

U.S. Supreme Court Holds for Trust in Due Process Case

Overview

On June 21, 2019, the U.S. Supreme Court issued its decision in *North Carolina Dept. of Revenue v. The Kimberley Rice Kaestner 1992 Family Trust* ("Kaestner"),¹ a case involving a North Carolina statute that subjects trusts to taxation based solely on the presence of a beneficiary who resides in North Carolina.² In a unanimous opinion authored by Justice Sotomayor, the Court affirmed the judgment of the North Carolina Supreme Court in holding that this statute, as applied to the facts of this case.

This Tax Alert briefly summarizes the background of *Kaestner* and the U.S. Supreme Court's decision, in addition to providing certain considerations.

Background

The Kaestner 1992 Family Trust ("the Original Trust") was created by Joseph Lee Rice III, a New York domiciliary, and was governed pursuant to New York law from inception through the tax years at issue before the U.S. Supreme Court (2005 – 2008). Trust administration was carried out in New York and Massachusetts and the trustee of the trust during the years at issue resided in Connecticut. At the time that Mr. Rice created the Original Trust, there were no connections between the trust and North Carolina. The Original Trust did not hold any real or personal property in North Carolina and also did not derive income from North Carolina sources during the years at issue.

Thus, until 1997, when one of the beneficiaries, Kimberley Rice Kaestner, moved to North Carolina along with her minor children, the Original Trust had no connection to North Carolina. Shortly after 1997, the Kimberly Rice Kaestner 1992 Family Trust ("the Trust") was formed by a division of the Original Trust into three separate trusts, one for each child of Joseph Rice and that child's descendants. Thereafter, the only connection between the Trust and North Carolina was the presence of Ms. Kaestner and her children as residents in North Carolina. During the tax years at issue, Ms. Kaestner and her children held a contingent interest in trust income and principal with any distributions being subject to the sole discretion of the Trustee. No distributions were made from the Trust during the years at issue. Although the Trust was to terminate in favor of Ms. Kaestner in 2009 when she reached age 40, the Court noted that a trust can be decanted under New York law. Indeed, in 2009, after the tax years at issue, the trustee decanted the trust with Ms. Kaestner's consent, thereby, suspending any final distribution to her.

Under N.C. Gen. Stat. § 105-160.2, a trust is defined as a resident of the state if there are one or more beneficiaries who reside in the state.³ The classification of a trust as a resident is significant in North Carolina because it presumptively subjects the Trust to income tax on all of the Trust's undistributed income, regardless of whether it is sourced within or outside of North Carolina.

The Trust filed fiduciary tax returns as a resident, but subsequently sought a refund of approximately \$1.3 million of tax paid on accumulated income for the tax years at issue. The refund claim was denied by the North Carolina Department of Revenue (the "Department"). In response, the Trust filed suit challenging the constitutionality of N.C. Gen. Stat. § 105-160.2 as a violation of the Due Process Clause of the Fourteenth Amendment, among other constitutional claims.

¹ *Kimberley Rice Kaestner 1992 Family Tr. v. N.C. Dep't of Revenue*, 139 S. Ct. 2213 (2019), located [here](#); See also *Kimberley Rice Kaestner 1992 Family Tr. v. N.C. Dep't of Revenue*, 371 N.C. 133, 133, 814 S.E.2d 43, 44 (2018) and [Multistate Tax Alert](#) for more details on the background of this case.

² N.C. Gen. Stat. § 105-160.2.

³ *Id.* (assessing tax "on the amount of the taxable income of the ... trust that is for the benefit of a resident of this State").

The North Carolina Business Court (a trial court) concluded that the portion of N.C. Gen. Stat. § 105-160.2 providing a trust may be taxed on income “that is for the benefit of a resident of this State” was unconstitutional under the Due Process Clause and Commerce Clause of the U.S. Constitution as applied to the Trust.⁴ On appeal, the North Carolina Court of Appeals affirmed the decision of the trial court on Due Process Clause grounds.⁵ The Department subsequently appealed those rulings to the North Carolina Supreme Court (the “N.C. Supreme Court”), which also affirmed the decisions of the lower courts.⁶

