

Trusts Go to Washington

North Carolina Dep't of Revenue v. Kaestner Family Trust

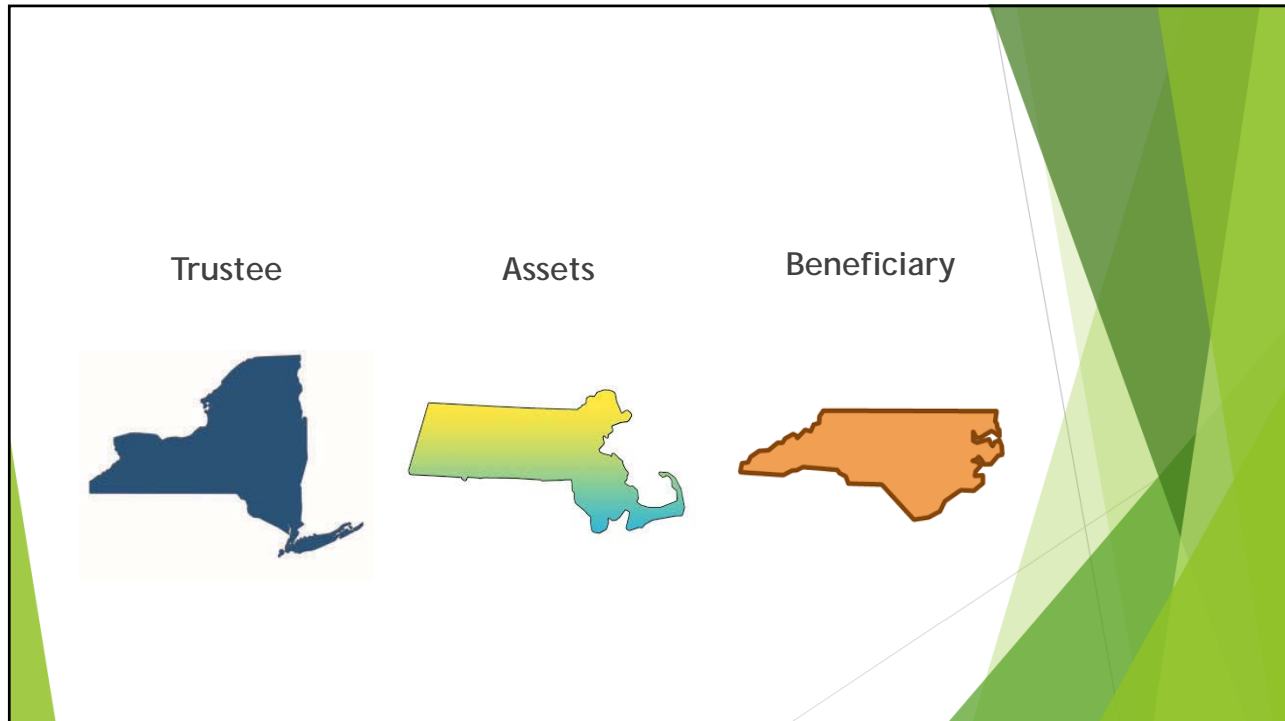
Angelo M. Grasso
Greenfield Stein & Senior, LLP

1

Kaestner Family Trust

- ▶ Initial trust created in 1992 by Joseph Lee Rice III (Settlor) and William B. Matteson (Trustee)
 - ▶ Primary beneficiaries: Settlor's descendants
 - ▶ Settlor & Trustee domiciled in New York; Trust subject to NY income tax
- ▶ 1995: Trustee moves to Florida
- ▶ 2002: Trust divided into 3 subtrusts for Kimberly Rice Kaestner, Daniel Rice and Lee Rice
- ▶ Kimberly Kaestner resides in North Carolina
 - ▶ Beneficiaries of Kaestner Trust: Kimberly and her 3 minor children
- ▶ 2005: David Bernstein, a CT resident, appointed Successor Trustee
- ▶ Trust's assets: equities, mutual funds, partnership investments
- ▶ Trustee has sole and absolute discretion to make/deny distributions
- ▶ No distributions made between 2005 and 2008

2



3

N.C. Statute §105-160.2

The tax imposed by this Part applies to the taxable income of estates and trusts as determined under the provisions of the Code...The taxable income of an estate or trust is the same as taxable income for such an estate or trust under the provisions of the Code...**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 computed under the provisions of this Part.

