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State Taxation of Trusts and Their Beneficiaries When There Are Multiple State Contacts[1]

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This article examines the state income taxation of testamentary trusts and individual trust beneficiaries when there are multiple state contacts. For matters of illustration, the focus is on states comprising the Northwest Idaho, Wyoming, Montana, Washington, Oregon, Nevada, and Utah. Since three of these states have no individual income tax, the essence of the inquiry is limited to the state income tax systems of Idaho, Utah, Montana, and Oregon. Although the focus is on states in the Northwest, the concept applies nationwide. Before moving on to an examination of the state taxation topic, a review of the basic federal system of taxing trust income may be beneficial.

Federal Taxation of Trust Income

Federal income tax laws classify trusts as simple or complex. A simple trust is a trust that (1) distributes, or is required to distribute, currently all income to its beneficiaries; (2) is not a charitable trust; and (3) does not distribute to beneficiaries amounts allocated to corpus.[2] A complex trust is any trust that is not a simple trust.[3] Complex trusts include trusts that have the discretion to accumulate income for future distributions. For purposes of simplicity, this discussion is limited to the income taxation of simple trusts.

Federal taxation of simple trusts starts with the various individual items of taxable income, including interest, dividends, rent, and capital gains.[4] Deductions are allowed for taxes, interest paid, charitable contributions, administrative expenses, and the costs of producing the taxable income that yields the taxable income of the trust.[5] A further and very important deduction is allowed for distributable net income

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1 This is an update of the following article: Gantt, Gamewell & John McGown Jr., *State Taxation of Trusts and Their Beneficiaries When There Are Multiple State Contacts*, 20 J. ST. TAX'N 1 (2001).

2 I.R.C. § 651.

3 I.R.C. § 661.

4 *See*, *e.g.,* I.R.C. §§ 641, 661.

5 *See*, *e.g.,* I.R.C. §§ 162, 167(d)-67(e), 642.

(DNI).[6] DNI is income that is distributable to, paid to, or credited to the accounts of the trust beneficiaries. Simply put, the purpose of the DNI deduction is to prevent the double taxation of trust income. In any given year income is taxed at the trust level, at the beneficiary level, or partly at each level, but not fully taxed at both levels. In that sense, one might say that there is some fairness to the federal system of taxing trust income in that the system is designed to avoid double taxation. On the other hand, the federal income tax rates that apply to trusts are steeply progressive. Ordinary trust income over $12,150 is taxed at 39.6 percent.[7] In most cases, long-term capital gains are taxed at no more than 20 percent.[8]

A simple trust is often designed to pay out all of its trust accounting income (commonly ordinary income), after allowable expenses, annually to its current income beneficiaries, and to retain within the trust all of its capital gains. The net result of this design is that current income beneficiaries pay ordinary federal income tax at whatever their individual marginal federal income tax rates may be on the ordinary income of the trust, and the trust pays the lower 20 percent maximum capital gains tax on the net long-term capital gains retained within the trust. Short-term capital gains within the trust are frequently avoided to minimize the higher ordinary income tax rates that would otherwise apply to them.

Overview of Idaho's Personal Income Tax Structure

Because the author is most familiar with the Idaho income tax system, it is used as an illustration of a state income tax structure. Idaho's individual and trust income tax, like that of most states with an individual and trust income tax, is patterned after the federal income tax statutes. Idaho starts with federal adjusted gross income and then makes a few additions and subtractions to reach Idaho taxable income.[9] That amount, to the extent it exceeds $10,568, is taxed at a flat 7.4 percent rate.[10] Taxable income from $1 to $10,568 is taxed at progressive rates that rise steeply from 1.6 percent to 7.1 percent.[11]

Unlike some states, Idaho offers limited preferential tax treatment for certain types of long-term capital gains on "qualifying assets" used

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6 I.R.C. § 643.

