

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

**June, 2019**

State Not Allowed Under Due Process Clause to Tax Undistributed Trust Income Solely on the Basis of Beneficiaries' Residence in the State Under the Specific Facts Where Beneficiaries Received No Trust Income, Had No Right To Demand Income, and Had No Assurance They Would Eventually Receive Income; Little Guidance Regarding Factors Used by Other States and In Other Situations for Taxing Trust Income

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## **Steve R. Akers**

Senior Fiduciary Counsel  
Bessemer Trust  
300 Crescent Court, Suite 800  
Dallas, TX 75201  
214-981-9407  
[akers@bessemer.com](mailto:akers@bessemer.com)  
[www.bessemer.com](http://www.bessemer.com)

## **Ronald D. Aucutt**

Senior Fiduciary Counsel  
Bessemer Trust  
703-408-3996  
[aucutt@bessemer.com](mailto:aucutt@bessemer.com)  
[www.bessemer.com](http://www.bessemer.com)

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## Table of Contents

Synopsis .....	1
Analysis.....	3
Observations.....	6

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### Important Information Regarding This Summary

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## Synopsis

In a 9-0 decision, the U.S. Supreme Court upheld lower court findings that the taxation of undistributed income from a trust by North Carolina based solely on the beneficiaries' residence in North Carolina violated the Due Process Clause, but the Court emphasized that its ruling was based on the specific facts of the case for the specific tax years in question.

The first paragraph of the opinion is an excellent synopsis of the case and the Court's holding.

This case is about the limits of a State's power to tax a trust. North Carolina imposes a tax on any trust income that "is for the benefit of" a North Carolina resident. N. C. Gen. Stat. Ann. §105–160.2 (2017). The North Carolina courts interpret this law to mean that a trust owes income tax to North Carolina whenever the trust's beneficiaries live in the State, even if—as is the case here—those beneficiaries received no income from the trust in the relevant tax year, had no right to demand income from the trust in that year, and could not count on ever receiving income from the trust. The North Carolina courts held the tax to be unconstitutional when assessed in such a case because the State lacks the minimum connection with the object of its tax that the Constitution requires. We agree and affirm. As applied in these circumstances, the State's tax violates the Due Process Clause of the Fourteenth Amendment.

*North Carolina Department of Revenue v. The Kimberley Rice Kaestner 1992 Family Trust*, 588 U.S. \_\_ (2019)(Justice Sotomayor), concurring opinion (Justice Alito, joined by Chief Justice Roberts and Justice Gorsuch), *aff'g Kaestner 1992 Family Trust v. North Carolina Department of Revenue*, 814 S.E.2d 43 (N.C. June 8, 2018), *aff'g* 789 S.E.2d 645 (N.C. App. 2016), *aff'g*, 12 CVS 8740 (N.C. 2015).

The decision is narrow in the sense that North Carolina may be unique in looking solely to the residency of a beneficiary, including a beneficiary whose interest is "contingent," but the opinion does respect the fundamental character of trusts and recognizes the distinct interests and functions of the settlor, trustee and beneficiaries. In addition the opinion implies that the Court's recent opinion in *South Dakota v. Wayfair, Inc.* 585 U.S. \_\_ (2018), will not have a major impact on the analysis of the constitutionality of state taxation of trusts. While the trend of cases over the last four years has been to find state taxation of trusts on various grounds to be unconstitutional (with most of those cases addressing systems that tax trusts based on the residency of the settlor of the trust), the Court appears to go out of its way to make clear that it is not addressing any of the other regimes for state taxation of trusts. The opinion provides minimal guidance as to the constitutionality of those various systems (or the North Carolina beneficiary-based system under other facts), but reiterates and applies traditional concepts that due process concerns the "fundamental fairness" of government activity and requires "minimum contacts" under a flexible inquiry focusing on the reasonableness of the government's action.

### Background; Basic Facts; Lower Court Opinions

1. **Background.** All of the 43 states plus the District of Columbia that impose an income tax on trusts tax the undistributed income of a non-grantor trust as a "resident trust" based on one or more of the following five criteria: (1) if the trust was created by a resident testator (for a testamentary trust), (2) if the trust was created by a resident trustor (for an *inter vivos* trust), (3) if the trust is administered in the state, (4) if the trust has a resident

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fiduciary, and (5) if the trust has a resident beneficiary. Observe that the governing law of the trust is not one of those criteria (except in Louisiana; also in Idaho and North Dakota that is a factor considered along with other factors). A trust included in one of the first two categories is sometimes referred to as a “founder state trust” (i.e., the trust is a resident trust if the founder of the trust was a resident of the state).

