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State Income Tax Issues With Trusts

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Presents

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State Income Tax Issues With Trusts

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I. INTRODUCTION

There's a wide variety of fiduciary income tax laws among the states and the District of Columbia. In jurisdictions that impose income tax on trusts, that tax may be a significant expense for nongrantor trusts that do not distribute all of their ordinary income earned and realized capital gains. Many states, however, have no fiduciary income tax at all or have a fiduciary income tax regime that is easily avoided.

Given these facts, and considering our mobile society, estate planning professionals need to be conversant with how to structure estate planning vehicles and transactions to minimize state income taxes. Numerous factors, sometimes leading to conflicting results in, or tax being imposed by, multiple states, must be taken into account.

II. HOW A TRUST IS OR MAY BECOME SUBJECT TO A STATE'S INCOME TAX

A. Whether a Trust is a "Resident" for Income Tax Purposes

If a trust is established in a state whose law imposes income tax on trusts, consideration may be given to moving the principal place of a trust's administration to a state that imposes no income tax on trusts (which will often require replacement of the existing Trustee). The laws of several states, however, impose income tax on trusts based on facts other than where the trust is administered that cannot be changed. The status of a nongrantor trust as a resident for state income tax purposes, or not, of such a state doesn't depend solely on where it's administered or where the Trustee resides. The income tax statutes of numerous jurisdictions[1] treat any irrevocable trust as a resident trust for income tax purposes if the settlor was a resident of the jurisdiction when the trust was created.[2]

In those relatively few states whose laws don't impose income tax on nongrantor trusts,[3] the concept of a trust's residency for income tax purposes is meaningless. Regarding the remaining states, whether a nongrantor trust is treated as a resident for income tax purposes often determines whether the trust's undistributed income and realized capital gains will be subject to income tax in one or more of such states and generally depends on the presence of one or more of the following factors:

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[1] District of Columbia, Illinois, Maine, Maryland, Michigan, Minnesota, Nebraska, Oklahoma, Pennsylvania, Vermont, Virginia, West Virginia and Wisconsin.

[2] The laws of several other states, *i.e.*, Alabama, Connecticut, Delaware, Missouri, Ohio and Rhode Island, impose their income tax on any irrevocable trust created by a state resident if, in a given tax year, one or more beneficiaries of the trust are residents of the state.

[3] Alaska, Florida, Nevada, South Dakota, Tennessee, Texas and Wyoming.

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- If the trust was established by Will, whether the testator resided in the state at his death (the "testator residence test");
- If the trust was established by an *inter vivos* instrument, whether the settlor resided in the state at the time the trust was established (if the trust was irrevocable from the moment of establishment) or at the time the trust became irrevocable (if the trust, at the time of establishment, was revocable) (the "settlor residence test");
- The location of the trust property;
- Whether the trust is administered in the state (the "place of administration test");
- Where the trustee resides (the "trustee residence test");
- Where the beneficiaries reside (the "beneficiary residence test"); and
- Whether the trust instrument provides that the trust is to be governed by the law of the state.

B. Possible State Income Tax Results

There is a dizzying array of possible state income tax outcomes for nongrantor trusts depending on the subject trust's facts and circumstances. For example:

- If the trust was established by the Will of a testator who resided in a state whose laws impose the testator residence test ("State A"), or if the trust, irrevocable from the moment of establishment, was established, by an *inter vivos* instrument, by a settlor who resided in a state whose laws impose the settlor residence test, the trust will be considered a resident of that state, and so will be subject to that state's income tax regime, indefinitely, regardless of the presence (or lack thereof) of any other factors.[4]
- If the trust is administered in a state whose laws impose the place of administration test ("State B"), the trust will be considered a resident of that state, and so will be subject to that state's income tax regime, for as long as the trust continues to be administered in that state, regardless of the presence (or lack thereof) of any other factors.[5]
- If the trust has one or more beneficiaries residing in a state whose laws impose the beneficiary residence test ("State C"), the trust will be considered a resident of that state, and so will be subject to that state's income tax regime, for as long as one or

[4] *See*, for example, Me. Rev. Stat. Ann. Tit. 36, §5102(4)(B), (C); Neb. Rev. Stat. §77-2714.01(6)(b), (c).
[5] *See*, for example, Colo. Rev. Stat. §39-22-103(10); S.C. Code Ann. §12-6-30(5).

more beneficiaries continue to reside in that state, regardless of the presence (or lack thereof) of any other factors.[6]

- If the trust is considered a resident of a given state because of the testator residence test or the settlor residence test, but no trust beneficiaries reside in the state, the state's laws do not impose income tax on the undistributed income and realized capital gains of the trust.[7]

- If the trust was established by a testator or settlor who resided in State A, is administered in State B and has one or more beneficiaries residing in State C, the trust will be subject to the income tax regimes of all three states! Depending on the identity of State A, State B and State C, there may or may not be credits under the laws of one or two of the states that would partially offset the income tax required to be paid to the other state or states.

