ACTEC Southeast Fellows Institute
Class II

State Income Taxation of Trusts: Challenges and Opportunities

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I. General Overview

Trusts are commonly used by estate planning attorneys to implement estate planning techniques to reduce estate taxes, to facilitate gifting to children and grandchildren and to provide asset protection for the trust beneficiaries. But, a review of the "state" of the transfer tax is important: The current transfer tax exemption amount is $11.58 million, per individual (scheduled to increase to $11.7 million per individual as of January 1, 2021), which means that a married couple can "shelter" in excess of $23 million ($23.4 million as of January 1, 2021, to be exact) from transfer taxes. The amount of the exemption largely eliminates the general population from the imposition of the estate/gift tax (collectively, the "transfer tax"), and for those in a taxable estate situation, the federal rate is 40% on the value of the estate *in excess* of the exemption amount. Accordingly, estate tax planning to reduce estate taxes has declined, but the overall use of trusts has increased – primarily because of the non-tax benefits trusts provide: asset protection planning, certainty regarding disposition of assets and retention of assets in a family. And while estate planners often focus on the transfer taxes their clients may face, and the transfer tax savings accomplished by using trusts, they may lose sight of the income tax consequences of the trusts that they encourage their clients to create.

While the transfer tax is imposed once, at the time of transfer and only on the value of the assets transferred exceeding the exemption amount, the income tax is imposed on a trust with more than $600 of taxable income in a year and is imposed annually. In addition to the income tax, the maximum Federal rate being 37% (20% for long term capital gains and qualified dividends), trusts also are subject to an additional tax on their net investment income at a rate of 3.8% - meaning that a trust could pay ***Federal*** income tax at a rate higher than 40.8%.

> **<u>For example</u>**, assume a client dies with assets valued at $15 million, leaving all of the assets in trust for their children. After using the client's available exemption amount, of $11.7 million, the client's estate will pay $132,000 in estate taxes ($15 million - $11.7 million * 40%). The net assets of the estate, $14,868,000 are fully invested and produce an income yield of 3% annually, which is $446,040 of taxable income. The annual federal income tax, alone, would be nearly $165,000.

Additionally, pursuant to changes implemented under the 2017 Tax Act, a taxpayer (which includes a trust) can deduct only $10,000 of combined state, local and property taxes. The result being that the aggregate Federal and state income taxes paid by a taxpayer is higher under current applicable law, as a result of the lost deduction for state taxes paid in excess of the $10,000 limitation.

What is important to note is that the income tax – both Federal and state – is imposed on the taxpayer, and a trust is a taxpayer. The trustee(s) of a trust is required to file Federal and state income tax returns for the trust, as the taxpayer. In addition to filing the Federal tax return, the trust is required to file a tax return in every state in which the trust is subject

to income tax – so the burning question is: How much income tax will a trust pay? And the related question: Where is a trust subject to state income tax?

II. Federal Taxation of Trusts

A. Non Grantor Trusts. Non grantor trusts are trusts that are classified as a separate taxpayer. The income taxation of non grantor trusts is very complex and as distributions are made to a trust beneficiary, there may be an allocation of the trust's taxable income to the recipient beneficiary. Accordingly, non grantor trusts are often referred to, for income tax purposes, as "quasi" pass through entities.

For a partnership, limited liability company or S corporation, the partners, members and shareholders, as applicable, are allocated the taxable income of the entity and receive a Schedule K-1 reporting their share of the entity's taxable income. For trusts, depending on whether the trust is a simple or complex trust and how much of the trust's "income" is distributed to the beneficiary, the beneficiary will receive a Schedule K-1 from the trust allocating a portion of the trust's taxable income (relative to the distribution of income made) to the beneficiary. Correspondingly, the trust will receive a deduction from its taxable income for the amount distributed and allocated to the beneficiary.

1. Simple Trusts.

A simple trust is one that requires the trustee to distribute all of the income to the trust beneficiary (or beneficiaries). Typical language indicating that the trust is a simple trust is: "The Trustee shall distribute all of the income to my spouse, A, at least annually." The most common form of a simple trust is a marital deduction trust (a QTIP trust). However, the term income refers to fiduciary accounting income (FAI), which is not necessarily the trust's taxable income.[1] While the trustee is required to distribute the trust's net fiduciary accounting income (FAI), which results in a deduction to the trust (discussed further, below), the result may not eliminate the tax liability of the trust.

Accordingly, it is possible, if not likely, for a simple trust to have a tax liability, even after taking into consideration the distributable net income deduction (DNI Deduction).[2]

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[1] See discussion, below, at Section II.B.4.a. for definition and determination of FAI.
[2] See below, at Section II.B.4. for discussion and calculation of DNI Deduction.

2. Complex Trusts.

A complex trust is one for which the trustee has discretion to distribute income (and principal) to the trust beneficiary (or beneficiaries). Typical language found in a complex trust is: "The Trustee may distribute any portion of the income and principal to my child, B, as the Trustee, in its discretion, determines necessary for B's health, education, maintenance and support." Accordingly, each year, the Trustee must evaluate the distributions, if any, made to the trust beneficiary (or beneficiaries), to determine how much FAI was distributed and what the resulting deduction to the trust will be.

B. Federal Taxation.

As noted, non grantor trusts are separate taxpayers and are subject to the same income taxes and rates of individuals, with some minor adjustments. Most notably, trusts are subject to the Federal income tax rates of individuals, but under a compressed rate structure. It is often said that trusts are subject to higher taxes rates than individuals – which is inaccurate in the pure sense of the terms; but accurate from an effective tax rate perspective. In other words, a trust will be subject to the highest individual tax rate with substantially less income than an individual. For 2022, the tax rates and brackets for individuals and trusts are:

Individuals (Single Filer)		**Trusts**	
Income	Rate	Income	Rate
0 - $10,275	10%		
$10,276 - $41,775	12%	0 - $2,750	10%
$47,776 - $89,075	22%	$2,751 - $9,850	24%
$89,076 - $170,050	24%	$9,851 - $13,450	35%
$170,051 - $215,950	32%	$13,451 +	37%
$215,951 - $539,900	35%		
$539,901 +	37%		

For a trust with taxable income of $15,000, the trust's Federal income tax liability will be $3,781, whereas an individual with $15,000 of taxable income will pay $1,594 (less than half).

1. Income Tax.

As seen in the above chart and short example, the compression of the income tax brackets results in trusts being subject to a higher tax liability. Of course, the IRC is more complex and does provide for preferential tax rates for items such as capital gains and qualifying dividend income. Trusts benefit from these same preferential rates, as do individuals. However, in addition to being subject to Federal income tax on taxable income, trusts also are subject to the net investment income tax (discussed below) and the alternative minimum tax.

Further, trusts do benefit from deductions, similar to the deductions available to individuals, such as charitable deductions for amounts paid or permanently set aside for

charity, interest expense and state taxes paid. In addition, trusts receive a tax deduction for expenses paid in the administration of the trust and for the production and preservation of income, which include:

- Investment expenses (incurred in connection with the production of income, such as investment advisory fees) – ***no longer deductible under the 2017 Tax Act***
- Trustee fees (fees paid to a trustee other than for investment advisory services)
- Accounting fees and legal fees

Trusts are also able to benefit from some unique deductions, not otherwise available to other taxpayers. One such deduction is for estate taxes paid to the extent paid on income earned by the estate or trust. See IRC Section 691(c). The other applicable deduction is for distributable net income, discussed in further detail, below.

2. Capital Gains Tax.

As noted above, capital gains (and qualified dividends) recognized by a trust are taxed at the preferential rates applicable to individual taxpayers. Currently, there are three brackets for capital gains tax rates, with rates as low as 0% (for trust taxpayers with taxable income less than $2,750), and as high as 20% (for trust taxpayers with taxable income of $13,450 or more). If the trust's taxable income is more than $2,750, but less than $13,450, the applicable rate will be 15%. As discussed in further detail, below, the applicability of the capital gains tax to trusts is significant, as typically capital gains are allocated to principal and therefore taxed to the trust as a taxpayer.

3. Net Investment Income Tax.

IRC Section 1411 imposes a tax, at the rate of 3.8%, on trusts on an amount equal to the lesser of: (a) the undistributed net investment income, and (b) the amount by which the trust's adjusted gross income exceeds the amount at which the highest tax rate is imposed (for 2022, this amount is $13,050). Accordingly, a determination of the trust's net investment income and the amount that is undistributed is relevant for determining the amount subject to the net investment income tax.

Investment income is defined as the gross income from (a) interest, dividends and royalties, (b) passive investments, including a trade or business that is considered a passive activity, and (c) gain from the disposition of investment property. Net investment income is determined by reducing investment income by allocable deductions. Because net investment income includes gains recognized from the sale of property held for investment (such as stocks), a trust will be subject to the net investment income tax upon recognition of net gains in excess of $13,050. This additional tax may not be applicable to an individual taxpayer because of the higher taxable income threshold of individual taxpayers before being subject to the net investment income tax. Accordingly, it may be beneficial, for income tax purposes, to allocate capital gains to a trust beneficiary.

The higher income thresholds applicable to individuals generally results in a lower income tax liability than if the income is taxed at the rates applicable to a trust. The challenge may

be in allocating the taxable income of the trust, comprised of capital gains, to the trust beneficiary, as gains typically are allocated for fiduciary accounting income purposes to principal and not income – and it is this allocation that can establish the distributable net income deduction.

