Planning to Minimize or Avoid State Income Tax on Trusts

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Editors' Synopsis: This article examines the myriad rules and standards that govern states' imposition of income tax on nongrantor irrevocable trusts. The article also offers suggestions regarding how to minimize such tax both for existing trusts and trusts to be created. Following the article is a comprehensive appendix summarizing each state's maximum trust income tax rate and the standard(s) that state uses when determining whether a trust will be subject to its tax.

I. INTRODUCTION

A. The Problem

Suppose that Reno Ricky, a Nevada resident, died in 2003 leaving $1,120,000 in trust to his sister, L.A. Laura, a California resident, as trustee, to use his GST exemption. Laura invested well and sold certain trust assets in 2007, producing a $1 million long-term capital gain. Having heard that state income tax is deductible for federal income tax purposes, she paid the California income tax by the end of 2007 with the hope of minimizing the trust's total tax. So, the trust paid $90,805 of California income tax on December 31, 2007, and $149,786 of federal income tax on April 15, 2008. If, instead of appointing Laura, Ricky had named his other sister, Seattle Sue, trustee and if the trust had no California resident beneficiaries, the trust would have owed $0 of state tax and the same $149,786 of federal income tax.

Or, suppose that Gotham Greta, a New York City resident, died in 2004 leaving $1,500,000 of stock in her family's film business to her brother, Yonkers Yorrick, as trustee, to use her GST exemption. In 2007, the business was sold and the trust incurred a $1 million long-term capital gain. Having spoken with Laura, Yorrick paid the New York State and City income tax on the gain by year end. Accordingly, the trust paid $104,851 of New York State and City tax on December 31, 2007, and $149,786 of federal income tax on April 15, 2008. But, if Greta had structured the trust to avoid New York tax, including by appointing her other brother, Philadelphia Phil, as trustee, the trust would have owed $0 of state and city tax and $149,786 of federal income tax.

State income tax is deductible for federal purposes,[1] but the deduction is worthless in the above examples due to the alternative minimum tax ("AMT"). Even if the AMT did not apply, the state income tax deduction would have been of limited value because it is a deduction not a credit and because, in 2007, the maximum tax rate on long-term capital gains was 15%.[2]

B. Background

Most states impose a tax on the income of trusts, ranging in 2007 from a rate of 3.00% for resident trusts in Illinois and 3.07% for such trusts in Pennsylvania to a top rate of 10.30% for resident trusts in California and 10.498% for such trusts in New York City. With proper planning, this tax may be minimized or avoided in many instances. Conversely, without proper planning, the income of a trust might be subject to tax by more than one state.

All income of a trust that is treated as a grantor trust for federal income tax purposes generally is taxed to the settlor, distributed ordinary income of a nongrantor trust generally is taxed to the recipient, and source income of a trust (e.g., income attributable to business activity) generally is taxed by the state where the activity occurs.[3] Thus, this article will focus on the tax savings opportunities for accumulated nonsource ordinary income and capital gains of nongrantor trusts.

In some instances, minimizing state fiduciary income tax will not be important, but, as shown in the above examples, in others, proper planning might produce large tax savings.

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[1] *See* Internal Revenue Code ("IRC") §§ 164(a)(3), 641(b).

[2] *See id.* § 1(h)(1).

[3] *See* TSB-A-07(1)l, 2007 N.Y. Tax Lexis 11 (Feb. 7, 2007) (sale of interest in Georgia partnership not New York source income); In re Ittleson, N.Y. DTA 819283 (Aug. 25, 2005) (nonresidents' gain from sale of painting was New York source income).

C. Scope

This article will summarize:

1. The circumstances, if any, in which the District of Columbia and each of the states tax the nonsource accumulated ordinary income and capital gains of a nongrantor trust based on state statutes, regulations, and 2007 fiduciary income tax return instructions;[4]
2. Pertinent cases and rulings;
3. The taxation schemes of particular states;
4. Planning and other issues for new trusts; and
5. Planning for existing trusts.

II. RULES FOR TAXATION OF TRUSTS

A. Introduction

Seven states—Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming—do not tax the income of trusts. (Florida's tax on intangible personal property was repealed for 2007 and later years.[5]) New Hampshire and Tennessee tax interest and dividends only.

As noted above, if a trust is a grantor trust for income tax purposes, all income (including accumulated ordinary income and capital gains) is taxed to the settlor, making planning difficult if not impossible while that status continues. With the exception of Pennsylvania and Tennessee, which do not follow the federal grantor trust rules at all, and for the District of Columbia and Louisiana, which tax the grantor only in limited circumstances,[6] all of the states that tax trusts essentially honor the federal grantor trust rules. Nevertheless, it might be possible to exploit differences between the federal and the applicable state grantor trust rules in a particular case. For instance, even though a trust might be a grantor trust for federal purposes in a given situation, it might be possible to structure it as a nongrantor trust for state purposes and to arrange matters so that the trust is not subject to that state's tax.

B. Bases of Taxation

All of the 44 taxing states, including New Hampshire and Tennessee, tax a nongrantor trust based on one or more of the following five criteria:

1. If the trust was created by the Will of a testator who lived in the state at death;
2. If the settlor of an inter vivos trust lived in the state;
3. If the trust is administered in the state;
4. If one or more trustees live or do business in the state; or
5. If one or more beneficiaries live in the state.

Louisiana taxes an inter vivos trust if the trust specifically provides that Louisiana law governs, but it does not tax such a trust if the trust specifies that the law of another state applies. Idaho and North Dakota consider the designation of its law as a factor in determining whether a trust is a resident trust. Otherwise, the designation of a state's law to govern a trust has no bearing on its tax classification.

In some states, a trust might be a resident trust under more than one category (e.g., because the trust was created by the Will of a resident and because the trust is administered in the state). In some other states, one or more of the above criteria will lead to the classification of a trust as a resident trust only in combination with other factors.

Because statutes that tax trusts on the same basis are not identical, it is imperative to analyze the statute in question. A trust might be treated as a resident trust by more than one state based on the residence of the testator or settlor, the place of administration, the residence of the trustees, and the residence of the beneficiaries. When creating a new trust in or moving an existing trust to an unfamiliar jurisdiction, the attorney must consider the income tax system of the intended situs.

The Appendix summarizes the criteria that the 44 taxing states employ in taxing trust income.

C. Trust Created by Will of Resident

Seventeen states—Connecticut, the District of Columbia, Illinois, Louisiana, Maine, Maryland, Michigan, Minnesota (trusts created or first administered in state after 1995), Nebraska, Ohio, Oklahoma, Pennsylvania, Utah, Vermont, Virginia, West Virginia, and Wisconsin—tax a trust created by the Will of a resident. New Jersey and New York tax on this basis in certain circumstances, and Idaho, Iowa, and Montana tax if this is one of several factors. Although Delaware, Missouri, and Rhode Island tax if the trust has at least one resident beneficiary, Arkansas and Massachusetts tax if the trust has at least one resident trustee. Alabama taxes on this basis if a trust has a resident fiduciary or current beneficiary.

D. Inter Vivos Trust Created by Resident

Twelve states—the District of Columbia, Illinois, Maine, Maryland, Minnesota (trusts created or

[4] For convenience, the District of Columbia is sometimes referred to as a state.

[5] 2006 Fla. Laws 312.

[6] D.C. Code §§ 47-1809.08–47-1809.09; La. Rev. Stat. Ann. § 47:187.

first administered in state after 1995), Nebraska, Oklahoma, Pennsylvania, Vermont, Virginia, West Virginia, and Wisconsin (trusts created or first administered in state after October 28, 1999)—tax an irrevocable trust created by a resident. New Jersey and New York tax on this basis in certain circumstances, and Connecticut, Delaware, Michigan, Missouri, Ohio, and Rhode Island tax if the trust has at least one resident beneficiary. Massachusetts taxes if the trust has at least one resident trustee and at least one resident beneficiary, but Arkansas taxes if the trust has at least one resident trustee. Idaho and Montana tax if this is one of several factors; Alabama taxes on this basis if a trust has a resident fiduciary or current beneficiary.

E. Trust Administered in State

Fifteen states—Colorado, Georgia, Indiana, Kansas, Louisiana (inter vivos trusts unless trust designates law of another state), Maryland, Minnesota (trusts created or first administered in state before 1996), Mississippi, New Mexico, North Dakota, Oregon, South Carolina, Utah (inter vivos trusts only), Virginia, and Wisconsin (inter vivos trusts created or first administered in state before October 29, 1999)—tax a trust if it is administered in the state. Idaho, Iowa, and Montana tax on this basis if it is combined with other factors. Hawaii taxes if the trust has at least one resident beneficiary. Oregon provides guidance on whether a corporate trustee is administering a trust in the state.