- If the trust was established by a testator or settlor who resided in State B, the trust is administered in State A and no beneficiary of the trust resides in State C, the trust is not subject to the income tax regime of any state, notwithstanding that each such state has a statutory scheme that imposes income tax on the undistributed income and realized capital gains of resident nongrantor trusts.

C. Additional Complexity

There are other issues that add still further complexity. First, while an irrevocable grantor trust, since it does not have a separate existence and is not recognized as a separate taxpayer for income tax purposes,[8] would seem not to be within the scope of this discussion,[9] grantor trust status inevitably ends, most often because of the death of the grantor, which may occur unexpectedly. At that juncture, depending on the presence at that time of one or more of the factors listed above, the trust's income tax posture could be surprising and unwelcome. Second, income of a nongrantor trust whose "source" is deemed to be in a given state in which the trust is not considered a tax resident will frequently be subject to tax under the laws of that state.[10] Third, there is a growing trend among state courts to strike down as unconstitutional state laws that purport to categorize nongrantor trusts as state tax residents solely because of connections to the state that are judged to be tangential or irrelevant to the question of whether the state provides a benefit to the trust that reasonably justifies that state's assessment of tax on the trust's income.[11]

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[6] *See*, for example, N.C. Gen. Stat. §105-160.2. *But see North Carolina Department of Revenue v. Kimberley Rice Kaestner 1992 Family Trust*, 586 U.S. ___, 139 S.Ct. 2213, 204 L.Ed.2d 621 (2019).

[7] *See*, for example, 30 Del. Code §1636; §143.331, RSMo.

[8] All items of a grantor trust's income, deduction and credit are attributed to and reported on the individual income tax returns of the grantor as if the trust property were owned directly and unqualifiedly by the grantor. *See* Rev. Rul. 85-13, 1985-1 C.B. 184.

[9] But at least one state, Pennsylvania, does not recognize the concept of a grantor trust.

[10] *See*, for example, §143.381.1, RSMo.

[11] *See*, for example, *Linn v. Department of Revenue*, 2 N.E.3d 1203 (Ill. App. 4th Dist. 2013); *Kimberly Rice Kaestner 1992 Family Trust v. North Carolina Department of Revenue*, 12 CVS 8740 (N.C. Super. Ct. April 23, 2015), *aff'd*

D. Specific State Examples

The following provides more detail concerning the income taxation of trusts in selected states. In almost every state that taxes trust income, the designation in a trust instrument of a particular state's law to govern trust administration is irrelevant to the trust's state tax residency.[12]

1. *Delaware*

Delaware provides many important advantages and planning opportunities with respect to trusts. In addition to trusts established under the Will of a Delaware decedent or established by a Delaware domiciliary, a trust can become a Delaware resident trust for Delaware income tax purposes if it has at least one Trustee located in Delaware.[13] Delaware resident trusts are entitled to a deduction for their federal taxable income that is retained for future distribution to nonresident beneficiaries. Delaware law, therefore, doesn't tax non-Delaware source ordinary income or capital gains in Delaware resident irrevocable trusts that benefit only individuals who reside outside Delaware.[14] These out-of-state beneficiaries usually will be subject to tax in their resident state as and when they receive income from the Delaware resident trust (unless, of course, they reside in a state that does not impose an income tax). Thus, in general, Delaware doesn't impose any income tax upon resident trusts except in cases where one or more trust beneficiaries live in Delaware and then only upon the portion of the trust income attributable to such beneficiaries.

Nonresident trusts are subject to Delaware income tax to the extent that such trusts have items of income and gain derived from Delaware sources (*i.e.*, income from real or tangible personal property located in Delaware or a business carried on in Delaware).[15]

The top tax rate for Delaware trusts is 6.6%.[16]

2. *Michigan*

Michigan law taxes trusts created by the Will of a resident decedent and *inter vivos* trusts created by an individual who was a Michigan resident at the time the trust became irrevocable.[17] Michigan law does not, however, impose income tax an *inter vivos* trust created by a Michigan resident if the Trustees, beneficiaries and the administration of the trust are all outside

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North Carolina Department of Revenue v. Kimberley Rice Kaestner 1992 Family Trust, 586 U.S. ___, 139 S.Ct. 2213, 204 L.Ed.2d 621 (June 21, 2019).

[12] The one exception seems to be Louisiana. *See* La. Stat. Ann. §47:300.10(3).

[13] 30 Del. Code §1601(8).

[14] 30 Del. Code §1636.

[15] 30 Del. Code §§1124 and 1639.

[16] 30 Del. Code §1102(a)(14).

[17] Mich. Comp. Laws §206.18(1)(c).

