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**USING A NEW HAMPSHIRE APT SHELTER TRUST TO**

**ELIMINATE STATE INCOME TAX:**

***These Specialized Versions of New Hampshire Self-Settled Asset Protection Trusts May Be Particularly Attractive to Residents of New York and Massachusetts***

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**Introduction**

Recent trust and tax law reforms in New Hampshire provide an opportunity for residents of certain high income tax states to use a specific type of irrevocable trust to avoid state income taxation on capital gains and interest and dividend income realized by the trust. Although the trust is irrevocable, the settlor (i.e., the client) can be a beneficiary of the trust, and the trust property will be protected from the settlor’s creditors. If the settlor and beneficiaries of the trust reside in a state that does not tax a trust based on the residence of its settlor or beneficiaries, such as New York or Massachusetts, the trust can avoid state income taxation altogether. The settlor’s transfer of property to the trust can be either a completed or incomplete gift for federal transfer tax purposes, depending upon the client’s goals in creating the trust.

**Legal Framework**

The trust (which is sometimes called an “asset protection trust” or an “APT”), must have at least one trustee located in New Hampshire. Some states, including New York and Massachusetts, require a significant, current connection between a trust and the state in order to subject the trust to state income tax. Consequently, neither New York nor Massachusetts will tax a trust if all of the following conditions are met:

* All of the trustees are domiciled in another state;
* The entire corpus of the trust, including real estate and tangible property, is located outside of the state; and
* All income and gains of the trust are derived from non-New York or Massachusetts sources.

New York and Massachusetts residents therefore can avoid taxes on income by creating a New Hampshire APT and appointing a New Hampshire trustee. The APT must be a “non-grantor” trust for federal income tax purposes. The APT will be a “non-grantor” trust if both of the following conditions are met:

* The trust’s income and principal may be distributed to a beneficiary, or accumulated by the trust, only with the consent of the members of a “distribution committee” all of whom are trust beneficiaries (excluding the settlor and the settlor’s spouse); and
* The settlor’s only power to control beneficial enjoyment is the power to direct to whom the remaining trust property is distributed upon the settlor’s death.[[1]](#footnote-2)

Importantly, New Hampshire does not impose any tax whatsoever on trusts that have no New Hampshire beneficiaries.

**Avoiding Abuse**

To avoid possible question of this strategy by a state’s revenue department, a settlor should not fund an APT with assets likely to be sold shortly after the creation of the trust. In addition, there should be no prearrangement between the settlor and the distribution committee to distribute assets back to the settlor at any particular time. In other words, distributions from the APT back to the settlor should be made solely in the discretion of the distribution committee, without any influence by the settlor. Furthermore, the settlor should not fund the APT with assets that the settlor will need to pay for living expenses. The settlor should fund an APT only with those assets that he or she will probably never need.

**Case Study**

An example may help clarify the APT structure and its tax benefits. The client, a Massachusetts resident, owns stock in a closely-held company that he anticipates will go public in 18 to 24 months, but no deal is currently in place. The client isn’t concerned about reducing his estate tax exposure, but would like to reduce or eliminate the Massachusetts capital gains tax that will be imposed on his stock if the company goes public and he sells his shares at a significant premium compared to the stock’s current value. The client’s stock is currently valued at $2 million.

In 2012, the client establishes a New Hampshire APT with a New Hampshire trustee. He names himself, his wife and his three adult children and their descendants as the “discretionary” beneficiaries of the APT. Although any beneficiary is *eligible* to receive a distribution of income or principal, no beneficiary is *entitled* to a distribution from the APT. The trust agreement names the client’s three children as the “distribution committee.” The children, as the committee members, have discretion to direct the New Hampshire trustee to distribute trust property to any of the beneficiaries. The trustee cannot make any distributions unless it’s directed to do so by the distribution committee.

The client’s company goes public in 2014, and the client sells his stock for $10 million. The $8 million of long term capital gain is subject to the federal capital gains tax, and the tax is payable by the trustee, out of the sale proceeds. However, the $8 million gain is *not* subject to the 5.3% Massachusetts capital gains tax that would have applied if the client had continued to own the stock in his own name at the time of the sale. As a result, the client avoids the $424,000 Massachusetts tax on the realized gain, *and* obtains asset protection for the trust property. Assuming that the trust remains in existence for ten years after the sale, with no distributions, the client will have sheltered approximately $760,000 from tax at the end of the ten year period, as illustrated below:

|  |  |  |
| --- | --- | --- |
|  | **With New Hampshire APT Shelter Trust** | **Without New Hampshire APT Shelter Trust** |
| Initial contribution by client (2012) | $2,000,000 | $2,000,000 |
| Plus: Additional proceeds from sale of stock (2014) | $8,000,000 | $8,000,000 |
| Equals: Total after sale | $10,000,000 | $10,000,000 |
| Less: Federal capital gains tax (15%) | $1,200,000 | $1,200,000 |
| Equals: Net assets after federal tax | $8,800,000 | $8,800,000 |
| Less: Massachusetts capital gains tax (5.3%) | $0 | $424,000 |
| Equals: Net assets after federal and state tax | $8,800,000 | $8,376,000 |
| Plus: Appreciation on net assets over ten year period, at 6%/year | $15,759,460 | $15,000,140 |
| Additional value realized by creating the New Hampshire APT shelter trust | **$759,320** | $0 |

The Granite State’s modern and progressive trust statutes offer Massachusetts families and their attorneys and wealth advisors the proverbial opportunity to have their cake and eat it too. Massachusetts resident advisors can carry out to the fullest extent a trustee’s fiduciary duty “to preserve the trust property,” without having to sacrifice their client relationships. To be sure, careful attention must be paid to structuring the trust properly to optimize the benefits of favorable trust jurisdiction. Rewards for this attention to detail include long term security, investment flexibility, confidentiality and mutually beneficial wealth preservation.

1. This power is called a “limited testamentary power of appointment.” If the trust agreement gives the settlor a limited testamentary power of appointment, the settlor’s transfer of property to the trust will be an incomplete gift for federal transfer tax purposes, and the trust property will be included in the settlor’s estate for estate tax purposes. [↑](#footnote-ref-2)