A Disruption in Trust Taxation: Kaestner & Paula Cases Reviewed

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Agenda

- ING Trusts
- Review of Kaestner Case
- Paula Case Update
- What To Do Now
- Q&A

ING Trust

- Taxpayers in high tax states (e.g. California, New Jersey, Illinois, Oregon) want to take advantage of zero tax states (e.g. Alaska and Nevada)
- Shifting income recognition to residents of low tax states accomplishes this
- **However…**

ING Trusts

- The client doesn't want to move
- The client doesn’t want to lose the benefit of the assets/income
- The asset(s) is/are high-value

ING Trusts Solve These Problems:

- The ING trust becomes the taxpayer residing in the low tax state
- The client can potentially receive distributions from the trust
- Transfers to the trust are tax-neutral
- Transfers to the trust are incomplete gifts- the trust is a Non Grantor trust
- Client can fund the trust without incurring gift tax and the trust is a separate taxpayer

The federal rules dictate the trust's design, which was pioneered by Jonathan.

But it doesn't end there.

Other requirements:

- The client’s home state also needs to not-tax the ING.
- Some states reach far in taxing trusts, often in what they consider a resident trust.
- Some states rely on sourcing rules to, at least, limit the usefulness of an ING.

ING Trusts

For example, before January 1, 2014, New York did not tax trusts that lacked certain, specific connections with the State of New York (see the exempt trust provision of N.Y. Tax Laws Section 605(b)(3)(D)). It appeared rather clear that a properly structured ING satisfied this exemption.

Beginning on January 1, 2014, New York provides that if the trust is not a grantor trust for federal income tax purposes and the transfer to the trust was an incomplete gift for federal gift tax purposes (i.e. an ING), the income of the trust will be taxed to the grantor for state and city purposes

Two recent court cases worth considering

- North Carolina Dep't of Revenue v. Kimberly Rice Kaestner 1992 Family Trust (SCOTUS, 2018)
- Paula's Trust, Et. Al. v. Franchise Tax Board (California 1st Appellate, 2020)

Kaestner Facts

- Joseph Lee Rice III formed a trust for the benefit of his children in his home State of New York.
- Rice appointed a fellow New York resident as the trustee.
- The trust instrument gave the trustee “absolute discretion” to distribute the trust’s assets to the beneficiaries. I
- In 1997 Rice’s daughter, Kimberley Rice Kaestner, moved to North Carolina.
- The trustee divided Rice’s initial trust into three separate sub-trusts including the Kimberley Rice Kaestner 1992 Family Trust (Trust).
- The Trust agreement provided that the Kaestner Trust would terminate when Kaestner turned 40, after the time period relevant here. After consulting with Kaestner and in accordance with her wishes, however, the trustee rolled over the assets into a new trust instead of distributing them to her.

Kaestner Facts

- During the tax years in issue Kaestner had no right to, and did not receive, any distributions.
- The Trust was subject to New York law.
- The grantor was a New York resident.
- No trustee lived in North Carolina.
- The trustee kept the Trust documents and records in New York.
- The Trust asset custodians were located in Massachusetts.
- The Trust maintained no physical presence in North Carolina, made no direct investments in the State, and held no real property there.
- There were only two meetings between Kaestner and the trustee in those years, both of which took place in New York.

Facts

- This was based on a North Carolina law authorizing the State to tax any trust income that “is for the benefit of” a state resident. N.C. Gen. Stat. Ann. §105–160.2.
- The State assessed a tax of more than $1.3 million for tax years 2005 through 2008.
- North Carolina taxed the Trust formed for the benefit of Kaestner and her three children.
- The state courts holding that the Kaestner’s in-state residence was too tenuous a link between the State and the Trust to support the tax.

Kaestner

Summary of Holding

Summary:

- The Supreme Court of the United States published its decision in North Carolina Department of Revenue v. Kimberley Rice Kaestner 1992 Family Trust (*Kaestner*) June 21, 2019.
- It holds that, by reason of the due process clause of the Fourteenth Amendment of the Constitution of the United States, a state may not impose its income tax on undistributed income of a trust merely because a beneficiary, who was eligible to receive but did not receive any distribution from the trust in the years in question, was a resident state.

Unanimous Decision?

- The decision was unanimous.
- But Justice Alito filed a concurring opinion, in which Chief Justice Roberts and Justice Gorsuch joined.
- That concurring opinion may temper certain statements made in the court’s opinion.

