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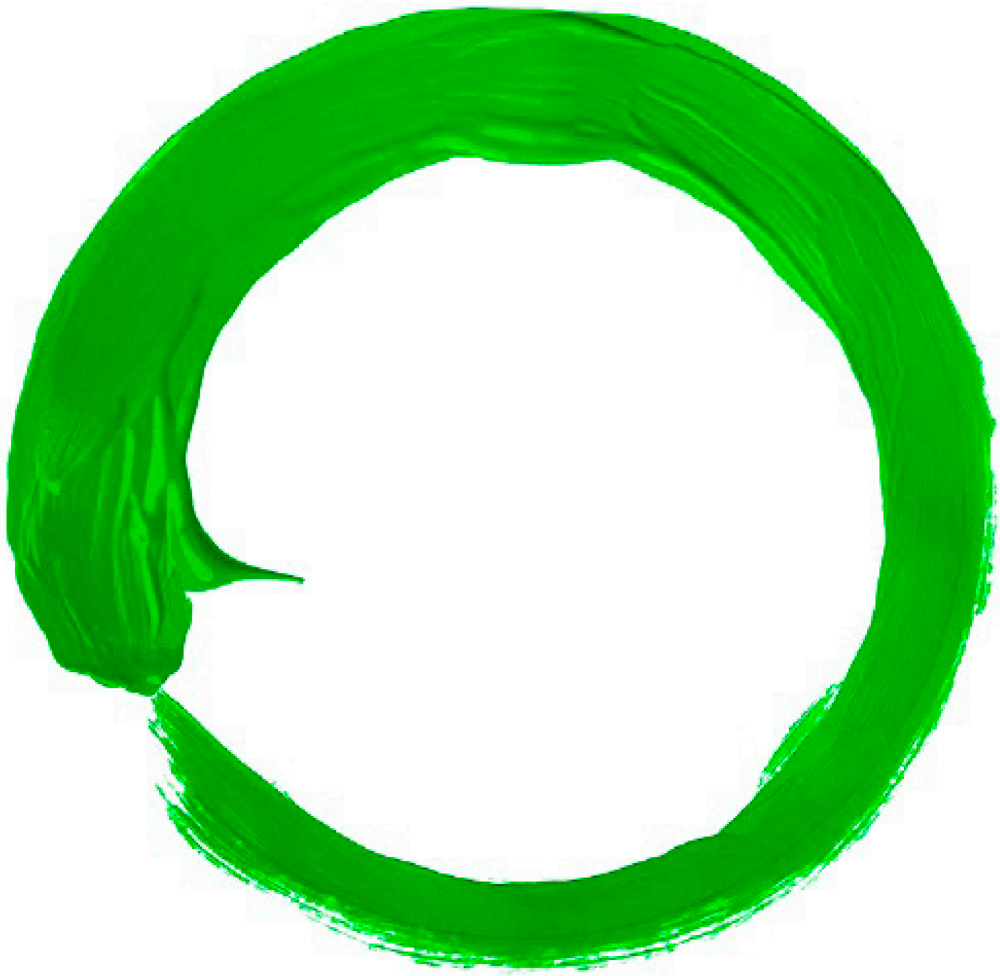

Inside Deloitte

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In this installment of Inside Deloitte, Canfield discusses the Supreme Court's decision in *North Carolina Department of Revenue v. Kaestner Family Trust*.

On June 21 the U.S. Supreme Court, in *Kaestner Family Trust*, held that a North Carolina statute that imposes income tax on all trusts with a beneficiary who resides in the state, violated the due process clause of the U.S. Constitution as applied.[1] This article analyzes the Supreme Court's opinion, discusses its immediate consequences in North Carolina, and explores the extent to which the opinion might extend to other states' laws regarding the income taxation of trusts.

Background and Procedural History

The Kimberley Rice Kaestner 1992 Family Trust was created by Joseph Rice, a New York domiciliary, and governed under New York law. A New York domiciliary initially served as trustee before being replaced by a Connecticut domiciliary for the tax years at issue before the Supreme Court.[2] At inception, there were no connections between the Kaestner Trust and North Carolina. In 1997, however, one of the discretionary beneficiaries, Kimberley Rice Kaestner, moved to North Carolina along with her minor children, who were also discretionary beneficiaries.[3] Despite being named as discretionary beneficiaries, Kaestner and her children did not receive any trust distributions during the tax years in question. Moreover, although the trust, by its terms, was scheduled to terminate upon Kaestner's 40th birthday, at which point she would have received the trust corpus, the trustee was authorized to, and in fact did, decant the trust into a new trust as permitted under New York administrative trust law.

