McDermott Will & Emery

CUTTING THROUGH THE CHAOS: STATING THE OBVIOUS – STATE TAX CONSIDERATIONS FOR THE PRIVATE CLIENT

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QUESTION SUBMISSIONS

During this webinar you can submit questions through the Zoom Q&A function

- The presenters will answer questions at the end of the presentation as time permits
- If your question is not addressed live, the presenters will do their best to answer your question via email

INDIVIDUAL RESIDENCY

TAX – THE GREAT MOTIVATOR

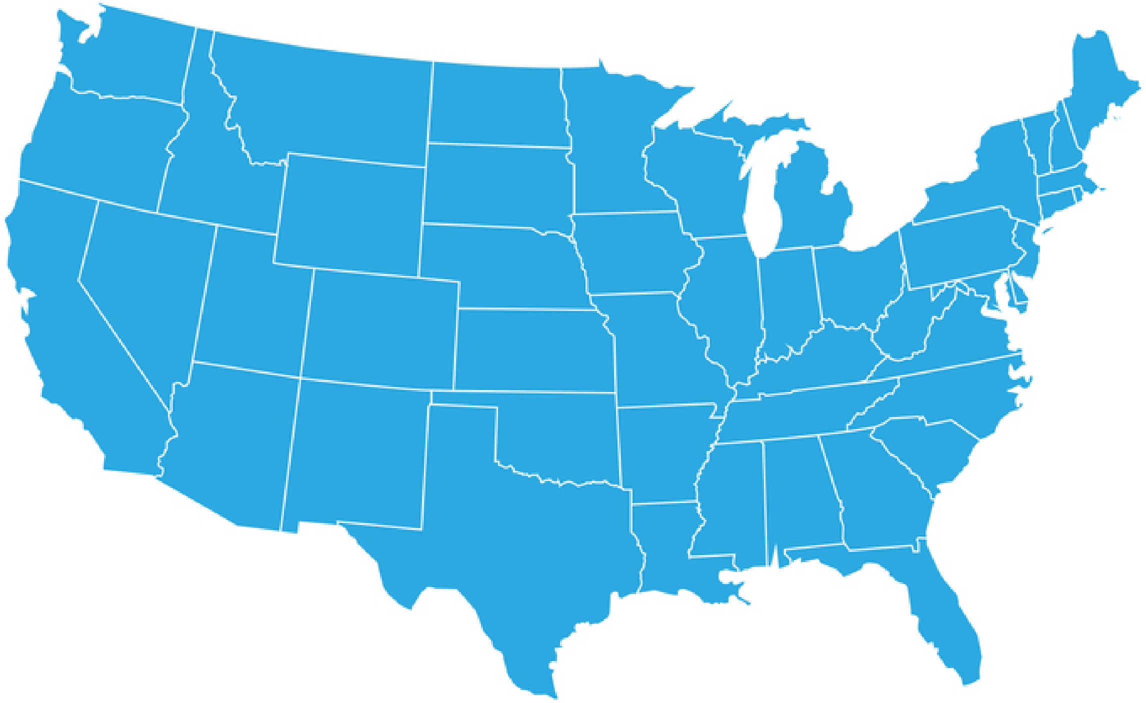
- Income tax rates vary substantially across the United States
  - No tax states: AK, FL, NV, SD, TX, WA and WY
  - States with limited income tax: NH and TN
  - Compare CA's highest tax rate of 13.3% and NY's highest combined state and city tax rate of 12.696%
- While we won't be focusing on estate or inheritance tax today, there are considerable differences among the states regarding the imposition of estate or inheritance tax
  - 33 states have no estate or inheritance tax, including CA
  - 5 states have an inheritance tax but no estate tax
  - MD not only has an inheritance tax but an estate tax too
  - Other states impose an estate tax but allow for a large estate tax exclusion, with NY allowing the maximum exclusion of $5,850,000
  - Still other states have their own estate tax exclusion amount, including MA ($1 million with 16% max rate) and CT ($5.1 million with 12% max rate and a cap of $15 million in state estate tax)
  - If moving residency to another state to avoid income tax, be careful not to then cause an estate or inheritance tax. For example, WA state has no state income tax but imposes a state estate tax on assets in excess $2,193,000 with a maximum estate tax rate of 20%

