

Trusts and Situs After Kaestner: Establishing Domicile, Relocating a Trust, and Taxing Beneficiaries

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NON-GRANTOR TRUSTS: UPDATE ON THEIR USES AND TAXATION

December 8, 2021

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I) Introduction

A) Building a Traditional “NGT” for State Income Tax Savings

- 1) Goal: Build a trust, transfers to which may be an incomplete gift or a completed gift, but which is a non-grantor trust
- 2) The IRC states that if a donor “transfers property by gift,” such donor will be liable for gift tax. However, not all transfers of property are considered “gifts” or, more appropriately “completed gifts.” This is important because only completed gifts are taxable gifts.

I) Introduction (cont.)

B) Use a Trust to Avoid State Income Tax...but...Avoid Grantor Status

- 1) States impose income taxes on a trust created by a state resident in various ways
 - Residence of the grantor
 - Residence of the trustee
 - Residence of the beneficiaries
 - Location of trust administration
 - Source income
- 2) Many of these grounds have been struck down as invalid and the list continues to grow
- 3) If a grantor trust, cannot avoid state income tax on the income earned in a trust
- 4) The income of a grantor trust is imputed to the grantor under Section 671 and, if the state imposes its income tax on the grantor Federal AGI, the state will tax the income imputed to the grantor under the grantor trust rules
- 5) Goal: To avoid state income tax on a trust, how can we have a trust that is an incomplete gift, can pay assets to the grantor, and still not be a grantor trust?

I) Introduction (cont.)

C) Basic Trust Description

- 1) What Makes a Trust a Non-Grantor Trust for Federal Tax Purposes?
- 2) Generally Created in Zero Income Tax State Which Permits Self-Settled Trusts. Examples: Nevada, South Dakota, Alaska, Delaware and Wyoming
- 3) Irrevocable and Spendthrift
 - a) Non-grantor trust for income tax purposes if distributions to grantor and grantor's spouse are subject to consent of an Adverse Party
 - Committee of "adverse parties"
 - Consent of an "adverse party"
 - b) Grantor and/or Grantor's spouse can retain certain powers specifically authorized by the Internal Revenue Code

I) Introduction (cont.)

C) Basic Trust Description (cont.)

c) If incomplete for gift and estate tax purposes

- Retained nonfiduciary inter vivos power of appointment for HEMS
- Retained testamentary power of appointment
- How to achieve marital deduction
- Retained “consent” power

d) If complete for gift and estate tax purposes, no retained powers (without consent of an “adverse party”) other than “fiddle” power

I) Introduction (cont.)

D) Federal Taxation of Non-Grantor Trusts

- 1) Role of DNI
- 2) Special rule for “S” corporations

E) State Taxation of Non-Grantor Trusts

- 1) How they do it
- 2) Constitutional limitations

II) Eleven Historical Uses

A) Saving State Income Taxes; Substantially Appreciated Asset

- Resident of state with state income tax contributes low basis asset to Trust
- Must not be source income of that state
- Trustee sells low basis asset
- Avoids state income tax on the sale
- Special rule if “S” corporation
 - Some source income
 - Deemed asset transaction

II) Eleven Historical Uses (cont.)

B) More on Saving State Income Taxes; Portfolio Income

- Resident of state with state income tax contributes investment portfolio to Trust
- Trustee continues to invest portfolio
- Avoids state income tax
- Is presence of some source income a problem?

II) Eleven Historical Uses (cont.)

C) Toggling and Income Shifting

D) Matrimonial

E) Asset Protection: an incidental benefit

F) SALT Limitation

G) PPVLI

- William D. Lipkind and Jonathan G. Blattmacher, “Income Tax Aspects of Variable Life Insurance Policies,” 122 J. Tax’n 52 (Feb. 2015)
- Jonathan G. Blattmachr and William E. Keenen, “*Webber* and the Investor Control Doctrine,” Taxnotes, Vol. 152, No. 5 (August 1, 2016)

II) Eleven Historical Uses (cont.)

- H) Avoid Implication of Self-Settled Trusts
- I) Use for IRC §199A for IRC §1202(e)(3) entities
- J) Testamentary Trusts
- K) Bespoke CLAT

III) Material Developments in 2021

A) H.R. 5376: Build Back Better Act

1) Section 138149

- Reduces IRC § 1202 exemption from 100% to 50%
- Effective September 13, 2021

2) Section 138201

- Increases application of IRC § 1411 (3.8%) for individuals and trusts primarily by eliminating the exception for material participation in a trade or business
- Effective January 1, 2022

III) Material Developments in 2021

A) H.R. 5376: Build Back Better Act

3) Sections deleted which may get reinstated

- Increases highest income tax bracket to 39.6%
- 25% tax rate on capital gains
- Acceleration of expiration of unified credit increase to January 1, 2022
- A plethora of changes to grantor trusts to make grantor trusts essentially tax toxic
- No minority interest valuation discount for passive (cash and marketable securities) interests

III) Material Developments in 2021

A) H.R. 5376: Build Back Better Act

4) Section 138203: Tax surcharge on income of wealthy commencing January 1, 2022

- Application to individuals
 - 5% on income over \$10,000,000
 - Additional 3% on income over \$25,000,000
- Application to trusts
 - 5% on income over \$200,000
 - Additional 3% on income over \$500,000

III) Material Developments in 2021 (cont.)

A) H.R. 5376: Build Back Better Act

5) Important Examples (table below subject to notes below):

		Individual			Non-Grantor Trust		
	Taxable Income	\$1,000,000	\$40,000,000	\$100,000,000	\$1,000,000	\$40,000,000	\$100,000,000
Pennsylvania	Federal (20%)	\$200,000	\$9,950,000	\$26,750,000	\$245,000	\$11,175,000	\$27,975,000
	1411 (3.8%)	\$38,000	\$1,520,000	\$3,800,000	\$38,000	\$1,520,000	\$3,800,000
	State (3.07%)	\$30,700	\$1,228,000	\$3,070,000	\$0	\$0	\$0
	Total Tax	\$268,700	\$12,698,000	\$33,620,000	\$283,000	\$12,695,000	\$31,775,000
California	Federal (20%)	\$200,000	\$9,950,000	\$26,750,000	\$245,000	\$11,175,000	\$27,975,000
	1411 (3.8%)	\$38,000	\$1,520,000	\$3,800,000	\$38,000	\$1,520,000	\$3,800,000
	State (13.4%)	\$134,000	\$5,360,000	\$13,400,000	\$0	\$0	\$0
	Total Tax	\$372,000	\$16,830,000	\$43,950,000	\$283,000	\$12,695,000	\$31,775,000

- Designed to show incremental impact of additional tax recognizing that individual may have other income.
- Assumes sale of partnership interest as opposed to sale of stock in an “S” corporation which creates additional issues and potential workarounds

6) Take Away

III) Material Developments in 2021 (cont.)