4. Distributable Net Income Deduction (DNI Deduction)

IRC Section 643 allows for a deduction from taxable income of the net income distributable to the trust beneficiary (or beneficiaries) (referred to as the DNI Deduction). Correspondingly, the beneficiaries who receive distributions from the trust, for which the trust receives a DNI Deduction, will receive a Schedule K-1 from the trust. The Schedule K-1 will report the amount of the trust's taxable income distributed to the beneficiary – the income will carry out its character as recognized at the trust level, and the beneficiary will pay the applicable income tax (at the beneficiary's tax rate) and the trust's taxable income is reduced by the amount of the DNI Deduction, thereby reducing the trust's tax liability.

The general rule regarding DNI carry-out is subject to some important exceptions.[3]

- Specific Sums of Money and Specific Property. IRC Section 663(a)(1) contains a special provision relating to gifts or bequests of "a specific sum of money" or "specific property." If an executor or trustee pays these gifts or bequests all at once, or in not more than three installments, the distributions will effectively be treated as coming from the "corpus" of the estate or trust. As a result, the estate or trust will not receive a distribution deduction for these distributions. By the same token, the estate or trust's beneficiaries will not be taxed on the estate's DNI as a result of the distribution.
    - Requirement of Ascertainability. In order to qualify as a gift or bequest of "a specific sum of money" under the Treasury Regulations, the amount of the bequest of money or the identity of the specific property must be ascertainable under the terms of the governing instrument as of the date of the decedent's death. In the case of the decedent's estate, the governing instrument is typically the decedent's Will or revocable trust agreement.
    - Formula Bequests. Under the Treasury Regulations, a marital deduction or credit shelter formula bequest *does not* usually qualify as a gift of "a specific sum of money." The identity of the property and the exact sum of money specified are both dependent upon the exercise of the executor's discretion. For example, as discussed below, an executor may elect to deduct many estate administration expenses on the estate's income tax return, or on its federal estate tax return. If the executor elects the former, the amount of the formula marital gift will be higher than if those expenses are deducted on the estate tax return. Since the issues relating to the final computation of the marital deduction (or credit shelter bequest) cannot be resolved on the date of the decedent's death, the IRS takes the position that these types of

[3] The materials in this section are courtesy of Mickey R. Davis and Melissa J. Willms, *Fiduciary Income Taxation and Subchapter J,* ABA Skills Training for Estate Planners – Fundamentals (2018).

bequests will not be considered "a specific sum of money." Treas. Reg. § 1.663(a)-1(b)(1); Rev. Rul. 60-87, 1960-1 CB 286. Thus, funding of formula bequests whose amounts cannot be ascertained at the date of death does carry out distributable net income from the estate.

  - Payments from Current Income. In addition, amounts that an executor can pay, under the express terms of the Will, only from current or accumulated income of the estate will carry out the estate's DNI. Treas. Reg. § 1.663(a)-1(b)(2)(i).
  - Distributions of Real Estate Where Title has Vested. The transfer of real estate does not carry out DNI when conveyed to the devisee thereof if, under local law, title vests immediately in the distributee, even if subject to administration. Treas. Reg. § 1.661(a)-2(e); Rev. Rul. 68-49, 1968-1 CB 304. State law may provide for immediate vesting either by statute or by common law. Therefore, a transfer by an executor of real property to the person or entity entitled thereto should not carry with it any of the estate's distributable net income. Presumably, this rule applies both to specific devisees of real estate and to devisees of the residue of the estate. Otherwise, the no-carry-out rule would be subsumed within the more general rule that specific bequests do not carry out DNI. Rev. Rul. 68-49, 1968-1 CB 304. Note, however, that the IRS Office of the Chief Counsel has released an IRS Service Center Advice Memorandum (SCA 1998-012) which purports to limit this rule to specifically devised real estate (not real estate passing as part of the residuary estate) if the executor has substantial power and control over the real property (including a power of sale).

- Income From Property Specifically Bequeathed. Under the statutes or common law of most states, a beneficiary of an asset under a Will is entitled not only to the asset bequeathed, but also to the net income earned by that asset during the period of the administration of the estate. *See, e.g.*, UNIF. PRIN. & INC. ACT § 201(1). Until the adoption of the separate share rule, DNI was reported on a pro rata basis among all beneficiaries receiving distributions. The items of income were not specifically identified and traced. As a result, the beneficiary may well have been taxed not on the income item actually received, but on his or her pro rata share of all income distributed to the beneficiaries. However, since the income earned on property specifically bequeathed appears to be a "separate economic interest," the separate share rule should change this result. This change means that if an estate makes a current distribution of income from specifically bequeathed property to the devisee of the property, the distribution will carry the DNI associated with it out to that beneficiary, regardless of the amount of the estate's other DNI or distributions. If the estate accumulates the income past the end of its fiscal year, the estate itself will pay tax on the income. When the income is ultimately distributed in some later year, the beneficiary will be entitled to only the net (after tax) income. In addition, the later distribution should not carry out DNI under the separate share rule, since it is not a distribution of current income, and since the accumulation distribution throwback rules (which still apply to certain pre-1985 trusts) do not apply to estates. The separate share rule, while complex to administer, has the advantage of making

the income tax treatment of estate distributions more closely follow economic reality.

- Interest on Pecuniary Bequests. State law or the governing instrument may provide that a devisee of a pecuniary bequest (that is, a gift of a fixed dollar amount) is entitled to interest on the bequest, typically beginning one year after the date of death. The provision for paying interest on pecuniary bequests does not limit itself to payments from estate income. Under the Uniform Principal and Income Act ("UPIA"), the executor must charge this "interest" expense to income in determining the estate's "net" income to be allocated to other beneficiaries. UNIF. PRIN. & INC. ACT § 201(3) (1997). Interest payments are not treated as distributions from the estate for DNI purposes. Instead, they are treated as an interest expense to the estate. As a result, they do not carry out estate income. Rev. Rul. 73-322, 1973-2 CB 44.

For purposes of determining the amount the trust is able to deduct from its taxable income as a result of the distribution of income to the trust beneficiary, the IRC and associated Treasury Regulations require a calculation of the trust's fiduciary accounting income (FAI). FAI is determined based on the governing law (through the Uniform Principal and Income Act, or UPAIA) and terms of the trust instrument, and is not necessarily the trust's *taxable* income.[4]

a) ***Fiduciary Accounting Income (FAI).***

FAI is determined based on the allocation of receipts and disbursements (expenses) as between principal and income. This concept is rooted in the determination of the rights of the trust beneficiaries to receive distributions from the trust. The allocation of receipts and disbursements between income and principal is determined based on applicable law and terms of the governing instrument, which may vest discretion in the trustee to allocate such items. In the absence of direction in the governing instrument, or the exercise of the trustee's discretion in such allocation, the UPAIA sets forth the standards for such allocation.

Consider the following example:

> Trust provides that the trustee shall distribute all of the income to the current beneficiary, A, annually. At the death of the current beneficiary, the trust principal shall be distributed to the remainder beneficiary, B.
>
> In year 1, trust receives $10 of interest income, $50 of rental income, $100 from the sale of stock (the basis of which was $50) and pays $20 in maintenance costs for the trust's property and $15 for property taxes.
>
> How much is the trustee required to distribute to A? Under typical fiduciary accounting principals (found in the UPAIA) the interest and dividend receipts are allocated to income, the maintenance disbursement is allocated as an expense to

[4] All states, except Illinois, Iowa and North Dakota have adopted the UPAIA.

income and the proceeds from the sale of stock and the disbursement for property taxes are allocated to principal:

	Income	Principal
Interest	$10	-0-
Dividend	$50	-0-
Proceeds from Sale	-0-	$100
Maintenance	($20)	-0-
Taxes	-0-	($15)
	$40	**$85**

The result under the UPAIA is that FAI is $40, which A is entitled to receive. This is important, because to the extent that only $40 is distributed to A, the calculation of the DNI Deduction is based on the amount actually distributed to A.

b) ***Distributable Net Income.***

IRC Section 643 provides that DNI is equal to the trust's taxable income, subject to the following adjustments:

- No deduction is allowed for distributable net income;
- No personal exemption is allowed;
- ***Capital gains are excluded, unless allocated to FAI***;
- Capital losses are excluded;
- Tax exempt income is included, net of any deductions allocated to such income.

In essence, DNI is the amount of FAI distributed to a beneficiary that represents the trust's taxable income.

c) ***Capital Gains.*** If capital gains are not allocated to income, the capital gains will be allocated to principal and the trust will be subject to income taxes (Federal, state and the net investment income tax) on the recognition of such gains. Recall that items allocated to principal are not included in FAI and therefore are not considered income for purposes of the DNI Deduction. Accordingly, capital gains recognized by the trust and not allocated to FAI will be subject to the net investment income tax (to the extent net investment income exceeds $13,050). Thus, the issue is whether the capital gains recognized by the trust are allocated to income or principal. The answer depends upon the terms of the trust instrument and the ability of the trustee to allocate gains to income.