STATE'S AUTHORITY FOR TAXATION

- States have the power to tax
  - "Unless restrained by constitutional provisions, the sovereign has power to tax all persons and property within its jurisdiction and enjoying the benefits and protection of its Laws." *Haavik v. Alaska Packers Ass'n.* 263, U.S. 510, 514 (1924)
  - But are subject to constitutional constraints.
- States have the right to tax people, property or commerce within their borders, but there are limits
  - Due Process Clause
    - Prohibits states from depriving "any person of life, liberty or property, without due process of law"
    - Prevents an abuse of that power that would amount to a confiscation of property or deprivation of personal rights
  - United States Supreme Court
    - States can tax all of the worldwide income of one of its residents
    - States can only tax nonresidents on the income earned within its borders

STANDARDS FOR ESTABLISHING RESIDENCY

- States differ on basis for taxation of individuals
  - Domicile
  - Residence
  - Days present in the state
    - Greater than 183 days
    - Nine months – CA
  - Some combination of the above



BASICS OF RESIDENCE

- Residence and domicile are not the same
  - Residence is more than a temporary place of abode
  - If domicile is established, residence will be presumed absent facts proving otherwise
  - Days present in a state provide the evidence for residence
- An individual can have multiple residences
  - The risk of double taxation is alive and well

BASICS OF RESIDENCE

- Domicile is:
  - The place you intend to have as your permanent home
  - Where your permanent home is located
  - The place you intend to return to after being away (as on vacation, business assignments, educational leave, or military assignment)
  - Determined on a facts and circumstances basis
  - Intention to return to permanent home is essential
- Only one domicile allowed at a time
  - Domicile does not change until you have abandoned your old domicile and established a new domicile outside the original state of domicile

BREAKING & ESTABLISHING DOMICILE

- Breaking bad
  - States from which taxpayers are fleeing will try to claim that domicile and residence have not changed
  - Fleeing taxpayers must be clear with actions and words as to their intent to change domicile
  - Proving non-residency is not the same as changing domicile if there is no intent to make a different residence a permanent place of abode
- Establishing a new permanent abode
  - States into which taxpayers are landing usually make it easy to establish residency
  - Taxpayers should not rely solely on the rules to establish residency to prove the change has been made
  - Embrace (not just state) the intent to permanently reside

THE MECHANICS OF CHANGING DOMICILE

- Preliminary planning
  - Decide on the effective date for the change
    - Preferably January 1
    - Preferably at least a year in the future
    - (The move must be completed by the effective date)
  - Educate the taxpayer as to what will be required
  - Assemble a team
    - Taxpayer
    - Point person in the family office
    - Lawyer in old domicile
    - Lawyer in new domicile
    - CPA

THE MECHANICS OF CHANGING DOMICILE

- Preliminary planning
  - Establish a checklist of things to be done
  - The best format is a grid with several columns
    - Task
    - Target date
    - Status
  - The grid should be updated on a regular basis
  - Establish mechanism for tracking days in old and new domiciles (e.g., diaries, charge slips)
  - Make sure that the taxpayer understands that days in new domicile must significantly exceed days in old domicile
    - It is not enough that days outside old domicile significantly exceed days in old domicile
    - One must do more than abandon the old domicile – one must establish the new domicile

THE MECHANICS OF CHANGING DOMICILE

- Sever business connections in old domicile
  - Managing one’s own investments through an office in the old domicile is not a problem
  - Avoid active involvement in a business in old domicile
    - If business is located in the old domicile, this may be a problem, even if the work is done from the new domicile
  - Board membership in a public company in the old domicile is not a problem. Board membership in a privately-held company may be a problem

THE MECHANICS OF CHANGING DOMICILE

- Charitable activities
  - Disengage from charitable activities in old domicile
    - This may require advance planning if the taxpayer has been deeply involved with some organizations
  - Get involved with charitable activities in new domicile
    - Make contributions
      - – E.g. *A small contribution to the neighborhood volunteer fire department may show more of a commitment to the new domicile than does a large contribution to the art museum*
    - Volunteer work
    - Move family foundation office
- Civic activities
  - Get involved in the new community
    - Volunteer work
    - Local politics
    - Write letters to local newspapers about local issues
    - Join business organizations
  - End civic activities in old domicile

