

A Review of the Landscape of State Income Taxation of Non-Grantor Trusts

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Introduction



What Kind of Trusts are There?

- Two General Categories of Trusts
 - Grantor
 - Non-Grantor
- Grantor Trusts
 - Not a separate taxpayer
 - All tax attributes allocated to grantor
- Non-Grantor Trusts
 - Separate taxpayer
 - 2 varieties
 - Complex (discretionary distributions)
 - Simple (mandatory income distributions)



Taxation of Non-Grantor Trusts

- Quasi Pass-Through Entities

- Non-grantor trusts are separate taxpayers.
- Taxed, generally, under the tax rules applicable to individuals.
- To the extent that net income is distributed to a beneficiary, the trust is treated as a pass-through entity.
 - The distributed net income is taxed to the beneficiary (the trust receives a deduction).
 - The trust issues a schedule K-1 to the beneficiary.
- Undistributed income is the trust's taxable income.
 - For Federal and State income tax purposes.

Net Accounting Income and Taxable Income - Example

- Trust receives the following items during the calendar year:
 - Interest income \$500
 - Dividend income \$1,500
 - Distribution from partnership \$2,500
 - Proceeds from sale of stock \$5,000
- Trust makes the following disbursements during the calendar year:
 - Trustee fee \$750
 - Property tax payment \$1,250



Net Accounting Income and Taxable Income - Example

Item	Trust Accounting Income	Trust Principal	Taxable Income
Interest	500	- 0 -	500
Dividend	1,500	- 0 -	1,500
Partnership Distribution	2,500	- 0 -	6,000
Stock Sale	- 0 -	4,000	4,000
Trustee Fee	(375)	(375)	(750)
Property Taxes	<u>- 0 -</u>	<u>(1,250)</u>	<u>(1,250)</u>
Total	\$4,125	\$2,375	\$10,000



Net Accounting Income and Taxable Income - Example

- Scenario 1:
 - Trust makes no distributions
 - Taxable income = \$10,000
- Scenario 2:
 - Trust distributes all trust accounting income to beneficiary
 - Resulting taxable income of trust:
 - \$10,000 less DNI deduction of \$4,125 = \$5,875
- In either scenario, trust's taxable income is subject to federal income tax at applicable rate(s).



What Do I Need to Know About the State Taxation of Trusts?

- The states have not adopted uniform rules. This lack of uniformity can lead to multiple taxation and unintended consequences.
- States apply a combination of individual income tax principles and corporate tax principles to trusts.
- There are significant constitutional limitations on the ability of a state to tax a trust.
 - Based on “nexus” – connection between the taxpayer (the trust) and the state seeking to impose the tax.
 - Nexus is easily determined for individuals – based on physical location. For corporations/entities, the determination of nexus can be more challenging (based on location, physical presence and activities in the state).
 - For trust’s, the determination is even more difficult.



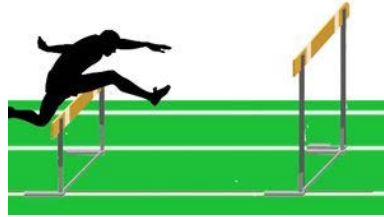
Constitutional Analysis

Under *Quill*, Due Process requires: (1) “some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax;” and (2) “that the income attributed to the State for tax purposes ... be rationally related to the values connected with the taxing State.” (Akin to “notice’ or ‘fair warning.’” Personal jurisdiction and subject matter jurisdiction.)

Under *Quill*, the Commerce Clause requires: “The first and fourth prongs, which require a **substantial nexus** and a relationship between the tax and State provided services, limit the reach of State taxing authority so as to ensure that State taxation does not unduly burden interstate commerce.” *Quill* citing *Complete Auto* test.



Due Process / Commerce Clause



Due Process	Commerce Clause
<u>Minimum Connection / Rationally Related</u>	<u>Substantial Nexus / Fairly Apportioned & Fairly Related</u>
<i>Combined</i> bases (nexus) for taxation	Nature of fiduciary obligations
Ascertainable Standards?	Nature of beneficial interests
Partial Distributions? Interrupted Patterns of Distributions?	“Counting heads” CA R&TC §§ 17742 – 17745; 17 NCAC 6B.3724(b)

Wayfair (2018)

Wayfair holds that *Quill*'s outdated requirement that **physical presence** of a vendor in a state is no longer absolutely necessary to meet the first prong of the *Quill*, Due Process requirement: (1) “some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax;”

Wayfair left *Quill*'s and *Complete Auto*'s, the Commerce Clause requirements untouched (**substantial nexus**).

