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In this installment of Inside Deloitte, Canfield explores the conceptual basis for state income taxation of trusts and examines some of the trends at the state judicial and legislative level that might shape future

constitutional debate.

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If a constitutional law professor were looking to fill a course syllabus, he would probably not start with a history of federal jurisprudence on the topic of state taxation of trusts. The paucity of case law from the U.S. Supreme Court and other federal courts on this subject, however, does not mean that constitutional questions regarding state taxation of trusts are sufficiently settled. To the contrary, the lack of clear guidance in this area, combined with a patchwork of state laws that are supported by varying and often conflicting

philosophical underpinnings, has created an uncertain environment in which some leading theories of taxation might be, at least in their application, unconstitutional.

Fortunately, the Court, on the heels of its landmark *Wayfair*¹ decision, which has resulted in sweeping changes to the state sales tax landscape, agreed to review a decision from the North Carolina Supreme Court — *Kimberley Rice Kaestner Family Trust v. North Carolina Department of Revenue* — regarding the state income taxation of a trust and related issues under the due process clause of the 14th Amendment of the U.S. Constitution.² Nonetheless, for various reasons, an enduring lack of clarity in this area is likely even after the Court renders its opinion in *Kaestner Family Trust*. As such, it is worthwhile to explore the conceptual basis for state income taxation of trusts, to examine some of the trends at the state judicial and legislative level that might shape the constitutional debate for years to come, and to preview *Kaestner Family Trust* — oral arguments for which were held on April 19.

State Residency: Concepts, Relevance, and Hypotheticals

As a baseline for imposing income tax on a trust, each state must grapple with the question of defining where a trust is deemed to reside. The issue of state residency is crucial because states generally impose income tax on all income of a resident trust, wherever earned.³ Conversely,

¹ *South Dakota v. Wayfair Inc.*, 138 S. Ct. 2080 (2018).

² *Kimberley Rice Kaestner Family Trust v. N.C. Department of Revenue*, 814 S.E.2d 43 (N.C. 2018); U.S. Supreme Court, Docket 18-457, petition for certiorari granted Jan. 11, 2019.

³ In this article, the term “trusts” is intended to refer strictly to non-grantor trusts. Grantor trusts are disregarded for income tax purposes with their tax attributes reported, generally, by the individual who funded the trust and who holds an economic interest in or powers over the trust.

nonresident trusts are only taxed to the extent that they earn income from sources in the taxing state. Given this dichotomy, the fiduciary of a trust that pays federal income tax is naturally inclined to carefully analyze the tax implications of being classified as a resident of any state, and to mitigate being deemed a resident of multiple states, which imposes greater complexity and potentially additional tax liability.

There are several theories about how to determine the state residency of a trust. Some states, such as New York, New Jersey, and Illinois, define the term “resident trust” based on the domicile of the grantor when she irrevocably created the trust. Other states (for example, Arizona) define residency by reference to the domicile of the trustee; or the principal place of administration (Colorado, Indiana, South Carolina); the place where the beneficiaries reside (North Carolina, Georgia, Tennessee); or some combination of factors (California, Iowa, Idaho).

Even in those instances in which determining trust residency seems straightforward, there are often factual nuances that complicate matters. The grantor, trustee, and beneficiaries of a trust (that is, the persons whose personal domicile most frequently contribute to a determination of trust residency in a given state) may not contribute equally in the final determination. For example, when considering the personal domicile of beneficiaries, should the domicile of a discretionary beneficiary who does not receive any distributions in a given year have equal weight with a beneficiary with a mandatory right to income or principal of a trust? Similarly, should someone receiving a distribution subject to the exercise of a power of appointment be considered a beneficiary?

When considering the domicile of trustees, who are the fiduciaries that should be considered trustees? Is the universe of fiduciaries limited strictly to named trustees, or does it include special trustees, trust protectors, or other parties with fiduciary duties, such as members of an investment committee or distribution committee? If these persons reside in multiple states, is it appropriate for every state that imposes tax, either in whole or in part, based on a trustee’s domicile, to tax the trust, even if a given person’s role in any given year is nominal?