THE MECHANICS OF CHANGING DOMICILE

- Club memberships
  - Join clubs in new domicile
  - Resign from clubs in old domicile or change membership to nonresident status
- Personal finances
  - Establish an office in new domicile (preferably not in home)
  - Move financial records to new domicile
  - Establish banking relationships in new domicile
  - Establish professional relationships in new domicile
- Registrations should be changed
  - Automobiles, boats, planes; drivers licenses; voting
- Post-change activities
  - Family office should monitor activities after the move
  - Keep track of days in old and new domiciles
  - Memorialize reasons for changes that increase time and activities in the old domicile
  - Preserve records for the inevitable income tax audit in the old domicile

STATE TAXATION OF TRUSTS

SIGNIFICANCE OF TRUST'S STATE TAX PRESENCE

- Perennial state tax law "hot topic"
- The entire income of an irrevocable non-grantor trust is subject to tax in the state of its residence
- Income sourced to a state can always be taxed by that state (income from activity or real estate located in the state, for example)
- Income distributed to a beneficiary is always subject to tax in the state where the beneficiary resides
- *What is at stake is income not sourced to the taxing state that is accumulated and capital gain not taxable to a beneficiary*

SIGNIFICANCE OF TRUST'S STATE TAX PRESENCE

- State tax rates are high and more likely to be increased rather than decreased
- Even low rates can produce a high state tax when the income is large
- Many wealthy beneficiaries do not need all trust income to be distributed each year
- 2017 Tax Act essentially eliminated the deduction for state income tax for larger trusts

RESIDENCY OF A TRUST

Where does a trust reside for state tax purposes?

- Can be difficult to determine because a trust (unlike an individual or a corporation) is neither a physical being nor a juridical entity
- A trust is a “fiduciary relationship with respect to property”
- A trustee has legal title to the trust’s property and equitable duties to the trust
- A trust’s beneficiaries have a beneficial interest in the assets of a trust, but there are many different kinds of beneficiaries
- There often are other officeholders with fiduciary or quasi-fiduciary duties

HOW DOES A STATE DETERMINE A TRUST'S TAX RESIDENCY?

- State taxation statutes generally consider the following factors:
  - Residence of grantor (at time of death or time when trust became irrevocable)
  - Place of administration
  - Residence or place of business of trustee (or *fiduciary* in California)
  - Residence of beneficiary
  - Other
- Source of income
  - Income producing property or activity within a state is sufficient nexus for state taxation of income associated with that property or activity
- Residency of grantor
  - Often used as a starting point under statutory definition of "resident" trust
  - A statute that taxes a trust based on this factor alone may be unconstitutional
- Factors vary state-to-state which presents planning opportunities for practitioners

HOW DOES A STATE DETERMINE A TRUST'S TAX RESIDENCY?

- Administration of a trust is complicated: different functions may be carried out in several states, but often would be where the trustee resides
- Governing law is also complicated
  - Typically addressed three issues: validity, construction/interpretation, and administration
  - Validity may or may not be entirely within the choice of the grantor and seems fixed in any event
  - Construction rules could be hard wired into the instrument, at least in theory, so using a state's rules in this area does not seem as if it should give a state enough contact to tax
  - Administration rules typically shift depending on where the trust is administered
- The state of settlor's domicile at the time of death (in the case of a testamentary trust) or at the creation or funding of an irrevocable lifetime trust
- The trust often has multiple beneficiaries who could live in a number of different states and the taxpayer/trustee has no control over where a beneficiary resides. The trustee also may not have all of the facts that would be necessary to assess the residence of the beneficiaries

STATE AUTHORITY FOR TAXATION

- Case law holds that residence of grantor alone is not sufficient contact with a state to impose a tax on all of the trust's income under the Due Process Clause or the Commerce Clause
- Disproportionate burden compared to the benefits received
- Planning consideration:
  - Many state laws tax a trust *permanently* based on residence of grantor when trust created. Residency changes, and ongoing taxation may be unconstitutional
- Due Process Clause: "No State shall make or enforce any law which shall…deprive any person of life, liberty, or property, without due process of law…"
  - Does the state have a "minimal connection" to the trust to make it fair to impose tax?
- Commerce Clause: "Congress shall have power to lay and collect taxes" and to "regulate Commerce…among the several States"
  - Does a state law interfere with interstate commerce?
  - There must be a "sufficient nexus" with the state

