Selecting Non Grantor Trust Situs After *Kaestner* - Is There Light at the End of the Tunnel?

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What Kind of Trusts are There?

- Two General Categories of Trusts
  - Grantor
  - Non-Grantor
- Grantor Trusts
  - Not a separate taxpayer
  - All tax attributes allocated to grantor
- Non-Grantor Trusts
  - Separate taxpayer
  - 2 varieties
    - Complex (discretionary distributions)
    - Simple (mandatory income distributions)

Taxation of Non Grantor Trusts

- Quasi Pass-Through Entities
  - Non-grantor trusts are separate taxpayers.
  - Taxed, generally, under the tax rules applicable to individuals.
  - To the extent that net income is distributed to a beneficiary, the trust is treated as a pass-through entity.
    - The distributed net income is taxed to the beneficiary (the trust receives a deduction).
    - The trust issues a schedule K-1 to the beneficiary.
  - Undistributed income is the trust’s taxable income.
    - For Federal and State income tax purposes.

Net Accounting Income and Taxable Income - Example

Trust receives the following items during the calendar year:

Item	Amount
Interest income	$500
Dividend income	$1,500
Distribution from partnership	$2,500
Proceeds from sale of stock	$5,000

Trust makes the following disbursements during the calendar year:

Item	Amount
Trustee fee	$750
Property tax payment	$1,250

Net Accounting Income and Taxable Income - Example

Item	Trust Accounting Income	Trust Principal	Taxable Income
Interest	500	- 0 -	500
Dividend	1,500	- 0 -	1,500
Partnership Distribution	2,500	- 0 -	6,000
Stock Sale	- 0 -	4,000	4,000
Trustee Fee	(375)	(375)	(750)
Property Taxes	- 0 -	(1,250)	(1,250)
Total	**$4,125**	**$2,375**	**$10,000**

Net Accounting Income and Taxable Income - Example

- Scenario 1:
  - Trust makes no distributions
  - Taxable income = \$10,000
- Scenario 2:
  - Trust distributes all trust accounting income to beneficiary
  - Resulting taxable income of trust:
    - \$10,000 less DNI deduction of \$4,125 = \$5,875
- In either scenario, trust's taxable income is subject to federal income tax at applicable rate(s).

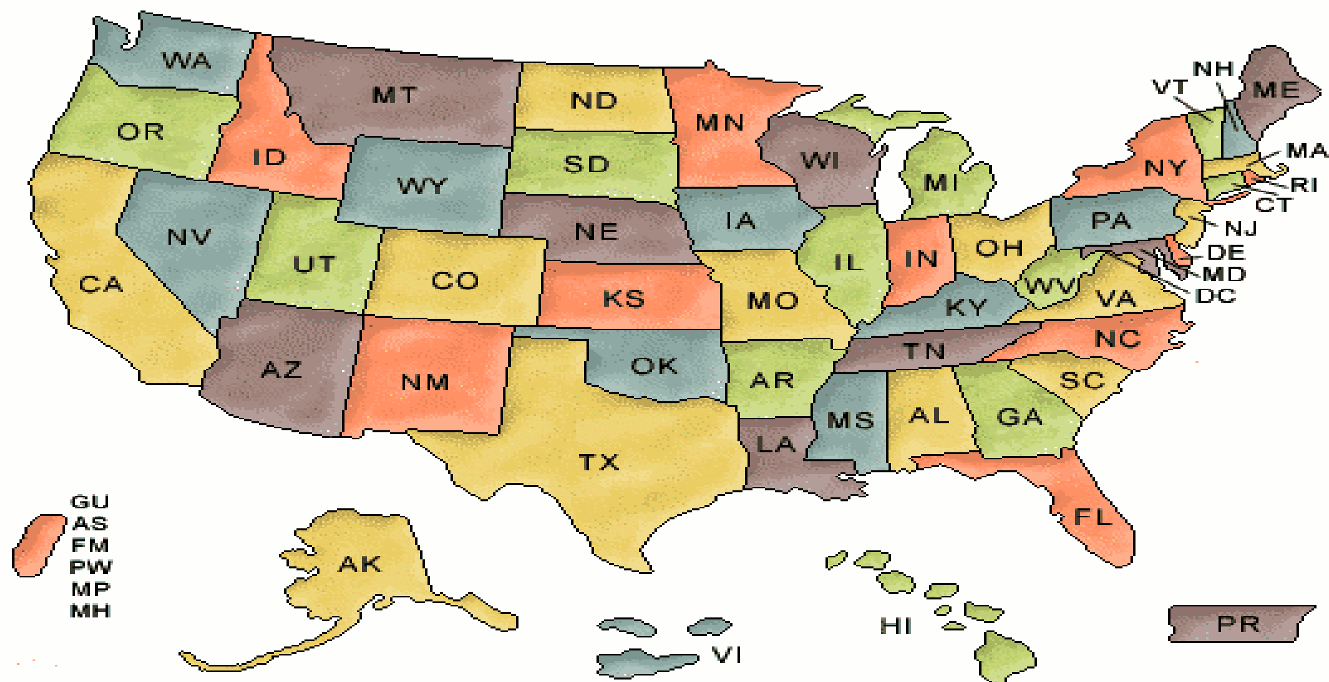
What Do I Need to Know About the State Taxation of Trusts?

