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State Income Taxation of Trusts, the Significance of State Residency for Fiduciary Income Tax Purposes, the State Fiduciary Income Taxation Rules, and the Impact of Recent Decisions

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Overview

- Introduction and Overview to State Taxation: *Linn, McNeil* and *Kaestner*
- 1. State Statutory Residency Issues
- 2. Statutory Residency Contacts
- 3. Supreme Court Precedent
- 4. Constitutional Analysis
- 5. Case Law References
- 6. Planning Considerations



Synopsis

- Trusts are subject to state income taxes in addition to federal income taxes
- How the states have historically determined and are continuing to interpret nexus with trusts is an evolving area deserving of increased attention by practitioners



Introduction

- We know that all trusts are subject to federal fiduciary income tax
- The 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?
 - Can a trust be moved to a different state or a no state taxing regime?

Introduction

- The *Linn*, *McNeil* and *Kaestner* 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?”

Introduction – *Linn*

Founder Statute, vacated the state

- Quick summary of the 2013 *Linn* case:
 - *Linn* was identified as a statutory resident trust
 - No income was earned in the state of 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

Introduction – *Linn*

Founder Statute, vacated the state

- 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
 - The trust would forever be burdened with paying Illinois tax on all of its worldwide income

Introduction – *Linn*

Founder Statute, vacated the state

- The Result:
 - 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



Introduction – *Linn*

Founder Statute, vacated the state

Personal Jurisdiction = Taxing Jurisdiction

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

Introduction – *McNeil*

Pennsylvania Discretionary Beneficiaries

- In a 2013 decision *McNeil*, the Pennsylvania grantor created two *inter vivos* trusts
- At the time of the case, the trusts were administered in Delaware, governed by the laws of Delaware, the trustees were located in Delaware and trust assets were held in Delaware
- The trust did not have any Pennsylvania source income



Introduction – *McNeil*

Pennsylvania Discretionary Beneficiaries

- The discretionary beneficiaries, however, lived in Pennsylvania
- Pennsylvania assessed fiduciary income tax because the grantor was a resident when the trust was formed
- The discretionary beneficiaries were residents, and that was the only connection to Pennsylvania



Introduction – *McNeil*

Pennsylvania Discretionary Beneficiaries

- The court found that the imposition of Pennsylvania’s fiduciary income tax violated the U.S. Constitution because relying only on resident discretionary beneficiaries lacked the “substantial nexus” necessary under the Commerce Clause

Introduction – *Kaestner*

North Carolina Discretionary Beneficiary

In *Kaestner*:

- (1) the settlor of the trust was not a North Carolina resident when the trust was executed,
- (2) the trust was governed under laws other than those of North Carolina,
- (3) the trustee was not a North Carolina resident,
- (4) the trust was administered outside of North Carolina, and
- (5) the trustee did not make any distributions from the trust to any North Carolina resident beneficiaries

Introduction – *Kaestner*

North Carolina Discretionary Beneficiary

- As in *McNeil*, the discretionary beneficiary lived in the purported taxing state (ie: North Carolina)
- Unlike *McNeil*, North Carolina assessed fiduciary income tax because the *beneficiary* was a resident when the trust was formed (not the Settlor)
- The residency of the discretionary beneficiary was the only connection to North Carolina



Introduction – *Kaestner*

North Carolina Discretionary Beneficiary


The court held that the trustee was not liable for North Carolina income tax because the state

- "did not demonstrate the minimum contacts necessary to satisfy the principles of due process required to tax an out-of-state trust."

