

State Income Taxation of Trusts

Gray Edmondson, J.D., LL.M.
Edmondson Sage Allen, PLLC
402 Enterprise Drive
Oxford, Mississippi 38655
(662) 371-4110

1

Analyzing the Trust: Why?

Uniform Probate Code §7-305 (1969)

“A trustee is under a continuing duty to administer the trust at a place appropriate to the purposes of the trust and to its sound, efficient management. If the principal place of administration becomes inappropriate for any reason, the Court may enter any order furthering efficient administration and the interests of beneficiaries, including, if appropriate, release of registration, removal of the trustee and appointment of a trustee in another state.”

2

Analyzing the Trust: Why?



Restatement (Third) of Trusts §76(2)(c)

“In administering the trust, the trustee's responsibilities include performance of the following functions: ... (c) managing the trust estate to provide returns or other benefits from trust property”

See also *Scott on Trusts*, §§613-615

3

Analyzing the Trust: Why?



Comments to Restatement (Third) of Trusts §76(2)(c)

“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.”

4

Analyzing the Trust: Why?



Uniform Trust Code §108(b)

“A is under a continuing duty to administer the trust at a place appropriate to its purposes, its administration, and the interests of the beneficiaries.”

The UTC has been passed or introduced in 37 states, some of which have not adopted this uniform provision.

5

Analyzing the Trust: Why?



Uniform Trust Code §106

“The common law of trusts and principals of equity supplement this [Code] , except to the extent modified by this [Code] or another statute of this state.”

6

Analyzing the Trust: Why?



Attorney Duties?

- In representing a trustee, does the attorney have a duty to advise the trustee to make changes, including resignation of the trustee, to minimize state income tax?
- In representing a beneficiary, does the attorney have a duty to advise the beneficiary to seek changes to minimize state income tax?
- If the attorney is serving as trustee, what duties (including continuing) does the attorney-trustee have to determine the “place appropriate to its purposes, its administration, and the interests of the beneficiaries.”

7

Analyzing the Trust: Why?



Attorney Duties?

- If there is a change in circumstances, what factors will be relevant in asking the “place appropriate to” the trust’s purposes, its administration, and the interests of the beneficiaries?
- This could include tax and non-tax considerations.
- Changes of circumstances could include relocation of beneficiaries, a change in trust assets, relocation of the trustee, relocation or death of the settlor, etc.
- To the extent a fact pattern does not fit Miss. Code Ann. § 91-8-108(c), common law rules should apply (i.e. Restatement).

8

Analyzing the Trust: Why?



- Trustees are liable for accurate and complete multi-state reporting
 - Must keep track of multiple beneficiaries' locations
 - Must hire accountants with the expertise to handle multi-state issues
 - Minnesota accountant working on a trust return for a testamentary trust created by a Wisconsin decedent with a California resident trustee. Does this accountant know to file and pay tax in California?

9

Analyzing the Income: Sourcing



- 24 states have adopted the Uniform Division of Income for Tax Purposes Act (“UDITPA”). Many other states follow similar rules.
- The UDITPA divides income between business income and non-business income.
 - Business income is apportioned among states.
 - Non-business income is allocated to a particular state.

10

Application of State Income Taxation



- This presentation deals with non-grantor trusts only. Grantor trusts are ignored for federal income tax purposes, which treatment is followed by most states.
- Non-grantor trusts may be formed during the lifetime of the settlor or at death (such as a testamentary trust under a Will).
- Income distributed to beneficiaries of a trust typically carry out the tax liability to the beneficiary. As such, this presentation generally deals only with accumulated trust income.
- Non-business income is allocated to residence of taxpayer. Business income is subject to state income tax allocation and apportionment. As such, planning typically involves non-business income.

11

Planning with Nongrantor Trusts



- There may be significant reasons why settlors desire to form lifetime non-grantor trusts, including:
 - Avoid state income tax on pending sale of appreciated asset not generating business income
 - Avoid state income tax on portfolio income
 - Income shifting (IRC §199A, SALT limitations, NIIT, IRC § 1202 (as may be limited under Build Back Better Act), capital gains income limitations (pending future legislation), etc.)
 - Matrimonial issues
 - Asset protection planning
 - Possible legislative inclusion of non-grantor trust assets in taxable estates (what is a “contribution” to a grandfathered grantor trusts?)

