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# What Have You Done For Me Lately? Constitutional Limitations on State Taxation of Trusts

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# WHAT HAVE YOU DONE FOR ME LATELY? CONSTITUTIONAL LIMITATIONS ON STATE TAXATION OF TRUSTS

*Bradley E.S. Fogel**

## I. INTRODUCTION

Suppose a resident of New Jersey creates an irrevocable inter vivos trust.[1] The settlor subsequently dies while a resident of New Jersey. Pursuant to the terms of her will, which is probated in New Jersey, her entire estate is paid to the trust. After a few years, one of the two trustees is a New York resident, the other is a resident of Connecticut. The trust's assets, intangibles such as stock in Delaware corporations, are held by the New York trustee in New York. All of the income beneficiaries of the trust reside in New York or Connecticut.[2]

Question: To what state, if any, must the trust pay income tax?

By New Jersey statute, this trust is defined as a New Jersey "Resident Trust" because it is an inter vivos trust created by a resident of New Jersey.[3] New Jersey taxes Resident Trusts on the entire income of the trust, subject to the usual deductions allowed to trusts.[4] In contrast, were the trust classified as a

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1. An inter vivos trust is a trust created by an individual (often referred to as the "settlor" or "trustor") during her lifetime, as compared to a testamentary trust which is created under an individual's will and becomes effective at the time of her death. *See* BLACK'S LAW DICTIONARY 821 (6th ed. 1990).

2. The facts of this example are loosely based on the New Jersey Tax Court decision in *Potter v. Taxation Div. Dir.*, 5 N.J. Tax 399 (1983).

3. *See* N.J. STAT. ANN. § 54A:1-2(o)(3)(a) (West 1986).

4. *See* N.J. STAT. ANN. § 54A:2-1 (West 1986). In addition to the usual deductions allowed to individuals, trusts are typically allowed a deduction for distributions of income made to beneficiaries. Since the beneficiary will commonly pay income tax

non-Resident, it would be subject to income taxation by the State of New Jersey solely on income derived from sources in New Jersey, *i.e.*, New Jersey source income.[5] New York, Connecticut and Delaware each define "Resident Trust" in a similar fashion as New Jersey.[6] Further, like New Jersey, New York, Connecticut and Delaware each tax Resident Trusts on all income and non-Resident Trusts only on the trust's source income.[7] Since the only asset held by the trust is stock in Delaware corporations, the income from which is neither New York, Connecticut, nor Delaware source income, none of those states tax the trust's income.[8] Therefore, pursuant to each of their statutes, New Jersey imposes an income tax on the entire income of the trust, but New York, Connecticut and Delaware do not tax any of the trust's income.

The New Jersey Tax Court, when confronted with this scenario, held that the income tax imposed by New Jersey on such a trust violates the due process clause of the United States Constitution.[9] The Court held that there was no "nexus" between New Jersey and the trust during the relevant tax years; therefore, New Jersey was constitutionally prevented from taxing this trust. Since New York, Connecticut and Delaware do not impose an income tax on this trust, although they could do

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on the distributions made to her, the deduction at the trust level prevents double taxation. This structure is similar under both the federal tax system and under that of most states. *See* I.R.C. §§ 642, 651, 662 (1997); Note, *State Taxation of Trust Income*, 2 REAL PROP., PROB. AND TR. J. 141, 144 (1967).

5. *See* N.J. STAT. ANN. § 54A:2-1.1 (West 1986). The income tax imposed by New Jersey on non-residents is equal to the tax that would have been imposed had the taxpayer been a resident multiplied by a fraction. The denominator of the fraction is the taxpayer's gross income from all sources and the numerator is the taxpayer's New Jersey source income. *Id.*

New Jersey source income includes, inter alia, income from New Jersey real property and income derived from employment in New Jersey. *See* N.J. STAT. ANN. §§ 54A:5-8(1), 54A:5-8(2) (West 1986 & Supp. 1997).

6. *See* CONN. GEN. STAT. ANN. § 12-701(a)(4) (West 1993); 30 DEL. CODE ANN. tit. 30, § 1136(a) (1997); N.Y. TAX LAW § 605(b)(3) (Consol. 1990 & Supp. 1997).

7. *See* CONN. GEN. STAT. ANN. §§ 12-711, -713 (West 1993); DEL. CODE ANN. tit. 30, §§ 1121, 1141 (1997); N.Y. TAX LAW §§ 631, 633 (Consol. 1990 & Supp. 1997).

8. *See* CONN. GEN. STAT. ANN. § 12-711(b) (West 1993); DEL. CODE. ANN. tit. 30, §§ 1121, 1122, 1124 (1997); N.Y. TAX LAW § 631(b) (Consol. 1990 & Supp. 1997).

For most purposes, Delaware source income does not include income derived from stock in Delaware corporations. *See* DEL. CODE ANN. tit. 30, § 1124(c) (1997).

9. *See* Potter v. Taxation Div. Dir., 5 N.J. Tax 399, 404-405 (1983).

so unembarrassed by the United States Constitution,[10] the trust wholly escapes state income taxation.

Would it matter if the trust was a testamentary trust created under the will of a New Jersey resident? The New Jersey Tax Court has held it would not.[11] Further, the fact that some of the contingent beneficiaries[12] of the trust were New Jersey residents did not provide sufficient nexus for New Jersey to constitutionally tax the trust.[13]

The preceding examples are loosely based on two New Jersey Tax Court cases decided the same day—*Pennoyer* and *Potter*. The focus of this article is the issue addressed in *Pennoyer* and *Potter* and numerous other state court decisions. Namely, can a state constitutionally tax a trust based solely on the residence of the settlor, in the case of an inter vivos trust, or the testator,[14] in the case of a testamentary trust, if there is no other connection between the taxing state and the trust during the tax year? The numerous courts that have addressed this issue have reached decisions that are not wholly consistent with one another. Further, in January 1997, the United States Court of Appeals for the District of Columbia Circuit addressed this issue and opined[15] that the earlier decisions have been overruled by the 1992 Supreme Court case *Quill Corp. v. North Dakota*.[16]

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10. *See* Greenough v. Tax Assessors, 331 U.S. 486 (1947) (holding that a state may tax a trust based on the residence of the trustees); New York *ex rel.* Whitney v. Graves, 299 U.S. 366 (1937) (holding that a state may constitutionally tax a non-resident on income derived from sources in that state).

11. *See* Pennoyer v. Taxation Div. Dir., 5 N.J. Tax 386 (1983).

12. A contingent beneficiary is a beneficiary that will benefit only upon the happening of some event, for example, a remainder person that receives the principal of the trust only if she is living at the death of the income (current) beneficiary. *See* BLACK'S LAW DICTIONARY 321 (6th ed. 1990).

13. *See Potter*, 5 N.J. Tax at 404.

14. Traditionally, the term "testator" has been used to describe a male who has died leaving a will (*i.e.*, testate) and the term "testatrix" has been used to describe a female leaving a will. *See* BLACK'S LAW DICTIONARY 1475 (6th ed. 1990). The trend, however, has been to use the term "testator" to refer to both genders. For grammatical ease, as well as to avoid the gendered term, this article will use the term "testator" to refer to males and females indiscriminately.

15. *See* District of Columbia v. Chase Manhattan Bank, 689 A.2d 539, 545 (D.C. Cir. 1997).

16. 504 U.S. 298 (1992).

Courts that have addressed this issue have likened taxation of such a trust to the imposition of an income tax on an individual born in the taxing state for the rest of that individual's life, irrespective of her residence.[17] In contrast, in holding that such a tax is constitutional, the tax has been likened to the imposition of an income tax upon a corporation by the state of incorporation.[18] Under this theory, the trust, like a corporation, owes its existence to the law of the taxing state and, thus, may be taxed by that state. Neither of these analogies are wholly satisfactory.[19] At the risk of oversimplifying the issue, it is evident that a trust is neither a corporation nor an individual and, thus, the constitutional basis of a state income tax on an individual or corporation is not necessarily a constitutional basis for the imposition of state income tax on a trust.

In these cases, if the trust is not taxed by the state of residence of the settlor/testator, the trust will frequently wholly escape state income taxation. While this result may seem inequitable at first blush, it is important to recognize that this arguable unfairness is not constitutionally significant.[20] Simply, the United States Constitution does not require that an entity be subject to state income tax. If it did, states that impose no income tax would be forced to adopt an income tax. This would be an unexpected result, especially in a state such as Florida in which the imposition of an income tax is prohibited by the state constitution.[21]

The issue of the constitutionality of a state income tax based solely on the residence of the settlor/testator[22] at the time of

17. *See* Blue v. Department of Treasury, 462 N.W.2d 762, 764-65 (Mich. Ct. App. 1990).

18. *See Chase Manhattan Bank*, 689 A.2d at 543-45.

19. *See infra* notes 156-76 and accompanying text.

20. *See* Westfall v. Director of Revenue, 812 S.W.2d 513, 517 (Mo. 1991) (en banc) (Blackmar, J., dissenting) ("The director argues that if the trust income from intangibles is not subject to taxation in Missouri it will not be taxed anywhere. I am unable to see how this is demonstrated from the record before us but, even if it is, it makes no difference. We are concerned here only with Missouri's power to tax.").

21. *See* FLA. CONST. art. 7, § 5(a). Alaska, Florida, Nevada, South Dakota, Texas, Washington and Wyoming impose no state income tax. *See* State Tax Guide (CCH).

22. Technically, the taxation of a testamentary trust is based on the residence of the testator at the time of her death. For grammatical ease, however, this article will frequently refer to the residence of the settlor/testator at the time of creation of the trust.

the creation of the trust has been addressed by several courts over the past hundred years.[23] Despite the fact that the issue has not arisen frequently, it is likely to come before various state courts more frequently in the future due to external factors. Namely, it has been said so many times that it borders on the trite to claim that this is an increasingly mobile society. Individuals are less likely to remain residents of the state (or even the nation) of their birth than they were years ago. Further, the rule against perpetuities,[24] which limits the duration of a trust, has been repealed, or greatly limited, in several states.[25] These two factors should increase the frequency with

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23. *See generally* District of Columbia v. Chase Manhattan Bank, 689 A.2d 539 (D.C. Cir. 1997); City of Augusta v. Kimball, 40 A. 666 (Me. 1898); Westfall v. Director of Revenue, 812 S.W.2d 513 (Mo. 1991); Blue v. Department of the Treasury, 462 N.W.2d 762 (Mich. Ct. App. 1990); Swift v. Director of Revenue, 727 S.W.2d 880 (Mo. 1987) (en banc); Mercantile-Safe Deposit & Trust Co. v. Murphy, 15 N.Y.S.2d 579 (N.Y. 1964); Taylor v. New York State Taxation Comm'n, 445 N.Y.S.2d 648 (N.Y. App. Div. 1981); Potter v. Taxation Div. Dir., 5 N.J. Tax 399 (1983); Pennoyer v. Taxation Div. Dir., 5 N.J. Tax 386 (1983); First Nat'l Bank of Boston v. Harvey, 16 A.2d 184 (Vt. 1940); Bayfield County v. Pishon, 162 Wis. 466 (Wis. 1916). *Harvey*, *Pishon* and *Kimball* did not, however, address the constitutional issues concerning the taxation of such a trust.

In *Hutchins v. Commissioner of Corporations and Taxation*, 172 N.E. 605 (Mass. 1930), the Supreme Judicial Court of Massachusetts addressed the issue of the constitutionality of a Massachusetts income tax based on the residence of the trustees. In *dicta*, the court addressed the issue of the state income taxation of a trust based solely on the residence of the testator. The holding of *Hutchins*, which invalidated a Massachusetts income tax on the entire income of a trust based on the Massachusetts residence of less than all of the trustees, is at least partially inconsistent with *Greenough v. Tax Assessors*, 331 U.S. 486 (1947), which was decided by the United States Supreme Court seventeen years later. In *Greenough*, the Court held that a state may tax the income of a trust based on the residence of less than all of the trustees in such state. *See id.* at 498. Further, the decision in *Hutchins* was partially based on the risk of double taxation. Nine years after *Hutchins*, the United States Supreme Court held that double taxation is not constitutionally prohibited. *See* Curry v. McCanless, 307 U.S. 357, 365-68 (1939).

This issue has also been addressed by the Virginia Department of Taxation. *See* Virginia Department of Taxation Letter Ruling, 1993 WL 372991 (Aug. 26, 1993).

24. The rule against perpetuities states that an interest must vest, if it is to vest at all, within 21 years after the death of a life in being at the creation of the interest. *See* ELIAS CLARK ET AL., GRATUITOUS TRANSFERS 744-83 (3d ed. 1985). While a detailed explanation of this rule is not appropriate here, the basic result is that the rule against perpetuities limits the duration of a trust.

25. These states include: Alaska (ALASKA STAT. § 34.27.050 (Michie 1997)); Delaware (DEL. CODE ANN. tit. 25, § 503 (1989 & Supp. 1996)); Idaho (IDAHO CODE § 55-111 (1997)); South Dakota (S.D. CODIFIED LAWS § 43-5-8 (Michie 1997)); and Wisconsin (WIS. STAT. ANN. § 700.16(5) (West 1981 & Supp. 1997)). *See also* Carolyn T. Geer, *Is Your Trust Well Placed?*, FORBES, June 16, 1997 at 190. The trend toward

which this issue is raised before state courts. First, the fact that an individual is less likely to remain a resident of his state of birth, which is likely to be his ancestors' state of residence, makes it more likely that trust beneficiaries and/or trustees, who are frequently the descendants of the settlor/testator, will reside outside the state of creation of the trust. Moreover, this possibility is increased by the fact that, considering the trend toward repeal of the rule against perpetuities, a trust may exist for a substantial length of time, or even indefinitely.[26]

While this issue has received attention from state courts, and is increasingly likely to be the subject of further state litigation, it has received relatively little attention from commentators.[27] This may be due to the fact that a trust that distributes all of its income will, frequently, pay no income tax.[28] Thus, the state (and federal) income tax liability of a trust may be minor. This lack of attention is unfortunate, however, since trusts are unique in that state income taxation of a trust is frequently based on the creation of the trust—an event that potentially occurred long before a particular tax year. This makes the constitutional limits on the income taxation of trusts particularly

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repeal of the rule against perpetuities seems to be gaining momentum. Thus, it appears likely that this list will soon be out of date.

A South Dakota trust company advertises that as a South Dakota trustee, it will administer a trust and keep the trust "going strong" through the year 2238. *Advertisement of Norwest Investment Management & Trust*, TRUSTS & ESTATES, July 1996, at 15.

26. This new found freedom is somewhat mitigated, however, by the federal generation-skipping transfer tax. *See* I.R.C. § 2601 (1997). As a gross oversimplification, this tax is imposed on transfers, either outright or in trust, to grandchildren or more remote descendants of the transferor. There is, however, a one million dollar exemption against this tax. Thus, it is a common estate planning technique for wealthy individuals to place one million dollars in a trust to pay income to grandchildren and more remote issue. *See generally* JEROME A. MANNING ET AL., MANNING ON ESTATE PLANNING 6-30 to 6-34 (5th ed., 1995). Currently, no states impose a state generation-skipping tax.

27. *See* Eileen Caulfield Schwab & William P. LaPiana, *The Income Taxation of New York Resident Trust*, N.Y. ST. B.J., March/April 1996, at 30 (discussing the New York State Department of Finance and Taxation regulations concerning this issue). As discussed *infra*, these regulations were passed in response to litigation in the New York State courts concerning the constitutional limitations or state taxation of trusts. *See infra* notes 56-58 and accompanying text.

28. *See infra* notes 40-47 and accompanying text.

interesting, even if the stakes are sometimes, but certainly not always, small.

An issue that has drawn the attention of commentators is the so-called situs of a trust.[29] The situs of a trust is, generally, the place of performance of the duties of the trustees, *i.e.*, the jurisdiction where the trustees and the bulk of the trust assets are located.[30] The components of the trust's situs, such as the residence of the trustees, are relevant to the issue of whether or not a particular state may constitutionally tax a trust and they will be discussed in that context. Trusts, however, are generally taxed based on the residence of the settlor/testator and not based on their situs.[31]

Part two of this article will discuss the statutory framework of the state taxation of trusts. Particularly, it will explore the distinction, alluded to earlier, between Resident and non-Resident Trusts that is made by many states, such as New Jersey. The purpose of part two is not to provide a state-by-state exegesis of the law regarding the state taxation of trusts—that purpose is best left to Commerce Clearing House.[32] Instead, part two will examine, in broad brush, the basic structure of trust income taxation by the states.

Part three of this article will discuss the 1929 United States Supreme Court case *Safe Deposit & Trust Co. v. Virginia*,[33] which held that Virginia may not impose an *ad valorem*[34] tax on an inter vivos trust that was created by a Virginia resident, since the trustee was a resident of Maryland. While this case seems especially relevant to the issue discussed herein, many state court cases that address this issue fail to even cite it.[35]

29. *See, e.g.*, HENDRICKSON & SILVERMAN, CHANGING THE SITUS OF A TRUST (1992).

30. *See id.* § 1.01.

31. *See infra* notes 48-52 and accompanying text.

32. *See generally* State Tax Reporter Series (CCH).

33. 280 U.S. 83 (1929).

34. An *ad valorem* tax is a tax imposed "according to value," that is, based on the value of property. The most common type of *ad valorem* tax is the real property tax imposed by many states; however, an *ad valorem* tax may be imposed on any property, real or personal, tangible or intangible. *See* BLACK'S LAW DICTIONARY 51 (6th ed. 1990).

35. *See, e.g.*, District of Columbia v. Chase Manhattan Bank, 689 A.2d 539 (D.C. Cir. 1997); Blue v. Department of the Treasury, 462 N.W.2d 762 (Mich. Ct. App.