August 22, 2018. *Kaestner* continued. US Supreme Court Docket 18A210. “Justice Sam J. Ervin, IV, dissented. Criticizing the majority’s understanding of *Quill* as overly rigid, Justice Ervin concluded that “**the presence of the beneficiaries** of the *Kaestner* Trust in North Carolina has some bearing on the proper performance of the required due process analysis.”



Wayfair (2018)

There is an important distinction between the Wayfair furniture company and all trustees, including trust companies.

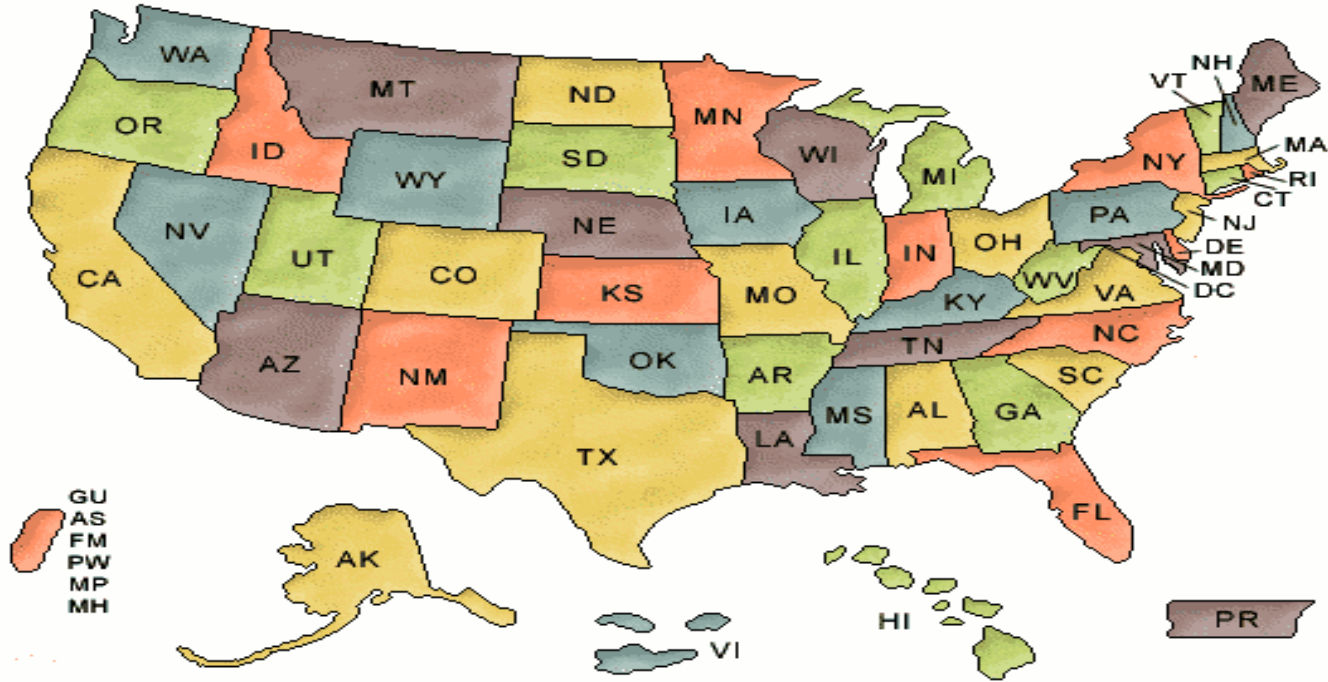
Legal ownership of property by a fiduciary for a person's benefit fundamentally is not the same as purposefully directing a product to an online customer.

Often, as in *Kaestner*, after the grantor and the trustee make their contract (i.e., the original trust agreement), the trustee has no control over where the beneficiary may move, and a trustee's legal title to the trust property is not akin to commercial activity.

Where is My Trust a “Resident Trust?”

- State statutes refer to “resident” trust for purposes of imposing income tax.
- Do you know where your trust is considered a “resident” trust for state tax purposes?
 - A trust is not an entity, therefore, residency is more difficult to determine.
 - The states have adopted different rules to impose tax on a trust – the relevant factors are: residency of grantor; residency of beneficiary; residency of trustee; and, situs of trust administration.
- Why is this important?
 - A fiduciary has an obligation to pay tax in states where the tax is due.
 - A fiduciary has a duty to pay tax only in states where tax is due.
 - Corollary: A fiduciary should not remit taxes (trust property) when not owed.

