

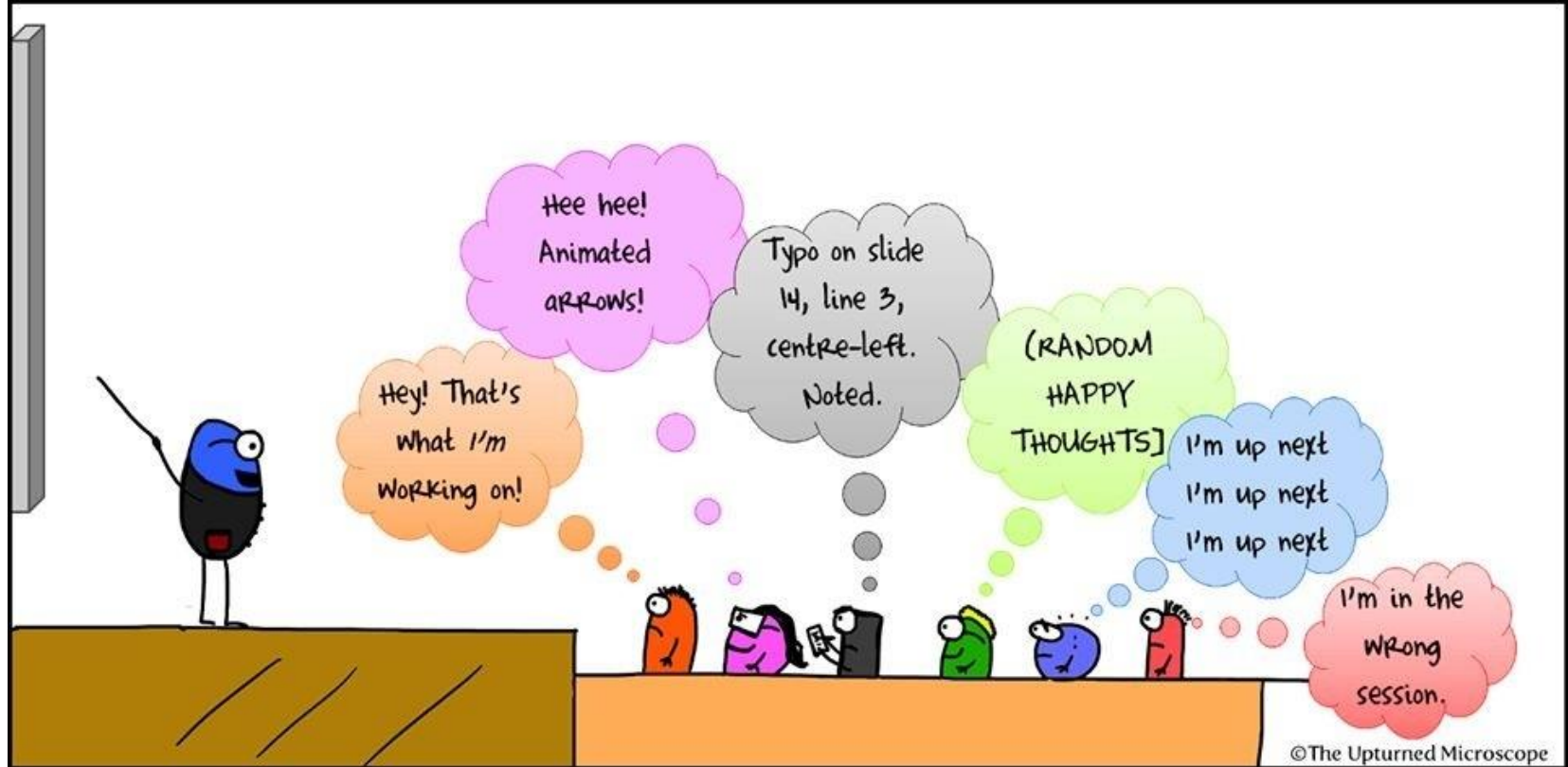
# States of Decay: Changes to the State Fiduciary Income Tax Landscape

ACTEC SE Regional Meeting 2018



# *Upturned Microscope Cartoon*

What people think about  
during your **conference talk**



# Carl L. King

Carl, a partner at his firm, represents individuals, helping them to achieve their family, financial and estate planning goals while minimizing their potential estate, gift and income tax liabilities.