B) Rev. Proc. 2021-3: Suspension of PLR

1) Reasons for suspending

2) What is an “adverse party”; income tax vs. gift tax

- Definition for gift tax more important
- Major issue is for income (taxable; not fiduciary) during Grantor’s lifetime
- Will a new ruling policy be retroactive? Is following existing PLRs a “safe harbor”?
- New potential workarounds

3) Take away: increased risk and uncertainty

IV) The Six Major Legal Issues

A) Federal Gift Tax: incomplete vs. complete gift

1) Retained power to change beneficiaries

- Income / Corpus / Remaindermen
- *Estate of Sanford v. Commissioner*, 308 U.S. 39 (1939)

2) Consent power is the key

- IRC § 2041(b)
- IRC § 2514(c)

3) IRS will not, at present, issue PLRs on Incomplete Non-Grantor Trusts

- Rev. Proc. 2021-3
- Grayson M.P. McCouch, “Adversity, Inconsistency, and the Incomplete Nongrantor Trust”, 39 Va. Tax Rev. 419 (2019-2020)
- Note: Workarounds to achieve same result

IV) The Six Major Legal Issues (cont.)

B) Federal Income Tax: grantor vs. non-grantor (IRC § 677(a))

- 1) Avoid state income taxes if non-grantor trust
- 2) Additional federal taxpayer
- 3) Adverse Party is the key
 - Definition
 - Use of Committee
 - Adverse for income tax purposes is not adverse for gift tax purposes
 - Never permit this to be an issue for ING Trust
- 4) General rule under IRC 672(a)
 - Important exceptions
- 5) Provisions of PLRs vs. single Adverse Party
 - IRS will not rule on single Adverse Party (Rev. Proc. 2020-3)

IV) The Six Major Legal Issues (cont.)

B) Federal Income Tax: grantor vs. non-grantor

6) Basic ING Structure. Example: PLR 201310002

- Use of Committee - can be for grantor and spouse only
- Unanimous Power and Consent Power
- Lifetime and Testamentary powers of appointment
 - Lifetime: corpus, HEMS, non-fiduciary
 - Testamentary: income
- Avoiding general power of appointment for Committee
 - Automatic increase in membership from class of beneficiaries
 - Never drop to two members of ING
 - Gift to grantor not a gift
 - Gift to beneficiary is gift by grantor
- Variations on Power of Appointment Committee powers

IV) The Six Major Legal Issues (cont.)

B) Federal Income Tax: grantor vs. non-grantor

7) How completed gift is different

- No consent power
- No lifetime or testamentary powers of appointment
- No need for unanimous consent power
- Trustee can make distributions to beneficiaries
- Single Adverse Party

IV) The Six Major Legal Issues (cont.)

B) Federal Income Tax: grantor vs. non-grantor

8) Some Specific Drafting Considerations

- Directed Trusts
- Role of decanting
- Community Property
- Increasing the Committee
- Obama Tax (IRC Section 1411)
- Non-Grantor Trust Article (See Appendix A)
- Default to grantor trust; avoid reversions
- Adverse Party

9) Leading Published Articles (See Appendix B)

IV) The Six Major Legal Issues (cont.)

C) State: Domicile State of Trust

- 1) Use state with no general trust taxation
- 2) Permit self-settled spendthrift trust. Nevada, South Dakota, Alaska, Delaware and Wyoming are prime jurisdictions.
- 3) State taxation of accumulated income in non-resident trusts. Different states have different criteria. For example, Arizona and California will each tax a non-resident trust if there is a resident trust fiduciary.
- 4) Community property issues

IV) The Six Major Legal Issues (cont.)

D) State: Domicile State of Settlor and Beneficiaries

1) Holdings and impact of *North Carolina Dept. of Revenue v. Kimberley Rice Kaestner 1992 Family Trust*, No. 18-457 (U.S. Jun. 21, 2019) and *Fielding v. Commissioner of Revenue*, Minnesota Supreme Court, No. A17-1177, July 18, 2018, cert. denied (U.S. Jun. 28, 2019).

- Mere residence of beneficiary is an insufficient nexus
- Beneficiary and Settlor?

2) Never want to have a trust fiduciary in Settlor's domicile state.

3) What if only contact with domicile state is trust settlor?
One or more trust beneficiaries?

4) Throwback Taxes. CA vs. NY

5) Source income

IV) The Six Major Legal Issues (cont.)

D) State: Domicile State of Settlor and Beneficiaries (cont.)

1) Variations

- New York; New Jersey
- California
- Connecticut; Pennsylvania; Virginia; Iowa

IV) The Six Major Legal Issues (cont.)

E) State: Unique rules on source income

1) General Rule

2) Special statutes deeming income to be source income

➤ New York

- NY Tax § 612(b)(41): If a New York resident establishes a trust which is an ‘incomplete gift trust’ for federal tax purposes, the trust will be deemed a ‘grantor trust’ for New York purposes
- NY Tax § 605(b)(3)(D): A New York ‘resident trust’ (established by a New York domiciliary) will not pay New York tax if three conditions are met:
 - None of the trustees are domiciled in New York
 - None of the assets are located in New York
 - The trust has no New York source income
 - New York takes the position that if there is any New York source income, no matter how small, all of the accumulated income in the trust is taxable to New York (see, New York Advisory Opinion TSB-A-20(2)I)
 - No one has yet attacked this statute on constitutional grounds

IV) The Six Major Legal Issues (cont.)

E) State: Unique rules on source income

2) Special statutes deeming income to be source income

➤ New York

- NY Tax § 631(b)(1)(A)(1): New York source income includes all income from an entity of which New York real property comprises 50%+ of its assets
- NY Tax § 632(a): New York source income of a nonresident partner of a partnership or shareholder of an S corporation includes the gain from the sale of the interest in such entity where the provisions of IRC § 1060 apply to such sale

IV) The Six Major Legal Issues (cont.)

E) State: Unique rules on source income

2) Special statutes deeming income to be source income

➤ New Jersey: Instructions to Form NJ-1041 and Tax Topics Bulletin GIT-12

- A New Jersey ‘resident trust’ (established by a New Jersey domiciliary) is not subject to New Jersey tax if three conditions are met:
 - None of the trustees are domiciled in New Jersey
 - None of the assets are located in New Jersey
 - The trust has no New Jersey source income
- New Jersey takes the positions that if there is any New Jersey source income, no matter how small, all of the accumulated income in the trust is taxable to New Jersey
- There is no statutory authority for this position
- No one has yet attacked this position on constitutional grounds

IV) The Six Major Legal Issues (cont.)

