



Delaware Tax Institute

State Fiduciary Income Tax Planning Issues

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Overview and Background

1. Migration is the norm now
 - We are a migrating people – over 40 million Americans move each year
 - Trusts are migrating too – both offshore to onshore and from state to state
 - In the case of trusts, planners must consider migration patterns of settlors, beneficiaries, trustees and other fiduciaries.
2. State statutes, regulations and case law are not uniform and states differ in how aggressive they are in pursuing possible revenue sources
 - This makes planning virtually impossible.
3. The federal rules governing fiduciary income taxation of trusts and estates are changing. Those states that piggyback on the federal rules governing fiduciary income taxation have to catch up. There are a number of states that don't piggyback on the federal rules, particularly when it comes to grantor trust tax treatment, so planning has to be done using a state by state approach. When a trust has contacts with multiple states, there is a significant risk of inconsistent and/or duplicative state income tax results.

Differing Bases for Imposition of State Fiduciary Income Tax

1. Possible Relevant Factors
 - Domicile of settlor (or testator)
 - Domicile of one or more fiduciaries
 - Domicile of beneficiaries
 - Situs or place of administration of the trust
 - Trust income sourced to the state
2. Domicile of Settlor or Testator
 - Should it matter whether the trust is inter vivos or testamentary?
3. Domicile of Fiduciaries
 - Should this include advisors and protectors?
 - What about trustees operating in multiple states?
4. Domicile of Beneficiaries
 - Should some or all of the trust's income be subject to multiple state's income tax if multiple beneficiaries reside in different locations

Differing Bases for Imposition of State Fiduciary Income Tax (continued)

5. Place of Trust Administration

- What constitutes administration?
- What about the situation where the trustee is in state A, the investment advisor is in State B and the distribution advisor is in State C?
- What happens when the trustee moves?

6. Source Income

- Pass-through entities (LLCs, LPs, S corporations): states take the position that income generated in the state by the pass-through entity will subject all of the owners of the pass-through entity to state income tax even if the owners are non-residents of that state

Constitutional Issues

1. Commerce Clause and Due Process Clause put limits on the authority of the states to tax
 - a) Complete Auto Transit, Inc. v. Brady – A four-part “dormant” commerce clause test:
 - i. Applied to an activity with a substantial nexus to the taxing state
 - ii. Fairly apportioned
 - iii. Must not discriminate against interstate commerce
 - iv. Fairly related to services provided by the state
 - b) Many cases before Quill Corporation v. North Dakota reached varying results, analyzing the sufficiency of the contacts between the taxing state and the non-resident taxpayer and the relationship between the tax and the non-resident taxpayer’s in-state activities.
 - c) Quill Corporation v. North Dakota – Physical Presence Requirement – Substantial Nexus Test

Constitutional Issues

(continued)

- d. Post-Quill state cases relying on Quill
 - i. District of Columbia v. Chase Manhattan – (D.C.) (Taxpayer Loss)
 - ii. Chase Manhattan Bank v. Gavin – (CT) (Taxpayer Loss)
 - iii. Residuary Trust A u/w/o Kassner v. Director, Division of Taxation – (NJ) (Taxpayer Win)
 - iv. McNeil v. Commonwealth of Pennsylvania – (PA) (Taxpayer Win)
 - v. Linn v. Department of Revenue – (IL) (Taxpayer Win)
 - vi. Kaestner 1992 Family Trust v. North Carolina Department of Revenue – (NC) (Taxpayer Win)
 - vii. Fielding for McDonald v. Commissioner of Revenue – 916 N.W. 2d 323 (Minn. 2018) (Taxpayer Win)
 - BUT Minnesota Department of Revenue has asked the U.S. Supreme Court to review the state Supreme Court's decision (11/27/18) in light of inconsistent rulings in other states and the Wayfair decision

Constitutional Issues

(continued)

2. South Dakota v. Wayfair, Inc. – U.S. S.Ct. Docket. No. 17-494 (06/21/2018) will now change the nexus analysis applied to the imposition of state fiduciary income tax
 - a) Wayfair **overturned** the physical presence standard of Quill v. North Dakota
 - b) Wayfair holds that the standard to be applied to determine the constitutionality of a state tax law is whether the tax applies to an activity that has a “substantial nexus” with the taxing state.
 - c) In Wayfair, the Court held that respondents had established substantial nexus through “extensive virtual presence.” Obviously, that conclusion is tied to the rise of the digital economy
 - d) Substantial nexus requires that the taxpayer avail “itself of the substantial privilege of carrying on a business in that jurisdiction”.
 - e) The question that remains for states to determine:
 - What type of economic nexus is sufficient to permit the imposition of the tax? (i.e. solicitation and advertising, sales volume, dollar threshold, etc.)

