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Practices

Estate, Trust & Business Planning

Fiduciary Advisory Services

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Education

New York University School of Law
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University of Alabama School of Law
(2009, J.D., *magna cum laude*; Alabama Law Review, Senior Editor; Hugo Black Scholar; Recipient of Anna C. Curry Leadership Award; Bench and Bar Legal Honor Society; SBA Vice-President)

Wake Forest University
(2006, B.A.)

Admissions

State Bar: Alabama

Jennifer is a corporate lawyer who focuses her practice on business planning, estate & trust planning, general counsel services, and tax planning. Her clients include closely-held businesses and their owners, as well as high-net-worth individuals and families. Jennifer facilitates planning strategies with her clients by counseling them on risk management and asset protection, succession and exit planning, and wealth preservation. She also assists clients with business formations and choice of entity issues. Jennifer also has experience managing strategic business transactions for her clients, including mergers and acquisitions.

Jennifer works closely with her clients to ensure that their estate and business plans mesh seamlessly and to help them realize their goals. Her exceptional skills have been recognized by Chambers and Partners and by Best Lawyers in America© in the area of Trusts & Estates.

Jennifer is a member of Maynard Nexsen's Board of Directors and is actively involved in the Firm's Recruiting and Women's Initiative committees. She serves as co-chair of The Forum of Alabama Businesswomen ("FAB"), an external program series led by Maynard Nexsen's Women's Initiative. Jennifer holds an LL.M. in taxation from New York University and received her J.D., *magna cum laude*, from the University of Alabama School of Law. She received her B.A. from Wake Forest University.

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Recognition

- → Birmingham Business Journal 2022 Top 40 Under 40
- → Best Lawyers® 2021 "Lawyer of the Year" for Trusts and Estates
- → The Best Lawyers in America© for Trusts and Estates and Tax Law (2020 - present), Closely Held Companies and Family Business Law (2023 - present)
- → Chambers and Partners HNW Guide: The World's Leading High Net-Worth Advisors, Up and Coming in "Private Wealth Law" (2019-present)
- → Mid-South Super Lawyers "Rising Star" in Closely Held Businesses (2019)

Community & Professional

- → Alabama State Bar Association
- → Birmingham Bar Association, former Young Lawyers' Section Executive Board
- → American Bar Association
- → Birmingham Tax Forum
- → Estate Planning Council of Birmingham Junior Board
- → The Forum of Alabama Businesswomen, Co-Chair
- → GirlSpring's Women's Committee
- → Girls on the Run Sneaker Soiree Committee
- → Softball/Baseball Board for Homewood
- → United Way's Professional Advisory Council
- → UAB Comprehensive Cancer Center, Young Supporters Board - Vice President Advisory Board Relations, former Vice-President Strategic Planning
- → Leadership UAB (2013-2021)
- → Juvenile Diabetes Research Foundation, Junior Board - Secretary (2011-2013)

News

07.27.2023
Maynard Nexsen's Estate, Trust & Business Planning and Fiduciary Advisory Practices Recognized at the Highest Level in 2023 Chambers High Net Worth Guide

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200 Maynard Attorneys Recognized in The Best Lawyers in America© 2023

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08.04.2021
Maynard Earns Top Marks from Chambers in the 2021 High Net Worth Guide

06.01.2021
Maynard Receives High Marks from Chambers and Partners in 2021

State Income Tax Situs of Trusts

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I. Overview: This analysis of tax situs focuses on whether a particular trust is a "resident trust" of a given state for purposes of a state's income taxation of trusts. We will analyze how to determine which state or states may tax a trust as a resident trust.

A. Context: This analysis focuses on an income tax imposed on the trust itself, rather than the grantor or a beneficiary.

1. Is trust a grantor trust? Since a grantor trust is not considered a separate taxpayer, and its income is attributed to its grantor for income tax purposes, it is typically taxed by the state where the grantor resides. This tax situs analysis will focus on nongrantor trusts.
2. Was any of the trust income distributed to the beneficiaries? When trust income is distributed to beneficiaries, the tax is typically imposed directly on the beneficiary, rather than the trust. This tax situs analysis will focus on taxation of the undistributed income of the trust.
3. Was any of the income "source income" of a particular state? If a trust earns income from a trade or business operated in a state, or from the ownership or sale of property located in a state, the trust may be taxed by that state for its "source" income in that state, even if it is not a resident trust in that state. But in order to impose an income tax generally on all of a trust's net income, the trust must be a resident trust.
4. Is the trust situated in a state that does not have an income tax? Several States do not impose a state income tax on trusts: Alaska, Florida, Nevada, South Dakota, Tennessee, Texas and Wyoming.

B. Two-Part Analysis: To find a trust's tax situs, there are two questions to consider.

Question 1: Which states might have criteria to impose an income tax on this trust? In order to answer this question, the trustee should begin by considering the five criteria on which states base their taxation of trusts. All states base their taxation of trusts on one or more of the following five criteria.

1. The trust was created by a resident of the state.
   a. Testamentary Trust – the testator was a resident of the state at the time of death.
   b. Inter Vivos Trust –the settlor was a resident of the state when the trust was created or when the trust became irrevocable.
2. One or more of the trustees resides in the state.
3. A trust beneficiary resides in the state.
4. The trust is administered in the state.

5. The trust is governed by the law of the state.[1]

Question 2: Is a state tax statute constitutionally valid, as applied to this trust? After identifying states that might impose a tax on the trust, the tax statutes of those states should be reviewed to see if the imposition of tax on the trust is valid under the due process clause and the commerce clause of the U.S. Constitution.

