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Constitutional Limitations

Taxpayers and their advocates must know the limitations of a state's authority to impose tax on trust income. In this first part of a two-part series, Thomas W. "TJ" Aldous of Williams Mullen uses Virginia law as a lens through which to review basic principles regarding the nature of trusts and trust income, including triggers of trust income tax liability. The second part of the series, appearing next week, discusses constitutional issues related to imposing income tax on trusts and how to reconcile seemingly divergent court decisions.

Taxation of Trust Income: What Is a Resident Trust And How Does a Jurisdiction Decide It Should Be Taxed?



BY THOMAS W. "TJ" ALDOUS

As states more aggressively seek to impose taxes on trusts,¹ some practitioners may question whether the states are exceeding their constitutional authority.² One concern is how states determine whether a trust is a resident because of the tax implications of a

¹ For example, New York Gov. Andrew Cuomo (D) signed legislation April 1 that closed the so-called resident trust loophole in New York.

² See, e.g., Seth Goldstein, "Resident" Taxpayers: Internal Consistency, Due Process, and State Income Taxation, 91 Colum. L. Rev. 119 (1991); Joseph W. Blackburn, *Constitutional Limits on State Taxation of Nonresident Trustee: Gavin Misinterprets and Misapplies Both Quill and McCulloch*, 76 Miss. L. J. 1 (2006); Bradley E.S. Fogel, *What Have You Done*

trust's residency status. If the trust is a resident of the

for Me Lately? Constitutional Limitations on State Taxation of Trusts, 32 U. Rich. L. Rev. 165, 182-184 (1998); Gamewell Gantt and John McGown, Jr., *State Taxation of Trusts and Their Beneficiaries When There are Multiple State Contacts*, 20 J. St. Taxn. 1 (2001); Bernard E. Jacob, *An Extended Presence, Interstate Style: First Notes on a Theme from Saenz*, 30 Hofstra L. Rev. 1133 (2002); Richard W. Nenno, *Planning to Minimize or Avoid State Income Tax on Trusts*, 34 ACTEC J. 131 (2008); Hellerstein & Hellerstein, *State Taxation*, ¶ 20.04 (Thomson Reuters/Tax & Accounting, 3rd ed. 2001, with updates through December 2013) (online version accessed on Checkpoint (www.checkpoint.riag.com) Dec. 1, 2013). Cf. Anthony J. Colangelo, *Spatial Legality*, 107 Nw. U. L. Rev. 69 (2012) (discussing how state interests have marginalized individual rights).

state, the state can tax all of the trust's income. If the trust is not a resident, the state can only tax income sourced in the state. A state has a financial incentive to define a resident trust broadly. Advisors, trustees and settlors are also becoming more attuned to state income tax issues because income tax planning is becoming as important as estate tax planning.

Trustees and their advisors must be cautious and aware of state overreach in the taxation of trusts. A trustee has a duty to administer a trust in accordance with the interests of the trust beneficiaries.³ A trustee must follow the law and pay the taxes properly imposed, at the risk of facing personal liability for costs (including tax penalties) that would not have been incurred if the tax had been properly paid.⁴ At the same time, a trustee should not pay a tax that the trust is not obligated to pay because the trustee could be subject to surcharge.

Supreme Court cases considering whether a state could constitutionally tax a trust have been based on an understanding of basic trust principles. Some courts and state tax departments have seemingly misunderstood the nature of a trust and this has caused uncertainty. This two-part article reviews basic principles regarding the nature of trusts and the constitutional authority of states to tax their residents. By way of example, part one examines these issues by describing what a resident trust is in Virginia⁵ and how the Virginia Department of Taxation has interpreted the statute defining a resident trust. Part two next week will then discuss Supreme Court and state law constitutional decisions affecting the taxation of trusts. It concludes with some thoughts on how seemingly divergent court decisions might be reconciled.

Overview of Trusts and Their Taxation

Legal and Beneficial Interests in a Trust

A trust⁶ is not a separate legal entity.⁷ The trustee holds legal title to and controls the trust property.⁸ The

³ Va. Code Ann. §§64.2-703(A), 64.2-763.

⁴ Determining the state or states in which a trustee must file an income tax return on behalf of a trust is fraught with uncertainty. More than one state may seek to tax a trust. A state may base its tax on the presence of a settlor, a beneficiary, a trustee or a trust asset. Therefore, a trustee must examine the statutes of each state where a settlor, beneficiary, trustee or trust assets have been resident, domiciled or present. A trustee must consider case law, regulations and other interpretive guidance. Overlaid on all of the statutory issues are the restrictions of the federal Constitution that limit a state's taxing authority. A trustee must consider whether the Constitution prohibits the state from taxing the trust in the manner prescribed by the statute. If the trustee believes the statute may be unconstitutional, the trustee must then determine whether to challenge the tax.

⁵ An analysis of Virginia's statute is applicable to other states because most states rely on the same premise for taxing a trust as a resident trust. States tax a trust as a resident trust when the settlor is present in the state, when the trust is administered in the state or when a beneficiary is present in the state. Only five states tax a trust because a beneficiary is present in the state. Virginia is not one of those states.

