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State Law & State Taxation Corner

Too Slender a Thread: The U.S. Supreme Court Holds That a Trust Lacks Due Process Nexus Based Solely on the In-State Residence of Beneficiaries Without the Right to Control Trust Distributions

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Introduction

States have traditionally imposed their income tax on the undistributed income of a trust if the grantor, testator or trustee is a resident of that state. As discussed in this column, there is plenty of case law holding that the presence of a grantor, testator or trustee exercising (at least at one time) control over the trust's assets or income in a particular state provides the "minimum contacts" required to give that state taxable nexus over the trust under the Due Process Clause of the U.S. Constitution. A handful of states have more controversially claimed the right to tax the undistributed income of a trust if one or more of its beneficiaries reside in the state. These states have typically pointed to broad statements by the California Supreme Court in *McCulloch v. Franchise Tax Board*,[1] and by the Connecticut Supreme Court in *Chase Manhattan Bank v. Gavin*,[2] that the state's laws were protecting the rights of the in-state beneficiaries to receive future distributions of income that the trust was accumulating, thereby giving the trust due process nexus in the taxing state.

This theory of state trust taxation now appears to be less tenable. On June 21, 2019, the U.S. Supreme Court unanimously held, in *North Carolina Department of Revenue v. Kimberley Rice Kaestner 1992 Family Trust*, that the North Carolina Department of Revenue could not constitutionally impose the North Carolina income tax on the undistributed income of an out-of-state irrevocable trust whose only contact with that state was that beneficiaries of the trust happened to be residing in North Carolina during the tax years at issue in the case.[3] The Supreme Court concluded, as had all the North Carolina courts in this case, that the mere presence of trust beneficiaries in North Carolina, without those beneficiaries having the right to control, possess, enjoy or receive assets of the trust, did not

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establish the necessary "minimum contacts" between the trust and North Carolina that the Due Process Clause would require in order to allow North Carolina to tax the undistributed income of the trust.

The Supreme Court's *Kaestner* decision shows that constitutional nexus standards still matter, even after the Court's landmark decision last year in *Wayfair, Inc. v. South Dakota*, which overruled the Court's longstanding physical presence nexus standard of the Commerce Clause, and replaced it with an economic presence nexus standard in an opinion that was rather deferential to the states.[4] In *Quill Corp. v. North Dakota*, the case that *Wayfair* overruled, the Supreme Court had declined to find that an out-of-state mail order vendor had the necessary physical presence to give the vendor sales and use tax nexus in North Dakota, based on the vendor having licensed a computer software program that allowed some of its North Dakota customers to do online checks of the vendor's inventories and prices.[5] The *Quill* majority opinion noted that "the existence in North Dakota of a few floppy diskettes to which Quill holds title seems a slender thread upon which to base nexus."[6] In the same vein, the *Kaestner* opinion seems to have concluded that the Due Process Clause requires a stouter taxable nexus thread than the mere presence in the taxing state of trust beneficiaries who have no right to control, possess, enjoy or receive distributions of trust income or assets.

State Approaches to Taxing Trusts on Their Undistributed Income

Over the years, states have developed a variety of approaches to taxing trusts on their undistributed income.[7] Under the applicable provisions of the Internal Revenue Code, the trust generally pays federal income tax on income that the trust accumulates as a result of the trustee having exercised the discretionary provisions in the trust instrument. When the trust makes a distribution of that accumulated trust income to the beneficiary of the trust, the beneficiary generally pays federal income tax on the amount of distributed income, offset by any federal income tax previously paid by the trust on that income.[8]

A number of states will tax a trust on its undistributed income if the trust's settlor or testator was a resident of the taxing state. For example, the Illinois Income Tax Act defines the term "resident" to include "a trust created by a will of a decedent who at his death was domiciled in this State" or "an irrevocable trust, the grantor of which was domiciled in this State at the time such trust become irrevocable."[9] Similarly, the New York personal income tax laws define a "resident trust" as "a trust, or portion of a trust, consisting of property transferred by will of a decedent who at his death was domiciled in this state" or "a trust, or portion of a trust, consisting of property of a person domiciled in this state at the time such trust, or part of a trust, became irrevocable."[10] As a resident of the state, the trust is subject to taxation by that state on all the trust's income, regardless of where the trust earned such income. Under the literal language of these statutes, the state would continue to be able to tax the trust on its income forevermore, merely because the settlor or the testator was a resident of the state at the time the trust became irrevocable or the testator died. Given that the trust was created under the laws of the state where the settlor or testator resided, that state has good grounds to assert due process nexus over the trust.

A number of courts have ruled, however, that a trust may lose (or never have had) due process nexus with the state where the settlor or testator resided. In *Safe Deposit & Trust Co. v. Virginia*, the U.S. Supreme Court held that Virginia could not impose its annual *ad valorem* property tax on intangible personal property of a trust that had been established by the will of a Virginia-resident decedent for the benefit of a Virginia-resident beneficiary, but the trust was managed by a trustee who was a nonresident of Virginia.[11] Significantly, the Virginia-resident beneficiary had no present right to control, possess or enjoy the intangible assets of the trust.

In *Mercantile-Safe Deposit & Trust Co. v. Murphy*, the New York Court of Appeals relied on the Supreme Court's *Safe Deposit & Trust* decision to hold that the Due Process Clause prohibited New York from taxing the accumulated income of an *inter vivos* trust that had been created by a New York-resident settlor for the benefit of beneficiaries who also resided in New York.[12] However, the New York-resident settlor had created the trust in Maryland with a trustee who was a Maryland resident, and the trust had been administered for some number of years in Maryland. After the settlor died, the income beneficiary of the trust was the settlor's widow, who was a New York resident. The New York Appellate Division nevertheless rejected the New York State Tax Commission's claim to tax the accumulated income of the trust on the sole basis that it was classified as a New York resident because of the settlor's residence in New York, finding "no merit either in the continuing jurisdiction theory advanced by [the Commission] or in their thesis that since the resident beneficiaries of the trust could be taxed on income distributed, the nonresident trustee can be taxed on income accumulated."[13] The New York Court of Appeals affirmed, citing the Supreme Court's *Safe Deposit & Trust* decision for the rule that "the imposition of a tax in the State in which the beneficiaries