In recent years, Carl's most rewarding professional work has included counseling families (all generations) during the growth of family offices, and providing legal advice with respect to some of the largest charitable gifts in North Carolina's history.

Carl has advised wealthy clients concerning complex gift and estate tax strategies including dynasty trusts, family limited liability companies, installment sales to grantor trusts, grantor retained annuity trusts ("GRATs"), split purchase trusts and the use of a wide variety of charitable entities.

Carl provides regular legal counsel to trusts and estates, advising them on sophisticated tax-saving opportunities, including disclaimers, tax elections and allocations and other related matters, and defends them in gift and estate tax audits.

Carl's recent speaking engagements have covered How Death Impacts Installment Sales; Fiduciary Income Tax; Advanced Income Tax Planning for Complex Trusts; Planning to Protect Fiduciaries.

Previously, Carl clerked both for the U.S. District Court and for the United States Securities and Exchange Commission. In 2008, Carl was selected as the Pro Bono Attorney of the Year by Legal Services of the Southern Piedmont for his work with wills clinics, which continues.





# Presenter & Thanks

Carl L. King

CULP ELLIOTT & CARPENTER, P.L.L.C.

6801 Morrison Boulevard; Suite 400

Charlotte, North Carolina 28211

[clk@ceclaw.com](mailto:clk@ceclaw.com)

<http://www.ceclaw.com/attorneys/carl-l-king/>

<https://www.ncbar.org/media/900418/kaestner818.pdf>

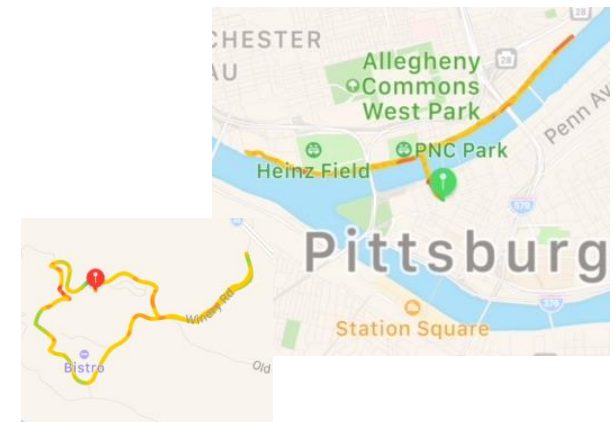


# Introduction

**Wales** [Change Region](#)

Top 100 eBirders in Wales, 2015 : **185** Species 2015 [Submit](#)

Observer	Complete Checklists	Species (% of total)	Most Recent Addition
1 Carl King	19	109 (58.92%)	Eurasian Kestrel (May 23, 2015)
1 Larry King	17	109 (58.92%)	Pied Avocet (May 23, 2015)
3 John Lewis	10	103 (55.68%)	Fieldfare (Nov 1, 2015)
4 Clive & Sheila Williamson	20	95 (51.35%)	Spotted Flycatcher (Jul 20, 2015)
5 Anthony Perry	4	93 (50.27%)	Great Crested Grebe (Jun 27, 2015)
6 Julianne Duncan	12	79 (42.7%)	Little Egret (Oct 1, 2015)
7 George Newell	14	78 (42.16%)	Eurasian Wren (Apr 5, 2015)
8 Phil Hampson	7	72 (38.92%)	European Starling (Apr 21, 2015)

