January 16, 2007

The State Income Taxation of Trusts: An Interesting Morass

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The state income taxation of trusts is an obscure yet quite interesting area of the tax law, blending constitutional considerations of Due Process and state jurisdiction to impose tax with the vagaries of differing state tax laws, differing state trust laws, varying provisions found in specific trust instruments, and myriad possible combinations of facts. The facts that can be relevant in analyzing the state taxation of trusts include the grantor's state of domicile (either when the trust is created or in later years), the domicile(s) of the trustee(s), the domicile or residence of the beneficiaries, the state law under which the trust (whether intervivos or testamentary) is created, the place at which the trust is administered, the location of the trust's assets, and the states from which the trust derives income. Depending upon the confluence of the relevant considerations, trust income and assets may be subjected to multiple state or local income taxes, or may escape state and local taxation altogether. As is often the case, our tri-state area includes differing approaches to the state taxation of trusts which provide important insights into this general subject, as well as a rich introduction to planning issues and considerations.

Overview of Federal Taxation

Before delving into the state tax issues, however, a brief overview of the federal taxation of trusts may be useful. Under the Internal Revenue Code, trusts are classified as grantor trusts or non-grantor trusts.[1] Grantor trusts are disregarded federally, and instead the grantor is treated as if he or she owns the assets, and directly earns the income, of the trust.[2] Income earned by a grantor trust is thus taxed, federally, to the grantor.

Non-grantor trusts are, by contrast, recognized as separate persons under the federal tax law, and are treated as something of a hybrid pass-through entity.[3] To oversimplify these federal rules, where a trust makes (or is required to make) current distributions to beneficiaries that carry out "distributable net income,"[4] the beneficiaries, and not the trust, are subject to tax on the distributed trust income. By contrast, where a trust accumulates income, it is the trust that is subject to tax; income accumulated in and taxed to the trust in prior tax years is not taxable to the beneficiaries when distributed to them.[5]

The federal scheme thus taxes trust income either to the grantor, or to the beneficiaries, or to the trust itself, or to some combination of these persons, depending upon the terms of the trust instrument, the flow of funds in any given tax year, and, in some cases, the administration of the trust. The state tax picture can be even more complex, particularly as the interested parties cross state lines, and invoke the rules of differing jurisdictions, as well as claims under federal and state constitutions.

With respect to grantor trusts, states' income tax laws generally conform to the federal definitions of income. States similarly follow the federal classification of entities in most cases. As a result, trust income that is considered as taxable to the grantor for federal purposes will likewise generally be taxed to the grantor for state purposes as well. However, while the federal "grantor trust" fiction is fairly easy to apply in the case of a resident, nonresidents pose interesting jurisdictional and enforcement problems for states.

For example, suppose a grantor trust with a New York-resident grantor owns rental real estate in Idaho. Idaho would presume to tax the grantor on the Idaho-source rental income. However, unlike a situation in which the real estate is owned by the taxpayer directly, or by an entity through which nexus can be attributed to the taxpayer (for example, a partnership, where traditional notions of agency generally have been relied upon to support jurisdiction to tax the partners), an individual who is treated for federal income tax purposes as the owner of the assets of a grantor trust may in fact have absolutely no contact with Idaho.

For instance, under certain circumstances the Internal Revenue Code treats a trust as a grantor trust if the income of the trust can be used to pay premiums on life insurance policies insuring the life of the grantor.[6] As a due pro-

cess matter, where a grantor has established an irrevocable trust of which he or she is neither a beneficiary nor a trustee, and over the course of time (but without involvement by the grantor) that trust has made an investment in Idaho, it is not at all clear that the federal income tax statute attributing trust income to the grantor would be sufficient to subject that grantor to the taxing jurisdiction of Idaho. Certainly, when framed as a question of whether an individual could be sued in Idaho based solely on his federal status as a grantor of the trust, the connection seems tenuous indeed. However, if Idaho does not have jurisdiction to impose its income tax on the grantor, and if it does not have some alternative mechanism for collecting tax from the trust (which clearly does have nexus), then Idaho may lose out on collecting tax on the rental income earned in the grantor trust.

Nongrantor Trusts

Turning to non-grantor trusts, the issues multiply. Perhaps the most significant issue here is which state(s) can tax accumulated trust income. On this point different states have adopted fundamentally different approaches to the taxation of trust income. These different approaches, when coupled with constitutional restrictions on the scope of state income taxation, can produce markedly different results.

Many state income tax statutes classify trusts as resident or nonresident based upon the domicile of the settlor at the time the trust was created, or became irrevocable, or received a transfer of property.[7] If a trust is classified as a resident trust, the state taxes that trust on all of its income, in the same manner as resident individuals are taxed. If the trust is classified as nonresident, it would be taxed only on its income derived from the nonresident state.