See Item 20.d of the 2012 Heckerling Musings found [here](#) and available at [www.bessemertrust.com/for-professional-partners/advisor-insights](http://www.bessemertrust.com/for-professional-partners/advisor-insights) for a summary of the court cases that have addressed the constitutionality of state tax systems that tax trusts based on the testator of a testamentary trust or settlor of an inter vivos trust residing in the state. Based on those cases, most commentators believe that taxing a nonresident trust solely because the testator or settlor was a resident is likely unconstitutional (but that conclusion is far from certain). However, if that state's court system is utilized, for example, because of a probate proceeding in that state, chances are better that the state would be found to have the authority to tax the trust.

For a very complete survey of the nexus rules in the various states, see the Bloomberg BNA Special Multistate Tax Report, 2017 Trust Nexus Survey, available at <http://src.bna.com/tBG> (published October 2017).

1. **Basic Facts of Kaestner.** The trust was originally created by a New York resident in 1992 for his three children. No party to the trust was in North Carolina until one of the daughters, Kimberly, moved to North Carolina in 1997 at age 28. The original trustee was a New York resident, and a Connecticut resident later became trustee. The trust was governed by the laws of New York. The financial assets were held by custodians in Boston. The financial books and records were kept in New York, and the tax returns and accountings were prepared in New York for administrative convenience. The trust eventually was separated into three subtrusts for the three children in 2002 and the separate shares became separate trusts in 2006. Kimberly's trust was formed for the benefit of Kimberly and her three children.

North Carolina taxed Kimberly's trust more than \$1.3 million in 2005-2008 based on N.C.G.S. §105-160.2, which provides that the state can tax a trust “that is for the benefit of a resident of this State.” The trust paid the tax and filed a claim for refund on the basis that the North Carolina tax provision was unconstitutional.

The beneficiaries were merely discretionary beneficiaries; the trustee had “absolute discretion” to distribute assets to the beneficiaries “in such amount and proportions” as the trustee might “from time to time” decide. No distributions were made to the beneficiaries during the tax years in question. A loan was made to Kimberly, which she repaid the following year.

The trustee provided Kimberly with accountings of trust assets, and she received legal advice about the trust from the trustee and his law firm in New York. She and her husband met with the trustee in New York to discuss investment opportunities for the trust and whether she wanted to receive income distributions.

The trust agreement provided that the trust would terminate in 2009 (on Kimberly's 40<sup>th</sup> birthday), but after the tax years in question and before the termination date, the trustee consulted with Kimberly and in accordance with her wishes the trustee decanted the trust into a new trust under the New York decanting statute (N.Y. Est., Powers & Trusts Law Ann. §10-6.6(b)).

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2. **Lower Court Opinions.** The trial court held that taxing the trust was unconstitutional under both the Due Process Clause and the Commerce Clause, but the Court of Appeals addressed only the Due Process Clause.

For its constitutional analysis, the North Carolina Supreme Court quoted rather extensively from the Due Process analysis (not the Commerce Clause analysis) in *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), overruled as to physical presence test in Commerce Clause analysis, *South Dakota v. Wayfair, Inc.*, 585 U.S. \_\_ (2018). Quoting *Quill*, “[t]he Due Process Clause requires some definite link, some minimum connection, between estate and the person, property or transaction it seeks to tax.” The North Carolina Supreme Court reasoned that “[t]his ‘minimum connection,’ which is more commonly referred to as ‘minimum contacts,’... exists when the tax entity ‘purposefully avails itself of the benefits of an economic market’ in the taxing state ‘even if it has no physical presence in the state.’ [quoting *Quill*].”

The North Carolina Supreme Court emphasized that the trust and the North Carolina beneficiaries have separate legal taxable existences and that “a taxed entity’s minimum contacts with the taxing state cannot be established by a third party’s minimum contacts” [citing several U.S. Supreme Court cases]. The court concisely concluded that the trust, “as a separate legal entity in the context of taxation, would have needed to purposefully avail *itself* of the benefits and protections offered by the State [citing *Quill*]. Mere contact with a North Carolina beneficiary does not suffice.” The court held that the statute authorizing taxation of the undistributed income of a trust based on the beneficiary’s residence is unconstitutional under the Due Process Clauses of the U.S. and North Carolina Constitutions as applied to the facts of this case.

