State Fiduciary Income Tax Developments

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Overview of State Income Taxation of Trusts: Is a Trust Resident?

Nongrantor trusts (“trusts”) under subchapter J, Part I of Code. See IRC §641 et. seq.

- We know nongrantor trusts are subject to *federal* fiduciary income tax
- Nongrantor trusts may also be subject to *state* income taxation

States tax a trust’s accumulated income based on the trust’s “residency” – a nebulous concept

Residency is determined by statutes, regulations, and case law

States’ determinations and interpretations of the nexus with trusts is an evolving area deserving of increased attention by practitioners and trustees

Recent taxpayer-friendly state court decisions have paved the way for more aggressive constitutional challenges

Some key questions are:

– When will a trust be subject to a state income tax regime?

– Under what authority will a state attempt to tax a trust?

– Is a trust at risk of being resident in multiple states?

– Can (or should) a trust be moved to a different state or a no state taxing regime?

What Is at Stake?

Where is the trust “resident”

The trust may be required to pay tax in more than one state. The trust may or may not get credit for tax paid in the other state or states

The trustee may need to file a return in more than one state

The tax could be at rates up to 13.3% (California)

Might a trustee have a duty to change a trust’s tax situs for existing trusts, or at least, should this question be considered?

Threshold Question – Is the Trust a **Resident** of the State?

If the taxpayer trust is deemed a “resident,” then the state can tax all of the trust income, in whatever state earned

If the taxpayer trust is not “resident” trust, then the state can only tax source income (i.e., income attributable or apportioned to that state)

Consider:

- State Statutes
- State Regulations
- Administrative and State Treasury Pronouncements
- Other Guidance Documents
- Constitutional Restrictions

Trust Residency: Intervivos v. Testamentary Trust

Many states deem a trust resident based on certain contacts with state:

- Residency of Settlor at time trust created and at death when testamentary trust created
- Contacts within state
- Location of trustee
- Location of beneficiaries

Courts finding “founder state” and beneficiary resident rules as unconstitutional applied to trusts

Blue v. Dep’t of Treasury, 462 NW.2d 762 (Mich. Ct. App. 1990)

Linn v. Dep’t of Revenue, 2 N.E.3d 1203 (Ill. App. Ct. 2013)

McNeil v. Commw., 67 A.3d 185 (Pa. Commw. Ct. 2013)

Kaestner v. North Carolina Dep’t of Revenue, 814 S.E. 2d 43 (N.C. 2018)

Fielding v. Comm’r of Revenue, 916 N.W.2d 323 (Minn. 2018)

Trust Residency: Intervivos v. Testamentary Trust

However, testamentary trusts requiring probate court involvement may create necessary link to tax and pass constitutional muster

- *D.C. v. Chase Manhattan Bank, 689 A.2d 539 (DC 1997)*
- *Chase Manhattan Bank v. Gavin, 733 A.2d 782 (CT 1999)*

Pre-*Quill* cases held otherwise on testamentary trusts

- *In re Swift*, 727 S.W.2d 880 (Mo. 1987)
- *Pennoyer v. Taxation Div. Dir.*, 5 N.J. Tax 386, 398-99 (1983)

Common Statutory Residency Factors

Personal Jurisdiction = Taxing Jurisdiction

The *Linn* trust ultimately argued that if the state could exercise personal jurisdiction, then it could exercise taxing jurisdiction

No personal jurisdiction, NO TAXATION

This is consistent with a fundamental holding of SCOTUS in *Quill Corp*. See also *Hanson v. Denckla*, 357 U.S. 235 (1958)

- Logic: "If a State court cannot obtain personal jurisdiction over the "person, property, or transaction" to be taxed, the tax cannot be reduced to a judgment and enforced due to the absence of a necessary party. Thus, the power of the department of revenue to levy the tax should not exceed the authority of the State courts to enforce such tax where the person, property, or transaction sought to be taxed lacks the minimum contacts necessary for *enforcement* of the State tax law." ACTC Amicus Brief in *Kaestner*, p. 27 (emphasis added)

