American Bar Association
Section of Taxation

State Fiduciary Income Tax Developments
Fiduciary Income Tax Sub-Committee

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David A. Berek
Baker & McKenzie LLP
Chicago, Illinois
david.berek@bakermckenzie.com

Raj A. Malviya
Miller Johnson
Grand Rapids, Michigan
malviyar@millerrjohnson.com
State Fiduciary Income Tax Developments

I. Introduction

A. Overview of State Fiduciary Income Taxation for Resident and Nonresident Trusts

Trusts are also subject to particular state’s tax regime, in addition to federal fiduciary income taxation, if such state imposes a state fiduciary income tax. Currently, 43 states and the District of Columbia impose a state fiduciary income tax.1 The seven states that do not impose a state-level income tax are: Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming. The question of whether a state can justify imposing a tax with continued entitlement to its share of fiduciary income tax revenue has become an important and developing issue in fiduciary income taxation. And, the migration of trusts to those states that do not impose a state-level income tax has become a common goal among practitioners.

1. Resident State Taxation

State fiduciary income taxation is generally based on “residency” within a state, and more broadly, contacts with the state. If a trust is determined to be a “resident” of a particular state, that state’s state statute will attempt to tax all of the trust’s income. 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 state statute, and supported by the level of contacts that exist with the state.2 Five commonly reviewed contacts discussed throughout this document include: (1) contacts with the decedent or decedent’s estate (i.e., a probate proceeding) that gave rise to a testamentary trust, (2) contacts with the state by the grantor when the grantor created an inter vivos trust in the state, (3) contact through the ongoing administration of the trust in the state, (4) contacts with the trustee of the trust in the state, and (5) contacts with the beneficiary of the trust in the state. Under one or more of these factors, the state statute may deem a trust a statutory resident.

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1 See Nenno, Let My Trustees Go! Planning to Minimize or Avoid State Income Taxes on Trusts, 46th Heckerling Inst. on Est. Pl., ch. 15 (2012) for a thorough review of various states with detailed charts addressing state-by-state application (hereinafter “Nenno”).

2 The issue of resident state taxation was most recently considered in the Supreme Court of North Carolina in Kaestner v. N.C. Dept. of Revenue, 814 S.E.2d 43 (N.C. 2018), aff’g 789 S.E.2d 645 (N.C. Ct. App. 2016), in Illinois under the decision of Linn v. Department of Revenue, 2 NE3d 1203 (Ill. App. Ct. 2013), as well as in Pennsylvania under the decision McNeil v. Commonwealth, 67 A3d 185 (Pa. Commw. Ct. 2013), all of which are discussed below.
2. Nonresident State Taxation

Alternatively, if the trust is not determined to be a resident as to a particular state, then a state may apportion tax on trust income based on only that amount of income attributed to such state. Case law has determined apportionment an important aspect of constitutional state taxation as discussed in Complete Auto Transport and the “substantial nexus” test of the Commerce Clause (see ¶1506). Nonresident state taxation follows the apportionment doctrine, where only state-sourced income is taxed by the state. The New Jersey decision of Residuary Trust is an example where the trust in question was determined not to be a resident trust, but New Jersey did tax state-sourced income to the trust as a nonresident trust.³

B. The Linn Example: Introduction to the Issue

The impact of the above general rules can be illustrated by a review of a 2013 Illinois decision: Linn v. Department of Revenue.⁴ The statutory residency requirement in Linn is the more commonly used amongst the states—the grantor was a resident of Illinois when the trust was created. The Linn decision evolved from an irrevocable inter vivos trust created in 1961. Over time, the administration of the trust involved less and less contacts with the state of Illinois, and by 2007 when the underlying proceedings began, where:

- No income was earned in the state of Illinois,
- None of the trust’s assets were located in Illinois,
- The trust was administered outside of Illinois, and
- Both the trustee and beneficiary resided outside of Illinois (in the state of Texas).

Thus, the trust had no connection with Illinois, except that the grantor was a resident of Illinois at the time the trust was created. This fact, under Illinois law, resulted in the premise that the trust would forever be burdened with paying Illinois tax on all of its worldwide income, regardless of how brief the grantor was a resident of Illinois.

- 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.

If, on the other hand, the grantor of such an inter vivos trust had not been resident of Illinois at the time the trust became irrevocable, the trust would be classified as a “nonresident” trust. A nonresident trust in Illinois is taxed on the income apportioned under 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.