⁶ A trust has been defined as "an arrangement of property in which the technical ownership is vested in one or more persons who are to hold, administer, or otherwise deal with the

beneficiary generally has no standing to sue on behalf of a trust.⁹ A beneficiary either owns a claim against the trustee to have the trust carried out or the beneficiary is an equitable owner of the trust property.¹⁰ A settlor has no interest in the trust or the trust property,¹¹ except as may be provided by law in limited circumstances¹² or reserved in the terms of the trust, and has no rights, liabilities, or powers with respect to trust administration.¹³ A settlor has no legal relationship with the beneficiaries or the trustee.¹⁴ He or she does not have standing to sue a trustee for breach of fiduciary duty¹⁵

property, as may be directed, for the benefit of some other person or persons to whom the property beneficially belongs." Joseph R. Long, *The Definition of a Trust*, 8 Va. L. Rev. 426, 432-33 (1922).

⁷ *Combs v. Dickenson-Wise Medical Group*, 355 S.E.2d 553, 233 Va. 177 (Va. 1987); *Yonce v. Miners Memorial Hospital Assn.*, 161 F. Supp. 178, 188 (D. Va. 1958). Legislation occasionally changes the common law. For example, some states require that trustees register trusts or provide that title to real estate may be in the name of a trust, rather than in the name of the trustee as at common law. See, e.g., Colo. Rev. Stat. §§15-16-101; 38-30-108.5.

⁸ See *Austin v. City of Alexandria*, 574 S.E.2d 289, 265 Va. 89 (Va. 2003) (holding that legal title to property was not conveyed by settlor who was also trustee because he did not specify he was acting as trustee and he had no legal title in his individual capacity).

⁹ *Blonstein v. Rubenstein*, No. FSTCV106004573S, 2011 Conn. Super. LEXIS 1952 (Conn. Super. Ct. July 26, 2011); *Naier v. Beckenstein*, No. CV075014236, 2008 Conn. Super. LEXIS 1262 (Conn. Super. Ct. May 13, 2008); RESTAT. 2D OF TRUSTS §281.

¹⁰ Commentators do not agree. See Amy Morris Hess et al., *Bogert Trusts & Trustees* §183 (3rd ed. 2007); Rufford G. Paton, *The Nature of the Beneficiary's Interest in a Trust*, 4 Miami L.Q. 441 (1949-1950).

¹¹ *Address v. Millstone*, 56 A.3d 323, 208 Md. App. 62 (Md. Ct. Spec. App. 2012) (holding that settlor of life insurance trust had no standing with respect to policy purchased by trust); *Krauch v. Krauch*, 20 A.2d 719, 179 Md. 423 (Md. 1941) (finding settlor's executor not a necessary party because settlor did not own property after transfer in trust). See also *Moore v. John Hancock Life Ins. Co.*, 876 So. 2d 443 (Ala. 2003); *Pike v. New York Life Ins. Co.*, 72 A.D.3d 1043, 901 N.Y.S.2d 76 (N.Y. App. Div. 2010) (per curiam); *Berardino v. Ochlan*, 2 A.D.3d 556, 770 N.Y.S.2d 75 (N.Y. App. Div. 2003) (per curiam); *Orentreich v. Prudential Ins. Co. of Am.*, 275 A.D.2d 685, 713 N.Y.S.2d 330 (N.Y. App. Div. 2000) (per curiam).

¹² While the settlor of an irrevocable trust traditionally has no continuing rights over the trust except for the right to terminate the trust with the beneficiaries' consent, the Uniform Trust Code also authorizes the settlor of an irrevocable trust to petition for removal of the trustee and to enforce or modify a charitable trust. See, e.g., Va. Code Ann. §§64.2-723, 64.2-759.

¹³ See *Continental Bank & Trust Co. v. Country Club Mobile Estates*, 632 P.2d 869 (Utah 1981) (holding that settlor could not extend option over property held by trustee even though settlor could revoke the trust); see also *In re Simon*, 2012 Pa. Dist. & Cnty. Dec. LEXIS 270 (Pa. County Ct. 2012) (noting that a settlor's powers are restricted to the powers actually reserved). See also Uniform Trust Code (Last Revised or Amended in 2010), drafted by National Conference of Commissioners on Uniform State Laws, p. 18 (Jan. 15, 2013).

¹⁴ *Flake v. Flake (In re Estate of Flake)*, 2003 UT 17, 71 P.3d 589 (Utah 2003); *Continental Bank & Trust Co. v. Country Club Mobile Estates*, 632 P.2d 869, 872 (Utah 1981).