Treasury Regulation Section 1.634(a)-3(b) provides that capital gains "are included in distributable net income to the extent that they are, *pursuant to the terms of the governing instrument and applicable local law*, or pursuant to a reasonable and impartial exercise of discretion by the fiduciary . . . (1) allocated to income . . . .; (2) allocated to corpus but treated consistently by the fiduciary on the trust's books, records and tax returns as part of a distribution to a beneficiary; or (3) allocated to corpus by actually distributed to the beneficiary or utilized by the fiduciary in determining the amount that is distributed or

required to be distributed to a beneficiary." (Emphasis added). This Regulation actually provides three ways in which capital gains may be included in FAI and therefore in distributable net income to allow the trust to deduct capital gains distributed to a beneficiary and for the beneficiary to be allocated the gains for income tax purposes. As a result, a closer look at applicable state law and the terms of a trust instrument is required to make this distribution.

(1) Does applicable state law grant a trustee the authority to allocate capital gains to income?

Applicable state law is determined by the governing law of the trust instrument, either as stated in the document or otherwise determined based on the situs of the trust, its place of administration, etc. The statutes applicable to a trustee's discretion to allocate receipts as between principal and income would be most relevant in this review and analysis. Assuming the applicable state law has adopted some form of the Uniform Trust Code ("UTC") and UPAIA, the analysis likely will include a review of Sections 816 of the UTC and 506 of the UPAIA.

Section 506 of the UPAIA reads as follows:

"Section 506 Adjustments between principal and income because of taxes.

(a) A fiduciary may make adjustments between principal and income to offset the shifting of economic interests or tax benefits between income beneficiaries and remainder beneficiaries which arise from:

(1) elections and decisions, other than those described in subsection (b), that the fiduciary makes from time to time regarding tax matters;

(2) an income tax or any other tax that is imposed upon the fiduciary or a beneficiary as a result of a transaction involving or a distribution from the estate or trust; or

(3) The ownership by an estate or trust of an interest in an entity whose taxable income, whether or not distributed, is includable in the taxable income of the estate or trust or a beneficiary."

While receipts from the sale of a capital asset are to be allocated to principal, pursuant to Section 404 of the UPAIA, the authority granted to a trustee under Section 506 permits a trustee to adjust the allocation in order to address tax issues as between the fiduciary and beneficiaries. However, it is not clear, from either the statutory language or comments, what this is to mean. The comment to the section includes the following language and example:

"Section 506(a) permits the fiduciary to make adjustments between income and principal because of tax law provisions. It would permit discretionary adjustments in situations like these: . . . (3) a trustee realizes a capital gain on the sale of a principal asset and pays a large state income tax on the gain, but under applicable federal income tax rules the trustee may not deduct the state income tax payment from the capital gain in calculating the trust's

federal capital gain tax, and the income beneficiary receives the benefit of the deduction for state income tax paid on the capital gain."

Can this example included in the comment be interpreted to permit an allocation of capital gains to income in order to equalize the tax benefits and burdens (which also results in reducing the overall tax liability of the trust and beneficiaries)? While somewhat ambiguous, an argument could be made that, when coupled with the example in the comment, this provision of the UPAIA authorizes a trustee to allocate capital gains to income in order to allow for the distribution of capital gains to the current beneficiary so that the corresponding tax liabilities and deductions are borne by the same taxpayer.

In addition, Section 816 of the UTC includes discretionary powers of a trustee. The relevant provision of this section reads as follows:

"Section 816. Specific powers of trustee. Without limiting the authority conferred by Section 815, a trustee may:

(16) Exercise elections with respect to federal, state, and local taxes."

The above language does not address allocation of receipts to principal, but rather the ability to make tax elections. This language is more applicable to sections (2) and (3) of the Regulation, but would not, on its own, authorize a trustee to *allocate* a receipt to income where such receipt would otherwise be allocated to principal. Therefore, the provisions of the UTC do not provide much support in advancing the argument that a trustee has discretionary authority to *allocate* capital gains to income pursuant to state law.

However, to the extent that a State has adopted a modified version of Section 816 of the UTC, the specific provision may provide support and authority for the ability of a trustee to take capital gains into consideration in determining a distribution made or to be made to a beneficiary, the Regulation provides that such gains would then be included in DNI. For example, the North Carolina version of Section 816(16) of the UTC reads as follows:

"Exercise elections with respect to federal, state, and local taxes including, but not limited to, considering discretionary distributions to a beneficiary as being made from capital gains realized during the year."

The Regulation states that if capital gain is "treated consistently . . . as part of a distribution to a trust beneficiary" **or** is "actually distributed to the beneficiary or utilized by the trustee in determining the amount that is distributed or required to be distributed to the beneficiary" then such capital gain is included in DNI. Accordingly, in some states, such as North Carolina, the relevant provision of the UTC adopted would authorize a trustee to consider capital gains in determining the amount of a beneficiary's distribution, then under sections (2) and (3) of the Regulation, the capital gain may be included in DNI.

As highlighted in the discussion above, a thorough review of the relevant statutory provisions is necessary to determine if applicable law does grant the trustee the authority

to allocate capital gains to (fiduciary accounting) income. Advisors should be wary of a rush to judgment or conclusion on this point. Just because the trust instrument may grant a trustee discretionary authority –a trustee may not have the authority to take an action not permitted pursuant to applicable law.

(2) Does the trust instrument direct or allow a trustee to allocate capital gains to income?

In the absence of a direction under local law requiring a trustee to allocate capital gains to (fiduciary accounting) income, a trustee may do so if the governing instrument grants the trustee discretionary authority and the exercise of such discretion is permitted under applicable law.

In exercising its discretion, which results in capital gains being included in DNI, the trustee either (i) allocates gains to income, (ii) consistently treats capital gains on the trust's books and records a part of a distribution, or (iii) uses capital gains in determining the amount that is distributed or required to be distributed to a beneficiary. With regard to the first section of the Regulation, the discretionary action is limited to an *allocation* of gains to income, which results in the inclusion of the capital gains in DNI thereby entitling the beneficiary to a greater distribution from the trust. In the third section of the Regulation, the trustee is using the amount of the gain in determining the amount the beneficiary is entitled to receive – having the same result as in the first section of the Regulation. It is the second section of the Regulation that is most complex to decipher.

The primary difference between the second and third section of the Regulation is the use of the word "consistently." The second section provides that the trustee must consistently treat capital gains as part of the distribution made to the beneficiary in order for the gains to be treated as part of FAI, and therefore DNI. The language used in the third section, which provides that the trustee actually distributes the gain to the beneficiary or uses the gain in determining the amount to be distributed to the beneficiary, is technically different from that used in the second section. However, the meaning is effectively the same as that used in the second section, which provides that the trustee treats the gain in determining the amount to be distributed. The only substantive difference is the term "consistently." The Regulation provides a number of examples, which attempt (in varying degrees of success) to highlight these differences.

Ironically, because of the complexities of determining DNI, it is likely that many trustees find themselves following the second or third section of the Regulation – that they account for capital gains in determining the amount distributable to the beneficiary. Thus, including capital gains in DNI, to the extent permitted pursuant to the terms of the trust agreement and applicable local law, may be appropriate in a majority of cases and supported by the Regulation.

5. Trust's Taxable Income.

Ultimately, the trust's Federal net taxable income will be determined based on the aggregate taxable income, less deductions, including the DNI Deduction. Because of the

timing of the determination of FAI, particularly as income is realized in the final days of the calendar year, the Code allows the trustee to take into consideration distributions made to a trust beneficiary within 65 days of the close of the year in determining the DNI Deduction. See IRC Section 663(b). In other words, distributions of FAI made prior to March 6th (5th in a leap year) to a beneficiary are treated as having been made prior to December 31st of the preceding year in calculating the trust's DNI Deduction.

The trust's tax liability will be based on its net taxable income, taking into consideration the preferential tax rates for dividend income and capital gains. In addition, the trust's net investment income may be subject to the NII Tax. The trustee is liable for the payment of the trust's tax liability, and failure to pay the taxes may subject the trustee to personal liability.[5] The Service also may attach the assets received by a beneficiary to recoup any taxes owed.[6]

III. State Taxation of Trusts

A. Current Status.

For any trust that is subject to Federal income taxation, the trust ***may*** also be subject to state income taxation. Trustees are fiduciaries who are obligated to determine and pay the appropriate taxes owed by the trust. Failure to pay income taxes owed by a trust may result in liability to the trustee, individually. Further, payment of excess taxes by the trust may subject the trustee to liability, individually, by a claim brought by the beneficiaries. Therefore, an assessment of the states in which the trust is subject to income tax is critical – although complex. States that impose an income tax on trusts do so, generally, by characterizing a trust as a "resident" trust of the applicable state. A determination of whether a trust is considered a resident trust of a particular state is required to determine the trust's state income tax liability.

The difficulty, in larger part, to answering this question is that a trust is a unique type of taxpayer. A trust is not an individual, but it is not an entity. A trust is created through the relationship of the trustee (or trustees) to the trust property and the trust beneficiaries. A trustee owes a fiduciary duty to the trust beneficiaries to manage the trust property for the benefit of the beneficiaries. It is accurate to describe the trustee as the legal title holder to property, for the benefit of another (the beneficiary), who holds equitable title to the trust property. It is this complex relationship between trustee, trust property and trust beneficiary that makes the determination of the relationship of the trust to a state difficult in assessing where the trust has "nexus."

