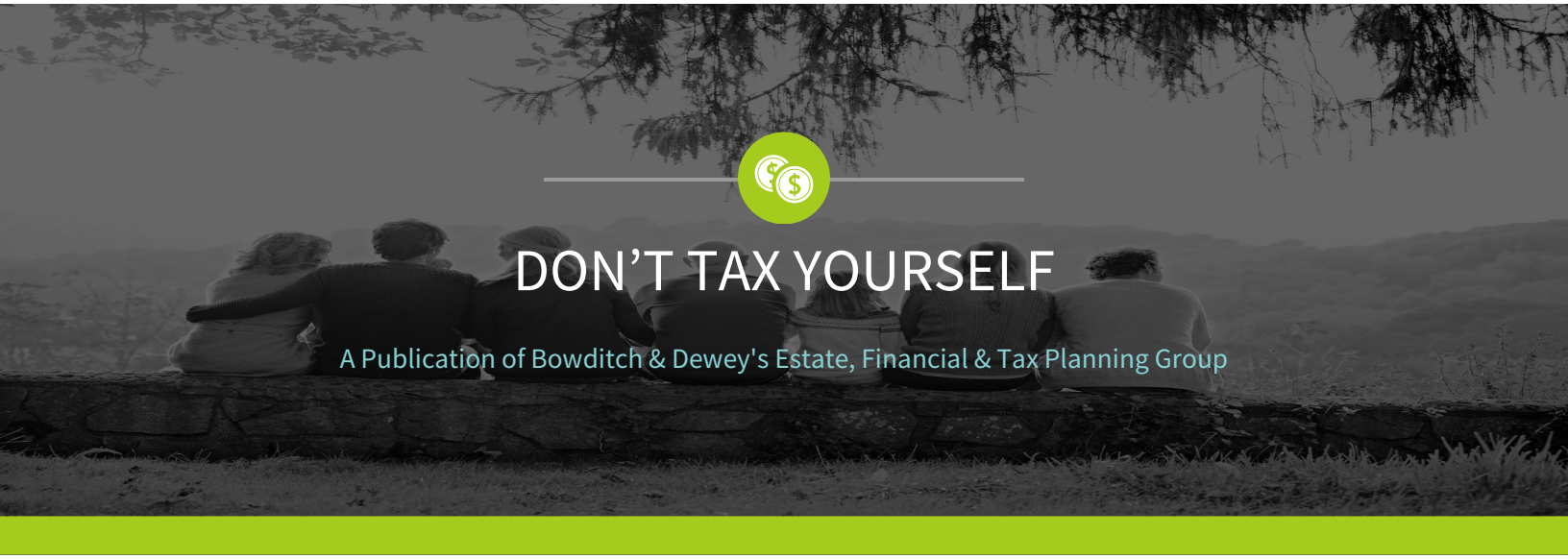

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U.S. Supreme Court Limits the Ability of States to Tax Out-of-State Trusts

BY ANTHONY J. DRAGGA • DECEMBER 19, 2019

Recently, the United States Supreme Court held that the state of North Carolina did not have the power to tax trust income based solely on the fact that a trust beneficiary lived in North Carolina. See N. Carolina Dep't of Revenue v. The Kimberley Rice Kaestner 1992 Family Tr., 139 S. Ct. 2213 (2019).

Joseph Rice III, a New York resident, set up a trust under New York law for his three children, giving the trustee "absolute discretion" to distribute the trust's assets to the beneficiaries. Rice's daughter, Kimberley, moved to North Carolina after the trust was created. Under North Carolina law, the state is permitted to tax any trust income that "is for the benefit of" a state resident.

From 2005-2008, North Carolina imposed a $1,300,000 tax liability on the subtrust created for Kimberley. During this time, no distributions of income were made to Kimberley or her children, and she had no right to demand distributions of trust income. Additionally, Kimberley's North Carolina residency was the trust's only connection to the state, and she had no control, possession or ability to use or enjoy the trust assets.

The trustee sued the North Carolina Department of Revenue, arguing North Carolina's law violated the Due Process Clause of the 14th Amendment. The state court agreed with the trust, holding that in-state residence of a beneficiary was too tenuous a link for the state to impose an income tax on the trust.

The U.S. Supreme Court upheld the lower court's decision, holding that "[t]he 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 to receive it."

In prior decisions, the U.S. Supreme Court has already upheld state taxation on out-of-state trust income in the following circumstances: (1) where the trust income is actually distributed to an in-state resident [see *Maguire v. Trefry*, 253 U.S. 12, 16–17 (1920)], (2) where the trustee is a resident of the state [see *Greenough v. Tax Assessors of Newport*,

331 U.S. 486, 498 (1947)], and (3) where the site of trust administration is based in the state [see *Hanson v. Denckla*, 357 U.S. 235, 251 (1958) and *Curry v. McCanless*, 307 U.S. 357, 370 (1939)].

In *Kaestner*, if distributions of trust income were made to Kimberley, they certainly would have been subject to income tax. *Kaestner* is a narrow but important decision for those few states which impose taxation based solely on the in-state residence of a trust beneficiary. The decision is a relief to settlors worried about potential, unexpected income tax exposure which, in effect, reduces the amount of wealth they can pass to future generations.