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THE LEGAL AND REGULATORY FRAMEWORK FOR STATE INCOME TAXATION OF TRUSTS

I. OVERVIEW

According to census records, some 35.9 million people in the United States moved between 2012 and 2013.[1] Tax practitioners are well aware of the fact that when an individual changes their state of residence, their personal income tax filing obligations will also likely change. What they may not realize, however, is the impact such a change of residence might have on the fiduciary income tax obligations of a trust of which that individual is a Settlor, Beneficiary, or Trustee. This is an issue that must be on the radar of every practitioner who provides advice or tax preparation services related to fiduciary income tax. Failure to fully examine the issues can result in penalties for failure to file required returns, interest on unpaid tax liabilities, and breach of fiduciary duty claims against Trustees. The statutes, regulations, and case law in each of the fifty states are constantly shifting as the states become more and more aggressive in pursuing possible revenue sources. Therefore, it is important to have an understanding of the issues involved, and the best practices to put in place, to avoid getting lost in this morass of differing tax regimes.

[1] Ihrke, David, *Reason for Moving: 2012 to 2013 Population Characteristics,* U.S. Department of Commerce, U.S. Census Bureau (June 2014), *available at* http://www.census.gov/prod/2014pubs/p20-574.pdf.

Fiduciary income tax issues are some of the most complex tax problems to analyze because they involve so many different areas of the law, including state laws applicable to trust administration, federal tax law, state tax law, and state and federal constitutional law. Before delving into an analysis of the applicable legal authorities, however, it is necessary to take a step back and review the fundamentals of fiduciary income taxation.

II. INTRODUCTION TO FIDUCIARY INCOME TAXATION OF TRUSTS

Generally speaking, fiduciary income taxation refers to the income taxation of estates and trusts, and in some instances the beneficiaries of such entities. At the federal level, the income tax provisions applicable to trusts (as well as estates, beneficiaries and decedents) are found in Subchapter J of the Internal Revenue Code of 1986 (the "Code").[2] Aside from the trust residency considerations discussed throughout the remainder of these materials, many state fiduciary income tax regimes are based upon the same principles which underlie the federal system. Therefore, it is helpful to begin with an examination of the federal system for taxing the income of trusts.

A. <u>GRANTOR TRUST OR NON-GRANTOR TRUST</u>

The first step in the analysis of the income tax provisions applicable to a given trust requires a determination of whether or not the trust is a grantor trust for federal income tax purposes. Under the rules set forth in sections 671 through 679 of the Code, if a trust is a "grantor trust" then the grantor is treated as the owner of all or a portion of the trust for federal income tax purposes and, thus, is the proper taxpayer.[3]

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[2] I.R.C. §§ 641-692.

[3] An analysis of the grantor trust rules and when a trust is considered to be a grantor trust is beyond the scope of these materials. This determination is made based upon the terms of the trust and the history of contributions made to the trust. While the person to whom the income of

B. FEDERAL GRANTOR TRUST TREATMENT

For federal tax purposes, once it is determined that a trust is a grantor trust, the tax treatment is fairly straightforward. Under section 671 of the Code, all the items of income, and all deductions and credits, of the trust must be included in computing the taxable income and credits of the grantor. The grantor, therefore, will report all of these tax items on his or her personal federal income tax return each year.[4] It is not necessary to examine whether or not the trust has made principal or income distributions to any beneficiaries or has accumulated any of its income; for a grantor trust these issues are irrelevant.[5] The trust itself does not pay any tax, and is essentially only required to file an informational return.[6]

C. STATE GRANTOR TRUST TREATMENT

It is important to note that not all the states follow the federal model regarding the treatment of grantor trusts. For example, Pennsylvania does not recognize grantor trust status, other than for settlor revocable trusts, and will tax a grantor trust as a separate entity for state income tax purposes.[7] Other states recognize grantor trusts, but impose filing requirements on such trusts.[8] Therefore, when dealing with a trust that is a grantor trust for federal tax purposes, it is still necessary to ensure that the trust will be considered a grantor trust for state tax purposes, and to review any filing and reporting requirements that might apply. In states that do rely on federal law for the tax treatment of grantor trusts and do not impose a separate tax reporting requirement on the trustee, the grantor will simply include the trust items of income and

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a grantor trust is attributed is not necessarily the individual who contributed funds to the trust, such deemed owner of a trust will be referred to herein as the "grantor".

[4] *See* Treas. Reg. § 1.671-4(b).

[5] *See* Acker, 852-3rd T.M., *Income Taxation of Trusts and Estates.*

[6] *See* Treas. Reg. § 1.671-4 (alternative filing methods for a grantor trust).

[7] Pennsylvania Department of Revenue, *Pennsylvania Personal Income Tax Guide*, Chapter 14, page 4.

[8] *See e.g.*, Code of Alabama § 40-18-25(g) (1975).

deduction on his or her state personal income tax returns based upon the domicile of the grantor and the sources of his or her income.

D. <u>FEDERAL NON-GRANTOR TRUST TREATMENT</u>

A non-grantor trust, on the other hand, is treated for federal tax purposes as a distinct taxable entity, separate and apart from the Settlor, Trustee or the beneficiaries.[9] The rules found in Subchapter J of the Code apply to determine the federal income tax consequences of the activities of a non-grantor trust. The rules that apply will vary depending on the terms of the trust and how the trust is administered, including how trust receipts are allocated and the distributions that are made from the trust during the tax year. In very broad, general terms, if no distributions are made from a trust, then all of the taxable income realized by the trust will be taxed to the trust itself, and the trust will pay tax on its income at the applicable trust income tax rates. If, however, distributions are made from the trust, then the taxable income realized by the trust will "pass through" to the trust beneficiaries and will be reported on their individual returns, at the applicable individual income tax rates. The trust will report its portion of the taxable income on its Form 1041–U.S. Income Tax Return for Estates and Trusts. The trust will issue each beneficiary who receives taxable distributions a Schedule K-1–Beneficiary's Share of Income, Deductions, Credits, etc. – reporting the beneficiary's share of such items to be reported on the beneficiary's personal income tax return. Each of these general taxation rules is subject to numerous exceptions and refinements, however, some of which are discussed further in this section.

[9] *See* Code § 641.

1. Rules Applicable to All Trusts – Trust Taxable Income and DNI

In order to determine the taxable income of a trust, you begin with the application of the rules generally applicable to all trusts under sections 641 through 644 of the Code. The general trust income tax rules provide that the federal taxable income of the trust will be determined in the same manner as would an individual's federal taxable income, taking into account its items of income, deduction and credit.[10] Certain adjustments applicable to trusts under Subchapter J are then taken into account, including a different personal exemption than is allowed for an individual and different rules applicable to charitable deductions.[11] Once the trust taxable income has been determined, if distributions have been made (or should have been made) to the trust beneficiaries during the taxable year, the Code then provides a mechanism for allocating the taxable income of the trust between the trust and its beneficiaries. The tax liability attributable to the income of a trust is generally allocated between the trust and its beneficiaries, and among the beneficiaries, in proportion to their respective shares of the distributable net income (or DNI) of the trust.[12] DNI determines how much of the income of a trust is taxed to the entity and how much is taxed to the beneficiaries.