State of Taxation Trusts - Overview



Breakdown of State Taxation of Trusts

- States treating trust as Resident Trust on basis of residence of grantor:
 - AL, AR, CT, DE, DC, IL, LA, ME, MD, MA, MI, MN, MO, NE, NJ, NY, OH, OK, PA, RI, UT, VT, VA, WV & WI
- States treating trust as Resident Trust on basis of residence of trustee or trust administration:
 - AZ, CA, CO, DE, HI, IN, IA, KS, KY, LA, MD, MA, MN, MS, NM, OR, SC, UT & WI
- States treating trust as Resident Trust on basis of residence of beneficiary:
 - AL, CA, CT, DC, DE, GA, MO, NC, OH, RI
- States that do not impose income tax on trusts:
 - AK, FL, NV, NH, SD, TN (as of 1/1/2021), TX, WA & WY
- States that use a multi factor analysis:
 - ID, MT, ND



Breakdown of State Taxation of Trusts

- Residence of Grantor

- Virginia – VA Code Section 58.1-302 defines a resident trust as a trust

- Created by Will of a decedent who at death was domiciled in the Commonwealth;
 - Created by a person domiciled in the Commonwealth.

But See VA Ruling 93-189, conceding that a trust with no resident trustee or beneficiary domiciled in the Commonwealth and having no property located in the Commonwealth does not have sufficient nexus to justify taxation. The ruling does state that “under Virginia law the Trust is a Virginia resident trust. . . . Should either a beneficiary, trustee or the Trust property become domiciled or located in Virginia, sufficient nexus may then exist to permit taxation of the Trust by the Commonwealth.”

- West Virginia – WV Code Section 11-21-7(c) defines a resident trust as a trust

- Created by Will of a decedent who at death was domiciled in the State;
 - Created by a person domiciled in the State.



Southeast Region – State Basis of Trust Taxation

- Residence of Beneficiary
 - North Carolina – N.C.G.S. 105-160.2
 - Tax is computed on the amount of the taxable income of the trust that is
 - for the benefit of a resident of the State
 - Is derived from sources or business carried on in the State
 - Georgia – O.C.G.A. 48-7-22
 - Tax is imposed on trust
 - Receiving income from business done in State;
 - Managing funds or property located in State;
 - Managing funds or property for benefit of residents in State.



Southeast Region – State Basis of Trust Taxation

- Principal Place of Administration
 - South Carolina – SC Code Section 12-6-30(5) defines a resident trust as a trust “administered in this State.”
- No state income taxation - Florida



Nexus – State Taxation of Trusts Based on Residency of Grantor

- *Blue v. Department of Treasury (1990)*
 - Fact that grantor of testamentary trust domiciled in Michigan not sufficient under due process clause.
- *District of Columbia v. Chase Manhattan Bank (1997)*
 - Fact that grantor of testamentary trust domiciled in District of Columbia sufficient under due process clause.
- *Chase Manhattan Bank v. Gavin (1999)*
 - Fact that grantor of testamentary trusts domiciled in Connecticut sufficient under due process clause and commerce clause.
- *Residuary Trust A v. Director (Kassner) (2013)*
 - Fact that grantor of testamentary trust domiciled in New Jersey not sufficient under due process clause (2013; aff'd, 2015).
- *Linn v. Department of Revenue (2013-2014)*
 - Fact that grantor of inter vivos trust domiciled in Illinois not sufficient under due process clause.



Nexus – State Taxation of Trusts Based on Residency of Grantor (Continued)

- *Fielding v. Commissioner of Revenue (MN)(2018, cert. denied 2019)*
 - Fact that grantor of inter vivos trust domiciled in Minnesota when trusts were created and ceased to be classified as grantor trusts not sufficient under due process clause.
 - The trusts argued that the Court should evaluate the single factor of the Minnesota statute defining a trust as a “resident” trust in its determination. The Commissioner advocated for an analysis of all contacts between the trust in the State in the evaluation. The Court considered all factors, including those beyond the residency statute.
 - The Court clarified that it was not redefining the statute, but evaluating all relevant facts when considering the application of the statutory definition to the due process clause analysis.



