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State taxes on trusts under fire

Joseph Rice created a trust in New York for his three children. A New York trustee was appointed, and the trust was to be governed by New York law. The trustee had complete discretion over distributions to the trust beneficiaries. At the time that the trust was created, no beneficiary lived in North Carolina. That changed in 1997, when a daughter, Kimberly Rice Kaestner, moved to North Carolina. Soon after, the trust was divided into three subtrusts, one for each beneficiary and his or her descendants.

North Carolina is one of three states that impose an income tax on the undistributed income of any trust that "is for the benefit of" one of its residents. For tax years 2005 through 2008, the state taxing authorities assessed income taxes of $1.3 million on the trust. During those years neither Kaestner nor her children received any trust distributions, nor did they have the legal right to demand distributions.

In a unanimous decision, the U.S. Supreme Court held for the taxpayer. Justice Sotomayor outlined the two-step process for determining whether a trust has sufficient contact with a state to permit taxation within the parameters of the Due Process clause. There needs to be a definite link, "some minimum connection," between the state and the property that it seeks to tax. Second, the income attributed to the State for tax purposes must be rationally related to "values connected with the taxing State."

Justice Sotomayor concluded: "When a tax is premised on the instate residence of a beneficiary, the Constitution requires that the resident have some degree of possession, control or enjoyment of the trust property or a right to receive that property before the State can tax the asset." In this case the trust was entirely discretionary, and the beneficiary had no ownership or right to demand the property. In such a circumstance, the demands of the Due Process clause are not satisfied, and state taxation of the trust is not permitted.

Compare this case. Reid and Ann MacDonald created four trusts for their four children in 2009. These were grantor trusts for the first 30 months of their existence, and then they became irrevocable. Under Minnesota law a trust that becomes irrevocable while the grantor is a Minnesota resident is known as a "resident trust," and as such will always be subject to Minnesota income taxes. Those taxes were paid in 2012 and 2013.

In 2014 a resident of Texas became the trustee. At that time none of the trust administration took place in Minnesota, and only one beneficiary resided in the state. The trust paid the income tax under protest, and it took the matter to the Minnesota courts.

The Supreme Court of Minnesota held that the contacts between the trust and the state were not sufficient to subject the trust to taxation, and the attempt to tax it violated due process. In evaluating what contacts are meaningful enough to support state taxation, the Court dismissed the residence of the grantor at the time of the trust's creation, because the trust itself has an independent legal existence. The fact that a Minnesota law firm was used was similarly not relevant. What matters are domicile of the trustee and the location of the trusts' administration, decision-making, and records. By 2014 all of these were outside the state.

Minnesota appealed the decision to the U.S. Supreme Court, and in June certiorari was denied, leaving the pro-taxpayer judgment intact.

—North Carolina Department of Revenue v. Kimberly Rice Kaestner 1992 Family Trust;

—Fielding v. Comm'r of Revenue

> *COMMENT: A denial of cert. does not have precedential value, but when coupled with the taxpayer victory in* Kaestner*, these decisions are welcome to estate planners. There had been concern following the* Wayfair *decision on interstate collection of sales taxes that still more taxation power might be handed to the state.*

SECURE Act still stalled

The Setting Every Community Up for Retirement Enhancement (SECURE) Act [H.R. 1994] passed the House on a bipartisan basis, a vote of 417 to 3, and appeared headed for quick approval in the Senate. However, a few GOP Senators objected to unanimous consent of the bill, and there was no progress before the August recess.

The SECURE Act includes substantial restrictions on stretch IRAs as a means to pay for new tax breaks for retirement savings. The fact that it passed the House overwhelmingly, on a bipartisan basis, suggests that there are few if any defenders of the stretch IRA strategy left in Congress. This tool may soon no longer be available to estate planners. In fact, seminars are already popping up on the internet on how to respond and what to tell clients who have stretch IRAs in their estate plans.

A key difference between an IRA and a 401(k)

When Lily and Bahman Amadi bought their first home, they came up short on the money needed for a down payment. Lily worked for the State of New York, and had been setting money aside in her 401(k) plan for retirement. She asked for and received $6,686 from the plan, which went toward purchasing the house. Lily may have received some poor advice from the plan administrator,

When they filed their joint tax return, the Amadis did not report the 401(k) distribution. IRS caught the omission, and assessed income tax as well as a 10% penalty for the premature distribution. Acting as her own attorney, Lily took the matter to the Tax Court. Her petition read, in part:

"We found our dream house, and we put all our savings into purchasing a house for our family. We were waiting for a letter from IRS, but not expecting to be fined so much, and other fees on top of that! The money that I had to cash out went to purchasing a house that we are paying very high taxes for. I wouldn't use my retirement money, if I could. I used it toward something that we needed for our growing family. We wanted to get a house after years of apartment living. I don't think we should pay tax on top of what we are paying, since we are paying taxes on our house."

There is no question that distributions from the pre-tax portion of a 401(k) plan must be included in taxable income. The harder problem is whether the 10% penalty should apply. IRC §72(t) waives the penalty for distributions used for first time home purchases, but only for distributions from "individual retirement plans." The Court declined to stretch this language to include an individual account plan, such as a 401(k) plan, although there is no policy justification for the distinction. A careful reading of the statute and its history compelled the result.

—Lily Hilda Soltani-Amadi et vir v. Commissioner; No. 2090-18S; T.C. Summ. Op. 2019-19

COMMENT: Presumably, if Lily had first rolled her 401(k) distribution into an IRA and then withdrawn the entire amount from the IRA, the statutory requirements would have been satisfied.

2020 budget blueprint

President Trump's budget blueprint for fiscal year 2020 calls for making permanent the changes of the Tax Cuts and Jobs Act of 2017. The total cost of permanence was projected by the Joint Committee on Taxation to be $919 billion over the next ten years. The cost is zero until 2026, which is when such a change would have revenue effect.

The costliest items, according to JCT's analysis, are maintaining the current rate structure ($747 billion), keeping the enlarged standard deduction ($424 billion), maintaining the current child tax credit ($284 billion), and keeping the current higher thresholds for the AMT ($386 billion). These costs would be offset to some extent, because scheduled tax breaks would be eliminated. These include removing the cap on the deduction for state and local taxes ($428 billion) and the restoration of personal exemptions ($700 billion).

Making the doubled exemption from the federal estate and gift tax permanent only loses $44 billion in the ten-year window.

The cryptocurrency crackdown

In *Notice 2014-21* the IRS made clear that bitcoin and similar cryptocurrencies are not money for tax purposes, they are property. As such they have a tax basis, and the transfer of cryptocurrency for value may generate taxable gain or loss. It's not clear that the cryptocurrency owners have been complying with the tax laws.

The IRS obtained a court order for the customer data held by Coinbase, a cryptocurrency exchange. Data was provided on all customer who had transactions worth $20,000 or more from 2013 through 2015. About 13,000 customer accounts were documented.

That data may have been the source for a series of warning letters that the IRS began sending to some 10,000 cryptocurrency owners in July. Three versions of the letter were made public. The mildest one outlines the tax requirements for owning and exchanging cryptocurrency. The most severe asks the recipients to declare under penalty of perjury that they are in compliance with all tax law requirements.

IRS Commissioner Chuck Rettig said, "Taxpayers should take these letters very seriously. The IRS is expanding efforts involving virtual currency."

—IR-2019-132

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