The place of trust administration has traditionally been defined as the place where the trust maintains its books and records. Where are the books and records maintained in a virtual world? In which state is the principal place of administration for an institutional trustee that administers a trust with a team of individuals, including trust officers, trust administrators, investment professionals, tax compliance staff, and others located throughout the United States?

Finally, aside from the parties involved, the trust instrument will expressly identify the governing law of the trust, which might be different from the state where the grantor or testator lived when the trust became irrevocable or the state where the trustee is domiciled, or the trust is principally administered. What if a trust is reformed or decanted invoking the governing law of a different state?

These hypothetical questions are intended to underscore the point that the determination of trust residency is seldom simple and can become thorny under the facts and circumstances. More importantly, the analysis of trust residency does not end the inquiry into whether a state is constitutionally warranted in imposing income tax on a given trust. These constitutional questions, though largely undecided at the federal level, have played out in various ways in the state courts and legislatures, and are worth exploring in greater detail.

Trends in State Taxation

As explained above, the residency (or residencies) of a trust is usually the core issue for state taxation because classification as a state resident creates a basis for taxation on worldwide income, as opposed to taxation strictly on state-source income for a nonresident. The state courts that have grappled with the issue of state residency, however, have identified numerous scenarios in which the statutory definition of “resident trust” is insufficient to warrant taxation of a trust in that state under the U.S. Constitution. Although state court cases and administrative rulings are, by their nature, limited in application to the applicable state, they are frequently cited by other states and have collectively served to establish guidelines to which multiple states adhere in their approach to trust taxation.

Due Process Limits to Grantor-Based Resident Taxation: The First Wave

Beginning in 1963, the New York Third Department Appellate Division, in *Mercantile-Safe Deposit & Trust Co v. Murphy*,⁴ addressed whether New York could impose state income tax on a resident testamentary trust under the due process clause, which prohibits states from “depriv[ing] any person of life, liberty, or property, without due process of law.”⁵ In *Murphy*, the trust qualified as a resident trust because it was created under the will of a New York domiciliary. The trust had no New York trustees, assets, or source income, but a discretionary beneficiary was a New York domiciliary. The court, citing the U.S. Supreme Court case *Safe Deposit & Trust Co. of Baltimore v. Virginia*,⁶ said that “although this trust must be deemed a resident trust by statutory definition . . . [the statutes] conflict with the due process clause of the Fourteenth Amendment of the Federal Constitution.” On appeal, the New York Court of Appeals affirmed the Third Department’s holding. New York later codified *Murphy* first in 1992, with a state administrative regulation,⁷ and in 2003 by enacting Tax Law section 605(b)(3)(D). Under the three-prong framework created by the statute, a trust may avoid taxation as a resident if:

- all the trustees are domiciled in a state other than New York;
- the entire corpus of the trust, including real and tangible personal property, is located outside New York; and
- all income and gains of the trust are derived from or connected with sources outside New York.⁸

Like New York, other states that define trust residency by reference to the domicile of the

grantor have been confronted with constitutional challenges that have limited the application of the relevant statutes. In 1983 the New Jersey Tax Court, in *Pennoyer*, held that the state, which also defines trust residency by the domicile of the person who irrevocably creates the trust, could not tax all undistributed income on a testamentary trust with no trustees or beneficiaries domiciled in New Jersey or assets in the state.⁹ The court, citing *Murphy*, explained that “constitutional due process requires a minimal link between the taxing state and the individual” and said that the creation of the trust under authority of the state probate courts was a “historical fact which, absent continuing contacts, is not a constitutional nexus justifying income taxation.” Unlike New York, New Jersey relies on its Division of Taxation to administer its exceptions to resident trust taxation principally through its instructions to the fiduciary income tax return, rather than via statute or regulation.¹⁰

