

# **State Income Tax Issues With Trusts**

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# STATE INCOME TAX ISSUES WITH TRUSTS

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## **A. Introduction**

Most states generally follow the federal rules for the income taxation of trusts. Thus, the ordinary income earned and capital gains realized in a grantor trust are taxed to the grantor or settlor. The ordinary income earned and capital gains realized in a nongrantor trust that distributes such income and gains are generally taxed to the recipient of the distributions. A nongrantor trust that does not distribute its ordinary income earned and capital gains realized is a separate, stand-alone taxable entity itself subject to federal fiduciary income tax and, potentially, if not certainly, subject to fiduciary income tax in one or more states. It is, therefore, precisely this type of trust that ordinarily can benefit the most from careful attention to, and analysis of the applicability of, the fiduciary income tax laws of the state or states that have or could have a connection or nexus to the trust. The entire focus of these materials is on this type of nongrantor trust.

## **B. State Variations in Systems for Taxing the Income of Trusts**

State income tax may be a significant expense for nongrantor trusts that do not distribute all their ordinary income earned and realized capital gains. In addition, many aspects of state fiduciary income taxation vary (often widely) from state to state.

### **1. Trust Residency in General**

If, under a given state's laws, a trust is a "resident trust," such will frequently be the trigger for that state's imposition of income tax on the trust. While the definition of "resident trust" varies from state to state, in general, in almost all states that tax trust income, the statutory scheme is grounded in one or more of the following threshold concepts:

- A testamentary trust is a resident trust if the testator was living in the state at his or her death.
- An *inter vivos* trust is a resident trust if the grantor or settlor is living in the state resident. There is variation as to the point at which the residence of the grantor will be determined, *e.g.*, date of creation, date of trust funding, current taxable year or date the trust became or becomes irrevocable. Coleman, "State Fiduciary Income Tax Issues," American College of Trust and Estate Counsel, March 2006 (hereinafter, "Coleman").
- An *inter vivos* trust is considered a resident trust after considering a set of factors. For example, Idaho considers a trust to be a resident trust if it meets at least three of the following five conditions: (a) the grantor lives in Idaho; (b) the trust is governed by Idaho law; (c) trust property is located in Idaho; (d) the trustee is

located in Idaho; or (e) the trust is administered in Idaho. Idaho Admin. Code Regs. 35.01.01.035.

- A trust is subject to income tax in the state if the trust has at least one resident trustee or resident beneficiary.
- A trust is subject to income tax in the state if it is administered in the state. An important issue that arises in this context is how each state defines the place of administration for income tax purposes, especially for large trusts with corporate fiduciaries that have operations in multiple jurisdictions. In Oregon, for example, a “major part of administration” test is used, which provides that a trust is considered administered in Oregon only if a major part of the administration of that trust occurs within Oregon. Or. Admin. R. § 150-316.282 (5); *see* Michaels & Twomey, “How, Why, and When to Transfer the Situs of A Trust,” 31 Est. Pln. 28 (Jan. 2004) (hereinafter, “Michaels & Twomey”). In California, “the residence of a corporate fiduciary of a trust means the place where the corporation transacts the major portion of its administration of the trust.” Cal. Rev. & Tax Code § 17742.

Nenno, “Planning to Minimize or Avoid State Income Tax on Trusts,” 34 ACTEC J 131 (2008) (hereinafter, “Nenno”); Nenno & Zaritsky, “State Income Taxation of Trusts Based Solely on Residence of the Testator/Settlor,” LISI Estate Planning Newsletter #1646 (May 26, 2010) at <http://www.leimbergservices.com> (hereinafter “Nenno & Zaritsky”).

A state may assert a right to tax a trust’s income if it falls into one or more of multiple categories. For example, Virginia taxes any trust (at a top tax rate of 5.75%) created by a Virginia resident, established under the will of a Virginia decedent or administered in Virginia. Va. Code Ann. §§ 58.1-302; 58.1-320; 58.1-360.

In almost every state that taxes trust income, the designation in a trust instrument of a state’s law to govern a trust is irrelevant to its state tax residency. Nenno, “Choosing and Rechoosing the Jurisdiction for a Trust,” 40 University of Miami School of Law Philip E. Heckerling Institute on Estate Planning (2006) (hereinafter, “Nenno, Choosing and Rechoosing”).