7 I.R.C. § 1.

8 I.R.C. § 1(h).

9 Idaho Code Ann. § 63-3022 (2014).

10 *Idaho Fiduciary Income Tax Instructions for Form 66* at 10, (2013) *available at* http://tax.idaho.gov/forms/EIN00044_08-22-2013.pdf (last visited Sept. 15, 2014); Idaho Code Ann. § 63-3024.

11 Idaho Code Ann. § 63-3024.

within the state in activities such as timber, mining, farming, ranching, processing, and manufacturing.[12] Unfortunately for most investors, trusts, and trust beneficiaries, the preferential capital gains tax treatment that applies to farmers, ranchers, loggers, and miners does not apply to gains on the stocks and bonds found in most investment portfolios. One may generalize that for most Idaho resident individuals and trusts, all taxable income over the lowest amounts, whether from ordinary income or capital gains, will be taxed at a flat rate of 7.4 percent.

Individuals from the surrounding tax-free states are aware that they do not pay state income taxes to states in which they do not reside and from which they have no income. They are expected, however, to pay income taxes on out-of-state income that they earn or receive from sources within the states imposing an income tax.

Taxpayers in states with a state income tax are no doubt aware that they pay state income taxes on all of their income to their home states, and that, like residents of the tax-free states, if they have income from another state imposing income tax, they must pay a nonresident income tax to the second state. The second tax, however, is often offset by a credit, generally the lesser of the tax imposed by the second state or the taxes imposed by the resident state on the same income, for taxes paid to other states on the taxpayers' home state income tax returns. One might assume that the same generalizations would apply to trusts and trust beneficiaries, but in the Northwest states the assumption is not entirely correct.

State Income Taxation of Trust Beneficiaries

If the trust beneficiary is a resident of one of the four Northwest states that impose a state income tax on individuals and trusts, the beneficiary pays a tax to his or her home state on his or her share of the trust's DNI. Up to this point there is no problem, and the taxation of trust income to the beneficiary initially appears little different from the state taxation of income such as dividends and interest received directly from other sources. Difficulties may exist, however, in the four states considered in this article, and those difficulties may lead to the specter of double state taxation of trust income.

The general scheme of state income taxation in the United States is for states imposing an income tax to do so on *all* the income of their resident taxpayers and on all the *in-state* source income of their nonresident taxpayers. For example, an Idaho resident who had rents from a seaside cabin in Oregon and timber income from land in Montana

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12 Idaho Code Ann. § 63-3022H.

would pay state income tax to Idaho on all of his or her income, including the income from the Oregon cabin and the Montana timber. The Idaho resident would also pay nonresident income taxes to Oregon and to Montana on his or her income from sources within those states. To mitigate the unfortunate effects of double state taxation, Idaho would allow this hypothetical taxpayer a credit for all or part of the state income taxes required to be paid to the other two states.

The credit for taxes required to be paid to other states is generally available for taxes paid to other states on income derived from within the other states. Hence, the source of income is of crucial importance with regard to the taxability of a nonresident's income in a foreign state. The source of income is also critical with regard to the availability of an offsetting credit for the taxes paid to the foreign state on the taxpayer's home state income tax return. The issue of offsetting credits is moot, of course, for taxpayers residing in tax-free states—they are simply expected to, and some of them actually do, pay the foreign state's tax on their income from sources within the foreign state.

Double taxation of individual income at the state level is generally avoided by a definition of resident taxpayer that is often linked to domicile. It is rare, but not impossible, for an individual to be a taxable resident of more than one state at the same time in a single tax year when the definition of resident taxpayer is based on the number of days present within a state and the taxpayer who travels frequently exceeds the minimum days presence test in one state and simultaneously satisfies the domicile test of a second state. Double state taxation of the same income (typically where the taxpayer maintains a "vacation" home) without the mitigating effects of a credit for taxes paid to other states can also occur if two or more states define the same income as in-state source income at the same time. Under certain circumstances, lack of congruity among the states has the potential to produce this obviously undesirable outcome.