A trust determines its income tax liability based on its taxable income; distributions to a beneficiary, however, are based upon fiduciary accounting income. A trust's fiduciary accounting income is determined based upon the terms of the trust document and the state law applicable to the administration of the trust. Since the taxable income and the fiduciary accounting income are often different, the Code uses the concept of DNI to reconcile the two types of income in order to determine who should bear the tax burden and to provide "a

[10] Code § 641(b).
[11] *See* Code § 642.
[12] *See* Danforth, Lane, and Zaritsky, *Federal Income Taxation of Estate and Trusts*, ¶3.01 (Warren, Gorham & Lamont 3rd ed.).

quantitative measure of the taxable income that the estate or trust may pass through to the beneficiaries."[13]

DNI is computed by starting with the trust's taxable income and then making the modifications set forth in section 643(a) of the Code. Generally, these modifications will be to increase the taxable income by the amount of any tax-exempt interest, the personal exemption, and any capital losses, and to decrease the taxable income by the amount of capital gains and any expenses that are attributable to tax-exempt interest.[14] Once the trust's DNI has been determined, it is necessary to establish the distributions that have been made to the trust beneficiaries in order to determine the federal income tax liability of each of the trust and its beneficiaries.

2. Classification of Trusts as Simple or Complex

The next step in analyzing the federal income tax treatment of trust income involves determining whether a trust is a simple trust or a complex trust. With a simple trust, the Trustee (1) is required to distribute all of its fiduciary accounting income to the beneficiaries each year; (2) is not authorized to make charitable distributions; and (3) does not make any distributions beyond the fiduciary accounting income of the trust.[15] Thus, the individual preparing a fiduciary income tax return will need to review the trust document to determine whether or not the Trustee is required to distribute all of its fiduciary accounting income and whether or not charitable distributions are permitted, and then will need to review how the trust was administered during the tax year at issue to see if any distributions of amounts in excess of

[13] Acker, 852-4th T.M., *Income Taxation of Trusts and Estates*, ¶II.C.
[14] Code § 643(a).
[15] Code § 651(a).

the fiduciary accounting income were made. If the requirements for being a simple trust are not met, then the trust will be a complex trust.

3. Taxation of Simple Trusts

As its name implies, the tax treatment of a simple trust is fairly straightforward. The trust will be entitled to deduct from its taxable income the amount of the income for the taxable year which is required to be distributed currently.[16] Here, since the Code uses only the word "income" it is referring to fiduciary accounting income.[17] The deduction is limited, however, to the amount of the trust's DNI.[18] This deduction is known as the income distribution deduction. The trust will pay tax on its taxable income in excess of the income distribution deduction. The trust beneficiaries, on the other hand, will include in their gross income the amount of income required to be distributed for the taxable year, whether it is actually distributed or not.[19]

4. Taxation of Complex Trusts

For a complex trust, the amount of income taxable to the trust is determined in accordance with the rules specifically applicable to complex trusts in sections 661 and 662 of the Code. After determining the trust's taxable income and DNI, section 661 provides that a complex trust is entitled to an income distribution deduction equal to any amount of income for such taxable year required to be distributed currently plus any other amounts properly paid or credited or required to be distributed for such taxable year. As with a simple trust, however, the deduction is limited to the DNI of the trust.[20] Also as with a simple trust, a beneficiary to whom a distribution is paid, credited, or required to be made by a trust will include an amount of the

[16] Code § 651(a).
[17] *See* Code § 643(b).
[18] Code § 651(b).
[19] Code § 652(a).
[20] Code § 661(a).

distribution in his or her gross income.[21] The determination of this amount is more complicated for a complex trust than it is for a simple trust due to the facts that a complex trust does not have to distribute all of its fiduciary accounting income, and can make principal distributions.

The distributions from a complex trust are separated into two tiers. The first tier consists of those distributions of income that are required to be made currently.[22] The second tier consists of all other amounts properly paid, credited or required to be distributed.[23] Thus, Tier 1 distributions are required distributions of fiduciary accounting income, while Tier 2 distributions are discretionary distributions of fiduciary accounting income and almost all principal distributions (other than specific bequests and charitable contributions). The effect of these tiers is that the beneficiaries of a complex trust who are required to take distributions will use up DNI first, before it is allocated to other beneficiaries. To the extent the DNI of a trust is greater than the amount of fiduciary accounting income required to be distributed, any Tier 2 distributions will not be taxable. In practice, this means that to make a tax-free principal distribution to a trust beneficiary, you first need to have distributions to an income beneficiary that use up DNI, or need for there not to be any DNI.

5. Determining and Reporting Taxable Income

For federal purposes, once the trust's taxable income under sections 641 and 642 has been determined, the fiduciary accounting income has been established, and the trust's DNI and income distribution deductions have been calculated, the trust's tax return preparer can prepare the Form–1041 for the trust, issue the Schedule K-1's to the beneficiaries, and determine the final trust income tax liability for federal purposes. At the state level, many states follow similar

[21] Code § 662(a).
[22] Code § 662(a)(1).
[23] Code § 662(a)(2).

models to the federal scheme in determining the taxable income of a trust, and allocating that income between the trust and its beneficiaries, although there are numerous deviations from the federal system. Therefore, once the federal return has been completed, preparing the state return will often be fairly straightforward as it will be based upon the tax information already reported for federal purposes. The critical and often most difficult step in preparing the state return is determining what state returns need to be prepared. It is therefore crucial for tax preparers, trust administrators, and trust drafters to have a complete understanding of which states' tax laws might apply to a given trust.

III. DIFFERING STATE BASES OF TAXATION

In order for a state to impose its tax laws upon an individual, a business or a trust, there must be a sufficient nexus between the individual, the business or the trust and the state whose laws are at issue. Nexus refers to a connection between the taxpayer, or the activities or property of the taxpayer, and a given state that allows the state to subject the taxpayer, its activities, or its property to its taxing jurisdiction without violating applicable limitations imposed by federal and constitutional law.[24] For an individual, the nexus with a taxing state is usually the domicile of the individual in the state, which can generally be clearly established.

A trust, however, does not always have a clear domicile, as the Trustee may be located in one state, the beneficiary may be in a second state, and trust assets may be located in a third state. Nexus can therefore be difficult to establish. In examining nexus for fiduciary income tax purposes, the states generally assert that they have sufficient nexus to tax trusts based on one or more of five trust characteristics: the domicile of the trust creator, the domicile of a fiduciary of

[24] *See* Handel, Rick, *A Conceptual Analysis of Nexus in State and Local Taxation*, The Tax Lawyer, Vol. 67, No. 4 at 626 (Summer 2014).

the trust, the domicile of a beneficiary of the trust, the place of administration of the trust, and whether or not a trust has income sourced to the state. While the laws of some states rely on only one of these characteristics, many will require that a trust have more than one characteristic before being subject to tax in that state. As will be discussed further below, while the states can enact laws which rely on only one characteristic to establish a sufficient nexus, the courts in some jurisdictions have required a more substantial connection before enforcing such laws.

A. DOMICILE OF TRUST CREATOR

The term "domicile" generally means an individual's permanent home where they intend to return and remain, even if they currently reside elsewhere.[25] Sixteen states consider a trust to be subject to taxation in that state if the trust was created under the will of an individual who was domiciled in that state at the time of the decedent's death.[26] Eleven states and the District of Columbia tax a trust if it was created by a domiciliary of the state during his or her lifetime.[27] Thus, when reviewing the potential fiduciary income tax exposure of a trust, it is important to establish where the creator was domiciled at the time the trust was created. Since the domicile of the creator is not a trust attribute that can be changed, few planning opportunities exist to avoid state fiduciary income taxation on this basis for existing trusts. This can, however, be a very important consideration for a client who is intending to create a new trust and who may have the opportunity to establish a new domicile in a state which does not impose income tax on the basis of the settlor's domicile.

