

**Constitutional Limits on State Taxation of a Nonresident Trustee:
Gavin Misinterprets and Misapplies Both *Quill* and *McCulloch***

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I. Introduction

In *Quill Corp. v. North Dakota*,¹ the United States Supreme Court established substantive limitations to state taxation under the Fourteenth Amendment's Due Process Clause² and under the Commerce Clause's negative sweep.³ *Quill* is recognized as the principal and preeminent statement of these important Constitutional principles limiting state taxing jurisdiction and authority.⁴

Certainly, states often view restrictions on their taxing authority as unwelcome.⁵ A recent opinion of the Supreme Court of Connecticut represents the most extreme of these cases. In *Chase Manhattan Bank v. Gavin*,⁶ the Supreme Court of Connecticut⁷ upheld the imposition of Connecticut income taxes on a New York trustee.⁸ The trustee

¹ *Quill Corp. v. North Dakota*, 504 U. S. 298, 112 S. Ct. 1904, 119 L.Ed.2d 91, (1992).

² U.S. CONST. amend. XIV, § 1.

³ *Quill*, 504 U.S. at 309. See U.S. CONST. art. I, § 8, cl. 3; *Gibbons v. Ogden*, 22 U.S. (9 Wheat.) 1, (1824) (recognizing the negative power of the Commerce Clause).

⁴ See, e.g., *Scholastic Book Club, Inc. v. Dep't of Treasury*, 567 N.W.2d 692 (Mich. Ct. App. 1997); *Magnetek Controls, Inc. v. Dep't of Treasury*, 562 N.W.2d 219 (Mich. Ct. App. 1997); *Town Crier, Inc. v. Dep't of Revenue*, 733 N.E.2d 780 (Ill. App. Ct. 2000).

⁵ See, e.g., *Blue*, infra at Note 118; John Caher, *State Tax Ruling Roils Controversy with Neighbors*, N.Y.L.J., (2001) (analyzing a fight between New York and Connecticut over allocation of a Connecticut resident's salary from a New York University). See Bernard E. Jacob, *An Extended Presence, Interstate Style: First Notes on a Theme from Saenz*, 30 HOFSTRA L. REV. 1133 (2002).

⁶ *Chase Manhattan Bank v. Gavin*, 249 Conn. 172, 733 A.2d 782 (Conn. 1999) (referenced in this article as "Gavin").

⁷ Concurring in Justice Borden's opinion were Justices Callahan, Norcott, Palmer, and Peters. Justices McDonald and Berdon dissented. *Id.* at 806.

⁸ The case involved taxation of four testamentary trusts of Connecticut decedents and one *inter vivos* trust (the Adolffson Trust) established by a Connecticut resident as settlor. The testamentary trusts ranged from

had no presence whatsoever in Connecticut.⁹ The trustee, all trust assets applicable state trust law, and all trust administration were outside of Connecticut.¹⁰ Indeed, the essential “critical link” cited by the Supreme Court of Connecticut to justify Connecticut’s taxation of the New York *inter vivos* trustee’s income was that the trust’s sole, noncontingent beneficiary was a Connecticut resident.¹¹ Connecticut’s sole contact with the testamentary trusts was the decedent settlor’s residence in Connecticut at the time of death, in one instance sixty-three years earlier.¹² Such testamentary trusts, however, were formed under New York law with New York administration and New Trustee.¹³ In such circumstances, domicile of the decedent should not be controlling.¹⁴

The Connecticut tax at issue was imposed upon the New York trustee’s entire accumulated, undistributed income and gains from the trust property.¹⁵ Connecticut’s authority to tax its own resident, *i.e.*, the *inter vivos* trust’s Connecticut beneficiary, on the beneficiary’s income from any domestic or foreign source is unquestioned.¹⁶ This

24 to 63 years old, having been formed many years previously under New York law by Connecticut decedents. *Id.* at 786-87.

⁹*Id.* at 787.

¹⁰*Id.*

¹¹ *Id.* at 802.

¹² *Id.* at 787.

¹³ *See infra*, Note 143, discussing *District of Columbia v. Chase*.

¹⁴ *Id.* Domicile should not be controlling, or even relevant.

¹⁵ *Gavin* at 785, 802.

¹⁶ *See Schaffer v. Carter*, 252 U.S. 37(1920).

would clearly include distributed and even distributable income of a foreign trustee *if* Connecticut law had imposed such a tax on the resident beneficiary.¹⁷

Gavin, however, held the New York trustee's undistributed or undistributable income taxable. In doing so, the Connecticut Supreme Court failed to honor the admonitions of *Quill* that a taxpayer must initiate its own due process contacts with the taxing jurisdiction.¹⁸ The *Gavin* opinion also gave little attention to the Supreme Court's Commerce Clause analysis¹⁹ which was essential to the Court's rejection of North Dakota's tax levy against *Quill*. To the limited extent *Gavin* addressed the Connecticut tax's discriminatory effect on interstate commerce, it misapplied *Quill*.²⁰ The Connecticut justices also refused to follow a clear line of well-reasoned and authoritative cases²¹ that went clearly against their *Gavin* holding.²²

The opinion then played a shell game of words in order to artificially place its facts as to the *inter vivos* trust within those of a single, California case it cited as precedent,²³ the facts, law, and holding of which were completely different.²⁴ The

¹⁷ *McGuire v. Trefry*, 253 U.S. 12 (1920). See discussion *infra* Part III A.

¹⁸ See *supra* Notes 1-4 and accompanying text. Also, see *infra*, Parts V, VI, and VII.

¹⁹ See discussion *infra* Part VII.

²⁰ See *infra* Note 211, et seq. and accompanying text.

²¹ See *Nenno & Sparks, Delaware Dynasty Trust*, at 32, published by Wilmington Trust, Wilmington Delaware: "The court's constitutional analysis particularly for the *inter vivos* trust is unpersuasive."

²² See *infra* Note 289.

²³ *McCulloch v. Franchise Tax Bd.*, 61 Cal. 2d 186, 37 Cal. Rptr. 636, 643 (1964), 390 P.2d 412 (Cal. 1964), (citations omitted), appeal dismissed, 379 US 133, 85 S. Ct. 278 (1964).

²⁴ See discussion *infra* Part VIII.

McCulloch case involved a unique California statute which was the predecessor of federal throwback rules.²⁵

The purpose of this article is to point out flaws in *Gavin*'s analysis and thereby hopefully lessen any inappropriate mischief to Constitutional principles that may result from its misguided holding.²⁶

The article first analyzes pre-*Quill* case law, and then discusses the *Quill* opinion. Thereafter, *Gavin*'s holding will be reviewed in light of this line of precedent cases, including its clearly misplaced reliance on *McCulloch*²⁷, the only precedent it cited for taxation of the *inter vivos* trust.

It is the recurring theme of this article that Constitutional due process analysis of state taxation of trusts has lost its way. Courts must return to the fundamental principles of the law of trusts. A "trust" is not "a legal person" or "an entity." In applying due process minimal contacts analysis, one must first determine what a "trust" is and what person's contacts with the taxing state must be analyzed. That is, in evaluating sufficiency of nexus for due process purposes, the law looks to the contacts of the "trustee" as a legal entity, not to contacts of a "trust", an abstraction, or to a beneficiary?

II. Synopsis of the Law of Trusts: *Inter Vivos* v. Testamentary

A. A "trust" is not a legal person under state law.

²⁵ See *infra* Note 246

²⁶See Jordan M. Goodman, *State Taxation of Business Trusts: Limits, Concerns and Opportunities*, 9 Feb. J. Multistate Tax'n 6 (2000).

²⁷ See *supra*, Note 23.

The artificial nature of trusts complicates jurisdictional analysis. A trustee is a legal person whether corporate or human. The term “trust” means “a *fiduciary relationship* with respect to property, subjecting the person [trustee] by whom the title to the property is held to equitable duties to deal with the property for the benefit of another person [beneficiary], which arises as a result of a manifestation of an intention to create it.”²⁸ Thus a trust is not a legal entity or person, but merely a “fiduciary relationship” whereby the trustee, a legal person, owns property subject to the duty to administer it on behalf of the beneficiary, a separate legal person. The property and associated income subject to this fiduciary duty is the fiduciary’s, i.e., the trustee’s. Such property and affiliated income is not held by any separate, distinct legal entity referred to as “the trust,” and not by the beneficiary.²⁹ A trust is a fiction, i.e. an abstraction.³⁰

As an “abstraction,” a trust may not sue or be sued or hold and transfer title to property in its own name.³¹ A trustee can sue or be sued based on the trustee’s actions or to determine issues pertaining to property held in such trustee’s name.³² The trustee need not sue in his name as trustee but solely in the trustee’s own name without reference to

²⁸ The Restatement, Second, Trusts, Section 2. [Emphasis added.] I Scott, Trusts Section 2.3 (4th ed. 1987). Also see *Randolph Foundation v. Appeal from Probate Court* 2001 WL 418059 (2001), at 16 (trust is an abstraction).

²⁹ In the 1913 Revenue Act, Section II, Paragraph D, the fiduciary withheld tax for the beneficiary's tax liability. Since 1916 taxes imposed on a "trust" are in reality fiduciary income taxes imposed on the fiduciary person in such person's capacity as fiduciary. See e.g. 26 U.S.C. Section 641(b), and *McCauley v. Comm.*, 44 F22 919(CCA5, 1930).

³⁰ See *Randolph Foundation, supra*, Note 28.

³¹ See *infra*, Note 32.

³² “The trustee can maintain such actions at law or suits in equity or other proceedings against a third person as he could maintain if he held the trust property free of trust.” Restatement, Second, Trusts, §280.

the trust relationship.³³ Furthermore, a beneficiary is in no way an agent of the trustee nor a necessary or even proper party to an action by the trustee.³⁴ A trust has no existence separate from the persons who hold differing interests therein. Modern “entity law”³⁵ generally recognizes the following legal persons: corporations, legal liability companies, general partnerships, limited liability partnerships, limited partnerships, REIT’S, and qualifying business trusts.³⁶

The law of trusts applies to both *inter vivos* trusts and testamentary trusts. A trust may be created during the owner’s lifetime through transfer of property by deed to a trustee. For testamentary trusts, property is merely transferred from the decedent by will to a trustee. Transfer of property to a trustee by deed or by will merely reflects two different methods of creating a trust relationship.³⁷ The method of transfer does not alter in any way requirements for creation of a trust relationship, e.g. settlor or testator’s capacity, intention to create a trust, designation of a beneficiary, duties to be performed by a trustee, etc.³⁸ Each method requires an effective transfer of property to a trustee, irrespective of the instrument used to accomplish such a transfer, i.e. deed, assignment, or will.

³³ *Id.*, subsection (h).

³⁴ *Id.*, subsection (i).

³⁵ See Blumberg, *The Corporate Entity In An Era of Multinational Corporations*, 15 DEJCL 283,286.

³⁶ _____, *Current Issues in Conveyance Practices*, 15438 NBI-CLE 1, 7.

³⁷ ULA Trust Code Sec 401. "Methods of Creating Trust. A trust may be created by: (1) transfer of property to another person as trustee during the settlor's lifetime or by will or other disposition taking effect upon the settlor's death." Restatement, Second, Trusts Sec. 17.

³⁸ *Id.*, Section 402

The law of the settlor's or testator's residence generally³⁹ controls the effectiveness of the transferring instrument, whether that instrument is a deed or a will.⁴⁰ In the context of an *inter vivos* transfer, the transferor's compliance with a state's statute of frauds or formalities for real estate deeds allows the resident transferor to effectively transfer property to the trustee.⁴¹ In the context of a testamentary transfer, transferor/decedent's compliance with a state's statute of wills and probate formalities similarly allows the resident to effectively transfer property to the trustee by will at death.⁴²

These resident state laws directly apply to and benefit the state's resident, whether *inter vivos* transferor or decedent. These and other state laws of the transferor's domicile indirectly benefit any transferee, resident or nonresident, on the other side of any such transfer or transaction.⁴³

Just as with an *inter vivos* trust, a testator may designate in his will which state law, other than the law of testator's residence, to apply to governance of the trust.⁴⁴ Likewise, the testator may designate administration in a nondomiciliary state and may

³⁹ Except, for example, effective transfer of real estate is determined by the law of the situs state.

⁴⁰ See *infra*, Note 46.

⁴¹ In the context of sales, compliance with the U.C.C. or a state's common law of contracts similarly enables a transferor to effectively transfer property.

⁴² See *infra*, Note 46.

⁴³ See discussion of *Quill* *infra*, at Notes 185- 186, and accompanying text.

⁴⁴ ULA Trust Code Sec 107. "Governing Law. The meaning and effect of a trust are determined by: (1) the law of the jurisdiction designated in the terms unless the designation of that jurisdiction's law is contrary to a strong public policy of the jurisdiction having the most significant relationship to the matter at issue; or . . ." [Emphasis added]

select a nonresident trustee.⁴⁵ In contrast, the validity of the testator's will as an effective dispositive instrument is determined by the law of the testator's state of residence.⁴⁶ Likewise, whether an instrument effectively conveys an interest in land is determined by the law of the situs of such land.⁴⁷

State law benefits afforded resident persons cannot, under due process, be attributed as an indirect benefit to every nonresident with whom such residents have personal or commercial relationships or dealings.⁴⁸ If one state can impose tax burdens on the basis of such imputed state law benefits, every state, county, municipality or other taxing jurisdiction will have wholly unfettered ability to tax nationwide. Such attribution, reattribution, or re-reattribution⁴⁹ would create an infinite chain unwittingly and wrongly subjecting every person to the jurisdiction of every political subdivision in the nation.

⁴⁵ ULA Trust Code Sec 108. Principal Place of Administration. (a) Without precluding other means for establishing a sufficient connection with the designated jurisdiction, terms of a trust designating the principal place of administration are valid and controlling if: (1) a trustee's principal place of business is located in or a trustee is a resident of the designated jurisdiction; or (2) all or part of the administration occurs in the designated jurisdiction. [Emphasis added]

⁴⁶ Fratcher, William A., *Scott on Trusts*, 4th Edition, 1989. Sec. 649-650. *Hanson v. Denckla*, 357 U.S. 235, 78 S. Ct. 1228, 2 L.Ed.2d 1283 (1958).

⁴⁷ *Id.*

⁴⁸ See *infra*, Note 218, et. seq., and accompanying text.

