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Wealth Management / Trusts & Estates

Pa. Trust Income-Tax Planning in the Wake of *McNeil*

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Special to the Legal

The American chemist and one-time Pennsylvania resident Robert L. McNeil Jr. amassed his personal fortune primarily through the development and mass commercialization of the pain reliever Tylenol. The Pennsylvania Commonwealth Court's holding in *McNeil v. Commonwealth*, Pa. Comm. Court, Nos. 651 F.R. 2010, 173 F.R. 2011 (May 24, 2013), a case involving trusts designed to preserve and protect a portion of McNeil's fortune, may serve as an elixir to eliminate the pain of the imposition of the Pennsylvania personal income tax (PIT) on certain Pennsylvania resident trusts and most certainly will cause the Pennsylvania Department of Revenue more than its fair share of headaches.

The Pennsylvania statute and the accompanying regulations subject the worldwide income of Pennsylvania resident trusts to a flat 3.07 percent PIT. The statute defines a resident trust as any trust, inter vivos or testamentary, that was created by a Pennsylvania resident or Pennsylvania resident decedent. The regulations further state that the residence of the trust's fiduciary and beneficiaries is immaterial to the question of taxation. The residency of the trust's settlor (i.e., grantor) is the single controlling factor in the imposition of the PIT.

In *McNeil*, the Commonwealth Court held that despite the settlor's Pennsylvania residency at the time of the trust's creation, the trust had insufficient connections to the state and accordingly the

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imposition of the PIT violated the commerce clause of the U.S. Constitution. The court applied a four-pronged test established under *Complete Auto Transit v. Brady*, 430 US 274 (1977). In *Complete Auto Transit*, the Supreme Court held that in order for a state tax to pass constitutional muster, (1) the taxpayer must have a substantial nexus to the state; (2) the tax must be fairly apportioned; (3) the tax being imposed upon the taxpayer must be fairly related to the benefits being conferred by the state; and (4) the tax may not discriminate against interstate commerce. While the court addressed each of the four prongs (and found that the application of the PIT under the circumstances violated the first three), it focused its attention and much of its analysis on the first test, the trust's nexus to the state. The court concluded that because the trust had no Pennsylvania situs assets, was not governed by Pennsylvania law, was administered outside of Pennsylvania and did not conduct business within Pennsylvania, the state did not have the authority to apply the PIT.

The *McNeil* decision has changed the landscape of the income taxation of Pennsylvania resident trusts, particularly in light of the state's decision not to pursue an appeal, and has pushed state income tax planning for trusts to the forefront. In general, trusts are subject to both federal and, in most cases, state income tax. Trusts are taxed as either grantor trusts or nongrantor trusts. The grantor trust is a federal income tax concept under Internal Revenue Code Sections 671-679, whereby the trust's settlor is deemed to own the trust's assets for income tax purposes and is liable for satisfaction of the tax liability on the trust's income. If a trust is a grantor trust, all of the trust's income tax items (i.e., gain, loss, deductions and credits) pass through to the settlor and the trust grows income-tax free. All but a handful of states recognize the federal grantor trust concept. (Pennsylvania ignores the federal concept and taxes all trusts.) Conversely, a nongrantor trust, or a complex trust, is a trust where the trust's accumulated income (income not distributed to the trust beneficiaries) is taxed at the trust level. Under a nongrantor trust, the trust receives an income-tax deduction for income distributed to a beneficiary and the beneficiary picks up the distribution on his or her personal income-tax return.

Most states tax nongrantor trust income. Of the states imposing tax, Pennsylvania

bears the lowest rate. (The New Jersey and New York tax rates are among the highest, at 8.97 percent and 8.82 percent, respectively.) As with the tax rates, the criteria employed by states in levying tax is varied. The residency of the settlor, trustee and the beneficiary are factors considered by some states; other states focus on the location of the trust's administration and assets. The settlor's residency, with exception, is the driving factor under the laws of Delaware, New Jersey and New York. Like Pennsylvania, Delaware, New Jersey and New York define resident trusts to include only testamentary or inter vivos trusts established by state residents. Delaware adds to its definition of resident trusts those trusts having one or more trustees located in Delaware. There are differences, however, even among these states. For example, Delaware generally imposes the tax only where one or more trust beneficiaries lives in Delaware and then only upon the portion of the trust income attributable to Delaware beneficiaries; New York exempts from tax resident trusts if all of the trustees and trust assets are located outside of the state; and New Jersey follows the New York practice but only exempts from tax testamentary resident trusts where the trustees and trust assets are outside of New Jersey.

