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## NAVIGATING TRUST TAXATION: STATE INCOME TAX

*Author: Kateryna Bakhnak*

*If you have any questions  
about this Advisory,  
please contact:*

**MICHAEL T. CLEAR**  
203.363.7675  
mclear@wiggin.com

**ROBERT W. BENJAMIN**  
212.551.2602  
rbenjamin@wiggin.com

**DANIEL L. DANIELS**  
203.363.7665  
ddaniels@wiggin.com

**SETH E. ELLIS**  
561.910.7510  
sellis@wiggin.com

**HELEN C. HEINTZ**  
203.363.7607  
hheintz@wiggin.com

**DAVID W. KESNER**  
203.498.4406  
dkesner@wiggin.com

**LEONARD LEADER**  
203.363.7602  
lleader@wiggin.com

**VANESSA L. MACZKO**  
203.363.7667  
vmaczko@wiggin.com

**ERIN D. NICHOLLS**  
203.498.4319  
enicholls@wiggin.com

**CAROLYN A. REERS**  
203.363.7668  
creers@wiggin.com

Like individuals, trusts are subject to income tax by the federal government and a majority of states. If a trust is characterized as a "grantor" trust, then its income is reported by the grantor thereof, who is usually the trust creator, and taxed as if earned by the grantor individually. If the trust is characterized as a "non-grantor" trust, then it is a taxpayer separate from the grantor and could owe tax to the federal government and one or more states.

Whether a state is entitled to impose income tax on a trust depends on the law of that state and generally looks at the following factors:

- Jurisdiction where trust was created, i.e. residency of trust
- Jurisdiction of administration of trust
- Residency of trustees
- Residency of trust beneficiaries

### TAXATION OF TRUSTS BY NEW YORK AND CONNECTICUT

New York and Connecticut tax non-grantor trusts based on whether the trust is a "resident" trust. A trust is considered a "resident" trust if any of the following are true:

1. The trust is created by a Will (a testamentary trust) of a decedent domiciled in New York or Connecticut at his or her death.
2. The trust is irrevocable and that consists of property of an individual domiciled in New York or Connecticut at the time when the property is transferred to the trust.
3. The trust is revocable and the trust holds property of a person domiciled in New York or Connecticut at the time the trust becomes irrevocable.

A resident trust is taxed on all of its income (and capital gains), regardless of its source. (It should be noted that a beneficiary is taxed on income distributed from the trust to him or her.)

### AVOIDING NEW YORK AND CONNECTICUT INCOME TAX

#### New York Exempt Resident Trust

A New York resident trust is exempt from New York income tax if it meets the following three-prong test under New York Tax Law §605(b)(3)(D):

1. None of the trustees are domiciled in New York;
2. The trust does not hold any New York real or tangible property; and
3. There is no New York source income.

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**MATTHEW E. SMITH**  
 203.363.7639  
 msmith@wigggin.com

**WILLIAM M. BROMLEY**  
 561.910.7530  
 wbromley@wigggin.com

**GEORGE R. FREUND**  
 561.910.7500  
 gfreund@wigggin.com

**KATERYNA BAKHNAK**  
 212.551.2855  
 kbakhnak@wigggin.com

**MARY MARGARET COLLEARY**  
 212.551.2637  
 mcolleary@wigggin.com

**RUTH FORTUNE**  
 203.363.7658  
 rfortune@wigggin.com

**ASHTON C. MALKIN**  
 561.910.7500  
 amalkin@wigggin.com

**MARISSA A. O'LOUGHLIN**  
 203.363.7674  
 moloughlin@wigggin.com

**KAITLYN A. PACELLI**  
 203.363.7635  
 kpacelli@wigggin.com

**ANDREW S. PHILBIN**  
 203.363.7606  
 aphilbin@wigggin.com

**MI-HAE K. RUSSO**  
 212.551.2619  
 mrusso@wigggin.com

If any of the above conditions are not met, the entirety of the income of the trust will be subject to New York taxation. As the identity of trustees and the nature of trust assets can change, the status of a resident trust as exempt can change during the term of the trust. Accordingly, exempt status must be considered each tax year. Further, even if the trust is exempt from New York taxation, the filing of a New York income tax return is required with a certification that the trust is nontaxable.

