The Supreme Court Limits States' Abilities to Tax Undistributed Trust Income from Out-of-State Trusts

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Introduction

Trustees annually distribute billions of dollars in trust income to beneficiaries, and state taxes on that income represent a major source of funding for many states' government services. In addition to taxing *distributed* trust income, eleven states, including North Carolina, permit taxation of *undistributed* trust income—the income a trust earned in a given year that was not distributed to a beneficiary.

In a case that has positive tax implications for in-state beneficiaries who may be entitled to undistributed trust income from out-of-state trusts, the Supreme Court put some limits on North Carolina's taxation of *undistributed* trust income. In North Carolina Department of Revenue v. The Kimberley Rice Kaestner 1992 Family Trust, the Court was asked to decide whether the presence of in-state beneficiaries alone empowers a state to tax trust income where the beneficiaries have no right to demand the income and are uncertain to receive it. The Court unanimously held that under those circumstances North Carolina's tax was unconstitutional.

The Kaestner Trust

Kaestner arose when North Carolina imposed over $1.3 million in taxes on undistributed income earned by the Kimberley Rice Kaestner 1992 Family Trust (the "Trust") from 2005 to 2008. The Trust was created in, stored in, and governed by the laws of New York, and earned no income, held no assets, and had no trustee in North Carolina. North Carolina's only connection to the Trust was the in-state residence of the Trust's beneficiaries.

After paying the tax bill under protest, the Trust filed suit claiming that North Carolina's tax violated the Fourteenth Amendment's Due Process Clause because the Trust lacked the necessary minimum contacts with the state. North Carolina argued that the presence of in-state beneficiaries alone satisfied the minimum-contacts requirement.

The Court's Decision

The Court agreed with the Trust, focusing on the first part of a two-step framework that requires (1) some "minimum connection" between the taxpayer and the state and (2) a rational relationship between the income the state seeks to tax and the benefits the state provides. Relying on settled personal jurisdiction precedent, the Court explained that a "minimum connection" requires certain "minimum contacts" with the state such that the tax does not offend "traditional notions of fair play and substantial justice." In trust-tax cases, whether a beneficiary's in-state contacts satisfy the minimum contacts requirement depends on "the extent of the in-state beneficiary's right to control, possess, enjoy, or receive trust assets."

Applying this test to the Trust, the Court concluded that because the beneficiaries never received money from the Trust during the relevant period, had no right to demand Trust distributions, and were not assured of ever receiving a distribution, the Kaestner beneficiaries lacked the requisite control or possession over the Trust for their contacts with North Carolina alone to establish jurisdiction and satisfy the Due Process Clause. Thus, North Carolina's tax was unconstitutional.

In holding North Carolina's tax unconstitutional, the Court declined to address several issues. First, since the Court held that the "minimum contacts" mandate was not met, it did not decide whether the tax bore any reasonable relationship to the benefits and protections provided by North Carolina. Additionally, the Court did not opine on the degree of possession, control, or enjoyment that would support a state tax, and expressly reserved "for another day" cases where the in-state beneficiary is certain to receive future trust distributions or has a right to assign a potential interest in trust income.

Conclusion

Kaestner limits the circumstances in which states may tax undistributed income from out-of-state trusts. Essentially, if the only connection the state has to the trust is the residence of a beneficiary, the state cannot tax that trust's undistributed income. In-state beneficiaries of out-of-state trusts thereby obtain beneficial tax consequences from the Court's decision. Future cases will likely address the due-process questions *Kaestner* left unanswered.

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