The *McNeil* case presents an opportunity for Pennsylvania trusts to minimize or avoid state tax on trust income. Nexus is the common theme that pervades the Delaware, New Jersey and New York statutes and was at the heart of the *McNeil* analysis and decision. The threshold question is whether there is sufficient contact between the trust and the state to justify the imposition of the tax. In Delaware, New York and now Pennsylvania, the residency of the individual establishing the trust, whether by testamentary or inter vivos instrument, by itself, is an insufficient nexus to trigger state tax. The location of assets, the settlor's domicile, the trustee's domicile, the governing law of the trust instrument, the beneficiaries' domiciles, and the location of the trust's administration are factors that create a potential nexus to a state for fiduciary income-tax purposes.

When drafting a trust, it is important to focus on each of the factors listed above. For example, a Pennsylvania settlor may create a trust governed by New Jersey law, with a New Jersey resident as trustee, and all assets and administration located in New Jersey. Under these facts, New Jersey and Pennsylvania tax may be avoided on the trust's income. What happens, however, if the trust has a California resident beneficiary? The trust's income may be subject to California income tax because the California statute imposes a tax (at the highest rate of any taxing state) on all trusts with a California resident trustee or resident noncontingent beneficiary. (California is an example of the several states that tax trusts based on the residency of the trustee or beneficiary.) Based on the foregoing, it is easy to see that the mobility of trustees and beneficiaries may trap the unsuspecting when advising on state trust income-tax implications.

Estate planners may utilize a number of strategies to avoid state income tax while still achieving the settlor's goals. For Pennsylvania, New Jersey and New York settlors, choosing an out-of-state trustee (such as a Delaware corporate trustee or a trusted friend or family member who lives outside the settlor's home state) removes a potential nexus for state income taxation. (As noted above, however, the income-tax implications of the state in which the trustee is located must be reviewed.) Naming a Delaware corporate trustee eliminates the uncertainty attendant with naming an individual trustee. Delaware imposes no Delaware income tax on trusts with no Delaware beneficiaries. Moreover, a corporate trustee is less likely than an individual trustee to move to a tax-disadvantaged jurisdiction in the future.

There are some possible planning techniques to explore when trying to minimize state income tax on trusts. For example, dividing the trust into multiple trusts may protect a portion of the trust assets from state fiduciary income tax. If the situs of the assets could subject the trust to state tax, dividing the trust into two or more trusts may reduce the tax on trust income. One trust could hold assets located outside the settlor's state and therefore would be state-tax exempt. The other trust could hold assets within the settlor's state and would be subject to state tax. Further, consider a trust that has been treated as a grantor trust as to the settlor but the settlor wishes to cease paying the tax on trust income and wishes for the trust to become a separate taxpayer for income tax purposes. If there is significant state income tax looming, there may be options to reduce the overall tax depending on which state taxes the trust. In this example, it would be important to consider the factors noted above, including the residence of the trustee, the location of the administration of the trust and the location of the beneficiaries.

While the *McNeil* court's decision presents considerable tax-saving opportunities for Pennsylvania settlors, tax professionals should be aware that such opportunities may be limited to trusts that fit within the specific facts of the *McNeil* case and should avoid having the tax tail wag the dog in the planning and implementation of trusts. Minimizing tax is an integral part of protecting, preserving and maximizing family wealth. In pursuit of this end, however, the practitioner should carefully consider other objectives, such as choice of trustee, trust flexibility and control. For example, the fees involved with a corporate trustee in another state may not outweigh the benefit of the estimated tax savings. In addition, a corporate trustee in another state may result in less flexibility and loss of control over the trust assets and investment choices in connection with the administration of trusts.

Although this summary just touches the surface of the state income-tax complexity that estate planners face when analyzing the income tax implications of trusts, it focuses on the major issues that one should address when advising clients in creating new trusts and administering existing trusts.

Meredith Walsh contributed to this article.

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