Updates
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US Supreme Court Finds in Favor of Taxpayer Trust Beneficiary in Kaestner

On June 21, 2019, the U.S. Supreme Court issued its opinion in *North Carolina Department of Revenue v. Kimberly Rice Kaestner 1992 Family Trust.* This unanimous decision stated that the State of North Carolina may not tax trust income that has not been distributed to the beneficiaries, for which the beneficiaries lack the right to demand the income, and for which the receipt of that income is uncertain simply because those beneficiaries reside in the state. The following alert summarizes current state approaches to the taxation of trusts, highlights the law and facts surrounding the Court's holding and provides analysis of the *Kaestner* case and its impact.

State Approaches to the Taxation of Trusts

Several states, including Alaska, Florida, Nevada, South Dakota, Texas, Washington and Wyoming, have no state-level taxation of trusts. Others, including the District of Columbia, tax trustees of what they classify as "resident" trusts. Resident trust status is typically established under one or more of the following criteria:

- If the trust was created by the will of a testator who was domiciled in the state at death;
- If the settlor of a trust was domiciled in the state when the trust became irrevocable;
- If the trust is administered in the state;
- If one or more trustees live or do business in the state;
- If one or more beneficiaries are residents in the state; or
- If the state's law is designated as the law governing the terms of the trust.

Additionally, certain states impose taxes on trusts where trust income is distributed to an in-state resident beneficiary. Notably, states including Pennsylvania, California and New York impose what is termed a "throwback tax," which is a tax levied in the year in which previously accumulated income is distributed to an in-state resident beneficiary.

The North Carolina Approach

North Carolina taxed the *Kaestner* trust based on N.C.G.S. §105-160.2, which, as highlighted by the Court, provides that the state can tax any trust "that is for the benefit of a resident of this State" regardless of whether the beneficiary actually receives distributions from the trust, has the right to demand income from the trust in a given year or could ever count on receiving income from the trust.

This approach is uncommon among the states that impose state-level taxation of trusts. In its opinion, the Court was able to identify only six states, including North Carolina, Montana, North Dakota, Georgia, Tennessee and California, whose laws could be interpreted as imposing a tax based solely on a beneficiary's residence. Among those six, the Court singled out North Carolina as the only state that applies its tax based solely on the residence of contingent beneficiaries.

Facts and History

The *Kaestner* trust was originally established under a trust agreement governed by New York law between a New York resident grantor and a New York resident trustee. During the tax years in question, the trustee was a resident of Connecticut. The financial assets of the trust were held by custodians in Massachusetts and the financial books and records of the trust were kept in New York. For administrative convenience, the tax returns and accountings were also prepared in New York. The trust maintained no physical presence in North Carolina, made no direct investments in North Carolina and held no real property there. Finally, and most notably:

- No party to the trust ever had a presence in or connection to North Carolina until a beneficiary moved to the state in 1997;
- The trust agreement provided that the trustee would have "absolute discretion" to distribute the trust's assets to the beneficiaries "in such amounts and proportions" as the trustee might "from time to time" decide; and
- During the tax years in question, the beneficiaries had no right to and did not receive any distributions from the trust.

North Carolina asserted that the trust owed North Carolina income tax based solely on the presence of a beneficiary in the state. For tax years 2005 through 2008, the trust paid North Carolina income tax and then sought a refund, challenging the constitutionality of the North Carolina statute. The North Carolina Business Court, the North Carolina Court of Appeals and the North Carolina Supreme Court all ruled that the North Carolina statute, as applied, violated the Due Process Clause of the United States Constitution. On January 11, 2019, the U.S. Supreme Court agreed to review whether the Due Process Clause prohibits states from taxing trusts based only on the in-state residency of trust beneficiaries.

The Court's Opinion

Justice Sotomayor, writing for the Court, first set forth the two-step analysis that the Court applies to determine if a state tax is permissible under the Due Process Clause. Citing previously established principles, the Court noted that the Due Process Clause requires the following:

- "[S]ome definite link, some minimum connection, between a state and a person, property or transaction it seeks to tax;" and
- That "the income attributed to the State for tax purposes must be rationally related to values connected with the taxing State."