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[25] Black's Law Dictionary, 7th Edition (West Group, 1999).

[26] Nenno, Richard W., *Let My Trustees Go! Planning to Minimize or Avoid State Income Taxes on Trusts*, 46 U.MIAMI HECKERLING INST. ON EST. PLAN. ch. 15, ¶ 1501.3 (2011).

[27] *Id.*

B. DOMICILE OF TRUST BENEFICIARY

Several states will subject a trust to state income tax if a beneficiary of the trust is domiciled in that state. Two notable states in this category are California and North Carolina.[28, 29] In California, if the domicile of a beneficiary in California is the sole connection of the trust to the state, then the beneficiary must be a "non-contingent" beneficiary.[30] A non-contingent beneficiary is a beneficiary whose interest in the trust is not subject to a condition precedent, such as surviving to a certain age which the beneficiary has not yet attained before being eligible to receive a distribution.[31] In North Carolina, there just needs to be a beneficiary residing in that state.[32] Planning to avoid state fiduciary income tax on the basis of the beneficiaries' domiciles is virtually impossible as it can change frequently throughout the period of administration of a trust and cannot be reliably predicted. Furthermore, there is limited ability to draft around this issue as a trust settlor will not generally wish to eliminate a beneficiary due to their place of domicile. Therefore, this factor is perhaps most important to those who are administering trusts and preparing trust income tax returns, who must ensure that they are aware of the domicile of each beneficiary of a trust to ensure an accurate reporting position.

C. DOMICILE OF TRUST FIDUCIARY

Many states will look to whether or not a trust fiduciary is domiciled in the state when setting forth the bases upon which a trust's income will be subject to tax in the state. California

[28] Cal. Rev. & Tax. Code § 17742(a).
[29] N.C. Gen. Stat. § 105-160.2.
[30] Cal. Rev. & Tax. Code § 17742(a).
[31] Cal. Code Regs. tit. 18, § 17742(b).
[32] *See* Memorandum to Revenue Laws Study Committee from the Legislative Committee of the Estate Planning and Fiduciary Law Section of the North Carolina Bar Association regarding G.S. 105-160.2, February 3, 2014, *available at:* http://www.ncleg.net/DocumentSites/committees/revenuelaws/Meeting%20Documents/2013-2014%20Meeting%20Documents/02-11-2014/ Income%20Tax%20on%20Estates%20and%20Trusts.pdf.

will subject a trust to tax in that state if any fiduciary is a resident of the state.[33] It should be noted that this provision refers to "fiduciaries" and not just trustees. California law defines a fiduciary to include a trustee and any person, whether individual or corporate, acting in any fiduciary capacity for any person, estate or trust.[34] It is not clear under California law whether a resident fiduciary such as a trust protector or direction investment advisor could subject a trust to taxation in California.[35] Similarly, in Virginia, a resident trust is subject to Virginia income tax.[36] The Virginia regulations define a resident trust as one which has a fiduciary who is a resident of Virginia.[37]

Delaware also imposes its fiduciary income tax on trusts with a Delaware domiciled Trustee.[38] Delaware, however, permits a deduction for taxable income set aside for future distribution to non-resident beneficiaries such that a trust will essentially only have fiduciary income tax liability to the State of Delaware if there is a Delaware resident Trustee and resident beneficiary.[39] Unlike the domicile of the trust creator or beneficiary, the domicile of a trust's fiduciaries can be planned for and changed. Trustees and advisors can often be removed and replaced to eliminate the nexus between a trust and a fiduciary-domicile state. In the planning stage, it is becoming commonplace to include provisions in trust agreements which specifically

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[33] Cal. Rev. & Tax. Code § 17742(a).

[34] Cal. Rev. & Tax. Code § 17006.

[35] Kinyon, Richard S. and Miller, Justin T., *When Should a Trust be Subject to California Income Tax?*, State Tax Notes Volume 72, Number 7 at 436 (May 19, 2014); c*f.* New York State Department of Taxation and Finance, TSB-A-04(7)I at 9 (November 12, 2004)(advisory opinion holding that investment advisory committee members are considered to be co-trustees for purposes of determining whether a New York resident trust is subject to New York income tax due to having a New York resident Trustee).

[36] Va. Code Ann. § 58.1-361.

[37] 23 Va. Admin. Code § 10-115-10.

[38] 30 Del. C. §§ 1601(8), 1635(a).

[39] 30 Del. C. § 1636(a).

provide that a fiduciary will not be eligible to serve in such a position if their domicile in a certain state will subject the trust to an income tax to which it would otherwise not be subject.

D. PLACE OF TRUST ADMINISTRATION

Similar to the domicile of the trustee, many states will impose their fiduciary income tax upon trusts administered within their state. Colorado, Georgia, Maryland, South Carolina, and Virginia are all included in this category.[40] Maryland law, for example, provides that a trust will be a resident trust, and thus subject to Maryland income tax, if it is principally administered within such state.[41] While the domicile of a trustee of a trust and the place of administration of the trust will often be identical, this is not always the case. For example, a corporate trustee may be domiciled in its state of incorporation but may administer trusts in local offices in states throughout the country. Activities which can be considered administration of a trust in a given state include: conducting accounting and bookkeeping, and selling and purchasing trust assets, in the state; making a majority of the discretionary decisions regarding the investment of trust assets in the state; making a majority of the discretionary decisions regarding the distribution of trust income and principal in the state; or a trust fiduciary's usual place of business being in the state.[42] As with the domicile of the trustee, if a trust is potentially subject to tax based upon its place of administration, a change in the trustee can often eliminate the issue, and careful trust drafting can prevent the issue from arising.

E. SOURCE INCOME

The final basis for state taxation of a trust which is frequently encountered is when a trust has income from sources within a given state. New York, for example, will subject a trust to

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[40] Nenno, *supra* note 26, at ¶1501.5.

[41] Md. Code Ann., Tax–Gen. § 10-101(k)(1).

[42] Colandreo and Roll, Bloomberg BNA Special Report: 2013 Trust Nexus Survey, Vol. 2013, No. 34 at 11 (August 23, 2013).

New York fiduciary income tax even if the trust is not considered to be a New York resident trust if the trust has income that is attributable to a business, trade, profession, or occupation carried on in New York State; attributable to the ownership of any interest in real property (including all or a portion of the gain or loss from the sale or exchange of an interest in certain entities that own real property) in New York State; or attributable to tangible personal property located in New York State.[43] In a recent survey by Bloomberg BNA, 43 states indicated that if a trust received income sourced to that state then the state would impose income tax on such income.[44] This result may seem fairly straightforward in certain situations, such as if a trust is receiving rental income on real property located in a given state. However, the source of a trust's income is not always so clear.

It is becoming more and more common for trusts to hold alternative investments such as private equity, hedge funds, venture capital, and shares of closely held corporations.[45] These investment vehicles are frequently pass-through entities for tax purposes, such as limited liability companies, limited partnerships, and S corporations. With pass-through entities, unlike other business entities such as C corporations, the states take the position that business income generated by the entity in the state will subject all the owners of the pass-through entity to state income taxation even if the owners are not residents of the state.[46] For example, if a trust owns shares of Microsoft, the trust will not have to pay income tax to each state where Microsoft does business. If, however, a trust owns a limited partnership interest in a hedge fund, organized as a Delaware limited partnership, which invests in oil and gas interests in Pennsylvania, the trust will

[43] New York TB-IT-620 (December 15, 2011).

[44] Colandreo & Roll, s*upra* note 42, at 8.

