Rationalizing the State Income Taxation of Trusts – Chasing Quill Feathers in the Wind[1]

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Quill Corp. v. North Dakota[2] removed the due process barrier against state laws intended to prevent local sales taxes avoidance by consumer purchases of goods from out of state mail-order retailers. In that decision, the Supreme Court relaxed the due process standard that must be met by a state requiring a non-resident retailer to collect use taxes on sales to resident consumers.[3] *Quill* adopted a standard that equates *in personam* judicial jurisdiction with tax jurisdiction. Contacts with a state "such that the maintenance of [a] suit [against a non-resident] does not offend 'traditional notions of fair play and substantial justice'" appear to be all that is needed to satisfy the due process requirements for the imposition by a state of use tax collection obligations.[4] Physical presence is not required. A purposeful direction of commercial activities at state residents, such as Quill's annual mailings of 24 tons of catalogs and flyers into North Dakota, is enough.

But Quill's purposeful direction of commercial activities was not enough to satisfy the dormant Commerce Clause.[5] In the end, it was the Commerce Clause that saved Quill from the burden of collecting use tax. *Quill* reaffirmed the four-part test for sustaining a state tax against a Commerce Clause challenge articulated by the Court in *Complete Auto*

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[1] This article was the basis for Carlyn McCaffrey's Mortimer H. Hess lecture delivered at the New York City Bar on May 10, 2010.

[2] 504 U.S. 298 (1992).

[3] The due process standard is based on the Due Process Clause of the United States Constitution, U.S. Const. amend. V., amend. XIV, §1.

[4] *Supra*, note 2 at 307.

[5] The dormant Commerce Clause doctrine is inferred from the power of Congress to regulate commerce conferred on it by U.S. Const. art. I, §8, cl.3. In general, its application limits the powers of states over interstate commerce, particularly the power to take actions that would discriminate against interstate commerce or unduly burden it.

Transit.[6] The Court reaffirmed its earlier conclusion in *Bellas Hess*[7] that the long-standing, substantial nexus requirement of the Commerce Clause, which now appears as the first prong of *Complete Auto's* four-part test, is not satisfied by a mail-order seller whose only contacts with the state are by mail or common carrier (at least when applied in the context of use tax collection issues).[8]

What does a Supreme Court decision dealing with the ability of a state to force a non-resident retailer to collect use taxes have to do with the power of a state to claim a trust as a resident for income tax purposes when its trustees are all non-residents and its administrative activities are all conducted out of state? The connection is not apparent. Yet, the *Quill* decision has played a surprising and likely inappropriate role in the recent development of the law on this issue.

Five years after *Quill*, in 1997, the District of Columbia Court of Appeals referred to that case's Due Process analysis and ruled that the District of Columbia, may, without violating the Due Process clause, treat, for local income tax purposes, the testamentary trust of a domiciliary as a resident of the District of Columbia with the result that all of its income was subject to the District's local income tax.

> While the Court's previous decisions had suggested that a state could not tax a corporation unless it had some physical presence within the state -- such as sales personnel or local retail stores -- these decisions had been preempted by general developments in the Court's due process jurisprudence. *See [Quill] at 306-08*. The Court overruled these decisions, noting that "it matters little that such solicitation [of business] is accompanied by a deluge of catalogs rather than a phalanx of drummers. The requirements of due process are met irrespective of a corporation's lack of physical presence in the taxing State." *Id.* at 308.[9]

A similar decision, again using *Quill's* Due Process analysis, was reached by the Connecticut Supreme Court two years later. Describing the Supreme Court's *Quill* analysis, the Connecticut Court said:

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[6] *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977). In order to satisfy the four-part test, the tax must:

> [1] . . . [be] applied to an activity with a substantial nexus with the taxing State, [2] . . . [be] fairly apportioned, [3] . . . not discriminate against interstate commerce, and [4] . . . [be] fairly related to the services provided by the State. *Id*, at 311

[7] *National Bellas Hess, Inc. v. Department of Revenue of Ill.*, 386 U.S. 753 (1967).

[8] 504 U.S. 298 at 311. Later case law has suggested that *Quill* does not require physical presence to satisfy the substantial nexus test when dealing with types of taxes other than the use tax. *E.g.*, *Capital One Bank v. Massachusetts Revenue Comm'r*, 453 Mass 1, 899 N.E.2d 76 (2009), *cert. denied* 129 S. Ct. 2827, 175 L. Ed. 2d 553(2009) and *Geoffrey Inc. v. Massachusetts Revenue Comm'r* 453 Mass. 17; 899 N.E.2d 87 (2009), *cert. denied* 129 S. Ct. 2853, 174 L. Ed. 2d 553 (2009).

[9] *District of Columbia v. The Chase Manhattan Bank*, 689 A.2d 539, 543 (1997).

> [T]he court "abandoned more formalistic tests that focused on a defendant's 'presence' within a State in favor of a more flexible inquiry into whether a defendant's contacts with the forum made it reasonable, in the context of our federal system of Government, to require it to defend the suit in that State." Thus, the court in *Quill Corp. v. North Dakota*, overruled, "as superseded by developments in the law of due process," the prior holdings in the area of sales and use taxes; that "some sort of physical presence" of the seller in the taxing state is required in order for the state to impose such a duty on the seller.[10]

The Executive Budget Bill submitted to the New York legislature earlier this year contained a proposal to impose New York's income tax on all testamentary trusts of New York domiciliaries (even if there were no other ties to the state) and on all inter vivos trusts created by New York domiciliaries without regard to the location of the trustees or the administration of the trust. [11] The Statement in Support of the proposal acknowledged its inconsistency with a prior New York Court of Appeals decision.[12] The Statement justified the proposal's departure from precedent by referring to recent case law, including the District of Columbia case.[13]

The misplaced reliance on *Quill* has muddied an area of the law already confounded by the historically inconsistent manner in which states have treated trusts for income tax purposes and by the recent interstate competition for trust business fueled by financial institutions based in states that impose no tax on trusts with local trustees.[14]

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[10] *Chase Manhattan Bank. v. Gavin*, 733 A.2d 782 (1999), *cert. denied*, 528 U.S. 965 (1999).

[11] NY A09710, amending NY Tax §605(b), introduced on January 19, 2010. The proposal provided some relief for trusts with ascertainable non-resident beneficiaries.

[12] Present New York law, which exempts New York trusts that were created by New York domiciliaries if certain requirements are satisfied "was enacted in 2003 in order to codify the rule originally set forth by the New York courts in Mercantile-Safe Deposit & Trust Company v. Murphy, 19 AD2d 765 (3d Dep't 1963). aff'd 15 NY2d 579 (1964)." Statement in Support of the Proposal, 14.