This same principle led courts in Missouri and Michigan to limit the scope of resident trust taxation for trusts with only a historical link to a domiciliary grantor. In the Michigan case,¹¹ the trust at issue was created by a Michigan domiciliary and held non-income-producing property in Michigan, but there were no other ongoing connections to the state. Accordingly, the court held that there were “insufficient connections between the trust and the State of Michigan to justify the imposition of an income tax” and further compared the case “to a hypothetical statute authorizing that any person born in Michigan to resident parents is deemed a resident and taxable as such, no matter where they reside or earn their income.”¹² Similarly, the Missouri Supreme Court ruled that a state cannot per se tax a testamentary trust created by a Missouri decedent and explained that one of four other factors must be present to support an

⁴ *Mercantile-Safe Deposit & Trust Co v. Murphy*, 15 N.Y.2d 579 (N.Y. 1964), *aff’d* 19 A.D.2d 765 (3d Dept. 1963). See also *Matter of Taylor v. State Tax Commission*, 445 N.Y.S.2d 648 (App. Div., 3d Dept. 1981).

⁵ U.S. Const. amend. XIV.

⁶ *Safe Deposit & Trust Co. of Baltimore v. Virginia*, 280 U.S. 83 (1929).

⁷ 20 NYCRR 105.23.

⁸ An accumulation, or “throwback,” tax may apply to the resident beneficiaries of a New York resident trust that is exempt from taxation. This may require the full taxation of the entire amount received even if more than the amount taxed for federal purposes. See N.Y. Tax Law section 612(b)(40). California imposes a similar throwback tax. See Cal. Rev. & Tax. Code section 17745.

⁹ *Pennoyer v. Taxation Division Director*, 5 N.J. Tax 386 (1983). See also *Potter v. Taxation Division Director*, 5 N.J. Tax 399 (1983) (similarly holding that an *inter vivos* trust with “less attenuated” connections to New Jersey could not be taxed on non-New Jersey-source income).

¹⁰ See 2018 NJ-1041 Instructions; see also New Jersey Tax Topic Bulletin GIT-12 (rev. Dec. 2018).

¹¹ *Blue v. Department of Treasury*, 462 N.W.2d 762 (Mich. Ct. App. 1990) (citing *In re Swift*, 727 S.W.2d 880 (Mo. 1987)).

¹² *Id.* at 764-65.

income tax that is premised on the residence of the person who created the trust.¹³

Although the District of Columbia Court of Appeals affirmed the right of the District to tax a resident testamentary trust due to the grantor having a domicile there, the court suggested, albeit in dicta in a footnote, that an *inter vivos* trust may be protected from taxation under the due process clause because an “irrevocable *inter vivos* trust does not owe its existence to the laws and courts of the District in the same way that the testamentary trust at issue [in this case] does.”¹⁴ The Supreme Court of Connecticut — in a split decision since the subject of negative commentary¹⁵ — sided with Connecticut in its attempt to tax testamentary and *inter vivos* trusts using their connections to a domiciliary grantor or decedent.¹⁶ Even so, this ruling, *Chase Manhattan Bank v. Gavin*,¹⁷ premised its state-friendly view of the due process clause, regarding an *inter vivos* trust at issue,¹⁸ on the existence of a mandatory beneficiary who was domiciled in Connecticut, which served to augment the baseline statutory definition of a resident trust in Connecticut as a trust with a grantor or decedent domiciled in the state. Connecticut administratively allows some *inter vivos* resident trusts to deduct undistributed income that is accumulated for the benefit of nonresident beneficiaries, which serves as a de facto exemption from income tax for an *inter vivos* trust created by a Connecticut domiciliary without beneficiaries who are domiciled in the state.¹⁹

¹³ *In re Swift*, 727 S.W.2d at 882. The court identified six factors: domicile of the settlor, place where trust is created, the location of trust property, the domicile of the beneficiaries, the domicile of the trustees, and the location of the trust administration. See Mo. Rev. Stat. section 143.331 for the current statute, which uses a multifactor residency test that considers the domicile of the settlor and the residence of the beneficiary.