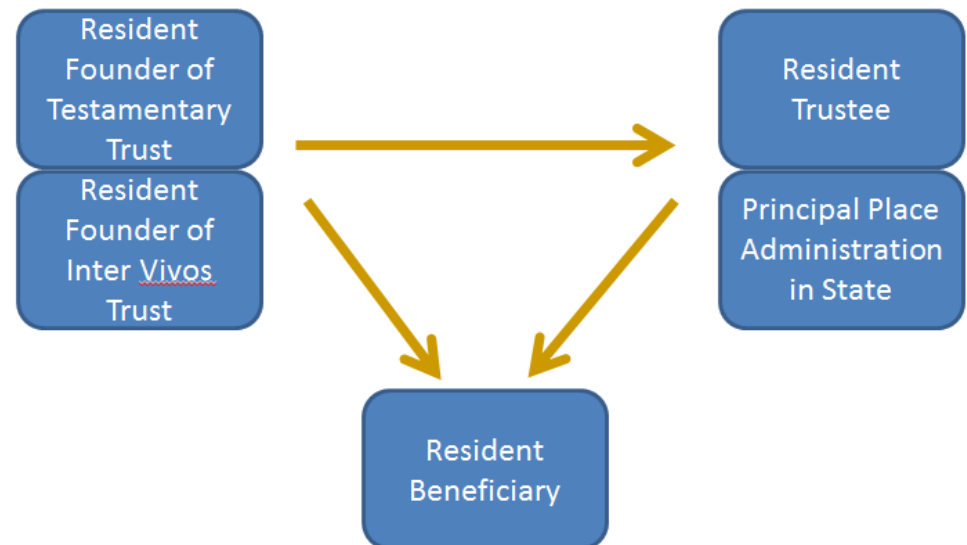


# Agenda:

## ACTEC SE Regional Meeting 2018

### States of Decay: Changes to the State Fiduciary Income Tax Landscape

- A. Fiduciary Duty
- B. Legal Trends
- C. Analysis
- D. Problems and Approaches



# *Fiduciary Duty*

## *Administrative Duties*

# The Three Fundamental Duties of Trustees





# The Three Fundamental Duties of Trustees

**Investment:** How does my trustee invest trust assets?

**Distribution:** In which ways might my Trustee distribute trust assets?

**Administration:** How does my Trustee handle administrative duties?

## Administrative Trustee

- Accurate reporting – (e.g., beneficiary notices)
- Taxes
- Compliance matters (e.g., banking)
- Decision to make payments of interest and principal on existing loans is probably a duty of administration
- Can be limited by statute or trust agreement

# UTC: Fiduciary Assessment of Place of Administration

“A trustee is under a **continuing duty** to administer the trust at a **place** appropriate to its purposes, its administration, and **the interests of the beneficiaries.**”

## - Uniform Trust Code Section 108(b)

UTC Fla. Stat. ch. 736.0108(4); S.C. 62-7-108(c); c.f., GA Code 53-12 (not fully UTC, absent); N.C.G.S. 36C-1-108 (absent); VA Code 64.2-706 (permissive, “the trustee, **may** transfer...,” also “court ... **may** transfer ... as it may deem appropriate”); WV Code 44D-1-108 (permissive, “the trustee, **may** transfer...”)

## UTC (State Law): Designation of Place of Administration

(a) Without precluding other means for establishing a sufficient connection with the designated jurisdiction, **terms of a trust designating the principal place of administration are valid and controlling** if:

- (1) a trustee's principal place of business is located in or a trustee is a resident of the designated jurisdiction; or
- (2) all or part of the administration occurs in the designated jurisdiction.

- Uniform Trust Code Section 108(a)

# New Yorker Cartoon



"I'm afraid I must concur with Dr. Hamilton and Dr. Movin.  
The cause of death was taxes."

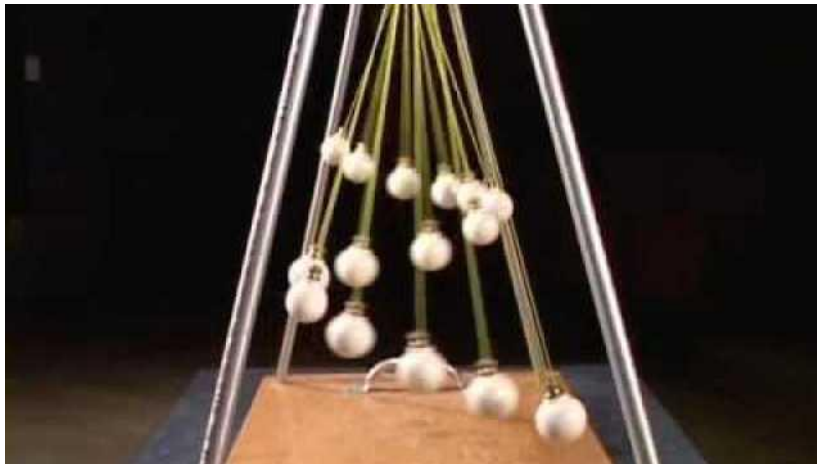
# State Duties and Obligations of Fiduciaries Concerning Taxes

Under IRC Code §6901, fiduciaries are personally liable for payment of a trust's or estate's income tax, including penalties imposed for failure to file a return or failure to pay the tax.

