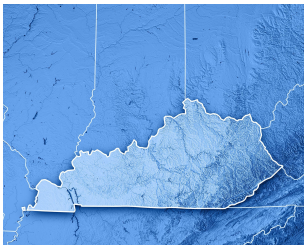

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An Outlier? Kentucky DOR's Trust Nexus Positions

Recently, Bloomberg Tax & Accounting released its *2020 Trust Nexus Survey* gathering states' varying positions regarding whether a trust is considered subject to income tax in their respective state. The survey covers basic nexus requirements and constitutional limitations as well as apportionment, throwback rules, and specifically, this year, any impact of the COVID-19 pandemic on state taxation of trusts. The following is a collection of the Kentucky Department of Revenue's ("KDOR" or the "Department") responses to same, and thus, what may subject a trust to Kentucky income tax.

First, to answer the question of where a trust is most likely to be taxed, the survey divided trust activities into six categories and asked states to determine which of the activities would trigger income tax liability in their state. The categories included trusts using the state's law to govern the trust, administering the trust in the state, having a trustor, trustee, or beneficiary that is domiciled in or is a resident of the state, and owning assets in the state. Kentucky and four other states were considered the *most likely places for a trust to be taxed*, as KDOR responded that each of the above categories could subject a trust to income tax. KDOR responded that it makes its nexus determination for trusts based on a "facts and circumstances test" that weighs each of these six factors.

Specific to whether a trustor's domicile or residency created nexus, KDOR responded that for both testamentary and inter vivos trusts, if the trustor's domicile is located in Kentucky, that creates nexus for income tax purposes. The survey also noted that the Department's answer for whether trustor residency for inter vivos trusts creates nexus changed from its response in the prior year.

Further, the Bloomberg survey found that the practice of determining a trust's residency based on location of its beneficiaries is not widely used by many states and often is difficult to track – especially considering the difficulty to foresee or control where a beneficiary is located. However, Kentucky, along with 10

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other states, responded that despite this difficulty the state will consider a beneficiary's location as a factor when determining a trust's nexus presence. For the first time, the survey divided this specific question into two, asking whether a trust's residency is based on the residency of both non-contingent and contingent beneficiaries. While three of the 11 states finding nexus based on the beneficiaries' residency responded yes only to non-contingent beneficiaries, KDOR responded yes to both contingent and non-contingent beneficiaries creating nexus. Thus, even if beneficiaries are subject to contingencies, if they are located in Kentucky, the trust could be subject to income tax.

Additional responses include that the Department noted that although there have been changes to certain trust income tax rules, Kentucky has had no statutory or regulatory change to nexus rules for trusts. KDOR cited KRS 141.010(7), 141.030, 141.020, 103 KAR 19:010, and Form 741 for its guidance on these issues, but offered up no judicial authorities. The Department also noted that, in determining nexus for a trust, it does not consider additional factors that are not located in the Kentucky Revised Statutes, meaning the Department has not issued additional guidance regarding supplemental factors it may consider for its facts and circumstances analysis.

In terms of constitutional considerations, KDOR provided that it does apply the principles of *North Carolina Department of Revenue v. Kaestner 1992 Family Trust*, 139 S. Ct. 2213 (2019). In *Kaestner*, the U.S. Supreme Court held that a contingent beneficiary with in-state residence was not a sufficient basis for the state to tax the trust as a resident. However, KDOR provided that it does not have other binding judicial precedent on the matter and does not respond to constitutional challenges at the administrative level. Additionally, the Department provided it does not apportion trust income and does not implement a throwback rule.

Kentucky also responded to questions regarding adjustments made in response to the COVID-19 pandemic. According to the Bloomberg survey, while some states have made exceptions to existing rules or provided leniencies due to changes as a result of the pandemic, KDOR provided it would not be making any

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adjustments in response to the pandemic. Specifically, the Department provided it has not been reviewing resident determinations or waiving trusts that are temporarily administered in-state due to COVID-19, nor has it issued guidance on the topic. Rather, the Department provided that it will continue to determine whether a trust has residency in the state based on a facts and circumstances analysis.

While the Supreme Court's recent *Kaestner* decision has certainly made some states begin to reconsider their respective trust taxation policies, based on the Department's survey responses, trusts are still facing a high level of scrutiny in Kentucky moving forward. For more information regarding tax policies, visit Frost Brown Todd's Tax Law Defined Blog.

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