

STATE TAXATION OF TRUSTS: THE FOLLY OF APPLYING IMMUTABLE RULES TO A MUTABLE RELATIONSHIP

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I. WHAT IS A TRUST -- THE FAILURE OF ANALOGIES

A. As A Matter of Federal Tax Law: It's Like A Natural Person.

In order to ascertain the locus of a trust for the purpose of taxing it, a jurisdiction first needs to define the essence of a trust. Federal rules for locating the "residence" of a trust for income taxing purposes remained ambiguous until the recent adoption of regulations interpreting 1996 legislation which defines a trust as either domestic or foreign by reference to the situs of administration and to the residence or place of incorporation or citizenship of persons who may exercise control over the trust. For reasons which are not germane to state taxation of trusts, the bias of the current federal rule is to find that a trust is "foreign" rather than "domestic". Until trust specific rules for determination of residence were adopted at the federal level, the dominant federal view was that the rules applicable to the determination of the residence of an alien individual should be applied for the purpose of determining a foreign trust's residence. See *B.W. Jones Trust v. Commissioner*, 132 F.2d 914 (4th Cir. 1943) (holding that a foreign trust is like an alien individual).

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B. As A Matter of Trust Law: It's a "Relationship".

In order to grasp the essence of a trust, it is best to start with trust law, but to quote one of the leading modern English authorities on trusts, "[t]here is no statutory definition of the trust which can be used as a major premise from which rules relating to the trust can be deduced." See D.J. Hayton, *The Law of Trusts* 6 (2nd edition 1993). The term "trust" refers to a legal relationship which is created either during the lifetime of the settlor or upon the death of a testator. The relationship endures until the termination of the trust. Notwithstanding that a trust does not fail for temporary want of a trustee, the essence of the relationship is embodied in the trustee who may move, change or otherwise mutate during the term of a trust. It is the trustee, and the place where the trustee discharges his fiduciary obligations, that is the logical starting point for the taxation of the trust.

C. The D.C. Appellate Court: It's Like a Corporation.

Contrary to the federal appeals court decision in *B.W. Jones* which concluded that a trust was analogous to a natural person for purposes of making a residence determination, a more recent and controversial decision by the court of appeals for the District of Columbia concluded that a testamentary trust is like a corporation. See *District of Columbia v. Chase Manhattan Bank*, 689 A.2d 539, 544-545 (D.C. Ct. App. 1997). Building on this analogy the appellate court for the District of Columbia reasoned that the trust in question owed its existence to D.C. law because it had been created subject to D.C. law and that, in consequence, such a trust could be taxed forever by the District of Columbia notwithstanding that the parties to the relationship which was the essence of the trust (and the trust assets as well) had long since moved to other jurisdictions. Although some parallels might be drawn between the formation of a company in a civil law jurisdiction (by agreement before a notary and subject to a ministerial decree of "no objection" with the company's seat of management thereafter determining the company's situs), the process of obtaining an Anglo-American style corporate charter from the state (and the consequences attendant thereon) is distinctly different from the process whereunder the legal relationship known as a trust is created.

Unlike the formation of a corporation which derives in the U.S. from the grant by the state of a "charter", the state plays no role in the "birthing" of an inter vivos trust in the United States and the state would rarely if ever have notice of the creation of an inter vivos trust by one of its residents because there is no requirement to register the formation of a family trust and no requirement that a family trust be administered in accordance with the law of the settlor's residence or subject to the supervision of its courts. The connection between a testamentary trust and the state of the testator's residence at the moment of his death is more material, but it is not necessarily an enduring connection. The District of Columbia Court of Appeals acknowledged in *Chase* that the argument in favor of perpetual taxing authority premised upon the situs at creation is less persuasive in the case of an inter vivos trust. See 689 A.2d 539, n.11 at 542. Commentators have correctly questioned, however, whether the difference in the degree of state involvement at the moment of creation adequately addresses the troubling question of whether, even in the case of a testamentary trust, nexus at origin confers a power to tax in perpetuity. See Fogel, *What Have You Done for Me Lately? Constitutional Limitations on State Taxation of Trusts*, 32 U. RICH. L. REV. 165, 213 (1998).

II. THE NEXUS TO TAX

A. Due Process.

Constitutional limitations found in the due process clause have driven much of the intellectual debate regarding the propriety of the several different bases upon which political subdivisions of the United States have asserted or eschewed the authority to tax the income of trusts. There is arguably no other area of tax law governing a material issue in respect of which there is so much diversity and so little uniformity. Distilling the constitutional debate over the application of due process in the context of state taxation of trusts to a single sentence: Is there sufficient minimum contact between a trust and a particular state to give notice or fair warning that there is a tax obligation to such state inherent in the activity?