⁴⁹ In a recent, well-reasoned opinion, the Alabama Administrative Law Division (the "Division") rejected an attempt by the Alabama Department of Revenue ("ADOR") to impute such benefits under Alabama law. ADOR was attempting to impute activities of an Alabama limited partnership to its nonresident limited partner. Lanzi, the limited partner, did not participate in management of the partnership or its assets, did not own property, earn income, or conduct business in Alabama, and resided in Georgia.⁴⁹ The Division's opinion held that the limited partnership was treated as a separate legal entity under Alabama law. The opinion then stated, "[b]ecause a partnership is a separate entity under current Alabama law, the presence and activities of a partnership in Alabama cannot be attributed to its nonresident [limited] partners for nexus purposes. Separate legal entities must be recognized as such." *Lanzi v. Alabama Department of Revenue*, No. INC. 02721 (Ala. Admin. Law Div. Sept. 26, 2003). This author acknowledges that he, along with Donald E. Johnson and David M. Wooldridge of Sirote & Permutt, P.C., represented Mr. Lanzi. The case is presently on appeal to the Alabama Court of Civil Appeals, the Circuit Court of Montgomery County having held that Alabama did have jurisdiction to tax the nonresident.

That is why *Quill's* due process analysis requires that a nonresident knowingly and deliberately direct its contacts at the foreign jurisdiction.⁵⁰

B. What legal “person”⁵¹ must have “purposefully directed its activities”⁵² at a state in order to meet the minimum contacts standard for due process purposes?

Sufficiency of contacts depends on the nature of the jurisdiction in question. For an *in rem* action, contacts with the subject property must be determined.⁵³ For *in personam* jurisdiction over a “person,” the contacts of such person must be determined. Analysis of jurisdiction to tax involves both *in rem* and *in personam* jurisdiction. If a state has jurisdiction as to property, then it has jurisdiction to tax the income from such property. That does not, however, equate to *in personam* jurisdiction over the owner of such property.⁵⁴

For example, a single member limited liability company (“LLC”) is a disregarded entity⁵⁵ for income tax purposes. However, under state laws it is a legal entity which can hold title to property, conduct business in its own name, and sue or be sued in its own

⁵⁰ See *infra*, Notes 185 - 186 and accompanying text; see also *Burger King v. Rudzewicz*, 471 U.S. 462 (1985) (taxpayer purposefully directed activities at the taxing state).

⁵¹ The term “person” in this article may be an individual, i.e., a human person, or a legally recognized entity such as a corporation, limited liability company, or partnership.

⁵² See *infra*, Note 185.

⁵³ Bogert, *The Law of Trusts and Trustees*, §292.

⁵⁴ Lowy and Vasquez, “*When is it Unconstitutional for States to Tax Nonresident Members of Limited Liability Companies*,” *State Tax Notes*, 633 (May 2003). (“The Power to Tax is empty without the power to collect the tax”. Jurisdiction to tax income is interdependent with personal jurisdiction over the taxpayer).

⁵⁵ See e.g. Chief Counsel Advisory, CCA 200216028.

name.⁵⁶ Thus income tax laws artificially render such an entity as nonexistent for income tax purposes. For income tax purposes, the person who is the LLC's single member is directly taxed.

Assume such an LLC is formed under the laws of State X, actively conducts business in State X, and owns property in State X. State X disregards the LLC for income tax purposes, thereby taxing Y, its single member. If Y is a nonresident of State X, having no direct contact with State X, can State X tax nonresident Y based solely on Y's ownership of the single member interest in the LLC?⁵⁷

Artificial, constantly evolving tax classifications and elections, should not and do not⁵⁸ control the parameters of constitutional due process for tax or other jurisdictional purposes. States have broad powers to impose income taxes subject only to constitutional limitations and their own states laws.⁵⁹ For example, in the context of a trust, tax on income may and at times is imposed on the settlor/grantor, the trustee, and/or the beneficiary. In the context of *Gavin*, Connecticut could tax the Connecticut resident settlor/grantor of a New York *inter vivos* trust. Taxation could be based on grantor trust rules⁶⁰ or on deemed realization of gain upon transfer of the Connecticut property of such

⁵⁶ *Id.*; For a general discussion, See Bishop and Kleinberger, Limited Liability Companies: Tax and Business Law, 2000 WL 12016.

⁵⁷ What if this entity under "check the box" Treas. Reg. 301.7701, had elected to be taxed as a corporation? Should the vagaries of a tax election determine due process nexus? What if the LLC elected to be taxed as a corporation, but then made a subchapter S election? Should due process analysis change again?

⁵⁸ See *supra*, Note 49. Re: Lanzi; e.g. If *Quill* had been a subchapter S corporation, would its shareholder owners then have nexus with North Dakota, individually, i.e., would the corporation's contacts be attributed to its shareholders merely because of a tax election?

⁵⁹ In addition to due process and commerce clause restrictions, "realization" is a further constitutional constraint imposed on income taxation. *Glenshaw Glass*, 349 U.S. 925 (1955).

⁶⁰ 26 U.S.C §§ 671-679.

a resident to the out-of-state trustee.⁶¹ Subject to realization issues,⁶² Connecticut could have chosen to tax the Connecticut resident beneficiary on income earned from property or activities of the nonresident trustee, just as California had done.⁶³ But, if Connecticut attempts to actually tax the nonresident trustee, the trustee itself must have knowingly directed its contacts at Connecticut.⁶⁴

III. Pre-Quill Cases

Predictably, there is a long line of state and federal cases addressing state jurisdiction to tax foreign trustees within the limits of federal due process. Following is an analysis of some of these cases and a summary of the principles they establish.

A. The earliest cases established three broad Constitutional principals.

First, it was established in *Bayfield County v. Pishon*⁶⁵ that a state could not tax a nonresident on income sourced outside such state.⁶⁶

⁶¹ See, e.g. 26 U.S.C. Sections 644 and 877, regarding tax on transfer of appreciated property. Also, grantor trust rules should apply to all “foreign”, i.e. out of state trusts. See e.g. 26 U.S.C. §679, and *infra*, Note 313.

⁶² A partner, S Corporation shareholder, grantor of a trust, or member of an LLC can be taxed on their allocable share of related income even though there has been no distribution and even in the absence of control over such distribution.

⁶³ See *infra*, Note 217, et. seq., and accompanying text. In *Lanzi, supra*, Note 49, the Division acknowledged the power of ADOR to impose its tax through withholding imposed upon the Alabama Limited Partnership.

⁶⁴ *Hanson v. Denckla, supra*, Note 46, and Quill, *infra*, Note 180.

⁶⁵ *Bayfield County v. Pishon*, 156 N.W. 463 (Wis. 1916).

⁶⁶ The issue was whether Wisconsin could impose a tax on a Wisconsin decedent’s testamentary trust’s income sourced outside Wisconsin. The trustee, trust property, and beneficiaries were outside Wisconsin. The court treated the trustee as a nonresident. If a resident, source of income would have been irrelevant.

Second, the U.S. Supreme Court in *Safe Deposit v. Virginia*⁶⁷ held that trust property has “a situs separate and apart from that” of trust beneficiaries.⁶⁸ *Safe Deposit* is cited for the rule that “the taxing power of a state is restricted to her confines and may not be exercised in respect of subjects beyond them.”⁶⁹

Third, in *Maguire v. Trefry*⁷⁰, the Supreme Court held that the state of a beneficiary’s residence could tax the beneficiary on distributions of current income⁷¹ irrespective of its source.⁷² In *Simmon*⁷³, the Supreme Judicial Court of Massachusetts

The court held on the facts that trust administration within Wisconsin of the Wisconsin settlor’s testamentary trust did not result in the trust’s income having a Wisconsin source. *Id.*

⁶⁷ In *Safe Deposit & Trust Co. of Baltimore, Md. v. Commonwealth of Virginia*, 280 U.S. 83, 50 S. Ct. 59, 74 L. Ed. 180, Nov. 25, 1929. The trustee was a resident of Maryland, and the beneficiaries were Virginia residents. Virginia sought to impose an ad valorem tax on trust property based upon the beneficiaries’ Virginia residency.

⁶⁸ Another early case, *Commissioner of Corporations and Taxation v. Simmon*, 198 N.E. 741, (1935), is discussed *infra*, Note 73. *Simmons* held a resident of Massachusetts nontaxable on distribution of accumulated income from a nonresident trustee (state income held to have become nontaxable trust principal under Mass. statutes).

⁶⁹ *Guaranty Trust Co. v. Virginia*, 305 U.S. 19, 23 (1938). The Court’s reasoning on the risk of double taxation in *Safe Deposit* would probably not be followed today. *Fogel, infra*, Note 114, at 180-182. *Pennoyer v. Taxation Div. Dir.*, 5 N.J. Tax 386, 395-96 (N.J. Tax Ct. 1983).

⁷⁰ *Maguire v. Trefry*, 253 U.S. 12 (1920). The Massachusetts Supreme Judicial Court upheld and the United States Supreme Court affirmed a Massachusetts tax on the Massachusetts resident beneficiary’s income received from the nonresident trust.

⁷¹ *Id.*, at 13-14. The case involved current income distributed to the beneficiary, not accumulated income as in *Simmon*, *McCulloch*, and *Gavin*, Notes 73, 23, and 6, respectively.

⁷² The plaintiff beneficiary was a Massachusetts resident. The trust was a testamentary trust of a Pennsylvania resident being administered under Pennsylvania law and the income producing property was in Pennsylvania. *Id.*

⁷³ 198 N.E. 741 (1935). See Ferrell, *State Taxation of Income Accumulated in Trusts*, 51 ABAJ 566 (June 1965).

ruled, however, that Massachusetts could not tax a Massachusetts resident beneficiary upon previously accumulated trust income when later distributed by a foreign trustee.⁷⁴

In 1935, both federal and Massachusetts statutes only taxed a trust beneficiary when “income,”⁷⁵ as defined by trust accounting rules, was distributed. The definition of “income” included only current year income. Previously accumulated income was treated as having become inextricably commingled with principal.⁷⁶ Thus, the foreign trustee’s distribution of accumulated income was treated as a distribution of principal by Massachusetts tax statutes.⁷⁷ A beneficiary’s receipt of principle from an estate or trust is viewed as a gift, bequest, or return of capital. Nevertheless, receipt of a gift or bequest could itself constitute “income” for tax purposes.

Income has been defined by the U.S. Supreme Court as an “undeniable accession to wealth clearly realized and over which the taxpayer has complete dominion.”⁷⁸ Therefore, there is no Constitutional barrier to taxation of the receipt of property whether state law treats it as “income” or “principal.” However, federal and Massachusetts tax statutes exclude gifts and inheritances from taxable income.⁷⁹ Thus, Massachusetts could

⁷⁴ “Foreign” meaning the trust had a nonresident settlor, a nonresident trustee, trust property was outside Massachusetts, and both trust law and trust administration were outside Massachusetts.

⁷⁵ Federal D.N.I rules did not come into existence until the 1940’s and 1950’s. See Blackburn, Unique Alabama Trust and Estate Income Tax Rules Create Traps for Alabama Lawyers. 60 Al Law 249 (July, 1999).

⁷⁶ See *infra*, Note 250

⁷⁷ The opinion cited MGLA 62 §§1 and 10.

⁷⁸ *Commissioner v. Glenshaw Glass*, 348. U.S. 426, 75 S. Ct. 473 (1935).

⁷⁹ See, e.g. 26 U.S.C. §102.

constitutionally have taxed the Massachusetts beneficiary on the distribution, but statutorily had not taxed it.⁸⁰

The *Simmon* opinion was rendered shortly before Professor Roger John Traynor wrote his classic article on taxation of trusts, settlors, and beneficiaries.⁸¹ Thereafter, as recommended by Professor Traynor, deficiencies in California principal and income statutes were remedied so as to enable California to later tax its resident beneficiaries upon actual distribution of previously accumulated trust income.⁸²

Thus, for the better part of a century it has been clear that a state can tax its residents on all income irrespective of source. The issue in *Simmon* was the state's own principle and income statutes which prevented taxation of residents on receipt of accumulated trust income, treating it as a nontaxable principal distribution. Nonresidents can only be taxed on income sourced within the taxing jurisdiction.

B. Later cases more sharply defined the issues.

In *Mercantile-Safe Deposit & Trust Co. v. Murphy*,⁸³ a New York resident created an *inter vivos* trust governed under Maryland law with a Maryland trustee and a New

⁸⁰ A revision of Massachusetts's principal income statutes to redefine income or elimination of the income tax exclusion for gifts and inheritance taxes would have empowered the state to tax its own resident.

⁸¹ *Infra*, Note; Traynor referenced *Simmon*, *infra*, Note 28.

⁸² See *infra*, Note 277 and Note 246 and accompanying text. See Cal. Rev. & Tax Code §17745(c) "... income accumulated by a trust continues to be income even though the trust provides that the income (ordinary or capital) shall become a part of the corpus."

⁸³ *Mercantile-Safe Deposit & Trust Co. v. Murphy*, 203 N.E.2d 490 (N.Y. 1964).

York beneficiary.⁸⁴ After Grantor's death⁸⁵, New York undertook to directly tax the Maryland trustee on accumulated trust income.⁸⁶

The Court of Appeals of New York affirmed the Appellate Division's judgment in favor of the trustee and against levy of the New York tax. The court reasoned that the inability of New York to tax the Maryland trustee was not due to the risk of double taxation. Rather, it was due to "the inability of a State to levy taxes beyond its border."⁸⁷

This case makes clear the rule that a state lacks the power to tax a trustee when the state lacked *in personam* jurisdiction over the trustee and lacked *in rem* jurisdiction over the trust property. There was no other contact with such state and the mere residency of the beneficiary and settlor were not deemed to be contacts of the nonresident trustee.⁸⁸

The court cites *Mercantile Safe Deposit & Trust Co.* for the proposition that:

"the imposition of a tax in the State in which the beneficiaries of a trust reside, on securities in the possession of the trustee in another State, to the control or possession of which the beneficiaries have no present right, is in violation of the Fourteenth Amendment."⁸⁹

⁸⁴ *Id.* at 490. *But, c.f. infra*, Note 122 and accompanying text (discussing *District of Columbia v. Chase Manhattan Bank*, 689 A.2d 539 (D.C. 1997)).

⁸⁵ The Grantor's wife, a New York resident, succeeded him as income beneficiary, but income distributions by the Maryland trustee to the wife were merely discretionary. The Trustee was domiciled in Maryland, where the trust, being a non-testamentary, *inter vivos* trust, was administered, and the assets were in the trustee's possession. When the grantor died, his will was probated in New York. *Mercantile-Safe Deposit & Trust Co.*, 203 N.E. 2d. at 490.

⁸⁶ *Id.* at 491

⁸⁷ *Id.*

⁸⁸ *Id.*

⁸⁹ *Mercantile-Safe Deposit & Trust Co.*, 203 N.E.2d at 490.