[45] *See* Bergmann and Johnson, *Selected Issues Concerning the State Income Taxation of Nonresident Trusts and Estates*, The Tax Adviser (September 1, 2011).

[46] Brown, William C., *A Primer of Income Tax Compliance for Multistate Pass-Through Entities and their Owners*, The Tax Lawyer, Vol. 67, No. 4 at 862 (Summer 2014).

be considered to have Pennsylvania source income and will be subject to Pennsylvania income tax even if the trust is not a Pennsylvania resident trust.[47]

Because of the difficulties of tracking down the disparate owners of pass through entities to enforce the state tax filing and payment obligations, many states require pass through entities to withhold or pay state income taxes attributable to nonresident owners unless the pass through entities' owners sign an agreement to file state nonresident returns and consent to the tax jurisdiction of the state.[48] When dealing with a trust partner or shareholder in a pass-through entity, the entity can be in the difficult position of needing to determine the residency of the trust in order to determine the entity's tax filing obligations. One method of filing that is often used, and in some cases required to be used, is for the entity to file a composite state income tax return reporting each non-resident partner's allocable share of the entity's income.[49] This composite filing can eliminate the need for each pass through entity owner to file a return in each state where the entity operates. Several states, however, do not permit certain types of nonresident owners to participate in composite filing. For example, California, Maryland, New Jersey, Pennsylvania and Wisconsin do not permit certain trusts to be included on a composite return.[50] Therefore, the trustee of a trust which invests in a pass-through entity operating in one or more of these states will be required to file a return in, and pay tax on its share of tax allocable to, each of these states.

Often a trustee will be able to structure the trust investments to avoid having source income from a state trigger a state's income tax. In the future, investment decisions will likely

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[47] *See e.g. Id.* at 863, citing *Marshall, Jr. v. Pennsylvania*, 41 A.3d 67 (Pa. Commw. Ct. 2012).

[48] *Id*. at 864.

[49] *Id*.

[50] *Id*. at 865.

become a greater consideration for trustees and investment advisers in making prudent investment decisions. In many instances, however, altering trust investments will not be possible. This is especially the case when dealing with closely held business interests which can often form the bulk of a trust's assets. Additionally, there is little than can be done in drafting a trust to avoid state income tax based on the source of the income. Therefore, the most important aspect of dealing with state income tax based on the source of the trust's income is to ensure that the tax professionals handling such a trust recognize the issues and make the determination of the most efficient way to handle the trust's tax reporting obligations.

IV. CONSTITUTIONAL LIMITATIONS

While the states have become more and more aggressive in attempting to impose their tax laws on the activities of individuals and trusts with fairly minor connections to the state, there are limits to the ability of the states to tax an individual or trust's income. In particular, the Commerce Clause and the Due Process Clause of the United States Constitution place limits on the authority of the states to tax.[51]

A. THE COMMERCE CLAUSE

The Commerce Clause of the U.S. Constitution provides that Congress shall have the power to regulate commerce with foreign nations and among the several states.[52] The U.S. Constitution specifically enumerates the powers which are granted to the federal government. The Tenth Amendment further provides that any powers that are not specifically granted to the federal government "are reserved to the states respectively, or to the people."[53] The Supreme Court has interpreted the Commerce Clause and the Tenth Amendment to provide that the

[51] Handel, *supra* note 24.
[52] U.S. CONST. art. I, §8, cl. 3.
[53] U.S. CONST. amend X.

"dormant" Commerce Clause prohibits state taxes that discriminate against or unduly burden interstate commerce.[54] In *Complete Auto Transit, Inc. v. Brady*, the United States Supreme Court set forth a four-part test that must be satisfied in order for a state tax to pass dormant Commerce Clause analysis: (1) the tax must be applied to an activity with a substantial nexus with the taxing state; (2) the tax must be fairly apportioned; (3) the tax must not discriminate against interstate commerce; and (4) the tax must be fairly related to services provided by the State.[55]

B. THE DUE PROCESS CLAUSE

While the Commerce Clause provides the federal government with an express grant of the power to regulate interstate commerce, the Due Process Clause of the Fourteenth Amendment to the U.S. Constitution provides an express limitation on the powers of the states. The Due Process Clause provides that no state shall "deprive any person of life, liberty or property, without due process of law."[56] In the area of state taxation, the United States Supreme Court has interpreted the Due Process Clause as placing a limit on the ability of the states to impose taxes beyond their borders, stating that, ""[D]ue process requires some definite link, some minimum connection between a state and the person, property, or transaction it seeks to tax."[57] When reviewing whether a state income tax imposed on a nonresident of the state violates the Due Process Clause, the Supreme Court has held that the test for determining whether the requirements of due process have been met is "whether the taxing power exerted by the state bears fiscal relation to protection, opportunities and benefits given by the state. The

[54] Handel, *supra* note 24 at 628.

[55] *Complete Auto Transit, Inc. v.* Brady, 430 U.S. 274 (1977).

[56] U.S. CONST. amend XIV, §1.

[57] Hellerstein, 1400-2nd T.M., *Federal Constitutional Limitations on State Taxation*, ¶ 1400.05.A. (citing *Miller Bros. Co. v. Maryland*, 347 U.S. 340, 344–45 (1954)).

simple but controlling question is whether the state has given anything for which it can ask return."[58] To summarize the pertinent case law, the courts have generally held that so long as there is a sufficient contact between the taxing state and a nonresident taxpayer, and the tax imposed is fairly related to the nonresident taxpayer's in-state activities, the tax will be upheld and will not be found to violate the Due Process Clause of the Fourteenth Amendment.[59]

C. SUPREME COURT CASES PRIOR TO QUILL CORP. V. NORTH DAKOTA.

In the area of fiduciary taxation, several Supreme Court cases from the first half of the 20th Century helped set the framework for the application of the Commerce and Due Process Clauses in analyzing multi-state fiduciary income tax issues, although the cases focused almost exclusively on the Due Process Clause at this point in time .

1. Safe Deposit & Trust Co. of Baltimore v. Virginia

In *Safe Deposit & Trust Co. of Baltimore v. Virginia*, a Virginia resident created an inter vivos trust for the benefit of his two minor sons, and transferred stocks and bonds to a Maryland trust company as Trustee of the Trust.[60] The Trustee was directed to invest and manage the trust fund, and accumulate the income for eventual distribution, along with the principal of the trust, in equal shares to each of the Settlor's sons when they attained the age of twenty-five. The Trustee administered the trust in Baltimore, Maryland for the benefit of the two sons, who were residents of Virginia. The Settlor of the trust died, while his sons were still minors, in Accomac County, Virginia. The county imposed an assessment for five years following the year of the settlor's death upon the whole corpus of the trust. The Trustee of the trust filed suit in Virginia, arguing that the tax assessment was unconstitutional as it taxed property beyond the jurisdiction

[58] *Wisconsin v. J. C. Penney Co.*, 311 U.S. 435, 444 (1940).
[59] Marcus, 1410-2nd T.M., *Limitations on States' Jurisdiction to Impose Net Income Based* Taxes, ¶ 1410.02.B.
[60] *Safe Deposit & Trust Co. of Baltimore v. Virginia*, 280 U.S. 83, 89 (1929).

of the Commonwealth of Virginia and therefore violated the Fourteenth Amendment.[61] While not directly addressing the Due Process Clause, the Court held that the Virginia tax did violate the Fourteenth Amendment as it attempted to tax things beyond the jurisdiction and control of the state. The Court stated that Virginia, the domiciliary state of the trust beneficiaries, could not impose a tax upon intangibles, in this case stocks and bonds, "in the hands of the holder of the legal title with definite taxable situs at its residence, not subject to change by the equitable owner."[62] Thus, the Court held that the mere presence of the trust beneficiaries in Virginia was not a sufficient connection to the state to permit taxation of the entire trust in Virginia.