- The states have not adopted uniform rules. This lack of uniformity can lead to multiple taxation and unintended consequences.
- States apply a combination of individual income tax principles and corporate tax principles to trusts.
- There are significant constitutional limitations on the ability of a state to tax a trust.
  - Based on “nexus” – connection between the taxpayer (the trust) and the state seeking to impose the tax.
  - Nexus is easily determined for individuals – based on physical location. For corporations/entities, the determination of nexus can be more challenging (based on location, physical presence and activities in the state).
  - For trust’s, the determination is even more difficult.

Where is My Trust a "Resident Trust?"

- State statutes refer to "resident" trust for purposes of imposing income tax.
- Do you know where your trust is considered a "resident" trust for state tax purposes?
  - A trust is not an entity, therefore, residency is more difficult to determine.
  - The states have adopted different rules to impose tax on a trust – the relevant factors are: residency of grantor; residency of beneficiary; residency of trustee; and, situs of trust administration.
- Why is this important?
  - A fiduciary has an obligation to pay tax in states where the tax is due.
  - A fiduciary has a duty to pay tax only in states where tax is due.
  - Corollary: A fiduciary should not remit taxes (trust property) when not owed.

State of Taxation Trusts - Overview



Breakdown of State Taxation of Trusts

- States treating trust as Resident Trust on basis of residence of grantor:
  - AL, CT, DE, DC, IL, LA, ME, MD, MA, MI, MN, MO, NE, NJ, NY, OH, OK, PA, RI, UT, VT, VA, WV & WI
- States treating trust as Resident Trust on basis of residence of trustee or trust administration:
  - AZ, AR, CA, CO, DE, HI, IN, KS, KY, LA, MD, MA, MN, MS, NM, OR, SC, UT & WI
- States treating trust as Resident Trust on basis of residence of beneficiary:
  - CA, CT, DC, DE, GA, MO, NC, OH, RI
- States that do not impose income tax on trusts:
  - AK, FL, NV, NH, SD, TN (as of 1/1/2021), TX, WA & WY
- States that use a multi factor analysis:
  - ID, IA, MT, ND

Nexus – State Taxation of Trusts Based on Residency of Grantor

- *Blue v. Department of Treasury (1990)*
  - Fact that grantor of testamentary trust domiciled in Michigan not sufficient under due process clause.
- *District of Columbia v. Chase Manhattan Bank (1997)*
  - Fact that grantor of testamentary trust domiciled in District of Columbia sufficient under due process clause.
- *Chase Manhattan Bank v. Gavin (1999)*
  - Fact that grantor of testamentary trusts domiciled in Connecticut sufficient under due process clause and commerce clause.
- *Residuary Trust A v. Director (Kassner) (2013)*
  - Fact that grantor of testamentary trust domiciled in New Jersey not sufficient under due process clause (2013; aff'd, 2015).
- *Linn v. Department of Revenue (2013-2014)*
  - Fact that grantor of inter vivos trust domiciled in Illinois not sufficient under due process clause.

Nexus – State Taxation of Trusts Based on Residency of Grantor (Continued)

- *Fielding v. Commissioner of Revenue (MN)(2018, cert. denied 2019)*
  - Fact that grantor of inter vivos trust domiciled in Minnesota when trusts were created and ceased to be classified as grantor trusts not sufficient under due process clause.
  - The trusts argued that the Court should evaluate the single factor of the Minnesota statute defining a trust as a "resident" trust in its determination. The Commissioner advocated for an analysis of all contacts between the trust in the State in the evaluation. The Court considered all factors, including those beyond the residency statute.
    - The Court clarified that it was not redefining the statute, but evaluating all relevant facts when considering the application of the statutory definition to the due process clause analysis.

Nexus – State Taxation of Trusts Based on Residency of Grantor (Continued)

- *Fielding v. Commissioner of Revenue (MN) (2018) (continued)*
  - The Court concluded that the "contacts on which the Commissioner relies are either irrelevant or too attenuated to establish that Minnesota's tax on the Trusts' income from all sources complies with due process requirements."
  - The trusts' connections with the State were:
    - Grantor was resident when trusts were created and became separate taxpayers.
      - Court found that the Grantor's connections with the State were irrelevant, as the Grantor does not represent the trusts and stating that the "relevant connections are Minnesota's connections to the trustee, not the connection to the grantor."
    - The trusts owned stock in a Minnesota corporation.
      - Because stock in a corporation is an intangible, it does not constitute property physically located in the State. "These intangible asses were held outside of Minnesota, and thus doe not serve as a relevant or legally significant connection with the State."
    - One beneficiary resided in Minnesota.