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of a trust reside, on securities in the possession of the trustee in another State [*i.e.*, Maryland], to the control or possession of which the beneficiaries have no present right, is in violation of the Fourteenth Amendment."[14]

In *Swift v. Director of Revenue*, the Missouri Supreme Court held that the Due Process Clause barred Missouri from taxing accumulated income of testamentary trusts that were created by the will of a Missouri-resident testator, but where all the trustees and beneficiaries of the trusts were nonresidents of Missouri and the trusts and their assets were managed outside Missouri.[15] As in *Mercantile-Safe Deposit & Trust*, the trusts were defined as residents of Missouri under the Missouri income tax laws because the testator had resided in Missouri at the time of his death, but the Missouri Supreme Court nevertheless found that Missouri law was providing no present protection or benefit to the trusts, the trustees, the beneficiaries or the assets of the trusts. Under these circumstances, the Missouri Supreme Court held that the trusts lacked the necessary minimum contacts with Missouri in order to be subject to taxation in Missouri under the Due Process Clause.[16]

Courts in Illinois, Michigan, Minnesota, New Jersey and Maine have followed the holdings of *Safe Deposit & Trust, Mercantile-Safe Deposit Trust*, and *Swift* in holding that a trust was not taxable by the state where the settlor had resided at the time when the *inter vivos* trust became irrevocable or the testator died, because the trust's trustee, beneficiary and trust administration were located outside that state.[17]

States have been on firmer constitutional ground when they tax the undistributed income of a trust whose trustee is a resident of the state or whose assets are administered in the state.[18] For example, the California personal income tax "applies to … the entire taxable income of a trust, if the fiduciary or beneficiary (other than a beneficiary whose interest in such trust is contingent) is a resident [of California] *regardless of the residence of the settlor*."[19] If the trust has multiple trustees or noncontingent beneficiaries, California taxes the California-source income of the trust and then requires the trust to apportion its non-California-source income, first, based on the ratio of the number of California-resident trustees to the number of total trustees and, then a second time, based on the number of California-resident beneficiaries to the total number of beneficiaries.[20] Georgia imposes its personal income tax on resident or nonresident fiduciaries managing funds or property of a trust located in Georgia.[21]

In *Greenbough v. Tax Assessors of Newport*, the U.S. Supreme Court held that the Due Process Clause allows a state to tax undistributed income of a trust with a trustee who resides in the state because the trustee "is the owner of [a] legal interest in" the trust property, and the trustee can turn to the laws of his state of residence for benefit and protection.[22] Similarly, the Supreme Court's decisions in *Hanson v. Denkla* and *Curry v. McCanless* rejected Due Process Clause challenges to state taxes on trusts where the settlor having the power to dispose of trust property was a resident of the taxing state or the trust administration being performed in that state.[23] The Supreme Court concluded in those cases that the presence of the trustee or the trust administration in the taxing state meant that the property of the trust was being possessed, controlled or managed in that state, giving the taxing state the minimum contacts with the trust required by the Due Process Clause.

State taxation of the undistributed income of a trust because it has beneficiaries residing in the state has been a more controversial proposition. Beneficiaries usually do not control, possess, manage or enjoy the assets or income of the trust to the degree that a trustee does. Indeed, giving a beneficiary too much right to demand or receive distributions from the trust would probably defeat the entire purpose of the settlor or testator in creating the trust in the first place, not to mention raise the prospect that the beneficiary has constructive possession of the trust's undistributed income and is subject to federal and state income taxation on the trust's income. These are probably only a couple of the reasons why there is a limited number of cases that have considered the question of whether a trust was subject to state taxation solely as a result of trust beneficiaries being residents of the taxing state.

In *McCulloch v. Franchise Tax Board*,[24] the plaintiff Robert P. McCulloch, a California resident, was the beneficiary of a testamentary trust created by his grandfather, who was a nonresident of California when the grandfather died. McCulloch was also one of three trustees of the trust, along with his brother, a Missouri resident, and the St. Louis Union Trust Company of Missouri.[25] The grandfather provided in the trust instrument that the trustees were authorized to distribute annually to those beneficiaries (here, McCulloch) over the age of 25 "such part of the net income of their respective portions held in trust as may be necessary or advisable to assist them in business, professionally or otherwise." Thereafter, "the net income of the trust estate, or of the respective trusts, not disbursed from year to year shall be added to the principal and thereafter invested or disbursed as herein authorized."[26] As each grandchild reached the age of 40, that grandchild was to receive a terminal distribution of his or her portion of the principal and accumulated income of the trust.[27]

When McCulloch's portion of the trust terminated in 1951, he received a distribution of all the assets of his trust, which included the income that the trust had accumulated during the five years from 1946 to 1950 when McCulloch

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resided in California.[28] The California personal income tax laws required the trust to pay tax on the discretionary accumulated income that the trust was holding for a beneficiary residing in California.[29] If the trust failed to pay the California income tax the trust owed on its accumulated income, McCulloch, as the California resident beneficiary, became liable for payment of the tax at the time he received a distribution of the accumulated trust income.[30] The California Franchise Tax Board assessed California personal income tax against McCulloch on the distribution he had received of five years of accumulated trust income in the 1951 tax year.[31] It was not particularly surprising that the Franchise Tax Board would tax McCulloch on the income that the trust had actually distributed to him.