Under North Carolina law, a trust is defined as a resident of the state if there are one or more beneficiaries who reside in the state.[4] In other words, the presence of one resident beneficiary, standing alone and irrespective of whether such beneficiary has a vested or contingent interest in trust income or principal, is sufficient in North Carolina to classify the trust as a resident. The classification of a trust as a resident is significant, both in North Carolina and most other states that impose fiduciary income tax, because it presumptively subjects the trust to income tax on all undistributed income from whatever source derived.[5]

Other states, such as California, also classify a trust as a resident based, in part, on the existence

[1] *North Carolina Department of Revenue v. Kimberley Rice Kaestner 1992 Family Trust*, 588 U.S. ___ (2019).

[2] The tax years were 2005 through 2008.

[3] The case implies that Kaestner and her children were the only beneficiaries of the trust, but that is nowhere expressly stated.

[4] N.C. Gen. Stat. section 105-160.2 (assessing tax "on the amount of the taxable income of the . . . trust that is for the benefit of a resident of this State").

[5] Please note that the term "trusts," as used in this article, is intended to refer strictly to non-grantor trusts. A grantor trust is disregarded for federal income tax purposes with its tax attributes reported, generally, by the individual who funded the trust and who retained an economic interest in or power over the trust.

of a resident vested beneficiary; but North Carolina, as outlined by the Supreme Court,[6] appears to be the only state that imposes income tax on a trust when the sole required connection between the trust and the state is the existence of a resident discretionary beneficiary.[7] For instance, California requires a beneficiary to possess a vested (that is, non-contingent) interest in a trust to cause the trust to be defined as a resident, and also employs an apportionment rule that reduces the percentage of trust income subject to tax for a trust with both nonresident and resident vested beneficiaries.[8] Likewise, other states require one or more additional factors other than the presence of a resident beneficiary as a necessary condition to justify taxation of the trust as a resident.[9]

To comply with North Carolina law the Kaestner Trust, for the tax years in question, paid income tax to North Carolina on undistributed income from all sources. Thereafter, the trust sought a refund of approximately $1.3 million of tax paid on total undistributed income for the applicable tax years, which the North Carolina Department of Revenue denied. The trust filed a lawsuit to challenge the constitutionality of the North Carolina statute, claiming it ran afoul of both the due process clause and commerce clause of the U.S. Constitution, among other claims. At the trial court level, the North Carolina Business Court concluded that the statute violated both the due process clause and commerce clause of the Constitution as applied to the Kaestner Trust.[10] Thereafter, the North Carolina Court of Appeals and North Carolina Supreme Court, respectively, affirmed the decision of the trial court, though only on due process clause grounds.[11]

The U.S. Supreme Court granted certiorari on appeal from the DOR, confining its review to the constitutionality of the North Carolina statute under the due process clause without regard to the commerce clause.[12]

Supreme Court Opinion

Test for Due Process Clause Analysis

The Supreme Court, in a unanimous opinion, affirmed the decisions of the lower North Carolina courts in holding that the statute, as applied, contravened the due process clause of the U.S. Constitution. The Court applied a two-part test, examining whether there was "some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax"[13] and whether "the income attributed to the State for tax purposes [was] rationally related to 'values connected with the taxing State.'"[14] Regarding the first prong, known as the minimum connection test, the Court explained that a state "has the power to impose a tax only when the taxed entity has 'certain minimum contacts' with the State such that the tax 'does not offend "traditional notions of fair play and substantial justice."'"[15] By contrast, the Court did not elaborate upon how its second prong applies in the context of fiduciary income tax or to the case at hand.

To inform its application of the prescribed two-part test of the due process clause, the Court revisited its historical approach to due process clause jurisprudence in the state tax arena generally. Regarding the state residency aspect of the North Carolina statute, the Court noted that "when assessing a state tax premised on the in-

[6] *See* note 29, *infra*, and accompanying text.

[7] *But see* Ga. Code Ann. section 48-7-22(a)(1)(C). As observed by the Supreme Court, *Kaestner Family Trust*, at 15, n.12, and noted in the Respondent's Brief at 52, n.20, there is dispute in the professional community about whether Georgia law is intended to apply similarly in this situation. *See* note 35, *infra*, for additional discussion.