F. Resident Trustee

Eight states—Arizona, California, Georgia, Kentucky, New Mexico, North Dakota, Oregon, and Virginia—tax if one or more trustees reside in the state. Idaho, Iowa (inter vivos trusts only), and Montana tax on this basis when combined with other factors. Delaware, Hawaii, and New Hampshire tax on this basis only if the trust has one or more resident beneficiaries. Arizona, California, and Oregon provide guidance on whether a corporate trustee is a resident. If some, but not all, of the trustees of a trust are California residents, California taxes only a portion of the income.

G. Resident Beneficiary

Five states—California, Georgia, North Carolina, North Dakota, and Tennessee—tax a trust if it has one or more resident beneficiaries. If a trust is taxed on this basis, California and Tennessee tax only income attributable to resident beneficiaries.

III. DETERMINING WHETHER IMPOSITION OF TAX IS CONSTITUTIONAL

A. Introduction

Notwithstanding the rules described above, a state may tax the income of a trust only if doing so will not violate either the Due Process Clause[7] or the Commerce Clause[8] of the United States Constitution. The Due Process Clause provides that:

> No State shall make or enforce any law which shall…deprive any person of life, liberty, or property, without due process of law….

The Commerce Clause provides that:

> The Congress shall have Power…[t]o regulate Commerce…among the several States….

B. Trust Created by Will of Resident

Although they did not involve the income taxation of trusts, two United States Supreme Court cases are relevant to this discussion.

1. In *Safe Deposit and Trust Company v. Virginia*,[9] the Court held that a Virginia tax on the value of an inter vivos trust, which had Virginia beneficiaries but a Maryland trustee, violated the Due Process Clause. The Court said:[10]

> Here we must decide whether intangibles—stocks, 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, may be taxed at the latter's domicile in another State. We think not.

2. In *Quill Corporation v. North Dakota*,[11] the Court considered the constitutionality of North Dakota's use tax on an out-of-state mail order business that had no outlets or sales representatives in the state. At the time, about $1 million of the business's $200 million of annual sales were made to about 3,000 North Dakota residents.[12] Regarding the Due Process Clause, the Court held that:[13]

> In this case, there is no question that Quill has purposefully directed its

[7] U.S. CONST. AMEND. XIV, § 1.
[8] U.S. CONST. ART. I, § 8, cl. 3.
[9] Safe Deposit & Trust Co. v. Virginia, 280 U.S. 83 (1929).
[10] *Id.* at 93.
[11] Quill Corp. v. North Dakota, 504 U.S. 298 (1992).
[12] *Id.* at 302.
[13] *Id.* at 308.

activities at North Dakota residents, that the magnitude of those contacts is more than sufficient for due process purposes, and that the use tax is related to the benefits Quill receives from access to the State. We therefore agree with the North Dakota Supreme Court's conclusion that the Due Process Clause does not bar enforcement of that State's use tax against Quill.

Regarding the Commerce Clause, however, the Court reaffirmed prior decisions that a business must have a physical presence in a state to justify the imposition of a use tax.[14]

The following state court decisions involve the constitutionality of taxing trusts on this basis.

1. In *Harrison v. Commissioner of Corporations and Taxation*,[15] the trustees of two trusts created by the Wills of New York residents sought abatements of Massachusetts income tax on realized capital gains. The trustees already had paid New York income tax on the gains because the testators were New York residents,[16] but it appeared that the gains also were subject to Massachusetts income tax because the trusts had Massachusetts trustees and beneficiaries.[17] In concluding that Massachusetts could not tax in the circumstances, the Supreme Judicial Court of Massachusetts held that:[18]

> When a situs for taxation is established for purposes of taxation in New York in the circumstances here disclosed, there seems to us to be no room for a situs of the same property for taxation within this Commonwealth. The principle, that the situs of intangible property held in trust, in the absence of other controlling factors follows the person of the trustee, becomes inapplicable because by a dominating law its situs is fixed in the place where the testamentary trust was created and established and is being administered under direction of its court. For all purposes incident to the cases at bar, its situs is immovably established within the State where the testamentary trust of which it is a part is being administered.

2. In *First National Bank v. Harvey*,[19] the Supreme Court of Vermont considered a request for a refund of Vermont income tax by the trustees of a Massachusetts trust created by the Will of a Vermont decedent. In sustaining Vermont's power to tax, the court observed:[20]

> We approve the reasoning in *Harrison v. Commissioner of Corporations and Taxation*, to the effect that a state has the power to establish a situs for purposes of taxation over testamentary trust funds, created by its deceased residents in intangible personal property being administered by appointees of its own court, under its own laws, and thus to continue for practical purposes within its jurisdiction all control over the trusts, and especially control for purposes of taxation; and hold that under our statutes the Legislature has established such a situs here for the purpose of taxing such trust funds, and whether the trustee is named in the will or appointed by the court makes no difference in this respect.

3. In *Taylor v. State Tax Commissioner*,[21] a New York intermediate appellate court reviewed a determination by the New York State Tax Commission that New York income tax was payable on gain incurred upon the sale of Florida real property held in a trust created by the Will of a New York decedent. Although the Will appointed two nonresident individual trustees and a New York corporate trustee, Florida law prohibited the corporate trustee from serving so that only the nonresident trustees served with respect to the Florida real estate. The court held that New York could not tax the gain as follows:[22]

> New York's only substantive contact with the property was that New York was the domicile of the settlor of the trust, thus creating a resident trust.

[14] *Id.* at 318–19.

[15] Harrison v. Comr. of Corps. & Taxation, 272 Mass. 422 (1930).

[16] *Id.* at 424.

[17] *Id.* at 425.

[18] *Id.* at 428.

[19] First Nat'l Bank v. Harvey, 111 Vt. 281 (1940).

[20] *Id.* at 297 (citation omitted).

[21] Taylor v. State Tax Comr., 445 N.Y.S.2d 648 (3d Dept. 1981).

[22] *Id.* at 649 (citations omitted).

> The fact that the former owner of the property in question died while being domiciled in New York, making the trust a resident trust under New York tax law, is insufficient to establish a basis for jurisdiction.

Taylor suggests that a state may not tax income simply because a trust was created by the Will of a resident.

4. In *Pennoyer v. Taxation Division Director*,[23] the New Jersey Tax Court framed the question as follows:[24]

> Taxpayer trustee contests a deficiency tax assessment of $100.68 for the fiscal year ended February 29, 1980, imposed by the Director of the Division of Taxation under the New Jersey Gross Income Tax Act. The assessment was imposed on the undistributed income of a testamentary trust created by the will of a New Jersey domiciliary. The trustee, beneficiaries and assets of the trust are all located outside New Jersey.

The court held:[25]

> Based on the facts of this case, I conclude that the creation of the subject trust in New Jersey in 1970, the probate proceeding in a New Jersey court and the jurisdiction and availability of the New Jersey courts are not sufficient contacts with the State of New Jersey to support taxation of the 1979-1980 undistributed income of the trust, and therefore, N.J.S.A. 54A:1-2(o)(2) may not constitutionally be applied in the subject case.

Thus, *Pennoyer* agreed with *Taylor*.

5. In *In re Swift,*[26] the Supreme Court of Missouri addressed the challenge to a Missouri tax assessment made by the trustees of an Illinois trust created by the Will of a Missouri testator. The court described the pertinent facts and legal principles as follows:[27]

> In this case, the trustees, the beneficiaries, the trust property, and the administration of the trust are in Illinois; the income earned by the trusts which the Director seeks to tax is the product of Illinois administration. The only connections with Missouri are Swift's domicile and death in this state and the creation and funding of the testamentary trusts through the probate administration of Swift's estate.
>
> The Director argues that the administration of Swift's estate by a Missouri probate court, together with Swift's Missouri domicile at death and the creation of the subject trusts by a "Missouri" will, provide a sufficient nexus to justify the imposition of income tax.
>
> We disagree. An income tax is justified only when contemporary benefits and protections are provided the subject property or entity during the relevant taxing period. In determining whether this state has a sufficient nexus to support the imposition of an income tax on trust income, we consider six points of contact: (1) the domicile of the settlor, (2) the state in which the trust is created, (3) the location of trust property, (4) the domicile of the beneficiaries, (5) the domicile of the trustees, and (6) the location of the administration of the trust. For purposes of supporting an income tax, the first two of these factors require the ongoing protection or benefit of state law only to the extent that one or more of the other four factors is present.

Applying the above standard, the court held that Missouri could not tax the income in question.[28]

6. In *Westfall v. Director of Revenue*,[29] the Missouri Supreme Court applied the *Swift* factors to a different fact pattern and upheld Missouri's right to tax

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[23] Pennoyer v. Taxation Div. Dir., 5 N.J. Tax 386 (1983).

[24] *Id.* at 388 (citation omitted).

[25] *Id.* at 399.

[26] In re Swift, 727 S.W.2d 880 (Mo. 1987).

[27] *Id.* at 882.

