The Story of Lisa: Three Different Approaches to State Fiduciary Income Taxation

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In this article, we will consider the story of Lisa and how various states tax the trust created for her benefit. (*The story of Lisa is purely fictional. Any resemblance to persons living or otherwise or to actual situations is purely coincidental.)*

Facts (or Fiction)

Lisa's father, Angelo, was a successful, self-made entrepreneur. Angelo built a large beverage distribution business on Long Island in New York state from the ground up. At the age of 70, Angelo sold his business for a handsome sum.

Lisa is married and has two minor children. She lives in Asheville, North Carolina. Lisa and her husband are both employed and own a home. Occasionally, Lisa's father helped her financially, but he had never made a large gift.

After the sale of his business closed, Angelo wanted to make a substantial gift to Lisa that would give her cash flow to improve her living standard and create a legacy for his grandchildren. Although Angelo had lived on Long Island his entire life, his tax adviser referred him to Smithers Trust Company of Delaware. Smithers and an attorney helped Angelo create an irrevocable Delaware trust known as the Lisa Legacy Trust. Smithers was named as the sole trustee. Lisa is entitled to all the trust's net income, and Smithers was given the discretion to distribute principal for the health, education, maintenance, or support of Lisa or any of her issue. Upon Lisa's death, the trust will be split into separate trusts for the primary benefit of each of her living children and each of her deceased children who has living issue. Angelo gifted $5 million in cash to the trust, which invested the funds in a portfolio of marketable securities managed by Smithers in Delaware. None of the trust's holdings are pass-through entities.

In 2018, the Lisa Legacy Trust earned $250,000 in net income, all of which was distributed to Lisa. The trust also had $100,000 of net long-term capital gain, which increased its corpus.

New York Analysis

New York generally imposes personal income tax on the New York taxable income of resident trusts. An inter vivos irrevocable trust created by a New York domiciliary is a New York resident trust. However, a New York resident trust is not subject to New York personal income tax if: all its trustees are domiciled outside New York; its entire corpus is located outside New York; and the trust has no New York-source income, determined as if the trust were a New York nonresident. If one or more of its trustees are domiciled in New York, a trust's intangible property is regarded as located in New York.

Although the New York Tax Law has a statutory provision that treats resident trusts lacking a sufficient connection to New York as nontaxable, the Due Process Clause of the U.S. Constitution must be satisfied before New York can impose income tax. In *Mobil Oil Corp. v. Commissioner of Taxes of Vermont*, the U.S. Supreme Court interpreted the Due Process Clause to require a minimum connection with the taxing state and a rational relationship between the income taxed by the state and the values of the taxpayer's income, assets, or activities within such state. If a New York resident trust with no New York trustee or assets had several million dollars of capital gain and $10 of New York-source income passing through from a partnership, it would not qualify as a nontaxable resident under the New York Tax Law. However, there does not appear to be a rational relationship between the income being taxed (several million dollars) and the value of the trust's activity in New York ($10). Consequently, New York could not tax all the trust's New York taxable income.

Nontaxable New York resident trusts must file an annual New York return certifying their lack of nexus to the state.

If a nontaxable New York resident trust accumulates income and then distributes it to a New York resident beneficiary in a later year, the distribution is taxable to the beneficiary, if it was accumulated after 2013, and the beneficiary was a New York resident at least 21 years old when the income was earned.

Since the Lisa Legacy Trust was irrevocable from its inception, and Angelo was domiciled in New York, when he created it, the trust is a New York resident. Smithers is the sole trustee, and it is domiciled in Delaware. The trust has no tangible property, and its intangible property is considered to be located outside New York, because the trust has no New York trustees. If the Lisa Legacy Trust were a New York nonresident, it would have no New York-source income, since its income comprises only interest, dividends, and capital gains from non-New York intangible property. Therefore, the Lisa Legacy Trust is a nontaxable New York resident trust. For each year that the trust is a nontaxable resident, it must file a New York return certifying that status.

Delaware Analysis

A Delaware resident trust is subject to Delaware income tax on its federal taxable income after Delaware adjustments. A trust that has only one trustee which is a business entity that has an

office in Delaware for conducting trust business during at least half of the taxable year is a Delaware resident trust.

A Delaware resident trust is allowed a deduction for its taxable income that has been set aside for later distribution to Delaware nonresident beneficiaries. The deduction is determined by computing the amount that would be distributed to each beneficiary, assuming the trust terminated on the last day of the taxable year. The presumed distributees may be living individuals or members of a class of beneficiaries not yet born. Beneficiaries not yet living are presumed to be residing with the person the relationship to whom determines or defines their membership in the class.

Since its only trustee is the Smithers Trust Company, which has an office in Delaware for conducting trust business, the Lisa Legacy Trust is a Delaware resident trust and subject to Delaware income tax on its federal taxable income after Delaware adjustments. However, all the trust's taxable income will ultimately be distributed to Lisa's issue. The future distributees either live in North Carolina or are presumed to be residing with Lisa in North Carolina. Therefore, all the trust's Delaware taxable income has been set aside for Delaware nonresidents. This entitles the trust to a deduction that will reduce its Delaware taxable income to zero.