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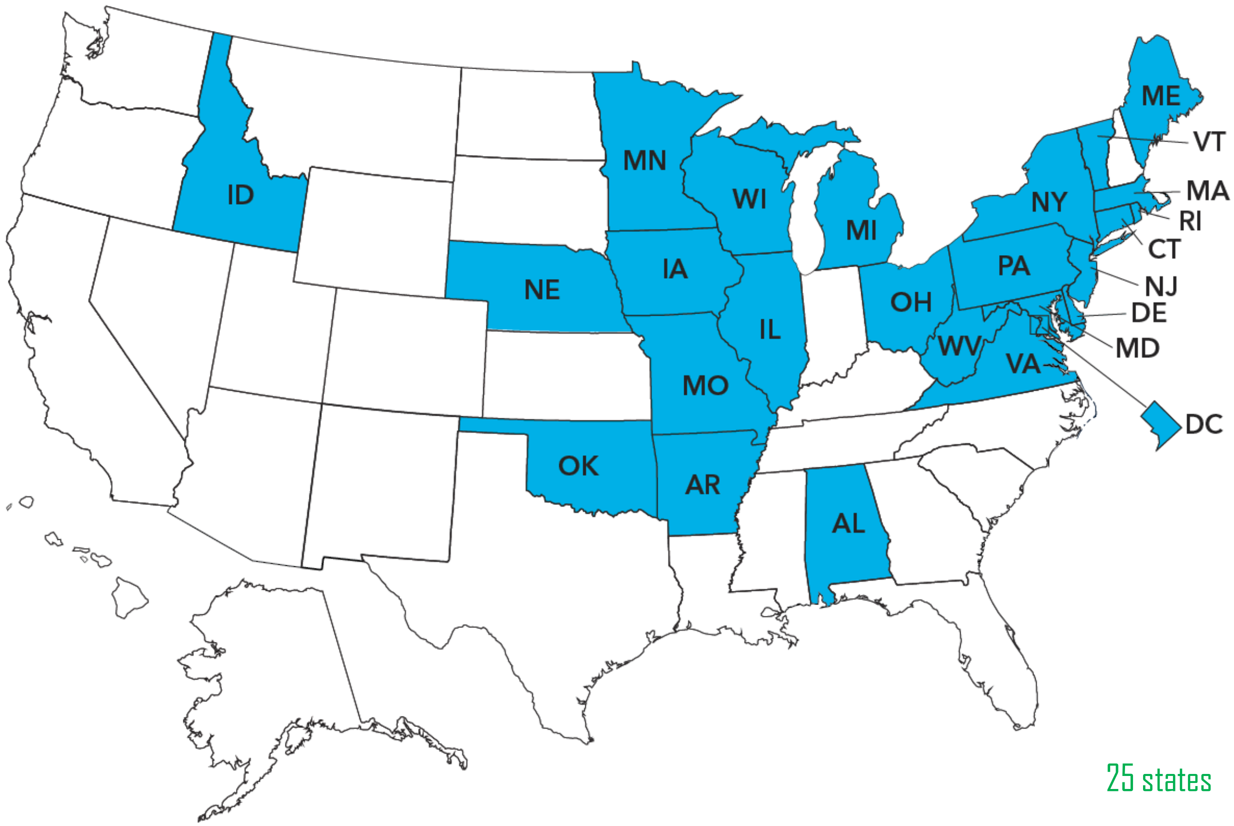
Five Common Criteria

There are generally five considerations to be aware of when dealing with a multi-jurisdictional trust administration *(not mutually exclusive, may overlap)*

1. Contacts with the decedent or decedent's estate that gave rise to the testamentary trust
2. Contacts with the state of the grantor who created an inter vivos trust
3. Contact through the ongoing administration of the trust
4. Contacts with the trustee of the trust
5. Contacts with the beneficiary of the trust