Nexus – State Taxation of Trusts Based on Residency of Grantor (Continued)

- *Fielding v. Commissioner of Revenue (MN) (2018) (continued)*
 - The Court concluded that the “contacts on which the Commissioner relies are either irrelevant or too attenuated to establish that Minnesota’s tax on the Trusts’ income from all sources complies with due process requirements.”
 - The trusts’ connections with the State were:
 - Grantor was resident when trusts were created and became separate taxpayers.
 - Court found that the Grantor’s connections with the State were irrelevant, as the Grantor does not represent the trusts and stating that the “relevant connections are Minnesota’s connections to the trustee, not the connection to the grantor.”
 - The trusts owned stock in a Minnesota corporation.
 - Because stock in a corporation is an intangible, it does not constitute property physically located in the State. “These intangible assets were held outside of Minnesota, and thus do not serve as a relevant or legally significant connection with the State.”
 - One beneficiary resided in Minnesota.



Nexus – State Taxation of Trusts Based on Residency of Beneficiary

- *Chase Manhattan Bank v. Gavin* (1999)
 - Fact that beneficiary of inter vivos trust domiciled in Connecticut sufficient under due process clause and commerce clause.
- *Safe Deposit v. Virginia*
 - Taxation of non-resident trustee unconstitutional, despite resident beneficiaries.



Nexus – State Taxation of Trusts Based on Residency of Beneficiary

- *North Carolina Department of Revenue v. Kimberley Rice Kaestner Trust*

- **Case History:**

- Case brought by taxpayer (trust) on claim for refund for taxes paid based on trust's classification as a resident trust in North Carolina, which classifies a trust as "resident" if trust beneficiary is resident of the State.
 - N.C.G.S. Section 105-160.2
- Taxpayer challenged constitutionality of the North Carolina statute.
- Business Court found in favor of the taxpayer on grounds that North Carolina statute was unconstitutional as applied to the taxpayer.
 - Court concluded the Statute violated both the due process and commerce clauses of the U.S. Constitution.
- State/Department of Revenue filed an appeal of the Business Court decision.
 - Appeal of right in North Carolina



Nexus – State Taxation of Trusts Based on Residency of Beneficiary

- *North Carolina Department of Revenue v. Kimberley Rice Kaestner Trust*

- **Case History:**

- North Carolina Court of Appeals upheld the Business Court decision in favor of the Taxpayer.
- The State filed an appeal with the North Carolina Supreme Court.
- North Carolina Supreme Court upholds decision of State Court of Appeals.
 - The State Supreme Court reiterated that its decision was based solely on the facts of the Case and the presumption that “any act passed by the legislature is constitutional” and “any individual challenging the facial constitutionality of a legislative act must establish that no set of circumstances exists under which the [a]ct would be valid.” (emphasis added).
- The State file a writ with the U.S. Supreme Court appealing the decision.
 - On January 11, 2019, the U.S. Supreme Court granted the Writ and oral arguments were heard on April 16, 2019.

Nexus – State Taxation of Trusts Based on Residency of Beneficiary

- *North Carolina Department of Revenue v. Kimberley Rice Kaestner Trust*
 - **The Decision:**
 - The U.S. Supreme Court, in a unanimous opinions, upholds the decision of the North Carolina Supreme Court.
 - Holding that the North Carolina statute, “as applied in these circumstances,” violates the due process clause of the U.S. Constitution.
 - The Court found that “the presence of in-state beneficiaries alone does not empower a State to tax trust income that has not been distributed to the beneficiaries.”
 - The Court limited its holding “to the specific facts presented,” stating that in reaching its decision it does “not imply approval or disapproval of trust taxes that are premised on the residence of beneficiaries whose relationship to trust assets differs from that of the beneficiaries here.”

Nexus – State Taxation of Trusts Based on Residency of Beneficiary

- *North Carolina Department of Revenue v. Kimberley Rice Kaestner Trust*
 - **The Decision** (continued):
 - The Court focused on the following facts in rendering its decision:
 - The trustee of the trust has “‘absolute discretion’ to distribute the trust’s assets to the beneficiaries “in such amounts and proportions” as the trustee might “from time to time” decide.”
 - The trustee’s contacts with the trust beneficiary were infrequent
 - The trust is subject to New York law and keeps the trust records in New York and the trust’s assets are held in a custody account in Massachusetts.
 - The trust maintained no physical presence or investments in North Carolina.
 - The Court analyzed the due process clause requirements for taxation, which requires a “fiscal relation to protection, opportunities and benefits given by” the taxing state.
 - The threshold question being: “Whether the state has given anything for which it can ask return.”