Due Process Clause. The U.S. Supreme Court has summarized the due process requirement as it relates to state taxation of a trust in the recent case of *North Carolina Deparment of Revenue v. The Kimberley Rice Kaestner 1992 Family Trust*:[2]

> In the context of state taxation, the Due Process Clause limits States to imposing only taxes that "bear fiscal relation to protection, opportunities and benefits given by the state." ... The power to tax is, of course, "essential to the very existence of government," but the legitimacy of that power requires drawing a line between taxation and mere unjustified "confiscation."... That boundary turns on "[t]he simple but controlling question ... whether the state has given anything for which it can ask return."[3]

The requirements of due process cannot be reduced to a bright-line rule, but involve a fact-specific analysis. The *Kaestner* court noted that there are two elements to that analysis.[4]

1. Minimum contacts. First, there is a requirement that "there must be some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax."[5]

2. Benefits Connected to the Taxing State. Second, the income attributed to the state for tax purposes must be rationally related to "values connected with the taxing state."[6] As the *Kaestner* court also noted, "Ultimately, only those who derive 'benefits and protection' from associating with a State should have obligations to the State in question."[7]

Commerce Clause. The U.S. Supreme Court has described a 4-part test for satisfying the Commerce Clause. A tax will be sustained against a Commerce Clause challenge "so long as the tax:

1. is applied to an activity with a substantial nexus with the taxing State,
2. is fairly apportioned,
3. does not discriminate against interstate commerce, and

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[1] Only Louisiana, Idaho and North Dakota use this criteria.
[2] 139 S.Ct. 2213 (2019)
[3] *Kaestner at* 2219-2220, citing, *Wisconsin v. J. C. Penney Co.*, 311 U.S. 435, 444, 61 S.Ct. 246, 85 L.Ed. 267 (1940), *McCulloch v. Maryland*, 4 Wheat. 316, 428, 4 L.Ed. 579 (1819), *Miller Brothers Co. v. Maryland*, 347 U.S. 340, 342, 74 S.Ct. 535, 98 L.Ed. 744 (1954), and *Wisconsin*, 311 U.S. at 444, 61 S.Ct. 246.
[4] *Kaestner* at 2220.
[5] Id., citing *Quill,* supra.
[6] Id.
[7] *Kaestner,* at 2220, citing *International Shoe Co.* v. *Washington*, 326 U. S. 310 , 66 S. Ct. 154 , 90 L. Ed. 95 (1945).

4. is fairly related to the services provided by the State." [8]

The requirements of the due process clause and the commerce clause are very similar as applied in the context of state taxation of trusts, and often the application of either test will yield the same result.

A Note about "minimum contacts" and "substantial nexus": Whereas, in the past a physical presence was considered to be a component of each of these requirements, the U.S. Supreme Court has ruled that a person or entity need not have a physical presence in a state in order for a state to establish that it has minimum contacts or a substantial nexus to that person.[9]

II. Case Studies: Since the constitutional requirements are very fact-specific, they are best understood in the context of various fact patterns. Case law over the last century provides examples of how the state and federal courts have applied the constitutional requirements to each of the criteria states use for imposing their taxes on trusts.

A. Criteria #1: The trust was created by a resident of the taxing state. Statutes that tax trusts based upon the residence of the testator or settlor are frequently challenged in the courts, and these challenges are often successful when there is no other connection with the taxing state.

1. Testamentary Trusts. Sixteen states plus the District of Columbia tax a trust solely because the testator lived in the state at death.[10] While many cases have found that systems based solely on the existence of a resident-settlor do not satisfy due process requirements, a couple of cases have upheld such taxing systems.

a. Case: *District of Columbia v. Chase Manhattan Bank.*[11]

Criteria: Testator resided in D.C.

Result: Tax Upheld

The D.C. Court of Appeals upheld the constitutionality of a D.C. statute that taxed a testamentary trust on the basis of the testator having resided in D.C.

- Trust created under will that was probated in D.C. courts.
- Trustee and trust assets were outside of D.C.
- All beneficiaries were outside of D.C.
- D.C. taxed the annual net income of the testamentary trust.
- The court concluded, "We hold that the Due Process Clause does not prevent the District from imposing such a tax, given the ***continuing supervisory relationship*** the District's courts have with respect to administration of such a

[8] *Quill Corp. v. North Dakota,* 504 U.S. 301, 311 (1997).
[9] See, *South Dakota v. Wayfair, Inc. 183 S. Ct. 2080 (2018)* and *Quill Corp. v. North Dakota,* supra.
[10] Connecticut (§12-701(a)(4)(C)- (D), (a)(5), (a)(6)); Illinois (35 Ill. Comp. Stat.5/1501(a)(20)(C)-(D)); Louisiana (La. Rev. Stat. Ann. §47:300.10(3)); Maine (Me. Rev. Stat. Ann. Title 36, §5102(4)(B)-(C)); Maryland (Md. Code Ann. Tax-Gen. §§10- 101(k)(1)(iii)); Michigan (Mich. Comp. Laws §206.18(1)(c)); MN, NE, OH, IK, PA, UT, VT, MA, DC, WV, WI
[11] *689 A.2d 539 (D.C. 1997)*

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." (emphasis added)[12]

- Legal scholars have criticized the *District of Columbia* opinion. Bradley E.S. Fogel notes the circularity of basing the rationale for constitutionality on the ongoing supervision of the courts. "Such analysis would allow the constitutionality of a tax imposed based on the residence of the settlor/testator at the time of the creation of the trust to turn on connections that are imposed, by statute, based on the residence of the settlor/testator at the time of the creation of the trust."[13]
- Richard W. Nenno notes that even though "the D.C. court made much of the 'continuing supervisory relationship that the Dirstrict's courts have with respect to administration of such a trust,' ... authorities indicated that courts of another state might have been responsible for handling controversies involving the trust."[14] He notes, for example, that the Restatement (Second) of Conflicts of Laws §267 provides that "the administration of a trust of interests in movables is usually supervised ... by the courts of the state in which the trust is to be administered."[15]

b. Case: *Chase Manhattan Bank v. Gavin*[16]

Criteria: Testator resided in Connecticut.

Result: Tax Upheld.

The Supreme Court of Connecticut upheld the constitutionality of a Connecticut statute that taxed four testamentary trusts on the basis of the testator having resided in Connecticut.

- The trust was created under a will that was probated in Connecticut courts.
- The trustee and all of the trust assets were outside of Connecticut.
- The trust was not administered in Connecticut.
- Beneficiaries of two of the testamentary trusts lived outside of Connecticut.