Introduction – *Linn, McNeil, Kaestner*

Scorecard

<i>Linn</i>	<i>McNeil</i>	<i>Kaestner</i>
Settlor was resident	Settlor was resident	Settlor was <u>not</u> a resident
Created in the taxing state, but vacated the state <ul style="list-style-type: none">• No assets in state• No trustee in state• No beneficiaries in state	Created in another state <ul style="list-style-type: none">• No assets in state• No trustee in state• Beneficiaries resided	Created in another state <ul style="list-style-type: none">• 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



Part 1

State Statutory Residency

Statutory Residency

- The *Linn, et. al.* decisions are an example of the complexity involved with state fiduciary income taxation where “multi-jurisdictional contacts” are present
- The next logical question is
 - What constitutes sufficient nexus with a state to justify imposing a state fiduciary income tax?
- However, for states with a statute, the first step is a determination of statutory residency

Statutory Residency

- A non-resident trust in most states including Illinois is taxed on the income *apportioned* under the state (Illinois) law
- This is the case even though the trustee may reside in Illinois, the trust offices and trust property may be located in Illinois, and all other domiciliary connections may be exclusively in Illinois

Statutory Residency

- The starting point in the analysis of the state income taxation of a trust is the determination of whether the trust will be treated as a “resident” trust
- States (that tax the income of a trust)* generally tax all the income of a resident trust, and only that portion of the state-sourced income of a non-resident trust

**** Not all states tax trusts***



Overview of State Trust Taxation

Resident State Taxation

- State fiduciary income taxation is generally based on residency with a state, and more broadly, the statutes should be based on contacts with the state
- If a trust is determined to be a “resident” of a particular state, that state will tax all of the trust’s income



Overview of State Trust Taxation

Non-Resident State Taxation

- Alternatively, if the trust is not determined to be a resident of a state under either a statute or contacts, then a state will typically apportion the tax based on only that amount of income attributed to such state
- Non-resident state taxation follows the apportionment doctrine, where only state-sourced income is taxed by the state

Overview of State Trust Taxation

- The determination of whether the trust will be treated as a resident trust, and thereby subject a trust to full state taxation, is based on the level of contacts that exist with the state
- The means by which the residence of a trust is determined is not uniform among the states
 - This is a planning opportunity – un-level playing field



Part 2

Examples of Statutory Residency Contacts

Five Common Criteria

There are generally five considerations to be aware of when dealing with multi-jurisdictional trust administrations

- 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

5 Common Criteria

Contacts

Founder Criteria: Decedent or Grantor

1. Contacts with the decedent or decedent's estate that gave rise to the testamentary trust
 - Will the decedent's state of residence, before death, subject the testamentary trust to state fiduciary income tax?
 - **27 states cite this as a statutory contact**

5 Common Criteria

Contacts

Founder Criteria: Decedent or Grantor

2. Contacts with the state of the grantor who created an *inter vivos* trust
 - Will the grantor's state of residence cause an *inter vivos* trust subject the trust to state fiduciary income tax?
 - **24 states cite this as a statutory contact**

5 Common Criteria

Contacts

Multi-Jurisdictional Trust Administration

3. Contact through the ongoing administration of the trust
 - Will the location of the trust administration cause state taxation?
 - **19 states cite this as a statutory contact**

5 Common Criteria

Contacts

Multi-Jurisdictional Trust Administration

4. Contacts with the trustee of the trust

- Will the residence of the trustee cause taxation to that trustee's state?
- **14 states cite this as a statutory contact**

5 Common Criteria

Contacts

Multi-Jurisdictional Trust Administration

5. Contacts with the beneficiary of the trust

- Will the residence of the beneficiary cause state taxation of the trust?
- **6 states cite this as a statutory contact**



Part 3

Supreme Court

Precedent

Constitutional Analysis

Constitutional Basis for State Taxation — A Perspective on Supreme Court Analysis

- One of the first reported Supreme Court cases to test the constitutionality of a state trust related tax law was the *Safe Deposit & Trust Co. v. Virginia* decided in 1929
- The *Safe Deposit* case did not involve fiduciary *income* tax, rather it involved a state intangibles tax assessed against a trustee from Maryland



Safe Deposit & Trust Co. v. Virginia

The Supreme Court held that the imposition of an intangibles tax by Virginia was unconstitutional because the situs of the property was in Maryland due to the trustee's residence, and

- Neither the grantor nor the beneficiaries who resided in Virginia had control over the trust estate of the trust



Safe Deposit & Trust Co. v. Virginia

This case highlights the importance of where the trustee resides and where the beneficiaries reside — an issue that continues to impact state taxation

- Should we look to the situs of the property and the residence of the trustee as the Supreme Court did in 1929?