## Analysis

1. **General Due Process Principles Regarding State Taxation.** The Due Process Clause of the Fourteenth Amendment provides that “[n]o State shall... Deprive any person of life, liberty, or property, without due process of law.” The Due Process Clause centrally concerns the “fundamental fairness of governmental activity” [citing *Quill Corp. v. North Dakota*]. The clause limits states to imposing only taxes that “bear[r] fiscal relation to protection, opportunities and benefits given by the state.” *Wisconsin v. J. C. Penney Co.*, 311 U.S. 435, 444 (1940). The Court applies a two-step process to make this determination.

First, and most relevant here, there must be some “some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax.” *Quill*, 504 U.S. at 306.

Second, “the ‘income attributed to the State for tax purposes must be rationally related to ‘values connected with the taxing State.’” *Ibid.*

Footnote 5 clarifies that because the Kaestner Trust does not meet the first test, the Court does not address the second.

In the context of state taxation, the state must have “certain minimum contacts” such that the tax “does not offend ‘traditional notions of fair play and substantial justice.’” [quoting *International Shoe Co.*, 326 U.S., at 316]. The “minimum connection” inquiry is “flexible” and focuses on the reasonableness of the government’s action [citing *Quill*, 504 U.S. at 307].

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2. **General Application of Due Process Principles to State Taxation of Trusts.** “One can imagine” various contacts “with a trust or its constituents” that might provide the “minimum connection” to justify taxation of the trust assets. The Court in the past has looked at “the relationship between the relevant trust constituent (settlor, trustee, or beneficiary) and the trust assets.” Prior cases have recognized that basing state taxation on income distributed to an in-state **beneficiary** or on a **trustee’s** in-state residence satisfies the Due Process Clause. Other cases “suggest” that a tax based on the site of **trust administration** is constitutional.

As to **beneficiary** contacts, specifically, “the Court has focused on the in-state beneficiary’s right to control, possess, enjoy, or receive trust assets.” A common governing principle for a State basing trust taxation on the residence of a trust beneficiary is that “the Due Process Clause demands 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 analogizes this analysis for **beneficiary** contacts to **settlor** or **trustee** contacts with a state. A state can tax a trust based on an in-settlor who retained the “power to dispose of” the trust property or to the in-state residence of a **trustee**. (The Court in footnote 7 makes clear that it is not addressing whether a lesser degree of control by a settlor could also sustain a tax by the settlor’s domicile state.)

The Court briefly summarizes the Due Process Clause analysis for the various types of trust constituents (beneficiary, settlor, and trustee), and particularly for beneficiaries. That summary is quoted in Item 8 of the Observations, below.

3. **Application of Principles to Kaestner Trust Facts.** The Court makes very clear that its conclusion that the Due Process Clause is not satisfied as to North Carolina’s taxation of the trust is based on the specific facts in these years. The Court concludes that the Kaestner Trust beneficiaries do not have the requisite relationship with the trust property to justify the state’s tax, but footnote 7 makes clear that the Court does “not decide what degree of possession, control, or enjoyment would be sufficient to support taxation.”

The Court points to various reasons that the mere residence of the beneficiaries in North Carolina does not supply the required “minimum connection” necessary to support state taxation of the trust.

First, the beneficiaries did not actually receive any income during the years in question.

Second, “the beneficiaries had no right to demand trust income or otherwise control, possess, or enjoy the trust assets in the tax years at issue.” The trustee had “absolute discretion” in deciding when, whether, and to whom distributions would be made. The Court emphasizes that “Critically, this meant that the trustee had exclusive control over the allocation and timing of trust distributions.” Distributions could be made to one beneficiary to the exclusion of others, “with the effect of cutting one or more beneficiaries out of the Trust.” The trustee and not beneficiaries made investment decisions. A spendthrift clause prevented beneficiaries from assigning their interests in trust property to anyone. (Footnote 9 makes clear that the Court does not address whether the absence of a spendthrift clause would mean that the minimum contacts requirements for due process is satisfied.) While the trust agreement directs the trustee to be liberal in exercising its distribution discretion and the trustee could not act in bad faith or some improper motive, the beneficiaries still could not demand distributions or direct that Trust assets be used for their benefit.