Nexus – State Taxation of Trusts Based on Residency of Beneficiary

- *Chase Manhattan Bank v. Gavin (1999)*
  - Fact that beneficiary of inter vivos trust domiciled in Connecticut sufficient under due process clause and commerce clause.

- *Safe Deposit v. Virginia*
  - Taxation of non-resident trustee unconstitutional, despite resident beneficiaries.

Nexus – State Taxation of Trusts Based on Residency of Beneficiary

- *North Carolina Department of Revenue v. Kimberley Rice Kaestner Trust*
  - ***The* Decision**:
    - The U.S. Supreme Court, in a unanimous opinion, holds that the North Carolina statute, "as applied in these circumstances," violates the due process clause of the U.S. Constitution.
      - The Court found that "the presence of in-state beneficiaries alone does not empower a State to tax trust income that has not been distributed to the beneficiaries."
      - The Court limited its holding "to the specific facts presented," stating that in reaching its decision it does "not imply approval or disapproval of trust taxes that are premised on the residence of beneficiaries whose relationship to trust assets differs from that of the beneficiaries here."

Nexus – State Taxation of Trusts Based on Residency of Beneficiary

- *North Carolina Department of Revenue v. Kimberley Rice Kaestner Trust*
  - ***The* Decision** (continued):
    - The Court focused on the following facts in rendering its decision:
      - The trustee of the trust has "'absolute discretion' to distribute the trust's assets to the beneficiaries "in such amounts and proportions" as the trustee might "from time to time" decide."
      - The trustee's contacts with the trust beneficiary were infrequent
      - The trust is subject to New York law and keeps the trust records in New York and the trust's assets are held in a custody account in Massachusetts.
      - The trust maintained no physical presence or investments in North Carolina.
    - The Court analyzed the due process clause requirements for taxation, which requires a "fiscal relation to protection, opportunities and benefits given by" the taxing state.
      - The threshold question being: "Whether the state has given anything for which it can ask return."

Nexus – State Taxation of Trusts Based on Residency of Beneficiary

- *North Carolina Department of Revenue v. Kimberley Rice Kaestner Trust*
  - ***The* Decision** (continued):
    - The Court concluded that the "residence of the Kaestner Trust beneficiaries in North Carolina alone does not supply the minimum connection necessary to sustain the State's tax." The Court pointed to the following facts:
      - The beneficiaries did not receive any income/distributions from the trust.
      - The beneficiaries had no right to demand income from the trust or otherwise control, possess or enjoy the trust property.
      - The beneficiaries had no expectation of receiving a distribution of any specific amount from the trust in any future year.

Nexus – State Taxation of Trusts Based on Residency of Beneficiary

- *North Carolina Department of Revenue v. Kimberley Rice Kaestner Trust*
  - ***The* Decision** (continued):
    - The Court's focus on these specific facts, along with footnotes 8 and 9, leave open the door that taxation based on the residence of a trust beneficiary may not violate the due process clause.
      - Footnote 8: "[W]e hold that the Kaestner Trust beneficiaries do not have the requisite relationship with the Trust property to justify the State's tax. We do not conclude what degree of possession, control or enjoyment would be sufficient to support taxation."
      - Footnote 9: "We do not address whether a beneficiary's ability to assign a potential interest in income from a trust would afford that beneficiary sufficient control or possession over, or enjoyment of, the property to justify taxation based solely on his or her in-state residence."

Nexus – Fiduciary Residence and Administration

- Based on recent cases, it would seem that situs of trust administration or residence of trustee should be respected as establishing sufficient nexus for state taxation of a trust.
  - But, what constitutes administration?
  - What if there are multiple trustees?
  - What if there are multiple fiduciaries – for example, in a directed trust.
- Some state statutes provide guidance as to what constitutes situs/administration:
  - **Iowa** provides that situs is determined based on relevant facts, such as: (a) residence of the trustees or a majority of them; (b) the location of the principal office where the trust is administered; and (c) the location of the evidence of the intangible assets of the trust (such as stocks, bonds, bank accounts, etc.).
  - **Montana** guidance states that a trust's principal place of administration is where the usual day to day activities of the trust are carried on. If it cannot be determined where the day to day activities are carried on, then it is determined as follows: a) if the trust has a single trustee, the principal place of administration of the trust is the trustee's residence or usual place of business; or (b) if the trust has more than one trustee, the principal place of administration of the trust is the residence or usual place of business of any of the co-trustees as agreed upon by them.