³ Residuary Trust v. Director, Division of Taxation, 27 NJ Tax 68 (2013).

The Illinois Department of Revenue argued at the trial level that the original trust agreement (which had since been modified) selected Illinois under the choice of law clause, and that this prior choice of law election justified substantial nexus with the state. The Illinois Appellate Court determined that the law subjecting the Linn trust to Illinois fiduciary income taxation was unconstitutional—but only as to the Linn taxpayer. Thus, inter vivos trusts created by Illinois residents that meet the facts of Linn no longer should be subject to Illinois fiduciary income taxation, based on the status of the grantor on creating the trust, yet the Illinois Department of Revenue has not conceded the issue, and similarly situated taxpayers must consider a reporting position that may require litigation to achieve the same result.

II. Residency

A. How Is the “Residence” of a Trust Determined

The Linn decision is an example of the complexity involved with state fiduciary income taxation where “multi-jurisdictional contacts” are present. The question is: what constitutes sufficient nexus with a state to justify imposing a state fiduciary income tax?

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. As discussed above, 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 nonresident trust. If the state taxes all the income of a resident trust, there will be a statute defining what is necessary to reach resident status. The means by which the residence of a trust is determined is not uniform among the states, but the following criteria is commonly recognized to support the residence of a trust.

1. Mobility and Multi-Jurisdictional Contacts

The state taxation issue is heightened when considering that the mobility of taxpayers increases the mismatch with state fiduciary income tax principles. Consider a family raised in Chicago, with a child that moves to Nevada. Does Illinois still have the power to tax that individual taxpayer? For individual income tax purposes, the answer is generally no, as with corporation taxation and partnership taxation for taxpayers that change situs. But for fiduciary tax purposes, if the taxpayer was originally a resident trust and the trust changed administrative situs as in Linn, Illinois would continue to try to tax the taxpayer.

5 Note that if choice of law was determinative for state taxation as the Illinois trial court concluded, every trust drafted since this case would select one of the seven jurisdictions identified above (Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming) as the “choice of law” state, regardless of origin or domicile.

6 Section 304 of the Illinois Income Tax Act. The Illinois Department of Revenue has indicated that they will not appeal the Linn decision, yet the State Legislature has no current plans to amend the statute.

7 See Nenno for more information on how diverse the state determination of residence can be, and note the summary chart below is included for quick reference.
Some initial considerations to be aware of when dealing with multi-jurisdictional trust administration:\(^8\)

- Will the decedent’s state of residence before death subject a testamentary trust to state fiduciary income tax?
- Will the grantor’s state of residence cause an inter vivos trust to be subject to state fiduciary income tax?
- Will trust administration cause state taxation?
- Will the residence of the trustee cause taxation to that trustee’s state?
- Will the residence of the beneficiary cause state taxation of the trust?

As the chart below depicts, most states base the analysis solely on the first two criteria, the residence of either the grantor (for an inter vivos trust) or testator (for a testamentary trust)—also referred to below as the “founder” criteria. Other states either base the analysis on one or both founder criteria, plus some other criteria, such as the place of administration, the residence of the trustee, and/or the residence of the beneficiary.

### III. Factors the States Apply to Determine State Fiduciary Taxation

The basis for taxing a trust on the residency of the grantor or testator has been referred to as a “founder criteria” trust, referring to the fact that the founder of the trust was a resident of the state when the trust was created, or became irrevocable, and therefore subject to tax in the state.\(^9\) The trust in *Linn* was such a founder criteria-based residency trust. A number of taxpayers (in addition to Linn) have successfully challenged the founder criteria trust style of state taxation where that is the only basis for taxation.\(^10\) In the chart below, the first two columns depict the founder criteria trust, and are the most commonly used criteria throughout the state taxing regimes. The chart also depicts the other factors various states consider:

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\(^8\) See Jeanne L. Newlon and Jennifer A. Birchfield, “State Income Taxation of Trusts” for a discussion of the state income taxation of trusts which can be found at: https://www.venable.com/state-income-taxation-of-trusts-at-the-dc-bar-10-18-2010/

\(^9\) Jacob, *An Extended Presence, Interstate Style: First Notes on a Theme From Saenz*, 30 Hofstra L. Rev. 1133 (Summer 2002).

