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***N.C. Department of Revenue***

***v.***

***Kimberley Rice Kaestner 1992 Family Trust***

Anna Moody

**July 15, 2019**

**Debevoise  
& Plimpton**

## What Is the Case About?

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### QUESTION PRESENTED

Does the Due Process Clause prohibit states from taxing trusts based on trust beneficiaries' in-state residency?

## North Carolina's Law

- N.C. Gen. Stat. § 105-160.2 (2017):
  - **“The tax is computed on the amount of the taxable income of the estate or trust *that is for the benefit of a resident of this State...* The fiduciary responsible for administering the estate or trust shall pay the tax.”**
- Under this law, North Carolina taxed the worldwide income of the Kaestner trust from 2005 to 2008, based solely on the residence of a contingent trust beneficiary.

# The Kaestner Trust

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## Connections to Different States

### Trust Connections to N.C.:

- Residence of contingent beneficiaries

### Trust Connections to Other States:

- Residence of settlor
- Residence of trustees
- Place of administration
- Location of assets and assets' custodian
- Source of income

## The Kaestner Trust (cont.)

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- Key features:
  - Beneficiaries had no right to demand income
  - Trustee has “absolute discretion” over distributions
  - Spendthrift provision
  - Assets did not become part of beneficiaries’ estates
  - No HEMS requirement, but milestones for distribution
  - Primary contingent beneficiaries (NC); residual contingent beneficiaries (NY and CT)

## **The Kaestner Trust (cont.)**

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- Required distribution to primary contingent beneficiaries at 40
  - BUT
- Decanting power for trustee under New York law
- No distributions to anyone from the Kaestner Trust

# The Constitutional Challenge

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- The Fourteenth Amendment to the U.S. Constitution:
  - “No state shall make or enforce any law which shall abridge the privileges or immunities of citizens of the United States; nor shall any state deprive any person of life, liberty, or property, without **due process of law**; nor deny to any person within its jurisdiction the equal protection of the laws.”

## What does Due Process mean?

- *International Shoe v. Washington* (U.S. Supreme Court, 1945):
  - “Due process requires only that in order to subject a defendant to a judgment *in personam*, if he be not present within the territory of the forum, he have certain **minimum contacts** with it such that the maintenance of the suit does not offend traditional notions of fair play and substantial justice.”

## Due Process for Taxes

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- *Quill Corp. v. North Dakota* (U.S. Supreme Court, 1992):
  - “Building on the seminal case of *International Shoe*, we have framed the relevant inquiry as whether a defendant had minimum contacts with the jurisdiction such that the maintenance of the suit does not offend **traditional notions of fair play and substantial justice.**”

## Due Process for Taxes

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- *Quill Corp. v. North Dakota* (U.S. Supreme Court, 1992):
  - “The Due Process Clause requires some definite link, some **minimum connection**, between a state and the person, property or transaction it seeks to tax, and that the income attributed to the State for tax purposes must be **rationaly related** to 'values connected with the taxing State.’”

## The Legal Backdrop

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- *Pre-International Shoe Framework:*
- A State can't tax its resident beneficiary for trust assets she never received. (*Brooke*, 1928)
- A State can't tax a nonresident trustee just because a trust beneficiary is a resident. (*Safe Deposit*, 1929)
  - » BUT
- A State can tax its resident for trust income she actually receives, and a State can tax its resident trustee for property he actually owns.

## The Law's Fate in N.C. State Court

- General Court of Justice, Superior County of Wake Court Division (2015): “The Court does not believe that the residency of the beneficiaries in North Carolina, standing alone, can be viewed as the Trust’s ‘purposeful’ activity in this State.”
- The Court of Appeals of North Carolina (2016): “The connection between North Carolina and the Trust was insufficient to satisfy the requirements of due process.”
- The Supreme Court of North Carolina (2018): “Because plaintiff and plaintiff’s beneficiaries are separate legal entities, due process was not satisfied solely from the beneficiaries’ contacts with North Carolina.”

## Key Arguments: The State

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- Unfairness (the “tax shelter” argument):
  - “To avoid state income taxes under [the state court’s] holding, all one needs to do is select a trustee in a state with no trust-income tax.”
  - Aggressive effort to portray the trust as a “judicially created tax shelter.”

## Key Arguments: The State

- The Trust = the Beneficiary:
  - “A beneficiary is the central figure in a trust. Serving the beneficiary’s interests is the trust’s reason for being.”
  - State of her residence provides her police, fire, schools.
  - Protects her right to “eventual enjoyment” of the income
  - Because the State provides those benefits, the Trust does not have to.

