

State Taxation of Trusts-Where Are We Today?

Take-Away: States use different factors to justify imposing income taxes on non-grantor trusts. As these trusts become more complex, it becomes a challenge to assess which states are justified in imposing its tax based on the trust's nexus with the state.

Background: Many non-grantor trusts are created these days which are intended to be multigenerational, where the trust is expected to continue for many generations of trust beneficiaries. Trust beneficiaries will come and go, as will individual trustees, which means that the 'face' of the trust will change over time. Additionally, as time passes, these trusts might be modified or decanted to add new 'players' like trust directors to deal with specific assets held in the trust. And it is possible that a trust might hold businesses that conduct business in many states at the same time. With the possible 'changing face' of a non-grantor trust over time, the perplexing question arises whether the trust has a nexus sufficient to allow multiple states to tax the trust's income.

Historic State Nexus Factors: States use several different factors to establish a trust's nexus with the state sufficient to justify imposing a state's income tax on the trust. Historically those factors have included: (i) the location of assets held in the trust; (ii) the location of the trustee, other 'fiduciaries', and beneficiaries; (iii) the type of assets and beneficiaries' interests in those trust assets; and (iv) the location of the settlor when the trust became irrevocable.

Michigan: Michigan taxes a trust under the Michigan Income Tax Act of 1967. [MCL 206.18(1)(c).] The statute defines a 'resident trust' as one that is created by a Michigan resident or with property from a Michigan resident when the trust becomes irrevocable. Consequently, the residence of the settlor or donor to the irrevocable trust is a key factor to the state's ability to impose a tax on the trust's accumulated income. A trust can be treated as a non-resident trust in Michigan, and therefore not subject to Michigan's income tax, if *all* of the following conditions are met: (i) the trustee is not a Michigan resident; (ii) the trust assets are neither located, nor administered, in Michigan; and (iii) All of the trust beneficiaries reside outside of Michigan.

Evolving Nexus Factors: Moreover, in recent years, with the onset of the *modern* trust where the trust may hold a variety of different assets and at the same time allocate the responsibility for various duties among many individuals, e.g., co-trustees, ‘dual’ trustees, administrative trustees, and trust directors, it has become even more difficult to monitor whether there may be income tax obligations owed by the trust to different, or multiple, states.

U.S. Supreme Court: The Court’s most recent foray into the realm of state taxation of trusts was *North Carolina Department of Revenue v. Kaestner 1992 Family Trust* 588 U.S. 262 (2018). There, the Court focused on the constitutional imposition of a tax on the trust’s income based on due process grounds. The Court held that the presence of in-state trust beneficiaries, that fact standing alone, does not empower the state to tax trust income that has not been distributed to the trust beneficiaries who have no right to demand that income and who are uncertain to receive the income in light of the trustee’s discretion. However, the Court did not address the constitutionality of state statutes that rely solely on the trust beneficiary’s residence to tax trust income.

State Court: Coming within a week of the Supreme Court’s *Kaestner* decision was a decision from the Minnesota Supreme Court, *Fielding v. Commissioner*, 916 N.W.2d 323 (Minnesota, 2018.) In *Fielding*, the Minnesota settlor created four separate trusts for his children. These trusts were initially *grantor* trusts until 2011 when the settlor released his *grantor* powers. These trusts adopted Minnesota as their governing law and one of the beneficiaries was a Minnesota resident. The original trustee lived in California. A successor trustee was appointed in 2012 who lived in Colorado. In 2014 a new trustee was appointed who lived in Texas. Thereafter, S stock held in the non-grantor trusts was sold. Some of the stock was sold midyear, so some Minnesota business income was taxed to the trusts in 2014. The Minnesota Department of Revenue took the position that the trusts were Minnesota resident trusts and thus *all* gain from the sale of the stock was subject to Minnesota’s income tax. The Minnesota Supreme Court ruled in favor of the trusts, emphasizing the location where the decisions were made regarding trust assets and the extent of state ‘services, benefits, and protections’ that were enjoyed by the trusts during the year when the stock was sold and the tax was imposed. A series of factors, including: (i) choice of law; (ii) limited beneficiary connection with the state; (iii) settlor domicile when the trusts became irrevocable; and (iv) business interests in a Minnesota S corporation, were all, taken together, insufficient to create a tax nexus in *Fielding*. After this decision,

Minnesota started to use a Resident Trust Questionnaire to help determine if a trust's minimum connections threshold has been met.

New Factors: Apparently in response to its loss in *Fielding*, the Minnesota Department of Revenue has identified a non-exhaustive list of factors to determine minimum connections to Minnesota for income tax purposes. Such a 'facts and circumstances' analysis is supposed to consider the following factors:

- The residency of trustees, fiduciaries, protectors, directors, advisors, and custodians
- The location of the trust's tangible and intangible assets
- The location of the administration of the trust investments, the distribution of trust assets, record-keeping, preparation of tax forms, and the undertaking of other administrative services and functions
- The laws made applicable to the trust by the governing trust instrument
- The residency of the trust beneficiaries and whether they have some degrees of possession, control, or enjoyment of the trust property, e.g., a 5+5 withdrawal right
- The domicile of the settlor or testator
- Whether and where the trust was probated; and
- Whether state courts have a continuing supervisory or other existing relationship with the trust.

New Concepts? New taxation concepts have appeared in recent years in state court decisions that reflect a state's intent to impose its state income tax on trust income, concepts that sometimes seem to be at odds with the language (or factors) used in the state's enabling income tax laws. One new concept is called the *unitary business principle*. Developed to deal with businesses that conduct business in multiple states, it encourages the determination of state apportionment of business income earned in more than one state by looking at entity unity. Yet another new taxation concept creeping into state business taxation finds a nexus to impose state taxes uses what is called the *investee apportionment* approach, which uses apportionment factors of the entity instead of the investor-taxpayer. How these concepts work their way into determining trust nexus to

justify a state imposing its income tax on trust income where there is little connection with the taxing authority is anyone's guess.

Conclusion: This can be a confusing area of the law, which I suspect will become even more complicated as trusts change their situs and their terms are modified to enhance flexibility, e.g., adding a trust director, who is a fiduciary, in the taxing state. If it is possible to discern a trend from state court decisions, it is that courts are disinclined perpetual trust income tax nexus based solely on the settlor's residency when the trust became irrevocable.

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