[13] "However, recent state and federal appellate decisions have upheld the constitutionality of taxing a percentage of trust income in cases where the trust grantor is a state resident according to the percentage of trust beneficiaries who are state residents. Many states also tax all of the income from testamentary trusts when the decedent was domiciled in that state, a practice that has also been upheld by state and federal courts." *Id* at 14-15.

[14] See, for example, the website of the Alaska Trust Company (http://www.alaskatrust.com/index.php?id=89), which lists as the first of 16 reasons to use Alaska Trust Company, the fact that "Alaska Has No State Income Tax on Trust Income. Therefore, trust beneficiaries can see the earnings in the trust compound free from state and local income taxes, thereby providing extraordinary year-on-year returns." Similar claims are made about Delaware on the website of the RBC Trust Company (Delaware) Limited (http://www.rbctrust.com/forms/mktg-Why-Delaware-Trust.pdf).

Even the federal government is not immune from the tax competition fray. In 1996, Congress changed the definition of domestic trust for United States income tax purposes to exclude all trusts that were either

This is an important issue for some states.[15] Trusts are a big and growing business, particularly in the economies of smaller states that have developed legal and tax systems with the goal of attracting trust business. Between 2002 and 2007, the gross incomes of complex and simple trusts reported on fiduciary income tax returns filed with the Internal Revenue Service almost tripled. The income tax collected more than tripled from $6.9 billion to $21.3 billion. In 2002, the amount of tax revenue collected from trusts was less than 1% of the amount collected from individuals. By 2008 it had grown to almost 2%.[16]

It is important that the state legislatures get this issue right. A state that extends its taxing jurisdiction too far runs the risk of a possibly successful Constitutional challenge as well as the loss of trust business to out of state trustees with too little contact in the state to give it *in personam* jurisdiction over them. This could result in a substantial loss of trust business by major multi-state financial institutions.[17]

This article first examines the Constitutional principles that could limit a state's power to require a trustee to pay income tax on a trust's income when the only connection between the state and the trustee is the residence or domicile of the trust's settlor either alone

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subject to the primary jurisdiction of a non-United States court or subject to the control of one or more non-United States persons as to one or more types of decisions. For example, a trust created under the will of a resident of New York, with a New York trustee, New York beneficiaries and property in New York, is not a United States taxpayer if a decision to remove trustees requires the consent of a non-United States person. Internal Revenue Code of 1986, as amended, §7701(a)(30) and (31). One of the principal objectives Treasury sought to achieve by implementing this new definition according to David K. Sutherland, former Associate International Tax Counsel and a principal draftsperson of the new law, was to level the competitive playing field for trust business between U.S. and foreign institutions. Under the former definition, a foreign person who might have preferred to use a U.S. financial institution as trustee was generally reluctant to do so because of the likelihood that the trust would have been taxed as a U.S. domestic trust. Under the new law a foreign person can easily use a U.S. financial institution without creating a domestic trust.

[15] The economic interests of the Federal Government lie with the states that impose no tax on trust income and with those who argue that the only basis for determining a trust's residence should be the residence of its trustees. This is so because, at any given level of trust income, it is likely to collect more revenue from trusts that pay no state income tax and that, therefore, are not entitled to state income tax deductions.

[16] Statistics derived from Internal Revenue Service Statistical Tables for the years 2002 and 2008, available at http://www.irs.gov/taxstats/indtaxstats/article/0,,id=96425,00.

[17] The issue of the state residence of a trust is of importance primarily to two kinds of trusts: (1) so-called simple trusts, which must distribute all accounting income currently, do not provide that any amounts are to be used for charity and do not distribute corpus, and (2) so-called complex trusts. The term "complex trusts" generally refers to all trusts other than (1) simple trusts, (2) grantor trusts, trusts the income from which is taxed, pursuant to §§671-679 of the Code, to their grantors or others who have or have had withdrawal rights over trust property and (3) charitable remainder trusts, the income from which is generally, pursuant to §664 of the Code, either not taxed or taxed to the non-charitable beneficiaries who receive distributions. The issue of state residence is generally not relevant to either grantor or charitable remainder trusts because their income is not subject to federal tax, and most states follow the federal rules for determining the taxable income of trusts. Simple trusts are subjected to federal income tax to the extent of accumulated income attributable to corpus and complex trusts are subjected to federal income tax on all undistributed income. References in this article to the "Code" are to the Internal Revenue Code of 1986, as amended.

or combined with the residence of one or more trust beneficiaries. It then suggests an alternate approach that could be a more appropriate method for collecting revenue on income generated by trusts with non-resident trustees. Finally, it suggests a series of steps that advisors should consider taking to protect trustees from taxation in any states other than those in which the trustees reside.

Constitutional Principles

Income Taxation of Individuals

A state may tax an individual's income based on either residency or the source of the income. In the case of its residents, a state's taxation power extends to all of its residents' income no matter what the source.

> That the receipt of income by a resident of the territory of a taxing sovereignty is a taxable event is universally recognized. Domicil itself affords a basis for such taxation. Enjoyment of the privileges of residence in the state and the attendant right to invoke the protection of its laws are inseparable from responsibility for sharing the costs of government.[18]

In the case of non-residents, taxing jurisdiction is limited to income that is derived from sources in the taxing state.

> [J]ust as a State may impose general income taxes upon its own citizens and residents whose persons are subject to its control, it may, as a necessary consequence, levy a duty of like character, and not more onerous in its effect, upon incomes accruing to non-residents from their property or business within the State, or their occupations carried on therein. . . .[19]

These principles do not prevent taxation of the same income by different states. Such taxation could occur either because the state of a taxpayer's residence and the states in which some or all of the taxpayer's income is sourced impose an income tax on the same income or because two or more states claim the taxpayer as a resident. Multiple taxation under these circumstances is not barred by the Due Process Clause,[20] but may raise concerns under the

[18] *New York ex rel Cohn v. Graves,* 300 U.S. 308, 312-313 (1937). *See also, Oklahoma Tax Comm'r v. Chickasaw Nation,* 515 U.S. 450, 462-3 (1995); *Lawrence v. State Tax Commission,* 286 U.S. 276 (1932).

[19] *Shafer v. Carter*, 252 U.S. 37, 52 (1920).

[20] *See, e.g., Curry v. McCanless,* 307 U.S. 357, 372-374 (1939), permitting both the state of a decedent's domicile and the state in which her trustee did business to impose an inheritance tax on stocks and bonds held in a trust over which the decedent had a general power of appointment at death. "In cases where the owner of intangibles confines his activity to the places of his domicil it has been found convenient to substitute a rule for a reason . . . by saying that his intangibles are taxed at their situs and not elsewhere, or perhaps less artificially,

Commerce Clause, which requires fair apportionment as well as nondiscrimination against interstate commerce.[21]

In order to mitigate this risk, most states allow their residents a credit for income taxes paid to other states on income sourced in those states. But because there is no standard definition of source for this purpose, the risk is not always eliminated.[22]

Despite the very broad power a state has to tax the income of its residents, there is no consistent definition of "residence" through-out the states. In the case of individuals, some states equate "residence" with domicile while some focus on the number of days an individual is present within the state during the tax year or the taxpayer's ownership of a permanent place of abode in the state. Individuals with contacts, commercial or otherwise, in multiple states are potentially exposed to multiple unapportioned taxes on all of their income.

