CASE ANALYSIS

NORTH CAROLINA v. KAESTNER

Supreme Court Sides with Trust in State Taxation Issue

BY **JEFFREY L. CARSON,** J.D., LL.M., CPWA®

Senior Vice President,
Nashville Office

jcarson@diversifiedtrust.com

In a decision much anticipated by professionals in the often intersecting worlds of taxation and trusts, the U.S. Supreme Court released its opinion in the case of *North Carolina Department of Revenue v. Kimberley Rice Kaestner 1992 Family Trust*, which concerns a dispute between the State of North Carolina and a resident who is a beneficiary of an irrevocable trust originally created in and governed by New York law.[1]

The Court made a clear statement in the decision, by unanimously siding with Respondent, the Kaestner Trust ("the Trust"). While the decision against Petitioner, The State of North Carolina ("the State"), was generally expected by industry insiders and Supreme Court watchers, it was somewhat of a surprise Justice Sotomayor authored the opinion. A concurring opinion was filed by Justice Alito in which Chief Justice Roberts and Justice Gorsuch joined. This article is a brief recap of the case history as well as an analysis of the Court's decision.

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Summary of Facts

Joseph L. Rice III established an inter vivos trust in 1992 with William B. Matteson as trustee (a New York lawyer and resident) and Rice's descendants as the initial primary beneficiaries. At the time of execution of the trust, the situs and governing law for the trust was established as the State of New York.

Ten years after formation, in 2002, the original trust was divided into three separate trusts, one for each of Mr. Rice's children. One of the separate trusts was the Kimberley Rice Kaestner 1992 Family Trust, benefitting Rice's daughter Kimberley Rice Kaestner, who, at the time of the division, was a legal resident and domiciliary of North Carolina.

In 2005, Matteson resigned as trustee of all three trusts. Mr. Rice appointed a successor trustee, an individual resident of Connecticut. To further complicate tracking the location of the pertinent parties, the custodian of all of the Trust's assets is located in Massachusetts. The only connection to North Carolina was the presence of Ms. Kaestner in the state, who relocated as a permanent resident in 1997.

The North Carolina Department of Revenue sought to tax the Trust based on the residency of Ms. Kaestner, as beneficiary under a statute which authorizes the State to tax any trust income that "is for the benefit of" a state resident.[2] Under the terms of the Trust, no beneficiary possessed an automatic right to a distribution of Trust assets, rather the agreement vested the trustee with "absolute discretion over the administration and disposition of the trust property".[3] In fact, no distributions were made to any beneficiary in North Carolina during the years at issue, a pivotal point of discussion in the oral arguments and eventual opinion of the Court.

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Procedural Background

Between the years 2005 to 2008, the Trust paid income taxes to North Carolina on income accumulated (but not distributed) in those years. In 2009, the Trust filed a claim for refund of the income taxes paid to the State for the four years in question.[4] The Trust's claim was denied by the State. As a result, the Trust representatives brought suit, requesting a refund of all taxes paid under a claim that the statute enabling the State to collect taxes from the Trust as a "resident trust" was unconstitutional under the Constitution of the State of North Carolina and the United States Constitution.

Finding the statute unconstitutional as applied, the trial court granted the Trust's motion for summary judgment, which the State appealed. The State Court of Appeals found that the mere fact a non-contingent beneficiary of the trust is domiciled in the State, alone, (whereas the trust location, its assets, and its trustee, are all outside the state) does not establish sufficient contacts with North Carolina to permit taxing the trust in the State.

The State Supreme Court affirmed the decision of the lower courts, finding the Trust did not have sufficient minimum contacts with the State to satisfy the Due Process requirements of the Fourteenth Amendment.[5] The State filed a Petition for Writ of Certiorari with the U.S. Supreme Court in October 2018, which the Court granted in January 2019. In February, oral argument was set for April 16, 2019.

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Argument on Appeal to US Supreme Court

The basic facts of the case were not in dispute. The matter in controversy before the Court centered on a question of law, with the primary issue concerning the Due Process argument that a state cannot tax a trust based solely on the presence of a beneficiary as a resident in the state and to whom no income has been distributed.

