
STATE FIDUCIARY INCOME TAX MATTERS

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THE BASICS

I. Fiduciary Income Tax: Bifurcation of Ownership

1. Legal Title → Trustee
2. Equitable Title → Beneficiary



THE BASICS

II. Fiduciary Income Tax:

Contingent vs. Non-Contingent Beneficiaries

1. Contingent Beneficiary → Has no current ownership rights and property is unvested; Beneficiary is not taxed on trust income
2. Non-Contingent Beneficiary → Has vested rights to receive trust property; Beneficiary is taxed on trust income



THE BASICS

VI. Fiduciary Income Tax:

Federal Tax vs. State Tax

1. Subchapter J of the Internal Revenue Code sets forth the rules governing **federal** income taxation of trusts and estates; Tax rates are based on taxable income after making DNI deduction.
2. **State** fiduciary income tax varies depending on a particular state's tax regime.



STATE FIDUCIARY INCOME TAX REGIMES



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RESIDENT VS. NON-RESIDENT TRUST

Determination as to whether a non-grantor trust is a “resident” or “non-resident” trust is very important.

A resident trust may be taxed by a state on ALL of its income.

A non-resident trust may be taxed by a state on its SOURCE income only.



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RESIDENT VS. NON-RESIDENT TRUST (CONT.)

“A state may apportion tax on trust income [of a non-resident trust] based on only that amount of income attributed to such state.”¹ This is known as the “apportionment doctrine.”



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1. “The State of the States: Fiduciary Income Tax Planning in the Wake of Kaestner and Fielding”, ACTEC Great Lakes Regional Meeting (12-14-2018), by David A. Berek, Esq., Jane G. Ditelberg, Esq. and Raj A. Malviya, Esq.

WHAT IS A “RESIDENT TRUST”?

IT DEPENDS!

States define “resident trust” differently.



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STATES HAVE THEIR OWN, UNIQUE DEFINITION OF
“RESIDENT TRUST”

ONE OR MORE OF FIVE
CONTACTS ARE
TYPICALLY USED TO DETERMINE
WHETHER THE TRUST IS A
“RESIDENT TRUST”:



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STATES HAVE THEIR OWN, UNIQUE DEFINITION OF “RESIDENT TRUST” (CONT.)

1. Trust is *created* under the will of a decedent domiciled in the state;
2. Trust is *administered* in the state;
3. *Trustee resides* in or does business in the state;
4. Some or all of the trust assets are *located in* the state; and
5. A trust *beneficiary resides* in the state.

See attached [Exhibit A](#): “Bases of State Income Taxation of Nongrantor Trusts for 2022” prepared by Richard W. Nenno, Esq.



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STATES HAVE THEIR OWN, UNIQUE DEFINITION OF
“RESIDENT TRUST”

Can a trust be a “resident trust” of
more than one state?

YES!



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MISSOURI

RSMo §143.331: A "resident estate or trust" means:

- (1) The estate of a decedent who at his or her death was domiciled in this state;
- (2) A trust that:
 - (a) Was created by will of a decedent who at his or her death was domiciled in this state; and
 - (b) Has at least one income beneficiary who, on the last day of the taxable year, was a resident of this state; or
- (3) A trust that:
 - (a) Was created by, or consisting of property of, a person domiciled in this state on the date the trust or portion of the trust became irrevocable; and
 - (b) Has at least one income beneficiary who, on the last day of the taxable year, was a resident of this state.



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IOWA

Iowa Admin. Code r. §701-700.3

(1) Testamentary trusts. The situs of a testamentary trust for tax purposes is the state of the decedent's residence at the time of death until the jurisdiction of the court in which the trust proceedings are pending is terminated. In the event of termination and the trust remains open, the situs of the trust is governed by the same rules as pertain to the situs of inter vivos trusts.

IOWA (CONT.)

Iowa Admin. Code r. §701-700.3

“(2)Inter vivos trusts. If an inter vivos trust is created by order of court or makes an accounting to the court, its situs is the state where the court having jurisdiction is located until the jurisdiction is terminated. The situs of an inter vivos trust which is subject to the grantor trust rules under 26 U.S.C. Sections 671 to 679 is the state of the grantor's residence, or the state of residence of the person other than the grantor deemed the owner, to the extent the income of the trust is governed by the grantor trust rules. If an inter vivos trust (other than a trust subject to the grantor trust rules in 26 U.S.C. Sections 671 to 679) is not required to make an accounting to and is not subject to the control of a court, its situs ***depends on the relevant facts of each case***. The relevant facts include, but are not limited to: the residence of the trustees or a majority of them; the location of the principal office where the trust is administered; and 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 26 U.S.C. 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. The residence of the beneficiaries of a trust is also not relevant in determining situs.”

[EMPHASIS ADDED]

IOWA (CONT.)

2023 Iowa Fiduciary Instructions, page 4 (10/31/2023):

“If the trust is a grantor trust, indicate the grantor’s or owner’s residence. If the trust, other than a grantor trust, is not required to make an accounting to and is not subject to control of a court, its situs depends on the relevant facts of the case including:

- The residence of the trustees
- The location of the principal office where the trust is administered
- The location of the evidence of intangible assets of the trust.”

