State Taxation of Trusts Held Unconstitutional
-Precedent Encourages the Establishment of Trusts to Accumulate Income -

We have been encouraging client's to consider planning to avoid tax on income associated with wealth passing to family members who live up north, and a new case further encourages this planning. Robert L. McNeil Jr. amassed his fortune as a result of Tylenol. In McNeil v. Commonwealth, Pa. Comm. Court, (May 24, 2013), the court ruled that there must be more nexus to a state to tax it than merely having the settlor a resident at the time of the trust's creation. Under Pennsylvania law the residence of the trust's trustee and beneficiaries has been irrelevant to the question of taxation: only the residence of the settlor has been determinative, which in this case was found not alone sufficient nexus to warrant taxation. Other states have similar rules. The case further strengthens the ability of those who migrate to Florida, who are settlors, trustees, or beneficiaries of old trusts created in northern states, to seek to avoid continued state income taxes by having them administered in Florida. Furthermore, as our last several Client Updates have recommended, Florida resident senior family members should consider planning that allows for deferral or elimination of state level taxation on wealth they have or are intending to pass to children or grandchildren who are residing in northern states.

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 tax 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 impose a tax.

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, for example, 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. However and similarly, it is likely that the domicile of beneficiaries would not alone be sufficient nexus to cause a trust, as a taxpayer with no other nexus, to constitutionally become subject to taxation by another state. As such, administration by parents or others as trustees in Florida should be explored as an opportunity for accumulation of income without exposure to northern state income tax.

We are happy to explore planning opportunities available to Florida residents who desire to create trust structures to benefit their northern family members.

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