Inter Vivos Trusts Created By Residents



25 states

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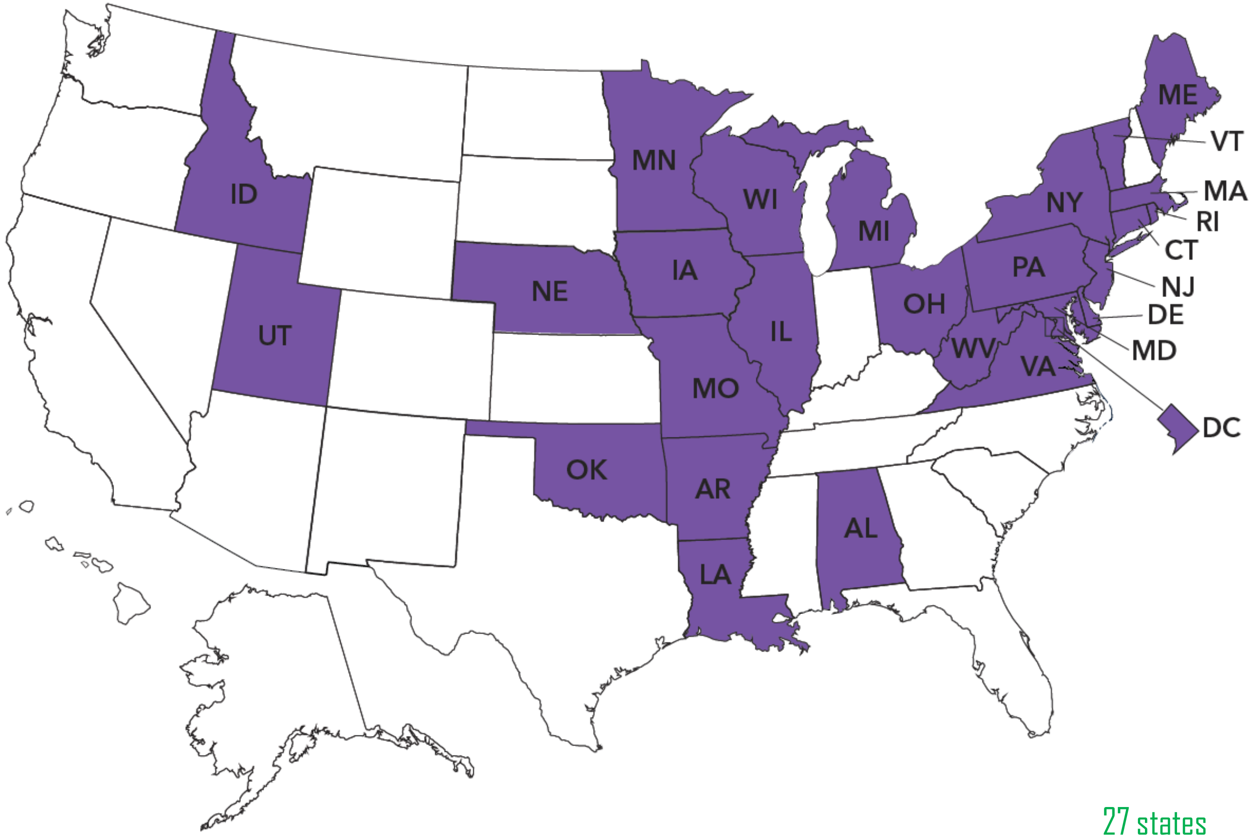
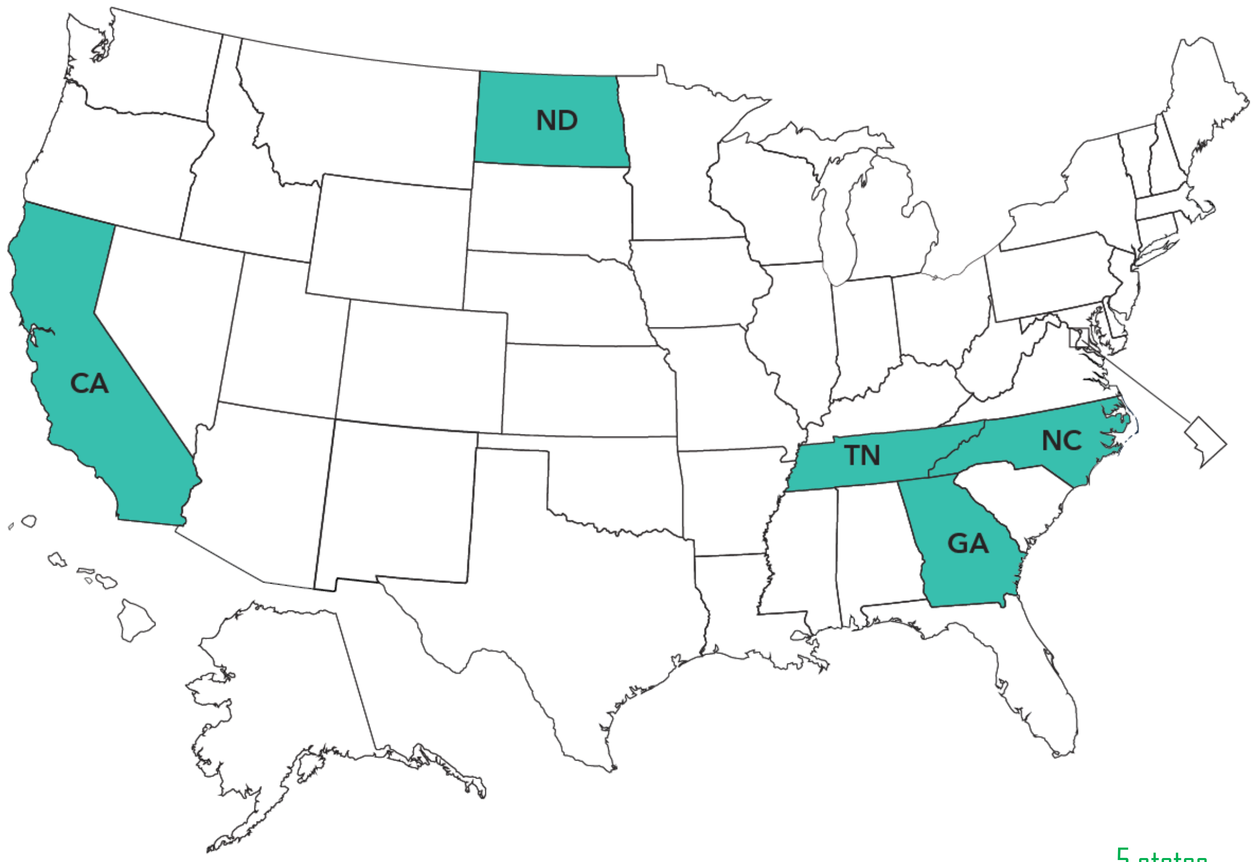
Trusts Created Under Will of Residents