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[12] 689 A.2d 539, 540, declining to follow *Blue v. Department of Treasury*, 185 Mich.App. 406, 462 N.W.2d 762, 764 (1990) and *Swift v. Director of Revenue*, 727 S.W.2d 880 (Mo.1987)

[13] *Bradley E.S. Fogel, What Have You Done for me Lately? Constitutional Limitations on State Taxation of Trusts, 32 U. Rich. L. Rev. 165, 196 (Jan. 1998)*

[14] Nenno, 869-2nd T.M., *State Income Taxation of Trusts*, III, C, 2b.

[15] Nenno, 869-2nd T.M., *State Income Taxation of Trusts*, VII, A,2, citing Restatement (Second) of Conflict of Laws §267 (1971). See 7 Austin W. Scott, William F. Fratcher & Mark L. Ascher, *Scott and Ascher on Trusts* §45.2.2.4.1, at 3102-14, §45.2.2.4.2, at 3114-22, §45.2.2.5, at 3122-25 (5th ed., 2010); Norman M. Abramson, Susan Gary, George G. Bogert & George T. Bogert, *The Law of Trusts and Trustee*, §292, at 22-33 (3d ed., 2014).

[16] 733 A.2d 782 (Conn. 1999).

- Connecticut taxed the undistributed taxable income of the testamentary trusts and an inter vivos trust.
- In its due process analysis, the Connecticut Supreme Court focused on the rational relationship requirement, concluding that the "seats of the trusts" – where they were established – provided their "principal legal protections and benefits."[17] The Court reasoned that because the trust came into existence by the probating of a will in a Connecticut probate court, the trust's viability as a legal entity is "inextricably intertwined with the benefits and opportunities provided by the legal and judicial system of Connecticut."[18]
- This case has also been criticized by legal scholars,[19] and the following cases in other state courts have reached an opposite conclusion in similar cases.

c. Case: *Pennoyer v. Taxation Division Director*[20]

Criteria: Testator resided in New Jersey.

Result: Tax Invalidated.

The New Jersey Tax Court held that the creation of a trust in New Jersey, the New Jersey probate proceeding and the availability of New Jersey courts are insufficient contacts to support taxation on the undistributed income of the trust.

- Trust was created under the will of a New Jersey resident.
- The trustee, all of the beneficiaries, and the assets were located outside New Jersey.
- The trust was administered in New York.
- The Court stated, "Constitutional due process requires a minimal link between the taxing state and the individual, property or transaction it seeks to tax, and also requires that a state grant some benefit to the taxpayer in return for the tax imposed."[21]
- Applying those due process requirement to subject case, the Court found, "The creation of the trust in 1971 through the probate process in New Jersey courts is an ***historical fact*** which, absent ***continuing contacts***, is not a constitutional nexus justifying income taxation of undistributed income earned in 1979-80."[22]

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[17] Id at 794

[18] Id at 799

[19] See, Joseph W. Blackburn, *Constitutional Limits on State Taxation of a Nonresident Trustee: Gavin Misinterprets and Misapplies Both Quill and McCulloch*, 76 Miss. L.J. 1, 4 (Fall 2006); Bernard E. Jacob, *An Extended Presence, Interstate Style: First Notes on a Theme From Saenz*, 30 Hofstra L. Rev. 1133, 1239 (Summer 2002).

[20] 5 N.J. Tax 386 (Tax Ct. 1983).

[21] Id. At 392-393, citing *Miller Bros. Co. v. Maryland*, 347 U.S. 340, 344-345, 74 S.Ct. 535, 538-539, 98 L.Ed. 744 (1954); *Wisconsin v. J.C. Penney Co.*, 311 U.S. 435, 61 S.Ct. 246, 85 L.Ed. 267 (1940), reh'g den. 312 U.S. 712, 61 S.Ct. 444, 85 L.Ed. 1143 (1941).

[22] Id. At 398

d. Case: *Taylor v. State Tax Commissioner*[23]

Criteria: Testator resided in New York; New York Trustee had no control over income-producing property.

Result: Tax Invalidated.

The Appellate Division Court in New York held that New York could not tax capital gain income from the sale of Florida property, which had been held in a testamentary trust of a testator who was domiciled in New York, because the property did not receive benefits of New York's laws or services and the trustee appointed in New York was not legally qualified to be the trustee of the Florida property.

- Trust was created under the will of a New York domiciliary.
- Trust held some real property in Florida, but under Florida law, the New York bank that served as trustee was prohibited from acting as trustee over Florida real property.
- Two individuals, who were both Florida residents, were appointed as trustees over the Florida property.
- Trust beneficiaries did not reside in New York.
- The Florida property was sold, and the proceeds were placed in an account maintained in New York.
- New York imposed an income tax on the gain from the sale of Florida property.
- Court found that the due process clause barred New York from imposing a tax on the trust because New York did not have a sufficient nexus with the sale of the Florida property, noting that the New York trustee did not have ***possession and control*** of the property.
- New York's only substantive connection to the Florida property was that the settlor of the trust was domiciled in New York, and this connection was deemed insufficient to justify imposition of the tax.

e. Case: *In re Swift*[24]

Criteria: Testator Resided in Missouri

Result: Tax Invalidated.

The Supreme Court of Missouri held that the state lacked sufficient connections to a testamentary trust to tax its income, where the only point of contact with the trust was that it was created under the will of a Missouri testator.

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[23] 445 N.Y.S.2d 648 (App.Div. 1981)

[24] 727 S.W.2d 880 (Mo. 1987)

- The trust property was located in Illinois, where the trust was administered.
- All trust beneficiaries resided in Illinois.
- The Court's due process analysis focused on both the state's points of contact with the trust and the benefits conferred by the state. It noted that the due process clause does not "permit Missouri to impose tax on an entity unless this state has sufficient connections with the entity to provide a basis for the state's authority to tax. The required nexus is found only where state law confers some benefit or protection for the property or entity subject to the tax."[25]
- To determine whether Missouri had a sufficient nexus to support the imposition of an income tax on trust income, the Court considered 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 is not sufficient unless one, or more, of the other four factors is present.[26]
- Court ruled that Missouri did not have sufficient nexus to impose income tax on the trust.

f. Case: *Blue v. Department of Treasury*[27]

Criteria: Testator resided in Michigan; Michigan assets did not produce income.