2. <u>Guaranty Trust Co. v. Virginia</u>

Nine years after the *Safe Deposit & Trust* case was decided, Virginia's tax statutes appeared again before the Supreme Court. This time, the application of Virginia's income tax to a New York trust with a beneficiary domiciled in Virginia was at issue. The trust at issue in *Guaranty Trust Co. v. Virginia* was a testamentary trust created under the Will of a New York resident for the benefit of his wife, who subsequently became a resident and citizen of Virginia.[63] The trustees took title to the trust property in New York, the trust was administered in New York, and New York law applied to the administration of the trust. The terms of the trust provided that the trustees had the discretion to make income distributions to the testator's wife for her care, support and comfort during her life, which the trustee's did in each of the tax years at issue.[64] New York imposed its income tax upon the full amount of the trust's income; Virginia also imposed its income tax upon the amounts received by the beneficiary, even though tax on such income had already been paid to the State of New York. The Trustees paid the tax in

[61] *Id*. at 90.
[62] *Id*. at 93.
[63] *Guaranty Trust Co. v. Virginia*, 305 U.S. 19, 20 (1938).
[64] *Id*. at 21.

Virginia, and then filed suit arguing that Virginia could not assess an income tax on income which had already been assessed taxes by the State of New York as it would violate the provisions of the Fourteenth Amendment to impose two state taxes on the same income.[65] The Supreme Court disagreed, however, and stated that the Due Process Clause only restricted the ability of the states to impose taxes beyond their borders, which the Virginia statute was not trying to do as, "the thing taxed was receipt of income within Virginia by a citizen residing there."[66] Thus, *Guaranty Trust Co. v. Virginia* clearly established that double taxation by more than one state was not *per se* unconstitutional so long as there was a sufficient connection to each state. In this case, the presence of a current beneficiary in one taxing state, and the administration and domicile of the trustees in another, were both sufficient bases to justify the imposition of each state's income tax.

3. Greenough v. Tax Assessors of Newport

Another nine years after *Guaranty Trust Co.*, the Supreme Court again had cause to review two states' differing bases for imposing tax on a trust. This time, a testamentary trust created by a New York testator, with assets located in New York, and administered in New York for the benefit of a current beneficiary who resided in New York, was being subject to a personal property tax in the state of Rhode Island due to the fact that one of the three trustees of the trust was a Rhode Island domiciliary.[67] The property held in the trust consisted of 500 shares of Standard Oil Company of New Jersey stock, intangible property subject to the Rhode Island tax. In challenging the tax, the Trustee again argued that the tax violated the Due Process Clause as taxing a trust holding intangibles merely because one trustee resided in Rhode Island "exacted

[65] *Id*. at 22.
[66] *Id*. at 23.
[67] *Greenough et al., v. Tax Assessors of Newport et al.*, 331 U.S. 486 (1947).

payment measured by the value of property wholly beyond the reach of Rhode Island's power and to which that state does not give protection or benefit."[68]

The Supreme Court upheld the tax on the basis that the state had a right to look to its citizens for revenue based upon intangible assets because the situs of intangibles is difficult to establish, leading to uncertainty as to which taxing district affords benefits or protection to the actual property that the intangibles represent.[69] Furthermore, the Court stated that Rhode Island did "offer benefit and protection through its law to the resident trustee as the owner of intangibles" since it was possible that someone could bring suit against the Rhode Island resident trustee.[70] Finally, while the Court noted the holding of *Safe Deposit and Trust Company v. Virginia*, it determined that the holding in such case did not impact its decision as it did not forbid taxation by a state of intangibles in the hands of a resident testamentary trustee.[71]

D. <u>STATE CASES PRIOR TO QUILL CORP. V. NORTH DAKOTA</u>

Following these Supreme Court opinions regarding the constitutionality of various state tax regimes, a number of fiduciary income tax cases were then brought in the state courts challenging the constitutionality of such taxes. In New York, the New York Court of Appeals held that it was unconstitutional for New York to tax the accumulated income of a trust which was created for the benefit of a New York resident by a New York domiciliary when the trust was created in Maryland, was administered in Maryland, and had a Maryland domiciliary trustee.[72] The court held that imposing tax upon the trust's accumulated income, which was not distributed to the New York resident beneficiary, attempted to "extend the taxing power of the

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68 *Id*. at 489.
69 *Id*. at 492.
70 *Id*. at 496.
71 *Id*.
72 *Mercantile-Safe Deposit & Trust Co. v. Murphy*, 19 A.D.2d 765, 242 N.Y.S.2d 26, 28 (App Div, 3d Dept 1963).

State to property wholly beyond its jurisdiction and thus conflict[ed] with the due process clause of the Fourteenth Amendment."[73]

In California, on the other hand, the Supreme Court of California upheld a tax on accumulated income distributed to a California resident beneficiary and co-Trustee from a trust created by a Missouri resident, with two Missouri co-Trustees.[74] The trust in question accumulated its income for five years prior to its ultimate distribution, during which time period the beneficiary was a resident of California. No state income tax was paid to California during the five year period.[75] Upon the termination of the trust at the end of the five year period, California imposed a tax on the accumulated income against the beneficiary.[76] The California Supreme Court held that the beneficiary/trustee's California residence established sufficient contact with the State of California to subject the trust to California income tax.[77] Since the trust did not pay the California tax due on its annual income, the Court held that California could constitutionally tax the beneficiary at the time he received the distribution of the accumulated income.[78]

Back on the East Coast in New Jersey, the New Jersey Tax Court held, in two cases that were argued together, that a New Jersey tax imposed on the undistributed income of a trust created by a New Jersey domiciliary which had non-New Jersey trustees and beneficiaries and no assets in New Jersey was unconstitutional. In the case of *Potter v. Taxation Division Director* the trust at issue was an inter vivos trust.[79] In *Pennoyer v. Taxation Division Director* the trust

[73] *Id*. at 766.
[74] *McCulloch v. Franchise Tax Bd.*, 61 Cal.2d 186, 390 P.2d 412, 415 (1964).
[75] *Id*.
[76] *Id*.
[77] *Id*. at 189.
[78] *Id*. at 190.
[79] *Potter v. Taxation Div. Director*, 5 N.J.Tax 399 (Tax Ct.1983).

was a testamentary trust.[80] The New Jersey Tax Court held that the domicile of the settlor of the trust in the State of New Jersey at the time of the creation of the trust was not a sufficient contact to support taxation by New Jersey.[81] Although the court noted that the creation of a trust in New Jersey resulted in the jurisdiction and availability of the New Jersey courts to enforce or interpret the trust, the Court held that these contacts were not sufficient to support the income tax at issue and therefore the statute creating the tax was unconstitutional.[82]

Finally, the Missouri Supreme Court also weighed in to hold that a tax statute in that state which imposed Missouri income tax on the income of a testamentary trust created under the will of a Missouri domiciliary when the trust property, administration, and beneficiaries where all located outside Missouri was unconstitutional.[83] The testator, who was a resident of Missouri at the time of his death, created trusts under his will for the benefit of his children. The children and the trustees were all Illinois residents, the trusts were administered in Illinois, and all the trust assets were held in Illinois.[84] Nevertheless, Missouri attempted to impose its income tax on the trust, arguing that the administration of the testator's estate by a Missouri probate court established a sufficient nexus. The Missouri Supreme Court disagreed, holding that Missouri law provided "no present benefit or protection to the subject trusts, their beneficiaries, trustees or properties," and that therefore the trust did not have sufficient contacts with Missouri as required by the Fourteenth Amendment.[85]

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[80] *Pennoyer v. Taxation Div. Director*, 5 N.J. Tax 386 (Tax Ct. 1983).
[81] *Potter*, 5 N.J.Tax at 404.
[82] *Pennoyer*, 5 N.J.Tax at 398.
[83] *Swift v. Director of Revenue*, 727 S.W.2d 880 (1987).
[84] *Id*.
[85] *Id*. at 882.