U.S. Supreme Court Decision

The Court began its analysis by reviewing its Due Process Clause precedent in regard to state taxation and applying its “...two-step analysis to decide if a state tax abides by the Due Process Clause”, as articulated in *Quill Corp. v. North Dakota*.⁷ In particular, the Court focused on the first prong of *Quill*, the requirement that “there must be ‘some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax.’”⁸ With respect to this analysis, known as the “minimum connection” test, the Court explained that a state “has the power to impose a tax only when the taxed entity has ‘certain minimum contacts’ with the State such that the tax ‘does not offend ‘traditional notions of fair play and substantial justice.’”⁹ In addition, the Court noted, “only those who derive ‘benefits and protection’ from associating with a State should have obligations to the State in question.”¹⁰

In reaching its conclusion, the Court evaluated the relevant precedent in the state trust tax context:

[A]ll of the foregoing cases reflect a common governing principle: When a State seeks to base its tax on the in state residence of a trust beneficiary, 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.¹¹

Further, the Court stated:

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.¹²

The Court identified three factors in its analysis of beneficiary possession and control:¹³ (a) the beneficiaries had no right to demand trust income or otherwise control, possess, or enjoy the trust assets in the tax years at issue (*i.e.*, all distributions were subject to the absolute discretion of the Trustee, the trust agreement precluded the sale or other disposition of an interest in the trust by a beneficiary and, that beneficiaries had no investment powers over Trust corpus), (b) the lack of actual beneficiary distributions from the Trust during the tax years at issue and (c) not only were the beneficiaries unable to demand distributions in the tax years at issue, but they also were not necessarily entitled to receive any specific amount from the Trust in the future (*i.e.*, with the Court citing the decanting of the Trust discussed above).¹⁴

⁴ *Kimberley Rice Kaestner 1992 Family Trust v. N.C. Dep’t of Revenue*, 2015 NCBC 36, P28, 2015 NCBC LEXIS 39, *32 (N.C. Super. Ct. Wake County (Bus. Ct.) Apr. 23, 2015), *aff’d*, *Kaestner v. N.C. Dep’t of Revenue*, 789 S.E.2d 645 (N.C. Ct. App. 2016)

⁵ *Kaestner v. N.C. Dep’t of Revenue*, 789 S.E.2d 645, 651 (N.C. Ct. App. 2016), *aff’g Kimberley Rice Kaestner 1992 Family Trust v. N.C. Dep’t of Revenue*, 2015 NCBC 36 (N.C. Super. Ct. Wake County (Bus. Ct.) Apr. 23, 2015) (The North Carolina Court of Appeals did not consider the Commerce Clause issue because N.C. Gen. Stat. § 105-160.2 as applied to the Trust failed on Due Process grounds.).

⁶ *Kimberley Rice Kaestner 1992 Family Tr.*, 371 N.C. at 144.

⁷ *Kimberley Rice Kaestner 1992 Family Tr. v. N.C. Dep’t of Revenue*, 139 S. Ct. at 2220.

⁸ *Id.* (citing *Quill Corp. v. North Dakota*, 504 U.S. 298, 306 (1992)).

⁹ *Id.* at 6 (citing *International Shoe Co. v. Washington*, 326 U.S. 310 (1945)).

¹⁰ *Id.*

¹¹ *Id.* at 2221-2222 (citing *Safe Deposit & Trust Co. of Baltimore v. Virginia*, 280 U. S. 83, 91 (1929)).

¹² *Id.* at 2222.

¹³ The Court also observed a variety of factors evincing a lack of connection with North Carolina, including lack of investment, location of trustee and location of settlor, despite recognizing that the case was premised on the residency of the beneficiaries.

¹⁴ *Id.* at 2223 (In a footnote, the Court stated: “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.” This observation is interesting since the decanting was done with the Kimberley Kaestner’s consent and, for a number of reasons the trust would only defer, but not necessarily eliminate, Ms. Kaestner’s control of the assets. Query whether the true issue is whether the beneficiaries were “certain to receive funds in the future” as North Carolina residents, inasmuch as they might move out of state prior to receiving a distribution.).