There are three sources of multiple tax exposure. First, more than one state can determine as a factual matter that a person meets the test for residence or domicile even if each state's test provides that an individual can be a resident of or domiciliary of only one state. A determination by the courts of one state that an individual is a resident or domiciliary cannot be effectively challenged in the courts of another state when the courts of both states have reached the same conclusion.[23]

Second, different states can adopt different definitions of residence. For example California's definition of resident includes all individuals who are in the state for "other than a temporary or transitory purpose" and all domiciliaries who are "outside the state for a temporary or transitory purpose."[24] New York's definition of resident includes (a) all domiciliaries other than those with no permanent place of abode in New York, with a

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by invoking the maxim, *mobilia sequuntur personam* . . . .But when the taxpayer extends his activities with respect to his intangibles, so as to avail himself of the protection and benefit of the laws of another state, in such a way as to bring his person or property within the reach of the tax gatherer there, the reason for a single place of taxation no longer obtains. . . ." *Id* at 367.

[21] *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977). *But see, Zunamon v. Zehnder,* 308 Ill. App. 3d 69 (Ill. App. 1 Dist. 1999) holding that the "due process clause does not prohibit a state from taxing all of its residents' income, even income earned in another state," *Id* at 78 and the "commerce clause is not intended to 'protect state residences from their own state taxes.'" *Id* at 79.

[22] Consider for example, *Sosa v. Bower,* Cook Count Cir. Ct. Dkt No. 02 L 50670 (June 26, 2003) sustaining, against a Commerce Clause challenge, the denial of a credit for income taxes paid to other states on the income sourced in those states because the base of operation of the taxpayer's employer, a baseball team, was in Illinois.

[23] See *Dorrance v. Thayer-Martin,* 13 N.J. Misc. 168 (Sup. Ct. 1935), *aff'd*, 116 NJL 362, *cert. denied*, 298 U.S. 678 (1936); *Dorrance v. Martin,* 12 F. Supp. 746 (D. N.J. 1935) *aff'd sub nom. Hills v. Martin,* 296 U.S. 393 (1935); *New Jersey v. Pennsylvania,* 287 U.S. 580 (1933); *Dorrance's Estate,* 309 Pa. 151 (1932), *cert. denied, 287 U.S. 660 (1932).*

[24] Cal. Rev. & Tax Code §17014.

permanent place of abode out of New York who spend no more than 30 days in the New York in the taxable year and (2) all individuals who maintain a permanent place of abode in New York and spend more than 183 days in New York in the taxable year.[25] Under these definitions, a domiciliary of California who is in New York for more than 183 days during a taxable year for a temporary purpose and who has a permanent place of abode in New York will be treated as a resident of both states for income tax purposes.

Finally, many states have adopted what is referred to under the jurisprudence of the Commerce Clause as "internally inconsistent taxing regimes."[26] An internally inconsistent taxing regime is one that, if adopted by more than one state would result in taxpayers with commercial activities in those states being taxed more heavily than those that operate in only one state.

The definitions of residence that currently apply in New York, New Jersey and Connecticut are examples of internally inconsistent taxing regimes. Each state's definition of resident is the same as New York's definition set forth above.[27] Because both New York and Connecticut have taken the position, with few exceptions, that presence in the state for even a portion of a day will constitute a full day for purposes of the day counting test,[28] it is not unusual for an individual with homes in both jurisdictions to be treated as a resident of both states. For example, an individual with a principal place of residence in Connecticut, and an apartment and job in New York City is likely to be in both states for at least part of more than 183 days in a taxable year. The same problem arises if an individual is treated as a resident of one of the states because of his or her domiciliary status and presence in the state for more than 30 days and as a resident of the other state because of his or her maintenance of a permanent residence and presence in the state for more than 183 days.

Although commentators have suggested that the adoption of internally inconsistent definitions of income could be vulnerable to a Commerce Clause challenge,[29]such challenges have not been successful.[30]

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[25] N.Y. Tax Law §605(b).

[26] *Container Corp. of America v. Franchise Tax Board,* 463 U.S. 159, 169 (1983).

[27] CTA § 52(a)(1); NJ Stat. §54A:1-2m; NY Tax Law §605(b).

[28] 20 NYCRR §105.20(c); Conn. Temp. rule 52(a)(1)-1(c). There appears to be no authority in New Jersey dealing with the partial day issue. New York's treatment of a portion of a day as a full day for purposes of the day counting rule has been upheld by the Court of Appeals. *Leach v. Chu*, 150 A.D. 2d 842 (1989). For a discussion of these issues, see Personal Income Tax Committee of the Association of the Bar of the City of New York, *Individual Double Taxation in the Tri-State Region,* 93 TNT 68-23 (March 18, 1993).

[29] Jerome R. Hellerstein & Walter Hellerstein, STATE TAXATION §20.03[1] (3d ed. 1998); Seth Goldstein, *"Resident" Taxpayers: Internal Consistency, Due Process, and State Income Taxation,* 91 COLUM. L. REV. 119 (1991).

[30] *Luther v. Comm'r of Revenue*, 588 NW2d 502 (Minn. 1999), *cert. denied*, 528 U.S. 821 (1999); *Tamagni v. Tax Appeals Tribunal*, 91 NY2d 530 (1998), *cert. denied*, 525 U.S. 931 (1998).

Income Taxation of Corporations

As is the case with the taxation of individuals, a state may tax a corporation's income based on either residency or the source of the income. In the case of its residents, a state's taxation power extends to all of its residents' income no matter what the source. A corporation is generally deemed to be domiciled in its state of incorporation.[31] In some cases, particularly in the case of federally chartered corporations, the residence or domicile of the corporation may be its principal office.[32]

Income Taxation of Trustees and Trusts

Nonresident Trusts

There should be no difficulty applying the source based state taxation rules to trustees and trusts. What ever a trust's residence, it should be subject, just as an individual is, to the income tax regimes of states within which its real estate and tangible personal property is located to the extent of the income generated by such property and of states within which it (or pass through entities such as partnerships and limited liability companies in which it has investments) have commercial operations. When taxing a non-resident trust, a state must be cognizant of the Due Process requirement that there be sufficient contact with the trustees to give the state *in personam* jurisdiction over them.[33] In addition, the four-part test for satisfying the Commerce Clause, as discussed above, should also be satisfied.[34]

Determining Trust Residence

The difficulty arises when attempting to define the residence of a trust. Residence or domiciliary status is necessary to give a state the power to tax all of a trust's income.