¹⁴ *District of Columbia v. Chase Manhattan Bank*, 689 A.2d 539 (D.C. App. 1997).

¹⁵ See, e.g., Joseph W. Blackburn, “Constitutional Limits on State Taxation of a Nonresident Trustee: *Gavin* Misinterprets and Misapplies Both *Quill* and *McCulloch*,” 76 *Miss. L.J.* 1, 4 (Fall 2006) (describing *Gavin* as “badly flawed”).

¹⁶ *Chase Manhattan Bank v. Gavin*, 733 A.2d 782 (Conn. 1999).

¹⁷ *Id.*

¹⁸ The case dealt with several trusts and varying fact patterns, including both testamentary and *inter vivos* trusts, some of which had beneficiaries domiciled in Connecticut and others which did not.

¹⁹ See Instructions to 2018 CT-1041, Connecticut Income Tax Return for Trusts and Estates.

Since these decisions, several states have limited the scope of resident trust determination without court intervention. In an administrative ruling, the Virginia Tax Commissioner explained that where “neither the beneficiaries, trustees, nor the Trust property are in Virginia. It appears as if none of these entities receive the benefit or protection of Virginia law. Thus, there does not appear to be sufficient nexus for Virginia to currently tax the undistributed assets of the Trust.”²⁰ Some state legislatures, for example Alabama,²¹ have created statutory rules that define a resident trust as having a domiciliary grantor plus one or more additional nexus points (in the case of Alabama, having a trustee or beneficiary as a resident or domiciliary). By doing so, these states may be arguably viewed as accepting, albeit tacitly, the premise that the domicile of the grantor or decedent testator cannot per se justify taxation of trust as a resident.

For trusts considering their exposure to tax as residents in states that attempt to delineate the precise permissible scope of resident trust taxation with a statute or administrative regulations, or with instructions that accompany the income tax return, there is a clearer roadmap.²² Moreover, these states are less likely to face the same questions raised in *Kaestner Family Trust* than states that ostensibly subject their resident trusts to perpetual taxation after having been created irrevocably by a domiciliary. By contrast, other states, such as Michigan and Vermont, have not enacted statutes, issued administrative law rulings, or published the instructions to the fiduciary income tax return in responding to applicable case law, thereby leaving trusts in a murkier environment when deciding whether their facts are sufficiently like the salient judicial precedent to render the trust exempt from income taxation.

²⁰ Virginia Tax Commissioner Ruling 93-189 (Aug. 26, 1993); see also Virginia Tax Commissioner Ruling 99-110 (May 13, 1999) (citing Ruling 93-189).

²¹ See Ala. Code section 40-18-1(33).

²² However, these provisions are not always clear; see, e.g., N.Y. TSB-A-04(7)I (determining that a New York resident trust is exempt from taxation despite having a corporate trustee with activities in New York and New York resident fiduciaries serving on an investment committee with a majority of New York nonresidents that made decisions via majority vote).

Place of Trustee and Place of Administration

Many states base residency on the domicile of the trustee and the place of administration.²³ There does not appear to be any court opinion on record that stands for the proposition that having a domiciliary trustee, absent other factors, is insufficient to justify taxation of a trust on all income. By analogy, however, the Supreme Court, in *Greenough*, held that the city of Newport, Rhode Island, could constitutionally impose a personal property tax on intangible property held by a New York resident trust with a trustee domiciled in Rhode Island.²⁴ Although the trustee's domicile is not a factor under Rhode Island law regarding the income taxation of trusts, the Court held the trustee's domicile could serve as a sufficient basis for the tax levied by Newport on a portion of the intangible personal property held by the trust and noted the benefit and protection of Rhode Island law.²⁵

Similarly, the California Supreme Court said in *McCulloch* that "the entire income of a discretionary trust, whether distributed or not, may be taxed by the state where all trustees reside, since that state provides to the trustees the protection requisite to the receipt and control of the disposition of trust income."²⁶ On the other hand, the central issue in *McCulloch* was the taxation of a California beneficiary, as opposed to the taxation of the trust itself, so the statement pertaining to the broader constitutionality of a tax based on the residence of a trustee is not binding and, moreover, the court limits its statement to a situation in which every trustee resides in the state.