[28] *Id.*

[29] Westfall v. Director of Revenue, 812 S.W.2d 513 (Mo. 1991).

trust income. The court reasoned:[30]

> Missouri was connected to the trust in *Swift* only by the settlor's domicile, point (1), and the situs of the trust's creation, point (2). Because of those limitations this Court properly determined Missouri lacked sufficient connection with the trust to impose Missouri income tax. The Rollins trust differs, however, from the trusts in *Swift* because the Rollins trust also satisfies point (3) of the test by its ownership of real estate in Columbia, Missouri. In addition, the trust instrument shows that under certain contingencies charities in Columbia will receive distributions; it specifies the Board of Trustees of the Columbia [Missouri] Public Library as a contingent beneficiary and the Boone County National Bank as a possible successor trustee. These considerations taken together with points (1), (2) and (3) provide a sufficient nexus to support the imposition of an income tax on trust income.

7. In *District of Columbia v. Chase Manhattan Bank*,[31] the first relevant case decided after the Supreme Court's *Quill* decision (summarized above), the District of Columbia Court of Appeals denied a $324,315 District of Columbia income tax refund to the trustee under the Will of a resident of the District. At the outset, the court summarized the facts and its conclusion as follows:[32]

> This case presents an issue of first impression in this court: can the District of Columbia, consistent with the Due Process Clause, tax the annual net income of a testamentary trust created by the will of an individual who died while domiciled in the District, when the trustee, trust assets, and trust beneficiaries are all presently located outside the District. We hold that the Due Process Clause does not prevent the District from imposing such a tax, given the continuing supervisory relationship which the District's courts have with respect to administration of such a trust, and in so doing we reject several decisions in other states holding that due process requires a greater connection between the trust and the taxing jurisdiction than the residence of the settlor.

Departing from *Taylor* and *Pennoyer*, this case indicates that a state may tax solely because the trust arises under the Will of a resident.

8. In *Chase Manhattan Bank v. Gavin*,[33] the Supreme Court of Connecticut denied the trustees' request on constitutional grounds for Connecticut income tax refunds in four testamentary trusts. The court summarized its analysis and conclusions as follows:[34]

> [T]he taxability of the income of the resident testamentary trusts in this case is based on the fact that the testators were Connecticut domiciliaries at the time of their deaths…. The plaintiff claims that this taxation scheme, as applied to it, violates the due process clause and the commerce clause of the federal constitution. We consider the plaintiff's contentions in turn. We conclude that none of them is persuasive.

Here, the Supreme Court of Connecticut agreed with the District of Columbia decision.

C. Inter Vivos Trust Created by Resident

The two United States Supreme Court cases cited in B, above, are relevant here as well. The following state court decisions involve the constitutionality of taxing trusts on this basis.

1. In *Mercantile-Safe Deposit and Trust Company v. Murphy*,[35] a New York intermediate appellate court addressed whether New York could tax the accumulated income of an inter vivos trust that had a resident current discretionary beneficiary. In holding that it could not, the court said:[36]

[30] *Id.* at 514 (citations and internal quotation marks omitted).
[31] District of Columbia v. Chase Manhattan Bank, 689 A.2d 539 (D.C. 1997).
[32] *Id.* at 540.
[33] Chase Manhattan Bank v. Gavin, 249 Conn. 172 (1999).
[34] *Id.* at 183.
[35] Mercantile-Safe Deposit & Trust Co. v. Murphy, 19 A.D. 2d 765 (3d Dep't 1963), *aff'd*, 15 N.Y.2d 579 (1964).
[36] *Id.* at 765–66 (citations omitted).

> It is conceded that the trustee is domiciled in the State of Maryland, that the trust is administered there and that the intangibles constituting its corpus have been at all times in its exclusive possession and control in that State. Although this trust must be deemed a resident trust by statutory definition the related statutes which impose a tax upon its accrued income undertake in the circumstances disclosed here to extend the taxing power of the State to property wholly beyond its jurisdiction and thus conflict with the due process clause of the Fourteenth Amendment of the Federal Constitution. We find no merit either in the continuing jurisdiction theory advanced by defendants or in their thesis that since the resident beneficiaries of the trust could be taxed on income distributed the nonresident trustee can be taxed on income accumulated.

Mercantile stands for the proposition that a state may not tax an inter vivos trust created by a resident simply because the trust has a resident current contingent beneficiary.

2. In *Potter v. Taxation Division Director*,[37] the New Jersey Tax Court described its task as follows:[38]

> Taxpayer trustee contests a deficiency tax assessment for the fiscal year ended February 29, 1980, imposed by the Director of the Division of Taxation under the New Jersey Gross Income Tax Act. The assessment was imposed on the undistributed income of an irrevocable inter vivos trust created by a New Jersey domiciliary. The trustee, beneficiaries and assets are all located outside New Jersey.

The court rejected New Jersey's ability to tax the trust for the following reasons:[39]

> Any benefit to the trust from the laws of the State of New Jersey relative to the distribution of assets from the estate to the trust can be accounted for in terms of the inheritance tax paid to the State of New Jersey on the assets distributed and transferred to the trust. The facts of this case indicate that the irrevocable inter vivos trust has a situs in New York, not New Jersey. The fact that contingent beneficiaries reside in New Jersey does not alter this conclusion. These beneficiaries are taxable on trust income distributed to them or on undistributed income over which they have control. The state in which a beneficiary is domiciled may tax trust income distributed to the beneficiary. The fact that contingent beneficiaries are domiciled in New Jersey does not constitute a contact sufficient to empower New Jersey to tax undistributed trust income where the contingent beneficiaries have no right to the undistributed trust income.

Hence, *Potter* stands for the same proposition as *Mercantile*.

3. In *Blue v. Department of Treasury*,[40] the Michigan Court of Appeals considered whether Michigan could tax the income of an inter vivos trust created by a resident. In concluding that imposition of Michigan tax in the circumstances would violate the Due Process Clause of the Fourteenth Amendment, the court said:[41]

> We hold that there are insufficient connections between the trust and the State of Michigan to justify the imposition of an income tax. We choose to follow the cases in Missouri and New York restricting the state's power to impose tax on resident trusts where neither the trustee nor the trust property are within the state. We conclude that there is no ongoing protection or benefit to the trust. All of the income-producing trust property is located in Florida while the only trust property in Michigan is non-income producing. Both the income beneficiary of the trust and the trustee are domiciled in Florida. Most importantly, the trust is

[37] Potter v. Taxation Div. Dir., 5 N.J. Tax 399 (1983).
[38] *Id.* at 401 (citation omitted).
[39] *Id.* at 405 (citation omitted).
[40] Blue v. Department of Treasury, 185 Mich. App. 406 (1990).
[41] *Id.* at 410–11.

administered and registered in Florida. We are unpersuaded by defendant's arguments that the fact that the trust is defined as a resident trust imparts legal protections and jurisdiction. We find that these protections are illusory considering that the trust is registered and administered in Florida. The state cannot create hypothetical legal protections through a classification scheme whose validity is constitutionally suspect and attempt to support the constitutionality of the statute by these hypothetical legal protections.

Notably, the court held that Michigan could not tax the trust even though the trust held Michigan real property.

4. *District of Columbia v. Chase Manhattan Bank*,[42] summarized in B, above, dealt exclusively with the income taxation of a trust, which was created by the Will of a District of Columbia decedent, that had no trustees, beneficiaries, or assets in the District. Nevertheless, the case sometimes is cited erroneously to support the taxation of an inter vivos trust in the same circumstances. But, the court was careful to note that it might not have upheld the District's right to tax an inter vivos trust as follows:[43]

> We express no opinion as to the constitutionality of taxing the entire net income of inter vivos trusts based solely on the fact that the settlor was domiciled in the District when she died and the trust therefore became irrevocable. In such cases, the nexus between the trust and the District is arguably more attenuated, since the trust was not created by probate of the decedent's will in the District's courts. An irrevocable inter vivos trust does not owe its existence to the laws and courts of the District in the same way that the testamentary trust at issue in the present case does, and thus it does not have the same permanent tie to the District. In some cases the District courts may not even have principal supervisory authority over such an inter vivos trust. The idea of fundamental fairness, which undergirds our due process analysis, therefore may or may not compel a different result in an inter vivos trust context.

5. In *Chase Manhattan Bank v. Gavin*,[44] mentioned in B, above, the Connecticut Supreme Court also denied the trustees' request on constitutional grounds for Connecticut income tax refunds in an inter vivos trust that had a current resident non-contingent beneficiary. The court held as follows:[45]

> The taxability of the income of the inter vivos trust in this case is based on the fact that the settlor of the trust was a Connecticut domiciliary when the trust was established and the beneficiary is a Connecticut domiciliary. The plaintiff claims that this taxation scheme, as applied to it, violates the due process clause and the commerce clause of the federal constitution. We consider the plaintiff's contentions in turn. We conclude that none of them is persuasive.