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For many states, the ultimate determination rests on a combination of these above criteria, given the recent constitutional challenges to basing residency solely on founder criteria. Thus, an understanding of the constitutional limitations in determining residence is important.

IV. Constitutional Issues

A. Constitutional Basis for State Taxation—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. 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. This case highlights the importance of where the trustee resides and where the beneficiaries reside, an issue that continues to impact state taxation.

The *Safe Deposit* case also illustrates one of the complicated aspects of state fiduciary taxation: the premise that you can have a bifurcation of the entity. Note that with corporations, partnerships, LLCs, and individuals, the residency can be changed due to the mobility of the entity or individual. With trusts, many state laws will attempt to cause resident taxation permanent at the onset, regardless of the movement of the parties. From a constitutional perspective, this connection must be purposeful.

In the 2014 decision of *Maryland v. Wynne*, the Supreme Court reviewed a tax case, which is a relatively uncommon occurrence. The issue in *Wynne* was whether Maryland’s refusal to grant tax credits to Maryland residents for income taxed out of state was unconstitutional. The Court held that such practice was unconstitutional, based on two popular constitutional premises in tax law challenges: the Commerce Clause and the Due Process Clause, both discussed below. And while *Wynne* is primarily a tax credit case, as we will see, in the

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13 In *Wynne*, the Supreme Court also addressed the Internal Consistency, which requires the Court to apply the tax in question to every state to see if interstate commerce would be put at a disadvantage when compared to intrastate
field of the administration of trusts in other states, the ability to capture a tax credit will be nearly as important as the state level taxation.

B. The Commerce Clause

The Commerce Clause is 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.”\(^{14}\) Furthermore, clause three of Section 8 gives Congress the power to “regulate Commerce … among the several States.” 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.\(^ {15}\) Specific to the state taxing power, the 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.’”\(^ {16}\)

1. The Substantial Nexus Test\(^ {17}\)

According to Complete Auto Transport, a tax does not violate the Commerce Clause if it (1) is applied to an interstate activity having a substantial nexus with the taxing state; (2) is fairly apportioned; (3) does not discriminate against interstate commerce; and (4) is fairly related to the services provided by the state.\(^ {18}\) These factors discussed in Complete Auto Transport represent the “substantial nexus” test of the Commerce Clause, and have been characterized as being more stringent than the minimum contact requirements of the Due Process Clause discussed below.\(^ {19}\)

\(^{14}\) U.S. Const. art. I, §8.


\(^{17}\) Noel, Charlotte, Substantial Nexus: The “Nexus Gap” Over Intangibles, J. of St. Tax, March-April, 2011 (CCH).


\(^{19}\) Quill Corp. v. North Dakota, 504 US 298, 313 (1992); U.S. Const. art. I, §8, cl. 3. In reviewing the Commerce Clause, the Supreme Court has imposed an even higher “substantial nexus” standard between the taxpayer and the taxing State. Note that on June 21, 2018, the Supreme Court eliminated the physical presence standard for out-of-state sellers of goods. In South Dakota v. Wayfair, Inc., 138 SCt 2080 (2018), the Court ruled that a state
From a state fiduciary tax perspective, three of the above factors of the substantial nexus test under *Complete Auto Transport* have a direct trust tax impact, because the substantial nexus with the taxing state is directly relevant to the contacts between the trust and the state. For example, if there are no ongoing contacts between the trust and the state, it would follow that the nexus is not substantial. Fairly apportioned is manifested in how the state apportions the tax, especially to certain beneficiaries.\(^{20}\) And fairly related to the services provided by the state is analogous to the necessary “ongoing nature” of those contacts.

C. **The Due Process Clause**

The Constitution provides that no one shall be “deprived of life, liberty or property without due process of law”—these 11 words are mentioned twice, in the Fifth Amendment and the Fourteenth Amendment.\(^{21}\) The words of the Due Process clause provide an assurance that all levels of government operate legally and fairly. 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.\(^{22}\) A tax allowed under the Due Process clause must still satisfy the requirements of the Commerce Clause to be constitutional.\(^{23}\) However, to satisfy the Due Process Clause, there must be minimum contacts with the taxing jurisdiction.