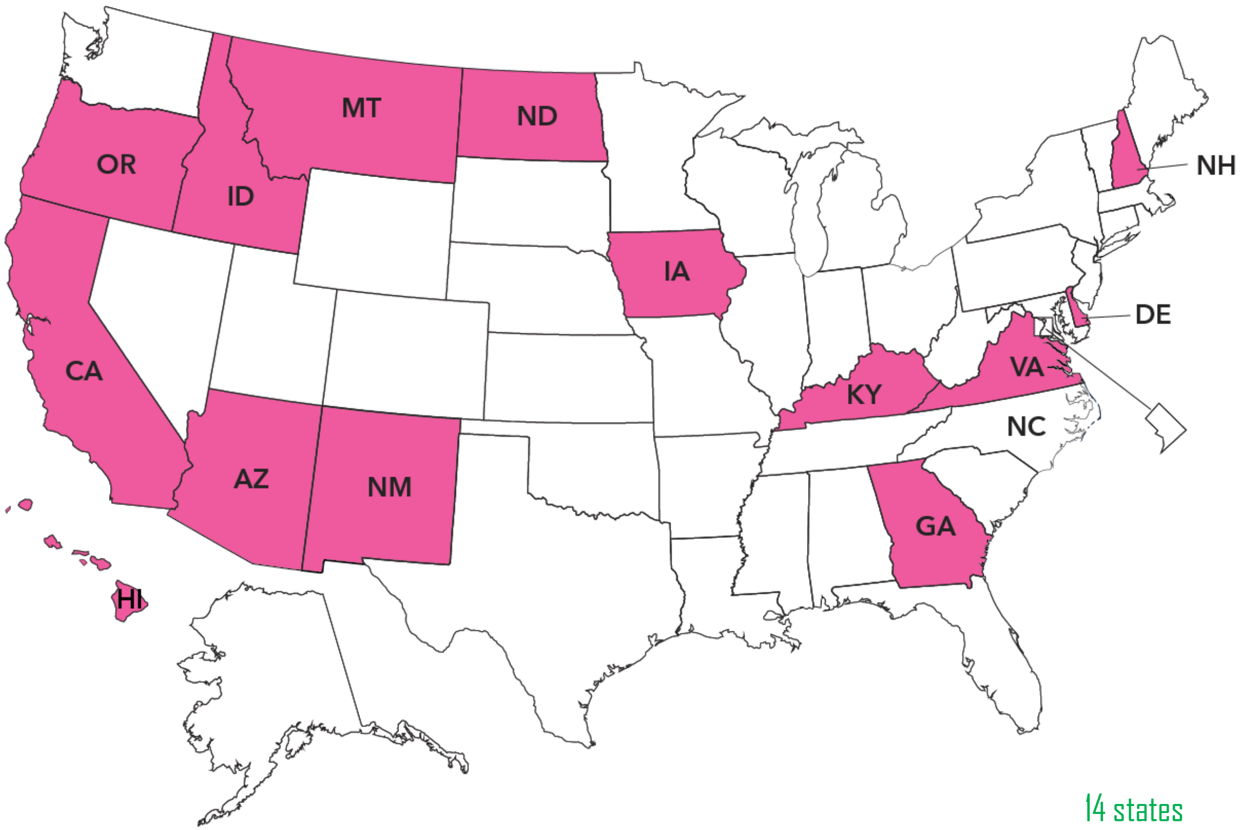
27 states

Resident Beneficiary as Sole Factor or a Factor



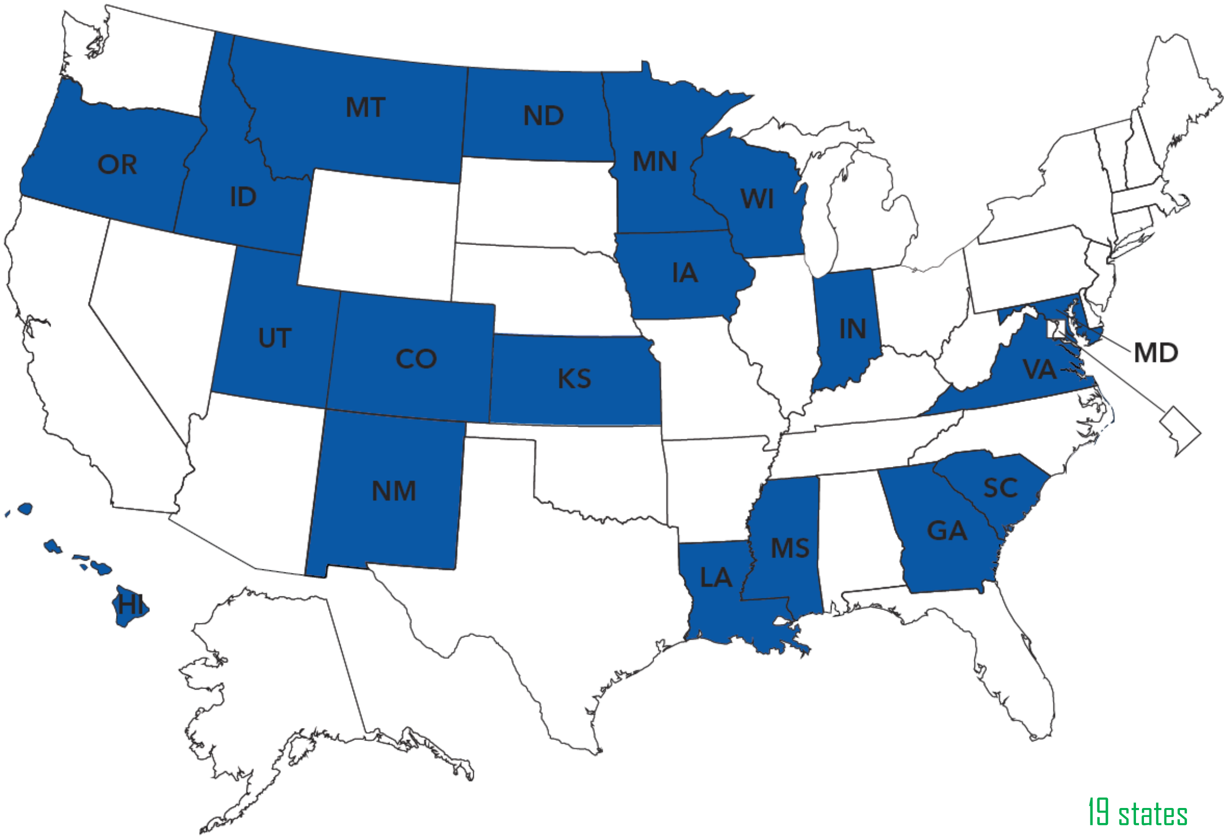
5 states

Resident Trustee



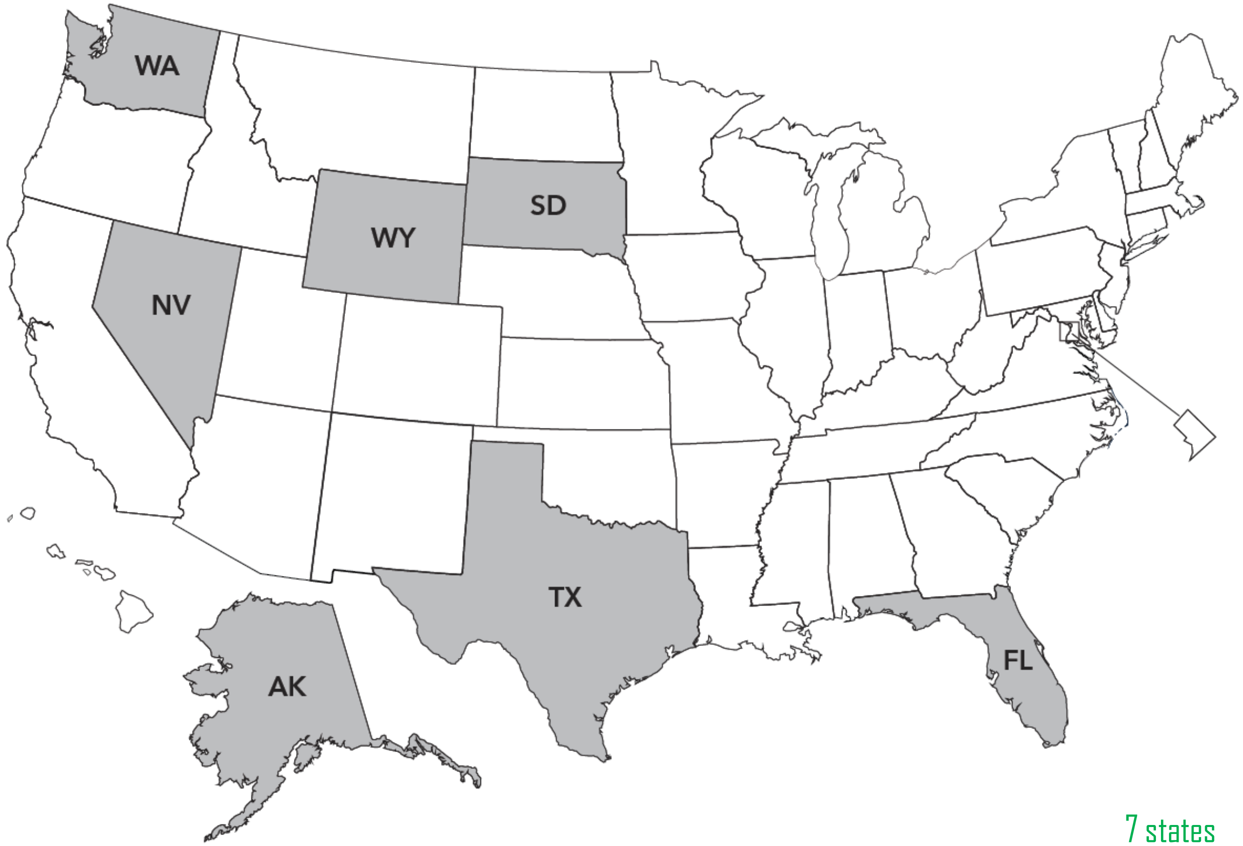
14 states

Trust Administered In State



19 states

No Individual Income tax



7 states

Constitutional Principles Governing State Taxation

Commerce Clause

Complete Auto Transit Inc. v. Brady, 430 U.S. 274 (1977)

Established four requirements that must be met for state tax laws to be constitutional under commerce clause:

- The taxpayer must have a **substantial nexus** to the taxing jurisdiction.
- The tax must be **fairly apportioned**.
- The tax must be **fairly related to benefits conferred by the taxing jurisdiction**.
- The tax **may not discriminate against any interstate commerce**.

Due Process Clause

Quill Corporation v. North Dakota, 504 U.S. 298 (1992), rev'd in part by *South Dakota v. Wayfair, Inc*. 138 S. Ct. 2080 (2018).

- Analyzed **both** Commerce and Due Process Clauses
- Established two additional requirements that must be met to meet due process test ("minimum contacts test")
  - The state must have definite link to the person, property or transaction that it seeks to tax.
  - Income must be rationally related to the values connected with the taxing state.
- Held that physical presence of mail order business was not required to satisfy minimum contacts. Due Process test under these requirements was therefore met.
- However, held that Commerce Clause test was not met; without "physical presence in taxing state", there is not substantial nexus, as required under *Complete Auto Transit*
- Other prongs of Complete Auto must also be met