Generally, state statutes follow this rule (e.g., “The fiduciary of an estate or trust described below **shall file an income tax return** under affirmation... [including] (1) Every estate or trust which has taxable income under this Part during the taxable year and is **required to file an income tax return** for the taxable year under the Code.” NCGS 105-160.5 *Returns*.)



# *Legal Trends*



# Legal Tests (under *Quill*)

**Due Process** requires: (1) “some definite link, some **minimum connection**, between a state and the person, property or transaction it seeks to tax;” and (2) “that the income attributed to the State for tax purposes ... be **rationally related** to the values connected with the taxing State.” (Akin to “‘notice’ or ‘fair warning.’” Also observe, personal jurisdiction and subject matter jurisdiction.)

The **Commerce Clause**, a narrower legal standard, requires that a valid tax statute must “limit the reach of State taxing authority so as to ensure that State taxation does not unduly burden interstate commerce:”

- (1) **Applied to an activity with a substantial nexus with the taxing state;**
- (2) Be fairly apportioned;
- (3) Not discriminate against interstate commerce, and
- (4) **Be fairly related to the services provided by the state**

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

# Resident Non-grantor Trusts

“There are two fundamental, but alternative, bases for state power to tax income: **residence** and source.” *Fielding v. Commissioner of Revenue (Minn. Tax 2017)* citing Hellerstein, Walter, *State Taxation* ¶ 6.04 (3d ed. 2017).

“That the receipt of income by a **resident** of the territory of a taxing sovereignty is a taxable event is universally recognized. **Domicil** [sic] itself affords a basis for such taxation.” *New York ex rel. Cohn v. Graves*, 300 U.S. 308, 312-313 (1937).

“**Residency** ... confers subject matter jurisdiction over a person’s worldwide income without regard to source.” *Fielding*.

# *Non-resident Non-grantor Trusts*

“Even when a state has personal jurisdiction over a **nonresident** taxpayer, the state may tax only income derived from in-state sources—not the taxpayer’s worldwide income.” *Fielding* at 17.

“As to residents [the state] may, and does, exert its taxing power over their income from all sources, whether within or without the state . . . . As to **nonresidents**, the jurisdiction extends only to their property owned within the state and their business, trade, or profession carried on therein, and the tax is only on such income as is derived from those sources. “ *Shaffer v. Carter*, 252 U.S. 37, 57 (1920).

# Trust Character and Grantor Trusts

“[T]he law has seen fit to deal with this abstraction [i.e., a trust] for income tax purposes as a separate existence.” *Anderson v. Wilson*, 289 U.S. 20, 27 (1933).

Also:

Generally, states follow Federal grantor trust rules.

(But see PA, TN, ~NY.)

# Key Question

What makes a trust a **resident** for state income tax purposes?





# Legal Authority – Years 1-20 of last 26

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

# Legal Authority – Last Six 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.
- *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.
- *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).
- *Fielding v. Commissioner of Revenue* (Minn. Tax, May 31, 2017; aff'd MN 2018, 2018 WL 3447690.) – Tax Statute unconstitutional 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.”