Seven states have no trust income tax: Alaska, Florida, Nevada, South Dakota, Texas, Washington and Wyoming. Nenno & Zaritsky, *supra*. Thus, if a trust is not established in one of these states, consideration may be given to moving the location of various aspects of a trust’s administration (depending on what aspect is triggering state income tax, such as the place of administration, the location of the beneficiaries, etc.) to one of these states to eliminate state income tax altogether. Many states, however, tax trusts based on facts that cannot be changed. For example, Nebraska, taxes a testamentary trust created under a will of a Nebraska decedent as well as an *inter vivos* irrevocable trust created by an individual who was a Nebraska resident at the time the trust was established.

Also, New Hampshire and Tennessee tax only a trust’s interest and dividends. N.H. Admin. Code Rev. 902.07; Tenn. Code Ann. § 67-2-102. When looking for states that are advantageous from a state income tax standpoint, some states, such as Illinois and Pennsylvania,

have such low tax rates (3% and 3.07%, respectively) that perhaps they should be considered as potential trust destinations as well. 35 ILCS 5/201(a); 72 P.S. § 7302.

- **Planning Point:** State income taxes are deductible for federal income tax purposes. However, the alternative minimum tax will often offset this deduction. Internal Revenue Code § 56(b).

## 2. Specific State Examples

The following provides more detail concerning the income taxation of trusts in selected states:

a) **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 be made into a Delaware resident trust if it has at least one trustee located in Delaware. 30 Del. C. § 1601(8).

Delaware resident trusts are entitled to a deduction for their federal taxable income that is retained for future distribution to nonresident beneficiaries. Delaware, therefore, does not tax non-Delaware source ordinary income or capital gains from Delaware irrevocable resident trusts that benefit individuals who reside outside Delaware. 30 Del. Code § 1636. 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 income tax). Thus, in general, Delaware does not 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). 30 Del. C. §§ 1124 and 1639.

The top tax rate for trusts in Delaware is 6.95%. 30 Del. C. § 1102(a)(12).

b) **Michigan.** Michigan also 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. Mich. Comp. Laws § 206.18(1)(c). Michigan may not, however, tax an *inter vivos* trust created by a Michigan resident if trustees, beneficiaries and the administration of the trust are outside of Michigan, even if the trust holds Michigan real property (non-income producing). *Blue v. Department of Treasury*, 185 Mich.App. 406, 462 N.W.2d 762 (1990). The top tax rate in Michigan is 4.35% through October 1, 2011. Mich. Comp. Laws § 206.51(1)(g).

c) **New Jersey.** A trust is subject to New Jersey income tax if: (1) the trust is established under the will of a New Jersey decedent; or (2) the trust was established by an individual who was a New Jersey domiciliary at the time the trust became irrevocable. The top tax rate for a New Jersey resident trust is 8.97%. NJSA §§ 54A:1-2(o); 54A:2-1.

However, in New Jersey, testamentary trusts cannot be taxed on their income if the trustees and trust assets are outside the state and there is no New Jersey source income. *Pennoyer v. Tax. Div. Director*, 5 N.J. Tax 386 (1983); *Potter v. Tax. Div. Director*, 5 N.J. Tax 399 (1983).

d) **Missouri**. A trust is subject to Missouri income tax if: (1) it was created by the will of Missouri decedent; or (2) 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 in Missouri. The top tax rate is 6.00%. Sections 143.011, 143.061, 143.311, 143.331, RSMo.

In *In re Swift*, 727 S.W.2d 880 (Mo. 1987), the Supreme Court of Missouri addressed the issue of whether a trust created under the will of a Missouri decedent was subject to Missouri income tax even though the trustees, beneficiaries, trust property and the trust administration were all in Illinois. The court stated that it considered “six points of contact” in determining whether Missouri’s taxation of a trust’s income was constitutional: (1) the settlor’s domicile; (2) the state in which the trust was created; (3) the location of trust property; (4) the domicile of the beneficiaries; (5) the domicile of the trustees; and (6) the location of the administration of the trust. Applying the above standard, the court held that Missouri could not tax the subject trust’s income.

