



WRMarketplace

An AALU Washington Report

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The AALU WR Newswire and WR Marketplace are published by the AALU as part of the Essential Wisdom Series, the trusted source of actionable technical and marketplace knowledge for AALU members—the nation’s most advanced life insurance professionals

Thursday, June 25, 2019

WRM#19-13

TOPIC: Supreme Court - Beneficiary Residency Alone Is Insufficient Basis for State Trust Taxation.

MARKET TREND: In which state is a trust subject to taxation? The recently decided Kaestner case provides the U.S. Supreme Court’s latest guidance on this important income tax issue.

SYNOPSIS: On June 21, 2019, the U.S. Supreme Court rendered its decision in the case of North Carolina Dep’t of Rev. v. Kimberley Rice Kaestner 1992 Family Trust, a case which asked for a decision on whether a non-grantor trust can be subjected to state income taxes on its undistributed income solely on the basis of a beneficiary’s residence in such state. The Supreme Court held no, so long as the beneficiaries: (1) did not receive any income from the trust during the years in question; (2) had no right to demand trust income or otherwise control, possess, or enjoy the trust assets in the years at issue; and (3) could not count on receiving income from the trust in the future. The Supreme Court, however, clearly limited its ruling to the circumstances presented, holding that it did not “imply approval or disapproval of trust taxes that are premised on the residence of beneficiaries whose relationship to trust assets differs from” those in the Kaestner case.

TAKE AWAYS: The Kaestner decision likely avoided a pandora’s box of issues that could have resulted from permitting state taxation based solely on a beneficiary’s residence, including other

states seeking to expand their trust taxation and increased administrative burdens for trusts with beneficiaries in multiple states. Notably, though, the limited holding does not appear to prevent a state from considering a beneficiary's residence as one of many factors when taxing a trust. Accordingly, clients and advisors should continue to monitor the residency of trust fiduciaries and beneficiaries to confirm that trust income is being accurately reported and paid to the appropriate states. They also should use this opportunity to review the situs of their trusts and whether any changes are recommended to address the trust's state tax exposure. Such potential exposure also should be considered when selecting a jurisdiction for a new non-grantor trust, factoring in the residence of the grantor, current and future trustees and beneficiaries, the sources of trust income, etc.

MAJOR REFERENCE: N. Carolina Dep't of Revenue v. The Kimberley Rice Kaestner 1992 Family Trust (U.S. Sup. Ct. June 21, 2019).

Non-grantor trusts are subject to federal and potentially state income tax on income not otherwise distributed to the trust beneficiaries each year.¹ Determining which state(s) may tax a trust's income, however, can involve a complex analysis of a variety of state tax laws and trust factors, including the residence of the trust grantor, trustee, and/or beneficiaries. In that regard, the recently-decided *Kaestner* case likely will limit the ability of states to tax a trust's undistributed income solely on the basis of a trust beneficiary's state residency.

DETERMINING TRUST "RESIDENCY"

States generally base their taxation of a trust's income on whether the trust is deemed to be a "resident" of the state. Each state has its own set of laws for determining a trust's residency for state income tax purposes,² which may include one or more of the following:

- **Grantor's Residence:** State of residence of a living grantor or the state of death of a grantor for a trust created under the grantor's will or revocable trust
- **Trustees:** State of residence of one or more trustees
- **Beneficiaries:** State of residence of one or more current trust beneficiaries
- **Trust Administration:** State of the trust's administration
- **Trust Income:** Whether or not any trust income is "sourced" to a given state

State tax residency rules, however, must be examined (as in *Kaestner*) against the backdrop of the constitutional concept of "Due Process." When applied to taxation, the Due Process Clause "requires some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax."³

WHY IT MATTERS - MULTI-STATE TAXATION

Taxation of a non-grantor trust by one state does not preclude its taxation by others if the trust is deemed a tax resident of multiple states under each applicable state's tax laws. In such a case,

the trust could face significant additional tax exposure, particularly if the taxing states have higher income tax rates. For example, while some states (e.g. Florida, Texas, Nevada) do not tax trust income, others, like New York (top rate of 8.82%), New Jersey (10.75%), and California (13.30%) are known for their high rates of income tax. Trusts with multiple trustees/fiduciaries and/or beneficiaries in different states may be especially vulnerable to such multi-state taxation.