Result: Tax Invalidated.

Court of Appeals of Michigan held that the due process clause prohibited taxation of a trust created by a Michigan resident, where the trustee and beneficiaries resided in another state and all of the income-producing property was outside of Michigan.

- The settlor of a revocable trust was a resident of Michigan. She died domiciled in Michigan, and her trust became irrevocable upon her death.
- The trustee and all beneficiaries resided in Florida.

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[25] Id. At 882, citing *Miller Brothers Co. v. Maryland*, 347 U.S. 340, 345, 74 S.Ct. 535, 539, 98 L.Ed. 744 (1954); *Safe Deposit and Trust Company v. Virginia*, 280 U.S. 83, 92, 50 S.Ct. 59, 60, 74 L.Ed. 180 (1929) and *Union Refrigerator Transit Company v. Kentucky*, 199 U.S. 194, 202, 26 S.Ct. 36, 50 L.Ed. 150 (1905).

[26] 727 S.W.2d 880 at 882

[27] 462 N.W.2d 762 (Mich. Ct. App. 1990)

- Trust held real property in Michigan that did not produce any income. All other trust property was held in Florida, where the trust was administered.
- After applying the *Swift* analysis, the Court stated, "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 administered and registered in Florida."[28]
- In requiring the minimum contacts to be concurrent with the tax year at issue, the Court stated, "We analogize the present case to a hypothetical statute authorizing that any person born in Michigan to resident parents is deemed a resident and taxable as such, no matter where they reside or earn their income. We believe this would be clearly outside of the state's power to impose taxes."[29]

g. Case: *Westfall v. Director of Revenue*[30]

Criteria: Testator resided in Missouri, plus trust held some income-producing property in Missouri.

Result: Tax Upheld.

The Missouri Court applied the same analysis that it used in the *Swift* case, but this time it found that a testamentary trust had sufficient contacts with the state to impose a tax because it held real property in Missouri, had contingent beneficiaries in Missouri, and a Missouri Bank was named in the governing instrument as a possible successor trustee.

- The testator was domiciled in Missouri.
- Trustee and all beneficiaries were domiciled outside of Missouri.
- Trust earned rental income from real property located in Missouri. Additional income was earned on intangible assets held by a trustee outside of Missouri.
- Trustees asserted that the trust was a nonresident trust and taxes should be imposed only on the trust's income derived from Missouri sources.
- Court held that application of the Missouri income tax to all of the trust's income was justified under the due process clause, distinguishing the case from Swift. "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) ... The Rollins trust differs, however, from the trusts in *Swift* because the Rollins trust also

[28] Id. at 764
[29] *Blue* at 764-765
[30] 812 S.W.2d 513 (Mo. 1991)

satisfies point (3) of the test by its ownership of real estate in Columbia, Missouri."[31]

- The court even considered some contingent possible connections in the future as relevant to the analysis. The trust instrument specified the Columbia Public Library, in Columbia, Missouri, as a contingent beneficiary and the Boone County National Bank as a possible successor trustee. It concluded, "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.'"[32]

- Whereas all of the justices of the Missouri Supreme Court concurred in the *Swift* opinion, the same court was divided over the *Westfall* case, with two justices dissenting, and another justice concurring in the result but finding that further analysis was needed.

    - It is especially suspect for a court to take into account the residence of a contingent successor trustee in determining whether the trust has a substantial nexus with the taxing jurisdiction. As noted in the dissent, "If in the future a resident of Missouri is appointed trustee of the Rollins trust, the taxgatherer may reappear."[33]

2. Inter Vivos Trusts. The trust was created by a resident settlor/grantor. Twelve jurisdictions tax an inter vivos trust on the sole basis of the settlor/grantor residing in that state at the time that the trust was created or at the time that the trust became irrevocable.[34] U.S. Supreme Court has not ruled on this basis of taxation, but many state court decisions call into question the constitutionality of a tax based only on the residence of the settlor, where there are no other points of connection to the state.

    a. Case: *William Fielding, Trustee of the Reid and Ann McDonald Irrevocable GST Trust for Maria V. MacDonald, et al. v. Commissioner of Revenue*[35]

    Criteria: The settlor resided in Minnesota.

    Result: Tax invalidated.

    - A Minnesota resident formed four irrevocable trusts in 2009. The trusts were taxed as grantor trusts until 2011, when the grantor relinquished his power to substitute trust assets.

    - In 2014, the trustee, an individual who resided in Texas, sold all of the trusts' stock in a Minnesota S corporation. Minnesota imposed its income tax on all of the trust's income for 2014, because it classified the trust as a resident trust, based on the residence of the settlor.

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[31] Id. at 514.
[32] Id., citing *Swift*, supra, at 882.
[33] *Westfall*, 812 S.W.2d 513, 517
[34] DC, IL, ME, MI, MN, NE, OK, PA, VT, VA, WY, WI
[35] 916 N.W.2d 323 (Minn. 2018)

- The Minnesota Supreme Court ruled that the application of the tax was invalid because it violated the due process clause of both the U.S. Constitution and the Minnesota Constitution.
- The court concluded that the settlor's residence in 2009, when the trusts were created, and in 2011, when the trusts became separate taxpayers, was "not relevant to the relationship between the Trusts' income that Minnesota seeks to tax and the protection and benefits Minnesota provided to the Trusts' activities that generated that income. The relevant connections are Minnesota's connection to the trustee, not the connection to the grantor who established the trust years earlier."[36]
- The court rejected the Tax Commissioners argument that ownership of stock of a Minnesota S Corporation provided a sufficient connection between the trust and the state. The Court noted, "These intangible assets were held outside of Minnesota, and thus do not serve as a relevant or legally sufficient connection with the State."
- The U.S. Supreme Court denied the state's certiorari petition on June 28, 2019.

b. Case: *McNeil v. Commonwealth*[37]

Criteria: The settlor resided in Pennsylvania, and discretionary beneficiaries resided in Pennsylvania.