Michigan, even if the trust holds Michigan real property (non-income producing).[18] The top tax rate in Michigan is 4.25%.[19]

3. *New Jersey*

A trust is considered resident in New Jersey and subject to New Jersey income tax if: (a) the trust is established under the Will of a New Jersey decedent; or (b) the trust was established by an individual who was a New Jersey domiciliary at the time the trust became irrevocable. The top income tax rate for a New Jersey resident trust is 10.75%.[20] However, a New Jersey resident trust isn't subject to New Jersey income tax if it has no tangible assets in New Jersey, no income from New Jersey sources and no New Jersey Trustee.[21]

4. *Missouri*

A trust is subject to Missouri income tax, as a resident trust, if: (a) it was created by the Will of a Missouri decedent; or (b) it is an *inter vivos* trust that was created by a Missouri resident. In both situations, however, the trust must have a resident income beneficiary on the last day of the taxable year if the trust is to be subject to tax. A trust created under the Will of a Missouri decedent where the Trustees, all the beneficiaries, the trust property and the administration of the trust are outside Missouri is not subject to Missouri income tax.[22] The top tax rate is 4.8%.[23]

5. *New York*

In New York, the tax statutes and regulations contain specific rules as to when a trust created by a New York resident will not be subject to New York income tax. These statutes and regulations make clear what actions a settlor must take to avoid New York trust income tax. New York law generally imposes income tax on trusts established under the Will of a New York decedent as well as trusts established by individuals who were New York residents when the trust became irrevocable.[24] The top tax rate for New York State is 10.9%.[25] If the trust resides in New York City, there's an additional 3.876% tax.[26] New York law imposes income tax on nonresident trusts' New York source income, which consists of income generated by real or tangible personal property located in New York or a business carried on in New York.[27]

New York income taxes (both New York State and New York City) don't apply to a resident trust if all of the following conditions are met: (a) all of the Trustees reside elsewhere;

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[18] *Blue v. Department of Treasury*, 462 N.W.2d 762 (1990).
[19] Mich. Comp. Laws §206.51(1)(h).
[20] NJSA §§54A:1-2(o); 54A:2-1.
[21] Form NJ-1041 Instructions; *Pennoyer v. Tax. Div. Director*, 5 N.J. Tax 386 (1983); *Potter v. Tax. Div. Director*, 5 N.J. Tax 399 (1983).
[22] *In re Swift*, 727 S.W.2d 880 (Mo. 1987).
[23] §§143.011, 143.061, 143.311, 143.331, RSMo.
[24] NY Tax Law §605(b)(3).
[25] NY Tax Law §601(c).
[26] NY Tax Law §1305.
[27] NY Tax Law §601.

(b) the entire principal, including real and tangible property, is located elsewhere; and (c) all income and gains are derived from non-New York State and/or City sources.[28]

A trust created by a New York resident is subject to New York tax if an adviser or trust committee member lives in New York even if the Trustee and all trust property are outside New York.[29] New York may not, however, assess income tax against an *inter vivos* trust that has no ties to New York other than that the trust was created by a resident and has a resident contingent beneficiary.[30]

6. *California*

A trust is a California resident for state income tax purposes if any fiduciary or a non-contingent beneficiary is a California resident.[31] Income is ratably apportioned, first, according to the number of California and non-California fiduciaries and, second, among the California and non-California non-contingent beneficiaries.[32] The top tax rate is 13.3%.[33] In California Franchise Tax Board Technical Advice Memorandum 2006-0002 (2/17/06), the Franchise Tax Board ("FTB") indicated that a current California beneficiary who is eligible to receive distributions from a non-California Trustee in the Trustee's discretion should be able to defer or avoid California tax. The FTB reasoned that a California beneficiary has a non-contingent interest only as of the time that the Trustee actually decides to distribute and, then, only to the extent of the amount of income distributed. Thus, when distributions are not being made, there is no resident beneficiary in this situation, and the trust is not a resident trust.

If California income tax on a trust is avoided because the California beneficiary's interest is contingent and the trust has no resident Trustee, when the California beneficiary's interest is distributed or is distributable, then such beneficiary will be subject to the amount of tax that would have accrued during the time period (not to exceed five years) that the trust accumulated income for such beneficiary.[34]

III. CONSTITUTIONAL CHALLENGES TO A STATE'S TAXATION OF A TRUST

The Due Process Clause of the United States Constitution requires "some definite link, some minimum connection, between a state and the person, property or transaction it seeks to