E. QUILL CORPORATION V. NORTH DAKOTA

In 1992, the United States Supreme Court issued an opinion in a tax case regarding the ability of a state to impose a use tax on out-of-state retailers whose goods are purchased by consumers within the state. While such a case would not appear to be of much concern to fiduciary tax practitioners, this decision had a significant impact on fiduciary income tax jurisprudence.[86] In *Quill Corporation v. North Dakota*, the Quill Corporation challenged a North Dakota statute which required it to collect and pay use tax on goods its customers purchased for use in North Dakota.[87] Quill, which was incorporated in Delaware, was a mail order office supply company with offices and warehouses in Illinois, California, and Georgia; it did not have any sale outlets, sale representatives, or other employees in North Dakota.[88] It did, however, have customers in North Dakota who purchased its products for delivery via mail.[89] North Dakota law required Quill to collect use tax from its customers in North Dakota and to remit the tax to the state.[90] Quill refused to collect the tax, arguing that North Dakota did not have the power to compel it to collect the tax, so the State of North Dakota filed an action requiring Quill to pay the taxes.[91] In reviewing the tax, the Supreme Court held that the Due Process Clause did not bar the enforcement of the use tax against Quill, but that its enforcement did create an unconstitutional burden on interstate commerce.[92] While the decision of the Supreme Court to strike down the application of North Dakota's use tax is of little concern to fiduciary tax

[86] McCaffrey and McCaffrey, *Rationalizing the State Income Taxation of Trusts – Chasing Quill Feathers in the Wind*, May 10, 2010, *available at:* http://www.nycbar.org/pdf/report/uploads/20071955-HessLectureRationalizingtheStateIncomeTaxationofTrust.pdf.
[87] *Quill Corporation v. North Dakota*, 504 U.S. 298 (1992).
[88] *Id*. at 302.
[89] *Id*.
[90] *Id*.
[91] *Id*. at 303.
[92] *Id*. at 298.

practitioners, the Court's analysis of the Due Process Clause and the Commerce Clause is important.

In holding that the North Dakota law did not violate the Due Process Clause, the Supreme Court relaxed the due process standard applicable to state taxes imposed on non-resident corporations. The Court held that a physical presence of some sort in the state is not required, but rather that the foreign corporation must only purposefully avail itself of the benefits of an economic market in the taxing state, and <u>purposefully direct its activities at the taxing state, in order to have sufficient contacts with the state for due process purposes</u>.[93] While the Court weakened the due process standard that has so often served as the basis for invalidating state income taxes, it also underscored the importance of performing a Commerce Clause analysis as well. In particular, the Quill decision upheld the four-part test of *Complete Auto,* which includes a requirement that a tax be applied to an activity with a substantial nexus with the taxing state.[94] The Court held that, at least for purposes of sales and use taxes, such substantial nexus requires a physical presence in the taxing state.[95] Whether this rationale will be extended to income tax from the sales and use tax arena remains to be seen.[96]

F. <u>POST-QUILL STATE CASES</u>

Following the Supreme Court's decision in *Quill*, two separate state court opinions came down upholding state fiduciary income taxes against due process challenges. In each case, the court relied on the Supreme Court's due process analysis in *Quill*. In *District of Columbia v. Chase Manhattan Bank*, the District of Columbia attempted to tax the net income of a

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[93] *Id*. at 307-308 (emphasis added).
[94] *Id*. at 310, (citing *Complete Auto Transit, Inc. v. Brady, 430 U.S. 274 (1977))*.
[95] *Id*. at 314.
[96] See Handel, *supra* note 24, at 670-678 (providing a detailed discussion of the application of sales and use tax jurisprudence to income tax cases).

testamentary trust created by a domiciliary of the District which had non-resident trustees and beneficiaries and was not administered in the District.[97] Stating that the Supreme Court's decision in *Quill* established that due process required only that the taxpayer have minimum contacts with the taxing jurisdiction, the District of Columbia Court of Appeals upheld the tax.[98] The court rejected the analysis of the Missouri Supreme Court in *Swift v. Director of Revenue*, and held that basing the taxation of a testamentary trust solely on the domicile of the testator is constitutionally permissible.[99]

In *Chase Manhattan Bank v. Gavin*, the Supreme Court of Connecticut also upheld a state fiduciary income tax which was based on the domicile of the trust creator in the State of Connecticut at the time the trust was created.[100] *Gavin* involved four testamentary trusts and one inter vivos trust. None of the trusts had trustees or assets located in Connecticut, and none of the trusts were administered in Connecticut.[101] Three of the trusts had Connecticut resident beneficiaries, and two did not.[102] As with the *District of Columbia v. Chase Manhattan Bank* court, the Connecticut Supreme Court cited to *Quill* and stated that the relevant test was whether there were sufficient minimum contacts between the trusts and Connecticut.[103] Unlike the *District of Columbia v. Chase Manhattan Bank* court, the Connecticut Supreme Court did analyze the constitutionality of the Connecticut tax under the dormant Commerce Clause analysis set forth in *Quill*.[104] The Court rejected the Trustee's arguments, however, that the

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[97] *District of Columbia v. Chase Manhattan Bank*, 689 A.2d 539 (1997).
[98] *Id*. at 542.
[99] *Id*. at 546-547.
[100] *Chase Manhattan Bank v. Gavin*, 249 Conn. 172 (1999).
[101] *Id*. at 178.
[102] *Id*.
[103] *Id*. at 184-186.
[104] *Id*. at 208.

potential for double taxation resulted in an undue burden on interstate commerce in violation of the Commerce Clause.[105]

While the holdings of both *District of Columbia* and *Gavin* have been frequently criticized as being flawed, perhaps even "bad law," they are indicative of the fact that the fiduciary income tax waters have become increasingly murky.[106] More recent developments at the state level in both the courts and the legislatures have done little to bring clarity to the issue.

V. RECENT CASE LAW AND STATUTORY DEVELOPMENTS

A. RESIDUARY TRUST A U/W/O KASSNER, V. DIRECTOR, DIVISION OF TAXATION

2013 started off with a fiduciary income tax decision out of New Jersey. *In Residuary Trust A u/w/o Kassner, v. Director, Division of Taxation*, the Tax Court of New Jersey was asked to determine whether New Jersey could impose its income tax on the undistributed income of a testamentary trust created by the will of a New Jersey domiciliary.[107] During the year at issue in the case, the trust did not have any New Jersey trustees, was not administered in New Jersey, and did not make any distributions to any beneficiaries.[108] The trust assets consisted of cash, bonds, and stock, including the stock of four S corporations.[109] The S corporations passed through both New Jersey source income and non-New Jersey source income to the trust.[110] For the year at issue, the trust paid New Jersey income tax on the net pro rata share of S corporation income that was allocated to New Jersey but did not pay tax on its interest income or on the net pro rata share

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[105] *Id*. at 211.