In *Westfall v. Director of Revenue*, 812 S.W.2d 513 (Mo. 1991), the Supreme Court of Missouri considered the constitutionality of taxation in Missouri of a trust that was created in Missouri by a Missouri resident, held Missouri real estate and whose governing instrument designated Missouri charities as contingent beneficiaries and named a Missouri organization as a successor trustee. After applying the six factors from *Swift*, the court concluded that Missouri could properly tax the income of the trust.

e) **New York**. In New York, the state tax statutes and regulations state specifically when a trust created by a New York resident will not be subject to state income tax. Thus, these statutes and regulations make clear what actions a settlor must take to avoid New York trust income tax. New York 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. NY Tax Law § 605(b)(3). The tax rate can be as high as 12.846% for trusts in New York City. NY Tax Law 601(c); 2010 Instructions to Form IT-205, Fiduciary Income Tax Return. New York taxes nonresident trusts on their New York source income, which consists of income attributable to real or tangible personal property located in New York or a business carried on in New York. NY Tax Law § 601.

New York will not, however, impose a tax on a resident trust if all of the following conditions are met: (1) all of the trustees are domiciled in a state other than New York; (2) the entire principal of the trust, including real and tangible property, is located outside of New York; and (3) all income and gains of the trust are derived from non-New York sources, determined as if the trust were a nonresident trust. 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). The disadvantage to the certainty provided by this safe harbor is less ability to challenge the application of the tax if the trust comes within the terms of the taxing statute.

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. TSB-A-04(7)I, 2004 N.Y. Tax Lexis 259 (Nov. 12, 2004). New York may not, however, tax 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. *Mercantile-Safe Deposit and Trust Company v. Murphy*, 19 A.D.2d 765 (3d Dept. 1963), *aff'd*, 15 N.Y.S.2d 579 (1964).

In *Taylor v. State Tax Commission*, 445 N.Y.S.2d 648 (N.Y.S. 1981), the state of New York attempted to apply its income tax on the gain incurred upon sale of Florida real property held in a trust created under the will of a New York decedent. The trustees were not New York residents. The court held that, since the domicile of the decedent was the only New York connection to this transaction, the state could not impose tax on the gain.

In NY State Department of Taxation Advisory Opinion (TSB-A-03(6)I), the Department of Taxation considered who would be the grantor for state income tax purposes if a trust (the “appointive trust”) was created by the exercise of a power of appointment by a resident of State A, but the original trust from which the appointive trust was created was created by a resident of State B. The Department of Taxation concluded that, if the power was a general power, the holder of the power was the grantor of the appointive trust, but, if the power was a special power, the grantor of the original trust was the grantor of the appointive trust.

f) **California.** A trust is a California resident for state income tax purposes if the trustee or a non-contingent beneficiary is a resident. Cal. Rev. & Tax Code §§ 17742(a). The top tax rate is 9.30%. Cal. Rev. & Tax Code §§ 17041(a),(e),(h).

In California Franchise Tax Board Technical Advice Memorandum 2006-0002 (2/17/06), the California 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 noncontingent interest only as of the time, and to the extent of the amount of income, that the trustee actually decides to distribute. 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 trustees, 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. Cal. Rev. & Tax. Code § 17745; *see also* California Franchise Tax Board Technical Advice Memorandum 2006-0002 (2/17/06), discussed *supra*.

See Nenno, “Planning to Minimize or Avoid State Income Tax on Trusts,” 31 ACTEC J. 131 (2008) (hereinafter, “Nenno”) for information about the income taxation of trusts in each state.

### 3. Source of Trust Income

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. *See, e.g.*, 72 Pa. Stat. §§ 3402-201 - 3402-202. *Nenno, supra.* 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. *Coleman, supra.*

#### **4. Trusts Subject to Tax In More Than One State or No State**

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 noncontingent 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. *Ariz. Rev. Stat. § 43-1301(5).* Conversely, a trust created by a California domiciliary, with no California trustee or non-contingent beneficiaries, would not be subject to income tax in California, and, if that trust were administered by, say, a Missouri trustee, 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 that does not 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. *Coleman, supra.*

#### **C. Changing a Trust’s Tax Residency**

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 statute 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. In addition, the trustee should also 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 that tax trusts based on the tax residence of the trustee, tax residence of the beneficiary or any other factor besides the tax residence of the individual who created the trust, provide much more flexibility in changing the tax residence of the trust for income tax purposes. *See Michaels & Twomey, supra.*

For example, if a state's law requires a trust to have a nonresident trustee to avoid state income tax, *e.g.*, California, Kentucky, Arizona, the practitioner must: (1) determine if the current trustee is willing to resign; (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 of the trustee and provides a non-judicial mechanism for the appointment of a successor trustee. Michaels & Twomey, *supra*.

