Too Thin A Reed: A Trust Cannot Be Taxed Based Solely on the Settlor's Domicile.

The commerce clause grants Congress the authority to regulate commerce among the states. Because this power is reserved to Congress, the Supreme Court has traditionally held that the Commerce Clause also restricts state power, barring legislation that imposes unreasonable burdens on interstate commerce, although some current justices disagree with this "dormant commerce clause" doctrine.

State and local taxes are frequently the subject of dormant commerce clause challenges. In a 1977 opinion, the Supreme Court developed a four part test that governs the validity of a state or local tax under the dormant commerce clause. Under this test, state and local taxes will be upheld if 1) they apply to a taxpayer that has a sufficient connection (or "nexus") to the jurisdiction imposing the tax; 2) they are fairly apportioned so that the state or political subdivision is taxing its fair share of the taxpayer's revenue, income or property; 3) they do not discriminate against interstate commerce; and 4) they are fairly related to the benefits provided by the taxing authority. *See Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977). While the test sounds clear enough, its application continues to keep appellate judges busy as they assess particular taxes and particular fact patterns.

Recently, the Commonwealth Court issued an opinion addressing a dormant commerce clause challenge to an income tax assessment issued to two trusts. *Robert L. McNeil Trust v. Commonwealth*, No. 651 F.R. 2010 (Pa. Commw. May 24, 2013). The relevant trusts had only two connections to Pennsylvania: *first*, when he established the trusts in 1959, the settlor lived in Pennsylvania; *second*, the discretionary beneficiaries lived in Pennsylvania. *Id.,* slip op. at 2. In contrast, the trust agreements provided that these were to be governed, administered and construed under Delaware law, the sole administrative trustee was based in Delaware and had no offices in Pennsylvania, the other trustees resided outside of Pennsylvania, and the trusts had no Pennsylvania assets or income. *Id.* at 3.

Based upon this compelling fact pattern, the Department of Revenue issued assessments of over $500,000 in taxes, interest and penalties for 2007, applying Pennsylvania's personal income tax to 100% of the trusts' income for the year. *Id.* at 4. On appeal, the Board of Finance and Review sustained the application of the tax, determining that the trusts were "resident trusts" because the settlor lived in Pennsylvania when he established them forty-eight years before the tax year. *Id.* at 4-5. While the Trusts raised a broad array of constitutional challenges to the tax assessments, the Board never addressed them, although it did eliminate the penalties. *Id.*at 5.

The trusts fared far better in Commonwealth Court. In analyzing the nexus requirement, the court quickly eliminated the residence of the discretionary beneficiaries as a relevant connection with Pennsylvania for several reasons:

- The Department of Revenue's own regulations pronounced this an irrelevant consideration, *id.* at 13 (citing 61 Pa. Code § 101.1);
- The beneficiaries were analogous to the customers of an out of state business, and the mere presence of customers in a state was insufficient to meet the nexus requirement, *id.* at 14 (citing *Quill Corporation v. North Dakota,* 504 U.S. 298 (1992)) ;
- The beneficiaries had no enforceable right to receive any distributions during the tax year covered by the assessment. *Id.* at 14-15 (distinguishing *Chase Manhattan Bank v. Gavin,* 733 A.2d 782 (Conn. 1999)).

As for the fact that the settlor was living in Pennsylvania when he established the trusts, the court was underwhelmed by this connection given his decision to have the trusts administered in Delaware; the court also noted that the settlor had retained no continuing control over the trusts through a power of appointment or otherwise. *Id.* at 15.

Having concluded that the trusts lacked an adequate nexus with Pennsylvania, the court next turned to the fair apportionment requirement, which has two separate tests: the internal consistency standard, which asks whether the adoption of the same tax in multiple jurisdictions would expose the taxpayer to the risk of multiple taxation, and the external consistency standard, which asks whether there is a rational relationship between the income being taxed and the intrastate value of the business that is subject to tax. *Id.* at 16 (citing *Philadelphia Eagles Football Club, Inc. v. City of Philadelphia,* 823 A.2d 108, 131 (2003)). Given the complete absence of any Pennsylvania income, assets or presence in the tax year, the court concluded that the external consistency requirement was not met.

Finally, the Commonwealth Court also concluded that the tax was not fairly related to the benefits provided to the trusts by Pennsylvania, since the trusts derived no benefits from Pennsylvania at all. *Id.* at 20-21.

While this is a big win for the taxpayer, it also should not be read too broadly, since it is hard to imagine a thinner case for a state's power to tax a non-resident. With a few more meaningful contacts and a legitimate effort to apportion the tax, a future case might reach a different result.

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