E) State: Unique rules on source income

2) Special statutes deeming income to be source income

- California: Position if partnership interest is integral to a California business enterprise
- Assume other States (or their taxing authorities) adopt similar positions

IV) The Six Major Legal Issues (cont.)

- F) Will Settlor's Domicile Respect Settlor's Choice of Law?
 - 1) Respect of choice of law
 - 2) Fraudulent conveyance considerations

V) Conclusion

Appendix A

NON-GRANTOR TRUST ARTICLE

- (a) It is the Grantor's intention that no transfer by the Grantor to any trust created hereunder shall be a completed gift, and it is also the Grantor's intention that during any period of time in which the Power of Appointment Committee is in existence (the "Applicable Period"), but only during the Applicable Period, the Grantor shall not be treated as the owner of any portion of any trust created hereunder under Sections 671 through 679 of the Code. Any and all provisions of this trust agreement shall be interpreted so as to fulfill and implement these intentions of the Grantor.

Appendix A

NON-GRANTOR TRUST ARTICLE

- (b) During the Applicable Period and only during the Applicable Period, the Trustee shall not have or exercise any power that would cause the Grantor to be treated as the owner of any portion of any trust created hereunder under Sections 671 through 679 of the Code. Specifically, but not by way of exclusion, no Trustee of any trust hereunder shall have the power to:
- Make any distributions to any beneficiary hereunder except as the Power of Appointment Committee appoints
 - Sell, exchange or otherwise deal with or dispose of the corpus or the income of the trust to either the Grantor or the Grantor's spouse for less than adequate consideration;
 - Lend the property of the trust to the Grantor or the Grantor's spouse, either directly or indirectly, without adequate security and adequate interest;
 - Guarantee any obligation of the Grantor or the Grantor's spouse without adequate security
 - Use the income of the trust to pay premiums on policies of insurance on the life of the Grantor or the life of the Grantor's spouse; or
 - Except as provided by Subarticle (c) of the LIFETIME FUND ARTICLE, transfer the property of the trust to a trustee of another trust pursuant to any state decanting statute.
- (c) During the Applicable Period and only during the Applicable Period, neither the Grantor nor the Grantor's spouse shall have the power to reacquire all or any part of the property of a trust created hereunder by substituting other property of equivalent value, whether acting in a fiduciary or non-fiduciary capacity.

Appendix B

TECHNICAL ANALYSIS

- 1) Blattmachr and Lipkind, “Fundamentals of DING Type Trusts: No Gift Not a Grantor Trust”, *Probate Practice Reporter* (April 2014)
- 2) Lipkind, “DING Redux”, *LISI Estate Planning Newsletter*, #2076 (March 12, 2013)
- 3) William D. Lipkind, “Tax Planning With Self-Settled Non-Grantor Trusts,” *Trusts & Estates* (June 2016)
- 4) William D. Lipkind, Martin M. Shenkman and Jonathan G. Blattmachr, “How ING Trusts can Offset Adverse Effects of Tax Law: Part I”, *Trusts & Estates* (September 2018), “How ING Trusts can Offset Adverse Effects of Tax Law: Part II”, *Trusts & Estates* (December 2018)

Trusts and Situs After Kaestner: Establishing Domicile, Relocating a Trust, and Taxing Beneficiaries

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Introduction

- This presentation deals with non-grantor trusts only. Grantor trusts are ignored for federal income tax purposes, which treatment is followed by most states.
- Non-grantor trusts may be formed during the lifetime of the settlor or at death (such as a testamentary trust under a Will).
- Income distributed to beneficiaries of a trust typically carry out the tax liability to the beneficiary. As such, this presentation generally deals only with accumulated trust income.
- Non-business income is allocated to residence of taxpayer. Business income is subject to state income tax allocation and apportionment. As such, planning typically involves non-business income.

Analyzing the Trust: Why?

Uniform Probate Code §7-305 (1969)

“A trustee is under a continuing duty to administer the trust at a place appropriate to the purposes of the trust and to its sound, efficient management. If the principal place of administration becomes inappropriate for any reason, the Court may enter any order furthering efficient administration and the interests of beneficiaries, including, if appropriate, release of registration, removal of the trustee and appointment of a trustee in another state.”

Analyzing the Trust: Why?

Restatement (Third) of Trusts §76(2)(c)

“In administering the trust, the trustee's responsibilities include performance of the following functions: ... (c) managing the trust estate to provide returns or other benefits from trust property”

See also *Scott on Trusts*, §§613-615

Analyzing the Trust: Why?

Comments to Restatement (Third) of Trusts §76(2)(c)

“A trustee's duty to administer a trust includes an initial and continuing duty to administer it at a location that is reasonably suitable to the purposes of the trust, its sound and efficient administration, and the interests of its beneficiaries.”

“Under some circumstances the trustee may have a duty to change or to permit (e.g., by resignation) a change in the place of administration. Changes in the place of administration by a trustee, or even the relocation of beneficiaries or other developments, may result in costs or geographic inconvenience serious enough to justify removal of the trustee.”

Analyzing the Trust: Why?

Uniform Trust Code §108(b)

“A is under a continuing duty to administer the trust at a place appropriate to its purposes, its administration, and the interests of the beneficiaries.”

The UTC has been passed or introduced in 37 states, some of which have not adopted this uniform provision.

Analyzing the Trust: Why?

Duties?

- In representing a trustee, is there a duty to advise the trustee to make changes, including resignation of the trustee, to minimize state income tax?
- In representing a beneficiary, is there a duty to advise the beneficiary to seek changes to minimize state income tax?
- If serving as trustee, what duties (including continuing) does the trustee have to determine the “place appropriate to its purposes, its administration, and the interests of the beneficiaries.”

Analyzing the Trust: Why?

Duties?

- If there is a change in circumstances, what factors will be relevant in asking the “place appropriate to” the trust’s purposes, its administration, and the interests of the beneficiaries?
- This could include tax and non-tax considerations.
- Changes of circumstances could include relocation of beneficiaries, a change in trust assets, relocation of the trustee, relocation or death of the settlor, etc.

Analyzing the Income: Sourcing

- 24 states have adopted the Uniform Division of Income for Tax Purposes Act (“UDITPA”). Many other states follow similar rules.
- The UDITPA divides income between business income and non-business income.
 - Business income is apportioned among states.
 - Non-business income is allocated to a particular state.

Analyzing the Income: Sourcing Business Income

- Business income is apportioned to the state where the income was generated under a variety of methods.
- In apportioning business income among various states, approaches may be used such as:
 - Three factor: (1) property located in state, (2) sales made to state residents, (3) payroll paid to state residents.
 - Single factor: sales in state
 - Market based sourcing vs. cost-of-performance based sourcing

Analyzing the Income: Sourcing Non-Business Income

- “Non-business income” is generally taxed in the state where the trust is a resident.
- There are certain exceptions such as where the non-business income results from rents, royalties, or capital gains, from real or tangible property located or utilized in another state. Gains from the sale of intangible property are taxed to the resident state. See UDITPA §§ 5-8.
- As a result, other than taxable income generated from property specifically situated in another state, the trust’s resident state will tax non-business income.