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Third, the beneficiaries “could not count on necessarily receiving a specific amount of income from the Trust in the future.” While the trust was scheduled to terminate in 2009, the New York decanting statute allowed the trust to distribute to a new trust with a longer termination date, which the trustee in fact did. As a result of these facts, one might view the interests of the beneficiaries as “contingent” on the exercise of the trustee’s discretion. The Court in footnote 10 says that it specifically is not addressing “whether a different result would follow if the beneficiaries were certain to receive funds in the future.”

In light of these three reasons, Kimberly and her children “had no right to ‘control or posses[s]’ the trust assets ‘or to receive income therefrom.’” “Given these features of the Trust, the beneficiaries’ residence cannot, consistent with due process, serve as the sole basis for North Carolina’s tax on trust income.”

4. **Rejection of State’s Counterarguments.** First, the State argued a prior case stands “for the broad proposition that that ‘a trust and its constituents’ are always ‘inextricably intertwined,’ and that because trustee residence support trust taxation, so too must beneficiary residence. This argument “fails to grapple with the wide variation in beneficiaries’ interests.” The relationship between beneficiaries and trust assets maybe very close in some situations, but not in others.

Second, the State argued that a ruling in favor of the Trust will undermine numerous state taxation regimes. The Court rejects that argument because few states rely on beneficiary residency as the sole basis for state taxation. Footnote 12 points out that five states (Alabama, Connecticut, Missouri, Ohio, and Rhode Island) look at a beneficiary’s residence in combination with other factors. Furthermore, three states (Georgia, Montana, North Dakota), that purportedly look at beneficiary residency apply flexible tests and may not rely on beneficiary residency alone. Tennessee uses beneficiary residency but will phase out its income tax by 2021. California applies beneficiary residency as a factor, but only where the beneficiary is not contingent. No other state has a regime that is clearly like that in North Carolina.

Third, the State argued that adopting the Trust’s position will lead to “opportunistic gaming of state tax systems,” by delaying taking distributions until the beneficiary moves to a state with a lower level of taxation. The Court responds that such gaming is by no means certain to occur because the trustee, not the beneficiary, has the power to make or delay distributions, and because the holding addresses only circumstances in which a beneficiary receives no income, has no right to demand income, and is uncertain necessarily to receive income. “In any event, mere speculation about negative consequences cannot conjure the ‘minimum connection’ missing between North Carolina and the object of its tax.”

5. **Not Address Rationale of North Carolina Supreme Court.** Footnote 11 observes that the Court does not address the Trust’s “broader argument that the trustee’s contacts alone determine the State’s power over the Trust.” The North Carolina Supreme Court reasoned that the Trust and the beneficiaries have separate legal taxable existences; the Trust itself must have sufficient “minimum contacts” with the State and mere contact with a beneficiary will not suffice.

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6. **Concurring Opinion.** A separate brief concurring opinion by Justice Alito, joined by Chief Justice Roberts and Justice Gorsuch, states that its purpose is to make clear that the opinion of the Court is based on the “unusually tenuous” connection between the Kaestner beneficiaries and the trust income, and that “the opinion of the Court merely applies our existing precedent and that its decision not to answer questions not presented by the facts of this case does not open for reconsideration any points resolved by our prior decisions.”

Existing opinions establish that a state in which tangible trust assets are located can tax those assets. *Curry v. McCanless*, 307 U.S. 357, 364-365 (1939). For intangible assets, the issue is whether a resident of the state imposing the tax has “control, possession, or the enjoyment of the asset.” For example, the state of the **trustee**’s residence can impose a personal property tax on the trust’s intangible assets. *Greenough v. Tax Assessors of Newport*, 331 U.S. 486 (1947). As to whether the connection between a **beneficiary** and the trust income is sufficient to allow the beneficiary’s state of residence to tax the trust income, the concurring opinion says that two prior cases (from about 90 years ago) provide a clear answer, based on the beneficiary’s lack of “control, possession, or enjoyment” of the assets of the trust income. *Brooke v. Norfolk*, 277 U.S. 27, 28-29 (1928); *Safe Deposit & Trust Co. of Baltimore v. Virginia*, 280 U.S. 83, 93-94 (1929) (Virginia could not apply its intangibles tax to assets of a trust with a Maryland trustee where neither the grantor nor the beneficiaries who resided in Virginia had control over the trust assets).