1. **Minimum Contacts and Due Process**

In *Kaestner*,\(^ {24}\) the North Carolina Supreme Court upheld the appellate court’s finding that only relying on the beneficiary’s residence in the state was not a sufficient contact. Relying on *Quill* and *International Shoe*, the court noted “it 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.”\(^ {25}\)

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\(^{20}\) See *Chase Manhattan Bank v. Gavin*, 733 A2d 782 (Conn. 1999), cert. denied, 528 US 965 (1999); Connecticut taxes the income of a trust based on the pro rata share of a non-contingent Connecticut resident beneficiary’s share of the trust, (at 790).

\(^{21}\) U.S. Const. art. V (“nor be deprived of life, liberty, or property, without due process of law”); U.S. Const. art. XIV (“nor shall any state deprive any person of life, liberty, or property, without due process of law”).


V. Minimum Contacts for State Law Taxing Power

A. Quill Corporation

From a state law perspective, the emphasis of the Due Process Clause as interpreted by Quill provides 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.”\(^2\) 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.\(^3\) Quill notes that the Commerce Clause stands for the premise that states should not burden commerce with “multiple or unfairly apportioned taxation.” Ultimately, 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.”\(^4\)

Generally, the residence of an individual or decedent’s estate in a state provides sufficient connection for taxation. Contact-based connections 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. Some states require more than just the individual or decedent’s estate as a contact point, as illustrated in Swift below.

B. Wayfair and its Impact on Quill

Wayfair will prove to be a landmark case in the state and local tax arena; however, the application of this landmark state and local tax case on fiduciary income taxation of trusts is not as clear. An understanding of the significance of Quill is necessary, and then an analysis of how Wayfair affects Quill is necessary. Quill was a mail order retailer that delivered merchandise to North Dakota customers by mail from outside North Dakota. The taxpayer in Quill had no physical presence in the state. The U.S. Supreme Court affirmed the bright-line “physical presence” standard it had previously established for Commerce Clause purposes with respect to a state’s sales/use tax collection obligations. An out-of-state seller must have a physical presence in the taxing state that is more than de minimis before the state may impose its sales and use tax collection obligation.

The U.S. Supreme Court in Wayfair expressly stated that physical presence is not required to satisfy the Due Process Clause. Justice Kennedy advocated for a review of the Quill physical presence standard in his concurrence in DMA I (U.S. 2015), stating: “Given these changes in technology and consumer sophistication, it is unwise to delay any longer a reconsideration of the Court’s holding in Quill… [Quill] should be left in place only if a powerful showing can be made that its rationale is still correct. The instant case does not raise this issue in

\(^2\) Id.

\(^3\) Id.

\(^4\) Id.
a manner appropriate for the Court to address it. It does provide, however, the means to note the importance of reconsidering doubtful authority. The legal system should find an appropriate case for this Court to reexamine Quill.”

In Wayfair the Supreme Court held that the physical presence standard for out-of-state sellers of goods under Quill was “unsound and incorrect”. 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. This holding, however, does not seem to impact state fiduciary taxation.

VI. State Case Law Analysis

A. Swift, Founder Criteria and Present Benefit Minimum Contacts for State Trust Laws: Six Points

Due Process “minimum contacts” in the context of state income taxation of trusts was concisely interpreted by In re Swift. The Swift court found that an income tax was justified only when there are benefits and protections provided during the relevant taxing period.29 The Swift court considered “six points of contact” in determining whether a state had sufficient nexus to support the imposition of an income tax on trust income as follows:

1. The domicile of the settlor,
2. The state in which the trust is created,
3. The location of the trust property,
4. The domicile of the beneficiaries,
5. The domicile of the trustees, and
6. The location of the administration of the trust.30

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.”31 The first factor was satisfied in Swift as the trusts were testamentary trusts created by the will of a Missouri domiciliary. However, the court found that Missouri provided “no present benefit” to the trusts, where 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.32 The court in Swift held that, since Missouri law provided no present

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29 In re Swift, 727 SW2d 880, 892 (Mo. 1987).
30 Id.
31 Id.
32 Id.
benefits or protections to the subject trust, beneficiaries, trustees or property, the State of Missouri did not have sufficient connections to impose an income tax—and therefore the tax violated the Due Process Clause.33

B. Blue, Founder Criteria and Ongoing Protection Minimum Contacts Required for State Law Taxing Power

The Michigan decision of Blue involved an inter vivos trust established by a Michigan resident, where all beneficiaries, trustees, income-producing assets and administration were located in Florida.34 The court found that there were “insufficient connections between the trust and the State of Michigan to justify the imposition of an income tax.”35 The Michigan appellate court held that the lack of ongoing protection and benefit of Michigan law resulted in unconstitutional taxation. As a result, Michigan has updated the instructions to the Michigan Form 1041 to alert taxpayers of the outcome in Blue, and inform taxpayers that if their fact situation meets with the profile in Blue, the trust may not be subject to Michigan state tax.