Part four explores the background of constitutional limitations on state taxation as established by other United States Supreme Court precedents. Particular mention will be made of the 1992 United States Supreme Court case *Quill Corp. v. North Dakota.*[36] *Quill*, which involved the constitutionality of a North Dakota use tax on a mail order house located outside of North Dakota, distinguished between the nexus requirement of the due process clause of the United States Constitution and the nexus requirement of the commerce clause. In explaining this distinction, the *Quill* Court noted that the two clauses are aimed at different constitutional concerns and, thus, are not, as had been previously thought, coextensive.[37]

In January 1997, the United States Court of Appeals for the District of Columbia Circuit addressed the issue of the District's imposition of an income tax on a trust based solely on the residence of the testator at the time of his death, and opined that *Quill* had overruled all of the earlier cases that had held that such a tax was unconstitutional.[38]

Part five will apply the relevant standards to the issue at hand; namely, the constitutionality of a state's imposition of an income tax on a trust that has little or no connection to the taxing state other than the fact that the settlor/testator was a resident of the taxing state. In this part, the distinction between inter vivos and testamentary trusts, and the arguably closer relationship between a state and a testamentary trust will be explored.[39] Further, the differences between the nexus requirements of the due process and commerce clauses will be discussed. The analogies that have been used by the state courts to analyze this issue will also be reviewed. Part five will also argue that the attempts to constitutionally justify income taxation of a trust based on certain connections, such as the

1990); Westfall v. Director of Revenue, 812 S.W.2d 513 (Mo. 1991); Potter v. Taxation Div. Dir., 5 N.J. Tax 399 (1983).

36. 504 U.S. 298 (1992).

37. Justice White argued that this "newly created" distinction was not supported by the evolution of the law regarding these two clauses. *Id.* at 325 (White, J., concurring in part and dissenting in part).

38. *See Chase Manhattan Bank*, 689 A.2d at 545.

39. *See id.* at 547 n.11.

jurisdiction of the state courts, rely on flawed and circular reasoning.

In part six, policy issues concerning the imposition of state income tax in this situation will be discussed. This section will review the fairness of the imposition of an income tax on a trust by a state with little connection between the two. Alternative bases for taxation will also be explored.

Part seven will discuss some of the "Trustee Issues" that would arise from a conclusion that a state may not constitutionally tax a trust if the only connection between the trust and the taxing state is the residence of the settlor/testator. These "Trustee Issues" include whether a trustee may be removed if that trustee's residence is the sole basis for a state's continuing jurisdiction to tax a trust and the issue of who is a trustee for constitutional purposes.

Part eight of this article will conclude and, in order to avoid spoiling the end of this "story," nothing further will be said about part eight at this time.

## II. STRUCTURE OF STATE TAX LAWS REGARDING THE INCOME TAXATION OF TRUSTS

Generally, states have modeled their statutes regarding the income taxation of trusts after the federal provisions.[40] By following the federal system, the states, by and large, attempt to

40. *See* JEROME R. HELLERSTEIN & WALTER HELLERSTEIN, STATE TAXATION ¶ 20.90 (2d ed. 1992).

To the extent the states deviate from the federal system, the deviations frequently eliminate some of the complexities contained in the federal system. *See* Note, *State Taxation of Trust Income, supra* note 4, at 144. For example, many states do not provide for an analog of the "throwback rule" contained in the Internal Revenue Code. *See* HELLERSTEIN & HELLERSTEIN, *supra*, ¶ 20.90. The federal throwback rule, generally, involves the taxation of distributions by the trust of income that has been accumulated in earlier years. *See* I.R.C. §§ 665-668 (1997); ARTHUR M. MICHAELSON & JONATHAN G. BLATTMACHR, INCOME TAXATION OF ESTATES & TRUSTS at 2-36 to 2-51 (1995).

The throwback rule was originally adopted as an anti-abuse provision to prevent taxpayers from taking advantage of the then-lower income rates for trusts by accumulating income in the trust so that the income tax is paid by the trust rather than by the beneficiary. *See* MICHAELSON & BLATTMACHR, *supra*, at 2-28. The federal throwback rule was largely repealed by the Taxpayer Relief Act of 1997. *See* H.R. 2014, 105th Cong. § 507 (1997).

tax trusts like individuals.[41] Of course, there are numerous differences between the income taxation of individuals and trusts due to the fundamental differences in their nature; for example, trusts generally receive an income tax deduction for administration expenses, such as trustee commissions.[42] The most important difference, however, is that for both federal and, for the most part, state purposes, a trust will receive an income tax deduction for distributions made to a beneficiary.[43] Correspondingly, the beneficiary will be taxed on distributions of income received from the trust.[44] Therefore, if a trust distributes all of its taxable income, then, under the federal tax system, as well as the tax systems imposed by many states, the trust will receive an income tax deduction that is equal to the distributions made to the beneficiaries, which, in turn, is equal to the whole of its taxable income. Thus, the trust may pay no state or federal income tax.[45]

This system of allowing a deduction to the trust for distributions of income received by the beneficiaries maintains a single level of income tax amongst the trust and the beneficiaries. In contrast, dividends paid from a corporation are taxed at both the corporate and at the shareholder level.[46] On the other end of the spectrum, a partner will report a fractional share of the

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41. *See* I.R.C. § 641(d) (1997); Note, *State Taxation of Trust Income*, *supra* note 4, at 144.

42. *See* MICHAELSON & BLATTMACHR, *supra* note 40, at 80.

43. *See* I.R.C. §§ 651, 661 (1997); Note, *State Taxation of Trust Income*, *supra* note 4, at 144. Generally, this deduction is limited to the extent of the trust's distributable net income (DNI). *See generally*, MICHAELSON & BLATTMACHR, *supra* note 40, at 2-45 to 2-53. The mechanics of DNI, however, are not relevant to the current discussion.

44. *See* I.R.C. §§ 652, 662 (1997); Note, *State Taxation of Trust Income*, *supra* note 4, at 146. The amount of income the beneficiary must include in his taxable income is also limited to the extent of the trust's DNI. *See* MICHAELSON & BLATTMACHR, *supra* note 40, at 2-45.

45. If during a particular tax year a trust has both capital gain and ordinary income, then, even if the trust distributes all of the income and all of the gain, the trust will typically owe income tax on its capital gain. This is due to the fact that capital gain is, typically, not included in DNI, and DNI is a limit on both the taxable income reported by the beneficiaries and the deduction received by the trust. *See* I.R.C. § 643(a)(3); Treas. Reg. § 1.643(a)-3; Note, *State Taxation of Trust Income*, *supra* note 4, at 144; *see also* *supra* notes 43-44.

46. *See* 1996 U.S. Master Tax Guide (CCH) ¶ 201 (1995).

partnership's taxable income regardless of whether the income is distributed.[47]

In an attempt to tax trusts in a fashion that is similar to the taxation of individuals, states frequently distinguish between Resident and non-Resident Trusts. While the definitions vary, they are generally based on the residence of the settlor, in the case of an inter vivos trust, or the testator, in the case of a testamentary trust. The District of Columbia definition is typical.

> For the purposes of this subchapter, estates and trusts are: (1) resident estates or trusts; or (2) nonresident estates or trusts. If the decedent was at the time of his death domiciled within the District, his estate is a resident estate, and any trust created by his will is a resident trust. If the decedent was not at the time of his death domiciled within the District, his estate is a nonresident estate, and any trust created by his will is a nonresident trust. If the creator of a trust was at the time the trust was created domiciled within the District, or if the trust consists of property of a person domiciled within the District, the trust is a resident trust. If the creator of the trust was not at the time the trust was created domiciled within the District, the trust is a nonresident trust. . . .[48]

Generally, states that make the distinction between Resident and non-Resident Trusts provide definitions that are similar to the District of Columbia definition quoted above.[49] For the most part, if a testamentary trust is created under the will of a resident of the state, then it is a "Resident Trust" for income tax purposes. Similarly, an inter vivos trust will be considered a "Resident Trust" if, at the time of the trust's creation, the settlor was a resident of that state.

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47. *See id.*; I.R.C. §§ 701, 702, 704 (1997).

48. D.C. STAT. § 47-1809.1 (1997 Repl. Vol.).

49. *See, e.g.*, COLO. REV. STAT. ANN. § 39-22-103(10) (West 1997) (Colorado defines any trust administered in Colorado as a Resident Trust); DEL. CODE ANN. tit. 30, § 1136(a) (West 1997); 35 ILL. COMP. STAT. ANN. 5/1501(a)(20) (West 1996 & Supp. 1997); MICH. COMP. LAWS ANN. § 206.18(c) (West 1986); MO. ANN. STAT. § 143.331 (West 1996); OKLA. STAT. tit. 68, § 2353(6) (1992 & Supp. 1998); PA. STAT. ANN. tit. 72, § 7301(s) (Law. Co-op 1990 & Supp. 1997); R.I. GEN. LAWS § 44-30-5(c) (1995).

These definitions provide the basis of the issues discussed in this article. A trust is determined to be a Resident or non-Resident Trust ab initio. This categorization, and the concomitant state income tax liabilities, then remain with the trust throughout its existence. Thus, for example, the District of Columbia may tax the income of a trust despite the fact that the basis of the tax, the creation of the trust by a District resident, occurred fifty-three years before the tax year.[50] Further, the same definition would provide for a state's imposition of an income tax on a trust based solely on the fact that the trust was created by a resident of that state potentially hundreds of years earlier.[51]

The distinction between Resident and non-Resident Trusts is significant. A Resident Trust, like a resident individual, is taxed on its entire income from whatever source, whether located in the state or not, whether located in the United States or not.[52] The constitutional basis for such a tax with respect to resident individuals is well settled.[53] In contrast, non-resident individuals and trusts are taxed only on income derived from sources within the taxing state, such as rental income from real property located in the state.[54] The United States Supreme Court has held that a state's imposition of an income tax on a non-resident is constitutional if limited to the non-resident's source income.[55]

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50. *See* District of Columbia v. Chase Manhattan Bank, 689 A.2d 539, 540-41 (D.C. Cir. 1997). The testator died in 1934; tax liability for 1987-1989 and 1991 was being disputed by the trustee, Chase Manhattan Bank. Chase was prevented from disputing its liability for income tax for 1990 on procedural grounds. *See id.* at 541 n.4.

51. *See supra* note 25 and accompanying text.

52. *See* HELLERSTEIN & HELLERSTEIN, *supra* note 40, ¶ 20.04[2]; *see, e.g.*, R.I. GEN. LAWS §§ 44-30-12, 44-30-16 (1995 & Supp. 1997).

53. *See* Oklahoma Tax Comm'n v. Chickasaw Nation, 115 S. Ct. 2214, 2222 (1995); New York *ex rel.* Cohn v. Graves, 300 U.S. 308, 312 (1937) (noting that "the receipt of income by a resident of the territory of a taxing sovereignty is a taxable event is universally recognized. Domicile itself affords a basis for such taxation. Enjoyment of the privileges of residence in the state and the intended right to invoke the protection of its laws are inseparable from responsibility for sharing the cost of government"); Shaffer v. Carter, 252 U.S. 37 (1920) (explaining that "as to residents the state may, and does, exert its taxing power over their income from all sources, whether within or without the state").

54. *See* HELLERSTEIN & HELLERSTEIN, *supra* note 40, ¶ 20.05[2]; *see, e.g.*, MISS. CODE ANN. § 27-7-23(b)(1) (1991 & Supp. 1997); N.J. STAT. ANN. § 54A: 5-8(1) (West 1986 & Supp. 1997); R.I. GEN. LAWS §§ 44-30-32(b)(i), 44-30-35, 44-30-32 (1995).

55. *See* New York *ex rel.* Whitney v. Graves, 299 U.S. 366, 372 (1937). In *Whit-*

Therefore, the classification of a trust as a Resident or as a non-Resident is crucial to determining its state income tax liability. If a trust holds only intangibles, such as stocks, as a resident of a particular state, it will owe state income tax on all of its income. If, however, the trust is not classified as a resident by any state, then it will wholly escape state income taxation, since the income from intangibles is, generally, not source income from any state.

New York, Connecticut and Massachusetts address, directly in their statutes defining Resident Trusts, or the regulations thereunder, the issue of the tenuous constitutional basis for the state income taxation of a trust whose sole connection to the state is the residence of the settlor/testator. After unsuccessfully litigating this issue several times,[56] the New York Commission of Taxation and Finance amended its regulations regarding the definition of Resident Trusts.[57] The amended regulations provide that no income tax is imposed on a trust if: (1) all the trustees are domiciled outside of New York, (2) there are no trust assets located in New York, and (3) the trust has no New York source income.[58]

Connecticut, in apparent recognition of the closer relationship between testamentary trusts and the state of residence of the testator,[59] provides that the income of an inter vivos "Resident Trust" is pro-rated based on the proportion of Connecticut resident non-contingent beneficiaries. No such proration is made for testamentary trusts.[60] Thus, for example, an inter vivos trust created by a resident of Connecticut with four income beneficiaries, two of which are Connecticut residents, pays income tax on one half (2/4) of its income to the state of Connecticut.[61] If

*ney*, the United States Supreme Court held that New York may tax a non-resident on gains received from the sale of a seat on the New York Stock Exchange. *See id.*

56. *See, e.g.*, Taylor v. New York State Taxation Comm'n, 445 N.Y.S.2d 648 (N.Y. App. Div. 1981); Mercantile-Safe Deposit & Trust Co. v. Murphy, 242 N.Y.S.2d 26 (N.Y. App. Div. 1963), *aff'd*, 15 N.Y.S.2d 579 (N.Y. 1964).

57. *See* Personal Income Tax Reg. § 105.23 (1997).

58. *See id.*

59. *See infra* notes 199-210 and accompanying text.

60. *See* CONN. GEN. STAT. ANN. § 12-701(a) (West 1993).

61. *See id.* § 12-701(a). For tax years prior to January 1, 1993, Connecticut provided an exemption similar to that provided by New York; namely, no Connecticut income tax was imposed on a Connecticut Resident Trust if: (1) none of the trustees were Connecticut residents, (2) no trust property was located in Connecticut, and

none of the beneficiaries of the trust are Connecticut residents, the trust would pay no Connecticut income tax.[62] In contrast, Connecticut would impose an income tax on all of the income of a similarly situated testamentary trust, irrespective of the residence of the beneficiaries.

Massachusetts provides for a broader definition of Resident Trusts in that the term includes an inter vivos trust created by an individual who died a Massachusetts resident, even if the individual was not a Massachusetts resident at the time of creation of the trust.[63] In order to be classified a Massachusetts Resident Trust, however, at least one trustee must be a Massachusetts resident.[64]

While the New York Commission of Taxation apparently amended its regulations in response to the losses on this issue it faced in the New York courts, no case addressing this issue has been litigated in Connecticut. Further, in 1930 the Massachusetts Supreme Court suggested, in *dicta*, that the imposition of an income tax on a trust based solely on the residence of the testator is constitutional.[65] Perhaps the Connecticut and Massachusetts legislatures' choice to provide for such an exception before any challenges in the state courts is evidence of their opinion that taxing a trust, or at least an inter vivos trust, whose only connection to such state is the residence of the settlor at the time of the trust's creation, would be either unfair or constitutionally prohibited, or both.

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(3) the trust had no Connecticut source income. *See id.*

Curiously, the current exception, which is discussed in the main text, is not necessarily narrower than the previous one. For example, under the current exception, applicable to tax years beginning after January 1, 1993, inter vivos trusts created by Connecticut residents are not taxed by Connecticut if none of the income beneficiaries are Connecticut residents, even if the trustees are Connecticut residents. In contrast, under the exception applicable to tax years prior to January 1, 1993, such a trust would be subject to Connecticut income tax. Of course, the exception applicable to taxable years beginning after January 1, 1993, applies only to inter vivos trusts while the exception applicable to tax years prior to January 1, 1993, applies to any Resident Trust, whether testamentary or inter vivos.

62. *See id.* Since zero of four of the income beneficiaries are Connecticut residents, the trust pays income tax on 0/4ths of its income to Connecticut.

63. *See* MASS. ANN. LAWS ch. 62, § 10(c) (Law Co-op. 1990).

64. *See id.*

65. *See* Hutchins v. Commissioner of Corporations and Taxation, 172 N.E. 605, 609 (Mass. 1930). The continued validity of *Hutchins* in light of subsequent United States Supreme Court cases is questionable. *See supra* note 23.

While the Resident/non-Resident Trust taxation system described above is the most common, and is, for the most part, the basis of the issues discussed in this article, it is not the only system employed. For example, under California law, the entire income of the trust is taxed by the State of California if all of the trustees or all of the income beneficiaries are California residents.[66] If some, but not all, of the trustees are California residents, the California taxable income is apportioned based on the number of trustees that are residents.[67] If some, but not all, of the trustees and some, but not all, of the beneficiaries are California residents, then the California taxable income of the trust is based on a formula that involves both the proportion of resident trustees and the proportion of resident beneficiaries.[68] In any event, regardless of the residence of any of the beneficiaries or any of the trustees, California, like most states, imposes an income tax on all California source income.[69] Similarly, Mississippi bases its income taxation of trusts on the residence of the trustees.[70] The United States Supreme Court has held that the income taxation of a trust based on the proportion of trustees of the trust that are residents of the taxing state is constitutional.[71]

## III. SAFE DEPOSIT & TRUST COMPANY OF BALTIMORE, MARYLAND

The sole Supreme Court case arguably analogous to the issue of the constitutional limitations on state income taxation of Resident Trusts, *Safe Deposit*,[72] has been largely ignored by the state courts that have addressed this issue.[73] *Safe Deposit* involved an inter vivos trust created by a Virginia resident.

66. *See* CAL. REV. & TAX. CODE § 17742 (West 1994).

67. *See id.* § 17743. Similarly, if some, but not all, of the beneficiaries are California residents, the California taxable income is apportioned based on the number of resident beneficiaries. *See id.* § 17744.

68. *See* California Franchise Tax Board Legal Ruling, 1959 WL 1349 (Oct. 27, 1959).

69. *See* CAL. REV. & TAX. CODE § 17041(b) (West 1994).

70. *See* MISS. CODE ANN. § 27-7-27 (1991); *Taxpayers and Rates* [Miss.], State Tax Guide (CCH) ¶ 15-561 (Nov. 1996).

71. *See* Greenough v. Tax Assessors, 331 U.S. 486, 486 (1947).

72. 280 U.S. 83 (1929).