Basis for Taxing Trusts

- With certain exceptions, states follow federal grantor trust laws of IRC §§ 671-679. As such, only non-grantor trusts are subject to state income tax. Distributed income is taxed to the beneficiaries. Therefore, it is only undistributed income of non-grantor trusts that cause a trust to incur income tax.
- Pennsylvania does follow the grantor trust rules; Arkansas, the District of Columbia, Louisiana, and Montana have modified grantor trust rules; and Massachusetts does not apply IRC § 679.
- Some states such as California, Pennsylvania, and New York have a “throwback” tax which will tax distributions of previously accumulated income upon distribution to a resident beneficiary.
- Some states do not tax the income of trusts: Alaska, Florida, New Hampshire, South Dakota, Texas, Washington, and Wyoming. Most Delaware trusts will not be subject to tax.
- States classify trusts as resident or non-resident. States will tax a resident trust on all undistributed income and nonresident trusts on income sourced to the state.

State Methods for Taxing Trusts

- Trust created by Will of resident: Connecticut, District of Columbia, Illinois, Louisiana, Maine, Maryland, Michigan, Minnesota, Nebraska, Ohio, Oklahoma, Pennsylvania, Vermont, Virginia, West Virginia, and Wisconsin
- Inter vivos trust created by resident: District of Columbia, Illinois, Maine, Maryland, Minnesota, Nebraska, Oklahoma, Pennsylvania, Vermont, Virginia, West Virginia, and Wisconsin
- Trust administered in the state: Colorado, Indiana, Kansas, Louisiana, Maryland, Minnesota, Mississippi, Montana, New Mexico, North Dakota, Oregon, South Carolina, Virginia, and Wisconsin
- Resident trustee: Arizona, California, Kentucky, Montana, New Mexico, North Dakota, Oregon, and Virginia
- Resident beneficiary*: California, Georgia, Montana, North Carolina, North Dakota, and Tennessee

*See later slides regarding recent case-law pertaining to taxation based on beneficiary residency.

Analyzing the Trust: Resident Trust?

- Resident of the Grantor (currently or at formation)
- Residence of the Trustee(s)
- Location of Trust Administration
- Residence of the Beneficiaries
- Inter Vivos or Testamentary Trust
- Created Through Court Administration
- Situs and Nature of Trust Assets
- Trust Choice of Law Provision

Analyzing the Trust: Basis for Taxation?

- Categorize income as business vs. non-business and sourcing.
- Determine what states may be involved (allocation, apportionment, and residency of trust). Carefully consider each state to which the trust has a connection.
- Once you know the states involved:
 - Determine what state statutes apply.
 - Determine whether each state in question has personal jurisdiction over the trustee or in rem jurisdiction over trust assets.
 - Determine whether imposition of tax by any relevant state is constitutional.
 - Determine whether trust assets generate source income taxable by one or more states.
 - Determine whether the basis for taxation may be movable.

Analyzing the Trust: Example

- Testamentary trust formed by New York resident
- Three beneficiaries located in California, Mississippi, and New York
- Co-Trustees residents of Mississippi and California
- Trust owns partnerships that generate income sourced in California, Pennsylvania, Mississippi, and New York

Analyzing the Trust: Example

- Income sources: California, Pennsylvania, Virginia, and New York
- Which states will attempt to tax the trust:
 - California (trustee and beneficiary)
 - New York (grantor and NY source income)
 - Mississippi (trustee, beneficiary, and MS source income)
 - Pennsylvania (source income)

Analyzing the Trust: Example

- Determine credits available for tax paid to another state
- Determine whether changes can be made to mitigate multi-state income tax obligations
- Determine whether state income tax can be mitigated by distributions (and to whom in what proportions considering non-tax factors)

Analyzing the Trust: Questions

- What about non-trustee fiduciaries and advisors – trust protectors, investment advisors, etc.?
- What about co-trustees with bifurcated responsibilities?
- Where is a trust administered when a corporate trustee has offices in the state but their trust administration office is elsewhere?

Analyzing the Trust: Annual Process

- Ask each year about the trustees, the beneficiaries, the trust assets, and about trust administration. People move, assets are bought/sold, etc.
- Ask about any plans for the upcoming year.
- Continue to impress upon clients the importance of watching state income tax consequences.

Analyzing the Trust: Resources on Basis for Taxation



- Nenno, Richard W., “Bases of State Income Taxation of Nongrantor Trusts for 2018,”
https://www.actec.org/assets/1/6/Nenno_state_nongrantor_tax_survey.pdf.
- Morrow, Edwin P., “State Residency and Source Income Factors for State Income Taxation of Irrevocable Non-Grantor Trusts,”
https://www.actec.org/assets/1/6/Morrow_State_Residency_and_Source_Income_Factors_for_Taxation_of_Irrevocable_Non-Grantor_Trusts.pdf

Analyzing the Trust: Constitutional Challenge? – Due Process Clause

- Trustee has some definite link, minimum contacts with the state; and
- Income attributed to the state must be rationally related to values connected with the state
- Physical presence not required
- *See Quill, Linn, Fielding, Kaestner*

Analyzing the Trust: Constitutional Challenge? – Dormant Commerce Clause

- Trustee has substantial nexus with the state (physical presence not required); and
- Tax must be fairly apportioned (internally and externally consistent); and
- Tax must be fairly related to services provided by the state; and
- Tax must not discriminate against interstate commerce.
- *See Complete Auto, Wayfair, Quill*

Analyzing the Trust: Constitutional Challenge?

- *Residuary Trust A U/W/O Kassner v. Dir. Div. of Taxation*, 28 N.J. 541 (NJ 2015).
- *Linn v. Department of Revenue*, 2 N.E. 3d 1203 (Ill. 2013).
- *Robert L. McNeil Jr. Trust ex rel. McNeil v. Commw.*, 67 A.3d 185 (Pa. 2013).
- *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).
- *Fielding for McDonald v. Commissioner of Revenue*, 2018 WL 3447690 (Minn. 2018).
- *Kimberly Rice Kaestner 1992 Family Trust*, 139 S.Ct. 2213 (2019).

Analyzing the Trust: Change?

- Stop Funding; Create New Trust
- Change Trustee
- UTC Transfer of Principal Place of Administration
- Nonjudicial Settlement
- Modification of Trust
- Decanting (statutory or per trust document)
- Merger/Severance, Division/Combination

UTC Change of Principal Place of Administration



Uniform Trust Code §108(c)

“Without precluding the right of the court to order, approve, or disapprove a transfer, the trustee, in furtherance of the duty prescribed by subsection (b), may transfer the trust’s principal place of administration to another State or to a jurisdiction outside of the United States.”

