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Hands Off Your Trust: U.S. Supreme Court Limits State Income Taxation of Trusts

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The U.S. Supreme Court recently decided a case that addresses how a state may tax a particular trust. State courts have been addressing similar questions with increasing frequency. Can a state assess income tax against a trust for your benefit simply because you live in that state? Or if your grandmother resided in that state when she created the trust, 30 years ago? What if the trustee, or one of several trustees, resides in that state?

Every state has its own set of rules for assessing income tax against a trust. In some situations, a trust might be required to file tax returns in three or more separate states. Just last week, the U.S. Supreme Court issued a unanimous decision in *North Carolina Department of Revenue v. Kimberley Rice Kaestner 1992 Family Trust*, barring North Carolina's taxation of a trust in a case where the in-state residence of a beneficiary was the trust's sole connection with North Carolina. Here, we take a closer look at the decision in *Kaestner* and how it impacts state taxation of trusts, and possibly you.

What happened in *Kaestner*?

The trust analyzed in *Kaestner* was an irrevocable trust created by a New York resident in 1992. The trustee was not a resident of North Carolina, and the trust did not hold any property located in North Carolina. In 1997, a beneficiary of the trust moved to North Carolina. According to the law in North Carolina, trusts can be assessed state income taxes simply because a trust beneficiary resides within its borders.

From 2005 to 2008, the trustee of the trust filed state income tax returns, in accordance with North Carolina law but under protest, as a result of the beneficiaries' in-state residence. The trustee paid the state income tax liability of the trust, despite the fact that the beneficiaries did not receive distributions from the trust and the beneficiaries had no right to demand distributions from the trust. The trustee retained discretionary authority over all trust matters, including distributions. The trustee sued the state of North Carolina for a refund and the case eventually made its way to the Supreme Court. The trust claimed that North Carolina's tax, based solely on the in-state residency of a beneficiary, was an unconstitutional violation of Due Process.

The Court ruled unanimously in favor of the trust, citing three key factors. First, the beneficiaries did not receive distributions from the trust for the years in question. Second, the trustee had absolute authority over the management and distribution of trust assets and the beneficiaries had no right to demand, control, possess, or enjoy the trust assets. Third, there was no guarantee that the beneficiaries would receive distributions in the future. These specific features of the trust sufficiently severed the connection between the trust and North Carolina. In the end, the beneficiaries' status as residents of North Carolina, whose interests in the trust were purely discretionary, did not create sufficient nexus between North Carolina and the trust to permit taxation under the Due Process Clause.

Does *Kaestner* mean that other states will stop taxing trusts?

Generally, no. It should be noted that North Carolina is among a very small minority of states that seek to tax trusts based purely on the residence of a trust beneficiary. The Court's decision is narrowly focused on North Carolina's statute, and specifically the imposition of tax stemming solely from a beneficiary's in-state residency. The *Kaestner* case is unlikely to have a substantial impact in states where trust taxing jurisdiction is rooted in additional elements of the trust-state relationship. For instance, other states that might consider the residence of a beneficiary also look to factors not found in the *Kaestner* decision, and many states already require that a trust have more than one contact with the state before it will impose income tax, such as a resident trustee or a resident trust creator.

How does this impact taxation by other states?

Importantly, the Court did not invalidate North Carolina's law as unconstitutional, rather it simply decided under a specific set of facts that North Carolina could not tax the trust. Nevertheless, the case does shed some light on other facets of state taxing jurisdiction over trusts. For instance, in previous holdings the Court found that a state can tax a trust based on the trustee's residence, which further suggests that a trust being administered in a particular state may also satisfy the minimum contacts necessary to justify state taxation. However, the question of state taxation regularly arises for a trust that has more than one trustee residing in different states. A common example is found in directed trusts, where there could be three or more trustees whose duties are separate and distinct from each other. If a state attempts to tax all or a portion of a trust based on a single trustee's residence, what is the result? Unfortunately, the Court's decision provides no additional guidance to help determine whether in such a case the presence of a single in-state trustee is sufficient to cause taxation in that state. It is likely that a separate analysis of the duties of each trustee in each particular state will be required to determine whether the contacts are sufficient to warrant taxation.

Similarly, the Court's decision does not provide guidance on whether taxing a trust solely based on the residence of the settlor of an inter vivos trust is sufficient to withstand constitutional scrutiny. The logic employed by the Court, however, suggests that the residency of the settlor of an inter vivos trust may not, on its own, be enough. Extending the reasoning in *Kaestner*, one could argue that, unless a settlor has the right to possess, control, or otherwise exercise some authority over the assets of a trust, residency alone should not satisfy the minimum contacts required for a state to tax an inter vivos trust. While a definitive answer to these questions is not provided in the Court's opinion, the implications of the analysis in *Kaestner* are potentially important to consider. We are likely to see many more cases arising at the state level in a post-*Kaestner* world, applying, limiting and expanding on the views expressed in the Court's opinion.

Should I review what states are taxing my trust?

It is important to review your trust's connections with any given state each year, because the current location of a trustee, trust property, or a beneficiary can have an impact on what states have those specific contacts necessary to impose tax. Your trust should also be analyzed to determine if there are opportunities to reduce, or even eliminate, the impact of state taxes on your trust.

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