This incongruity can lead to a problem with no remedy. Assume that Alice Attorney is domiciled in Montana[13] but spends 275 days (including partial days) at her Idaho vacation home during 2012.[14] She is taxed on all her income by both states. The availability of the credit for taxes paid to other states under such circumstances is confusing at best because of restrictions that limit the credit for taxes paid to other states to taxes that are attributable to out-of-state source income from the point of view of the home state.[15] The state courts would likely uphold

13 MONT. CODE. ANN. § 15-30-2101 (2013), which defines resident to include "any person domiciled in the state of Montana. . .."

14 IDAHO CODE ANN. § 63-3013.

15 IDAHO CODE ANN. § 63-3029, MONT CODE ANN. § 15-30-2302.

each state's taxing scheme and provide no remedy for Alice. In fact, her only remedy (other than a constitutional attack) might be to request each state to use the alternate dispute resolution program offered by the Multistate Tax Commission—a strictly voluntary process.[16]

State Income Taxation of the Resident Trust

When it comes to the state taxation of trust income, the four non-tax-free states in the Northwest define a resident trust in such a way that potential double taxation of trust income appears a very real possibility. Current definitions of resident trust in the four Northwest states that impose income tax are as follows:[17]

Idaho

A trust is treated as a resident trust if three or more of the following conditions exist:

a. The domicile or residency of the grantor is in Idaho;

b. The trust is governed by Idaho law;

c. Trust property is located in Idaho; [All, any, a majority?]

d. The domicile or residency of a trustee is in Idaho; [Current Idaho State Tax Commission Rules say *a* trustee; return instructions say *the* trustee. Idaho Code Section 63-3015, effective July 1, 2014, says *the* trustee. The question of co-trustees is not addressed. If *a* is correct, the domicile or residence of any co-trustee in Idaho will tilt this factor in favor of taxation.]

e. The administration of the trust takes place in Idaho. Administration of the trust includes conducting trust business, investing assets of the trust, making administrative decisions, record-keeping and preparation and filing of tax returns. [It is unclear whether it takes a majority or only one of the listed acts of administration or perhaps even a single action not listed to tilt this factor in favor of taxation.][18]

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[16] Multistate Tax Comm'n ("MTC"), *The Alternative Dispute Resolution Program*, www.mtc.gov/Resources.aspx?id=278 (Resources and Public Services Section) (last visited Sept. 15, 2014).

[17] Comments in brackets have been added by the author.

[18] *Idaho Fiduciary Income Tax Instructions for Form 66* at 1-2, (2013) *available at* http://tax.idaho.gov/forms/EIN00044_08-22-2013.pdf (last visited Sept. 15, 2014); Idaho Code Ann. § 63-3015 (2014).

Utah

"Resident estate" or "resident trust" means:

a. an estate of a decedent who, at the time of his death, was domiciled in Utah;

b. a trust, or a portion of a trust, consisting of property transferred by will of a decedent who at his death was domiciled in Utah; or

c. a trust administered in Utah.

d. A trust shall be considered to be administered in Utah if:

(i) the place where the fiduciary transacts a major portion of its administration of the trust is in Utah; or

(ii) the fiduciary's usual place of business is in Utah.[19]

Oregon

Residency definitions:

A trust is a resident trust if a trustee is an Oregon resident or if the trust administration is in Oregon. If there are several trustees and one of them is an Oregon resident, the trust is an Oregon resident trust. A trust can be a part-year resident if a trustee moves in or out of Oregon during the tax year.

If the trustee is a corporate fiduciary engaged in interstate trust administration, the trust is an Oregon resident only if the trustee conducts the major part of the trust's administration in Oregon.[20]

Montana

No distinction is made between living trusts and testamentary trusts. [This is also true in Idaho and Oregon.]

A trust is a resident trust if the principal place of administration is in Montana.

Generally speaking, the 'principal place of administration' of a trust is the usual place where its day-to-day activities are carried on

[19] *Utah Fiduciary Income Tax TC-41 Forms & Instructions* at 3 (2013) *available at* http://tax.utah.gov/forms/current/tc-41inst.pdf (last visited Sept. 15, 2014).