- This power is subject to certain notice requirements and may be generally allows a simple method to change place of principal administration.
- If principal place of administration the basis for a state’s taxation of the trust, this may be a viable alternative to use.

Nonjudicial Settlement Agreements



Uniform Trust Code §111

Except as it would violate a material purpose of the trust, provided the terms could be properly approved by a court, “interested persons may enter into a binding nonjudicial settlement agreement with respect to any matter involving a trust.”

The subject matter of a nonjudicial settlement agreement may include “resignation or appointment of a trustee” and “transfer of a trust’s principal place of administration.”

Nonjudicial Settlement Agreement



- States without a nonjudicial settlement agreement statute: Alaska, California, Colorado, Connecticut, Georgia, Hawaii, Indiana, Louisiana, Nevada, New York, Oklahoma, Rhode Island, South Dakota, and Texas.
- All remaining states have some form of nonjudicial settlement agreement statute.
- All states with a nonjudicial settlement agreement statute require consent of interested parties.

Nonjudicial Modification



Uniform Trust Code §411

“A noncharitable irrevocable trust may be modified or terminated upon consent of the settlor and all beneficiaries, even if the modification or termination is inconsistent with a material purpose of the trust.”

Nonjudicial Modification

- States Without Nonjudicial Modification Statute: Alaska, Colorado, Connecticut, Georgia, Hawaii, Idaho, Indiana, Louisiana, Nevada, Oklahoma, Rhode Island, Texas, and Washington.
- States with Nonjudicial Modification Statute: Arkansas, California, Delaware, District of Columbia, Florida, Iowa, Kansas, Kentucky, Michigan, Minnesota, Mississippi, Missouri, Montana, New Jersey, New Mexico, New York, North Carolina, Pennsylvania, South Dakota, Tennessee, Utah, Vermont, Wisconsin, and Wyoming.
- States Adopting UTC § 411(a) or a similar statute but require court approval: Alabama, Arizona, Maine, Maryland, Massachusetts, Nebraska, New Hampshire, North Dakota, Ohio, Oregon, South Carolina, Virginia and West Virginia, Wyoming (court approval not required if trust protector authorized to modify).

Nonjudicial Modification

- Modification by trust instrument: In addition to statutory nonjudicial modification, it may be possible to modify nonjudicially through terms of the trust instrument.
- Power to modify: The trust protector, trustee, or third party may be granted power to amend the provisions of the trust.
- Flexibility with powers of appointment: Someone may be given a power of appointment over trust assets allowing that person to exercise his or her power to appoint assets to a more favorable jurisdiction (essentially a decanting as discussed below, merely not through a decanting statute).
 - Can this change the identity of the grantor?
 - Does it matter whether the power is a general or limited power of appointment?

Judicial Modification

Uniform Trust Code §412

- (a) The court may modify the administrative or dispositive terms of a trust or terminate the trust if, because of circumstances not anticipated by the settlor, modification or termination will further the purposes of the trust. To the extent practicable, the modification must be made in accordance with the settlor's probable intention.
- (b) The court may modify the administrative terms of a trust if continuation of the trust on its existing terms would be impracticable or wasteful or impair the trust's administration.

Judicial Modification

Uniform Trust Code §416

“To achieve the settlor’s tax objectives, the court may modify the terms of a trust in a manner that is not contrary to the settlor’s probable intention. The court may provide that the modification has retroactive effect.”

Decanting

- What is decanting? Power of a trustee to distribute trust assets to the trustee of another trust for the benefit of one or more of the beneficiaries of the original trust.
- Why decant? Can be used to expand or remove beneficiaries. Often used to change trust administrative provisions, including choice of law.
- Notice requirements vary by state. States with decanting statutes vary on notice requirements as well as how broadly trust provisions can be changed.
- Consider the potential gift and income tax consequences of decanting.

Decanting States

1. Alabama
2. Alaska
3. Arizona
4. Colorado
5. Delaware
6. Florida
7. Georgia
8. Illinois
9. Indiana
10. Kentucky
11. Michigan
12. Minnesota
13. Missouri
14. Nevada
15. New Hampshire
16. New Mexico
17. New York
18. North Carolina
19. Ohio
20. Rhode Island
21. South Carolina
22. South Dakota
23. Tennessee
24. Texas
25. Virginia
26. Washington
27. Wisconsin
28. Wyoming

Dividing or Combining Trusts

Uniform Trust Code §417

“After notice to the qualified beneficiaries, a trustee may combine two or more trusts into a single trust or divide a trust into two or more separate trusts, if the result does not impair rights of any beneficiary or adversely affect achievement of the purposes of the trust.”

Dividing or Combining Trusts

Restatement (Third) of Trusts §68

“The trustee may divide a trust into two or more trusts or combine two or more trusts into a single trust, if doing so does not adversely affect the rights of any beneficiary or the accomplishment of the trust purposes.”

Merger or Combination of Trusts

- Merger requirements: As long as applicable state statute satisfied, which generally require that the rights of beneficiaries not be impaired and that the trust purposes not be adversely affected, trusts may be merged into a new trust with different administrative provisions.
- Limitations on merger: Opposed to a trust division, a merger generally cannot be used to remove a beneficiary.
- State law variance: Over 40 states have statutes allowing merger without court approval, but those states differ regarding the requirements to complete the merger (i.e. substantially similar terms, consent, etc.). Only Alaska, Hawaii, Nevada and Oklahoma have no trust merger statute.

New Trusts: Considerations

- Testamentary vs. Lifetime Trusts: Connection to state by testamentary trust created by in-state probate/court administration
- Residence of settlor and beneficiaries: For a mobile settlor, is it better to form a trust in one state vs. another?
- State of administration and/or residence of the trustee: Will location of the trustee cause avoidable state income tax?
- Drafting flexible trusts: movable situs, remove/replace powers over trustee, decanting power, right to delegate duties, etc.

Trusts and Situs After Kaestner: Establishing Domicile, Relocating a Trust, and Taxing Beneficiaries

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“The choice of a state in which to establish a trust is as critical as the decision to create one.”

** Elizabeth Mathieu, President of Neuberger & Berman*

Jurisdiction Matters

- ▶ Trust laws vary significantly from state to state.
- ▶ A few states are “in a race” to establish the most progressive trust laws in an attempt to capture trust business.
- ▶ Tier 1 Trust Jurisdictions*
 - ▶ South Dakota
 - ▶ Delaware
 - ▶ Nevada
 - ▶ Alaska



* *Trusts & Estates Magazine, January 2020 Issue*

Top Tier Trust Jurisdiction Factors

What are the factors considered when determining top tier trust jurisdictions?