Nexus – State Taxation of Trusts Based on Residency of Beneficiary

- *North Carolina Department of Revenue v. Kimberley Rice Kaestner Trust*
 - **The Decision** (continued):
 - The Court concluded that the “residence of the Kaestner Trust beneficiaries in North Carolina alone does not supply the minimum connection necessary to sustain the State’s tax.” The Court pointed to the following facts:
 - The beneficiaries did not receive any income/distributions from the trust.
 - The beneficiaries had no right to demand income from the trust or otherwise control, possess or enjoy the trust property.
 - The beneficiaries had no expectation of receiving a distribution of any specific amount from the trust in any future year.

Nexus – State Taxation of Trusts Based on Residency of Beneficiary

- *North Carolina Department of Revenue v. Kimberley Rice Kaestner Trust*
 - **The Decision** (continued):
 - The Court’s focus on these specific facts, along with footnotes 8 and 9, leave open the door that taxation based on the residence of a trust beneficiary may not violate the due process clause.
 - Footnote 8: “[W]e hold that the Kaestner Trust beneficiaries do not have the requisite relationship with the Trust property to justify the State’s tax. We do not conclude what degree of possession, control or enjoyment would be sufficient to support taxation.”
 - Footnote 9: “We do not address whether a beneficiary’s ability to assign a potential interest in income from a trust would afford that beneficiary sufficient control or possession over, or enjoyment of, the property to justify taxation based solely on his or her in-state residence.”

Nexus – Fiduciary Residence and Administration

- Based on recent cases, it would seem that situs of trust administration or residence of trustee should be respected as establishing sufficient nexus for state taxation of a trust.
 - But, what constitutes administration?
 - What if there are multiple trustees?
 - What if there are multiple fiduciaries – for example, in a directed trust.

Nexus – Fiduciary Residence and Administration

- Some state statutes provide guidance as to what constitutes situs/administration:
 - **Iowa** provides that situs is determined based on relevant facts, such as: (a) residence of the trustees or a majority of them; (b) the location of the principal office where the trust is administered; and (c) the location of the evidence of the intangible assets of the trust (such as stocks, bonds, bank accounts, etc.).
 - **Montana** guidance states that a trust's principal place of administration is where the usual day to day activities of the trust are carried on. If it cannot be determined where the day to day activities are carried on, then it is determined as follows: a) if the trust has a single trustee, the principal place of administration of the trust is the trustee's residence or usual place of business; or (b) if the trust has more than one trustee, the principal place of administration of the trust is the residence or usual place of business of any of the co-trustees as agreed upon by them.



Nexus – Fiduciary Residence and Administration

- Some state statutes provide guidance as to how to handle multiple trustees in determining if the trustee is resident in the state:
 - **Arizona** provides that if at least one fiduciary is a resident of the state the trust is a resident trust. However, if the sole fiduciary is a corporate entity, then the trust is classified as resident only if administration occurs in Arizona.
 - In **Hawaii**, if the sole fiduciary, or all fiduciaries if more than one, is/are resident of Hawaii, the trust is a resident trust, regardless of where administration takes place. If the trust is not administered in Hawaii, but ½ or more of the trust fiduciaries are resident, then the trust is a resident trust.
 - **New Mexico** defines a trustee is resident of the state if the trustee is domiciled in the state or is an individual who is physically present in the state for more than 185 days during the taxable year.



Compliance Considerations

Whether / How to File? Options.

- File showing all income (or \$0)
- File with apportionment argument
- File and claim refund
- Take principled position not to file

Post-Deprivation Remedies (Statutes of Limitation)

- The general rule is that **a statute, when declared unconstitutional, is as inoperative as if it had never been passed and never existed, and thus is void *ab initio*.** 16A Am. Jur. 2D Constitutional Law § 195
- “And in the future, States may avail themselves of a variety of procedural protections against any disruptive effects of a tax scheme’s invalidation, such as providing by statute that refunds will be available to only those taxpayers paying under protest, or **enforcing relatively short statutes of limitation applicable to refund actions**.... Such procedural measures would sufficiently protect States’ fiscal security when weighed against their obligation to provide meaningful relief for their unconstitutional taxation.” *McKesson Corp. v. Division of Alcoholic Beverages and Tobacco, Dept. of Business*, 496 U.S. 18, 50, 110 S.Ct. 2238, 2257 (June 4, 1990). See also *Reich v. Collins*, 513 U.S. 106, 115 S.Ct. 547 (Dec. 6, 1994) (holding that Georgia must honor a refund statute as its post-deprivation remedy).