12

Other Nongrantor Trust State Income Tax Considerations



- ING Trusts:
 - Trusts established in a state without state income tax designed to be incomplete gifts for wealth transfer tax purposes but nongrantor trusts for income tax purposes.
 - Allows trust to receive nonbusiness income free from state income tax without transfer tax consequences, and also potentially protecting assets from claims of settlor's creditors.
 - Often used as part of liquidity events.
- 645 Elections:
 - Allows a revocable trust to combine income tax reporting with estate of decedent and is often advisable to avoid additional costs.
 - If estate administered in state with state income tax, but revocable (now irrevocable) would not be subject to state income tax, consider advisability of election.
- Double Taxation: State tax credits typically available only for business income. As such, be careful in situations where multiple states may determine trust to be resident.

13

Analyzing the Income: Sourcing Business Income



- Business income is apportioned to the state where the income was generated under a variety of methods.
- In apportioning business income among various states, approaches may be used such as:
 - Three factor: (1) property located in state, (2) sales made to state residents, (3) payroll paid to state residents.
 - Single factor: sales in state
 - Market based sourcing vs. cost-of-performance based sourcing

14

Analyzing the Income: Sourcing Non-Business Income



- “Non-business income” is generally taxed in the state where the trust is a resident.
- There are certain exceptions such as where the non-business income results from rents, royalties, or capital gains, from real or tangible property located or utilized in another state. Gains from the sale of intangible property are taxed to the resident state. See UDITPA §§ 5-8.
- As a result, other than taxable income generated from property specifically situated in another state, the trust’s resident state will tax non-business income.

15

Analyzing the Trust: Resident Trust?



- Resident of the Grantor (currently or at formation)
- Residence of the Trustee(s)
- Location of Trust Administration
- Residence of the Beneficiaries
- Inter Vivos or Testamentary Trust
- Created Through Court Administration
- Situs and Nature of Trust Assets
- Trust Choice of Law Provision

16

Basis for Taxing Trusts



- With certain exceptions, states follow federal grantor trust laws of IRC §§ 671-679. As such, only non-grantor trusts are subject to state income tax. Distributed income is taxed to the beneficiaries. Therefore, it is only undistributed income of non-grantor trusts that cause a trust to incur income tax.
- Pennsylvania does follow the grantor trust rules; Arkansas, the District of Columbia, Louisiana, and Montana have modified grantor trust rules; and Massachusetts does not apply IRC § 679.
- Some states such as California, Pennsylvania, and New York have a “throwback” tax which will tax distributions of previously accumulated income upon distribution to a resident beneficiary.
- Some states do not tax the income of trusts: Alaska, Florida, New Hampshire, Nevada, South Dakota, Tennessee, Texas, Washington, and Wyoming. Most Delaware trusts will not be subject to tax.
- States classify trusts as resident or non-resident. States will tax a resident trust on all undistributed income and nonresident trusts on income sourced to the state.

17

State Factors for Taxing Trusts



- Trust created by Will of resident: Connecticut, District of Columbia, Illinois, Louisiana, Maine, Maryland, Michigan, Minnesota, Nebraska, Ohio, Oklahoma, Pennsylvania, Vermont, Virginia, West Virginia, and Wisconsin
- Inter vivos trust created by resident: District of Columbia, Illinois, Maine, Maryland, Minnesota, Nebraska, Oklahoma, Pennsylvania, Vermont, Virginia, West Virginia, and Wisconsin
- Trust administered in the state: Colorado, Indiana, Kansas, Louisiana, Maryland, Minnesota, Mississippi, Montana, New Mexico, North Dakota, Oregon, South Carolina, Virginia, and Wisconsin
- Resident trustee: Arizona, California, Kentucky, Montana, New Mexico, North Dakota, Oregon, and Virginia
- Application of State Law: Idaho, Louisiana and North Dakota.
- Resident beneficiary*: Alabama, California, Connecticut, Georgia, Montana, North Carolina, North Dakota, Ohio, and Rhode Island

*See later slides regarding recent case-law pertaining to taxation based on beneficiary residency.