At this point in the historical review, it is clear that residence of the settlor and/or beneficiary in a state does not cause such state to have either *in rem* or *in personam* jurisdiction over trust property or the trustee. Indeed, residence of the settlor and/or the beneficiary is wholly irrelevant in establishing jurisdiction⁹⁰ as to the nonresident trustee or trust property.⁹¹

In *Pennoyer v. Taxation Division Director*,⁹² a New Jersey domiciliary's will created a testamentary trust.⁹³ The trustee designated by the will was a resident of New York, assets were maintained in New York⁹⁴, and the beneficiaries were not residents of New Jersey.⁹⁵ Taxes were assessed against the trustee by New Jersey. The New Jersey Tax Director claimed the availability of New Jersey courts and the creation of the trust relationship through probate⁹⁶ of decedent's will in New Jersey were sufficient to uphold the tax.⁹⁷

⁹⁰ Reference to *in personam* jurisdiction over the trustee is only as to matters pertaining to the particular trust relationship at issue. See *infra*, discussion of Shaffer at Note 221, et seq. and accompanying text.

⁹¹ Residence of the settlor is only relevant if, due to default in planning, law of the state of residence governs the trust. *Infra*, Note 104.

⁹² *Pennoyer v. Taxation Division Director*, 5 N.J. Tax 386 (N.J. Tax Ct. 1983).

⁹³ *Id.* at 390.

⁹⁴ *Id.* at 391.

⁹⁵ *Id.* at 390-91. Also, see *supra*, Note 45.

⁹⁶ Probate merely affected the transfer of testator's property to the trustee. Creation and governance of the trust occurs under laws designated in the instrument itself, i.e. New York, not New Jersey. See *supra*, Note 44.

⁹⁷ *Id.* at 392.

The opinion⁹⁸ discussed several state court cases that had addressed the question.⁹⁹ The court stated that the protection and control a state exercises over property could give a state the right to tax the income of that property.¹⁰⁰ Ultimately, the court held, “[t]he creation of the trust in 1971 through the probate process in New Jersey courts is an [sic] historical fact which, absent continuing contacts, is not a constitutional nexus justifying income taxation of undistributed income earned in 1979-80.”¹⁰¹

Based on *Pennoyer*,¹⁰² a state cannot tax a trustee based solely on historical contacts technically established through transfer of property by a resident to a nonresident.¹⁰³ The trust must actually be created and administered under New Jersey law and must continue to receive significant benefits under New Jersey law. Compare this holding with *District of Columbia v. Chase Manhattan Bank*, which upheld *in personam* jurisdiction over the trustee when the resident decedent’s will did not designate

⁹⁸ The court’s opinion noted that the United States Supreme Court had not addressed the issue of taxability of a trust on undistributed trust income. *Id.* at 393. But see *supra*, Note 89.

⁹⁹*Id.* at 393. The court discusses *Guaranty Trust Co. v. Virginia*, 305 U.S. 19 (1938); *Safe-Deposit & Trust Co. v. Virginia*, 280 U.S. 83 (1929); *Bayfield County v. Pishon*, 156 N.W. 463 (Wis. 1916); and *Taylor v. State Tax Comm’n*, 445 N.Y.S.2d 648 (N.Y. App. Div. 1981).

¹⁰⁰ *In rem* jurisdiction. However, trust property was held in New York by the New York trustees. *Pennoyer*, 5 N.J. Tax at 397.

¹⁰¹ Lack of *in personam* jurisdiction over the trustee. *Id.* at 397 - 398. “Since the trust in not administered in New Jersey and the trustee, trust assets and beneficiaries are not located in New Jersey, the only contact between this trust and New Jersey is the fact that the grantor was domiciled here, letters were issued here, the trustee is amenable to service of process here, and the courts are available to resolve disputes relating to the trust.” [Emphasis added.]

¹⁰² *Supra*, Note 92.

¹⁰³ Again, a state’s statute of wills merely controls effectiveness of the transfer of a decedent/resident’s property into the trust. If the will designates a foreign trustee, foreign administration, and foreign applicable law, such foreign law establishes and controls the fiduciary relationship. See *supra*, Note 44. If New Jersey law provided for a lifetime transfer of a resident’s personal property to an out of state transferee, such transferee, whether a trustee or otherwise, does not become subject to *in personam* jurisdiction in New Jersey, nor does New Jersey have *in rem* jurisdiction because of the transfer.

foreign applicable law or foreign administration. D.C. law and D.C. administration applied to the nonresident trustee's trust relationship in the absence of such a designation.¹⁰⁴

Thus, in *Mercantile, Pennoyer, and Potter*,¹⁰⁵ state courts in New York and New Jersey had ruled that domicile of a trust's settlor, standing alone, was an insufficient basis for a state to have *in personam* jurisdiction over a nonresident trustee or in *rem* jurisdiction over all trust assets. In *Mercantile*, the added presence of the trust's sole beneficiary failed to establish *in personam* jurisdiction over a nonresident trustee when trust property,¹⁰⁶ applicable trust law, and trust administration were all elsewhere. It was clear from this line of cases that domicile of the settlor and of the beneficiary was not sufficiently related to production of trust income or to contacts of the trustee to permit taxation of the nonresident trustee and property. In *Pennoyer*, it was held that mere probate of a resident's will did not create *in personam* or *in rem* jurisdiction in decedent's state of residence.

¹⁰⁴ *Infra*, Note 147, et. seq. and accompanying text. In *Potter v. Taxation Division Director*, 5 N.J. Tax 399 (N.J. Tax Ct. 1983), a New Jersey resident created an *inter vivos* trust. The trust instrument designated New York law to govern trust administration. All trust assets and trustees were located outside New Jersey. The trust was designed as a "pour-over" trust, which would receive assets as a beneficiary under the settlor's will. Although New Jersey law applied to effectiveness of the will's transfer of property to the trust, New York law applied to the trust relationship itself. Following the settlor's death, New Jersey claimed it had sufficient contacts to impose a tax on the New York trustee based on the fact that the settlor was domiciled in New Jersey at the time of the trust's creation and at the time of the settlor's death. The court held that the contacts between New Jersey and the *inter vivos* trust were even less than those argued in *Pennoyer*. Indeed, the existing pour-over trust, previously established as an *inter vivos* trust and not as a testamentary trust funded through New Jersey probate, was no different than any other beneficiary under decedent's will. The *Potter* court relied on the reasoning of *Pennoyer* in disallowing the tax. Again, this opinion is distinguished from *District of Columbia v Chase* (See *infra*, Note 143) in which resident state law applied to the trust. The distinction between *inter vivos* and testamentary trusts should be irrelevant.

¹⁰⁵ See *supra*, Notes 89, 92, and 104.

¹⁰⁶ Presence of trust property should only be relevant as to *in rem* jurisdiction over such property and income therefrom. Location of property is irrelevant in establishing *in personam* jurisdiction over its owner, whether the owner is considered to be the trustee or the "trust" as an abstract relationship.

In, *Swift v. Director of Revenue*,¹⁰⁷ Missouri courts considered what more was required than settlor/decedent's domicile. Missouri sought to impose a tax on testamentary trusts created by will of a Missouri resident. The trustees, trust property, beneficiaries, and the trust administration were all outside Missouri.

The court held that the trusts¹⁰⁸ were not afforded any protection or benefit under Missouri law that constituted sufficient nexus to uphold the tax. The tax levy failed the Due Process test of the Fourteenth Amendment.¹⁰⁹ The *Swift* court's holding follows the holdings in *Mercantile, Pennoyer, Potter, and Taylor*.¹¹⁰ However, the opinion then suggested "relevant" factors to be used to guide the decision-making process in the future. The court considered the following six factors to be relevant in determining whether a sufficient nexus existed to support general *in personam* jurisdiction over the trustee as a Missouri resident¹¹¹:

(1) [T]he domicile of the settlor, (2) the state in which the trust is created, i.e. applicable state law, (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. For purposes of supporting an income tax, the first two of these factors require the ongoing protection or benefit of state law only to the extent that one or more of the other four factors is present.¹¹²

¹⁰⁷ *Swift v. Director of Revenue*, 727 S.W.2d 880 (Mo. 1987) (en banc).

¹⁰⁸ Again, the issue should be whether the nonresident trustee knowingly directed its activities at Missouri, e.g. knowingly became trustee of a trust relationship established and administered under Missouri law.

¹⁰⁹ *Id.*

¹¹⁰ Respectively, *supra* Notes 83 through 106, and *infra* Note 204.

¹¹¹ Residency solely as to the trust relationship at issue. Even as a nonresident, the trustee would be taxed on income from property in Missouri as Missouri source income.

¹¹² *Id.* at 882.

However, it is the thesis of this article that some of these factors are relevant and some are not. Contact number 3, the location of trust property, applies only to the questions of *in rem* jurisdiction on a property by property analysis. Contact number 2 (law governing trust creation and operation), 5 (domicile of trustee), and 6 (location of trust administration) are the only factors relevant to the issue of *in personam* jurisdiction over the trustee. Contacts 1 (settlor domicile) and 2 (beneficiary domicile) are only relevant as to a state's taxation of the settlor or the beneficiary.¹¹³

The *Swift* rationale and pronouncement of relevant factors to provide guidelines for the essential “more” for *in personam* jurisdiction has become widely accepted.¹¹⁴ Nevertheless, this article suggests that its listed factors should not have included residence of the settlor or the beneficiary.

The issue in *Westfall v. Director of Revenue*¹¹⁵ was whether a tax may be imposed on all of a resident trust's income when only part of the income was produced from property actually located in the state.¹¹⁶ The settlor was domiciled in Missouri at the time of his death, his will was admitted to probate in Missouri,¹¹⁷ and the trust was subject to

¹¹³ See *supra*, Note 98.

¹¹⁴ Bradley E.S. Fogel, *What Have You Done For Me Lately*, 32 URMDLR 165, at 206 M. Read Moore, Amy L. Silliman, *State Income Taxation of Trust: New Case Creates Uncertainty*, 24 Est. Pln. 200 (June, 1997).

¹¹⁵ *Westfall v. Director of Revenue*, 804 S.W.2d 27 (Mo. Ct. App. 1990), *aff'd*, 812 S.W.2d 513 (Mo. 1991).

¹¹⁶ *Id.* at 28. Also see *infra Taylor*, Note 204.

¹¹⁷ Wills are always admitted to probate in the state of decedent's domicile. Again, probate merely effects the transfer of property into the trust, but, if the decedent so directs, the trust can be created under the laws of a different state. Probate does not equate to trust creation. A trust is created under applicable laws designated by its Settlor and in the absence of designation, domicile state laws apply.

Missouri law and administration.¹¹⁸ No income was distributed to Missouri residents, no trustees were residents of Missouri, and no legal proceedings took place in Missouri on behalf of the trustee or the beneficiaries.¹¹⁹

Under the Missouri statute, the entire income of the trustee could be taxed, and credits were available to resident trustees for taxes paid to other states.¹²⁰ No credit was given, however, because the trustee did not pay tax to any other state.¹²¹ The court looked to the six factors stated in *Swift* to determine the validity of the tax.¹²² The trustee tried to distinguish *Swift*, but the court, based on Missouri contacts, held the tax valid.¹²³ *Westfall* is consistent with and follows *Mercantile, Pennoyer, Potter, Taylor* and *Swift*.

Again, this article's thesis is in full accord with the result, but not the full rationale, of *Swift*¹²⁴. Location of property in a state clearly establishes *in rem* jurisdiction over the income derived from such property. Location of property has little or nothing to do with *in personam* jurisdiction over the trustee, however. As in *Chase*¹²⁵, the trust relationship, by default, was created under Missouri law and administered in

¹¹⁸ *Id.* Note that the last two factors could have been changed if the trust instrument had designated applicable law of a different state and a different location for trust administration. See *infra*, Note 143 *re Chase*.

¹¹⁹ *Id.* at 28-29.

¹²⁰ *Id.* at 29. The tax credit would have avoided double taxation and resulted in proper allocation of the tax burden, as required by the Commerce Clause. See *infra*, Note 195.

¹²¹ *Id.*

¹²² *Id.* at 29-30. See *Swift v. Director of Revenue*, 727 S.W.2d 880, 882 (Mo. 1987) (en banc). *Swift* is discussed *supra* at Notes 96 through 101 and accompanying text.

¹²³ *Westfall*, 804 S.W.2d at 30.

¹²⁴ *Supra*, Note 96.

¹²⁵ *Infra*, Note 147.

Missouri. Therefore, the trustee knowingly accepted its obligations under and subject to Missouri law.

In *Blue v. Department of Treasury*¹²⁶, a Michigan resident created a revocable *inter vivos* trust.¹²⁷ The trustee was a Florida resident, the trust was formed and administered under Florida law, and the trust assets were located in Florida, except for one piece of real estate, which was located in Michigan.¹²⁸ The Michigan real estate did not produce income. The income beneficiary was a Florida resident. Since the settlor was a resident of Michigan, Michigan's "founder" trustee rules treated the trust as a Michigan resident based solely on domicile of the settlor. Michigan assessed taxes on income from trust property accumulated by the trust between 1982 and 1987.

The trial court held the tax invalid under the Due Process Clause.¹²⁹ On appeal, the Michigan Department of Treasury claimed that sufficient nexus existed to support taxation because the trust received the protection and benefits of Michigan laws.¹³⁰ The Michigan Court of Appeals, in disallowing the tax, stated:

The state cannot create hypothetical legal protections through a classification scheme whose validity is constitutionally suspect and attempt to support the constitutionality of the statute by these hypothetical legal protections. 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 earn their

¹²⁶ *Blue v. Dep't of Treasury*, 462 N.W.2d 762 (Mich. Ct. App. 1990).

¹²⁷ *Id.* at 763.

¹²⁸ *Id.*

¹²⁹ *Id.*

¹³⁰ *Id.* at 764. Note that the Settlor received the benefits of Michigan law, but not the trustee.

income. We believe this would be clearly outside of the state's power to impose taxes.¹³¹

The court followed *Swift* and *Mercantile-Safe Deposit* in holding the tax invalid under the Due Process Clause.¹³²

Blue clearly supports the thesis of this article. The Michigan property was clearly subject to the *in rem* jurisdiction of the State of Michigan. The property produced no income, however, and its presence established no basis whatsoever for *in personam* jurisdiction over the Florida trustee. The trust relationship, knowingly accepted by the Florida trustee, was created and administered under Florida law.¹³³

IV. Summary of Pre-Quill Precedent

Certain broad pre-Quill principles were clear. States could tax their own residents on their worldwide income.¹³⁴ Just as clearly, states could not impose taxes, i.e. lacked *in rem* or general *in personam* jurisdiction on income or persons beyond their borders, but could tax income sourced from property within the taxing state. However, as usual, the devil is in the details.

