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U.S. Supreme Court addresses state income taxation of trusts in *Kaestner*

BY OLIVER R. MERRILL

On June 21, 2019, the U.S. Supreme Court issued its decision in *North Carolina Department of Revenue v. Kimberley Rice Kaestner 1992 Family Trust*, unanimously holding that "the presence of in-state beneficiaries alone does not empower a State to tax trust income that has not been distributed to the beneficiaries where the beneficiaries have no right to demand that income and are uncertain to receive it." *Kaestner* simultaneously sheds light on states' jurisdiction to tax trust income while also providing a narrow opinion that is of limited precedential and practical impact. Here, we take a closer look at the Court's decision in *Kaestner*, how it impacts state taxation of trusts, and what questions arise in its aftermath.

Background

The trust at issue in *Kaestner* was an irrevocable trust created in 1992. The Kimberley Rice Kaestner 1992 Family Trust (the "Trust") first originated when Joseph Lee Rice III, Ms. Kaestner's father, formed a trust for the benefit of his children. Rice, a New York resident, formed the Trust under New York law and appointed a New York resident as Trustee (a Connecticut resident later became trustee). At the time, none of the beneficiaries resided in North Carolina. The trust agreement gave the trustee "absolute discretion" to make distributions to the beneficiaries in such amounts and proportions as the trustee might from time to time decide. The trustee was authorized to exclude beneficiaries from distributions, with the effect of cutting one or more beneficiaries out of the Trust.

Ms. Kaestner moved to North Carolina in 1997, and she and her children were residents of North Carolina during the relevant time period of 2005 to 2008. After Ms. Kaestner's move, the trustee divided the initial trust into subtrusts, including the Trust, in its current form, for the benefit of Ms. Kaestner and her children. The original trust agreement still governed the Trust, and the trustee retained absolute discretion over the management of Trust assets, as well as the timing and allocation of distributions.

From 2005 to 2008, North Carolina's sole connection to the Trust was the in-state residence of the beneficiaries. During this time, the beneficiaries did not receive distributions from the Trust. New York law continued to govern the Trust. The trustee never resided in North Carolina. The Trust's records were maintained in New York, while its assets were maintained in Massachusetts. The Trust had no direct investments in North Carolina.

North Carolina law imposes tax on trust income "for the benefit of" a North Carolina Resident.[1] North Carolina therefore asserted jurisdiction to tax the income of trusts with a resident beneficiary, without any additional contacts to the state. North Carolina assessed a tax on the accumulated (undistributed) income earned by the Trust from 2005 to 2008. The trustee paid the Trust's state income tax liability under protest, and filed suit for a refund claiming that North Carolina's tax, based on the in-state residency of a beneficiary, alone, was an unconstitutional violation of Due Process. The case made its way to the Supreme Court, where the constitutionality of state trust taxation would take center stage.

The Outcome

The Court held that North Carolina's tax, based solely on the in-state residence of discretionary beneficiaries, was unconstitutionally applied against the Trust in violation of Due Process. The opinion cited three key factors. First, the beneficiaries did not receive distributions during the years in question. Second, the trustee had absolute authority over the management and distribution of trust assets while the beneficiaries had no right to demand, control, possess, or enjoy the trust assets. Third, there was no guarantee that the beneficiaries would receive distributions in the future.[2]

A state may impose taxes only where certain "minimum contacts" exist between the state and the taxed person or entity such that the tax "does not offend traditional notions of fair play and substantial justice." The inquiry is fact-dependent; only those who derive "benefits and protection" from a state should be subject to the obligations of the state.[3] In part, the Due Process Clause limits states to imposing only taxes that bear "fiscal relation to protection, opportunities and benefits" afforded by the state. Due Process analysis requires two steps. First, and most relevant in *Kaestner*, there must be some "definite link, some minimum connection, between a state and the person, property, or transaction 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.'"[4] In this case, North Carolina lacked sufficient contact to the Trust to constitutionally tax the Trust's income.[5] The in-state residence of beneficiaries, with purely discretionary interests, without more, does not pass constitutional muster.