1. Lack of Uniformity.

Currently, there is no uniformity by the states as to the basis of taxation of trusts. Unlike the taxation of individuals, where residency (based on physical domicile) and source of income determines the basis of taxation, a trust may be subject to taxation in a state based

[5] See Treasury Regulation Section 1.641(b)-2(a).
[6] Id.

on a variety of factors, many of which are not in the control of either the trustee or the beneficiary.

This lack of uniformity can result in the over or underpayment of taxes by a trust. For instance, assume that you are the trustee of a trust, and you reside in Maryland and the beneficiary of the trust resides in North Carolina. You advise your accountant that you are trustee of a trust and ask the trustee to prepare the trust income tax returns. The accountant prepares and files a federal return and Maryland State return for the trust, as Maryland treats the trust as "resident" in Maryland because of the residence of the trustee in Maryland. The accountant assumes that each state taxes trusts under the same general principals and that the trust is not subject to tax in any other state. However, North Carolina's statute basis the taxation of trusts on the state of residence of the ***beneficiary***, therefore, North Carolina considers the trust a "resident" trust and will subject the trust to taxation in North Carolina. In this example, the trust is subject to income taxation in both Maryland and North Carolina, and generally the tax credit available by these states for state tax paid to another jurisdiction is based on source income[7] – in other words, business income attributable to the state/jurisdiction. Therefore, generally, all non-source taxable income (interest and dividend income) could be subject to taxation in multiple jurisdictions without offsetting credits.

Attached, as Exhibits, are charts setting forth the basis on which the states determine a trust to be a resident trust:

Exhibit A – States that do not impose a tax on trusts;
Exhibit B – States that impose a tax based on residence of grantor;
Exhibit C – States that impose a tax based on residence of trustee;
Exhibit D – States that impose a tax based on residence of beneficiary;
Exhibit E– States that impose a tax based on administration of the trust;
Exhibit F – State that use a multi factor analysis.

Note: The charts reflect current statutes and not case rulings that may implicate the constitutionality of the state's statute.

2. Basis of Taxation.

Generally, the basis of taxation of trusts by the states is "nexus." The primary factors under which a state may consider a trust to have nexus with the applicable state, and accordingly subject the trust to income taxation, are:

- Trust was created by a resident of the state;
- Trust is administered in the state;
- Trustee resides in the state; or,
- Beneficiary resides in the state.

[7] See N.C.G.S. Section 105-160.4.

B. Constitutionality. The Supreme Court has addressed the issue of the constitutionality of the states to tax taxpayers under two clauses of the U.S. Constitution – the Due Process Clause the Commerce Clause. Under both, the state must show some nexus between the taxpayer and the state imposing the tax.

1. Due Process Clause.

The Due Process Clause of the U.S. Constitution provides, in part, that "[n]o State shall make or enforce any law which shall . . . deprive any person of life, liberty, or property, without due process of law. . . ." Accordingly, a state must adhere to the requirements of due process in order to subject a person to the payment of tax. The application of the Due Process Clause to the ability of a state to impose tax on a taxpayer was most recently applied in <u>*Quill Corporation v. North Dakota*</u> (504 US 298 (1992)), where Justice Stevens explained that:

"The Due Process Clause requires some definite link, some minimum connection, between a State and the person, property or transaction it seeks to tax, and that the income attributed to the State for tax purposes must be rationally related to values connected with the taxing State. . . . [w]e have framed the relevant inquiry as whether a defendant had minimum contacts with the jurisdiction such that the maintenance of the suit does not offend traditional notions of fair play and substantial justice."

The standard for meeting the Due Process Clause is a fairly low threshold. Applying this minimal standard, in <u>*Quill*</u>, the Supreme Court found that the taxpayer, a mail order business with no physical presence in North Dakota, was subject to tax on sales made to the state. However, the Supreme Court, in this same case, found the imposition of tax on the taxpayer violated the Commerce Clause.

2. Commerce Clause.

The Commerce Clause of the U.S. Constitution provides, in part, that "Congress shall have Power . . . [t]o regulate Commerce . . . among the several States." While similar in language, the Supreme Court has found the standard and application of the Due Process and Commerce Clauses to be very different.

In <u>*Quill*</u>, the Court explained that "[d]ue process centrally concerns the fundamental fairness of governmental activity. Thus, at the most general level, the due process nexus analysis requires that we ask whether an individual's connections with a state are substantial enough to legitimate the state's exercise of power over him. We have, therefore, often identified "notice" or "fair warning" as the analytic touchstone of due process nexus analysis. In contrast, the Commerce Clause and its nexus requirement are informed not so much by concerns about fairness for the individual defendant as by structural concerns about the effect of state regulation on the national economy. . . . [T]he "substantial nexus" requirement is not, like due process' "minimum contacts" requirement, a proxy for notice, but rather a means for limiting state burdens on interstate commerce. Accordingly, . . . , a corporation may have the "minimum contacts" with a taxing state as required by the Due

Process Clause, and yet lack the "substantial nexus" with that state as required by the Commerce Clause." *Id*. At 312-313.

To meet the constitutional standard for taxation under the Commerce Clause, the statute must satisfy the following requirements: (a) the taxpayer must have a substantial nexus to the taxing jurisdiction, (b) the tax must be fairly apportioned, (c) the tax must be fairly related to the benefits being conferred by the taxing jurisdiction, and (d) the tax must not discriminate against interstate commerce. See *Complete Auto Transit, Inc. v. Brady*, 430 US 247 (1977). While this standard and test is clear, and reflects a significant hurdle for state taxation, the state courts have been inconsistent in finding in favor of taxpayers in applying this test and standard.

a) ***State Taxation based on residency of Grantor.***

It should first be noted that a trust is a separate taxpayer, but is ***not*** the equivalent of an entity for state law purposes. A trust is created by virtue of a relationship between a trustee and the beneficiaries, created by a grantor. Once created, the grantor, in that sole capacity, has no actual activity with regard to the trust or its administration. Thus, basing taxation of a trust solely on the state of residence of a grantor seems insufficient to meet the Commerce Clause standard. However, several cases have found statutes taxing a trust on the basis of the state of residence of the grantor as constitutional. See:

- *District of Columbia v. Chase Manhattan Bank*, 689 A2d 539 (DC, 1997) – Trust created under Will of resident decedent, subject to taxation in District of Columbia, despite non-resident trustee and beneficiary.
- *Chase Manhattan Bank v. Gavin*, 733 A2d 782 (CT, 1999) – Inter vivos trust created by Connecticut resident held resident trust under Connecticut statute.

Although, in recent years the state Courts have been siding with taxpayers. See:

- *Residuary Trust A v. Director*, 27 NJ Tax 68 (Tax Ct., 2013) - Residency of grantor of testamentary trust in New Jersey insufficient to permit taxation in New Jersey under Due Process analysis.
- *Linn v. Department of Revenue*, 2 NE2d 1203 (ILL App, 2013) – Grantor of inter vivos trust domiciled in Illinois insufficient to support taxation of trust in Illinois under Due Process Clause.
- *William Fielding v. Commissioner of Revenue of State of Minnesota* (MN, 2018) – Four trusts created by a Minnesota resident and funded with stock in a Minnesota closely held business did not have sufficient nexus with Minnesota to be considered resident trusts.

William Fielding v. Commissioner of Revenue of State of Minnesota is the most recent case challenging the taxation of a non-grantor trust based on the residence of the grantor. In this case, the grantor of the trusts was domiciled in Minnesota when the trusts were created and ceased to be classified as grantor trusts. Notably, the trustee of the trusts was resident in Texas, but the trusts all held stock in a Minnesota corporation.

In challenging the constitutionality of the Minnesota statute, the taxpayer (the trustee of the trusts) urged the court to consider the sole factor set forth in the statute (residence of the grantor), whereas the Department of Revenue advocated for a broader analysis of all contacts between the trust and the State.

The Court agreed with the taxpayer and stated that it would not redefine the statute. However, the Court did go on to evaluate all relevant facts in considering the statute and due process clause. Specifically, the Court found that (1) the residence of the grantor was irrelevant, as the grantor does not represent the trusts and the relevant connection is between the State and the trustee, (2) the trusts' stock in a Minnesota corporation does not constitute property physically located in Minnesota, as the stock is an intangible and therefore is not a relevant connection with the State, and (3) one beneficiary residing in the State is insufficient.

b) ***State Taxation based on residency of Beneficiary***

It should be noted that only 3 states (California, Georgia and North Carolina) use the residence of a beneficiary of a trust as the sole factor in the determination that the trust is a "resident" trust.[8] 7 other states classify a trust as resident if a beneficiary resides in the state and another factor is satisfied. Notably, residence of a trust beneficiary is least within the control of the trustee or grantor, leading to several challenges to statues basing taxation on this factor. To the extent that a trust is a separate taxpayer, whose activities are viewed through its trustee, not beneficiary, taxation based on residence of the beneficiary would seem to be the least supported by the tenants of the Due Process and Commerce Clauses. Accordingly, several of these states, including North Carolina, have faced challenges on the constitutionality of the statute:

- *McNeill v. Commonwealth*, 67 A3d 185 (PA, 2013) – Beneficiary domiciled in Pennsylvania was insufficient, alone, to satisfy the Commerce Clause requirements to substantiate the taxation of the trust in Pennsylvania.
- *Chase Manhattan Bank v. Gavin*, 733 A2d 782 (CT, 1999) – Beneficiary resident of Connecticut insufficient to support taxation under the Due Process and Commerce Clauses.
- *Kimberly Rice Kaestner v. North Carolina Department of Revenue* (US, 2019).