## Observations

1. **Significance of State Trust Income Taxation Issues.** States use a variety of factors to determine whether the state can tax the undistributed income of non-grantor trusts. Questions surrounding the state taxation of trust income are arising more frequently as (1) states are strapped for revenue and are getting more aggressive and (2) beneficiaries and individual trustees are more mobile, which may have the effect of changing the tax situs. These issues impact important estate planning decisions; for example, planners must be careful in naming family members as trustee without considering whether the appointment could cause the trust to be subject to income tax in the state of the trustee’s residence. These issues are exacerbated by the trend of splitting up trustee functions among co-trustees, increasing the possible likelihood of having at least one co-trustee in a state that uses the trustee’s residence as a basis for taxing trusts.

2. **Significance (and Insignificance) of *Kaestner*.**

The Due Process and Commerce Clauses of the U.S. Constitution both place limits on the ability of a state to tax income when the income is not directly produced within the state. In particular, courts over the last century have grappled with when a state can tax the undistributed income of trusts based on some connection to the state and still satisfy the Due Process Clause’s requirement of fundamental fairness. A number of state court cases have addressed this issue (increasingly over the last decade, as discussed in Item 9 below), but *Kaestner* is the Supreme Court’s first effort to address this important issue regarding state taxation of trust income in many decades. For that reason, the case is highly significant.

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The opinion is helpful in reiterating established guidance regarding the Due Process Clause's limits on the ability of states to tax income and the general principles for when a state can tax trust income under the Due Process Clause. The opinion is very limited, however, in establishing guidelines for what specific connections that a state has with a trust income *will satisfy* the due process requirements.

3. **Steve Akers Points Out That Ron Aucutt Told Us That Three Months Ago.** Ron Aucutt's summary of the *Kaestner* case over three months ago turns out to be an excellent summary of where we are now in our understanding of the constitutionality of state trust taxation systems. The last two sentences of his article accurately predicted the planning situation following the *Kaestner* opinion "While tax lawyers will undoubtedly parse the Court's opinion (or opinions) very carefully, we should expect the Court's holding to be only an acceptance or rejection of the particular way North Carolina taxes trusts. A lot of extrapolation and simple guesswork will probably still be needed to answer most of the questions and evaluate the impact on most other states."
4. **Recognition of Fundamental Trust Concepts.** The opinion respects the fundamental character of trusts and recognizes the distinct interests and functions of the settlor, trustee and beneficiaries. An amicus brief filed by The American College of Trust and Estate Counsel was designed primarily to inform the Court about fundamental trust concepts and fiduciary income taxation concepts, and the importance of the nature and connection of the settlor, trustee, and beneficiaries of a trust to trust income with respect to the constitutionality of state taxing systems.
5. **Little Guidance Regarding Degree of Beneficiaries' Connection to Trust Income That Would Justify State Taxation Based on Beneficiaries' Residence in the State.** The opinion reiterates again and again that it is based on the very specific facts for the particular years in question, and that the *Kaestner* beneficiaries' "unusually tenuous" (in the words of the concurring opinion) connection to the trust income in those years was not sufficient to meet the due process fundamental fairness requirement.

The opinion leaves open the possibility that states may be able to tax undistributed trust income based on a trust beneficiary's residence in the state in certain situations (for example, *possibly* if the beneficiary received some income during the year in question, had the right to demand income from the trust during that year, or had a vested interest in ultimately receiving that trust income). The opinion reiterated various times that it was not addressing what situations involving a beneficiary's connection to trust income would satisfy the due process requirements. See n.8 ("We do not decide what degree of possession, control, or enjoyment [by trust beneficiaries] would be sufficient to support taxation"); n.10 ("We have no occasion to address, and thus reserve for another day, whether a different result would follow if the beneficiaries were certain to receive funds in the future"); n.11 ("Even if beneficiary contacts—such as residence—could be sufficient in some circumstances to support North Carolina's power to impose this tax, the residence alone of *Kaestner* Trust beneficiaries cannot do so for the reasons given above").

The opinion points out in footnote 12 that the North Carolina beneficiary-based regime may be unique, leaving open the question of the constitutionality not only of the North Carolina regime in other fact situations but also the constitutionality of the other (possibly different) beneficiary-based state trust taxing systems. For example, one of the factors mentioned in *Kaestner* is that the resident-beneficiary was not assured of ultimately receiving the trust income. The Court in footnote 10 said that it specifically was not addressing "whether a

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different result would follow if the beneficiaries were certain to receive funds in the future." For example, one of the factors that California uses in taxing the undistributed income of trusts is whether any "non-contingent" beneficiaries reside in California.