The result in *Kaestner* was certainly favorable to the Trust, however the Court's opinion is narrowly focused on North Carolina's statute, and specifically the imposition of tax stemming solely from a beneficiary's in-state residency. The fact that the in-state residence of a contingent beneficiary was the *sole* connection to the State is critical to the court's reasoning. Given both the unique factual circumstances presented and North Carolina's unique law, the effect of *Kaestner* on state trust taxation, more generally, is unclear. *Kaestner*'s implications are further limited by its purposefully narrow opinion, such that its impact may derive from the questions raised rather than those answered.

The Fallout

Narrow Holding Limits Precedential Value

North Carolina is one of only a handful of states that impose trust taxes based solely upon beneficiary residence, without more. Other states that impose tax on trusts income do so by looking at one or more additional factors. These factors include (a) the residency of the trust creator (testamentary or inter vivos), (b) the place of trust administration, and (c) the residency of fiduciaries, in addition to the residence of the beneficiaries. The *Kaestner* opinion addresses North Carolina's statute specifically, and its reliance on beneficiary residence, alone. Accordingly, the *Kaestner* decision does not say that North Carolina's statute is unconstitutional, but rather that it was unconstitutionally applied in this circumstance. It therefore offers little guidance as to the constitutionality of taxing regimes that rely on factors other than, or in addition to, beneficiary residence.

Furthermore, the Court emphasized that its holding is limited to the specific circumstances presented by this case. The Court's decision hinged upon the contingent nature of the beneficiaries' interests in the Trust, while also noting the Trust's lack of administrative or fiduciary contact with the state. The elements of "possession, control, and enjoyment of trust property" were central to determining whether sufficient state contact existed. As discussed, the trustee held absolute discretionary authority over trust administration, as well as the allocation and timing of distributions. The trustee did not make distributions to the beneficiaries during the relevant tax years. The trustee was not a resident of North Carolina, nor did any of the administrative or investment activities of the trust occur in-state. Because the beneficiaries did not have rights to possess, control, or enjoy assets of the Trust, nor any guarantee of such rights in the future, their residence could not, alone, justify the tax imposed. Thus, the Court's analysis depends heavily upon what the concurrence calls an "unusually tenuous" connection between the beneficiaries and the Trust's income. The Court limited its holding to the specific facts presented, and did not "imply approval or disapproval of trust taxes that are premised on the residence of beneficiaries whose relation to trust assets differs from that of the beneficiaries here." The relationship between the resident beneficiaries and the Trust's assets here was insufficient, but the Court declined to expand upon what relationship might suffice to support state taxation. Thus, not only is *Kaestner* narrowly applicable to a minority state taxing statute, but it only addresses the instance of purely discretionary beneficiaries.

The Court declined to address what sorts of beneficial interests might be sufficient to support state taxation. It remains unclear, for example, whether a state tax could be levied against a trust where a trustee holds less-than-absolute discretionary authority, as might be the case for beneficiaries entitled to distributions for an ascertainable standard. Would a state tax pass muster where a trust provides for mandatory income distributions, or grants an in-state beneficiary the right to withdraw assets upon attaining a specified age in the absence of a decanting option? The Court reserved these issues for another day.

Additionally, the *Kaestner* opinion focuses its analysis only on the Due Process clause. In fact, the Kaestner opinion does not take up the second prong of Due Process analysis as a result of the determination that the first prong was not satisfied. Prior state cases dealing with state taxation of trust income have considered the Commerce Clause in addition to the Due Process Clause. In addition to constitutional Due Process standards, taxing states must also satisfy the Commerce Clause's requirement for "substantial nexus" between the state and the activity it seeks to tax. Thus, *Kaestner* sheds little light on how the Commerce Clause or the second prong of Due Process analysis might impact the viability of state trust income taxation.

Given these limiting factors, it seems unlikely that the holding itself will provide much in the way of precedential value. The impact is particularly muted in states where trust taxing jurisdiction is rooted in additional elements of the trust-state relationship. Nevertheless, for practitioners in North Carolina or states with similar trust taxing statutes, it may provide tax planning considerations where the circumstances are substantially similar to those presented in *Kaestner*.