Neither Congress nor the Supreme Court has established any guidelines for determining the state residence of a trust. In fact, the Supreme Court has shown a decided lack of interest in achieving a resolution of this issue. Each time in recent years that it has been given the opportunity to rule on state residence issues, whether for individuals or trusts, it has declined to do so.[35]

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[31] *Cream of Wheat Company v. County of Grand Forks*, 253 U.S. 325 (1920).

[32] *Lehman Brothers Bank, FSB v. State Bank Comm'r*, 937 A. 2d 95 (2007).

[33] *Quill v. North Dakota*,504 U.S. 298(1992). See text accompanying notes 2-4.

[34] *Complete Auto Transit, Inc. v. Brady,* 430 U.S. 274, 279 (1977). See text accompanying notes 5-8.

[35] *Chase Manhattan Bank, Trustee, et al. v. Gene Gavin*, 733 A.2d 782 (1999), *cert. denied*, 528 U.S. 965 (1999) (residence of a trust); *Luther v. Comm'r of Revenue,* 588 N.W. 2d 502 (Minn. 1999), *cert. denied*, 528

Individuals generally have actual physical places of residence where they spend time. Juridical entities such as corporations, limited liability companies and limited partnerships which owe their existence to a filing or registration under the laws of a particular jurisdiction have the kind of connection with these jurisdictions that has traditionally justified subjecting them to the jurisdiction's tax regimes.

A common law trust, of course, is neither a physical being nor a juridical entity.[36] It has no physical location. It is a creature of the common law and, although a particular trust instrument may provide that a trust is to be governed by the laws of a particular state, it does not owe its existence to the laws of that state.[37] A trust is a "fiduciary relationship with respect to property."[38] It confers on a trustee legal title to property and imposes on her a set of equitable duties with respect to the property. It also confers on one or more other persons, the beneficiary or beneficiaries, a beneficial interest in and a set of rights with respect to the property. The nature of the equitable duties and the rights of the beneficiaries are dependent upon a combination of the terms of the instrument that creates the fiduciary relationship and the state or national laws applicable to the trust.

Yet, we often speak of a trust having a "situs." The factors that go into a determination of situs could be relevant in determining a trust's residence for state income tax purposes. A reference to a trust's situs is generally understood to mean its connection with a particular state or nation depending on such factors as:

U.S. 821 (1999) (residence of an individual); *Tamagni v. Tax Appeals Tribunal,* 91 NY2d 530 (1998), *cert. denied,* 525 U.S. 931 (1998)(residence of an individual).

[36] The focus of this article is on common law trusts, not on so-called "Statutory Trusts" formed under the laws of certain states. *See, e.g.,* Del. Code §§3801-3862. These trusts, which are used primarily for financing transactions and other investment and commercial purposes, are separate legal entities, more closely related to corporations than to common law trusts. The characterization in §7701(a) of the Code of a trust as a "person" and a separate tax paying entity is a tax fiction that provides a convenient way of describing the manner in which income generated by trust assets is to be taxed. Despite the fact that the Code refers to a trust as a "person," the regulations recognize its true nature. Treas. Reg. §301.7701-4(a) provides that "[I]n general, the term 'trust' refers to an arrangement created either by a will or by an inter vivos trust declaration whereby trustees take title to property for the purpose of protecting or conserving it for the beneficiaries under the ordinary rules applied in chancery or probate courts." References in this outline to "Treas. Reg." refer to the regulations promulgated under the Code by the Treasury.

[37] The United States Supreme Court's apparent disagreement with this principal in *Mullane v. Central Hanover Bank & Trust Co.,* 339 U.S. 306 (1950) should probably be limited to those particular species of trusts that are specifically authorized by statute, such the common trust funds authorized by New York's common trust fund legislation, which were the subject of the litigation in the *Mullane* case.

[38] RESTATEMENT (THIRD)) OF TRUSTS §2 (2003).

1. the state where individual trustees live or where corporate trustees are organized or maintain their principal place of business,

2. the state where the trust is administered,

3. the state whose laws govern the validity, administration and construction of the trust,

4. the settlor's domicile at the time of death in the case of a testamentary trust, and

5. the settlor's domicile or residence at the time of creation or funding of an inter vivos trust or at the time a revocable inter vivos trust becomes irrevocable.

Each of these factors, either alone or in combination with one or more of the others, has been held to justify a conclusion that trusts are residents of a particular state.[39] The case law dealing with the validity of these various factors as determinatives of state residence is discussed below.

Place of Residence of Trustees and Place of Administration

At least 13 states treat trusts as residents for income tax purposes if one or more of the trustees are residents of the state or if the trust is administered within the state.[40] At least 9 more states treat trusts as residents based on the residence of the trustee or the place of administration combined either with the residence or domicile of the settlor or the residence or domicile of a beneficiary or both. These approaches to establishing trust residence are likely to be impervious to any Constitutional attack.[41] But, as Roger Traynor observed more

[39] This inconsistency among the states in their treatment of trusts was recently characterized by tax journalist David Cay Johnston as ". . . a riot of uncoordinated rules that some can exploit – a fact that is celebrated by a few as a benefit because of supposed tax competition." David Cay Johnston, *Getting Dinged by the DING*, 2010 TNT 59-8 (March 29, 2010).

[40] This article does not attempt to provide a description of all of the various approaches used by the different states in imposing their income taxes on trusts. For more detailed descriptions of the state laws that determine the residence of trusts for state income tax purposes, see Richard W. Nenno & Howard M. Zaritsky, *Proposed New York Fiduciary Income-Tax Changes: Let My Trustees Go!*, 35 Tax Management Estates, Gifts & Trusts J. 3 (2010) 147 and Virginia Coleman, *State Fiduciary Income Tax Issues*, ALI-ABA, PLANNING TECHNIQUES FOR LARGE ESTATES (2009).

[41] See *Greenough v. Tax Assessors of Newport*, 331 U.S. 486 (1947)(confirming Rhode Island's power to impose an ad valorem tax on half of the value of a trust created by a non-resident and administered outside of Rhode Island when one of two trustees was a Rhode Island resident); *Harvard Trust Company v. Comm'r*, 284 Mass. 225 (1933) (confirming Massachusetts's power to tax the income of a trust created by the will of a Vermont resident when the trustee was a Massachusetts resident); and *Pabst v. Wisc. Dep't of Taxation*, 19 Wis. 2d 313(1963) (confirming Wisconsin's power to impose its income tax on out-of-state trustees who administered a trust in Wisconsin).

than 70 years ago, these approaches are also likely to be self-defeating.[42] The response to such rules by tax-motivated settlors and those who advise them will often be to select trustees that are not residents of states that impose trust income tax based on trustee residence and that will administer the trust in states that do not impose state income tax based on in-state administration.

