividends and does not include any New York source income, such as rents. Suppose further that Robert, a married New York City resident, earned a lot of money this year. He pays the top federal marginal rate of 37% New York state income tax rate of 10.90% and New York City tax of 3.876% so his combined marginal tax rate is an astoundingly confiscatory 51.776%!

Let's further assume that his children's highest combined marginal tax rate is only 25%.

Let's review the four scenarios:

1. If Robert accumulates the income inside of the Trust and the Trust is the taxpayer, then the Florida Trust, assuming it has at least $13,000 of income, will pay the highest federal income tax rate of 37% but will avoid the New York state income taxes. **This saves almost 15% of income taxes!**
2. If Robert accumulates the income inside of the Trust and Robert is the taxpayer, then he pays the 51.776%.
3. If Robert distributes the income to himself, he also pays combined federal and state taxes of 51.776%.
4. If Robert distributes the income to his children and they pay the tax at 25% then the savings is an astonishing **26.776%!**

Please note that if Irene left her trust share outright to Robert, then he would not have the ability to take advantage of potential income tax savings scenarios.

STATE INCOME TAXES

The above example illustrates how state income taxes may affect the ultimate outcome to your beneficiaries. Where your beneficiaries reside, and in some cases, where the trustee of their share resides, has an economic effect on the income tax outcome.

SIMPLE/ COMPLEX TRUSTS

A simple trust is one that distributes all of its income every year. When a trust accumulates its income it becomes a complex trust. Income taxation of complex trusts is beyond the scope of this whitepaper

FLORIDA TRUSTS

As a client of the firm, you're a Florida resident, and your revocable living trust is governed by Florida law. You're likely aware that Florida does not impose a state income tax. After your death, the trusts created for your loved ones will usually remain Florida trusts, no matter where your beneficiaries reside. Does this mean that the income generated by your trust is not taxed as income under state law?

As you see above in Robert's example above, that certainly isn't the case under two of the four scenarios. A beneficiary who receives an income distribution is taxed on that income. If that beneficiary is subject to state income tax, then that tax applies.

Diving deeper, which state income tax laws apply depends upon several variables.

Those variables include:

- The beneficiary's state of residence
- Whether the beneficiary or the trust is the taxpayer
- Whether the income is "source income" in another state
- In some cases, the trustee's state of residence.

DIFFERENCE BETWEEN A REVOCABLE (GRANTOR) TRUST AND IRREVOCABLE (NON-GRANTOR) TRUST

Attached to this whitepaper is the 2022 Non-Grantor Trust State Income Tax Chart created by attorney Steve Oshins in Las Vegas, Nevada. This chart details the state income tax treatment of the trusts that your beneficiaries receive via gift during your lifetime or will one day inherit from you after your passing.

It's important to remember that during your lifetime a trust you create for yourself will have different income tax treatment than the trust you create for your loved ones after your death, or even an irrevocable trust for your loved ones that you create during your lifetime, which I call a "Gift Trust".

Examples of lifetime gift trusts include:

- Irrevocable Life Insurance Trusts
- Dynasty Trusts
- Heritage Trusts
- Charitable Remainder Trusts

During **your** lifetime **your** revocable living trust is a "grantor trust," a term defined in the Internal Revenue Code. A grantor trust simply means that it is income tax neutral. The creator of the trust (called the "Grantor" or "Settlor") is attributed the income earned by the trust, and it therefore appears on the Grantor's Federal Income Tax Return Form 1040, as well as any state income tax return that applies.

For most Florida residents, there is no state income tax unless they have "source income" from a state that imposes a state tax. Examples of source income include that from a business situated in such a state, or rental income from property located in such a state.

In my example, if Irene is a Florida resident and only has interest and dividend income on investments, she will not pay any state income tax as a Florida resident. If, however, Irene also owns a rental home on the Jersey shore, she will pay New Jersey state income tax on the net rental income earned there. This will be true even if Irene transfers her New Jersey property into a Florida revocable trust.

When Irene dies and the New Jersey shore property is inherited by Robert and Lynn in their respective trust shares, they will have New Jersey source income triggering state income tax.

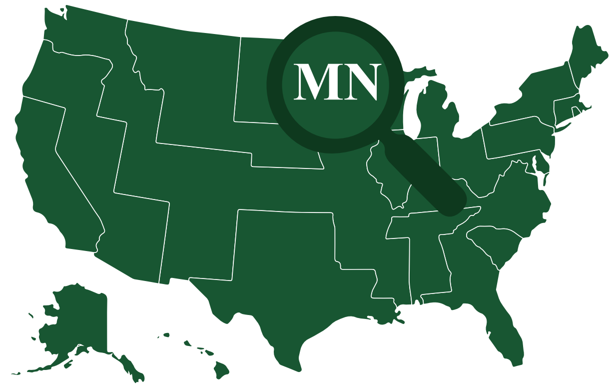
STATE INCOME TAXATION – LOCATION, LOCATION, LOCATION!

