The Importance of Choosing a Home for Your Trust

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For income tax purposes, trusts are often called "conduit entities." In other words, a trust which makes distributions to its beneficiaries will generally not be required to pay income taxes on the income earned by the trust. Rather the income will be taxed to the beneficiary if the income is distributed. The income retained by the trust will be subject to tax at the trust level. Various states may lay claim to a right to tax a particular trust's accumulated income, however. This creates a situation in which multiple states will seek to tax the same income.

By way of background, state income taxes affect a trust differently depending upon whether the trust is a "resident trust" or a "nonresident trust." *A resident trust is taxed by the state of residency on all of its income while a nonresident trust is only taxed on income sourced to that state*. Investment income is taxable to the trust only in its state of residency. In determining whether a trust is a resident or nonresident, states look to a variety of factors, including: the residence of the settlor or decedent; the residence of the trustee; where the beneficiaries reside; where the trust is administered; or a combination of these factors.

States do not apply the above factors uniformly which may result in a trust being "claimed" as a resident by more than one state. Many states have provisions which provide a credit to a resident trust for the tax it pays to another state on income derived in that state. Since investment income is to be taxed only where the trust is resident, a state claiming residency over a trust will not provide a credit for taxes paid to other states on investment income.

If multiple states classify a trust as a resident, the trust will effectively pay income taxes in multiple states on the very same earnings. Until a legislative resolution of this conflict is undertaken, trustees, beneficiaries and their advisers should be aware of this issue. For trust arrangements with multiple state contacts (such as settlors, trustees, and beneficiaries), regular review of the tax laws of the various jurisdictions in which the parties reside and the investment and distribution strategies of each trust may help to minimize this risk.

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