

U.S. Supreme Court Hears Oral Arguments in North Carolina Trust Due Process Case

Overview

On April 16, 2019, the U.S. Supreme Court (the "Court") heard oral arguments in *North Carolina Dept. of Revenue v. The Kimberley Rice Kaestner 1992 Family Trust*,¹ a case involving North Carolina's estate and trust regime which subjects trusts to taxation based solely on the North Carolina residency of its beneficiaries.² The issue before the Court is whether the Due Process Clause of the U.S. Constitution prohibits states from taxing trusts based on the in-state residency of the trust's beneficiaries. However, because the Court has framed the issue in a broad manner, not specific to the North Carolina tax regime, the Court's holding in *Kaestner* may establish the modern Due Process Clause standard for the taxation of trusts for state tax purposes.

In response to the Court's grant of certiorari in *Kaestner*, the North Carolina Department of Revenue (the "Department") released a notice to clarify the impact of *Kaestner* on similarly situated taxpayers considering filing claims for refund.

This tax alert briefly summarizes the background of *Kaestner*, the lower court decisions, the Court's grant of certiorari and hearing of oral arguments, and the notice released by the Department in response to *Kaestner*.

Background

When taxing trusts, North Carolina assesses tax "on the amount of the taxable income of the ... trust that is for the benefit of a resident of this State."³ During tax years 2005 through 2008 (the "tax years at issue"), The Kimberley Rice Kaestner 1992 Family Trust (the "Trust"), a New York trust, had no connections with North Carolina other than the presence of resident discretionary beneficiaries.⁴ The Trust did not distribute any income to the beneficiaries during the tax years at issue.

The Trust sought a refund of approximately \$1.3 million of tax paid on accumulated income for the tax years at issue in accordance with N.C. Gen. Stat. § 105-160.2, which was denied by the Department. Suit was then filed by the Trust challenging the constitutionality of N.C. Gen. Stat. § 105-160.2 as a violation of the Due Process Clause and Commerce Clause of the U.S. Constitution, among other claims. The North Carolina Business Court (a trial court) concluded that the portion of N.C. Gen. Stat. § 105-160.2 providing that 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.⁵ On appeal, the North Carolina Court of Appeals affirmed the decision of the trial court on Due Process grounds.⁶ The Department subsequently appealed those rulings to the North Carolina Supreme Court (the "N.C. Supreme Court").⁷

¹ *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), cert. granted (U.S. Jan. 11, 2019) (No. 18-457).

² N.C. Gen. Stat. § 105-160.2.

³ N.C. Gen. Stat. § 105-160.2.

⁴ All documents, financial books and records, and legal records related to the Trust were kept in New York along with the preparation of all tax returns and accountings. Additionally, the custodian of the Trust's assets was located in Massachusetts, and the trustee was a resident of Connecticut.

⁵ *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

⁶ 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 constitutional muster on Due Process grounds. *The Kimberley Rice Kaestner 1992 Family Trust v. North Carolina Department of Revenue*, 12 CVS 8740 (2015); aff'd, *Kaestner v. N.C. Dep't of Revenue*, 789 S.E.2d 645, 651 (N.C. Ct. App. 2016).

⁷ *Kimberley Rice Kaestner 1992 Family Tr.*, 371 N.C. at 144.

North Carolina Supreme Court's Decision

The N.C. Supreme Court considered the narrow issue of whether the Trust had sufficient minimum contacts with North Carolina, solely based on the presence of resident beneficiaries, to comport with the Due Process Clause of the U.S. Constitution, and ultimately, affirmed the decisions of the lower courts.⁸ The N.C. Supreme Court relied upon longstanding precedent which dictates that minimum contacts "exists when the taxed 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'"⁹ As "a taxed entity's minimum contacts with the taxing state cannot be established by a third party's minimum contacts with the taxing state,"¹⁰ the N.C. Supreme Court concluded that the activities of the beneficiaries alone could not satisfy Due Process requirements for the state to tax the Trust.