- Commerce Clause is a more rigorous test to satisfy

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Wayfair's impact on *Quill* and Physical Presence

- In *South Dakota v. Wayfair, Inc*. 138 S. Ct. 2080 (2018), **a sales tax case**, the Supreme Court overturned the **physical presence** requirement under the **Commerce Clause**
  - The physical presence standard for out of state sellers of goods under *Quill* was "unsound and incorrect"
  - Now under *Wayfair*, a state may impose a state sales tax on an in-state consumer, notwithstanding the lack of the seller's physical presence in that state
  - We already know that Quill, on its own, said physical presence wasn't required to satisfy minimum contacts under the **Due Process Clause**
  - But *Wayfair* took this a step further and abandoned the physical presence test under *Complete Auto*
  - Does this holding even apply to state **fiduciary** taxation?
  - What about differences in sales transaction vs. fiduciary relationship of trust
  - Still need to meet all tests under Due Process **and** Commerce Clause to pass constitutional muster

Trends: Authority – Years 1-20 of last 27

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- *Quill Corp. v. North Dakota,* 504 U.S. 298 (**1992**) (physical presence in the taxing state was required for a business to have "substantial nexus" with the taxing state under the Commerce Clause when use tax assessed).

- *District of Columbia v. Chase Manhattan Bank*, 689 A.2d 539 (D.C. **1997**) (Due Process Clause does not prevent the District from imposing a tax on Founder Trust grounds where District courts have a continuing supervisory role).