[8] *See* Cal. Rev. & Tax Code section 17744. To illustrate, if a California non-grantor trust has two beneficiaries, one of whom is a California resident and one of whom resides elsewhere (and no California resident trustees), then only 50 percent of the accumulated income of the trust will be subject to income tax in California.

[9] *See, e.g.*, Ala. Code section 40-18-1(33); Mass. Code Regs. tit. 830, section 62.10.1(1)(b) (for *inter vivos* trusts); Mo. Rev. Stat. section 143.331(2), (3); Mont. Admin. R. section 43.30.101(16) (for *inter vivos* trusts); Ohio Rev. Code Ann. section 5747.01(I)(3) (for *inter vivos* trusts); and R.I. Gen. Laws section 44-30-5(c).

[10] *Kimberley Rice Kaestner 1992 Family Trust v. North Carolina Department of Revenue*, 2015 NCBC 36, 28 (N.C. Super. Ct. Wake County (Bus. Ct.) Apr. 23, 2015), *aff'd*.

[11] *Kaestner v. North Carolina Department of Revenue*, 789 S.E.2d 645, 651 (N.C. Ct. App. 2016), *aff'd Kimberley Rice Kaestner 1992 Family Trust v. North Carolina Department of Revenue*, 371 N.C. 133; 814 S.E.2d 43, 44 (2018).

[12] *See also Kaestner Family Trust*, at 7, n.4 (discussing scope of review); *cf. South Dakota v. Wayfair Inc.*, 585 U.S. __ (2018) (addressing both the commerce clause and due process clause).

[13] *Kaestner Family Trust*, at 5 (citing *Quill Corp. v. North Dakota*, 504 U.S. 298, 306 (1992)).

[14] *Id.* at 5-6 (citing *Quill*, 504 U.S. 298, 306).

[15] *Id.* at 6 (citing *International Shoe Co. v. Washington*, 326 U.S. 310, 316 (1945)).

state residency of a constituent of a trust — whether beneficiary, settlor, or trustee — the Due Process Clause demands attention to the particular relationship between the resident and the trust assets that the State seeks to tax."[16]

More specifically, the Court explained that "when a tax is premised on the in-state 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."[17]

Thus, the Court construed the due process clause as demanding "a pragmatic inquiry into what exactly the [resident] beneficiary controls or possesses and how that interest relates to the object of the State's tax."[18] To perform this inquiry, a resident beneficiary who receives a current distribution of trust assets, or has the ability to compel a distribution, or possesses an inalienable right to future possession of the trust assets (or some combination of these three benefits) must be distinguished from a resident beneficiary who has no current enjoyment of trust assets, cannot compel such enjoyment, and may not ultimately receive future possession of the trust assets. This distinction, as discussed later, is important when endeavoring to apply the principles set forth in *Kaestner Family Trust* to other state laws or to forecast how North Carolina might respond to the case.

Application of Test to the Kaestner Trust

In applying its due process clause tests, the Court identified three salient factors:

- the contingent nature of the North Carolina resident beneficiaries' interest;
- the lack of actual distributions to the North Carolina resident beneficiaries during any of the relevant tax years; and
- the inability of such beneficiaries to compel future distributions given the ability of the trustee to alter the original dispositive scheme.[19]

Insofar as the Court focused on the contingent nature of the beneficiaries' interests, as opposed to examining the constitutional bona fides of beneficiary-based taxation of trusts categorically, the opinion rests on exceedingly narrow grounds. To this point, Justice Samuel A. Alito Jr., in his concurring opinion, observed that "the opinion of the Court is circumscribed" because of the "unusually tenuous" connection between the beneficiaries and North Carolina.[20] In particular, the Court clarified that "we address only the circumstances in which a beneficiary receives no trust income, has no right to demand that income, and is uncertain necessarily to receive a specific share of that income."[21] The Court also disclaimed that "we have no occasion to address, and thus reserve for another day, whether a different result would follow if the beneficiaries were certain to receive funds in the future."[22] Accordingly, it is unclear whether the Court may have reached another opinion if any, or several, of the three aforementioned characteristics regarding beneficiary control over the trust assets and income were different.