Based on these factors, the Court held that North Carolina did not have the requisite minimum connection to the Trust to justify taxation:

We hold the 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 ever to receive it. 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.¹⁵

Considerations

Due to the Court's narrow holding, the ramifications of the *Kaestner* decision may be fairly limited. The Court stated that the opinion "does not address state laws that consider the in-state residency of a beneficiary as one of a combination of factors, that turn on the residency of a settlor, or that rely only on the residency of non-contingent beneficiaries... We express no opinion on the validity of such taxes".¹⁶ In addition, the Court expressly distinguished other state statutes, which premise taxation on the residency of a beneficiary.¹⁷ Notably, the Court specifically distinguished the current California law in the text of the case, as well as in three footnotes, by noting that the Court is not addressing state laws that consider residence of a beneficiary in combination with other factors or rely upon non-contingent beneficiaries.¹⁸ The Court also declined to entertain whether the result would have been different if one or more of the North Carolina beneficiaries of the Trust had possessed an inalienable right to receive future income.¹⁹

Fiduciaries of trusts with North Carolina beneficiaries may want to evaluate the trust's filing position in light of the Court's decision, including evaluating the following factors: whether any North Carolina beneficiaries possess a current non-contingent interest, whether any contingent interest will become non-contingent at some future date while the beneficiary is North Carolina resident; and, whether any non-contingent interest may be subject to alteration because of the applicability of a decanting or similar provision under governing state law.²⁰

Refund Claims

On February 20, 2019, the North Carolina Department of Revenue published Important Notice: United States Supreme Court Agrees to hear North Carolina Trust Income Taxation Case ("Notice").²¹ The Notice identified that the Supreme Court decision was a contingent event, as defined under N.C. Gen. Stat. § 105-241.6, to meet an exception to the general statute of limitations. The Notice stated taxpayers could file a Form NC-14, *Notice of Contingent Event or Request to Extend Statute of Limitations*, prior to the expiration of the general statute of limitations, to notify the Department and preserve the right to claim a refund. However, as indicated in the Notice, taxpayers are generally required to perfect any protective claims by filing a refund claim within six months after the contingency concludes, per N.C. Gen. Stat. § 105-241.6(5)(a).

On July 2, 2019, the Department published Important Notice: Decision in the *Kaestner* Case ("Notice 2"), which states that the contingent event concluded on June 21, 2019.²² Accordingly, taxpayers who filed a Form NC-14 related to the *Kaestner* case are required to file an amended return on or before December 21, 2019. Notice 2 also indicates a taxpayer that did not previously file a Form NC-14, but believes it may qualify for a refund, should file an amended

¹⁵ *Id.* at 2221.

¹⁶ *Id.* at 2225, referencing Cal. Rev. & Tax. Code Ann. § 17742(a).

¹⁷ *Id.* at 2225, n.12 (citing statutes in Alabama, Connecticut, Missouri, Rhode Island, Ohio, Montana, North Dakota, Georgia, Tennessee and California). The Court noted that Georgia law is subject to dispute as to whether it mandates taxation of a trust based on the presence of a resident beneficiary, and distinguished Tennessee law not on substantive grounds, but by observing that the Tennessee Hall Income Tax will be repealed in full by 2021.

¹⁸ *Id.* at 2221, nn.10, 15, 12 (both citing Cal. Rev. & Tax Code Ann. §17742(a)); see also 15, n.13 (citing Cal. Rev. & Tax Code Ann. §17745(b), which imposes "throwback tax" on certain beneficiaries), and 15 (citing Cal. Rev. & Tax Code Ann. §17742(a)). California imposes tax on trusts based on non-contingent resident beneficiaries.

¹⁹ See *supra* note 15.

²⁰ North Carolina enacted a decanting statute (the process by which a trustee appoints trust property to a new trust for the benefit of the same trust beneficiaries) effective October 2010. The applicable statute is found at N.C.G.S. Section 36C-8-816.1.

²¹ *Important Notice: United States Supreme Court Agrees to Hear North Carolina Trust Income Taxation Case*, N.C. Dept. of Rev. (2/20/19), located [here](#).

²² *Important Notice: Decision in Kaestner Case*, N.C. Dept. of Rev. (7/2/19), located [here](#).

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return reflecting an overpayment or claim for refund. To facilitate processing, Notice 2 provides an address to submit an amended North Carolina estates and trust income tax return.

Taxpayers with previously filed protective claims, or potential future refund claims, should evaluate the requisite steps and timing to seek refunds from North Carolina, and should seek assistance from their tax advisor.

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