Conduit Nature of State Taxation

Safe Deposit is also important because it illustrates one of the complicated aspects of state fiduciary taxation

- The premise that with a trust, you can have a bifurcation of the entity - Commonly referred to as the conduit nature of fiduciary income taxation



Conduit Nature of State Taxation

- Note that with corporations, partnerships, LLC's, and individuals, the residency can be changed due to the mobility of the entity or individual
- With trusts, many state laws will attempt to make permanent resident taxation at the onset, regardless of the movement of the parties

Mobility of Taxpayers

- Why is this issue so important?
 - The mobility of taxpayers increases the mismatch with state fiduciary income tax principles

- Example
 - Consider a family raised in Chicago, and a child moves to Nevada
 - Does Illinois still have the power to tax that individual?
 - Not for individuals, corporations, partnerships, but for fiduciary purposes, they will try
 - Remember, beneficiaries and trustees are mobile also



Conduit and Mobility = Connections

- From a constitutional perspective, this inflexibility of mobility must be based on strong connections to the state, otherwise, the state law will be deemed unconstitutional
- These connections we will see must be “purposeful” and “availing”



Part 4

Constitutional Analysis



The Commerce Clause

- The Commerce Clause can be found under Article I of the U.S. Constitution
- Article I provides the basis for our federal income tax stating in Section 8 that “Congress shall have power to lay and collect taxes”
- Clause three of Section 8 gives Congress the power to “regulate Commerce ... among the several States”



The Commerce Clause

- The Supreme Court has historically interpreted from this power, the *negative* inference that if the Constitution granted to Congress the power to regulate commerce, then the states cannot regulate interstate commerce
- The taxing power has implications on interstate commerce when a state taxes “out of state” taxpayers



The Commerce Clause

- The Supreme Court has ruled that no State may impose a tax which discriminates against interstate commerce either by
 - Providing a direct commercial advantage to local business, or
 - By subjecting interstate commerce to the burden of multiple taxation



The 'Substantial Nexus' Test

A tax does not violate the Commerce Clause if:

- It is applied to an interstate activity having a substantial nexus with the taxing state
- Is fairly apportioned
- Does not discriminate against interstate commerce
- Is fairly related to the services provided by the state



The Commerce Clause

- These factors represent the “substantial nexus” test of the Commerce Clause, and have been characterized as being more stringent than the minimum contacts requirements of the Due Process Clause



The Due Process Clause

- The Due Process Clause of the Constitution acts as a safeguard from arbitrary denial of life, liberty, or property by the Government without some interpretation of the law
- The Constitution provides that no one shall be “deprived of life, liberty, or property without due process of law”
- The words of the Due Process clause provide an assurance that all levels of government operate legally and fairly



The Due Process Clause

- As applied to states, it empowers states to tax the income of its residents, regardless of the origination of which state the income was derived
- A tax allowed under the Due Process clause must still satisfy the requirements of the Commerce Clause to be constitutional



Part 5

Case Law References

Quill and Connections

- From a state law perspective, the Due Process Clause emphasis is that there must exist “some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax”
- As well as a rational relationship between the tax and the “values connected with the taxing state”

Quill and Connections

- The connection between the Commerce Clause and the Due Process Clause for state tax law purposes is summarized by the *Quill* Court as “**distinct but parallel limitations**” on a state’s taxing power
- *Quill* notes the Commerce Clause stands for the premise that states should not burden commerce with “multiple or unfairly apportioned taxation”



Quill and Connections

- The combination of the Commerce Clause and the Due Process Clause holds that the taxing power exerted by the state must bear some “fiscal relation to protection, opportunities and benefits given by the state”

Quill and Connections

- *Generally*, the residence of an individual in a state provides sufficient connection for taxation — such as sales tax
- Contact-based connection analysis regarding state trust tax law can be difficult because of the bifurcation between the trustee legal owner and the beneficiary beneficial owner, as well as other contacts related to administration