There are several California state court cases supporting California's statute taxing trusts based on residence of beneficiary. See: *McCulloch v. Franchise Tax Board*, 61 Cal 2d 186 (1964); *In re First National Bank of Chicago*, 1964 Cal. Tax Lexis 39 (1964); and, *In re Erdman*, 1970 Cal. Tax Lexis 50 (1970). However, all of these cases were decided prior to the U.S. Supreme Court case of *Quill* and *Kaestner*.

Most notably, on June 21, 2019 the U.S. Supreme Court issued a unanimous opinion, delivered by Justice Sotomayor, in the matter of the *North Carolina Department of*

[8] California's statute also classifies a trust as "resident" if the trust is administered in California, but administration is not an additional required fact for classification of the trust as resident.

Revenue v. Kimberley Rice Kaestner 1992 Family Trust, holding that as applied to the Kimberley Rice Kaestner 1992 Family Trust (the "Trust"), the North Carolina statute subjecting the Trust to state income taxation, which is based solely on the trust beneficiary's residence in the state, violates the Due Process Clause.

The opinions of the North Carolina courts have been based solely on the facts and circumstances of this Trust and the contacts of the trustee to North Carolina and the rights of the beneficiary, who resident in North Carolina. The U.S. Supreme Court's opinion is similarly constructed. Justice Sotomayor, who wrote the Court's opinion, reinforced that the Court's holding is limited "to the specific facts presented" and that the Court's decision does not "imply approval or disapproval of trust taxes that are premised in the residence of beneficiaries whose relationship to trust assets differs from that of the beneficiaries here." Specifically, footnote 8 states that the Court does not "decide what degree of possession, control, or enjoyment would be sufficient to support taxation."

In evaluating the relationship of between the trust assets and the party to the trust the state seeks to tax, the Court focused on possession, control and enjoyment as critical in supporting state taxation under the Due Process Clause. In the context of the Trust, the Court specifically noted the beneficiaries' inability to compel distribution, which were solely in the trustee's discretion. In addition, during the years at issue, the beneficiaries never received a distribution from the Trust, and had no right to "otherwise control, possess, or enjoy the trust assets."

In its opinion, the Court evaluated prior decisions on the issue, noting that the relationship between the relevant trust constituents (settlor, trustee, or beneficiary) and the trust assets is critical in the Due Process analysis. "Due Process Clause demands attention to the particular relationship between the resident and the trust assets that the state seeks to tax. Because each individual fulfills different functions in the creation and continuation of the trust, the specific features of that relationship sufficient to sustain a tax may vary depending on whether the resident is a settlor, beneficiary or trustee."

Additionally, the Court reviewed its precedent of the sufficiency of possession and control of the trust property as to the settlor to justify taxation under the Due Process Clause. A significant number of states define a resident trust, for state income tax purposes, as a trust whose grantor was resident of the state.[9]

While the opinion does not provide guidance on what circumstances would support state taxation of trusts based on the residence of a trust beneficiary, in reading between the lines, possession, control and enjoyment are the critical factors. Where the trust beneficiary has no right to compel distributions, has no expectation regarding distributions, nor the power to appoint or control the trust property, taxation is not supported.

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[9] Alabama, Arkansas, Connecticut, Delaware, District of Columbia, Illinois, Louisiana, Maine, Maryland, Massachusetts, Michigan, Minnesota, Missouri, Montana, Nebraska, New Jersey, New York, Ohio, Oklahoma, Pennsylvania, Rhode Island, Utah, Vermont, Virginia, West Virginia, Wisconsin.

c) ***Trust Administration***

Of the states that classify a resident trust based on the administration of the trust occurring in the state, only some have provided guidance or clarification as to what constitutes "administration," or sets out additional factors that must be satisfied for be considered a resident trust. Specifically:

Hawaii provides that if administration occurs in the state, residence of the fiduciary is irrelevant. However, if administration is partly carried on in the state, the trust will be classified as a resident trust if half or more of the fiduciaries are resident in Hawaii.

Indiana provides that administration is where the trust's records are kept and where the trustee is located.

Iowa subjects trusts with a situs in Iowa to taxation as resident trusts. A trust has a situs in Iowa if it was created by court order or makes an accounting to the court in Iowa. If a trust was not created by the court or is not required to account to the court, situs is determined based on relevant facts, such as: (a) residence of the trustees or a majority of them; (b) the location of the principal office where the trust is administered; and (c) the location of the evidence of the intangible assets of the trust (such as stocks, bonds, bank accounts, etc.). The residence of the grantor of a trust, not subject to the grantor trust rules under Code Sections 671 to 679, is not a controlling factor as to the situs of the trust, unless the person is also a trustee. A statement in the trust instrument that the law of a certain jurisdiction shall govern the administration of the trust is not a controlling factor in determining situs.

Kentucky provides that principal place of administration may be determined based on the terms of the trust, if (a) a trustee's principal place of business is located in or a trustee is a resident of the designated jurisdiction; or (b) all or part of the administration occurs in the designated jurisdiction. Additionally, principal place of administration may be determined based on the trustee under a continuing duty to administer the trust at a place appropriate to its purposes, its administration, and the interests of the beneficiaries. The trustee, may transfer the trust's principal place of administration to another state or to a jurisdiction outside of the United States.

Louisiana classifies a trust as resident if the trust agreement states that the trust is governed by the laws of Louisiana. If the trust agreement is silent on governing law, then the trust is classified as a resident trust if it is administered in the state.

Minnesota classifies a trust as a grantor trust based on two separate sets of factors; (1) if the grantor is a resident of Minnesota (if the trust was created or became irrevocable after 12/31/95), and (2) if two or more of the following conditions are satisfied: (a) a majority of the discretionary decisions of the trustees relative to the investment of trust assets are made in Minnesota; (b) a majority of the discretionary decisions of the trustees relative to the distributions of trust income and principal are made in Minnesota; (c) the official books and records of the trust, consisting of the original minutes of trustee meetings and the

original trust instruments, are located in Minnesota. Notably, if the trustees delegate decisions and actions to an agent or custodian, the actions and decisions of the agent or custodian must not be taken into account in determining whether the trust is administered in Minnesota, ***if***: (i) the delegation was permitted under the trust agreement; (ii) the trustees retain the power to revoke the delegation on reasonable notice; and (iii) the trustees monitor and evaluate the performance of the agent or custodian on a regular basis as is reasonably determined by the trustees. The term "fiduciary" means a guardian, trustee, receiver, conservator, personal representative, or any person acting in any fiduciary capacity for any person or corporation.

Oregon defines a resident trust as one of which the fiduciary is a resident of Oregon or the administration of which is carried on in Oregon. In the case of a fiduciary that is a corporate fiduciary engaged in interstate trust administration, the residence and place of administration of a trust both refer to the place where the majority of fiduciary decisions are made in administering the trust.

Utah defines trust administration as follows: (a) if the trust does not specify a place of administration and the fiduciary transacts a major portion of its trust administration in Utah; (b) the fiduciary's usual place of business is in Utah, or (c) the trust states that Utah is the place of administration, and any administration of the trust is done in this state. But note, a trust administered *by a corporate trustee in Utah is not subject to income tax* as a result of a subtraction from taxable income.

Wisconsin classifies trusts that became irrevocable prior to *October 29, 1999* as resident based on the administration of the trust. A trust will be considered administered in the state of domicile of the corporate trustee of the trust at any time that the grantor of the trust is not a resident of this state: (a) Trusts that have any assets invested in a common trust fund, as defined in Code Section 584, maintained by a bank or trust company domiciled in this state that is a member of the same affiliated group, as defined in Code Section 1504, as the corporate trustee; (b) trusts the assets of which, in whole or in part, are managed, or about which investment decisions are made, by a corporation domiciled in this state if that corporation and the corporate trustee are members of the same affiliated group, as defined in Code Section 1504;

d) ***Resident Trustee***

Determining the residence of a trustee or fiduciary of a trust is a fairly straightforward determination – much more so than determination of a trust's principal place of administration (discussed above). But, application of this seemingly simple concept is complicated in situations where there are multiple trustees other the trust is administered as a directed trust with trust directors serving in non-trustee fiduciary roles. Thus, analyzing the residence of multiple trustees and fiduciaries can complicate the determination of where the trust is considered resident.

With regard to multiple trustees, a few states that use the residence of the trustee as the basis for taxation address this:

Arizona provides that if at least one fiduciary is a resident of the state the trust is a resident trust. However, if the sole fiduciary is a corporate entity, then the trust is classified as resident only if administration occurs in Arizona.

California also subjects trusts with a resident fiduciary to state taxation, but apportions based on the number of California resident fiduciaries.

Delaware does subject trusts to state taxation if: (a) the trust has (i) more than one trustee all of whom are individuals and ½ or more are resident, or (ii) a corporate trustee having an office for the conduct of trust business in the state, ***and*** (b) ***resident beneficiary.***

Hawaii, if the sole fiduciary, or all fiduciaries if more than one are resident of Hawaii, the trust is a resident trust, regardless of where administration takes place. If the trust is not administered in Hawaii, but ½ or more of the trust fiduciaries are resident, then the trust is a resident trust.