6. **Guidance as to Factors That Would Justify State Taxation of Trust Income.** Page 6 of the opinion addresses three taxing regimes that do pass the Due Process Clause's "minimum contacts" requirement: (1) taxation of actual trust distributions to a state resident, *Maguire v. Trefry*, 253 U.S. 12, 16-17 (1920); (2) taxation based on the residence of the trustee, *Greenough v. Tax Assessors of Newport*, 331 U.S. 486 (1947); and (3) possibly taxation based on the place of administration (cases *suggesting* that is constitutional are *Hanson v. Denckla*, 357 U.S. 235, 251 (1958) (involving personal jurisdiction, not trust taxation, issues), and *Curry v. McCanless*, 307 U.S. 357, 370 (1939)).

In addition, cases are clear that states can tax income that comes from sources within the state (sometime referred to as "source income").

7. **Minimal Guidance as to Settlor-Based Regimes.** The most prevalent factor that is used by states for taxing undistributed trust income is whether the trust was originally created by a resident of the state. The opinion provides little guidance regarding whether those systems will satisfy the due process requirements. The opinion does observe that prior cases have upheld systems based on the settlor's residence in situations in which the settlor had the "power to dispose of" the trust property, *Curry v. McCanless*, 307 U.S. 357, 364-365 (1939), or the "right to revoke" the trust, *Graves v. Elliott*, 307 U.S. 383, 387 (1939). Beyond those cases, in which the settlor retains the clear power to control or possess the trust property, the opinion gives no guidance regarding the constitutionality of settlor-based taxing regimes. The opinion notes that neither *Curry* nor *Graves* explored "whether a lesser degree of control by a settlor also could sustain a tax by the settlor's domicile (and we do not today address that possibility)." *Kaestner* n.7

Although a few exceptions exist, a wide variety of state cases have found that systems based solely on the existence of a resident-settlor do not satisfy due process requirements (see Item 20.d of the 2012 Heckerling Musings found [here](#) and available at [www.bessemertrust.com/for-professional-partners/advisor-insights](http://www.bessemertrust.com/for-professional-partners/advisor-insights)), including a number of recent cases over the last several years (see Item 9 below).

Even among settlor-based regimes, the constitutionality analysis may vary. Taxation of testamentary trusts by the state of the decedent's residence may have a somewhat greater possibility of withstanding constitutional muster than inter vivos trusts because of the utilization of the state's probate courts in the establishment of the testamentary trusts. The courts have generally focused their constitutional analysis of state taxation of trusts under the Due Process Clause (and the involvement of the local courts in creating the trust is an additional contact with the state that may help support the existence of the required "minimum contacts" required for due process), but the state taxation must also be permitted under the Commerce Clause, which requires a **substantial nexus** between the activity being taxed and the taxing state, and the local court involvement might help in establishing that the required substantial nexus exists.

Another variance is that some settlor-based state regimes also add a "nonresident resident trust" exception (such as New Jersey and New York); the state cannot tax the income of a "resident trust" created by a resident-settlor if no trustees, assets or source income are present in that state.

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Settlor-based state systems can sometimes create planning opportunities for trusts created by residents in other states. Because such a state only taxes trusts created by settlors who reside in the state, residents of other states that have a nonresident resident trust exception can create trusts in a settlor-regime state without state income taxation. For example, New York resident-settlors may create trusts with New Jersey trustees and assets and not be subject to New York taxation (because of the absence of a New York trustee or New York assets) or New Jersey taxation (because the trust was not created by a New Jersey testator or settlor).

The *Fielding* case (discussed in Item 12 below) involves the constitutionality of a settlor-based system, and could potentially result in Supreme Court guidance for settlor-based regimes (if the Court should grant petitioner's certiorari request in that case).