- ▶ Asset Protection
- ▶ Dynasty Trust / Rule Against Perpetuity
- ▶ State Taxation
- ▶ Privacy Rules
- ▶ Modern Trust Laws

What is a Domestic Asset Protection Trust?

- ▶ A ***self-settled*** trust that protects assets from creditors (including future spouse).
- ▶ Strategy that legally shields assets from third party liability (future spouse) while permitting settlors to receive ***income***, retain some ***control*** over trust assets AND enjoy a ***discretionary beneficiary interest*** during their lifetime.
- ▶ Most states do **NOT** have an Asset Protection Trust Statute.

Domestic Asset Protection States

- ▶ Several states have passed Domestic Asset Protection Statutes.
- ▶ **South Dakota, Nevada, Alaska, and Delaware** are consistently recognized as having the most robust and powerful Asset Protection Statutes in the nation.*

* ***Best Situs for DAPTs in 2019***

Mark Merric, Daniel G. Worthington, Paul MacArthur and John E. Sullivan, Trusts & Estates Magazine, January 2019

Domestic Asset Protection States

- ▶ Very compelling planning tool for high-risk individuals and pre-marital planning.
- ▶ Not all Domestic Asset Protection Statutes are created equally.
- ▶ Fraudulent Conveyance (look-back):
 - ▶ South Dakota – 2 years
 - ▶ Delaware – 4 years
- ▶ Best of both worlds - domestic and offshore asset protection in one instrument.

Dynasty Trust

- ▶ **South Dakota** allowed for the first Dynasty Trust in the nation in 1983 by **abolishing the rule against perpetuities**.
- ▶ Beginning of **Modern Trust law**.
- ▶ Definition – A trust that is not subject to the rule against perpetuities and, therefore, lives forever.
- ▶ Driven by state law.



Directed Trusts

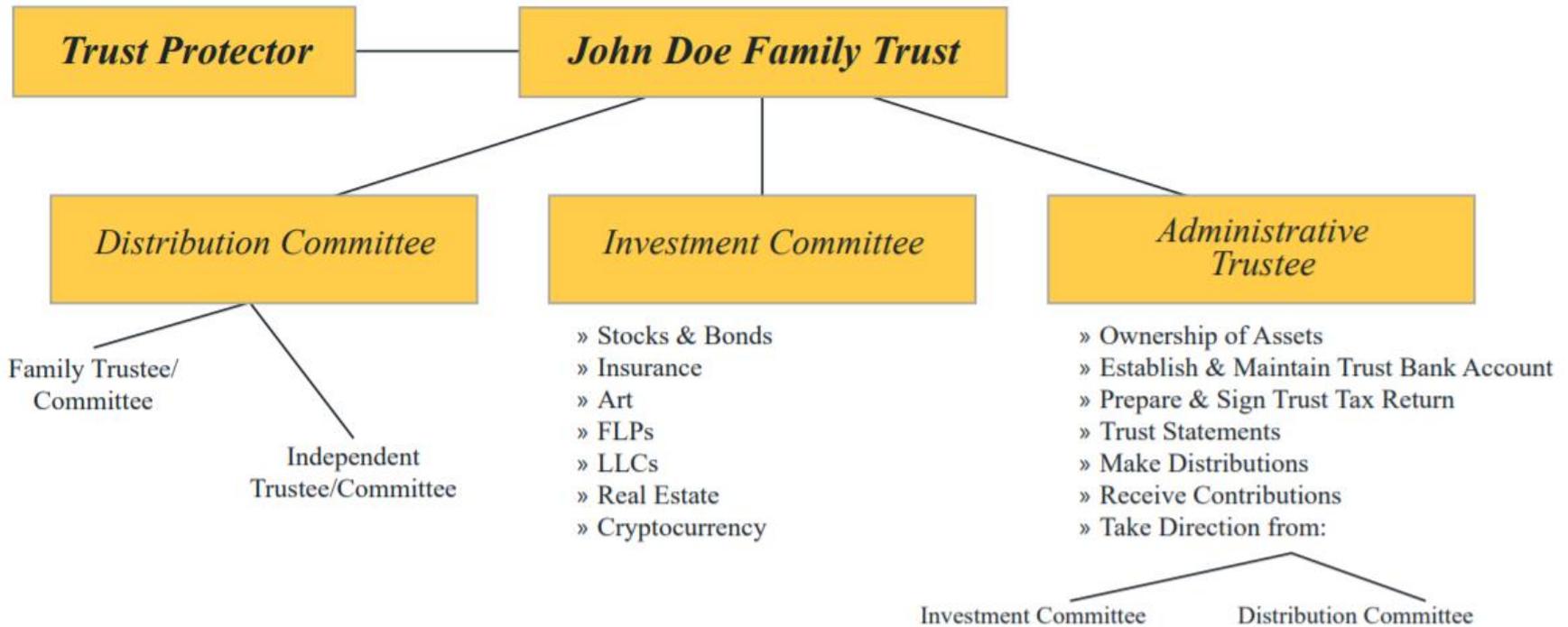
- ▶ Through **bifurcating liability**, the directed trust model creates a legal framework allowing trustees and beneficiaries to work with asset managers and independent trust companies of their choosing.
- ▶ Directed trusts provide a family with maximum **flexibility and control** regarding the trust's asset allocation, diversification, investment management, and distributions.



Directed Trusts

- ▶ A directed trust can be used by a settlor who wants to fund an irrevocable trust with a closely held company or a specialized asset, but who also wants to **place control** of such assets in the hands of a particular individual (or group of individuals) familiar with the company's operations or that type of specialized asset.
- ▶ The directed trust concept **unbundles** functions (asset management and trust services) that have traditionally been bundled by large bank-based corporate trustees.

Typical Modern “Directed” Trust Structure



The Trust Protector: *A Super Trustee*

- ▶ The Trust Protector, often used in conjunction with a **Directed Trust**, delivers far more **control** to settlors of trusts, beneficiaries, and their advisors than ever before.
- ▶ The inclusion of a Trust Protector allows the settlor, beneficiaries, and their advisors to **modify** and **control** many important aspects of the trust and provide direction to the trustee with respect to investment management, jurisdiction, and trust distributions.



The Trust Protector

Reasons why a settlor may wish to appoint a Trust Protector include:

- ▶ The settlor wishes for a mechanism to easily replace the trustee or change trust situs.
- ▶ Protectors allow for a great degree of **flexibility** when dealing with changes in circumstances, including both factual circumstances (death, premature divorce, previously unknown children) and legal changes (any legal changes, but most frequently changes to applicable revenue laws).