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[28] NY Tax Law §605(b)(3)(D); NY Comp. Codes R. & Regs. Title 20 §105.23; Advisory Opinion TSB-A-10(5)I (6/8/2010); Advisory Opinion TSB-A-10(4)I (6/8/2010).
[29] TSB-A-04(7)I, 2004 N.Y. Tax Lexis 259 (Nov. 12, 2004).
[30] *Mercantile-Safe Deposit and Trust Company v. Murphy*, 242 N.Y.S.2d 26, 19 A.D.2d 765 (3d Dept. 1963), *aff'd*, 15 N.Y.2d 579, 255N.Y.S.2d 96, 203 N.E.2d 490 (1964); *see also Taylor v. State Tax Commission*, 445 N.Y.S.2d 648, 85 A.D.2d 821 (3d Dept. 1981) (New York could not tax a testamentary trust when the only connection to the state was the decedent's domicile).
[31] Cal. Rev. & Tax. Code §§17043(a), 17742(a).
[32] Cal. Rev. & Tax. Code §§17743, 17744; Cal. Code Regs. Tit. 18, §§17743, 17744.
[33] Cal. Rev. & Tax. Code §17041(a), (e), (h).
[34] Cal. Rev. & Tax. Code §17745; *see also* California Franchise Tax Board Technical Advice Memorandum 2006-0002 (2/17/06), discussed in the text above.

tax."[35] A link or connection can exist even without a physical presence in the taxing state.[36] In applying this rationale to trusts, courts have based their decisions on whether a state has sufficient "minimum contacts" with the testator or settlor, the Trustees, the trust property and/or the beneficiaries.

A. *District of Columbia v. Chase Manhattan Bank*

In *District of Columbia v. Chase Manhattan Bank*,[37] the District of Columbia sought to tax a testamentary trust created by a resident of the District of Columbia upon his death in 1934. During the relevant time period, the sole Trustee was Chase Manhattan Bank, located in New York. All the trust assets were held in accounts at Chase, and no beneficiary was a resident of the District of Columbia. Chase brought this case to obtain a refund of income taxes it had paid to the District of Columbia for the years 1987-1991, asserting that the District's taxation of the trust violated the Due Process Clause.

The court pointed out the "courts of the District of Columbia have exercised continuing supervisory jurisdiction over the trust since its inception," which has included annual accountings and trust-related litigation. Thus, because the "District created the legal environment which permitted the trust to come into existence, established the trust when [the testator's] will was probated, and has provided access to its courts to all parties with an interest (or potential interest) in the trust," the District's jurisdiction over the trust "reflects a sufficient nexus" to justify the District's taxation of the trust.

B. *Chase Manhattan Bank v. Gavin*

In *Chase Manhattan Bank v. Gavin*,[38] the court considered five trusts created by a Connecticut resident, four testamentary and one *inter vivos*. Connecticut law imposed income tax on the trusts for the tax year at issue, 1993. The Trustee paid the tax and then brought this claim against the state seeking a refund, claiming that the Connecticut taxation scheme violated the Due Process Clause (as well as the Commerce Clause; the *Gavin* holding with respect to the Commerce Clause is discussed below). At the relevant time:

- Chase Manhattan Bank, a New York corporation, was the Trustee of all the trusts.
- Both the current beneficiary and the remainder beneficiaries of the *inter vivos* trust were Connecticut residents. With respect to two of the testamentary trusts, Connecticut residents held interests as current beneficiaries and as remainder beneficiaries, and, with respect to the other two testamentary trusts, no beneficiaries were Connecticut residents.
- All the assets of all the trusts were outside of Connecticut.

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[35] *Quill Corporation v. North Dakota*, 504 U.S. 298, 112 S.Ct. 1904, 119 L.Ed.2d 91 (1992), *overruled on other grounds, South Dakota v. Wayfair*, 585 U.S. ___, 138 S.Ct. 2080, 201 L.Ed.2d 403 (2018).
[36] *See South Dakota v. Wayfair, supra,* note 35.
[37] *District of Columbia v. Chase Manhattan Bank*, 689 A.2d 539 (D.C. App. 1997).
[38] *Chase Manhattan Bank v. Gavin*, 733 A.2d 782 (Conn. 1999).

- Chase, as Trustee, hadn't been subject to any judicial or administrative proceeding in Connecticut other than in connection with accountings filed with the probate court for three of the testamentary trusts.

Regarding the testamentary trusts, relying on *Quill*, the court found that, because Connecticut provided benefits to the testamentary trusts such as the laws that allow for the creation of wills and trusts and their administration, as well as a forum for the litigation of disputes concerning wills and trusts, Connecticut had a sufficient connection to the testamentary trusts to tax them under the Due Process Clause.

Regarding the *inter vivos* trust, the court held that the existence of a Connecticut beneficiary of the trust constituted a sufficient connection to support Connecticut's taxation thereof, because the Connecticut domiciliary "enjoyed all of the protections and benefits afforded to other domiciliaries." Thus, although the court considered this issue a closer one than its consideration of the tax imposed on the testamentary trusts, the court held that the tax on the *inter vivos* trust didn't violate the Due Process Clause.

