State Income Taxation of Trusts - Fifty-One Different Stories and a Few Surprise Endings

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A. WHAT IS THE PROBLEM (BIG PICTURE)?

1. Forty-three states and the District of Columbia\(^2\) impose an income tax on trusts at top tax brackets ranging in size. For instance, at the lower end is Pennsylvania with a 3.07% rate, and at the higher end New York State in which residents of New York City (combining both New York State and New York City income taxes together) have a top bracket of 12.696%.

(a) Often, however, the income tax planning (other than with respect to the use of a grantor trust) plays "second fiddle" to the transfer tax considerations.

(b) Even once the planning is in the income tax arena, the time devoted to federal income tax considerations often far exceeds the time for state income tax considerations. It might be suggested that this is in part to the lower state tax brackets.

(c) The states have a number of different systems for taxing trusts. As a consequence it is more difficult for the trustees and their advisors to keep track of, or even be aware of, the different fiduciary income tax rules for multiple states. Furthermore, continuing professional education programs directed at professionals from multiple states often focus on the federal income tax, rather than on state income tax, in order to capture the greatest audience and avoid the difficulty in discussing so many states' laws.

\(^1\) The author would like to acknowledge Richard W. Nenno of Wilmington Trust Company and thank him for authorizing the use and distribution of his chart entitled "Bases of State Income Taxation of Nongrantor Trusts" for this presentation to the Chicago Estate Planning Council. Also, much of the information in this document is based on the information in that chart, as well as Richard Nenno's materials used as part of his presentation at the 2012 Heckerling Estate Planning Institute entitled "Let My Trustees Go - Planning to Minimize or Avoid State Income Taxes on Trusts."

\(^2\) References in this document to a "state" or "states may be referring to the District of Columbia, as well as all fifty states.
(d) So there is a concern that some trustees (or other fiduciaries) and their advisors may not always be aware of all of the state income tax returns that need to be filed and therefore not all of the state income tax returns are being properly filed. The cumulative effect of multiple years of returns not filed and state income taxes not being paid, with penalties and interest, may result in significant liability.

2. In most cases, if the trust is a grantor trust for federal income tax purposes, the taxation of the trust income is taxed to the grantor for state income tax purposes, as well as federal income tax purposes. Also, in the case of a nongrantor trust, the ordinary income that is distributed is generally taxed to the recipient beneficiary. Furthermore what is often called a trust's "source income" (e.g., income attributed to certain assets located or activities occurring in a state, such as income from tangible personal property, business activities or real estate) is generally taxed by the state where the activities are occurring or the assets are located.

3. The issue is, however, what state can tax a nongrantor trust on its accumulated ordinary income and capital gains that are not "source income" of that state. In fact, there are a number of different state tax systems that do not follow the same rules for when the trust has sufficient nexus with a state so as to allow the state to tax the nongrantor trust's income.

(a) As a result, it is possible that a trust may be subject to income tax by multiple states, sometimes to the surprise of the trustee and the trustee's advisors. For instance, if an irrevocable trust is created by a grantor who was an Illinois resident at the time the trust became irrevocable, there are three trustees (one residing in Arizona, one residing in California and the other residing in Georgia), the trust is being administered in Georgia, and a current noncontingent beneficiary of the trust resides in North Carolina, the trust is subject to income tax in all five states identified in this sentence.

(b) On the flip side of the coin, in some circumstances, the trust may not be subject to income tax in any state. For instance, if an irrevocable trust is created by a grantor who has always resided in Florida, the three trustees reside in Illinois, Michigan and Indiana, the trust is being administered in Illinois, and all of the beneficiaries reside in either Virginia, Massachusetts or Illinois, the trust is not subject to state income tax in any of the states identified in this sentence so long as there is no "source income" for any of these states.

4. Tracking the state income tax rules for a trust is crucial, not just at the time the trust is established, but throughout its administration. The grantor, the trustee and the trust's advisors need to be aware of in what states the trust must file fiduciary income tax returns at the inception, and they need to have a system in place
to monitor the changes in relevant facts for determining in what states the trust must file fiduciary income tax returns in future years.