Swift

Six Points

- The *Swift* Due Process “minimum contacts” in the context of state trust income taxation typically include
 - The domicile of the settlor of the trust
 - The state in which the trust is “created”
 - The location of the trust property
 - The domicile of the beneficiaries
 - The domicile of the trustees
 - The location of the administration of the trust

Swift

Missouri Trust Tax Law

- The Missouri Supreme Court in *Swift* continued in finding that
 - “[f]or purposes of supporting an income tax, the first two of these factors require the ongoing protection or benefits of state law only to the extent that one or more of the other four factors is present”

Swift

Missouri Trust Tax Law

- The Missouri Court went on to hold that, since Missouri law provided no present benefits or protections to the trust, beneficiaries, trustees or property
 - The State of Missouri did not have sufficient connections to impose an income tax
 - None of the beneficiaries or trustees were Missouri residents, the trust property was held, managed, and administered in Illinois, and all trust income-generating business was conducted in Illinois

Blue

Michigan Inter Vivos Trust

- *Blue* involved an *inter vivos* trust established by a Michigan resident, where all beneficiaries, trustees, income-producing assets and administration was in Florida
- The Court found “insufficient connections between the trust and the State of Michigan to justify the imposition of an income tax”
- The lack of ongoing protection and benefit of Michigan law resulted in unconstitutional taxation

Pennoyer

New Jersey Testamentary Trust

- The issue before the court was the New Jersey income taxation of a testamentary trust established under the will of a New Jersey decedent, where the trustee, beneficiaries and trust assets were all outside of New Jersey
- The court held that taxation by New Jersey was unconstitutional

Pennoyer

New Jersey Probate not Important

- In the view of the court, the creation of the trust by the probate process was not a sufficient basis for the required state nexus, benefits, or protection to tax accumulated income of the trust
- The court viewed the prior probate administration as merely “an historical fact”

Chase

D.C. Testamentary Trust Probate Matters

- Resident trust status of a testamentary trust of D.C. decedent where the trustee, beneficiaries, and trust assets were not in the District
- The court upheld resident trust status against a constitutional attack, viewing the trust as an entity similar to a corporation (rather than just a form of ownership), and finding that the creation of the trust under the will admitted to probate in the District was sufficient

Gavin

Connecticut Probate Matters

- *Gavin* considered Connecticut income taxation regarding both *inter vivos* and testamentary trusts where the settlor or testator was a Connecticut resident
- There were no Connecticut trustees and no property in Connecticut
- The court held that the creation of testamentary trusts through the Connecticut probate process was a sufficient contact

Gavin

Non-Contingent Beneficiaries

- For the *inter vivos* trusts, residence of a beneficiary in Connecticut was considered a sufficient contact for purposes of taxation
- “In the present case, the critical link to the undistributed income sought to be taxed is the fact that the noncontingent beneficiary of the *inter vivos* trust during the tax year in question was a Connecticut domiciliary”



Gavin

Non-Contingent Beneficiaries

- The non-contingent beneficiary of that trust was a Connecticut domiciliary receiving the consequent advantages of residence
- “[D]uring the tax year ..., as a Connecticut domiciliary [the beneficiary] enjoyed all of the protections and benefits afforded to other domiciliaries”

Gavin

Non-Contingent Beneficiaries

- “Her right to the eventual receipt and enjoyment of the accumulated income was, and so long as she is such a domiciliary will continue to be, protected by the laws of the state”
- Remember — this beneficiary is non-contingent
 - She will receive the property

Gavin

Non-Contingent Beneficiaries

- Connecticut also taxes the income of a trust based on the pro rata share of a non-contingent Connecticut resident beneficiary's share of the trust
- This provides additional constitutional protections — apportionment
- Because there was only one non-contingent beneficiary in Gavin, and she was a Connecticut resident, and therefore 100% of the trust income was taxable by Connecticut