Result: Tax invalidated.

While many of the cases have analyzed the due process clause of the U.S. Constitution, in this case the Commonwealth Court of Pennsylvania based its ruling on the commerce clause. The court ruled that the residence of the settlor was an insufficient basis for taxation by Pennsylvania, even when discretionary beneficiaries resided in the state.

- Two trusts were created by resident of Pennsylvania.
- Trusts were administered in Delaware by a corporate trustee in Wilmington, Delaware.
- Trusts were governed by Delaware law.
- Three individuals served as general trustees, and none of them resided in Pennsylvania.
- Trusts did not have any assets in Pennsylvania.
- Trusts' discretionary beneficiaries resided in Pennsylvania, but did not receive any distributions in 2007.
- Pennsylvania imposed an income tax on the trust for 2007 based upon the residency of the settlor and the residency of the discretionary beneficiaries.

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[36] Id. At 330

[37] 67 A.3d 185 *(Pa. Commw. Ct. 2013)*

- Court analyzed whether the tax, as applied, violated any of the 4 prongs of the commerce clause test:

  (1) the taxpayer must have a substantial nexus to the taxing jurisdiction;

  (2) the tax must be fairly apportioned;

  (3) the tax being imposed upon the taxpayer must be fairly related to the benefits being conferred by the taxing jurisdiction; and

  (4) the tax may not discriminate against interstate commerce.

- The court found that the tax violated the first prong because "neither settlor's residency nor the residency of the beneficiaries provides the Trusts with the requisite presence in Pennsylvania to establish a substantial nexus."[38] The court considered the first prong to require a physical presence in the state, following *Quill*[39]. The *Wayfair*[40] decision has since eliminated the physical presence requirement. Even without the physical presence requirement, the result in *McNeil* would not have changed, because the trust still may have failed the substantial nexus test, and in any event, it failed two other prongs of the test.

- The court analyzed the requirements of the fair apportionment prong by asking "whether the jurisdiction is taxing economic activity that occurs in other jurisdictions"[41] and whether there is "a rational relationship between the income attributed to the state and the intrastate values of the business being taxed."[42]

- The court reasoned, "The imposition of the [personal income tax] on the Trusts' income, when all of that income was derived from sources outside of Pennsylvania, is inherently arbitrary and has no rational relationship to the Trusts' business activity that occurred in Pennsylvania. Accordingly, the imposition of the [tax] here does not satisfy the fair apportionment prong."[43]

- Finally, the court analyzed the third prong, saying "Taxes are fairly related to the services a state provides where the taxpayer benefits directly or indirectly from the state's protections, opportunities, and services."[44]

- The court found that the trust did not benefit from the state's protections, opportunities and services because the trusts "had no physical presence in Pennsylvania, none of their assets or interests were located in Pennsylvania, and they were established under and were governed by Delaware law."[45]

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[38] Id. at 195
[39] *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992)
[40] *South Dakota v. Wayfair, Inc.* 183 S. Ct. 2080 (2018)
[41] Id.
[42] Id.
[43] *McNeil*, at 196-197
[44] Id. at 197
[45] Id. at 197-198

c. Case: *Potter v. Taxation Division Director*[46]

Criteria: Settlor resided in New Jersey.

Result: Tax invalidated.

New Jersey Tax Court ruled that neither the residence of the settlor or the residence of contingent beneficiaries is sufficient basis for imposition of New Jersey's income tax on the trust.

- A New Jersey resident created an irrevocable inter vivos trust. Upon her death, some additional assets were poured over from her estate to the trust.
- The trustee and all trust assets were located in New York.
- The trust was created in New York and governed by New York law.
- No beneficiaries resided in New Jersey.
- New Jersey attempted to impose its income tax on the trust, based on the domicile of the settlor.
- Some contingent beneficiaries resided in New Jersey, but the New Jersey Tax Court found that fact did not alter its conclusion that the trust had its situs in New York, not New Jersey.
- For the same reasons articulated in *Pennoyer v. Taxation Div. Director*[47], the court concluded New Jersey did not have authority to tax the trust.

B. Criteria #2: One of the trustees resides in the state. Only 4 states impose their tax on a trust based on the residence of at least one of the trustees in the state.[48] Other states consider the residence of one or more trustees as one factor in determining a trust's residency, but other factors are also considered.[49] The U.S. Supreme court has made it clear that the residence of the trustee is a valid basis for imposing tax on a trust.

1. Case: *Greenough v. Tax Assessors of Newport*[50]

Criteria: Trustee resided in Rhode Island.

Result: Tax Upheld.

- Testamentary trust was created under the will of a New York resident, and the will was probated in New York.
- All beneficiaries resided in New York.
- One trustee resided in New York, and one trustee resided in Rhode Island.
- The trust held intangible personal property, which consisted of shares of stock. The evidences of the intangible property in the trust were at all times in New York.

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[46] 5 N.J.Tax 399 (1983)
[47] 5 N.J. Tax 386 (Tax Ct. 1983).
[48] AZ, CA, NM, OR
[49] DE, HI, ID, IA, KY, MT, ND
[50] 331 U.S. 486 (1947)

- A Rhode island municipality assessed a tax on the Rhode Island trustee based upon the value of the intangible personal property held by the trust. Since 1 out of 2 trustees resided in Rhode Island, the tax was apportioned, so that it was based on one half of the value of the intangible personal property.
- The Court equated the residence of the trustee with the situs of the intangible property. "Since the intangibles themselves have no real situs, the domicile of the owner is the nearest approximation, although other taxing jurisdictions may also have power to tax the same intangibles."[51]
- Court noted, "Normally the intangibles are subject to the ***immediate control*** of the owner. This close relationship between the intangibles and the owner furnishes an adequate basis for the tax on the owner by the state of his residence as against any attack for violation of the Fourteenth Amendment."[52] (emphasis added)
- Court reasoned that "when testamentary trustees reside outside of the jurisdiction of the courts of the state of the seat of the trust, third parties dealing with the trustee on trust matters or beneficiaries may need to proceed directly against the trustee as an individual for matters arising out of his relation to the trust. Or the resident trustee may need the benefit of the Rhode Island law to enforce trust claims against a Rhode Island resident."