73. See *supra* note 35 and accompanying text.

After the settlor's death, the sole trustee of the trust, the Safe Deposit & Trust Company of Baltimore, was a Maryland resident. The beneficiaries were residents of Virginia; however, the trustee was directed to accumulate, rather than distribute, trust income until the beneficiaries attained twenty-five years of age. Virginia imposed an *ad valorem*[74] tax on the entire corpus of the trust based on the residence of the beneficiaries. The Supreme Court held that Virginia was constitutionally prohibited from taxing the trust because "nobody within Virginia has [a] present right to . . . control or possession, [of the trusts' assets] or to receive income therefrom, or to cause them to be brought physically within" Virginia.[75] The Court rejected application of the doctrine *mobilia sequuntur personam*, a maxim that implies that the movables held by the trust were in Virginia for tax purposes, because they "followed" the beneficiaries who held the beneficial interests.[76]

The decision in *Safe Deposit* is based largely on the risk of double taxation. The Court noted that the securities held by the trust were taxable in the State of Maryland, where they were located.[77] Since the stocks were taxable in Maryland, the Court held that they could not also be taxed in Virginia.[78] The Court stated that "[t]he adoption of a contrary rule would involve possibilities of an extremely serious character by permitting double taxation both unjust and oppressive."[79] Thus, the holding of *Safe Deposit* was predicated on the fact that a contrary

74. *See supra* note 34.

75. Safe Deposit & Trust Co. v. Virginia, 280 U.S. 83, 91 (1929). None of the state courts that have addressed the issue of the constitutional limitations on the state taxation of Resident Trusts have confronted a Resident Trust with income beneficiaries that are residents of the same state as the trust. The tenor of these decisions, however, indicates that these courts would hold this connection to be a sufficient nexus for taxation. Moreover, in *Swift v. Director of Revenue*, 727 S.W.2d 880 (Mo. 1987), the court created a six-part test, which is discussed *infra*, to determine the constitutionality of a state's taxation of a trust. *See id.* at 882; *see also infra* notes 185-98 and accompanying text. The trust at issue in *Safe Deposit* meets three of the six *Swift* factors, which should be sufficient to constitutionally justify state taxation. *See Swift*, 727 S.W.2d at 882.

76. *See Safe Deposit*, 280 U.S. at 92. *Mobilia sequuntur personam* literally means that movables follow the person. *See* BLACK'S LAW DICTIONARY 1003 (6th ed. 1990).

77. *See Safe Deposit*, 280 U.S. at 91.

78. *See id.* at 92.

79. *Id.* at 93.

rule could lead to taxation of the entire corpus of the trust by both Virginia and Maryland.

Justice Holmes, in dissent, argued that double taxation is not constitutionally prohibited.[80] The dissent agreed that the securities were taxable by Maryland, but reasoned that that did not limit the right of Virginia to also tax the securities.[81]

Justice Holmes' dissent was prophetic. In cases decided subsequent to *Safe Deposit*, the Supreme Court held that double taxation is not constitutionally prohibited. For example, in *Curry v. McCanless*,[82] the Supreme Court held that both Tennessee and Alabama may impose an estate tax on the same estate.[83] Thus, the constitutional prohibition against double taxation, which was the intellectual underpinning of the Court's decision in *Safe Deposit*, has been undermined by *Curry* and other cases that hold that double taxation is not constitutionally prohibited. Therefore, if a fact pattern similar to that of *Safe Deposit* were to come before the Supreme Court today, it is doubtful that the Court would follow the analysis of *Safe Deposit* without analyzing the underlying issues under the constitutional theories established by the more recent cases. Despite the fact that the intellectual basis of *Safe Deposit* has

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80. *See id.* at 96-97 (Holmes, J., dissenting).

81. *See id.* Justice Holmes explained,

> I am of opinion that on principle [the trust corpus] can be taxed [by Virginia]. In the first place I do not think that it matters that the owners, residing in Virginia, have only an equitable title. To be sure the trustee having the legal title and possession of the bonds in Maryland may be taxed there. But that does not affect the right of Virginia by reason of anything that I know of in the Constitution of the United States.

*Id.*

82. 307 U.S. 357 (1939).

83. *See id.* at 368; *see also* Paul J. Hartman, *Constitutional Limitations on State Taxation of Corporate Income from Multinational Corporations*, 37 VAND. L. REV. 217, 267 (1984).

*Cory v. White*, 457 U.S. 85 (1982), is similar in result to *Curry*. In *Cory*, both Texas and California asserted that Howard Hughes was a resident of their respective states at the time of his death. Thus, both states imposed an estate tax on Mr. Hughes' estate. The Supreme Court ruled that it had jurisdiction to settle the dispute, but the action was barred by the Eleventh Amendment; thus, the estate was subject to state estate taxation by both California and Texas. *See id.* at 91. For a detailed discussion of *Cory*, see Kathleen Leslie Roing, *Due Process Limits on State Estate Taxation: An Analogy to the State Corporate Income Tax*, 94 YALE L.J. 1229 (1985).

been undermined by more recent Supreme Court precedents, it has never been expressly overruled.

Despite the weakened authority of *Safe Deposit*, it seems any court addressing the issue of the constitutional limitations on the state taxation of trusts would, at the very least, discuss the case, since it remains part of the very scant Supreme Court precedent that directly involves the constitutionality of state taxation of trusts. Despite this fact, however, several of the cases that have addressed this issue have disregarded *Safe Deposit* without so much as a citation.[84]

A court addressing the constitutionality of state income taxation of a trust based solely on the residence of the settlor/testator may distinguish *Safe Deposit* on its facts; for example, *Safe Deposit* involved an *ad valorem* tax rather than a state income tax. This would be a particularly reasonable approach since the holding of *Safe Deposit* has been undermined by subsequent Supreme Court decisions. It seems, however, that *Safe Deposit* should be distinguished explicitly, with due regard given to the Supreme Court's decision and analysis of the distinctions. This is especially true considering the Supreme Court's admonition to the lower courts that, rather than try to anticipate whether or not Supreme Court precedent is still good law, the lower court should follow the precedent and leave it to the Supreme Court to overrule its own decisions.[85]

Messrs. Hellerstein and Hellerstein, distinguished commentators in the area of state taxation, have argued that the cases that hold that a state may not tax a trust based solely on the residence of the settlor/testator at the time of the creation of the trust have so held based on erroneous reliance on *Safe Deposit Trust*.[86] Certainly, some of the cases that have decided

84. *See, e.g.*, District of Columbia v. Chase Manhattan Bank, 689 A.2d 539 (D.C. Cir. 1997); Blue v. Department of the Treasury, 462 N.W.2d 762 (Mich. Ct. App. 1990); Westfall v. Director of Revenue, 812 S.W.2d 513 (Mo. 1991); Potter v. Taxation Div. Dir., 5 N.J. Tax 399 (1983).

85. *See* Rodriguez de Ouijas v. Shearson/American Express, Inc., 490 U.S. 477, 484 (1989) ("If a precedent of this Court has direct application in a case, yet appears to rest on reasons rejected in some other line of decisions, [the lower court] should follow the case which directly controls, leaving to [the Supreme Court] the prerogative of overruling its own decisions.").

86. *See* HELLERSTEIN & HELLERSTEIN, *supra* note 40, ¶ 20.09[2].

this issue cite *Safe Deposit*; however, an analysis of these cases shows that many of these courts are not basing their decisions on *Safe Deposit* in any substantial fashion.[87] Moreover, as discussed above, some of the cases that have addressed this issue have not even cited *Safe Deposit*. Thus, the argument that these courts' decisions are based on erroneous reliance on *Safe Deposit* seems flawed.[88]

The conclusion to the analysis of *Safe Deposit* is multi-faceted. On the one hand, it is apparent that the analysis in *Safe Deposit* has been undermined by subsequent Supreme Court precedent. This is not to say that the Supreme Court could not today reach the same decision; however, the Court is unlikely to do so without analyzing the facts under more recent Supreme Court precedent. On the other hand, some of the state courts, which have dismissed *Safe Deposit* without so much as a citation, have not given the 1929 Supreme Court decision its due regard.[89]

Based on the above analysis, this article deals with *Safe Deposit* as the state courts should have dealt with it when addressing the constitutional limitations on the state taxation of Resident Trusts. Namely, after analyzing *Safe Deposit*, it is recognized that the underpinnings of the decision have been overruled by later Supreme Court precedent.[90] Therefore, having dealt with *Safe Deposit*, and determined it not to be controlling (a court could distinguish it on the facts), more recent

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87. *See, e.g.*, Swift v. Director of Revenue, 727 S.W.2d 880, 882 (Mo. 1987) (citing Safe Deposit & Trust Co. v. Virginia, 280 U.S. 83 (1929); Miller Bros. Co. v. Maryland, 347 U.S. 340 (1954)). *Safe Deposit* and *Miller Bros. Co.* are cited to support the well-settled proposition that a state may not tax an entity unless it has "sufficient connections with the entity to provide a basis for the states' authority to tax." *See Swift*, 727 S.W.2d at 882; *see also* Pennoyer v. Taxation Div. Dir., 5 N.J. Tax 386, 396 (1983) (arguing that *Safe Deposit* has not been weakened to the extent that it supports the proposition that "a state may not impose a tax beyond its borders").

88. *See supra* note 35 and accompanying text.

89. *See supra* note 84 and accompanying text.

90. Of course, *Safe Deposit*, and numerous other Supreme Court cases, support the well settled proposition that a state may not constitutionally tax an entity unless there is a nexus between the state and the activity sought to be taxed. The ultimate holding of *Safe Deposit*, that Virginia may not tax an inter vivos trust created by a Virginia resident, even though all trust beneficiaries reside in Virginia, must not, however, be accepted without review of the more recent Supreme Court precedents regarding the constitutional limitations on state taxation. *See Safe Deposit*, 280 U.S. at 61; *Miller Bros. Co.*, 347 U.S. at 342.

precedent will be analyzed to determine the constitutional limitations on the state taxation of a trust when the sole connection between the trust and the state is the residence of the settlor/testator at the time of creation of the trust.

## IV. THE CONSTITUTIONAL LANDSCAPE AND SUPREME COURT PRECEDENT

The power of a state to tax is subject to limitation by the United States Constitution on numerous constitutional theories: due process, commerce clause, equal protection, privileges and immunities, intergovernmental immunity, and the prohibition of state taxation of Native Americans.[91] The most significant of these limitations, however, are the limitations imposed by the due process and commerce clauses,[92] and this article is mainly concerned with the limitations imposed by these two clauses. A state income tax on a trust could certainly be held invalid on another constitutional theory.[93] While these other constitutional theories impose meaningful limitations on the power of a state to tax the income of a trust, they do not impose additional limitations on the subject that is the concern of this article, since they do not effect the required nexus between an entity sought to be taxed and the potentially taxing state.[94]

A state tax is evaluated for repugnance to the commerce clause based on the four part test established in the 1977 Supreme Court case *Complete Auto Transit Inc. v. Brady*.[95] In order not to run afoul of the commerce clause, the taxing state must show, first, that the tax is applied to an activity with a "substantial nexus" to the taxing state. Second, the tax must be fairly apportioned to the activities carried on in the taxing

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91. *See* RONALD D. ROTUNDA & JOHN E. NOWAK, TREATISE ON CONSTITUTIONAL LAW § 13.1 (1992).

92. *See id.* For the most part, the due process and the commerce clauses are the most common constitutional bases for the invalidation of a state tax.

93. For example, a state law that imposed a higher rate of tax on a trust if the trustees were not residents of the taxing state could be invalid under the privileges and immunities clause regardless of the connection, or "nexus," between the trust and the taxing state. *See id.* § 13.4(a)(2).

94. *See* Seth Goldstein, *Resident Taxpayers: Internal Consistency, Due Process, and State Income Taxation*, 91 COLUM. L. REV. 119, 125-127 (1991).

95. 430 U.S. 274 (1977).

state. Third, the tax may not discriminate against interstate commerce. Fourth, the tax must be fairly related to the services or benefits provided by the state.[96]

Under the *Complete Auto* test, for example, a state may tax a proportional share of the income derived from a "unitary business" conducted partially in the taxing state.[97] Thus, Vermont may tax a proportionate share of the world-wide income derived from Mobil Oil Corporation's unitary business of selling petroleum products based on Mobil's sale of petroleum in Vermont.[98] Such a tax, however, must be both internally and externally consistent.[99] A tax is internally consistent if the apportionment formula employed by the state is such that if an identical formula was employed by every jurisdiction, no more than all of the income of the unitary business would be taxed. A tax is externally consistent if it accurately reflects a reasonable sense of how the income in the unitary business is actually generated.[100]

The due process clause places two closely related restrictions on a state's power to tax. First, there must be a "minimal connection" between the activities sought to be taxed and the taxing state. Second, the income attributed to the state for tax purposes must be "rationally related" to the values connected with the taxing state.[101]

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96. *See id.* at 279; Quill Corp. v. North Dakota, 504 U.S. 298, 311 (1992).

97. *See* Allied-Signal, Inc. v. Director, Div. of Taxation, 504 U.S. 768, 772 (1992).

98. *See* Mobil Oil Corp. v. Commissioner of Taxes, 445 U.S. 425 (1980).

The method of apportionment, or the apportionment formula, has been the subject of substantial constitutional debate. *See, e.g.*, Container Corp. of Am. v. Franchise Tax Bd., 463 U.S. 159, 164 (1983) ("[W]e have long held that the Constitution imposes no single [apportionment] formula on the [s]tates . . . ."); Norfolk and W. Ry. Co. v. Missouri State Tax Comm'n, 390 U.S. 317 (1968) (invalidating a tax on a railroad based on the proportion of miles of track located in Missouri); Moorman Mfg. Co. v. G.D. Bair, 437 U.S. 267 (1978) (upholding a single factor apportionment formula based on gross sales). The various constitutional methods of apportionment are not, however, relevant to the topics discussed in this article. *See generally* Paul J. Hartman, *Constitutional Limitations on State Taxation of Corporate Income from Multinational Corporations*, 37 VAND. L. REV. 217 (1984).

99. *See Container Corp.*, 463 U.S. at 169.

100. *See id.*

101. *See Moorman Mfg.*, 437 U.S. at 272-73.

The 1992 Supreme Court case, *Quill Corp. v. North Dakota,*[102] discussed the limitations imposed by the due process and commerce clauses. *Quill* involved facts that are quite similar to *National Bellas Hess, Inc. v. Department of Revenue,*[103] which was decided by the Supreme Court in 1967 and partially overruled by *Quill*. In *Quill*, the Supreme Court was faced with a taxpayer, Quill Corporation, that was a mail order house incorporated in Delaware. No Quill employees worked in North Dakota or were residents of North Dakota, and Quill owned no property in North Dakota. Quill delivered merchandise ordered by North Dakota residents via U.S. mail or common carrier.[104] North Dakota imposed a use tax on merchandise sold by Quill to North Dakota residents.[105] Quill Corporation challenged the tax on both due process and commerce clause grounds.

Prior to *Quill*, it had been noted by courts, including the *National Bellas Hess* Court, and commentators that the requirements of the due process clause were essentially coextensive with the first and fourth prongs of the four-part *Complete Auto* test.[106] *Quill*, however, distinguished between the "minimum contacts" requirement of the due process clause and the nexus requirements of the commerce clause.[107] The *Quill* Court reasoned that the due process clause concerns the fundamental fairness of governmental activity; thus, the relevant issues are "notice" and "fair warning."[108] In contrast, the nexus re-

102. 504 U.S. 298 (1992).

103. 386 U.S. 753 (1967).

104. *See Quill Corp.*, 504 U.S. at 301.

105. A use tax is, essentially, a sales tax that is collected by merchants that are non-residents of the taxing state. *See* BLACK'S LAW DICTIONARY 1543 (6th ed. 1990). If a state is unable to collect the use tax from the merchant, the liability for the tax frequently falls upon the resident customer. It has been noted, however, that compliance with this tax by residents is quite low; thus, as a practical matter, a state is unlikely to collect its use tax unless the state can make the collection directly from the merchant. *See* Miller Bros. Co. v. Maryland, 347 U.S. 340, 343 (1954) ("The collection of the use tax from inhabitants is a difficult administrative problem. . . ."); Michael T. Fatale, *Geoffrey Sidesteps Quill: Constitutional Nexus, Intangible Property and the State Taxation of Income*, 23 HOFSTRA L. REV. 407, 409-10 n.13 (1994).

106. *See Quill Corp.*, 504 U.S. at 305 ("[A]lthough we have not always been precise in distinguishing between the two, the Due Process Clause and the Commerce Clause are analytically distinct."); *National Bellas Hess*, 386 U.S. at 756; *Miller Bros. Co.*, 347 U.S. at 344-45 (applying the same standard under the due process and commerce clause); ROTUNDA & NOWAK, *supra* note 91, § 13.4(a); Goldstein, *supra* note 94, at 127-28.

107. *See Quill Corp.*, 504 U.S. at 305.

108. *See id.* at 312; Allied-Signal, Inc. v. Director, Div. of Taxation, 504 U.S. 768,

quirement of the *Complete Auto* test is concerned with the effects of state taxation on interstate commerce.[109]

In *Quill*, the Court equated the due process requirements for a valid state tax with the due process requirements for state jurisdiction under *International Shoe*.[110] Thus, a state tax would not be held invalid under the due process clause provided that there exists "minimum contacts" between the taxpayer and the state. By adopting the *International Shoe* standard, the Supreme Court rejected a "formalistic" approach to its due process jurisprudence.[111] Thus, while physical presence would be probative of a taxpayer's "minimum contacts" with a state, is not a necessary requirement to a state's power to impose a valid tax under the due process clause.[112]

The *Quill* Court held that Quill Corporation had "purposefully directed" its activities towards the residents of North Dakota. Thus, the Court held that North Dakota may impose a use tax on Quill Corporation unhindered by the due process clause of the United States Constitution. Regarding the fact that Quill Corporation had no physical presence in North Dakota, the Court noted that "it matters little that such solicitation is accomplished by a deluge of catalogues rather than a phalanx of drummers: [t]he requirements of due process are met irrespective of a corporation's lack of physical presence in the taxing [s]tate."[113] Thus, the Supreme Court partially overruled *National Bellas Hess* which had required physical presence of a

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777-78 (1992). ("The reason the commerce clause includes this limit is self-evident: In a Union of 50 states, to permit each State to tax activities outside its borders would have drastic consequences for the national economy, as businesses could be subjected to severe multiple taxation.").