### New York Tax Law 658(f)—Accumulation Distribution (a.k.a. Throwback Tax)

Qualification as an exempt resident trust may be problematic if the trust holds accumulated income and there are New York beneficiaries. As noted above, a beneficiary is taxed on income distributed from the trust to him or her. However, in the case of a New York exempt resident trust, a distribution to a New York beneficiary will carry out income from the current year (in which the distribution is made), as well as income accumulated in prior years which had not been distributed.

**Example:** In Year 1, a New York exempt resident trust earns \$1,000 of interest, which is accumulated and added to principal. In year 2, the trust earns another \$1,000, also added to principal. Year 3, the trust also earns \$200. In Year 3, the New York beneficiary of the trust receives a distribution of \$500. Under the accumulation distribution rule, the entire \$500 is subject to New York income tax when received by the beneficiary (\$200 for Year 3 and the remaining \$300 is treated as a distribution of the prior year's accumulated income).

There are exceptions to the accumulation distribution rule:

- The distributed income was already taxed;
- The income was earned prior to January 1, 2014;
- The income was earned during a period when the beneficiary was not a New York resident; or
- The income was earned before the beneficiary turned twenty-one (21).

Bookkeeping and tracking become very important when dealing with a New York exempt resident trust.

### Taxation of Connecticut Resident Trusts

Under Connecticut General Statutes §12-701(a)(4), resident trusts may avoid Connecticut income tax on all or a part of their non-Connecticut source income if the following two conditions are met:

- The trust is an *inter vivos* trust (not a testamentary trust created under a Will); and
- The trust has a minimum of one or more nonresident, noncontingent beneficiaries.

A nonresident beneficiary is a beneficiary who lives outside of the state of Connecticut, and a noncontingent beneficiary is a beneficiary with a present beneficial interest, such as an individual to whom distributions can be made currently.

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*This publication is a summary of legal principles. Nothing in this article constitutes legal advice, which can only be obtained as a result of a personal consultation with an attorney. The information published here is believed accurate at the time of publication, but is subject to change and does not purport to be a complete statement of all relevant issues.*

## NAVIGATING TRUST TAXATION: STATE INCOME TAX

If the above two requirements are met, then the taxable income of the trust only includes (1) Connecticut source income and (2) non-Connecticut source income multiplied by a fraction the numerator of which is the number of resident, noncontingent beneficiaries and the denominator of which is the number of the total number of noncontingent beneficiaries.

Accordingly, a Connecticut resident *inter vivos* trust can avoid Connecticut income tax if there is no Connecticut source income and no Connecticut beneficiaries. Even if the trust is not subject to Connecticut income tax, the filing of a Connecticut income tax return is required.

### What is state source income?

New York and Connecticut source income includes:

1. Ownership of real property, including income derived from certain entities that hold real estate if certain requirements are met, or ownership of tangible property in the state;
2. Business, trade, profession or occupation carried on in state, or income related to a business, trade, profession or occupation carried on in state;
3. Distributive share of New York or Connecticut partnership income or gains;
4. Share of New York or Connecticut estate or trust income or gain;
5. Sales, conveyances or other dispositions of shares of stock in a cooperative apartment; or
6. Shareholders of New York or Connecticut S-corporation.

## CONCLUSION

As noted above, the residency of a trust is not the only factor to be considered when determining state taxation of a trust. A trust can be subject to income tax in multiple states. The tax preparer should be aware of and consider the following:

- Where the trust is being administered;
- Residency of trustees;
- Residency of trust beneficiaries; and
- Location of assets and source of income of the trust.

Based on circumstances, it may be possible to minimize or reduce exposure to state income taxation of a trust. You should consult with your Wiggin and Dana attorney to avoid negative income tax implications.