One could query whether the lack of conflict or case law on this topic suggests that a state is inoculated from a challenge claiming the existence of a domiciliary trustee is an insufficient connection to allow for taxation under the due process clause. That seems unlikely, particularly given the trend of identifying multiple fiduciaries for a single trust. To avoid uncertainty, some states

impose constraints on their ability to tax all income. Although California, consistent with the quotation in the paragraph from *McCulloch*, taxes some trusts on all trust income when all fiduciaries live in California²⁷, section 17743 of the Revenue and Tax Code creates an apportionment formula of taxation for trusts with a mix of resident and nonresident fiduciaries.

If, consequently, a California trust has two trustees — one of whom is a California resident, while the other resides elsewhere (and no California resident beneficiaries) — then only 50 percent of the trust's accumulated income will be subject to income tax in California.²⁸ Likewise, Hawaii administratively imposes resident income tax status automatically when all fiduciaries live in the state, but not necessarily when there are multiple trustees, some of whom reside elsewhere.²⁹ Arizona law provides that a corporate trustee is defined as a domiciliary if it administers the trust principally in the state; consequently, a trust having an institutional trustee with an Arizona presence will not automatically be treated as an Arizona resident absent additional facts.³⁰

As with the residence of the trustee, it has been common for courts to discuss place of administration as a potential factor in cases that deal with the constitutionality of a state taxing regime based on residency of the grantor as a starting point.³¹ Still, it does not appear that any courts have directly addressed whether the place of administration can serve as a stand-alone nexus point, nor does it appear that any courts have attempted to delimit the level of activity that creates "administration" for a trustee that performs different functions in different jurisdictions.

²³ For example, the residence of the trustee has been discussed, at least as a point of observation, in all cases cited in this article.

²⁴ *Greenough v. Tax Assessors*, 331 U.S. 486 (1947).

²⁵ See R.I. Gen Laws section 44-30-5(c).

²⁶ *McCulloch v. Franchise Tax Board*, 61 Cal. 2d 186, 195 (Cal. 1964).

²⁷ One notable exception applies: Because California also relies on the residence of the beneficiaries as a basis for taxation, the apportionment rules involving trustees will not apply if all non-contingent beneficiaries reside in California. See Rev. and Tax Code section 17744.

²⁸ This apportionment rule was recently presumed to be valid in *Paula Trust v. California Franchise Tax Board*, No. CGC-16-556126 (Cal. Super. Ct., Mar. 7, 2018). This case is under appeal with the FTB regarding the interplay between the apportionment formula and the taxation of California-source income. That discussion is beyond the scope of this article.

²⁹ See Haw. Admin. Rules section 18-235-1.17.

³⁰ See Ariz. Rev. Stat. section 43-1301(5).

³¹ See, e.g., *Blue*, 462 N.W.2d 762; and *Murphy*, 15 N.Y.2d 579.

Despite the relative lack of successful legal challenges to this conceptual basis for taxation, several states have moved away from defining residency as the principal place of administration. In 1995 Minnesota removed its administration-based regime in favor of a grantor-based definition of a resident trust, and Wisconsin followed suit in 1999.³² Earlier this year, Virginia amended its statute to remove place of administration as potential grounds for defining a trust as a resident as of July 1, 2019, instead of relying solely on the grantor's residence.³³

Given the above, it can be said that there is perhaps a trend away from taxing trusts by using principal place of administration as the key point of contact, even in the absence of any federal or state court cases that cast constitutional doubt on the viability of this theory. Curiously, the states that have jettisoned an administration-based approach now generally use a grantor-based definition, which seems to fly against the constitutional due process clause headwinds described in these cases.