Application to North Carolina

In terms of immediate application in North Carolina, the opinion did not foreclose the possibility of a different outcome if a beneficiary receives income distributions from the trust, if a beneficiary can compel distributions, or even when a beneficiary holds a vested inalienable remainder interest in the trust income or principal. Rather, the Court stated that it did not wish to "imply approval or disapproval of trust taxes that are premised on the residence of beneficiaries whose relationship to trust assets differs from that of the beneficiaries here."[23]

Put differently, the opinion does not invalidate a resident-beneficiary-based taxation approach per se, thus leaving open a range of potential ameliorative responses from North Carolina. As one possible measure, the state may redefine a resident trust as any trust with a

[16] *Id.* at 10.

[17] *Id.*

[18] *Id.* at 9.

[19] Which, as explained earlier, actually occurred when the trustee elected to decant the trust before the 40th birthday of the presumptive remainder beneficiary.

[20] *Id.* at 1 (Alito, J., concurring)

[21] *Id.* at 16.

[22] *Id.* at 12, n.10, *citing* Cal. Rev. & Tax Code section 17742(a).

[23] *Kaestner Family Trust*, at 7.

resident beneficiary who actually receives an income distribution in a given year, a non-contingent current income beneficiary regardless of whether such beneficiary receives a distribution, or a resident beneficiary who has a vested future interest that cannot be reduced or eliminated. Likewise, North Carolina might determine that a separate nexus point in addition to a resident beneficiary is required to give rise to trust residency, such as the presence of a North Carolina resident trustee, who would seem to have the requisite control over trust assets required by the Supreme Court.

Alternatively, the North Carolina legislature might pivot to a definition of residency that is premised on the domicile of the grantor who creates the trust,[24] or the principal place of administration, or some combination of these factors. Finally, from a mechanical standpoint, North Carolina, rather than enacting legislation or an administrative regulation, may simply update its fiduciary income tax return instructions or release additional guidance via the DOR to update the definition of beneficiary residency or to exempt specific resident trusts from tax, which would be consistent with at least one other state.[25]

Regarding potentially affected trusts (that is, trusts that paid tax to North Carolina based on the residency of discretionary beneficiaries who did not receive current distributions), the DOR published guidance on February 20, 2019, that included instructions on how to file protective claims for eventual refunds.[26] As explained in the notice, taxpayers who filed protective claims have six months from the conclusion of a "contingent event" to seek refunds in the form of an amended return or claim for refund.

On July 2 the DOR published additional guidance stating that the date of the Supreme Court decision (June 21, 2019) marked the end of the contingent event in this case, which means that taxpayers who filed protective claims must file amended returns or claims for refund before December 21, 2019.[27] The guidance also instructs a trust taxpayer that did not previously file a protective claim, but believes it may qualify for a refund, to file an amended return reflecting an overpayment or claim for refund within the statute of limitations. Similarly situated trusts would therefore appear to be authorized to pursue refunds through amended fiduciary income tax returns for tax years with an open statute of limitations. From a substantive standpoint, however, it is unclear how North Carolina intends to assess the validity of refund claims given the limited nature of the *Kaestner Family Trust* opinion.

Prospectively, fiduciaries of trusts with North Carolina beneficiaries should monitor responses from North Carolina and consider how their trusts align with the factors identified by the Supreme Court as relevant in its due process clause analysis. In particular, trustees may want to review whether their North Carolina beneficiaries possess a current vested interest in trust income or principal (manifested by current distributions or the right to such distributions), and whether future interests in trust income and principal could be subject to divestment under an applicable decanting statute or provision in the trust agreement that allows the trustee to alter the existing blueprint of disposition set forth in the trust instrument. Depending on these factors, some trusts may prove exempt from future tax in North Carolina.

Broader Application

In a June 17 article in *Tax Notes State*, I explored the historical development of state case law in the area of trust tax residency.[28] Against this backdrop, I examined the various state approaches to trust taxation from a constitutional standpoint and proposed a range of potential outcomes to *Kaestner Family Trust*, some of which entertained the possibility of a ruling with

[24] This definition, however, has been struck down or limited in some cases. *See, e.g., Fielding v. Commissioner of Revenue*, 916 N.W.2d 323 (Minn. 2018); *Linn v. Department of Revenue*, 2 N.E.3d 1203 (Ill. App. Ct. 2013); and *McNeil v. Commonwealth*, 67 A.3d 185 (Pa. Commw. 2013). For a more detailed summary, see "Constitutional Limits on the State Taxation of Trusts," note 28, *infra*.