6. In *Frances M. Rosen Irrevocable Trust v. State ex rel. Oklahoma Tax Commission*,[46] the Court of Civil Appeals affirmed a decision of the Tax Commission that denied the trustee of an irrevocable trust refunds of Oklahoma fiduciary income taxes for 1994, 1995, and 1996. Although the settlor lived in Oklahoma when she created the trust in 1990, she and the trustee had moved to Nevada by 1994. The court did not consider the constitutional aspects of the matter.

D. Trust Administered in State

There are no relevant United States Supreme Court cases. The following Wisconsin cases considered this issue.

1. In *Wisconsin Department of Taxation v. Pabst*,[47] the Supreme Court of Wisconsin held that Wisconsin could not tax a trust because the administration did not occur in the state. The court justified its conclusion as follows:[48]

[42] District of Columbia v. Chase Manhattan Bank, 689 A.2d 539 (D.C. 1997).

[43] *Id.* at 547 n.11.

[44] Chase Manhattan Bank v. Gavin, 249 Conn. 172 (1999).

[45] *Id.* at 183.

[46] Frances M. Rosen Irrevocable Trust v. State ex rel. Okla. Tax Comm'n, 2001 OK Civ. App. 114 (2001).

[47] Wisconsin Dep't of Taxation v. Pabst, 15 Wis. 2d 195 (1961).

[48] *Id.* at 202.

> To administer the trusts involved would be to manage, direct, or superintend the affairs of these trusts. Weber [a Wisconsin resident] did not perform these functions. The policy decisions were made by the nonresident trustees. Weber implemented those policy determinations. The trustees decided whether to distribute the income, whether to seek investment advice, and whether ministerial duties should be delegated to someone other than themselves. Ministerial acts performed in Wisconsin included an annual audit made by a Milwaukee certified public accountant and the filing of federal tax returns in the Milwaukee office of the internal revenue department. The activities carried on in Wisconsin were only incidental to the duties of the trustees.

2. In *Pabst v. Wisconsin Department of Taxation*,[49] the same court held that Wisconsin could tax a different Pabst family trust because administration did occur in the state. At the outset, the court indicated a change of approach regarding income taxation in Wisconsin:[50]

> The key word of the statute, insofar as this appeal is concerned, is 'administered.' In *Wisconsin Department of Taxation v. Pabst,* we had before us the application of this same statute to two other trusts created by the settlor Ida C. Pabst. The decision cited the definition of 'administer' in Webster's Third New International Dictionary which stressed the element of managing, directing, or superintending affairs.
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> Nevertheless, upon further consideration we now conclude that the statutory word 'administered' as applied to an inter vivos trust of intangibles means simply conducting the business of the trust. The problem of determining whether such a trust is administered in Wisconsin may be made more difficult when the business of the trust is partly conducted in other states as well as in Wisconsin. In such a situation, a proper application of the statute would appear to require the conclusion that the trust is being administered in Wisconsin within the meaning of the statute if the major portion of the trust business is conducted in Wisconsin.

The court concluded:[51]

> In the instant case Wisconsin has extended the protection of its laws to the activities of Weber in carrying on the business of the trust at the office of Pabst Farms, Inc. Although no rent was paid by the trust for the use of such office, we deem this an entirely fortuitous circumstance. The only office that the trust had was maintained in Wisconsin and the major portion of the trust's business was transacted here during the period in question. We are satisfied there was a sufficient nexus with Wisconsin to permit it to impose the income taxes which it did, and we so hold.

E. Resident Trustee

In *Greenough v. Tax Assessor of Newport*,[52] the United States Supreme Court held that Rhode Island's ad valorem tax on an out-of-state trust with a Rhode Island cotrustee did not violate the Due Process Clause.

The following state cases addressed this issue.

1. In *Harrison v. Commissioner of Corporations and Taxation*,[53] discussed in B above, the Supreme Judicial Court of Massachusetts also considered the trustees' request for an abatement of Massachusetts income tax on gains incurred by a trust created by the Will of a resident of the District of Columbia. In holding that the Commonwealth could not tax the entire gain, the court observed that:[54]

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[49] Pabst v. Wisconsin Dep't of Taxation, 19 Wis. 2d 313 (1963).

[50] *Id.* at 321 (citation omitted).

[51] *Id.* at 329.

[52] Greenough v. Tax Assessor of Newport, 331 U.S. 486 (1947).

[53] Harrison v. Comr. of Corps. & Taxation, 272 Mass. 422 (1930).

[54] *Id.* at 430.

> The jurisdiction to tax rests solely on the fact that one of three trustees was resident in this Commonwealth. We are of opinion that this fact will not support a tax upon the entire gain to the trust.

The court then rejected the Commonwealth's contention that a proportionate amount of the gain was taxable as follows:[55]

> The defendant argues upon this aspect of the case that if the tax is bad to the extent that the nonresident trustees had an undivided part interest, then it is valid upon the proportion of the income attributable to the resident trustee. This contention cannot be supported. Manifestly that situation was not before the mind of the Legislature in enacting § 10.

2. In *McCulloch v. Franchise Tax Board*,[56] the Supreme Court of California held that California could tax a beneficiary on accumulated income distributed to him from a Missouri trust because a cotrustee was a California resident. The court said:[57]

> We conclude that California could constitutionally tax plaintiff as the resident beneficiary upon the accumulated income when it was distributed to him. But plaintiff in the instant case was simultaneously beneficiary and a trustee. No possible doubt attaches to California's constitutional power to tax plaintiff as a trustee. His secondary role as a trustee reinforces the independent basis of taxing plaintiff as beneficiary.

F. Resident Beneficiary

There are no pertinent United States Supreme Court cases. The following California cases considered this issue.

1. In *McCulloch v. Franchise Tax Board*,[58] the Supreme Court of California held that California could tax a California resident beneficiary on accumulated income distributed to him from a Missouri trust for the reason just quoted.[59]

2. In *In the Matter of the Appeal of The First National Bank of Chicago, Trustee for Virginia Kirk Cord Trust, et al.*,[60] the California State Board of Equalization ruled that California could tax six trusts being administered in Illinois because all beneficiaries were California residents. It said:[61]

> Appellant also urges that section 17742 (formerly 18102) is unconstitutional if it purports to tax the non-California income of a foreign trust which is administered by a nonresident trustee. This argument has been fully answered by the California Supreme Court in *McCulloch v. Franchise Tax Board* wherein the court held that California could constitutionally tax a Missouri trust on income which was payable in the future to a beneficiary residing in this state, although such income was actually retained by the trust. The fact that the resident beneficiary was also one of the trust's three trustees was not relied upon by the court in holding that the residence of the beneficiary afforded a constitutionally sufficient connection to bring the trust's income within California's tax jurisdiction.

3. In *In the Matter of the Appeal of C. Pardee Erdman*,[62] the California State Board of Equalization, following *McCulloch* and *Cord*, ruled that California could require California resident remainder beneficiaries to pay California tax on accumulated income and capital gains that had not previously been paid by the trustee of two trusts being administered in Illinois.

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[55] *Id.* at 431.

[56] McCulloch v. Franchise Tax Board, 61 Cal. 2d 186 (1964).

[57] *Id.* at 198.

[58] *Id.* at 186.

[59] *Id.* at 198.

[60] In the Matter of the Appeal of The First National Bank of Chicago, Trustee for Virginia Kirk Cord Trust, et al., 1964 Cal. Tax Lexis 39 (1964).

[61] *Id.* at 6–7 (citation omitted).

[62] In the Matter of the Appeal of C. Pardee Erdman, 1970 Cal. Tax Lexis 50 (1970).

IV. SPECIFIC STATE CONSIDERATIONS

A. New York

In 2007, the top rate for a nongrantor trust that was a resident of New York State but not of New York City was 6.85% on income over $20,000.[63] If a trust also resided in New York City, it also was subject to New York City tax at a rate of up to 3.648% on income over $50,000.[64] Hence, a New York City resident trust was taxable at a rate of up to 10.498%.

The New York tax law defines a resident trust as:[65]

> (B) a trust, or a portion of a trust, consisting of property transferred by will of a decedent who at his death was domiciled in this state, or
>
> (C) a trust, or portion of a trust, consisting of the property of:
>
> (i) a person domiciled in this state at the time such property was transferred to the trust, if such trust or portion of a trust was then irrevocable, or if it was then revocable and has not subsequently become irrevocable; or
>
> (ii) a person domiciled in this state at the time such trust, or portion of a trust, became irrevocable, if it was revocable when such property was transferred to the trust but has subsequently become irrevocable.

But, the following provision was added in 2003 to read in relevant part as follows:[66]

> (D)(i) Provided, however, a resident trust is not subject to tax under this article if all of the following conditions are satisfied:
>
> (I) all the trustees are domiciled in a state other than New York;
>
> (II) the entire corpus of the trusts, including real and tangible property, is located outside the state of New York; and
>
> (III) all income and gains of the trust are derived from or connected with sources outside of the state of New York, determined as if the trust were a non-resident trust.
>
> (ii) For purposes of item (II) of clause (i) of this subparagraph, intangible property shall be located in this state if one or more of the trustees are domiciled in the state of New York.