C. Bank of America and Trust Administration in a State

In Bank of America v. Massachusetts Department of Revenue,36 the question was whether the bank qualified as an inhabitant of the state subject to the state fiduciary income tax. The bank served as trustee or co-trustee on 34 inter vivos trusts, and maintained 200 branch offices. The record indicated that the trust administration involved employing staff at the branch offices, maintaining relationships with beneficiaries, including timing of distributions, administration of trust assets and records, research for clients and meetings with trust grantors, beneficiaries, and their representatives. Administration outside of the state included “policy and procedures related to administrative investment components of trusts.” Ultimately, the Massachusetts Supreme Court looked to whether the trustee’s administration of the trusts took place within Massachusetts. The court determined that the permanent offices and the engagement of regular business activities qualified the bank as an inhabitant, and therefore concluded that the trusts were subject to fiduciary income tax in Massachusetts because of the connections with the state.

D. Mercantile Safe Deposit and Control over the Property Necessary by New York Beneficiaries

In Mercantile Safe Deposit, control over the property by New York beneficiaries proved to be the deciding factor for taxation in New York. The grantor and beneficiaries of an inter vivos trust were New York residents and therefore New York taxed the trust as a resident trust.37

33 Id.
35 Id.
However, the trustee was domiciled in Maryland, the trust was administered in Maryland, and intangibles held in the trust were subject to control of the trustee in Maryland.

The highest court of New York held that taxation by New York on the basis of the residence of the grantor and beneficiaries would be unconstitutional under the Due Process Clause because neither the grantor nor the beneficiaries controlled or had a present right to the possession of the trust estate. Therefore, New York lacked a sufficient constitutional nexus to tax an inter vivos trust where an out-of-state trustee performed all of his duties as trustee outside of New York. The appellate court concluded that taxing the trust’s income would “extend the taxing power of the State to property wholly beyond its jurisdiction and thus conflict with the due process clause.”

E. **Kassner and New Jersey Testamentary Trusts with Undistributed S Corporation Income**

*Kassner Residuary Trust v. Director, Division of Taxation* involved a testamentary trust created by the will of a New Jersey domiciled resident. The trust owned four S Corporations, but the Trust owned no assets in New Jersey. The Division’s official guidance publication gave taxpayers unequivocal advice that undistributed trust income would not be taxable if the trustee was not a New Jersey resident and the trust had no New Jersey assets. The trustee was not a New Jersey resident and the trust was administered in another state. The New Jersey Appellate Court affirmed the New Jersey Tax Court holding that New Jersey cannot tax a trust’s undistributed non-New Jersey income if the trustee, assets and beneficiaries are all located outside New Jersey. The court noted that in this situation, the trust lacks minimum contacts with the State (relying on the principles recognized in *Potter* and *Pennoyer*).

In the lower court decision, the New Jersey Tax Court specifically rejected the argument that the “lack of a presence [of the trust] in New Jersey [could] be overcome by the Supreme Court’s ruling in *Quill Corp*.” The court distinguished *Quill Corp.* on the basis that the taxpayer in that case “actively conduct[ed] a mail order business that targeted the residents of the [taxing] state,” whereas the trust at issue was merely a “passive owner of stock” and carried out no business in the state, and the tax at issue in *Quill Corp.* was a use tax, as opposed to an income tax.

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38 Mercantile-Safe Deposit & Trust Co. v. Murphy, 242 NYS2d at 28.


F.  *Pennoyer and Probate Administration for Testamentary Trust Not Enough*

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.\(^{42}\) The court held that taxation by New Jersey was unconstitutional. 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.”\(^{43}\)

G.  *D.C. v. Chase Manhattan Bank and Probate Is Enough to Withstand Challenge*

The issue before the court in this case was the District of Columbia resident trust status of a testamentary trust of D.C. decedent where the trustee, beneficiaries, and trust assets were not in the District.\(^{44}\) 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 of Columbia was sufficient to uphold the constitutional challenge to the tax.