109. *See Quill Corp.*, 504 U.S. at 311. As the Supreme Court noted in *Quill*, the purpose of the commerce clause was to prevent the state taxes and duties that hindered interstate commerce under the Articles of Confederation government. *See id.*

110. *See id.* at 307.

111. *See id.* at 306-07.

112. *See id.* at 307-08 (citing Burger King Corp. v. Rudzewicz, 471 U.S. 462 (1985)).

Similarly, *International Shoe Co. v. Washington*, 326 U.S. 310, 316 (1945), held that physical presence was not necessary for a state court to exercise jurisdiction. In so doing, *International Shoe* greatly limited *Pennoyer v. Neff*, 95 U.S. 714, 723 (1877), which had required physical presence for personal jurisdiction. *Pennoyer* was explicitly overruled in *Shaffer v. Heitner*, 433 U.S. 186, 212 (1977).

113. *Quill Corp.*, 504 U.S. at 308.

taxpayer in the taxing state under the due process and commerce clauses.[114]

A divided Supreme Court affirmed the commerce clause holding of *National Bellas Hess*. The majority admitted that the physical presence requirement of *National Bellas Hess* is not wholly consistent with the Court's more recent commerce clause jurisprudence; however, the Court argued that this did not imply repudiation of the *National Bellas Hess* commerce clause rule. The *Quill* Court noted that the first and fourth prongs of the *Complete Auto* commerce clause test, which require a "substantial nexus" and a "relationship between the tax and state-provided services," are intended to limit the reach of the taxing state in order to ensure that state taxation does not overly burden interstate commerce.[115] In contrast, the due process "minimum contacts" requirement is more accurately conceptualized as a "proxy for notice."[116] Based on this distinction, the *Quill* Court reaffirmed the physical presence requirement of the commerce clause holding of *National Bellas Hess*. The Court noted, however, that this holding is limited to the context of sales and use taxes. Moreover, the Court's holding was partially based on the fear that a contrary ruling would upset reliance by mail order businesses on their exemption from state sale and use taxes.[117]

The *Quill* Court recognized that the bright-line commerce clause test of *National Bellas Hess*, which they had reaffirmed, like other bright-line tests, "appears artificial at its edges."[118] The Court noted that the constitutional authority of a state to collect a sales or use tax from a vendor may turn on the presence of a small sales force, plant, or office in the potentially taxing state. The artificiality of this rule, the Court reasoned, was more than offset by the benefit of clearly established boundaries regarding sales and use taxes. Thus, the issue of the constitutional limits regarding state sales and use taxes

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114. *See id.*
115. *See id.* at 313.
116. *Id.*
117. *See id.* at 316-18. The dissent, in contrast, questioned how any party could reasonably rely on an ability to conduct affairs without being taxed. *See id.* at 331-32 (White, J., concurring in part and dissenting in part).
118. *Id.* at 315.

would be protected from the "quagmire" of constitutional limitations on other state taxes.[119]

Therefore, North Dakota was prevented from collecting its use tax from Quill Corporation by the commerce, but not the due process, clause. The Court noted that since taxation was prevented solely by the dormant commerce clause, Congress could permit such taxation by statute.[120]

Justice White dissented from the majority's holding regarding the commerce clause and argued that the commerce clause holding of *National Bellas Hess* was inconsistent with the Court's more recent commerce clause precedents and should be overruled. Justice White also argued that the distinction, drawn by the majority, between the nexus requirements of the due process and commerce clauses was not supported by the language of the requirements or their derivation.[121]

Justices Scalia, Kennedy and Thomas agreed with the majority that the commerce clause holding of *National Bellas Hess* should not be overruled. They argued, however, that the majority should not have revisited the merits of the issue, but instead, should have adhered to that principle merely on the basis of stare decisis.[122]

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119. *See id.* at 315 (noting "[o]ur law in this area is something of a 'quagmire' and the 'application of constitutional principles to specific state statutes leaves much room for controversy and confusion and little in the way of precise guides to the States in the exercise of their indispensable power of taxation'") (citing Northwestern States Portland Cement Co. v. Minnesota, 358 U.S. 450, 457-58 (1959)).

The dissent, in contrast, warned of the deluge of litigation that the physical presence standard imposed by the majority was likely to cause. *See id.* at 331 (White, J., concurring in part and dissenting in part). The concurrence, however, noted that the physical presence requirement, which had been in place since *National Bellas Hess*, has not previously led to such a "flurry of litigation." *Id.* at 321 (Scalia, Kennedy and Thomas, J.J., concurring in part and concurring in judgment).

120. *See id.* at 318.

121. *See id.* at 325-327 (White, J., concurring in part and dissenting in part).

122. *See id.* at 320 (Scalia, Kennedy & Thomas, JJ., concurring in part and concurring in judgment).

The views of Justices Thomas, Scalia and Rehnquist regarding the commerce clause have recently come under attack based on their purported lack of regard for *stare decisis* when, in a recent dissent penned by Justice Thomas, they argued that the entire line of Supreme Court jurisprudence regarding the dormant commerce clause should be overruled and that an 1868 case limiting the Import-Export clause should also be overruled so that the Export-Import clause may partially replace the dormant commerce clause. *See* Camps Newfound/Owatonna, Inc. v. Town of Harrison, The ramifications of the *Quill* commerce clause holding for state income taxation of a trust with little connection to the potentially taxing state are unclear. *Quill* was an attempt to retain a straight-forward "bright-line" test regarding the commerce clause limitations on a state's power to tax; however, the *Quill* Court expressly limited its holding to sales and use taxes.[123] Moreover, even if a court were to apply the physical presence requirement of *Quill* to a state's income taxation of a trust with minimal connections to that state, it is difficult to see how such a physical presence requirement would be applied. As will be discussed *infra*,[124] a trust is something of a hybrid between an entity and a mere relationship. Thus, it is difficult to determine where, if anywhere, a trust can be said to have a physical presence, although, clearly, the residence of the trustees, the beneficiaries, the settlor/testator or the location of trust assets are all possibilities.

Due to the unclear implications of *Quill*, in order to determine the constitutionality of a state's income taxation of a trust where the sole connection between it and the potentially taxing state is the residence of the settlor/testator at the time of the creation of a trust, one must delve into the "quagmire" of the constitutional limitations on state taxation warned of in *Quill*.[125]

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Maine, 117 S. Ct. 1590, 1615 (1997) (Thomas, Scalia, JJ., Rehnquist, C.J., dissenting) ("That the expansion effected by today's decision finds some support in the morass of our negative Commerce Clause case law only serves to highlight the need to abandon that failed jurisprudence and to consider restoring the original Import-Export clause check on discriminatory state taxation to what appears to be its proper role."). The portion of the dissent that proposed overruling *Woodruff v. Parhan*, 75 U.S. 123 (1869), was not joined by Justice Rehnquist. *See also* Richard D. Friedman, *Judicial Activism Saves Us From Bad Law; Time to Clean House*, N.Y. TIMES, June 9, 1997, at A24; Anthony Lewis, *Abroad at Home; Beware, Judicial Activist!*, N.Y. TIMES, June 2, 1997, at A15.

123. *See Quill Corp.*, 504 U.S. at 317-18.

124. *See infra* notes 164-68 and accompanying text.

125. *See Quill Corp.*, 504 U.S. at 315; *see also* Northwestern States Portland Cement Co. v. Minnesota, 358 U.S. 450, 457 (1959) ("That there is a 'need for clearing up the tangled underbrush of past cases' with reference to the taxing power of the States is a concomitant to the negative approach resulting from a case-by-case resolution of the 'extremely limited restrictions that the Constitution places upon the states. . . .'").

## V. TRUSTS WITH LITTLE CONNECTION TO THE TAXING STATE

Several state courts have addressed the issue of the constitutionality of income taxation of a trust by a state whose only connection to the trust is the residence of settlor/testator at the time of the creation of the trust. Of these cases, the decided weight of authority is that the imposition of such an income tax is constitutionally prohibited.[126] Only one of these cases, *District of Columbia v. Chase Manhattan Bank*,[127] was decided subsequent to *Quill*. In this 1997 case, which is the sole case to find such a tax constitutional, the United States Court of Appeals for the District of Columbia Circuit held that the District may tax such a trust and suggested that the earlier contrary cases were overruled by *Quill*.[128]

*Chase* involved the imposition of an income tax by the District of Columbia on a testamentary trust created under the will of a District resident.[129] The tax was challenged by the trustee, Chase Manhattan Bank, on due process grounds, but not commerce clause grounds. As the District of Columbia noted in its brief, the tax could not be invalidated on commerce clause grounds since the commerce clause does not restrict the power of Congress, even when legislating merely for the District of Columbia.[130]

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126. *See, e.g.*, Blue v. Department of the Treasury, 462 N.W.2d 762 (Mich. Ct. App. 1990); Westfall v. Director of Revenue, 812 S.W.2d 513 (Mo. 1991); Swift v. Director of Revenue, 727 S.W.2d 880 (Mo. 1987); Pennoyer v. Taxation Div. Dir., 5 N.J. Tax 386 (1983); Potter v. Taxation Div. Dir., 5 N.J. Tax 399 (1983); Taylor v. New York State Taxation Comm'n, 445 N.Y.S.2d 648 (N.Y. App. Div. 1981); *see also* Virginia Department of Taxation Letter Ruling, 1993 WL 372991 (Aug. 26, 1993).

127. 689 A.2d 539 (D.C. Ct. App. 1997).

128. *See id.* at 545. As previously discussed, in *Hutchins v. Commissioner of Corporations and Taxation*, 172 N.E. 605 (Mass. 1930), the Massachusetts Supreme Court suggested, *in dicta*, that taxation based solely on the residence of the testator was constitutionally acceptable. *See Hutchins*, 172 N.E. at 609-10. As mentioned, however, *Hutchins* has likely been overruled by subsequent United States Supreme Court precedents. *See supra* note 23.

129. *See Chase Manhattan Bank*, 689 A.2d at 539.

130. *See* Brief for the District of Columbia at 12 n.6, District of Columbia v. Chase Manhattan Bank, 689 A.2d 539 (D.C. Ct. App. 1997) (No. 95-TX-1599).

### A. *Due Process Clause*

Turning first to the due process clause, the issue is largely reduced to whether there are "minimum contacts" between the trust and the potentially taxing state.[131] The difficult issue, however, is whether any of the numerous possible connections between the potentially taxing state and the trust are constitutionally sufficient. The various state courts that have addressed the issue, for the most part, have held these connections inadequate to sustain the constitutionality of the tax.[132] As noted, however, these cases were decided prior to *Quill*.

#### 1. Jurisdiction of the State Courts and Periodic Accountings

One of the most significant connections between a trust and the state of residence of the settlor/testator is that the state courts will assert jurisdiction over the trust.[133] The availability of the state courts, even if it is never utilized by the trust, is a benefit that the trust has received from the potentially taxing state. Tested against the "simple but controlling question" described by the Supreme Court in *J.C. Penney Co.* of whether the state has given anything "for which it can ask return,"[134] this benefit may be sufficient to constitutionally justify the tax.

There are numerous states that may assert jurisdiction over a trust. For example, the New York courts assert jurisdiction over an inter vivos trust if: (1) the trust was created by a New

131. *See* Quill Corp. v. North Dakota, 504 U.S. 298, 306-07 (1992); Miller Bros. Co. v. Maryland, 347 U.S. 340, 344-45 (1954).

132. *See supra* note 128 and accompanying text.

133. *See* WILLIAM F. FRATCHER, SCOTT ON TRUSTS §§ 566-67 (4th ed. 1989); *see, e.g.*, CAL. PROB. CODE § 17300 (West 1991); N.Y. SURR. CT. PROC. ACT § 207 (McKinney, Consol. & Gould 1997).

134. Wisconsin v. J.C. Penney Co., 311 U.S. 435, 444 (1940) ("The test is whether property was taken without due process of law, or, if paraphrase we must, whether the taxing power exerted by the state bears fiscal relation to protection, opportunities and benefits given by the state. The simple but controlling question is whether the state has given anything for which it can ask return."). The attempt by the *J.C. Penney Co.* Court to reduce the issue into the one "simple but controlling question" has been called by some commentators a "sweeping oversimplification" of the due process limitations on a state's power to tax. *See* HELLERSTEIN & HELLERSTEIN, *supra* note 40, ¶ 6.03.

York resident, (2) an acting trustee resides in New York, or (3) if any trust assets are located in New York.[135] Thus, for example, based on the argument that the availability of the state courts allows the imposition of an income tax on the entire income of a trust, a trust whose sole connection to New York is the location of minimal property in the state may be subject to income tax on all of its income by New York for that reason. While such a tax intuitively seems to be a constitutional anathema, this result is merely the obvious outcome of the argument that the availability of the state courts provides a sufficient basis for the jurisdiction to tax. On the other hand, even this result may not be constitutionally prohibited. Under the due process clause, the requirement is "minimum contacts."[136] This connection has been found where a mail order house mails catalogues into the taxing state or, in the *in personam* jurisdiction context, where a nonresident is served with process while passing through the state.[137] Thus, due to the relatively low standard, perhaps the availability of the courts is a sufficient contact. A conclusion that a state tax on the entire income of a trust is constitutional based on the jurisdiction of the state courts, which in turn may be based on the presence of even minor property in the state,[138] may, however, be viewed as contradicting the Supreme Court's holding that a non-Resident may be taxed only on source income from the taxing state.[139]

In *Chase*, Chase Manhattan Bank, as trustee, argued that the jurisdiction of the District of Columbia courts (and their review of accountings) was not a sufficient nexus to justify the imposition of the income tax by the District since, in order to avail itself of the jurisdiction of the state courts, Chase was obligated to pay court fees.[140] These fees, Chase argued, com-

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135. *See* N.Y. SURR. CT. PROC. ACT § 207; *see also* FRATCHER, *supra* note 133, §§ 570-71.

136. *See Quill Corp.*, 504 U.S. at 306; International Shoe Co. v. Washington, 326 U.S. 310, 316 (1945).

137. *See Quill Corp.*, 504 U.S. at 305-09; Burnham v. Superior Court of Cal., 495 U.S. 604 (1990).

138. *See* N.Y. SURR. CT. PROC. ACT § 207.

139. *See* New York *ex rel.* Whitney v. Graves, 299 U.S. 366 (1937).

140. *See* Brief for Chemical Bank (a/k/a Chase Manhattan Bank), Trustee of the Esther L. Guth Trust at 30 n.20, District of Columbia v. Chase Manhattan Bank, 689 A.2d 539, 543 n.8 (D.C. Cir. 1997) ("The trustee also maintains that whatever bene-

pensated the District for use of its courts. Thus, the District courts had not given anything for which they could ask an additional return in the guise of an income tax. This argument has some intuitive appeal. It is, however, contrary to established tenets of the constitutional limitations on taxation.

There is no constitutional requirement that the amount a state may exact from an entity by way of a tax must be reasonable compensation to the state for the value of the services it has provided.[141] If this were so, a state would be required to prove that it provided proportionately greater services to a wealthy individual, who will presumably pay higher taxes, than a less wealthy individual.

Further, since state income tax rates are generally progressive, not only would the state have to show that it provided services of greater value to its wealthy residents, but the amount of the additional services would have to be progressive. That is, an individual who earns twice as much as another individual would need to receive more than two times the value of services than the poorer individual. Moreover, this "quid pro quo" argument put forth by Chase seems inconsistent with the Supreme Court's holding that a resident may be taxed on all of its income by its state of residence. There is no indication in these cases that a resident may only be taxed up to the value of the services it received from the state of residence.[142]

Some jurisdictions require that the trustees of a trust created by one of their residents submit periodic accountings to their courts.[143] Presumably, this is for the purpose of allowing the court to monitor both the trust and the trustees in an ongoing fashion. It has been argued that these periodic accountings provide a sufficient nexus for the imposition of income tax on

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fits have accrued to the trust from the accountings have already been paid for in the form of court fees. This argument misses the point. . . .").

141. *See Chase Manhattan Bank*, 689 A.2d at 543 n.8.

142. *See* Oklahoma Tax Comm'n v. Chickasaw Nation, 115 S. Ct. 2214, 2222 (1995); New York *ex rel.* Cohn v. Graves, 300 U.S. 308 (1937).

143. *See, e.g.*, CONN. GEN. STAT. ANN. § 45a-177 (West 1993); D.C. R. CIV. P. 305 (1997).

An accounting or the trustee's "account" is a financial summary of the trust's activities, including investments and distributions. *See generally* CAL. PROB. CODE § 10900 (West 1991); ROBERT A. HENDRICKSON & JOSEPH A. ROTELLA, ESTATE AND TRUST ACCOUNTING, LASSER ESTATE TAX TECHNIQUES § 48.03 (1994).

the trust.[144] A state court's periodic review of accountings prepared by the trustees is, arguably, a benefit provided by the state. If the issue is reduced to the inquiry, described in *J.C. Penney Co.*, of whether "the state has given anything for which it can ask return,"[145] it seems that periodic accountings, like the continuing jurisdiction of the state courts, may be sufficient to constitutionally justify the tax. On the other hand, the requirement of periodic accountings may be viewed, with equal validity, as a rather insignificant benefit bestowed upon the trust. In fact, since the trust must pay the necessary legal and court fees in order to prepare and submit these accountings, they may be viewed as more of a burden than a benefit. In this case, permitting the state to use the requirement of periodic accountings as a "hook" to collect the income tax allows a state to constitutionally justify the imposition of an income tax by imposing an additional burden on the trust.