18

Analyzing the Income: Resources



- Nenno, Richard W., “Bases of State Income Taxation of Nongrantor Trusts for 2018,”
https://www.actec.org/assets/1/6/Nenno_state_nongrantor_tax_survey.pdf.
- Morrow, Edwin P., “State Residency and Source Income Factors for State Income Taxation of Irrevocable Non-Grantor Trusts,”
https://www.actec.org/assets/1/6/Morrow_State_Residency_and_Source_Income_Factors_for_Taxation_of_Irrevocable_Non-Grantor_Trusts.pdf

19

California Taxation of Irrevocable, Non-grantor Trusts



- California-source income of a trust is subject to tax
- Other income is subject to tax based on the residence of the:
 - Fiduciaries
 - Beneficiaries with a non-contingent interest
- Facts not considered:
 - Residence of the settlor
 - Governing law

20

California Source Income is Always Taxable



- California imposes tax on 100% of California source income
 - For example, rent from California real property
- Taxpayer in *Paula Trust* made an argument based on the statutory structure that source income should be subject to apportionment, just like all other income, based on the number of California fiduciaries.
- Taxpayer lost on appeal.
- California Supreme Court denied cert.
 - *Steuer v. Franchise Tax Board*, 51 Cal.App.5th 417 (2020), review denied (Oct. 14, 2020)

21

Other Trust Income Subject to California Tax



- **Resident Fiduciaries**
 - California imposes income tax on a trust if one or more fiduciaries are California residents.
 - If there is a combination of resident and non-resident fiduciaries, the income is apportioned.
- **Resident “non-contingent beneficiaries”**
 - California imposes income tax on a trust if one or more “non-contingent beneficiaries” are California residents.
 - If there is a combination of resident and non-resident beneficiaries, the income is apportioned.

22

What is a “Fiduciary” For CA Purposes?



- R&T 17006 defines fiduciary to mean guardian, trustee, executor, administrator... or “any person...acting in any fiduciary capacity for any person, estate or trust”
- Anyone who owes a duty to the beneficiaries of the trust and can be sued by them for breach of that duty
 - Trustee
 - Investment direction adviser
 - Distribution direction adviser
 - Trust protector
 - Person who holds powers in a “non-fiduciary capacity”?

23

California Residency Requirements for Individuals



- A California “resident” includes an individual who is:
 1. In California for other than a temporary or transitory purpose; or
 2. Domiciled in California and outside the state for a temporary or transitory purpose.
- Presumed California resident if present for more than 9 months

24

California Residency Requirements for Corporate Entities



- “The residence of a corporate fiduciary of a trust means the place where the corporation transacts the major portion of its administration of the trust.”
 - Cal. Rev. & Tax. Code Sec. 17742(b)
- “Major portion” of trust administration depends on the facts and circumstances.
- Facts not considered:
 - State in which entity is incorporated
 - Location of entity headquarters

25

Multiple Fiduciaries: California Apportionment



- Trustee:
 - Joe Smith, resident of Santa Cruz, CA
- Investment direction advisor:
 - Jane Roberts, resident of Salt Lake City, UT
- Trust Protector:
 - Aunt Molly, resident of Tuscon, AZ
- 1 of 3 fiduciaries is in California
 - 1/3 or 33% of trust income is taxable in California

26

California Resident Beneficiaries



- California taxes trust income if the beneficiaries
 - are California residents, and
 - have non-contingent interests

- What is a “non-contingent interest”?
 - Not defined, but likely means:
 - Vested interest
 - Beneficiary has an absolute right to receive the trust income at some future point
 - For example:
 - A beneficiary of a post-death administrative trust who will receive the entire trust property outright at the end of the administration has a non-contingent interest.

27

Discretionary Trust = Contingent Beneficiary



- A California resident beneficiary’s interest in a discretionary trust is contingent when
 - the terms of the trust instrument give
 - the trustee absolute discretion to determine
 - whether to make distributions to a beneficiary
 - *Steuer, et al. v. Franchise Tax Bd.*, No. A154691, 2020 Cal. App. LEXIS 592 at *23 (June 29, 2020), aff’g in part and rev’g in part *Paula Trust, et al. v. Cal. Franchise Tax Bd.*, No. CGC-16-556126, 2018 Cal. Super. LEXIS 644 (Cal. Super. Ct. Feb. 6, 2018)

28

California Throwback tax



- Trust income that is not taxable by California currently may be subject to “throwback tax” when later distributed to a California beneficiary
- California and a few other states impose a throwback tax
 - New York
 - Pennsylvania

29

California Throwback Tax



- Throwback tax applies to income that was not subject to tax in California when it was earned because beneficiary had a contingent interest.
 - Cal. Rev. & Tax Code § 17745
- Throwback tax applies to the beneficiary, *IF*
 - Beneficiary was a resident of California when income earned and
 - Beneficiary is a resident of California in the year when the income is distributed.