B. The Material Points of Contact.

There are four primary bases upon which a state may assert nexus adequate for levying tax upon the income of a non-grantor trust (viz. a trust which for income tax purposes is treated as an entity distinct from the person who has contributed property to the trust or who may revoke the trust and vest its assets in himself).

The contact points upon which the taxation of a non-grantor trust may be based include

- (i) the residence of the settlor at the time an irrevocable trust is funded or at the time a previously revocable trust becomes irrevocable or the residence of the testator at the moment of death where a testamentary trust is created under the terms of a will;
- (ii) the residence of the trustee;
- (iii) the place of trust administration (very frequently but not universally synonymous with the residence of the trustee); and
- (iv) the residence of the beneficiary.

C. The California Way.

California assesses tax on trust income which is generated by a non-grantor trust and is accumulated by the trust only if either at least one of the trustees or a noncontingent beneficiary is resident in California. In cases where there are multiple trustees or multiple noncontingent beneficiaries only some of whom are California residents, a fractional allocation is performed. The California approach seriously discourages the purposeful selection of California as a situs for professional trust administration, but it is very defensible approach from a constitutional standpoint and is likely to be altered only if major financial institutions in the State of California work to persuade the California legislature that a tax law that seriously discourages the selection of California as a base of administration for large family trusts serves only to deprive California of profitable financial services industry business without generating any material compensating

tax revenue. Cf. *Ronald Family Trust*, 2000 WL 1137423 (Cal. St. Bd. Eq.); reh. denied 2000 WL 1563189 (Cal. St. Bd. Eq.).

III. AUDACITY TRUMPS REASON

A. Taxation Premised Upon Dubious Nexus . . . A Legitimate Exercise of Taxing Power?

A state which endeavors to levy a tax on the income of a departed trust solely on the ground that such state was the residence of a settlor at the moment of trust formation is in no position to confer any meaningful benefit upon the departed trust or its property or its beneficiaries. Its assessment on such ground alone could accordingly be characterized more akin to an act of extortion than to a legitimate exercise of taxing power. Cf. *Union Transit Co. v. Kentucky*, 199 U.S. 194, 202 (1905). At least 18 states purport to tax a trust based solely upon the residence of the settlor or testator at the moment of the formation of an irrevocable inter vivos trust or a testamentary trust, but the courts of most of these states either have never been asked to adjudicate the constitutionality of a tax premised upon such nexus where the nexus has later “worn off” or (as is the case in New Jersey) have concluded that insufficient continuing contact may destroy nexus.

By winning judicial sanction from their own courts to push nexus to the outer limits of minimum contact in the form of contact at the moment of creation and nothing more, the District of Columbia and the State of Connecticut have upset the precedent created by the Missouri Supreme Court in *John S. Swift Jr. Trust v. Director of Revenue*, 727 S.W. 2d 880 (Mo. 1987). The Swift decision identified the domicile of the settlor and the jurisdiction of creation as meaningful but potentially irrelevant points of contact and required as a condition to the assessment of tax on trust income that at the time of determination of whether there exists nexus to tax there must be either trust property located in the taxing jurisdiction, a beneficiary domiciled in such jurisdiction, a trustee domiciled in such jurisdiction, or trust administration in such jurisdiction. The Swift test for nexus has been characterized as excessively formalistic but the reasoning in Swift has drawn higher marks than that in Chase. Cf. Fogel, *supra* 32 U. RICH. L. REV. 165, 206-210.

B. Lack of Uniformity and Overreaching Cost the Fisc.

Confusion engendered by the diverse approaches of the 50 states to the taxation of trusts, uncertainty regarding the constitutional limitations imposed upon state taxation and gross overreaching by a small number of jurisdictions encourage non-compliance and produce less revenue for the fisc than would reasonably be the case if all states acted in a coordinated and logical manner. "If a Resident Trust has connections to the state that are arguably inadequate to constitutionally support the income taxation of the trust by the state, then the trustee may reasonably take the position that the trust owes no income tax to that state and has no obligation to file state income tax returns. The only way for the state to contest the trustee's position is to audit the trust, which may be difficult since the trust likely files no tax return." See Fogel, *supra*, 32 U. RICH. L. REV. 165, 228 (1998).