## Legal Authority – Last Six Years (cont'd)

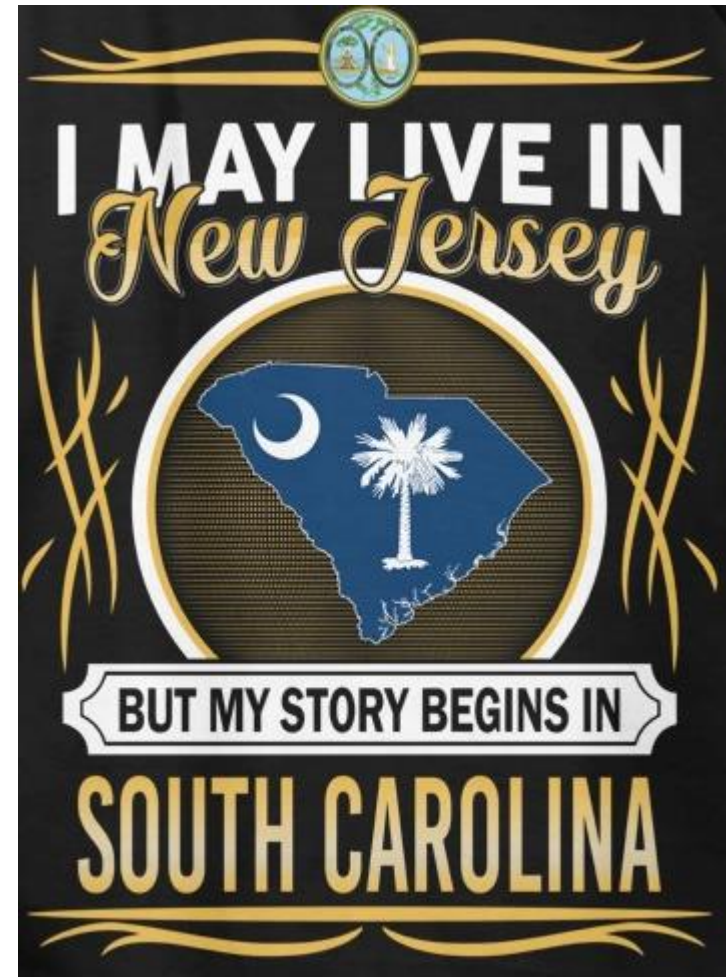
- *Kaestner 1992 Trust v. N.C. Dept of Revenue* (**2015**, affirmed N.C. App. **July 5, 2016**. *aff'd* NC **June 8, 2018**) – NC could not tax non-source income of discretionary trust under NC's beneficiary-based statutory scheme, where trustee and administration was in N.Y., even though all the beneficiaries were N.C. residents.
- *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*



# Real Story

- In 2005, South Carolina residents formed and funded irrevocable trust.
- In 2011, original GA Corporate Trustee resigns in favor of NJ Corporate Trustee.
- “1. The legal situs of the Trust is transferred from South Carolina to New Jersey.” (2011)
- Trust owns intangible assets.
- Grantors, in fact, were living in NC vacation home in 2015 and 2016.
- Sole beneficiary (U.S. Citizen) living in France (resident of SC?) in 2015-16.
- Trustee calls me (NC counsel) in March 2016 asking question about items on 2015 SC fiduciary income tax return.