2. Residence of corporate trustee. Corporate trustees often have a physical location in several states. In their statutes, Arizona, California, New Mexico and Oregon look to the state where the trust is administered to determine whether the corporate trustee is a resident.
   - Arizona's statute provides, "If a corporate fiduciary engaged in interstate trust administration is the sole fiduciary of a trust, or is a cofiduciary with a nonresident, the trust is a resident trust only if the corporate fiduciary conducts the administration of the trust in this state."[53]
   - Similarly, California's statute says, "For purposes of this article the residence of a corporate fiduciary of a trust means the place where the corporation transacts the major portion of its administration of the trust."[54]
   - In New Mexico, the relevant statute provides, "A trust is domiciled in New Mexico if the trustee is a resident of New Mexico or if the principal place from which the trust is managed or administered is in New Mexico."[55]
   - Likewise, Oregon's statute states, "In the case of a fiduciary that is a corporate fiduciary engaged in interstate trust administration, the residence and place of administration of a trust both refer to the place where the majority of fiduciary decisions are made in administering the trust."[56]

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[51] Id. at 493
[52] Id. (emphasis added)
[53] Ariz. Rev. Stats. § 43-1301(5)
[54] California Revenue & Taxation Code § 17742
[55] Instructions to New Mexico Fiduciary Income Tax Return. (Form FID-1)
[56] OR Rev Stat § 316.282(d)

3. Co-trustees. Where there is more than one trustee, and the trustees reside in different states, a question could arise as to whether a tax based on residency of the trustee must be apportioned between the states where the trustees reside.

   - In *Greenough*[57], the court noted that the statute in question apportioned the tax, taking into account that one trustee resided in Rhode Island, whereas a co-trustee resided in New York. Since only half of the trustees resided in Rhode Island, the tax was applied to only half of the value of the trust property. Thus, there was no reason for the court to consider whether a tax that was not so apportioned would have also been upheld.
   - Where there are two or more trustees of the trust, California's tax is apportioned according to the number of trustees resident in California.[58]
   - If the tax is not apportioned, it could be subject to challenge under the commerce clause of the U.S. Constitution. As noted above, one of the four prongs of the commerce clause test is that a tax be fairly apportioned.[59]

C. Criteria # 3: A trust beneficiary resides in the state. When income is distributed to a beneficiary, there is no doubt that the state where the beneficiary resides may tax that income. But when a state taxes the undistributed income of a trust, based on the residence of a beneficiary, this criteria of taxation has been successfully challenged in several cases.

1. Case: *Brooke v. City of Norfolk*[60]

   Criteria: Beneficiary resided in the state.

   Result: Tax invalidated.

   U.S. Supreme Court found application of tax invalid where the state of Virginia sought to imposes taxes upon the corpus of a trust based upon the residence of the beneficiary.

   - Trust was created and administered in Maryland by a settlor who resided in Maryland.
   - Trust income was payable to the two daughters of the settlor, one of whom resided in Virginia.
   - Beneficiary did not dispute the imposition of tax upon income actually received by her, but challenged Virginia's tax upon the whole corpus of the trust.
   - Court emphasized that the trust property was not within the possession and control of the beneficiary. Instead, it was within the possession and control of the trustee.
   - Court concluded, "The assessment is a bare proposition to make the [beneficiary] pay upon an interest to which she is a stranger. This cannot be done."

2. Case: *Safe Deposit & Trust Co. of Baltimore v. Virginia*,[61]

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[57] *Greenough v. Tax Assessors of Newport, 331 U.S. 486, 498 (1947)*
[58] California Revenue & Taxation Code § 17743
[59] *Quill Corp. v. North Dakota,* 504 U.S. 301, 311 (1997).
[60] 277 U.S. 27 (1928)
[61] 280 U.S. 83 (1929)

Criteria: Beneficiaries resided in the state.

Result: Tax invalidated.

U.S. Supreme Court again invalidated the imposition of a Virginia tax upon the whole corpus of a trust, based upon the residence of the beneficiaries.

- Inter vivos trust was created by a Virginia resident.
- Trustee was located in Maryland.
- Beneficiaries resided in Virginia.
- Court focused its analysis on whether intangibles – stocks, bonds – held by the trustee have their situs in the state where the trustee resides or in the state where the beneficiaries reside. In deciding that the intangibles reside with the trustee, the Court observed that the beneficiaries lacked control over the trust property.
- Court stated, "A statute of a State which undertakes to tax things wholly beyond her jurisdiction or control conflicts with the Fourteenth Amendment."[62]

3. Case: *North Carolina Department of Revenue v. The Kimberley Rice Kaestner 1992 Family Trust*[63]

Criteria: Discretionary Beneficiary Resided in North Carolina.

Result: Tax Invalidated.

U.S. Supreme Court ruled that a North Carolina statute imposing tax upon a "trust that is for the benefit of a resident of this State" was unconstitutional as applied to a trust whose only North Carolina beneficiary had an interest in the trust that was subject to the complete discretion of the trustee.