Due Process Limits to Grantor-Based Resident Taxation: The Second Wave

In this decade, there has been a second wave of court decisions that have chipped away at state statutes that seek to tax trusts as residents, without exception, based on the historical connection to the grantor. In *McNeil v. Commonwealth*, the Commonwealth Court of Pennsylvania held that the state could not tax a resident trust that did not have any Pennsylvania trustees, source income, or property in the state, despite the existence of a domiciliary beneficiary.³⁴ The beneficiary in *McNeil* was a discretionary beneficiary, but this appears to have had no bearing on the decision because the court

dismissed the difference between a mandatory beneficiary and discretionary beneficiary as irrelevant.

Shortly thereafter, *Linn v. Department of Revenue*, citing *Murphy*, affirmed that Illinois cannot tax a resident *inter vivos* trust with no connection to the state aside from the resident status of the grantor.³⁵ The *Linn* court, however, citing *Gavin*,³⁶ suggested that testamentary trusts may have a stronger connection to a state than *inter vivos* trusts, but expressed no judgment as to whether the added connection would have any legal ramifications when viewed through a due process clause lens. In both *McNeil* and *Linn*, the courts observed the trusts had a choice of law provision to elect to apply the governing law of a state other than the state in which the grantors resided, which suggests that the applicable choice of state law could be a dispositive or contributing factor in a state due process clause analysis.³⁷

Finally, in 2018, the Minnesota Supreme Court, in *Fielding v. Commissioner of Revenue*, upheld a lower court ruling that Minnesota could not constitutionally tax a resident trust in perpetuity without considering circumstances beyond where the grantor lived.³⁸ In *Fielding*, one of the beneficiaries resided in Minnesota and the trust generated income from the sale of a Minnesota S corporation during the tax year in question, but the court, citing several of the aforementioned cases, found neither connection to be sufficient to allow for taxation under the due process clause. As noted, Minnesota switched from an administration-based definition of residency to an approach predicated on the grantor's residence that, post-*Fielding*, is limited in its breadth.

Kaestner Family Trust and Its Significance

Background

Few states attempt to tax trusts as residents when there are no connections to the state aside from the presence of a domiciliary beneficiary.

³² Virginia and Minnesota still define residency based on the place of administration for trusts that were created before an effective transition date. Minn. Stat. section 290.01(7b) (imposing an effective date of Dec. 31, 2995); and Wis. Stat. section 71.14(3m) (imposing an effective date of Oct. 29, 1999).

³³ See H.B. 2526 (Va. 2019) (amending Va. Code Ann. section 58.1-302).

³⁴ *McNeil v. Commonwealth*, 67 A.3d 185 (Pa. Commw. 2013); see also *Hansjoerg Wyss 2004 Descendant's Trust*, No. 1608934, Board of Finance and Revenue (affirming *McNeil* and noting that "the Department's own regulations clearly state that "[t]he residence of the fiduciary and the beneficiaries of the trust shall be immaterial [pursuant to the definition of 'resident trust' under] 61 Pa. Code [section] 101.1.")".

³⁵ *Linn v. Department of Revenue*, 2 N.E.3d 1203 (Ill. App. Ct. 2013).

³⁶ See *Gavin*, 733 A.2d 782.

³⁷ Delaware law for *McNeil* and Texas law for *Linn*.

³⁸ *Fielding v. Commissioner of Revenue*, 916 N.W.2d 323 (Minn. 2018).

