McDermott Will & Emery

State Income Tax Considerations and Current Income Tax Litigation

Chase Center on the Riverfront
Tuesday, October 26, 2016
10:30 AM — 12:00 PM

www.mwe.com

Boston Brussels Chicago Dallas Düsseldorf Frankfurt Houston London Los Angeles Miami Milan Munich New York Orange County Paris Rome Seoul Silicon Valley Washington, D.C.

Strategic alliance with MWE China Law Offices (Shanghai)

Presenters

James H. Cundiff
Partner
McDermott Will & Emery LLP
227 West Monroe Street
Chicago, IL 60606
(312) 984.7535
jcundiff@mwe.com

Thomas M. Forrest
President
U.S. Trust Company of Delaware
DE5-002-04-12
1100 N. King Street
Wilmington, DE 19884
302.416.3392
thomas.m.forrest@ustrust.com

George W. Kern
Managing Director
Regional Director
Bessemer Trust Co. of Delaware
1007 N. Orange Street, St 1450
Wilmington DE 19801
302.230.2684
kern@bessemer.com

Architecture Is Evolving – No Longer Safe To Ignore Or "Stay Put"

McDermott Will & Emery

- After a period of stability, recent cases have challenged the validity of state income tax regimes
  - Three cases decided in 2013
  - Two trust tax cases decided in 2016
  - In addition, a Supreme Court decision on state taxation in 2016
- Evolution is resulting from a combination of:
  - Success of constitutional challenges
  - Availability of tax-free jurisdictions
  - Relatively low cost to move trusts and administer in new jurisdiction

Five Bases for Income Taxation of Trusts

McDermott Will & Emery

- Trust created under a resident's will
- Inter vivos trust created by a resident
- Trust administered within a state
- Resident trustee
- Resident beneficiary

Tax Haven States

- Many states do not impose an income tax on trusts under any circumstances
  – Alaska
  – Florida
  – Nevada
  – South Dakota
  – Texas
  – Washington
  – Wyoming

Quasi-Tax Haven States

- Other states do not impose an income tax unless trust beneficiaries live in state
  - Delaware
  - New Hampshire
- Other states are tax free if trust not created by state resident
  - Connecticut
  - Illinois
  - New York

Income Taxation Is Not The Only Consideration

McDermott Will & Emery

- Other factors are relevant in choosing a state for trust situs
  - Trust laws
  - Court systems
  - Creditor protection laws
  - Private trust company laws
  - Perpetual trust provisions
  - Investment rules

Why Are Trusts So Difficult To "Tax" Locate?

McDermott Will & Emery

- Trusts are <u>not</u> entities
- Trusts are fiduciary relationships between trustees and beneficiaries
  - Difficult to determine where a fiduciary relationship "lives," and states take different approaches
  - Compare with corporations and individuals
    - Corporations and individuals are taxed based on:
      - State of residence (corporations are resident of state of incorporation or principal place of business)
      - States where they have source income

Trusts Are Complicated Relationships

McDermott Will & Emery

– Trusts can involve multiple parties and assets located in various states:
  - Trustees
  - Other officeholders
    - Investment advisers, protectors, removers, appointers
    - Fiduciary and non-fiduciary responsibilities
  - Beneficiaries
    - Current, remainder, mandatory, discretionary
  - Trust assets and income
    - Real property, intangible property, source income

How Are Trusts Created?

McDermott Will & Emery

- "Testamentary Trust"
  - A trust created under a decedent's will
  - Some probate courts issue letters of trusteeship authorizing the trustees to act
- "Inter Vivos Trust"
  - A trust created by conveyance during a person's lifetime
  - The trust can be revocable or irrevocable
  - A revocable trust that becomes irrevocable at death is still an inter vivos trust

“Once Taxable, Forever Taxable”

- Tax regimes based solely on residence of grantor are under scrutiny
  - “Resident trust” defined in statute as:
    - Testamentary trust created by decedent residing in state at death or
    - Inter vivos trust created by grantor residing in state when trust became irrevocable
  - No additional, ongoing connections are required
  - If individuals can move, why not trusts?