¹⁵ *Blonstein v. Rubenstein*, No. FSTCV106004573S, 2011 Conn. Super. LEXIS 1952 (Conn. Super. Ct. July 26, 2011); *Peplau v. Roberto*, 2010 Conn. Super. LEXIS 2979 (Conn. Super. Ct. Nov. 12, 2010); Restat. 2d of Trusts, §200.

and is not a necessary party in a suit between a trustee and a beneficiary.¹⁶

Trust as Separate Tax Entity

Although a trust is not a separate legal entity, some states and the federal government tax a trust as though it were a separate entity.¹⁷ Taxing a trust as a separate tax entity is a mechanism legislatures use to prescribe a regime specific to trusts.¹⁸ It does not change the nature of the trust or the relationship of the parties. In fact, it enhances and strengthens the state law fiduciary obligations of the trustee.¹⁹

First, a trustee's personal accounts are separate from his fiduciary accounts. Treating the trust as a separate entity for tax purposes requires that a trustee file a return for the trust and a separate personal return. Filing a separate return for a trust is consistent with the requirement that a trustee account separately for trust assets and disbursements.

Second, filing a separate return for a trust eliminates potential self-dealing. If a trustee were required to report the trust's income on the trustee's personal return, as would a sole proprietor using IRS Form 1040 Schedule C, tax attributes attributable to trust assets, such as depreciation or tax credits, could be attributed to and offset the trustee's personal income. Taxing a trust as a separate entity sets a clear line that eliminates any improper benefit inuring to the trustee.

¹⁶ *Krauch v. Krauch*, 20 A.2d 719, 179 Md. 423 (Md. 1941) (finding settlor not a necessary party in dispute between trustee and beneficiary).

¹⁷ Congress has taxed trusts as though they are legal entities, adopting a conduit theory where the trust acts as a conduit through which income passes to the beneficiary. See H.R. Rep. No. 83-1337, 83d Cong. 2d Sess. 60-64 (1954). See I.R.C. §641(b). In *Greenough v. Tax Assessors of Newport*, 331 U.S. 486, 493-95 (1947), the Supreme Court stated:

A trust, this Court has said, is "an abstraction." For federal income tax purposes it is sometimes dealt with as though it had a separate existence. *Anderson v. Wilson*, 289 U.S. 20, 27. This is because Congress has seen fit so to deal with the trust. This entity, the trust, from another point of view consists of separate interests, the equitable interest in the *res* of the beneficiary and the legal interest of the trustee. The legal interest of the trustee in the *res* is a distinct right. It enables a settlor to protect his beneficiaries from the burdens of ownership, while the beneficiary retains the right, through equity, to compel the legal owner to act in accordance with his trust obligations. The trustee as the owner of this legal interest in the *res* may incur obligations in the administration of the trust enforceable against him, personally. Nothing else appearing, the trustee is personally liable at law for contracts for the trust. . . . Of course, the trustee when acting within his powers for the trust is entitled to exoneration or reimbursement and the trust *res* may be pursued in equity by the creditor for payment.

¹⁸ Taxing a trust as though it were a separate entity does not mean the trust is, in fact, a separate legal entity. Defining a trust as a separate entity for tax purposes is simply an administrative mechanism. A trust could be taxed like an individual, a C corporation or a partnership. Because of the unique features of a trust relationship, a separate tax scheme for trusts is sometimes deemed appropriate by a legislature.

¹⁹ A trustee is required to file the tax return. Va. Code Ann. §58.1-381(C) (requiring trust return to be filed by fiduciary).

Third, filing one return on behalf of a trust requires a unified approach when there are multiple trustees. One return eliminates the need for allocating trust income, deductions and credits among multiple trustees. If each trustee could separately report items of the trustee's proportionate share of income, deductions or credits, each trustee could take a different reporting position for various types of income, deductions or credits.

States' Authority to Tax Their Residents

Residence is a constitutional basis for a state to tax a person. A state can tax all of a resident's income, wherever earned.²⁰ Although a state has some flexibility in defining whether a taxpayer is a resident, a state's definition of "resident" is subject to constitutional restrictions. For example, a state cannot say that any individual born in the state to resident parents is deemed a resident and is taxable as a resident no matter where the person resides or earns his income.²¹

For a majority of the states, including Virginia, a trust is a resident trust if it is created by a resident of the state. It does not matter that the trustee may be a nonresident and that the income being taxed is earned on assets not situated in the state. These states assert the right to tax all of a trust's income no matter where the trustee resides or earns trust income. They fail to appreciate the nature of a trust by requiring a nonresident trustee, over whom they do not have jurisdiction, to pay tax on income not sourced in the state.

Virginia's Definition of a Resident Trust

Virginia imposes an income tax on all trusts,²² but the tax is imposed only on the "Virginia taxable income" of the trust.²³ If the trust is a resident trust, it is taxed on all of its accumulated income; its Virginia taxable income is the trust's federal taxable income, subject to specified adjustments.²⁴ If the trust is a nonresident trust, its Virginia taxable income is limited to its Virginia source income, subject to specified adjustments.²⁵ A resident estate or trust is required to file an income tax return if it is required to file a federal return, or if it has any Virginia taxable income for the year.²⁶

A nonresident trust is a trust that is not a resident trust.²⁷ In Virginia, a resident trust is one that meets one of the following criteria:²⁸

1) A trust created by will of a decedent who at his death was domiciled in the Commonwealth.