McCulloch bravely argued that the California income tax assessment violated the Due Process Clause "because California could not have taxed him as a beneficiary of the income during the years of its accumulation; that the evidence of ownership of the trust assets and the accumulated income reposed in Missouri from 1946 to 1951 and during that period plaintiff did not actually receive, own or control the income to connect it with California."[32] The California Supreme Court was having none of it. Citing the U.S. Supreme Court's decision in *Greenough v. Tax Assessors* as recognizing that "the residency of a trustee constitutes a valid basis for imposing local taxes upon trust corpus apportioned to the trustee's interest," the California Supreme Court reasoned that "in like manner property taxes apportioned to the value of the equitable interest may be imposed by the state of the beneficiary's residence …. The laws of the state of residence afford benefit and protection to the resident beneficiary or trustee."[33] That the California Supreme Court cited *Safe Deposit & Trust Company* as support for this holding is curious because that Supreme Court decision had reached the opposite conclusion on this point. Nevertheless, the California Supreme Court concluded that:

> The tax imposed by California upon the beneficiary is constitutionally supported by a sufficient connection with, and protection afforded to, plaintiff as such beneficiary during the years of his residence in this state, enjoyed the protection afforded by California for his eventual receipt of those assets. California grants the beneficiary the interim protection of its laws so that he may ultimately obtain the benefit of the accumulated income.[34]

For good measure, the California Supreme Court observed, "plaintiff in the instant case was simultaneously beneficiary and trustee. No possible doubt attaches to California's constitutional power to tax plaintiff as a trustee. His secondary role as a trustee reinforces the independent basis of taxing plaintiff as beneficiary."[35]

Thirty-five years later, in *Chase Manhattan Bank v. Gavin*, the Connecticut Supreme Court considered whether the Connecticut Department of Revenue was violating the Due Process Clause or the Commerce Clause by imposing the Connecticut personal income tax on the undistributed income of four testamentary trusts and one *inter vivos* trust.[36] Chase Manhattan Bank, based in New York, acted as a trustee of the four testamentary trusts, all of which had been created by the will of a testator who resided in Connecticut at the time of his death.[37] Chase Manhattan Bank also served as trustee of the *inter vivos* trust, which had been created by a settlor who was a resident of Connecticut at the time that trust became irrevocable.[38]

Two of the testamentary trusts (the Parry Trust and the Dallet Trust) had never had beneficiaries who were residents of Connecticut.[39] However, the other two testamentary trusts (the Stewart Trust and the Worcestor Trust) and the *inter vivos* trust (the Adolfsson Trust) had one or more Connecticut-resident beneficiaries.[40] Chase Manhattan Bank, as the trustee, was given the discretion to determine whether and how much income of each of the trusts to distribute to each of the beneficiaries of those trusts in a given year.[41] Significantly, under the Connecticut personal income tax statutes, all five of the trusts were considered to be Connecticut residents, and taxable on all their accumulated income, as a result of the testator having been a resident of Connecticut when he died, or the settlor of the *inter vivos* trust having been a Connecticut resident at the time the trust became irrevocable.[42]

Chase Manhattan Bank, the trustee, did not fare well before the Connecticut Supreme Court on its argument that imposing Connecticut personal income tax on the undistributed income of the four testamentary trusts and the *inter vivos* trust violated the Due Process Clause "because, for each trust, the trustees, the trust assets and administration were located outside of Connecticut's borders."[43] By presenting this due process issue as, "for Connecticut's power to tax these trusts to be upheld, Connecticut must provide the trusts with contemporaneous benefits, protections and opportunities," Chase Manhattan Bank seemed to invite the Connecticut Supreme Court to focus on the protections that Connecticut law provided *to the beneficiaries* of the trusts with regard to their right to receive future distributions of the accumulated income of the trusts. A more traditional due process nexus argument might have focused the Connecticut Supreme Court's attention instead on whether the trusts were being managed in Connecticut or earned any of their income from investment activity

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in Connecticut. Presented that way, the court might well have concluded that Connecticut was not allowed to tax the accumulated income of the five trusts because they were being managed by Chase Manhattan Bank in New York, and all of their income was derived from sources in New York.

The Connecticut Supreme Court acknowledged that, in *Greenough v. Tax Assessors of Newport*, the "United States Supreme Court itself has validated the proposition that the state where *the trustee* is located provides constitutionally significant protections, opportunities and benefits to the trust for tax purposes."[44] In *Greenough*, the Supreme Court rejected a Due Process Clause challenge to a proportionally imposed Rhode Island *ad valorem* tax on an out-of-state trust for which one of the two trustees was a resident of Rhode Island, but the assets of the trust were in New York, the beneficiary was a resident of New York and the Rhode Island-resident trustee did not exercise any trust powers in Rhode Island. The Connecticut Supreme Court then made a remarkable leap in logic in its *Chase Manhattan Bank* opinion:

> Admittedly, neither the trustee, its function of administering the trusts, nor the tangible evidence of the trusts' intangible assets—the "cash" or the actual security certificates—is located in Connecticut. *This state, however, by virtue of its legislative scheme, in effect has taken the practical position of treating the seats of the trusts—where they were established, and where their principal legal protections and benefits have been and are provided—as domiciliaries of the state*.[45]

Following this line of thought, the Connecticut Supreme Court reasoned that:

> Thus, just as a state may tax all of the income of a domiciliary, irrespective of its source, because of the legal benefits and opportunities it provides that permit the beneficiary to receive and enjoy the income, so may Connecticut tax the income of these testamentary trusts because of the benefits and opportunities that it provides to them. All of the testamentary trusts were established under their respective wills because the laws of this state provide for such establishment. *Blodgett v. Bridgeport City Trust Co.,* 115 Conn. 127, 142, 161 A. 83 (1932). The validity of a testamentary trust is normally determined by the validity of the will, which in turn is ordinarily determined by the law of the testator's domicile Thus, Connecticut's laws assure the continued existence of the trusts as mechanisms for the disposition of the testators' property according to the terms of the trusts as provided by the respective wills. In addition, the original trustees and their successors were approved by the respective Probate Courts in which the wills were probated.[46]

Thus, while the *Chase Manhattan Bank* opinion includes the broad and often-quoted statement that Connecticut was constitutionally entitled to tax the undistributed income of the two testamentary trusts that had Connecticut-resident beneficiaries "because of the legal benefits and opportunities it provides that permit the beneficiary to receive and enjoy the income," it is abundantly clear that the Connecticut Supreme Court upheld the tax assessments in no small part because each of the four testamentary trusts (including the two trusts with beneficiaries who were nonresidents of Connecticut) had been established pursuant to the Connecticut probate laws by testators who resided in Connecticut when they died. This point was driven home by the Connecticut Supreme Court as follows:

> We conclude that this panoply of legal benefits and opportunities is comparable to those general legal benefits and opportunities that justify the imposition of taxes on the income of individual domiciliaries of the state. Just as the vitality of the trust as an economic entity is inextricably intertwined with the administration of the trust assets by a trustee located in New York, the viability of the trust as a legal entity is inextricably intertwined with the benefits and opportunities provided by the legal and judicial systems of Connecticut and its legal viability is inextricably intertwined with its economic vitality. Neither its economic vitality nor its legal viability trumps the other for purposes of due process and taxation. These contacts with Connecticut are sufficiently "fiscal" in nature to satisfy the due process clause and gave the testamentary trusts fair warning that they were subject to its tax jurisdiction.[47]

It is far from clear that the Connecticut Supreme Court would have upheld the tax assessment against the testamentary trusts with Connecticut-resident beneficiaries if the testators who created those trusts had *not* resided in Connecticut.

As for the *inter vivos* trust in the *Chase Manhattan Bank* case, the Connecticut Supreme Court announced that the "same fundamental test applies to the inter vivos trust that applied to the testamentary trusts: whether the taxing power exerted by the state bears fiscal relation to protection, opportunities and benefits given by the state."[48] The Court explained:

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> In the present case, the critical link to the undistributed income sought to be taxed is the fact that the noncontingent beneficiary of the inter vivos trust during the tax year in question was a Connecticut domiciliary. The accumulated income eventually will be paid either outright to her when she reaches the age of forty-eight or, if she does not live that long, according to the exercise of her testamentary power of appointment or, in default of such exercise, to her then living descendants. Thus, during the tax year of 1993, as a Connecticut domiciliary she enjoyed all of the protections and benefits afforded to other domiciliaries. Her right to the eventual receipt and enjoyment of the accumulated income was, and so long as she is such a domiciliary will continue to be protected by the laws of the state. We conclude that just as a state may tax all of the present income of a domiciliary, irrespective of its place, or origin or the nature of its source, a state may, on the basis of the same justification, tax the income of an inter vivos trust that is accumulated for the ultimate benefit of a noncontingent domiciliary, and that is subject to her ultimate power of disposition. Although the connection is more attenuated than in the case of a testamentary trust, it is sufficient for purposes of due process of law. Furthermore, just as the state may tax the undistributed income of a trust based on the presence of the trustee in the state because it gives the trustee the protection and benefits of its laws; see *Greenough v. Tax Assessors, supra,* 331 U.S. 496; it may tax the same income based on the domicile of the sole noncontingent beneficiary because it gives her the same protections and benefits. In both instances, the state has given something for which it can ask return, and there is a definite and sufficient link between the contact with the state and the income sought to be taxed.[49]

The Connecticut Supreme Court sought to draw support for this holding from the California Supreme Court's decision in *McCulloch v. Franchise Tax Board*, which the Connecticut Supreme Court somewhat inaccurately presented as having "upheld, against a due process challenge, California's taxation of the undistributed income of an out-of-state testamentary trust based solely on the California residence of the beneficiary of the trust."[50] As discussed earlier, that beneficiary, McCulloch, was also serving as a California-resident trustee of the trust, giving California an unquestionable right under the Due Process Clause to tax at least a portion of the undistributed income of the trust. Moreover, the California tax assessment in the *McCulloch* case was on the terminal distribution of trust assets that McCulloch, as the California-resident beneficiary, had actually received during the tax year at issue in the case. A state may always tax a resident individual on income received, regardless of the source of that income.

The Connecticut Supreme Court's criticism of the U.S. Supreme Court's holding in *Safe Deposit & Trust Co. v. Virginia* is also dubious. In *Safe Deposit & Trust*, the Supreme Court invalidated a Virginia *ad valorem* property tax assessment against an *inter vivos* trust created by a Virginia resident, for the benefit of Virginia-resident individuals, but having a Maryland bank as the trustee. The Supreme Court treated the intangible investment assets of the trust as being sitused for property tax purposes in Maryland, where the trustee, the legal owner of those intangible assets, was located. The Connecticut Supreme Court asserted in its *Chase Manhattan Bank* opinion, that "[c]entral to the Court's reasoning in *Safe Deposit & Trust*, however, was the notion that the 'adoption of a contrary rule would involve possibilities of an extremely serious character by permitting double taxation, both unjust and oppressive."[51] Pointing out that subsequent Supreme Court decisions had abandoned this Due Process Clause concern over the risk of double taxation of intangibles, the Connecticut Supreme Court characterized the *Safe Deposit & Trust* decision as obsolete in order to ignore the inconvenient fact that the Supreme Court had *not* allowed Virginia to tax the intangible investment assets of the trust based on the trust having beneficiaries who were residing in Virginia.

Moreover, the Connecticut Supreme Court might well have upheld Connecticut's taxation of the *inter vivos* trust based on it being defined as a Connecticut resident, taxable on all its income in Connecticut, because the settlor had been a Connecticut resident on the date that the *inter vivos* trust became irrevocable. This statutory analysis would have made the constitutional analysis in the *Chase Manhattan Bank* unnecessary.

Thus, regardless of all the discussion in the *McCulloch* and *Chase Manhattan Bank* cases of beneficiaries residing in the taxing states—California and Connecticut, respectively—it is fair to point out that the trusts in those cases had other, significant contacts with the tax state. In *McCulloch*, there was a California-resident trustee, and in *Chase Manhattan Bank*, the testator and the settlor had been Connecticut residents, thereby subjecting the four testamentary trusts and the *inter vivos* trust to Connecticut tax on all their undistributed income. Neither of those cases held that the state could have taxed the undistributed trust income based solely on a beneficiary residing in the taxing state.