Due Process Limits State's Right to Tax

- The 14th Amendment to the Constitution provides in part: "No state shall make or enforce any law which shall abridge the privileges or immunities of citizens of the United States; nor shall any state deprive any person of life, liberty, or property, without due process of law; nor deny to any person within its jurisdiction the equal protection of the laws."
- The Due Process Clause limits States to imposing only taxes that "bea[r] fiscal relation to protection, opportunities and benefits given by the state." Wisconsin v. J. C. Penney Co., 311 U. S. 435.
- Compliance with the Clause's demands "requires some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax," and that "the 'income attributed to the State for tax purposes . . . be rationally related to "values connected with the taxing State," ' " Quill Corp. v. North Dakota, 504 U. S. 298.

Due Process Limits State's Right to Tax

- That "minimum connection" inquiry is "flexible" and focuses on the reasonableness of the government's action. Id., at 307. Pp. 5–6.
- "When a State seeks to base its tax on the in-state residence of a trust beneficiary, the Due Process Clause demands a pragmatic inquiry into what exactly the beneficiary controls or possesses and how that interest relates to the object of the State's tax." Safe Deposit, 280 U. S., at 91.
- Comment: What might this vague minimum connection mean to other contacts? This will be discuss below.
- Quill was overturned in part last year by South Dakota v. Wayfair, Inc., 585 U. S. ___ (2018).

Commerce Clause Not Addressed

- The *Kaestner* decision was based solely on due process.
- Another attack on a state imposing its income tax on undistributed trust income is the commerce clause contained in Article I, Section 8, Clause 3 of the Constitution.
- That was not addressed by the Court even though the trail court in North Carolina found that that too foreclosed income taxation of the trust’s undistributed income.
- Previously the Supreme Court in the Quill case analyzed the distinction between the minimum contacts for nexus required under the Due Process Clause and the substantial nexus required by the Commerce Clause. Quill Corp. v. North Dakota (91-0194), 504 U.S. 298 (1992).

Holding Limited in Scope

The decision is limited to the facts of the case. And it means that a state, such as North Carolina, may not impose its income tax on undistributed trust income merely because a beneficiary who resides in the state is eligible to receive trust distributions.

The decision does not provide the parameters of when a state may so impose its tax. But it is filled with significant discussion of the issue.

That discussion may inform states on how to rig their state income tax laws so they can impose their state income tax on undistributed income of trust. It also should inform practitioners on how to try to structure and trustees how to administer trusts to avoid a state tax.

Reasoning of the Court

Minimum Connection

Minimum Connection

- Supreme Court of the United States agreed with the decision of the Supreme Court of North Carolina that the state could impose its tax on the undistributed income of the trust because the state "lacks the minimum connection with the object of its tax that the Constitution requires."

- The court found that North Carolina's only connection to the trust in the tax years in question was the state residency of the trust beneficiaries.

- The Trust had no physical presence in North Carolina, made no direct investments in the State, and held no real property there.

- The trustee chose not to distribute any of the income, and that the trustee's contacts with beneficiary were "infrequent." The trustee kept the trust documents and records in New York, and the Trust asset custodians were located in Massachusetts.

Federal Income Taxation of Trusts

- For Federal income tax purposes, trusts and their beneficiaries are taxed on trust income under a unique set of rules, unlike corporations and their shareholders (including so-called S corporations) or partnerships and their partners or any other tax entities and their beneficiaries or owners.
- Section 641(b) provides that trusts and decedents' estates are to be taxed as individuals are except as otherwise provided in the Code.
- Section 641(c) provides that they will be taxed as individuals are except as provided in Subchapter J. However, sections outside of Subchapter J provide some of the unique treatment of trusts and decedents' estates. Example: Section 167 provides for the treatment of deprecation on property held by a trust and for an estate and the treatment for those entities is somewhat different.

DNI and Kaestner

- A key difference between the taxation of an individual and a trust or estate is that a trust or estate is entitled to an income tax deduction for its distributable net income (DNI) that is distributed or treated as distributed to a beneficiary who must include the DNI in income.
- Sections 651-652 and 661-662. Section 643(a) defines DNI.
- To the extent an estate or trust is not entitled to a distribution of its DNI, the income will be taxed to the estate or trust. The issue dealt with in *Kaestner* was the ability of a state to tax such undistributed income.

Other Trust Taxation Schemes

- Most states tax on the basis of the Federal income tax rules. But at least two do not: Pennsylvania and Tennessee. Hence, the issue of the right of those states to tax trust income may be somewhat different than it might be in other states, such as North Carolina.

- Grantor trusts, have their income, deductions and credits against tax attributed to the trust's grantor, or to someone who has certain powers to demand the income or corpus of the trust. See Sections 671-679.