²⁰ See *Oklahoma Tax Comn. v. Chickasaw Nation*, 515 U.S. 450, 453 (1995).

²¹ See *Blue v. Michigan Dept. of Treas.*, 462 N.W.2d 762, 185 Mich. App. 406 (Mich. Ct. App. 1990).

²² A trust exempt from federal income tax (such as a private foundation or a charitable remainder trust) is not required to file a return and is exempt from tax (except trusts that have unrelated business income). See Va. Dept. of Taxn., Virginia Rulings of the Commissioner PD 94-302 (Sept. 30, 1994) and PD 02-145 (Nov. 20, 2002).

²³ Va. Code Ann. §58.1-360.

²⁴ Va. Code Ann. §58.1-361; Va. Regs. §10-115-40.

²⁵ Va. Code Ann. §58.1-362; Va. Regs. §10-115-50.

²⁶ Va. Code Ann. §58.1-381.

²⁷ Va. Code Ann. §58.1-302.

²⁸ Va. Code Ann. §58.1-302.

2) A trust that was created by a person domiciled in the Commonwealth.

3) A trust that consists of property of a person domiciled in the Commonwealth.

4) A trust that is administered in the Commonwealth.²⁹

Virginia gives a resident a credit for income tax paid on "earned or business income or gain on the sale of a capital asset" from sources outside the state.³⁰ Earned income does not include interest, dividends, distributions of earnings and profits and other passive income.³¹ Business income is income reported on a federal schedule C, E or F.³² Much, if not all, of trust income is often from dividends and interest. This income would not qualify for the tax credit and if the trust is considered a resident in another state, this income could be subject to double taxation.

If the estate or trust is a nonresident, the tax is imposed on the trust's Virginia source income.³³ Because Virginia source income excludes nonbusiness dividends and interest,³⁴ a nonresident trust with intangible investments in Virginia producing only interest and dividends will not pay the Virginia income tax.³⁵

Domicile

A trust is a resident trust if the settlor who created or contributed property to the trust was domiciled in Virginia.³⁶ Under a very broad reading of the statute defin-

²⁹ The Virginia Department of Taxation modifies the definition of a resident trust (and estate) on its website. There it states, "The fiduciary of a resident estate or trust must file a return: (1) if the estate or trust is required to file a federal fiduciary income tax return or (2) if it had any Virginia taxable income for the taxable year. 'Resident estate or trust' means the estate of a Virginia resident decedent, a trust created under the will of a Virginia resident, or an estate or trust administered by a Virginia resident or under the supervision of a Virginia court. The fiduciary of a nonresident estate or trust receiving income from Virginia sources must also file a return." Va. Dept. of Taxn., Fiduciary Income Tax, <http://www.tax.virginia.gov/site.cfm?alias=Fiduciary> (last accessed Feb. 18, 2014.) No mention is made of a trust that is created by a Virginia domiciliary. The instructions for Form 770, Fiduciary Income Tax Returns, do include a trust created by a person domiciled in Virginia.

³⁰ Va. Code Ann. §§58.1-332(A), 58.1-371.

³¹ Va. Regs. §10-110-221(B)(2).

³² Va. Regs. §10-110-221(B)(3).

³³ Va. Code Ann. §58.1-362.

³⁴ Va. Code Ann. §58.1-302.

³⁵ Va. Dept. of Taxn., Virginia Ruling of the Commissioner PD 99-179 (June 30, 1999).

³⁶ A settlor is a person, including a testator, who creates or contributes property to a trust. Va. Code Ann. §64.2-701. It must be assumed that the statute's (Va. Code Ann. §58.1-302) reference to a trust "consisting of property of a person domiciled in the Commonwealth" means a trust that was not "created" by the settlor but to which the settlor added property. The statute requires that the trust "consist of property of a person domiciled in the Commonwealth." The only time that a trust consists of property of a person domiciled in the Commonwealth is at the time of contribution. Once the property is contributed to the trust, title passes to the trustee and the trust property is no longer the property of the settlor. The statute might also be construed to refer to a Virginia beneficiary's ownership of the equitable interest in the trust property, which would be property of a person domiciled in Virginia. This would cause the trust to be taxed if a beneficiary were in Virginia. There is no evidence that the Virginia Tax Commissioner

ing a resident trust,³⁷ every trust, wherever administered, with a Virginia settlor is subject to the Virginia fiduciary income tax. A Delaware, South Dakota or Alaska dynasty trust created by a Virginia domiciliary would be subject to Virginia's income tax. An irrevocable trust created by a Virginia domiciliary with a Florida trustee of real estate located in Florida for the sole benefit of a Florida domiciliary and resident would be subject to Virginia income tax under the statute. On the other hand, if a Florida domiciliary contributed real estate located in Virginia to a trust with a Florida trustee and a Virginia beneficiary, the trust would not be a Virginia resident trust because the settlor was not domiciled in Virginia (unless the trust is otherwise deemed to be administered in Virginia).