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. Colo. Rev. Stat. 39-22-103(10).

As indicated above, under the trust income tax provisions of California, if a trust is administered by a California trustee or has California noncontingent beneficiaries, regardless of whether its settlor is or was a resident of California, the trust income will be subject to California income tax. According to Cal. Rev. & Tax. Code §§ 17743-17744, however, only a proportionate share of the trust's taxable income from sources outside California will be subject to tax when there are nonresident co-trustees or nonresident beneficiaries. 18 Cal. Code Regs. 17743-17744. Thus, it appears that the California income tax can be substantially reduced by the appointment of one or more non-California co-trustees. Nenno, Choosing and Rechoosing, *supra*; see also Ark. Code Ann. § 26-51-203.

- ➔ **Planning Point:** If a trust's tax residency cannot be transferred so that the trust is not subject to state income tax at all, states that tax trust income based solely on the residence of the testator or settlor might be an option for transferring the tax residency of a trust because, as discussed above, a trust created by a nonresident will be subject to tax only on the income derived from sources in that state. The trust, however, must not have been established in one of these states.

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 a court petition. 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. Michaels & Twomey, *supra*.

- ➔ **Planning Point:** 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 transaction will be considered to have taken place in the final tax year of the former state of tax residency. Nenno & Zaritsky, *supra*.

Trustees and their advisors should also 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 is 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. Sherby, "It May Not be Broken, But it May Need Fixing: Techniques, Tools and Pitfalls in Changing the Trust (Selected Issues in Division, Merger, Change of Situs, Construction, Instruction, Reformation and Modification Actions)," American College of Trust and Estate Counsel (Fall 2009).

Considerations involving a trust's residency for state income tax purposes also are very important when a trust has a tax residency in Massachusetts and the grantor has moved to another state. If the grantor dies while residing in the new state with same trust in place, the trust, provided it still has a Massachusetts trustee and, if an *inter vivos* trust, has a Massachusetts beneficiary, will remain a resident trust for Massachusetts income tax purposes, regardless of if or when it was funded during life. 62 Mass. Gen. Laws § 10. Thus, the grantor in this situation should revoke the Massachusetts trust and establish a new trust in the new home state or whichever state tax residence is most appropriate.

- **Planning Point:** 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 attorney might also advise the trustee to segregate funds to pay the taxes, penalties and interest if the filing position is unsuccessful. Nenko, *supra*.
  
- **Planning Point:** Even if the trust's tax residency for state income tax purposes is moved, a change in the situs or governing law is a separate question. The governing law of a trust generally involves the law governing the validity, construction and administration of the trust (*e.g.*, trustee liability, trust accounting, characterizing beneficial interests and compensation), while the situs of a trust generally involves the disposition of the trust property. Bogert, et. al., *The Law of Trusts and Trustees*, § 296. Ideally, the trust instrument should specify that, if there is a change in situs, the laws of the state to which situs has been shifted will apply. If such a provision is not included, a conflict-of-laws analysis must be applied, which will depend on whether the issue involves a matter of trust validity, construction or administration, whether the trust is an *inter vivos* or testamentary trust and whether real property or personal property is involved. Restatement (Second) of Conflict of Laws §§ 267-282; Nenko, *Choosing and Rechoosing*, *supra*.

- ➔ **Planning Point:** 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).

## D. Constitutional Challenges to a State's Taxation of Trusts

There is a long history of case law holding that, under either or both of the Due Process Clause or the Commerce Clause of the U.S. Constitution, the fact that a testator under whose will a trust was created was domiciled in a particular jurisdiction at his or her death, or that a trust grantor was domiciled in a particular jurisdiction at the time of creation of the trust, standing alone, is insufficient to justify imposing income tax on the trust. *See, e.g., Safe Deposit and Trust Company v. Virginia*, 280 U.S. 83 (1929) (holding that Virginia could not constitutionally tax an *inter vivos* trust with Virginia beneficiaries but a Maryland trustee that held assets in Maryland). The current trend among the courts considering this issue, however, is to expand the ability of a jurisdiction to tax the income of such a trust.