¹³¹ *Id.* at 764-65. [Emphasis added] The suspect classification scheme was the treatment of a "Founder Trust", i.e., a trust created by a Michigan resident, as a "resident trust" taxable in Michigan on its worldwide income. The same scheme was present in New York law (See *supra*, Note 83) and was also held unconstitutional.

¹³² *Id.* at 764.

¹³³ One author argues that *Blue* and *Westfall* are "inconsistent" because *Blue*, too, technically meets the first three *Swift* factors. The major distinction that can be made of *Blue* is that the Michigan property of the trust was non-income producing. The *Blue* court was fair in its decision and justified in using the strong language quoted, *supra*, to admonish states for finding "hypothetical legal protections" and "constitutionally suspect" classifications for imposing a tax. *Blue*, 462 N.W.2d at 762.

¹³⁴ See *supra*, Note 70; also *Cook v. Tait*, at 265 U.S. 47, 55 (1924) (stating, "the native citizen who is taxed may have domicile, and the property from which his income is derived may have situs, in a foreign country and the tax be legal-- the government having power to impose the tax").

In *Mercantile*, *Blue*, *Pennoyer* and *Potter*,¹³⁵ New York, Missouri, and New Jersey all held that mere residency of a settlor, i.e., a Founder Trust, was an insufficient basis for a state to impose general *in personam* jurisdiction over and tax a nonresident, *inter vivos* trustee.¹³⁶ In *Mercantile*, the residency of the income beneficiary in New York, in addition to the Settlor's residency failed to uphold New York's attempt to tax the out-of-state trustee on undistributed trust income held for the benefit of New York residents.¹³⁷

The rulings in *Pennoyer*, *Mercantile*, *Swift*, *Blue*, *Westfall*, *Taylor* and *Potter* are well-established and well-reasoned. First, they appropriately reflect the legal distinction between the trustee and the settlor and/or beneficiaries as separate legal persons. Standing alone, residence of the settlor was clearly found to provide insufficient nexus for taxation of a nonresident trustee.¹³⁸

The state of the settlor's domicile could, under various theories, tax the resident settlor on trust income. Grantor trust rules¹³⁹ are a clear example of income tax theories under which a resident settlor can be taxed on a foreign trust's accumulated income. But

¹³⁵ *Chase Manhattan Bank v. Gavin*, 733 A.2d 782 (Conn. 1999), refused to follow these cases.

¹³⁶ The nexus was insufficient to treat the *inter vivos* trustee as a "resident." As a nonresident, the trustee could still be taxed on income sourced within the state or as the result of the trustee being subject to general *in personam* jurisdiction.

¹³⁷ Distributed income could, of course, have been taxed by New York to its resident income beneficiary. Even income initially accumulated within the trust could have been taxed by New York to its resident beneficiary when ultimately distributed. *See, e.g., McCulloch v. Franchise Tax Bd.*, 390 P.2d 412, 414-15 (Cal. 1964).

¹³⁸ *See* Bernard E. Jacob, *An Extended Presence, Interstate Style: First Notes on a Theme from Saenz*, 30 HOFSTRA L. REV. 1133 (2002), for a critical scholarly analysis of "Founder-State Trusts."

¹³⁹ I.R.C. §§ 671-679 (West 2002). In particular, see § 679, which applies grantor trust rules to foreign (non-U.S.) trusts with U.S. beneficiaries.

residence of the settlor will not provide nexus to allow taxation of a nonresident trustee or claim the trustee is a resident of the taxing state.

Likewise, domicile of a trust's beneficiary clearly establishes a state's nexus to tax the beneficiary but provides no basis whatsoever for taxation of the legally distinct trustee. Beneficiaries can, of course, be taxed upon distributed income or even on accumulated trust income when distributed at a future date.¹⁴⁰ Taxation of the beneficiary on accumulated trust income before ultimate distribution would be more an issue of realization than of nexus.¹⁴¹

Mere domicile of the settlor and/or the beneficiary should provide no nexus for treating the trustee as a resident or subject to *in personam* jurisdiction as to the trust relationship. Obviously, the trustee is a legal person separate and distinct from the settlor and/or beneficiary. The trustee must have created nexus through its own contacts directed at the taxing state.¹⁴² A resident settlor's establishment of a foreign *inter vivos* trust, *i.e.*, applicable foreign law, foreign administration, and foreign trustee, provides no nexus between the foreign trustee and settlor's state of residence.¹⁴³ Establishment of a similar foreign¹⁴⁴ testamentary trust also provides no nexus with the foreign trustee.

¹⁴⁰ See discussion of *Simmon*, *supra* Note 73, and accompanying text. See also, discussion of *McCulloch v. Franchise Tax Bd.*, 390 P.2d 412 (Cal. 1964), *infra* Part IX and federal throwback rules, discussed *infra*, Note 246

¹⁴¹ See *infra*, Note 78 and accompanying text.

¹⁴² The fiduciary must itself have directed relevant activities at the taxing state as required by *Quill*. See *infra*, 160 and 185.

¹⁴³ In *D.C. v Chase*, *infra* Note 147, D.C. law and D.C. administration were, by default, applicable law to the trust, even though trustee, trust assets and beneficiaries were outside of D.C.

¹⁴⁴ The term "Foreign" meaning applicable foreign law, foreign administration, and a foreign trustee.

Relevant factors affecting *in personam* jurisdiction over the trustee as to the trust relationship include only: (1) the trust relationship is governed by state law¹⁴⁵; (2) a trustee lives in the state; or (3) the trust is administered in the state.¹⁴⁶ Situs of property is only relevant as to *in rem* jurisdiction and is not relevant to establish *in personam* jurisdiction over the trustee. Residency of the settlor or beneficiary is not relevant factors.

In *District of Columbia v. Chase Manhattan Bank*,¹⁴⁷ a post-*Quill* case, a D.C. tax on a foreign trustee was upheld. The trust relationship was established by the will of a resident of D.C., subject to D.C. law, and administered in D.C.¹⁴⁸ The opinion noted that a trust “created” under D.C. law and with D.C. administration, much like a domestic corporation, was a creature of the law of its state of organization.¹⁴⁹

¹⁴⁵ In *Swift*, this factor is confusingly described as “the state in which the trust is created.” This terminology confuses the issue of probate and compliance with a state’s statute of wills [wholly irrelevant factors] on one hand, and the law which governs establishment and operation of the trust relationship on the other.

¹⁴⁶ IDAHO ADMIN. CODE 35.1.1.35 (2003). See *Income Taxation of Trust Income: Idaho Law, Practical Drafting* 6618-6619 (October, 2001).

¹⁴⁷ *District of Columbia v. Chase Manhattan Bank*, 689 A.2d 539 (D.C. 1997).

¹⁴⁸ Professor Roger John Traynor had predicted taxation of testamentary trusts on this basis many years ago in his classic article on trust taxation. See Roger John Traynor, *State Taxation of Trust Income*, 22 IOWA L. REV. 268 (1937) (discussed *infra* Part VIII).

¹⁴⁹ *Chase Manhattan Bank*, 689 A.2d at 544. The will did not designate foreign applicable law or foreign administration, so, by default, D.C. law applied. See *supra*, Note 44. The opinion refused to extend its holding to an *inter vivos* trust established by a D.C. resident as follows:

We express no opinion as to the constitutionality of taxing the entire net income of *inter vivos* trusts based solely on the fact that the settlor was domiciled in the District when she died and the trust therefore became irrevocable. In such cases, the nexus between the trust and the District is arguably more attenuated, since the trust was not created by probate of the decedent's will in the District's courts. An irrevocable *inter vivos* trust does not owe its existence to the laws and courts of the District in the same way that the testamentary trust at issue in the present case does, and thus it does not have the same permanent tie to the District. In some cases the District courts may not even have principle supervisory authority over such an *inter vivos* trust. The idea of fundamental fairness, which under girds our due process analysis, therefore may or may not compel a different result in an *inter vivos* trust context. (Emphasis added). Everything the court stated

The *Chase* opinion's finding of sufficient nexus was based on the specific facts of that case. Despite dictum¹⁵⁰, nexus was not based on mere residency of the decedent in the District. Neither was nexus founded on mere probate of decedent's will in the District. Nexus was based on the trust relationship being administered in the District under District laws. Decedent had not designated administration or laws of another jurisdiction. The foreign trustee accepted its duties subject to such conditions.

Other than the unprecedented holding in *Gavin*, none of these cases found due process nexus based solely on the residence of the settlor and/or beneficiary in the taxing state.

V. **Quill Corp. v. North Dakota**¹⁵¹

Quill Corporation conducted a mail order business throughout the United States. Although Quill was not a resident of North Dakota and had no physical presence in the state, *i.e.*, no warehouse, office, etc., it did make catalogue sales of products into North Dakota.¹⁵² The United States Supreme Court addressed the validity of the North Dakota use tax on a nonresident under both the Due Process Clause and the Commerce Clause of the U. S. Constitution.¹⁵³

as to an *inter vivos* trust is equally applicable to a testamentary trust when the will designates foreign law and foreign administration.

Id. at 547 n.11. Again, in the "present case" the will failed to invoke foreign law or foreign administration.

¹⁵⁰ *Id.*

¹⁵¹ See *supra*, Note 1.

¹⁵² *Id.* at 302.

¹⁵³ *Id.* at 305.

In addressing North Dakota’s ability to tax Quill’s North Dakota activities¹⁵⁴ within due process limits, the Court noted that the Due Process Clause required: (1) “some definite link, some minimum connection, between a state and a person, property or transaction it seeks to tax,”¹⁵⁵ and (2) “that the income attributed to the State for tax purposes must be rationally related to values connected with the taxing State.”¹⁵⁶ The North Dakota tax being levied in this case was a use tax. Relying on *International Shoe Company v. Washington*¹⁵⁷ and its progeny, the Court stated, “we have framed the relevant inquiry as whether a defendant had minimum contacts with the jurisdiction ‘such that the maintenance of the suit does not offend traditional notions of fair play and substantial justice.’”¹⁵⁸

The Court continued its analysis and held that due process could be satisfied even if a taxpayer had no physical presence within the taxing state.¹⁵⁹ Regarding the imposition of a sales/use tax, the Court held that such reasoning “justifies the imposition of the collection duty on a mail order house that is engaged in continuous and widespread solicitation of business within a state. Such a corporation clearly has ‘fair warning that

¹⁵⁴ North Dakota never attempted to tax Quill as a “resident.”

¹⁵⁵ *Id.* (quoting *Miller Bros. Co. v. Md.*, 347 U.S. 340, 344-45 (1954)).

¹⁵⁶ *Id.* (quoting *Moorman Mfg. Co. v. Blair*, 437 U.S. 267 (1978)). Quill was clearly being taxed as a nonresident. The North Dakota tax would only be imposed on Quill’s North Dakota sales. Quill would not be subject as a resident taxpayer to general taxation by North Dakota on all its sales. *Id.* at 303.

¹⁵⁷ *Int’l Shoe Co. v. Wash.*, 326 U.S. 310 (1945).

¹⁵⁸ *Quill*, 504 U.S. at 307 (citations omitted).

¹⁵⁹ *Id.* at 308.

[its] activity may subject [it] to the jurisdiction of a foreign sovereign.”¹⁶⁰ Thus, North Dakota’s sales/use tax levy was held to satisfy the Court’s due process standard.

Analysis of the negative sweep of the Commerce Clause, *i.e.*, those aspects of state activity prohibited because they may unduly interfere with interstate commerce, ultimately led to a determination that the sales/use tax could not be imposed by North Dakota. The Court analyzed the negative impact of state taxation on interstate commerce. The Court then noted that it had “adopted a ‘multiple-taxation doctrine’ that focused not on whether a tax was ‘direct’ or ‘indirect,’ but rather on whether a tax subjected interstate commerce to “*a risk of multiple taxation.*”¹⁶¹

The Court ultimately held that it would apply the four-part test which it first established in *Complete Auto Transit, Inc. v. Brady*¹⁶² to the Commerce Clause question.¹⁶³ The Court stated that “under *Complete Auto*’s four-part test we will sustain a tax against a Commerce Clause challenge so long as the ‘tax [1] is applied to an activity with a substantial nexus with the taxing State, [2] is fairly apportioned, [3] does not discriminate against interstate commerce, and [4] is fairly related to the services provided by the State.”¹⁶⁴

Again, this test was being applied to the allocable, *i.e.* North Dakota source, sales of a nonresident. Neither *Complete Auto* nor *Quill* dealt with classification and taxation

¹⁶⁰ *Id.* (alterations in original), quoting *Shaffer v. Heitner*, 433 U.S. 186, 218 (1977) discussed *infra* at Note 218, et seq. and accompanying text.

¹⁶¹ *Id.* at 309 (emphasis added).

¹⁶² *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977).

¹⁶³ *Quill*, 504 U.S. at 310.

¹⁶⁴ *Id.* at 311 (citation omitted) [emphasis added].

of a resident on its worldwide income. Even if state law denominates or classifies a trust as being a “resident trust”, imposition of a tax on the trustee must not violate due process or the commerce clause of the U.S. Constitution.¹⁶⁵

At least in the context of sales/use taxes and the mail order business, the Court reaffirmed the continued applicability of the bright line presence test set forth in *National Bellas Hess, Inc. v. Department of Revenue*¹⁶⁶ as applied to factor [1] of *Complete Auto*’s four-part Commerce Clause test.¹⁶⁷ The Court was also emphatic that the due process “minimum contacts” test required much less than the “substantial nexus” test of the Commerce Clause, stating, “[a] tax may be consistent with due process and yet unduly burden interstate commerce.”¹⁶⁸ The Court held that the first and fourth prongs of the *Complete Auto* test “require a substantial nexus and a relationship between the tax and state-provided services,” to ensure that state taxation does not unduly burden interstate commerce.¹⁶⁹

VI. Are State Benefits Afforded a Beneficiary Attributable to a Nonresident Trustee for Due Process Purposes?

A. *Gavin*

¹⁶⁵ See *supra*, Note 135 and *Blue* re “constitutionally suspect classifications”.

¹⁶⁶ *Nat’l Bellas Hess, Inc. v. Dep’t of Revenue*, 386 U.S. 753 (1967).