The time at which the settlor must be domiciled in Virginia is an issue. If the trust is a testamentary trust, meaning a trust created under a decedent's will, the statute itself specifies that the decedent must be domiciled in Virginia at the time of his or her death. The statute does not specify when the person creating an *inter vivos* trust or contributing property to the trust needs to be domiciled in Virginia. It could be at the time the trust is created or at the time the tax is imposed. For example, a settlor living in Maryland could create or contribute property to a Maryland trust and then become domiciled in Virginia. The Virginia statute simply states that the trust must have been created by a person domiciled in Virginia. The statute is vague enough to be read to cause the Maryland trust to spring to life as a Virginia resident trust upon the settlor's change of domicile.

The Virginia Tax Commissioner has taken the position that the settlor of an *inter vivos* trust must be domiciled in Virginia at the time the trust was created. In Tax Commissioner Ruling 92-147,³⁸ a settlor created a trust while domiciled in Illinois. The trust was amended while the settlor resided in Illinois. The settlor was the trustee of the trust. The settlor moved to Virginia in 1982 and died in Virginia in 1989 as a Virginia domiciliary. At the settlor's death, the beneficiary of the trust was settlor's spouse, who remained a Virginia domiciliary. The successor trustee was an Illinois domiciliary, and all of the trust assets were located outside of Virginia. The commissioner determined that the trust was not a Virginia resident trust. It was not created by will, it was not created or amended when the settlor was domiciled in Virginia, and it did not own any Virginia property. The trust was not required to file a Virginia fiduciary income tax return.

A settlor can be domiciled in Virginia even if the settlor resides in another state. Domicile is not the same as residence. Domicile requires an intent to make a state one's home for an indefinite period of time,³⁹ while resi-

has construed the statute to mean that a trust is a resident trust if a beneficiary is a Virginia domiciliary. Instead, there is evidence to the contrary. In Tax Commissioner Ruling 13-18, a cotrustee was also a beneficiary of the trust. The commissioner said that the trust did not meet the criteria of a trust created by or consisting of property of a person domiciled in Virginia. The sole issue in that ruling was whether the trust was administered in Virginia. Va. Dept. of Taxn., Virginia Ruling of the Commissioner PD 13-18 (Feb. 5, 2013).

³⁷ Va. Code Ann. §58.1-302.

³⁸ Va. Dept. of Taxn., Virginia Ruling of the Commissioner PD 92-147 (Aug. 19, 1992).

³⁹ See *Howe v. Howe*, 18 S.E.2d 294, 179 Va. 111 (Va. 1942).

dence simply requires being present in a state for more than an insubstantial period of time.⁴⁰ There is no ruling on this issue, so advisors outside of Virginia should be aware that a trust created by a Virginia domiciliary while temporarily residing outside of Virginia could be a Virginia resident trust subject to tax on its worldwide income.⁴¹

[A] trust created by a Virginia domiciliary while temporarily residing outside of Virginia could be a Virginia resident trust subject to tax on its worldwide income.

If the trust is settled by a Virginia domiciliary, the statute makes no provision for the termination of residency status. According to the Virginia Tax Commissioner, a trust created by a Virginia domiciliary remains a Virginia resident trust so long as the settlor, the beneficiaries, the trust assets or the trustees are in Virginia. In Tax Commissioner Ruling 97-147,⁴² the commissioner ruled that a trust, created under the will of a Virginia domiciliary, was a resident trust and was subject to tax as a Virginia resident because the decedent's son, a beneficiary of the trust, resided in Virginia. It did not matter that the trust was administered by a New York bank and that all trust assets were in New York.

There is an exception to the above rule. A trust created by a Virginia domiciliary will not be taxed as a resident trust if the settlor is deceased or is no longer domiciled in Virginia and if the beneficiaries, the trustees and the trust assets are not located in Virginia. In Tax Commissioner Ruling 99-110,⁴³ the commissioner ruled that a trust created under a Virginia decedent's will would no longer be subject to Virginia fiduciary income tax when the trustee was in New York, the beneficiaries

⁴⁰ See *Smith v. Smith's Ex'r*, 94 S.E. 777, 122 Va. 341 (Va. 1917).

⁴¹ Compare Tax Commissioner Ruling 00-197, which was issued in 2000 when the Virginia estate tax was in effect. At the time of the ruling, for income tax purposes, an individual was a Virginia resident (i) if the individual was domiciled in Virginia at any time during the year or (ii) if the individual resided in Virginia for more than 183 days during the year. For estate tax purposes, only a Virginia domiciliary was subject to the Virginia estate tax. Va. Code Ann. §58.1-901. In the ruling, the taxpayer was originally a nonresident non-domiciliary. In April 1995, the taxpayer was no longer able to care for himself and was placed in a nursing home in Virginia. The taxpayer did not have the capacity to change his domicile. Therefore, when the taxpayer died in February 1999, the taxpayer was not a Virginia domiciliary and the taxpayer's estate was not required to file a Virginia estate tax return. Furthermore, the taxpayer was only required to file Virginia income tax returns in those years he resided in Virginia for more than 183 days. In the year of his death, the taxpayer resided in Virginia for less than 183 days, so no resident income tax return was required. Va. Dept. of Taxn., Virginia Ruling of the Commissioner PD 00-197 (Oct. 25, 2000).