The availability of the state courts and the periodic accountings that may be required are possible "minimum connections" between a trust and a state that may justify the imposition of the income tax. These possible connections, however, arise out of the initial event that is, by state statute, the basis for the imposition of the income tax; that is, the creation of the trust by a resident of the state. The residence of the settlor/testator at the time of the creation of the trust engenders three events, namely: (1) the classification of the trust as a Resident Trust (and the concomitant state income tax liabilities); (2) the continuing jurisdiction of the state courts; and (3) the periodic accountings that may be required. Evaluating the constitutionality of the tax based on the latter two events allows the state to constitutionally justify an income tax by the same "constitutionally suspect" classification that is the basis of the tax; namely, the residence of the settlor/testator at the time of the creation of the trust.[146] Such analysis would allow the constitutionality of a tax imposed based on the residence of the settlor/testator at the time of creation of the trust to turn on

144. *See* Brief for the District of Columbia at 6, *Chase Manhattan Bank*, 689 A.2d at 6.

145. Wisconsin v. J.C. Penney Co., 311 U.S. 435, 444 (1940).

146. *See* Blue v. Department of the Treasury, 462 N.W.2d 762, 764 (Mich. Ct. App. 1990).

connections that are imposed, by statute, based on the residence of the settlor/testator at the time of the creation of the trust. This analysis is circular in its reasoning.

To use an extreme example: suppose a state were to classify all trusts created by blonds as Residential Trusts and tax all Resident Trusts on all trust income wherever earned. The state's probate laws similarly provide that all trusts created by blonds are subject to the continuing jurisdiction of the state courts and the trustees must submit annual accountings to the state courts. One would not analyze the constitutionality of such a taxation system based on the continuing jurisdiction of state courts and the requirement of periodic accountings; rather, one would seek to analyze the constitutionality of the underlying classification, namely that those trusts that are created by blonds are Resident Trusts. Similarly, the issue at hand must be analyzed in terms of the basis for taxation as provided in the statute, namely the residence of the settlor/testator.

2. Residence of the Settlor/Testator

The residence of the settlor/testator at the time of the creation of the trust is, clearly, a significant connection between the trust and the state. Even courts that have found that this connection does not by itself constitutionally justify state income taxation, have admitted the significance of this relationship.[147] It has been noted that a trust "owes its very existence" to the law of the state of residence of the settlor/testator.[148] The state, through its system of laws, has created an environment in which the settlor/testator may create the trust. Moreover, even if the law of that state does not govern the trust, it is likely that the transfer of the assets to the

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147. *See, e.g.*, Swift v. Director of Revenue, 727 S.W.2d 880, 882 (Mo. 1987). *Swift* established a six-factor test for the constitutionality of state income taxation of a trust, which is discussed *infra*. The state of residence of the settlor/testator at the time of the creation of the trust meets the first two factors. *See infra* notes 185-98 and accompanying text.

Applying the *Swift* test, a trust created by a resident of the state of Missouri may be constitutionally taxed on all of its income by the state of Missouri based on the fact that a minor trust asset is located in Missouri. *See* Westfall v. Director of Revenue, 812 S.W.2d 513, 514 (Mo. 1991).

148. *See Chase Manhattan Bank*, 689 A.2d at 543.

trust was a conveyance subject to the laws of the residence of the settlor/testator. It is the laws of the settlor/testator's residential state that have allowed her to accumulate wealth in order to transfer it to the trust. The trust, to a large extent, seems to owe its existence to the munificent laws of the state of residence of the testator/settlor. These relationships seem powerful evidence of "minimum contacts" between the state and the trust that should allow the state to constitutionally impose an income tax on the trust.[149]

On the other hand, all of these connections potentially occurred some time ago. The issue, thus, becomes whether a constitutionally sufficient nexus between a state and a trust may be a nexus that arose in the recent or distant past. Drawing from the language of *J.C. Penney Co.*, if the issue is usually whether the state has given anything for which it can ask return, the issue now becomes: if a state once gave something for which it could have asked return, may the state continue to ask return indefinitely?[150] Unsurprisingly, the answer is unclear. For example, suppose a resident of a potentially taxing state dies leaving an estate that becomes the subject of lengthy and expensive litigation in the probate courts of the state. The outcome of this litigation is that a testamentary trust is funded with the estate assets. The trustee, however, is not a resident of the state nor are the beneficiaries. Is there a significant enough relationship between this trust and the state to justify income taxation by the state for the entire existence of the trust? If not, when does the trust stop being subject to income taxation by the state? The day the trust is funded, the day after, or some period of time after that when the relationship that is the basis for the tax, and the purported constitutional nexus, "wears off"? Moreover, if the trust was the subject of continuing litigation in the state's probate courts, would that provide sufficient nexus for the imposition of the income tax in these later years?[151]

149. *See* Quill Corp. v. North Dakota, 504 U.S. 298, 307 (1992).

150. *See J.C. Penney Co.*, 311 U.S. at 444.

151. As discussed *supra*, the state's probate court would assert jurisdiction over the trust based on the residence of the testator. *See supra* notes 133-39 and accompanying text.

In the above described situation, the relationship between the trust and the state is quite close. It seems that there are "minimum contacts" between the trust and the state as required by *Quill* and *International Shoe*. In this example, allowing the trust to escape paying the state income tax is, arguably, inequitable. This is a trust that has, and possibly is, frequently taken advantage of benefits provided by the state. The trust has been the subject of litigation and is benefiting from the state courts and the legal structure they provide. Therefore, intuitively, it seems that the relationship between such a trust and the potentially taxing state is close enough to constitutionally justify the tax.

Does this analysis change over time? For example, suppose that the trust described above is a dynasty trust.[152] Assume further that fifty years after creation of the trust, no trust assets nor beneficiaries nor trustees are located in, or are residents of, the potentially taxing state, nor have any of them been such for the last fifty years. In that fifty-year period, the trustees have not once availed themselves of the courts of the potentially taxing state, although they may have conducted proceedings in the courts of other states. Can the state constitutionally tax the trust when the "minimum connection" between the trust and the state is an event that occurred half a century earlier? Is a fifty-year-old nexus still a valid nexus? If the answer is yes, then is a hundred-year-old nexus still a valid nexus, a hundred and fifty years, two hundred years, etc.?[153]

In *Blue v. Department of Treasury*,[154] the Michigan Supreme Court was faced with an inter vivos trust created by a Michigan resident. The trustee was a resident of Florida and all trust assets were located in Florida, except for a single non-income producing parcel of real property located in Michigan.

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152. A dynasty trust is a trust intended to last for a substantial period of time, such as the maximum period of time allowed under the rule against perpetuities, or, if the trust is not subject to the rule against perpetuities, indefinitely. *See* Al W. King III et al., *Dynasty Trusts: What the Future Holds for Today's Technique*, TRUST & ESTATES, April 1996, at 28-45.

153. If the trust is subject to the rule against perpetuities, a 200 year old trust may not be possible. As previously noted, however, several states have abolished the rule against perpetuities, and numerous international jurisdictions have no rule against perpetuities. *See supra* note 25 and accompanying text.

154. 462 N.W.2d 762 (Mich. Ct. App. 1990).

The *Blue* court held that there were insufficient connections between Michigan and the trust for the imposition of the income tax. It addressed the fact that the nexus between Michigan and the trust was a past event by means of the following analogy: "We analogize the present case to a hypothetical statute authorizing that any person born in Michigan to resident parents is deemed a resident and taxable as such, no matter where they reside or own their income. We believe this would be clearly outside the states' power to impose taxes."[155]

Certainly, there are some similarities between the hypothetical individual envisioned by the *Blue* court and a trust with little connection to the state of its creation. Both the individual and the trust are "created" in the potentially taxing state and, sometime later, this fact is the sole connection between the state and the individual or trust.

At the risk of stating the obvious, however, a trust is not an individual, and there are important constitutional differences between a trust created under the laws of a potentially taxing state and an individual born to parents who are residents of the state.[156] A trust owes its existence to the laws of the taxing state to a much greater extent than does the individual. Even if the trust is governed by the laws of another state and has been executed outside of the potentially taxing state, the trust still owes a great deal to the state. It is the law of the residence of the settlor/testator that has allowed her to accumulate wealth and transfer it to the trust.

In contrast, an individual born to resident parents seems to owe much less of her existence to the potentially taxing state. Arguably an individual is, to some extent, "created" by the munificent laws of the state of her birth. For example, the individual was likely born in a state-licensed (or state-operated) hospital and her parents likely arrived at the hospital via the state-created or state-run infrastructure system.

It is, however, quite a stretch to draw an analogy between a Resident Trust, with little connection to a potentially taxing

155. *Blue*, 462 N.W.2d at 764-65.

156. The analogy employed by the *Blue* court is not that outrageous. Similar standards, for example, establish the United States citizenship of an individual born to United States residents. *See* 8 U.S.C.A. § 1401 (West 1970 & Supp. 1997).

state, and an individual born to resident parents. While such a trust can be said to be "created" under the laws of the residence of the settlor/testator, it is something of an intellectual leap to make a similar argument about an individual being "created" under the laws of his parents' residence. While there are some similarities between the hypothetical individual discussed by the *Blue* court and the income taxation of a Resident Trust with little connection to the potentially taxing state, the differences seem to far outweigh the similarities. While it is possible, as has been done in the preceding few paragraphs, to draw similarities and distinctions between such an individual and a trust, the basic difference is so fundamental as to defy citation: individuals are not trusts.

The Supreme Court has held that an individual may be taxed on her entire worldwide income by the state of her residence.[157] By labeling certain trusts "Resident Trusts," the states attempt to tax trusts in a similar fashion. The constitutional problem with this structure, however, is that the residence of an individual implies an ongoing connection between the individual and the taxing state. Indeed, the Supreme Court's decision that a state may tax the world-wide income of its residents was based on the substantial ongoing benefits provided by the state to the resident.[158] In contrast, the "residence" of a trust is determined ab initio—an observation that likely motivated the court's analogy in *Blue* of an income tax based on the state of an individual's birth.[159]

Thus, the issue of whether a Resident Trust may be taxed as a resident of a particular state is not resolved by the "resident" status of the trust. While there may be some intuitive appeal to such an argument, the differences are too constitutionally significant. Thus, the fact that individuals may constitutionally be taxed based on residency does not necessarily imply that trusts may be constitutionally taxed based on the concept of Resident Trusts.

157. *See* Schaffer v. Carter, 252 U.S. 37 (1920).

158. *See* New York *ex rel.* Cohn v. Graves, 300 U.S. 308, 312 (1937) ("Enjoyment of the privileges of residence in the state and the attendant right to invoke the protection of its laws are inseparable from responsibility for sharing the costs of government.").

159. *See supra* notes 48-56 and accompanying text; *Blue*, 462 N.W.2d at 764-65.

At least one court has analogized, although not with quite the same vehemence as the court in *Blue*, the income taxation of a trust by the state of residence of the settlor/testator to the income taxation of a corporation by the state of incorporation.[160] Since the entire income of a corporation may be taxed by the state of incorporation regardless of the place of the corporation's business, this analogy attempts to justify the imposition of income tax by the state of residence of the settlor/testator.[161] The similarities between such a trust and a corporation that does little or no business in the state of incorporation are striking. Both are created under the laws of the potentially taxing state. Both, to some extent, seem to owe their existence to the laws of that state.

The differences, however, are also substantial. A corporation, unlike a trust, is an ongoing business. A corporation may choose to reincorporate in another state, or a foreign jurisdiction. In contrast, a trust, once created as a Resident trust, will remain a "Resident Trust," until it terminates.[162] Further, depending on the laws of the state and the terms of the trust, it may not be possible for the trust to terminate prior to the time, if any, prescribed in the trust instrument.[163]

Another important distinction between a trust and a corporation is that a trust is a hybrid between an entity and a relationship between various parties. This dichotomy can be illustrated in numerous ways. For example, income tax is imposed on the trust, which militates towards a conclusion that the trust is an entity.[164] Moreover, the jurisdiction of the state

160. *See* District of Columbia v. Chase Manhattan Bank, 689 A.2d 539, 542 (D.C. Cir. 1997).

161. *See* Cream of Wheat Co. v. Grand Forks County, N.D., 253 U.S. 325, 328 (1920); 2 RONALD D. ROTUNDA & JOHN E. NOWAK, TREATISE ON CONSTITUTIONAL LAW § 13.4 (2d ed., 1992).

162. *See supra* notes 48-55 and accompanying text.

163. Some states allow an irrevocable inter vivos trust to be revoked if all of the beneficiaries and the settlor consent. *See, e.g.*, N.Y. EST. POWERS & TRUSTS LAW § 7-1.9 (Consol. 1979 & Supp. 1997). This exception is, however, quite narrow; for example, except in limited circumstances, a trust may not be terminated pursuant to E.P.T.L. § 7-1.9 if any of the beneficiaries of the trust are minors. *See* Patrick J. Rohan, *New York Civil Practice—EPTL*, ¶ 7-1.9; *see generally* FRATCHER, *supra* note 133, §§ 329a-347.

164. *See* I.R.C. § 641(a) (1997). The trust, however, is treated as a conduit in that it receives a deduction for items of income distributed to the beneficiaries. *See* I.R.C.

courts is, generally, discussed in terms of jurisdiction over the trust rather than the parties.[165] On the other hand, a trust cannot sue or be sued. Rather, a prospective plaintiff would sue the trustees and, correspondingly, if the trust is aggrieved, the suit will be maintained by the trustees, as plaintiffs.[166] Indeed, the fiduciary duties of trustees are owed to the beneficiaries rather than to the trust. In contrast, the directors of a corporation owe their duties to the corporation.[167] *Black's Law Dictionary* exemplifies this conflict in that it defines a trust both as "a legal entity" and "a fiduciary relationship."[168]

Another flaw of the corporation-trust analogy is that the state of incorporation has a much closer ongoing relationship with the corporation than does the state of creation of a trust. For example, any person, whether or not a resident of Delaware, may create a Delaware corporation; however, a Delaware corporation must maintain a registered office in the State of Delaware.[169] A New York corporation must maintain an office in New York.[170] In addition, a New York corporation must designate the New York Secretary of State as its agent for the service of process.[171] These contacts, however, are results of the event—the incorporation of the corporation—that gives rise to the taxation by the state of incorporation. This is, arguably, similar to basing the constitutionality of taxing a trust on a nexus, such as the continuing jurisdiction of that state's probate courts, that is merely the result of the event that is the basis

§§ 651, 661 (1997).

165. *See, e.g.*, N.Y. SURR. CT. PROC. ACT § 207; BOGERT & BOGERT, TRUST & TRUSTEES § 292, at 237 (2d ed., 1992) (explaining "the forum court must have jurisdiction over one or more of the trust, the trust parties, and the trust property").

166. *See* FRATCHER, *supra* note 133, §§ 280.6, 265, 277.

167. *See* 3 WILLIAM M. FLETCHER, FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 837.50 (1994 & Cum. Supp. 1997); *see also In re* Healthco Int'l Inc., 208 B.R. 288 (Bank., D. Mass. 1997) (holding that the business judgment rule was unavailable as a defense to directors of a corporation since the board resolved that a particular Board action was in "the best interests of the company's stockholders" rather than in the best interests of the company).

168. BLACK'S LAW DICTIONARY 1508 (6th ed. 1990).

169. *See* DEL. GEN. CORP. LAW §§ 101(a), 102(a)(2) (1997). Frequently, the "registered office" is merely an agent used by the corporation for the service of process.

170. *See* N.Y. BUS. CORP. LAW § 402(a)(3) (1983 & Supp. 1997). The corporation must file its certificate of incorporation in the New York county in which its office is located.

171. *See id.* § 304(a).

for the taxation of the trust by the state.[172] As stated by the *Blue* court, this may allow a constitutionally "suspect" classification to be the nexus for a state's jurisdiction to tax.[173]

The state of incorporation bears a different relationship to the corporation than does the state of the residence of the settlor/testator to a trust. A corporation is created by the laws of the state in which it is incorporated. It remains subject to those laws for as long as it is incorporated in that state.[174] In contrast, a trust is not necessarily governed by the law of the state of residence of the settlor/testator at the creation of the trust.[175] Thus, a "Resident Trust" may be created by and exist due to the law of another state. This difference in relationship implies that while a corporation receives benefits from the state of incorporation that may justify the imposition of income tax by that state, a trust may not receive similar benefits from the state of residence of the settlor/testator.[176]

There are, clearly, similarities and differences between trusts and corporations that militate both for and against the efficacy of a constitutional analogy between the two. The resolution may be recognition of the fact that the differences between trusts and corporations are too great to allow blind adherence to the constitutional precedent regarding the income taxation of corporations.

### B. *Commerce Clause*

If one concludes that the connection between the state of residence of the settlor/testator of a trust is sufficient, in and of itself, to constitutionally justify the imposition of an income tax by the state upon the entire income of the trust under the due

172. *See supra* note 146 and accompanying text.

173. *See* Blue v. Department of the Treasury, 462 N.W.2d 762, 764 (Mich. Ct. App. 1990).

174. *See* FLETCHER, *supra* note 167, § 4025.

175. *See* BOGERT & BOGERT, *supra* note 165, § 301; *see also* N.Y. EST. POWERS & TRUSTS LAW § 3-5.1(h) (1979); R.I. GEN. LAWS §§ 18-1-1, 18-1-2 (1996). For example, a trust created by a Rhode Island resident may provide that New York law governs the agreement.

176. *See* Wisconsin v. J.C. Penney Co., 311 U.S. 435, 444 (1940).

process clause, then an additional inquiry must be made under the commerce clause.[177]

In *Quill*, the United States Supreme Court drew a distinction between the nexus requirements of the due process clause and the nexus requirement contained in the first and fourth prongs of the *Complete Auto* commerce clause test. In holding that the connections between a mail order house and a state permitted imposition of a tax under the due process clause, but not under the commerce clause, the Supreme Court effectively held that the commerce clause requires a more substantial connection between the state and the taxpayer than the "minimum connections" standard of the due process clause. The Court in *Quill*, however, expressly limited its holding to sales and use taxes.[178] Moreover, to the extent the Court's holding was premised on the fear of upsetting the well settled exemption of mail order businesses from sales and use taxes, it is clearly inapplicable to the income taxation of trusts.[179]

The reasoning of the commerce clause holding of *Quill* is, however, arguably applicable to the income taxation of trusts. The Court in *Quill* noted that the commerce clause, unlike the due process clause, imposes limits on the power of a state to tax in order to avoid overburdening interstate commerce with state taxes.[180] If the constitutional limits on the power of a state to tax a trust were, for example, coextensive with a state court's jurisdiction as provided in the state's probate code, then every state in which the trust has property or in which a trustee resides could tax the entire income of the trust.[181] It seems that this overburdening of a multi-state trust is a circumstance that the commerce clause holding of *Quill* sought to avoid.