(a) One reason is to ensure all necessary state income tax returns are filed in a timely fashion, in order to avoid penalties, interest and possible claims of a breach of fiduciary duty.

(b) Another reason is to take remedial action, if possible, both to avoid unintentionally subjecting a trust to a state's income tax system and to minimize the overall state income tax bill.

B. THE TAXPAYER'S PREFERRED APPROACH - "NO TAX" STATES

1. Needless to say, the approach favored by the taxpayers is to not tax income, including a trust's income.

2. There are seven states that do not tax any income of trusts.

   (a) Alaska
   (b) Florida
   (c) Nevada
   (d) South Dakota
   (e) Texas
   (f) Washington
   (g) Wyoming

3. New Hampshire and Tennessee are not "no tax" states, but they do limit what income is taxed.

C. WHAT ARE THE VARIOUS APPROACHES USED BY STATES THAT DO TAX THE INCOME OF RESIDENT TRUSTS?

1. What is a Resident Trust?

   (a) The remaining forty-four states treat certain nongrantor trusts as a "resident trust" and tax some part or all of the trust's income based on one or more of the following five criteria:

   (i) If the grantor of an inter vivos trust resides in the state.

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3 Not all states uniformly use the term "resident trust" to cover this concept, but for purposes of this outline, this term will be used for all states.
(ii) If the trust is administered in the state.

(iii) If one or more of the trustees reside or do business in the state.

(iv) If one or more beneficiaries reside in the state.

(v) If the trust was created by the Will of a person who is the resident of the state at the time of death.

(b) In some states, only one of the five criteria is needed to trigger "resident trust" status, but in other states, the "resident trust" status requires more than one of the five criteria or other additional factors.

(c) The choice of governing law identified in the trust interest generally does not constitute a basis for a state to tax the trust. The following states are exceptions, however, to this general rule:

(i) Louisiana taxes a trust if the trust specifically provides that Louisiana law is the governing law, but not if the trust designates another state as the state of governing law.

(ii) If Idaho or North Dakota are designated as the state whose law governs the trust, it is one of the factors considered for determining whether the trust is a "resident trust."

2. Taxing an Inter Vivos Trust Based on the State in Which the Grantor Resides

(a) Sometimes this is called the "Founder-State-Trust" approach.

(b) Illinois is one of the states that falls in this category. In Illinois, an irrevocable trust, the grantor of which was domiciled in Illinois at the time the trust becomes irrevocable, is a "resident trust."

(i) A trust shall be considered irrevocable to the extent that the grantor is not treated as the owner thereof under the Internal Revenue Code ("IRC") Sections 671 through 678.

(ii) This allows for some interesting planning, such as moving a grantor out of Illinois prior to grantor trust status terminating.

(iii) Note that grantor trust status under IRC Section 679 is not included.
(c) In addition to Illinois, the following states tax under the Founder-State-Trust approach:

(i) District of Columbia

(ii) Maine

(iii) Maryland

(iv) Minnesota

(v) Nebraska

(vi) Oklahoma

(vii) Pennsylvania

(viii) Vermont

(ix) Virginia

(x) West Virginia

(xi) Wisconsin

(d) The constitutionality of the Founder-State-Trust approach has come under question, although the issue has not been directly addressed by the United States Supreme Court. For a detailed discussion of this subject, see Richard Nenno, *Let My Trustees Go! - Planning to Minimize or Avoid State Income Taxes on Trusts*, 2012 Heckerling Estate Planning Institute.

(i) In general a state cannot tax a trust just because it wants to, and a state may tax the income of a trust only if its laws for doing so do not violate the United State Constitution.

