



ALERTS

U.S. Supreme Court Limits Ability Of States To Tax Trust Income

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In its recent decision in [North Carolina Department of Revenue v. Kimberley Rice Kaestner 1992 Family Trust](#), the U.S. Supreme Court held that in-state residency does not suffice, on its own, as the basis for a state imposed tax on a trust.

The court specifically noted that the North Carolina tax on the Kaestner Trust violated the due process clause of the Fourteenth Amendment, and it affirmed the lower courts' granting of summary judgment in the Kaestner Trust's favor. As a result, the North Carolina Department of Revenue must refund any and all taxes and penalties paid by the trustee with interest.

Factual Background

Joseph Lee Rice III formed a trust in New York with a New York resident as the trustee. The trust was for the benefit of Rice's three children and their descendants, and the trustee had absolute discretion to distribute the assets to the beneficiaries. When Rice's daughter, Kimberly Rice Kaestner, moved to North Carolina, the trust was divided into three separate trusts, one for each child and that child's descendants. North Carolina attempted to tax the trust intended for Kaestner and her children based on their in-state residency. The asserted liability was \$1.3 million for the years 2005 through 2008. The trustee paid the \$1.3 million tax under protest, and then sued the North Carolina Department of Revenue in state court, arguing the trust's tax violated the due process clause of the Fourteenth Amendment and seeking a refund of all taxes, penalties and interest paid.

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James R. Robinson

Partner

Atlanta, Los Angeles

P 404-264-4042

F 404-264-4033

jrobinson@btlaw.com

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Procedural History

The trial court decided Kaestner's North Carolina residence was too tenuous a link between the state and the trust to support such a tax, and that it violated the due process clause. The North Carolina Court of Appeals and the North Carolina Supreme Court affirmed this holding, reasoning that "the Kaestner Trust and its beneficiaries have legally separate, taxable existences and thus that the contacts between the Kaestner family and their home State cannot establish a connection between the Trust itself and the State." Certiorari was granted to the U. S. Supreme Court to decide "whether the Due Process Clause prohibits States from taxing trusts based only on the in-state residency of trust beneficiaries."

Supreme Court Holding

The Supreme Court held 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 ever to receive it." This is based on three findings by the court that the beneficiaries: 1.) "...did not receive any income from the Trust during the years in question..."; 2.) "...had no right to demand Trust income or otherwise control, possess, or enjoy the trust assets in the tax years at issue"; and 3.) "...could not count on necessarily receiving any specific amount of income from the Trust in the future."

Supreme Court Reasoning

The court applied a two-step analysis to determine whether a state tax abides by the due process clause: 1.) there must be "some definite link [or] 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. A state has a definite link or minimum connection if the taxed entity has minimum contacts with the state under *International Shoe*. The court classified this inquiry as flexible with the basic idea that "only those who derive benefits and protection from associating with a State should have obligations to the State in question."

However, the due process analysis is narrowed in the context of state trust taxes by focusing on Constitutional requirement that the in-state beneficiary have some right to control, possess, enjoy, or receive trust assets before the state can tax them. The court cited *Safe Deposit & Trust Co. of Baltimore v. Virginia* and *Brooke v. Norfolk* in which a state's taxation of an entire trust premised on the in-state residence of beneficiaries was invalidated since no one within the respective states had the present right to control, possess, or receive income from the trust at issue.

The court reinforced its analysis with a case in which a state tax based on in-state residency was upheld because of the direct connection between the beneficiary and the state. In *Maguire v. Trefry* and *Guaranty Trust Co. v. Virginia*, the court decided that states may tax trust income that is *actually distributed* to an in-state beneficiary because the beneficiary owns and enjoys an interest in the trust property, and the state can exact

a tax in exchange for offering beneficiary protection.

Analysis of Outcome

In this case, North Carolina improperly imposed a tax on the Kaestner Trust. The beneficiaries did not receive any income or distributions from the trust during the years in question. Since the trustee maintained absolute control over the trust with a fiduciary duty, Kaestner had no right to demand distributions or otherwise control, possess, or enjoy the trust assets during the taxing years. Additionally, Kaestner could not guarantee she would receive any money from the trust in the future.

Furthermore, Rice created the trust in New York to be governed by New York law with a New York trustee, and all trust documents and records stayed in New York, so the trust itself retained no physical presence in North Carolina. While a beneficiary lived in North Carolina during 2005-2008, the trustee maintained absolute control over the assets and chose not to distribute them to Kaestner and her children. Moreover, the communication between the trustee and Kaestner was infrequent.

The state's counterarguments that trusts and constituents are always inextricably intertwined, that ruling in favor of the trust would undermine numerous state taxation regimes, and that adopting the trust's position would lead to opportunistic gaming of state tax systems were unpersuasive to the court. Those arguments did not consider the variety of beneficiary interests, only accounted for a minute impact, and lacked certainty.

As a result of the Supreme Court's decision, the criteria for state-imposed tax on a trust is that in-state beneficiaries must receive a distribution or have the right to control, possess or enjoy the assets within that state.

For more information, please contact the Barnes & Thornburg attorney with whom you work or James Robinson at 404-264-4042 or james.robinson@btlaw.com.

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