

## RESOURCES

# North Carolina Court Rules That North Carolina Fiduciary Income Tax Law Is Unconstitutional - at Least as It Relates to Some Out-of-State Trusts

Recently, the Wake County, North Carolina Superior Court, in an unpublished decision by the Business Court, ruled that N.C.G.S. 105-160.2 was unconstitutional “as it applied” to one of the North Carolina beneficiaries of an out-of-state trust. *Kimberly Rice Kaestner 1992 Family Trust vs. North Carolina Department of Revenue*, 12 CVS 8740 (April 23, 2015).

## A. Background.

North Carolina assesses income tax on the income of an out-of-state trust holding assets for the benefit of one or more North Carolina residents, **even where** (1) the trustee is not a North Carolina resident, (2) the trust’s assets are held outside North Carolina, and (3) the Trust instrument provides that the trust is governed by the laws of a state other than North Carolina. Specifically, North Carolina General Statute Section 105-160.2 imposes income tax on the amount of taxable income of a trust that is “for the benefit of a resident of North Carolina.” Moreover, the North Carolina Administrative Code requires a fiduciary to file a North Carolina income tax return if a trust derives any income for the benefit of a North Carolina resident. 17 NCAC 6B.3716(b)(2).

## B. The Kaestner Trust Case.

On April 23, 2015, the North Carolina Business Court held that such taxation is unconstitutional under the Due Process Clause and the Commerce Clause of the United States Constitution “as applied” to the Kaestner Family Trust, where the only connection of the foreign trust to North Carolina was the North Carolina residence of the trust’s discretionary beneficiaries.

**1. Facts.** In the Kaestner Family Trust case, Joseph Lee Rice III created an irrevocable trust in 1992 for the benefit of his children. The Trust was created in New York and was governed by New York law. When the Trust was initially created, Mr. Rice and the trustee all resided and were domiciled in New York. Also, at the time the Trust was created, no primary or contingent beneficiary was a resident or domiciliary of North Carolina. In 1997, Mr. Rice’s daughter, Kimberly Rice Kaestner, moved to North Carolina.

During the relevant tax years at issue, the Trust invested in financial investments and the custodian of the Trust’s assets was located in Boston, Massachusetts. All legal, tax and financial books and records for the Trust were prepared in New York.

Under the terms of the Trust, neither Ms. Kaestner nor any of the beneficiaries had the absolute right to demand any of the assets or income of the Trust. Instead, distributions of income and principal could be made by the Trustee at its “sole discretion.” Indeed, during the tax years at issue, no distributions were made from the Trust to North Carolina beneficiaries.

During the 2005 through 2008 tax years, the Trust filed North Carolina income tax returns and reported, as taxable income, Ms. Kaestner’s share of the income accumulated in the Trust, even though no income was actually distributed to Ms. Kaestner or to her children. The Trust then filed a refund request to request a refund of income taxes from North Carolina of over \$1.3 Million paid by the Trust during those tax years. In the refund law suit, the Trust argued that N.C.G.S. 105-160.2 violated the Due Process and Commerce Clauses of the United

States Constitution, as well as the Constitution of the State of North Carolina.

**2. The Due Process Challenge.** According to the Business Court, in determining whether the North Carolina statute violated the Due Process Clause of the United States Constitution, the Court must focus on the Trust's contacts and relationships with North Carolina, rather than focus upon the beneficiary's contacts with North Carolina.

Here, the Trust never had any physical presence in North Carolina, never owned any real property located in North Carolina and never invested directly in any North Carolina based investments. Also, the Trust never kept any records in North Carolina as the principal place of administration of the Trust was outside the State of North Carolina.

Since the Trust never had any physical contacts with North Carolina, the Court then reviewed and scrutinized whether there were any benefits conferred upon the Trust by North Carolina to determine whether North Carolina has constitutional authority to tax income held by the Trust. The Court viewed whether the Trust had "purposely availed" itself of the benefits and laws of North Carolina such as by keeping tangible or intangible property in North Carolina or by using property in North Carolina or by conducting business in North Carolina.

The Business Court suggested that, with respect to the actions of the Trust, the maintenance of an office in North Carolina, the ownership of assets in North Carolina, and the transaction of business in North Carolina might provide sufficient contacts to permit the taxation of trust income. However, the Court noted that the only connection between the Trust and North Carolina was the fact that Ms. Kaestner and her three children lived in North Carolina.

The Court, therefore, concluded that N.C.G.S. 105-160.2 violated the Due Process and the Commerce clauses of the U.S. Constitution "as applied" to the Trust in this case.

**3. Commerce Clause Challenge.** Likewise, for the same reasons, the Court also found that, with respect to the Commerce Clause challenge to the statute, the Trust lacked "substantial nexus" with North Carolina and therefore the Statute violated the Commerce Clause of the United States constitution "as applied" to the Trust in this case.

**Note:** The North Carolina Department of Revenue may well appeal this decision to the North Carolina Court of Appeals.

**Also Note:** There are several important observations to be drawn from this case. First of all, the Court ruled that the North Carolina fiduciary income statute was unconstitutional "as applied," rather than "on its face." If the Court had ruled that the North Carolina statute was unconstitutional "on its face," then virtually any out-of-state trust, that pays North Carolina tax, could seek a refund of income taxes paid to North Carolina based upon the Kaestner Trust decision. However, this case may have very little precedential value to other out-of-state trusts, since the tax was deemed unconstitutional only "as applied" to the Kaestner Trust.

Finally, the North Carolina Department of Revenue was unable to show any physical connection or business connection between the Trust and the State of North Carolina. The Business Court may well have reached a different result if the Trust had invested in any assets or businesses located in, or operating in North Carolina.

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