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The *Kimberley Rice Kaestner 1992 Family Trust* Case

On June 21, 2019, the U.S. Supreme Court addressed that particular nexus question in *North Carolina Department of Revenue v. Kimberley Rice Kaestner 1992 Family Trust*.[52]

The predecessor of the trust involved in this case was created in New York in 1992 by Joseph Lee Rice ("Rice") for the benefit of his children, pursuant to a trust agreement between Rice and the initial trustee, William B. Matthewson. Both Rice and Matthewson were residents of New York. This Joseph Lee Rice, III Family 1992 Trust was governed by New York law.[53]

Critically, the agreement governing the Joseph Lee Rice, III Family 1992 Trust provided that the trustee would have "absolute discretion" to distribute the trust's assets to the beneficiaries "in such amounts and proportions" as the trustee might "from time to time" decide.[54] The trustee was required to distribute the assets of the portion of the trust benefitting Kimberley Rice Kaestner ("Kaestner"), Rice's daughter and a primary beneficiary of the trust, when she reached the age of 40.[55]

In 2005, Matthewson was replaced as trustee by David Bernstein, who was a resident of Connecticut. Bernstein remained as the trustee and continued to be a Connecticut resident throughout the litigation of the *Kaestner Trust* case. In 1997, Kaestner moved to North Carolina.[56] She and her minor children were residents of North Carolina during the 2005 through 2008 tax years at issue in this case.[57] Ironically, Kaestner and her children were no longer living in North Carolina during the litigation of the *Kaestner Trust* case.

On December 30, 2002, the Joseph Lee Rice, III Family 1992 Trust was subdivided into three subtrusts, one of which was for the benefit of Kaestner and her children. The original trust agreement for the Joseph Lee Rice, III Family 1992 Trust governed the newly formed Kimberley Rice Kaestner 1992 Family Trust (the "Kaestner Trust"). This means that the Kaestner Trust was governed by New York law and administered by a Connecticut-resident trustee, Bernstein, who continued to exercise absolute and exclusive control over distributions from the Kaestner Trust to its beneficiaries.[58] The trustee maintained the Kaestner Trust documents and records in New York. The investments of the Kaestner Trust were in the custody of financial institutions in Boston, Massachusetts.[59]

During the 2005–2008 tax years at issue in the *Kaestner Trust* case, the trustee decided not to make any distributions of current or accumulated trust income to Kaestner or her children. The only contact between the trustee and Kaestner during those tax years took place in New York.[60]

North Carolina law provides that the state's income tax on an estate or trust "is computed on the amount of the taxable income of the estate or trust that is for the benefit of a resident of this State."[61] The North Carolina Department of Revenue interpreted this statutory language as imposing tax on all the accumulated income of the Kaestner Trust on the sole basis that the beneficiaries, Kaestner and her children, resided in North Carolina, even though those beneficiaries had received no distributions of income from the Kaestner Trust during the 2005–2008 tax years, the beneficiaries had no right to demand income from the Kaestner Trust, and they could not count on ever receiving any income from the trust.[62]

When the Department denied $1.3 million in refund claims that the Kaestner Trust had filed for the 2005–2008 tax years, the trust filed a complaint in the North Carolina Superior Court, Wake County, alleging that the Department's assessment of tax on the undistributed income of the trust violated the Due Process Clause because the trust did not have sufficient minimum contacts with North Carolina.[63] The North Carolina Superior Court, Court of Appeals and Supreme Court all ruled in favor of the Kaestner Trust on this nexus question. The North Carolina Supreme Court held on June 8, 2018, that:

> That plaintiff and its North Carolina beneficiaries have legally separate, taxable existences is critical to the outcome here because a taxed entity's minimum contacts with the taxing state cannot be established by a third party's minimum contacts with the taxing state. *See Walden v. Fiore*, 571 U.S. 277, 284-86, 134 S. Ct. 1115, 1122, 188 L. Ed. 12 (2014) (stating that "unilateral activity of another party or a third person is not an appropriate consideration when determining whether a defendant has sufficient contacts with a forum State" (*quoting Helicopteros Nacionales de Colombia, S.A. v. Hall*, 466 U.S. 408, 417, 104 S. Ct. 1868, 1873, 80 L. Ed. 2d 404 (1984))); *Hanson v. Denkla*, 357 U.S. 235, 253, 78 S. Ct. 1228, 1239-40, 2 L. Ed. 2d 1283 (1958) ("The unilateral activity of those who claim some relationship with a nonresident [party] cannot satisfy the requirement of contact with the forum State."). *Here it was plaintiff's beneficiaries, not plaintiff, who reaped the benefits and protections of North Carolina's laws by residing here. Because plaintiff and plaintiff's beneficiaries are separate legal entities, due process was not satisfied solely from the beneficiaries' contacts with North Carolina*.[64]

The North Carolina Supreme Court ultimately decided the due process nexus question as follows:

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> For taxation of a foreign trust to satisfy the due process guarantee of the Fourteenth Amendment and the similar pledge in Article I, Section 19 of our state constitution, the trust must have some minimum contacts with the State of North Carolina such that the trust enjoys the benefits and protections of the State. When, as here, the income of a foreign trust is subject to taxation solely based on its beneficiaries' availing themselves of the benefits of our economy and the protections afforded by our laws, those guarantees are violated. Therefore, we hold that N.C.G.S. § 105-160.2 is unconstitutional as applied to collect income taxes from plaintiff for tax years 2005 through 2008. Accordingly, we affirm the decision of the Court of Appeals that affirmed the Business Court's order granting summary judgment for plaintiff and directed that defendant refund to plaintiff any taxes paid by plaintiff pursuant to section 105-160.2 for tax years 2005 through 2008.[65]

The U.S. Supreme Court agreed to hear the Department's appeal of the decision of the North Carolina Supreme Court in the *Kaestner* case, at least in part because of the Department's claim that the North Carolina Supreme Court's decision in *Kaestner* had created a split with the California and Connecticut Supreme Courts on this same due process nexus question.