As I noted above, a factor that clients should be aware of with state income taxation is not only the location of the beneficiaries but the location of the Trustee. Some states, like California and Georgia, impose a state income tax when the trustee is a resident of that state or is a state-chartered entity.

To illustrate by example, let's assume that Lynn is incapable of managing her trust share. Irene therefore names her brother Scott, a California resident, to act as a Trustee for her daughter Lynn's share. Lynn is a resident of Georgia. Scott has the discretion to distribute the income to Lynn, or to Lynn's two sons, Anthony and Alan, who both reside in Texas.

Turning to the accompanying chart, we see that California has a top state income tax rate of 13.3% and that income tax rate applies if the trust has either a California trustee or a California non-contingent beneficiary, then the state income tax is apportioned based on the number of trustees and whether they reside in California or not, or it's applied if there is a non-contingent beneficiary who is a California resident.

We also see that Georgia imposes its state income tax rate of 5.75% if there is trust property located in Georgia, or if the trustee is managing funds for the benefit of a Georgia resident, whether contingent or not.



Whoa! Your head might be spinning from the legal terminology. Allow me to sort this out:

Contingent Beneficiary – If the Trustee has the power to distribute income or to not so distribute income to a beneficiary, then that individual is called a "contingent beneficiary." His receipt of income is contingent upon the Trustee's decision to distribute. Since Scott can choose to accumulate income rather than distribute it, or he can distribute it evenly or unevenly amongst Lynn, Anthony and Alan, all three are contingent beneficiaries.

Non-Contingent or Mandatory Beneficiary – If the Trustee must (or shall) distribute income to a beneficiary, then they are a mandatory, or noncontingent beneficiary.

Reviewing the accompanying chart, whether a beneficiary who resides in a state that taxes income is contingent or non-contingent could trigger the tax. It's important to review these issues inside of your estate plan.

WHICH STATE GETS TO TAX THE INCOME?

In my illustration where Lynn, Anthony and Alan all live in different states, remember that where Anthony and Alan reside, Florida and Texas, those states do not impose a state income tax. Georgia and California do. Under Georgia law, because the Trustee is managing the trust share for Lynn, a contingent beneficiary and Georgia resident, Georgia state income tax applies under the law.

But wait! There's a 2019 United States Supreme Court case that holds otherwise – *North Carolina Department of Revenue v. Kimberly Rice Kaestner 1992 Family Trust.* In that case a non-grantor trust was established in New York for Kimberly Kaestner and her three children who all became a North Carolina residents. The trustee had full discretion whether or not to distribute income to Kimberly or her kids. North Carolina assessed $1.3 million of income taxes for the tax years 2005 to 2008. The Trustee paid the tax under protest, filed a claim for refund and litigated the case.

The Supreme Court ruled that the presence of in-state beneficiaries alone does not empower a State to tax trust income that has not been distributed to the beneficiaries and where the beneficiaries have no right to receive it.

Apparently, Georgia law does not conform to Kaestner, but to date has not been amended or changed. So the Trustee would have to determine whether they would file and pay the tax and then object on the grounds that the law is unconstitutional. What about California state income tax law that would impose a tax because Scott is a California resident? That tax might apply. So it may behoove the parties for Scott to resign and name a different Trustee.

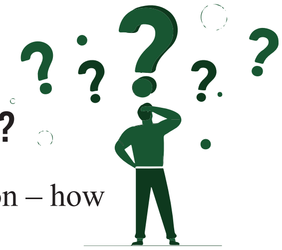
Assuming both state income taxes apply in this example, because California tax applies and exceeds Georgia's state income tax, the two states may have to share in the revenue proportionally.

DIFFERENT STATES – DIFFERENT LAWS

Take a look at Hawaii's law and compare it to California. Where California law imposes a tax where the trustee is a California resident, for Hawaii state income tax to apply there must be a Hawaiian beneficiary.

This illustrates the point that state taxation is different depending upon each state's law. See the attached index of all 50 states.

NOTICE: This memo does not constitute legal advice to any one individual client's situation.



HOW DOES THIS ALL APPLY TO YOU?

All of this begs an important question – how does this apply to you?

To review the points of this whitepaper:

1. Embedding income tax planning for your beneficiaries into your estate plan could result in thousands of dollars of savings to them when they inherit your estate,

2. When so doing, one must know whether your beneficiaries reside in a state that taxes income, and what the rules are under that state's law,

3. It's also helpful to know what your beneficiaries' marginal income tax rates are, and to communicate that information to us, and

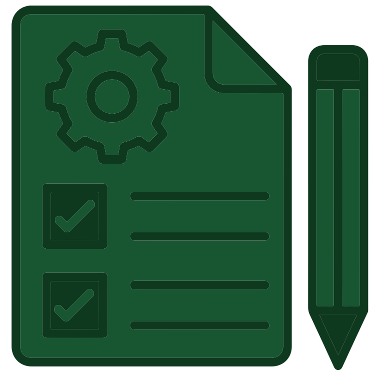
4. If your beneficiaries move to a different state, it's important to let us know as each state's laws are different.