North Carolina Analysis

North Carolina does not categorize trusts as either residents or nonresidents of the state. Rather, North Carolina law provides that trusts are taxable on all income that benefits North Carolina resident beneficiaries and all North Carolina-source income.

In June 2018, the Supreme Court of North Carolina upheld lower-court rulings in *The Kimberley Rice Kaestner 1992 Family Tr. v. N.C. Dep't of Revenue* that the state could not tax the income of a trust created by a New York resident under New York law with a Connecticut resident as its sole trustee, because it did not own property in North Carolina, and it had no North Carolina-source income. The beneficiaries of the Kaestner Trust were all North Carolina residents. Distributions could be made from the trust only at the discretion of the trustee. All meetings between the primary beneficiary and the trustee to discuss investment opportunities for the trust and whether the trust would make any distributions took place in New York. No distributions were made from the trust during any of the years at issue. The trust made a loan to the primary beneficiary, which was repaid. The trust's fiduciary accountings and tax returns were prepared in New York, where all its financial and legal records were maintained. The custodian of the trust's financial assets was located in Massachusetts.

The Kaestner Trust argued that North Carolina's taxation of its income based solely on the residence of its beneficiaries violated the Due Process and Commerce Clauses of the U.S. Constitution as well as the Law of the Land provision of the state constitution.

The North Carolina Supreme Court cited a 1928 United States Supreme Court opinion, *Brooke v. City of Norfolk*, finding that Virginia could not tax its resident on the property of a trust of which the resident was a beneficiary, because the trust was created and administered in Maryland, and the property never entered Virginia and was never in the beneficiary's possession and control. The Court held that assessing the beneficiary for tax on the property "is a bare proposition to

make the petitioner pay upon an interest to which she is a stranger." The North Carolina Supreme Court concluded this United States Supreme Court ruling indicated that a trust and its beneficiary are legally independent entities.

The North Carolina Supreme Court considered the Due Process Clause and the Law of the Land arguments first. Since it already concluded that the Kaestner Trust and its beneficiaries were to be treated as legally independent of one another, the court analyzed whether the trust had nexus to the state without regard to the residence of its beneficiaries. Of course, on that basis, no minimal connection between the Kaestner Trust and the state was found, and the court ruled that the requirements of the Due Process Clause and the state's Law of the Land provision had not been met. Since this meant the tax was unconstitutional, the court did not address the Commerce Clause.

In October 2018, the North Carolina Department of Revenue filed a petition for certiorari with the United States Supreme Court seeking review of the Kaestner Trust case. It is unclear why the state is pursuing this matter further or what new arguments it might make to support its position. Perhaps, it is inspired by the U.S. Supreme Court's decision in the *Wayfair case*, in which the Court found nexus under the Commerce Clause could exist without physical presence.
Under the statute as it now stands, the Lisa Legacy Trust is subject to North Carolina tax on all its income, since all its beneficiaries are North Carolina residents. However, the Lisa Legacy Trust has no connection to North Carolina other than the residence of its beneficiaries, which the highest court in the state has found insufficient to meet the requirements of the Due Process Clause. Unlike the Kaestner Trust, the Lisa Legacy Trust did make distributions to its income beneficiary. However, the beneficiary is subject to North Carolina tax on the income associated with those distributions, since she resides in the state. Taxing the trust would mean taxing income over which Lisa and her issue have no possession or control. In this author's opinion, unless the North Carolina Department of Revenue gets its desired result in the U.S. Supreme Court, the Lisa Legacy Trust does not have income subject to tax in North Carolina.

The decision to be made with regard to the Lisa Legacy Trust's North Carolina income tax is a difficult one. The state clearly intends to administer the law as written, until it has exhausted its final avenue of appeal. Therefore, while the state's petition is under consideration at the Supreme Court, or after certiorari is granted but before an opinion is rendered by the Court, the trust faces the risk of enforcement action, which could be costly. The Lisa Legacy Trust's tax advisers should consider filing the return in accordance with state law, having the trust pay the tax, and filing a written notice with the state that a contingent event is preventing the taxpayer from possessing the information needed to file an accurate and definite refund claim. This notice extends the closing of the period for claiming a refund to six months after the contingent event concludes.

Conclusion

The varied approaches states take in taxing the income of trusts require tax advisers to carefully consider each state individually. Ideally, state tax issues should be identified before a trust is created. While the fictitious trust in this article appears to have overcome the reach of three states (if the Kaestner Trust survives the Supreme Court challenge), the ending could easily have been an unhappy one. If Lisa was a co-trustee of the trust, that would give rise to a connection to

North Carolina that would allow the state to tax all the trust's income. If Smithers was not warned by the trust's tax adviser, it might have invested in publicly traded partnerships that would give the trust New York-source income, which would disqualify it from being a nontaxable New York resident. If one of Lisa's children grows up and moves to Delaware, it may be time to change trustees, since the Delaware deduction for income set aside for nonresident beneficiaries would be reduced. Communication and coordination among tax advisers, trustees, beneficiaries, and investment advisers leads to advance planning that minimizes state taxes and prevents the development of a crisis. A failure to plan is a plan to fail.

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