SCOTUS Finds that Application of North Carolina's Trust Income Tax Is Unconstitutional

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On Friday, June 21, 2019, the Supreme Court of the United States ruled in *North Carolina Department of Revenue v. Kimberley Rice Kaestner 1992 Family Trust* that a state cannot tax a trust based only on a trust beneficiary's residency. In her unanimous opinion written for the Court, Justice Sotomayor wrote that North Carolina's trust income tax, which was imposed on any trust having a beneficiary resident in North Carolina, "violates the Due Process Clause of the Fourteenth Amendment." (The Due Process Clause of the Fourteenth Amendment provides "nor shall any state deprive any person of life, liberty, or property, without due process of law.")

Nearly thirty years ago, Joseph Lee Rice III created a trust for his children. Mr. Rice was a resident of New York; the trust was governed by New York law; and the initial trustee of the trust was a New York resident. None of the trust's beneficiaries lived in North Carolina when the trust was created. Under the terms of the trust agreement, the trustee had absolute discretion over distributions to trust beneficiaries.

In 1997, one of Mr. Rice's children — Kimberley Rice Kaestner — moved to North Carolina. Sometime afterward, the trustee of the trust divided the original trust into separate subtrusts for Mr. Rice's children, including the Kimberley Rice Kaestner 1992 Family Trust (the "Kaestner Trust").

Under North Carolina General Statutes § 105-160.2, North Carolina imposes an income tax on "the amount of the taxable income of the estate or trust that is for the benefit of a resident of this State." Based solely on the residency of Ms. Kaestner, North Carolina taxed all of the Kaestner Trust's taxable income and collected more than $1.3 million in state income tax from the Kaestner Trust for the years 2005-2008. During that time, the trust was administered by a trustee resident in Connecticut, and the trustee had only infrequent contacts with Ms. Kaestner and made no distributions to her.

The Kaestner Trust sought a refund of its North Carolina income taxes paid for the years 2005-2008. North Carolina's trial and appeals courts found that the tax on the Kaestner Trust was indeed unconstitutional and must be refunded. On June 21, the Supreme Court of the United States affirmed the North Carolina courts' decision.

In arriving at the Court's decision, Justice Sotomayor explained that the Due Process Clause limits states' power to tax. Quoting earlier cases, she wrote that a state may only impose taxes "that 'bea[r] fiscal relation to protection, opportunities and benefits given by the state.'" The Court then applied a two-step analysis to determine whether such a relationship exists. 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."'" In asking whether a State has the required "minimum connection" with the person to be taxed, the Court emphasized that "only those who derive 'benefits and protection' from associating with a State should have obligations to the State in question."

In the specific context of taxing a trust based on the residency of a beneficiary, the Court referred to prior cases that made "a pragmatic inquiry into what exactly the beneficiary controls or possesses and how that interest relates to the object of the State's tax." The Court found that, to tax a trust based on the residency 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."

Applying these tests to the Kaestner Trust, the Court noted that the beneficiaries of the Kaestner Trust received no trust income, were not entitled to demand current distributions, and had no vested right to eventual distributions. In other words, the beneficiaries of the Kaestner Trust did not have possession, control, or enjoyment of the trust property or a right to receive the property. Based on these facts, the Due Process Clause prohibited North Carolina's taxation of the Kaestner Trust.

After rendering its ruling, the Court clarified the scope of its decision, stating "[t]oday's decision does not address state laws that consider the in-state residency of a beneficiary as one of a combination of factors, that turn on the residency of a settlor, or that rely only on the residency of noncontingent beneficiaries."

The Court's decision in *Kaestner* is particularly interesting in light of Virginia's recent change to its trust taxation statute and what many considered to a be a potential trend in the expansion of state taxing powers as evidenced by the Court's *Wayfair* decision last year.

Effective next week, on July 1, Virginia will no longer tax a trust for being administered in Virginia. For *inter vivos* trusts, that will leave only one basis for taxing a trust as a resident of Virginia—if the trust was created or funded by a person domiciled in Virginia. Interestingly, the Supreme Court is currently considering whether to hear a case appealed from the Minnesota Supreme Court asking whether the Due Process Clause is violated when a state taxes a trust based solely on the residency of the settlor. See *Comm. of Rev. v. William Fielding, et al*. If the Supreme Court agrees to hear the *Fielding* case and extends the reasoning of *Kaestner*, Virginia's income taxation of trusts could be curtailed even further.

The Court's decision in *Kaestner* is distinguishable from *Wayfair* and other recent laws that have expanded nexus standards for state tax purposes. *Wayfair* was a sales tax case decided under the Commerce Clause because it involved the impact of out-of-state or "remote" sellers on interstate commerce. Although many states have enacted economic nexus laws for income tax purposes, the focus has remained on remote sellers and Commerce Clause principles. By contrast, in *Kaestner*, the alleged nexus-creating activity was the taxpayer's physical presence within the state. As physical presence within a state has generally created nexus for sales tax and (non-trust) income tax purposes, *Kaestner* should not be viewed as changing any well-established principles with regard to those taxes.

We will continue to monitor legal developments in this area. If you have any questions about federal or state income taxation of estates or trusts, please contact any member of our team.

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