(ii) By analogy to the United States Supreme Court's rulings on other state taxes and rulings by various federal and state courts on state fiduciary income tax, the constitutional challenges that may be relevant are based on the Commerce Clause and the Due Process Clause of the Fourteenth Amendment.
(e) A number of other states now require the Founder-State-Trust approach be combined with other factors (e.g., existence of a resident trustee or beneficiary) in order to achieve "resident trust" status, including:

(i) Connecticut
(ii) Delaware
(iii) Michigan
(iv) Missouri
(v) New Jersey
(vi) New York
(vii) Ohio

3. Taxing an Inter Vivos Trust Based on the State in Which a Trustee Resides

(a) If any trustee resides in one of the following states, the trust's income is taxable in that state:

(i) Arizona
(ii) Georgia
(iii) Kentucky
(iv) New Mexico
(v) North Dakota
(vi) Oregon
(vii) Virginia

(b) California also taxes the trust's income if any trustee resides in California, but if there is more than one trustee and not all trustees reside in California, only a portion of the trust's income is taxed in California.
(c) In the following states, this characteristic, when coupled with other factors (e.g., existence of a resident beneficiary), results in "resident trust" status:

(i) Delaware
(ii) Hawaii
(iii) Idaho
(iv) Iowa
(v) Montana
(vi) New Hampshire

(d) Questions have arisen in certain states as to whether this test also applies to persons with other types of roles, such as a trust protector or an investment advisor (in the case of a directed trustee). There is not always clarity on what roles are covered and what constitutes a fiduciary in the context of a state's fiduciary income tax laws.

(e) Some states, but not all, expressly provide guidance on whether a corporate trustee is a resident, including:

(i) Arizona
(ii) California
(iii) Oregon

4. Taxing an Inter Vivos Trust Based on the State in Which a Beneficiary Resides

(a) If any beneficiary resides in one of the following states, the trust's income is taxable in that state:

(i) Georgia
(ii) North Carolina
(iii) North Dakota

(b) California and Tennessee each taxes the trust's income if any beneficiary resides in that state, but if there is more than one beneficiary and not all reside in that state, only the portion of the
trust's income attributable to those resident beneficiaries is taxed in that state.

(c) In other states, this characteristic, when coupled with other factors (e.g., existence of a resident beneficiary), results in "resident trust" status:

(d) Which beneficiaries are counted in this analysis varies between states. Generally it is not a contingent beneficiary, but it will be important to carefully review the state's law on the subject.

5. Taxing an Inter Vivos Trust Based on the State in Which the Trust is Administered

(a) If a trust is administered in one of the following states, the trust's income is taxable in that state:

(i) Colorado

(ii) Georgia

(iii) Indiana

(iv) Kansas

(v) Louisiana (unless the trust instrument provides another state's law governs)

(vi) Maryland

(vii) Minnesota

(viii) Mississippi

(ix) New Mexico

(x) North Dakota

(xi) Oregon

(xii) Wisconsin
(b) In other states, this characteristic, when coupled with other factors (e.g., existence of a resident beneficiary), results in "resident trust" status, including:

(i) Idaho
(ii) Iowa
(iii) Hawaii
(iv) Montana
(v) Utah

(c) The issues of what actions or behavior constitutes administration, and when a corporate trustee is administering a trust in a state is not always clearly answered.

(i) If there is any fiduciary residing in a state, is it possible that there is at least some administration occurring in that state?

(ii) What if a fiduciary spends part of the year in multiple states?

6. Taxing a Testamentary Trust Created by a Testator Residing the State at the Time of Death

(a) This is another version of the "Founder-State-Trust" approach, with the death of the testator being the event that creates the irrevocable trust.

(b) Once again, Illinois is one of the states that falls in this category.

(c) In addition to Illinois, the following states tax under this approach:

(i) Connecticut
(ii) District of Columbia
(iii) Louisiana
(iv) Maine
(v) Maryland
(vi) Michigan
(vii) Minnesota
(viii) Nebraska
(ix) Ohio
(x) Oklahoma
(xi) Pennsylvania
(xii) Vermont
(xiii) Virginia
(xiv) West Virginia
(xv) Wisconsin

(d) As mentioned above, the constitutionality of the Founder-State-Trust approach has also come under question.

(e) A number of other states require that the Founder-State-Trust approach be combined with other factors (e.g., existence of a resident trustee or beneficiary) in order to achieve "resident trust" status, including:

(i) Alabama
(ii) Arkansas
(iii) Delaware
(iv) Idaho
(v) Iowa
(vii) Missouri
(vii) Montana
(viii) New Jersey
(ix) New York
(x) Rhode Island
D. **ON WHAT BASIS DO STATES TAX TRUST INCOME OF A NONRESIDENT TRUST?**

1. **What is a Nonresident Trust?**
   
   (a) It will vary from state-to-state, but in general, it is a trust that is not a "resident trust" under the relevant state law.