- Trust created in New York in 1992 by a New York resident.
- Initial trustee was a New York resident, and successor trustee was a resident of Connecticut.
- Trust was divided into 3 separate trusts in 2002. One of those trusts was held for the benefit of a North Carolina resident and her children, who all resided in North Carolina.
- North Carolina attempted to impose its income tax on all of the accumulated, undistributed income of the trust held for North Carolina beneficiaries.
- Trust assets were held by a custodian in Boston, Massachusetts. The ownership documents pertaining to all trust assets, along with the trust's financial books and legal records, were located in New York.
- Distributions from the trust were to be made, if at all, by the Trustee, in his absolute discretion. No distributions were made to the North Carolina residents.
- In a 9-0 decision, the U.S. Supreme Court held that "the presence of in-state beneficiaries alone does not empower a State to tax trust income that has not been

[62] Id. at 92.
[63] 139 S. Ct. 2213, 204 L. Ed. 2d 621 (2019)

distributed to the beneficiaries where the beneficiaries have no right to demand that income and are uncertain ever to receive it."[64]

- The Court noted the narrowness of the ruling. "In limiting our holding to the specific facts presented, we do not imply approval or disapproval of trust taxes that are premised on the residence of beneficiaries whose relationship to trust assets differs from that of the beneficiaries here."[65]

D. Criteria # 4: A trust is administered in the state. Eleven states impose tax on a trust if it is administered in their state.[66] There don't appear to be any cases challenging this basis of taxation. The *Kaestner* court, in its review of precedent, noted, "The Court's cases also suggest that a tax based on the site of trust administration is constitutional."[67]

Multiple Trustees: Where there is only one trustee who administers the trust, this criteria would appear to have similar validity as taxation of a trust based upon the residency or domicile of the trustee. But where there is more than one trustee, and the trustees reside in different states, there is a possibility of the trust being subjected to taxation in multiple states, raising the same questions of apportionment that are raised when a tax is based upon the residency of a trustee.

E. Criteria # 5: A trust is governed by the law of the state. Only 3 states use the governing law of the trust as a basis for taxation.

1. Louisiana's tax statute provides that an inter vivos trust shall be considered a resident trust if the trust instrument provides that the trust shall be governed by the laws of the state of Louisiana.

   - If the trust instrument provides that the trust is governed by the laws of any state other than the state of Louisiana, then the trust shall not be considered a resident trust.

   - If the trust instrument is silent with regard to the designation of the governing law, then the trust shall be considered a resident trust only if the trust is administered in this state.

2. In Idaho, governing law is one of five factors used to determine whether a trust is a resident trust. A trust is treated as a resident trust if three of the following five conditions exist during the taxable year:

   (a) The domicile or residency of the grantor is in Idaho;

   (b) The trust is governed by Idaho law;

   (c) The trust has real or tangible personal property located in Idaho;

   (d) The domicile or residency of the trustee is in Idaho;

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[64] *Kaestner,* 139 S. Ct. 2213, 2221

[65] Id.

[66] CO, IN, KS, LA, MN, MS, NM, OR, SC, UT, WI

[67] *N.C. Dep't. of Revenue v. The Kimberley Rice Kaestner 1992 Family Trust*, 139 S. Ct. 2213, 2220 (2019), citing *Hanson v. Denckla*, 357 U.S. 235, 251, 78 S. Ct. 1228, 2 L.Ed.2d 1283 (1958); *Curry v. McCanless*, 307 U.S. 357, 370, 59 S. Ct. 900, 83 L.Ed. 1339 (1939).

(e) The administration of the trust takes place in Idaho.

Administration of the trust includes conducting trust business, investing trust assets, making administrative decisions, recordkeeping and preparation and filing of tax returns.[68]

3. Similarly, North Dakota considers the designation of its law as one factor among others in determining whether a trust is a resident trust. But North Dakota's Administrative Code does not specify how many of the factors are required to classify a trust as a resident trust.[69]

4. If a trust is not governed by the law of any of these 3 states, then the trust's governing law is not likely to be a factor is determining its tax situs.

III. Comparison of State Laws

A. Alabama. Resident trusts are taxed on their income at a rate of up to 5.0%. Alabama's income tax statutes define a resident trust as a trust that is described by both of paragraphs (a) and (b):

(a) The trust is created by the will of a decedent who was an Alabama resident at death or by a person who was an Alabama resident at the time such trust became irrevocable; and

(b) for more than 7 months during the taxable year, a person who either resides in or is domiciled in Alabama is either a fiduciary of the trust or a beneficiary of the trust to whom distributions currently may be made[70]

Potential Challenges. Although Alabama combines two criteria in its tax statute, one of the criteria, the residence of the trustor/settlor, has frequently been challenged in the courts of other states. Where that criteria is combined with the presence of an Alabama trustee, the tax would not likely be challenged on constitutional grounds. But if the tax were imposed on the basis of an Alabama settlor combined with a discretionary beneficiary who resides in Alabama, the tax might well be held unconstitutional, as applied in that scenario.

Other Alabama Details:

a. A taxpayer who is taxed as the owner of a grantor trust for federal income tax purposes will also be taxed as the owner of that trust for Alabama income tax purposes.[71]

b. Alabama Administrative Code § 810-3-29-.07(c) provides:

The fiduciary of a trust is domiciled in Alabama if the individual, or group of individuals, who carry out the fiduciary responsibilities of the trust are located in

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[68] ID ST § 63-3015
[69] ND Admin. Code § 81-03-02.1-04
[70] Ala. Code §40-18-1(33)(a)-(b)
[71] Ala. Code §40-18-25(j)

Alabama. If the trustee is a corporate fiduciary engaged in interstate trust administration, the fiduciary is treated as being domiciled in Alabama if the trustee conducts the major part of its administration of the trust in Alabama.

c. With respect to nonresident beneficiaries only, Alabama Code §-18-14 provides that income derived through a trust is taxable by Alabama only to the extent it is derived from property owned or business transacted in Alabama.

B. Georgia. Georgia imposes its income tax at a rate of up to 5.75% on both resident fiduciaries and nonresident fiduciaries who are:

(A) Receiving income from business done in this state;
(B) Managing funds or property located in this state; **or**
(C) Managing funds or property for the benefit of a resident of this state."[72]

Georgia's tax statute is very similar to the North Carolina statute that was found to be unconstitutional as applied to The Kimberley Rice Kaestner 1992 Family Trust.[73] Following that case, the Georgia Department of Revenue issued a bulletin conceding that Georgia may not tax a nonresident trustee of a trust in which:

1. The beneficiaries did not receive any income from the trust during the years in question;
2. The beneficiaries had no right to demand trust income or otherwise control, possess, or enjoy the trust assets in the tax years at issue; and
3. Not only were the beneficiaries unable to demand distributions in the tax years at issue, but it was also uncertain whether they would ever receive any income from the trust in the future.