- But see earlier, *Blue* (Mich. 1990); Swift (Mo. 1987); *Pennoyer,* (N.J. Tax Ct. 1983); *Potter* (N.J. Tax Ct. 1983); *Mercantile-Safe Deposit & Trust Co. v. Murphy* (N.Y. 1964).

- *Chase Manhattan Bank v. Gavin*, 733 A.2d 782 (Conn. **1999**) (held state had power to tax four testamentary trusts and one inter vivos trust—with varying degrees of attenuated contacts—as Resident Trusts on the "Founder Trust" theory under both the Commerce Clause and the Due Process Clause).

- Commentary on *Gavin*: ("insupportable" (**2002**); "misguided… badly flawed" (**2006**).

- Nenno, Richard W.; *Let My Trustees Go! Planning to Minimize or Avoid State Income Taxes on Trusts*, Heckerling Institute on Estate Planning, Volume 46, Chapter 15 (June **2012**).

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Trends: Last Seven Years

- *McNeil v. Commonwealth of Pennsylvania* (**2013**) – PA could not tax an inter vivos trust where there was no trustee in PA, no real or tangible property in PA and no PA source income.

- *Residuary Trust A u/w Kassner v. Director, Division of Taxation* (**2013**) – NJ could not tax retained income where testamentary trust had NY trustee/bene, even though trust owned four NJ S corporations – affirmed on appeal on non-constitutional grounds (tax dept equitably estopped from applying new policy retroactively; May 28, **2015**).

- *Linn v. Department of Revenue* (**2013-14**) – holding that IL could not tax an inter vivos trust where there was no trustee in IL, no real or tangible property in IL and no IL source income.

- *Fielding v. Commissioner of Revenue (Minn. Tax, May 31, **2017**; aff'd* MN **2018**, 2018 WL 3447690.) – Tax Statute unconstitutional as applied even where the settlor was a MN resident, one trust had a beneficiary who was a resident of MN, a MN attorney created the trust, MN was the governing law of the trust, the original documents were kept in MN, and "the Trusts' primary trust asset and source of income during 2014 was stock in FFI, a closely held S-Corporation which was incorporated in the State of Minnesota and has always been headquartered in Minnesota."

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Trends – Last Seven Years (cont'd)

- *Kaestner 1992 Trust v. N.C. Dept of Revenue* (**2015**, affirmed N.C. App. **July 5, 2016**. *aff'd* NC **June 8, 2018**) – NC could not tax trustee's non-source accumulated income of discretionary trust under NC's beneficiary-based statutory scheme, where trustee and administration was in N.Y., even though all the beneficiaries were N.C. residents during four subject years.
- *Bank of America v. Comm'r of Rev.* (Mass. July 11, **2016**) – Corporate trustee held to be "inhabitant" of MA based on the Bank's presence and trust-related activities performed generally in MA (200 branches) on behalf of the (35) subject trusts even though its principal place of business was in NC. MA is a "Founder Trust" state, but with the added requirements for inter vivos trusts of resident beneficiaries and a MA trustee.

Analysis of Key Decisions

The Recent *Linn*, *McNeil*, *Kaestner, and Fielding* decisions are important to practitioners because of the impact to the administration of trusts

- **The statutory residency requirement in *Linn* is the most commonly used amongst the states**

The issue presented in Linn was:

"When (or more precisely: how long) will a trust be subject to state fiduciary income taxation?"

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Linn

Summary of the 2013 *Linn* case:

- Linn was identified as a statutory resident trust,
- No income was earned in Illinois,
- None of the trust's assets were located in Illinois,
- The trust was administered by a non-Illinois trustee, and
- The beneficiary resided outside of Illinois.

Linn

The trust lacked connections with Illinois, yet

Because the grantor was a resident of Illinois when the trust was created:

- The trust was a deemed Illinois resident trust, and
- Illinois fiduciary income tax applied on all the income

As a result, the trust would **forever** be burdened with paying Illinois tax on all of its worldwide income.

The Illinois Appellate Court ultimately found the taxation of the trust violated the Due Process Clause of the Constitution:

- Because there was not a sufficient minimum connection between the trust and the State of Illinois
- No personal jurisdiction, no taxation

Comparing Constitutional Requirements to Recent Decision

Requirements for state tax laws to apply	**Required by *Complete Auto Transit* in 1977**	**Required by *Quill* in 1992**	***The Kimberley Rice Kaestner 1992 Family Trust v. North Carolina Dept. of Rev.***	***Residuary Trust A v. Dir., Div. of Taxation***
1. The taxpayer has a **substantial nexus** to the taxing jurisdiction.	Yes	Yes, and created bright line rule for determining substantial nexus: physical presence in the taxing state to satisfy this prong of test	The N.C. tax statute violated this prong because it taxed a trust for merely having beneficiaries in the state.	Court did not reference this.
2. The tax must be **fairly apportioned**.	Yes	Yes	Court declined to address this prong.	Court did not reference this.
3. The tax must **be fairly related to benefits conferred** by the taxing jurisdiction.	Yes	Yes	Court declined to address this prong.	Court did not reference this.
4. The **tax may not discriminate against any interstate commerce**.	Yes	Yes	The N.C. tax statute violated this prong because there were not sufficient contacts between the trust and the state.	Court did not reference this.
A. The state must have a definite link to the person, property or transaction that it seeks to tax.	No	Yes	There was no physical presence in the state nor was there purposeful activity in the state.	Court held that taxation could not be imposed unless there was a N.J. trustee or assets in N.J.
B. Income must be rationally related to the values connected with the taxing state.	No	Yes	Trust has not done anything to seek out the protection, opportunities, and benefits conferred by N.C.	Court did not reference this.

