# State Taxation of Trust Income – Supreme Court Rejects Aggressive Approach in *Kaestner* Decision

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On June 21, the United States Supreme Court released its highly anticipated decision in *North Carolina Department of Revenue v. Kimberly Rice Kaestner 1992 Family Trust* (the *Kaestner* decision). In its opinion, the Supreme Court confirmed that a state may not tax income earned by a trust and not distributed out to a beneficiary where the trust's only connection with the state is that a beneficiary resides there. The decision is welcome news for administrators and beneficiaries of large trusts.

## CASE SUMMARY

When New Yorker Joseph Lee Rice III established a trust for the benefit of his children, he provided that the trust was to be governed under the laws of the state of New York and that a New York-resident trustee was to have "absolute discretion" in determining whether the beneficiaries were to receive any distributions of income. This discretion included the amount of income each separate beneficiary was to receive, if the trustee determined they were to receive any at all. After Mr. Rice formed the trust, his daughter, Kimberly Rice Kaestner, moved to the state of North Carolina and resided there for a number of years. During this time, the trust was divided into three subtrusts for the benefit of each of Mr. Rice's children for administrative purposes, although in all cases the subtrusts vested in the trustee the sole discretion to make distributions and were governed by the original trust document.

The law in North Carolina clearly permitted the state to tax all income earned by resident beneficiaries, including income received from taxable trust distributions. At issue in the *Kaestner* decision, however, was North Carolina's power to tax the income accumulated in the trust for the benefit of an in-state resident even when not actually distributed. The Supreme Court determined under the limited circumstances of the case that the imposition of income tax on an out-of-state trust's undistributed income violates the Due Process Clause and is unconstitutional.

## STATE TAXATION OF TRUSTS

The Supreme Court made clear that its decision was not intended to disturb existing precedent concerning the taxation of income attributable to trusts and beneficiaries. That case law provides that the Due Process Clause can tolerate the state taxation of trust income distributed to in-state beneficiaries because when such distributions occur, the beneficiaries own and enjoy interests in the distributed property. When the beneficiaries' rights vest as such, the Supreme Court indicated, it is reasonable for the state to exact a tax on the income in exchange for protections provided to a resident's property rights available under state law.

Likewise, the Supreme Court noted that a state has the authority to tax the accumulated income inside a trust based on the location of the settlor, the location of the trustee, or the location where the trust is administered. Each of these relationships creates the necessary nexus between a trust and a state because the trustee, or in some cases the settlor, is the legal owner of the trust property and can turn to his or her home state for legal protection. After all, a trustee may need to interact with the legal system in his or her home state frequently because trustees incur personal liability, must enter into contracts on the trust's behalf, have a fiduciary duty to enforce the trust's legal claims, and may need to resolve administration issues.

The requisite connection under the Due Process Clause between a trust and a taxing state is not met where the only connection between the trust and the state is that a beneficiary resides there, provided the beneficiary has no rights to compel a distribution. Outside these particular facts, the Supreme Court was careful to cut off any additional inferences.

## LIMITED APPLICABILITY

The Supreme Court's unanimous opinion, along with an accompanying concurring opinion, carefully circumscribed the *Kaestner* decision only to the specific fact pattern analyzed. Critical to the decision reached was the inability of the North Carolina-resident trust beneficiary to compel any sort of distribution from the trust. The trust's terms vested the power to make distributions, if any, solely with the trustee, and prohibited the beneficiary from participating in any investment decisions. The Supreme Court noted the trust held no investments that generated North Carolina source income as well.

The Supreme Court additionally rejected North Carolina's argument that the trust's accumulated income should be subject to tax on the theory that the only beneficiary of the particular subtrust being considered was a North Carolina resident. The state argued that all the income in the subtrust would ultimately need to be distributed to a North Carolina beneficiary, and therefore the accumulated income should be subject to tax in North Carolina by extension. The Supreme Court rejected this argument for two reasons: first, that the trustee clearly retained the power under the terms of the trust to exclude any one of

the three original beneficiaries from distributions entirely, and second, that because it was possible that the trust could be rolled over under the laws of the state of New York into another trust, it was not absolutely certain that the North Carolina-resident beneficiary would eventually receive all the trust's accumulated principal. The Supreme Court did not elaborate as to whether it would have relied on this rationale had the trust terms or New York law mandated a definite payout to the beneficiary at a fixed point in the future.

The Supreme Court also disclaimed any reliance of taxpayers on the opinion in evaluating the constitutionality of state statutes where the residency of a beneficiary is but one of many factors impacting the taxation of accumulated trust income. A footnote provides that at least 10 other states have such multifactor requirements for taxing trust incomes, including Rhode Island, Connecticut, and California.

## PRACTICAL APPLICABILITY AND POLICY IMPLICATIONS

Trusts are subject to tax on accumulated income, which is income earned in a given year and not distributed to beneficiaries. If income is earned and distributed in the same year, then this income – as well as the corresponding income tax liability – becomes attributable to the beneficiaries in addition to reducing the trust's total taxable income. After a trust pays income tax on accumulated income, the remaining funds are considered principal in the following year. The distribution of principal has no income tax effect on a beneficiary. The *Kaestner* decision makes clear that the rules for imposing state tax on the income of a trust are different from the rules for imposing state income tax on beneficiaries receiving trust distributions. A trust is usually subject to state tax based on where it is administered or where the trustee resides. Beneficiaries are instead taxed in the state of their residency when they receive taxable distributions, and potentially where they have the right to compel that such distributions be made.

The Supreme Court's *Kaestner* framework creates opportunities to reduce a trust's state income tax burden. For example, there is nothing preventing a settlor from establishing a trust in a state where the trustee and the administrative operations are not subject to a trust-level tax on accumulated income. The trust also could ensure that when and if taxable distributions are made, beneficiaries are located in low- or no-state-tax jurisdictions. Indeed, the Supreme Court and state of North Carolina both expressed concern that a taxpayer could reside in North Carolina and effectively eschew taxable distributions until he or she relocated to a tax-exempt state. The Supreme Court rejected this argument because it determined the particular facts of the case were narrow and the risks of potential gaming were merely speculative. And this argument itself ignores another fatal flaw in the analysis: if a trust is administered in a state with no trust-level income tax – or no income tax at all, for that matter – then it can simply accumulate income to principal and distribute principal to beneficiaries in a tax-free manner regardless of whether the beneficiaries would be subject to tax on distributions of income.

In any event, the *Kaestner* decision is a victory for trusts and for taxpayers who use trusts as a component of estate planning. Although the decision impacts a very narrow set of facts – a state imposing income tax on a trust's income solely based on the residency of a beneficiary – it reinforces strategic fiduciary income tax planning used to avoid state income tax on trust income.

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