# 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.

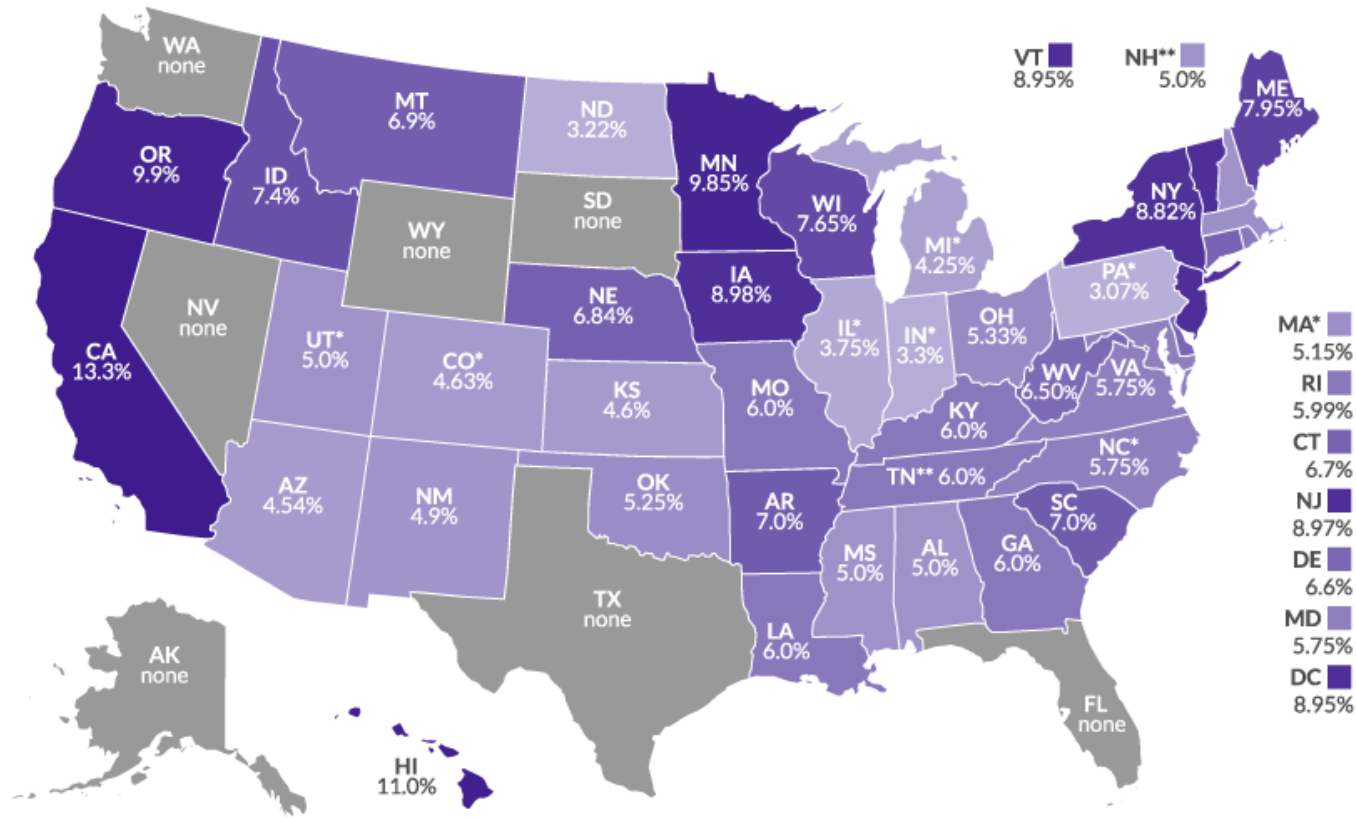
Scope: \$20mm assets earning 3.0% (\$600k) at 5% tax = \$30,000 / year.