¹⁶⁷ *Quill*, 504 U.S. at 317 (stating, “the continuing value of a bright-line rule in this area and the doctrine and principles of *stare decisis* indicate that the *Bellas Hess* rule remains good law”). The *Bellas Hess* test remains good, at least as applied to state sales and use taxes and the mail order business, but the Supreme Court also stated that “the bright-line rule of *Bellas Hess* furthers the ends of the dormant Commerce Clause.” *Id.* at 314.

¹⁶⁸ *Id.* at 313 n.7.

¹⁶⁹ The [p]urpose of the Commerce Clause is to insure a national economy free from unjustifiable local entanglement. . .” *National Bellas Hess, supra*, Note 166. Realize that the first and fourth prongs of this test address the same two issues as due process analysis, i.e. (1) sufficiency of nexus, and (2) relationship between state tax and state benefits provided. See *supra*, Note 156.

The facts of *Gavin* were summarized in the Introduction to this article. Connecticut taxed a New York trustee based on claimed in *personam* jurisdiction as to the trust relationship. The trustee had no Connecticut contacts, trust property was in New York, trust administration was in New York, and New York law governed the creation and enforcement of the trust relationship.¹⁷⁰

The *Gavin* opinion justified its taxation of the foreign trustee of the single *inter vivos* trust by citing benefits Connecticut law provided to the trust's Connecticut beneficiary.¹⁷¹ Based on this analysis, Connecticut would tax, and claim compliance with due process, any estate or trust, whether testamentary or *inter vivos*,¹⁷² established by even a nonresident settlor, if such estate or trust had a Connecticut beneficiary.¹⁷³ The following benefits to the *Gavin* beneficiary cited by the opinion would apply equally to a Connecticut beneficiary of any nonresident estate or trust, whether or not established by a Connecticut settlor:

In the present case, the *critical link* to the undistributed income sought to be taxed is the fact that *the non-contingent beneficiary* of the *inter vivos* trust during the tax year in question *was a Connecticut domiciliary*. The accumulated income eventually will be paid . . . to her . . . [or] to her then living descendants. Thus . . . *she enjoyed* all the protections and benefits afforded to other domiciliaries. *Her right* to the eventual receipt and enjoyment of the accumulated income was . . . protected by the laws of the

¹⁷⁰ See *supra*, Note 9

¹⁷¹ *Id.* at 803. Minimum contacts were deemed satisfied by “the presence in the state of a noncontingent beneficiary who receives the benefits and protections of the state's laws.”

¹⁷² Regarding *inter vivos* trusts, the *Gavin* court stated “[a]lthough this is a closer case than that with respect to the testamentary trusts, we conclude that the state's taxation scheme of the undistributed income of the *inter vivos* trust satisfies the due process clause.”

¹⁷³ Although the settlor in *Gavin* was a Connecticut resident when the *inter vivos* trust was established, that was not, and could not have been, the basis for finding minimum contacts for due process purposes. See *infra*, Note 174.

state. We conclude that . . . a state may . . . tax the income of an *inter vivos* trust that is *accumulated for the ultimate benefit of a non-contingent domiciliary*...¹⁷⁴

Connecticut law benefited its resident beneficiary. If the beneficiary's noncontingent status satisfied the "realization" requirement for "income," Connecticut could clearly tax its beneficiary.¹⁷⁵ The Gavin opinion, however, improperly attributed such benefits to the New York trustee for purposes of due process. Again, the New York trustee had no contacts with Connecticut and derived no benefits from Connecticut law.¹⁷⁶ Once this attribution from beneficiary to trustee is allowed to occur, there is the potential for endless reattribution of state law benefits, *i.e.*, why stop with mere single attribution? This rationale would and did turn due process on its head in the context of Gavin: "Where there is jurisdiction neither as to person nor property, the imposition of a tax would be *ultra vires* and void."¹⁷⁷

Could shareholder domicile states tax nonresident corporations that have no business or other contact with such state, or vice versa, as a result of attribution of state law benefits from a resident shareholder to such corporation? We know the answer to this rhetorical question—it is clearly No!¹⁷⁸

¹⁷⁴ *Id.* at 802 (emphasis added). See discussion *infra*, Note 218.

¹⁷⁵ See discussion of *Simmon* and *Glenshaw Glass*, *supra*, Note 73.

¹⁷⁶ See *supra*, Notes 9 - 13 and accompanying text.

¹⁷⁷ *Miller Bros. Co. v. State of Maryland*, 347 U.S. 340, 341 citing *City of St. Louis v. Wiggins Family Co.*, II Wall. 42S430.

¹⁷⁸ See *infra*, Note 180.

In *Canon Manufacturing Co. v. Cudahy Packing Co.*,¹⁷⁹ the Supreme Court first held that corporate contacts cannot be attributed to shareholders of the corporation and vice versa.¹⁸⁰ This principle has clearly been extended to a limited partnership and attribution of its contacts to limited partners.¹⁸¹ If general partners are agents acting on behalf of their partnership, contacts of the general partner can be attributed to the partnership. This is solely because the partner's actions as agent are actions of the partnership.¹⁸² However, beneficiaries, as such, are not agents of the trustee. Clearly, the beneficiary and the trustee are distinct legal persons.¹⁸³

In *Quill*, the Supreme Court looked to the Taxpayer's direct contacts with, and benefits derived from, North Dakota. Indirect benefits of North Dakota law to Quill's North Dakota customers or vendors which might be attributed to Quill were not even analyzed by the Court¹⁸⁴. To establish "minimum contacts" for due process, the Supreme Court noted that "*Quill*" itself had mailed 24 tons of sales catalogs into the state and had itself made sales there of approximately \$1 million. As a result, *Quill* itself was found to have "purposefully directed its activities at North Dakota..."¹⁸⁵ *Quill* was not and could

¹⁷⁹ *Cannon Mfg. Co. v. Cudahy Packing Co.*, 267 U.S. 333 (1925).

¹⁸⁰ A subsidiary corporation's operations in North Carolina failed to establish due process nexus between North Carolina and the subsidiaries' parent corporation, i.e. its shareholder. Separateness of the subsidiary was not a "pure fiction" and was respected. *Id.* at 337.

¹⁸¹ *Sher v. Johnson*, 911 F.2d 1357 (9th Cir. 1990).

¹⁸² *Id.* at 1366. For a well-reasoned analysis of the fallacies of nexus attribution, see Lowery and Vasquez, "When Is It Unconstitutional For States To Tax Nonresident Members of Limited Liability Companies?" *State Tax Notes*, May 19, 2003, at 633.

¹⁸³ See *supra*, Notes 28, et. seq. and accompanying text.

¹⁸⁴ See *infra*, Note 186.

¹⁸⁵ *Quill*, 504 U.S. at 308.

not be subjected to tax merely because North Dakota law applied to and benefited *Quill*'s customers or vendors and thereby indirectly benefited *Quill*. Such state benefits were not and could not be attributed to *Quill*.¹⁸⁶

B. *Gavin*'s Treatment of Trust Relationships as Forever Establishing Tax Jurisdiction Over the Trustee when Trustees, Trust Property, Trust Administration, and Applicable Trust Law were all Outside of Connecticut.

State taxation of a trustee, whether the trust relationship was testamentary or *inter vivos*, must pass both the due process and commerce clause requirements established under *Quill*. Even if the settlor resided in the taxing state, tax policies which create a risk of multiple taxation nevertheless discriminate against interstate commerce and are unconstitutional.¹⁸⁷

The *Gavin* opinion clearly recognized that taxation of a trustee when the trust relationship was actually established, governed, and administered under the taxing state's applicable law was easily justified.¹⁸⁸

Taxation of the trustee of an *inter vivos* trust relationship established, governed, and administered outside the taxing state under laws of a foreign jurisdiction can hardly be justified on the same principles however.¹⁸⁹ Likewise, testamentary trust relationships, like *inter vivos* trust relationships, can clearly be established, administered,

¹⁸⁶ *Quill*, citing *Bellas Hess*, focused on the taxpayer's direct contacts with its *North Dakota* customers, not the mere fact that taxpayer *had* customers in the state. *Id.* at 313. Indeed, the *North Dakota* Supreme Court relied on similar, *Gavin*-like, general economic benefits and economic climate provided by its laws, *Id.* at 304, but was reversed by the Supreme Court.

¹⁸⁷ See Part B.3. below.

¹⁸⁸ *Gavin*, at 200, citing *District of Columbia v. Chase Manhattan Bank*.

¹⁸⁹ See *supra*, Note 149.

and subject to laws of a foreign jurisdiction.¹⁹⁰ Such testamentary trust relationships have no more contact with the jurisdiction of the Decedent's domicile than a similar *inter vivos* trust relationship.¹⁹¹

VII. Gavin's Failed Commerce Clause Analysis

As stated in *Quill*¹⁹² and *Complete Auto*,¹⁹³ a state tax will be sustained under a Commerce Clause challenge¹⁹⁴ only so long as the tax (1) is applied to an activity with *substantial nexus* with the taxing state, (2) is fairly apportioned, (3) does not discriminate against interstate commerce, and (4) is fairly related to services provided by the state.¹⁹⁵

1. Substantial Nexus: Substantial nexus requires more than “minimum contacts”, “slightest presence”, or “minimal nexus” under due process.¹⁹⁶ In *Gavin*, out-of-state banks, as trustees, had to have “a substantial nexus” with Connecticut in order for Connecticut to levy an income tax on such out-of-state trustees¹⁹⁷. Yet, except in its due

¹⁹⁰ By default, i.e. by failure of the instrument to designate foreign law and foreign administration, District laws applied to the creation and administration of the trust in *Chase*. See Notes 147 and 149.

¹⁹¹ See *supra* Notes 40 - 46 and discussion of *Shaffer, infra*, Note 218. et seq.

¹⁹² See *supra* Notes 149 - 151 and accompanying text.

¹⁹³ See *supra* Note 139 and accompanying text.

¹⁹⁴ The Commerce Clause's negative sweep is the source of limitations on a state's power to tax interstate transactions. See *Quill*, 504 U.S. at 309 (stating, “[the Court’s] interpretation of the ‘negative’ or ‘dormant’ Commerce Clause has evolved substantially over the years, particularly as that Clause concerns limitations on state taxation powers”).

¹⁹⁵ *Id.* at 311 (citing *Complete Auto Transit, Inc.*, 430 U.S. at 279).

¹⁹⁶ *Id.* at 315 n.8.

¹⁹⁷ Only legal persons can have nexus, i.e. can direct their activities at the taxing state. Trusts are not legal persons. Trusts are merely abstract relationships between persons. See *supra*, Note 30 et. seq. and accompanying text.

process analysis, *Gavin* makes no analysis whatsoever as to sufficiency of the out-of-state bank's contacts as a trustee with the State of Connecticut. As previously discussed¹⁹⁸, the trustee's contacts with Connecticut even failed the minimal due process nexus requirement.

The *Gavin* opinion merely suggests that the out-of-state bank fails to address the four separate aspects of the Commerce Clause test.¹⁹⁹ The opinion itself merely addressed whether risk of multiple taxation would unconstitutionally impact selection of out-of-state trustees as contrasted with domestic trustees not subject to such risk?²⁰⁰

2. Fair Apportionment. Fair apportionment of the tax among states involved in the taxed activity is also required.²⁰¹ As stated by the dissent in *Gavin*, Connecticut's income tax is not apportioned at all.²⁰² There was no tax credit available from Connecticut for the trustees' taxes paid to New York.²⁰³ Apportionment requires a rational and measured fragmenting of the transaction or tax base so that each state taxes

¹⁹⁸ See *supra*, Notes 185 and 186.

¹⁹⁹ *Gavin*, 733 A.2d at 805.

²⁰⁰ See *infra*, Note 204.

²⁰¹ *Quill*, 504 U.S. at 311 (citing *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977)).

²⁰² *Gavin*, 733 A.2d at 808. The trusts were all treated as "resident" trusts under *Gavin*, and residents are taxed on all income without allocation. Connecticut did not even allow tax credits. *Id.* at 786.

²⁰³ *Id.* at 804. The trustee and trust property were in New York and New York law applied to trust administration. The *inter vivos* trust was formed under New York law. Also, see *supra*, Note 116 et. seq. and accompanying text.

only that part of the whole activity or base most closely related to such state.²⁰⁴ *Gavin* taxed all of the trustee's income, not merely some apportioned part.

Trust assets, administration, applicable laws, and trustees were all outside of Connecticut. Nevertheless, the trustee was treated as a "resident" in *Gavin*, i.e. taxed on all their income, irrespective of the source of such income.

Rational allocation has been attempted by many states in many ways. The "UDITPA" applies uniform allocation rules to all signatory states.²⁰⁵ Under the UDITPA there are different allocations for business and for non-business²⁰⁶ income. Sales of a business's assets are allocated in one fashion and sale of its stock is allocated in another.²⁰⁷ Also, states such as New York have their own unique allocation rules.²⁰⁸ Pass-through entities add another layer of complexity to the allocation confusion.

²⁰⁴ In *Taylor v. State Tax Commission*, 445 N.Y.S.2d 648 (N.Y. App. Div. 1981), a testamentary trust was created by the will of a decedent who died while residing in New York. The trust assets included real property in Florida. Since Florida law prohibited a foreign corporation from acting as trustee over Florida property, decedent's sons were appointed as trustees of the Florida property. The trust excluded capital gains from the Florida property when calculating its New York taxable income. The court held that neither New York laws nor New York services were of benefit to the Florida property. The court stated, "[t]he fact that the former owner of the property in question died while being domiciled in New York, making the trust a resident trust under New York tax law, is insufficient to establish a basis for jurisdiction". Thus, new York taxation of gain on the Florida property violated the Fourteenth Amendment to the U.S. Constitution.

²⁰⁵ Unif. Div. Of Income for Tax Purposes Act.

²⁰⁶ See, e.g., *Ex parte Uniroyal Tire Co.*, 779 So. 2d 227 (Ala. 2000); *Allied-Signal, Inc. v. Director*, 504 U.S. 768 (1992).

²⁰⁷ *Mobile Oil v. Comm'r of Taxes*, 455 U.S. 425 (1980).

²⁰⁸ See N.Y. Tax Law §§210.3 and §§208.9.