[25] *E.g.*, New Jersey, which created exceptions to tax for resident trusts via guidance from its Division of Taxation.

[26] N.C. DOR, "Important Notice: United States Supreme Court Agrees to Hear North Carolina Trust Income Taxation Case" (Feb. 20, 2019).

[27] N.C. DOR, "Important Notice: Decision in *Kaestner* Case" (July 2, 2019).

[28] Michael Canfield, "Constitutional Limits on the State Taxation of Trusts," *Tax Notes State*, June 17, 2019, p. 1011.

significant, wide-reaching consequences for resident trusts in multiple states, or even a new test for due process clause jurisprudence. Expectations for a major shift in the state trust tax landscape, however, may have been tempered by a Supreme Court opinion confined to the particular facts of the case and to the statute at hand.

Given that California law, like North Carolina law, allows for a trust to be taxed on undistributed income of a trust based purely on the presence of a resident beneficiary, some commentators and practitioners awaited the opinion in *Kaestner Family Trust* with a keen eye on its potential application to California.[29] Despite such speculation, the Supreme Court distanced itself from the notion that its opinion may extend to the Golden State by distinguishing the California statute on several grounds. First, the Court, citing California statutory law that requires a beneficiary to have a non-contingent interest, cautioned that its ruling does not address whether a future interest held by a resident beneficiary might create sufficient grounds to tax a trust as a resident.[30]

Second, the Court, again citing California law, explained that the Kaestner Trust did not challenge the concept of "throwback taxation," under which a previously contingent beneficiary is taxed on the whole of a distribution of previously accumulated, untaxed income, regardless of its federal taxation.[31] As North Carolina law, like the overwhelming majority of states, does not impose throwback taxation on trust beneficiaries, this statement, albeit in dicta, seems to underscore the Court's effort to fortify its opinion from being construed as extending to California. Similarly, the opinion is not per se incompatible with other aspects of California law, including, of particular note, an administrative ruling in California that provides that an otherwise contingent beneficiary of a trust becomes non-contingent upon an actual distribution in a given year.[32] Since the *Kaestner Family Trust* opinion dealt with a trust that made no distributions during the period in question, it does not address a scenario in which a state premises its definition of residency in part on whether a resident beneficiary receives a distribution in a given tax year; thus, the analysis set forth by the California Franchise Tax Board in this administrative ruling appears to be unaffected by the holding or the rationale of the Supreme Court.

Lastly, the *Kaestner Family Trust* opinion should not have immediate consequences on other state taxing regimes that either expressly do not consider the presence of resident beneficiaries as a determinant of residency or view the presence of resident beneficiaries as one of multiple factors in determining trust residency. Regarding the former, the Court, in a lengthy footnote, expressly distinguished each state statute that imposes resident income tax on a trust based on the existence of a resident beneficiary, either standing alone or in conjunction with other factors.[33] Regarding the latter, there are several state statutes, all of which appear to be cited by the Court, that require an additional nexus point besides the presence of a resident beneficiary to subject a trust to resident taxation. For example, Rhode Island and Missouri employ two-factor residency tests that require a resident beneficiary to be present in addition to the trust having been created irrevocably by a domiciliary.[34]

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[29] Note, however, that although California taxes trusts with no connection to the state aside from a resident non-contingent beneficiary, California also imposes income tax based on the presence of resident trustees. *See* Cal. Rev. & Tax Code section 17742(a).

[30] *Kaestner Family Trust*, at 12, n.10. In doing so, the Court seemed to imply that California imposes tax on trusts with beneficiaries who possess a mere future interest in the trust, which appears to be an inaccurate recitation of California law. Moreover, to warrant taxation based purely on a beneficiary with a future interest within the scope of the *Kaestner Family Trust* ruling, the trust instrument and state law would both need to prevent any party from decanting the trust into a new trust, the terms of which might deprive the beneficiary of the enjoyment of the trust's assets.

[31] *Kaestner Family Trust*, at 15, n.13, citing Cal. Rev. & Tax Code section 17745(b). New York also imposes a throwback tax on resident beneficiaries who receive distributions of income that were untaxed due to the trust, despite being defined as a resident trust, qualifying for exemption from tax based on a lack of nexus. *See* N.Y. Tax Law section 612(b)(40).

[32] *See* California Franchise Tax Board, Technical Advice Memo. 2006-002 (Feb. 17, 2006).

