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Trusts, Beneficiaries, and the Application of State Income Tax

By Daniel B. Waters

In *North Carolina Department of Revenue v. Kimberley Rice Kaestner 1992 Family Trust*, Case No. 18-457, 588 U.S. __ (2019), the Supreme Court revived the two-prong test from *Quill v. North Dakota, 504 U.S. 298 (1992)* and held that a state may not subject trust income to tax if the only connection to the state is the presence of a beneficiary. Joseph Lee Rice III, a New York resident, established a trust in New York for the benefit of his children. The initial trustee was also a New York resident, while the trust custodian was in Massachusetts. The trust held no real property in North Carolina. The trustee had infrequent contact with the beneficiary, Kimberly Rice Kaestner, who had moved to North Carolina in 1997 after the trust had been established. The original trust agreement provided the trustee absolute discretion to distribute the trust's assets to the beneficiaries.

For the tax years 2005 through 2008 the North Carolina Department of Revenue ("NCDOR") assessed a tax against the income of the trust for each year. The tax was assessed based on a North Carolina statute that taxed any trust income that is "for the benefit of" a North Carolina resident. The trust paid the tax under protest and filed suit in state court for a refund. Kaestner won at the trial level and obtained favorable verdicts up through the North Carolina Supreme Court. NCDOR appealed once more to the U.S. Supreme Court, and in a unanimous decision, NCDOR lost their final appeal. The Court found there was insufficient connection between North Carolina and the income it was seeking to tax and ruled the taxing statute unconstitutional. The trust in question is now entitled to receive a refund of more than $1.3 million.

This is a great victory for trust and estate planning attorneys. We now have a bright-line test for advising clients on when a state cannot tax trust income. Unfortunately, an in-depth analysis reveals that this holding is severely limited by its facts. Whether by design or chance, every factor that needed to go in the trust's favor was present, including: the absolute discretion of the trustee to distribute assets, the lack of any distributions to the beneficiary, the lack of contact between the beneficiary and the trustee, the inability of the beneficiary to assign any rights under the trust, the sole-discretion of the trustee in making investment decisions, and a New York law that allowed the trustee to roll over the initial trust assets into a new trust at the expiration of the trust in question.

The question for estate planners is what happens when any one of those factors is altered? On July 2, 2019, the NCDOR issued a notice regarding the timing of filing refunds for those taxpayers that properly filed a Notice of Contingent Event based on *Kaestner*. The deadline for filing an amended return for those taxpayers is December 21, 2019. We expect that we will see additional litigation as variations of facts make their way through the NCDOR refund process.

The attorneys at Roetzel are happy to discuss any questions you may have on this case and its impact on the administration of your trust.

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