Nexus – Fiduciary Residence and Administration

- Some state statutes provide guidance as to how to handle multiple trustees in determining if the trustee is resident in the state:
  - **Arizona** provides that if at least one fiduciary is a resident of the state the trust is a resident trust. However, if the sole fiduciary is a corporate entity, then the trust is classified as resident only if administration occurs in Arizona.
  - In **Hawaii,** if the sole fiduciary, or all fiduciaries if more than one, is/are resident of Hawaii, the trust is a resident trust, regardless of where administration takes place. If the trust is not administered in Hawaii, but ½ or more of the trust fiduciaries are resident, then the trust is a resident trust.
  - **New Mexico** defines a trustee is resident of the state if the trustee is domiciled in the state or is an individual who is physically present in the state for more than 185 days during the taxable year.

Planning Considerations and Opportunities

Incomplete Nongrantor Trusts - “INGs”

- Nevada incomplete Nongrantor Trust: “NING”
- Delaware incomplete Nongrantor Trust: “Ding”
- Primary purpose is to eliminate state income taxes on sale of closely held business or highly appreciated assets
- Generally created by residents of high-tax states
- May be ideal for assets that have substantial built in gains or ordinary income
- Grantor/spouse may be beneficiaries

What is an Incomplete Nongrantor Trust?

Primary elements of an ING:

- The trust is created in a state that allows self-settled asset protection trusts.
- The gift to the trust is "incomplete" on formation.
- Trust is not treated as a grantor trust; income is not taxed to the grantor under Subpart E of Subchapter J.
- Trust resident in a state that does not tax trust income, and income not subject to tax in any other state.

Structure

INGs are typically created in a state that allows self-settled asset protection trusts

- Grantor, spouse, descendants, and other family members may be beneficiaries;
- Trustee (generally an institution) does not have discretion to make distributions or to accumulate income;
- Instead, a Distribution committee, consisting of grantor (with certain limitations) and “adverse parties” within the meaning of 672(a), directs the trustee.

Incomplete Gift:

- Grantor retains a limited testamentary power of appointment over the trust in order that the remainder interest will not be a completed gift; and
- Grantor retains a lifetime power of appointment or distribution power such that the term interest will not be a completed gift.

Structure

Achieving Nongrantor Status

- Trust must be carefully drafted to contain no “triggers” that would cause grantor trust status under IRC 671-678
- Adverse “Distribution Committee” within the meaning of IRC 672(a)
  - Members include other trust beneficiaries
  - Adverse parties’ consent required for grantor or spouse to receive discretionary distributions.

No tax link to another jurisdiction:

In order for the ING state tax planning technique to succeed, trust income should not be taxable in any state.

Hypothetical Example of ING

	No DING	DING
Gain on stock sale	$10,000,000	$10,000,000
Deductible State Tax	$10,000	- 0 -
Federal Taxable Income	$9,990,000	$10,000,000
Federal Capital Gain Tax	$2,377,620	$2,380,000
Net Investment Tax	$376,200	$380,000
State (NJ) Tax	$897,000	- 0 -
Total Tax	$3,650,820	$2,760,000
Benefit of DING		$890,820

Scenario 1 – Change Trust Situs

- Grantor, while domiciled in New Jersey, created an irrevocable trust for the benefit of his grandchildren, all of whom reside in New Jersey and Florida. Grantor died in 2018, domiciled in New Jersey
  - Grantor's son is the current trustee, and he resides in New Jersey and administers the trust in New Jersey
  - The trust's assets are cash and marketable securities
  - Grantor's daughter is the named successor trustee, and she resides in Florida

Scenario 1 – Change Trust Situs

- Recommended course of action:
  - Change trustee from son to daughter and change situs/principal place of administration from NJ to FL
  - Trading the Jersey Shore for the Gulf Coast

Scenario 2 – Multi State Taxation

- Grantor, domiciled in Virginia, creates an irrevocable trust for the benefit of her descendants, all of whom reside in North Carolina.
  - Grantor's close advisor, who resides in South Carolina, is Trustee of the Trust
  - You advise that pursuant to applicable statutes in each taxing jurisdiction the Trust is considered a "resident" trust in each of VA, NC and SC
  - The Trust hold cash and marketable securities, generating interest, dividend and capital gains, annually

Scenario 2 – Multi State Taxation

- You advise of recent decisions affecting the NC taxation of trusts (Kaestner) and Virginia's statutory change (effective 7/1/2019) and authority from the VA Department of Revenue, both of which may limit the ability of NC and VA to subject the Trust to taxation
- You also advise that if administration of the Trust is moved from South Carolina, taxation by SC may be avoided – you consider states that subject trusts to taxation based on residence of the grantor, and decide to migrate north, to Illinois

Questions?