C. The Futility of Enforcement When Contact is Lacking.

The likely futility (save where a large multi-state corporate fiduciary is acting as trustee) of jurisdictions such as the District of Columbia and Connecticut seeking to levy income taxes on departed trusts in respect of which neither a trustee nor a beneficiary nor trust property may any longer be found within its borders can be discerned from the failed efforts of the Internal Revenue Service to obtain information from, and to levy tax upon, former residents of the United States who have departed and maintain no meaningful continuing contacts with the United States. See Executive Summary from JCT Report on Individual Expatriation scheduled for release February 12, 2003, BNA Daily Tax Report (February 12, 2003), p. L-1 ("... the IRS generally has ceased all compliance efforts directly relating to the income, estate, and gift tax obligations of former citizens and former long-term residents under the Alternative Tax Regime, other than compiling a Certificate of Loss of Nationality ("CLN") database for such individuals ... the Joint Committee Staff believes the key reason for inadequate enforcement of the Alternative Tax Regime is the inability to obtain necessary information from individuals ...")

IV. IS A BRIGHT LINE TEST FOR THE TAXATION OF TRUSTS POSSIBLE

A. Taxation Based Upon Trustee Residence.

State taxation of a trust (characterized as “domestic” for federal purposes) based solely on the residence of the trustee (subject to a deduction for trust accounting income required to be distributed or actually distributed in lieu of being accumulated which income would be taxed by the jurisdiction in which the distributee beneficiary resides) has some appeal and is easily enforceable. The primary and quite understandable objection would be that several states within the United States offer substantial concessions with respect to the taxation of resident trusts. As a result, a bright line test establishing trustee residence as the sole ground for the taxation of accumulated trust income would accelerate the already occurring migration of trust business to select jurisdictions such as Delaware, New Jersey and South Dakota and would permit all accumulated income of such a trust to escape state level taxation much as U.S. source income accumulated by a foreign estate and later paid to a U.S. beneficiary may escape any federal income tax. Cf. IRC § 665(b) (accumulated distribution rules apply only to trusts).

B. Taxation Based Upon Beneficiary Residence.

Taxation of a trust itself based solely upon the residence(s) of its beneficiaries would be difficult to enforce if the trustee’s place of residence did not coincide with the place of residence of any of the beneficiaries, and such approach would produce arbitrary and capricious results. No state presently levies a tax upon a trust solely by reason of the residence of a contingent beneficiary within its borders. By contrast, linking taxation of trust income to a beneficiary who has actually received trust income or for whom trust income has been set aside is defensible from a constitutional standpoint, and it is very enforceable.

Opponents of linking the taxation of trust income exclusively to the act of receipt by, or set aside for, a beneficiary would argue that unless the exceedingly complex federal rules governing accumulation distributions from offshore trusts to United States persons were imported into state law, a beneficiary would derive, at the minimum, the advantage of state tax deferral until receipt or set aside, and by removal of his residence from a high tax state to a low tax (or no tax) state

immediately in advance of an anticipated distribution the beneficiary could avoid tax altogether at the state level.

A U.S. citizen or resident's entire freedom to move at will from one state to another without state permission does, however, mean that, absent a constitutionally dubious imputation system, there will always be the opportunity for individuals to avoid state income tax if they are willing to suffer the inconvenience of a change of residence to avoid taxes and if they know how to take advantage of an income trapping mechanism whether it be by investment in a non-dividend paying growth stock, contribution to a pension trust, investment in whole or universal life insurance or suggestion to the trustee of a family trust created by a parent or remoter ancestor that distributions be deferred.

C. Modify the Definition of "DNI", Eschew the Complexity of Time Value Recapture and Tax the Act of Beneficiary Receipt.

Given the ability of well advised settlors to place material assets in trust with corporate fiduciaries situated in domestic jurisdictions of convenience, the best and simplest means for those states wishing to tax trust income to derive material revenue in respect of same is to focus upon distributions to or set asides for beneficiaries at a time when the beneficiaries are resident within the taxing state's jurisdiction and to keep the tax on such distributions or set asides simple. Such a species of "remittance based taxation" would be somewhat analogous to the Singapore approach to the taxation of income generated by its residents outside of Singapore. It will not satisfy the tax purists but its simplicity and its enforceability make it a fairer and more effective revenue raiser than other approaches to the taxation of trust income.

