November 28, 2022

Planning for the Massachusetts Millionaire Tax—Individuals and Trusts

On November 8, 2022, Massachusetts voters approved a measure placed on the ballot by initiative petition that amends the state's Constitution to impose an additional 4% tax on that portion of annual taxable income in excess of $1,000,000 reported on any income tax return. The $1,000,000 figure is to be adjusted annually to reflect any increases in the cost of living. This additional tax becomes effective on January 1, 2023.

The effect of the additional tax can be significant. For example, the income tax liability of a Massachusetts resident individual (or a resident non-grantor trust) with taxable income of $1,500,000 would increase by $20,000. If instead the taxable income were $10,000,000, the increase resulting from the additional tax would be $360,000.

In simplest terms, there are three main strategies to minimize or avoid the additional tax:

1. Accelerate income into 2022, before the additional tax becomes effective;

2. Spread income across multiple taxpayers or multiple years; and

3. Avoid Massachusetts income tax altogether on non-Massachusetts-source income by moving out of Massachusetts.

These strategies should be considered in planning for both individuals and trusts. However, in determining whether to implement any strategy to mitigate the additional tax, the expected tax reduction should be weighed against the cost of the strategy being considered.

Basic planning for individuals—spreading and accelerating income

The language in the constitutional amendment specifying that the additional tax is based on the excess over $1,000,000 per tax return makes it likely that spouses filing separately will each be able to shelter the first $1,000,000 of their individual income from the additional tax. This leads to some basic planning opportunities. If a couple has substantial unearned income, that income could be spread between the spouses to ensure that each makes full use of the first $1,000,000 of income that is free of the additional tax. Therefore, if one spouse earns income in excess of $1,000,000 and the other does not, it would make sense to consider shifting investment assets into the name of the other spouse. If, after shifting income to the spouse who earns less, filing separate returns results in tax savings for Massachusetts tax purposes, but not for federal purposes, you could also consider filing separately for Massachusetts purposes and filing jointly for federal purposes.

Another strategy for individuals is to accelerate income realization before the additional tax goes into effect on January 1, 2023. For example, individuals who were considering converting their traditional IRA to a Roth IRA may want to do so before year-end. Similar considerations apply to individuals who are considering the sale of real estate or the sale of a business.

Spreading income over multiple years is another way of minimizing or avoiding the additional tax. For example, if you are selling an asset with significant unrealized appreciation, consider an installment sale that would spread the gain over multiple years. The same concept applies to multiple assets within a portfolio. Staggering the sale of portfolio assets over multiple calendar years (even by simply postponing certain sales from December to January) could lead to tax savings. Of course, this technique should be considered only after the additional tax comes into effect. As discussed in the previous paragraph, one should generally try to accelerate income in 2022, rather than postpone it to a future year.

Asset selection and tax-advantaged financial products may also help mitigate the additional tax. For example, investment in assets that generate income that is exempt from state tax, such as many Massachusetts municipal bonds, may become more attractive. Private placement life insurance (PPLI) and private placement variable annuities (PPVA), may also become more attractive simply because the income tax deferral, and in some cases tax elimination, that they provide will become more valuable.

Planning for individuals—moving out of Massachusetts

Massachusetts taxes the worldwide income of any individual who is either domiciled in Massachusetts or who is a resident of the state. In contrast, Massachusetts taxes income of an individual who is neither domiciled in Massachusetts nor a resident of Massachusetts only to the extent the income derives from a Massachusetts source. An individual could therefore escape the taxing authority of Massachusetts over non-Massachusetts source income by changing his or her domicile and ending his or her residency in the Commonwealth.

For most, this is a drastic step that would not make sense. However, for individuals who are not employed in Massachusetts and already spend considerable time in one or more other states, this may not be such a dramatic change.

"Domicile" is a subjective concept that means the place an individual considers to be his or her home. If a person leaves Massachusetts but intends to return, that person's domicile remains in Massachusetts. There are several objective manifestations of the intention to change one's domicile, which generally revolve around establishing new roots in a new place. A domicile determination requires an analysis of all facts and circumstances, and no single fact or circumstance is determinative. Owing to the inherently factual and complex nature of the domicile issue, it is often the subject of contention between taxpayers and the Massachusetts Department of Revenue. Claiming that one is no longer domiciled in Massachusetts therefore comes with inevitable risk, especially if connections with Massachusetts remain.

