“Kaesting” Doubt on the State Fiduciary Income Tax System

Article
Spring 2019
Delaware Banker Magazine

The U.S. Supreme Court will soon render a decision that could have a significant impact on the manner in which some states tax income accumulated in nongrantor trusts. The case pending before the U.S. Supreme Court, *North Carolina Dep’t of Revenue v. The Kimberley Rice Kaestner 1992 Family Trust* (No. 18-457), involves a North Carolina statute that assesses a tax upon the undistributed income of a nonresident trust based upon the residence of trust beneficiaries within the state. The North Carolina Supreme Court found the statute to be unconstitutional as applied to a particular trust and, in a somewhat surprising development, the U.S. Supreme Court granted certiorari and will hear the North Carolina Department of Revenue’s case. State legislatures and wealth management professionals anxiously await the U.S. Supreme Court’s decision due to its potential impact on state coffers and the trust industry nationwide, particularly in jurisdictions like Delaware that generate substantial business from trusts settled by, and for the benefit of, out-of-state residents.

THE KAESTNER CASE

The trust at issue in *Kaestner* derived from a trust that was originally settled by a New York resident in 1992 for the benefit of his three children. One of the settlor’s children, Kimberly Kaestner, moved to North Carolina in 1997. In 2006, the original trust was divided into three separate trusts for administrative convenience, with one such trust for each of the settlor’s three children and their respective descendants. The trusts, including the trust for the benefit of Kimberly Kaestner and her descendants (the “Trust”), remained governed by New York law.

During the years at issue, the trustee of the Trust was a resident of Connecticut and the Trust’s assets were maintained by a custodian in Massachusetts. The Trust’s books and records were maintained in New York and the Trust’s accountings were prepared in New York. Consequently, the Trust’s only connection to North Carolina was the residence of the Trust’s beneficiaries.

Under the terms of the Trust’s governing instrument, Trust beneficiaries did not have an absolute right to Trust principal or income, but rather the trustee had discretion to make distributions. No distributions were made to beneficiaries in North Carolina during the years at issue, although a loan was made to Kimberly Kaestner to enable her to pursue an investment opportunity during the relevant period, but the loan was subsequently repaid.

From 2005 to 2008, North Carolina assessed taxes upon the Trust’s accumulated income in excess of $1.3 million pursuant to a North Carolina statute that applies an income tax that is “computed on the amount of the taxable income of the estate or trust that is for the benefit of a resident of [North Carolina].” N.C. GEN. STAT. § 105-160.2 (2017). The Trust paid the assessed taxes and subsequently requested a refund from the state. After the refund request was denied, the Trust filed a complaint challenging the constitutionality of the North Carolina statute. The Trust successfully argued at both the trial level and intermediate court of appeals that the North Carolina statute is unconstitutional as applied to the Trust.

In affirming the courts below, the North Carolina Supreme Court found that the North Carolina statute violated the Due Process Clause, as applied to the Trust. *North Carolina Dep’t of Revenue v. The Kimberley Rice Kaestner 1992 Family Trust*, 814 S.E.2d 43, 51 (N.C. 2018). The Fourteenth Amendment of the United States Constitution provides, in part, that no state shall “deprive any person of life, liberty, or property without due process of law.” U.S. CONST. amend XIV. In the taxation context, the Due Process Clause “requires some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax.” *Id.* at 48 (quoting *Quill Corp. v. North Dakota*, 504 U.S. 298, 306 (1992)). The minimum connection requirement (commonly known as the “minimum contacts” requirement) is satisfied when the entity sought to be taxed “purposely avails itself of the benefits of an economic market” in the taxing state “even if it has no physical presence in the State.” *Id.*

Although trusts are not entities in the traditional sense, the North Carolina Supreme Court recognized that nongrantor trusts are treated under the Internal Revenue Code and North Carolina law as separate entities for tax purposes. Critical to its ruling, the North Carolina Supreme Court found that a taxed entity’s minimum contacts with the taxing state cannot be established by a third party’s (i.e. the beneficiary’s) minimum contacts with the state. The Trust, as a separate taxable entity, would have needed to purposely avail itself of the benefits and protections offered by the State, and mere contact with a North Carolina beneficiary does not suffice. Ultimately, the North Carolina Supreme Court determined that the due process requirement could not be satisfied in this instance because “it was the beneficiaries, not the Trust, that availed themselves of the benefits and protections of North Carolina’s laws.” *Id.* at 49.