The Trust Protector

Reasons why a settlor may wish to appoint a Trust Protector include (continued):

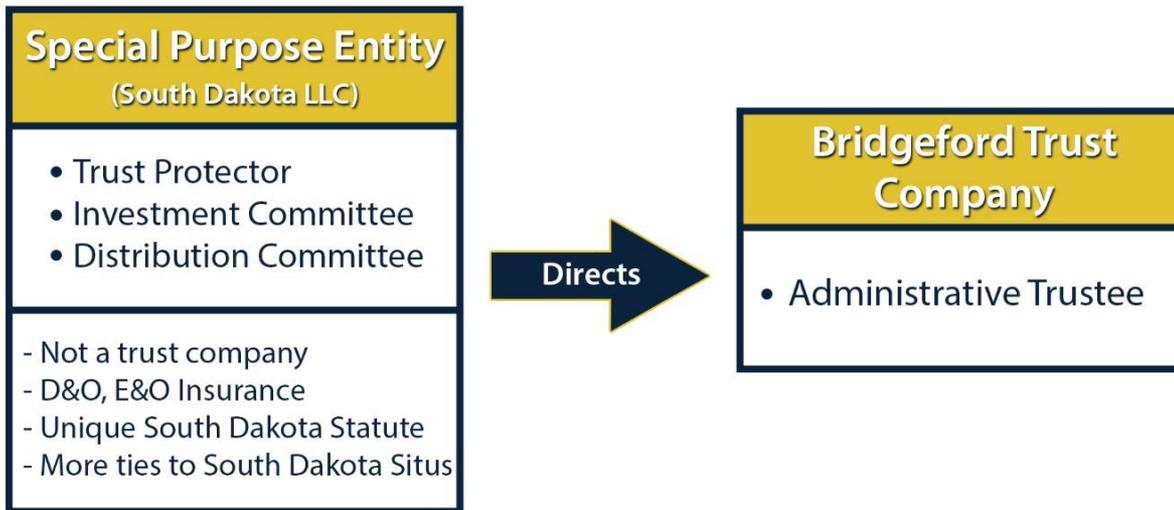
- ▶ The settlor may be concerned that the trustee may not pay sufficient attention to his wishes.
- ▶ The settlor wishes certain powers to be withheld from the trustees.
- ▶ The settlor wishes a third party to act as a main point of contact between the beneficiaries and the trustees.

South Dakota Special Purpose Entity

- ▶ Places a **liability umbrella** over the individuals filling the roles of trust protector, investment committee, and/or distribution committee, therefore protecting them from personal claims connected to their actions in this capacity.
- ▶ Also used to **destroy nexus** between in state trust protectors, investment committee members, and/or distribution committee members, therefore maintaining the jurisdictional integrity of a resident trust with situs in a progressive trust jurisdiction like South Dakota.



South Dakota Special Purpose Entity



Family Advisor: *Trust Protector Light*

- ▶ Appropriately referred to as a “Trust Protector Light,” because of its **non-fiduciary status** and limited powers.
- ▶ Excellent option for settlors of trusts and beneficiaries who may want family advisors, such as attorneys, CPAs, or investment advisors, to have some control and input over important aspects of trust administration without elevating the position to that of a fiduciary.



Family Advisor

The Family Advisor role, similar to the Trust Protector, has the power to **modify**, **control**, and **participate** in many important aspects of trust administration.

The powers that may be granted to the Family Advisor are:

- ▶ **Remove and appoint** a trustee, a fiduciary provided for in the governing trust instrument, trust advisor, investment committee member, or distribution committee member.
- ▶ **Appoint a successor trust protector or a successor family advisor**.

Family Advisor

- ▶ Advise the trustee on matters concerning any beneficiary; receive trust accountings, investment reports, and other information from the trustee or to which a beneficiary is entitled; attend meetings, whether in person or by any other means, with the trustee, investment trust advisors, distribution trust advisors, or other advisors, whether in person or by any means, electronic or otherwise; and to consult with a fiduciary regarding both fiduciary and non-fiduciary matters or actions, all without any power or discretion to take any action as a fiduciary.
- ▶ Provide direction regarding notification of qualified beneficiaries pursuant to § 55-2-13.

Trust Matter Privacy

- ▶ Very important issue for high net worth families and closely held business owners.
 - ▶ **Quiet Trust** – No disclosure requirement.
 - ▶ **Court Seal** – Keeps trust information out of the public domain.
- ▶ **South Dakota** – Total Seal Forever / Not Discretionary
 - ▶ Delaware – Seal for 3 years / discretionary.
 - ▶ Most States – Open to the public.



The Pandora Papers

- ▶ Massive data breach involving 14 foreign service providers.
- ▶ 11.9 million confidential documents.
- ▶ “There is no evidence in the Pandora Papers documents that any of the foreigners with trusts in the United States sheltered criminal proceeds.” - The Washington Post
- ▶ Irresponsible Reporting – The Rest of the Story.

Choosing the Correct Jurisdiction

	South Dakota	Nevada	Wyoming	Alaska	Delaware
Dynasty Trusts	Yes <i>Ranked as #1 ^[1]</i>	Yes <i>Ranked as #2 ^[1]</i> <i>State constitution prohibits modification to RAP ^[2]</i>	Yes <i>Ranked as #5 ^[1]</i> <i>State constitution prohibits modification to RAP ^[2]</i>	Yes <i>Ranked as #4 ^[1]</i>	Yes <i>Ranked as #7 ^[1]</i>
State Income Taxation	No	No	No	No <i>Future uncertain</i>	No <i>Only for non-residents</i>
Community Property Trusts	Yes ^[3]	No	No	Yes <i>Future uncertain</i>	No
Domestic Asset Protection Statute	Yes ^[4] <i>2 year statute of limitations</i> <i>Exception for child support</i>	Yes ^[4] <i>2 year statute of limitations</i> <i>No exceptions for child and spousal support</i>	Yes ^[4] <i>4 year statute of limitations</i> <i>Exception for child support</i>	Yes ^[4] <i>4 year statute of limitations</i> <i>Exception for divorcing spouse</i>	Yes ^[4] <i>4 year statute of limitations</i> <i>Exceptions for child and spousal support</i>
Trust Protector	Yes	Yes	Yes	Yes	Yes

* Denotes superior distinction among jurisdictions.

