

June 28, 2019

North Carolina Department of Revenue v. Kimberley Rice Kaestner 1992 Family Trust

United States Supreme Court Rules for Taxpayer in Trust State Income Taxation Case

On June 21, 2019, the United States Supreme Court ruled that the presence of in-state beneficiaries alone does not empower a state to tax trust income where the income has not been distributed to the beneficiaries and the beneficiaries have no right to demand the income and are uncertain to receive it.

BACKGROUND

In 1992, Joseph Lee Rice III, a New York resident, formed a discretionary trust under New York law for the benefit of his children and appointed a New York resident as trustee. When the settlor's daughter, Kimberley Rice Kaestner, subsequently moved to North Carolina, that state assessed tax on the trust's income under a law authorizing the taxation of trust income that is for the benefit of a state resident.¹ During the relevant time period, Kaestner had no right to receive, and did not receive, any distributions from the trust. All of the trust's assets were located outside of North Carolina and the trustee was not a North Carolina resident.

The trustee paid the tax under protest and sued the North Carolina taxing authority in North Carolina state court, arguing that the tax as applied to the trust violates the Due Process Clause of the Fourteenth Amendment. The North Carolina courts held the tax to be unconstitutional on the basis that the in-state residence of the beneficiaries was too tenuous a link between the state of North Carolina and the trust to support the tax.

The Supreme Court affirmed, holding that the presence of in-state beneficiaries alone in instances where trust income has not been distributed to the beneficiaries and the beneficiaries have no right to demand the income and are uncertain to receive it does not supply the minimum connection necessary to sustain North

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Carolina's tax under the Due Process Clause, which limits a state to imposing taxes that bear fiscal relation to protection, opportunities and benefits given by the state.²

The Supreme Court limited its ruling to the facts of the case, expressly stating that its decision does not address state laws that consider the in-state residency of a beneficiary as one of a combination of factors (such as in Connecticut), that turn on the residence of a settlor, or that rely on the residency of noncontingent beneficiaries (such as in California).³ The Court noted that the only states other than North Carolina that tax trusts based solely on the residence of the trust's beneficiaries, regardless of whether a beneficiary's interest is contingent or noncontingent or whether any other factors are met, are Georgia and Tennessee.

Although the Court's decision is narrowly tailored and will impact trust taxation in only a few states, it is a useful reminder to clients to consider the impact of state income taxation in connection with their trust planning.

PLANNING CONSIDERATIONS

As a general matter, a trust can be subject to tax as a resident of a state, or a trust can be treated as a non-resident of a state if the trust does not have minimum contacts with the state. If a trust is treated as a non-resident, the trust generally will be subject to income tax only on its in-state source income, and if a trust is treated as a resident, the trust generally will be subject to state income tax on all of its income, unless an exemption applies. Under New York law, for example, a trust created by a New York resident may be subject to tax on all of its income, provided that the trust will not be subject to tax on non-New York source income if the trust has no New York trustees, assets, or New York source income and no distributions are made to New York resident beneficiaries. A trust created by a non-New York resident is not subject to New York tax except on New York-source income.

Clients may wish to review the impact of state trust income tax rules on their trust planning.

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ENDNOTES

¹ N.C. Gen. State. Ann. §105-160.2.

² *N.C. Dep't of Revenue v. The Kimberley Rice Kaestner 1992 Family Trust*, No. 18-457 (S. Ct. June 21, 2019) at 1.

³ *Ibid.*, at 15.

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