C. *Fielding v. Commissioner of Revenue*

1. *Facts*

In *Fielding v. Commissioner of Revenue*,[39] Reid V. MacDonald (the "Grantor") formed four grantor trusts in 2009 (the "Trusts"), while domiciled in Minnesota. The Trusts were funded with shares of common stock in Faribault Foods, Inc., a Minnesota Subchapter S corporation. The Trustee, trust administration, and all but one of the beneficiaries of the Trusts were always located outside of Minnesota.

In 2011, the Grantor gave up the power to substitute trust assets, and the Trusts became irrevocable. Under Minnesota Statute § 290.01, subd. 7b(a)(2), Minnesota law defines a "resident trust," in part, as "an irrevocable trust, the grantor of which was domiciled in this state at the time it became irrevocable." At the time the Trusts became irrevocable, the Grantor was domiciled in Minnesota.

On August 1, 2014, the Trustee sold the stock held by the Trusts, resulting in substantial deposits in each of the Trusts' accounts. Under the trust terms, the Trustees made distributions to each beneficiary during 2014. Each Trust timely filed a 2014 Minnesota income tax return as a Minnesota "resident trust" and paid the reported tax under protest, including a statement asserting that the statutory definition of a "resident trust" was unconstitutional. Each Trust then filed an amended 2014 Minnesota income tax return without treating itself as a Minnesota "resident trust," and requested a refund.

[39] *Fielding v. Commissioner of Revenue*, 916 N.W.2d 323 (Minn. July 18, 2018), *aff'g*, 2017 Minn. Tax LEXIS 28 (Minn.T.C. 2017), *cert. denied* __ U.S. __ (2019).

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2. *Analysis*

The Trustee argued that Minnesota's definition of a "resident trust" violated the due process provisions of the Minnesota and United States constitutions.

Due process analysis imposes two constraints on state taxation. There must be both "a minimum connection" between a state and the person, property or transaction subject to tax and a rational relationship to the benefits conferred on the taxpayer by the State.[40] The Court found that the statute failed the due process analysis for three reasons.

First, the Court held that the Grantor's residence at the time the trusts became irrevocable was "not relevant to the relationship between the Trusts' income that Minnesota seeks to tax and the protection and benefits Minnesota provided to the Trusts' activities that generated that income. The relevant connections are Minnesota's connection to the trustee, not the connection to the grantor who established the trust years earlier." Thus, the Court looked largely to the trusts' independence as a legal entity, separate from the grantor or beneficiary.[41]

Second, the trusts owned no physical property in Minnesota that might serve as a basis of taxation.[42] The trusts owned interests in intangible property (the stock of a Minnesota company), but those intangible assets were held outside the state of Minnesota.

Third, the Court did not find any contacts with Minnesota by the grantor, the trusts or the beneficiaries, that occurred prior to the tax year at issue to be relevant. Citing Luther, the Court found that the relevant facts for evaluating the sufficiency of a taxpayer's contacts are drawn from the tax year at issue.

D. *North Carolina Department of Revenue v. Kimberley Rice Kaestner 1992 Family Trust*

1. *Facts*

In *North Carolina Department of Revenue v. Kimberley Rice Kaestner 1992 Family Trust*,[43] Joseph Lee Rice, III (the "Settlor"), a resident of New York, created the Joseph Lee Rice, III Family 1992 Trust for the benefit of his children. William B. Matteson, also a resident of New York, served as the initial Trustee. The trust agreement provided that the Family Trust was to be governed by the laws of the State of New York. In 1997, Kimberley Rice Kaestner, one of the Settlor's children, moved to North Carolina. William B. Matteson resigned as Trustee in 2005, and David Bernstein, a Connecticut resident, became Trustee.

In 2006, pursuant to the terms of the Family Trust Agreement, Bernstein divided the Family Trust into three separate trusts for each child. One of the separate trusts was the Kimberley Rice Kaestner 1992 Family Trust (the "Kaestner Trust"). The Kaestner Trust benefited

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[40] *Luther v. Commissioner of Revenue*, 588 N.W.2d 502 (Minn. 1999).
[41] *See Greenough v. Tax Assessors of Newport*, 331 U.S. 486, 67 S.Ct. 1400, 91 L.Ed. 1621 (1947).
[42] *See, e.g., Westfall v. Dir. of Revenue*, 812 S.W.2d 513 (Mo. 1991).
[43] *North Carolina Department of Revenue v. Kimberley Rice Kaestner 1992 Family Trust, supra,* note 6.

Kaestner as well as her three children, each of whom resided in North Carolina from 2005 to 2008, the tax years at issue. The contingent beneficiaries of the Kaestner Trust were Kaestner's siblings, none of whom resided in North Carolina.