If there is a sufficient connection between a state and a trust to allow state taxation of the trust under the due process

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177. Quill Corp. v. North Dakota, 504 U.S. 298, 308-09 (1992).

178. *See id.* at 317-18 ("In sum, although in our cases subsequent to *Bellas Hess* and concerning other types of taxes we have not adopted a similar bright-line, physical-presence requirement, our reasoning in those cases does not compel that we now reject the rule that *Bellas Hess* established *in the area of sales and use taxes*.") (emphasis added).

179. *See id.* at 318 n.10.

180. *See id.* at 313 n.7.

181. *See supra* note 135 and accompanying text.

clause, then, under *Quill*, the issue becomes one of the magnitude of the connections. If the connections between the trust and the state are in the range that pass muster under the due process clause but fail under the commerce clause, then the state may not tax the trust regardless of the presence of "minimum contacts" which satisfy the requirements of the due process clause.[182] Since this distinction seems quantitative rather than qualitative, it is difficult to determine whether the connections between a trust and a state are sufficient to justify taxation under the commerce clause. Certainly, it seems that the connections discussed above regarding the due process clause would militate towards a conclusion that the standards of the commerce clause are met. Considering the difficulty in determining whether these connections suffice in the due process context, however, it seems nearly impossible to determine if they are met in the commerce clause context. This is particularly the case if the sole distinction between the two is the question of magnitude, as suggested in *Quill*.

Perhaps the issue of the different nexus requirements under the commerce and due process clauses can be viewed from a different perspective. Prior to *Quill*, the overwhelming majority of the cases held that a state whose sole connection to a trust is that the settlor/testator was a resident of that state at the time of the trust's creation may not constitutionally tax the trust.[183]

Additionally, it was generally thought that the nexus requirements of the due process clause and the commerce clause were identical.[184] Indeed, prior to *Quill*, the courts that addressed the constitutional limitations on the state taxation of Resident Trusts drew no such distinction, although those decisions tend to discuss the due process clause rather than the commerce clause. If, however, one accepts the conclusion of most of the

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182. Obviously, the connections between Quill Corporation and North Dakota were of the magnitude described by this "band" between the two clauses.

183. *See, e.g.*, Blue v. Department of the Treasury, 462 N.W.2d 762 (Mich. Ct. App. 1990); Westfall v. Director of Revenue, 812 S.W.2d 513 (Mo. 1991); Swift v. Director of Revenue, 727 S.W.2d 880 (Mo. 1987); Potter v. Taxation Div. Dir., 5 N.J. Tax 399 (1983); Pennoyer v. Taxation Div. Dir., 5 N.J. Tax 386 (1983). *See also supra* note 128 and accompanying text.

184. *See supra* notes 103-06 and accompanying text.

state courts prior to *Quill*, that a state may not constitutionally tax such a trust, the issue may be reduced to whether *Quill* decreased the required connections under the due process clause, increased the required connections under the commerce clause, or both. To the extent the Supreme Court did either of these, it seems that the *Quill* Court decreased the nexus requirement of the due process clause and left the nexus requirement of the commerce clause unchanged.

The *Quill* Court overruled *National Bellas Hess*, but only with respect to its due process clause holding. Since the facts of *National Bellas Hess* and *Quill* are essentially identical, connections between a taxpayer and a state that were held insufficient under the due process clause in *National Bellas Hess* were held sufficient in *Quill*. In contrast, connections that were held insufficient under the commerce clause in *National Bellas Hess* were similarly held insufficient in *Quill*.

Extrapolating from *National Bellas Hess* and *Quill*, one could reasonably conclude that *Quill* decreased the connection required by the due process clause while leaving the nexus requirement of the first and fourth prongs of the *Complete Auto* commerce clause test unchanged. Thus, a connection that was held insufficient under the due process clause prior to *Quill*, when the due process nexus requirements were thought to be coextensive with the commerce clause requirements, should be constitutionally lacking under the commerce clause after *Quill*, since the commerce clause requirements were not affected by *Quill*. This argument may make some intuitive sense. There is, however, no Supreme Court precedent holding that the mathematical law of syllogism applies to constitutional due process and commerce clause analysis.

### C. *State Court Decisions*

In *Swift v. Director of Revenue*,[185] the Missouri Supreme Court provided what may be the most complete analysis of the constitutional limitations on the state taxation of Resident Trusts that has been undertaken by any court. The *Swift* court

185. 727 S.W.2d 880 (Mo. 1987) (en banc).

was confronted with a testamentary trust created under the will of a Missouri resident. During the tax years in question, none of the beneficiaries or trustees were Missouri residents, all trust assets were located in Illinois and all trust business was conducted in Illinois. The *Swift* court held:

> In determining whether this state had sufficient nexus to support the imposition of an income tax on trust income, we consider six points of contact: (1) the domicile of the settlor, (2) the place in which the trust is created, (3) the location of trust property, (4) the domicile of the beneficiaries, (5) the domicile of the trustees, and (6) the location of the administration of the trust.[186]

The first two of these six possible points of contact are met by a trust whose sole connection to the potentially taxing state is the residence of the settlor/testator at the time of the creation of the trust. The *Swift* court argued that, for the purposes of supporting the constitutionality of the income tax, these first two factors require the ongoing protection of the law of Missouri only to the extent that one or more of the other four factors are present. Thus, a trust created by a Missouri resident requires the protection of Missouri law only if trustees, trust property, or beneficiaries are Missouri domiciliaries, or, if the trust is administered in Missouri. Based on this analysis, the *Swift* court held that the trust did not require the ongoing protection of the law of Missouri and, thus, was not subject to income tax by the state of Missouri.

Clearly, the *Swift* court attempted to draw a reasoned constitutional analysis from an area of law that the Supreme Court has described a "quagmire."[187] The shortcomings of the six factor *Swift* test are, to some extent, exemplified in *Westfall v. Director of Revenue*,[188] which was decided by the Missouri Supreme Court (the same jurisdiction as *Swift*) four years later. The facts of *Westfall* were essentially identical to the facts of *Swift*, except that the trust in *Westfall* earned $3,500 of rental income from real property located in Missouri. The *Westfall* court, in what it described as a mere application of the six fac-

186. *Id.* at 882.
187. Quill Corp. v. North Dakota, 504 U.S. 298, 315 (1992).
188. 812 S.W.2d 513 (Mo. 1991) (en banc).

tor *Swift* test, held that the presence of the Missouri real property implied that the trust now met the first, second and third of the six possible connections. Thus, Missouri was not constitutionally prohibited from taxing the entire income of the trust.[189]

The six-part *Swift* test does not, however, reach the same conclusion that has been reached by some of the other state courts. For example, in *Potter v. Taxation Division Director*,[190] a New Jersey resident created an inter vivos trust. During the tax years in question, the trustee, beneficiaries, and trust assets were located without New Jersey; however, a few contingent beneficiaries were New Jersey residents.[191] The New Jersey Tax Court held that these connections were insufficient to allow New Jersey to constitutionally tax the trust. In contrast, if the facts of *Potter* are tested against the standard established in *Swift*, the trust in *Potter* would meet the first (domicile of the testator), second (place in which the trust is created) and fourth (domicile of beneficiaries) of the six *Swift* factors; therefore, under *Swift*, the *Potter* trust should be subject to taxation by New Jersey.[192]

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189. *See id.* at 514. In addition to the Missouri real property, "under certain contingencies" Missouri charities would receive distributions and one of the charities was, potentially, a successor trustee. The *Westfall* decision does not seem to be based on these two additional connections to any significant degree. Indeed, these connections are discussed in only two sentences of the decision and are not mentioned by the dissent or the concurrence. This is somewhat curious since, as will be discussed *infra*, the residence of contingent beneficiaries seems to constitutionally justify the increased taxation of the trust by the state of residence of the settlor/testator under the reasoning of *Swift*. *See infra* notes 192-93 and accompanying text.

The concurrence argued that the decision reached by the majority, while constitutionally correct, was not a mere application of the six factor *Swift* test. *See Westfall*, 812 S.W.2d at 515. The dissent, in contrast, argued that the result reached by the majority is inconsistent with *Swift*. *See id.* at 516-17 (Blackmar, J., dissenting). The dissent noted, "the director [of revenue] argues that if the trust income from intangibles is not subject to taxation in Missouri it will not be taxed anywhere. I am unable to see how this is demonstrated by the record before us but, even if it is, it makes no difference." *Id.* at 517 (Blackmar, J., dissenting).

190. 5 N.J. Tax 399 (1983).

191. *See id.* at 405.

192. This analysis assumes that when the *Swift* court discussed the residence of the beneficiaries, it meant to include both current and contingent beneficiaries. This is a reasonable assumption since the interests of the Missouri resident contingent beneficiaries would "require the ongoing protection . . . of [Missouri] state law." Swift v. Director of Revenue, 727 S.W.2d 880, 882 (Mo. 1987).

This hypothetical application of the *Swift* test to the facts of *Potter* may seem to be an indication of the overly formalistic approach of the *Swift* court; however, it is also, arguably, a vindication of the reasoning in *Swift*. As discussed above, *Swift* held that the mere creation of the trust in the potentially taxing state, *i.e.*, the satisfaction of the first two factors, only necessitated the continuing protection of the state to the extent that one of the other four factors is present. If, as in *Potter*, there are contingent beneficiaries that reside in the potentially taxing state, then the interests of these contingent resident beneficiaries may require the protection of the law of the potentially taxing state. Thus, the state of residence of the settlor/testator may constitutionally tax the entire income of the trust. Therefore, while *Swift* is inconsistent with *Potter*, this may be the result of the *Potter* court's failure to consider the ramifications of the residence of the contingent beneficiaries, rather than evidence of an overly formalistic approach in *Swift*.

The situation addressed in *Westfall* is more difficult. Since the income derived from the Missouri real property is Missouri source income, Missouri could clearly tax that income.[193] The *Westfall* court, however, used the presence of this small amount of Missouri source income as a "hook" to justify taxing the entire income of the trust. The *Westfall* court did not discuss the total annual income of the trust. The lack of such a discussion implies that the proportional magnitude of the Missouri source income was not a factor in the court's decision. Thus, even if the Missouri source income was a minimal portion of the trust's total income, its presence would allow the state to impose an income tax on the entire trust income. If the income of the trust is substantial enough, as compared to the source income from the state, the tax imposed by the state due to this source income may be many times the value of the source income. For example, in *Westfall*, it is likely that the income tax imposed by Missouri exceeded the $3,500 of Missouri source income earned by the trust.[194]

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193. *See* MO. ANN. STAT. § 143.181 (West 1996); New York *ex rel.* Whitney v. Graves, 299 U.S. 366 (1937).

194. As mentioned, the *Westfall* court did not disclose the total amount of income earned by the trust during the tax year. As a practical matter, however, it seems unlikely that the trustees would find it economically prudent to litigate the issue un-

Moreover, the holding of *Westfall* is inconsistent with *Blue*. In *Blue*, the Michigan Court of Appeals held that an inter vivos trust created by a Michigan resident could not be taxed by Michigan despite the fact that the trust held a parcel of non-income producing real property.[195] The facts of *Blue* are not "on all fours" with *Westfall*. *Blue* involved an inter vivos rather than a testamentary trust and the real property in *Westfall* was income producing ($3,500) while the real property in *Blue* produced no income.[196] Both the *Westfall* and *Blue* trusts, however, met the first (domicile of the settlor), second (place in which the trust is created), and third (location of trust property) of the six *Swift* factors.[197] Therefore, the *Swift* test implies that both the *Blue* and *Westfall* trusts may be constitutionally taxed by their respective states, which is contrary to the holding of *Blue*.

The limitations of *Swift* are not necessarily evident from the application of the *Swift* test to the facts of *Westfall*, *Potter*, *Blue* or any other individual set of facts.[198] Instead, the flaw is inherent in the *Swift* court's attempt to create a test to fit every set of facts, rather than undertaking a less formalistic analysis of the underlying constitutional issues.

### C. *Constitutional Differences Between Inter Vivos and Testamentary Trusts*

To a large extent, the issues discussed herein are unaffected by a trust's status as a testamentary or inter vivos trust. Indeed, some of the courts that have addressed this issue have not clearly delineated the distinctions between the two types of trusts, in terms of the constitutional nexuses between each type of trust and the state of its creation.[199] In contrast, in *Chase*,

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less the total amount of tax potentially owed to the State of Missouri far exceeded the $3,500 of Missouri source income.

195. *See* Blue v. Department of the Treasury, 462 N.W.2d 762, 763 (Mich. Ct. App. 1990).

196. *See id.*; Westfall v. Director of Revenue, 812 S.W.2d 513, 513 (Mo. 1991); *Swift*, 727 S.W.2d at 882.

197. *See Swift*, 727 S.W.2d at 882.

198. *See infra* notes 245-62 and accompanying text.

199. *See, e.g.*, *Blue*, 462 N.W.2d at 764 (addressing an inter vivos trust but discussing cases, such as *Swift*, at length without mention of the fact that they involved

which upheld the imposition of an income tax on a testamentary trust, the court noted that its analysis with respect to a testamentary trust may not hold true with respect to inter vivos trusts.[200]

Much of the analysis contained herein is not affected by the "character" of the trust. Mention must be made, however, of the closer relationship between the state of residence of the testator of a testamentary trust and the state of residence of the settlor of an inter vivos trust.

A state's probate courts have "primary jurisdiction" over a testamentary trust created under the will of a resident of that state.[201] No such primary jurisdiction exists in the case of inter vivos trusts. The closer relationship between testamentary trusts and the potentially taxing state is apparent in numerous ways. For example, a testamentary trustee is, generally, appointed by the probate court, and prior to doing so, the probate court must ascertain that the potential trustee is qualified to act as trustee.[202] Moreover, the state may require that a testamentary trustee post a bond, swear to faithfully discharge her duties, etc.[203] In contrast, a probate court generally will not be involved in the selection of trustees of an inter vivos trust.[204] Certainly, the probate court may remove a trustee, or fill a vacancy;[205] however, for the most part the court is uninvolved.

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testamentary trusts).

200. *See* District of Columbia v. Chase Manhattan Bank, 689 A.2d 539, 547 n.11 (D.C. Cir. 1997); *see also* Potter v. Taxation Div. Dir., 5 N.J. Tax 399, 405 (1983). *Potter* involved an inter vivos trust and the Court held that the connections were less substantial than in *Pennoyer v. Taxation Div. Dir.*, 5 N.J. Tax 386 (1983), since *Pennoyer* involved a testamentary trust.

201. *See* Feltman v. Coulter, 528 P.2d 821, 824 n.1 (Ariz. 1974) (en banc) ("The rule of law is well settled that the courts of the testator's domicile and of the state in which the will is probated have primary jurisdiction over testamentary trusts."); RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 267 (1971); FRATCHER, *supra* note 133, § 570.

202. *See* FRATCHER, *supra* note 133, § 557; *see, e.g.*, IOWA CODE § 633.10(4) (West 1992); N.C. GEN. STAT. § 36A-107 (1994); N.Y. SURR. CT. PROC. ACT §§ 707, 708 (1980 & Supp. 1997).

203. *See, e.g.*, N.Y. SURR. CT. PROC. ACT § 708.

204. *See* FRATCHER, *supra* note 133, § 557; *see, e.g.*, IOWA CODE ANN. § 633.10(4); N.Y. SURR. CT. PROC. ACT § 724.

205. *See, e.g.*, IOWA CODE ANN. § 633.10(4); N.Y. SURR. CT. PROC. ACT § 709. In this case, the court would determine the suitability of the potential trustee and hear objections to her appointment.

Further, states that require a trustee to submit periodic accounting, make this requirement of testamentary, but not of inter vivos, trusts.[206] Moreover, some states require that the account of a testamentary trustee be settled judicially; however, all states allow the trustee of an inter vivos trust to settle his account informally.[207]

The closer relationship between a testamentary trust and the state of that trust's creation, as compared to the relationship between an inter vivos trust and its state of creation, may be constitutionally significant. These additional connections may constitutionally justify the imposition of a state income tax on a testamentary trust whose sole connection to the potentially taxing state is the residence of the testator, even if the residence of the settlor of an inter vivos trust may not provide a sufficient constitutional nexus for taxation.

The differences between a testamentary and an inter vivos trust are clearly significant. In determining whether the necessary "minimum contacts" exist between a trust and a state for due process purposes, or in determining whether the necessary nexus is present for commerce clause purposes, the added connections between a testamentary trust and the state must be taken into consideration.[208]

The additional contacts between a testamentary trust and the state, however, are derived from the same event that is the basis for the imposition of the income tax on the trust; namely, the residence of the testator. This one event determines the location of the probate proceedings, the court that appoints the testamentary trustees, and provides the basis for the tax and the continuing jurisdiction of those courts.[209] Therefore, at-

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206. *See, e.g.*, CONN. GEN. STAT. ANN. § 45a-177 (West 1993); D.C. CIV. R. 305; IOWA CODE ANN. § 633.10(4); HENDRICKSON & ROTELLA, *supra* note 143, § 48.20[1].

207. *See, e.g.*, CONN. GEN. STAT. ANN. § 45a-179 (West 1993). Settlement of the trustees account is the approval of either an informal or a court formal accounting prepared by the trustees. Settlement of the account releases the trustee from liability for the time period covered by the accounting. *See* HENDRICKSON & ROTELLA, *supra* note 143, §§ 48.03, 48.20; BOGERT & BOGERT, *supra* note 165, § 974.

208. The nexus requirement is contained in the first and fourth prongs of the *Complete Auto* commerce clause test. *See supra* notes 93-106 and accompanying text. The "minimum contacts" standard for due process analysis was discussed in *Quill*, which adopted the standard established in *International Shoe*. *See* Quill Corp. v. North Dakota, 504 U.S. 298, 307 (1992).