"Residency" is a simpler concept. It merely requires maintaining a permanent place of abode in Massachusetts (which could even be a hotel room) and spending at least 183 days in the Commonwealth during a particular calendar year.

If you are considering leaving Massachusetts, we would be happy to talk with you about your particular circumstances.

Trust planning—existing trusts

Many individuals have either created trusts or are beneficiaries of trusts. There are two types of trusts from an income tax perspective – grantor trusts and non-grantor trusts.

Grantor trusts include revocable trusts and irrevocable trusts over which the funder of the trust (the "grantor") has retained some level of control that causes all trust income to be taxed to the grantor on his or her individual income tax returns. Income that is distributed to beneficiaries of grantor trusts is tax-free to the beneficiaries.

Non-grantor trusts are trusts that file their own tax returns and pay their own taxes on capital gains and undistributed income. Income that is distributed to beneficiaries of non-grantor trusts is taxed in the beneficiaries' hands.

Grantor Trust Planning. Because the income of grantor trusts is taxed to the grantor and reported on his or her own income tax returns, that income will be subject to the additional Massachusetts income tax if the grantor is subject to that tax, which should be taken into consideration in the grantor's planning. With respect to irrevocable grantor trusts, an additional planning consideration is whether grantor trust status should be ended, which is possible in most cases. At that point the trust becomes a non-grantor trust and the planning considerations set out below become relevant. A variant of this technique is to first divide the grantor trust into multiple trusts (with different beneficiaries) and then end grantor-trust status with respect to some or all of the resulting trusts, thus spreading the trust income among multiple taxpayers (as further discussed below).

Non-Grantor-Trust Planning. With respect to non-Massachusetts-source income, the Massachusetts income tax, including the additional tax, applies to (1) all trusts created under the will of a Massachusetts decedent and (2) all trusts created by a Massachusetts resident during lifetime, but only while at least one trustee of the trust is a Massachusetts resident. Most trusts fall into the second category, and there is an opportunity to remove such trusts from the taxing authority of Massachusetts altogether by changing the trustees to non-residents of Massachusetts.

Another strategy for an existing non-grantor trust is to consider dividing the trust. For example, if the trust is currently a pooled trust for the benefit of the grantor's children, the trust could be divided into multiple non-grantor trusts, one for the benefit of each child. This could allow the income to be spread across multiple taxpayers and multiple returns to potentially alleviate or eliminate the additional tax. Whether it is possible to divide the trust depends on the terms of the trust. And whether a trust division will be respected for tax purposes depends on complex rules that should be consulted carefully before embarking on a division plan. Just as dividing an existing non-grantor trust could mitigate the additional tax, so could establishing multiple nongrantor trusts from the outset.

Trust planning— "ING" trusts

Some taxpayers have sought to avoid Massachusetts income tax on unearned income by transferring income-producing assets to a so-called incomplete gift non-grantor trust, or ING trust. Because of the additional tax, ING trusts may experience increased popularity, although they are a relatively rare and risky technique.

The main idea behind an ING trust is to establish an irrevocable trust that accomplishes two goals. The first goal is for the trust to qualify as a non-grantor trust, so that as long as it does not have Massachusetts resident trustees, it will not be subject to Massachusetts income tax on non-Massachusetts source income. To accomplish this goal, the grantor must have limited rights and control over the trust property and income. The second goal is for the transfers to the trust to qualify as an "incomplete gift" because the grantor of the trust does not want the funding of the trust to be treated as a taxable gift for federal gift tax purposes. This goal can be achieved by the grantor retaining a minimum degree of control over the disposition of the trust property. To be successful, ING trusts therefore require that the grantor have sufficient control over the trust assets to avoid causing completed gifts, but not so much control that the trust will be treated as a grantor trust. This task is fraught with technical and factual questions that make ING trusts a technique that is often touted but whose complexity is often overlooked.

Starting in 2021, the IRS no longer issues rulings on ING trusts, which means there is no way to obtain advance assurance on the key federal gift tax and grantor trust aspects of the arrangement. In addition, certain states have attacked ING trusts and nullified their tax benefits (e.g., New York). It is conceivable that one day Massachusetts might follow suit. In most cases, an ING trust is too aggressive a technique, and we do not generally recommend it. Nevertheless, if you are interested in learning more about ING trusts, we would be happy to help you determine whether an ING trust can be right for your situation.