From 2005 to 2008 the Kaestner Trust's assets were held by a custodian in Boston, Massachusetts. The ownership documents for some of the assets were located in New York, along with financial and legal records. Tax returns and trust accountings were all prepared in New York. The Kaestner Trust provided that all income and principal distributions from the trust were in Bernstein's discretion. Neither Kaestner nor her children received distributions from the Kaestner Trust between 2005 and 2008. However, two loans were made from the Kaestner Trust during the same period: a $250,000 loan was made to Kaestner for an investment and another loan was made to a separate trust "to enable [the trust] to make a capital call on a limited partnership interest" held in that trust. Both loans were eventually repaid to the Kaestner Trust. Kaestner and Bernstein communicated regularly regarding Kaestner's need for distributions and investment of the trust assets. In 2009, Bernstein transferred the Kaestner Trust assets to a new trust, the KER Family Trust.

Each year, from 2005 to 2008, the North Carolina Department of Revenue (the "State") taxed the Kaestner Trust on its income. The Kaestner Trust paid the taxes and sought a refund for the taxes paid, which the State denied in 2011. Section 105-160.2 of the North Carolina statutes provides, in relevant part, that the state may tax the income of a trust "that is for the benefit of a resident of [North Carolina]." The Kaestner Trust sued, alleging that this statute was unconstitutional under the Due Process and Commerce Clauses of the United States Constitution as well as Article I, Section 19 of the North Carolina Constitution.

2. *Analysis*

The Supreme Court of North Carolina observed that the Due Process Clause requires "some definite link, some minimum connection, between a state and a person, property or transaction [the government] seeks to tax"[44] and that the income attributed to the state for tax purposes must be rationally related to values connected with the taxing state.[45] "[I]t is essential in each case that there be some act by which the [party] purposefully avails itself of the privilege of conducting activities within the forum state, thus invoking the benefits and protections of its laws."[46]

The North Carolina Supreme Court found it critical here that a trust is a legally independent entity from its beneficiary, and that in this situation, it was the trust beneficiaries, and not the trust, that were North Carolina residents. Given the separate legal entities, the court found that the beneficiaries' contact with North Carolina was insufficient to satisfy due process.

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[44] Quoting *Quill Corporation v. North Dakota*, *supra* note 35, at 508 U.S. 298, 306.
[45] *Id*.
[46] Quoting *Skinner v. Preferred Credit,* 361 N.C. 114, 123, 638 S.E.2d 203, 210-11 (2006).

The United States Supreme Court, also quoting *Quill*,[47] largely agreed, requiring a "minimum connection" between the state and the person, property or transaction it seeks to tax. The notion of minimum connection arose from the Court's landmark *International Shoe* decision,[48] which the Court applied here stating: "[u]ltimately, only those who derive 'benefits and protection' from associating with a State should have obligations to the State in question." Notwithstanding that the Department of Revenue had argued before the Court that in-state beneficiaries certainly derive benefits and protection from the State, the Court observed that no income was distributed to the beneficiaries and that they had no right to receive any income on demand. Because the beneficiaries didn't receive or have a right to income, the Court concluded there was no connection between the State and the thing being taxed, the income, as required by the Due Process Clause. The Court didn't believe it was generating new law, and the opinion noted earlier cases in which, in the context of beneficiary contacts, specifically, the Court focused on the extent of the in-state beneficiary's right to control, possess, enjoy or receive trust assets.[49]

In affirming the North Carolina Supreme Court, however, the United States Supreme Court assiduously avoids making any sort of sweeping pronouncement. While agreeing that the Kaestner Trust beneficiaries lacked a relationship with the trust that merit taxation under North Carolina law, the Court stated: "We do not decide what degree of possession, control, or enjoyment would be sufficient to support taxation."

IV. CHANGING A TRUST'S RESIDENCY TO AVOID STATE INCOME TAX

A. In General

To change a trust's tax residency for state income tax purposes, the Trustee and his, her or its advisors must analyze the rules and procedures regarding trust tax residency in the existing and prospective jurisdictions of residence. In addition, the steps that must be taken will be based on which characteristics of the trust need to be changed to take the trust outside the scope of the resident state's taxation regime and establish it as having a tax residency in the target state. Thus, changing trust tax residency involves a close analysis of the statutes of both jurisdictions, the terms of the trust instrument and the characteristics, including the location, of the Trustee, the trust assets and the beneficiaries. Also, the Trustee should determine whether the desired benefits available are significant enough to justify the costs and risks that will be incurred in connection with the change of tax residency.

States whose laws tax trusts based on the tax residence of the Trustee, tax residence of the beneficiary, location of administration or any other factor besides the tax residence of the individual who created the trust at the time of creation provide more flexibility in changing the tax residence of the trust for income tax purposes.

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[47] *Quill Corporation v. North Dakota*, 504 U.S. 298, 306 (1992), overruled on other grounds, *South Dakota v. Wayfair*, 585 U.S. ___ (2018).
[48] *International Shoe Co. v. Washington*, 326 U.S. 310, 66 S.Ct. 154, 90 L.Ed. 95 (1945).
[49] *See* Turney P. Berry and Charles A. Redd, "Supreme Court Decides *Kaestner* But Teaches Little," *Trusts & Estates*, August 2019.