8. **Summary of Opinion's Guidance Regarding Beneficiary, Settlor, or Trustee Based Taxing Regimes.** Future cases addressing the constitutionality, under the Due Process Clause, of factors used by states for taxing trust income will focus on the following summary in *Kaestner*:

In sum, when assessing a state tax premised on the in-state residency of a constituent of a trust—whether beneficiary, settlor, or trustee—the Due Process Clause demands attention to the particular relationship between the resident and the trust assets that the State seeks to tax. Because each individual fulfills different functions in the creation and continuation of the trust, the specific features of that relationship sufficient to sustain a tax may vary depending on whether the resident is a settlor, beneficiary, or trustee. When a tax is premised on the in-state residence 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. Cf. *Safe Deposit*, 280 U. S., at 91–92.<sup>8</sup> Otherwise, the State's relationship to the object of its tax is too attenuated to create the "minimum connection" that the Constitution requires. See *Quill*, 504 U.S. at 306.

<sup>8</sup>As explained below, we hold that the *Kaestner* Trust beneficiaries do not have the requisite relationship with the Trust property to justify the State's tax. We do not decide what degree of possession, control, or enjoyment would be sufficient to support taxation.

9. **Recent Trend of Cases Rejecting Constitutionality of State Trust Taxation for Settlor-Based Systems.** Recent cases have held or suggested that Illinois, Minnesota, New Jersey, and Pennsylvania could not tax trusts merely because the "founder" (settlor) of the trust was a resident of those states when the trust was created. *E.g., William Fielding, Trustee of the Reid and Ann MacDonald Irrevocable GST Trust for Maria V. MacDonald, et al., v. Commissioner of Revenue* (Minn. Tax Ct. May 31, 2017); *Residuary Trust A u/w/o Kassner v. Director, Division of Taxation*, 2015 N.J. Tax LEXIS 11, 2015 WL 2458024 (N.J. Sup. Ct. App. 2015), aff'd 27 N.J. Tax 68 (N.J. Tax Ct. 2013); *Linn v. Dep't of Revenue*, 2013 IL App. (4th) 121055 (2013); *McNeil v. Commonwealth of Pennsylvania*, Pa. Comm. Court, Nos. 651 F.R. 2010, 173 F.R. 2011 (2013). For further discussion about the details of each of these cases see Item 22.a of the Current Developments and Hot Topics Summary (December 2014) found [here](#) and Item 17.c of the Current Developments and Hot Topics Summary (December 2017) found [here](#) and available at [www.bessemertrust.com/for-professional-partners/advisor-insights](http://www.bessemertrust.com/for-professional-partners/advisor-insights).

Contrary to this recent trend is *T. Ryan Legg Irrevocable Trust v. Testa*, 75 N.E.3d 184 (Ohio 2016), *cert. denied*, 2017 U.S. LEXIS 5567 (U.S. 2017). The Ohio Supreme Court upheld imposition of Ohio income tax on a nonresident Delaware trust's sale of Ohio S corporation interests, based on a state statute requiring that nonresidents pay Ohio income tax on taxable gains from the sale of a 20% or greater interest in an Ohio pass-through entity. An earlier Ohio case held that the statute was unconstitutional as applied to a seller that had not

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availed himself of Ohio's protections and benefits in a direct way. The Ohio Supreme Court nevertheless upheld the imposition of the Ohio tax in this case, even though the Delaware trust had not availed itself of Ohio protections and benefits, because the trust's settlor was from Ohio and that same person was the original founder and manager of the pass-through entity (though he had withdrawn from the business before the year in question).

Another recent state case addresses a Massachusetts tax on trust income if the trust has a settlor, at least one beneficiary, and at least one trustee that is an "inhabitant" of Massachusetts. The case concluded that Bank of America met the trustee-inhabitant requirement, even though it was not domiciled in Massachusetts, based on its various activities in Massachusetts and based on a construction of the tax statute. *Bank of America N.A. v. Commissioner of Revenue*, 54 N.E.3d 13, 474 Mass. 702 (Mass. 2016).