4

Taxes Paid

- ▶ 2005: \$79,634
- ▶ 2006: \$106,637
- ▶ 2007: \$1,099,660
- ▶ 2008: \$17,241
- ▶ Claim for refund filed in 2009; denied
- ▶ Trust commenced litigation, claiming statute is unconstitutional under Due Process Clause, Commerce Clause, and Article I, Section 19 of North Carolina's Constitution ("land of the law" clause)

5

North Carolina Decisions

- ▶ Trial court concluded statute violated *both* the Due Process Clause and the Commerce Clause, ordered a refund
- ▶ North Carolina Court of Appeals affirmed on Due Process Clause grounds
 - ▶ Did not reach issue of Commerce Clause
- ▶ NC Supreme Court affirmed 6-1 on Due Process Clause
 - ▶ Trust beneficiaries are essentially 3rd parties to a trust
 - ▶ 3rd parties presence in a forum/state does not matter for due process concerns
 - ▶ ∴ Trust beneficiaries presence in a state does not matter for due process
- ▶ Dissent: too formalistic, presence-based analysis
 - ▶ *South Dakota v. Wayfair*, 138 S. Ct. 2080 (2018)
- ▶ North Carolina petitions for certiorari; granted

6

Key Precedent

- ▶ *Brooke v. City of Norfolk*, 277 U.S. 27 (1928)
 - ▶ City & State taxed trustee of Maryland trust when none of the trust property had ever been in Virginia
 - ▶ Unconstitutional - Property held by a Maryland trustee "was not within the state, does not belong to the [beneficiary] and is not within her possession or control."
- ▶ *Safe Deposit & Trust Co. v. Virginia*, 280 U.S. 83 (1929)
 - ▶ Virginia assessed a state intangibles tax against Maryland trustee
 - ▶ Unconstitutional - Actual situs of property was in Maryland; neither grantor nor beneficiaries (who resided in Virginia) had control over property
- ▶ *Hanson v. Denckla*, 357 U.S. 235 (1958)
 - ▶ The presence of trust beneficiaries in one state (Florida) did not confer on that state jurisdiction over the trustee who had no other connections to the state
 - ▶ See also *Mercantile Safe-Deposit & Trust Co. v. Murphy*, 19 A.D.2d 765, 242 N.Y.S.2d 26 (3d Dep't 1962), *aff'd* 15 N.Y.2d 579, 203 N.E.2d 490 (1963).
- ▶ *Greenough v. Tax Assessors of Newport*, 331 U.S. 486 (1947)
 - ▶ State could tax income earned by a trustee based on the trustee's presence within the state

7

North Carolina's Arguments

1. Trust did not satisfy both elements of *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992). To show a Due Process Clause violation, Trust must demonstrate:
 - ▶ North Carolina lacks minimum connection to the Trust
 - ▶ Income attributed to the state for tax purposes is not rationally related to the values connected with the taxing state
2. Beneficiary's presence in North Carolina satisfies minimum connection
 - ▶ Fundamental fairness vs. formalism
 - ▶ Trust has no entity status because it is an abstraction
 - ▶ Beneficiary is the central figure of the trust
 - ▶ North Carolina gave beneficiary services for years in question, which the Trust did not have to pay
3. All income was for the benefit of North Carolinians
 - ▶ Tax avoids the creation of a tax shelter
 - ▶ North Carolina will lose money if tax struck down

8

NYSBA's Amicus Brief

1. The central figure to a trust is the trustee, *not* the beneficiary
 - ▶ Taxpayer, fiduciary, legal title holder to trust property
 - ▶ Absolute discretion of trustee in this instance
2. Due Process Clause
 - ▶ "Definite link" and "minimum connection" to state
 - ▶ *Mercantile Safe-Deposit & Trust Co. v. Murphy*, 19 A.D.2d 765, 242 N.Y.S.2d 26 (3d Dep't 1962), *aff'd* 15 N.Y.2d 579, 203 N.E.2d 490 (1963).
 - ▶ This is not a tax shelter
3. Dormant Commerce Clause
 - ▶ No substantial nexus
 - ▶ Tax is not fairly apportioned
 - ▶ Tax is neither internally nor externally consistent

9




10



This case involves a statute that taxes trust income in proportion to the interests of in-state beneficiaries. Now, trust beneficiaries, it bears remembering, are the true owners of trust income under trust law. Because of all the benefits and protections that states extend to their residents, the states' pro rata tax on trust income comports with due process.