Over 50 Years Since *Mercantile* …

McDermott Will & Emery

- Tax regimes based on the residence of the grantor have been under attack for years, with limited success until recently.
- *Mercantile-Safe Deposit & Trust Co. v. Murphy* was decided in 1963.
  - NY adopted regulations in 1992, and amended its statute in 2003 to codify the holding in *Mercantile* that the NY state income tax will not apply to a resident trust if:
    - No NY resident trustees
    - No NY property and
    - No NY source income

Other Relevant Cases Establishing Framework

McDermott Will & Emery

- *Pennoyer* – New Jersey (1983)
- *In re Swift* – Missouri (1987)
- *Blue v. Michigan* – Michigan (1990)
- *Westfall v. Department of Revenue* – Missouri (1991)
- *Quill Corp. v. North Dakota* – U.S. Supreme Court (1992)
- *District of Columbia v. Chase Manhattan Bank* – D.C. (1997)
- *Chase Manhattan Bank v. Gavin* – Connecticut (1999)

Challenges Based on Constitutional Grounds

McDermott Will & Emery

- Due Process Clause
  - Minimum connection between a state and the trust
  - Tax must be rationally related to values connected with the taxing state
- Commerce Clause
  - Tax must be:
    - Applied to activity with a substantial nexus with the taxing state
    - Fairly apportioned
    - Cannot discriminate against interstate commerce
    - Fairly related to the services provided by the state

Litigation Heats Up in a Mobile Society – Three Cases in 2013

McDermott Will & Emery

- New Jersey
  - *Residuary Trust A v. Director* (2013)
    - Due Process grounds
- Pennsylvania
  - *McNeil v. Commonwealth of Pennsylvania* (2013)
    - Commerce Clause grounds
- Illinois
  - *Linn v. Department of Revenue (2013)*
    - Due Process grounds

Residuary Trust A v. Director (New Jersey)

McDermott Will & Emery

- Testamentary trust created by New Jersey grantor
- During 2006:
  - No New Jersey trustees or officeholders
  - No New Jersey property
  - No trust administration in New Jersey
- Source income (from S Corps) and location of beneficiaries ignored by court because of guidance issued by department of revenue

McNeil v. Commonwealth of Pennsylvania

McDermott Will & Emery

- Inter vivos trusts created by Pennsylvania resident
- During 2007:
  - No Pennsylvania trustees or officeholders
  - No Pennsylvania property
  - No Pennsylvania source income
  - No Pennsylvania governing law provisions
  - No trust administration in Pennsylvania
- Pennsylvania beneficiaries did not provide basis for taxation, per state tax regulations.

Linn v. Department of Revenue (Illinois)

McDermott Will & Emery

- Inter vivos trust initially created by Illinois grantor
- During 2006, no other Illinois contacts
  - No Illinois trustees or officeholders
  - No Illinois beneficiaries
  - No Illinois property
  - No Illinois source income
  - No Illinois governing law provisions
  - No trust administration in Illinois

Important Recent Cases

McDermott Will & Emery

- Massachusetts
  - *Bank of America, N.A. v. Commissioner of Revenue* (2016)
    - Statutory interpretation of term “inhabitant”
    - No constitutional arguments made on appeal
- North Carolina
  - *Kaestner 1992 Family Trust v. North Carolina (2016)*
    - Due Process grounds
- Relevant Supreme Court Decision
  - *Maryland v. Wynne (2016)*
    - Benchmark case for Commerce Clause analysis
    - Commerce Clause grounds

Bank of America v. Comm'r of Revenue (Massachusetts)

- Taxation requires Massachusetts residency or inhabitance of parties:
  - At lease one grantor or creator of the trust
  - At lease one trustee
- Case involves irrevocable inter vivos trusts
- Question was the residency or inhabitance of a corporate trustee?
- Bank argued that test was aimed at individuals and Bank failed trustee test, or alternatively, that it was the single domicile of the Bank
- Commissioner argued that the rules applied to Bank and a "permanent abode" would be anywhere that Bank does business for > 183 days
- Court favorably narrowed holding – Bank is inhabitant because a) the Bank maintained presence and activities in the state AND b) the Bank performed in state corporate trustee work for the particular trusts at issue

Kaestner 1992 Family Trust v. Dept. of Revenue (North Carolina)

McDermott Will & Emery

- New York resident created the Trust for the benefit of his descendants. Beneficiary of the Trust established residency in North Carolina.
  - All Trust administration and activities are out of state
  - No distributions to the trust beneficiary
  - Beneficiary cannot compel Trust distributions

  North Carolina assessed a tax on the undistributed Trust income based on the benefits provided to the North Carolina resident.
- Issue -- can North Carolina tax a trust based solely on the presence of a beneficiary in the state?
- Department argued that similar to domicile of trustee, the domicile of the beneficiary and the associated protections provided by the state, including benefits with respect to accumulated property, satisfy the minimum contacts of Due Process
- Court held that Supreme court holding in *Brooke v. Norfolk* controls and that the connections between a state and a beneficiary are insufficient to satisfy the requirements of Due Process, essentially agreeing that the "trust" and the beneficiary are "strangers" to each other.