The above provision codifies the holdings of the *Taylor* and *Murphy* cases cited above, which later were implemented by administrative regulations.

Commentators succinctly summarize the reach of the New York fiduciary income tax as follows:[67]

> Essentially, New York will not tax a trust that has no New York trustees, no New York assets, and no New York source income.

The Technical Services Division of the Office of Tax Policy Analysis of the New York State Department of Taxation provided guidance in 2003 on whether or not the donee of a power of appointment is the "transferor" to the appointive trust for New York income tax purposes.[68] It concluded that:[69]

[63] N.Y. Tax Law § 601(c)(1).

[64] 2007 NY IT-205-I at 20.

[65] N.Y. Tax Law § 605(b)(3)(B)–(C).

[66] *Id.* § 605(b)(3).

[67] Philip J. Michaels & Laura M. Twomey, *How, Why, and When to Transfer the Situs of a Trust*, 31 Est. Plan. 28, 29 (Jan. 2004).

[68] TSB-A-03(6)I, 2003 N.Y. Tax Lexis 313 (Nov. 21, 2003). *See* Richard B. Covey & Dan T. Hastings, *State Taxation of Trust Income, Effect of Exercise of Power of Appointment*, Prac. Drafting 7549 (Jan. 2004). *Accord* Conn. Dep't of Revenue Servs. Ruling 2005-2 (Jan. 14, 2005), available at www.ct. gov/drs/cwp/view.asp?a=1513&q=289024 (last visited Oct. 14, 2008). *See* Richard B. Covey & Dan T. Hastings, *State Taxation of Trust Income; Effect of Exercise of Power of Appointment; Connecticut Law*, Prac. Drafting 9100 (Oct. 2007).

[69] *Id.* (citation omitted).

> [T]he residency of an appointive trust created by the exercise of a power of appointment is determined based on the domicile of the donor of the property who transferred the property to the trust. A person who transfers property held in trust to an appointive trust by the exercise of a general power of appointment over the trust property is considered the donor of the trust property for purposes of determining the residency of the appointive trust. Conversely, a person who transfers property held in trust to an appointive trust by the exercise of a special power of appointment over the trust property is not considered the donor of the trust property for purposes of determining the residency of the appointive trust. The donor of the special power of appointment is considered the donor of the trust property for purposes of determining the residency of the appointive trust.

In 2004, that agency issued guidance that indicated that an adviser or committee that directs the trustee on investment, distribution, or other matters or that has a veto power over the trustees actions will be treated as a cotrustee.[70] Accordingly, a trust will be subject to New York tax if such an adviser or committee member lives in New York even if the trustee and all trust property are outside the state.

B. New Jersey

New Jersey follows New York's approach. Thus, New Jersey defines a resident trust as follows:[71]

> A resident …trust means:…
>
> (2) A trust, or a portion of a trust, consisting of property transferred by will of a decedent who at his death was domiciled in this State, or
>
> (3) A trust, or portion of a trust, consisting of the property of:
>
> (a) A person domiciled in this State at the time such property was transferred to the trust, if such trust or portion of a trust was then irrevocable, or if it was then revocable and has not subsequently become irrevocable; or
>
> (b) A person domiciled in this State at the time such trust, or portion of a trust, became irrevocable, if it was revocable when such property was transferred to the trust but has subsequently become irrevocable.

The top rate for a New Jersey resident trust in 2007 was 8.97% on income over $500,000.[72]

The instructions for the 2007 New Jersey Gross Income Tax Fiduciary Return provide in relevant part as follows:[73]

> If a resident trust…does not have any assets in New Jersey or income from New Jersey sources, and does not have any trustees…in New Jersey, it is not subject to New Jersey tax. However, a New Jersey Gross Income Tax Fiduciary Return should be filed with a statement attached certifying the trust's…exempt status.

C. California

Under California's sui generis system, a resident trust was taxed in 2007 at a rate of up to 10.30% on income over $1 million[74] on two bases:[75]

> The tax applies to the entire taxable income…of a trust, if the fiduciary or beneficiary (other than a beneficiary whose interest in such trust is contingent) is a resident, regardless of the residence of the settlor.

Rules are provided for determining the residence of a corporate fiduciary[76] and for other purposes.[77]

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[70] TSB-A-04(7)I, 2004 N.Y. Tax Lexis 259 (Nov. 12, 2004). *See* Richard B. Covey & Dan T. Hastings, *State Income Taxation of Trusts, New York Law*, PRAC. DRAFTING 8228 (July 2005).

[71] NJSA § 54A:1-2(o).

[72] *Id.* §54A:2-1(b)(5).

[73] 2007 Form NJ-1041 at 1.

[74] CAL. REV. & TAX CODE §§ 17041(a), (e), (h), 17043(a).

[75] *Id.* § 17742(a). *See id.* §§ 17743–17744.

[76] *Id.* § 17742(b).

[77] *Id.* § 17745.

Even if a Californian is receiving current income distributions from a trust that has a non-California trustee, the trustee should be able to defer or avoid California taxation of accumulated ordinary income and capital gains if distribution of such income and gains is within the trustee's discretion. In this connection, in a 2006 Technical Advice Memorandum,[78] the California Franchise Tax Board ruled that:

1. A resident beneficiary of a discretionary trust has a noncontingent interest in the trust only as of the time, and to the extent of the amount of income, that the trustee actually decides to distribute;
2. Accumulated income is taxable to a trust when it is distributed or distributable to a resident beneficiary; and
3. The conclusion in 1 above is unaffected if the trustee may or does distribute principal (capital gains) to the current beneficiary.[79]

The California Franchise Tax Board may enter into voluntary disclosure agreements with certain trusts and nonresident beneficiaries.[80] A trustee or beneficiary might want to take advantage of this procedure, for example, because a trust that had not been subject to California income tax now must pay such tax due to the move of a trustee or beneficiary to California.

D. Idaho and Virginia

Some states tax a trust only if it satisfies several requirements. For example, Idaho taxed a trust in 2007 at a rate of up to 7.80% only if it met at least three of the following five conditions: the grantor lived in Idaho, the trust was governed by Idaho law, trust property was located in Idaho, a trustee lived in Idaho, or the trust was administered in Idaho.[81] Similarly, in 2007, Virginia taxed a trust (the top rate was 5.75%) created by a Virginia resident only if a trustee, a beneficiary, or trust property was located there.[82] A resident of such a state should design a trust to be exempt from such state's fiduciary income tax.

E. Delaware

A trust is a resident trust in Delaware if it was created by the Will of a Delaware resident or by an inter vivos instrument created by such a resident or if the trust has a resident trustee.[83] In 2007, the top rate was 5.95% on income over $60,000.[84] The trustee of a Delaware resident trust may deduct income (including capital gains) set aside for future distribution to nonresident beneficiaries.[85] In calculating comparable deductions, some states treat all unknown or unascertained beneficiaries as residents,[86] but Delaware treats them as residents or nonresidents based on the current residence of their known or putative parents or other identifying persons.[87] Because Delaware has a small population, few Delaware trusts pay Delaware income tax.

V. PLANNING, ETHICAL, AND OTHER ISSUES FOR NEW TRUSTS

A. Introduction

The state fiduciary income tax implications of a trust should be considered in the planning stage because it is much easier not to pay a tax in the first place than to obtain a refund. In planning to avoid one state's tax, the attorney must make sure that the trust will not be taxed in one or more other states.

B. Trust Created by Will of Resident

As a general rule, a client will have a better chance of avoiding state income tax by creating and funding a revocable trust in another jurisdiction during life than by creating trusts in his or her Will. This is because the cases summarized in III, B, and III, C, above, show that courts are less likely to tax inter vivos trusts than testamentary trusts. Even in New York and New Jersey, where a testamentary trust can avoid tax by having no fiduciary, assets, or source income in the state, the inter vivos trust might be the preferred vehicle because it will escape the income tax that otherwise would be payable by the probate estate.

Regardless of the above, clients will create testamentary trusts. In II, C, above, seventeen states are listed that tax a trust solely because the testator lived in the state at death. Although the highest courts in two of these jurisdictions—the District of Columbia and Connecticut—have upheld the jurisdiction's ability to tax on this basis, the constitutionality of the imposition of the tax might be subject to attack in another state.

In New York and New Jersey, the rules for avoiding tax are clear and should be followed strictly.

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[78] Cal. Franchise Tax Board Technical Advice Memorandum 2006-0002 (Feb. 17, 2006).

[79] *Id.*

[80] CAL. REV. & TAX CODE §§ 19191–19192.

[81] IDAHO ADMIN. CODE Regs. 35.01.01.035. *See* Richard B. Covey & Dan T. Hastings, *Income Taxation of Trust Income, Idaho Law*, PRAC. DRAFTING 6618, 6618–19 (Oct. 2001).