On June 21, 2019, the U.S. Supreme Court unanimously ruled in the *Kaestner Trust* case 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 of ever receiving it."[66] Writing for the Supreme Court, Justice Sonia Sotomayor distinguished the facts of the Kaestner Trust from those of Supreme Court precedents that had upheld state taxation of undistributed income of an out-of-state trust where (1) trust income was being distributed to an in-state beneficiary in *Maguire v. Trefry*,[67] (2) the trust had a trustee residing in the taxing state in *Greenough v. Tax Assessors of Newport*,[68] and (3) the trust was being administered in the taxing state in *Hanson v. Denkla* and *Curry v. McCanless*.[69] Those scenarios all easily established the minimum contacts that the Due Process Clause requires in order to allow the state to tax the undistributed income of the out-of-state trust. In the *Kaestner* case, however, the Department was asserting its taxation powers based solely on the in-state residence of the beneficiaries of the Kaestner Trust.[70]

Justice Sotomayor explained that where a state is relying on the due process contacts of a beneficiary with the taxing state to support taxation of the undistributed income of an out-of-state trust, the Supreme Court's decisions have focused on whether the beneficiary has a right to control, possess, enjoy or receive the assets or income of the trust. So, in *Safe Deposit & Trust Co. v. Virginia*, the Supreme Court invalidated a property tax assessment on the assets of a trust with a Virginia-resident settlor and a Virginia-resident beneficiary on due process grounds, because the trustee, who resided in Maryland, had the discretionary authority to make distributions to the Virginia-resident beneficiary and "nobody within Virginia ha[d] present right to [the trust property's] control or possession, or to receive income therefrom."[71] Similarly, in *Brook v. Norfolk,* the Supreme Court rejected a property tax assessment on the entire assets of a trust having a beneficiary who resided in the taxing state because the trust assets were "not within the State, di[d] not belong to the [beneficiary] and [were] not within her possession or control."[72]

On the other hand, Justice Sotomayor explained, in *Maguire v. Trefry* and *Guaranty Trust Co. v. Virginia*, the Supreme Court held that the resident beneficiary had the necessary elements of possession, control and enjoyment of the trust assets for due process purposes because the beneficiary had received an actual distribution of trust income on which the state was taxing the resident beneficiary.[73] Justice Sotomayor distilled from these Supreme Court cases the following "common governing principle: When a State seeks to base its tax on the in-state residence of a trust beneficiary, the Due Process Clauses demands a pragmatic inquiry into what exactly the beneficiary controls or possesses and how that interest relates to the object of the State's tax."[74] Indeed, Justice Sotomayor observed, this same analysis of who controls, possesses or enjoys the assets or income of the trust had provided the legal basis for the Supreme Court's decisions upholding state taxes on trusts whose settlor or trustee was a resident of the taxing state on the grounds that person had the "power to dispose of" the trust assets or income, in the case of a settlor, or was "the owner of [a] legal interest in" the trust assets or income, in the case of a trustee.[75]

From this sorting out of the Supreme Court's cases involving state taxation of trusts, Justice Sotomayor concluded:

> In sum, when assessing a state tax premised on the in-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. Because each individual fulfills different functions in the creation and continuation of the trust, the specific features of that relationship sufficient to sustain a tax may vary depending on

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> whether the resident is a settlor, beneficiary, or trustee. 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. Cf. *Safe Deposit*, 280 U.S., at 91-92. Otherwise, the State's relationship to the object of its tax is too attenuated to create the "minimum connection" that the Constitution requires. *See Quill*, 504 U. S., at 306.[76]

Turning to the facts of the *Kaestner Trust* case, the Justices unanimously held that "[a]pplying these principles here, we conclude that the residence of the Kaestner Trust beneficiaries in North Carolina alone does not supply the minimum connection necessary to sustain the State's tax."[77] After all, Kaestner and her children had not received a distribution of any income from the Kaestner Trust during the 2005–2008 tax years for which the Department had assessed North Carolina income tax against the Kaestner Trust. Under the terms of the trust instrument, Kaestner and her children had no right to demand trust income or otherwise control, possess or enjoy the trust assets or income in the tax years at issue in the case. That right to receive trust distributions was within the "absolute discretion" of the Connecticut-resident trustee. Moreover, the Justices concluded, Kaestner and her children "also could not count on necessarily receiving any specific amount of income from the Trust in the future.[78] "Like the beneficiaries in *Safe Deposit*, then, Kaestner and her children had no right to control, posses[s]" the trust assets 'or to receive income therefrom.'"[79]

Justice Samuel Alito, Chief Justice John Roberts and Justice Neal Gorsuch wrote a short concurring opinion emphasizing that the *Kaestner Trust* opinion of the Supreme Court "merely applies our existing precedent and that its decision not to answer questions not presented by the facts of this case does not open for reconsideration any points resolved by our prior decisions."[80] It is unclear what this concurring opinion really added to the Supreme Court's analysis in *Kaestner Trust* of how the Due Process Clause limits a state's right to tax an out-of-state trust based solely on the in-state residence of beneficiaries of the trust.

It is interesting that neither opinion in the *Kaestner Trust* case discussed or even cited the California Supreme Court's *McCulloch* decision or the Connecticut Supreme Court's *Chase Manhattan Bank* decision, which had purportedly created the split among state supreme courts that caused the U.S. Supreme Court to hear the appeal of the *Kaestner Trust* case. However, the unanimous *Kaestner Trust* opinion appears to cast serious doubt on the continued ability of states to tax the undistributed income of an out-of-state trust based solely on the protections that resident beneficiaries may enjoy under their state's laws to receive future distributions of income from the trust. In the *Chase Manhattan Bank* case, the beneficiary was entitled to a distribution of the remaining income and assets of the trust when the beneficiary reach a stated age, just as Kaestner was, yet the Supreme Court did not view that fact as giving Kaestner the requisite right to control, possess or enjoy the assets and income of the Kaestner Trust that would have justified North Carolina in taxing the accumulated income of the Kaestner Trust. Thus, it is unlikely the Supreme Court would have affirmed the holding of the Connecticut Supreme Court in the *Chase Manhattan Bank* case that the Connecticut law protections afforded to the in-state beneficiaries to receive future trust distributions justified Connecticut in taxing the undistributed income of the trust. The *McCulloch* decision also appears tenuous to the extent the California Supreme Court relied on California legal protections afforded to the California-resident beneficiary, McCulloch, as grounds for upholding the California income tax assessment in that case. Of course, as previously discussed, McCulloch was also a co-trustee, giving him greater control, possession or enjoyment of the trust assets and income than is usually the case with a trust beneficiary. And, in the *McCulloch* case, California was actually taxing McCulloch himself on the terminal distribution that he had received from the trust, hardly a radical proposition of tax law.

