

Using Delaware Trusts to Reduce Pennsylvania Personal Income Tax



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In an earlier issue of the *Delaware Banker*, Mr. Nenno explained how New Jersey testators, settlors, trustees, and beneficiaries are particularly well-positioned to save New Jersey gross income tax by creating trusts in or moving them to Delaware.¹ Similarly, Pennsylvanians should consider using Delaware trusts to reduce Pennsylvania personal income tax. This article explains why.

Current Rules

In Pennsylvania, the trustee of a Resident Trust must file a return if the trust has Pennsylvania taxable income or loss; the trustee of a Nonresident Trust must file a return if the trust has Pennsylvania-source taxable income or a Pennsylvania resident beneficiary.² The Keystone State does not have federal grantor-trust rules for irrevocable trusts³ but permits trustees to take a distribution deduction.⁴ Starting in 2020, the Commonwealth also allows a decedent's personal representative and the trustee of the decedent's former revocable trust to make an I.R.C. § 645 election.⁵

In 2022, the Commonwealth taxed the Pennsylvania net taxable income of trustees of irrevocable trusts at 3.07%,⁶ and this rate is not scheduled to change.⁷ Pennsylvania defines “Resident Trust” as a trust that is created or funded by a Pennsylvania resident testator or settlor as follows:⁸

“Resident Trust” means:

- (1) A trust created by the will of a decedent who at the time of his death was a resident individual; and
- (2) Any trust created by, or consisting in whole or in part of property transferred to a trust by a person who at the time of such creation or transfer was a resident.

In Pennsylvania, an individual is a resident for tax purposes if the individual is domiciled in the Commonwealth or if the individual maintains a permanent place of abode and spends more than 183 days there during the taxable year.⁹ A “Nonresident Trust” is a trust that is not a “Resident Trust.”¹⁰

Pennsylvania taxes trustees of Resident Trusts on the following seven specific classes of income:

- Taxable interest income
- Taxable dividend income
- Net income or loss from the operation of a business, profession, or farm
- Net gain or loss from the sale, exchange, or disposition of property
- Net income or loss from rents, royalties, patents, or copyrights
- Estate or trust income
- Gambling and lottery winnings.¹¹

Trustees of Nonresident Trusts are taxed on the above classes of income attributable to Pennsylvania sources.¹² In Pennsylvania, trustees must make estimated tax payments for trusts¹³ and must withhold tax from source income distributable to nonresident beneficiaries.¹⁴

The Commonwealth assesses a throwback tax on accumulation distributions to resident beneficiaries from Nonresident Trusts. Hence, a regulation provides:¹⁵

Amounts received by a resident beneficiary from a nonresident . . . trust shall be taxable to the beneficiary in the year received to the extent that such income was not subject to tax under this article. The resident beneficiary shall be allowed a credit against the tax otherwise due under this article for his pro rata share of any income tax, wage tax or tax on or measured by gross or net earned or unearned income imposed on the . . . trust with respect to such income by another state. The credit shall not exceed the proportion of the tax otherwise due. Reference should be made to § 111.4 (relating to limitation on credit).

Safe Harbor

The Commonwealth offers a safe harbor for when a trust that meets the definition of Resident Trust will be taxed as a Nonresident Trust. Thus, according to the Pennsylvania fiduciary income tax return instructions, a trust created by a resident will not be taxed in the following circumstances:¹⁶

An inter vivos trust or a testamentary trust created by a resident can become a nonresident trust if the settlor is no longer a resident or is deceased, and the trust lacks sufficient contact with Pennsylvania to establish nexus. Any one of the following conditions provides sufficient contact for a resident trust to remain a resident trust or to requalify as a resident trust:

- The trust has a resident trustee;
- Any trust administration occurs in Pennsylvania;
- Trust assets include:
 - Real or tangible personal property located within Pennsylvania, or
 - Stock, securities or intangible personal property, evidenced by the documents, certificates or other instruments that are physically located, or have a business situs within Pennsylvania; or
 - The situs of the trust is Pennsylvania as provided in 20 PA. C.S. § 7708.

Section 7708(a) specifies:¹⁷

Without precluding other means for establishing a sufficient connection with the designated jurisdiction, provisions of a trust instrument designating the situs of the trust are valid and controlling if:

- (1) a trustee's principal place of business is located in or a trustee is a resident of the designated jurisdiction;
- (2) all or part of the trust administration occurs in the designated jurisdiction; or
- (3) one or more of the beneficiaries resides in the designated jurisdiction.