[82] P.D. 93-189, 1993 VA. TAX LEXIS 187 (1993).

[83] 30 DEL. C. § 1601(8).

[84] *Id.* § 1102(a)(11).

[85] *Id.* § 1636.

[86] *See, e.g.,* MASS. GEN. LAWS ch. 62, § 10(a).

[87] 30 DEL. C. § 1636(b).

In Idaho, Iowa, and Montana, where the testator's residence is one of several factors that determine taxability, the attorney should arrange other factors to avoid tax. Delaware, Missouri, and Rhode Island tax a testamentary trust that has at least one resident beneficiary. If the applicable tax law does not apportion tax based on the number of resident and nonresident beneficiaries, the client might create multiple trusts to free the income attributable to assets held for nonresident beneficiaries from tax.

Because Alabama, Arkansas, and Massachusetts might tax a testamentary trust that has a resident fiduciary, tax may easily be avoided by appointing a nonresident fiduciary. In this connection, it is common practice for attorneys in Boston law firms to serve as trustees of trusts created by Massachusetts residents. In such a case, the attorney should discuss the appointment and its implications with the client because such an appointment often will cause the trust's accumulated income and capital gains to be subject to Massachusetts income tax (usually at 5.30%)[88] that could be avoided by appointing a non-Massachusetts trustee.[89]

The courts that sustained a jurisdiction's right to tax a testamentary trust solely because of the testator's residence did so because of ongoing benefits available to the trust through that state's judicial system. In the District of Columbia, Connecticut, and other states, a trust might escape taxation if the Will designates the law of another state to govern the trust and gives the courts of that other state exclusive jurisdiction over the trust. The Will also might direct the trustee to initiate a proceeding to have the court of the other state accept jurisdiction.

A state that taxes on this basis is a good place for a resident of another state to create a trust.

C. Inter Vivos Trust Created by Resident

In II, D, above, twelve states are listed that tax a trust solely because the settlor lived in the state. None of the cases summarized in III, C, above, held that a state could tax solely on this basis. Although the *Gavin* case in Connecticut held that taxation was constitutional if a trust has a resident noncontingent beneficiary, the *Mercantile* case in New York held that the state could not tax a trust that had a resident current discretionary beneficiary and the *Blue* case in Michigan held that the state could not tax a trust that held unproductive Michigan real estate.

With proper planning, the attorney easily can avoid taxation by New York and New Jersey in many situations. In Idaho and Montana, the attorney often may manipulate other factors to avoid taxation. In Alabama, Connecticut, Delaware, Massachusetts, Michigan, Missouri, Ohio, and Rhode Island, the attorney should make sure that portions of trusts attributable to nonresident beneficiaries are not taxed needlessly. The attorney should avoid appointing resident fiduciaries in Alabama, Arkansas, and Massachusetts.

As with a testamentary trust, the attorney might increase a trust's ability to escape tax by designating in the governing instrument that the law of another state will govern the trust and that the courts of that state will have exclusive jurisdiction over it.

Residents of other states should consider creating trusts in states that tax on the basis of the settlor's residence.

D. Trust Administered in State

An attorney should think long and hard before having a client create a trust in one of the fifteen states (other than Minnesota and Wisconsin) listed in II, E, above, that tax a trust solely because it is administered in the state. This is a factor that can be managed to avoid taxation by Idaho, Iowa, and Montana, which tax based on several factors. Taxation can be avoided in Hawaii even if the trust has a resident beneficiary. In any event, the attorney should ensure that all administration occurs outside the state in question.

E. Resident Trustee

A trust can avoid taxation by the eight states listed in II, F, above, if it does not have a resident fiduciary. This factor may be managed to avoid taxation by Idaho, Iowa, and Montana. The attorney must be mindful of this factor if a trust has resident beneficiaries in Delaware, Hawaii, and New Hampshire.

F. Resident Beneficiary

The five states listed in II, G, above, tax a trust solely because it has resident beneficiaries. The attorney should ensure that income on assets attributable to nonresident beneficiaries won't be taxed unnecessarily. He or she also should make sure that tax on accumulated income and capital gains that might ultimately be distributed to nonresident beneficiaries won't be taxed prematurely.

G. Filing Position

In some cases, it will be entirely clear whether a trust must pay a state's fiduciary income tax, while,

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[88] Mass. Gen. Laws ch. 62, § 4. On November 4, 2008, Massachusetts voters will decide whether to repeal the Commonwealth's income tax, but repeal is not expected to pass (see Tom Herman, *A Tax Revolt is Quietly Brewing In Some States*, Wall St. J., Aug. 20, 2008, at D1, D2).

[89] *Id.* § 10(c).

in others, taxability will not be so evident. In uncertain cases, the attorney might request a ruling from the state's taxation department if it has a procedure for issuing rulings. To minimize penalties and interest in unclear situations, the attorney might advise the trustee to file a timely return reporting that no tax is due and citing comparable cases from other jurisdictions. The attorney might also counsel the trustee to segregate funds to pay taxes, penalties, and interest if the filing position is unsuccessful. In any event, the attorney and trustee should take a no-tax position in an uncertain case only after advising the settlor and beneficiaries in writing of the proposed action.

This author is unaware of any case in which the taxation department of one state has sued a trustee in a court in another state to collect tax allegedly due the first state. Nor is this author aware of a reported case in which a trustee has been surcharged for failing to minimize income tax. However, this author has heard that such cases are pending in New York State and believes that a successful surcharge case is inevitable.

H. Self-Settled Trust Option

In several instances,[90] the Internal Revenue Service ("IRS") has ruled that irrevocable self-settled trusts were nongrantor trusts. On the basis of these rulings, settlors are avoiding California, Massachusetts, New Jersey, and New York income tax on accumulated income and capital gains. Such settlors might later be able to receive discretionary distributions of the untaxed income. Although the IRS announced in July of 2007 that it is studying one aspect of the structure approved in the rulings (i.e., whether a member of a distribution committee has a general power of appointment),[91] clients may continue to use this strategy while that study is ongoing by employing different approaches (e.g., by appointing a three-member distribution committee in which a member who ceases to act is not replaced).

I. Source Income

The attorney should make sure that a small amount of source income will not taint an entire trust.[92] For example, it appears from the statute quoted in IV, A, above, that this is the case in New York.

J. Ethical Concerns

In some instances, it will be clear to the attorney that a trust will not be subject to state fiduciary income tax. In other situations, however, it will not be clear whether the tax of a given state applies to the trust or, if it does, whether imposition of the tax is constitutional in the circumstances. The ABA Committee on Ethics and Professional Responsibility has advised that:[93]

> [A] lawyer may advise reporting a position on a return even where the lawyer believes the position probably will not prevail, there is no "substantial authority" in support of the position, and there will be no disclosure of the position in the return. However, the position to be asserted must be one which the lawyer in good faith believes is warranted in existing law or can be supported by a good faith argument for an extension, modification or reversal of existing law. This requires that there is some realistic possibility of success if the matter is litigated. In addition, in his role as advisor, the lawyer should refer to potential penalties and other legal consequences should the client take the position advised.

VI. PLANNING FOR EXISTING TRUSTS

A. Introduction

Every trustee should review all trusts that he, she, or it administers to identify all trusts that are paying state income tax. With the assistance of counsel, the trustee should determine whether that tax can be reduced or eliminated. If tax has been paid erroneously, the trustee should request refunds for open years. If the trustee discovers that tax can be escaped, the trustee should consider filing a "final" return in the year before the occurrence of a major transaction (e.g., the sale of a large block of low-basis stock). At the same time, the trustee and the advising attorney must

[90] PLRs 200731019 (May 1, 2007), 200729025 (Apr. 10, 2007), 200715005 (Jan. 3, 2007), 200647001 (Aug. 7, 2006), 200637025 (June 5, 2006), 200612002 (Nov. 23, 2005), 200502014 (Sept. 17, 2004), 200247013 (Aug. 14, 2002), 200148028 (Aug. 27, 2001). *See* Thomas R. Pulsifer & Todd A. Flubacher, *Eliminate a Trust's State Income Tax*, 145 TR. & EST. 30 (May 2006); Bruce D. Steiner, *The Accidentally Perfect Non-Grantor Trust*, 144 TR. & EST. 28 (Sept. 2005).

[91] I.R. 2007-127, 2007 I.R.B. LEXIS 589 (July 9, 2007).

[92] *See* Philip J. Michaels & Laura M. Twomey, *How, Why, and When to Transfer the Situs of a Trust*, 31 EST. PLAN. 28, 29 (Jan. 2004).

[93] ABA Comm. on Ethics and Prof'l Responsibility, Formal Op. 352 (1985). *See* Dennis J. Ventry, Jr., *Lowering The Bar: ABA Formal Opinion* 85-352, 112 TAX NOTES 69 (July 3, 2006).

make sure that steps taken to avoid one state's tax won't subject the trust to tax elsewhere.