CONSTITUTIONAL ISSUES IN TRUST TAXATION

***North Carolina v. The Kimberley Kaestner* 1992 Family Trust, 139 S. Ct. 2213 (2019)**

- Facts:
  - NY resident established an inter vivos trust; trust split into three separate trusts for each of grantor's children
  - One of the trusts was for the benefit of Kimberley Rice Kaestner, a NC resident and domiciliary
  - Trustee resided in CT; no NC assets; NC law did not apply
  - Only contact the trust had with NC was the in-state residence of a current discretionary beneficiary
- Holding: Taxation of income of family trust based solely on the residence of a beneficiary who has never (and may never) receive a distribution was unconstitutional because the trust did not have sufficient minimum contacts with the State of NC to satisfy due process
  - Due process clause requires a minimum connection between a state and the person it seeks to tax
  - Discretionary beneficiary's residence as the sole connection to NC is not sufficient to satisfy this requirement
- This is the first Supreme Court decision on trust income tax in decades

CONSTITUTIONAL ISSUES IN TRUST TAXATION

Impact of Kaestner

- Though narrow, the decision provides some clues as to what would be considered sufficient nexus for taxation
- Residency of trustee
  - At least 5 states tax based on residency of the trustee
    - AZ, CA (residency of the *fiduciary*), KY, NM and OR
  - At least 8 also require another connection in addition to a trustee's residence (i.e., residence of settlor or of a trust beneficiary)
    - AL, AR, DE, HI, MA, NJ, NY and ND
  - See *Greenough v. Tax Assessors of Newport*, 333 U.S. 486 (1947)

CONSTITUTIONAL ISSUES IN TRUST TAXATION

Impact of Kaestner

- Place of administration
  - At least 7 states tax if trust is administered in that state
    - CO, IN, KS, MS, NM, OR and SC
    - CA will tax a trust if its corporate fiduciary conducts the major portion of its administration in CA
  - At least 2 states also require another connection
    - HI and NJ
  - Decision states that prior cases "suggest" that tax based on site of trust administration is constitutional
  - See *Hanson v. Denckla*, 357 U.S. 235 (1958) and *Curry v. McCanless*, 307 U.S. 357 (1939)

CONSTITUTIONAL ISSUES IN TRUST TAXATION

Impact of Kaestner

- Residency of the settlor
  - At least 21 states and DC tax based on residency of the settlor
  - A few also require the residency of a beneficiary
    - AL, CT, DE, ID, IL, IO, LA, ME, MD, MA, MI, MN, MO, NE, OH, OK, RI, VT, VI, WV, and WI
  - See *Curry v. McCanless,* 307 U.S. 357 (1939) and *Graves v. Elliot*, 307 U.S. 383 (1939)

CONSTITUTIONAL ISSUES IN TRUST TAXATION

Fielding v. Comm'r of Revenue, 916 N.W.2d 323 (Minn. 2018)

- Facts:
  - A MN domiciliary was grantor of four trusts when they became irrevocable
  - Trusts were created in MN with MN law firm; trust documents held by MN law firm
  - Trusts designated MN law to govern trust terms
  - Primary beneficiary of one of the trusts was a MN resident
- Holding: Imposition of MN income tax based on single factor of grantor's domicile when the trusts became irrevocable violated Due Process
  - The court determined that to satisfy due process, a two-part test is required:
    - "[M]inimum connection" between the state and the person, property or transaction subject to the tax
    - Income subject to the tax must be "rationally related" to the benefits conferred on the taxpayer by the state
  - Decided on a narrow issue, but court examined under broader scope and determined that the facts were "irrelevant or too attenuated" to meet due process
- Petition for writ of certiorari *filed* with the U.S. Supreme Court on November 15, 2018 (No. 18-664) and *denied* on June 28, 2019. *Bauerly v. Fielding*, 139 S. Ct. 273 (2019)