In arriving at this conclusion, the N.C. Supreme Court was not persuaded by the decisions of the highest courts in Connecticut and California which reached the opposite result on the Due Process question.¹¹ In these cases, which involved facts similar to *Kaestner*, the Supreme Courts of Connecticut and California both concluded that the beneficiary's state of residence could properly tax the accumulated income of a trust because the state provides the beneficiary with benefits and protections incident to their eventual enjoyment of such accumulated income.¹² However, according to the N.C. Supreme Court, the Supreme Courts of Connecticut and California misconstrued the relationship between a trust and beneficiary and failed to consider that a trust has a legal existence apart from the beneficiary for tax purposes which would require the trust itself to have "some definite link, some minimum connection" in the state to satisfy the Due Process clause.¹³ The issue before the Court is therefore, whether the Due Process Clause of the U.S. Constitution prohibits states from taxing trusts based on the in-state residency of the trust's beneficiaries.

U.S. Supreme Court Hears Oral Arguments

On April 16, 2019, the Court heard oral arguments in *Kaestner*. Throughout the arguments, several of the Justices expressed concerns about the Department's position, given the specific provisions of the Trust. These Justices, including Justices Breyer and Sotomayor, focused their questions on the Trust's provisions which gave "absolute discretion" to the trustee to determine if, when, and to what extent, distributions were to be made.¹⁴ Justices Alito and Kavanaugh also seemed focused on narrowing the argument to the specific facts at hand.¹⁵ The Justices generally seemed wary of the Department's attempt to tax all of the accumulated income of the Trust during the tax years at issue, given the authority vested by the Trust instrument in the Trustee, and that no distribution was actually made.

Justice Breyer was particularly concerned with the fairness of the State's attempt to impose a tax on the Trust income as it accumulated, given that the North Carolina beneficiary may not be distributed any of that income for years, if ever.¹⁶ The Justice pointedly asked the North Carolina Solicitor General, Counsel for the Petitioner, at one point "...do you discount the increased value of the trust by the time she has to wait? Because she has nothing that increased in value more than [the income of the Trust] discounted by the probability that she will ever get it and when."¹⁷

Justice Kagan provided the most intense questioning of Counsel for the Respondent Trust, challenging the assertion that the North Carolina beneficiary did not receive a benefit during the tax years. The Justice stated, "...well, if she moves from state to state to state, then each state for those particular years where she lives in the state can tax [the

⁸ *Id.* at 140.

⁹ *Id.* at 139, citing *Quill Corp. v. N.D.*, 504 U.S. 298, 307 (1992).

¹⁰ *Kimberley Rice Kaestner 1992 Family Tr.*, 371 N.C. at 140-41, citing *Walden v. Fiore*, 571 U.S. 277, 284-86, 134 S. Ct. 1115, 1122, 188 L. Ed. 2d 12 (2014).

¹¹ *Chase Manhattan Bank v. Gavin*, 249 Conn. 172 (Conn. 1999), cert. denied, 528 U.S. 965 (1999); *McCulloch v. Franchise Tax Bd.*, 61 Cal. 2d 186 (1964).

¹² *Chase Manhattan Bank*, 249 Conn. at 205 (internal citations omitted); *McCulloch*, 61 Cal. 2d at 196 (emphasis omitted).

¹³ *Kimberley Rice Kaestner 1992 Family Tr.*, 371 N.C. at 141-142.

¹⁴ See Supreme Court of the United States Transcript of Oral Argument, Case No. 18-457 at

https://www.supremecourt.gov/oral_arguments/argument_transcripts/2018/18-457_4d46.pdf at pages 6, 9-11, and 21.

¹⁵ *Id.* at 40-41, 47.

¹⁶ *Id.* at 10-11 and 38.

¹⁷ *Id.* at 10.

accumulated income of the Trust]...¹⁸ She went on to say, “[f]or these tax years, North Carolina is providing services to a person who and the only person who is going to benefit from the income growth of this trust.”¹⁹

The overall tone of the arguments and focus of the Justices’ questioning may indicate a reluctance on their part to address the issue presented in a broadly applicable way. However, only time will tell. A decision in *Kaestner* is expected sometime during the current Court session, which ends in June.