Under this approach, it is the domicile of the settlor on the relevant date that forever governs the tax residence of the trust. The location of the trustees, trust administration, trust assets, or beneficiaries is irrelevant, as is the state law under which the trust was established or administered. Unlike an outright gift, in which case the donor's domicile would have no relevance to the state taxation of income subsequently earned from the gifted property, a transfer in trust, under these types of statutes, ostensibly gives the settlor's home state perpetual taxing jurisdiction over the subsequently earned income, even after the settlor has died.

In a 1929 case, however, the Supreme Court held that a similar type of tax regime violated the Due Process Clause of the Fourteenth Amendment. In that case the Court considered a personal property tax that Virginia sought to impose on trust assets that were held in Maryland, by a Maryland trustee, under an intervivos trust established by a Virginia-domiciled settlor for the benefit of his Virginia-domiciled sons.[8] Finding that "no person in Virginia has a present right to their enjoyment or power to remove them,"[9] the Court held that the trust's securities "have acquired a situs separate from that of the beneficial owners,"[10] specifically a situs in Maryland. As a result, Virginia's attempt to "tax things wholly beyond her jurisdiction or control conflicts with the Fourteenth Amendment."[11]

New York

New York's Court of Appeals followed this analysis in concluding, in 1964, that New York similarly lacked the jurisdiction to impose its income tax on a trust, based solely upon the fact that the trust was established by a New York domiciliary.[12] In that case a New Yorker established an intervivos trust under Maryland law, which became irrevocable upon his death. He transferred shares of stock to the trust, which were held by the Maryland trustee in Maryland, for the benefit of New York domiciliaries. The Court concluded that New York could not impose income tax on the income derived from the stock: "the lack of power of New York State to tax in this instance stems not from the possibility of double taxation, but from the inability of a state to levy taxes beyond its border."

New Jersey reached the same conclusion, in a pair of cases decided in 1983.[13] Where the trustee, beneficiary, trust assets and trust administration were all located outside New Jersey, the New Jersey court found no jurisdiction to tax either an intervivos trust established under New York law, or a testamentary trust established under the will of a New Jersey domiciliary.[14]

The results of these cases have found expression in New York's tax statute. Specifically, while the Tax Law still defines a trust as "resident" if the settlor is a New York domiciliary,[15] the statute also provides that a resident trust will not be subject to New York tax if (i) all the trustees are domiciled in another state; (ii) the entire corpus of the trust is located outside New York; *and* (iii) the trust derives no income from New York sources. Thus, notwithstanding the New York domicile of the settlor on the key date, a trust can break its taxable linkage to New York if all three elements for exemption are satisfied.

New York's statutory exemption is not without issues. To qualify, it is necessary to identify all of the persons who are considered "trustees," and to ascertain their domicile. This may be more complex than it seems. For example, in an Advisory Opinion[16] relating to a long-established trust with a complex governance structure, the State opined that labels alone did not resolve the identity of the trustees, but instead it required a factual examination, outside the scope of the rulings process, to determine who was a "trustee" whose domicile mattered. The state did opine that the domicile of a corporate trustee was based upon its "commercial domicile" (also a factual inquiry), and not merely its state of incorporation.

As a further indication of the potential for controversy under the exemption, New York challenged the resignation of a New York domiciled trustee asserting, ultimately unsuccessfully, that the resignation of the trustee required a court order, and could not be effective based solely upon the parties' compliance with the terms of the trust instrument governing the replacement of trustees.[17] It also remains to be seen whether the statute's cliff effect—that one dollar of New York income reverts

the entire trust to taxation as a resident—will survive constitutional scrutiny.[18] Nevertheless, New York's statute provides a path that, if properly followed, can enable New York domiciliaries to establish trusts—both intervivos and testamentary—that are not taxed in New York.

Connecticut

The picture in Connecticut is quite different. Connecticut's statute presents a bifurcated approach to taxing trusts. Testamentary trusts are classified as residents, and taxed on total income, based on the domicile of the decedent at death.[19] In the case of intervivos trusts, however, the tax is based on the location of the beneficiary; to the extent Connecticut residents are "noncontingent beneficiaries," Connecticut taxes the accumulating income of the trust.[20]

This scheme was challenged in the 1990's by Chase Manhattan Bank.[21] In that case, Connecticut's Supreme Court upheld the imposition of Connecticut's tax on the income of a testamentary trust established by the will of a Connecticut domiciliary, even though the trustee and the trust asserts were located outside the state. As a testamentary trust, the trust was considered as established under Connecticut law, and was subject to the ongoing jurisdiction and protections of the Connecticut courts. This was held sufficient to establish Connecticut's jurisdiction to tax the testamentary trusts on an ongoing basis.

