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Insights: Alerts

Kaestner Trust: Three Key Takeaways

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Written by **Jeffrey S. Reed**

On June 21, 2019 the United States Supreme Court issued its opinion for *North Carolina Department of Revenue v. Kimberly Rice Kaestner 1992 Family Trust*. Not surprisingly, based on how oral argument went, the Court ruled that the Due Process Clause bars a state from taxing undistributed trust income when a trust's sole connection to the state is the presence of in-state beneficiaries. This alert briefly summarizes the facts and the Court's holding before providing three key takeaways.

Facts

The trust was a sub-trust of a trust formed outside North Carolina (the settlor was in New York). The trustee resided outside North Carolina (in Connecticut), the trust documents and records were stored outside North Carolina (in Massachusetts), and the trust made no direct investments in North Carolina (all trust assets were intangible). The beneficiaries of the trust (Kaestner and her children) resided in North Carolina, but did not receive any distributions from the trust during the years at issue.

A North Carolina statute provides that a trust must pay income tax to the state if the trust benefits North Carolina.[1] Complying with the statute, the trust paid North Carolina income tax for tax years 2005 through 2008 and then filed refund claims to recover the tax paid, challenging the constitutionality of the statute. The trial court, appeals court, and the North Carolina Supreme Court all ruled that imposing an income tax on the trust solely based on the in-state presence of beneficiaries was unconstitutional under the Due Process Clause.

The Court's (Limited) Holding

The United States Supreme Court agreed with the North Carolina courts. In ruling in favor of the trust, the Court emphasized these three facts: (1) the beneficiaries received no income from the trust during the years in question; (2) the beneficiaries had no right, under the trust agreement, to demand income or assets from the trust, but rather distributions were at the sole discretion of the trustee; and (3) the beneficiaries could not count on necessarily receiving any specific amount of income from the trust in the future (distributions were solely at the discretion of the trustee). "Given these features of the trust, the beneficiaries' residence cannot, consistent with due process, serve as the sole basis for North Carolina's tax on trust income." [2]

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The Court carefully limited its holding to the facts before it.[3] As a result, the Court's opinion supports the proposition that a state cannot tax undistributed trust income merely because a beneficiary or beneficiaries reside in the state. But the Court declined to adopt a broad categorical Due Process Clause rule that applies to all fact patterns involving beneficiaries.

Three Key Takeaways

While the Court carefully crafted a narrow opinion, several noteworthy things that can be gleaned from the opinion. Here are three.

1. Features of the Trust Agreement are Central to the Due Process Clause Nexus Analysis. The Court's opinion focuses on the lack of formal control the beneficiaries have over the trust assets and distributions under the trust agreement. Drafters of trust agreements seeking to rely on the opinion will want to vest the trustee with total oversight over trust assets and the timing of distributions (or lack thereof). Before filing a refund claim, any trust currently paying income taxes to a state solely due to the presence of an in-state beneficiary will want to review the trust agreement and consider the degree of control the beneficiary has over trust assets and distributions under the agreement.

2. Opportunistic State Income Tax Planning with Trusts is Okay, But a Cost Must be Paid. The Court's opinion interestingly acknowledges that it may be possible to engage in "opportunistic gaming of state tax systems" by locating the trustee in a state that does not tax trust income, and then delaying trust distributions until beneficiaries move to a state like Florida, Nevada, or Texas that does not impose a personal income tax.[4] The Court seems uncertain that such gaming will occur, but in any event is conscious that the opinion encourages drafters of trust agreements to weigh state tax savings against the downside of giving beneficiaries limited control over trust assets. "Settlors who create trusts in the future will have to weigh the potential tax benefits of such an arrangement against the costs to the trust beneficiaries of lesser control over trust assets."[5] So state income tax planning with trusts is permissible but the settlor must be willing to pay the price of giving the beneficiary limited control over trust assets.

3. The Court Did Not Break New Ground with its Due Process Clause Analysis, But Rather Re-Affirmed Due Process Clause Nexus Principles from *Quill*. Many practitioners were hoping that the Court would use the case as a vehicle for expounding Due Process Clause nexus principles. But the Court created no new Due Process Clause nexus test, and did not formulate the familiar principles in a new way. Rather, the Court's Due Process Clause nexus summary closely follows that from *Quill*, under which the requisite nexus will not exist unless: (1) "there is some definite link, some minimum connection, between a state and the person property or transaction it seeks to tax" and (2) the "income attributed to the State for tax purposes must be rationally related to values connected with the taxing State."[6] This indicates the continued viability of Due Process Clause nexus, but the Court neglected to give practitioners any new guidance that can

easily be applied to different tax types or fact patterns.

Footnotes

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[1] *See* N.C. Gen. Stat. § 105-160.2.

[2] Slip Opinion at 13.

[3] E.g. "In limiting our holding to the specific facts presented…" Slip opinion at 7.

[4] Slip opinion at 16.

[5] *Id.*

[6] Slip opinion at 5-6, quoting *Quill Corp v. North Dakota*, 504 US 298, 306 (1992) (additional citations omitted).

Related People

Jeffrey S. Reed

Partner

New York, NY

t 212.775.8792

jsreed@kilpatricktownsend.com