TAX & ESTATE PLANNING

Supreme Court Finds State Tax on Trust Income Unconstitutional

By Maureen E. Loughran

INTRODUCTION

The United States Supreme Court recently decided in the case *North Carolina Dept. of Revenue v. Kimberley Rice Kaestner 1992 Family Trust* (588 U.S. (2019)) that a State cannot tax income of a trust based solely on a beneficiary's in-state residency, especially if no distributions are made. This case ruling clarifies a minimum relationship that must exist between a State and a trust to justify state taxation, and it issues important guidance to creators of trusts that have beneficiaries who reside outside of the State where the trust is created and/or administered.

CASE SUMMARY

In 1992, New York resident Joseph Lee Rice III created a trust for the benefit of his children. At that time, Joseph designated New York as the trust's situs and appointed a New York resident as the trustee. Several years later, the original trust was split into three sub-trusts under the original trust: one for each of Joseph's children.

As it was drafted, the trust provided that the trustee would have "absolute discretion" to distribute the trust's assets to the beneficiaries as the trustee so decides. In other words, the beneficiaries had no rights or authority under the trust to demand or direct distributions of income or principal from their sub-trusts.

Kimberley Rice Kaestner, Joseph's daughter, moved to North Carolina in 1997. During the period from 2005 to 2008, North Carolina imposed taxes *in excess of $1.3 million* on Kimberley's sub-trust, even though neither Kimberley nor her children received income or principal from the sub-trust during that time. Generally, a State must have a minimum relationship with a trust to tax its income; however, under North Carolina's tax statute, the State claimed it had the authority to tax income of a trust solely based on the premise that the beneficiary lived within the State.

The successor trustee of Kimberley's sub-trust appealed North Carolina's taxation, citing it was unconstitutional and violated the 14th Amendment's Due Process Clause. The trustee argued that although the Constitution grants broad authority to States to levy taxes, the relationship between Kimberley's sub-trust and the State was too tenuous to justify the taxes. The trustee argued that because (a) the trust was governed by the State of New York; (b) the successor trustee was a resident of Connecticut; (c) no distributions had been made to the beneficiary or her family while residing in North Carolina; (d) the sub-trust had no investments or property within North Carolina; and (e) the trust had no other physical presence within North Carolina, the State could not establish a minimum connection sufficient to impose the taxes.

North Carolina defended its tax arguing that the Supreme Court's ruling in *Greenlough v. Tax Assessors of Newport* (1947)—that the in-state residency of a trustee alone establishes a minimum connection sufficient to justify a State tax on trust income—suggests that a trustee and a beneficiary are both "constituents" of a trust. The State further cautioned that a ruling against North Carolina's tax statute could encourage "forum shopping" and manipulation of tax laws.

Ultimately, the Supreme Court found that in-state residency of a trust beneficiary alone is not enough to justify State tax on a trust. The Court went on to state that the Constitution requires that an in-state resident beneficiary have some degree of possession, control or enjoyment of the trust property or a right to receive such property before the State can tax the assets.

CONCLUSIONS

North Carolina Dept. of Revenue v. Kimberley Rice Kaestner 1992 Family Trust highlights the importance of careful planning—not just careful drafting—when it comes to developing an estate plan or trust. An estate plan is not "one size fits all," rather, substantial legal knowledge and skill must be exercised when creating a strategy to effectively preserve and distribute accumulated wealth and assets and avoid unnecessary taxes. As such, we offer the following recommendations for individuals, families, business owners and professional practitioners considering their estate planning needs:

- Thoughtfully consider future circumstances. Today trusts can exist in perpetuity, therefore, a trust must be flexible enough to adapt to law changes while still containing rules to accomplish an individual's goals. Striking this balance can be difficult, but the counsel of a seasoned estate planning attorney can make it easier.

- Be aware that each State's laws are different and must be taken into account. An effective legal strategy must be tailored around the specific needs and situational elements of each individual or family. Whether the needs are simple or complex, an experienced estate planner can help structure the right trust to effectively provide the flexibility needed to minimize unnecessary tax liabilities and even save thousands (or in this case, *millions*) of dollars to preserve a family's assets for generations to come.

Whether your estate planning concerns are personal or financial, we encourage you to consult with an experienced attorney who specializes in tax and estate planning to ensure that your documents are effectively structured to meet your unique needs. For assistance, please call us at 312-372-1947.

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