State Fiduciary Income Tax Developments

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

- Panel focuses on nongrantor trusts (“trusts”) under subchapter J, Part I of Code. See IRC §641 et. seq.
- We know that nongrantor trusts are subject to federal fiduciary income tax
- Trusts are also subject to state income taxation at the applicable state tax rate
- States have historically assessed income tax to trusts based on residency
- Residency is determined by statutes and case law
- How the states have historically determined and are continuing to interpret nexus with trusts is an evolving area that deserves increased attention by practitioners
- Recent taxpayer friendly state court decisions have paved the way for more constitutional challenge
- The key questions are:
  - When will a trust be subject to a state income tax regime?
  - Under what authority will a state attempt to tax a trust?
  - Is a trust at risk of being resident in multiple states?
  - Can a trust be moved to a different state or a no state taxing regime?
What Is at Stake?

• Where is the trust “resident”?
• The trust may be required to pay tax in more than one state. The trust may or may not get credit for tax paid in the other state or states.
• The trustee may need to file a return in more than one state.
• The tax could be at rates greater than 13.3% (California in 2018).
• Should trust situs be changed for existing trusts?
Threshold Question – Is the Trust Deemed a Resident of the State?

- If the taxpayer trust is deemed a “resident,” then the state can tax all of the trust income, in whatever state earned.
- If the taxpayer trust is not a “resident” trust, then the state can only tax source income (i.e., income attributable or apportioned to that state).
- Consider:
  - State Statutes
  - State Regulations
  - Administrative and State Treasury Pronouncements
  - Other Guidance Documents
  - Constitutional Restrictions
Trust Residency: Intervivos v. Testamentary Trust

- Many states deem a trust resident based on certain contacts with the state
  - Residency of Settlor at time the trust was created, and at death when testamentary trust created
  - Contacts within the state
  - Location of trustee
  - Location of beneficiaries
- Courts finding “founder state” and beneficiary resident rules as unconstitutional can be applied to trusts
  - *Fielding v. Comm’r of Revenue*, 916 N.W.2d 323 (Minn. 2018)
Trust Residency: Intervivos v. Testamentary Trust

• However, testamentary trusts requiring probate court involvement may create the necessary link to tax and pass constitutional muster.
  o *D.C. v. Chase Manhattan Bank*, 689 A.2d 539 (DC 1997)
  o *Chase Manhattan Bank v. Gavin*, 733 A.2d 782 (CT 1999)

• Pre *Quill* cases held otherwise on testamentary trusts
  o *In re Swift*, 727 S.W.2d 880 (Mo. 1987)
Analysis of Key Decisions

• The *Linn, McNeil, Kaestner, and Fielding* decisions are important to practitioners because of their 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?”
Linn

• Summary of the 2013 *Linn* case:
  o Linn was identified as a statutory resident trust;
  o No income was earned in Illinois;
  o None of the trust’s assets were located in Illinois;
  o The trust was administered by a non-Illinois trustee; and
  o The beneficiary resided outside of Illinois.
The trust lacked connections with Illinois, but because the grantor was a resident of Illinois when the trust was created:
- The trust was a deemed an Illinois resident trust, and
- Illinois fiduciary income tax applied on all the income.

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

The Illinois Appellate Court ultimately found the taxation of the trust violated the Due Process Clause of the Constitution:
- Because there was not a sufficient minimum connection between the trust and the State of Illinois, and
- No personal jurisdiction means no taxation.
Common Statutory Residency Factors

• Personal Jurisdiction = Taxing Jurisdiction
  o The Linn trust ultimately argued that if the state could exercise personal jurisdiction, then it could exercise taxing jurisdiction.
  o No personal jurisdiction, NO TAXATION.
There are generally five considerations to be aware of when dealing with a multi-jurisdictional trust administration *(not mutually exclusive, may overlap)*:

1. Contacts with the **decedent** or decedent’s estate that gave rise to the testamentary trust
2. Contacts with the state of the grantor who created an inter vivos trust
3. Contact through the ongoing administration of the trust
4. Contacts with the trustee of the trust
5. Contacts with the **beneficiary** of the trust
Inter Vivos Trusts Created By Residents

25 states
Trusts Created Under Will of Residents

27 states
Resident Beneficiary

5 states
Resident Trustee

14 states
No Individual Income Tax

7 states
Constitutional Principles Governing State Taxation

### Commerce Clause


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

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

### Due Process Clause


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

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

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<tr>
<td>1. The taxpayer has a substantial nexus to the taxing jurisdiction.</td>
<td>Yes</td>
<td>Yes, and created bright line rule for determining substantial nexus: physical presence in the taxing state to satisfy this prong of test</td>
<td>The N.C. tax statute violated this prong because it taxed a trust for merely having beneficiaries in the state.</td>
<td>Court did not reference this.</td>
</tr>
<tr>
<td>2. The tax must be fairly apportioned.</td>
<td>Yes</td>
<td>Yes</td>
<td>Court declined to address this prong.</td>
<td>Court did not reference this.</td>
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<tr>
<td>3. The tax must be fairly related to benefits conferred by the taxing jurisdiction.</td>
<td>Yes</td>
<td>Yes</td>
<td>Court declined to address this prong.</td>
<td>Court did not reference this.</td>
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<tr>
<td>4. The tax may not discriminate against any interstate commerce.</td>
<td>Yes</td>
<td>Yes</td>
<td>The N.C. tax statute violated this prong because there were not sufficient contacts between the trust and the state.</td>
<td>Court did not reference this.</td>
</tr>
<tr>
<td>A. The state must have a definite link to the person, property or transaction that it seeks to tax.</td>
<td>No</td>
<td>Yes</td>
<td>There was no physical presence in the state nor was there purposeful activity in the state.</td>
<td>Court held that taxation could not be imposed unless there was a N.J. trustee or assets in N.J.</td>
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<td>B. Income must be rationally related to the values connected with the taxing state.</td>
<td>No</td>
<td>Yes</td>
<td>Trust has not done anything to seek out the protection, opportunities, and benefits conferred by N.C.</td>
<td>Court did not reference this.</td>
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Survey of Key State Court Decisions

