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Trust Wins Due Process Challenge to North Carolina State Income Tax

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Last week, the US Supreme Court ruled that North Carolina may not tax a trust's income when the trust's only contact with the state is the in-state residence of discretionary beneficiaries. The Due Process Clause requires a minimum connection between a state and the person it seeks to tax. The mere residency of the discretionary beneficiaries of a trust is not sufficient to satisfy this requirement.

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IN DEPTH

On June 21, 2019, the US Supreme Court unanimously held that North Carolina's tax law that imposes an income tax on trust income that is "for the benefit of" a North Carolina resident violates the Due Process Clause of the United States Constitution when applied to tax the income of a trust on the sole basis of the in-state residence of discretionary beneficiaries. *North Carolina v. The Kimberley Rice Kaestner 1992 Family Trust*, Case No. 18-457 (S. Ct. June 21, 2019) (Sotomayor, J.) (Alito, J. filing a concurring opinion, in which Roberts, C. J. and Gorsuch J. joined).

The *Kaestner* trust was created by a New York resident, was subject to New York law, and had a trustee who was a resident of Connecticut. The trust documents and records were kept in New York and its assets were custodied in Massachusetts. The trustee made no direct investments in North Carolina. The only contacts the trust had with North Carolina was the in-state residence of its current beneficiaries. But none of the current beneficiaries had received a distribution from the trust during the relevant tax years, none of them had a right to compel distributions, none of them had any fixed right to receive future distributions, none of them had the right to assign their interests in the trust and none of them had the right to participate in investment decisions.

The Court's conclusion in *Kaestner* is consistent with its 1929 decision in *Safe Deposit Box and Trust Company v. Virginia,* 280 U.S. 83 (1929). Virginia imposed its intangible personal property tax on property held by the Maryland trustee of a trust held for the benefit of Virginia resident beneficiaries that was created by a Virginia settlor. The Court decided that the imposition conflicted with the Fourteenth Amendment because the property sought to be taxed was wholly beyond the jurisdiction or control of Virginia.

The *Kaestner* decision, however, was rooted more specifically in the Due Process principles articulated in the Court's 1992 decision in *Quill v. North Dakota,* 504 U.S. 298 (1992), overruled on other grounds, *South Dakota v. Wayfair, Inc.*, 585 U.S.____ (2018). *Quill* confirmed that a state must satisfy a two prong test before it can impose its tax on a person, property, or transaction. First, 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." Standing alone, the in-state residency of beneficiaries who may never receive anything from the trust is not sufficient to satisfy these tests. If a state tax is to be justified by the state residence of a beneficiary, the beneficiary is required to have "some degree of possession, control, or enjoyment of the trust property or a right to receive that property."

The Court's decision in *Kaestner* is a narrow one. North Carolina and only one other state, Tennessee, have statutes that use the residency of trust beneficiaries as the sole criterion for the imposition of tax—but the opinion noted that Tennessee's income tax will be phased out by 2021. The decision does not hold a statute of this type unconstitutional on its face. Instead, it holds only that the application of the rule to tax a trust that has no contacts with the state other than the residency of contingent beneficiaries will not survive a Due Process attack and offers no guidance as to the quantity of required relationship. The Court may well have reached a different conclusion if there had been more contacts between the trust and the state or if the trust instrument had given resident beneficiaries the right to receive future distributions of trust funds. The Court observed that California applies its tax on the basis of beneficiary residency only when the beneficiary's interest is not contingent and expressly stated that it was not considering whether it would have reached a different result if the North Carolina resident beneficiaries were certain to receive trust funds in the future. In a footnote it mentioned that the taxpayer trust had raised no objection to the possible imposition of a state tax on a resident beneficiary when it received a future distribution of income accumulated in a prior year. Both California and New York have tax systems that impose a tax, commonly referred to as a "throw-back tax," under certain circumstances on a resident beneficiary who receives trust income accumulated in a prior year. Cal. Rev. & Tax. Code Ann. §17745(b); N.Y. Tax Law §612(b)(40).

The decision does, however, provide some clues as to what the Court is likely to find sufficient when dealing with three of the criteria that other states use to justify the imposition of their taxes on trust income—the residency of the trustees, the place where the trust is administered and the residency of the settlor of the trust.

The residency of trustees

At least six states tax the income of trusts if one or more of the trustees are residents of the state—Arizona, California, Kentucky, New Mexico, Oregon, and Virginia.. At least eight other states require another connection such as the residence of the trust's settlor or the residence of a trust beneficiary—these states are Alabama, Arkansas, Delaware, Hawaii, Massachusetts, New Jersey, New York and North Dakota*.* There is a strong clue in the *Kaestner* opinion that the in-state residency of a trustee is a sufficient connection. The Court referred approvingly to its 1947 decision in *Greenough v. Tax Assessors of Newport*, 331 U.S. 486 (1947). In that decision, the Court upheld the right of Rhode Island to impose its intangible personal property tax on the resident trustee of a trust established under the will of a New York resident because the trustee is the owner of a legal interest in the trust property, "may incur obligations in the administration of the trust enforceable against him personally," and, as a resident, is entitled to the benefit and protection of Rhode Island laws. Rhode Island had no other contacts with the trust.