[106] *See e.g.* Nenno, *supra*. note 26, at ¶1502.5 (discussing one professor's critique of the *Gavin* decision.)

[107] *In Residuary Trust A u/w/o Kassner, v. Director, Division of Taxation*, 27 N.J.Tax 68 (2013).

[108] *Id*. at 70.

[109] *Id*.

[110] *Id*.

of S corporation income that was allocated outside New Jersey.[111] The New Jersey Director of the Division of Taxation asserted that the trust should have paid New Jersey income tax on all of its income for the year at issue, while the taxpayer filed a notice of protest asserting that New Jersey law prohibited the imposition of state income tax on the undistributed income of a testamentary trust.[112]

The Court began its analysis by noting that under the relevant principles of the prior New Jersey cases of *Pennoyer* and *Potter*, New Jersey would only have sufficient contacts to tax the entire trust if the trustee was located in New Jersey and trust assets were located in New Jersey.[113] The Court specifically rejected the Director's arguments that the *District of Columbia v. Chase Manhattan Bank* and *Gavin* cases, following *Quill*, permitted taxation even if the only connection was the testator's domicile before his death.[114] Since the trustee of the trust was clearly not located in New Jersey, the key issue became whether or not trust assets were located in New Jersey.[115]

The Director argued that the trust owned assets in New Jersey "by virtue of the flow through characteristic of the S corporations in which Trust A owns stock (owning stock of an S Corporation that owns New Jersey assets)."[116] The court rejected this argument, however, and held that New Jersey could not subject the trust to taxation on its out of state income because it

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[111] *Id*. at 71.
[112] *Id*.
[113] *Id*. at 72 (citing *Potter v. Taxation Div. Director, 5 N.J.Tax 399 (Tax Ct.1983)*; *Pennoyer v. Taxation Div. Director, 5 N.J. Tax 386 (Tax Ct. 1983)*).
[114] *Id*. at 76 (citing *District of Columbia v. Chase Manhattan Bank*, 689 A.2d 539 (1997); *Chase Manhattan Bank v. Gavin, 249 Conn. 172 (1999); Quill Corporation v. North Dakota, 504 U.S. 298 (1992)*).
[115] *Id*. at 76.
[116] *Id*. at 77.

did not have sufficient contacts with New Jersey to satisfy constitutional due process requirements.[117]

B. MCNEIL V. COMMONWEALTH OF PENNSYLVANIA

In a victory for the taxpayers, the Commonwealth Court of Pennsylvania held that Pennsylvania's statute taxing all the income of a trust solely based on the fact that the settlor of the trust was domiciled in Pennsylvania at the time the trust was created violated the Commerce Clause.[118] The trusts at issue in the McNeil case were created by Robert L. McNeil, Jr. when he was a resident of Pennsylvania. The trusts were governed, construed, and administered in accordance with Delaware law, and Wilmington Trust Company served as the Administrative Trustee.[119] None of the general Trustees were Pennsylvania residents; none of the trust assets were located in Pennsylvania and there was no Pennsylvania source income during the period of time at issue in the case.[120] All of the trusts' discretionary beneficiaries were residents of Pennsylvania.[121]

The Pennsylvania statute at issue provided that "Every resident . . . trust shall be subject to, and shall pay for the privilege of receiving . . . income . . . a tax upon each dollar of income received by that resident during that resident's taxable year . . . ."[122] The Pennsylvania statute defined a "resident trust" as including "[a]ny trust created by . . . a person who at the time of such creation . . . was a resident."[123] Therefore, the Pennsylvania Department of Revenue asserted that the trusts owed tax on all of their reported income for the year 2007, the year at

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[117] *Id*. at 78 (citing *Pennoyer v. Taxation Div. Director, 5 N.J. Tax 386 (Tax Ct. 1983)*).
[118] *McNeil v. Commonwealth*, 67 A.3d 185, Pa. Comm. Court, Nos. 651 F.R. 2010, 173 F.R. 2011 (2013).
[119] *Id*. at 188.
[120] *Id*. at 189.
[121] *Id*. at 188.
[122] 72 P.S. § 7302(a).
[123] 72 P.S. § 7301(s)(2).

issue in the case. The Commonwealth Court began its constitutional analysis by considering whether the Department of Revenue's imposition of the Pennsylvania income tax on the McNeil Trusts violated the Commerce Clause.[124] The Commonwealth Court noted that the applicable test was the four-part test established in *Complete Auto*, along with the substantial nexus test set forth in *Quill*.[125] The Commonwealth Court stated that it was, "mindful that we are reviewing the presence that the Trusts, as the taxpayers, have within Pennsylvania."[126] The Court concluded that the only two contacts the Trusts had with Pennsylvania, the residency of the discretionary beneficiaries and the residency of the settlor, were not sufficient to establish the necessary nexus required under *Complete Auto*.[127] Furthermore, the Court also held that the fair apportionment and fairly related parts of the *Complete Auto* test were not satisfied.[128] Therefore, the Court held that the imposition of the Pennsylvania income tax on all of the income of the trusts violated the Commerce Clause.[129]

It should be noted that the *McNeil* case was decided by an intermediate appellate court, and not the Pennsylvania Supreme Court. Furthermore, it is not clear whether the application of the case will be limited to trusts that exactly match the fact pattern in McNeil. The case does, however, present a clear planning opportunity to explore.

C. <u>LINN V. DEPARTMENT OF REVENUE</u>

In *Linn v. Department of Revenue*, an Illinois appellate court held that Illinois' imposition of its state income tax on a trust which no longer had substantial connections to Illinois violated

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[124] *McNeil,* 67 A.3d at 192.
[125] *Id*. (citing *Quill Corporation v. North Dakota, 504 U.S. 298 (1992); Complete Auto Transit, Inc. v. Brady, 430 U.S. 274 (1977)*).
[126] *Id*. at 193.
[127] *McNeil,* 67 A.3d at 195.
[128] *Id*. at 196-198.
[129] *Id*. at 198.

the Due Process Clause.[130] The trust at issue in Linn was originally established in 1961 by an Illinois resident, and was administered in Illinois by Illinois resident trustees.[131] The trust agreement provided that the trust would be construed and administered in accordance with Illinois law, and that the validity of the trust would be determined in accordance with Illinois law.[132] Between 2002 and 2006, the assets of the original trust were appointed to a new trust pursuant to a limited power of appointment granted to the trustees of the trust, and the appointive trust was reformed to remove all references to Illinois law such that the resulting trust would only be subject to Texas law and would thereafter be administered solely in Texas.[133] In April 2007, the trustees of the trust filed a 2006 nonresident Illinois income tax return reporting that no tax was due.[134] The Illinois Department of Revenue reclassified the trust as an Illinois resident trust, and subjected all of the trust's reported income to Illinois tax.[135] The trustees of the trust paid the tax and then filed a declaratory judgment action asserting that Illinois' imposition of income tax on the trust violated both the Due Process Clause and the Commerce Clause.[136]

The court began with the Due Process analysis, noting that *Quill* requires a minimum connection between the state and the entity the tax is imposed upon, though not a physical presence in the state.[137] The court then examined the contacts between the trust and the State of Illinois, noting that the only connection for the period at issue was that the original trust was

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[130] Linn v. Department of Revenue, 2 N.E.3d 1203, 2013 IL App (4th) 121055 (December 18, 2013).
[131] *Id*. at 1204.
[132] *Id*. at 1205.
[133] *Id*. at 1206.
[134] *Id*.
[135] *Linn*, 2 N.E.3d. at 1206.
[136] *Id*.
[137] *Id*. at 1208 (citing *Quill Corporation v. North Dakota, 504 U.S. 298 (1992)*).