11



JUSTICE SOTOMAYOR: But it still begs the question, what makes it your right under any circumstance to tax all of the trust income when there's no guarantee that she is going to receive all of it at any point?

MR. SAWCHAK: Several points. One is, during the entire period when the income is accumulating, the state is providing her with protection and benefits...

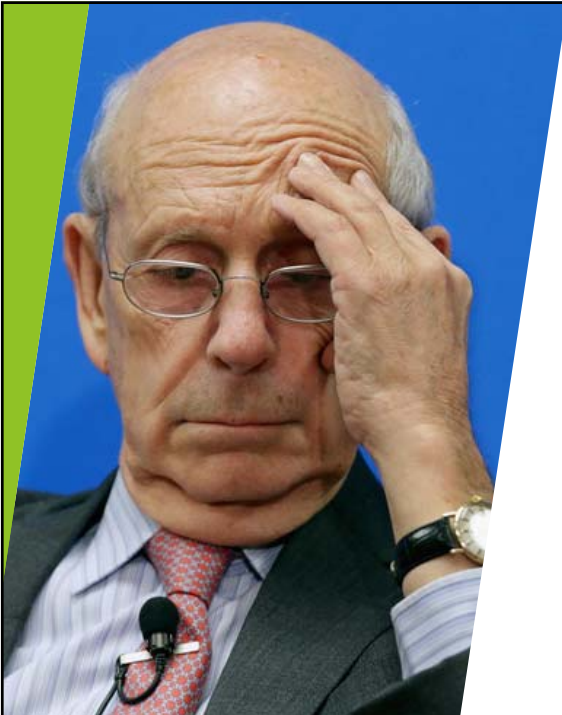
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JUSTICE SOTOMAYOR: But the trustee doesn't have to pay for that. He's not required to. The trust doesn't require it. It gives him discretion to pay for some of her expenses, but nothing in the trust says that she has to pay for the benefits that you're giving her as a state.

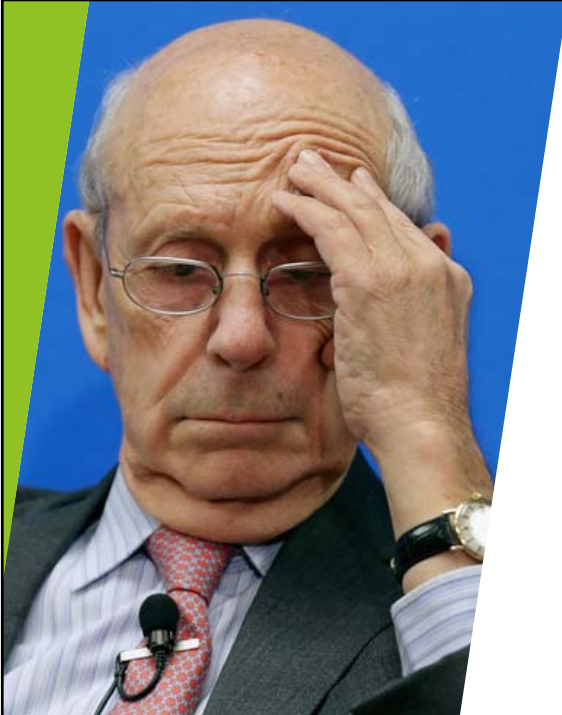
MR. SAWCHAK: But it is the very fact that those benefits and protections are being extended that enables the trustee to not give distributions.

13



JUSTICE BREYER: Look, the trustee lives in New York, okay? The settlor is in New York. All the administration is in New York. There is one thing that's going to happen in North Carolina. The thing that's going to happen in North Carolina is if she is there when it's distributed, she'll get some money. Okay? Which you're totally free to tax. But that isn't what you want to tax. You want to tax all these things which are everyone except her is in New York, and moreover, we don't even know if she'll ever get the money.