C. Mississippi. Resident trusts are taxed on their income at a rate of up to 5.0%.[74] Miss. Code § 27-7-5(1). According to the instructions for the Fiduciary Inocme Tax Return,

> "a resident trust is any trust that is administered by the trustee in Mississippi. A trust being administered outside of Mississippi shall not be considered a resident trust merely because the governing instrument or a law requires that the laws of Mississippi be followed with respect to interpretation or administration of the trust."[75]

Nonresident trusts are taxed on their Mississippi source income.[76]

D. Louisiana. Resident trusts are taxed on their income at a rate of up to 4.25%.

1. A testamentary trust is taxed as a resident trust in Louisiana if it was created by last will and testament of a decedent who at his death was domiciled in Louisiana.

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[72] GA Code Ann. §48-7-22(a)(1)(A)-(C)
[73] *North Carolina Department of Revenue v. The Kimberley Rice Kaestner 1992 Family Trust*, 139 S.Ct 2213 (2019)
[74] Miss. Code § 27-7-5(1)
[75] See Instructions for Form 81 Fiduciary Income Tax Return (Estates and Trusts)
[76] Miss. Code § 27-7-5(3)

2. As discussed above, an inter vivos trust is taxed as a resident trust if the trust instrument provides that designates Louisiana the trust shall be governed by the laws of the state of Louisiana.

   - If the trust instrument provides that the trust is governed by the laws of any state other than the state of Louisiana, then the trust shall not be considered a resident trust.

   - If the trust instrument is silent with regard to the designation of the governing law, then the trust shall be considered a resident trust only if the trust is administered in this state.

E. California. In general, a trust's entire taxable income is subject to tax in California at a rate of up to 13.3% if the fiduciary ***or*** a noncontingent beneficiary is a resident of California.[77] A noncontingent beneficiary is one whose interest is not subject to a condition precedent.[78] A beneficiary whose interest in a trust is subject to the sole and absolute discretion of the trustee holds a contingent interest in the trust.[79]

There are five different situations that can occur when determining the taxability of a trust.

1. If the trustee (or all the trustees, if more than one) is a California resident, the trust is taxed on all income from all sources.[80]

2. If the noncontingent beneficiary (or all the noncontingent beneficiaries, if more than one) is a California resident, the trust is taxed on all income from all sources.[81]

3. If at least one trustee is a California resident and at least one trustee is a nonresident and all beneficiaries are nonresidents, the trust is taxed on all California source income plus the proportion of all other income that the number of California resident trustees bears to the total number of trustees.[82]

4. If all of the trustees are nonresidents and at least one noncontingent beneficiary is a California resident and at least one noncontingent beneficiary is a nonresident, the trust is taxed on all California source income plus the proportion of all other income that the number of California resident noncontingent beneficiaries bear to the total number of noncontingent beneficiaries.[83]

5. If a trust has a mix of California resident and nonresident fiduciaries or noncontingent beneficiaries, the trust's taxable income is first apportioned pro rata according to the number of resident fiduciaries, with the remaining amount apportioned pro rata according to the number of noncontingent beneficiaries.[84]

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[77] Cal. Rev. & Tax. Code §17742(a)
[78] Title 18, California Code of Regulations, Section 17742(b)
[79] California Franchise Tax Board Technical Advice Memorandum 2006-0002, February 17, 2006
[80] Cal. Rev. & Tax. Code §17742
[81] Id.
[82] Cal. Rev. & Tax. Code §17743
[83] Cal. Rev. & Tax. Code §17744
[84] See California Form 541, California Fiduciary Income Tax Return, Schedule G, California Source Income and Deduction Apportionment.

Practitioner Filip Babic provides the following example[85] that illustrates how the two-step apportionment operates:

Example: T sets up an irrevocable trust for the benefit is his two children, A and B. A is a California resident and B is a Wisconsin resident; both are noncontingent beneficiaries. T picks his personal attorneys to serve as trustees; one is a California resident, and the other is an Oregon resident. The trust has $100,000 of non-California-source taxable income in 2022.

Under the first tier of California's apportionment formula, one-half of the income (or $50,000) is allocated to California because one-half of the fiduciaries are residents of California (Cal. Rev. & Tax. Code §17743). Under the second tier, one-half of the remaining $50,000 (or $25,000) is allocated to California because one-half of the noncontingent beneficiaries are residents of California. In sum, $75,000 of the trust's income is allocated to California under the apportionment formula. Note, that the trust will be required to file a California Form 541 and apportion its income on Schedule G accordingly.

IV. Conclusions. Given the variety of state taxing schemes and the wide range of case law evaluating those schemes, there are several general principles that may form the basis for a successful challenge of a state's tax.

1. Although many state tax statutes still tax testamentary trusts based upon the residence of the testator, this criteria for taxation is on shaky ground. Many taxpayers have been successful in challenging taxation where the ***residence of the testator is the only connection*** between the trust and the taxing state.
2. If a state's tax is based upon a connection to the trust that occurred ***in the past***, but no longer exists during the tax year in question, the basis for taxation may be challenged.
3. If a state's tax is based upon the residence of a person, whether the trustee, the settlor, or a beneficiary, consider whether that person has ***possession or control*** over the trust property. If not, the basis for taxation may be challenged. For this reason, challenges to taxation based upon the residence of the ***beneficiary*** often succeed because of the ***beneficiary's lack of control*** over the trust property.
4. If more than one state imposes income taxes on the trust, the taxes must be ***fairly apportioned*** in order to comply with the commerce clause.

[85] Babic, F., *Income taxation of trusts in California*, Tax Insider newsletter, July 26, 2018 (https://www.thetaxadviser.com/newsletters/2018/jul/income-taxation-trusts-california.html)