The place where the trust is administered

At least eight states tax the income of trusts that are administered in the state—these states are Colorado, Indiana, Kansas, Mississippi, New Mexico, Oregon, South Carolina and Virginia (Nenno, Bases of State Income Taxation of Nongrantor Trusts). At least two other states, Hawaii and North Dakota, require another connection. The opinion's clue as to the sufficiency of the administration connection is less clear. The decision tells us only that prior cases "suggest that a tax based on the site of trust administration is constitutional." The prior cases referred to are *Hanson v. Denckla,* 357 U.S. 235 (1958) and *Curry v. McCanless*, 307 U.S. 357 (1939), neither of which deals directly with the significance of the place of administration. In both cases, not only were the trusts administered outside of the relevant state, but the residency of the trustees was also out of state.

The residency of the settlor of an inter vivos trust

Whether the residency of the settlor is a sufficient connection to permit a state to tax a trust is of far greater importance to taxpayers than the first two criteria. It is relatively simple for settlors to protect their trusts from state taxation by selecting trustees who live in states that do not impose tax based on the residence of trustees or on the place of trust administration. It is impossible for them to take steps to protect previously funded trusts from state taxation on this basis and far more inconvenient for them to change their domicile to protect trusts they may fund in the future.

At least 21 states now impose income tax on trusts created and funded by settlors who were state residents at the time the trusts became irrevocable. A few of them also require the residency of a trust beneficiary—Alabama, Connecticut, Delaware, Idaho, Illinois, Iowa, Louisiana, Maine, Maryland, Massachusetts, Michigan, Minnesota, Missouri, Nebraska, Ohio, Oklahoma, Rhode Island, Vermont, Virginia, West Virginia and Wisconsin.

The *Kaestner* clue as to the insufficiency of the settlor's residence is good news for taxpayers. The clue suggests that something else will likely be needed. The opinion states that there must be an inquiry into what the settlor "controls or possesses and how that interest relates to the object of the State's tax." It then refers to *Curry v. McCanless*, discussed above in relation to the trust administration connection, and another case decided the same year, *Graves v. Elliott,* 307 U.S. 383 (1939). In both cases the Supreme Court sustained the power of a state to tax a trust with a resident settlor but only because the settlor retained significant powers over the trust property. The settlor in the *Curry* case was the beneficiary of the trust during her life and retained the power to direct how the trust property would be disposed of at her death. The settlor in the *Graves* case retained the power to revoke the trust.

Obviously, an inquiry into a settlor's retained control will find none in the case of a settlor who is no longer living. Even if the settlor is alive and a resident of the taxing state, if the trust is an irrevocable nongrantor trust which is intended to escape estate taxation at the death of the settlor, it is likely that the settlor will not have retained sufficient control over the trust to justify state taxation of the trust. A conclusion that the residency of the trust's settlor alone is not sufficient to give a state taxing rights is consistent with most of the state court opinions that deal with this issue. The decision of the Minnesota Supreme Court in *Fielding v. Commissioner of Revenue*, 916 N.W. 2d 323 (2018) is the most recent decision to reject the residency of the settlor as a basis for state taxation. The State of Minnesota filed a petition in the US Supreme Court on November 15, 2018, asking the Court to review this decision. If the Court grants the petition, the opinion it issues in the case may give a clearer answer to the question as to if and when the residency of a settlor of an *inter vivos* nongrantor trust may be used to satisfy the minimum connection test of the Due Process clause.

Practice Note: *Kaestner* teaches us that the residency of a discretionary beneficiary alone will not be enough to permit a state to tax a trust and that residency of the trust's settlor will probably not be enough. There is a risk, however, that the existence of any additional factors will create a sufficient connection.

The settlor who wants to avoid state taxation of a trust with a beneficiary living in a state that uses the residence of a beneficiary either alone or in conjunction with other factors should consider eliminating all other contacts with the state and limiting that beneficiary's control over and measurable interests in the trust. If, for example, a discretionary beneficiary has annual withdrawal rights, state taxation of the trust might survive a constitutional challenge. Because the future location of beneficiaries is difficult to predict, the trust instrument should contain sufficient flexibility to permit future restrictions to the beneficiary's interest and controls over the trust.

Settlors who live in states that impose tax on trusts based on the in-state residency of the settlor will want to eliminate all other contacts between the state and their trusts and to minimize their controls over their trusts. The trustees should be out of state residents, the trust should be administered out of the state, the trust instrument should not provide that the trust is subject to the laws of the settlor's state of residence, and the trustees should avoid investing in tangible personal or real property located in the state. In the case of trusts to be funded at death, *inter vivos* trusts rather than testamentary trusts should be used to receive trust assets in order to avoid an argument that the probate courts of the state of domicile at death have continuing jurisdiction over testamentary trusts.