California, which taxes any trust with an individual beneficiary who has a non-contingent (that is, mandatory) right to trust income or principal is the most noteworthy, but Georgia, North Dakota, and North Carolina take a similar approach.³⁹

In *Kaestner Family Trust*, the sole connection between North Carolina and the trust was the presence of a discretionary beneficiary who lived in the state and did not receive any distributions during the tax years in question. The trust was created by a New York domiciliary, administered entirely outside North Carolina, governed by New York law, and neither generated North Carolina source income nor held property located there. Accordingly, the North Carolina Supreme Court upheld several lower court rulings, each of which held that North Carolina could not impose resident trust status on the trust. In its initial brief to the U.S. Supreme Court, the North Carolina Department of Taxation attempted to frame the issue as deciding a “direct split” between state courts as to whether the residence of the beneficiary is relevant under the due process clause.⁴⁰

The attorneys for the trust, in response, accused the department of attempting to manufacture this notion of a split between courts, and argued that the cases they cited⁴¹ were not germane to the question whether the residency of a beneficiary can serve as a basis for determining trust residency since most of the cases cited by the department deal with the importance, if any, of the grantor’s residence.⁴²

In almost every case cited by the department, the beneficiary’s residence is relevant only as an extenuating circumstance to augment the baseline test for residency, as opposed to the lone grounds for creating nexus to the state.⁴³ Thus, the question

whether the residence of one beneficiary can serve as the sole basis for imposing tax for a non-distributing trust having no state-source income appears to be a matter of first impression, as opposed to a split among state courts.⁴⁴

What Might the Court Decide?

Against this backdrop, there are several avenues down which the Supreme Court might travel in *Kaestner Family Trust*, and its rationale will be as important as its holding. The opinion will undoubtedly inspire detailed exegeses from commentators in the trust planning and administration community and exacting review by state lawmakers and state taxing authorities. Given the nuanced differences among state laws in this area, and the multiple baseline theories for defining residency, the range of potential consequences from *Kaestner Family Trust* is broad and the stakes could be high.

Overturing the Lower Court Decision

Perhaps the most straightforward result would be to overrule the lower court ruling and uphold the North Carolina statute. If the Supreme Court rules in favor of North Carolina, then the distinction between mandatory and discretionary beneficiaries (assuming all beneficiaries can be identified — which may not be possible when a trust incorporates a broad power of appointment) would become irrelevant by implication, which would pave the way for any state to tax trusts that have a domiciliary beneficiary, either in conjunction with another factor (such as having a domiciliary trustee) or absent any other nexus point. California could scrap its “non-contingent” requirement for beneficiaries in determining their nexus to tax and could even eliminate its apportionment formula. This result would be a resounding victory for income-taxing states using beneficiary domicile as a nexus consideration because it would grant the Court imprimatur to

³⁹ See N.C. Gen. Stat. section 105-160.2; Cal. Rev. & Tax. Code section 17742; N.D. Admin. Code section 81-03-02.1-04(2); and Ga. Code Ann. section 48-7-22(a).

⁴⁰ See Petitioner’s Reply Brief in Support of Petition for Writ of Certiorari at 1, 3, 6, 12, *Kimberley Rice Kaestner Family Trust v. North Carolina Department of Revenue*, No. 18-457.

⁴¹ These cases include, *inter alia*, *Fielding*, 916 N.W.2d 323; *Murphy*, 15 N.Y.2d 579; *Linn*, 2 N.E.3d 1203; *Blue*, 462 N.W.2d 762; and *Potter*, 5 N.J. Tax 399.

⁴² See Respondent’s Brief in Opposition to the North Carolina Department of Revenue’s Petition for Writ of Certiorari at 7, *Kimberley Rice Kaestner Family Trust v. North Carolina of Revenue*, No. 18-457.

⁴³ See, e.g., *Blue*, 462 N.W.2d 762; *Murphy*, 15 N.Y.2d 579; and *Swift*, 727 S.W.2d 880.

⁴⁴ *But see McCulloch*, 61 Cal. 2d 186, noting, in dictum, that “the beneficiary’s state of residence may properly tax the trust on income which is payable in the future to the beneficiary, although it is actually retained by the trust, since that state renders to the beneficiary that protection incident to his eventual enjoyment of such accumulated income.” California applies an apportionment formula when a trust has multiple beneficiaries and only some reside in the state.

that factor and create another valuable tool in the other states' taxing toolkits. But it would also create a logistical hurdle — a trust cannot reside in all 43 states that levy a trust income tax, and trustees may struggle to monitor annually for changes in residence or domicile among the beneficiaries.