209. *See* BOGERT & BOGERT, *supra* note 165, § 292; *see, e.g.*, CONN. GEN. STAT.

tempting to constitutionally justify the imposition of the income tax on a testamentary trust based on these additional connections shares the same logical flaw as does basing the constitutionality of the tax on the continuing jurisdiction of the courts over the trust.[210] Both the primary jurisdiction over a testamentary trust and the imposition of the income tax are based on the same event—the residence of the testator at the time of his death. This connection must be determined constitutionally sufficient or insufficient.

Even this initial connection, however, may be greater in the context of testamentary trusts. A state's probate courts, and therefore the state, are much more closely involved in the creation of a testamentary trust, as discussed above. Therefore, in determining whether there is a sufficient constitutional connection between a trust and a state, based on the event of the trust's creation, one must consider whether the trust is a testamentary or inter vivos trust. In the case of a testamentary trust, the possible connections between the trust and the potentially taxing state are more significant. Whether these additional connections are significant enough to constitutionally justify the imposition of the income tax on the entire income of the trust is unclear. The additional connections are effects of the residence of the testator at the time of his death. Thus, the basis of these connections is the same past event that provides the statutory basis for the imposition of the income tax—an event that potentially occurred long before the particular tax year. This possible lapse of time is the same constitutional problem addressed earlier in this article.[211] Is a past nexus a constitutional basis for taxation? Does a nexus "wear off" over the passage of time?

## VI. POLICY ISSUES

Having considered the issue of whether or not a state may constitutionally tax a trust where the only connection between the trust and the state is the fact that the settlor/testator was

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ANN. § 45a-98 (West 1993 & Cum. Supp. 1997); N.Y. SURR. CT. PROC. ACT § 205.

210. *See supra* note 146 and accompanying text.

211. *See supra* notes 150-76 and accompanying text.

a resident of that state at the time of creation of the trust, this article now turns to normative considerations. Namely, the issue of whether a state should tax such a trust.

The overriding issue that militates against state income taxation of such a trust is the issue of fairness. A trust taxed as a Resident Trust may pay substantial income tax to a state that has had no connection with it for some significant period of time, perhaps several decades.[212] If the imposition of a state tax can be seen as payment for the services and benefits received from the taxing state,[213] then such a trust would pay taxes to a state, yet receive little in return during that tax year. This seems inequitable. The inequity is exacerbated by the potential for the trust to be subject to additional state income tax in other states that, for example, base the imposition of the income tax on the residence of the trustees or beneficiaries.[214] In all likelihood, the state that taxes the trust as a Resident Trust will allow that trust a credit for the taxes paid to the other state. Such credits, however, do not fully avoid double taxation.[215] Moreover, a taxing state is not required to provide such a credit.

Of course, this issue could arise with respect to a trust that has a constitutionally sufficient nexus with more than one state. For example, a New Jersey Resident Trust with one New Jersey resident trustee and one California resident trustee would be taxed by New Jersey on all of its income and by California on one-half of its income.[216] This result also seems arguably inequitable. Moreover, the potential for unfairness is aggravated absent constitutional limitations on the power of a state to tax a Resident Trust.

Altering the facts of the preceding example, suppose that the trust was a District of Columbia Resident Trust. The sole trustee is a Mississippi resident. All beneficiaries are residents of California and all trust property is located outside the District

212. *See supra* notes 50-53 and accompanying text.
213. *See* Wisconsin v. J.C. Penney Co., 311 U.S. 435, 444 (1940).
214. *See* CAL. REV. & TAX. CODE §§ 17742-17744 (West 1994).
215. *See* Goldstein, *supra* note 94, at 125-27.
216. *See* CAL. REV. & TAX. CODE § 17744; N.J. STAT. ANN. §§ 54A:1-2(o)(3)(a), 54A:2-1 (West 1986 & Cum. Supp. 1997).

of Columbia, California and Mississippi. As a District of Columbia Resident Trust, the District of Columbia would tax all trust income, despite the attenuated connections between the trust and the District.[217] California would tax all of the income of the trust since all of the beneficiaries are California residents.[218] Mississippi, which bases its tax on the residence of the trustees, would also tax all of the income of the trust.[219] Thus, the trust would be subject to multiple state taxation on all of its income. If, however, the Constitution were to limit the power of a state to tax a Resident Trust, then this trust would, at worst, be taxed on all of its income by Mississippi and California, but would not be taxed by the District of Columbia. Moreover, if the residence of the beneficiaries was held to be an insufficient nexus, as in *Safe Deposit*, then California would also be constitutionally prevented from taxing the trust. Of course, this example is extreme. Generally, the issue will be potential taxation of all of the trust's income by two, rather than three states. This example illustrates, however, that while a constitutional limit on a state's power to tax a Resident Trust may not eliminate double taxation in all contexts, it decreases the potential in most situations.

In light of this potential for inequity, a court may feel compelled to hold that a state is constitutionally prohibited from taxing a trust where the sole connection between the state and the trust is the residence of the settlor/testator at the time of the creation of the trust. Even if a state is not constitutionally prohibited from taxing such a trust, the state legislature may follow the examples of Connecticut and Massachusetts, which exempt a trust from the "Resident Trust" classification if the only connection between the trust and the state is the residence of the settlor/testator.[220]

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217. *See* District of Columbia v. Chase Manhattan Bank, 689 A.2d 539, 543 (D.C. Cir. 1997).

218. *See* CAL. REV. & TAX. CODE §§ 17742, 17744.

219. *See* MISS. CODE ANN. § 27-7-27 (1972); *Taxpayers and Rates* [Miss.], State Tax guide (CCH) ¶ 15-561 (Nov. 1996).

220. *See* CONN. GEN. STAT. ANN. § 12-701(a)(4) (Cum. Supp. 1997); MASS. ANN. LAWS Ch. 62, § 10(c) (Law. Co-op 1990). The New York Department of Taxation regulations exempt such trusts; however, the Commission of Taxation amended its regulations after unsuccessfully litigating this battle numerous times. *See supra* note 56 and accompanying text.

Thus, fairness is the sole issue that militates for a constitutional limit on the power of a state to tax a Resident Trust. In contrast, numerous factors tend toward the conclusion that a state may constitutionally tax a trust where the only connection between the state and the trust is the residence of the settlor/testator at the time of creation of the trust.

Noted commentators in the area of state taxation have argued that constitutional limitations on a state's power to tax Resident Trusts would lead to tax avoidance.[221] While this argument is not fully developed, it seems that this assertion is based on the assumption that an individual who plans to create a trust will arrange the trust so that it could take advantage of such a constitutional limitation and avoid payment of state income tax altogether. For example, a Missouri resident who wishes to create a testamentary trust for his children may, if the children are not Missouri residents, appoint a trustee located outside the state of Missouri in order to avoid the Missouri income tax.[222] Moreover, a trust that has only a minor connection to a particular taxing state may, in an effort to avoid income taxation by that state, divest itself of that connection. For example, a trust whose sole connection to a state is ownership of real property located in that state may sell or distribute such property. If the sole connection is the residence of a trustee, that trustee may resign.[223]

Considering the magnitude of state income tax rates, this possible tax avoidance argument clearly has some merit.[224]

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221. *See, e.g.*, HELLERSTEIN & HELLERSTEIN, *supra* note 40, ¶ 20.09[2].

222. *See* Swift v. Director of Revenue, 727 S.W.2d 880, 882 (Mo. 1987). If such an individual actually wanted to create a trust for the benefit of individuals located within and without Missouri, she could create two trusts. One trust would have connections to Missouri and, thus, be subject to Missouri income tax, the other would be drafted to have no connections to Missouri and would be exempt from Missouri income tax.

223. *See* Westfall v. Director of Revenue, 812 S.W.2d 513, 514 (Mo. 1991). In *Westfall*, the entire income of the trust was subject to income taxation by Missouri due to a small parcel of income-producing Missouri real property. *See id.* It seems likely that the trustees sold the property, if permitted to do so by the trust instrument, soon after the *Westfall* decision.

224. *See Table of 1997 Rates*, State Tax Guide (CCH) ¶ 15-100 (Aug. 1997). The highest state income rate is 12%, which is imposed by North Dakota on income in excess of $50,000. *See Taxpayers and Rates* [N.D.], State Tax Guide (CCH) ¶ 15-711 (Sept. 1997); *see also* Goldstein, *supra* note 94, at 119-20 (noting that the burden of

This is especially true considering that if a Resident Trust is not taxed by its state of residence, it will likely escape state income taxation altogether.[225] This argument, however, fails to recognize that a taxpayer may arrange her activities in such a way so as to minimize her tax burden.[226] This is no more of an egregious example of tax avoidance than when a resident of New York relocates to Florida, in order to decrease her state income tax burden. The tax avoidance argument is untenable because the settlor/testator essentially would be arranging her affairs in such a way as to minimize the tax burden. While this may to some extent be labeled tax avoidance, it is more fairly viewed as tax planning that does not militate against a constitutional limit on the taxation of Resident Trusts.[227]

An argument that does militate against constitutional limits on the state taxation of Resident Trusts is the fact that such a constitutional limitation will, to the extent that it is applied, frequently result in a trust owing no state income tax. This result is not constitutionally significant, but it is, however, arguably unfair.[228] Of course, a trust that has connections to a state with no income tax may avoid payment of state income tax, such as a trust created by a resident of Florida.[229] In this case, however, the trust merely is benefiting from the state legislature's decision not to impose an income tax. Constitutional limitations on state income taxation of Resident Trusts would allow a trust with connections solely to relatively high income tax states to wholly escape state income taxation. For example, a testamentary trust created under the will of a New Jersey resident, where the beneficiaries and trustees are resi-

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providing numerous government services has been shifted to the states resulting in increased state taxes).

225. *See supra* note 20 and accompanying text.

226. This point was quite eloquently stated by Judge Learned Hand: "Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes." Helvering v. Gregory, 69 F.2d 809, 810 (2d. Cir. 1934), *aff'd*, 293 U.S. 465 (1935).

227. *See generally* Paul J. Donahue, *The Rule of* Sheldon v. Commissioner*: Is it an Economically Efficient Evolution of the Sham Transaction Doctrine?*, 13 VA. TAX REV. 165 (1993).

228. *See* Westfall v. Director of Revenue, 812 S.W.2d 513, 517 (Mo. 1991) (Blackmar, J., dissenting).

229. *See* FLA. CONST. art. 7, § 5(a).

dents of New York and Connecticut, would not be taxed by any state.[230] Thus, in this case, a trust that has connections only to states that impose an income tax wholly escapes state taxation. To the extent that the trust receives benefit from any of these states, such as using the state courts, the trust receives a benefit without making payment therefor in the form of state income taxes.

An administrative problem with a constitutional limit on the state income taxation of Resident Trusts is that the trust's liability to the state will be constitutionally barred in certain years and not in others. As the Virginia Tax Department noted, a trust that had no connection to Virginia during a particular tax year could not constitutionally be taxed by Virginia that year; however, circumstances may change—trustees or beneficiaries may relocate in Virginia, trust assets may be brought into Virginia, etc.[231] If any of these connections arise in later years, then during that tax year, Virginia would no longer be prohibited from imposing an income tax on the trust. This is certainly an added complexity in the state income taxation of trusts in light of constitutional limitations on the state taxation of Resident Trusts.

The argument that this added complexity militates against a constitutional limit on the state income taxation of Resident Trusts is weak. The annual inquiry that must be made to determine if a state may constitutionally tax is, *mutatis mutandis*, the same annual inquiry that must be made regarding the residence of an individual. Admittedly, the determination of the residence of an individual may be easier; however, the character of the two issues is similar. Therefore, while constitutional

230. This trust would be a New Jersey Resident Trust, but the New Jersey Tax Court has held that such a trust may not be constitutionally taxed by New Jersey. *See* Pennoyer v. Taxation Div. Dir., 5 N.J. Tax 386, 398 (1983).

Neither New York nor Connecticut would classify such trust as a "Resident Trust" and, therefore, would impose an income tax only on the New York or Connecticut source income of the trust. *See* CONN. GEN. STAT. ANN § 12-701(a)(4), 12-700(b) (Cum. Supp. 1997); N.Y. TAX LAW §§ 631, 633, 601(e); *see also supra* notes 1-14 and accompanying text. Of course, the trust may be taxed on source income from any particular state by that state. *See* New York *ex. rel.* Whitney v. Graves, 299 U.S. 366, 374 (1937).

231. *See, e.g.*, Virginia Dep't of Tax. Letter Ruling, 1993 WL 372991 (Aug. 26, 1993).

limits on the state income taxation of Resident Trusts may cause administrative difficulties, the states have not found similar administrative difficulties overwhelming in analogous situations.

Perhaps the overriding advantage of a structure that defines certain trusts as Resident Trusts ab initio is its simplicity. Such a structure determines to which state the trust will pay income tax at the time of creation of the trust. Further, under this structure, the residence of a trust is, for the most part, easily determined, or at least as easily determined as the residence of the settlor/testator.[232]

The states could further the purpose of avoiding double taxation and administrative simplicity if they were to adopt a single system. In the unitary business context, the Supreme Court has refused to dictate a particular method of apportionment of a unitary business' income. The Supreme Court has, however, required that each method of apportionment be "internally consistent." A state taxation structure is internally consistent if, assuming that every jurisdiction adopted an identical system, it would result in no more than all of the entity's income being taxed.[233] If one were to apply this "internal consistency" requirement to the income taxation of trusts, both the Resident Trust system and taxation based on the residence of the trustees (or beneficiaries) are internally consistent. Each of these systems are internally consistent because, if every state adopted any one of these systems, none of them would result in more than all of the trust's income being taxed.[234] Therefore, while

232. Of course, the residence of the settlor/testator may not always be easily determined. For example, upon the death of Howard Hughes, both Texas and California asserted that Mr. Hughes was a resident of that state and both states imposed an estate tax on Mr. Hughes' estate. *See* Cory v. White, 457 U.S. 85, 86 (1982).

233. *See* Container Corp. of Am. v. Franchise Tax Bd., 463 U.S. 159, 169 (1983).

234. *See id.* With respect to the Resident Trust taxation structure, since, theoretically, the settlor/testator could have only one residence at the time of creation of the trust, only one state would define the trust a Resident Trust and, thus, only this state would tax the entire income of the trust. Therefore, this system is internally consistent.

The California system, which bases the income tax on the proportion of beneficiaries or trustees that are California residents, may not be internally consistent since, if every state were to adopt an identical system, the entire income of the trust would be taxed by the state of residence of the trustees and the state of residence of the beneficiaries. *See* CAL. REV. & TAX. CODE §§ 17742-17744 (West 1994).

it may be superior, from a policy point of view, for all states to adopt a uniform basis for the income taxation of trusts, it is unlikely that the Supreme Court is going to force such a standard. Further, there does not seem to be movement among the states to adopt such a uniform system.

The policy issues discussed in this part militate both for and against the constitutional rule discussed in this article. On the one hand, such a constitutional rule may result in tax avoidance and facilitate a trust in escaping state income taxation. On the other hand, such a constitutional limitation serves the purpose of avoiding a trust's liability for income tax to a state that has an attenuated connection to the trust and from which the trust receives little or no benefit. Such a constitutional limitation also limits the possibilities of double taxation. Therefore, just as no clear answer arises from the application of constitutional precedent to this issue, no clear answer arises, from a policy perspective, regarding whether the existence of such a rule is preferable.

## VII. TRUSTEE ISSUES

If a state is constitutionally prohibited from taxing a trust where the sole connection between the trust and the state is the residence of the settlor/testator at the time of creation of the trust, numerous issues involving the trustees of such a trust arise. Namely, if the sole nexus between a taxing state and a trust is the residence of a particular trustee, may that trustee be removed so that the trust can avoid such state's income tax? Further, an issue arises as to who is a trustee for constitutional nexus purposes.

The residence of the trustees is a crucial nexus between a trust and the potentially taxing state.[235] Indeed, the residence of the trustee in and of itself constitutionally justifies the impo-

235. The residence of the trustees is the fifth of the six *Swift* factors. *See* Swift v. Director of Revenue, 727 S.W.2d 880, 882 (Mo. 1987). Further, if the trustee is a resident of a particular state, it is likely that the trust would be administered in that state (the sixth *Swift* factor). Therefore, the residence of the trustee determines at least one and possibly two of the *Swift* factors.

sition of a state income tax.[236] Moreover, the Supreme Court has noted that the state of residence of the trustee may be the preferred jurisdiction for a single tax on the trust.[237]

Posit a Resident Trust where the only connection between it and the potentially taxing state, aside from the residence of the settlor/testator, is the fact that one of numerous trustees is a resident of that state. Based on the residence of that one trustee, the state constitutionally taxes all of the income of the trust. Clearly, depending on the magnitude of the income tax imposed by the state, there would be some impetus for such a trustee to resign.[238] If that trustee does not wish to resign, may he be removed?

Generally, a trustee will be removed only for a relatively serious breach of trust.[239] For example, a trustee may typically be removed for incompetence or for breach of his duties, such as a duty of loyalty to the beneficiaries.[240] A trustee may also be removed for disagreement or disharmony between the trustees or between the trustee whose removal is sought and the beneficiaries, but in order to be removed, the trustee must generally be at fault, the disharmony must be relatively severe and it must endanger the trust.[241] If a trustee invests impru-

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236. *See* Greenough v. Tax Assessors, 331 U.S. 486, 498 (1947).

237. *See id.* at 490. ("It may well be that sound fiscal policy would be promoted by a tax upon trust intangibles levied only by the State that is the seat of a testamentary trust. Or, it may be that the actual domicile of the trustee should be preferred for a single tax.").

238. In the case of a testamentary trustee, the trustee may need the permission of the court to resign absent an instruction in the will permitting resignation. *See* FRATCHER, *supra* note 133, § 106; *see, e.g.*, ALA. CODE § 19-3-210 (1990 Repl. Vol.); MD. CODE ANN. EST. & TRUSTS § 15-111 (1991 Repl. Vol.); N.Y. SURR. CT. PROC. ACT § 715 (Consol. 1980). As a practical matter, however, courts do not frequently force a testamentary trustee who wishes to resign for a good reason to continue to serve. *See* FRATCHER, *supra* note 133, § 106.1.