30

Planning for California Tax on Trusts



- Establishing a trust outside of California allows one to avoid California state income tax currently, if
 - the fiduciaries are not California residents, and
 - The beneficiaries' interests are contingent
- Considerations/Pitfalls:
 - Maintenance of fiduciaries outside California
 - Throwback tax at time of distribution

31

Best Practices When Creating New Trusts



- Consider current and potential future residences of trustees and fiduciaries
- Avoid mandatory income and principal distribution provisions
- Provide flexibility to change situs or to decant without court involvement
- Allow for trustee, protector, investment advisor ability to appoint successor
- Consider administration location and using trust companies in domestic asset protection jurisdiction (AK, DE, NV, SD, WY)

32

Best Practices When Creating New Trusts – CA specific



- For directed non-CA trusts, avoid assigning fiduciary roles to CA residents
- Specifically define protector as a non-fiduciary (DE and SD allow)
- Consider creating separate subtrusts for CA and non-CA source income
- Be careful with granting testamentary general powers of appointment to CA resident beneficiary

33

Analyzing the Trust: Basis for Taxation?



- Categorize income as business vs. non-business and sourcing.
- Determine what states may be involved (allocation, apportionment, and residency of trust). Carefully consider each state to which the trust has a connection.
- Once you know the states involved:
 - Determine what state statutes apply.
 - Determine whether each state in question has personal jurisdiction over the trustee or in rem jurisdiction over trust assets.
 - Determine whether imposition of tax by any relevant state is constitutional.
 - Determine whether trust assets generate source income taxable by one or more states.
 - Determine whether the basis for taxation may be movable.

34

Analyzing the Trust: Common Questions



- What about non-trustee fiduciaries and advisors – trust protectors, investment advisors, etc.?
- What about co-trustees with bifurcated responsibilities?
- Where is a trust administered when a corporate trustee has offices in the state but their trust administration office is elsewhere?

35

Analyzing the Trust: Constitutional Challenge? – Due Process Clause



- Trustee has some definite link, minimum contacts with the state; and
- Income attributed to the state must be rationally related to values connected with the state
- Physical presence not required
- See *Quill*, *Linn*, *Fielding*, *Kaestner*

36

Analyzing the Trust: Constitutional Challenge? – Dormant Commerce Clause



- Trustee has substantial nexus with the state (physical presence not required); and
- Tax must be fairly apportioned (internally and externally consistent); and
- Tax must be fairly related to services provided by the state; and
- Tax must not discriminate against interstate commerce.
- See *Complete Auto*, *Wayfair*, *Quill*

37

Analyzing the Trust: Annual Process



- Ask each year about the trustees, the beneficiaries, the trust assets, and about trust administration. People move, assets are bought/sold, etc.
- Ask about any plans for the upcoming year.
- Continue to impress upon clients the importance of watching state income tax consequences.

38

Analyzing the Trust: Constitutional Challenge?



- *Residuary Trust A U/W/O Kassner v. Dir. Div. of Taxation*, 28 N.J. 541 (NJ 2015).
- *Linn v. Department of Revenue*, 2 N.E. 3d 1203 (Ill. 2013).
- *Robert L. McNeil Jr. Trust ex rel. McNeil v. Commw.*, 67 A.3d 185 (Pa. 2013).
- *District of Columbia v. Chase Manhattan Bank*, 689 A. 2d 539 (D.C. 1997).
- *Chase Manhattan Bank v. Gavin*, 733 A.2d 782 (Conn. 1999).
- *Fielding for McDonald v. Commissioner of Revenue*, 2018 WL 3447690 (Minn. 2018).
- *Kimberly Rice Kaestner 1992 Family Trust*, 139 S.Ct. 2213 (2019).

39

Constitutional Challenge? - *Kaestner*



- New York resident formed a trust under New York law.
- Beneficiaries had no right to demand income or otherwise control, process, or enjoy trust assets. The trustee had absolute discretion. Also, the beneficiaries had no right to any specific future distribution.
- Beneficiary resided in North Carolina during relevant years.
- The trustee had no physical presence in North Carolina, no trust administration took place in North Carolina, and no distributions were made to North Carolina beneficiary during years at issue.
- Using state statute, North Carolina attempted to tax undistributed trust income.
- Supreme Court held (9-0) that the presence of an in-state beneficiary alone does not establish sufficient nexus for taxation of undistributed trust income.
- Potentially less significant than the case may appear. Supreme Court specifically based holding on facts of the case and also said the opinion does “not decide what degree of possession, control, or enjoyment would be sufficient to support taxation.”

