Trusts and Estates

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Supreme Court Holds North Carolina Trust Tax Law Unconstitutional

The United States Supreme Court recently decided an important case involving a state's ability to tax the undistributed income of a trust. In *North Carolina Department of Revenue v. Kimberley Rice Kaestner 1992 Family Trust*, No. 18-457 (June 21, 2019), the Court held that North Carolina did not have the power to subject the trust to income tax on its undistributed income when the only contact with North Carolina was the residence of beneficiaries who received no distributions from the trust.

The Kaestner trust was created by a New York resident and was governed by New York law. The trust was not a so-called grantor trust that was taxable to the grantor and thus was a separate taxpayer under federal tax law. The trustee was never a North Carolina resident (for the years in question, the trustee was a Connecticut resident working in New York), and the assets of the trust were located in Massachusetts. The trustee had complete discretion over whether, and in what amounts and proportions, to make distributions to the beneficiaries. All the income of the trust was from non-North Carolina sources. When the trust was created, none of the beneficiaries lived in North Carolina. However, several years later all the beneficiaries of the trust moved to North Carolina. During the years covered by the case, no distributions were made to any of the beneficiaries.

North Carolina law provides that the undistributed income of an out-of-state trust is taxed by North Carolina if a beneficiary of the trust resides in that state. The trust challenged the constitutionality of application of this law on these facts. The North Carolina courts held for the taxpayer, finding that the North Carolina taxing statute violated the due process clause of the United States Constitution. They held that if the only connection of the trust with North Carolina is the residence of a trust beneficiary, that connection is not constitutionally sufficient to impose North Carolina's income tax on the accumulated income of the trust.

The Supreme Court has now unanimously agreed with the result of the North Carolina decisions. The Supreme Court opinion is deliberately narrow and confined to the facts of the case, in which not only were no distributions made to the North Carolina beneficiaries, but the beneficiaries had no assurance of receiving any distributions in the future.

Both the majority opinion and the concurring opinion in the Supreme Court expressly declined to give any indication how the result might differ if some of the critical facts were different. Based on this decision, trying to determine how the Court might apply the principles it distilled from older cases to different fact patterns, or to the tax law of different states, would be speculative. The basic rule seems to be that the trust must benefit significantly from the state in a given year in order for the state to be able to tax the trust's undistributed income that year, but the hard part is determining where to draw the line.

Many states have considered the issue of what contacts are necessary in order to allow a state to impose an income tax on the undistributed income of a non-grantor trust:

(a) California imposes an income tax on the undistributed income of a non-grantor trust if a beneficiary with a noncontingent interest in the trust or a trustee resides in California. Although it is not entirely clear what the term "noncontingent" means, if a beneficiary has a right to income from the trust or if distributions are made to the beneficiary, the interest is noncontingent. If the trust is a discretionary trust in which no beneficiary has a right to income and no distributions have been made to a California resident, no beneficiary's interest is noncontingent, and the trust is not subject to income tax on its undistributed income if it has no California trustee. Under the facts in the *Kaestner* case, California would not have subjected the trust to current taxation. Given the Court's narrow holding, it would appear that the Court's decision does not impact California's taxation of trusts.

(b) Illinois imposes an income tax on the undistributed income of a non-grantor trust if the grantor of the trust was a resident of Illinois at the time the trust became irrevocable (or if it later ceased to be a grantor trust). The *Kaestner* decision, in conjunction with the relatively recent Linn case in the Illinois courts, will help a trustee determine when a trust with an Illinois grantor has insufficient contacts with Illinois so as to make the imposition of Illinois income tax on the trust unconstitutional.

(c) New York imposes an income tax on the undistributed income of a non-grantor trust if the grantor of the trust was domiciled in New York at the time the trust became irrevocable except in any year in which the trust has no (i) trustee domiciled in New York, (ii) real estate or tangible personal property located in New York or (iii) New York source income, such as income from an unincorporated business located in New York. The *Kaestner* decision will not change the taxation of trusts in New York.

(d) Virginia, Maryland and the District of Columbia all impose an income tax on undistributed trust income based solely on the residency of a non-grantor trust, not the residency of any one or all of the trust beneficiaries. Each of these jurisdictions considers a trust to be a resident trust of the respective jurisdiction if the trust was created by the will of a decedent who was domiciled in the jurisdiction on the date of death. Virginia and D.C. also consider a trust to be a resident trust if the trust was created by or consists of property of a person domiciled in the jurisdiction. Maryland is the only jurisdiction of these three that considers the place of principal administration of the trust and the current residency of the creator of the trust when determining whether the trust is a resident trust. We do not believe the *Kaestner* decision will change the taxation of trusts in Virginia, Maryland and the District of Columbia.

As a result of the Supreme Court's decision, it is likely that some of the few states that base their trust income tax on the mere residence of a beneficiary will change their laws to bring their trust-taxing statutes into conformance with the decision. If you have any questions about the income tax rules in your state, please feel free to call any member of the Trusts & Estates practice on the firm's website in your state.

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