10. **Impact of Decanting Statute.** One of the reasons the Court gave for concluding that the beneficiaries did not have the requisite "minimum connection" with the income being taxed was that they were not assured of ever receiving the income. The tax years in question were 2006-2008, and the trust agreement said that the trust would terminate in 2009. To reason that the beneficiaries were not assured of receiving the income when the trust would terminate in the *following* year (as to the 2008-year tax) may seem somewhat of a stretch. Apparently, as of 2008, the Court would have been relying on the fact that the trustee had the authority to distribute the assets to a longer-term trust under the New York decanting statute, so the beneficiaries were not assured of receiving the income.
11. **Not Adopt Rationale That Trust Itself Must Have Contacts With State.** The Court did not adopt the reasoning of the North Carolina Supreme Court that the Kaestner Trust and the beneficiaries have separate legal taxable existences, and that the Kaestner Trust itself (rather than trust beneficiaries) must have sufficient "minimum contacts" with the state.
12. **No Decision on Whether Supreme Court Will Hear *Fielding*.** In *William Fielding, Trustee of the Reid and Ann MacDonald Irrevocable GST Trust for Maria V. MacDonald, et al., v. Commissioner of Revenue*, (Minn. Tax Ct. May 31, 2017), the court addressed the Minnesota statute providing that an inter vivos trust is treated as a resident trust if the grantor was a Minnesota resident when the trust became irrevocable. The taxpayer paid income tax on all income earned by the trust in 2014, but filed a claim for refund, alleging that Minnesota's taxation of non-Minnesota income merely on the basis of the grantor being domiciled in Minnesota when the trust became irrevocable was unconstitutional, violating the due process clauses of the Minnesota and U.S. Constitutions, and the Commerce Clause of the U.S. Constitution. The Commissioner tried to point to other (rather minimal) contacts with Minnesota. While the court reasoned that all contracts with Minnesota would be considered, the court concluded that the only factor that was relevant for consideration was the statute's description of the grantor's domicile when the inter vivos trust became irrevocable and whether that basis was sufficient on constitutional grounds. The court concluded that the grantor-domicile sole basis under the Minnesota statute for treating an inter vivos trust as a Minnesota resident trust violated the Due Process clauses of the Minnesota and United States constitutions. Minnesota was not entitled to tax the income from the sale of stock (of a Minnesota corporation) or income from an out of state investment account. The Minnesota Supreme Court affirmed on July 18, 2018, largely following the reasoning of the Minnesota Tax Court. The state filed a certiorari petition with the United States Supreme Court, but the Court has not yet indicated whether or not it will hear the *Fielding* case.

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13. **Minimal Apparent Impact of *Wayfair* on State Taxation of Trusts.** *South Dakota v. Wayfair*, 138 S. Ct. 2080 (U.S. 2018), holds that states may require sellers to collect sales tax on internet purchases for remission to the purchaser's state even where the seller does not have a physical presence in the purchaser's state. *Wayfair* does not involve trust income taxation, but some of the recent trend of trust state income tax cases have cited *Quill Corp v. North Dakota*, and *Wayfair* overrules the physical presence test in *Quill* for applying the Commerce Clause. However, the state trust taxation cases have quoted *Quill* primarily for its discussion of the Due Process Clause, not the Commerce Clause. The fact that the Court in *Wayfair* overruled the *Quill* case in one respect (albeit not related to the Due Process Clause) has raised some question as to whether the Court might change its analysis of the constitutionality of states' taxation of trust income. See a detailed discussion of this issue in Item 8.d-e of Estate Planning Current Developments and Hot Topics (June 2019) found [here](#) and available at [www.bessemertrust.com/for-professional-partners/advisor-insights](http://www.bessemertrust.com/for-professional-partners/advisor-insights).

That question has been answered; *Wayfair* appears to have no impact on the constitutionality of state taxation of trusts (at least under a Due Process Clause analysis). The *Wayfair* case was not even mentioned in the *Kaestner* opinion, other than including it in the citation of the *Quill* case to point out that *Wayfair* overruled *Quill* "in part on other grounds" – that is, as to an issue other than *Quill*'s discussion of the Due Process Clause.

Some of the state trust income tax cases have addressed both the Commerce and Due Process Clauses. Taxing states must satisfy both the Due Process Clause, which requires **minimum contacts**, and the Commerce Clause, which requires a **substantial nexus** between the activity being taxed and the taxing state. *Wayfair*'s overruling of the physical presence test in *Quill*'s analysis of the Commerce Clause could conceivably have an impact on any future cases that test state taxation of trust income under the Commerce Clause. *Wayfair* says that an essential element of the Commerce Clause is that an activity exists "with substantial nexus with the taxing State" which can be established when the taxpayer "avails itself of the substantial privilege of carrying on business in that jurisdiction."

14. **Approach While Awaiting Determination of Constitutionality.** If a state attempts to tax the accumulated income of a trust based solely on the settlor's residence when the trust was created or a beneficiary's residence under facts different than the *Kaestner* facts, what should the trust do? The most conservative approach would be to pay the tax and request a refund based on the unconstitutionality of the tax.