Overly broad²⁰⁹ trustee nexus and residency statutes are sometimes referred to conservatively as Founder State Trusts. Even if a trustee were a resident, the right of other states to tax income from sources within such other states must be recognized and adjustments made to avoid the risk of multiple tax burdens.²¹⁰

3. Discrimination Against Interstate Commerce The principle focus of the *Gavin* opinion's Commerce Clause analysis was whether or not a Connecticut "settlor would choose a Connecticut bank, over an out-of-state bank, as trustee *solely* because of the potential for future multiple taxation of some portion of the trust's future income."²¹¹ The appropriate test, however, was whether or not the "practical effect" of the Connecticut tax was to "discriminate against interstate commerce."²¹²

As noted, *supra*, the *Gavin* opinion stated, "although we agree that there are such incentives and risks, we conclude that they are too remote and speculative to constitute a dormant commerce clause violation."²¹³ The opinion found the speculative nature in the selection of a trustee from its belief that multiple and diverse factors²¹⁴ would be

²⁰⁹ "The Founder-State Trust is inconsistent with the relations of states of the American Union and with the reality, and realistic expectations, of the citizens of each state." Bernard E. Jacob, *An Extended Presence, Interstate Style: First Notes on a Theme from Saenz*, 30 HOFSTRA L. REV. 1133, 1240 (2002).

²¹⁰ See *infra*, Note 212..

²¹¹ *Gavin*, 733 A.2d at 806 (emphasis added).

²¹² *Quill Corp. v. N.D.*, 504 U.S. 298, 311 (1992).

²¹³ *Id.* at 805. See *infra*, Note 214 et. seq. and accompanying text.

²¹⁴ "The choice of bank as trustee is likely to be animated by many imponderables, among them: the prior experience of the testator or settlor; the financial performance of the various banks in the pool of available choices; the current location of the likely beneficiaries; the current location of the various banks in the pool; and, of course, the tax implication, if any. We simply are not sufficiently persuaded of the underlying validity of the plaintiff's assumption about how such a multifaceted decision as the choice of a trustee is likely to be made." *Id.* at 806.

considered by a Connecticut settlor before selecting a trustee. The Connecticut court found that its tax imposed on a foreign trustee would indeed subject the trust income to the risk of multiple taxation,²¹⁵ a risk not shared by the domestic trustees. Thus, even if a state tax created an undue burden on interstate commerce, the *Gavin* opinion would not find a Commerce Clause violation unless it could determine the precise role such tax played in commercial decisions of consumers of interstate products and services. Indeed, the opinion stated that the adverse impact of the multiple taxes must be the “sole”²¹⁶ determinative factor on economic decisions affecting interstate commerce. In summary, as well-stated by one commentator:

“[I]f a state elects to attempt to tax income from trusts having contacts on which the Connecticut Supreme Court supported its tax ...there are strong arguments to support a challenge to the enforceability of such tax.”²¹⁷

4. Relation to State Benefits Provided. *Shaffer v. Heitner*²¹⁸ was decided by the Supreme Court in the same time frame as it decided *Complete Auto*.²¹⁹ In *Shaffer*, the Supreme Court analyzed personal jurisdiction under the *International Shoe*²²⁰ due process standard.²²¹ As part of the application of this standard, the Supreme Court also analyzed whether the minimum contacts of a party were related to the subject matter at issue. In

²¹⁵ “[B]ecause the property of all of these trusts consisted only of cash and securities in the tax year in question, no credit would have been available to them under the current tax scheme.” *Id.* at 804.

²¹⁶ See *supra*, Note 211.

²¹⁷ Guitierrez, Jr., *The State Income Taxation of Multi-Jurisdictional Trusts*, 36 Univ. of Miami Institute on Estate Planning §1309.2 (2002).

²¹⁸ *Shaffer v. Heitner*, 433 U.S. 186 (June, 1977).

²¹⁹ See *supra*, Note 162.

²²⁰ See *supra*, Note 157.

²²¹ “Minimum contacts” such as do not offend traditional notions of “fair play and substantial justice”. See *supra*, Note 158 and *Shaffer*, 433 U.S., at 203 and 207.

essence, this became a second due process requirement. “[T]here is no necessary relationship between holding a position as a corporate fiduciary [subject of the litigation] and owning stock or other interest in the corporation [parties’ sole due process contact with Delaware].²²² The Supreme Court also directly rejected a state’s claim that benefits provided through application of state laws to an issue, necessarily gave the state jurisdiction over the parties associated with such issue.²²³ “The issue is personal jurisdiction, not choice of law. It is resolved in this case by considering the acts of the [appellants]”.²²⁴

(1) Minimum contacts, and (2) relation of such contact to the subject matter at issue, i.e. production of income or subject matter of litigation. In *Heitner*, parties had property in Delaware [thereby satisfying (1) above], but the property was not the subject matter of the litigation in which personal jurisdiction was sought [thereby, not satisfying (2) above].

The Appellee’s discredited argument in *Shaffer* was much the same as Connecticut’s in *Gavin*:

“[Appellee] notes that Delaware law provides substantial benefits to corporate officers and directors, and that . . . [it is] only fair and just to require Appellants, in return for these benefits to respond in the State of Delaware.”²²⁵

But the Court absolutely rejected this general “legal benefits” argument and stated “this line of reasoning . . . does not demonstrate that Appellants have ‘purposefully availed

²²² *Shaffer*, at 214.

²²³ *Id.*, at 215. “[W]e have rejected the argument that if a state’s law can properly be applied to a dispute, its courts necessarily have jurisdiction over the parties to that dispute.”

²²⁴ *Id.*, (citations omitted) [Emphasis added]. *Quill*, likewise, ignored general benefits derived from applicability of North Dakota law but focused instead on *Quill’s* own acts directed at North Dakota. See *supra*, Note 185.

²²⁵ *Id.*, at 215-216

themselves of the privilege of conducting activities within the forum state.’ *Hanson v. Dencla*, 357 U.S. 235, at 253.²²⁶

In *Complete Auto’s* four-part test for state taxation’s compliance with the Commerce clause, Steps One²²⁷ and Four essentially repeat this dual due process standard. Step One requires adequate nexus.²²⁸ Step Four requires the necessary relationship between state benefits provided and the subject of taxation.²²⁹

Gavin wrongly held that the Connecticut law benefits afforded the Connecticut beneficiary²³⁰ subjected the nonresident trustee to Connecticut jurisdiction for due process purposes. This analysis was squarely rejected by the Supreme Court in *Shaffer*²³¹, whether the relationship to state services provided test is applied in the due process context or as Step Four in the Commerce Clause analysis.²³²

²²⁶ *Id.*, at 216

²²⁷ See *supra*, Note 168.

²²⁸ Substantial v. Minimum Contacts. See *supra*, Note 196.

²²⁹ See *supra*, Note 156.

²³⁰ See *supra*, Note 173. Connecticut law did not benefit the earning of the income from trust property. Connecticut law merely protected the beneficiary’s receipt and enjoyment of income when distributed.

²³¹ See *Northwestern States Portland Cement Co. v Minnesota*, 358 U.S. 450, 464 – 465 (1959), (taxes are “levied only on the portion of the taxpayer’s net income which arises from its activities within the taxing state”).

²³²“Resident” Taxpayers: Internal Consistency, due process, and State Income Taxation, 91 Colum. L. Rev. 119, 141+ (1991)

VIII. The Importance of Roger John Traynor²³³ to the Analysis of both *McCulloch* and *Gavin*

Justice Roger John Traynor was among the most influential and highly esteemed jurists and legal scholars of the twentieth century.²³⁴ From 1928 to 1940, Professor Traynor served as tax advisor to the California Board of Equalization where he was responsible for complete reform of California's sales and use tax, personal income tax, and corporate franchise taxes. He took a leave of absence in 1937 to serve at the U.S. Treasury Department to help Treasury draft the Revenue Act of 1938. He served as associate justice of the California Supreme Court from 1940-1964, serving as Chief Justice from 1964-1970.

Among his prolific writings, Professor Traynor authored the classic insightful article, "State Taxation of Trust Income."²³⁵ As associate justice of the California Supreme Court, he was in the majority of the Supreme Court of California on its *McCulloch* opinion. Indeed, the special California statutes²³⁶ analyzed in *McCulloch*

²³³ Professor of Law, University of California, Advisor to the California State Board of Equalization. He "played an important role in drafting important [California] tax laws." National Tax Association Tax Conference, Indianapolis, Indiana, September 29, 1936 @ 157. . . .

²³⁴ In his writing and jurisprudence, he established national legal principles of product liability with strict liability; extension of strict product liability through the distribution chain; action for intentional infliction of emotional distress; "moderate and restrained" doctrine in conflict of laws; the fiduciary obligation owed by majority shareholders to minority shareholders; admission of custom and practice evidence in contract litigation; the "exclusionary rule" barring improperly obtained evidence; abolition of sovereign immunity; no fault divorce through elimination of defense of recrimination; abolishment of laws prohibiting miscegenation; and citation of law review articles in judicial decisions. See generally, "Roger John Traynor", Legal Encyclopedia, published by Thomson & Gale; West's Encyclopedia of American Law, The Gale Group, Inc. 1998. Answers.com 13 Mar 2006. <http://www.answers.com>. Also see Friendly, "Ablest Judge of His Generation," 71 Cal L R 1039-1044 (No. 4, July 1983); White, "Introduction" in The Traynor Reader: A Collection of Essays by the Honorable Roger J. Traynor, (San Francisco: The Hastings Law Journal, Hastings College of the Law, 1987)(<http://uchastings.edu/?pid=1408>)

²³⁵ Roger John Traynor, *State Taxation of Trust Income*, 22 IOWA L. REV. 268 (1937).

²³⁶ See *supra*, Notes 195 - 199 and accompanying text.

reflected in detail the views expressed by Professor Traynor in his early article dealing with state taxation of trustees, beneficiaries, and settlor/grantors.²³⁷

Traynor's article first analyzed settled law on state taxation of residents and nonresidents. He discussed a state's right to tax domestic trustees on all their accumulated income whether earned within or without its borders.²³⁸ He also acknowledged the right of a state to tax all income earned within its borders by nonresident trustees, thereby resulting in two states possibly taxing the same income.²³⁹ Likewise, he discussed the well-established right of a state to tax resident beneficiaries upon distributions of current income.

Traynor's article, however, then focused on how the complexity of trusts had created obstacles to a state's ability to tax accumulated trust income. Nonresident, complex trusts located in states selected for minimum taxation could and were being used to shelter income. Through accumulation of income by a nonresident trustee, the state of the beneficiary's residence could be prevented from taxing such income. *Simmon*²⁴⁰

²³⁷ Indeed, *McCulloch* cites Professor Traynor's article in FN9. '(W)hile the complexity of the trust itself and of the relations of the parties thereto complicates the problem of effective taxation, it should not obstruct the claims of a state to tax trust income, so far as possible, as it income is accorded of a trust. Trust income is accorded protection in its production, receipt and enjoyment to the same extent as other income; it measures in like manner ability to pay. It measures in like manner ability far as possible upon the same basis. If the obstacles interposed by the trust device are to be circumvented, jurisdiction to tax should be found wherever substantial claims to tax are reinforced by effective power to compel payment.' (Emphasis added.) Traynor, *State Taxation of Trust Income* (1937) 22 Iowa L. Rev. 268, 271- 272. Power to collect is an essential element of tax jurisdiction.

²³⁸ Traynor, *supra* Note 235.

²³⁹ *Id.* Former §17980, renumbered today as §18005, provides a credit for trustee taxes paid to its state of domicile, e.g. Missouri, against California taxes paid by the beneficiary on the same income. Though the *McCulloch* opinion doesn't mention availability of the credit, §18005 provides a credit to the beneficiary for taxes the trustee paid on the same income to Missouri, thereby properly minimizing taxation of the same income by two different states.

²⁴⁰ See *supra*, Note 73

clearly reflected how a subsequent distribution of previously accumulated trust income could also avoid taxation by the beneficiary's state of residence depending on a state's principal and income statutes applicable to trusts.

Professor Traynor's article explored ways in which such states could tax such accumulated income within the bounds of due process. Clearly Traynor felt and stated that a state's "jurisdiction to tax should be found wherever [1] substantial claims to tax are reinforced by [2] *effective power to compel payment*."²⁴¹ "Substantial claims to tax" refers to the state's due process nexus to the income. "Effective power to compel payment" refers to *in personam* jurisdiction over the taxpayer in order to compel his tax payment. "The power to tax is empty without the power to collect the tax; hence the power to collect is a necessary predicate to a state's power to tax."²⁴² Traynor then analyzed the due process quandary of how to tax a foreign trustee's accumulated income when a taxing state lacked due process nexus with the trustee and current income was not being distributed to its resident beneficiary..

His solution was that such a state should tax its own residents, whether settlor or beneficiary, *not* the foreign trustee who lacked nexus with the taxing state.²⁴³

Traynor proposed taxing a resident settlor pursuant to Grantor trust principles, though grantor trust laws²⁴⁴ were not enacted for another 20 years. Regarding beneficiary

²⁴¹ See *supra*, 237.

²⁴² See *Lowy supra*, Note 54. "Power" to collect tax, i.e. personal jurisdiction over the taxpayer, pairs the jurisdiction to tax with *in rem* or *in personam* jurisdiction.

²⁴³ Clearly, Traynor was analyzing circumstances in which the trustee, settlor, and beneficiary lived in different states, and trust income was accumulated, not distributed. *Id* at 274 ("... the various parties are domiciled in different states").

²⁴⁴ *Id* at 284 – 291.

taxation, Traynor stated, “if a tax is effectively to reach such income, and thereby the recipient’s ability to pay, it must be imposed at the domicile of the beneficiary when the income is currently distributable.”²⁴⁵ Traynor was proposing a system of beneficiary taxation upon distribution of accumulated income 20 years prior to enactment of the federal throw back rules which were later enacted based on his tax principles.²⁴⁶

Traynor recognized that the state of a beneficiary’s residence was limited (1) to taxation of its resident beneficiary, and (2) to imposing such a tax only when the income was distributable.²⁴⁷ Traynor’s position is absolutely clear and diametrically opposed to Connecticut taxing the New York trustee based solely on the domicile of the beneficiary:

The state of either the Settlor’s or the beneficiary’s domicile would likewise have difficulty in collecting a tax from a non-resident trustee on income which was neither produced, received nor enjoyed within its borders during the period of accumulation²⁴⁸

²⁴⁵ Traynor at 275, *supra*, Note 237. (Emphasis added). Traynor opposed taxing the entire accumulated income to the California beneficiary solely in the year of distribution since progressive rate schedules would impose an inappropriate tax burden on such beneficiary. Thus, following Traynor’s philosophy, the beneficiary’s tax was calculated separately for each year of accumulation under §17745(d). See *supra*, Note 275.

²⁴⁶“The throwback rules of §§ 665 through 668 taxed distributions of accumulated income by a complex trust roughly as though they had been distributed to the beneficiaries in earlier years, with credit for taxes paid by the trust when it reported the income. The throwback rules were intended to curb use of accumulation trusts as tax-avoidance devices.” Bittker and Lokken, Federal Taxation of Income, Estates and Gifts, ¶ 81.5.

