

## Trust Tax Drag

**Quick-Take:** Locating a dynastic non-grantor trust in a state that does not impose a state income tax can greatly help to avoid a *tax drag* on the accumulation of wealth.

**Background:** In 2026, a non-grantor trust finds itself at the highest marginal federal income tax bracket of 37% when its income exceeds \$16,000. Add to that the federal net investment income tax (NIIT) of 3.8% and the trust's accumulated income is eroded by almost 41%. Add to that a state income tax, like Michigan's 4.25%, and a trust's accumulated (undistributed) income is exposed to aggregate income tax erosion of over 45%.

**Tax Drag** The amount by which investment returns of the non-grantor trust are reduced by these income taxes is often referred to as a *tax drag*. Moving a non-grantor trust to a state which does not impose a state income tax can help to mitigate the *tax drag* while permitting the trust assets to compound much faster, which is often the motivation for a dynasty-type of non-grantor trust (along with avoiding federal estate and generation skipping transfer taxes imposed at each generation.)

**No Income Tax States:** The following states do not impose a tax on a non-grantor trust's income: Alaska, Florida, Nevada, New Hampshire, South Dakota, Tennessee, Texas, and Wyoming. Most of these are well-known 'trust haven' states with laws that are specifically designed to attract 'trust business.'

**Delaware:** Only Delaware, also a well-known 'trust haven' state, imposes a state income tax on a non-grantor trust. Delaware imposes a 6.60% income tax if the trust is created by the Will of a Delaware resident, or the trust settlor was a Delaware resident, or the majority of the trustees are Delaware residents for more than one-half of the year, or in all cases if there is a Delaware resident beneficiary..

**Michigan:** Michigan's tax is imposed on the income of a non-grantor trust if the trust is established by a Michigan's resident's Will, or the settlor was a Michigan resident at the

time the trust became irrevocable. [MCL 206.18.] Michigan's statute provides a technical definition of the word *resident*:

1. *Resident means:*

- *An individual domiciled in the state. 'Domicile' means a place where a person has his true, fixed, and permanent home and principal establishment to which, whenever absent therefrom he intends to return, and domicile continues until another permanent establishment is established. If an individual during the taxable year being a resident becomes a nonresident or vice versa, taxable income shall be determined separately for income in each status. If an individual lives in this state at least 183 days during the tax year or more than ? the days during the taxable year of less than 12 months he shall be deemed a resident individual domiciled in this state.*
  
  - *The estate of a decedent who at his death was domiciled in this state.*
  
  - *Any trust created by will of a decedent who at his death was domiciled in this state and any trust created by, or consisting of property of a person domiciled in this state at the time the trust becomes irrevocable.*
2. *For the purpose of the definition of 'resident', a taxable year shall be deemed to be terminated at the date of death.*
3. *The term 'resident' when referring to a corporation means a corporation organized under the laws of this state.*

**Planning:** Unfortunately, not all states use the same definition for a *resident trust* that is subject to income taxation in that state. Some states impose a state income tax on a non-grantor trust based on the settlor's residence (or the testator) (e.g., Pennsylvania), some on whether there is a resident trustee (e.g., Arizona), some on whether property is located in the state (e.g., Georgia), some on the residence of a beneficiary (e.g., Ohio), some on

whether the trust's administration takes place in the state (e.g., Indiana), or some combination of these various facts (e.g., Alabama.) Consequently, if the goal is to situs (locate) a non-grantor trust in a state to minimize any *tax drag*, a careful examination of each state's rules to impose an income tax on a non-grantor trust must take place.

**Conclusion:** With the One Big Beautiful Bill Act (OB3) creating a \$40,000 state and local tax (SALT) deduction, there may be multiple non-grantor trusts created just to exploit this larger federal income tax deduction, albeit until 2029. If this trend takes place, there may be even more interest in locating these non-grantor trusts in a state that does not impose any fiduciary income tax or decanting an existing non-grantor trust to one of the states that does not impose a fiduciary income tax on trust income.

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