KANSAS

Kansas Stat. Annotated §79-32, 109(d): "Resident trust" means a trust that:

- (1) Is administered in this state;
- (2) was created by or consists of property owned by a person domiciled in this state on the date the trust or portion of the trust became irrevocable; and
- (3) has at least one income beneficiary who, on the last day of the taxable year, was a resident of this state."



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ARKANSAS

Ark. Code Ann. § 26-51-201(b)

“However, no state income tax shall be due this state from a trust or estate created by a nonresident donor, trustor, or settlor, or by a nonresident testator even though administered by a resident trustee or personal representative except on income derived from:

- (1) Lands situated in this state, including gains from any sale thereof;
- (2) Any interest in lands situated in this state, including, without limitation, chattels real, including gains from any sale thereof;
- (3) Tangible personal property located in Arkansas, including gains from any sale thereof; and
- (4) Unincorporated businesses domiciled in Arkansas.”



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NEBRASKA

Neb. Rev. Stat. §77-2714.01(6): “Resident estate or trust shall mean (a) the estate of a decedent who at his or her death was domiciled in this state, (b) a trust or portion of a trust consisting of property transferred by the will of a decedent who at his or her death was domiciled in this state, or (c) a trust or portion of a trust consisting of the property of an individual domiciled in this state at the time such individual may no longer exercise the power to revest title to such property in himself or herself.”



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HYPOTHETICAL #1: “HOMEBODIES”

SITUATION: Mom and Dad lived in Springfield, Missouri. and they died residents of Springfield. They had 3 children who all left the “nest”, but loved Mom’s home-cooking, so they didn’t go far. One child moved to St. Louis, one to Kansas City, MO and one stayed in Springfield. All three children were especially busy taking care of their kids and working. The trust owned all Missouri situated property with the exception of the cattle farm outside of Hot Springs, Ark.

To take any burden off the children, Mom and Dad created a joint revocable trust and named an Arkansas Trust Company to serve as Trustee. Upon the death of the survivor of Mom and Dad, the trust became irrevocable. Separate trusts were created for each child.

QUESTION: In which states are each of the children’s trusts considered to be a “resident” trust?

ANALYSIS: All three trusts are “resident” trusts under Missouri law because the Settlers were from Missouri and the bene’s live in Missouri. With respect to the income derived from the cattle farm only, the trusts are also “resident” trusts of Arkansas.

HYPOTHETICAL #2: “LEFT THE NEST”

SITUATION: Same facts as Hypothetical #1, EXCEPT Mom’s cooking was terrible, so the three children moved far, far away. One child moved to Garden City, KS, one to Omaha, NE and one to Wichita, KS. The trust owned all Missouri-sitused property with the exception a producing oil well in Kansas.

This time, Mom and Dad named a Nebraska Trustee.

QUESTION: In which states are each of the children’s trusts considered to be “resident” trusts?

ANALYSIS: None of the trusts are considered “resident” trusts under Missouri law because no beneficiary resides in Missouri. Because the settlors were Missouri residents, the trusts are not “resident” trusts under Nebraska law. Finally, because the trusts are not administered in the state of Kansas, they are not “resident” trusts under Kansas law either. These trusts are not “resident” trusts of any state!

HYPOTHETICAL #3: “SPRINKLE & SPRAY PROBLEMS”

SITUATION: Nebraska residents, Aunt and Uncle, created a joint revocable trust. Upon the survivor’s death, the trust became irrevocable and continued as a “sprinkle/spray” trust for the benefit of their nieces. One lived in Missouri, and the other lived in Iowa.

Aunt and Uncle named 3 Co-Trustees – one with a principal office in Kansas, and two Trustees from Iowa.

QUESTION: In which states is this trust considered to be a “resident” trust?

ANALYSIS: The trust is a “resident” trust of Nebraska because the Settlers were domiciled there. The trust is not a Missouri “resident” trust because even though a beneficiary lives in Missouri, the Settlers were not domiciliaries of Missouri. Since there is no KS beneficiary or Settlor, the trust would not be considered a “resident” trust of Kansas. Finally, because a majority of the Co-Trustees are in Iowa (but not because of the Iowa bene), the trust would likely be a “resident” trust of Iowa per the “facts and circumstances” test (especially if assets are located there). So, this trust is likely a resident trust of 2 states: Nebraska and Iowa.

CONSTITUTIONAL LAW

QUESTION:

Is a state's income tax on a trust's
income constitutional?



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CONSTITUTIONAL LAW

ANSWER:

Yes, if it does not violate the Due Process Clause or the Commerce Clause



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CONSTITUTIONAL LAW

Due Process Clause

Specifically, it's a procedural due process analysis – enforcing an unfair state levy would deny an individual's right to “life, liberty or property.”²

“In a taxation context, the Due Process Clause limits states to imposing taxes which ‘bear[] fiscal relation[s] to protection, opportunities and benefits given by the state.’”³



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2. Virginia Law & Business Review 15:237 at 244 (2021).
 3. See *id.*, citing *Wisconsin v. J.C. Penney Co.*, 311 U.S. 435, 444 (1940).