Example 1: Jane, a resident of Colorado, creates a non-grantor trust for the benefit of Beth, a North Carolina resident. Under the trust, distributions to Beth are fully discretionary, and she has no right to demand or receive any income or other distributions. Jane names Acme Trust Company of Delaware as the trustee, and her sister Jill, a resident of California, as distribution advisor (deemed to be a co-trustee under California law). Colorado would not tax the trust as a resident because it is not administered in that state. As for the other states, however, the trust will be a resident for state income tax purposes as follows:

- **Delaware:** Residence of the trustee (although a full tax exemption applies if the income is accumulated for beneficiaries who are not current Delaware residents);
- **North Carolina (before *Kaestner*):** Residence of the beneficiary; and
- **California:** Residence of the investment advisor (who is deemed a co-trustee).⁴

The most difficult of these factors to control, and the focal point of the *Kaestner* case, is the residency of beneficiaries (who cannot be removed or replaced, unlike trustees, or simply moved to another jurisdiction, as with the trust’s administration or situs).

WHAT HAPPENED IN KAESTNER

Kaestner involved a North Carolina statute⁵ imposing a tax on any trust income that “is for the benefit of” a North Carolina resident. North Carolina applied this law to tax a trust whenever a trust’s beneficiaries lived in North Carolina. Pertinent facts of the case include:

- The grantor, a New York resident, established the trust in 1992. At that time, none of the beneficiaries were North Carolina residents.
- In 2002, the trustee divided the trust into separate trusts for each of the grantor’s three children, only one of whom was then a North Carolina resident.
- During the tax years at issue:
 - The trustee was a Connecticut resident.
 - The trust assets consisted of various financial instruments custodied in Massachusetts. Books and records were kept in New York, where tax returns and accountings also were prepared.

- The Trust maintained no physical presence in North Carolina, made no direct investments in North Carolina, and held no real property there.
 - The trustee: (1) had full discretion and control over all trust distributions; and (2) did not make any distributions to the North Carolina resident beneficiary.
 - The beneficiaries had no right to demand income from the trust or otherwise control the trust assets.
- The trustee filed North Carolina income tax returns and paid North Carolina income taxes in excess of \$1,000,000. The trust filed refund claims for the subject tax years, which the North Carolina Department of Revenue denied. The trust then filed suit claiming that the taxes collected were in violation of the Due Process Clause of the U.S. Constitution.
 - Ultimately, the North Carolina Supreme Court proclaimed that “[w]hen, as here, the income of a foreign trust is subject to taxation solely based on its beneficiaries' [and not the trust itself, as a separate entity] availing themselves of the benefits of [North Carolina’s] economy and the protections afforded by [North Carolina’s] laws,” the Due Process Clause was violated.⁶

The U.S. Supreme Court granted certiorari in the case to decide whether the Due Process Clause prohibits states from taxing trusts based only on the in-state residency of trust beneficiaries.

WHAT THE U.S. SUPREME COURT DECIDED

The U.S. Supreme Court upheld the decision of the North Carolina Supreme Court on the narrow issue above, ruling that “[t]he 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.”⁷

The opinion indicated that, in the trust beneficiary context, the Court’s due process analysis involves a pragmatic inquiry of state trust taxes that focuses on the extent of the in-state beneficiary’s right to control, possess, enjoy, or receive trust assets. In ruling on the *Kaestner* case, the Court found that the residence of the Trust beneficiaries in North Carolina alone did not supply the minimum connection necessary to sustain the State’s tax because:

- The beneficiaries did not receive any income from the Trust during the years in question;
- They had no right to demand Trust income or otherwise control, possess, or enjoy the Trust assets in the tax years at issue; and
- They also could not count on necessarily receiving any specific amount of income from the Trust in the future.

But the Court also clearly stated that “in limiting our holding to the specific facts presented, we do not imply approval or disapproval of trust taxes that are premised on the residence of beneficiaries whose relationship to trust assets differs from that of the beneficiaries here.”

WHAT NOW

Celebrate the Status Quo. The *Kaestner* decision is a victory for taxpayers and their advisors as it likely avoided a Pandora's box of issues that could have resulted from permitting state taxation based solely on a beneficiary's residence. For example, revenue-strapped states may have been emboldened to expand the reach of their current statutes to generate more income tax revenue from trust taxation. The administrative costs and burdens on trustees for accurate tax reporting also would have increased significantly, with trustees forced to verify the tax residency of each beneficiary and file tax returns in each required state accordingly.