   (b) Similar to the term "resident trust," the term "nonresident trust" may or may not be expressly used in a particular state's statutes.

2. **Based on "Source Income"**

   (a) What is often called a nonresident trust's "source income" (e.g., income attributed to certain assets located or activities occurring in a state, such as income from tangible personal property, business activities or real estate) is generally taxed by the state where the activities are occurring or the assets are located.

   (b) What type of income is defined as "source income" varies from state to state.

      (i) Some states' statutes are very detailed on the subject. See, for instance, Ohio's provisions in ORC § 5474.011 et seq.

      (ii) Other states' statutes on the subject are more streamlinced. See, for instance, Massachusetts provisions in M.G.L. ch. 62, § 5(A).

E. **WHAT ARE THE OPTIONS FOR PROACTIVE OR REMEDIAL PLANNING?**

1. **Planning for Existing Trusts**

   (a) If a trigger for state fiduciary income tax is the state of residency of one or more of the trustees:

      (i) It may be possible to change the trustees (by resignation, declination or removal). Of course, there will be cases in which this suggestion is not met with enthusiasm by the trustee in question, the grantor, or the beneficiaries.

      (ii) The same would apply for other roles (fiduciary or otherwise) that might trigger the state fiduciary income tax.
(iii) Theoretically one could ask the trustee to move to a different (and more tax friendly) state, but it may be difficult to persuade the trustee to make the move.

(b) If a trigger for state fiduciary income tax is the state of residency of one or more of the beneficiaries:

(i) It may be possible to reorganize the trust into multiple trusts using available powers to sever the trust, and to segregate the beneficiaries of one state into a separate trust from those of another state.

(ii) Decanting the trust may be another option to get to a similar result. In this case, the existing trust would be decanted into one or more new trusts that are structured to avoid or minimize the resulting state fiduciary income tax.

(iii) Other options may be to have the beneficiaries who are residing in the state in question disclaim their interest or move to another state.

(c) If a trigger for state fiduciary income tax is the state in which administration of the trust occurs:

(i) The activities constituting "administration" under the relevant state's fiduciary income tax law may be moved out of that state.

(ii) Query: Depending on how "administration" is defined under a state's law, how likely is that that there would be administration in the state simply because a trustee resides in the state (even on a part-time basis)?

(d) If a trigger for state fiduciary income tax is the state in which grantor resides at some designated point in time or in which the testator resides at death:

(i) Consider having the grantor change his or her state of residency prior to the designated point in time.

(A) In the case of a grantor trust with an Illinois grantor, this is a planning idea that should be considered prior to the termination of grantor trust status.

(B) In the case of a testamentary trust, the testator can consider moving prior to death. For example, this
may be an additional tax benefit in having an Illinois resident move his or her residency to Florida (or certain other states) prior to death.

(ii) Be careful about having multiple grantors for a trust, if the states of residency of the grantors will differ.

(iii) When a grantor moves, avoid adding property to an existing trust if either the original state of residency or the new state of residency has this trigger in its fiduciary income tax rules. Instead once a grantor is residing in the new state, the grantor should create a new trust in the second state for the additions.

(iv) Consider a general power of appointment for a beneficiary if this will shift the identity of who is considered the grantor to the beneficiary who may reside in a better state for state fiduciary income tax purposes. This is a possibility in New York, and one approach is to allow a trustee or a trust protector to grant the beneficiary this power of appointment. Of course, the party will need to consider the transfer tax and creditor implications before granting the beneficiary this power.

(v) Consider whether a constitutional challenge in court would make sense if the state in question follows the Founder-State-Trust approach. Of course, it may be difficult to persuade a trustee to spend the legal fees for this type of challenge based on the applicable cost benefit analysis.