⁴² Va. Dept. of Taxn., Virginia Ruling of the Commissioner PD 97-147 (March 27, 1997).

⁴³ Va. Dept. of Taxn., Virginia Ruling of the Commissioner PD 99-110 (May 13, 1999).

were domiciled in North Carolina and the trust property was located outside of Virginia.⁴⁴ In Tax Commissioner Ruling 08-160,⁴⁵ a trust governed by Pennsylvania law and administered by a Pennsylvania trustee was a Virginia resident trust when the trust was funded because the settlor and the beneficiary were both residents of Virginia. The commissioner ruled that the trust was no longer a Virginia resident trust when the settlor and beneficiary were no longer Virginia residents.

Another important consideration is whether a holder of a power of withdrawal, such as one found in a *Crummey* trust,⁴⁶ is a person who contributes property to a trust under the statute. Virginia law defines a resident trust as one that consists of property of a person domiciled in Virginia.⁴⁷ A right of withdrawal is substantially equivalent to ownership of the property over which the right may be exercised. The Virginia Uniform Trust Code defines a settlor as a person, including a testator, who creates or contributes property to a trust.⁴⁸ It also treats as a settlor a person who has a power of withdrawal.⁴⁹ The power holder remains a settlor unless the right of withdrawal has lapsed in an amount less than the greater of 5 percent of the value of the trust assets or the annual exclusion.⁵⁰ Although no ruling provides any guidance, a trustee could anticipate that Virginia might tax trusts administered outside of Virginia with Virginia beneficiaries who have rights of withdrawal, or lapsed rights of withdrawal if the lapse exceeded the annual exclusion of 5 percent of the value of the trust assets.

Trust Administered in Virginia

A trust is a resident trust if the trust is administered in Virginia. A trust is administered in Virginia if, for example, its assets are located in Virginia, its fiduciary is a resident of Virginia, or it is under the supervision of a Virginia court.⁵¹ Each of these factors will be considered separately below.

Resident Fiduciary

Individual Trustee

By regulatory interpretation, if there is a single individual trustee, the trust is administered in Virginia if the trustee resides in Virginia. In Tax Commissioner Ruling 97-121,⁵² Texas grandparents created trusts for the benefit of their Virginia grandchildren. The settlor's

⁴⁴ In 1991, the Virginia Tax Commissioner had ruled (Va. Dept. of Taxn., Virginia Ruling of the Commissioner PD 91-177 (Aug. 23, 1991)) that a trust created under a will of a Virginia domiciliary was a Virginia resident trust even though the sole beneficiary, the trustee, and the trust assets were all located in North Carolina.

⁴⁵ Va. Dept. of Taxn., Virginia Ruling of the Commissioner PD 08-160 (Aug. 29, 2008).

⁴⁶ In a *Crummey* trust, the beneficiary is given a present interest in the trust assets through a right of withdrawal that can be exercised by the beneficiary for a limited period of time, typically 30 days.

⁴⁷ Va. Code Ann. §58.1-302.

⁴⁸ Va. Code Ann. §64.2-701.

⁴⁹ Va. Code Ann. §64.2-747.

⁵⁰ Va. Code Ann. §64.2-747(B)(2).

⁵¹ Va. Regs. §10-115-10.

⁵² Va. Dept. of Taxn., Virginia Ruling of the Commissioner PD 97-121 (March 7, 1997).

son, a resident of Virginia, was appointed as trustee. None of the trust property was located in Virginia and the trust had no income from Virginia sources. The trustee hired an agent outside of Virginia to invest and keep the records of the trust. The trustee argued that the trust was not a Virginia trust because it was administered outside of Virginia. The commissioner ruled that the trustee was principally responsible for ensuring that the agent performed the delegated activities. Because the trustee was primarily responsible for administering the trusts, the trusts were administered in Virginia and were Virginia resident trusts.

Corporate Trustee

If the trustee is a corporate trustee, the trust is administered in Virginia if the decisions concerning the trust are made in Virginia. In Tax Commissioner Ruling 97-457,⁵³ the commissioner considered for the first time whether trusts administered by an institutional trustee would be Virginia resident trusts. In the ruling, the trustee's main office was located in another state and the intangible assets were located in New York, but the personnel who administered the trusts were part of a division located in Virginia. The commissioner summarily concluded that the trusts managed by the Virginia division would be Virginia resident trusts.