# Factual Application

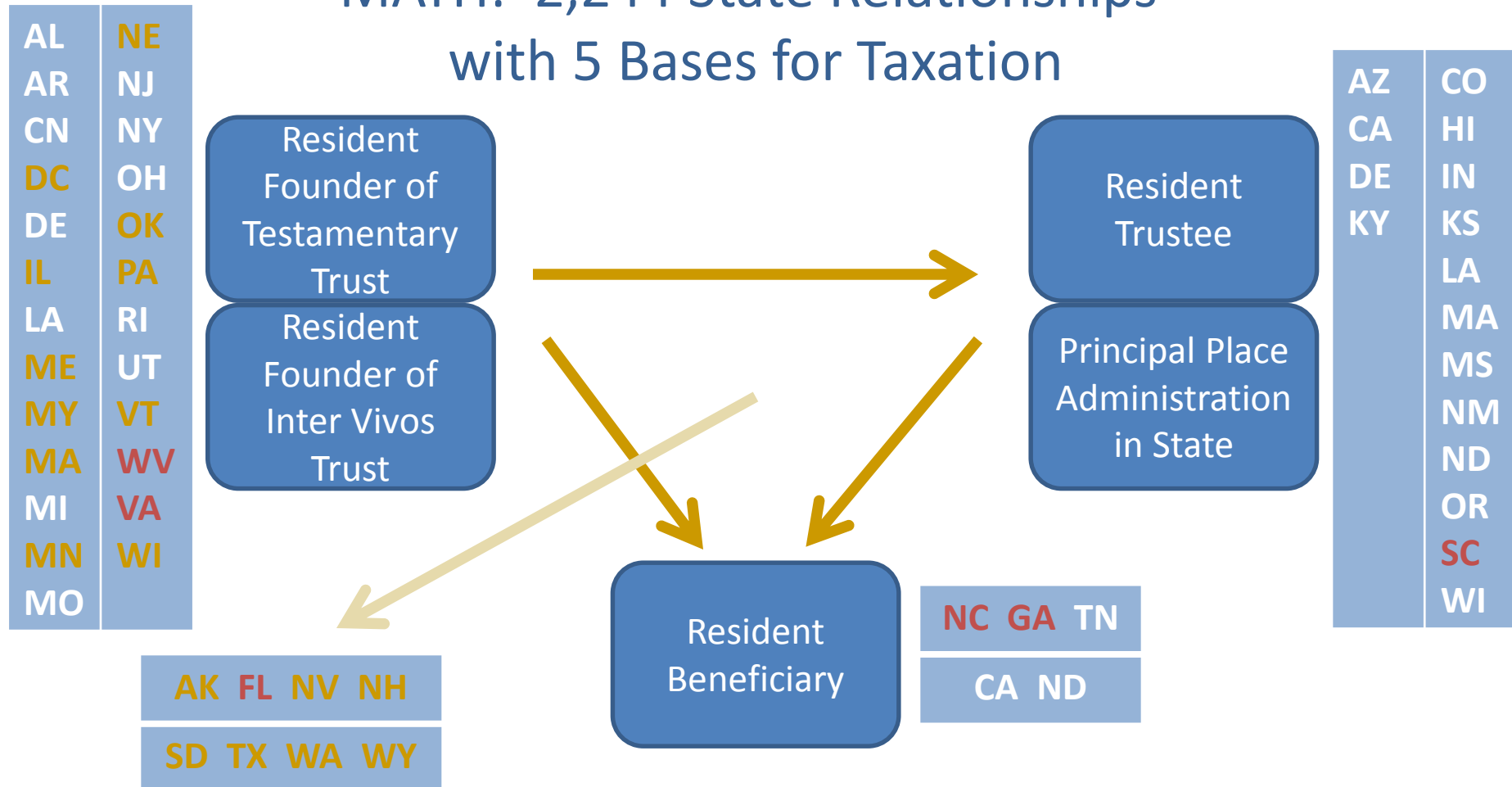
## 2,244 State Relationships

Top State Marginal Individual Income Tax Rates in 2015 (as of Apr 15, 2015)



# Factual Application

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



# Constitutional Analysis

Under *Quill*, Due Process requires: (1) “some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax;” and (2) “that the income attributed to the State for tax purposes ... be rationally related to the values connected with the taxing State.” (Akin to “‘notice’ or ‘fair warning.’” Personal jurisdiction and subject matter jurisdiction.)

Under *Quill*, the Commerce Clause requires: “The first and fourth prongs, which require a **substantial nexus** and a relationship between the tax and State provided services, limit the reach of State taxing authority so as to ensure that State taxation does not unduly burden interstate commerce.” *Quill* citing *Complete Auto* test.

# Constitutional Analysis (2018)

*Wayfair* holds that *Quill's* outdated requirement that **physical presence** of a vendor in a state is no longer absolutely necessary to meet the first prong of the *Quill*, Due Process requirement: (1) “some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax;”

*Wayfair* left *Quill's* and *Complete Auto's*, the Commerce Clause requirements untouched (**substantial nexus**).

**August 22, 2018.** *Kaestner* continued. US Supreme Court Docket 18A210. “Justice Sam J. Ervin, IV, dissented. Criticizing the majority’s understanding of *Quill* as overly rigid, Justice Ervin concluded that “**the presence of the beneficiaries** of the *Kaestner* Trust in North Carolina has some bearing on the proper performance of the required due process analysis.”

# Constitutional Analysis (2018)

There is an important distinction between the Wayfair furniture company and all trustees, including trust companies.

**Legal ownership of property by a fiduciary for a person's benefit fundamentally is not the same as purposefully directing a product to an online customer.**

Often, as in *Kaestner*, after the grantor and the trustee make their contract (i.e., the original trust agreement), the trustee has no control over where the beneficiary may move, and a trustee's legal title to the trust property is not akin to commercial activity.

# Based on One Factor (cf., Swift)?

Categorize Statutory Factors	Facts
Founder (testamentary / IV)	What was the residency of the grantor / testator?
Resident Trustee	Does the Trust have a resident trustee? Any resolutions re" co-trustees?
Principal Place of Administration	Where is PPA conducted? <ul style="list-style-type: none"> <li>• Recall UTC 108(a)</li> <li>• Possible for resident trustee of one state to conduct the administration in a different state.</li> </ul>
Beneficiaries	Where are beneficiaries located? <ul style="list-style-type: none"> <li>• Discretionary or contingent?</li> </ul>

“As applied” constitutional analysis vs. relevancy.