## Key Arguments: The State

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- Federalism:
  - “The due-process rule that the state adopted here... lays waste to the states’ taxing authority.”
  - *Wayfair 2.0*
  - Decision for the trust would invalidate a majority of state laws

## Key Arguments: The Trust

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- This Is Settled Law:
  - “The Court has twice addressed and decided the question presented, and those precedents control here.”
  - Pre-International Shoe, but based on fairness
  - Heavy reliance on personal jurisdiction cases

## Key Arguments: The Trust

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- The Trust = the Trustee
  - The trustee owns the property
  - The trustee pays the tax
  - The trustee must challenge the tax
  - The state must have minimum contacts with him

## Key Arguments: The Trust

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- Federalism:
  - States get to choose tax policy for themselves
  - No interference from States without a legitimate interest
  - Always at least one State that could have taxed this income
  - “North Carolina’s grievance is not that the States lack constitutional power to tax, but rather that the states with constitutional power to tax have not chosen to exercise it.”

# ***Amici***

## For North Carolina

- 10 Law Professors
- 20 States and D.C.

## For Neither Party

- American College of Trust & Estate Counsel
- 3 Law Professors

## For the Trust

- NYS Bar Association
- U.S. Chamber of Commerce
- 4 States (South Dakota, Alaska, Nevada & Texas)
- American College of Tax Counsel
- 1 Trustee
- Council on State Taxation
- 9 Washington State Tax Practitioners
- 1 Law Professor
- 6 State Trust and Bank Associations

# Oral Argument

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## Oral Argument

“So, unless they die, they’re going to get this money?”



“She’s seeing a substantial asset of hers increase in value in the bank, and even if she can’t touch it right now, she’s getting richer and richer because of it. And that’s influencing her life choices because she knows she’s eventually going to enjoy that money.”

“Was it the trustee’s money? .... He possesses it with a fiduciary duty to increase that money for her.

## What's at Stake?

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- **11 states** tax nonresident trusts based partly on a beneficiary's residence:
  - Alabama, California, Connecticut, Georgia, Missouri, Montana, North Carolina, North Dakota, Ohio, Rhode Island, Tennessee
- **3 states** tax nonresident trustees for undistributed income based solely on a contingent beneficiary's residence:
  - Georgia, North Carolina, Tennessee

## What's at Stake?

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- Most States tax based on some combination of factors
- Most common factor is **settlor's** residence
  - When the trust became irrevocable
  - Upon death, for testamentary trust

## The Decision

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Affirmed. June 21, 2019

Justice Sotomayor delivered the opinion for a unanimous Court. Justice Alito filed a concurrence in which Chief Justice Roberts and Justice Gorsuch joined.

*The presence of in-state beneficiaries alone does not 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.*

## Critical Decision Points

- Possession and Control
  - Critical that the trustee had exclusive control over the allocation and timing of trust distributions
  - Where the beneficiary owns and enjoys an interest in trust property, the State can exact a tax in exchange for offering the beneficiary protection.
- *Wayfair*:
  - *Mere speculation about negative consequences cannot conjure the “minimum connection” missing between North Carolina and the object of its tax.*

## Critical Decision Points

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- Narrowly Limited to the Facts
  - 1) Beneficiaries did not receive any income
  - 2) Beneficiaries had no right to demand income or otherwise control, possess, or enjoy the trust assets in the years at issue
  - 3) No guarantee the beneficiaries would ever receive any specific amount of income from the trust.

## What is Sufficient?

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- *One can imagine many contacts with a trust or its constituents that a State might treat, alone or in combination, as providing a ‘minimum connection’ that justifies a tax on trust assets.*
  - » Distribution to an in-state resident
  - » Resident trustee
  - » Site of trust administration (probably)
  - » Others?
- *We do not decide what degree of possession, control, or enjoyment would be sufficient to support taxation*

# Open Questions

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- Open Questions:
  - Can beneficiary contacts ever be sufficient?
  - What degree of possession and control is sufficient?
  - What if beneficiaries were certain to receive funds in the future?
  - What if the beneficiaries could assign a potential interest in income from a trust?

## Concurrence

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- The decision not to answer questions not present by the facts of this case does not open for reconsideration any points resolved by our prior decisions.

## What's Next?

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- Critical next battle: Settlor-based taxes
  - *Similar analysis also appears in the context of taxes premised on the in-state residency of settlors and trustees.*
    - » *Curry: settlor retained power to dispose of the property*
    - » *Graves: settlor retained right to revoke a trust and to demand transmission to her of the intangibles*
  - Key: practical control over the trust assets
- *Fielding*: cert denied