Under well-established precedent, the Court has declared the Due Process Clause requires "minimum contacts" connecting a state and the property it seeks to tax.[6] It is generally agreed if such minimum contacts are established, then the property in question is entitled to and does in fact enjoy the benefits and protections of the forum state such that taxation is warranted. In finding that the Trust did not have sufficient minimum contacts, the State Supreme Court relied upon the reasoning set forth in *International Shoe* to emphasize that the U.S. Supreme Court has addressed the minimum contacts question and that a trust's contact with the forum state itself and not the trust's contacts with persons who reside in the state is the key factor in making the determination.[7]

The author was present at oral arguments held on April 16, 2019. The gallery was filled to capacity with both trust industry professionals as well as regular tourists and casual spectators. The Solicitor General for North Carolina had barely finished his introductory remarks when Justice Ginsburg went right to the heart of the matter by questioning the ability of the State to tax accumulated income that had not been received by the beneficiary. Then Ginsburg appeared to doubt the position of the State to levy a tax based solely upon the tenuous connection of only the residency of the beneficiary in the State.[8] Justice Sotomayor joined in the discussion by confirming the beneficiary did not receive distributions during the years in question. Further, Sotomayor raised the possibility that the beneficiary may never, in fact, receive a distribution from the Trust.[9] Seizing on Sotomayor's line of questioning, Justice Gorsuch grilled the State's counsel on the issue of

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fundamental fairness in taxing undistributed income.[10] Gorsuch also took the State's counsel to task in a back and forth debate concerning precedents that could be overturned if the Court adopted the State's position.[11] At one point, Justice Gorsuch stated counsel's argument was "slicing the baloney a little too thinly", which drew laughter from the normally silent gallery.[12]

Perhaps the most confrontational (and confusing) questions were raised by Justice Stephen Breyer posed in hypothetical scenarios addressed to the State's counsel in a self-confessed attempt to frame a better understanding of the facts.[13] It was clear from the author's observation of the arguments, a majority of the Justices were dubious of the State's standing to tax the Trust based upon solely the presence of a beneficiary in the State. Justice Kagan was the only one of the nine Justices seeming to be open to the arguments of the State. Based upon her questioning, it appeared Kagan was following the State's argument that Kaestner, as beneficiary was the party to the arrangement who actually owned the Trust assets and also the only one who would receive tangible benefits from such ownership. Further, Kagan seemed more inclined to adopt the State's argument that a sufficient nexus was created between the State and the beneficiary based upon the in-state residency of the beneficiary as opposed to taxation based upon the location of the trustee or the governing law of the Trust.[14]

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Supreme Court's Decision

In its June 21, 2019 opinion authored by Justice Sotomayor, the Court issued a unanimous decision affirming the State Supreme Court's previous finding that the State violated the taxpayer's Due Process Rights under the Fourteenth Amendment.

In its opinion, the Court stated, "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 to receive it."[15]

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While Justice Sotomayor's analysis hewed closely to the position of the Trust, it is enlightening to consider the concurring opinion of Justice Alito. In the beginning of the succinct opinion, Alito states the reason he is writing separate from the Court's majority is "to make clear that the opinion of the Court merely applies our existing precedent and that its decision not to answer questions not presented by the facts does not open for reconsideration any points resolved by our prior decisions." On the basis of this language, as well as the author's observation of Alito's questioning at oral arguments, it is evident the Justice wanted to remove any doubts about whether the Court was deviating from established precedent. The Court left unanswered multiple questions raised in *Kaestner*, particularly those concerning the degree of possession, control and enjoyment that would be sufficient to support a state tax on trust assets (as they arise outside the specific fact pattern of *Kaestner*). However, with Justice Alito's concurring opinion, at least it was made clear there has been and continues to be a "governing standard" for the minimum contacts analysis that should continue to be followed going forward.[16]

Conclusion

In conclusion, what practical effect will the Court's decision have for professional advisors as well as trustees and beneficiaries in jurisdictions with a state income tax on trusts? It is clear the Court did not intend to break any new ground in its opinion. By focusing on the specific facts in the case and agreeing with the Trust's position, the Court made clear it was not going to overturn well-established precedent. If we can take any direction from the Court's analysis it will be specific to instances in which beneficiaries receive no income distributions, have no possession or control over income and also have no reasonable expectation to ever receive such income; admittedly a very narrow set of facts that will not be broadly applicable for future situations.