The chart below lists these states in four different categories.[43] The tax motivated settlor would be likely always to avoid trustees from states listed in the first portion of the chart because using such a trustee would expose their trusts to state income tax even if there were not other contacts with the state. If the tax motivated settlor is a resident of a state listed in the second portion of the chart, he or she would probably avoid the use of a trustee in the settlor's place of residence because that too would expose the trust to state income tax. If a trust has or is likely to have a beneficiary resident in a state listed in the third portion of the chart, a trustee from that state would probably not be selected. Finally, if a trust has a resident settlor and has or is likely to have a beneficiary residing in Massachusetts or unborn or unascertained beneficiaries, Massachusetts trustees are likely to be avoided.

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[42] Roger John Traynor, *State Taxation of Trust Income,* 22 IOWA L. REV. 268 (1936). *See* discussion *infra* note 77.

[43] This chart shows those states that will impose their income tax on a trust on account of the residence of the trustee or place of administration, either for this reason alone or when combined with the residence of the settlor or a beneficiary. It should not be relied on for a conclusion that the selection of a nonresident trustee would be sufficient to avoid that state's tax. Before reaching this conclusion, careful consideration should be given to each state's other criteria for determining tax residence. Citations to the applicable statutes in these states are listed in Appendix A.

	State	Resident Trustee	Administered in State	Resident Trustee + Resident Settlor	Resident Trustee + Resident Beneficiary	Administered in State + Resident Beneficiary
	States That Tax Trusts Based on Residence of Trustee or Place of Administration Alone					
1	Arizona	√				
2	California	√				
3	Colorado		√			
4	Indiana		√			
5	Kansas		√			
6	Kentucky	√				
7	Maryland		√			
8	Mississippi		√			
9	New Mexico	√	√			
10	North Dakota	√	√			
11	Oregon	√	√			
12	South Carolina		√			
13	Virginia	√	√			
	States That Require the Additional Contact of a Resident Settlor					
1	Alabama			√		
2	Michigan			√		
3	New Jersey			√		
4	New York			√		
	States That Require the Additional Contact of a Resident Beneficiary					
1	Delaware				√	
2	Hawaii				√	√
3	New Hampshire[44]				√	
4	Ohio				√	
	State That Requires the Additional Contact of a Resident Settlor and Resident Beneficiary					
1	Massachusetts[45]			√	√	

[44] There is some confusion about the scope of the New Hampshire tax on dividends and interest. N.H. Rev. State Ann. §77:10 provides that the income received by trustees, any one of whom is an inhabitant of New Hampshire, will be subject to the New Hampshire tax. Regulations issued by the New Hampshire Department of Revenue Administration (§902.07) provide that the taxable interest and dividend income of a trust shall be all of such income received by the trustees if all of the beneficiaries are residents of New Hampshire or a pro-rata portion if some of them are New Hampshire residents. The confusion is caused by N.H. Rev. State Ann. §77.11, which provides that income accumulated in trust for the benefit of unborn or unascertained persons will be treated as if accumulated for New Hampshire residents. A literal application of this rule would result in the typical dynasty trust, which is generally expected to benefit future unborn generations, subject to New Hampshire tax. The authors understand that a group of New Hampshire tax attorneys are working with the Department of Revenue Administration to issue a new regulation that reverses this treatment.

[45] Like New Hampshire, Massachusetts treats trust income accumulated for "unborn or unascertained persons" as if accumulated for the benefit of a Massachusetts resident. Mass. Gen. L. ch. 62, § 10.

State Whose Laws Govern the Validity, Administration and Construction of the Trust

One state, Louisiana, treats a trust as a resident of Louisiana for income tax purposes if "the trust instrument provides that the trust shall be governed by the laws of the state of Louisiana."[46] If no provision is made as to the governing law of the trust, the trust will be treated as a Louisiana resident only if the trust is actually administered in Louisiana.[47]

It is not clear that a governing law provision, without more, is sufficient to justify claiming a trust as a state resident. But those settlors who are trying to avoid subjecting their trusts to Louisiana income tax can easily protect their trustees from the necessity of challenging this provision by the simple expediency of choosing another state's governing law.

The Settlor's State of Domicile at the Time of Death in the Case of a Testamentary Trust

Fifteen states and the District of Columbia treat a trust as a state resident if the trust is a testamentary trust created under the will of a domiciliary whether or not the trust has any additional contacts with the state.[48] The case law that considers the automatic classification by a state of a domiciliary's testamentary trust as a resident is sparse but, on balance, favors permitting it.

The earliest case to consider the validity of imposing a state tax on out of state trustees of a testamentary trust with no ties (other than the historical tie of probate) to the taxing state seems to have been the 1898 decision of the Supreme Court of Maine in *City of Augusta v. Kimball.*[49] The tax in issue was a personal property tax. The tax assessors for Augusta attempted to collect from nonresident trustees a tax allocated to the portion of the trust held for the purpose of paying annuities to two residents of Augusta. The Maine Supreme Court rejected the attempt, concluding that:

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[46] La. Rev. Stat. Ann. §47:300.10(3)(b).

[47] *Id.*

[48] These states are Connecticut (Conn. Gen. Stat. §12-701), Illinois (35 ILCS §5/1501(a)(20), Louisiana (La. Rev. Stat. Ann. §47:300.10(3)(b), Maine (Me. Rev. Stat. Ann. tit. 36, § 5102(4)(B)), Maryland (Md. Code Ann., Tax–Gen. §10-101(k)(1)(ii)), Michigan (Mich. Comp. Laws § 206.18(1)(c)), Minnesota (Minn. Stat. § 290.01 Subd. 7b(a)(1)), Nebraska (Neb. Rev. Stat. § 77-2714.01(6)(a)), Ohio (Ohio Rev. Code Ann. § 5747.01(I)(2)), Oklahoma (Okla. Stat. § 2353(6)(a)), Pennsylvania (72 P.S. §7301(s)(1)), Vermont (32 Vt. Stat. Ann. §5811(11)(B)(i)), Virginia (Va. Code Ann. § 58.1-302)), West Virginia (W. Va. Code § 11-21-7(c)(1)) and Wisconsin (Wis. Stat. § 71.14(2)). D.C.'s position may be found at D.C. Code §47-1809.01.

[49] 91 Me. 605 (1898).

