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Client Alert: U.S. Supreme Court Rejects State Attempt to Tax Undistributed Income of a Trust Based Solely on Trust Beneficiaries Residing in the State

On June 21, 2019, the United States 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 state's income tax on the undistributed income of an out-of-state irrevocable trust whose only contact with North Carolina was that the beneficiaries of the trust happened to reside in North Carolina.[1] While states often impose their income taxes on a trust if the grantor, testator or trustee is a resident of that state, the North Carolina income tax statutes have an unusual provision stating that "the tax is computed on the amount of taxable income of the estate or trust that is for the benefit of a resident of this state, or for the benefit of a nonresident to the extent that the income is derived from North Carolina sources."[2] This North Carolina statute, on its face, authorized the North Carolina Department of Revenue to tax the undistributed income of the Kimberley Rice Kaestner 1992 Family Trust (the "Trust"), but the Supreme Court concluded, as all the North Carolina courts had, that the mere presence of beneficiaries of the Trust in North Carolina, without those beneficiaries having the right to control, possess, enjoy or receive assets of the Trust, did not establish the necessary "minimum contacts" between the Trust and

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North Carolina that the Due Process Clause of the U.S. Constitution would require to subject the Trust to taxation in North Carolina.

The Department acknowledged in its briefs that the state's only connection with the Trust during the 2005-2008 tax years at issue was the in-state residence of the Trust's beneficiaries. The Trust was governed by New York law, having been created 30 years earlier by a New York resident. The original trustee, a New York resident, was later succeeded by the current trustee, a Connecticut resident. The Trust maintained its records in New York, and the custodianship of its assets was with Massachusetts financial institutions. Critically, the Trust instrument gave the Connecticut trustee "absolute discretion" to decide whether to make distributions of the Trust's income or assets to the beneficiaries, and in such amounts as the trustee deemed appropriate. During the tax years at issue in the case, the beneficiaries, Kimberley Rice Kaestner and her children, did not receive any distribution from the Trust.

In surveying its prior decisions addressing the Due Process limits on state taxation of trusts, the Supreme Court justices explained that the Court had upheld state taxes imposed on (a) income actually distributed by a trust to beneficiaries residing in the taxing state, (b) a trust whose grantor or trustee was a resident of the taxing state, or (c) a trust that was administered in the taxing state. The receipt of trust income, the presence of a grantor, or the presence of a trustee exercising (at least at one time) control over the trust assets provided the minimum contacts to give the taxing state Due Process nexus over the trust, all absent in the *Kaestner* case. The Supreme Court's precedents further established that where a state is asserting the power to tax the income of a trust based solely on the residence of the trust's beneficiaries in the state, the Due Process Clause requires that those beneficiaries have the right to control, possess, enjoy or receive trust assets in the taxing state. Kimberley Rice Kaestner and her children had not such rights because the trustee of their Trust had the absolute discretion to decide whether, and in what amounts, to make distributions of the Trust's income to the beneficiaries of the Trust, and made no such distributions to Ms. Kaestner and her children during the tax years for which the Department assessed income tax liability against the Trust on its undistributed income.

In light of this decision, trustees may wish to review any current and prior state income tax filings and determine if any income tax was paid to North Carolina and other states which rely on the residence of the beneficiary as its sole basis for taxation and see if refund opportunities exist.   Moreover, trustees may wish to review the governing trust instruments and consider what actions can be taken to minimize the right of beneficiaries to control, possess, enjoy or receive trust assets, which may (1) minimize the state income tax exposure if a beneficiary moves to North Carolina or any other state which uses the residency of a beneficiary to tax a trust and (2) improve the creditor protection afforded by such trusts.

Should you have any questions concerning this or any related issue, do not hesitate to contact John Biek, Eric Mann or another member of Neal Gerber Eisenberg's Taxation group or Private Wealth group.

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

[2] N.C. Gen. Stat. § 105-160.2.