Curiously, even though the safe harbor indicates that the presence of a resident trustee and § 7708(a) indicates that the presence of a resident trustee or a resident beneficiary will cause a trust to be taxed as a Resident Trust, a regulation states that in classifying a trust for income-tax purposes “[t]he residence of the fiduciary and the beneficiaries of the trust shall be immaterial.”¹⁸ It is unknown whether appointing resident advisers or protectors rather than resident trustees will be successful in escaping tax, but the safe course is to assume that it will not.

Case Law

Hope is not lost if a trust does not fall within the above safe harbor (for example, if the settlor is living or still resides in the Commonwealth) thanks to the Pennsylvania Commonwealth Court’s 2013 decision in *McNeil v. Commonwealth*,¹⁹ which saved over \$500,000 of tax and which is the poster child for how Delaware trusts can save Pennsylvania tax. In 2007, two trusts, which had been established by a Pennsylvania resident settlor, had Pennsylvania resident discretionary beneficiaries, non-Pennsylvania individual trustees, and a Delaware corporate trustee. The court held that Pennsylvania’s imposition of tax in the circumstances would violate the dormant Commerce Clause of the United States Constitution.²⁰

The court reviewed the governing dormant Commerce Clause principles from the United States Supreme Court’s 1977 *Complete Auto Transit, Inc. v. Brady* decision²¹ as follows:²²

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Commerce Clause cases are governed by *Complete Auto Transit, Inc. v. Brady*, in which the U.S. Supreme Court established a four prong test to determine whether a state tax withstands constitutional scrutiny. Those four prongs are: (1) the taxpayer must have a substantial nexus to the taxing jurisdiction; (2) the tax must be fairly apportioned; (3) the tax being imposed upon the taxpayer must be fairly related to the benefits being conferred by the taxing jurisdiction; and (4) the tax may not discriminate against interstate commerce. To pass constitutional muster, all four prongs must be satisfied and the failure to meet any one of these requirements renders the tax unconstitutional.

The court found that imposition of tax would violate prongs (1), (2), and (3); it did not address prong (4).

Regarding the first prong, the court concluded:²³

[W]e hold that neither Settlor's residency nor the residency of the beneficiaries provides the Trusts with the requisite presence in Pennsylvania to establish a substantial nexus and, therefore, the first prong of Complete Auto is not met and the imposition of the PIT [personal income tax] here violates the Commerce Clause of the U.S. Constitution.

Regarding the second prong, the court reasoned:²⁴

[T]he imposition of the PIT on the Trusts' income, when all of that income was derived from sources outside of Pennsylvania, is inherently arbitrary and has no rational relationship to the Trusts' business activity that occurred in Pennsylvania. Accordingly, the imposition of the PIT here does not satisfy the fair apportionment prong of *Complete Auto*.

Regarding the third prong, the court found:²⁵

In 2007, the Trusts had no physical presence in Pennsylvania, none of their income was derived from Pennsylvania sources, none of their assets or interests were located in Pennsylvania, and they were established under and were governed by Delaware law. Hence, . . . the Trusts do not benefit from Pennsylvania's roadways, bridges, police, fire protection, economic markets, access to its trained workforce, courts, and laws. We recognize that the Trusts' discretionary beneficiaries almost certainly benefit from Pennsylvania's societal and legal framework because they reside in Pennsylvania; however, they are not the taxpayer in this matter and, importantly, as discretionary beneficiaries, they have no present or future right to distributions from the Trusts. Moreover, pursuant to Sections 302 and 305 of the Tax Code the beneficiaries will pay PIT on any distributions they do receive from the Trusts, which are fairly related to the benefits they receive from residing in Pennsylvania. Similarly, Settlor, who was deceased in TY 2007, is not the taxpayer in this matter.

Thus, the Department's imposition of the PIT on the Trusts' entire income is not reasonably related to the

benefits Pennsylvania provides the Trusts. Therefore, the Commonwealth's imposition of the PIT here does not satisfy the fairly related prong of *Complete Auto*.