14



Now there's something wrong with that. I don't know, it doesn't say specifically about trusts in the Constitution, but thus, I mean, lots of trusts say there are 10 beneficiaries, each one lives in a different state, and I, the trustee, have total discretion as to who to give this money to and maybe I'll give it to none of them. So here's a woman who might get none of it, and you want to tax that. Is that right?

15

Issues Raised to North Carolina

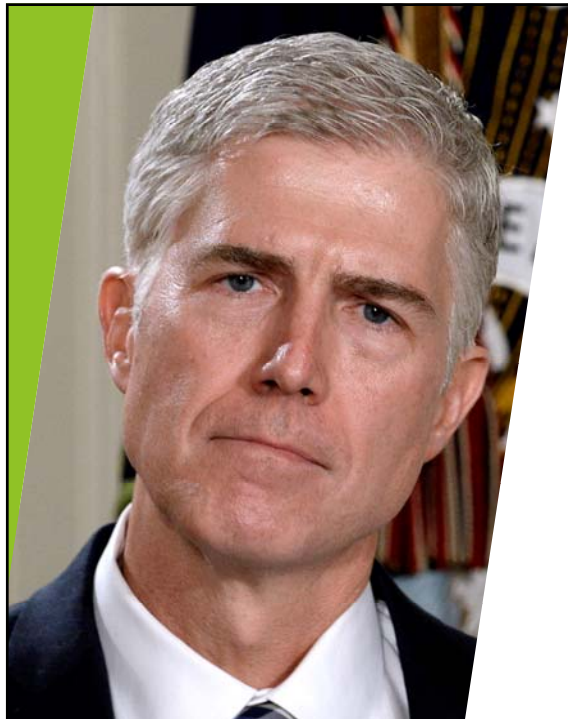
- ▶ Present value discount (Breyer)
- ▶ Apportionment of taxes among beneficiaries and different states (Alito & Roberts)
- ▶ Rarity of this tax (Kavanaugh)
- ▶ Status of beneficiaries (Kagan)
- ▶ Taxation with unequal distributions (Breyer)
 - ▶ 5 beneficiaries, one lives in North Carolina, \$1 million in income
 - ▶ Eventually, the NC beneficiary gets \$3, remaining get \$999,997
 - ▶ NC taxes \$200,000, not \$3
- ▶ Trust's response: throughout the time period in question, the beneficiaries "had true ownership of the accumulating assets"