Filing for Refund Claims in North Carolina

On February 20, 2019, the Department issued *Important Notice: United States Supreme Court Agrees to Hear North Carolina Trust Income Taxation Case* (the “Notice”),²⁰ which clarifies the impact of *Kaestner* on similarly situated taxpayers considering filing claims for refund. The Notice explains that taxpayers are entitled to request a refund of tax paid to North Carolina by either filing an amended return reflecting an overpayment due or by filing a claim for refund.²¹ Generally, such a request for refund must be filed within the general statute of limitations period, which is the later of: (1) three years after the due date of the return, or (2) two years after payment of the tax. However, North Carolina provides an exception to the general statute of limitations for obtaining a refund due to a “contingent event,” which is defined to mean “litigation or a state tax audit initiated prior to the expiration of the statute of limitations” which prevents a taxpayer from possession of the information necessary to file an accurate and definite request for refund.²²

As *Kaestner* is currently pending before the Court, the Notice explains that the filing of an amended return or claim for refund after June 8, 2018 (the date the N.C. Supreme Court rendered its decision in *Kaestner*) is premature and cannot be processed. The Notice instructs a fiduciary of a similarly situated trust to file Form NC-14, Notice of Contingent Event or Request to Extend Statute of Limitations, prior to the expiration of the general statute of limitations for obtaining a refund for any year the contingent event prevents the trust from filing a definite request for refund with the Department. Taxpayers that are subject to a contingent event that properly file Form NC-14 with the Department will have a period of six months after the contingent event concludes to request a refund of an overpayment. The Notice makes clear that the Department will return all refund claims prematurely filed and will not keep record of such claims.

Considerations

While a decision in *Kaestner* is expected sometime during the current US Supreme Court session, which ends in June, it is important that similarly situated taxpayers understand the statute of limitations applicable to returns filed in North Carolina and consider the implications of the Notice to their facts.

In answering the specific question of whether imposing an income tax on the Trust by North Carolina during the tax years at issue comports with Due Process Clause requirements, *Kaestner* provides the current Court with the opportunity to establish a modern interpretation of the nexus standard for state taxes, in general, under the Due Process Clause of the U.S. Constitution. In *South Dakota v. Wayfair, Inc. et al.*,²³ the Court restated the due process standard as articulated more than fifty years ago in *Miller Brothers Co. v. Maryland*²⁴ and later *Quill v. North Dakota*,²⁵ that there be “some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax.”²⁶ A new interpretation of Due Process requirements by the Court could have ramifications for all types of taxpayers, not simply trusts. However, the Court may also choose not to address this broader issue and instead more narrowly tailor its holding to apply in situations similar to *Kaestner*.

¹⁸ *Id.* at 44.

¹⁹ *Id.*

²⁰ N.C. Dept. of Rev. (2/20/19).

²¹ N.C. Gen. Stat. § 105-241.7(b)

²² N.C. Gen. Stat. § 105-241.6(b)(5)a.

²³ *South Dakota v. Wayfair, Inc.*, 138 S. Ct. 2080 (2018).

²⁴ 347 U.S. 340 (1954).

²⁵ 504 U.S. 298 (1992).

²⁶ *Miller Brothers Co. v. Maryland*, 347 U.S. 340, 344-345 (1954).

Contacts:

If you have questions regarding this alert, please contact any of the following Deloitte Tax professionals:

Valerie Dickerson

Partner

Deloitte Tax LLP, Washington DC
+1 202 220 2693
vdickerson@deloitte.com

Greg Bergmann

Partner

Deloitte Tax LLP, Chicago
+1 312 486 9811
gbergmann@deloitte.com

Arthur Tilley

Managing Director

Deloitte Tax LLP, Charlotte
+1 704 887 1551
atilley@deloitte.com

Snowden Rives

Manager

Deloitte Tax LLP, Washington DC
+1 202 220 2753
srives@deloitte.com

Jeremy Sharp

Manager

Deloitte Tax LLP, Washington DC
+1 202 220 2147
jesharp@deloitte.com

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