Limited Guidance on Other Taxation Regimes

Kaestner addressed some elements of constitutionally legitimate state taxes on trusts. The Court confirmed that a tax on trust income distributed to an in-state resident is permissible under the Due Process Clause. So, too, is a tax based on a trustee's in-state residence, as well as those focused upon the location of trust administration.[6] The Court declined to expand further upon these principles, however. The question of state taxation frequently arises in the context of a trust with multiple trustees residing in different states. Would a single trustee's residence in a state seeking to tax the trust assets be sufficient? What if the trust were "directed," or otherwise provided for fiduciaries with separate, distinct, or delegated duties? The *Kaestner* decision does not offer answers to these questions, and seems to indicate only that it would require facts and circumstances analysis.

The Court also declined to address whether state taxation of trust income on the basis of settlor-residency would pass constitutional muster. Particularly in the case of an inter vivos trust, the logic employed by the Court suggests that a settlor's residency, alone, may be insufficient where the settlor does not retain clear power to possess, control, or enjoy the trust assets. While prior cases have upheld taxation of such trusts where the settlor retained the right to revoke the trust or the power to dispose of trust property, the issue of whether a lesser degree of control by a settlor also could sustain a tax by the settlor's domicile was left unaddressed. Settlor-residence is a prevalent factor in many state taxing regimes, and despite recent state court decisions that have addressed the issue (including, notably, the 2013 Illinois case of *Linn v. Department of Revenue*), federal guidance remains elusive. The Court may have the opportunity to confront some of these questions in the pending *Fielding* case,[7] but until then the issue remains murky.

Conclusion

While the *Kaestner* decision leaves unanswered many questions about the bounds of state taxation of trusts, the implications of the Court's analysis remain important. The holding's precedential value is significantly minimized as a result of the narrowness of the opinion and the unique facts of the case. Nevertheless, it is a rare Supreme Court decision that confronts when a state may constitutionally tax the undistributed income of trusts within the bounds of the Due Process Clause. We are likely to see many more cases arising at the state level in a post-*Kaestner* world, and they will undoubtedly apply, limit, and expand upon the views expressed in the Court's opinion. Practitioners and fiduciaries should review trust "contacts" with any given state each year, to determine whether the trust may be subject to state taxation, and if there are opportunities to reduce, or eliminate, state taxes. Reviewing "trust-state contacts" may be particularly important for successor fiduciaries of existing trusts to determine whether state returns have been properly filed, and whether the trust may have potential state tax liabilities. The analysis in *Kaestner* provides significant issues to consider even if its direct impact on the world of trusts will be muted.■

Oliver Merrill is an attorney in the Private Clients, Trusts and Estates Group of Schiff Hardin LLP, where he works with clients to address their tax and estate planning needs. He received his LLM (Tax) from Northwestern University Pritzker School of Law, and his J.D. from the University of Wisconsin Law School.

1. N.C. Gen. Stat. Ann. §105-160.2.
2. Interestingly, the Trust was initially designed to terminate in 2009. As permitted under New York's decanting statute, the trustee instead distributed the assets into a new trust, extending the termination date. The Court noted that one therefore might characterize the interests of the beneficiaries as "contingent" on the exercise of the trustee's discretion. In footnote 10, the Court expressly declined to address whether a different result might follow if the beneficiaries were certain to receive funds in the future.
3. *International Shoe Co. v. Washington*, 326 U.S. 310 (1945).
4. Citing *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).
5. Footnote 5 of the opinion explains that because the Trust in *Kaestner* did not meet the first step in this analysis, the Court did not address the second.
6. Citing *Maguire v. Trefry*, 253 U.S. 12 (1920), *Greenough v. Tax Assessors of Newport*, 331 U.S. 486 (1947), *Hanson v. Denckla*, 357 U.S. 235 (1958), and *Curry v. McCanless*, 307 U.S. 357 (1939).
7. The Court has not yet indicated whether or not it take up the issues presented in *William Field, Trustee of the Reid and Ann MacDonald Irrevocable GST Trust for Maria V. MacDonald, et al. v. Commissioner of Revenue*, a Minnesota Tax Court case addressing a state statute that provides an inter vivos trust with a resident settlor at the time the trust becomes irrevocable is a "resident trust" for state tax purposes.