

Which State Can Tax a Trust?



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What are the limits on one state's power to tax the undistributed income of a trust with no connection to that state, other than the mere fact that a discretionary income beneficiary lives in that state? Authority is divided over whether the residence of a beneficiary or settlor of an out-of-state trust is sufficient, for due process purposes, to allow a state to subject trust income to taxation. The U.S. Supreme Court recently heard arguments in *North Carolina Department of Revenue v. Kimberley Rice Kaestner 1992 Family Trust* on this issue.

The beneficiary in the *Kaestner* case never received any discretionary income distributions from the trust at issue, but North Carolina still taxed the undistributed income from the trust. The North Carolina Supreme Court held that undistributed trust income could not be taxed by North Carolina solely based on the residence of the beneficiaries when the trustee was out-of-state and the trust had no assets located in the state. The court further held that there were insufficient "minimum contacts" with the State of North Carolina to satisfy due process in that the trust did not purposefully avail itself of any benefits under North Carolina law.

The North Carolina Revenue Department appealed the ruling to the U.S. Supreme Court. The U.S. Supreme Court heard the case on April 16, 2019.

Last year, the U.S. Supreme Court issued the *South Dakota v. Wayfair, Inc.* decision, which changed the way states can tax businesses. The *Wayfair* decision changed the established "physical presence" test in sales tax cases, mainly due to the fact so many people are doing business via e-commerce.

In light of the "minimum contacts" requirements of established case law, the U.S. Supreme Court will likely rule that a state's taxation of a trust based solely on a discretionary income beneficiary's residence in that state violates the Due Process Clause. Allowing taxation based solely on the residence of a discretionary beneficiary would allow a state to tax a trust on the basis of what might occur, not on the facts as they are. In light of the *Wayfair* decision, it will be interesting to see how the Court rules. Stay tuned to see how the U.S. Supreme Court rules in the *Kaestner* case to see if there will be future changes to how states can establish nexus and tax a trust.