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Linn, McNeil, Kaestner Scorecard

Linn	***McNeil***	***Kaestner***
Settlor was resident Illinois	**Settlor was resident** Pennsylvania	**Settlor was <u>not</u> a resident** North Carolina
Created in the taxing state, but vacated the state • No assets in state • No trustee in state • No beneficiaries in state	Created in another state • No assets in state • No trustee in state • Beneficiaries resided	Created in another state • No assets in state • No trustee in state • New beneficiary in new state
Beneficiary exercised power and moved trust out of state	Beneficiary was contingent, discretionary	Beneficiary was contingent, discretionary
No connections	**Old connections**	**New connection**

Planning: Recognize Differences in Residency & Nexus Links

States have different standards for "resident" trusts

Trusts are taxed as though they behaved like individuals…

- Income tax imposed on their entire income in their state of legal residence, with credits for taxes paid to other states as a nonresident
- Like corporations, they often "reside" in multiple states
- In litigation, Commerce Clause and Due Process analysis for taxability
- Geared toward entities w/presence in multiple states and apportioned income
- By beneficiary/trustee/state law applied
  - Using the state's law as the governing law of the trust,
  - Administering the trust in the state,
  - Having a grantor that is a resident of the state,
  - Having a trustee that is a resident of the state,
  - Having a beneficiary that is a resident of the state,
  - Owning assets located in the state, or
  - Receiving state-source income

Timing

- Determine trust residency at the moment the trust is created? When it becomes irrevocable?
- By combination of factors

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Trust Residence Factors

Some of the factors are more easily controlled than others after creation of the trust:

- Governing law
- State where the trust is administered
- Location of the trustee
- Residence of a beneficiary
- Location of the trust's fixed assets, its source of trust income.
- Grantor's state of residence at the time of creation of the trust

The Future

"Due to increasing state interest in attracting financial institutions, the group decided to **eliminate** any factor from the residency test related to **trustees** or **trust administration**."

Disque, Lila of Multistate Tax Commission. *Interstate Taxation of Trusts.* "State Income Taxation of Trusts Holding Business Interests" ABA RPTE Spring Symposia *(Apr. 30, 2015)*

Two Fiduciary Problems

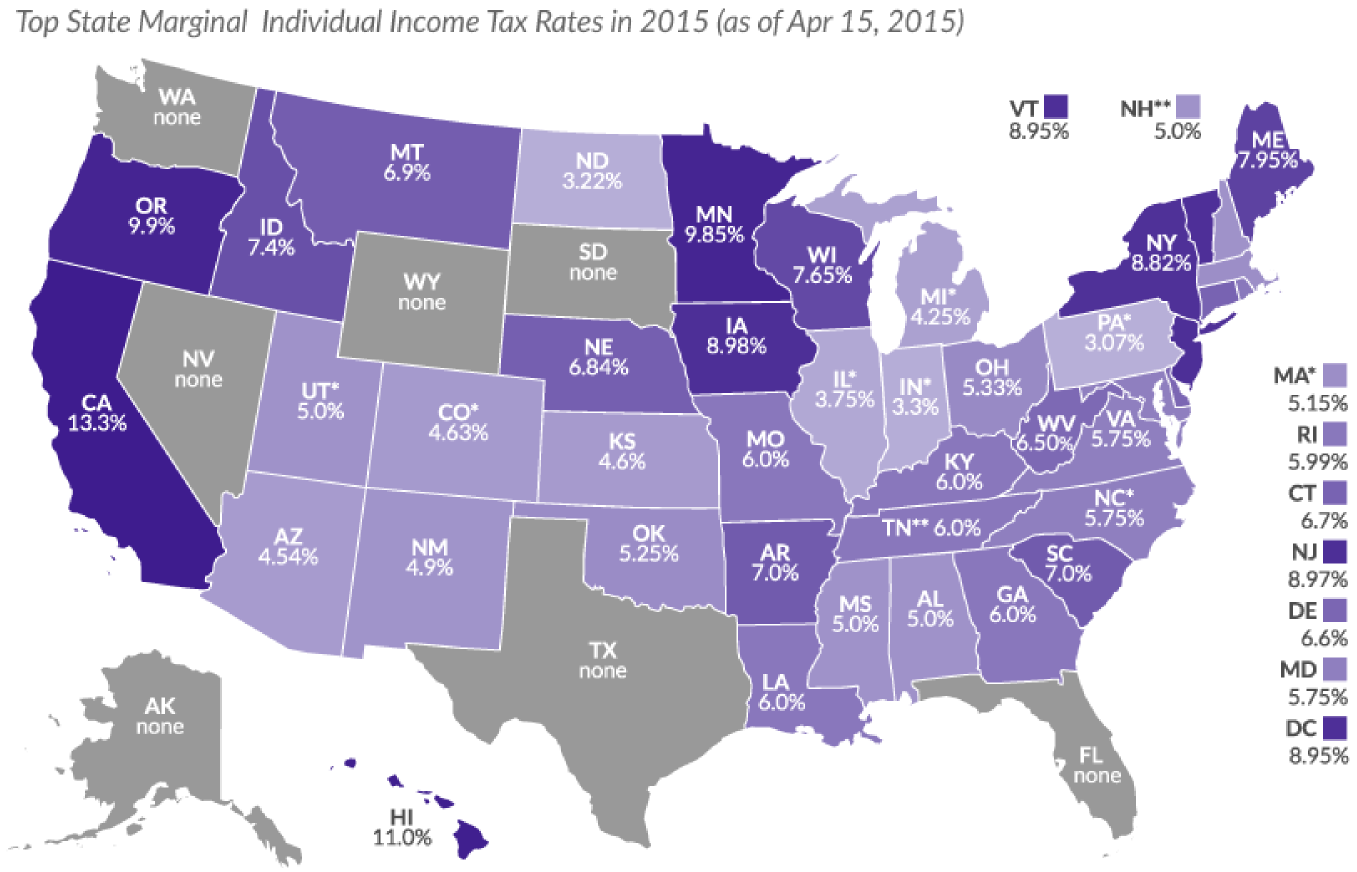
1. Trustee fails to pay tax in a state where tax is owed

