Recent Resident Trust Rulings: Can Your Clients' Trusts Avoid State Income Tax?

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Income tax planning has become more important than ever because of increased estate tax exemption amounts and generally higher state and federal income tax rates. One tax imposed by a number of states is on the income of trusts known as "resident trusts." Generally, these long-arm statutes impose a tax on a trust's income solely because of the state of residence of the grantor or a beneficiary of the trust, regardless of any other nexus of the trust to that state.

Recently, some trusts that meet the definitions of resident trusts under their states' statutes have challenged such laws. Specifically, rulings in *Fielding v. Comm'r of Revenue*, No. A17-1177, 2018 WL 3447690 (Minn. July 18, 2018), and *Kimberley Rice Kaestner 1992 Family Tr. v. N. Carolina Dep't of Revenue*, 814 S.E.2d 43 (N.C. 2018), involved such challenges, which addressed the constitutionality of resident trust statutes in Minnesota and North Carolina, respectively.

In *Fielding*, a Minnesota resident established four trusts and funded them with shares of a Minnesota corporation. The trusts met Minnesota's statutory definition of resident trusts by virtue of being created by a Minnesota grantor. The trustee (a non-resident of Minnesota) eventually sold the shares of the corporation and, during the tax years in question, held the proceeds in investment accounts outside Minnesota. At the time in question, only one beneficiary of one trust was a Minnesota resident.

The Minnesota Supreme Court held that Minnesota's resident trust statute, as applied to the trusts, was unconstitutional because the connection of the grantor or the beneficiaries to Minnesota did not create a sufficient nexus between the trust and the state, and accordingly, Minnesota could not tax the income of the trusts.

In *Kaestner*, a trust was created by a nonresident of North Carolina. During the tax years at issue, the trustee was a Connecticut resident. All income of the trust was generated outside of North Carolina. Kimberly Rice Kaestner, a discretionary beneficiary of the trust, became a resident of North Carolina, although no distributions were made to her during the tax years at issue. North Carolina's resident trust statute provides that "tax is computed on the amount of the taxable income of the estate or trust that is for the benefit of a resident of this State."

The Supreme Court of North Carolina held that North Carolina's resident trust statute, as applied to the trust, violated the Due Process Clauses of the United States and North Carolina Constitutions, as the trust did not have sufficient minimum contacts with the state of North Carolina. The court further held

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that the connections of a beneficiary of a trust to North Carolina were not relevant for purposes of satisfying due process requirements. Accordingly, North Carolina was not permitted to tax the income of the trust.

These cases apply only to the states and trusts at issue, but they provide useful constitutional analysis of resident trust statutes and present some interesting planning opportunities.

States Without State Income Tax

For those practicing in states that don't have a state income tax, there will not generally be any income tax savings to be gained by establishing trusts outside of the state. Particularly for those in trust-friendly jurisdictions, however, practitioners may find it beneficial to be aware of methods to implement nonresidents' tax planning such as creating non-grantor trusts and amending existing trusts.

States with State Income Tax

For those practicing in states that have a state income tax, practitioners should consider advising clients to establish trusts outside of their state of residence or to move existing trusts to different states to avoid imposition of state income tax. This may also involve structuring trusts to be taxed as non-grantor trusts. Part of this analysis will involve determining the source of the trust's income and whether the state's income sourcing rules will capture the trust income even if the trust is established in or moved to another jurisdiction.

For clients who have previously established trusts in other jurisdictions, practitioners should consider whether to advise them to have their trusts seek refunds or change their filing status and stop paying tax in future years. For future years, consideration should be given as to whether the trustee could simply stop paying state income tax (and risk an audit) or to have the trustee pay the tax and request a refund. The latter is generally advisable so as to avoid interest and penalties in the event the state is successful.

Although the referenced cases provide good authority for those in Minnesota and North Carolina, they don't actually strike down the resident trust laws. Rather, the application of the resident trust laws to the trusts at issue violated due process rights. Accordingly, the resident trust statutes of these states are still in effect, and practitioners (even those in Minnesota, North Carolina, and other states where resident trust statutes have been successfully challenged) should be cautious in advising clients to proceed in a manner that doesn't conform to the statutes.

Finally, practitioners should know that states are aware of these cases, likely don't want to lose the revenue generated by the resident trust statutes, and could seek to enact laws that attempt to conform to due process requirements. In addition, cases like *Fielding* and *Kaestner* could have been decided differently based on slightly different facts. Accordingly, practitioners should keep apprised of recent cases and legislative updates that may further expand on the application of resident trust statutes to trusts or that adjust the requirements of resident trusts. n

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