Massachusetts provides that at least one trustee must be a resident of Massachusetts and in addition at least one of the following conditions must exist: (a) at the time of the creation of the trust the grantor (or any one of several grantors) was a resident of Massachusetts; (b) during any part of the year for which income is computed the grantor (or any one of several grantors) resided in Massachusetts; (c) the grantor (or any one of several grantors) died a resident of Massachusetts. The residence outside of Massachusetts of the grantor, any trustee or any beneficiary, or any or all of such persons, will not remove such a trust from the taxing jurisdiction of Massachusetts.

New Mexico defines a trustee is resident of the state if the trustee is domiciled in the state or is an individual who is physically present in the state for more than 185 days during the taxable year.

e) ***Multi Factor Nexus***

While there has been significant litigation challenging the constitutionality of state statues classifying trusts as resident, only a few states use a multi-factor determination, the basis of which is determining if the trust has sufficient connections or nexus to the taxing jurisdiction:

Idaho uses a multifactor test requiring three (3) conditions for the *entire taxable year*, including that the trustee is domiciled or resident in Idaho and administration takes place in Idaho.

Montana is a multi factor state, much like Idaho, which classifies a trust as a resident trust if it establishes a sufficient connection to Montana. The factors considered to determine whether a trust has a sufficient connection to Montana include: (a) the grantor's domicile; (b) the location where the trust was created; (c) the location of trust property; (d) the beneficiaries' domicile; (e) the trustees' domicile; (f) and the location of the trust's administration.

Montana Department of Revenue guidance provides the following examples of resident trusts: (1) trust that designates Montana as its principal place of administration; (2) trust that is primarily administered by a trustee or representative who is a Montana resident or whose principal place of business is located in Montana; (3) any irrevocable trust created by, or consisting of property of, a Montana resident on the date the trust or portion of the trust became irrevocable and has at least one income beneficiary who, for all or some portion of the trust's current taxable year, was a Montana resident; (4) any trust created by the will of a decedent who was a Montana resident at the time of the decedent's death; or (5) any trust created by, or caused to be created by, a court as a result of the death of an individual when (A) property was transferred to an irrevocable inter vivos trust as a result of a decedent's death; (B) the decedent was a Montana resident at the time of the decedent's death; and the trust has at least one income beneficiary who, for all or some of the trust's current taxable year, was a Montana resident.

North Dakota is another multi-factor jurisdiction. North Dakota provides that a trust or estate is a resident trust or estate when it has a relationship to the state sufficient to create nexus. This includes, but is not limited to, the following contacts: (a) a beneficiary of the trust or estate is a domiciliary or resident of this state; (b) the trustee or executor is a domiciliary or resident of this state; (c) Assets making up any part of the trust or estate have situs in this state; (d) any or all of the administration or income production of the trust or estate takes place within this state; and (e) the laws of this state are specifically made applicable to the trust or estate or to the opposite parties with respect to their fiduciary relationship.

3. Examples of Multi-Jurisdictional State Taxation.

Consider the following example, while a hypothetical, is not too remote of a scenario as to be negligible:

Grantor, resident of Virginia, creates an irrevocable non-grantor trust (the "Trust") for the benefit of grantor's child and child's descendants, all of whom are residents of North Carolina. Grantor appoints close family friend, who is a resident of South Carolina, as Trustee. Trust is funded with cash and marketable securities, which generate approximately $100,000 of taxable interest and dividend income, annually, and the Trust has nominal deductible expenses of $5,000. The Trust provides for discretionary distributions of income to the beneficiaries, and the Trustee has not made any distributions in the past 3 years.

In additional to the Federal income tax owed by the Trust, the Trust is considered a resident trust in each of North Carolina, South Carolina and Virginia.[10] The Trustee will be required to file state fiduciary income tax returns in Virginia, North Carolina and South Carolina, and pay applicable income taxes in all three jurisdictions, without any offset or credit for

[10] This analysis is based on Virginia's statute, though Virginia rulings have indicated that Virginia will not tax a trust if the trust's only nexus to Virginia is the domicile of the grantor.

the taxes paid in each jurisdiction. Accordingly, the aggregate state income taxes paid by the Trust in all three jurisdictions is:

State/Jurisdiction	Tax Rate	Tax
North Carolina	5.5%	$5,225.00
South Carolina	7.0%	$6,650.00
Virginia	5.75%	$5,462.50
		$17,337.50

Alternatively, consider the following example:

Grantor, resident of Kentucky, creates an irrevocable non-grantor trust (the "Trust") for the benefit of grantor's child and child's descendants, all of whom are residents of Tennessee. Grantor appoints close family friend, who is a resident of North Carolina, as Trustee. Trust is funded with cash and marketable securities, which generate approximately $100,000 of taxable interest and dividend income, annually, and the Trust has nominal deductible expenses of $5,000. The Trust provides for discretionary distributions of income to the beneficiaries, and the Trustee has not made any distributions in the past 3 years.

The Trust is not considered a resident Trust of Kentucky, Tennessee or North Carolina. Accordingly, the Trust does not owe state income taxation in any jurisdiction.

C. Reform.

With the increase in attention to income taxes, taxpayers, including trusts, are more cognizant of the income tax implications of their actions and activities. It is not uncommon for a taxpayer to take action to avail itself of more favorable laws, including tax laws. States with more favorable laws in the administration of trusts, and lower tax rates, have seen a significant rise in the number of trust established in their jurisdiction. But, given the multiple factors evaluated in determining the state of "residence" of a trust, establishing a trust in a jurisdiction with no income tax may not eliminate a trust's state tax liability.

Many have called for reform in this area – but the likelihood of states agreeing to participate in uniform rules is low. At this point, trustees should be advised to carefully review the statutes of the jurisdictions that may have grounds to classify the trust as a resident trust and follow the current statutory provisions in filing and paying taxes.

D. Ancillary State Income Tax Issues Involving Trusts.

As noted in the previous section, the Federal taxation of trusts becomes even more complex when the trust owns an interest a pass-through entity. This is also true with regard to the state income taxation of trusts – specifically when the pass-through entity is an operating business (or holds real property) subject to taxation in a specific state due to such business operations (or location of the real property). In such situations, there may be unintended adverse state income tax consequences.

For example, assume that a revocable trust ("Trust") holds an interest in an S corporation ("S Corp") that owns real property in South Carolina. The grantor of the Trust dies, and the Trust's basis in the S Corp stock is adjusted to fair market value (in this example, $1,000) pursuant to the provisions of IRC Section 1014. The trustee and beneficiaries of the Trust all reside in North Carolina.

The S Corp sells the real estate and a significant capital gain ($1,000) is recognized and is taxable for Federal and South Carolina income tax purposes. The S Corp liquidates and distributes the proceeds from the sale of the real estate to the Trust. For Federal income tax purposes, the allocation of the gain on the sale of the real property increases the Trust's basis in the stock of the S Corp so that up on liquidation of the S Corp the gain recognized on the sale of the real property is offset by the loss recognized on the liquidation of the S Corp, as set forth below:

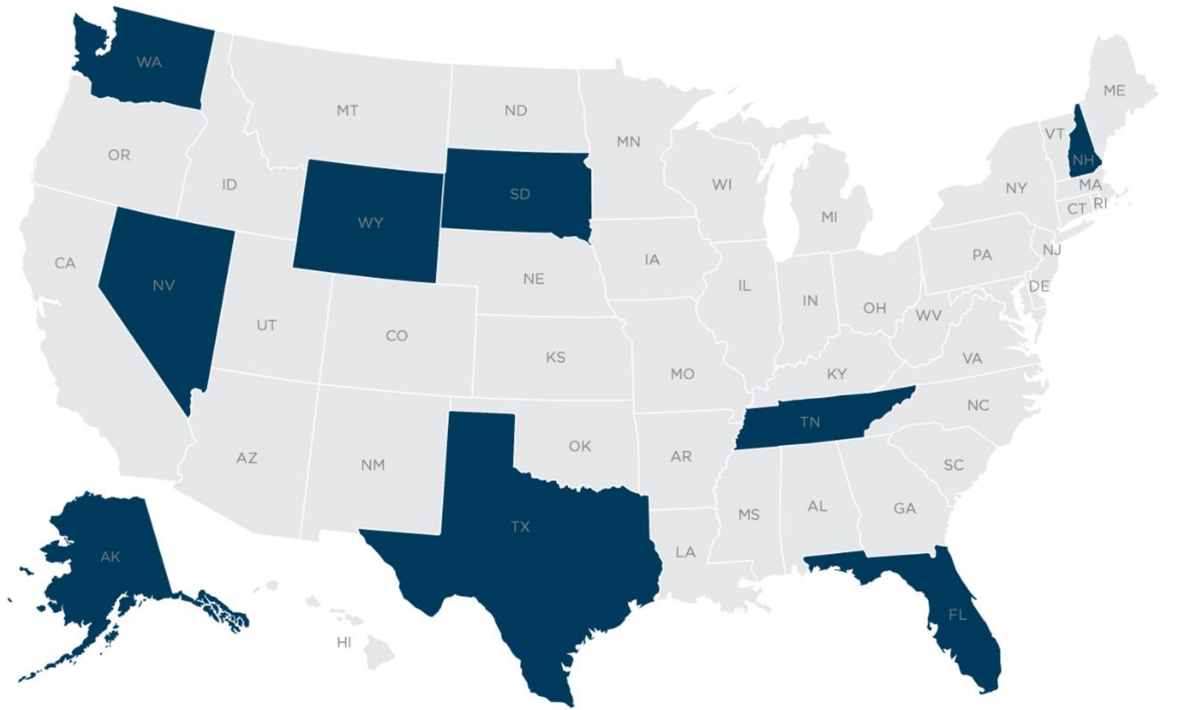
Adjusted Tax Basis in S Corp Stock (IRC Section 1014)	$1,000
Increase in Tax Basis by Allocation of Gain (IRC Section 1367)	$1,000
Basis after Allocation of Gain	$2,000
Liquidating Distribution	$1,000
Loss on Liquidation	($1,000)