²⁴⁷ *Infra*, Note 249

²⁴⁸ *Id.* at 288. Again “power” to collect tax is an essential element of jurisdiction to tax. Traynor recognized there was no personal jurisdiction, i.e. no power, to collect the tax from a nonresident trustee.

Traynor was also concerned about the validity under state law to tax the resident beneficiary on accumulated trust income even when distributed.²⁴⁹ The issue, as in *Simmon*, was whether state principal and income laws permitted taxation of the distribution as “income.” His concern was based on the trust’s accumulated income having blended with principal and having become a nontaxable gift, bequest, or return of capital when later distributed.²⁵⁰

The foregoing concerns, along with others,²⁵¹ and the analysis of Professor Traynor were addressed and reflected in the unique California Statute²⁵² analyzed in *McCulloch*.²⁵³ As Advisor to the California State Board of Equalization,²⁵⁴ it is likely Professor Traynor participated in drafting the unique California statutes modeled after his own proposals. First, Professor Traynor’s analysis of the constitutional power “to compel payments”²⁵⁵ by the state of the settlor’s and beneficiaries’ residence resulted in a tax

²⁴⁹ There are Constitutional “realization” issues in taxing a beneficiary prior to actual distribution, assuming the beneficiary cannot control distribution. If the beneficiary controls distribution, constructive receipt satisfies realization. See *Glenshaw Glass*, *supra*, Note 78.

²⁵⁰ “The validity of such a tax would depend largely upon the theories with regard to the nature of capital and income. Thus, in *Commissioner v. Simmon*, the Massachusetts Supreme Court held invalid an income tax regulation making accumulated income taxable to the resident beneficiary when received from a nonresident trustee on the ground that such accumulated income constituted ‘capital’ and not ‘income’ in the hands of the beneficiary.” *Id.* at 281 (footnote omitted). *Simmon* is discussed *supra*, Note 78.

²⁵¹ Professor Traynor also raised the concern that taxation of a lump sum on distribution would throw income into higher brackets than imposition of an annual tax on smaller, annual income. *Id.* at 280-81. Taxing income annually, as was done in *McCulloch*, is required by the California statute. *McCulloch v. Franchise Tax Bd.*, 390 P.2d 412, 417 (Cal. 1964).

²⁵² See *infra*, Note 272

²⁵³ See *supra*, Note 23

²⁵⁴ See *supra* Note 235 and *infra*, Note 283.

²⁵⁵ Absence of “power” to compel payment from the nonresident trustee equates to lack of in personam jurisdiction over such nonresident trustee.

actually imposed on a California resident beneficiary.²⁵⁶ Likewise, the constitutional issue of realization²⁵⁷ resulted in California delaying taxation until income was actually distributed to the resident beneficiary. The state statutory issue of capital vs. income²⁵⁸ was addressed by revising California's principal and income statutes.²⁵⁹ Double taxation criticism under the Commerce Clause was satisfied by allowing the beneficiary a tax credit for taxes paid by the trustee to its state of residence.²⁶⁰

The discussion below reflects that Traynor's theories were reflected and implemented in the California statutes and in the *McCulloch* opinion. The opinion noted that the tax was actually imposed on the California resident beneficiary, not the foreign trustee. The tax was calculated on each year's annual income, not on the accumulated lump sum actually distributed. The beneficiary's obligation to pay was postponed until actual distribution. The beneficiary absolutely did not pay the tax previously levied against the trustee.

As stated in §17745(d), "The tax attributable to the *inclusion of that distributed income in the gross income of that beneficiary* for the year...had it been includable in the gross income of the beneficiary ratably ...for the period that the trust accumulated or acquired income for that contingent beneficiary..."²⁶¹

²⁵⁶ See *supra*, Note 273 and §17745, subsection (a).

²⁵⁷ *Glenshaw Glass, supra*, Note 78.

²⁵⁸ See discussion of *Simmon, supra*, Note 73.

²⁵⁹ Cal. Rev. and Tax Code, §17745(c).

²⁶⁰ *Supra*, Note 239.

²⁶¹ Clearly this statute was the predecessor and model for the federal throwback rules. See *supra* Note 246.

The *McCulloch* opinion and Professor Traynor's article stand for the clear proposition that a state of the settlor's or beneficiary's residence cannot constitutionally tax a foreign trustee. *Gavin*'s citation of *McCulloch* as authority was wholly misplaced.

IX. McCulloch Is Not Precedent for Gavin.

*McCulloch*²⁶² is the only case the *Gavin* opinion even attempted to claim as precedent for its holding as to Connecticut's taxation of the New York *inter vivos* trustee. *Gavin* mischaracterized *McCulloch* as "a closely analogous"²⁶³ case. *McCulloch* is not closely analogous to *Gavin* on its facts, on applicable law, or on its holding. As analyzed below, *McCulloch* in no way established even the slenderest precedential thread for *Gavin*'s wholly unprecedented holding.

On the facts, *McCulloch* was an action to recover income taxes assessed against and previously paid by plaintiff, a California resident who was both a trustee²⁶⁴ and beneficiary of a foreign trust.²⁶⁵ The California resident was one of three trustees.²⁶⁶ Pursuant to a very unique California statute,²⁶⁷ the beneficiary had paid the California tax

²⁶² See *supra*, Note 23.

²⁶³ *Gavin*, *supra*, Note 6.

²⁶⁴ See CAL. REV. & TAX. CODE §17743 (West 1994) (stating, "[w]here the taxability of income under this chapter depends on the residence of the fiduciary and there are two or more fiduciaries for the trust, the income taxable under Section 17742 shall be apportioned according to the number of fiduciaries resident in this state pursuant to rules and regulations prescribed by the Franchise Tax Board"). One-third was an allocable portion in *McCulloch*.

²⁶⁵ *McCulloch v. Franchise Tax Bd.*, 390 P.2d 412, 414-15 (Cal. 1964). The testamentary trust was formed and administered under the laws of the state of Missouri under the will of a Missouri decedent. *Id.* at 415.

²⁶⁶ *Id.* at 414. In *Gavin*, no trustee was a resident of Connecticut.

²⁶⁷ CAL. REV. & TAX. CODE §§ 17742 et. seq. (West 1994). See *infra*, 271. Connecticut had no similar statute and the California statute was essential to taxation of the California beneficiary in *McCulloch*.

levied on such resident beneficiary.²⁶⁸ The California beneficiary's California tax was calculated by inclusion of income distributed from the nonresident trustee in the transferee beneficiary's personal tax return.²⁶⁹

McCulloch was more closely analogous to *Simmon*²⁷⁰ than *Gavin*, except that California had a statute²⁷¹ which had no equivalent in Massachusetts, Connecticut, or anywhere else. The provisions currently in effect are found in sections 17742 through 17746 of the California Revenue and Taxation Code.²⁷²

²⁶⁸ *McCulloch*, 390 P.2d at 415.

²⁶⁹ Section 17745(d) taxed the beneficiary anew on the distributed "income" and never makes the beneficiary liable as a transferee for the unpaid taxes of the foreign trustee. See *infra*, Notes 273 and 284.

²⁷⁰ See *supra*, Note 73.

²⁷¹ Section 18102 (now §17742) provided as follows:

Except as otherwise provided in Articles 2 and 4 of this chapter, the income of an estate or trust is taxable to the estate or trust [nevertheless, See Section 18106 below and *infra*, Note **Error! Bookmark not defined.**273. The tax applies to the entire net income of an estate, if the decedent was a resident, regardless of the residence of the fiduciary or beneficiary, and to the entire net income of a trust, if the fiduciary or beneficiary is a resident, regardless of the residence of the settlor.

Section 18103 read as follows:

Where the taxability of income of a trust depends on the residence of the fiduciary and there are two or more fiduciaries for the trust, the income taxable under Section 18102 shall be apportioned according to the number of fiduciaries resident in this State pursuant to rules and regulations prescribed by the commissioner.

Section 18105 provided in part: "[t]axes on income of an estate or trust which is taxable to the estate or trust . . . shall be paid by the fiduciary."

Yet, when such tax was not paid by the trustee, section 18106 [renumbered §17745] imposed personal liability for taxes on trust *income* on the resident beneficiary to include such income in the beneficiary's tax return when the income was distributed. See *McCulloch* at 640-641, and *infra* Note 273.

²⁷² Cal. Rev. & Tax Code §§ 17742-17746 (West 1994).

Section 17745²⁷³ is entitled “Income Taxable to Beneficiaries.” The title “Income Taxable to Beneficiaries” is clearly an irrefutable declaration that “income” is taxable to the “beneficiary.” Section 17745 specifically provides as follows:

(a) If, for any reason, the taxes imposed on income of a trust which is taxable to the trust because the fiduciary or beneficiary is a resident of this state are not paid when due and remain unpaid when that income is distributable to the beneficiary, . . . if the taxes are not paid when due, *such income shall be taxable to the beneficiary when distributable to him.* . . .

(d) The tax attributable to the ***inclusion of that income in the gross income of that beneficiary for the year*** . . . shall be the aggregate of the taxes which would have been attributable to that income *had it been included in the gross income of that beneficiary* ratably for the year of distribution and the five preceding taxable years, or *for the period that the trust accumulated* or acquired income for that contingent beneficiary, whichever period is the shorter. (Emphasis added)

There are two reasons why the beneficiary is taxed on the distributed income but spread over the years the trust had realized such income. First and foremost, it’s a mechanism preferred by Professor Traynor for reducing the tax penalty on the beneficiary.²⁷⁴ The penalty arose from taxing five or more years of income accumulation to the beneficiary in a single year.²⁷⁵

Secondly, when a trust accumulates income, generally the trust is taxed and not the beneficiary. When the accumulated funds are later distributed to the beneficiary, federal and state tax law treats the income as having been inextricably commingled with

²⁷³ West’s Ann. Cal. Rev. & T. Code § 17745.

²⁷⁴ Substantially the same approach was utilized in the federal throwback rules where a complex trust was used to shelter income. See *infra*, Note 284

²⁷⁵ This statute deliberately reflects the sentiment expressed by Professor Roger Traynor in his classic tax article (See *infra*, Note 235) that the trust income distributed should not be included in the aggregate on the beneficiary’s tax return for the year of distribution. Due to progressive rate schedules, taxing the income from years of trust accumulation to the beneficiary entirely in the year of distribution would constitute a tax penalty on the beneficiary who exercised no control over the trust’s decision to accumulate.

and become a part of nontaxable trust principal.²⁷⁶ This tax principle “would prevent taxation of accumulated income when received by the beneficiary. This would in effect obstruct taxation of such income altogether whenever it were derived from intangibles, in view of the difficulties in reaching either of the other parties [settlor or trustee].” Having a statute that levies, but does not collect, a tax on the beneficiary during each year the trust has income avoids a later argument by the beneficiary that he or she can’t be taxed in the year of distribution since the previously accumulated income might now constitute principal under state law.²⁷⁷

This second purpose is also clearly reflected in §17745, subsection (c), which appears to be a direct reaction to the holding in *Simmon*,²⁷⁸ as follows:

(c) The tax on that income which is taxable to the beneficiary under subdivisions (a) or (b) is a tax on the receipt of that income distributed or on the constructive receipt of that distributable income. For purposes of this section income accumulated by a trust continues to be income even though the trust provides that the income (ordinary or capital) shall become a part of the corpus. (Emphasis added.)

The *McCulloch*²⁷⁹ opinion did only what the statute mandated, no more and no less. In *McCulloch*, no tax levied on the nonresident trustee was ever paid by anyone.²⁸⁰ No such tax was paid by the trustee. Nor was any such tax on the nonresident trustee ever paid by the California resident beneficiary. Rather, the California resident

²⁷⁶ See discussion of *Simmon*, *supra* Note 73 and accompanying text. See *infra*, Note 283.

²⁷⁷ *Id.* This is a state principal and income statutory issue, not a constitutional question. The plaintiff/beneficiary in *McCulloch* unsuccessfully made this argument.

²⁷⁸ See *supra*, Note 73

²⁷⁹ See *supra*, Note 23.

²⁸⁰ *Infra*, Note 283.

beneficiary paid only a separate and distinct tax calculated on the pass through of the trust's income to and inclusion with the beneficiary's other taxable income and deductions.²⁸¹ Eminent academic commentators clearly disagree.²⁸²

In *McCulloch*, a Missouri trustee earned, but accumulated, income each year from 1946 through 1950. "The trust paid state income taxes to Missouri upon its income for the years 1946 to 1950 inclusive; it paid no income tax to California during that period."

²⁸³ California "imposed upon plaintiff [beneficiary] liability for income taxes upon the accumulated income [subsequently] distributed by the trust ..."²⁸⁴

In 1951, when the terminal distribution was made to the California beneficiary, California, then and only then, levied a separate income tax on the beneficiary.²⁸⁵ The

²⁸¹ See *supra*, Note 273.

²⁸² 3 J. Hellerstein & W. Hellerstein, *State Taxation* (2005), ¶ 20.09, states as follows: "Finally, the California Supreme Court relied on the presence of an in-state beneficiary to sustain the state's power to tax a trust, created by a nonresident decedent and administered outside the state, on income it was accumulating for the in-state beneficiary. The trust, which was administered in Missouri, had failed to pay taxes to California on the accumulated income, and, upon distribution of the accumulated income to the beneficiary, the beneficiary became liable for the trust's tax." (Emphasis added).

Again, the beneficiary did not "become liable for the trust's tax" as it would have if the statute had actually provided for a "transferee tax." Instead, the beneficiary became liable for the beneficiary's own tax on income passed-through from the trust.

²⁸³ *McCulloch*, 390 P.2d at 416. "Since the trust failed to pay this state's tax upon its annual income, California can constitutionally tax the beneficiary at the time he receives the accumulated income; ..." *Id.* at 414-15 (emphasis added).

²⁸⁴ *Id.* at 415. The statute was the predecessor of the federal "throwback rules" imposing a tax directly on the beneficiary at the time of distribution. See e.g. Int. Rev. Code of 1954, §665. California's very unique tax on the beneficiary of a trust is not a typical transferee tax provision. Indeed, it is a misnomer to describe it as a "transferee tax" at all. In actuality, it is merely a new direct tax on the trust beneficiary as the result of trust income being distributed, i.e., "transferred to," and taxed directly to such beneficiary. For typical transferee tax liability, see e.g., §26 U.S.C.A. 6901 (Transferee of property is liable for Transferor's unpaid income and/or transfer taxes plus a pro rata portion of any interest owed by Transferor thereon to the extent of FMV of property received from the Transferor.)

