U.S. Supreme Court Finds North Carolina's Taxation of a Beneficiary's Undistributed Share of a Trust to Violate The Due Process Clause

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On June 21, 2019, a unanimous United States Supreme Court issued its opinion in **North Carolina Department of Revenue v. Kimberley Rice Kaestner 1992 Family Trust.** The court found that the Kaestner Trust beneficiaries did not have the requisite relationship with the Trust property to justify the North Carolina's state tax. The Court did not specifically address the "degree of possession, control, or enjoyment would be sufficient to support taxation."

Background

Joseph Lee Rice III formed a New York trust (the "Trust") for the benefit of his children and appointed a New York resident as the trustee. The Trust agreement granted the trustee "absolute discretion" to distribute the Trust's assets to the beneficiaries. The trustee subsequently divided the Trust into separate subtrusts for each child. The Trust agreement provided that the subtrusts would terminate when each child turned age 40, after the time period relevant here. The state of North Carolina sought to tax the subtrust created for the child then living within the state under a law authorizing the state to tax any trust income that "is for the benefit of" a state resident.[1] North Carolina ultimately assessed a tax of more than $1.3 million for tax years 2005 through 2008. The tax was assessed notwithstanding the fact that the child living in North Carolina had no right to, and did not receive, any Trust distributions. Of additional note is the fact that the trustee (i) kept the Trust documents and records in New York, (ii) the Trust asset custodians were located in Massachusetts; (iii) the Trust maintained no physical presence in North Carolina; and (iv) the Trust made no direct investments in the state and held no real property there. The trustee paid the tax under protest and then sued the taxing authority in state court, arguing that the tax violated the Fourteenth Amendment's Due Process Clause.

State Court Argument

In state court, North Carolina argued that "a trust and its constituents are always inextricably intertwined, and thus, because trustee residence supports state taxation, so too must beneficiary residence," and adopting the Trust's position "would lead to opportunistic gaming of state tax systems." The North Carolina state courts disagreed and found the child's in-state residence was too tenuous a link between the state and the Trust to support the tax. As a result, the North Carolina tax violates the Due Process Clause of the Fourteenth Amendment.

U.S. Supreme Court

The U.S. Supreme Court granted certiorari to decide whether the Due Process Clause ("Clause") prohibits states from taxing trusts based only on the in-state residency of trust beneficiaries. In the context of state taxation, the Clause limits states to imposing only taxes that "bea[r] fiscal relation to protection, opportunities and benefits given by the state."[2]

In determining whether a state action violates the Clause, the Supreme Court applies a two (2) step analysis: (i) "there must be some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax;" and (ii) "the 'income attributed to the State for tax purposes must be rationally related to values connected with the taxing State." The "minimum contacts" inquiry is "flexible" and focuses on the reasonableness of the government's action. The Supreme Court has previously found (i) a tax on trust income distributed to an in-state resident passes muster under the Clause[3]; (ii) a tax based on a trustee's in-state residence; and (iii) a tax based on the site of trust administration is constitutional.[4]

In reaching its decision, the Supreme Court found that North Carolina's tax on the Trust did not meet the first requirement of some minimum connection to the state. The residency of a Trust beneficiary, not receiving any distributions from the Trust, insufficient to "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."

ENDNOTES

1 *N. C. Gen. Stat. Ann. § 105–160.2.*
2 ***Wisconsin v. J. C. Penney Co.****, 311 U. S. 435, 444 (1940).*
3 ***Maguire v. Trefry****, 253 U. S. 12, 16–17 (1920).*
4 ***Hanson v. Denckla****, 357 U. S. 235, 251 (1958).* ◊