

NATURE OF TRUSTS

- A trust is "a fiduciary **relationship** with respect to property, subjecting the person by whom the title to the property is held to equitable duties to deal with the property for the benefit of another person, which arises as a result of a manifestation of an intention to create it."¹

STATE TREATMENT OF TRUSTS AS INDIVIDUALS

- **Taxation of individuals:** impose an income tax on their entire income in their state of legal residence, with credits for taxes paid to other states as a nonresident.
- **Taxation of trusts:** impose an income tax on their entire income in their state of legal residence, with credits for taxes paid to other states as a nonresident.
- **Residence**
 - **Individuals:** A person's legal residence is the one he regards as his true home or primary residence for the tax year.
 - **Trusts:** Most states find trust residence based on some variation of the following seven categories:
 - 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.
 - Other states (Alaska, Florida, New Hampshire, Nevada, South Dakota, Texas, Washington, Wyoming) do not tax trusts at the "entity" level, and so have no need to assess trust residence.
 - With careful planning a trust may not be a resident of *any* state.
 - Alternately, a trust can be considered a "resident" of any number of states.
- **Credits**
 - **Individuals:** When people earn money from out-of-state activities, they usually remit tax on that income to the other state as a non-resident.
 - Individual's state of legal residence still taxes their entire income, but will typically offer a tax credit for taxes already paid to the other state.
 - **Trusts:** frequently have a multistate tax presence and can be subject to tax on their full income on all of their states of legal residence.
 - Therefore, trusts may not be legally entitled to any credits for income paid to another state as a non-resident because they paid tax as a resident.
 - Practitioner comments regarding problematic state tax credits:
 - In many states, the credit is limited to tax paid to another state on income derived from that state. See, e.g., Mo. Rev. Stat. § 143.081(1); Conn. Gen. Stat. § 12-704(a). Thus, for example, the credit would be available to offset income tax paid by a resident to another state based on income derived from real property located in that other state. The

¹ Restatement (Second) of Trusts (1959) § 2 (*emphasis added*).

credit would not be available, however, to offset state tax imposed on income from intangibles, such as stock.²

- [I]n some states the credit is available only if the other state's tax is imposed "irrespective of the residence or domicile" of the taxpayer. Haw. Rev. Stat. § 235-55(a); see also, e.g., Mont. Code Ann. § 15-30-124(c)(2). This limitation would prevent a trust deemed a resident of more than one state from using the credit because the tax is imposed based on the trust's residence in both states.³

STATE TREATMENT OF TRUSTS AS CORPORATIONS: NEXUS LITIGATION

- In tax litigation, courts have relied on corporate case law to determine when a trust is taxable. *Note, I specifically looked for cases regarding inter vivos trusts, because they present challenges that testamentary trusts may not.*
- **Before *Quill v. North Dakota***, 504 U.S. 298 (1992)
 - Michigan Court of Appeals came to the same conclusion, found that state taxation of an *inter vivos* trust with no *current* connection to the state was unconstitutional b/c no ongoing protection or benefit to the trust.⁴
- **After *Quill v. North Dakota***, 504 U.S. 298 (1992)
 - Heavier reliance on *Quill* Due Process Clause and Commerce Clause analysis, even though *Quill*'s applicability to trust litigation is debatable.
 - *Quill*: sales and use tax
 - *Quill*: involved an entity that was itself engaged in interstate commerce
 - ***District of Columbia v. Chase Manhattan Bank*, 689 A.2d 539 (1997)**
 - **Distinguished between testamentary trust nexus and *inter vivos* trust nexus**
 - Testamentary trust probated in 1935 could constitutionally be taxed as a resident trust in the District of Columbia even though the trustee, trust assets, and trust beneficiaries were located in other states, because the District created a legal environment that permitted a testamentary trust to come into existence.
 - Court declined to extend its holding to *inter vivos* trusts:
 - **"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

² Bradley E.S. Fogel, *State Income Taxation of Trusts*, 19-AUG Prob. & Prop. 36, 38-39 (2005)

³ *Id.*

⁴ *Blue v. Department of Treasury*, 462 N.W.2d 762, 764 (Mich. Ct. App. 1990).

the same permanent tie to the District.”⁵ (*emphasis added*)

▪ ***Chase Manhattan Bank v. Gavin*, 733 A.2d 782 (Conn. 1999)**

• **Established Commerce Clause applicability in trust nexus litigation**

- Although the trustees, trust assets, and administration were located outside of the state's borders, the court did permit the state to tax the undistributed income of the *inter vivos* trust.
 - Tax was permissible under the Due Process Clause because the noncontingent beneficiary of the trust was a state domiciliary. Regarding dormant Commerce Clause analysis, the court rejected the state's argument that the Commerce Clause was inapplicable because the trusts were not engaged in interstate commerce.⁶
 - **In this respect, the entities that are affected by the state taxing scheme are in-state banks and out-of-state banks that provide financial services to trusts as trustees.** Although there is nothing in this record to indicate the degree of competition between the two groups, it is fair to assume, in this economy, that they may be actual or prospective competitors to provide such services to the Connecticut market for them.⁷