Other State Income Tax Considerations

- Multi State Taxation

- Grantor, resident of Virginia, creates an irrevocable non-grantor trust (the “Trust”) for the benefit of grantor’s child and child’s descendants, all of whom are residents of North Carolina.
- Grantor appoints close family friend, who is a resident of South Carolina, as Trustee.
- Trust is funded with cash and marketable securities, which generate approximately \$100,000 of taxable interest and dividend income, annually, and the Trust has nominal deductible expenses of \$5,000.
- The Trust provides for discretionary distributions of income to the beneficiaries, and the Trustee has not made any distributions in the past 3 years.

Other State Income Tax Considerations

- Multi State Taxation
 - Where is Trust considered a resident Trust?

Answer

- North Carolina
- South Carolina
- Virginia

Trust will pay aggregate state income taxes in excess of 18%!!

Other State Income Tax Considerations

- Trusts Crossing State Lines

- A trust or estate is taxed on business income earned in a state, whether or not the trust or estate is a resident of the state
- This rule applies whether the business income is earned directly or through a partnership or S corporation
- The ownership interest itself, whether stock or a partnership interest, has a situs, for state income tax purposes, in the state in which the trust or estate resides

Other State Income Tax Considerations

- Trusts Crossing State Lines - Example
 - A holds 100% of S corporation, with zero basis
 - S corporation holds land with zero basis and \$1 million value
 - A dies, stepping up basis in stock to \$1 million but not changing the land's basis
 - Stock is transferred to trust for benefit of A's descendants.
 - Corporation sells land for \$1 million
 - Trust reports \$1 million gain on K-1 from S corporation
 - Basis in Trust's stock increases to \$2 million -
 - (\$1 million new basis at death plus \$1 million K-1 income)

Other State Income Tax Considerations

- Trusts Crossing State Lines - Example
 - Corporation liquidates, distributing \$1 million cash to Trust
 - Trust has \$1 million loss on liquidation -
 - (\$1 million proceeds minus \$2 million basis)
 - For federal income tax purposes, \$1 million capital loss on liquidation offsets \$1 million capital gain on K-1
 - Suppose Trust is treated as a resident trust in North Carolina, and land is in South Carolina
 - Sale of real property is South Carolina income
 - Loss on liquidation is North Carolina loss
 - South Carolina does not allow offset, because Trust is nonresident
 - Could action be taken to change state of residence of Trust to South Carolina to reduce overall tax liability?

Additional Considerations

Should Facts Be Changed? Consider Tax Year

- *Linn*: Analysis applied tax year by tax year. See also *Kaestner* (NY→NC→CA)
- *Swift*: More than two bases of taxation required for constitutionality?

Income from Tangible or Intangible Assets?

- *Fielding*: Distinction between (source) *income* from resident S Corporation (MN) vs. *capital gains* from sale of corporate stock, an intangible asset (TX).

Rates

- Credits for taxes paid to other states sometimes are available for Resident Trusts; usually are not available concerning source income of Non-resident Trusts. Consider reciprocity and statutory design.

Four Updates

1. Four Legislative Efforts
2. Instructions to Form D407
3. Discussions with Trust Company Executives
4. Audit and Reporting Experience



Four Legislative Efforts

1. **2015 S.B. 468:** Cleared Judiciary Committee, was delayed pending *Kaestner*. Residence of trust based on BOTH (1) presence of North Carolina beneficiary, AND (2) Principal Place of Administration in NC.
2. **3/9/2020** Draft Proposal from NCDOR. Residence based on BOTH (1) presence of North Carolina beneficiary, where (2) ANY of six additional conditions exist (three *Kaestner* conditions, trustee, PPA, grantor holding “any power”).
3. **5/21/2021** Working draft of Bankers’ Association proposal. Residence based on BOTH (1) presence of North Carolina beneficiary, AND (2) if both (a) majority of Investment decisions AND (b) majority of distribution decisions occur in-state.
4. Approx. **3/1/2022** NCDOR formal *Request for Legislative Changes*. Taxing the accumulated income of all trusts “administered in this state.”



