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State Income Taxes and Fiduciary Income Tax Returns

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Determining for a specific combination of a trust (or estate) and a state whether the trust or estate is a resident or nonresident for income tax filing purposes is not nearly as simple as many practitioners assume. Arizona has unique rules for determining when a trust is a resident trust, and merely having one fiduciary move into the state has an impact on that issue.

As well, other states have various rules that independently determine if a trust or estate is a resident for that state. In this presentation, we'll look at two states that have very different rules than Arizona for this purpose—California and Michigan—as well as very different rules from each other.

Arizona Rules. Arizona law treats estates and trusts under separate rules. An important issue to note is that the fact that an estate or trust was drafted under Arizona law or indicates that it is to be interpreted under Arizona law has nothing to whether the estate or trust is or isn't an Arizona resident for income tax purposes.

The key impact of an estate or trust being a resident of Arizona is that all income of that estate or trust that is *taxable to the estate or trust* will have an Arizona income tax imposed. As well, a resident trust generally will be required to file a state return if it has sufficient gross income. What it does *not* govern is the taxation of amounts distributed to the beneficiaries and allowed as an income distribution deduction. That means even if a trust or estate is an Arizona resident, amounts distributed to the beneficiaries that are not Arizona source income will only be subject to Arizona income tax if the *beneficiary* is an Arizona resident.

Estates are treated as a resident for Arizona based upon the residency of the decedent at the date of death (ARS §43-1301(4)). In fact, this is the test that most states impose for an estate—so, generally, an estate is going to be a resident of a state only if the decedent was treated as a resident of that state for income tax purposes at his/her date of death.

Trust are more complicated beasts, and states do not follow anything resembling a standard test for residency. Arizona's test has the advantage of being relatively simple—but it can also be incredibly far reaching, bringing in trusts that have very little to do with the state of Arizona. ARS §43-1301 (5) provides that a resident trust is:

> a trust of which the fiduciary is a resident of this state. *If a trust has more than one fiduciary, the trust is a resident trust if at least one of the fiduciaries is a resident of this state.* If a corporate fiduciary engaged in interstate trust administration is the sole fiduciary of a trust, or is a cofiduciary with a nonresident, the trust is a resident trust only if the corporate fiduciary conducts the administration of the trust in this state.

It is important to note that the test is fairly simple—if an individual trust is an Arizona resident or a corporate trustee conducts administration in the state of Arizona, a trust is automatically a resident trust. That's true no matter how many other fiduciaries there may be involved.

The Arizona Revised Statutes don't make it clear, but the Arizona Department of Revenue has indicated informally that they will apply this test at the end of the trust's year—so we take a look at the residency of the fiduciary at the end of the year (normally December 31 except in the final year of the trust). No matter when the test is applied, though, it is clear that a trust can move into and out of Arizona residency status.

What does this mean for Arizona practitioners? It means that you need to be aware that if you have an Arizona resident client who is named or becomes trustee of a trust, then that trust *is* an Arizona resident trust. As well, if all fiduciaries move out of the state, or all fiduciaries become nonresidents, the trust is no longer an Arizona resident.

As well, please remember that estates do not follow this rule—if an estate starts out as an Arizona resident estate it will always be an Arizona resident. As well, remember that Arizona follows federal law in general, so if a revocable trust has elected to be treated as part (or even all) of an estate during administration of the estate, while that federal "fiction" is in place, the entity follows the estate rules for Arizona purposes. If "estate" period ends for federal purposes and the entity begins to be treated as a trust, then the residency status begins to be tested under the trust rather than the estate rules.

Finally, remember that Arizona will still require a fiduciary return from a nonresident trust or estate if there is Arizona source income. So if a trust receives income such as rental income from Arizona real estate, a return would still be filed. However, in that case only the Arizona source income would be subject to tax by the state of Arizona at the trust level. A similar rule will apply for most other states.

<u>Other states.</u> It is important to note that Arizona's test for trust residency is rather unusual. As should be clear from a quick review of the rule, if all states adopted this rule then a trust would be a resident of every state in which it had a fiduciary. So if you have a trust with three fiduciaries, the state could end up being a resident trust of three states.[1]

However, it's not that simple. We'll consider two states—first, our large next door neighbor of California, and then Michigan, a Midwestern state from which many Arizonans have links back to.