### 1. Due Process Clause

In *Quill Corporation v. North Dakota*, 504 U.S. 298 (1992), the United States Supreme Court considered whether a statutory duty imposed by the state of North Dakota on a mail order business to collect and pay a use tax on goods purchased within the state violated the Due Process Clause. The business was not physically present in the state; it had no outlets or sales representatives in North Dakota. The business had solicited business in North Dakota through catalogs and flyers, advertisements in national periodicals and telephone calls, which gave rise to approximately \$1 million in sales to North Dakota customers.

The court explained that the Due Process Clause requires “some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax.” The court abandoned the reasoning of prior cases that focused on a taxpayer’s physical presence within the state at issue and held that a business did not need to have a physical presence in the state to permit the state to collect use tax from its in-state customers. Following the logic of Due Process Clause cases concerning “judicial jurisdiction,” the court stated that the business had substantially benefited from the state’s economic activity and legal infrastructure. Furthermore, the business’s activity gave it “fair warning that its activity subjected it to the taxing jurisdiction of the state.”

Following *Quill*, courts that have subsequently faced the issue of whether an income tax imposed on a trust by a particular jurisdiction violated the Due Process Clause have based their decision on whether a state has sufficient “minimum contacts” with the testator or trust grantor, the trustees, the trust property and/or the beneficiaries.

a) ***District of Columbia v. Chase Manhattan Bank*, 689 A.2d 539 (D.C. App. 1997).** In this case, William A. Lalor was a resident of the District of Columbia when he died in 1934. He created a trust (the “Trust”) the governing instrument of which provided that, after Mr. Lalor’s death, annuities were to be paid to certain relatives and friends for a period of

years, after which the remaining Trust property would be distributed to the descendants of Mr. Lalor's nieces.

The sole trustee during the relevant time period of this case was Chase Manhattan Bank ("Chase"), located in New York. All the Trust assets were held in accounts at Chase. During the relevant time period, all the beneficiaries, including both present or remainder beneficiaries, resided outside of the District of Columbia.

The District of Columbia taxed the income of a testamentary trust if the decedent created the trust under his will and died while a resident of the District of Columbia. The Trust paid income tax to the District of Columbia from 1987-1991. Chase then brought this case to obtain a refund of these income taxes, asserting that the District of Columbia's taxation of the Trust income violated the Due Process Clause of the U.S. Constitution.

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.

The court began its analysis by reviewing the *Quill* decision, stating that the court in that case "rejected the notion that a corporation's 'lack of physical presence in the taxing State' rendered unconstitutional any attempt by the state to tax the corporation's activities with respect to the state." The court then stated that the "critical question, then, is whether the relationship between the District and the testamentary trust of one of its residents is sufficiently close to justify the District's classification of the trust itself as a resident for purposes of taxation."

The court explained that the District of Columbia's power to resolve disputes over the Trust and to order accountings gives the District of Columbia a "justifiable, though not necessarily exclusive," jurisdiction over the Trust. The court added that, even though a state may have jurisdiction over a non-resident testamentary trust, the state in which such trust was created "retains jurisdiction - indeed, the principal, continuing jurisdiction - over the trust." This jurisdiction, according to the court, gives it the power to tax all the income of such trust. Thus, because the "District created the legal environment which permitted the trust to come into existence, established the trust when Lalor'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 of Columbia's jurisdiction over the Trust "reflects a sufficient nexus" between the District of Columbia and the Trust to justify the District of Columbia's imposition of tax over the net income of the Trust.