²⁸⁵ Ca. Rev. & Tax Code, §17745(a), "... such income shall be taxable to the beneficiary when distributable to him."

tax calculation and its collection clearly and deliberately fell solely on the California beneficiary, *not* the Missouri trustee.²⁸⁶

Although the statute ostensibly undertook to initially tax the foreign trustee on its undistributed annual income in 1946, 1947, 1948, 1949 and 1950, both the statute and the Supreme Court of California ultimately placed the real tax burden on the California beneficiary.²⁸⁷

The California Supreme Court in its *McCulloch* opinion, clearly and correctly held that the residence of a beneficiary of a foreign trust was a sufficient basis for California to tax such California resident beneficiary.²⁸⁸ As noted by the Connecticut Supreme Court in *Gavin*, “[w]e agree with the reasoning of the California Supreme Court that ‘the laws of the state of residence afford benefit and protection to the *resident beneficiary* [no reference to *the foreign fiduciary*]....”²⁸⁹ Further, the *Gavin* opinion also correctly agreed with the California Supreme Court’s statement in *McCulloch* that:

The tax imposed by California upon the *beneficiary* [no reference to the foreign trustee] is constitutionally supported by a sufficient connection with, and protection afforded to, [the] plaintiff as such *beneficiary* . . . California grants the *beneficiary* [no reference to the foreign trustee] the interim protection of its laws so that he [the beneficiary] may ultimately obtain the benefit of the accumulated income . . . [The] [p]laintiff’s [Beneficiary’s] residence here confers the essential minimum connection . . . necessary for due process of law, [*i.e.*, unquestionably satisfies due

²⁸⁶ See *supra*, Notes 273 and 283 and accompanying text.

²⁸⁷ The opinion did not require the beneficiary to pay the trust’s tax or associated interest for late payments back to 1946.

²⁸⁸ *McGuire v. Trefry*, 253 U.S. 12 (1920) (holding that Massachusetts can tax its resident beneficiary on distributed current income from a Pennsylvania trust). See Walter L. Nossaman, *State Taxation of Income*, 24 CAL. L. REV. 524 (1936).

²⁸⁹ *Gavin*, 733 A.2d at 802 (emphasis added) (quoting *McCulloch*, 390 P.2d at 412).

process for taxation of the resident California or Connecticut beneficiary, but does *not* support taxation of the foreign trustee in either case].²⁹⁰

The *Gavin* opinion then jumps from Connecticut's right to tax its own resident beneficiary as in *McCulloch*, to claim a state's right to tax a foreign trustee who has no connection, minimum or otherwise, with the State of Connecticut.²⁹¹ This is an unsustainable and utterly indefensible leap in logic.

This flawed logic then led the Supreme Court of Connecticut to make its decision to disregard a contradictory, but well-reasoned, body of precedent. As the *Gavin* opinion itself stated in footnote 25, “[w]e disagree, therefore, with the reasoning of those cases relied on by the plaintiff in which courts have found the domicile of a beneficiary of an *inter vivos* trust insufficient for due process purposes.”²⁹² Courts have long held that the domicile of a beneficiary was an insufficient contact to satisfy due process requirements for taxation of an otherwise foreign trustee.²⁹³

The *McColloch* opinion clearly addressed “due process” from the standpoint of California's imposing a tax on its own resident beneficiary just as Missouri had properly taxed the trustee resident in Missouri:

We find no reason in constitutional principles or in practical application . . . why the tax [on the beneficiary] founded upon the residence of the beneficiary should not be sustained. We shall point out that just as the

²⁹⁰ *Id.* (emphasis added) (3rd & 7th alteration in original) (quoting *McCulloch*, 390 P.2d at 412).

²⁹¹ The mere attributed benefit of Connecticut law is insufficient for either due process or commerce clause purposes. See *Shaeffer supra*, Note 283. Of course, a beneficiary's residence in a state supports taxation of such resident beneficiary. This is all the California Supreme Court did in *McCulloch*.

²⁹² *Gavin*, 733 A.2d at 802 n.25. The court refers to *Blue v. Dep't of Treasury*, 462 N.W.2d 762 (Mich. Ct. App. 1990); *Potter v. Taxation Division Director*, 5 N.J. Tax 399 (1983); *Mercantile-Safe Deposit & Trust Co. v. Murphy*, 203 N.E.2d 490 (N.Y. App. Div. 1964). *Id.*

²⁹³ See *supra*, Part III. B., and *Simmon, supra*, Note 73.

protection and benefits afforded by the state of the residence of the trustee [e.g., Missouri]²⁹⁴ serve as the basis for the constitutionality of the [Missouri] tax as to him, so do those factors serve as the basis for the constitutionality of *the* [California] *tax as to the beneficiary*.²⁹⁵

In *McCulloch*, Missouri taxed its trustee. In like manner, California imposed a tax on its resident California beneficiary. The opinion, like §18106,²⁹⁶ repeatedly made it clear that California’s tax was ultimately on the beneficiary:

*We conclude that California could constitutionally tax plaintiff as the resident beneficiary upon the accumulated income when it was distributed to him.*²⁹⁷ (Emphasis added)

Connecticut in *Gavin* and Massachusetts in *Simmon*, unlike California in *McCulloch*, lacked a state statute to impose a tax on the Connecticut or Massachusetts beneficiary, respectively, upon receipt of the trust’s accumulated income.

The *Gavin* opinion engaged in a logical disconnect by holding that since Connecticut could²⁹⁸, but statutorily did not, tax the Connecticut beneficiary; it had nexus

²⁹⁴ With one of three trustees resident in California, California could have imposed a pro rata one-third tax based on trustee residence in California. See *supra*, Note 271 re former §18103.

²⁹⁵ *McCulloch*, 390 P.2d at 418 (emphasis added). The tax *imposed by California upon the beneficiary* is constitutionally supported by a sufficient connection with, and protection afforded to, plaintiff as such beneficiary. The state of residence of a trustee can tax, *i.e.*, can have minimum contacts to tax, the trustee’s income.

²⁹⁶ §18106 has been renumbered as §17745. See *supra*, Note 273 and accompanying text of subsections (a) and (d).

²⁹⁷ *McCulloch*, at 420-21 (emphasis added) (citations omitted).

²⁹⁸ Under Due Process, Connecticut “could” have taxed its resident beneficiary upon distribution. Under Connecticut state statutes, however, Connecticut, like Massachusetts in *Simmon*, could not tax the resident on the distribution of accumulated income.

to tax the foreign trustee. Therein lies the fundamental and very dangerous flaw in the opinion's unprecedented holding.²⁹⁹

X. Pre- and Post-Gavin State Residency Rules for Trustees

States have historically applied myriad nexus rules to trustee taxation.³⁰⁰ California's approach, established statutorily and judicially upheld by Professor Roger John Traynor, was discussed above.³⁰¹ Idaho, similar to Missouri in *Swift*,³⁰² taxes "trusts" as residents if they satisfy at least three out of five (six in *Swift*) characteristics:³⁰³

A New York "resident" trust, i.e., created by a New York resident settlor, is a nonresident trust for income tax purposes if "(1) all trustees are domiciled in a state other than New York;³⁰⁴ (2) the entire corpus of the trust, including real and tangible personal property, is located outside of New York State [non-business intangibles deemed located outside the state]; and (3) all income and gains of the trust are derived from, or connected with, sources outside of New York State."³⁰⁵ New Jersey has a similar standard. "If a

²⁹⁹ Attribution to the nonresident of benefits of Connecticut law to the Connecticut beneficiary was rejected by the Supreme Court in *Shaffer*, since the necessary relationship to the fiduciary's income earned in New York was insufficient for both due process (*Shaffer*) and commerce clause (*Complete Auto*, Step Four) purposes. See *supra*, Note 283.

³⁰⁰ Nenno and Sparks, Delaware Dynasty Trusts, Total Return Trusts, and Asset Protection Trusts, printed by Wilmington Trust Bank.

³⁰¹ See discussion *supra* Part VII.

³⁰² *Swift v. Director of Revenue*, 727 S.W.2d 880 (Mo. 1987) (en banc).

³⁰³ See *supra*, Note 146

³⁰⁴ See, e.g., *In re John Frankel Trust*, 1980 N.Y. Tax LEXIS 39 (New York State Tax Commission) (holding that a trust created by New York resident and administered under Connecticut law could be taxed as "resident" New York trust where majority of trustees were New York residents).

³⁰⁵ N.Y. COMP. CODES R. & REGS. tit. 20, § 105.23 (2003).

resident trust or estate does not have any assets in New Jersey or income from New Jersey sources, and does not have any trustees or executors in New Jersey, it is not subject to New Jersey tax.”³⁰⁶

At least one nationally respected Connecticut commentator, Mr. Frank Berall,³⁰⁷ at the time of the adoption of Connecticut’s current income tax on trusts, analyzed Connecticut’s tax statute as being in the mainstream.³⁰⁸ In many respects, Mr. Berall stated parallels between New York and Connecticut law as follows:

A resident trust will *not be taxed* if all its trustees are nonresidents, its entire corpus is located outside Connecticut and all its income and gains are derived from or connected with sources outside Connecticut.³⁰⁹

Anticipating the *Gavin* issue, though not its holding, Mr. Berall further stated:

The fact that such a trust still has resident beneficiaries should *not* make it a resident trust. *A tax cannot be imposed by Connecticut merely because trust beneficiaries reside here*, if the trust’s assets are possessed by a trustee in another state; *otherwise it would violate the due process provision of the Fourteenth Amendment to the federal constitution.*³¹⁰

³⁰⁶ Form NJ-1041, Instructions, 2002 New Jersey Gross Income Tax Fiduciary Return.

³⁰⁷ Frank S. Berall, formerly of the Hartford Bar and former frequent national lecturer on income taxation of trusts and on estate planning.

³⁰⁸ Frank S. Berall & Suzanne Brown Walsh, *Income Taxation of Estates and Trusts*, 65 CONN. B.J. 377 (1991).

³⁰⁹ *Id.* at 378 (emphasis added).

³¹⁰ *Id.* (emphasis added) (citing *Safe Deposit & Trust Co. v. Virginia*, 280 U.S. 83 (1929); *Guaranty Trust Co. v. Virginia*, 305 U.S. 19, 23 (1938); *Mercantile Safe-Deposit and Trust Co. v. State Tax Commission*, 19 A.D.2d 765 (3rd Dept. 1963)). These cases were rejected by the *Gavin* opinion’s wholly unprecedented holding. See *supra* Note 262 and accompanying text.

It seems that local politics and desperation for more state revenue have contributed to the dangerous, unprecedented holding of *Gavin*.³¹¹

Conclusion

The result in *Gavin* is not consistent with the relations of states within the American Union or with the expectations of U.S. citizens.³¹² Instead of butchering constitutional limitations on state taxation of foreign trustees, whether testamentary or *inter vivos*, states should merely review and revise their own rules on taxation of grantors, trustees, and beneficiaries.

Unconstitutionally expansive Founder State Trust rules are not the answer. Like Justice Traynor, states should look to adoption and/or modification of traditional federal grantor trust rules and throwback rules. Too many states merely conform their grantor

³¹¹ The same pressures can be seen in Alabama's new resident trust tax statute. HB19 was part of a comprehensive trust tax reform package enacted by the Alabama legislature. HB19 defined a resident trust as a trust that is described in either (a) or (b) below:

- (a) A trust: (1) Created by the will of a decedent who was an Alabama resident at death or . . . who was an Alabama resident [including seven-month nondomiciliary resident] at the time the trust became irrevocable; and (2) For more than seven months during the taxable year, an individual who either resides in [nondomiciliary resident] or is domiciled in Alabama is either *a fiduciary* of the trust *or a beneficiary* to whom distributions may currently be made. [OR] (b) a trust that has Alabama as its principal place of administration during the taxable year.

Clearly, a nondomiciliary resident could meet the requirements of both (a)(1) and (a)(2). A Florida domiciliary could, for example, have established a Florida or a Delaware trust and a permissive beneficiary of such a trust. A clear example could be a Delaware self-funded spendthrift trust. If, for unrelated business reasons, the Florida resident spent seven months in Alabama and either died in an auto crash or for some other reason the trust became irrevocable, the Delaware trust of a Florida resident with a Delaware trustee is forever an Alabama resident trust.

Tying taxation solely to trust administration is similarly flawed. A Texas resident could establish a trust with the Texas affiliate of an Alabama bank holding company. If, wholly unbeknownst to the Texas settlor, all the holding company's trust administration is conducted at its Alabama headquarters, the trust will be taxed forever as a resident Alabama trust.

³¹² See Jacob, *supra*, Note 5.

trust rules to federal grantor trust rules. Under I.R.C. § 679, the federal government taxes a U.S. citizen on all income of a foreign, i.e., outside the U.S., trust that has a U.S. beneficiary and was established by the U.S. grantor. A state which conformed to federal grantor trust rules, could, under its counterpart of Section 679, tax its citizen grantors on trusts they might establish in Bermuda as a tax haven. However, if the same state resident grantor created a similar trust in Delaware as a state tax haven, it is not a “grantor” trust for federal purposes or for conforming state law purposes.

States like Connecticut that are interested in taxing income placed in out-of-state trusts by Connecticut residents, should establish grantor trust rules which parallel § 679, but which define a “foreign” trust as being established and domiciled outside the state of Connecticut, not merely outside the U.S. This approach does, of course, subject the trust’s income to the risk double taxation which should be mitigated by income allocation or tax credits as required by *Complete Auto’s* commerce clause analysis.

Likewise, states like Connecticut, that want to tax a foreign trustee’s accumulated income based on the state’s benefits provided to the trust’s beneficiary, should adopt laws similar to California’s throwback rules. Such laws could parallel federal throwback rules which were in turn based on California’s Traynor tax model. Throwback rules would impose the state income tax on its resident beneficiary at the time of a subsequent distribution. Today, under the U.S. Internal Revenue Code, federal “throwback rules” apply primarily to foreign, i.e. non-U.S., trusts.³¹³ The federal rationale and need of the

³¹³ 26 U.S.C.

throwback rules for foreign trust taxation serves essentially the same remedial purpose states need to apply to out-of-state trusts with resident beneficiaries.³¹⁴

Gavin is a badly flawed ruling which, in most respects, has no precedent whatsoever. It was founded on state desperation for revenues and local politics by reflecting the tax adage “Don’t tax you, don’t tax me, tax the fella behind the tree.” In *Gavin*, the “you” and the “me” are Connecticut resident settlor’s and beneficiaries, and the “fella behind the tree”, is a nonresident trustee.