Is Double Taxation Constitutional? *Maryland v. Wynne*

- U.S. Supreme Court previously held that the Commerce Clause and Due Process Clause allow the taxation of income by more than one state, provided that the tax is:
  - 1) applied to an activity with a substantial nexus to the taxing state;
  - 2) is fairly apportioned;
  - 3) does not discriminate against interstate commerce in favor of intrastate commerce; and
  - 4) is fairly related to the services provided by the taxing state
- Issue: Does Maryland's tax that provides a credit for taxes paid to other states for the state portion of the income tax but not for the county portion, violate the Commerce Clause?
- The Supreme Court ruled 5-4 that the tax failed the "internal consistency" test and discriminated against interstate commerce by subjecting income earned out of state to a higher tax rate than income earned entirely within state. Maryland's tax essentially operated as a tariff
- *Wynne* does not require states to provide a full credit for taxes paid to other states and political subdivisions. As a practical matter, this method is likely the most feasible since state taxing regimes generally prefer to tax residents on all income and tax nonresidents based on sourced income. Double taxation itself is not unconstitutional
- *Wynne* is the defining constitutional benchmark for state and local personal income taxes under the dormant Commerce Clause analysis. Following *Wynne*, taxpayers should watch for states or political subdivisions that impose taxes that violate the internal consistency doctrine

Evolutionary Changes : NY Revisions

McDermott Will & Emery

- New York revised statute in 2014 to include:
  - "Throwback tax" on distributions to resident beneficiaries from a New York exempt resident trust
    - Income accumulated after 12/31/2013 will be taxable to resident beneficiaries when/if there are distributions in subsequent years
    - "Income" not included in DNI (typically capital gains) would not be subject to throwback tax
  - Grantor trust treatment of certain "incomplete non-grantor trusts" (DING/NING) created by New York residents

– California (another high tax state) has long had a "throwback" tax

State Tax Regimes Based on Residency of Grantor Are Vulnerable

McDermott Will & Emery

- Taxation based solely on resident status of grantor could be vulnerable in other states
  - Connecticut *
  - District of Columbia
  - Maine
  - Michigan *
  - Nebraska
  - Ohio *
  - Oklahoma
  - Vermont
  - West Virginia

** Testamentary trusts do not require additional connection*

Which Trusts Will Benefit From Situs Change?

McDermott Will & Emery

- Examine trusts that are paying state income tax on dividends, interest, capital gains or other income retained in trust
- A trust's location generally will not affect:
  - Trusts taxed as grantor trusts as to grantors or beneficiaries
    - Grantor trusts are taxed to grantor or beneficiaries individually
  - Trusts that distribute all income
    - Trusts distributing income currently are taxed to income beneficiaries

But, Take Into Account Future Taxation

McDermott Will & Emery

- Even if taxes would not be decreased currently, consideration should be given to future events so that trusts are positioned favorably with respect to taxing states
  - Termination of grantor trust status
  - Location of trustees and administration
  - Flexibility to change situs and governing law

Is Your Trust Already Out Of Taxing State?

McDermott Will & Emery

- … or arguably out of a taxing state?
- Trust matrix should be developed to analyze connections with current taxing state(s)
  - Testamentary vs. inter vivos trust
  - Residence of trustees
  - Residence of beneficiaries
  - Location of trust assets
  - Source of trust income
  - Governing law provisions

Some Connections Are Stronger Than Others

McDermott Will & Emery

- Taxation based on in-state trust administration or residence of fiduciary are difficult to challenge
  - No cases have held for taxpayers on those facts
- Compare with taxation based on nominal connections
  - De minimus amount of source income
  - Single parcel of non-income producing real estate
  - Residency of beneficiary

Determining Where A Trust Is Administered

- Residence of trustees and other officeholders
- Location of trust records
- Custody of trust assets
- State where fiduciary decisions are made
- Court supervision over trust
- Are connections contractual or imposed by trust instrument?