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B. Examples and Strategies to Consider

For example, if a state's law requires a trust to have no resident Trustee to avoid state income tax, such as California, Kentucky and Arizona, the practitioner must: (1) determine if the current Trustee is willing to resign or may be removed, (2) locate a suitable out-of-state Trustee and (3) coordinate the change of Trustees. This process will generally not involve a court proceeding, assuming the trust instrument or state law permits the resignation or removal of the Trustee and provides a non-judicial mechanism for the appointment of a successor Trustee.

The advisor must ensure that the steps taken to change a trust's tax residency do not inadvertently cause the trust to be subject to state income tax elsewhere. For example, the advisor would presumably seek to avoid designation of a new Trustee situated in, say, Colorado, whose laws subject a trust to income taxation if the trust has its place of administration there.[50]

As indicated above, under California trust income tax laws, if a trust has a California-resident fiduciary or has California non-contingent beneficiaries, regardless of whether its settlor is or was a resident of California, some or all of the trust income will be subject to California income tax. Only a proportionate share of the trust's taxable income from sources outside California will be subject to tax when there are nonresident co-fiduciaries or nonresident beneficiaries.[51] Thus, it appears that the California income tax can be substantially reduced by the appointment of one or more non-California co-fiduciaries.

The transfer of a trust's residency for income tax purposes from one state to another might be accomplished through a provision in the trust instrument (*e.g.*, provisions allowing for resignation, removal, appointment and/or replacement of a Trustee), by statute or by a court order. If the parties need to move a trust's tangible personal property out of state to achieve the desired tax results, the Trustee may need court approval before removing the property from the state.

Trustees and their advisors should consider dividing trusts to the extent allowable under the law of the applicable state (*see, e.g.*, Uniform Trust Code § 417) to minimize exposure to a state's income tax. Dividing a trust into separate trusts for each beneficiary may be more equitable to beneficiaries and preserve part of the trust against state income tax. For example, as stated above, a trust may be subject to Missouri income tax only if the trust has a resident income beneficiary on the last day of the taxable year. If a trust has two beneficiaries, one a Missouri resident and the other a resident of Texas (which does not impose an income tax on trusts), dividing the trust so that one share is held for the sole benefit of the Missouri beneficiary and other share is held for the sole benefit of the Texas beneficiary will preserve the trust for the Texas beneficiary from Missouri state income tax.

The change of a trust's residency for state income tax purposes becomes an especially important consideration when the Trustee is considering engaging in a transaction that may give rise to significant state income tax (such as the sale of low-basis stock). The parties should consider changing the tax residency before the transaction takes place such that no part of the

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[50] Colo. Rev. Stat. §39-22-103(10).
[51] *Supra*, note 32.

transaction will be considered to have taken place in the final tax year of the trust's tax residency in the state from which the trust is migrating.

Once a trust's state tax residency has been changed, to begin the running of the statute of limitations and perhaps minimize interest and penalties, the Trustee would be well advised to file a final tax return in the prior state of residency showing that no tax is due. The lawyer might also advise the Trustee to segregate funds to pay the taxes, penalties and interest if the filing position is unsuccessful.

Taking steps to change the state tax residence of a trust will not cause a trust that is exempt from federal generation-skipping transfer tax because it was irrevocable before September 26, 1985 to lose that status. Treas. Reg. § 26.2601-1(b)(4)

V. DETERMINING THE SOURCE OF INCOME FOR STATE INCOME TAX PURPOSES

Generally, states tax resident trusts on all their world-wide income and tax nonresident trusts only on the income generated from real property, tangible personal property or business interests within the state, *i.e.*, the "source" income of the nonresident trust.[52] Thus, the planning opportunities available from changing the tax residency are limited to realized capital gains and accumulated income that are not considered "source" income.

A. *Residuary Trust A v. Director, Division of Taxation*

In *Residuary Trust A v. Director, Division of Taxation*,[53] the New Jersey Tax Court ruled that the trust did not owe New Jersey income tax on undistributed out-of-state income for tax year 2006 because it did not own New Jersey assets. On appeal, the Superior Court affirmed.[54] The trust was created under a decedent's Will, and the sole Trustee resided and administered the trust outside New Jersey. The trust owned stock in four New Jersey S Corporations, and the S Corporations owned assets located in New Jersey. The Division of Taxation attempted retroactively to apply to Residuary Trust A its 2011 notice, which stated that the Division would impose tax on undistributed, non-New Jersey income if the trust earned income from New Jersey-source assets. Both the Tax Court and the Superior Court rejected the propositions that: (1) ownership of stock in a company that owned New Jersey assets constituted ownership of New Jersey assets for purposes of taxing all undistributed income of the trust; and (2) the Division could retroactively apply guidance not issued until five years after the tax year at issue.