DUE PROCESS (“MINIMUM CONTACTS”)

In re Swift, 727 SW2d 880 (Mo. 1987)

“Six points of contact” in determining whether a state had sufficient nexus to support the imposition of an income tax on trust income as follows:

1. The domicile of the settlor,
2. The state in which the trust is created,
3. The location of the trust property,
4. The domicile of the beneficiaries,
5. The domicile of the trustees, and
6. The location of the administration of the trust.

DUE PROCESS (“MINIMUM CONTACTS”)

“[f]or purposes of supporting an income tax, the first two of these factors require the ongoing protection or benefits of state law only to the extent that one or more of the other four factors is present.” *In re Swift*, 727 SW2d 880, 892 (Mo. 1987)

“Missouri was connected to the trust in *Swift* only by the settlor's domicile, point (1), and the situs of the trust's creation, point (2). Because of those limitations this Court properly determined Missouri lacked sufficient connection with the trust to impose Missouri income tax.” *Westfall v. Director of Revenue*, 812 S.W.2d 513, 514 (Mo. 1991)

CONSTITUTIONAL LAW

“dormant” Commerce Clause

“...since Congress has power over interstate commerce, states cannot discriminate against or unduly burden interstate commerce, even in the absence of federal legislation regulating the activity.”⁴



STATE TAXING POWER

The Supreme Court has ruled that no State may “impose a tax which discriminates against interstate commerce either by providing a direct commercial advantage to local business, or by subjecting interstate commerce to the burden of ‘multiple taxation.’” *Northwestern States Portland Cement Co. v. Minnesota*, 358 US 450, 458 (1959).

CONSTITUTIONAL LAW

“dormant” Commerce Clause (cont.)

The “Substantial nexus” test set forth in *Complete Auto Transit, Inc. v. Brady*, 430 US 274, 277 (1977) provides that:

“A tax does not violate the Commerce Clause if it:

1. Is applied to an interstate activity having a substantial nexus with the taxing state;
2. Is fairly apportioned,
3. Does not discriminate against interstate commerce, and
4. Is fairly related to the services provided by the state.”⁵



CONSTITUTIONAL LAW: NOTABLE CASES

- *Linn v. Department of Revenue* (2NE3d 1203 (Ill. App. Ct. 2013))
 - Trust with no connection to Illinois other than grantor being a resident when trust was created.
 - Holding – unconstitutional
- *Quill Corp. v. North Dakota* (504 US 298, 305 (1992))
 - “taxing power exerted by the state must bear some ‘fiscal relation to protection, opportunities and benefits given by the state.’”⁶
- *Kaestner v. N.C. Dept. of Revenue* (814 S.E.2d 43 (N.C. 2018))

⁶. See fn 1 at page 24.

CONSTITUTIONAL LAW: NOTABLE CASES

(cont.)

- **Kaestner (cont.)**
 - Holding – the North Carolina statute violated the Due Process Clause
 - “Given the trust and its beneficiaries having legally separate taxable existences, the taxed entity’s (trust) minimum contacts within the taxing state cannot be established by a third party’s (discretionary beneficiary) minimum contacts with the taxing state.”⁷
 - “it is the trust’s contacts within North Carolina – not the beneficiaries who reside there – that must suffice to establish minimum contacts.”⁸

7. See fn 1 at page 32.

8. See fn 1 at page 33.

PLANNING TO MINIMIZE STATE TRUST INCOME TAXATION

1. Replacing Trustees (but only 4 states base tax on this alone)
2. Administer in a different state (but only 7 states base tax on this alone).
3. Include flexibility in trust agreement to change situs or trustee and include choice of law clause.
4. Avoid creating a testamentary trust in states that impose fiduciary tax based on testator's residence at death alone.



PLANNING TO MINIMIZE STATE TRUST INCOME TAXATION (CONT.)

5. For resident-beneficiary standard state, based on *Kaestner*, avoid tax undistributed trust income “by drafting trust agreements so that all beneficiaries’ interests are contingent.”⁹



PLANNING TO MINIMIZE STATE TRUST INCOME TAXATION
(CONT.)

ING TRUST

“INCOMPLETE NONGRANTOR TRUST”



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PLANNING TO MINIMIZE STATE TRUST INCOME TAXATION (CONT.)

- Type of domestic asset protection trust (DAPT)
- Transfers to ING's are incomplete gifts (e.g., settlor retains a test. POA)
- Purpose – to eliminate income tax on undistributed trust income (contrast with a grantor trust)
- NOTE – not available for Arkansas taxpayers (In the Matter of ***, Ark. Dep't of Fin. & Admin., Office of Hearings & Appeals Opinion No. 20-755 (Aug. 7, 2020))



PLANNING TO MINIMIZE STATE TRUST INCOME TAXATION (CONT.)

- No more issued PLR's on ING Trusts (Rev. Proc. 2021-3; Jan. 4, 2021)
- Only works in:
 - DAPT states; and
 - States in which resident trust status is based on having an in-state Trustee or trust administration (& avoid nexus to settlor's resident state)



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