Understand the Limited Scope. Under the *Kaestner* decision, a state cannot tax a trust's income solely on the basis of the residence of a beneficiary who does not receive and has no right to receive trust income now or ever and has no other powers or control over the trust assets.⁸

A case involving different facts, however, especially anything that involves a beneficiary who has greater rights to control, possess, or access trust assets, may result in a different outcome. Importantly, the holding does not appear to prevent consideration of a beneficiary's residence as one of many factors for state taxation.⁹

Example 2: Returning to Example 1 above, Beth's residence as a beneficiary in North Carolina, without further connections, will no longer suffice to tax the trust in that state. A different distribution advisor also could be appointed, pursuant to the terms of the trust agreement, who is located in a state that would not impose state tax on the trust due to the distribution advisor's residence in that state. Left only with residency in Delaware, the trust can take advantage of the laws that generally permit the undistributed income of a trust with no Delaware beneficiaries to go untaxed by that state. But suppose the trust agreement allows Beth to serve as an investment advisor to the trustee, a fiduciary position? If Beth holds this additional power to control the trust's investment portfolio, even without the power to receive income, it's unclear that this trust would escape taxation in North Carolina based on the holding in *Kaestner*.

Consider and Plan for State Tax Impact. Ultimately, the *Kaestner* case should serve as a meaningful prompt to advisors to review the residence of all beneficiaries and fiduciaries of existing trusts (especially where beneficiaries are serving in some fiduciary capacity), and each relevant state's due process thresholds in connection with the taxation of trusts, to confirm that trust income is being accurately reported and the correct amount of tax is being paid to the appropriate states.

Clients and advisor also should use this opportunity to review the situs of their trusts and consider the advantages and possible issues associated with changing fiduciaries or moving to other jurisdictions to address the trust's state tax exposure. The potential for such exposure also should be considered when selecting the trust jurisdiction for a new non-grantor trust, factoring in the residence of the grantor, current and future trustees/fiduciaries and beneficiaries, sources of trust income, and the location of any trust real property. Establishing a trust in a low or no-tax

state may help the trust deal with future state tax obligations on undistributed income (assuming the grantor's residence or other factors do not already trigger taxation in a specific state). The planning considerations for existing or new non-grantor trusts are discussed in more detail in [WRMarketplace No. 15-38](#).

TAKE AWAYS

The Kaestner decision likely avoided a Pandora's box of issues that could have resulted from permitting state taxation based solely on a beneficiary's residence, including other states seeking to expand their trust taxation and increased administrative burdens for trusts with beneficiaries in multiple states. Notably, though, the limited holding does not appear to prevent a state from considering a beneficiary's residence as one of many factors when taxing a trust. Accordingly, clients and advisors should continue to monitor the residency of trust fiduciaries and beneficiaries to confirm that trust income is being accurately reported and paid to the appropriate states. They also should use this opportunity to review the situs of their trusts and whether any changes are recommended to address the trust's state tax exposure. Such potential exposure also should be considered when selecting a jurisdiction for a new non-grantor trust, factoring in the residence of the grantor, current and future trustees and beneficiaries, the sources of trust income, etc.

NOTES

¹ Any income that is distributed to a non-grantor trust beneficiary is reported on such beneficiary's individual return and deducted from the trust's entity level return. Compare to the taxation of grantor trusts, where the grantor is personally taxed on the trust's income at his or her individual income tax rates, both at the federal level and by his or her state of tax residence.

² A resident trust for state income tax purposes will be taxed by the state on all of the trust's undistributed income, as contrasted to a "non-resident" trust, for which states usually tax only income generated from sources within such state, including income from rental property or a business located in the state.

³ *N. Carolina Dep't of Revenue v. The Kimberley Rice Kaestner 1992 Family Tr.*, No. 18-457, 2019 WL 2552488 (U.S. June 21, 2019).

⁴ If there are multiple trustees and/or multiple beneficiaries who are not California residents, income is apportioned.

⁵ N.C. Gen. Stat. §105-160.2.

⁶ *Kimberley Rice Kaestner 1992 Family Tr. v. N. Carolina Dep't of Revenue*, 814 S.E.2d 43 (N.C. 2018), cert. granted sub nom. *N. Carolina Dep't of Revenue v. Kimberly Rice Kaestner 1992 Family Tr.*, 139 S. Ct. 915, 202 L. Ed. 2d 641 (2019), and aff'd sub nom. *N. Carolina Dep't of Revenue v. The Kimberley Rice Kaestner 1992 Family Tr.*, No. 18-457, 2019 WL 2552488 (U.S. June 21, 2019).

⁷ *N. Carolina Dep't of Revenue v. The Kimberley Rice Kaestner 1992 Family Tr.*, 2019 WL 2552488 (emphasis added).

⁸ Trusts that have the same facts as Kaestner and have paid state income taxes on undistributed income in states, like North Carolina, solely on the basis of a beneficiary's residence in that state, may want to consider filing protective refund claims for all open tax years to take advantage of the new United States Supreme Court precedent.

⁹ *N. Carolina Dep't of Revenue v. The Kimberley Rice Kaestner 1992 Family Tr.*, 2019 WL 2552488.