• Pre *Quill* Decisions
  - *In re Swift*, 727 S.W.2d 880 (Mo. 1987)
Survey of Key State Court Decisions

• Post *Quill* Decisions
  
  o *D.C. v. Chase Manhattan Bank*, 689 A.2d 539 (DC 1997)
  
  o *Chase Manhattan Bank v. Gavin*, 733 A.2d 782 (CT 1999)
  
  
  
  o *Kaestner v. North Carolina Dep’t of Revenue*, 814 S.E.2d 43 (N.C. 2018)*
  
  o *Fielding v. Comm’r of Revenue*, 916 N.W.2d 323 (Minn. 2018)

*At time of this slide, petition for certiorari has been granted by the U.S. Supreme Court*
# Linn, McNeil, Kaestner Scorecard

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<tr>
<th>Linn</th>
<th>McNeil</th>
<th>Kaestner</th>
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| Settlor was resident  
Illinois | Settlor was resident  
Pennsylvania | Settlor was not a resident  
North Carolina |
| Created in the taxing state, but vacated the state  
• No assets in state  
• No trustee in state  
• No beneficiaries in state | Created in another state  
• No assets in state  
• No trustee in state  
• Beneficiaries resided | Created in another state  
• No assets in state  
• No trustee in state  
• New beneficiary in new state |
| Beneficiary exercised power and moved trust out of state | Beneficiary was contingent, discretionary | Beneficiary was contingent, discretionary |
| No connections | Old connections | New connection |
Planning: Recognize State Differences in Residency and Nexus Links

- States have different standards for resident / nonresident trusts
- Trusts are taxed as though they behaved like individuals…
  - Income tax imposed on their entire income in their state of legal residence, with credits for taxes paid to other states as a nonresident.
  - Like corporations, they often “reside” in multiple states.
  - In litigation, Commerce Clause and Due Process analysis for taxability.
  - Geared toward entities with a presence in multiple states and apportioned income.
  - By beneficiary/trustee/state law applied:
    - Using the state’s law as the governing law of the trust;
    - Administering the trust in the state;
    - Having a grantor that is a resident of the state;
    - Having a trustee that is a resident of the state;
    - Having a beneficiary that is a resident of the state;
    - Owning assets located in the state; or
    - Receiving state-source income.
- Timing
  - Determine trust residency at the moment the trust is created? Or when it becomes irrevocable?
  - By a combination of factors
Trust Residence Factors

- Some of the factors are more easily controlled than others after creation of the trust:
  - Governing law
  - State where the trust is administered
  - Location of the trustee
  - Residence of a beneficiary
  - Location of the trust’s fixed assets, its source of trust income
  - Grantor’s state of residence at the time of creation of the trust
Planning: Practical Considerations

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

• Planning Opportunities Available
  o *Fielding v. Comm’r of Revenue*, 916 N.W.2d 323 (Minn. 2018)

• If there is enough income anticipated to be accumulated to be worth it, consider:
  o Changing trustees for existing irrevocable trusts
  o administering elsewhere (may include fiduciaries like investment advisors in directed trusts)
    o If the source income taints an entire trust’s income for state residency (e.g. NJ, NY), sell the asset or split/decant the trust to wall off the source income
    o For some states, consider using living trusts rather than testamentary trusts
    o For any longer term trust design, add the ability to change situs/trustees as part of any substantial estate plan
    o Consider INGs as a potential solution to avoid state income tax
    o Consider completed gift “SLANTs” as a potential solution to avoid state income tax on large gains AND utilize the temporary $11.4 million (2019) exclusion now that taxpayer-favorable “clawback” regulations have been proposed
Credits and Mismatch

• Ability to offset may be limited (e.g., the state may allow credit for tax against certain income only).
  o Credit may be allowed for tax on income from real property but not on income from intangibles.
• Credits may be allowed only if the other state’s tax is imposed “irrespective of the residence or domicile” of the taxpayer.
  o The credit won’t apply because the trust is taxed as a resident in each state.
• Mismatch on Classification
  o Trusts may not be legally entitled to any credits for income paid to another state as a nonresident because they paid tax as a resident.
What Do Good Residency Rules Look Like?

- Rules should offer a measure of certainty to both state and taxpayer.
- Rules should accommodate state policy goals.
  - E.g., many states wish to attract trustee activity.
- Rules should pass constitutional muster.
- Rules should reflect where the activity of trust is located.
- Rules should be sufficiently simple (e.g. mind and management concept).
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