CONSTITUTIONAL ISSUES IN TRUST TAXATION
OTHER IMPORTANT DECISIONS

- State prevailed:
  - *District of Columbia v. Chase Manhattan Bank*, 689 A.2d 539 (D.C. 1997)
  - *Chase Manhattan Bank v. Gavin*, 733 A.2d 782 (Conn. 1999)
- Taxpayer prevailed:
  - *Mercantile-Safe Deposit & Trust Co. v. Murphy*, 203 N.E.2d 490 (N.Y. 1964)
  - *Taylor v. State Tax Commissioner*, 445 N.Y.S.2d 648 (3d Dept. 1981)
  - *Pennoyer v. Taxation Div. Dir.,* 5 N.J. Tax 386 (Tax Ct. 1983)
  - *Potter v. Taxation Div. Dir.*, 5 N.J. Tax 399 (Tax Ct. 1983)
  - *In re Swift*, 727 S.W.2d 880 (Mo. 1987)
  - *Blue v. Dep't of Treasury*, 462 N.W.2d 762 (Mich. Ct. App. 1990)
  - *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992)
  - *McNeil v. Commonwealth*, 67 A.3d 185 (Pa. Commw. Ct. 2013)
  - *Linn v. Department of Revenue*, 2 N.E.3d 1203 (Ill. App. Ct. 2013)
  - *Fielding v. Comm'r of Revenue*, 916 N.W.2d 323 (Minn. 2018), *cert. denied*, 139 S. Ct. 2773 (2019)
  - *N.C. Dep't of Rev. v. Kaestner,* 1992 Family Trust, 139 S. Ct. 2213 (2019)

PLANNING CONSIDERATIONS

- Minimize/avoid state taxation:
  - Consider the rules of the situs to which the settlor and trust has ties
    - Grantor could move
  - Consider choice of trustees (e.g., use of private trust company)
  - Consider selection of governing law
  - Build flexibility in trust instrument
    - Provide mechanism to change governing law/place of administration
    - Provide mechanism to remove and replace trustees
    - Allow for decanting
  - Avoid testamentary trusts
  - Avoid giving fixed interests to beneficiaries
  - Consider challenging constitutionality of the law
  - Change situs/place of administration

WINGS, DINGS & QSBS PLANNING

WINGS, DINGS & OTHER INGS

- Wide variation in income tax rates around the country created an impetus to change residence to a low or no tax state
  - Changing residence is not always feasible or desirable
  - Clients also may not want to gift away assets during life, nor use their estate tax exemption amounts
  - Clients do not want to relinquish control over their assets
  - The solution? WINGs, DINGs and NINGs

WINGs, DINGs, NINGs – WHAT ARE THEY?

- Trusts designed to avoid or minimize state income taxation of trust income
- ***I***ncomplete gift ***N***on-***G***rantor Trust
  - Does not avoid federal income tax
  - Does not remove assets from the grantor's taxable estate for federal or state estate tax purposes
  - INGs are nongrantor trusts, so may be subject to state income tax in the jurisdiction in which it is sitused
- The ING must be established and administered in a jurisdiction that allows for creditor protected self-settled trusts and has no state income tax on trust income
  - Common jurisdictions are WY, DE, NV, SD, FL and AK
  - Bad jurisdictions are CA and NY

THE BENEFITS OF INGs

- Avoid state income tax
- Grantor can continue to benefit from the assets in the ING
- Each ING is a separate taxpayer and can qualify for a separate QSBS election

THE POWERS

- Permissible distributions
  - "Grantor's Consent Power"
    - At any time pursuant to the direction of a majority of Distribution Committee, *with the written consent of Grantor*, the Trustees shall distribute to Grantor or the beneficiaries such amounts of the net income or principal as directed by Distribution Committee
  - "Unanimous Member Power"
    - At any time pursuant to the direction of all Distribution Committee members, other than Grantor, the Trustees *shall distribute to the beneficiaries* such amounts of the net income or principal as directed by Distribution Committee
  - "Grantor's Sole Power"
    - At any time, Grantor, in a *nonfiduciary capacity, may*, but shall not be required to, distribute to *any one or more of the beneficiaries* other than herself, such amounts of the principal (including the whole thereof) as Grantor deems advisable to provide for the *health, maintenance, support and education of Grantor's issue*
  - Grantor's testamentary limited power of appointment

QUALIFIED SMALL BUSINESS STOCK (QSBS) – WHAT IS THE BENEFIT?