> [T]he taxing power of the state necessarily stops at the state boundary lines. It cannot reach over into any other jurisdiction to seize upon persons or property for the purposes of taxation. Apart from the source of their title and authority as trustees, these defendants could not be made in any way amenable to the taxing powers of this state, since neither they nor any of their property were within the state or subject to its jurisdiction.[50]

Eighteen years later, the Wisconsin Supreme Court reached a similar conclusion as to the application of its income tax law to a nonresident trustee of the testamentary trust of a Wisconsin domiciliary in *Bayfield County v. Pishon.*[51] This decision, however, was based on the court's reading of the term "resident" in Wisconsin's taxing statute to exclude nonresident trustees from the term "person residing within the state," rather than on any constitutional principles.

The nonresident trustees in the next case to consider this issue, *First National Bank of Boston v. Harvey,*[52] was a victory for Vermont's state tax collector. Again, a testamentary trust was involved. The only trustee was a Massachusetts institution that administered the trust out of Vermont. The Vermont Supreme Court concluded that the Vermont legislature had the power to control "the acquirement of property by descent or by will" and that this power included the power to provide that "the intangible personal property of a resident testator whose will has been allowed by the probate court, shall be within the jurisdiction of that court for all purposes of administration [including taxation], no mater in what jurisdiction a trustee named in such will may reside, or where the property is kept."[53]

Forty-one years later, the pendulum swung back in favor of the trustees. In *Taylor v. State Tax Commissioner,*[54] the Appellate Division of the New York State Supreme Court concluded that nonresident trustees holding title to Florida real estate by appointment by a Florida court were not required to pay New York income tax on gain from the sale of the Florida real estate despite the fact that they were designated as testamentary trustees under the will of a New York domiciliary. New York Tax §§ 601, 605 and 618 treated all

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[50] *Id.* At 607. The decision cites a series of United States Supreme Court decisions in support of its conclusion, including, *Railroad v. Jackson,* 74 U.S. 262 (1868), and *Foreign-held Bonds Tax Case,* 82 U.S. 300 (1872).

[51] 162 Wis. 466 (1916).

[52] 111 Vt. 281 (1940).

[53] *Id.* at 296, relying, in part, on *Harrison v. Comm'r,* 272 Mass. 422 (1930), a case in which the Massachusetts Supreme Court determined that Massachusetts lacked jurisdiction to impose its income tax on the Massachusetts resident trustees of a New York resident trust because New York had the power to "establish situs for purposes of taxation over a testamentary trust fund created by its deceased residents in intangible personal property being administered by appointees of its own court . . . . [leaving] no room for a situs of the same property for taxation within this Commonwealth." *Id* at 609.

[54] 85 A.D. 2d 821 (1981).

testamentary trusts of New York domiciliaries as New York residents. In the view of the court, the historical domicile of the testator was insufficient to establish a basis for jurisdiction over the trustees. The significance of this trustee victory is weakened by the fact that Florida, not New York provided the statutory framework governing the descent of property and the judicial supervision of the trustees. In 1983, the Tax Court of New Jersey in *Pennoyer v. Taxation Division Director*[55] concluded that the creation of a trust in New Jersey, the New Jersey probate proceeding and the continued availability of the New Jersey courts to the non-resident trustees and beneficiaries is not sufficient to justify continued tax jurisdiction over a testamentary trust. This conclusion may reflect an historic trend toward trust administration that is unsupervised or only lightly supervised by the courts.

The Missouri Supreme Court in *Swift v. Director of Revenue*,[56] also concluded that the creation of a trust under the will of a Missouri domiciliary, without more, does not provide Missouri with sufficient nexus to justify its continued tax jurisdiction over the trust. In that court's view, contemporary benefits and protections are needed. It suggested that a court should consider six points of contact in determining whether sufficient nexus existed:

> (1) the domicile of the settlor, (2) the state in which the trust is created, (3) the location of trust property, (4) the domicile of the beneficiaries, (5) the domicile of the trustees, and (6) the location of the administration of the trust. For purposes of supporting an income tax, the first two of these factors require the ongoing protection or benefit of state law only to the extent that one or more of the other four factors is present.[57]

It is unclear from the opinion whether any one of the contacts listed in (3) through (6) would be sufficient or whether it would be necessary to show the presence of either of the contacts in (1) and (2).

The significance of the *Swift* opinion's contacts requirement was somewhat diminished four years later when the Missouri Supreme Court concluded that a testamentary trust was subject to Missouri's income tax jurisdiction by reason of a small real estate investment in Missouri.[58]

The two most recent chapters that have been written in the testamentary trust judicial saga were delivered by the District Columbia Court of Appeals in 1997 and by the Connecticut Supreme Court in 1999. Both courts decided against the testamentary trustees.

[55] 5 N.J. Tax 386 (1983).

[56] 727 S.W.2d 880 (Mo. 1987).

[57] *Id.* at 882.

[58] *Westfall v. Dir. of Revenue,* 812 S.W. 2d 513 (1991).

The District of Columbia's decision, *District of Columbia v. The Chase Manhattan Bank*,[59] upheld the validity, against a Due Process challenge, of a statute that characterized a domiciliary's testamentary trust as a tax resident trust despite the fact that the trustee was a nonresident and administered the trust in New York. The court first decided that it had jurisdiction to tax the trust because, based on *Quill*, the trust's physical presence in the District of Columbia was not required. All that was required was sufficient contact to make it reasonable for the District to exercise jurisdiction. It then observed that a state may tax the entire income of its residents without regard to the source of its income. And finally, it determined that it was constitutionally reasonable to treat the trust as a tax resident because (1) "in the context of individuals and corporations. . . the concept of residence, if established by reference to sufficient minimum contacts, carries significant legal weight" and because (2) "the Supreme Court has equated a state's power to exercise jurisdiction over an entity and the state's power to tax that entity."[60] In the view of the court, "sufficient minimum contacts" were established by the "District's continuing, supervisory jurisdiction over the entire trust" and by the fact that,

> A testamentary trust, like a corporation, is a creature of the laws of the state where it is created and owes its very existence to those laws. . . . "[A corporation] must dwell in the place of its creation, and cannot migrate to another sovereignty. The fact that its property and business were entirely in another sate did not make it any less subject to taxation in the state of its domicile."[61]

This conclusion is based on a flawed reading of *Quill*. *Quill*'s focus was on a state's power to require a non-resident, not a resident, to collect a tax which had a reasonable relationship to its activities that were directed to state residents. It gave no consideration at all to the factors that should be taken into account in determining whether a taxpayer is a resident because the taxpayer's residency was not an issue.

The Connecticut Supreme Court's approach to this issue in *Chase Manhattan Bank v. Gavin*[62] was similar to the District of Columbia Court of Appeal's approach. Its analysis starts by drawing the same puzzling connection between the due process nexus requirements for taxing nonresidents and the due process requirements for establishing residence.[63] Although the court's due process analysis may not be relevant, its ultimate basis for upholding the Connecticut residence status of the testamentary trusts involved was the

[59] 689 A.2d 539 (D.C. Ct. of App. 1997).