Having held that imposition of tax would violate the dormant Commerce Clause,²⁶ the court did not have to decide whether it would violate the Due Process or the Equal Protection Clause of the United States Constitution or the Uniformity Clause of the Pennsylvania Constitution.²⁷

The *McNeil* decision was based, in part, on the fact that the trust had no physical presence in Pennsylvania. In the meantime, the United States Supreme Court eliminated the physical-presence requirement under the dormant Commerce Clause.²⁸ Soon after, the Commonwealth Court of Pennsylvania disavowed *McNeil*'s physical-presence test in applying Pennsylvania Personal Income Tax to a nonresident partner of a partnership that disposed of Pennsylvania real property.²⁹

In our view, the elimination of the physical-presence requirement would not have changed the outcome in *McNeil* because the Commonwealth failed to meet two of the other Complete Auto criteria. Moreover, the Commonwealth might not have been able to meet the substantial-nexus prong even without the physical-presence requirement.

Establishing Trusts' Residency Status

The tax return instructions contain the following caution for trustees seeking to have a Resident Trust taxed as a Nonresident Trust:³⁰

CAUTION: Do not file an amended return to change the residency status of a trust. You must file a REV-65 Petition for Refund, with the Board of Appeals.

Planning: Federal Nongrantor Trust; Pennsylvania Nongrantor Trust

Pennsylvania testators, settlors, trustees, and beneficiaries should structure – and consider moving – federal nongrantor trusts to qualify for the above safe harbor and, where the safe harbor is not available, minimize the trusts' connections to the Commonwealth (for example, by transferring trusts to Delaware trustees) with the hope of obtaining favorable outcomes from the filing of REV-65 petitions. Although REV-65 petitions typically are denied by the Board of Appeals, numerous trustees (almost 100 as of this writing) have succeeded by appealing adverse Board of Appeals rulings to the Board of Finance and Revenue.³¹ In appropriate situations, court appeals of adverse Board of Finance and Revenue decisions might be advisable.

The potential tax reduction for the trustee of a Pennsylvania Resident Trust on a \$1 million long-term capital gain incurred in 2022 was \$30,700. Hence, there would be \$30,700 of additional assets to produce income for the beneficiaries and, through the elimination of the state-income-tax drag, to enhance the trustee's performance in that and future years. This planning is all the more important given the current \$10,000 per year limitation on the federal deduction for state taxes.³²

Pennsylvanians also might want to create and fund Delaware revocable trusts during life to escape the Pennsylvania income

tax that otherwise would be payable by their probate estates.

Planning: Federal Grantor Trust; Pennsylvania Nongrantor Trust

Given that Pennsylvania does not have grantor-trust rules for irrevocable trusts, it might be possible to design a trust to be a grantor trust for federal purposes and a nontaxable nongrantor trust for Pennsylvania purposes. Pennsylvania's treatment of all irrevocable trusts as nongrantor trusts has serious consequences. For example, the tax return instructions offer the following guidance for GRATs and GRUTs:³³

GRATs and GRUTs are ordinary trusts that are not exempt from PA-41 Fiduciary Income Tax Return, filing requirements or taxation. These types of trusts must file a Pennsylvania trust tax return, pay tax on any retained earnings, and report the income to the beneficiary on the same basis as any other ordinary trust.

Moreover, according to Pennsylvania practitioners, the sale of assets in exchange for a promissory note is a taxable event in the Commonwealth. Furthermore, the settlor of a Pennsylvania trust may not take a credit for taxes paid by the grantor of a trust that was treated as a grantor trust by another state "because Petitioner and the Grantor are two separate taxpayers and the same taxpayers did not pay tax on the same income in Pennsylvania and another state."³⁴

Pennsylvanians who create trusts that are treated as grantor trusts for federal purposes often must pay all federal income taxes attributable to such trusts even though they do not have access to the trusts' assets. Except for trusts that give the trustee discretion to reimburse the grantor for income taxes, grantors of such trusts have the choice to pay such taxes (which might become burdensome over time), to release the powers that trigger grantor-trust treatment (which will deplete the trust fund), or to toggle between grantor-trust and nongrantor trust treatment (with its practical and tax-related challenges). Pennsylvanians might consider establishing new trusts in or moving existing trusts to Delaware, where a Delaware statute gives trustees of grantor trusts discretion to reimburse the settlor for federal, state, county, metropolitan-region, city, local, foreign, or other income tax liability unless prohibited by the governing instrument.³⁵ Using this statutory power, the trustee might reimburse the settlor for some taxes in one year, for no taxes in a second year, and for all taxes in a third year.