Determining Whether Source Income Exists

McDermott Will & Emery

- Source income generally includes income from:
  - Real or tangible personal property located in state
  - Business carried on in state
  - Distributive share of state partnership income or gain
  - S corporation with state income or gain
- Source income generally does not include:
  - Interest, dividends or gains on intangible property (e.g., marketable securities)
  - C corporation income

Assess Strength Of “No Tax” Argument

- Does the trust fit squarely within the facts of relevant authority?
  - Consider statutory law of taxing state
  - Consider case law
    - Taxing state
    - Other jurisdictions
- Many trusts will be in a gray area
- Consider ongoing personal jurisdiction
  - Review long-arm statute of taxing state

Mechanics Of Getting Out Of Taxing State

McDermott Will & Emery

- Different mechanisms may be available to move the trust to a new state
  - Trust instrument may permit change in situs and governing law
  - Trust modification
    - Judicial or non-judicial
  - Decanting
    - Use law of new jurisdiction if possible
  - Severance
    - Separate tainted assets, income or beneficiaries
- It is often easy to establish situs with a tax favorable state and more difficult to eliminate nexus with the old state

Consider Other Tax Consequences

McDermott Will & Emery

- Treatment for federal income tax purposes
- When considering a decanting or other modification to avoid state income tax, consider whether modifications could have unintended federal tax consequences.
- Notice 2011-101
  - IRS is examining consequences of decantings in terms of:
    - Income tax
    - Gift tax
    - Generation-skipping transfer ("GST") tax

Filing Returns And Paying Tax

McDermott Will & Emery

- Trustees will have to weigh connections and ascertain reasonableness of reporting position
- Options include:
  - File but claim no tax due
  - File, then seek refund of tax paid
  - File final state income tax return
    - Tax status of a “final” return
    - Statute of limitations issues
- Consider risk of interest and penalties if state prevails on an underpayment
- Consider fiduciary responsibilities – a double edged sword
  - Trustee Should not pay tax that is not due
  - Trustee may be responsible for penalties associated with failure to pay tax that is due
  - Consider benefit of agreements with beneficiaries consider tax planning

Special Considerations from … Experience

McDermott Will & Emery

- Works of art in various states (see page 36)
- Section 645 election (see page 36)
- Select tax compliance issues (see page 37)
- Qualified Domestic Trust/directed trust investment issue (see page 38)
- Real estate in various states
- Alternative investment assets and source income
- LLCs, FLPs …
- Selection of corporate trustee
  - State Charted Trust Company
  - National Association
  - Private Trust Company
  - Location of service activities of corporate trustee

Experience: Art Collections and Section 645 Elections

McDermott Will & Emery

- Art Collections
  - Artwork held in LLC vs. artwork held directly by a trust
  - Some trusts pay substantial sales and use tax
  - Sale of artwork may generate capital gains/collectibles income
  - What are state income tax consequences?
- IRC Section 645 election
  - State income tax aspects of Section 645 election
  - Grantor lives in gross income state vs. Federal adjustment state vs. residence of beneficiaries
  - Pennsylvania estate with trust located in Delaware (and vice versa)

Experience: Tax Compliance Matters

McDermott Will & Emery

- Incorrect income tax returns filed by prior trustee
  - Revocable trust returns vs. irrevocable trust returns
  - No state income tax returns filed since trust established many years ago – and required in prior state
  - Amended tax returns? Who files tax returns?
- Is a new TIN required for a trustee receiving a trust assets as a result of a decanting?
- Trust contacts with multiple states create complex issues, sample:
  - Delaware Trust with Delaware and Indiana Co-Trustees
  - Oregon Investment advisor, Rhode Island and California beneficiaries

Experience: QDOT

McDermott Will & Emery

- Directed Delaware QDOT – Issues?

Staying Current on Tax Laws

- The lapse in activity in the state income tax area has ended abruptly
- Case law and statutory law are evolving relatively quickly
- Trustees will be required to stay current on changes in trust income tax laws
  - Avoid actions causing state income tax
  - Avoid inaction resulting in taxation through a change in law