[20] *Oregon Fiduciary Income Tax Form 41* at 2 (2013) *available at* http://www.oregon.gov/dor/BUS/docs/form-41-fiduciary-income_101-041_2013.pdf (last visited Sept. 15, 2014).

by the trustee or person who is primarily responsible for the administration of the trust. If the principal place of administration of the trust cannot be identified under that standard, and assuming that the trust agreement does not identify a different location, then it is determined as follows:

(i) if the trust has a single trustee, the principal place of administration of the trust is the trustee's residence or usual place of business; or

(ii) if the trust has more than one trustee, the principal place of administration of the trust is the residence or usual place of business of any of the cotrustees as agreed upon by them. If not agreed upon by the cotrustees, the principal place of administration of the trust is the residence or usual place of business of any of the cotrustees.[21]

Example

Mel and Maribell are residents of Utah and domiciled in Utah. They are married and have three children. Mel is a prosperous executive who has accumulated a substantial estate. He has two brothers and one sister. The older brother lives in Montana, and the younger brother lives in Idaho. The sister lives in Oregon. The older brother tends to take charge.

Mel dies. His will leaves half of his estate in trust for Maribell for the rest of her life and the remainder directly to their three children. Mel's three siblings are co-trustees of his testamentary trust. The trust is funded with cash from Mel's life insurance, with stocks and bonds Mel accumulated during his years as a highly paid corporate employee, and with promissory notes he acquired from an Idaho resident. The trustees write off the promissory notes as uncollectable, they make a decision to continue to hold the stocks Mel owned at his death, they reinvest the proceeds of the bonds as they come due, and they use the life insurance proceeds to buy several mutual funds. All the transactions take place with an online broker over the Internet, and the three co-trustees all participate regularly in the investment decisions by telephone conference calls, e-mail, and letters sent to each other by regular mail. A checking account is maintained for the trust with an online Internet bank. Check-writing duties are delegated to the brother in Idaho, but at least two of the three trustees must sign all checks. No bank or broker-

21 *Montana Form FID-3 Instructions* at 15 (2013) *available at* http://www.revenue.mt.gov/Portals/9/tax_professionals/software_vendors/FID-3_Instructions.pdf (last visited Sept. 15, 2014).

age statements are mailed to the trustees. Copies of the trust's account records and bank balances are available on the Internet. The online brokerage firm has its home office in Atlanta; the Internet bank exists only in cyberspace. Federal income tax returns for the trust are prepared by a CPA in Oregon, who is hired by the sister who lives there.

Where should state income tax returns be filed and what income should be reported to what states by the trust? Where should the beneficiaries file state income tax returns and what income should they report on those returns? What credits, if any, are available for income taxes paid to other states?

Analysis

The trust is a resident trust in Utah because Mel was a Utah resident domiciled in Utah at the time of his death and because the assets passed to the trust under his will.

The trust is a resident trust in Idaho because three parts of the five-part Idaho test appear to be satisfied: *a*, and arguably *the*, trustee is a resident of Idaho, one or more acts of administration appear to have been committed in Idaho, and there are "assets in Idaho" because it is arguable that assets of the trust are in Idaho. The assets are intangibles; therefore, their domicile is deemed to follow the domicile (residence) of the co-trustee in Idaho.

The trust is a resident trust in Oregon because one of the co-trustees is an Oregon resident.

The trust is a resident trust in Montana because a trustee is domiciled in Montana (if in Montana *the* also means *a*), and because the take charge brother is primarily responsible for the administration in Montana.

If the above analysis is correct, the trust must file state income tax returns in all four states, and if capital gains are added to corpus, the trust must pay state income taxes on the income retained in the trust in all four states. The trust must also pay state income taxes in Idaho on the income distributed to Maribell, the income beneficiary, unless she files an individual income tax return in Idaho and pays an Idaho income tax on her share (in this case, 100 percent) of the trust DNI.[22] This is true even though Maribell is a resident of Utah and even though she is also expected to pay Utah (and Oregon and Montana) income taxes on the same trust income. How can this be?