16

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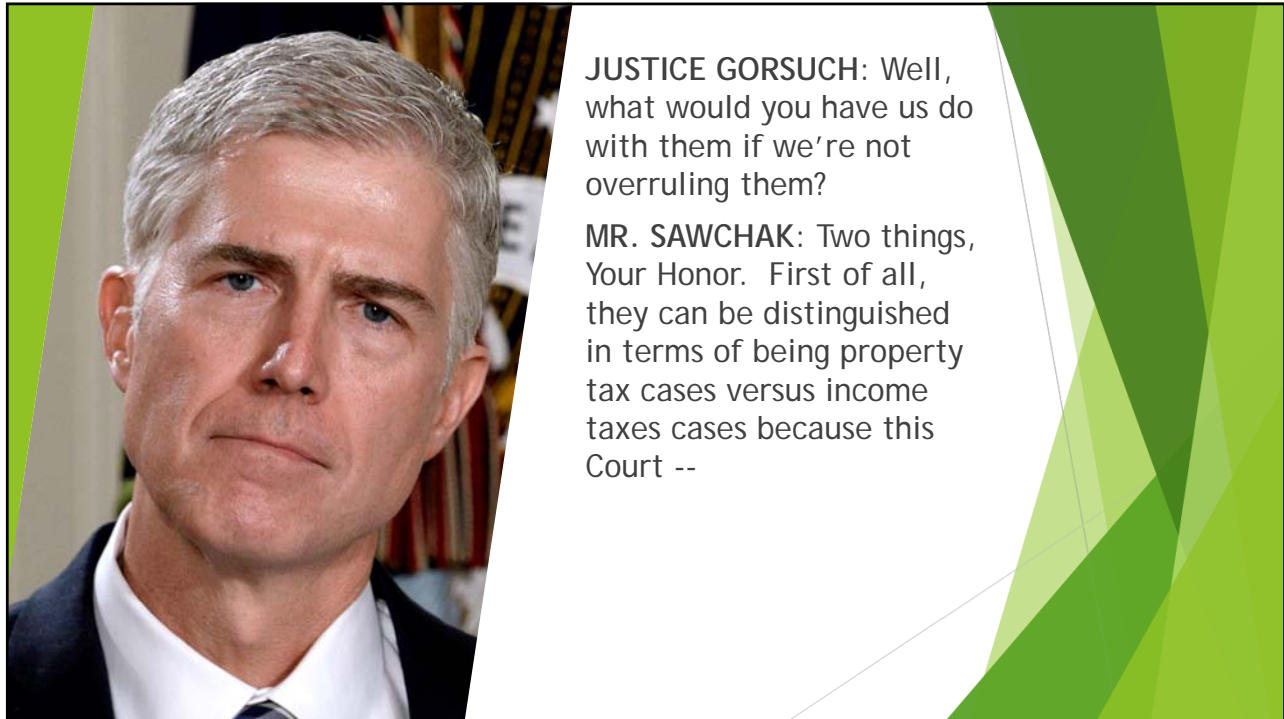
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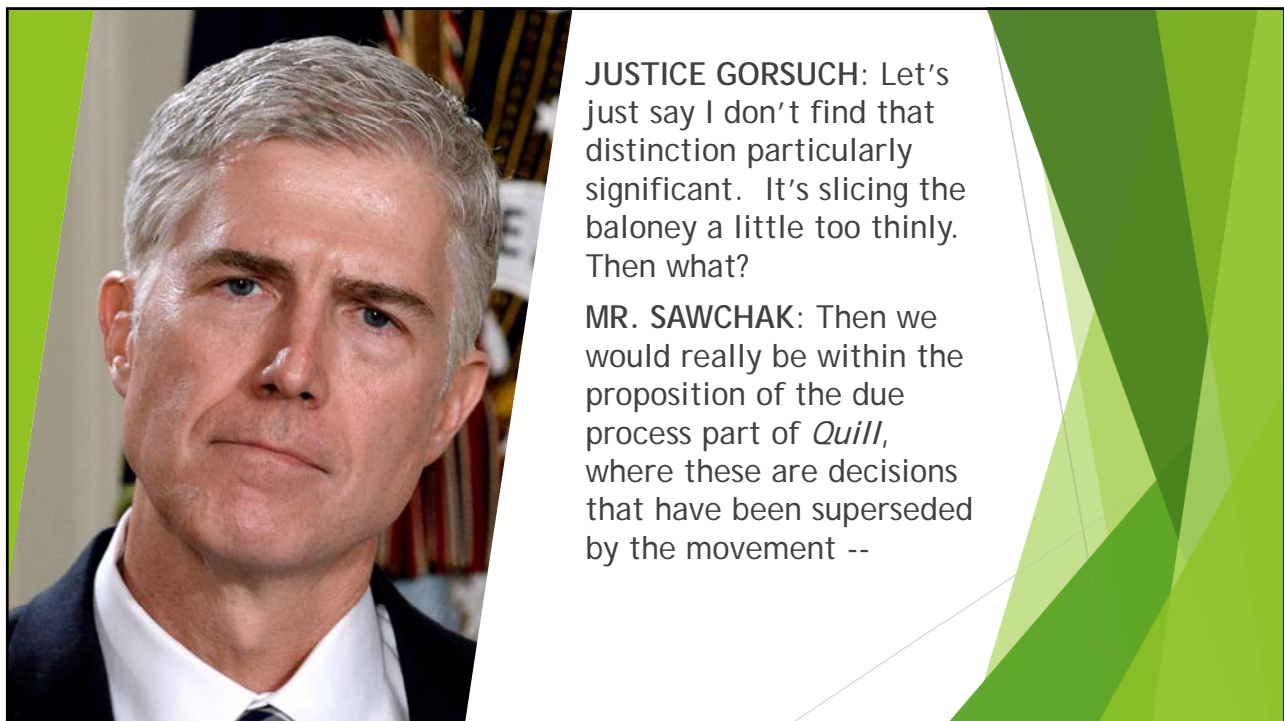
JUSTICE GORSUCH: And counsel, along those lines, if I'm - if I'm understanding your position correctly, because you think that the rule is inequitable, you'd have us overrule *Safe Deposit* and *Brooke*, two decisions of this Court that suggest that that's the correct rule, is that right?