DING Trust Option

Pennsylvanians might use a type of Delaware asset protection trust (APT)³⁶ known as the Delaware incomplete gift nongrantor trust (DING Trust) to eliminate Pennsylvania income tax on undistributed ordinary income and capital gains. DING Trusts are designed with two goals in mind: to prevent transfers from being completed gifts; to have the trusts treated as nongrantor trusts for federal purposes. The second goal is easily accomplished because Pennsylvania treats all irrevocable trusts as nongrantor trusts. The planner then can focus on structuring transfers to be incomplete gifts so that the settlor of the DING Trust, which is a self-settled trust, might be able to receive tax-free distributions of the untaxed income in later years.

Adverse Treatment of CRTs

Pennsylvanians might want to establish their CRTs in or move them to Delaware. That's because Pennsylvania taxes CRTs at the trust level. Hence, the instructions to the Pennsylvania fiduciary income tax return provide:³⁷

CRATs, charitable remainder trusts, CRUTs and pooled income fund trusts of public charities are ordinary trusts that are not exempt from PA-41, Fiduciary Income Tax Return, filing requirements or taxation. These types of charitable trusts must file a Pennsylvania trust tax return, pay tax on any undistributed income, and report the income to the beneficiary on the same basis as any other ordinary trust.

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.³⁸

Duty to Minimize Tax

Section 108(b) of the Uniform Trust Code 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,"³⁹ and § 108's comment acknowledges that a change of situs might be desirable "to secure a lower state income tax rate."⁴⁰ Pennsylvania's version of § 108⁴¹ does not include an equivalent of § 108(b). The comment to § 7708 reports that this was done "to avoid the implication of a duty that the trustee consider the laws of all conceivable jurisdictions to which the situs of a trust may be moved and establish and re-establish situs accordingly."⁴²

Trustees paying Pennsylvania tax should not relax, though, because under the duty to administer the trust in accordance with its terms and applicable law, § 76 of the Third Restatement of Trusts⁴³ offers the following comment:⁴⁴

A trustee's duty to administer a trust includes an initial and continuing duty to administer it at a location that is reasonably suitable to the purposes of the trust, its sound and efficient administration, and the interests of its beneficiaries. . . .

Under some circumstances the trustee may have a duty to change or to permit (e.g., by resignation) a change in the place of administration. Changes in the place of administration by a trustee, or even the relocation of beneficiaries or other developments, may result in costs or geographic inconvenience serious enough to justify removal of the trustee.

Moreover, at least on this issue, trustees must consider the laws of as few as two jurisdictions – Pennsylvania (how to escape its tax as discussed above) and a state that will not tax the trust's income. It is generally known that nearby Delaware usually will not tax trusts created by Pennsylvanians (see below).

Delaware Considerations

Delaware taxes trustees in certain circumstances,⁴⁵ with a top rate of 6.60% on taxable income over \$60,000.⁴⁶ But, trustees

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of trusts created by Pennsylvania residents will not have to pay Delaware income tax – or even file a Delaware return – as long as there are no Delaware resident beneficiaries.⁴⁷

Conclusion

Pennsylvania’s low flat income tax rate, its disregard of grantor-trust rules for irrevocable trusts, its adverse tax treatment of CRTs, and its other quirks distinguish the Commonwealth’s tax system from those of other states. Through the discerning use of Delaware trusts, Pennsylvania testators, settlors, trustees, and beneficiaries often may greatly reduce the impact of the Pennsylvania personal income tax or eliminate it altogether. As fiduciaries, trustees that are paying Pennsylvania personal income tax, like many trustees before them, have a duty to engage in this planning to fulfill their duty to administer trusts “in accordance with . . . the interests of the beneficiaries”⁴⁸ – not the interests of the Commonwealth’s Department of Revenue – and face potential liability if they fail to do so. If nothing else, it’s the right thing to do.