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22 IDAHO CODE ANN. § 63-3022L (2014).

Problem

If Mel's trust is indeed a resident trust in each of the four states, it will be subject to tax in each state at very significant marginal rates of 7.4 percent in Idaho,[23] 5.0 to 6.3 percent in Utah,[24] 9.9 percent in Oregon,[25] and up to 6.9 percent in Montana.[26] Moreover, although a deduction for state income taxes paid will be available on the trust's federal income tax return, and although a deduction for at least some of the state income taxes may be available on some of the state returns, the dollar for dollar credit for state income taxes paid to other states is unlikely to be available. The net result is multiple taxation of the trust income. The problem is compounded because the favorable income tax treatment for capital gain will not apply at the state level in the four states in which the trust income is taxable. Each of the four states defines *income from a resident trust* as in-state source income for the state in question. That definition combined with restrictions that limit the credit for taxes paid to other states to taxes that are attributable to out-of-state source income from the point of view of the home state, effectively negates the availability of the credit, as unfair as that may seem.

TAXATION OF DNI AT THE STATE LEVEL

Recall that at the federal level, a simple trust is entitled to a DNI deduction for income that is distributed to or credited to the beneficiaries. The beneficiaries then report their shares of the DNI on their personal returns and pay income tax on their respective shares of the DNI at their individual marginal income tax rates. The net result is that a simple trust that distributes all ordinary income to its beneficiaries pays federal income tax on only the capital gains, if any, retained within the trust. The four states surveyed for this article generally follow that format.

There is an important practical issue faced by state taxing authorities. By following federal law,[27] a simple trust is allowed a DNI deduction for income distributed or credited to the beneficiaries. For federal income tax purposes, such beneficiaries are required to file a federal income tax return reporting their share of the DNI that was deducted by the trust.[28] However, for state income tax purposes, the beneficiary may

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23 *Idaho Instructions for Form 66* at 10; IDAHO CODE ANN. § 63-3024.

24 *Utah Fiduciary Income Tax TC-41 Forms & Instructions* at 6-7 (2013) *available at* http://tax.utah.gov/forms/current/tc-41inst.pdf (last visited Sept. 15, 2014).

25 *Oregon Fiduciary Income Tax Form 41* at 2.

26 *Montana Form FID-3 Instructions* at 13 (2013); MONT CODE ANN. § 15-30-2153 (2013).

27 I.R.C. §§ 643, 651.

28 This assumes the filing requirements are met. *See* I.R.C. §1.

reside outside the state taxing the trust. Put another way, the state may be allowing a DNI deduction to the trust but be unable to tax the person(s) who received the DNI.

Idaho's trust income tax return is Form 66. For resident trusts, the starting point is federal adjusted total income, which is before the DNI deduction, which deduction is generally allowed for Idaho purposes. For nonresident trusts, the starting point is federal total income before any deductions. Then there are various Idaho adjustments to arrive at Idaho taxable income, including the DNI deduction. Idaho has struggled in recent years to find a solution to the perceived problem of nonfiling nonresident beneficiaries. The current "solution" is to require income tax withholding at the highest marginal rate (i.e., 7.4 percent) on the individual's share of income from the trust required to be included in the individual's Idaho taxable income.[29] This is impractical for several reasons. First, there may be no distributions from which to withhold. Second, the trust is unlikely to know the beneficiary's Idaho taxable income from the trust at the time of distribution. In lieu of back-up withholding, Idaho Code Section 63-3022L allows a trust to file a composite return, with the trust reporting the Idaho taxable income of the beneficiaries and paying the related Idaho tax at the rate applicable to Idaho corporations (i.e., 7.4 percent).[30] If the trust fails to withhold or to file a composite return, then the trust is liable for Idaho tax on the nonresident beneficiaries' Idaho taxable income at the highest corporate rate of 7.4 percent.[31] Interestingly, there is no provision for an offset for any Idaho tax paid by the nonresident beneficiaries (although the beneficiaries should realize that they receive credit for the tax paid by the trust on their behalf and therefore not overpay).