Multiple Trustees

If there are multiple trustees, the trust is administered in Virginia only if the trustees in Virginia control the administration. The Virginia Tax Commissioner's rulings indicate that a trust is administered where decisions are made. This position is consistent with the Uniform Trust Code, which has been enacted in more than half of the states, including Virginia.⁵⁴ The Uniform Trust Code places a trust's location at its principal place of administration. The principal place of administration of a trust is typically where the trustee is located.⁵⁵ The trust can also designate a principal place of administration so long as the trustee's principal place of business is in the state or the trustee resides in the state or if all or part of the administration actually takes place in the designated state.⁵⁶ Locating a trust's principal place of administration will ordinarily determine which court has primary if not exclusive jurisdiction over the trust.⁵⁷

⁵³ Va. Dept. of Taxn., Virginia Ruling of the Commissioner PD 97-457 (Nov. 18, 1997).

⁵⁴ <http://www.uniformlaws.org/Act.aspx?title=Trust%20Code> (Feb. 5, 2014).

⁵⁵ Uniform Trust Code (Last Revised or Amended in 2010), drafted by National Conference of Commissioners on Uniform State Laws, Comment to §108 (Jan. 15, 2013).

⁵⁶ Va. Code Ann. §64.2-706(A).

⁵⁷ See Uniform Trust Code (Last Revised or Amended in 2010), drafted by National Conference of Commissioners on Uniform State Laws, cmt. to §108 (Jan. 15, 2013). See, e.g., Va. Code Ann. §64.2-711.

Locating a trust's principal place of administration will ordinarily determine which court has primary if not exclusive jurisdiction over the trust.

In Tax Commissioner Ruling 99-168,⁵⁸ a nonresident settlor created a living revocable trust. At the settlor's death, a Virginia trustee became a co-trustee of the living revocable trust. The trust was divided into a marital trust for the benefit of settlor's husband and separate trusts for the benefit of each of settlor's son and daughter. The husband, son and daughter were co-trustees of their separate trusts. None of them lived in Virginia. Less than 1 percent of the trust assets were located in Virginia. Settlor's probate estate was administered outside of Virginia by her husband and attorney. Before the trust division, the Virginia trustee administered the trust in consultation with, and at the direction of, the co-executors. The Virginia trustee paid the debts, taxes and expenses as the co-executors requested and sold trust property to make those payments and to make distributions to the beneficiaries. The Virginia trustee opened a small checking account to facilitate the payment of estate debts, taxes, expenses and bequests. The Virginia trustee kept the records. These activities constituted the administration of a trust in Virginia. The trust was subject to Virginia fiduciary income tax.

In Tax Commissioner Ruling 02-101,⁵⁹ a trust was established by a nonresident of Virginia. A bank located outside of Virginia was appointed as trustee. The books and records of the trust were maintained outside of Virginia. None of the beneficiaries resided in Virginia. A five-member committee, acting by majority vote, directed the trustee as to trust distributions and investments. The trust inquired whether the appointment of a Virginia resident to the committee would cause the trust to be a Virginia resident trust. The commissioner concluded that the trust would not become a Virginia resident trust because members of the committee did not individually exercise control over the trust. The trust would not be a Virginia resident trust so long as the committee did not operate in Virginia and was not controlled in Virginia.

In Tax Commissioner Ruling 07-164,⁶⁰ trusts created by a nonresident of Virginia were administered by a Virginia trustee. The trusts proposed changing the administration of the trust by adding three co-trustees who were not Virginia residents. The Virginia trustee would remain a trustee, two nonresident individuals would serve as trustees and a nonresident corporate trustee would serve as a trustee. The commissioner stated that where a committee administers a trust, and the members of the committee cannot exercise control of the trust individually, so long as the committee does not operate in Virginia or is not controlled in Virginia,

⁵⁸ Va. Dept. of Taxn., Virginia Ruling of the Commissioner PD 99-168 (June 22, 1999).

⁵⁹ Va. Dept. of Taxn., Virginia Ruling of the Commissioner PD 02-101 (June 24, 2002).

⁶⁰ Va. Dept. of Taxn., Virginia Ruling of the Commissioner PD 07-164 (Oct. 10, 2007).

membership in the committee by a Virginia resident does not make the trust a Virginia resident trust. Because a majority of trustees controlled the trust, the trust was not a Virginia resident trust.

In Tax Commissioner Ruling 13-18,⁶¹ a Florida settlor created an irrevocable *inter vivos* trust governed by Florida law. The settlor never resided in Virginia and the trust had no Virginia property. It was administered by a Florida corporate trustee and an individual Virginia resident trustee. The Virginia co-trustee was also the beneficiary of the trust. The Virginia co-trustee could replace the corporate trustee with another independent trustee. The commissioner ruled that the trust was not being administered in Virginia, reasoning that the Virginia trustee did not control the trust decisions because both trustees had to agree. The trust was not administered in Virginia and was not a Virginia resident trust because the Virginia trustee could not control the trust.