2. Planning for New Trusts

(a) If a trigger for state fiduciary income tax is the state of residency of one or more of the trustees:

(i) Pick the choice of trustees carefully and consider giving to a trusted third party the power to remove and name successors, in case a trustee is unwilling to voluntarily resign.

(ii) Do not forget to carefully consider the state of residency of other parties being named for other positions, such as a trust protector or an investment advisor.
(b) If a trigger for state fiduciary income tax is the state of residency of one or more of the beneficiaries:

(i) Consider drafting multiple trusts when there are multiple beneficiaries, so that a beneficiary residing in a state with this trigger will not subject the entire trust to fiduciary income tax in that state, when the other beneficiaries do not reside in that state.

(ii) Build in options for decanting or severing the trust in the future to address possible new beneficiaries residing in different states or beneficiaries changing their state of residency.

(c) If a trigger for state fiduciary income tax is the state in which administration of the trust occurs:

(i) In choosing the trustee, consider what activities constituting "administration" under the relevant states' fiduciary income tax law, and then draft the trust instrument and the choices of trustees to minimize that impact.

(ii) The same may apply to other roles, such as trust protectors and investment advisors.

(d) If the trigger for state fiduciary income tax is the state in which grantor resides at some designated point in time or in which the testator resides at death:

(i) Consider the advantage of using a grantor trust to delay when the state of residency of the grantor counts.

(ii) Consider the advantage of using a grantor trust to simply delay when the trust is subject to the state fiduciary income tax.

(iii) Consider whether a provision in the trust instrument allowing a trustee or a third party to grant a beneficiary a general power of appointment will allow the identity of who is treated as the grantor to shift to the beneficiary, who may reside in a better state for state fiduciary income tax purposes.

(iv) For some states, such as Massachusetts, if a former resident of the state wants to appoint a trustee who is a resident of
that state after the former resident has moved from that state, it may be advisable to revoke any revocable trust established prior to moving from that state and create a new revocable trust, rather than amending the old trust so as to identify the new state of domicile or residency.

F. MONITORING AND MAINTENANCE - WHO, WHEN AND HOW?

1. One Key Question is Who is Taking Responsibility for Advising the Trustee About State Fiduciary Income Returns

   (a) If there is a team of advisors, the lines of responsibility are often blurred among the various advisors (e.g., the lawyer, the accountant, the financial planner). If a corporate trustee is involved, there is often an assumption that corporate trustee has the internal staff to handle this issue without outside assistance.

   (b) Of course, the answer may depend on where they are in the history of the establishing and administering the trust, as well as what the historical or agreed-to roles are among the advisors and the trustee or other fiduciaries.

      (i) For instance, if it is at the planning and drafting stage, when the initial list of trustees or beneficiaries are being selected, the parties involved in the planning and drafting may be the logical choice.

      (ii) If it involves the preparation and filing of the income tax returns, the assumption may be that the tax return preparers are handling the evaluation for those purposes.

      (iii) During regular administration when facts may from time to time change, there is no single answer. This may leave unanswered who is monitoring a developments for proactive planning purposes.

   (c) Answering the question may depend on who regularly has or is collecting the necessary information to make these determinations, and who they are sharing this information with. For instance, who is getting notice, preferably in advance, of any changes in residential addresses for trustees and the relevant beneficiaries.

   (d) This question should be discussed with the trustee and the other professional advisors, as well as the grantor.
(i) The "big picture" problem and examples of possible problems should be discussed with all relevant parties to be sure they understand the issues and risks.

(ii) Confirming the discussion and conclusions in writing may be advisable. Provisions addressing the matter in engagement letters may also help clarify and memorialize the roles and in turn protect the advisors and the clients.

2. When Should Trusts be Reviewed to Determine What States' Fiduciary Income Tax May be Imposed on a Trust?

(a) At the Beginning

(i) Clients creating inter vivos trusts and the trustees for these new trusts will want to be sure they know what states will be taxing the trusts.

(ii) Upon the death of a testator, the fiduciaries of the trusts will want to know what states will be taxing the trust.

(b) Annually in Conjunction with Filing the Tax Income Returns

(i) At least annually, the trustee should have the trust's facts reviewed to determine what state fiduciary income tax returns should be filed.