However, for state income tax purposes, the Trust recognizes a gain in South Carolina (of $1,000), but the loss recognized on the liquidation of the S Corp is allocable to the state where the Trust is subject to taxation – here, North Carolina. The S Corp stock is an intangible asset and transactions involving the stock are taxable, for state income tax purposes, to the state where the Trust is subject to taxation. Because North Carolina taxes trusts based on the residency of the beneficiaries, the Trust is subject to tax in North Carolina. Because South Carolina taxes trusts based on the residency of the trustee, the Trust is not subject to tax in South Carolina. Accordingly, the loss recognized on the liquidation of the S Corp will not offset the gain recognized on the sale of the real property. However, if North Carolina also taxed trusts solely on the residency of the trustee (and not based on the residence of the beneficiaries), the Trust could have appointed a trustee resident in South Carolina prior to the transaction in order to "match" the gain and loss for state income tax purposes.

Therefore, careful review of the state income taxation rules implicated in similar transactions may highlight the opportunity to engage in pre-transaction planning for state income tax purposes.

EXHIBIT A

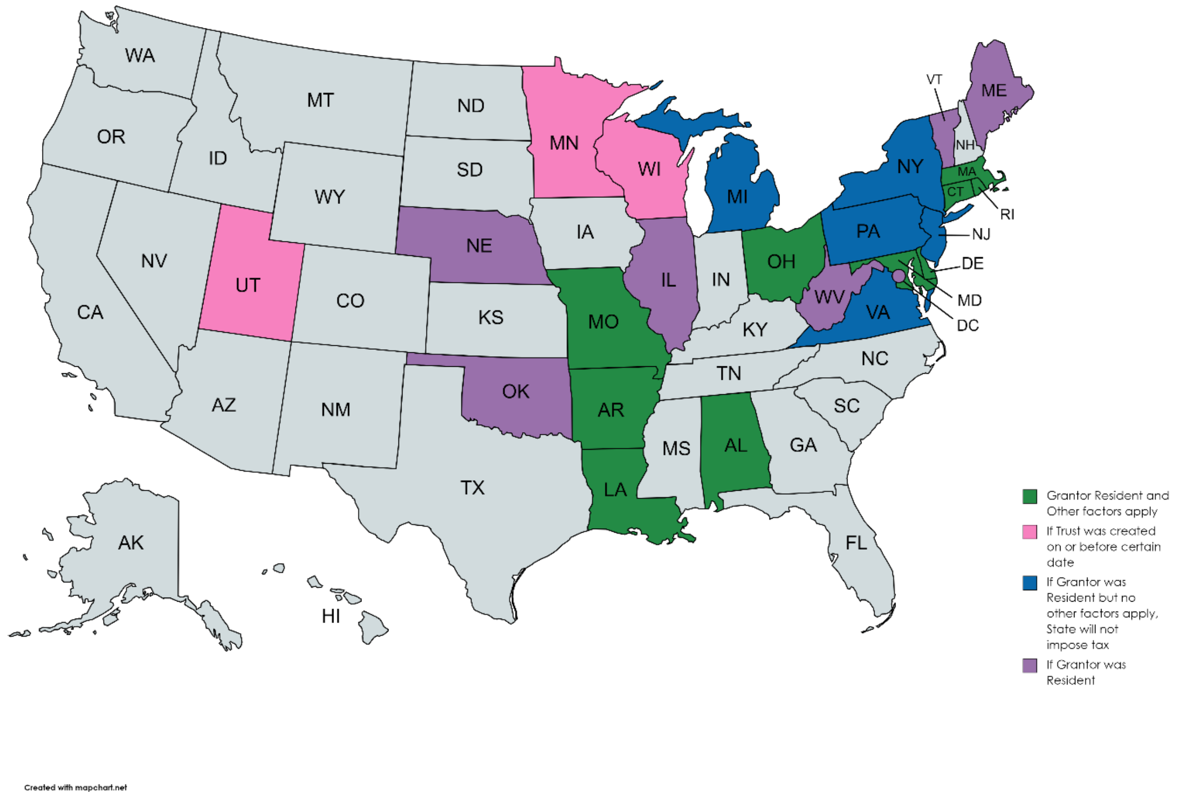
STATES THAT DO NOT IMPOSE A TAX ON TRUSTS



States: Alaska, Florida, Nevada, New Hampshire, South Dakota, Tennessee (as of 1/1/2021) Texas, Washington and Wyoming.

EXHIBIT B

STATES THAT IMPOSE A TAX BASED ON RESIDENCE OF GRANTOR



States: Alabama, Arkansas, Connecticut, Delaware, District of Columbia, Illinois, Louisiana, Maine, Maryland, Massachusetts, Michigan, Minnesota, Missouri, Nebraska, New Jersey, New York, Ohio, Oklahoma, Pennsylvania, Rhode Island, Utah, Vermont, Virginia, West Virginia, Wisconsin

Courts in **Illinois, Minnesota** and **Pennsylvania** have held that the grantor's residence is constitutionally insufficient to tax the income of an inter vivos trust. *Linn v. Department of Revenue*, 2 NE2d 1203; *Fielding v. Commissioner of Revenue*, MN Sup. Ct., No. A17-1177; *McNeill v. Commonwealth*, 67 A3d 185.

Notes:

States highlighted in Purple: If grantor of trust was resident of state, or if trust was created by testamentary devise and testator was resident of state, then trust is subject to income tax.

States highlighted in Green: If grantor of trust was resident of state, or if trust was created by testamentary devise and testator was resident of state, and trust has either (i) resident fiduciary (AL, AR, MA) or (ii) resident beneficiary (AL, CT (solely for inter vivos trusts), DE, MA, MD, MO, OH, RI), then trust is subject to income tax. Louisiana subjects trusts created by Will of resident decedent to tax, and inter vivos trusts created by resident grantor that is administered in Louisiana to tax.

States highlighted in Pink: Tax only certain trusts based on date of creation.

Minnesota taxes only trusts created after 1995.

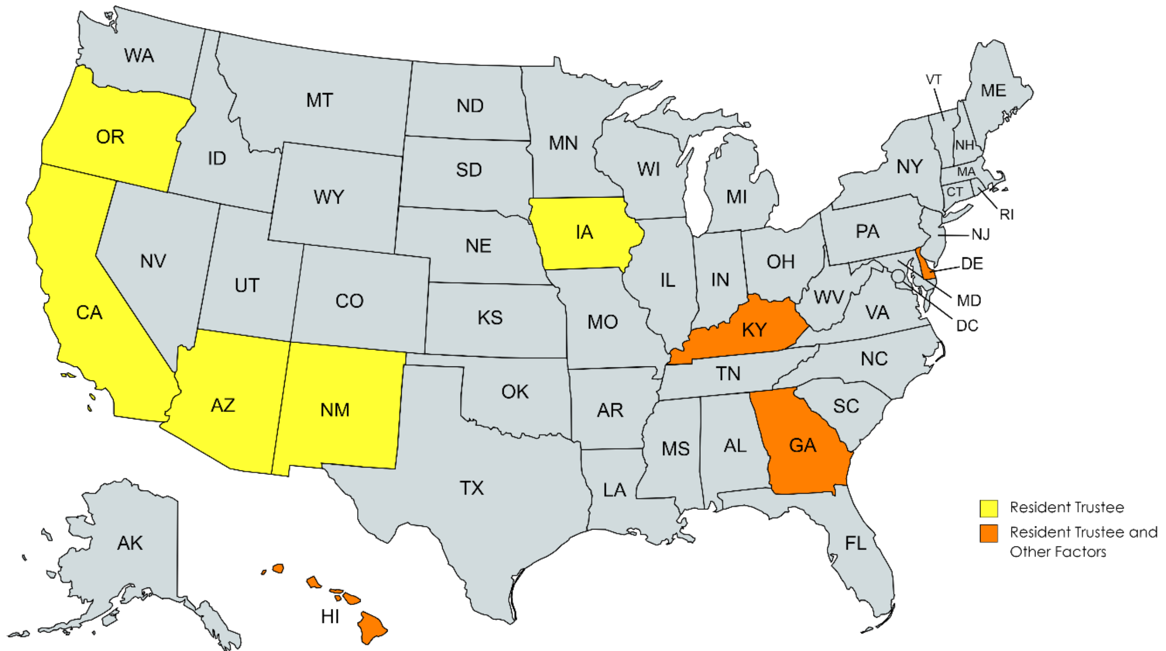
Utah taxes only trusts under Will and inter vivo struts created before 2003.

Wisconsin only taxes trust created after October 28, 1999.

States highlighted in Blue: Will not treat a trust as resident if there is no other connection to the state, such as no assets, income or resident trustee (MI, NJ, NY, PA).