initially created in Illinois.[138] Furthermore, the court noted that the trust did not meet any of the "factors that would give Illinois personal jurisdiction over the trust in litigation: the provisions of the trust instrument, the residence of the trustees, the residence of its beneficiaries, the location of the trust assets, and the location where the business of the trust is to be conducted."[139] Therefore, the court held that insufficient contacts existed between Illinois and the trust to satisfy the Due Process Clause, and therefore the imposition of the Illinois income tax on the trust for the year at issue was unconstitutional.[140] As with the *McNeil* case, the *Linn* decision was not appealed by the taxing authority, and therefore there is no state supreme court decision on the issue. Until such a case is taken up by the Illinois Supreme Court, however, *Linn* is "binding authority for trustees of trusts that can eliminate all contact with Illinois."[141]

D. KAESTNER 1992 FAMILY TRUST V. NORTH CAROLINA DEPARTMENT OF REVENUE

In North Carolina, cross motions for summary judgment are currently pending before the North Carolina Business Court in the case of *The Kimberly Rice Kaestner 1992 Trust v. North Carolina Department of Revenue*, a case in which the plaintiff has challenged the ability of North Carolina to tax a trust on all of its income solely on the basis of a trust beneficiary residing in the state of North Carolina. [142] The statute at issue imposes North Carolina income tax on all the

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[138] *Id*.

[139] *Id*. at 1211 (citing *Sullivan v. Kodsi*, 359 Ill. App. 3d 1005, 1011, 836 N.E.2d 125, 131 (2005))(internal citations omitted).

[140] *Id*.

[141] Cundiff and Halleron, *Illinois Trust Taxation Deemed Unconstitutional*, *available at:* http://www.mwe.com/Illinois-Trust-Taxation-Deemed-Unconstitutional-03-31-2014, McDermott Will & Emery (March 31, 2014).

[142] Complaint, *The Kimberly Rice Kaestner 1992 Trust v. North Carolina Department of Revenue*, 12-CVS-8740 (North Carolina Business Court, County of Wake June 20, 2012), *available at* http://www.ncbusinesscourt.net/TCDDotNetPublic/default.aspx?CID=3&case Number=12CVS8740.

accumulated income of a trust if any beneficiary of the trust is a resident of North Carolina.[143] According to the plaintiff in the case, the trust in *Kaestner* was not created by a North Carolina resident, does not have any trustee located in North Carolina, does not own property in North Carolina, is governed by New York law, and does not have any income that was distributed to a North Carolina resident or required to be distributed to a North Carolina resident.[144] The plaintiff has claimed that the sole connection between the trust and the state of North Carolina is that a North Carolina resident is a permissible, discretionary beneficiary of the trust, although no distributions were made from the trust to such beneficiary during the tax years at issue.[145] Therefore, the plaintiff has argued that the North Carolina tax violates both the Due Process Clause and the Commerce Clause and is unconstitutional.[146] The North Carolina Department of Revenue, on the other hand, has argued that the in-state residence of the trust beneficiaries is a sufficient nexus to serve as a basis for taxation of the trust by the State of North Carolina, citing *McCulloch v. Franchise Tax Board* and *Chase v. Gavin*.[147] Final briefs were filed in this case on October 14, 2014, and a decision should be forthcoming shortly. Due to a recent change in

[143] North Carolina General Statue Section 105-160.2.

[144] Response in Opposition to Defendant's Motion for Summary Judgment and Reply in Support of Plaintiff's Motion for Summary Judgment at 1, *The Kimberly Rice Kaestner 1992 Trust v. North Carolina Department of Revenue*, 12-CVS-8740 (North Carolina Business Court, County of Wake October 1, 2014), *available at* http://www.ncbusinesscourt.net/TCDDotNet Public/default.aspx?CID=3&case Number=12CVS8740.

[145] *Id*. at 2.

[146] *Id*. at 5, 21.

[147] Defendant's Reply to Plaintiff's Response and Reply to Motions for Summary Judgment, at 10, The Kimberly Rice Kaestner 1992 Trust v. North Carolina Department of Revenue, 12-CVS-8740 (North Carolina Business Court, County of Wake October 14, 2014), available at http://www.ncbusinesscourt.net/TCDDotNet Public/default.aspx?CID=3&case Number=12CVS8740.

North Carolina law, any appeal from the Business Court's decision would be immediately appealable to the North Carolina Supreme Court.[148]

E. NEW YORK STATUTORY CHANGES

In addition to the recent cases affecting state fiduciary income tax, New York also made significant legislative changes on April 1, 2014. In particular, the new legislation provides for a throwback tax on distributions of accumulated income to New York resident beneficiaries of New York "resident" trusts.[149] As enacted, New York Tax Law section 612(b)(40) taxes New York resident beneficiaries of non-grantor trusts (other than incomplete gift non-grantor trusts) on accumulation distributions on a throwback tax basis.[150] The throwback tax applies to distributions, made after December 31, 2013 to New York residents, of previously accumulated, undistributed trust income where the income was not previously subject to New York tax.[151] Therefore, the tax will apply to trusts created by New York resident grantors where the trust is exempt from New York income taxation because it has no New York resident trustees, source income, or property located in the state.[152] It should be noted that New York resident trusts were required to file a Fiduciary Income Tax Return and attach a New York Resident Trust Nontaxable Certification beginning in 2010 even though no tax was due.[153] The new provisions

[148] N.C. Gen. Stat. § 7A-27(a)(2).

[149] Caney and Deutsch, *Major changes to New York State transfer tax and fiduciary income tax laws*, *available at:* http://sites.edechert.com/10/3255/april-2014/2014-04-28-major-changes-to-new-york-state-transfer-tax-and-fiduciary-income-tax-updates.asp?sid=692ceedc-81f7-4832-828d-3a87799b4221, Dechert LLP (April 29, 2014).

[150] N.Y. Tax Law § 612(b)(40), added by 2014 N.Y. Laws 59, Part I, § 1 (Mar. 31, 2014).

[151] *See Insights on Recent New York Transfer and Fiduciary Tax Developments*, *available at:* http://www.northerntrust.com/documents/white-papers/wealth-management/insights-new-york-transfer-fiduciary-developments.pdf, Northern Trust Insights on Wealth Planning, April 11, 2014.

[152] *Id*.

[153] *See* New York State Department of Taxation and Finance, TSB-A-11(4)(I) (July 27, 2011).

of New York law also impose a filing requirement on Trustees making accumulation distributions to resident beneficiaries.[154] The return must include (i) information identifying the beneficiary, (ii) the amount of such accumulation distribution, and (iii) such other information as the commissioner may require.

The New York legislation also provides that New York will no longer recognize so called "ING Trusts" (incomplete gift non-grantor trusts), but rather will treat such trusts as grantor trusts, such that the individual transferring property to such trust will be treated as the owner of the trust for tax purposes.[155]

These developments illustrate that while the states are continuing to push the envelope with regard to their ability to impose taxes, taxpayers are fighting back and scoring some victories that are helping to establish the line for how far the states can go. As the case law develops further, however, the states can be expected to enact new legislation, resulting in constantly shifting waters that will require careful navigation to safely pass through.

[154] N.Y. Tax Law § 658(f)(1), added by 2014 N.Y. Laws 59, Part I, § 4 (Mar. 31, 2014).
[155] N.Y. Tax Law § 612(b)(41), added by 2014 N.Y. Laws 59, Part I, § 1 (Mar. 31, 2014).