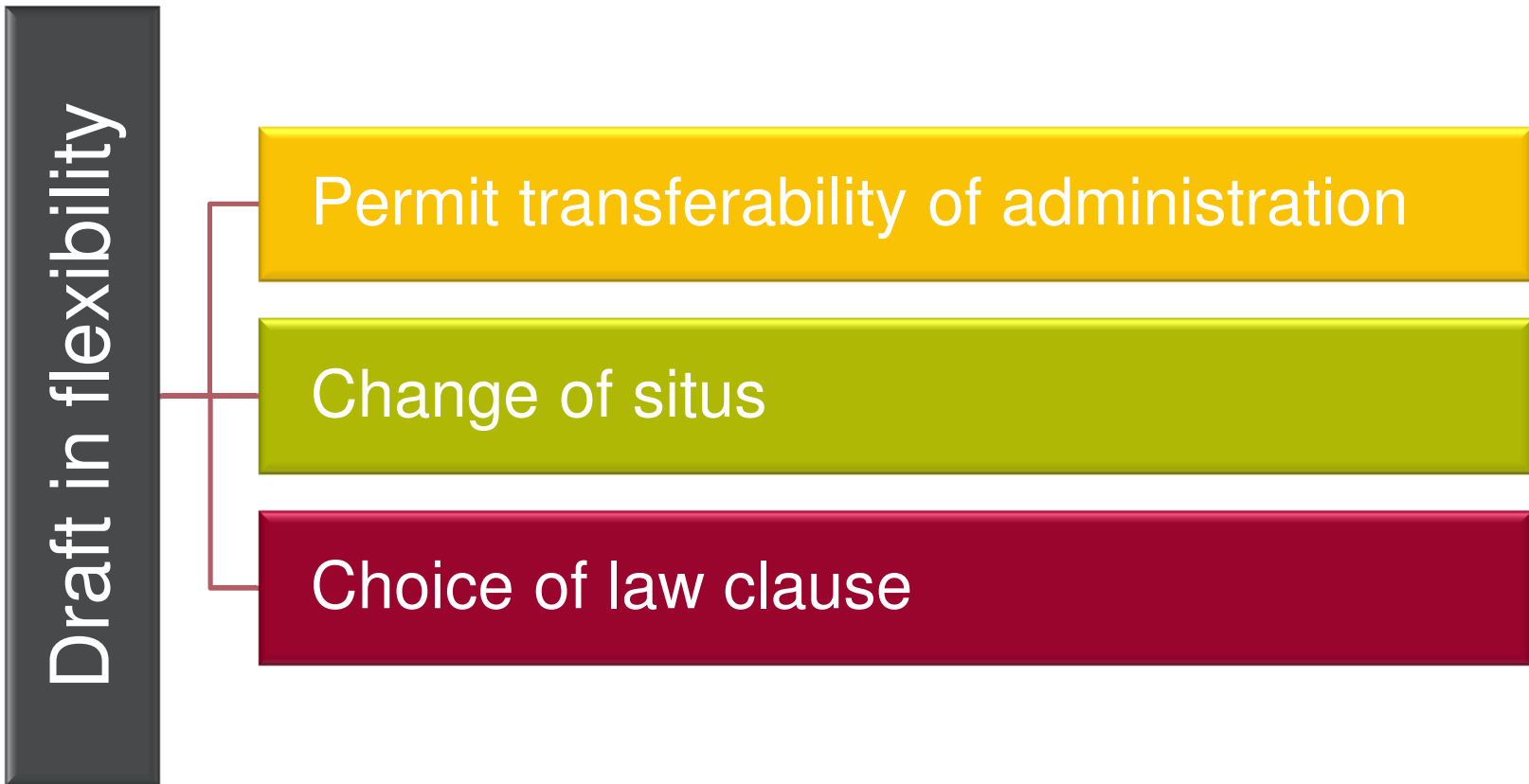


Part 6

Planning

Considerations

Planning Considerations



Decanting



- Decanting is based on the concept of pouring old wine into a new bottle
- With trusts, same concept — pouring old assets into a new trust
 - Does this action create a connection to state?
 - Purposeful availment?



Severance From the State

- What are the connections to the state?
 - Can they be severed?
 - Discretionary beneficiaries
 - Watch-out for sourced income