MR. SAWCHAK: Not overrule them, Your Honor. They could be --

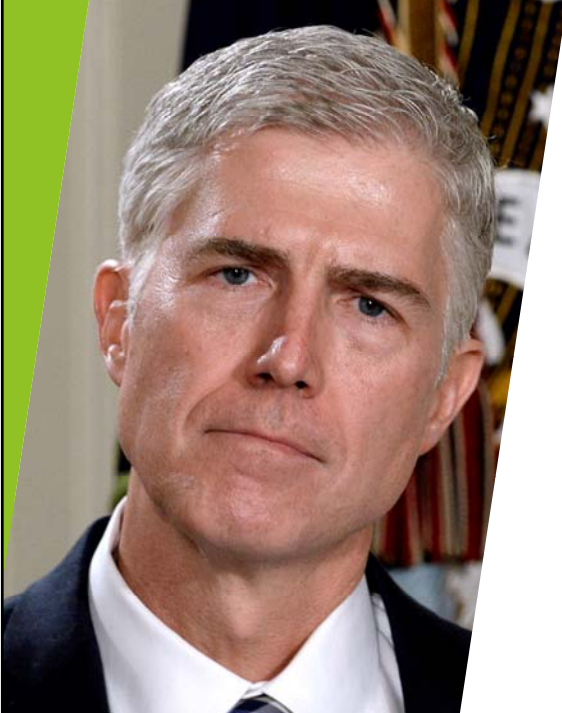
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JUSTICE GORSUCH: Right. You're asking us to overrule them. I mean, it's a polite of saying overrule isn't it?

MR. SAWCHAK: They've probably, frankly, already been laid aside by other - by the due process decisions, as this Court's noted in...


JUSTICE GORSUCH: But that's a - that's a *really* nice way of saying overrule them.

21

This was really not the beneficiary's money during the tax years. She didn't possess it or control it. She didn't access it. She couldn't use it. She couldn't buy anything with it, promise it to someone else. She couldn't have any say in how it was invested. She didn't receive any of it, and she had no guarantee that she would ever receive a penny of it in North Carolina or anywhere else.



22



JUSTICE KAGAN: Mr. O'Neil, do you think that New York can tax this income?

MR. O'NEIL: For periods of time in which the trust was administered in New York, yes, New York, could tax the income.


JUSTICE KAGAN: So the state of administration can tax the income?

MR. O'NEIL: Yes, Justice Kagan.

JUSTICE KAGAN: And the state of the trustee can tax the income?

MR. O'NEIL: That's correct.