Court’s Comments on State Taxation of Trust Income

Factors to Consider

Kaestner Discussion: Factors Supporting Taxation

- Although the court limited its holding to the precise facts before it, many of its statements may be informative of when a state might impose its income tax on income that is not attributed to a beneficiary.
- Even if several additional factors would weigh in favor of allowing a state to its tax on the trust (e.g., settlor was domicile in the state when the trust became irrevocable, one or more trustees resided in the state or the trust held assets in the state), North Carolina presumably could not have imposed its tax because the tax was premised on only one factor: a North Carolina resident was a beneficiary to whom the trustee could make distributions.
- North Carolina imposed its tax even if the trust had no relationship with the state other than one or more beneficiaries resided there. If the grantor had resided there or North Carolina law governed the trust, the result might have been different.
- In other words, in determining if the state could impose its tax, one first must see what the basis for the tax under that state’s law.

Clients That Will Fight: Paula

- CA settlor. CA Trust. One CA trustee.
- Trust sold limited partnership interest in a CA LP and earned capital gains from the sale.
- Lower court ruled that Trusts do not pay CA tax based on source of income. Appeals court reversed.

What was at stake?

Example:

- NV resident with CA business sells business. It is reported as an asset sale under IRC 338 (h)(10). Most/all business assets are located in CA.
- Because of the sourcing rules, because all the assets are in CA, CA tax is owed on the entire sale. If it was a stock sale, generally, the client would not pay CA tax.
- However, under the lower court’s ruling in Paula, if the assets were sold by an ING, no CA tax (at least not initially).
- If Paula was upheld, it would significantly increase the applicability of INGs for CA residents or owners of CA businesses/assets.

Results

- Paula’s Trust lost.
- But court affirmed Paula is a contingent (i.e. discretionary) beneficiary.
- Remanded to trial.

Why It Matters

- The Court’s opinion is odd.
- When interpreting statutes, court’s can use extra evidence when the statute is ambiguous.
- The Court relied on extra evidence to interpret the statute but never explained why it was ambiguous.
- The Court highlights the distinction between imposition of tax and the computation of tax, denies Paula any usefulness to this distinction, and then conflates the two concepts to support its interpretation.
- And worst of all, it opens the door on the definition of “resident.”

Who/What is a Resident Now?

- The Court declares that CA's definition of a resident is not necessarily "limiting".
- The Court doesn't tell us what the definition is or could be limited to.
- The Court confirms that residents pay tax on all their income and nonresidents pay tax on only their source income.
- How do we know if an ING is a resident, and pays tax on all its income, or is a nonresident and pays tax on only the source income?

Is an ING a Resident of California?

- Kaestner is helpful. We should examine the relationships between the settlor/beneficiary/trustee and the assets the state wants to tax.
- Always use trustees outside of the home state.
- Owning intangible assets is preferred because they are deemed located in the same place as their owner (i.e. the INGs situs).
- Reducing settlor's/beneficiary's possession, control, or enjoyment is preferred.

Is California Law Worth a Constitutional Battle?

- CA imposes a tax on every trust. R&T 17041(e). This seems clearly problematic for CA.
- CA will tax a trust an all of its income if a noncontingent beneficiary is a resident of CA. This seems potentially problematic for CA. Does "noncontingent" always mean the same thing as "no right to demand income"?
- In the alternative, consider if a client's income can be segregated into non-source and source.
- One case provides a simple example. Edward McAneeley was a hockey player for the Oakland Hockey Club.
- His 3-year contract was terminated before the third year started resulting in a termination fee.
- Edward was not a resident of CA and the termination fee was not CA source income.
- Can a client's income be divided into source and nonsource streams? Is the nonsource stream sufficient to justify an ING's tax brackets?

Example

- Michigan law identifies a trust as a resident if a settlor was a resident when the trust becomes irrevocable.
- MI taxes rents from real property located in the state, royalties from tangible personal property owned by a resident trust, and capital gains from the sale of intangible personal property owned by a resident trust.
- In 1990, MI's Appellate Court declared the application of these statutes as to the taxpayer unconstitutional even though the MI-resident-settlor formed the trust and the trust owned MI real property.
- The Court noted that the Trustee and most of the property was not in MI but emphasized that the trust administration and situs of the trust was not in MI.
- This case was decided nearly 30 years before Kaestner but they are very similar in attitude. A state's taxing authority is limited and trusts can provide an avenue for relief.

Last Note

New York law identifies a resident trust in a manner very similar to Michigan, but it provides an exemption that use to permit ING trusts because the ING trust lacked certain connections with the state.

New York chose to attack INGs not by denying them the exemption (i.e. using a method similar to Michigan, which is problematic) but by decoupling the state's grantor trust rules from the federal grantor trust rules as to ING trusts.