Utah's trust income tax return, Form TC-41, starts with federal taxable trust income. The return then allows the DNI deduction for amounts distributable to beneficiaries.

Oregon modifies the computation of taxable trust net income in several respects, but it does not appear to make a distinction between income distributions to residents and nonresidents for purposes of the DNI deduction (Oregon Form 41).

Montana also allows a full deduction (subject to certain modifications largely related to tax-exempt interest) for all income distributed to or to be distributed to simple trust beneficiaries (Montana Form FID 3). No distinction is made in Montana between resident and nonresident beneficiaries.

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29 IDAHO CODE ANN. § 63-3036B (2014).

30 IDAHO CODE ANN. § 63-3025.

31 IDAHO CODE ANN. § 63-3022L.

Utah, Oregon and Montana expect nonresident trust beneficiaries to report their share of the trust income as nonresident taxpayers, but none of the three states penalize the trust at the DNI deduction level if the beneficiaries fail to honor their individual income tax obligations. This contrasts with Idaho, where the income tax responsibility for nonresident beneficiaries lies with the trustee.

A Possible Solution for Nonresident Beneficiaries

As shown above, the incongruities that exist among the four states surveyed may lead to double taxation of trusts and trust beneficiaries within those states. The problem occurs when a single trust is classified as a resident trust and taxed on all of its income in more than one state at the same time. The problem is compounded when offsetting credits for taxes paid to the other states are not allowed. The obvious solution would be an interstate compact and a modification of state laws to limit a given trust to resident taxpayer status in no more than a single state in a single tax year. Logically, the trust so classified should be expected to pay a state income tax, after an allowable DNI deduction for distributions to beneficiaries, on its retained trust income. In the opinion of the author, trust beneficiaries should be required to include on only the tax returns of their home states trust income from intangible passive investments such as stocks and bonds, mutual funds, bank deposits, certificates of deposit, and similar items that do not represent income from an active activity actually carried on by the trust within one of the other states. It stretches the doctrine of fairness to classify such passive income as in-state source income from states other than the state of the beneficiary's residence merely because one of several co-trustees may be a resident of a foreign state that also wants to capture a tax on income that in reality has little or no nexus to the foreign state.[32]

Since there are few reported cases on this subject in the states in question, it is unlikely that the questions raised in this article will be fully resolved by new legislation in the near future. Meanwhile, individuals wanting to avoid the problem should limit their choices of trustees and co-trustees to residents of their home states and to individuals who are unlikely to change their residence. Among the individuals to be avoided are those now residing in tax-free states who may someday move to one of the states imposing a state income tax (which are far greater in number than the tax-free states). In some of the states sur-

[32] For a recent decision on the nexus issue, *see* Robert L. McNeil, Jr. Trust *ex rel.* v. Pennsylvania, 67 A.3d 185 (Pa. Commw. Ct. 2013). Memorandum from Richard W. Nenno & BNA Tax Mgmt. on State Income Taxation of Trs. (June 3, 2013) *available at* https://www.wilmingtontrust.com/repositories/wtc_sitecontent/PDF/State_Income_Tax_Trustees.pdf (last visited Sept. 15, 2014).

veyed, a change of residence by the grantor to a nontax state before death is also a factor, but surprisingly less so than one might expect. That strategy is a factor to be considered in Idaho and Utah, but it appears to be irrelevant in Oregon and Montana. The use of inter vivos trusts in lieu of testamentary trusts is also only a partial factor, and possibly only so in Utah. As trusts continue to have valid uses, even as the need to employ them for federal estate tax savings devices declines because of increases in the estate tax exemption amounts, grantors may want to pay greater attention to income tax consequences at both the state and federal levels.