The court also mentioned that the fairness issue of double taxation was not relevant in this case because the District of Columbia provided a deduction for the payment of income taxes to another state.

b) ***Chase Manhattan Bank v. Gavin, 733 A.2d 782 (Conn. 1999)***. In this case, Chase Manhattan Bank ("Chase"), a New York corporation, was the trustee of four testamentary trusts (the "Testamentary Trusts") and one inter vivos trust (the "*Inter Vivos* Trust"). Regarding two of the Testamentary Trusts, none of the beneficiaries were Connecticut residents. As for the two other Testamentary Trusts, Connecticut residents held interests as

current beneficiaries and as remainder beneficiaries. Regarding the Inter Vivos Trust, both the current beneficiary and the remainder beneficiaries were Connecticut residents.

All Testamentary Trusts and the *Inter Vivos* Trust were resident trusts under Connecticut law, which were defined as: (1) a trust created under the will of a Connecticut decedent; or (2) an *inter vivos* trust created by an individual who was a Connecticut resident at the time such trust became irrevocable, or if the trust never became irrevocable, the time that the trust was funded. During the tax year at issue, 1993, all the assets of the Testamentary Trusts and the *Inter Vivos* Trust, and all aspects of the administration of such trusts, were outside of Connecticut. Chase, as Trustee, had not been subject to any judicial or administrative proceeding in Connecticut, other than accountings filed with the probate court for three of the Testamentary Trusts.

Chase paid the 1993 income taxes imposed on the Testamentary Trusts and the *Inter Vivos* Trust. Chase then brought this claim against the state seeking refunds for such taxes, claiming that the Connecticut taxation scheme, as applied to it in its capacity as trustee, violated the Due Process Clause and the Commerce Clause.

The court considered the challenge under the Due Process Clause to the Testamentary Trusts first. Relying on *Quill*, the court explained that the Due Process Clause requires a “link, some minimum connection” between the state and the subject it seeks to tax. The court added that, traditionally, the Due Process justification for a state to tax a resident’s income, irrespective of its source, is based on the notion that the taxing jurisdiction, “by virtue of its legal system, provides the social structure pursuant to which the domiciliary receives and enjoys that income.” Similarly, the “United States Supreme Court itself has validated the proposition that the State where the trustee is located provides constitutionally significant protections, opportunities and benefits to the trust for tax purposes.” *Quoting Greenough v. Tax Assessors*, 331 U.S. 486 (1947).

These benefits include providing the laws that allow for the creation of wills and trusts and their administration, as well as providing a forum for the litigation of disputes concerning such instruments. Such benefits are advantageous for both the trustees and the beneficiaries. Under this reasoning, the court believed that the state was justified in taxing the Testamentary Trusts’ undistributed income despite the fact, for example, that Chase made all investment decisions and kept all the assets outside Connecticut.

The court also rejected an argument by Chase that the *Quill* case is inapplicable to this case because the *Quill* case dealt with use taxes and not income taxes, asserting that the different taxes at issue in these cases do not distinguish the analysis employed by the *Quill* court. In rejecting another argument by Chase, the court found that the Connecticut tax met the Due Process Clause requirement that the benefits provided by the state and the tax must be contemporaneous.

Regarding the *Inter Vivos* Trust, Chase argued that this issue should be controlled by *Safe Deposit & Trust Co. v. Virginia*, 280 U.S. 83 (1929), in which the court decided that the state of Virginia was prohibited under the constitution from taxing an *inter vivos* trust with Virginia beneficiaries and a Maryland trustee that held assets in Maryland. The nexus to the state that it believed justified its tax was the fact that the current beneficiary of the *Inter Vivos* Trust was a

Connecticut domiciliary. Chase argued that the residence of the beneficiary of the *Inter Vivos* Trust does not satisfy the Due Process requirement that the taxpayer's taxable activity purposefully be directed at the taxing state.

The court began its analysis by explaining that the same test that applied to the Testamentary Trusts discussed above applies to the *Inter Vivos* Trust. The court stated that the Connecticut domiciliary "enjoyed all of the protections and benefits afforded to other domiciliaries." This conclusion was sufficient under the Due Process Clause for Connecticut to tax the income of the *inter vivos* trust. The court also distinguished *Safe Deposit & Trust Co.* by asserting that the main basis of the court's decision in that case, that allowing the tax would give rise to double taxation, had been abandoned as a limitation on the taxation of intangibles under the Due Process Clause. See *Curry v. McCanless*, 307 U.S. 357 (1939). 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 did not violate the Due Process Clause.