DELAWARE CONNECTION - OVERVIEW OF FIDUCIARY INCOME TAX APPROACHES AROUND THE COUNTRY

States use a variety of methods to tax trust income. Some states, like North Carolina, aggressively target trusts based on *de minimus* connections to the state. Nearly half of all states tax a trust’s accumulated income and capital gains merely because the settlor resided in the state at a particular time, for instance at the time the trust was funded, when the trust became irrevocable, or at any time during the current tax year. Some states, including New York, Massachusetts, Missouri and Ohio,

tax trusts created by residents if certain other contacts with the state exist, such as if a trustee or beneficiary are present in the state or if some trust administration occurs in the state.

Other states, like Delaware, South Dakota, and New Hampshire, have favorable tax environments to encourage settlors and fiduciaries to administer trusts in their respective jurisdictions. Delaware, similar to other leading trust jurisdictions, does not generally impose taxes upon trusts except in cases where one or more trust beneficiaries live within the state. Even then, Delaware only taxes the portion of the trust income attributable to the Delaware resident beneficiaries. Consequently, Delaware is a popular jurisdiction for out-of-state settlors because it may be possible to eliminate state income taxes on undistributed trust income, allowing trust assets to grow at a greater rate.

DELAWARE'S APPROACH TO FIDUCIARY INCOME TAXATION

The manner in which Delaware taxes a trust is based on whether a trust is a "resident trust" or "nonresident trust." A non-grantor trust is treated as a "resident trust" for Delaware income tax purposes if:

1. The trust is created by the will of a decedent who at death was domiciled in Delaware; or
2. The trust is created by, or consists of property of, a person domiciled in Delaware; or
3. During more than half of any taxable year, the trust has only one trustee who is either a Delaware resident individual, or a corporation, partnership or other organization having an office for the conduct of trust business in Delaware; or
4. During more than half of any taxable year, the trust has more than one trustee and one of the trustees is a corporation, partnership or other organization having an office for the conduct of trust business in Delaware; or
5. During more than half of any taxable year, the trust has more than one trustee all of whom are individuals and one-half or more of whom are Delaware residents. 30 Del. C. § 1601(8).

Indeed, many trusts qualify as "resident trusts", within the meaning of Section 1601(8) of Title 30 of the Delaware Code, because the trust has a Delaware trustee without any other connection to the state.

A Delaware nonresident trust is any trust that is not a resident trust. 30 Del. C. § 1601(5). Delaware nonresident trusts are only subject to Delaware state income tax to the extent that they have items of income, gain, loss and deduction derived from, or connected with, sources located within the State of Delaware. 30 Del. C. § 1639. Consequently, nonresident trusts, even those with Delaware beneficiaries, are frequently not subject to Delaware income taxation. Indeed, a nonresident trust that does not have Delaware source income is not even required to file a Delaware income tax return. 30 Del. C. § 1605(b)(1).

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Delaware resident trusts are potentially subject to the Delaware income tax imposed upon individuals, but are allowed income tax deductions for (i) federal distributable net income that is actually distributed and (ii) federal taxable income (including capital gains), as modified for Delaware purposes, that is set aside for future distribution to nonresident beneficiaries. 30 Del. C. § 1635 and 1636. The practical effect of these two deductions is that a Delaware resident trust never pays Delaware income tax if (1) the trust has no living beneficiaries who are residents of Delaware; and (2) the trust's beneficiaries are not identified as a result of their relationship to a Delaware resident. In cases where one or more beneficiaries reside in Delaware, the portion of the trust's accumulated income and accumulated capital gains allocable to the Delaware resident beneficiaries is subject to Delaware income taxation. A resident trust that has no Delaware resident beneficiaries is not required to file a Delaware income tax return. 30 Del. C. § 1605(b)(1).

TAKEAWAYS

The most obvious risk that *Kaestner* poses to Delaware is that the U.S. Supreme Court will expand the view of what constitutes a "minimum contact" in the trust context, thereby making it more difficult or perhaps impossible for some Delaware resident trusts to avoid taxation by other states. If, for example, North Carolina is permitted to tax income accumulated in a Delaware resident trust based upon a beneficiary's residence in North Carolina, the perceived advantage of establishing a resident Delaware trust may at first glance diminish. Moreover, other states may enact similar statutes, which could increase the cost and burden of administering a trust with beneficiaries in numerous jurisdictions. It should be noted, however, that even if the North Carolina statute is upheld as applied in *Kaestner*, planning opportunities designed to avoid or mitigate the impact of such a statute likely will abound.

More than a dozen amicus briefs have been filed by industry groups, academics and states. The highly-anticipated argument before the U.S. Supreme Court is scheduled for April 16, 2019.

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J. Zachary Haupt, "*'Kaesting'* Doubt on the State Fiduciary Income Tax System," *Delaware Banker Magazine* (Spring 2019)

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