2. Trustee pays tax to a state where tax is not owed

<u>Scope</u>: $20mm assets earning 3.0% ($600k) at 5% tax = $30,000 / year.

Factual Application

2,244 State Relationships



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Factual Application

MATH: 2,244 State Relationships with 5 Bases for Taxation

AL AR CN DC DE IL LA ME MY MA MI MN MO

NE NJ NY OH OK PA RI UT VT WV VA WI

Resident Founder of Testamentary Trust

Resident Founder of Inter Vivos Trust

Resident Trustee

Principal Place Administration in State

AZ CA DE KY

CO HI IN KS LA MA MS NM ND OR SC WI

AK FL NV NH

SD TX WA WY

Resident Beneficiary

NC GA TN

CA ND

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Planning:
Practical Considerations

- In many states, there is a duty to locate a trust in an appropriate jurisdiction
- Paying tax when not required could subject the trustee to surcharge
- What if you are unsure whether tax is due:
  - Request a ruling
  - File a return showing no tax due, with proper disclosures
  - Do not file a return, and advise beneficiaries (and settlor if appropriate)
  - File the return and pay the tax, and file for refund. It may be appropriate to advise the beneficiaries (and settlor).

Planning: Enabling Flexibility and Adaptation

Planning Opportunities Available

Fielding v. Comm'r of Revenue, 916 N.W.2d 323 (Minn. 2018)

Kaestner v. North Carolina Dep't of Revenue, 814 S.E.2d 43 (N.C. 2018)

Linn v. Dep't of Revenue, 2 N.E.3d 1203 (Ill. App. Ct. 2013)

If anticipated accumulated income is worth it, consider:

Changing trustees for existing irrevocable trusts

Administering elsewhere (may include fiduciaries like investment advisors in directed trusts)

- If source income taints an entire trust's income for state residency (e.g. NJ, NY), sell the asset or split/decant the trust to wall off the source income
- For some states, consider using living trusts rather than testamentary trusts
- For any longer term trust design, add ability to change situs/trustees as part of any substantial estate plan
- Consider INGs as a potential solution to avoid state income tax
- Consider completed gift "SLANTs" as a potential solution to avoid state income tax on large gains AND utilize the temporary $11.4 million (2019) exclusion now that taxpayer-favorable "clawback" regulations have been proposed

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Additional Considerations

Should Facts Be Changed? Consider Tax Year

- *Linn*: Analysis applied **tax year by tax year**. See also *Kaestner* (NY→NC→CA)
- *Swift*: More than two bases of taxation required for constitutionality

Income from Tangible or Intangible Assets?

- *Fielding*: Distinction between (source) *income* from resident S Corporation (MN) vs. *capital gains* from sale of corporate stock, an intangible asset (TX)

Rates

- Credits for taxes paid to other states sometimes are available for Resident Trusts; usually are not available concerning source income of Non-resident Trusts. Consider reciprocity and statutory design

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Compliance Considerations

Whether / How to File? Options.

- File showing all income
- File and claim refund
- File with apportionment argument
- Take principled position not to file

Post-Deprivation Remedies (Statutes of Limitation)

- The general rule is that **a statute, when declared unconstitutional, is as inoperative as if it had never been passed and never existed, and thus is void *ab initio*.** 16A Am. Jur. 2D Constitutional Law § 195
- "And in the future, States may avail themselves of a variety of procedural protections against any disruptive effects of a tax scheme's invalidation, such as providing by statute that refunds will be available to only those taxpayers paying under protest, or **enforcing relatively short statutes of limitation applicable to refund actions**…. Such procedural measures would sufficiently protect States' fiscal security when weighed against their obligation to provide meaningful relief for their unconstitutional taxation." *McKesson Corp. v. Division of Alcoholic Beverages and Tobacco, Dept. of Business*, 496 U.S. 18, 50, 110 S.Ct. 2238, 2257 (June 4, 1990). See also *Reich v. Collins*, 513 U.S. 106, 115 S.Ct. 547 (Dec. 6, 1994) (holding that Georgia must honor a refund statute as its post-deprivation remedy)

Credits and Mismatch

Ability to offset may be limited (*e.g.*, state may allow credit for tax against certain income only)

- Credit may be allowed for tax on income from real property but not on income from intangibles

Credits may be allowed only if the other state's tax is imposed "irrespective of the residence or domicile" of the taxpayer

- The credit won't apply because the trust is taxed as a resident in each state

Mismatch on Classification

- Trusts may not be legally entitled to any credits for income paid to another state as a nonresident because they paid tax as a resident

What Do Good Residency Rules Look Like?

Rules should offer a measure of certainty to both state and taxpayer

Rules should accommodate state policy goals

E.g., many states wish to attract trustee activity

Rules should pass constitutional muster

Rules should reflect where activity of trust is located

Rules should be sufficiently simple (e.g. mind and management concept)

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