B. Trust Created by Will of Resident

If a state imposes its tax on a testamentary trust if the testator lived there at death, whether or not tax will continue to apply raises complex constitutional issues that were discussed in III, above. The constitutional issues involve the question of whether the state statute creating the basis on which the income tax is imposed violates various federal and state constitutional mandates, including the Commerce Clause and the Due Process Clause of the United States Constitution, and therefore can be safely ignored in the absence of any continuing nexus between the trust and the original state.

As discussed in IV, above, New York, New Jersey, and other states offer clear guidance on how to avoid tax. To escape tax in these states or to improve prospects for avoiding tax in states where the rules are not as clear, the trustee might explore transferring the trust's situs to another state, which might be accomplished by a provision in the governing instrument or by a state statute or court procedure. Wisconsin recognizes that a change of situs will end a testamentary trust's liability for tax,[94] and a Pennsylvania ruling came to this result.[95]

C. Inter Vivos Trust Created by Resident

To determine whether a state's income tax on an inter vivos trust created by a resident can be avoided, the trustee and attorney should go through a process comparable to that described in B, above.

D. Trust Administered in State

Here, it might be possible to escape tax simply by changing the place where the trust is administered, with or without court involvement.

E. Resident Trustee

In states that tax on this basis, it should be possible to escape tax simply by replacing the resident fiduciaries with nonresident fiduciaries.

F. Resident Beneficiary

Short of having the beneficiary move, it is difficult if not impossible to prevent a resident beneficiary from being taxed on current distributions. Nonetheless, the attorney and trustee should make sure that tax is not paid prematurely on accumulated income and capital gains.

G. Federal Transfer Tax Consequences

Taking action (e.g., changing the trustee or place of administration) to avoid state income tax will not cause a trust that is grandfathered for federal generation-skipping transfer tax purposes (because it was irrevocable on September 25, 1985) to lose that status.[96] Because the IRS says that it is safe to modify a trust to which GST exemption has been allocated if the change would have been acceptable for a grandfathered trust,[97] the trustee and attorney may take steps to avoid state income tax in an exempt trust without adverse tax consequences.

VII. CONCLUSION

Managing state income tax liability is a critical aspect of planning and administering a trust. If done properly, the attorney and trustee may provide substantial benefits to the beneficiaries. If done poorly, it may subject the trust to significant needless cost. As far as this author is aware, no court has yet held an attorney or trustee liable for failing to minimize or avoid state income tax, but such a case probably is not far off. Accordingly, attorneys and trustees ignore this crucial issue at their peril.

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[94] *See* 2007 Wis. Form 2 at 1.

[95] No. PIT-01-040 (July 27, 2001).

[96] *See* Reg. § 26.2601-1(b)(4)(i)(D)(2).

[97] *See, e.g.*, PLR 200841027 (May 30, 2008).

Appendix

BASES OF STATE INCOME TAXATION OF NONGRANTOR TRUSTS

State	Citations	Top 2007 Rate	Trust Created by Will of Resident	Inter Vivos Trust Created by Resident	Trust Administered in State	Resident Trustee	Resident Non-contingent Beneficiary
Alabama	Ala. Code §§ 40-18-1, 40-18-2, 40-18-5, 40-18-25; Ala. Admin. Code r. 810-3-25-.10–810-3-25-.12, 810-3-25-.14; Pp. 2–3 of instructions to 2007 Ala. Form 41.	5.00% on inc. over $3,000	X[1]	X[1]			
Alaska	No income tax imposed on trusts.						
Arizona	Ariz. Rev. Stat. §§ 43-1001(2), 43-1011, 43-1301(5), 43-1311; P. 1 of instructions to 2007 Ariz. Form 141AZ.	4.54% on inc. over $150,000				X	
Arkansas	Ark. Code Ann. §§ 26-51-201, 26-51-203, 26-51-406; Ark. Inc. Tax. Reg. §§ 4.26-51-102, 9.26-51-102; Pp. 1, 3 of instructions to 2007 Ark. AR1002.	7.00% on inc. over $49,999	X[2]	X[2]			
California	Cal. Rev. & Tax. Code §§ 17041(a), (e), (h), 17043(a), 17731, 17742–17745; Cal. Code Regs. tit. 18, §§ 17743–17744; P. 14 of instructions to 2007 Cal. Form 541.	10.30% on inc. over $1 million				X	X
Colorado	Colo. Rev. Stat. §§ 39-22-103(10), 39-22-104, 39-22-401; P. 3 of instructions to 2007 Colo. Form 105.	4.63%			X		
Connecticut	Conn. Gen. Stat. §§ 12-700(a)(6)(D), (a)(7), 12-701(a)(4)(C), (D), (a)(19); Conn. Agencies Regs. §§ 12-701(a)(4)-1, 12-701(a)(9)-1; Pp. 5, 7 of instructions to 2007 Form CT-1041.	5.00%	X	X[3]			
Delaware	30 Del. C. §§ 1102(a), 1105, 1601(8), 1605(b), 1631, 1635–1636; P. 1 of instructions to 2007 Del. Form 400-I.	5.95% on inc. over $60,000	X[4]	X[4]		X[4]	

Bases of State Income Taxation of Nongrantor Trusts

State	Citations	Top 2007 Rate	Trust Created by Will of Resident	Inter Vivos Trust Created by Resident	Trust Administered in State	Resident Trustee	Resident Non-contingent Beneficiary
District of Columbia	D.C. Code §§ 47-1806.03, 47-1809.01, 47-1809.03, 47-1809.08–47-1809.09; P. 6 of instructions to 2007 D.C. D-41.	8.50% on inc. over $40,000	X	X			
Florida	No income tax imposed on trusts; Florida intangible personal property tax repealed for 2007 and later years.						
Georgia	Ga. Code Ann. §§ 48-7-20(b), (d), 48-7-22, 48-7-27, Ga. Comp. R. & Regs. r. 560-7-3-.07; P. 2 of instructions to 2007 Ga. Form 501.	6.00% on inc. over $7,000			X	X	X
Hawaii	Haw. Rev. Stat. §§ 235-1, 235-2.3, 235-4, 235-4.5, 235-51; Haw. Admin. Rules § 18-235-1.17; P. 1 of instructions to 2007 Haw. Form N-40.	8.25% on inc. over $40,000			X[4]	X[4]	
Idaho	Idaho Code §§ 63-3011B, 63-3011C, 63-3024; Idaho Admin. Code Regs. 35.01.01.035, 35.01.01.075, 35.01.01.261; P. 1 of instructions to 2007 Idaho Form 66.	7.80% on inc. over $24,736	X[5]	X[5]	X[5]	X[5]	
Illinois	35 Ill. Comp. Stat. 5/201(a), (b)(3), 5/1501(20); Ill. Admin. Code tit. 86, § 100.3020(a); P. 4 of instructions to 2007 IL-1041.	3.00%	X	X			
Indiana	Ind. Code §§ 6-3-1-3.5, 6-3-1-12(d), 6-3-1-14, 6-3-2-1; Ind. Admin. Code tit. 45, r. 3.1-1-21(d), r. 3.1-1-12; P. 1 of instructions to 2007 Ind. Form IT-41.	3.40%			X		
Iowa	Iowa Code §§ 422.4–422.7, 422.9; Iowa Admin. Code r. 701-89.3(422); P. 1 of instructions to 2007 Iowa Form IA 1041	8.98% on inc. over $60,435	X[5]		X[5]	X[5]	

Bases of State Income Taxation of Nongrantor Trusts

State	Citations	Top 2007 Rate	Trust Created by Will of Resident	Inter Vivos Trust Created by Resident	Trust Administered in State	Resident Trustee	Resident Non-contingent Beneficiary
Kansas	Kan. Stat. Ann. §§ 79-32,109, 79-32,110(a)(2), (d), 79-32,134; P. 3 of instructions to 2007 Kan. Form K-41.	6.45% on inc. over $30,000			X		
Kentucky	Ky. Rev. Stat. Ann. §§ 141.010(9)–(11), 141.020, 141.030(1); 103 Ky. Admin. Regs. 19:010; Pp. 1, 5 of instructions to 2007 Ky. Form 741.	6.00% on inc. over $75,000				X	
Louisiana	La. Rev. Stat. Ann. §§ 47:181–47:182, 47:187, 47:300.1–47:300.3, 47:300.6, 47:300.10(3); P. 5 of instructions to 2007 La. Form IT-541.	6.00% on inc. over $50,000	X		X[6]		
Maine	Me. Rev. Stat. Ann. tit. 36, §§ 5102(1-C), (A), (4), 5111, 5121, 5160, 5403; P. 11 of instructions to 2007 Form 1041ME.	8.50% on inc. over $18,950	X	X			
Maryland	Md. Code Ann., Tax–Gen. § 10-101(e), (g), (k)(1), 10-102, 10-105; P. 1 of instructions to 2007 Md. Form 504.	4.75% on inc. over $3,000	X	X	X		
Massachusetts	Mass. Gen. Laws ch. 62, §§ 4, 10(a), (c), (e); Mass. Regs. Code tit. 830, § 62.10.1; P. 4 of instructions to 2007 Mass. Form 2.	5.30% (12.00% for short-term gains & gains on sales of collectibles)	X[7]	X[4, 7]			
Michigan	Mich. Comp. Laws §§ 206.16, 206.18(1)(c), 206.51(1)(f), (g), (6); P. 2 of instructions to 2007 MI-1041.	4.01%	X	X[8]			
Minnesota	Minn. Stat. §§ 290.01 Subd. 7b, 290.03(3), 290.06 Subd. 2c; P. 1 of instructions to 2007 Minn. Form M2.	7.85% on inc. over $75,000	X[9]	X[9]	X[10]		