5. We also need to know where the trustee of each trust share resides.

ACTION PLAN

If you are a new client to the firm:

- Ask for our initial client packet and complete our client organizer,
- In that client organizer, provide us information about your investment income, as well as any business, rental, or other source income that you may have here in Florida and/or in any other state,
- Let us know as much about your beneficiaries as you can per the above.



If you are an existing client of the firm and wish to explore these issues in greater detail:

- If you have a trust that has continuing trust provisions, you may already have much or all of these strategies embedded in your plan, especially if we have updated your trust within the past two years,

- Provide us as much information about your beneficiaries and trustees as you can, relative to the above,

- If you haven't already done so, enroll in our Client Care Elite program, and let us know when you schedule your appointment that you would like to focus on these issues.

Hope this helps you create the best plan for your loved ones!

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ABOUT
CRAIG R. HERSCH

Craig R. Hersch is a Florida Bar Board Certified Wills, Trusts & Estates attorney and holds his Florida CPA license, with over 30 years of experience in his practice.

Craig is a partner at Sheppard, Brett, Stewart, Hersch, Kinsey & Hill and has created several trademarked processes tied to his estate planning and administration practice, including The Family Estate & Legacy Program and The Estate Settlement Program.

Craig has authored six books for clients: The Florida Estate Planning Guide, Selecting Your Trustee, Common Cents Estate Planning, Legal Matters When a Loved One Dies, Asset Alignment and Your Estate Plan and Common Cents Estate Planning II. His work has appeared in several professional journals, including The Practical Tax Lawyer, and The Florida Bar Journal, as well as being on the editorial advisory board for Trusts & Estates Magazine, the premier trade journal for estate planning attorneys, CPA's, and financial advisors. Craig also writes a weekly estate planning column that is published in Sanibel's Island Sun newspaper and on his firm's blog.

Craig is a multiple graduate of the University of Florida with accounting and law degrees and has provided his expertise as a continuing education lecturer for The Florida Bar and the Florida Institute of Certified Public Accountants.

Craig holds an AV Martindale Hubbell rating, the highest attainable by the independent national attorney rating service, has been selected as a Worth 100 Top Attorney and has been named to the Super Lawyers list every year since 2009, a highly-esteemed recognition given to no more than five percent of attorneys in Florida.

During his free time, Craig enjoys competing in triathlons, having finished an Ironman distance race and seven half-Ironman races over the last decade. Craig is married to his wife, Patti, and they have three daughters: Gabrielle, Courtney, and Madison.

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ABOUT
MICHAEL B. HILL

Michael B. Hill is a partner at Sheppard Law Firm. Michael is a Florida Board Certified Will, Trusts & Estates attorney concentrating his practice in estate and wealth preservation and business succession planning.

Michael has extensive tax, legal and technology skills, enabling him to create unique plans for meeting client's individual and family needs.

Michael is a double graduate of the University of Florida, receiving his Bachelor of Science in Accounting in 1998, and his Juris Doctor, with honors, in 2001. He is a member of the Florida Bar Association, the American Bar Association, and the Lee County Bar Association.

Michael and his wife, Jamie, have four children, Connor, Chase, Lindsay, and Caleb. In his free time, when there is any, Michael enjoys playing golf, working out, and watching most Gator sports. As an alumnus of the Fightin' Gator Marching Band, you may be able to spot him on Florida Field as a member of the Alumni Band, which marches at one home football game each year.

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HAYLEY E. DONALDSON

Hayley E. Donaldson has been recently promoted to partner with the Sheppard Law Firm, working closely with estate planning attorneys Craig R. Hersch and Michael B. Hill.Hayley helps guide family members in the trust administration and probate process after the passing of their loved one.

Additionally, she assists clients with their tax and estate planning, drafting simple and complex wills, trusts, and related estate planning documents.Hayley received her Juris Doctor from the University of Florida Levin College of Law, graduating first in her class. In law school she was a member of the Florida Law Review and Volunteer Income Tax Assistance (VITA) program which assists lower income individuals with their yearly tax returns.

Hayley is also a Certified Public Accountant (CPA) and worked previously as an Internal Audit Consultant for a national firm. Hayley has a Masters in Professional Accounting from the University of Texas and holds degrees in Accounting and Finance from the University of Miami. Raised in Fort Myers, she is also a proud graduate of the International Baccalaureate program at Fort Myers High School.

In her free time, Hayley enjoys running, swimming, and watching the Boston Red Sox.

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