▪ ***Robert L. McNeil, Jr. Trust ex rel. McNeil v. Com.*, 67 A.3d 185 (Pa. Commw. Ct. 2013)**

• **Interpreted *Quill* to require actual physical presence**

- Department of Revenue imposed income tax on two *inter vivos* trusts because the trusts' settlor resided in Pennsylvania when he established the trusts in 1959, and the trusts' discretionary beneficiaries were Pennsylvania residents. (Pennsylvania determined trust residence based on whether the grantor was a resident “at the time of death, creation of the trust or the transfer of the property.”)⁸
- Court held that the tax did not satisfy the Commerce Clause under the four prongs laid out in *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977): (1) substantial nexus; (2) fair apportionment; (3) fair relation to the benefits being conferred by the taxing jurisdiction; and (4) no discrimination against interstate commerce.
- “[t]o rely on Settlor's residence in Pennsylvania approximately forty-eight years before the [tax year] in question to establish the Trusts' physical presence in Pennsylvania in 2007 would be the equivalent of

⁵ *Id.* at 547 n.11

⁶ *Id.* at 803.

⁷ *Id.* at 803-04.

⁸ 61 Pa. Code § 101.1.

applying the slightest presence standard rejected by the U.S. Supreme Court in *Quill*.⁹

- *However*, a comment toward the end of the opinion indicated that the court might have found substantial nexus if the resident beneficiaries had had a vested (rather than discretionary) interest in the trust.

- **Result: trusts are taxed like individuals under state law, applying residency rules, but the jurisdiction to tax them has been evaluated using corporate-type nexus principles.**

CONSIDERATIONS FOR RESIDENCY PROJECT

- Consider Due Process Clause and Commerce Clause nexus
- Residence rules should offer a level of certainty to both state and taxpayer
- Residence rules should accommodate state policy goals

POTENTIAL SOLUTIONS

- *Note: no solution is a complete fix; there will always be tax planning opportunities.*
- **Uniform Residence Rules**
 - Consider eliminating trustee-related factors.
 - If these factors are left in, they are unlikely to close any residency loopholes. In all likelihood, those factors would take place in a tax-free jurisdiction from the beginning – and if not, they are easy enough to move by switching trustees or amending the trust instrument.
 - Recall constitutional nexus considerations.
 - Of all the factors, the grantor’s residence at the time the trust was created is the only absolutely unchangeable factor.
 - But the least changeable factor is often the most distant factor, and may not hold up under Due Process Clause or dormant Commerce Clause analysis.
 - Mix of factors? Require one plus another? And/or? Alternatives? Hierarchy?
- **Uniform Apportionment**
 - California already has a system of apportionment for trusts that would provide a convenient model.
 - Trust residence is based on residence of a fiduciary or a non-contingent beneficiary.¹⁰
 - California first taxes the trust based on the ratio of resident to nonresident fiduciaries and then by the ratio of resident to nonresident beneficiaries.¹¹
 - For **example**, a trust has four trustees, two which are California residents, and four noncontingent beneficiaries, one of which is a California resident. Half of the trustees are California residents and one-fourth of the noncontingent bene-

⁹ *McNeil*, at 195

¹⁰ Cal. Rev. & Tax. Code § 17742(a).

¹¹ California FTB Legal Ruling No. 238 (Oct. 27, 1959).

fiduciaries are California residents. California will tax the retained income of the trust as follows:

$$\begin{array}{l}
 \text{CA Fiduciaries:} \quad \frac{2}{4} \left(\$ 100,000 \right) = \$ 50,000 \\
 \text{All Fiduciaries:} \quad \frac{2}{4} \left(\$ 100,000 \right) = \$ 50,000 \\
 \text{CA Beneficiaries:} \quad \frac{1}{4} \left(\$ 100,000 - \$ 50,000 \right) = \$ 12,500 \\
 \text{All Beneficiaries:} \quad \frac{1}{4} \left(\$ 100,000 - \$ 50,000 \right) = \$ 12,500
 \end{array}
 \left. \vphantom{\begin{array}{l} \\ \\ \\ \end{array}} \right] = \$ 62,500 \text{ subject to taxation in CA}$$

- California also imposes **throwback** applicable to the in-state beneficiaries.¹²
 - Where a trust has accumulated income that has not been taxed in California, and then makes a distribution to an in-state beneficiary, it will then be subject to taxation if 1) tax was previously due and not paid, or 2) the beneficiary had a contingent interest when the income accumulated. The accumulated net income distributed to the beneficiary is taxed as though it had been included in the beneficiary's income in the year of distribution and a maximum of five preceding years (or less if the income has accumulated over fewer than five years). California offers a **credit** on this amount for taxes paid to other states.
- **California has considered deleting the residence of a fiduciary as a basis for imposition of California taxation** and apportioning WRT resident beneficiaries.
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¹² Cal. Rev. & Tax. Code § 17745(d).