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Avoid State Taxes on Crypto With US Supreme Court's Recent Trust Decision?

EXPERT TAKE

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The United States Internal Revenue Service (IRS) treats Bitcoin and other cryptos as property. That means each property transfer can trigger taxes, with a tax hit to both the recipient and the transferor. A key question is the market value at the time of the transfer. Some crypto investors put crypto in legal entities such as corporations, LLCs or partnerships. Another avenue is a trust that holds crypto assets.

In North Carolina Dept. of Revenue v. Kimberley Rice Kaestner 1992 Family Trust, the U.S. Supreme Court unanimously said that a state could not tax out-of-state residents on trust income without minimum contacts. We'll come back to that case, but should note that trusts can be taxed in several different ways, depending on their type. There are living trusts that people usually use for estate planning, but living trusts are not separately taxed.

Crypto and living trusts

So, if you transfer Bitcoin to your living trust, it usually isn't a taxable transfer, since your living trust isn't really a separate taxpayer. It is still you, so you still report the gain or loss on a later sale on your personal tax return. There are also nongrantor trusts, in which the transferor is not taxed on them. These are separately taxed, and a separate trust tax return must be filed.

Trust tax rules can be complex, but that means the trust itself pays the taxes. There can be another tax on the distribution to beneficiaries. But leaving distribution issues aside, where does the trust pay taxes? That depends. Some trusts are foreign, meaning that they are set up outside the U.S. Those rules are complex, but if you are a U.S. person, you should not assume that you can avoid U.S. taxes with a foreign trust.

Still, it might be possible to have your trust pay the lower corporate tax rate of 21% rather than your individual tax rate.

What about state taxes?

This is where things get more interesting. Some trusts are set up with an eye on reducing or avoiding state taxes — say, if you are in California and don't want to move to Nevada before you sell your Bitcoin. You want to cut the sting of California's high 13.3% state tax, but you aren't willing to move — at least, not yet. You could consider setting up a new type of trust in Nevada or Delaware.

A "NING" is a Nevada Incomplete Gift Non-Grantor Trust. A "DING" is its Delaware sibling. There is even a "WING" in Wyoming. The usual grantor trust for estate planning doesn't help, since the grantor must include the trust income on his/her own tax return. With a Nevada or Delaware Incomplete Gift Non-Grantor Trust, the donor makes an incomplete gift to the trust, and the trust has an independent trustee.

The idea is to keep the grantor involved but not as the owner. The state of New York changed its law to make the grantor taxable no matter what, but the jury is still out on these trusts in California and other states. Some marketers of NING and DING trusts offer them as alternatives or adjuncts to a physical move.

The idea is for the income and gain in the NING or DING trust not to be taxed until distributed, when the distributees will hopefully no longer be in the high tax state. The trustee must not be a resident of the high tax state. Parents frequently fund irrevocable trusts for children and may not want the trust to make distributions for years, removing future appreciation from the parents' estates. Tax-deferred compounding can yield impressive results, even if only state tax is being sidestepped.

For tax purposes, most trusts are considered taxable where the trustee is situated. For NING and DING trusts, a common answer is an institutional trust company. Trust investment and distribution committees should also not be residents. The facts, documents and details matter, and states like California may well push back. However, doesn't the Supreme Court's recent North Carolina case help?

North Carolina case

The court ruled that North Carolina's tax statute asserting jurisdiction on a foreign trust based solely on the residence of a beneficiary was too broad. But it is still constitutional for a state to tax based on the residence of the trustee or the site of the trust's administration. Who forms the trust matters, too. In the North Carolina case, the trust was formed by the taxpayer's father, and he was a resident of New York.

The taxpayer in the case was the daughter, and she was not the trustee and had no control over the trust. She didn't even receive any distributions from the trust in the years involved in the case. That made it a pretty compelling case for the Supreme Court to tell North Carolina it couldn't tax her.

California case

In contrast, many NING/DING trusts are formed by the person in the high tax state trying to avoid state tax — a person in California, for example. And then there's the distribution question, as some NING/DING trusts do anticipate that the settlor might receive distributions. The administration can be touchy too, as some NING/DING trusts include the settlor/beneficiary as a member of a distribution committee that exercises control over trust distributions.

Depending on the facts of the NING/DING trust, therefore, the Supreme Court's ruling seems pretty limited. In fact, the case is limited to the handful of states that use beneficiary residence as the sole factor for determining the state's taxing jurisdiction. The court said its ruling should not impact states that consider beneficiary residence as only one of several factors for determining their jurisdiction to tax. Interestingly, California is one of five states identified in the case that establishes jurisdiction based entirely on the beneficiary's residence.

Even here, though, the opinion carves out California's tax statute as an issue to resolve at a later date. California law only allows the state to assert jurisdiction based solely on the beneficiary residence when the beneficiary's interest is not contingent (such as not subject to the discretion of a trustee). The North Carolina case involved a trustee who had discretion to control distributions, or to not make distributions at all.

So, will your NING/DING trust work to shield you and your beneficiaries from state tax? Creative trusts can be worth trying, depending on the right facts, but you need to be careful. You don't want to be low-hanging fruit for the high tax state to attack.