➔ **Planning Point:** Thus, this decision would not appear to extend taxability to an *inter vivos* trust in which the only contact was the domicile of the settlor at the time the trust was created. Nenko & Zaritsky, *supra*.

c) **The Distinction Between *Inter Vivos* and Testamentary Trusts.**

Although it is impossible to predict whether any court would now hold under due process analysis that physical presence of some sort is required, apparently the trustees of trusts, especially *inter vivos* trusts, with no connection to a state other than the fact that the testator or grantor was domiciled in the state at a relevant time would have the strongest basis on which to argue that the imposition of income tax by that state would violate due process requirements. As the District of Columbia Court of Appeals stated in *Chase Manhattan Bank*:

We express no opinion as to the constitutionality of taxing the entire net income of inter vivos trusts based solely on the fact that the settlor was domiciled in the District when she died and the trust therefore became irrevocable. In such cases, the nexus between the trust and the District is arguably more attenuated, since the trust was not created by probate of the decedent's will in the District's courts. An irrevocable inter vivos trust does not owe its existence to the laws and courts of the District in the same way that the testamentary trust at issue in the present case does, and thus it does not have the same permanent tie to the District. In some cases the District courts may not even have principal supervisory authority over such an inter vivos trust. The idea of fundamental fairness, which undergirds our due process analysis, therefore may or may not compel a different result in an inter vivos trust context.

See Nenko, *supra*; see also Coleman, *supra* ("a tax on an inter vivos trust of a resident decedent with no other tie to the state is highly questionable.")

## 2. Commerce Clause Analysis

In *Quill*, the United States Supreme Court held that, although purposeful targeting by mail of North Dakota customers constituted sufficient “presence” in North Dakota under due process analysis, imposition of a use tax was unconstitutional under the Commerce Clause. Specifically, the Court stated that the Commerce Clause, “by its own force,” prohibits state actions that interfere with interstate commerce. *South Carolina State Highway Department v. Barnwell Brothers, Inc.*, 303 U.S. 177 (1938). The Court stated that a tax does not violate the Commerce Clause so long as it: (a) is applied to an activity with a substantial nexus with the taxing state; (b) is fairly apportioned; (c) does not discriminate against interstate commerce; and (d) is fairly related to the services provided by the state. Ultimately, the Court concluded that it was unconstitutional for North Dakota to impose a use tax on retailers whose only presence in North Dakota is by common carrier or U.S. Mail. In reaching this conclusion, the Court distinguished the “minimum contacts” test relating to the due process analysis from the “substantial nexus” test relating to the Commerce Clause analysis. Specifically, the Court said that due process requirements address whether an individual’s connections are substantial enough to legitimize the exercise of state power but that the Commerce Clause addresses structural concerns about the effects of state regulation on the national economy. The presence in the state can be one that is not related to activity being taxed.

For Commerce Clause purposes, the Court favored a “bright line” rule (such as: it is unconstitutional for a state to impose a use tax on a business where the only presence of the business in the state is by means of common carriers or U.S. Mail) because a “bright-line rule would encourage settled expectations and foster investment by businesses and individuals.” The Court stated that a bright line rule is also beneficial because “as we have so frequently noted, our law in this area is something of a “quagmire” and the “application of constitutional principles to specific state statutes leaves much room for controversy and confusion and little in the way of precise guides to the States in the exercise of their indispensable power of taxation.”

All but one of the reported cases that have addressed the constitutionality of imposing income tax on a trust based on the domicile of the testator or trust grantor have not engaged in Commerce Clause analysis. One post-*Quill* case, however, *Gavin*, did so engage, finding that Connecticut did not violate the Commerce Clause by imposing its income tax on a trust. The plaintiff in *Gavin* had asserted that Connecticut’s scheme of fiduciary income taxation violated the Commerce Clause because it subjected trusts with non-Connecticut trustees to “a risk of multiple taxation,” without providing a tax credit for taxes on intangibles paid to another state. Thus, Connecticut had impermissibly promoted Connecticut trustees and consequently “discriminat[ed] against interstate commerce by putting that commerce into an inferior position to local commerce.” The court, relying on *Quill*, held that the risks associated with subjecting trusts to income tax imposed by multiple states on intangibles were too remote and speculative to constitute a violation of the Commerce Clause.