40

Constitutional Challenge? - *Fielding*



- Minnesota resident established trusts with shares of closely-held Minnesota S-corporation.
- Non-Minnesota trustee and 3 of 4 beneficiaries resided outside Minnesota.
- Annually, business operating pass-through income recognized by the trust reported and paid to Minnesota.
- Upon sale of shares of stock in Minnesota S-corporation, no Minnesota tax paid. State of Minnesota challenged.
- Minnesota Supreme Court held:
 - Sale of S-corporation shares was not business income (as opposed to operating income).
 - An in-state grantor and residency of a single beneficiary in Minnesota of the trust insufficient nexus for taxing undistributed trust income.
- State of Minnesota petitioned the US Supreme Court for certiorari and was denied.

41

Constitutional Challenge? – *Kassner*



- New Jersey resident established trust with shares of four New Jersey S-corporations.
- Sole Trustee resided in New York and administered trust exclusively outside of New Jersey.
- The trust paid tax on the share of pass-through income attributable to the New Jersey S-corporations, but not its other income.
- New Jersey had previously published guidance stating that if the trustee of a trust is not a New Jersey resident and the trust owned no New Jersey assets, then the trust's undistributed income would not be subject to taxation.
- Prior to ruling New Jersey admitted that the trust was not deemed to own New Jersey assets merely because it owned shares in the New Jersey S-corporations.
- Without addressing constitutional issues, the Court found that New Jersey was bound by its previous guidance, and as such could not tax the trust's undistributed income.

42

Constitutional Challenge? – *Linn*



- An Illinois resident originally created several trusts, governed under Illinois law.
- Eventually the beneficiary of one of these trusts exercised her power of appointment over the corpus to create a new trust governed under Texas law and with a Texas trustee.
- No beneficiaries were Illinois residents and the only contacts with the state were that the grantor and original trustee were Illinois residents and Illinois law was used in the original trust agreement.
- Appellate Court of Illinois found there to be insufficient contacts for Illinois to constitutionally tax the trust.

43

Constitutional Challenge? – *McNeil*



- Similar to the others, Pennsylvania attempting to tax the income of a trust created by a resident-grantor.
- Trust had no Pennsylvania source income, had no assets in Pennsylvania, and was governed by Delaware law.
- Court held that merely having discretionary beneficiaries in Pennsylvania was insufficient contacts to allow taxation of the trust on these facts.
- Court also noted that a trust and its beneficiaries are different tax entities that cannot be aggregated.

44

Constitutional Challenge? – *Noell Industries*



- Doesn't directly deal with taxation of trust income, but facts are very similar to the previous cases with an LLC functioning in much the same way as many of the trusts in the previous cases.
- A Virginia resident had an operating Virginia corporation, which he founded several years earlier. Eventually he contributed the corporation to a newly formed LLC in exchange for a majority interest.
- The LLC operated across multiple states, including Idaho.
- When the LLC sold its ownership interest in the corporation, Idaho claimed (1) that the gain was "business income" and attempted to tax it.
- The Idaho Supreme Court held that sale of the equity interests in the subsidiary by the parent did not constitute business income, and therefore was not taxable by Idaho.
- U.S. Supreme Court denied writ of certiorari on February 22, 2021, even following the Multistate Tax Commission's filing of an amicus brief.

45

Analyzing the Trust: Change?



- Stop Funding; Create New Trust
- Change Trustee
- UTC Transfer of Principal Place of Administration
- Nonjudicial Settlement
- Modification of Trust
- Decanting (statutory or per trust document)
- Merger/Severance, Division/Combination

46

New Trusts: Considerations



- Testamentary vs. Lifetime Trusts: Connection to state by testamentary trust created by in-state probate/court administration
- Residence of settlor and beneficiaries: What are the current and potential future residencies of settlors, fiduciaries, and beneficiaries? For a mobile settlor, is it better to form a trust in one state vs. another?
- State of administration and/or residence of the trustee: Will location of the trustee cause avoidable state income tax?
- Drafting flexible trusts: movable situs, remove/replace powers over trustee, decanting power, right to delegate duties, discretionary distributions, etc.

47



State Income Taxation of Trusts

Gray Edmondson, J.D., LL.M.
Edmondson Sage Allen, PLLC
402 Enterprise Drive
Oxford, Mississippi 38655
(662) 371-4110

48