Importing federal trust accounting rules aimed at distributions from an offshore trust to a U.S. person into state law to filter out the benefit of tax deferral would enrich no one but accountants and members of the tax bar. Modifying the federal definition of distributable net income to include capital gains (as is already the case at the federal level in respect of foreign trusts) would be a simple fix which would prevent capital profits generated by a trust from escaping state income tax on distribution. Eschewing efforts to impose throwback principles for the purpose

of catching distributions aimed at the low income year of a beneficiary, and eschewing complex surcharge provisions to capture the otherwise lost time value of money, would enhance compliance and diminish the incentive on the part of the very wealthy to remove their residences to more favorable tax jurisdictions in advance of large anticipated trust, pension or insurance distributions.

V. HOW DO PLANNERS AND TRUSTEES COPE WITH PRESENT CIRCUMSTANCES

A. Does It Matter What Law Governs the Trust?

The law governing determination of the essential validity of a trust at the moment of formation is typically determined by reference either to the residence of the settlor or to the residence of the trustee who first accepts the trust, and it is immutable. Such law should be as irrelevant to the ongoing determination of nexus for taxing as is the residence of the settlor at the moment of irrevocable funding.

More material to taxing nexus is the law which governs the administration and interpretation of a trust in place. Such law may and should change at such times as the place of trust administration is changed (typically by reason of a change of trustee or, in the case of a natural person trustee, a change of residence). It is dubious whether a court in State A asked to interpret a trust in accordance with the law of State B would be inclined to do more in most circumstances (and absent costly presentations in support of foreign law principles) than to assume that the law of State B was no different from the law of State A. Given this practical reality, nothing is to be gained from having a trust which has acquired a new place of administration remain subject to interpretation in accordance with the laws of its former place of administration, an action which may only invite the tax authority of its place of former administration to find grounds to continue to assess a tax on such trust's income.

B. Planning for Changes in Trustee Residence or in Place of Trust Administration.

Complex trust agreements of the international variety typically instruct the trustee and any trust advisor who is contemplating a change in the place of trust administration to "have due regard for the taxation of a trust and its beneficiaries and for the security of the trust property . . ." when choosing a jurisdiction in which

to administer and manage a trust. Although such language is not commonplace in most domestic trusts, the suggestion of one commentator that it should be included in a domestic trust agreement is well taken.

Where the trustee is a natural person, the trust and its beneficiaries are of necessity hostage to the potential tax implications of a change of residence by the trustee. Regardless of what the trust agreement says, most individuals are not going to arrange their personal lifestyles in deference to their obligations as trustees. This is a material argument in favor of a corporate fiduciary where substantial assets are involved and a long term non-grantor trust is contemplated.

C. Keep Track of Beneficiary Residence.

The mobility of beneficiaries complicates the task of a trustee who is obliged to provide the state equivalent of a federal "K-1" to beneficiaries resident in jurisdictions which tax trust income at the state level. One commentator's suggestion that beneficiaries be required to notify a trustee in the event of a change of residence would seem to impose an obligation upon a party not subject to the terms of the trust agreement or declaration, but absolving a trustee from surcharge in the event a beneficiary incurs interest charges or penalties by reason of a failure to properly report trust income at the state level where the trustee has not been properly informed of the beneficiary's current residence would be entirely reasonable.

D. Defining and Identifying "Trustees".

The question "who is a fiduciary for purposes of determining trust nexus" in those states which tax a trust on the basis of the residence of a trustee is, to borrow from the words of Winston Churchill, a riddle wrapped within an enigma. Does the State of California acquire nexus sufficient for assessing state income taxes solely by reason of the residence within the California of either

- (a) an individual holding a limited power of appointment over a trust exercisable in a fiduciary capacity, or

- (b) a person acting in the role of protector whose power is limited to removing a corporate fiduciary and replacing such fiduciary with a successor independent fiduciary, or
- (c) a trust advisor who acting in a fiduciary capacity may direct the weighting of investment or the retention of certain assets or securities, but who leaves to the trustee the day-to-day investment management chores?

Logic and the examples contained in the California Code of Regulations Title 18, § 17743 suggest that, for nexus and allocation purposes, a “fiduciary” in this context is a trustee who holds and administers trust property from which a tax may be paid, not a person who exercises certain reserved or appointed powers in a fiduciary capacity, but who does not hold trust assets and who has no means to take them into his possession. Nonetheless the question is not wholly free of doubt.

One commentator who has addressed this issue in the context of a New Jersey example has correctly observed that a trust protector who controls trust distributions and trust investments might provide more nexus than a trustee who is a mere custodian, but he has conceded that “it is important to realize . . . that expanding the class of individuals whose residence may be constitutionally significant increases the complexity of a constitutional limitation on the state income taxation of Resident Trusts”. See Fogel, *supra*, 32 U. RICH. L. REV. 165, 223.