(ii) This review should include getting updated information from the trustees, beneficiaries and grantor in order to do the necessary analysis.

(c) At Any Time that the State of Residency of a Beneficiary or a Trustee (or Other Fiduciary) Changes

(i) Ideally, notice of the change would be given in advance of the move to those who are responsible for evaluating the state income tax issues.

(iii) In the case of a change of trustee or other fiduciary, this information will need to be evaluated, especially with respect to where the future administration will occur.
(e) **At Any Time that the Administration of the Trust is Moved to Another State**

(i) Ideally a notice of the change will be given in advance to the appropriate advisors. This may allow remedial or proactive planning if the change would result in additional or different state fiduciary income taxes. Of course, notice in advance of the death of a trustee or other advisor may not be practical.

(ii) In order to get this information in advance of the annual review for tax return preparation, the trustees and beneficiaries need to understand the possible significance of such a change, and the advantages of giving notice of it as soon as possible to the appropriate advisors.

(f) **Special Rules for Grantor Trusts**

(i) Whenever grantor trust status is to end, notice (in advance where possible) should be given to the appropriate advisors. This may allow remedial or proactive planning if the change will otherwise result in additional or different state fiduciary income taxes.

(ii) The grantor, the trustees and any party have control over a provision triggering "grantor trust" status needs to understand the possible significance of such a change and the advantages of giving notice of it as soon as possible to the appropriate advisors.

(iii) While most states follow the federal grantor trust rules, there are several exceptions to be aware of:

(A) Neither Tennessee nor Pennsylvania follow the federal grantor trust rules for irrevocable trusts.

(B) Louisiana and the District of Columbia have limitations on when the grantor will be taxed.
(g) Contributions by New Grantors or of New Assets to an Existing Trust

(i) Ideally the appropriate advisors will receive advance notice of the proposed contribution. This might allow remedial or proactive planning if the contribution would result in additional or different state fiduciary income taxes.

(ii) In order to get this information in advance, the trustees and the grantor need to understand the possible significance of such a contribution and the advantages of giving notice of it as soon as possible to the appropriate advisors.

(iii) In general, having multiple grantors contributing to the same trust should be discouraged.

3. A New Client with Old Trusts

(a) Client Intake

(i) When being engaged by a new client whose planning already includes one or more inter vivos trusts, one topic for discussion is how the income tax returns for the trusts have been and are being handled.

(ii) If the client does not want you to undertake a reasonable investigation, it is advisable to document the limitation on your engagement in writing.

(iii) You do not want to find yourself suddenly responsible for past problems with the fiduciary income tax returns if you do not know about them and are not asked to investigate.

(b) Coordination with Other Advisors

(i) It is important to be proactive in talking with the other advisors and coordinating everyone's efforts.

(ii) Document the lines of responsibility for evaluating and preparing the trust's state fiduciary income tax returns among the advisors.
G. POSSIBLE RESOURCES TO ASSIST IN IDENTIFYING THE CORRECT STATES FOR FILING STATE FIDUCIARY INCOME TAX RETURNS

1. New Tax Management Portfolio. Richard W. Nenno is authoring a new Tax Management Portfolio on the subject. It is expected that it will be published before the end of 2013.

2. New BNA Program to Track States for Filing Fiduciary Income Tax Returns

   (a) In conjunction with the presentations at the 2012 Heckerling Estate Planning Institute, the speakers discussed the need for a program that would assist the trustee and their advisors in determining the states for which a state fiduciary income tax return will or may be due.

   (b) Over the last year, BNA has started to develop a "navigator" program that can be used to periodically determine in what states a trust's state fiduciary income tax returns must be or may need to be filed.

      (i) The program will not prepare the returns.

      (ii) It will involve answering a number of questions about a trust, which in turn will lead to an evaluation of what state fiduciary income tax returns may be needed

      (iii) The hope is that the program will be available this year.

      (iv) Routinely using this type of program and then following its recommendations may serve as evidence of the trustee and the trustee's advisors taking reasonable steps to comply with the trustee's fiduciary duty.