[60] *Id.* at 544.

[61] *Id.* at 545, quoting *Cream of Wheat Co.*, 253 U.S. 325 (1920).

[62] 733 A.2d 782 (1999), *cert. denied*, 528 U.S. 965 (1999).

[63] The opinion observes that neither party raised the second part of the due process requirement – that the income attributed to the state must be rationally related to values connected with the taxing state. As a result, the court did not discuss it. Arguably, the second prong of the test is no more relevant than the first one. Neither prong applies to a resident or plays any role in the determination of a taxpayer's status as a resident. *Id.* at 800.

benefits Connecticut provided them including the assurance under its laws of the continued existence of the trusts, as well as legal and administrative oversight.

> We conclude that this panoply of legal benefits and opportunities is comparable to those general legal benefits and opportunities that justify the imposition of taxes on the income of individual domiciliaries of the state. Just as the vitality of the trust as an economic entity is inextricably intertwined with the administration of the trust assets by a trustee located in New York, the viability of the trust as a legal entity is inextricably intertwined with the benefits and opportunities provided by the legal and judicial systems of Connecticut, and its legal viability is inextricably intertwined with its economic vitality. Neither its economic vitality nor its legal viability trumps the other for purposes of due process and taxation.[64]

The Connecticut Supreme Court also discussed a dormant Commerce Clause challenge. The trustees' argument was not that the Commerce Clause potentially applied to protect the trusts themselves. Trusts, of course, are not generally engaged in interstate commerce. Instead, the argument was that the Commerce Clause should be applied in order to protect the interstate market for trustee services. If testamentary trusts are automatically treated as residents of the domicile of their testators, the trustees argued that testators will be incentivised to select only resident trustees. To do otherwise would be to run the risk of multiple taxation because the state of the residence of the trustees would be able to impose its tax on their trusts. The court rejected the argument on the ground that it was not qualified to make a determination that the prospect of "multiple taxation of some portion of the trust's future income" would have a significant impact on "such a multifaceted decision as the choice of a trustee is likely to be made." [65]

The trend in the case law toward upholding the classification of all testamentary trustees as taxpaying state residents, no matter what their present connection with the state of origin, may be a Pyrrhic victory for the states who adopt this position. Advisors who are drafting testamentary plans for current clients will likely make provisions in their documents for a pour – over of assets that pass under a will to the trustees under an inter vivos trust instrument rather than to testamentary trustees. Once the unique link that exists between a testamentary trust and the probate court of the jurisdiction in which the will was probated is broken, the underpinnings of both of the *Chase* decisions, in so far as they apply to testamentary trusts, will collapse. The probate courts will become the repository of the poorly funded and poorly planned testamentary trusts, siphoning judicial recourses while adding comparatively little to the state fisc.

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[64] *Id*. at 799-800.

[65] *Id.* at 806

The State of the Settlor's Domicile or Residence at the Time of Creation or Funding of an Intervivos Trust or at the Time a Revocable Inter Vivos Trust Becomes Irrevocable

Seven states[66] and the District of Columbia[67] treat an inter vivos trust as a state resident if the settlor was a resident or domiciliary of the state at the time he or she funded the trust or, if the trust was initially revocable, at the time the trust became irrevocable, whether or not the trust has any additional contacts with the state. Six states will do so only if the trust also has resident beneficiaries.[68]

The keystone case striking down a state law that treated a trust as a state resident because its settlor was a domiciliary is *Mercantile-Safe Deposit & Trust Company v. Murphy*.[69] The case focused on a trust established by a New York domiciliary. It became irrevocable at his death and received his residuary estate. After his death, his wife and children, all of whom were New York residents, were the beneficiaries. The trustee was a Maryland corporation. It held the trust assets in Maryland and administered the trust in that state. Under §605 of New York's Tax Law, the trust was treated as a tax resident of New York because of the settlor's domiciliary status at the time of his death. The New York Court of Appeals affirmed the Appellate Division's conclusion that New York's imposition of an income tax on the trust's undistributed income would conflict with the Fourteenth Amendment.[70]

Both opinions relied on the Supreme Court's 1929 decision in *Safe Deposit & Trust Co. v. Virginia*.[71] This case held that the imposition of a tax in the resident state of trust beneficiaries on property in the possession of nonresident trustees when the beneficiaries have no present right to control or possession, is in violation of the Fourteenth Amendment. No consideration was given to the significance of the settlor's domicile at the time of his death. This is not surprising because once a trust becomes irrevocable, its settlor, in the absence of specifically retained powers over the trust, has neither standing to involve himself or herself in its administration nor standing to object to the manner in which it is being administered. As a result, the settlor's domicile arguably should play no role in determining where a trust should pay tax.

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[66] These states are Illinois, Maine, Maryland, Nebraska, Vermont, Virginia, and West Virginia.

[67] D.C. Code §47-1809.01.

[68] These states are Connecticut, Delaware, Missouri, Ohio, Pennsylvania, Rhode Island,

[69] 19 A.D. 2d 765 (1963), *aff'd* 15 N.Y. 2d 579 (1964). Similar decisions were reached in *Blue v. Mich. Dept. of Treasury*, 185 Mich. App. 406 (1990) and *Potter v. Taxation Division Director,* 5 N.J. Tax 399 (1983).

[70] As a result of this decision, New York eventually amended its tax law to provide that resident trusts would not be subject to New York income tax unless they had one or more trustees resident in New York, New York source income, or real estate or tangible personal property located in New York. NY Tax §605(b)(3)(D). Rather than amend its statute after the New Jersey Tax Court reached similar conclusions in *Potter* and *Pennoyer*, New Jersey simply amended the instructions to its fiduciary income tax return.

[71] 280 U.S. 83 (1929).

The Connecticut Supreme Court refused to follow either *Safe Deposit & Trust* or *Mercantile-Safe Deposit* in *Chase Manhattan Bank v. Gavin,* the case earlier discussed in connection with testamentary trusts.[72] The opinion dealing with this issue focused on an inter vivos trust created by a Connecticut resident for the primary benefit of a single Connecticut resident. The court expressed doubt as to the continued validity of *Safe Deposit & Trust* because of its statement that to permit the beneficiaries' state of residence to tax the trust would permit "double taxation, both unjust and oppressive,"[73] noting that the Supreme Court reversed its prohibition against double tax in *Curry v. McCanless.*[74] But, as the New York Court of Appeals stated in *Mercantile,* the "lack of power of New York to tax in this instance stems not from the possibility of double tax but from the inability of a State to levy taxes beyond its border."[75]

Even with its rejection of *Mercantile,* the Connecticut Supreme Court seemed to find it difficult to uphold the statute. It conceded that the connection between Connecticut and the trust was more attenuated than in the case of a testamentary trust. In the end it concluded that taxing the trust was justified because the beneficiary's right to eventual receipt of the accumulated trust income will continue to be protected by Connecticut so long as she is a domiciliary.[76] The beneficiary of the trust had substantial rights and controls over it. She was to receive all of the trust property if she reached the age of 48 and, if she died before then, had a power of appointment over the trust property. It is not clear that the court would have reached the same conclusion if the beneficiary's rights were less substantial.