The District of Columbia has so held as well, likening a testamentary trust of an in-state domiciliary to a corporation that is established under domestic law; in both cases, the legal existence of the entity derives from the state's laws and protections, and this is sufficient to confer upon the state ongoing jurisdiction to tax. [22] Both the Connecticut and D.C. decisions questioned the ongoing validity of the 1929 Supreme Court decision, and indicated that their conclusions were rooted in the more modern Due Process jurisdiction articulated by the Supreme Court in *Quill*, the sales tax case decided in 1992.[23] It is however questionable whether the analysis applied to a testamentary trust, which does indeed owe its existence to the laws of the decedent's state of domicile, can be equated to an intervivos trust established by a domiciliary of one state under the laws of, and with trustees and trust assets located in, a different state. The announced demise of the Supreme Court's analysis in *Safe Deposit & Trust* may therefore prove premature.

Turning to Connecticut's treatment of the intervivos trust, the Court found this a "closer case." However, it ultimately upheld the imposition of Connecticut tax on the intervivos trust, concluding that "the critical link to the undistributed income sought to be taxed is the fact that the noncontingent beneficiary of the intervivos trust during the tax year in question was a Connecticut domiciliary."[24] Because the Connecticut statute purported to tax only that portion of the accumulating trust income that was attributable to the "noncontingent beneficiary" resident in Connecticut, Due Process was satisfied.[25]

Conclusion

Given the endless possible fact patterns, differing state statutes, and ever-developing concepts of nexus, concise summaries of the state tax issues facing trusts are impossible to provide. Suffice it to say that this is an area of opportunity, and peril, that can be well worth analyzing.

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[1] I.R.C. §§671-679.

[2] Treas. Reg. §1.671-3(a); Prop. Treas. Reg. §1.671-2(f); Rev. Rul. 85-13, 1985-1 Cum. Bull. 184. But see *Rothstein v. Comm'r*, 84-1 USTC ¶9505 (2d Cir. 1984) (sale between grantor and grantor trust respected as a transaction between two separate persons).

[3] I.R.C. §641.

[4] "Distributable net income" generally does not include capital gain. I.R.C. §643(a)(3); Treas. Reg. §1.643(a)-3.

[5] Special rules apply, however, to distributions by foreign trusts. See I.R.C. §665.

[6] I.R.C. §677(a)(3).

[7] See, *e.g.,* N.Y. Tax Law §605(b)(3).

[8] *Safe Deposit & Trust Co. of Baltimore, MD v. VA*, 280 U.S. 83 (1929). The ongoing vitality of this case has been questioned (see *Chase v. Gavin* and *D.C. v. Chase*, discussed below).

[9] *Id.*, at 92.

[10] *Id.*, at 93.

[11] *Id.*, at 92.

[12] *Mercantile-Safe Deposit Trust Co. v. Murphy*, 15 N.Y.2d 579 (N.Y. 1964).

[13] *Pennoyer v. Tax'n Div. Dir.*, 5 N.J. Tax 386 (1983); *Potter v. Tax'n Div. Dir.*, 5 N.J. Tax 399 (1983).

[14] Note that, in the case of the testamentary trust, the New Jersey courts had fundamentally the same contacts with the trust as existed in the Connecticut and D.C. cases discussed below.

[15] N.Y. Tax Law §605(b)(3).

[16] TSB-A-04(7)I (JP Morgan Chase Bank).

[17] *In re The John Heffer Trust, James G. Rosenberg, Trustee*, DTA No. 820351, June 22, 2006. The State Department of Taxation and Finance declined to appeal this Administrative Law Judge determination, and as a consequence it does not have precedential effect.

[18] See *Westfall v. Dir. of Revenue*, 804 S.W. 2d 1990 (Mo. Ct. App. 1990), 812 S.W. 2d 513 (Mo. Sup. Ct. 1991).

[19] CT Gen. Stats. §12-701(a)(4)(C).

[20] CT Gen Stats. §12-701(a)(4)(D).

[21] *Chase Manhattan Bank, Trustee v. Gavin*, 249 Conn. 172 (Conn. 1997).

[22] *D.C. v. Chase Manhattan Bank*, 689 A2d 539 (D.C. Ct. Apps. 1997). See also *Frances M. Rosen Irrevocable Trust v. Oklahoma*, 31 P.3d 406 (Ct. App. 2001), in which the Oklahoma Court of Civil Appeals held that the establishment of a trust under Oklahoma law permitted the ongoing taxation of the trust by Oklahoma, even after the settlor and trustee had relocated to another state.

[23] *Quill Cop. v North Dakota*, 504 U.S. 290 (1992).

[24] *Chase v. Gavin*, supra, at note 21. Under the facts described in the case there was a single Connecticut beneficiary to whom trust distributions were required to be made on a specific date; if she did not survive to that date she had a power of appointment.

[25] See also *McCulloch v. Franchise Tax Board*, 61 Cal 2d 186 (1964) (upholding a California tax regime that imposed tax on trust income attributable to California resident beneficiaries, and required the beneficiary to pay the tax upon receiving the distribution, if the tax had not been paid by the trust).

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