Outlining longstanding precedent, the Court further noted that when a state seeks to impose a tax based on the in-state residency of a trust beneficiary, certain conditions must be met. The Court stated that,"the Due Process Clause demands a pragmatic inquiry into what exactly the beneficiary controls or possesses and how that interest relates to the object of the State's tax," and "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."

Applying the principles set forth above, the Court found that state residency of a beneficiary alone is not enough for North Carolina's statute to satisfy the first criteria of the Court's Due Process analysis. First, the *Kaestner* beneficiaries did not receive any income from the trust during the years in question. Second, the *Kaestner* beneficiaries had no right to demand trust income or otherwise control, possess or enjoy the trust assets; such decisions were left to the trustee's absolute discretion. Finally, the *Kaestner* beneficiaries had no guarantee or assurance that they would eventually receive a specific share of trust's income. As such, the Court ruled that the North Carolina statute, as applied, violated the Due Process Clause of the United States Constitution.

Analysis and Impact

It is important to note that the Court's opinion is very narrowly crafted. As set forth previously, North Carolina's statute is an outlier and the Court went to great lengths to make clear that its holding is limited to the specific facts set forth in this case. There are, however, several noteworthy items that can be taken from the opinion:

- **Relief Should be Available in Certain Circumstances:** The most obvious takeaway is that trustees who have paid tax to North Carolina, or any other state, based solely on the residency of a contingent beneficiary should be entitled to immediate relief. Trustees and planning professionals should review the residencies of their beneficiaries, the relevant dispositive terms of their trust agreements and the histories of their state income tax filings to determine whether claims for refunds should be pursued.
- **Narrow Planning Opportunities Exist:** Although somewhat limited in its application, the Court acknowledges that a trustee, given adequate discretion under the trust agreement and a lack of other factors that could provide an adequate basis for taxation (such as trustee residency or situs of administration), may avoid state-level taxation by simply delaying distributions to a beneficiary until he or she moves to a state with no, or a lower level of, taxation.

- **Trust Terms Are Key to Due Process Analysis:** In making its decision, the Court focused heavily on how the beneficiary's degree of possession, control and enjoyment of the trust property affected its due process analysis. The Court further analyzed and outlined how the specific terms of the *Kaestner* trust agreement informed its decision. If settlors decide that the previously discussed tax benefits outweigh the restrictions to their beneficiaries' access to trust assets, the *Kaestner* opinion provides a solid guide for professionals to draft or modify trust agreements accordingly.
- **Narrow Holding; Uncertainty Still Prevails:** While some hoped that the Court might use *Kaestner* as an opportunity to set forth a new comprehensive roadmap on state-level taxation of trusts, the Court's opinion is very narrow and does little to that effect. While *Kaestner* joins a trend of taxpayer-friendly cases at the state level[1], uncertainty still prevails. This case is a continuation of what promises to be many more years of litigation surrounding the increasingly aggressive attempts of various states to tax trust income. As such, any trustee who has paid or is paying tax to a state such as California, Illinois, or New York, based on factors not specifically addressed in *Kaestner* (such as the residency of a grantor, the residency of a non-contingent beneficiary or the distribution of previously accumulated income) should continue to monitor developments in this area.

In light of this important opinion, Perkins Coie is assisting clients in determining whether there are new opportunities for planning or relief. We will continue to monitor cases involving the state-level taxation of trusts as they develop.

We recommend that you consult with your estate planning attorney, income tax advisor or other planning professional to determine whether this opinion applies to your individual situation.

Endnote

[1] See, e.g., *Linn v. Dep't of Revenue* in Illinois, *William Fielding, Trustee of the Reid and Ann MacDonald Irrevocable GST Trust for Maria V. MacDonald, et al., v. Commissioner of Revenue* in Minnesota, *Residuary Trust A u/w/o Kassner v. Director, Division of Taxation* in New Jersey, and *McNeil v. Commonwealth of Pennsylvania* in Pennsylvania.

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