Conclusion

Many state tax commentators are interpreting the *Kaestner Trust* case as a narrow decision on the facts of the case, with limited precedential value. This common view may reflect the statement by Justice Sotomayor that "[i]n limiting our holding to the specific facts presented, we do not 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."[81] It may also seek to make sense of the statement in the concurring opinion in *Kaestner Trust* that "the opinion of the Court merely applies our existing precedent … and does not open for reconsideration any points resolved by our prior decisions."[82] Of course, these judicial observations are true of any number of the Supreme Court's decisions over the years.

This limited view of the *Kaestner Trust* opinion does not appear to do full justice to the case. Indeed, the Supreme Court's unanimous decision in favor of the Kaestner Trust was a mild surprise in light of the considerable deference

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that the Court showed to the states in the 2017–2018 term, notably in the Court's *Wayfair* case overruling the 50-year-old physical presence nexus standard for the Commerce Clause. So, it is noteworthy that all nine Justices interpreted the Court's precedents as prohibiting states from taxing the undistributed income of an out-of-state trust whose only contact with the taxing state was the presence in the state of beneficiaries who had no right to control, possess, enjoy or receive the assets or income of the trust due to the trustee's "absolute discretion" to make distributions to those beneficiaries. The Justices rejected the argument by North Carolina that as long as the states afforded legal benefits and protections to beneficiaries located in the state, it did not matter whether the trust had a presence in the state to support imposing tax on the trust's undistributed income. It would have been difficult to conclude that the Kaestner Trust was earning the undistributed income in North Carolina—or otherwise purposely availing itself of the marketplace in that state—merely because beneficiaries of the Kaestner Trust had moved to North Carolina.

Time will tell how broadly the holding of the *Kaestner Trust* case applies, but the discretionary powers that the trustee of the Kaestner Trust was given are not unusual in the trust world. Therefore, we should expect to see many trusts relying on the *Kaestner Trust* case to defend against the attempt by a beneficiary's state of residence to tax the undistributed income of the trust. And trustees may wish to review the governing trust instruments and consider what actions might be taken to minimize the right of beneficiaries to control, possess, enjoy or receive trust assets or income. If a trust can show that the beneficiary does not have the right to control, possess, enjoy or recover distributions of the trust's assets, the *Kaestner Trust* case teaches that the Due Process Clause prohibits the beneficiary's state of residence from taxing the trust on its undistributed income, if that is the only contact point between the trust and the taxing state.

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ENDNOTES

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1 *McCulloch v. Franchise Tax Board*, 61 Cal. 2d 186, 390 P. 2d 412 (1964), *app. dismissed*, SCt, 379 US 133 (1964).

2 *Chase Manhattan Bank v. Gavin*, 249 Conn. 172, 733 A.2d 782 (1999), *cert. denied*, SCt, 528 US 965 (1999).

3 *North Carolina Department of Revenue v. Kimberley Rice Kaestner 1992 Family Trust*, No. 18-457, 588 US _____ (U.S. June 21, 2019), *aff'g* 371 N.C. 133, 814 S.E.2d 43 (2018).

4 *Wayfair, Inc. v. South Dakota*, SCt, 138 SCt 2080 (2018).

5 *Quill Corp. v. North Dakota*, SCt, 504 US 298, 302 n.1 (1992).

6 *Id*., at 315 n.8.

7 For a good discussion of state income taxation of trusts, *see* II J. Hellerstein & W. Hellerstein, State Taxation ¶ 20.09 (3d ed. 2019).

8 Code Sec. 641.

9 35 ILCS 5/1501(a)(20)(C) and (D).

10 N.Y. Tax Law §605(b)(3).

11 *Safe Deposit & Trust Co. v. Virginia*, SCt, 280 US 83 (1929).

12 *Mercantile-Safe Deposit & Trust Co. v. Murphy*, 19 A.D. 2d 765, 242 N.Y.S. 2d 26 (3d Dep't 1963), *aff'd*, 15 N.Y.2d 579, 203 N.E.2d 490, 255 N.Y.S. 2d 96 (1964).

13 *Mercantile-Safe Deposit & Trust Co.*, 19 A.D. at 766, 242 N.Y.S.2d at 28.

14 *Mercantile-Safe Deposit & Trust Co.*, 15 N.Y. 2d at 581, 255 N.Y.S. 2d at 97.

15 *Swift v. Director of Revenue*, 727 S.W.2d 880 (Mo. 1987).

16 *Id*., at 882.

17 *Linn v. Department of Revenue*, 2013 Ill. App. (4th) 121055, 2 N.E.3d 1203 (4th Dist. 2013) (Illinois was prohibited by the Due Process Clause from taxing accumulated income of an irrevocable *inter vivos* trust created by the will of an Illinois-resident grantor under Texas law where the trust was administered, and the trustee, protector and noncontingent beneficiary all resided outside Illinois); *Blue v. Michigan Department of Treasury*, 185 Mich. App, 406, 462 N.W.2d 762 (1990) (Michigan was not allowed to tax undistributed income of an irrevocable *inter vivos* trust created by a Michigan resident, where the trustee, beneficiary and income-producing assets of the trust were in Florida); *Fielding v. Commissioner of Revenue*, 916 N.W.2d 323 (Minn. 2018) (four irrevocable trusts lacked sufficient due process contacts with Minnesota to be subject to Minnesota income tax even though the trusts were defined as Minnesota residents because the settlor was a Minnesota resident when the trust became irrevocable); *Pennoyer v. Taxation Division Director*, 5 N.J. Tax 386 (1983) (New Jersey income tax could not be imposed on undistributed income of an irrevocable *inter vivos* trust created by a New Jersey resident, where the trustee, beneficiaries and all assets of the trust were located outside New Jersey); *City of Augusta v. Kimball*, 91 Me 605, 40 A. 666 (1898).