Bases of State Income Taxation of Nongrantor Trusts

State	Citations	Top 2007 Rate	Trust Created by Will of Resident	Inter Vivos Trust Created by Resident	Trust Administered in State	Resident Trustee	Resident Non-contingent Beneficiary
Mississippi	Miss. Code Ann. §§ 27-7-5(1), 27-7-27; CMSR 48-030-001, Regs. 101, 1001; P. 1 of instructions to 2007 Miss. Form 81-110.	5.00% on inc. over $10,000			X		
Missouri	RSMo §§ 143.011, 143.061, 143.111, 143.121, 143.311, 143.331, 143.341; P. 1 of instructions to 2007 Form MO-1041.	6.00% on inc. over $9,000	X[11]	X[11]			
Montana	Mont. Code Ann. §§ 15-30-101(32), 15-30-103, 15-30-111, 15-30-135, 15-30-137; P. 1 of instructions to 2007 Mont. Form FID-3.	6.90% on inc. over $14,900	X[5]	X[5]	X[5]	X[5]	
Nebraska	Neb. Rev. Stat. §§ 77-2714.01(6), 77-2715, 77-2715.02, 77-2716, 77-2717; Neb. Admin. Code REG-23-001, REG-23-004; P. 2 of instructions to 2007 Neb. Form 1041N.	6.84% on inc. over $15,150	X	X			
Nevada	No income tax imposed on trusts.						
New Hampshire	N.H. Rev. Stat. Ann. §§ 77:1, 77:10–77:11; N.H. Code Admin. R. Ann. 902.07; P. 10 of instructions to 2007 N.H. Form DP-10.	5.00%				X[4]	
New Jersey	NJSA §§ 54A:1-2(o), 54A:2-1, 54A:5-1, 54A:5-3; P. 1 of instructions to 2007 Form NJ-1041.	8.97% on inc. over $500,000	X[12]	X[12]			
New Mexico	N.M. Stat. Ann. §§ 7-2-2–7-2-3, 7-2-7(C); P. 1 of instructions to 2007 N.M. Form F1D-1.	5.30% on inc. over $16,000			X	X	

Bases of State Income Taxation of Nongrantor Trusts

State	Citations	Top 2007 Rate	Trust Created by Will of Resident	Inter Vivos Trust Created by Resident	Trust Administered in State	Resident Trustee	Resident Non-contingent Beneficiary
New York	N.Y. Tax Law §§ 601(c)(1), 605(b)(3)(B), 611–612, 618; N.Y. Comp. Codes R. & Regs. tit. 20, §§ 105.23, 118.1; P. 2 of instructions to 2007 N.Y. Form IT-205.	6.85% on inc. over $20,000 (10.498% for NYC resident on inc. over $50,000)	X[12]	X[12]			
North Carolina	N.C. Gen. Stat. §§ 105-134.1, 105-134.2(a)(3), 105-134.5, 105-160.1–105-160.2, 105-228.90; N.C. Admin. Code tit. 17, r. 06B.3716; P. 1 of instructions to 2007 N.C. Form D-407.	8.00% on inc. over 120,000					X
North Dakota	N.D. Cent. Code §§ 57-38-01(12), 57-38-02, 57-38-07, 57-38-29; N.D. Admin. Code § 81-03-02.1-04; P. 2 of instructions to 2007 N.D. Form 38.	5.54% on inc. over $10,450			X	X	X
Ohio	Ohio Rev. Code Ann. §§ 5747.01(A), (I)(3), (S), 5747.02(A)(5), (D), (E); P. 1 of instructions to 2007 Ohio Form IT 1041.	6.555% on inc. over $200,000	X	X[4]			
Oklahoma	Okla. Stat. tit. 68, §§ 2353(6), (12), 2355(B), (F); Okla. Admin. Code § 710:50-23-1(c); P. 2 of instructions to 2007 Okla. Form 513.	5.65% on inc. over $90,000	X	X			
Oregon	Or. Rev. Stat. §§ 316.022(6), 316.037(1)(a), 316.267, 316. 282(1)(d), (2); Or. Admin. R. 150-316.282(3); P. 1 of instructions to 2007 Or. Form 41.	9.00% on inc. over $7,150			X	X	
Pennsylvania	72 P.S. §§ 7301(s), 7302, 7305; 61 Pa. Code §§ 101.1, 105.4; P. 5 of instructions to 2007 Form PA-41.	3.07%	X	X			

Bases of State Income Taxation of Nongrantor Trusts

State	Citations	Top 2007 Rate	Trust Created by Will of Resident	Inter Vivos Trust Created by Resident	Trust Administered in State	Resident Trustee	Resident Non-contingent Beneficiary
Rhode Island	R. I. Gen. Laws §§ 44-30-1(a), (e), 44-30-2(a)(1), (b), 44-30-2.6(a), (b), (c)(2)(A)(5), 44-30-5(c); R.I. Code R. PIT. 90-13; Pp. 1-1, 1-3 of instructions to 2007 Form RI-1041.	9.90% on inc. over $10,450	X[4]	X[4]			
South Carolina	S.C. Code Ann. §§ 12-6-30(5), 12-6-510–12-6-520, 12-6-560, 12-6-610; P. 1 of instructions to 2007 Form SC1041.	7.00% on inc. over $13,150			X		
South Dakota	No income tax imposed on trusts.						
Tennessee	Tenn. Code Ann. §§ 67-2-102, 67-2-110(a); P. 1 of instructions to 2007 Tenn. Form Inc. 250.	6.00%					X
Texas	No income tax imposed on trusts.						
Utah	Utah Code Ann. §§ 59-10-103(1)(a), (r), (w), 59-10-104, 59-10-201, 75-7-103(1)(i); Pp. 1–2 of instructions to 2007 UT Form TC-41.	6.98% on inc. over $5,500	X		X[13]		
Vermont	Vt. Stat. Ann. tit. 32, §§ 5811(11)(B), 5822(a), (a)(5); P. 1 of instructions to 2007 Vt. Form FI-161.	9.50% on inc. over $10,450	X	X			
Virginia	Va. Code Ann. §§ 58.1-302, 58.1-320, 58.1-322, 58.1-360–58.1-361; 23 Va. Admin. Code § 10-115-10; P. 1 of instructions to 2007 Va. Form 770.	5.75% on inc. over $17,000	X	X	X	X	
Washington	No income tax imposed on trusts.						

Bases of State Income Taxation of Nongrantor Trusts

State	Citations	Top 2007 Rate	Trust Created by Will of Resident	Inter Vivos Trust Created by Resident	Trust Administered in State	Resident Trustee	Resident Non-contingent Beneficiary
West Virginia	W. Va. Code §§ 11-21-3, 11-21-4e, 11-21-7(c), 11-21-11–11-21-12, 11-21-18; W. Va. Code St. R. § 110-21-7(7.3); P. 2 of instructions to 2007 W. Va. Form IT-141.	6.50% on inc. over $60,000	X	X			
Wisconsin	Wis. Stat. §§ 71.01(4), (11), (13), (16), 71.02(1), 71.06(1p), 71.14(2), (3), 71.17(4), 71.122, 71.125(1); P. 1 of instructions to 2007 Wis. Form 2.	6.75% on inc. over $142,650	X	X[14]	X[15]		
Wyoming	No income tax imposed on trusts.						

1 Provided that trust has resident fiduciary or current beneficiary.
2 Provided that trust has resident trustee.
3 Provided that trust has resident noncontingent beneficiary.
4 Provided that trust has resident beneficiary.
5 Provided that other requirements are met.
6 Unless trust designates governing law other than Louisiana.
7 Provided that trust has Massachusetts trustee.
8 Unless trustees, beneficiaries, and administration are outside Michigan.
9 Post-1995 trusts only.
10 Pre-1996 trusts only.
11 Provided that trust has resident income beneficiary on last day of year.
12 Unless trustees and trust assets are outside state and no source income.
13 Inter vivos trusts only.
14 Trusts created or first administered in Wisconsin after October 28, 1999, only.
15 Irrevocable inter vivos trusts administered in Wisconsin before October 29, 1999, only.

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