[33] *Kaestner Family Trust*, at 15, n.12 (citing statutes in Alabama, California, Connecticut, Georgia, Missouri, Montana, North Dakota, Ohio, Rhode Island, and Tennessee). Note that Georgia law, as discussed in note 7, *supra*, is subject to dispute; also note that the Court did not distinguish Tennessee law on substantive grounds, but simply observed that the Tennessee income tax will be repealed in full by 2021.

[34] *See* Ala. Code section 40-18-1(33); Mo. Rev. Stat. sections 143.331(2), (3); and R.I. Gen. Laws section 44-30-5(c).

It is unclear, and not addressed by *Kaestner Family Trust*, whether those statutes might be deemed unconstitutional if the resident beneficiary possessed an identical interest to the beneficiaries of the Kaestner Trust (that is, contingent in the present and future). Nonetheless, to the extent that the Court did not explicitly prohibit states in all cases from taxing trusts as residents based on the presence of a resident beneficiary, it remains possible that states with beneficiary-based systems (in whole or in part), including North Carolina, will seek to modify the level of control that a resident beneficiary must possess to be taxed as a resident, rather than adopting a whole new definition of trust residency.

In fact, Georgia issued a policy bulletin in response to *Kaestner Family Trust*, which stated that "with respect to facts that are specifically like those in *Kaestner*, a nonresident trust fiduciary would not be subject to Georgia taxation [but] otherwise, the fiduciary would be subject to taxation."[35] This bulletin potentially opens the door for certain trusts to seek refunds from Georgia on identical facts to *Kaestner Family Trust* and to stop paying tax prospectively on such facts, but it also affirms that Georgia, and perhaps other states, will seek to impose tax on trusts based purely on the presence of a resident beneficiary as long as the nature of the beneficiary's interest can be distinguished from *Kaestner Family Trust*. In addition, there are still numerous theoretical bases for imposing income tax on trusts as residents of a state, none of which are necessarily vitiated by *Kaestner Family Trust* or other existing federal or state court precedent.

Conclusion

In my aforementioned June article, I postulated that "an enduring lack of clarity in this area is likely even after the Supreme Court renders its opinion in *Kaestner Family Trust*."[36] The Supreme Court, by delivering a narrow, fact-specific ruling, has left the state income tax landscape largely undisturbed, thereby declining an invitation to alleviate this lack of clarity. For this reason, one might expect to see continued growth in state and perhaps federal jurisprudence in this area as tax practitioners and fiduciaries seek to determine the constitutional boundaries of numerous state statutes that vary significantly in their conceptual basis and specific application. Inasmuch as the Supreme Court reserved some questions "for another day,"[37] one wonders when, and if, that day might come, and what that day might bring.[38]

In the meantime, fiduciaries and practitioners are left to grapple with the patchwork of state laws regarding trust residency, and to consider how their trusts fit within these divergent taxing theories, both in terms of compliance for existing trusts and planning for new trusts. ■

[35]Georgia Department of Revenue, Policy Bulletin IT-2019-02, "Taxation of Nonresident Trust Fiduciaries — Effect of Kaestner Decision." The bulletin identified three factors from *Kaestner Family Trust* that it deemed relevant: "(1) [t]he beneficiaries did not receive any income from the trust during the years in question; (2) the beneficiaries had no right to demand trust income or otherwise control, possess, or enjoy the trust assets in the tax years at issue; and (3) not only were the beneficiaries unable to demand distributions in the tax years at issue, but it was also uncertain whether they would ever receive any income from the trust in the future." On the topic of the aforementioned dispute about the scope of the relevant Georgia statutes as discussed in note 7, *supra*, the bulletin appears to serve as a statement that the Georgia DOR deems a trust to be subject to tax on facts that are not substantially identical to *Kaestner Family Trust*, despite having a nonresident trust fiduciary.

[36]To be clear, this viewpoint was common in the industry and the author chose this quotation to complete a topic sentence and not as proof of his prescience.

[37]*Kaestner Family Trust*, at 12, n.10.

[38]We know, however, that the day for clarity will not come as soon as it possibly could have: the Supreme Court on June 28, 2019, denied certiorari in *Fielding v. Commissioner*, *supra* note 24, in which the Minnesota Supreme Court, on due process clause grounds, struck down, as applied, a Minnesota statute that imposes income tax on trusts based solely on the presence of a domiciliary grantor.