EXHIBIT C

STATES THAT IMPOSE A TAX BASED ON RESIDENCE OF TRUSTEE



States: Arizona, California, Delaware, Hawaii, Iowa, Kentucky, Massachusetts, New Mexico, Oregon

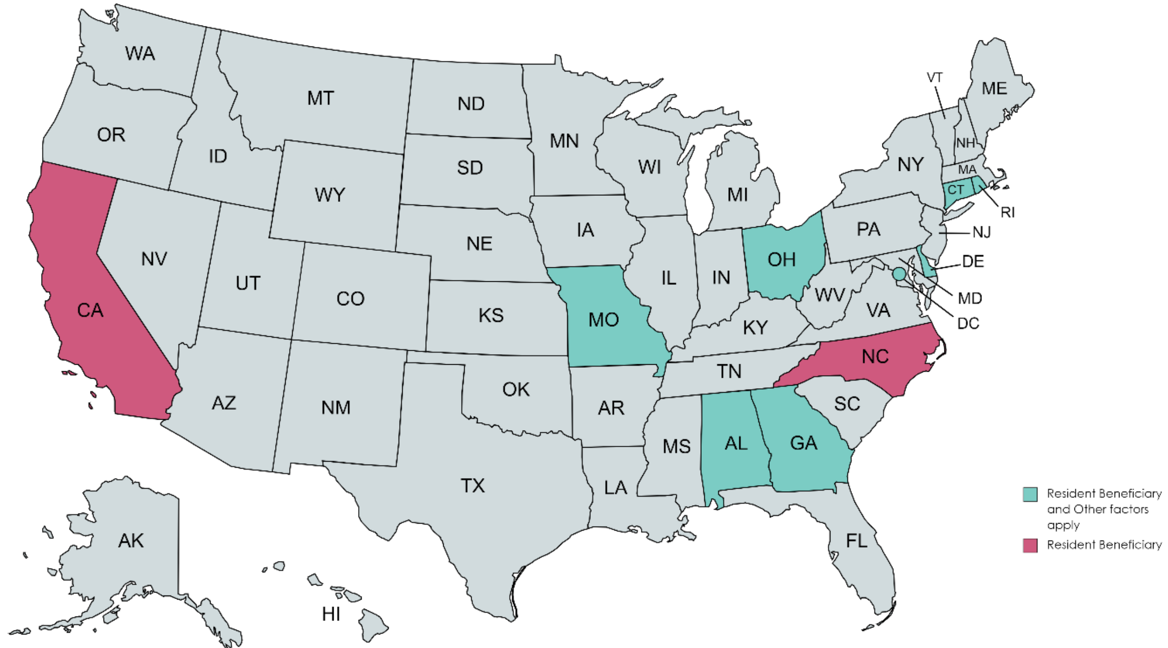
Notes:

States highlighted in Yellow: If trustee is resident of state, trust is subject to income tax.

States highlighted in Orange: If trustee is resident of state and other requirements are satisfied (for example, a beneficiary of trust also is resident of the state (DE, GA, HI and KY)) then trust is subject to income tax.

EXHIBIT D

STATES THAT IMPOSE A TAX BASED ON RESIDENCE OF BENEFICIARY

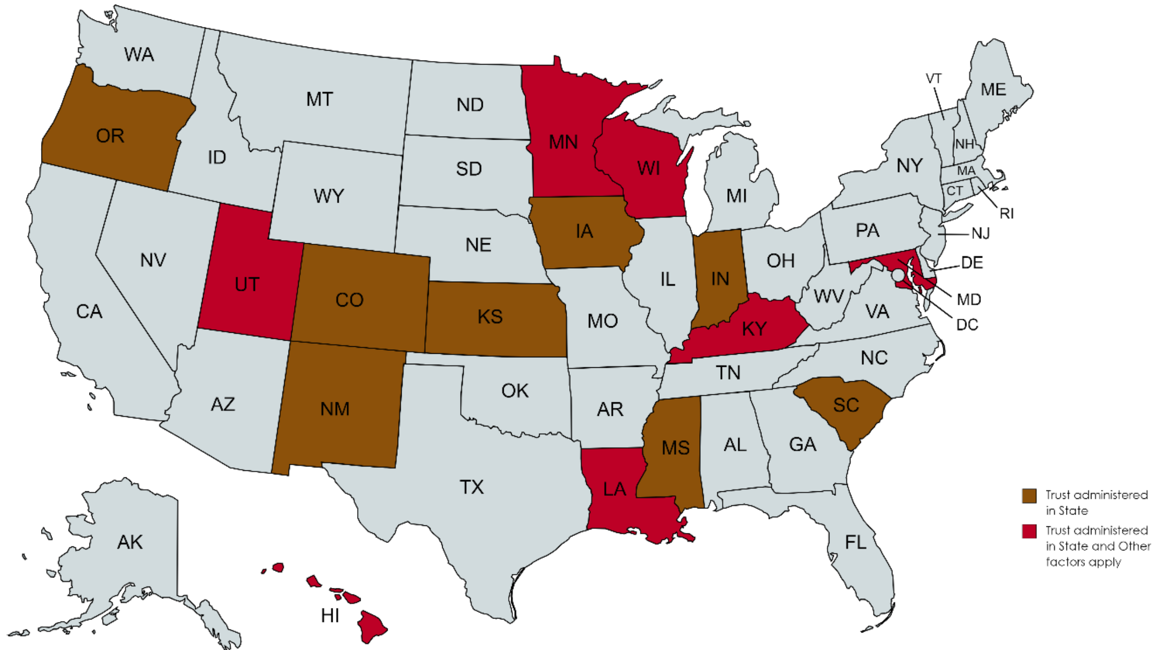


States Alabama, California, Connecticut, Delaware, District of Columbia, Georgia, Missouri, North Carolina, Ohio, Rhode Island.

Note: States highlighted in Aqua require additional factors - see Exhibit B, and for Georgia, Exhibit C.

EXHIBIT E

STATES THAT IMPOSE A TAX BASED ON ADMINISTRATION OF THE TRUST



States: Colorado, Hawaii, Indiana, Iowa, Kansas, Kentucky, Louisiana, Maryland, Minnesota, Mississippi, New Mexico, Oregon, South Carolina, Utah, Wisconsin

Notes:

States highlighted in Brown: If trust is administered in state, trust is subject to income tax.

States highlighted in Red: Only if other factors apply or only certain trusts based on date of creation.

If trust is administered in state and other requirements are satisfied (for example, a beneficiary of trust also is resident of the state (HI, KY and MD) or trust provides for governing law of state (LA)) then trust is subject to income tax.

Louisiana taxes all testamentary trusts administered in State, regardless of domicile of testator, and taxes all inter vivos trusts administered in State, unless governing law of trust is ***other than*** Louisiana.

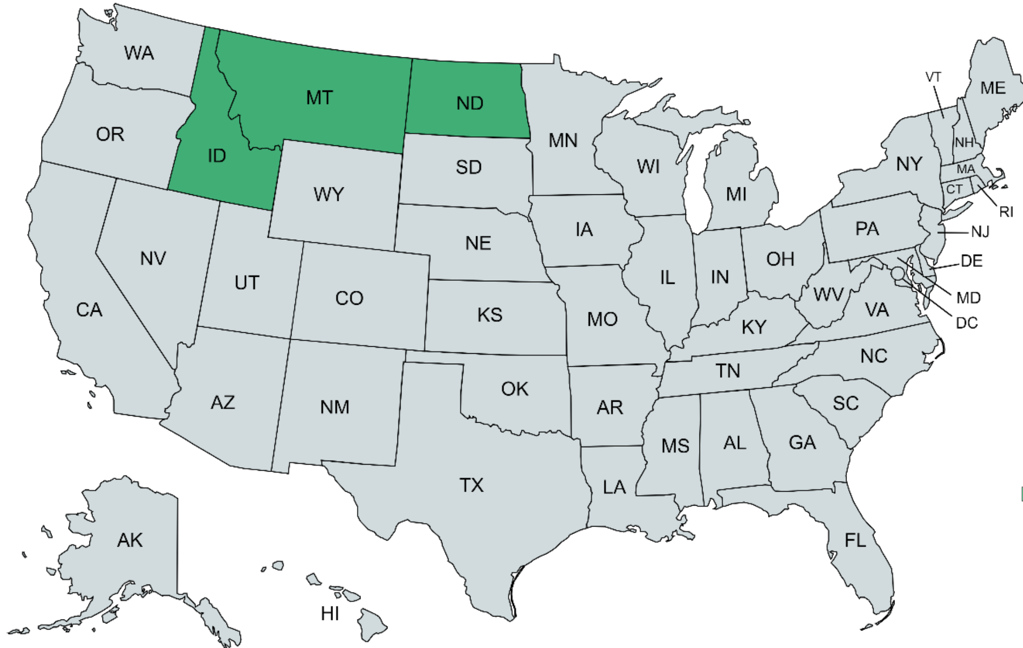
Minnesota taxes only trusts created before 1996.

Utah taxes only trusts under Will and inter vivo trusts created before 2003.

Wisconsin only taxes inter vivos trusts administered in state before October 29, 1999.

EXHIBIT F

STATES THAT IMPOSE A TAX BASED ON MULTIPLE FACTORS TO ESTABLISH NEXUS



States: Idaho, Montana and North Dakota