Trust Assets in Virginia

Although the regulation⁶² could suggest that the presence in Virginia of trust assets alone is sufficient to cause the trust to be a Virginia resident trust, it is unlikely that the presence of trust assets in Virginia alone determines whether a trust is administered in Virginia, thereby giving Virginia the power to tax all of the trust's income.⁶³ At most, the presence of trust assets should only be a factor among many to consider. By analogy, before 1996 when Congress adopted an objective test to determine whether a trust was a U.S. trust or a foreign trust, the presence of trust assets was only one factor in determining whether a trust was a U.S. trust. When examining whether a trust was domestic or foreign the courts and the IRS considered factors such as the residence of the trustee, the location of the trust assets, the country under whose laws the trust was created, the nationality of the grantor, and the nationality of the beneficiaries.⁶⁴ If an examination of those factors indicated that a trust had sufficient foreign contacts, it was deemed comparable to a nonresident alien individual and thus a foreign trust.⁶⁵ Of all the factors, the primary consideration was the location of the trustee.⁶⁶ If there was more than one trustee, then the location of the trust corpus could determine the residency of the trust.⁶⁷

⁶¹ Va. Dept. of Taxn., Virginia Ruling of the Commissioner PD 13-18 (Feb. 5, 2013).

⁶² Va. Regs. § 10-115-10.

⁶³ See, e.g., *District of Columbia v. Chase Manhattan Bank*, 689 A.2d 539, 546 (D.C. 1997) (stating, in dicta, that “[i]t would make very little constitutional sense to say that [a state] can acquire jurisdiction to tax the entire income of the trust based on the presence of only a portion of the trust assets within its borders.”).

⁶⁴ See S. Rep. No. 94-938, at 215 (1976); see also H.R. Rep. No. 94-658, at 206 (1975); Staff of J. Comm. on Taxn., 94th Cong., “General Explanation of the Tax Reform Act of 1976” at 218 (J. Comm. Print 1976).

⁶⁵ *Id.*

⁶⁶ See 854-3rd T.M., *U.S. Taxation of Foreign Estates, Trusts and Beneficiaries*, 854.III.C.

⁶⁷ See, e.g., *Maximov v. U.S.*, 373 U.S. 49 (1963); *B.W. Jones Trust v. Comr.*, 46 B.T.A. 5331 (1942), *aff'd*, 132 F.2d 914

Therefore, if there are multiple trustees, with some trustees in Virginia and other trustees not in Virginia, the presence of trust assets in Virginia could indicate that the administration actually takes place in Virginia. Otherwise, the presence of trust assets in Virginia, when no trustee is in Virginia, should not be determinative.

Trusts Under Supervision of Virginia Court

Trusts that are under the supervision of a Virginia court include trusts administered pursuant to a court settlement. They also include testamentary trusts. Trusts not created under a will usually are not subject to the continuing supervision of a court.⁶⁸ They are usually not required to file accountings with a court, nor do the trustees need court approval for their appointment or resignation.⁶⁹ When a trust is created by will, the trustee named⁷⁰ in the will must qualify before a court (or clerk) before proceeding to act as a trustee.⁷¹ The court must approve the trustee's resignation or a change of trustee.⁷² Unless the requirement is properly waived, the testamentary trustee is also required to file annual accountings before a commissioner of accounts.⁷³ In addition, a change in the principal place of administration of a testamentary trust requires court consent.⁷⁴

Conclusion

The Virginia Tax Commissioner asserts that a trust created by a Virginia settlor (whether the trust is testamentary or *inter vivos*) is a resident trust so long as a beneficiary, the settlor or trust assets remain in Virginia. The presence of the trustee in Virginia is not necessary. As will be discussed in next week's article, the U.S. Constitution likely prohibits a state from taxing a trust on all of its income wherever earned, as a resident trust, when the trustee is not a resident of the state. A prudent trustee should not blindly accept Virginia's, or another state's assertion of authority to impose its tax on a nonresident trustee.

(4th Cir. 1943); I.R.S. Rev. Rul. 60-181, 1960-1 C.B. 257; I.R.S. Rev. Rul. 73-521, 1973-2 C.B. 209; I.R.S. Rev. Rul. 70-242, 1970-1 C.B. 89; I.R.S. Rev. Rul. 87-61, 1987-2 C.B. 219; I.R.S. Priv. Ltr. Rul. 9525059 (March 28, 1995).

⁶⁸ Va. Code Ann. § 64.2-1300 (requiring only trustees who qualify before a court to file an inventory and accounting); trustees under an *inter vivos* trust usually are not required to qualify before the court. See Va. Code Ann. § 64.2-1403.

⁶⁹ *Id.*

⁷⁰ An individual trustee of a testamentary trust does not have to be a Virginia resident. Va. Code Ann. § 64.2-1426. Bond with surety is generally required unless a resident trustee also serves.

⁷¹ Va. Code Ann. § 64.2-1401(B). The exclusive jurisdiction for appointment of a testamentary trustee is in the court where the will was admitted to probate. Va. Code Ann. §§ 64.2-1401(A); 64.2-710(B) (noting exception of continued judicial supervision for trusts subject to Part A of Subtitle IV of Title 64.2).

⁷² Va. Code Ann. § 64.2-1424.

⁷³ Va. Code Ann. §§ 64.2-1300(C), 64.2-1306, 64.2-1307.

⁷⁴ Va. Code Ann. §§ 64.2-706(F), 64.2-700(A).