^[1] Attorney Steve Oshins' "9th Annual Dynasty Trust State Rankings Chart"

^[2] Worthington, Daniel G.; Merric, Mark; Sullivan, John E.; and Thomas, Ryan "Which Situs is Best in 2020?" *Trusts & Estates* January 2020

^[3] South Dakota Special Spousal Trusts, House Bill 1039 (2016) (Sections 29-42)

^[4] Attorney Steve Oshins' "11th Annual Domestic Asset Protection Trust State Rankings Chart"

^[5] Attorney Steve Oshins' "8th Annual Trust Decanting State Rankings Chart"

^[6] Murphy, Mary; Iyengar, Akshay; and Zhang, Alexandria "Tax Revenue Volatility Varies Across States, Revenue Streams" *PEW* August 2018

Choosing the Correct Jurisdiction

	South Dakota	Nevada	Wyoming	Alaska	Delaware
Directed Trusts	Yes	Yes	Yes	Yes	Yes
Decanting Statute	Yes <i>Ranked as #1 [5]</i>	Yes <i>Ranked as #2 [5]</i>	Yes <i>Ranked as #14 [5]</i>	Yes <i>Ranked as #9 [5]</i>	Yes <i>Ranked as #3 [5]</i>
Trust Privacy Provision	Yes - Total Privacy Seal Forever <i>Automatically attaches</i>	No Total Privacy Seal [2] <i>Subject to judge discretion</i>	No Total Privacy Seal [2] <i>Subject to judge discretion</i>	No Total Privacy Seal [2] <i>Subject to judge discretion</i>	Yes - Three Year Privacy Seal [2] <i>Subject to judge discretion</i>
Special Purpose Entity	Yes [2] <i>Codified by statute</i>	No	No	No	No
Family Advisor	Yes	No	No	No	No
State Fiscal Health	Ranked as #1 [6]	Ranked as #29 [6]	Ranked as #48 [6]	Ranked as #50 [6]	Ranked as #38 [6]

* Denotes superior distinction among jurisdictions.

[1] Attorney Steve Oshins' "9th Annual Dynasty Trust State Rankings Chart"

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Kaestner Case: Introduction

- ▶ The Supreme Court's recent decision in the Kaestner case provides the most important constitutional tax guidance in decades.
- ▶ What can be learned from the Kaestner ruling and what are the practical implications going to be for practitioners?
- ▶ What is the relevance of the Supreme Court's Denial of Cert. in the Fielding case?

State Trust Taxation: Setting the Stage

- ▶ Income retained in a trust is taxed in most states at applicable income tax levels.
- ▶ A handful of states do not have an income tax and, therefore, do not tax retained income in trusts, including South Dakota.
- ▶ Many sophisticated practitioners believe that there is a simple and compelling state tax planning opportunity by properly situsing a trust in a state that does not have an income tax or tax trusts.



State Trust Taxation (cont'd)

- ▶ Resident Trust – A trust established by a resident of a particular state.
- ▶ Sourced v. Non-Sourced undistributed trust income.
- ▶ Prior to recent SCOTUS activity, there was a clear trend in case law across the country denying state authority to tax retained income in a resident trust.

SCOTUS Accepts Kaestner Case

- ▶ In January of 2019, SCOTUS granted Writ of Certiorari to review and hear the Kaestner case, prompting the attention of planners and practitioners across the country.
- ▶ Recognizing the importance of the case, South Dakota took the lead in organizing the commission of an Amicus Brief in support of the taxpayer - an effort involving multiple jurisdictions and experts from across the nation.



Kaestner Case: Key Facts

- ▶ New York taxpayer formed a trust under New York law. Beneficiary resided in North Carolina during tax years in question.
- ▶ No distributions were made to the beneficiaries during years at issue.
- ▶ Trustee had no physical presence in North Carolina, and trust had no property in the state.
- ▶ North Carolina attempted to tax undistributed trust income.

The Supreme Court's Holding

- ▶ The presence of in-state beneficiaries alone does not establish sufficient nexus for taxation of undistributed trust income.
- ▶ Taxation of undistributed trust income, under these facts, was a violation of the Due Process Clause of the United States Constitution.

Taxpayer Prevails

- ▶ In an unanimous decision, the Supreme Court strikes down North Carolina's attempt to tax undistributed income of a resident trust properly situated and administered in a no income tax state. *North Carolina Department of Revenue v. Kimberley Rice Kaestner 1992 Family Trust*, 18-457 (2019).

The Fielding Case: Key Facts

- ▶ Minnesota resident established four irrevocable trusts with shares closely held in a Minnesota S Corp.
- ▶ Non-Minnesota trustee.
- ▶ One Minnesota beneficiary.
- ▶ Shares were subsequently sold and assets were managed by an investment manager outside the state of Minnesota.
- ▶ Minnesota attempted to tax undistributed income.

The Minnesota Supreme Court's Ruling

- ▶ In-state grantor/settlor of a trust is alone not enough to establish nexus such that to tax undistributed income.
- ▶ Minnesota's attempt to tax undistributed income, under these facts, was a violation of the Due Process Clause of the United States Constitution.

SCOTUS Denies Cert: Important Timeline of Events and Significance

What does Denial of Cert. mean?

- ▶ At least 4 justices did not want to review the case.
- ▶ **NOT** an expression of opinion on the merits of the case.
- ▶ However, as stated by Justice Robert Jackson, “It is just one of the facts of life that **today every lower court does attach importance to denials and to presence or absence of dissent from denials, as judicial opinions and lawyers’ arguments show.**”

SCOTUS Denies Cert: Important Timeline of Events and Significance

Does the unique procedural nature and timing of denial give us guidance?

- ▶ Petition for Cert. in Kaestner was filed in October 2018, and response was due to Court by 2018.
- ▶ Fifteen days later Petition for Cert. in Fielding was filed.
- ▶ Cert. was granted to Kaestner on January 11, 2019.
- ▶ SCOTUS subsequently denied a request to consolidate the cases for argument.
- ▶ SCOTUS first considered the Fielding case in conference in February 2019.

SCOTUS Denies Cert: Important Timeline of Events and Significance (cont'd)

Does the unique procedural nature and timing of denial give us guidance? (cont'd)

- ▶ SCOTUS issued decision in Kaestner affirming lower Court's decision June 21, 2019.
- ▶ Fielding was relisted for conference on June 27, 2019, and subsequently Cert was denied, allowing the decision of the MN Supreme Court that residence of the settlor does not establish sufficient nexus under due process to tax undistributed Trust income to stand.

What We Know

Not Constitutional (taxation of undistributed trust income)

- ▶ In-state discretionary beneficiary not enough for nexus (Kaestner).
- ▶ In-state grantor/settlor not enough for nexus (Fielding).

Clearly Constitutional (Taxation of Undistributed Trust Income)

- ▶ In-state trustee presence and trust administration is enough to establish nexus.
- ▶ Sourced Income.

“Legal experts contend that there have been more changes in trust law in the last twenty years than have taken place in the prior two centuries. These changes promise to affect every aspect of how trusts are administered for years to come.”

** Joseph F. McDonald, Esq III, Trusts & Estates Magazine, February 2012*

Additional Information

As an independent, full service trust company with South Dakota Trust powers, Bridgeford Trust Company provides trust and fiduciary services to domestic and international families across the country and around the world.

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