Legislative Options

The power of states to keep trusts created by their residents tethered to their taxing systems has become more difficult to exercise as trusts and trustees become increasingly mobile. Although there have been recent victories by some states, over time it is likely that trusts and trustees will continue to migrate away from taxing jurisdictions.

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[72] *See* text accompanying notes 62-65 .

[73] 280 U.S. 83, 93 (1929).

[74] 307 U.S. 357, 372-374 (1939).

[75] 15 N.Y. 2d 579, 581 (1964).

[76] The court's partial reliance on the California Supreme Court's decision in *McCulloch v. Franchise Tax Board*, 61 Cal.2d 186 (1964), seems misplaced. Although the California court seemed to uphold the validity of a statute that taxed a trust because of the California residence of its beneficiary, the specific question before it was whether California could tax the resident beneficiary when she received distribution from the trust of previously untaxed income.

In 1936 Roger Traynor foresaw this problem and posed at least a partial solution to it.[77] His proposed solution, while not perfect and certainly not simple, would go a long way toward preserving preventing some of the revenue loss states sustain when trusts that accumulate income for future distributions to their residents do so in another state, generally one that imposes no state income tax.

As then-Professor Traynor pointed out, the persons who ultimately enjoy trust income are not the trust or the trustees, but the beneficiaries. As the ultimate recipients, they seem to be the appropriate persons to bear the tax burden. In the case of many trusts, it is impossible to determine with accuracy which individuals will ultimately receive income accumulated for future distribution. In some cases, individual beneficiaries must live until a particular age or outlive another beneficiary in order to receive a distribution of accumulated income. In other cases, trust distributions are within the discretion of a trustee.

Until the identity of the recipient is known, imposing current taxation on them seems unjustified. But once income is distributed to a resident of the state, there can be no further objection to state taxation. What is suggested here is consideration of California's backup system of trust taxation.[78] California provides for current taxation of a trust with California residents with non-contingent interests. When accumulated income is ultimately distributed to a California resident, to the extent California income tax has not been paid, the recipient, whether or not he or she had a non-contingent interest, must pay income tax on the amount received. Although the beneficiaries under this system would enjoy a period of state-tax free deferral, in the end the state will collect. The amount collected is likely not to be as substantial as it could have collected if it could sustain a system of current taxation based on the residence of the settlor or the beneficiaries. But this system is one that is more likely to enjoy continued viability and less likely to be avoided by movements of assets and trustees to states with little or no state income tax.[79]

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[77] Roger John Traynor, *State Taxation of Trust Income,* 22 IOWA L. REV. 268 (1936).

[78] Cal. Rev. & Tax Code §17743.

[79] The suggested approach is similar to the one used by the Federal government to tax income accumulated in foreign trusts. See Code §§665-668. The Federal system imposes an interest factor that in some cases will eliminate the advantage of the tax deferral. States could adopt a similar approach.

Planning Thoughts

The inconsistencies in approaches to the state taxation of trusts present planning challenges. If the minimization of state taxation is an important client goal, keep the following considerations in mind:

1. ***Initial Trustees.*** Select trustees that are not residents of a state that imposes an income tax based on the residence of its trustees.

2. ***Removing and Replacing Trustees.*** Provide a mechanism for removing and replacing trustees and include as a factor to consider in exercising the power to remove and replace whether the residence of a trustee or proposed trustee would cause the trust to be subject to state income tax.

3. ***Selection of Governing Law.*** Select the governing law of a state that does not impose a state income tax. A successful future challenge to a state's attempt to impose an income tax could treat the selected governing law as a relevant contact with that state.

4. ***Provide a Mechanism for Changing the Governing Law.*** If the initial state selected becomes a taxing jurisdiction, it may be desirable to change the trust's governing law.

5. ***Avoid Testamentary Trusts.*** Avoid the use of testamentary trusts whether or not the client is domiciled in a jurisdiction that treats such trusts as resident taxpayers. The constitutionality of a state income tax on domiciliary testamentary trusts may well be upheld. The constitutionality of a state income tax on the inter vivos trusts of its domiciliaries is less likely to be upheld. A state that does not tax its domiciliaries' testamentary trusts today, may do so tomorrow. And once the trust has been set up under a will and subject to a local probate court, it may be difficult to remove it from the jurisdiction.

   Testamentary trusts can generally be avoided by funding a revocable trust during the client's lifetime with all or virtually all of his or her assets or by creating a minimally funded inter vivos trust that will be the recipient of assets passing under the will.

6. ***Avoid Giving Fixed Interests to Beneficiaries.*** Avoid giving fixed interests in trusts to beneficiaries who live in states with rules similar to California's that tax a trust based on the existence of beneficiaries with non-contingent interests.

7. ***Provide a Mechanism for Adding Beneficiaries With Non-Contingent Interests.*** Some states will subject a trust to income tax if the trust was

8. ***Provide Decanting Provisions.*** A decanting provision that permits trustees to move assets out of one trust into another in another jurisdiction could prove invaluable if the tax laws of the original jurisdiction change.

APPENDIX A

AZ	Ariz. Rev. Stat. § 43-1301(5)
CA	Cal. Rev. & Tax. Code § 17742
CO	Colo. Rev. Stat. §39-22-103(10)
IN	Ind. Admin. Code Rule 3.1-1-12
KS	Kan. Stat. Ann. § 79-32, 109(d)
KY	Ky. Rev. Stat. Ann. § 141.030
MD	Md. Code Ann., Tax Gen. §10-101(k)(1)(iii)
MS	2010 Miss. Form 81-100
NM	N.M. Stat. Ann. §7-2-2(I),(S)
ND	N.D. Admin. Code § 81-03-02.1-04(2)(d)
OR	Or. Rev. Stat. §316.282(1)(d)
SC	S.C. Code Ann. § 12-6-30(5)
VA	Va. Code Ann. § 58.1-302
AL	Ala. Code § 40-18-1(33)
MI	Mich. Comp. Laws 206.18(1)(c)
NJ	N.J. 1041 Instructions page 1
NY	N.Y. Tax Law §605(b)(3)
DE	30 Del. C. § 1601(8)
HI	Haw. Rev. Stat. §§235-1; 235-4.5
NH	N.H. Admin. Rules Rev. 902.07
OH	Ohio Rev. Code Ann. §5747.01(I)(3)
MA	Mass. Gen. Laws ch. 62 § 10