H.  *McNeil and the Importance of Discretionary Beneficiaries under the Pennsylvania Statute*

The Commonwealth Court of Pennsylvania in a 2013 decision with a result similar to *Linn*, decided *McNeil v. Commonwealth*.\(^{45}\) In *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. The discretionary beneficiaries, however, lived in Pennsylvania.

Pennsylvania assessed fiduciary income tax because the grantor was a resident when the trust was formed.\(^{46}\) The discretionary beneficiaries were residents, and that was the only connection to Pennsylvania. 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.


\(^{43}\) *Id.*

\(^{44}\) *District of Columbia v. Chase Manhattan Bank*, 689 A2d 539 (D.C. 1997).


\(^{46}\) 72 P.S. § 7301(s).
I.  *Gavin* and Treatment of Non-Contingent Beneficiaries

The question presented in *Gavin* was whether the Connecticut income taxation of inter vivos or testamentary trusts was proper, where the settlor or testator was a Connecticut resident, but there were no Connecticut trustees and no property in Connecticut.\(^{47}\) Regarding testamentary trusts, the court held that the creation of testamentary trust through the Connecticut probate process was a sufficient contact. For the inter vivos trusts, the residence of a beneficiary in Connecticut was considered a sufficient contact for purposes of taxation. The court in *Gavin* held “the critical link to the undistributed income sought to be taxed is the fact that the non-contingent beneficiary of the inter vivos trust during the tax year in question was a Connecticut domiciliary.”\(^{48}\) The non-contingent beneficiary of that trust was a Connecticut domiciliary receiving advantages of residency and “enjoyed all of the protections and benefits afforded to other domiciliaries. 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.”\(^{49}\)

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.\(^{50}\) This provides additional constitutional protections. Because there was only one non-contingent beneficiary in *Gavin*, and she was a Connecticut resident, therefore 100% of the trust income was taxable by Connecticut.

J.  *Kaestner* and the Residence of the Beneficiary

In *Kaestner*, the North Carolina Supreme Court found that only relying on the beneficiary’s residence in the state was not a sufficient contact to “purposefully avail” the trust of the privilege of conducting activities within the State.\(^{51}\) A potentially unresolved issue in North Carolina, where the state has not amended the limited unconstitutional nature of the statute, is the distinction between primary beneficiaries versus contingent beneficiaries.\(^{52}\)


\(^{48}\) *Gavin*, 733 A2d at 802.

\(^{49}\) *Id.*

\(^{50}\) *Gavin*, 733 A2d at 790.


\(^{52}\) The holding and its “unconstitutional” determination was limited to the particular taxpayer, and was not a blanket “unconstitutional” determination.
VII. Conclusion

A. Trends Practitioners Should Plan For

In each of the *Linn* and *McNeil* decisions, the analysis holds that the traditional “founder residence” alone is not constitutionally sufficient to support the fiduciary income tax of the trust to the state. These decisions challenged the state nexus on constitutional grounds, that the state taxing regime violated the Commerce Clause of the U.S. Constitution. Given the constitutional scrutiny to founder-state based residency, the other criteria considered may play an increased role in the determination of residency.

The other criteria typically used by states include the place of administration of the trust, the residence of the trustee, and the residence of the beneficiary—discretionary or otherwise. While it is difficult to plan around where the beneficiaries will locate, and what type of beneficiaries a trust has, the choice of trustee is somewhat within the control of the administration.

Approximately 19 states (based on the Nenno research reproduced in the chart), base the state fiduciary taxation of trusts on the place of administration of the trust. With an individual trustee, the determination of where the trust is being administered may be straightforward—it is where the individual trustee is administering the trust. If a corporate trustee is acting, and the corporate fiduciary has trust operations in multiple states where administration takes place, the trust administration will likely be a fact-intensive analysis, and perhaps favor utilization of a corporate trustee because of this flexibility.

53 *See* the Nenno article for detailed state law information. Examples of states with a “place of administration” tax system include Colorado, Georgia, Hawaii, Idaho, Indiana, Iowa, Kansas, Louisiana, Maryland, Minnesota, Mississippi, Montana, New Mexico, North Dakota, Oregon, South Carolina, Utah, Virginia, and Wisconsin.