18 *See, e.g.,* Ariz. Rev. Stat. §43-1301(1)(b)(5); Ark. Code Ann. §26-51-203; Cal. Rev. & Tax Code §17742.

19 Cal. Rev. & Tax Code §17742(a) (emphasis added).

20 Cal. Rev. & Tax Code §17743 and §17744; Cal. Code Regs., tit. 18, §17743; Cal. Code Regs., tit. 18, §17744; Cal. FTB Legal Ruling 238 (Oct. 27, 1959).

21 Ga. Code §48-7-22(a)(1)(B). *See also* Colo. Rev. Stat. Ann. §39-22-103(10); S.C. Code Ann. §12-6-30(5); Va. Code. Ann. §58.1-302.

22 *Greenough v. Tax Assessors of Newport*, 331 U.S. 486, 498 (1947).

23 *Hanson v. Denkla*, SCt, 357 US 235, 251 (1958); *Curry v. McCanless*, SCt, 307 US 357, 370 (1939).

24 *McCulloch v. Franchise Tax Board*, 61 Cal. 2d 186, 390 P.2d 412 (1964), *app. dismissed*, SCt, 379 US 133 (1964).

25 61 Cal. 2d at 190.

26 *Id.*

27 *Id.*

28 *Id*., at 189.

29 Cal. Rev. & Tax Code §17731; *see also Supreme Constitutional or Statutory Limits on the Power to Tax*, 12 Hastings L.J. 23, 38, 39 (1960).

30 *McCulloch*, 61 Cal. 2d at 190–191 (citing former Cal. Rev. & Tax Code §18106, now §17745).

31 *Id*., at 189.

32 *Id*., at 193–194.

33 *Id*., at 194–195 (citing *Safe Deposit & Trust Co. v. Virginia*, SCt, 280 US 83 (1929)).

34 *Id*., at 196.

35 *Id*., at 198.

36 *Chase Manhattan Bank v. Gavin*, 249 Conn. 172, 733 2d 782 (1999), *cert. denied*, SCt, 528 US 965 (1999).

37 *Id*., at 175–176.

38 *Id*., at 176.

39 *Id*., at 178.

40 *Id*., at 178–179.

41 *Id*., at 178–179.

42 *Id*., at 176–177 (citing Conn. Gen. Stat. §12-701(a)(4)).

43 *Id*., at 183.

44 *Id*., at 189 (emphasis added) (quoting *Greenough v. Tax Assessors of Newport*, SCt, 331 US 486, 488 (1947)).

45 *Id*., at 191 (emphasis added).

46 *Id*., at 192–193.

47 *Id*., at 200.

48 *Id*., at 204.

49 *Id*., at 204–205.

50 *Id*., at 205.

51 *Id*., at 206 (quoting *Safe Deposit & Trust Co. v. Virginia*, SCt, 280 US 83, 93 (1929)).

52 *North Carolina Department of Revenue v. Kimberley Rice Kaestner 1992 Family Trust*, No. 18-457, SCt, 588 US ____ (U.S. June 21, 2019), *aff'g* 371 N.C. 133, 814 S.E.2d 43 (2018) (hereinafter "*Kaestner Trust*").

53 *Kaestner Trust*, 814 S.E.2d at 45.

54 *Kaestner Trust*, 588 US ____, slip op. at 2.

55 *Kaestner Trust*, 814 S.E.2d at 45.

56 *Kaestner Trust*, 588 US____, slip op. at 2.

57 *Id*.

58 *Id*., slip op. at 3.

59 *Kaestner Trust*, 814 S.E. 2d at 45.

60 *Kaestner Trust*, 588 US____, slip op. at 3.

61 N.C. Gen. Stat. §105-160.2.

62 *Kaestner Trust*, 588 US_____, slip op. at 1.

63 *Id*., slip op. at 4.

64 *Kaestner Trust*, 814 S.E.2d at 49 (emphasis added).

65 *Id*., at 51.

66 *Kaestner Trust*, 588 US _____, slip op. at 7.

67 *Maguire v. Trefry*, SCt, 253 US 12, 16–17 (1920).

68 *Greenough v. Tax Assessors of Newport*, SCt, 331 US 486, 498 (1947).

69 *Hanson v. Denkla*, SCt, 357 US 235, 251 (1958); *Curry v. McCanless*, SCt, 307 US 357, 370 (1939).

70 *Kaestner Trust*, 588 US____, slip op. at 7.

71 *Id*., slip op. at 8 (quoting *Safe Deposit & Trust Co. v. Virginia*, SCt, 280 US at 91).

72 *Id.* (quoting *Brook v. Norfolk*, SCt, 277 US 27, 29 (1928)).

73 *Maguire v. Trefry*, SCt, 253 US 12, 17 (1920); *Guaranty Trust Co. v. Virginia*, SCt, 305 US 19, 21–23 (1938).

74 *Kaestner Trust*, 588 US ____, slip op. at 9 (*citing Safe Deposit & Trust Co*., SCt, 280 US at 91).

75 *Id*., slip op. at 9–10 (quoting *Curry v. McCanless*, SCt, 307 US 357, 370 (1930)); *Greenough v. Tax Assessors of Newport*, SCt, 331 US 486, 494 (1947)). *See also Graves v. Elliott*, SCt, 307 US 383, 387 (1939) (a settlor's "right to revoke [a] trust and to demand the transmission to her of the intangibles … was a potential source of wealth" subject to taxation by the settlor's state of residence).

76 *Id*., slip op. at 10.

77 *Id*., slip op. at 11.

78 *Id*., slip op. at 12.

79 *Id*., slip op. at 13 (quoting *Safe Deposit & Trust*, 280 US at 91).

80 *Id*., slip op. at 1 (Alito J., concurring).

81 *Id*., slip op. at 7.

82 *Id*., slip op. at 1 (Alito J., concurring).

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