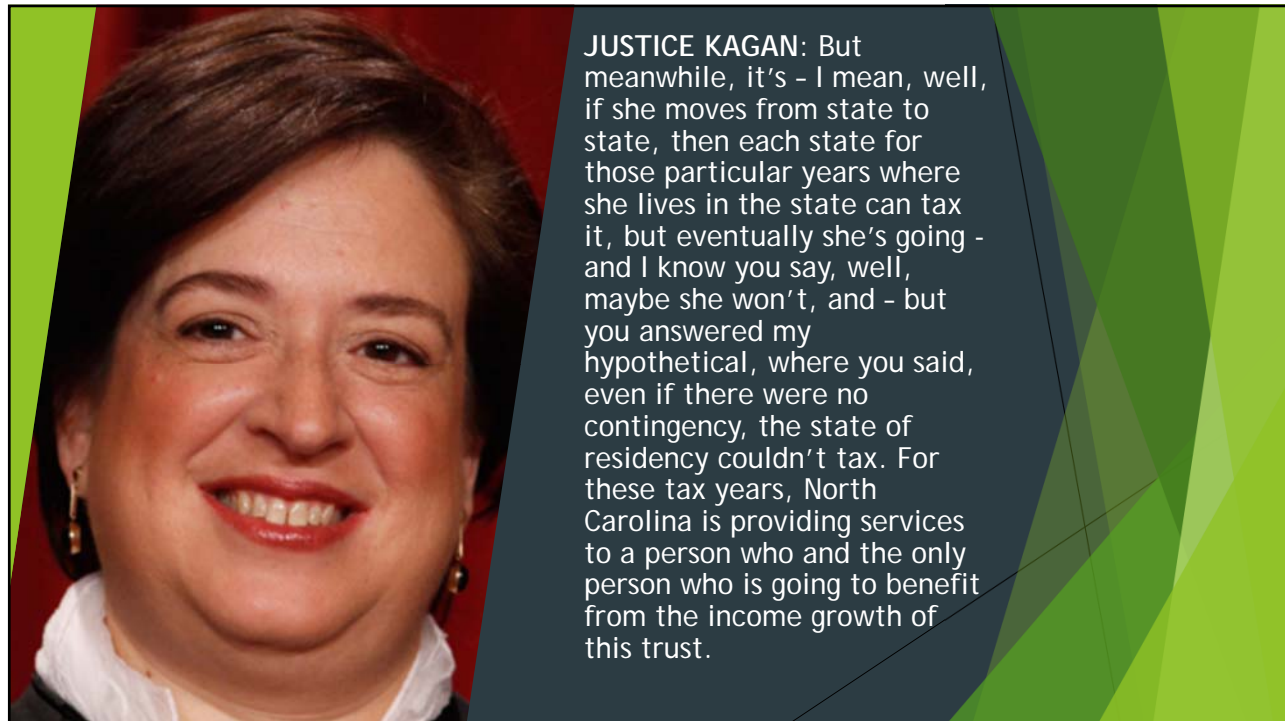
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JUSTICE KAGAN: And the only state that can't tax the income is the state that is providing services to the person who's going to benefit from the income growth?

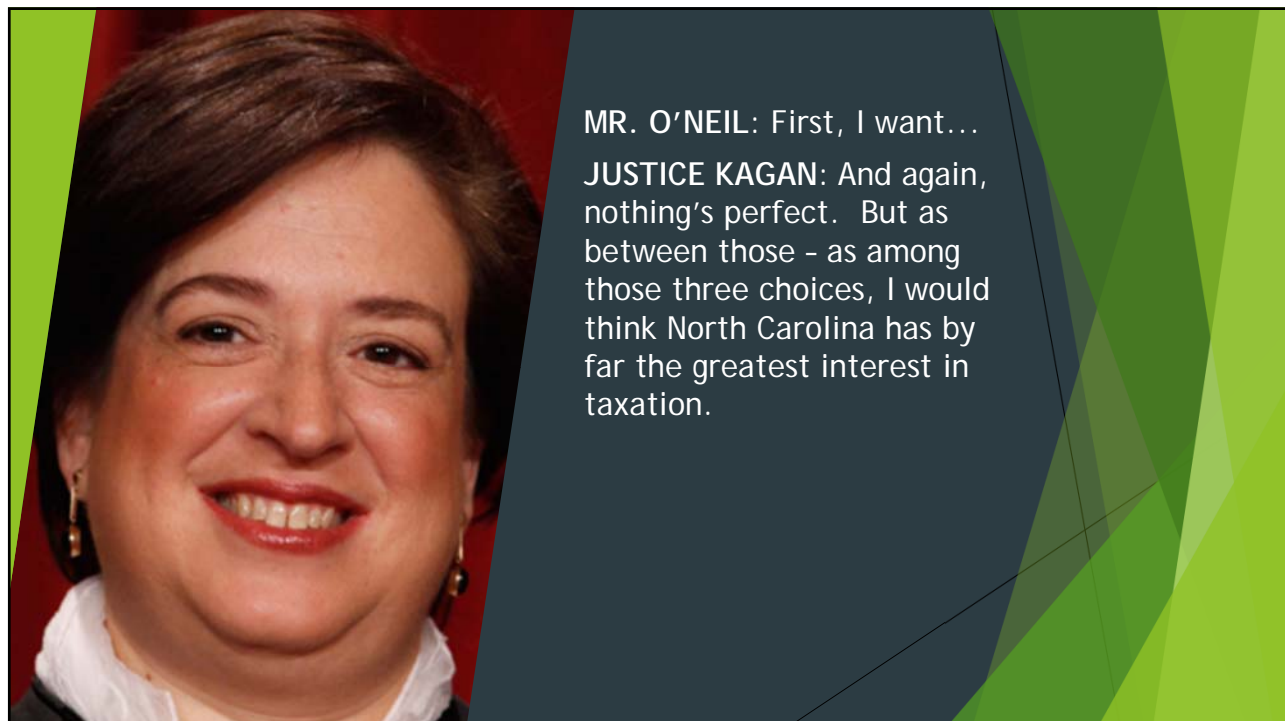
MR. O'NEIL: The state where the beneficiary resides is really no differently situated from any other state. The fact that the beneficiary lives there is just - it's advantageous from the perspective of the trustee. The beneficiary can move from state to state during each of these years and nothing about the trust administration would change.