Upholding the Lower Court Decision

If the Supreme Court upholds the lower court, then the Court's prevailing line of reasoning will be critical in shaping the path forward. The Court might draw a distinction between a mandatory and discretionary beneficiary and conclude that the North Carolina statute is unconstitutional insofar as it allows for a discretionary beneficiary to serve as the sole connection between the state and the trust. By focusing narrowly on the discretionary nature of the beneficiary's interest, the door would remain open for North Carolina and other states to define a resident trust as one with a mandatory domiciliary beneficiary (or even a discretionary beneficiary that received a distribution in any given year), which, notably, is consistent with the California approach. This viewpoint would appear to validate any state statute or regulation that deems the existence of a domiciliary mandatory beneficiary to be a pertinent factor in combination with some other connection to the state.

If, however, the Court decides that the residence of any beneficiary is irrelevant in a state's right to tax under the due process clause, then the ruling could be wider-reaching. States such as North Carolina, Georgia, and California would likely need to reconsider their basic approach to determining a trust's residency. Further, states that use the beneficiary's residence as an additional due process clause nexus point, rely on state judicial precedent regarding a beneficiary's residence as germane in determining residency, or as a factor that can prevent a trust from being determined to be nonresident will likely need to consider whether such a viewpoint remains valid.

Playing a Wildcard

As if the possibilities were not amply intriguing, the writ of certiorari from the U.S. Supreme Court hints at a radical shift in how the due process clause will hereafter be applied to

trusts in stating that "the Due Process Clause should not have different meanings in different states."⁴⁵ If the Court intends to eliminate a perceived split and to create parity across all states, one cannot foreclose the possibility of a ruling that departs sharply from traditional notions of the factors that give rise to state residency for trusts. The Court might completely redefine how states approach trust taxation by creating a new test or framework for constitutionality under the due process clause, which could extend to states with a grantor-based, trustee-based, administration-based, or multifactor-based residency approach.

Beyond Kaestner

Even if *Kaestner Family Trust* casts doubt on the viability of using the beneficiary's residence to justify a determination of trust residency for taxation purposes, the Supreme Court, assuming the "wildcard" scenario above does not come to fruition, probably will not reach beyond the facts of the case to address other grounds that states use to determine trust income taxation. Thus, the greater likelihood is that even after the opinion, there will be continuing uncertainty regarding all the various conceptual approaches to state income taxation of trusts described in this article.

Given the trend of state courts toward limiting the scope of a state's ability to tax trusts by looking to the grantor's residence, more states may be inclined to adopt an approach that focuses either on the residence of the trustees, the place of administration, or whether its laws are identified as the law of the trust. Although such methodologies may be more likely to sit on constitutional terra firma, their objectivity suggests easier tax planning.

To illustrate, a grantor who is domiciled in a state that defines residency by reference to the trustee's domicile or the place of administration enjoys greater latitude in determining the applicable state of residency for the trust by selecting her preferred governing law of the trust and by nominating a fiduciary in any state, including Alaska, Florida, Wyoming, or South

⁴⁵ Question Presented, *North Carolina Department of Revenue v. The Kimberley Rice Kaestner 1992 Family Trust* (No. 18-457).

Dakota, which do not levy an income tax. Consequently, a state might prefer an immutable test — incapable of change under any circumstance, by continuing to define a resident trust based on the grantor's residence, notwithstanding potential constitutional concerns. Or perhaps, to avoid constitutional challenges, a state might keep the grounds for residency determinations purposefully vague, relying on the conservative nature of fiduciaries to encourage compliance. In such a case, a state would avoid addressing an adverse result in *Kaestner Family Trust* altogether.

The permissible scope of state fiduciary income taxation remains shrouded in uncertainty. With *Kaestner Family Trust*, however, the Supreme Court has the opportunity to take an important step toward removing some degree of uncertainty — and providing constitutional law professors with another compelling topic to fill their syllabi.

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