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Notes:

- 1- Richard W. Nenno, *Using Delaware Trusts to Reduce New Jersey Income Tax*, 16 Del. Banker 22 (Fall 2020).
- 2- Instructions to 2022 Form PA-41 at 1.
- 3- See Instructions to 2022 Form PA-41 at 5.
- 4- See 72 P.S. § 7305.
- 5- See 72 P.S. § 7331(g).
- 6- 72 P.S. § 7302.
- 7- 72 P.S. § 7302.
- 8- 72 P.S. § 7301(s).
- 9- 72 P.S. § 7301(p).
- 10- 72 P.S. § 7301(n). See *David C. Matthews Fam. Tr.*, BF&R Docket No. 1917374 (Feb. 10, 2020), www.bfrcases.patreaury.gov (Petitioner was not a Resident Trust in 2016 because “Petitioner’s grantor was not a Pennsylvania resident at the time Petitioner was created, and Petitioner and its grantor owned no Pennsylvania property at the time of the grantor’s death or at any time during 2016.”).
- 11- See Instructions to 2022 Form PA-41 at 6. See also 72 P.S. § 7302(a).
- 12- See 72 P.S. § 7302(b).
- 13- See 72 P.S. § 7325–7326.
- 14- See 72 P.S. § 7324.
- 15- 61 Pa. Code § 105.5(c).
- 16- Instructions to 2022 Form PA-41 at 4.
- 17- 20 Pa. C.S. § 7708(a). Section 7708(b) gives rules for determining situs when the trust instrument is silent.
- 18- 61 Pa. Code § 101.1.
- 19- 67 A.3d 185 (Pa. Commw. Ct. 2013).
- 20- U.S. Const. art. I, § 8, cl. 3.
- 21- 430 U.S. 274 (1977).
- 22- *McNeil*, 67 A.3d at 192 (citations omitted; emphasis in original).
- 23- *Id.* at 195.
- 24- *Id.* at 196–97 (citation and internal quotation marks omitted).
- 25- *Id.* at 197–98 (citations omitted). Although the opinion recites that the Settlor was deceased, he was in fact living. Courts have invalidated the taxation of inter vivos trusts whose settlors were in fact living under similar statutes of other states (see, e.g., *Fielding for MacDonald v. Comm’r of Revenue*, 916 N.W.2d 323 (Minn. 2018)).
- 26- *Id.* at 198.
- 27- *Id.* at 198 n.17.
- 28- *South Dakota v. Wayfair, Inc.*, 138 S. Ct. 2080 (2018).
- 29- *Andrews v. Commonwealth*, 196 A.3d 1090, 1098 n.13 (Pa. Commw. Ct. 2018).
- 30- Instructions to 2022 Form PA-41 at 19. Pa. REV-65 *Board of Appeals Petition Form*, available at www.revenue.pa.gov/FormsandPublications/otherforms/Documents/rev-65.pdf (last visited July 25, 2023).
- 31- See, e.g., *Felger Elizabeth Y Tr: U/W*, BF&R Docket No. 2010371 (July 8, 2021), www.bfrcases.patreaury.gov (“The Department of Revenue shall issue a refund in the amount of \$__ to Petitioner”).

- 32- See IRC §§ 164(b)(6)(B), 641(b).
- 33- Instructions to 2022 Form PA-41 at 3–4.
- 34- *Arthur Dantchik Trust For Descendants*, BR&R Docket No. 2204243 (Jan. 26, 2023), www.bfrcases.patreasury.gov. The ruling does not give the basis on which the other state classified the trust as a grantor trust.
- 35- See 12 Del. C. § 3344.
- 36- See 12 Del. C. §§ 3570–3576.
- 37- Instructions to 2022 Form PA-41 at 3.
- 38- See I.R.C. § 664(b).
- 39- UTC § 108(b).
- 40- UTC § 108 cmt.
- 41- 20 Pa. C.S. § 7708.
- 42- Jt. St. Govt. Comm. Comment to 20 Pa. C.S. § 7708.
- 43- Restatement (Third) of Trusts § 76 (2003). Like other restatement provisions, § 76 is understood as “describing the law in a given area and guiding its development” (Black’s Law Dictionary 1570 (11th ed. 2019)).
- 44- Id. cmt. b(2) (2003) (cross references omitted). The Reporter’s Note for § 76 quotes the portion of the Comment under UTC § 108 quoted above.
- 45- See 30 Del. C. §§ 1601(8), 1631.
- 46- 30 Del. C. § 1102(a)(14).
- 47- See 30 Del. C. §§ 1605(b), 1636.
- 48- 20 Pa. C.S. § 7771.

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