Problem States

1. New York

- a. Resident trust defined as a trust established by a New York domiciled testator or trustor
- b. BUT a resident trust is not subject to tax if it is exempt because it meets all of the following conditions:
 - i. All trustees domiciled in a state other than New York
 - ii. Entire corpus, including real estate and tangibles, is located outside of New York
 - iii. All income and gains are derived from non-New York sources
- c. There is a throwback tax on distributions of accumulated income to New York resident beneficiaries from exempt resident trusts
- d. DING trusts do not work in New York: incomplete gift non grantor trusts are treated as grantor trusts for New York income tax purposes

2. Massachusetts

- a. “Resident trust” includes (i) testamentary trusts of Massachusetts residents and (ii) inter vivos trusts created by Massachusetts residents that also either have a least one resident trustee or a grantor that continues to reside in Massachusetts or a grantor that died in Massachusetts

Problem States

(continued)

3. Pennsylvania

- a. Another example of a very broad definition of “resident trust” and a very narrow definition of “exempt resident trust”
- b. Pennsylvania does not follow the federal grantor-trust rules for irrevocable trusts
- c. Pennsylvania taxes CRTs at the trust level

4. California

- a. “Resident trust” is defined using two criteria – the residences of the fiduciaries and the residences of the noncontingent beneficiaries
- b. A trust that has multiple fiduciaries is taxed proportionally based on the number of fiduciaries in California
- c. A trust that has multiple beneficiaries is taxed proportionally based on the number and interest of beneficiaries in California
- d. Apparently, DINGs are still viable for California residents

Moving Trusts

1. Does the trustee have a duty to consider moving to minimize or eliminate state income taxation?
 - Before a major transaction?
 - Each time a trustee or beneficiary moves?
 - Annually?
2. What factors should be considered?
 - Basis for imposition of tax in both the current state and the state the trust is proposing to move to
 - Constitutional issues
 - Permitted mechanisms to accomplish the move (merger, decanting, NJSA, court petition, specific language in the trust)
 - Non-tax issues involved in the move (i.e., changes in the law governing the administration of the trust, need for fiduciaries to be removed or resign., etc.)

Useful References

1. 2014 Delaware Tax Institute. “The Legal and Regulatory Framework for State Income Taxation of Trusts”, Janice M. Matier (reprinted here with permission)
2. 2018 ACTEC Annual Meeting. “Minimizing or Eliminating State Income Taxes on Trusts”, Richard W. Nenno
3. 2018 University of Miami Heckerling Institute. “Putting it on & Taking it off: Managing Tax Basis Today (for Tomorrow)”, Paul S. Lee
4. 2017 Delaware Tax Institute. “State Tax Developments and Planning Considerations”. Jerome K. Grossman, Thomas M. Forrest, Janice M. Matier, Jordon N. Rosen



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Mr. Sparks practices primarily in the areas of estate planning, estate administration, tax-exempt organizations and fiduciary litigation. He received his B.A. degree, *summa cum laude*, from Dartmouth College and his J.D. from Yale Law School where he served as a Senior Editor of the Yale Law Journal. He clerked for Judge Caleb Wright of the U. S. District Court for the District of Delaware. He is a fellow of the American College of Trust and Estate Counsel ("ACTEC") and currently the ACTEC State Chair for Delaware. He is a member of the Real Property and Trusts Section of the Pennsylvania Bar Association and the Tax and Estates and Trusts Sections of the American Bar and Delaware Bar Associations. He is a past chairman of the Delaware Bar Association Section of Taxation, a past Chairman of the Delaware Bar Association Estates and Trusts Section, and a past Chairman of the Estate Planning Council of Delaware, Inc. He is a frequent speaker and author on estates, trusts, and other tax-related topics having appeared on many occasions for ACTEC, The University of Miami Estate Planning Institute, the Delaware Tax Institute and the Delaware Bankers Association Trust Conference. Significant fiduciary litigation in which Mr. Sparks has been involved includes the Pew Trusts in Pennsylvania, the Gore trusts in Delaware, and numerous cases representing corporate fiduciaries, including Wilmington Trust, BNY Mellon, J.P. Morgan Chase, and Fiduciary Trust.

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