# 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.

## *Fielding Analysis*

[A]s-applied challenges are analyzed under all the ***relevant*** circumstances.... The Commissioner simply assumes, however, that *all* the contacts between Minnesota and the Trusts are relevant when applying **section 290.01, subdivision 7b(a)(2)**. We cannot agree. When evaluating a constitutional challenge to a statute, **a court must first determine the statute's meaning; must next apply the statute in accordance with legislative intent; and only then must decide whether the statute, as applied, violates the constitution....** We will not, as the Commissioner requests, consider other (nexus) factors such as the storage in Minnesota of trust instruments or the Minnesota domicile of a beneficiary.”

# Kaestner's Wake: Might Be Constitutional

Description of Trust	Comment
<b>Marital trusts</b> granting a general power of appointment—especially an inter vivos power—to a North Carolina domiciled beneficiary, such as certain older trusts qualifying for the marital deduction under IRC § 2056(b)(5).	To avoid problems with disparate beneficial interests under 17 NCAC 6B.3724(b), such a trust would need to be <b>payable outright to the spouse</b> at some date or to the spouse's estate.
Trusts exclusively for the benefit of individual beneficiaries who are residents of North Carolina, such as trusts qualifying for the <b>GST Annual Exclusion</b> under IRC § 2642(c).	After <i>Kaestner</i> , the beneficiary also likely must hold <b>some form of vested right</b> to undistributed taxable income. Otherwise, it is unclear that the trustee of a discretionary trust ever will pay income to a North Carolina beneficiary (i.e., the beneficiary may move to a different state prior to any distribution).

# Kaestner's Wake: May Be Unconstitutional

Description of Trust	Comment
<b>Discretionary Irrev. Trusts</b> without any contact with North Carolina other than beneficiaries domiciled in North Carolina.	These are the <i>Kaestner</i> facts. Arguably, no other fact is <b>relevant</b> for determining resident trust status under <i>N.C.G.S. Section 105-160.2</i> . See <i>Fielding, supra</i> .
Discretionary trusts benefitting multiple beneficiaries with varying interests across more than one generation.	The presence of the <b>trustee's discretion, as a substantial contingency</b> , makes it difficult for the NCDOR to show that undistributed income is “for the benefit” of any North Carolina beneficiary.
Marital “QTIP” trusts qualifying under IRC § 2056(b)(7).	<i>Per capita</i> income taxation of disparate beneficial interests under <b>17 NCAC 6B.3724(b)</b> appears unconstitutional “ <b>as applied</b> ” by North Carolina under the Commerce Clause.

# Compliance Considerations

## Whether / How to File? Options.

- File showing all income
- File with apportionment argument
- File and claim refund
- 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).

# 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.**”

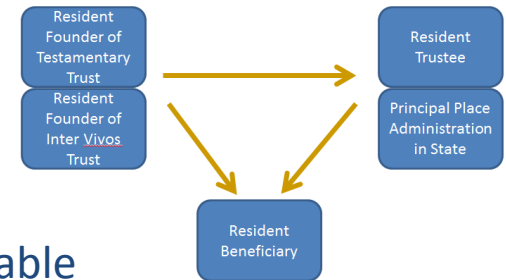
Disque, Lila of Multistate Tax Commission. *Interstate Taxation of Trusts*.

“State Income Taxation of Trusts Holding Business Interests.” ABA RPTE Spring Symposia (Apr. 30, 2015).

# The Future – NC 2015 S.B. 468

(b) The tax is computed on the amount of the taxable income of an estate or trust as follows:

- (1) On a nonresident estate or nonresident trust, but only to the extent that the income:
  - (i) is derived from North Carolina sources and is attributable to the ownership of any interest in real or tangible personal property in this State or
  - (ii) is derived from a business, trade, profession, or occupation carried on in this State;
- (2) On a resident estate;
- (3) On a **resident trust** that is for the benefit of a **resident current beneficiary**....



(e) The following definitions apply in this section:

- (5) Resident trust. - A trust which has its **principal place of administration in North Carolina**, as defined in G.S. 36-1-103(13a).



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- 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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# Questions and Answers



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