California. California has a rather unique set of tests that determine residency. California Revenue and Taxation Code §17742(a) provides the general rule. The California test for estate's residency is virtually identical to Arizona, looking at the residency status of the decedent.[2]

For trusts, California first looks to see if all the fiduciaries are California residents or all the beneficiaries are California residents (again, like Arizona, corporate trustees are tested by where the "majority" of administration takes place). If either of those are true, then the trust is treated as a "full" California resident and all income taxable to the trust (that is, not treated as distributed to the beneficiaries) is taxable to the state of California.

If no beneficiary and no fiduciary is a California resident, then we have a nonresident trust, taxable only on California source income.

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1 Note that nothing holds that a trust, or an individual for that matter, cannot be treated as a resident of multiple states. In fact, the Arizona credit for taxes paid to another state for fiduciary returns actually only allows the credit *if* the trust or estate is treated as a resident entity by more than one state. And, as we'll discover, it's very possible for a trust to be resident in no state.

2 "The tax applies to the entire taxable income of an estate, if the decedent was a resident, regardless of the residence of the fiduciary or beneficiary..." CA Revenue & Taxation Code §17742(a)

If the answer is still open, that means some of the fiduciaries are California residents (but not all), some of the beneficiaries are California residents (but not all) or both are true. In that case, if all fiduciaries are nonresidents, then the income of the trust is taxable to California based on the proportion of California fiduciaries.[3] Similarly, if all beneficiaries are nonresident, then the income is assigned to California based on the proportion of California fiduciaries and their interests.[4] If both are true, then you have a multiple factor calculation. But what you end up with in any case is a "partially resident" California trust.

Michigan. Michigan takes an approach that is more consistent between estates and trust. For estates, again we look at the domicile of the decedent.[5] For a trust, the test is actually fairly similar. There you look towards the domicile of a) the decedent if the trust were established under a will or b) the residency of the person who created the trust or whose property became part of the trust at the time the trust become irrevocable. As you will note, for Michigan a trust and estate both are tested once and then retains their residency status forever.

Examples. We'll consider a couple of examples to look at how these rules would apply in these three states.

Example 1. A trust is established by A, a resident of Arizona, holding only publicly traded stock. The trust's income beneficiary is B, a resident of Arizona. C, a resident of Michigan, is appointed trustee of the trust. The trust is not an Arizona trust since its only trustee is not an Arizona resident. The trust is also not a Michigan resident trust.

Example 2. The same facts as example 1, except that B moves to the state of California. Now the trust is a California resident trust. If income is not distributed, then the trust will pay California state income tax on its'

3 CA Revenue & Taxation Code §17743

4 CA Revenue & Taxation Code §17744

5 Michigan Compiled Laws §206.18(1)(b). Unlike the Arizona and California law, this law refers to domicile. However, both Arizona and California generally look towards domicile to determine residency of an individual, so even though they reference residence, in most cases the domicile and income tax residency for Arizona and California purposes will be the same. Michigan has an overriding provision in their income tax code that provides if a person lives in Michigan 183 or more days during the year, they are deemed to be domiciled.

earnings.

Example 3. Again, the same facts as example 1 except that now A, who established the trust, is domiciled in Michigan at the time the trust becomes irrevocable. The trust is now a Michigan resident trust.

Example 4. Continuing example 3 to combine it with 2—now B (the beneficiary) moves to California. The trust remains a Michigan resident trust, since it when it become irrevocable A was domiciled in Michigan. As well, it now has only California beneficiaries, so it is also a California resident trust.

Example 5. The facts are the same as in 4, except now the trustee moves to Arizona and becomes an Arizona resident. The trust is now a resident trust for all three states.

Action Points. What this exercise points out is that it is not a simple matter to determine for which states a resident trust return is required. I would suggest that you inquire of the residency status and/or domicile (if different) of the original party who set up the trust, the trustees and the beneficiaries. Working from that list of states, you need to determine if your facts create a resident trust return filing requirement for each of the states in question.

When you have the list of states, you can turn both to the instruction booklets posted on the Revenue Department websites (which usually will have a summary of the issues) as well as the statutes for the states. Most state statutes are available on the FindLaw website (http://www.findlaw.com) though in many cases the law is not updated in "real time" by the entity hosting the site FindLaw will refer to, which is quite often the state in question.