B. N.Y. Tax Law §631

Income and gain from real property owned by a pass-through entity or a non-publicly traded C corporation with one hundred or fewer shareholders is New York source income if the property is located in New York and has a fair market value that "equals or exceeds fifty percent

[52] *See, e.g.*, 30 Del. Code §§1124 and 1639.
[53] *Residuary Trust A v. Director, Division of Taxation*, 27 N.J. Tax 68 (N.J. Tax Ct. 2013).
[54] *Residuary Trust A v. Director, Division of Taxation*, Docket No. A-3636-12T1, 2015 WL 2458024 (N.J. Super. Ct. May 28, 2015).

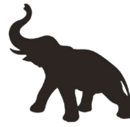
of all the assets of the entity on the date of sale or exchange of the taxpayer's interest in the entity."[55]

VI. TRUSTS THAT ARE SUBJECT TO STATE INCOME TAX IN MULTIPLE STATES

Because the states vary considerably regarding most aspects of trust income taxation, it is almost always possible that a trust will be considered a resident trust for income tax purposes in more than one state and, therefore, subject to income tax in more than one state (or, perhaps, not be subject to state income tax at all). For example, as discussed above, a trust may have California non-contingent beneficiaries, which would make that trust a resident for California income tax purposes. If the Trustee is located in Arizona, then the trust would also be considered a resident for Arizona income tax purposes.[56] Conversely, a trust created by a California domiciliary, with no California fiduciary and no California non-contingent beneficiaries, would not be subject to income tax in California, and, if that trust were administered by, say, a Missouri Trustee, it would not be subject to Missouri income tax either. Note that results such as this can occur where neither of the relevant states is one of the seven states that doesn't impose any fiduciary income tax at all.

In cases involving multi-jurisdictional trusts, it is often necessary to conduct an analysis of the relevant state statutes and the sources of trust income to determine whether some of the income is subject to tax in one state while the rest of the income is subject to tax in the other state or whether there are one or more items of income that are actually subject to income tax in both states. Due to the lack of uniformity among the states, any credits a state may provide to a trust that is subject to double taxation of income may or may not offset, in whole or in part, the income tax paid to the other state.[57]

[55] NY Tax Law §631(b)(1)(A)(1). The New York State Department of Taxation and Finance has issued a separate bulletin on what does and does not constitute source income for purposes of assessing New York tax on nonresidents. N.Y. Tax Bull. TB-IT-615 (Dec. 15, 2011).
[56] Ariz. Rev. Stat. § 43-1301(5).
[57] A United States Supreme Court decision outside the fiduciary income tax context, however, may force states to provide a full tax credit in order to comply with the "dormant" Commerce Clause of the United States Constitution. *Comptroller of the Treasury v. Wynne*, 578 U.S. 542, 135 S.Ct. 1787, 191 L.Ed.2d 813 (2015).



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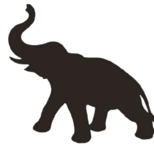

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To be Completed by the Provider

Provider: Cannon Financial Institute (CA Provider #12179)

Subject Matter/Title: State Income Tax Issues with Trusts

Date and Time of Activity: February 20, 2024, 1:00-2:30 PM ET, 12:00-1:30 PM CT, 11:00AM-12: 30 PM MT, 10:00AM- 11:30 AM PT

Location: Teleconference

Length of Presentation: 1.5 Hours

ELIGIBLE CALIFORNIA MCLE CREDIT:

TOTAL HOURS: 1.5

Legal Ethics:

Elimination of Bias in the Legal Profession:

Competence:

To Be Completed by the Attorney after Participation in the Above-Name Activity

By signing below, I certify that I participated in the activity described above and am entitled to claim the following California MCLE credit hours:

TOTAL HOURS: ______________________

(You may not claim credit for the following sub-fields unless the provider is granting credit in these areas as listed above.)

Legal Ethics:______________________

Elimination of Bias in the Legal Profession:______________________

Competence: ______________________

Attorney Signature:

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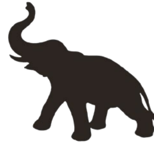

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(834686)

February 20, 2024

Laurie Sebestyen
Professional Education Coordinator

Continuing Legal Education Credits for this course are as follows:

Colorado – 2.0 General Credits

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Virginia MCLE Board

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Member Name: ______________________________ **VSB ID#:** ______________________

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Course ID: NLL0552

Sponsor: Cannon Financial Institute

Title: State Income Tax Issues with Trusts

Credits:	1.5	0.0	0.0
	CLE	**(Ethics)**	**Well-being**

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By my signature below I certify:

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____ Credit is awarded for actual time in attendance (0.5 hr. min) rounded to the nearest half hour. (1hr 15 min = 1.5hr)

____ The sessions I am claiming had written instructional materials to cover the subject.

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