24



JUSTICE KAGAN: But meanwhile, it's - I mean, well, if she moves from state to state, then each state for those particular years where she lives in the state can tax it, but eventually she's going - and I know you say, well, maybe she won't, and - but you answered my hypothetical, where you said, even if there were no contingency, the state of residency couldn't tax. For these tax years, North Carolina is providing services to a person who and the only person who is going to benefit from the income growth of this trust.

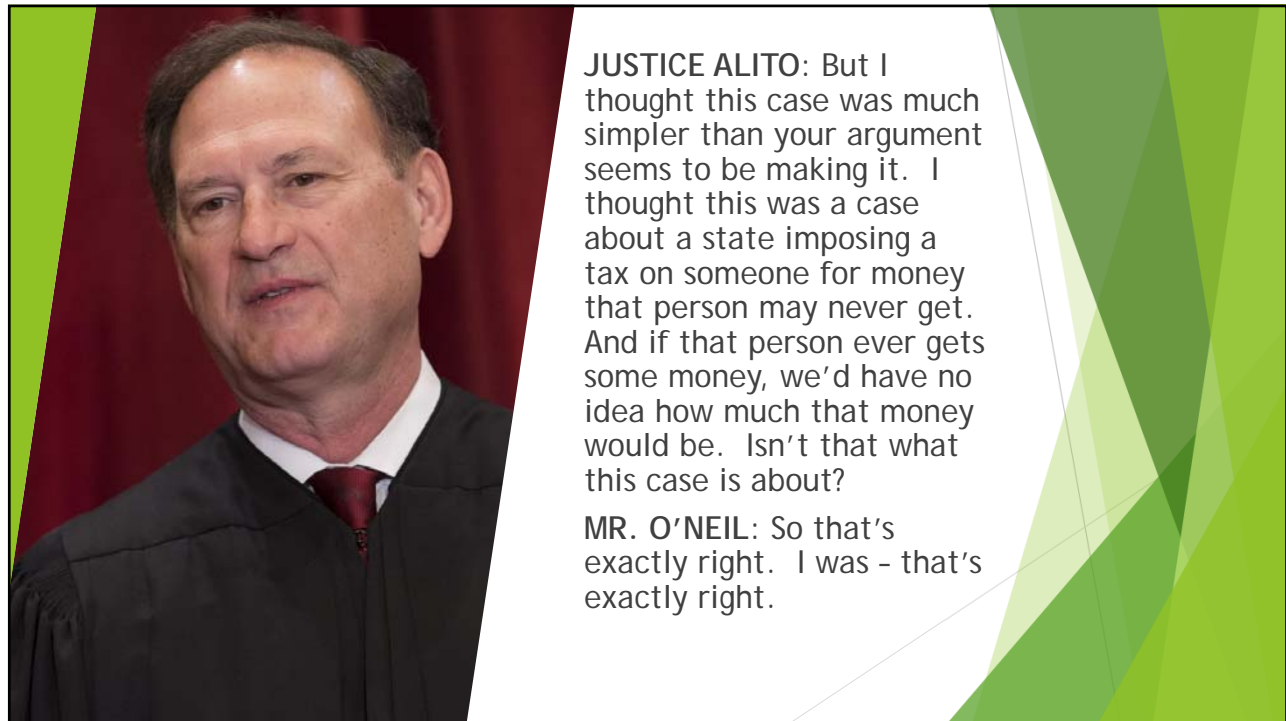
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MR. O'NEIL: First, I want...

JUSTICE KAGAN: And again, nothing's perfect. But as between those - as among those three choices, I would think North Carolina has by far the greatest interest in taxation.

26



27



28