2015 Senate Bill 468

- (b) The tax is computed on the amount of the taxable income of an estate or trust as follows:
- (1) On a nonresident estate or nonresident trust, but only to the extent that the income:
 - (i) is derived from North Carolina sources and is attributable to the ownership of any interest in real or tangible personal property in this State or
 - (ii) is derived from a business, trade, profession, or occupation carried on in this State;
 - (2) On a resident estate;
 - (3) On a **resident trust** that is for the benefit of a **resident current beneficiary**....
- (e) The following definitions apply in this section:
- (5) Resident trust.- A trust which has its **principal place of administration in North Carolina**, as defined in G.S. 36-1-103(13a).



NCDOR Proposal 3/9/2020

(d) Trusts. - The taxable income of a trust includes taxable income that is for the benefit of a resident of this State where any of the following conditions exist:

- (1) The resident of this State received income or other benefit from the trust.
- (2) The resident of this State had a right to demand income or other benefit from the trust.
- (3) The resident of this State is certain to receive income or other benefit from the trust.
- (4) The trustee is a resident of this State.
- (5) The trust is administered in this State.
- (6) The grantor of the trust is a resident of this State and either (i) holds any power over trust assets or trust administration or (ii) receives any benefit from the trust.



NC Bankers' Association Working Draft 5/21/2021

(b) The tax is computed on the amount of the taxable income of an estate or trust as follows:

- (3) On a resident trust that is for the benefit of a resident current beneficiary....
- (5) Resident trust. – A trust is a resident trust only if both conditions are met:
 - (i) a majority of the discretionary decisions of the trustees relative to the **investment** of trust assets are made in North Carolina; and
 - (ii) a majority of the discretionary decisions of the trustees relative to the **distributions** of trust income and principal are made in North Carolina;

NCDOR 2022 Request for Legislative Changes 3/1/22

§ 105-160.1. Definitions.

(b) "Resident trust" is defined as:

- (i) A trust, or a portion of a trust, consisting of property transferred by will of a decedent who at his or her death was domiciled in this state; or
- (ii) a trust administered in this state.

§ 105-160.2. Imposition of tax.

(a) The taxable income of a resident estate or a resident trust is the same as taxable income for such an estate or trust under the provisions of the Code....

NCDOR 2022 Request for Legislative Changes 3/1/22

“Reason for Study

[W]hile the Court held that North Carolina’s statute was unconstitutional as applied in the *Kaestner* case, the Court did not fully define the circumstances under which the statute would be constitutional. The Department recommends defining these circumstances statutorily rather than through litigation.”

NC-D407A Instructions (Line 6)

“Important. On June 21, 2019, the United States Supreme Court (“Court”) held that 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.” North Carolina Department of Revenue v. The Kimberley Rice Kaestner 1992 Family Trust (“Kaestner”), 139 S. Ct. 2213, 2221 (2019). By contrast, the Court stated that taxation of trust income based on distributions of trust income to an in-state resident, a trustee’s in-state residence, or in-state trust administration does not violate the Constitution. Id. at 2220. Trusts with connections to the State should carefully analyze those connections to determine if the connections are sufficient for the State to tax the entity’s undistributed taxable income under the Due Process Clause. If Line 5 includes undistributed income for the benefit of a resident beneficiary that meets the facts and circumstances of Kaestner such that the income is not taxable to North Carolina, enter the amount of such income on Line 6.”



Discussion with Top Executive Trust Officers



Range of Audit Experience

1. Refunds issued on fully-disclosed alternative approach to 17 NCAC 6B.3724(b) under Dormant Commerce Clause (per capita approach to income)
2. Wealthy out of state Taxpayers taking position that North Carolina does not have adequate Constitutional authority to tax discretionary trusts with NC beneficiaries; decisions not to file.
3. Mixed results to taxpayer claims that *Kaestner* applies to discretionary trusts in NC.
 1. Multiple audits. Several with much larger stakes than *Kaestner*.
 2. Some refunds issued or reporting positions apparently accepted.
 3. At least one denied reporting position with *excessive* IDR. Taxpayer elected not to fight.



State Taxation of Trusts – The Future

- Where does all of this leave us?
- What should we be looking at in advising our clients (trustees, grantors, beneficiaries)?



Questions or Comments?



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