- **QSBS, IRC Section 1202**
  - Partial or full exclusion of eligible capital gain for non-corporate holders if stock is held for 5+ years
- **Rollover of QSBS, IRC Section 1045**
  - Gain on sale of QSBS held for 6 months+ can be “rolled over” / deferred if proceeds from sale used to purchase other QSBS within 60 days of the sale

QUALIFIED SMALL BUSINESS STOCK (QSBS) – BENEFITS

- **Section 1202 – QSBS General Requirements**
  - Stock in a domestic C corporation (both common and preferred)
  - Issued on or after August 11, 1993, directly to the holder
  - Issued in exchange for money or other property (≠ stock) or as compensation for services
  - Owner must be an individual, trust, estate, or pass-through entity (≠ corp)
  - Aggregate assets of company may not exceed $50M (determined by tax basis) at any time between August 11, 1993, and the time of issuance
  - At least 80% of the corporation’s assets are used in a qualified active trade or business (see certain exceptions)
  - Certain redemptions and offsetting short positions are prohibited

QUALIFIED SMALL BUSINESS STOCK (QSBS) – REQUIREMENTS

- **QSB Requirement: $50M Maximum Asset Value**
  - **Facts**: Company raises a round of funding over $50M, but at the time of stock issuance the gross assets are under $50M
    - **Query**: Does the stock qualify for QSBS status?
    - **Answer**: No. IRC Section 1202(d)(1)(A) and (B) require that ***at all times*** between 8/11/93 and the moment "immediately after" the issuance, the aggregate gross assets of the corporation did not exceed $50M
    - **Quibble**: If the company was not a corporation when the asset value exceeded $50M, the stock could qualify for QSBS so long as the asset value was under $50M from the time of the conversion until immediately after the stock issuance

QUALIFIED SMALL BUSINESS STOCK (QSBS) – ELIGIBLE GAIN

- “**Eligible Gain**” = gain from sale / exchange of QSBS held for 5+ years
  - **Per-issuer limitation** = greater of:
    - $10M, reduced by gain taken into account in prior years; or
    - 10 x aggregate adjusted bases of QSBS issued by such corporation and disposed of by the taxpayer during the taxable year
  - Adjusted basis of stock determined without regard to any addition to basis after date on which such stock was originally issued
  - Example:
    - T acquires QSBS stock in XYZ Corporation for $6M
    - T sells stock for $100M and all QSBS requirements are met
    - 10 times T’s basis, or $60M of the $94M gain, is eligible for exclusion

QUALIFIED SMALL BUSINESS STOCK (QSBS) – GIFTS AND BEQUESTS OF QSBS

- **Gifts & Bequests**
  - **Gifts**: Direct gifts of QSBS to an individual or trust retain QSBS status
    - Donor’s basis and holding period carry over to the recipient
    - Gifts of QSBS may be ideal because benefit of any step-up at death is diminished by IRC Section 1202 gain exclusion
  - **Bequests**: Transfers of QSBS at death to qualified holder retain QSBS status
    - Distributions from trusts based on beneficiary’s death?
    - Testamentary powers of appointment?
- **Holding Period**: Tacks on transferor’s holding period

QUALIFIED SMALL BUSINESS STOCK (QSBS) – TRANSFERS TO TRUSTS

- **Non-Grantor Trusts**
  - **Non-grantor trust**: Separate “taxpayer” → IRC Section 1202 exclusion
- **Grantor trust**: → non-grantor trust = separate “taxpayer”
- **Multiple trusts vs “one pot” trust**: Multiple non-grantor trusts → multiple IRC Section 1202 exclusions
  - Substance over form: Trusts should differ in meaningful aspects
  - Gifts to multiple trusts: Direct QSBS transfers (Gifts of LLC/LP units of entity owning QSBS will not preserve QSBS status of stock.)
  - Initial investments: Include trusts in LLC/LP from inception so they are partners when partnership acquires QSBS

THANK YOU

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