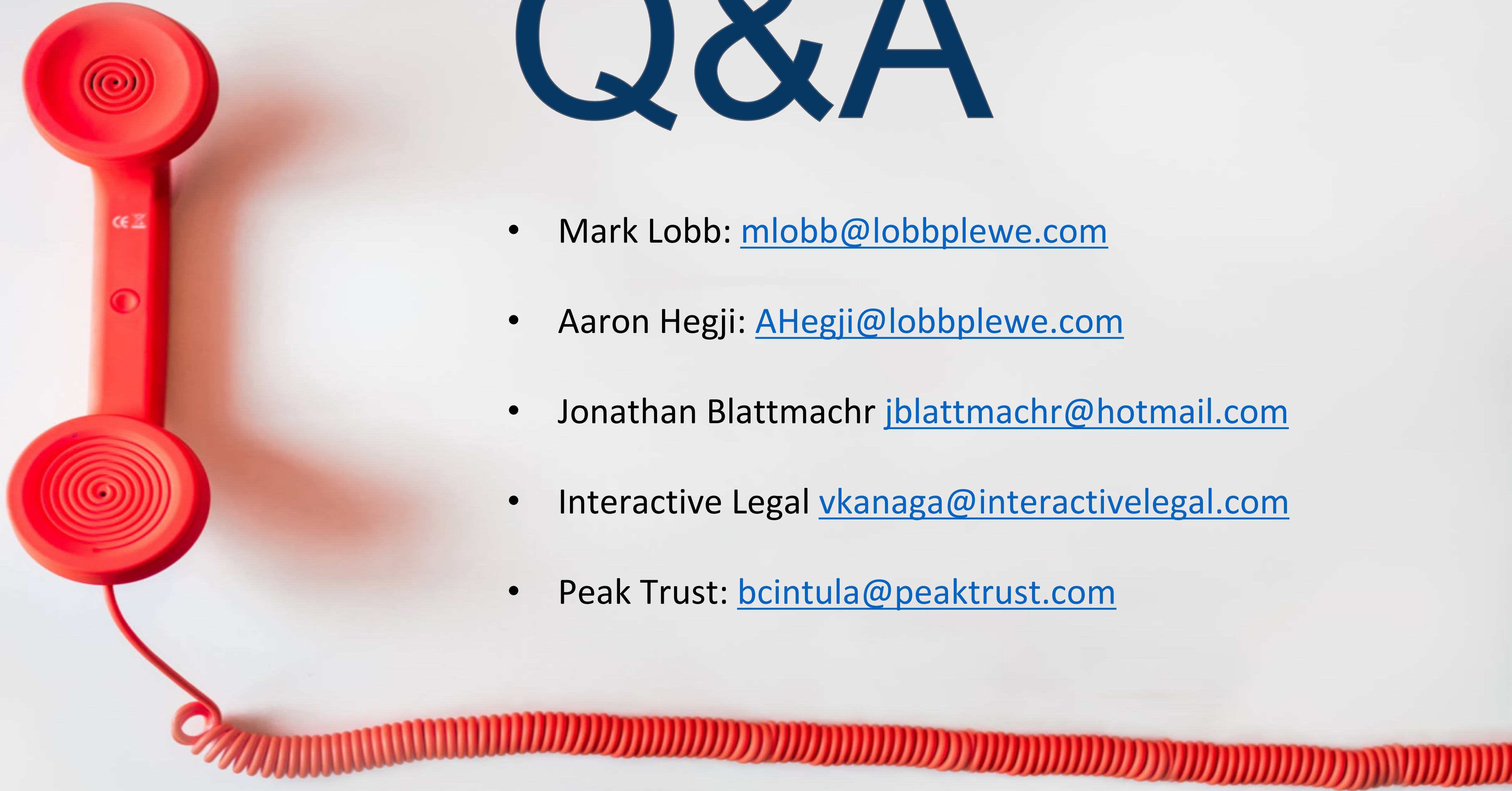
This is also problematic for New York because of its decision in Mercantile Safe Deposit and Trust Company v. Murphy, 15 *N.Y.*2d 579 (*N.Y.* 1964), which held that the state could not impose its income tax on undistributed income of a trust created by a New Yorker for members of his family who also were New Yorkers, where the sole trustee was not in New York. Some practitioners believe it may be unconstitutional for New York to attempt to do indirectly what it cannot do directly—i.e. tax the grantor of an ING because it cannot tax the trust."

- Every client residing in a high-tax state (note that MI is only 4.25%, but it's a flat tax on all forms of income) and every client with assets or businesses in a high-tax state should contemplate if an ING is useful to her or his estate.

- Anyone in CA with a CA beneficiary should consider filing a protective claim for refund

- Take action to avoid the tax. Ex: consider decanting the trust to a trustee in Nevada or Alaska

- Put assets in limited liability company



Q&A

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