As the facts in *Kaestner* show, grantors and trustees have little control over the choice of domicile and relocation decisions of beneficiaries. Where a party to a trust arrangement may be domiciled at creation of the trust could change at various stages in the lifecycle of administration; a fact that must be considered, but admittedly impossible to predict at the time of drafting. As a matter of practice, planners should be more concerned with the effective tax rates in jurisdictions that levy a tax on trust income and less concerned with the breadth of the applicable state tax statute. Practitioners may be able to use the unknown of eventual beneficiary residency as a discussion point when advising clients in their planning to address options in selecting trust situs and governing law jurisdictions, as well as ways in which a jurisdiction with an unfavorable tax regime can be avoided altogether.

The effect of the Court's decision may prove to be status quo for the majority of states that have a number of broad categories that can trigger taxation of trusts as "resident trusts" (i.e., governing law, administration, location of grantor, location of trustee, location of assets) apart from the location of a beneficiary in the state.[17] For the few states with taxation based solely on the residency of a beneficiary (or at least as a primary factor), the Court's decision will likely be a topic in future discussions concerning whether a source of revenue could be lost in certain *Kaestner*-specific situations.[18] Despite the narrow holding and limited potential application, the Kaestner opinion should direct planners and trustees further towards the most favorable trust jurisdictions.

DIVERSIFIED TRUST

ATLANTA

400 Galleria Parkway, Suite 1400
Atlanta, GA 30339
Phone: 770.226.5333

GREENSBORO

701 Green Valley Road, Suite 300
Greensboro, NC 27408
Phone: 336.217.0151

MEMPHIS

6075 Poplar Avenue, Suite 900
Memphis, TN 38119
Phone: 901.761.7979

NASHVILLE

3102 West End Avenue, Suite 600
Nashville, TN 37203
Phone: 615.386.7302

1 Case No. 18-457; 588 U.S. ____ (2019)
2 N.C. Gen. Stat. Ann. §105-160.2
3 See Brief for the Respondent in Case No. 18-457, pg. 3 and Art. 1 §§ 1.1 of The Kimberley Rice Kaestner 1992 Family Trust
4 An aggregate amount in excess of $1.3 million dollars
5 371 N.C. 133, 814 S.E. 2d 43 (N.C. 2018)
6 *International Shoe Co. v. Washington*, 326 U.S. 310 (1945)
7 *See supra* n. 6
8 See Official U.S. Supreme Court Transcript of Oral Arguments dated April 16, 2019; pgs. 3:22-25 and 4:14-17.
9 *See supra* n. 8; pgs. 6:2-6.
10 *See supra* n. 8; pgs. 28:10-13.
11 *Safe Deposit & Tr. Co. v. Virginia*, 280 U.S. 83 (1929) and *Brooke v. City of Norfolk*, 277 U.S. 27 (1928); *See supra* n. 8; pgs. 26:13-19.
12 *See supra* n. 8; pgs. 27:4-7.
13 *See supra* n. 8; pgs. 11:2-6, 8-14 and 12:13-16.
14 *See supra* n. 8; pgs. 33:16-17, 20-21; 34:2-4, 15-16; 35:22-25; 36:1-11; 39:10-25; 40:4-6; 44:3-6; 45:5-9 and 61:10-13.
15 *See supra* n. 1, Syllabus, pg. 1.
16 *See supra* n. 1, Concurring Opinion, pg. 4.
17 An excellent resource in the BNA 2017 Trust Nexus Survey, Vol. 24, No. 10, which presents, in part, the criteria varies widely for making a determination whether a trust is a "resident" trust for application of the jurisdiction's income tax.
18 In addition to North Carolina, only Georgia and Tennessee also tax a non-resident trustee for undistributed income *solely* on the in-state residency of a beneficiary. California imposes a tax only if the resident beneficiary receives income or has a right to receive income in a particular year. Tennessee currently only taxes dividend and interest income, but will join the non-tax states with a full repeal of the tax as of 2022 (Tenn. Code Ann. §67-2-110(a)).