239. *See* BOGERT & BOGERT, *supra* note 165, § 527; FRATCHER, *supra* note 133, § 107; *see, e.g.*, *In re* Estate of Weiss, 227 N.Y.S.2d 378, 383 (Surr. Ct. N.Y. Cty. 1962) (refusing to remove a fiduciary despite a finding that he acted "arbitrarily" and "unduly complicated the administration of the estate"); *Estate of Rad*, N.Y.L.J., July 6, 1994, at 28, Col. 6 (Surr. Ct. N.Y. Cty. 1994) (removing fiduciary who threatened to "mutilate" co-fiduciary's spouse).

240. *See* RESTATEMENT (SECOND) OF TRUSTS § 107, cmt. b (1959); 76 AM. JUR. 2D *Trusts* §§ 258-260 (1992).

241. *See* 63 A.L.R.2d 523-44; 76 AM. JUR. 2D *Trusts* § 261 (1992).

dently, but in good faith, and causes losses to the trust, the remedy is surcharge of the trustee rather than removal.[242]

Considering the high standard required for removal of a trustee, it seems unlikely that a court would remove a trustee where the sole basis for his removal is the fact that, through no fault of his own, his position as trustee subjects the trust to income taxation by a particular state. This situation is somewhat analogous to a situation where a trustee's removal is sought because the beneficiaries of the trust wish to avoid paying his commissions. It seems quite clear that, considering the narrow grounds for which removal is granted, such a trustee would not be removed. Therefore, it is unlikely that a trustee may be removed simply for the fact that her position as trustee subjects the trust to income taxation by a particular state.

A more interesting question from a constitutional perspective is, who is deemed to be a trustee? For example, suppose the only connection between a New Jersey Resident Trust and New Jersey is the fact that a trust protector is a resident of New Jersey.[243] Is the residence of the trust protector a sufficient connection between New Jersey and the trust to constitutionally justify the income taxation of the trust by New Jersey? Further, what if rather than a trust protector, a New Jersey investment advisor was delegated broad authority by the trustees to make investment decisions on behalf of the trust? Could this be a constitutionally sufficient nexus?

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242. *See* 76 AM. JUR. 2D *Trusts* §§ 481-82 (1992).

243. A trust protector is sometimes used in a situation where a settlor/testator desires to give a certain individual some control over the trust, but, perhaps for tax reasons, does not wish to give this person the more substantial powers of a trustee. For example, if a trustee has a beneficial interest in the trust, then if she, as trustee, has the power to make discretionary distributions to herself, as beneficiary, she would have a general power of appointment, for gift and estate tax purposes. *See* I.R.C. § 2041 (1997). Thus, every exercise of the trustee/beneficiary's power in favor of another would be a taxable gift. In this situation, an independent party may be appointed trust protector in order to control the discretionary distributions to the beneficiary/trustee.

Trust protectors are frequently involved in the area of foreign trusts. If an individual wishes to create a foreign trust in order to protect assets from her domestic creditors, appointing a U.S. citizen as a trustee may vitiate this purpose. Typically, however, a U.S. settlor will wish to appoint a U.S. individual to oversee the actions of the foreign trustee and to control some trust decisions. The use of a trust protector for that role is common. *See* Howard M. Zaritsky, *Foreign Trusts, Estates and Beneficiaries*, 911 T.M. (BNA) (Dec. 8, 1997).

It would, of course, be simpler to ignore the residence of any party other than the trustees, settlor/testator and beneficiaries. In some situations, however, such a bright-line rule seems to make little sense. For example, a trust protector who controls trust distributions and trust investments seems to have a closer relationship to a trust than the trustee who is, effectively, merely the custodian of the trust assets. In this case, it seems that the residence of the trust protector should be at least as constitutionally significant as the residence of the trustee. In contrast, if the trust protector's only power is to remove one corporate trustee and appoint another corporate trustee, perhaps the residence of the trust protector does not create any meaningful constitutional nexus between the trust and her state of residence.

From a constitutional perspective, the identity of the trustee is not the essential issue. The issue is the nexus between the trust and the potentially taxing state. To the extent this nexus can be satisfied merely by the residence of a trustee,[244] it should be equally satisfied by the residence of a trust protector or investment advisor whose power over the trust is sufficiently broad. Therefore, who is a trustee for constitutional nexus purposes is not the appropriate question. The correct question is who are the parties with significant connections to the trust and are those connections significant enough to constitutionally justify the imposition of the income tax by that party's state of residence? It is important to realize, however, that expanding the class of individuals whose residence may be constitutionally significant increases the complexity of a constitutional limitation on the state income taxation of Resident Trusts.

## VIII. CONCLUSION

This article now comes to the point where an attempt must be made to draw a conclusion from the various pronouncements regarding the constitutional limitations on state taxation as they apply to trusts. In effect, order must be made out of the

244. *See* Greenough v. Tax Assessors, 331 U.S. 486, 498 (1947).

"quagmire" that the Supreme Court has admitted its precedent has created in this area.[245]

First and foremost, the primary issue of this article must be discussed. Namely, may a state constitutionally tax a trust where the only connection between the trust and the state is the residence of the settlor/testator at the time of the trust's creation? Unfortunately, the answer to this question is not clear. On the one side, the event that is the purported nexus—the creation of the trust—may have occurred decades ago.[246] During any given tax year, such a trust may have no more connection to the potentially taxing state than does a fifty-year-old resident of another state who was born in that state.[247] On the other hand, the creation of the trust is a significant event. It is this event that, under state law, provides the basis for numerous connections between the state and the trust, such as the jurisdiction of state courts over the trust.[248] Of course, allowing these connections, which are based on the residence of the settlor/testator to constitutionally justify a tax imposed based on the residence of the settlor/testator, is flawed reasoning.[249] As some of the courts that have addressed this issue have noted, the availability of the state courts is a significant benefit conferred upon the trust by the state. Thus, the state has given something for which it may ask for payment in the form of income tax.[250] This argument does not, however, address the concern that it allows the state through a "constitutionally suspect" classification system to overreach its jurisdiction to tax.[251]

Coupled with these concerns is the problem that trusts are in a unique situation when it comes to the constitutionality of a state income tax imposed on them. A state of incorporation may tax all of the income of the corporation.[252] The contacts creat-

245. *See* Quill Corp. v. North Dakota, 504 U.S. 298, 315 (1992).

246. *See supra* note 25 and accompanying text.

247. *See* Blue v. Department of the Treasury, 462 N.W.2d 762, 764-65 (Mich. Ct. App. 1990).

248. *See* FRATCHER, *supra* note 133, § 565-67.

249. *See supra* note 146 and accompanying text.

250. *See* Wisconsin v. J.C. Penney Co., 311 U.S. 435, 444 (1940).

251. *See Blue*, 462 N.W.2d at 764.

252. *See* Cream of Wheat Co. v. Grand Forks County, N.D., 253 U.S. 325, 328 (1920); *see also* 2 ROTUNDA & NOWAK, *supra* note 91, § 13.4.

ed by incorporation, however, are greater than the contacts generated by the creation of a trust by a resident of a particular state. Further, a corporation may reincorporate in another state. In contrast, a trust is defined as a taxable "Resident Trust" ab initio and, once so defined, remains a Resident Trust until termination. In contrast, an individual may not constitutionally be taxed based merely on her residence at the time of her birth.[253] A trust, however, is much more a creature of the law of the residence of the settlor/testator than an individual is of the residence of her birth.

Added to this confusion is the fact that testamentary trusts have a closer relationship to the state of their creation than do inter vivos trusts. Moreover, it is unclear whether a constitutional limitation on the state income taxation of Resident Trusts is, from a policy perspective, desirable. Further, a constitutionally sufficient nexus may be generated by the residence of a trust protector, investment advisor or other party as well as the trustees and beneficiaries.

If one must draw a conclusion from the various conflicting decisions and factors, it seems that the more reasonable conclusion is that a state is constitutionally prohibited from imposing an income tax on the entire income of a trust based solely on the fact that the trust was created by a resident settlor/testator. This conclusion is consistent with the decided weight of authority.[254] Further, the few cases to the contrary are atypical.[255]

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253. *See Blue*, 462 N.W.2d at 764-65.

254. *See* Blue v. Department of the Treasury, 462 N.W.2d 762 (Mich. Ct. App. 1990); Westfall v. Director of Revenue, 812 S.W.2d 513 (Mo. 1991); Swift v. Director of Revenue, 727 S.W.2d 880 (Mo. 1987); Potter v. Taxation Div. Dir., 5 N.J. Tax 399 (1983); Pennoyer v. Taxation Div. Dir., 5 N.J. Tax 386 (1983); Mercantile-Safe Deposit & Trust Co. v. Murphy, 15 N.Y.S.2d 579 (N.Y. 1964); Taylor v. New York State Taxation Comm'n, 445 N.Y.S.2d 648 (N.Y. App. Div. 1981).

255. In *Hutchins v. Commissioner of Corporations and Taxation*, 172 N.E. 605 (Mass. 1930), the Supreme Judicial Court of Massachusetts addressed the constitutionality of a income tax imposed on a trust based on the residence of the trustee. This court mentioned, in *dicta*, that a tax imposed on the basis of the residence of a settlor/testator would be constitutional. *See id.* at 608. The continued validity of *Hutchins* is questionable. *See supra* note 23.

*District of Columbia v. Chase Manhattan Bank*, 689 A.2d 539 (D.C. Cir. 1997), involved a tax imposed by the District of Columbia. Since the commerce clause does not limit Congress' power to legislate, even when legislating merely for the District of

Most of the cases that have addressed this issue have not drawn a distinction between the limits imposed by the commerce clause and the limits imposed by the due process clause. This is probably due to the fact that prior to 1992 the Supreme Court had not clearly enunciated the differences between the nexus requirements emanating from these two clauses.[256] Arguably, in 1992 the Supreme Court lowered the nexus requirements under the due process clause and left the nexus requirements of the commerce clause unchanged. It appears, however, that an income tax imposed on a trust based solely on the residence of the settlor/testator may be constitutionally prohibited by both clauses. Under the lower due process nexus requirement, it is obviously more likely that a trust may be found to have a sufficient nexus with a state based solely on the fact that the trust was created by a resident of that state. Whether the constitutionality of such a tax is being evaluated under the commerce clause or under the due process clause, the basic constitutional shortcoming is the same. Namely, the sole nexus between the state and such a Resident Trust is an event that occurred in the past, perhaps the relatively distant past. There may be no continuing nexus between the state and the trust except for the contacts, such as the jurisdiction of the state courts, which are based on the same past event. This is the unique problem of state income taxation of trusts as opposed to state income taxation of corporations, individuals or other entities. Under these circumstances, this event cannot serve as the constitutional basis for the state income tax in perpetuity. There must be a constitutional limit to such taxation; at some point, the nexus established by the creation of the trust by a resident must wear off.

Such a constitutional limitation is clearly the less workable conclusion. Absent such a limitation, a trust would simply be defined as Resident Trust ab initio and its liability to the state would be similarly determined and immutable. In contrast, such a constitutional limitation would require the annual evaluation of the nexus between the state and the trust.[257] Thus, to de-

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Columbia, the tax was not challenged on commerce clause grounds. *See id.* at 541 n.7.

256. *See* Quill Corp. v. North Dakota, 504 U.S. 298, 305 (1992).

257. *See* Virginia Dep't of Tax. Letter Ruling 1993 WL 372991 (Aug. 26, 1993).

termine the state tax liability of such a trust, one would need to evaluate whether any trustees, beneficiaries, contingent beneficiaries, trust protectors, investment managers, or other parties with a connection to the trust were residents of that state or if the trust held any property in that state. Further, if the trust avails itself of the state courts during that tax year, this may also provide a constitutionally sufficient nexus.

It seems that a trust created in a particular state has a closer relationship to that state during its infancy, *i.e.*, during the first few years of the trust's existence. Thus, based solely on the residence of the settlor/testator, a state may constitutionally tax the income of a trust during its first few years of existence, but may be unable to constitutionally tax the trust in later years. Of course, the immediate question that arises is when does the state become constitutionally prohibited from taxing the trust—when does the nexus wear off? This distinction, however, defies easy classification and creates a particularly unworkable and administratively difficult standard.

Based on the difficulty of administering such a constitutional limitation, the Supreme Court, if it were to decide this issue, may opt for a "bright-line" test. Of course, there is more than one possible bright-line test, including only allowing state taxation of a trust if a trustee is a resident of the state, or allowing unfettered taxation of a trust by the state of residence settlor/testator. The former alternative, however, would severely undermine the Resident Trust classification system in place in many states. Moreover, it would effectively impose a single method of trust income taxation on the states, and the Court has been unwilling to impose a single formula for taxation in similar contexts. The advantages of the bright-line test, however, are obvious: easy administrability, and the certainty that is so desirable in the taxation context.[258] Moreover, the Supreme Court has recently upheld such a bright-line test based on similar concerns despite the Court's own admission that such test was "artificial at its edges."[259] On the other hand, the Su-

258. *See Quill Corp.*, 504 U.S. at 315-16.
259. *Id.* at 315.

preme Court went to great pains to limit that decision to the context of sales and use taxes.[260]

Thus, if the Supreme Court were to address this issue today, it is unclear how it would, or should, rule. On the one hand, its precedent supports such a constitutional limitation. On the other hand, the Supreme Court has recently voiced the need for certainty and bright-line tests in an area that has been described by the Court as a "quagmire."[261] Perhaps this issue can be best addressed in the following context: is it equitable for a state to exact a tax from a trust if the trust has had no connection to that state since the moment of its creation decades ago?[262] Probably not.

It is, however, clear that the current uncertainty regarding the constitutional limitations on the state income taxation of Resident Trusts costs the state treasuries in terms of lost revenue. If a Resident Trust has connections to the state that are arguably inadequate to constitutionally support the income taxation of the trust by the state, then the trustee may reasonably take the position that the trust owes no income tax to that state and has no obligation to file state income tax returns. The only way for the state to contest the trustee's position is to audit the trust, which may be difficult since the trust likely files no tax return. Moreover, even if such a Resident Trust is unlucky enough to be audited and a state income tax liability is finally determined, the trust would owe merely the back tax and, perhaps, interest. Penalties are unlikely since the trustee's position was based on the theory that the state was constitutionally prohibited from taxing the trust—a theory that may easily be classified as reasonable in most close cases given the current uncertainty in the state of the law. In this case, the trust is in no worse a position for having lost the "audit lottery" than if the trust had paid the income tax in a timely fashion. It may owe interest, however, if the trustee had the funds to invest while the interest was accruing. Therefore, since there is little downside to losing the audit lottery, a Resident Trust with little, or even moderate, connection to the state of resi-

260. *See id.* at 317-18.
261. *See id.* at 315.
262. *See supra* notes 212-20 and accompanying text.

dence is effectively encouraged to take the position that taxation of the trust by the state is constitutionally prohibited.

To assuage this uncertainty regarding the constitutional limits on the state income taxation of Resident Trusts, and prevent the resulting losses to the state treasuries, one may look to either the courts or the legislature. The state courts and/or the federal courts may attempt to clearly delineate these constitutional limits. This approach, however, seems unlikely to be successful in eliminating the uncertainty in this area. The Supreme Court describes its own case law regarding constitutional limitations on state taxation as a "quagmire."[263] Moreover, as discussed above, even the very thorough analysis of this issue undertaken by the *Swift* court leaves substantial unanswered questions regarding the extent of these constitutional limits.[264] In short, court attention has been unable to bring clarity to this or closely related areas up to this point and it seems unreasonable to expect it to do so in the future.

Thus, if the current uncertainty regarding the constitutional limits on the state taxation of Resident Trusts is to be eliminated, the state legislatures must act. One possibility is for the state legislatures to follow the example of the states that employ the Resident Trust taxation system, but exempt a Resident Trust from taxation if the connection between the state and the trust is attenuated.[265] These exemptions do not, however, eliminate the uncertainty in this area.[266] Moreover, this course of action leaves unchanged a taxation system that bases the taxation of trusts on the "constitutionally suspect" Resident Trust classification.[267]

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263. *Quill Corp.*, 504 U.S. at 315.

264. *See supra*, notes 185-98 and accompanying text.

265. *See supra* notes 40-71 and accompanying text.

266. For example, Connecticut Resident Trusts with no present connection to the state of Connecticut are exempt from taxation by Connecticut only if the trust is inter vivos. A testamentary Connecticut Resident Trust with no current connection to the state is taxed on all of its income. *See supra* notes 60-62 and accompanying text. In contrast, the New Jersey Tax Court has held that a similarly situated testamentary New Jersey Resident Trust may not constitutionally be taxed by New Jersey. *See* Pennoyer v. Taxation Div. Dir., 5 N.J. Tax 386 (1983).

267. Blue v. Department of the Treasury, 462 N.W.2d 762, 764 (Mich. Ct. App. 1990).

In order to truly eliminate the uncertainty in this area, and prevent the resulting losses to the state treasuries, the state legislature must act proactively. The states should abandon the Resident Trust classification system since it is constitutionally flawed and fails to account for changing events that occur during the existence of the trust. In its place, the states may adopt a system that bases the state taxation of trusts on current connections between the state and the trust, such as the residence of the trustees or beneficiaries.[268] In addition to avoiding the constitutional issues inherent in the Resident Trust taxation system, such a system has the added advantage in that it reflects the current nexus between the trust and the various states. Until the states abandon the "constitutionally suspect"[269] Resident Trust classification system, the state taxation of trusts will likely remain mired in uncertainty regarding the constitutional limits on the states' power to tax.

268. *See supra* notes 66-71 and accompanying text. The Supreme Court has explicitly held that taxation of a trust based on the residence of the trustees is constitutional. *See* Greenough v. Tax Assessors, 331 U.S. 486, 486 (1947). The *Greenough* Court also noted that the residence of the trustees "may be preferred for a single tax". *Id.*

269. *Blue*, 462 N.W.2d at 764.