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Tax Talk with Stephen Yost, Esq., CPA, LLM

To what State do I owe tax on these assets or this income? This question can often be daunting, especially in light of parties whom have multiple residences or entities whose beneficiaries are located in multiple states. Estate plans and trust agreements often contemplate beneficiaries who are residents of multiple states. Complications arise as beneficiaries move from state to state prior to estate settlement or distributions from a trust. This coupled with the governing law of the estate plan or trust agreement as well as the beneficiary's ability to control the underlying assets are all variables to be considered in assessing State tax exposure.

In performing an analysis underlying this state tax question, one should first turn to the classic Supreme Court holding all first-year law students cover in their civil procedure class, International Shoe. A State has the power to impose a tax only when the taxed entity has "certain minimum contacts" with the State such that the tax "does not offend 'traditional notions of fair play and substantial justice'".[1] Only those who derive "benefits ad protection" from associating with a State should have obligations to the State in question.[2] State statutes and regulations must consider the "minimum contacts" standard set forth by the Court. The degree to which those contacts meet the standard set forth by the Court is a question often posed in State tax controversies.

This question was posed to the US Supreme Court in North Carolina Department of Revenue v. The Kimberley Rice Kaestner 1992 Family Trust. This case was decided on June 21, 2019. The question before the Court was whether a North Carolina statute authorizing the State to tax trust income on the sole basis that the trust beneficiaries resided in the State violated the Due Process Clause of the Fourteenth Amendment. The Court held in this case 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 not right to demand that income and are uncertain to receive it.[3] This case presented an interesting and all too common fact pattern. The Trust in question was formed in New York and had beneficiaries who resided in North Carolina. During the

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[1] International Shoe Co. v. The State of Washington, 326 U.S. 316 (1945)
[2] Id, 319
[3] North Carolina Department of Revenue v. The Kimberley Rice Kaesterner 1992 Family Trust, 1239 S.Ct. 2213 (2019)

period in question the beneficiaries had no right nor received any distributions from the Trust. In addition, the Trust had made no direct investments within the State of North Carolina or held any real estate in North Carolina. The Trust Instrument provided that all powers of the Trust resided with the Trustee and would be governed under New York State law by a Trustee resident in New York. Notwithstanding this set of facts, the State of North Carolina assessed tax of more than $1.3 million for the years 2005 through 2008.

The Due Process Clause limits States to imposing only taxes that "bea[r] fiscal relation to protection, opportunities and benefits given by the state."[4] In the trust beneficiary context, the Court's due process analysis of state trust taxes focuses on the extent of the in-state beneficiary's right to control, possess, enjoy or receive trust assets.[5] When a State seeks to base its tax on the in-state residence of a trust beneficiary, the Due Process Clause demands a pragmatic inquiry into what exactly the beneficiary controls or possesses and how that related to the object to the State's tax.[6]

The holding in North Carolina Department of Revenue v. The Kimberly Rice Kaestner 1992 Family Trust made it clear that the Due Process Clause analysis was limited to the facts and circumstances of the case. The holding provides a good foundation to be applied in the design and execution of an estate plan or trust agreement. However, consideration should also be given to nexus of assets, income distributions and control over assets in concluding on whether there is exposure to State tax liability. Trusts or estate plans which contemplate distributions or vest the election to make distributions with the beneficiaries, the law provided for in North Carolina Department of Revenue v. The Kimberly Rice Kaestner 1992 Family Trust is probably not precedent that can be relied upon. Likewise, the trust or estate plan that includes direct investment or real estate within the State in question will have a similar result. If a State can afford protection and rights to beneficiaries, then a more in-depth analysis should be performed in order to appreciate the potential tax liability that State could impose.

The law developed out of this holding of the Court should hopefully bring about some amendment to our own Connecticut General Statutes in the next legislative session. In the meantime, the Court has provided a narrow application to a set of circumstances not uncommon in the marketplace. Please feel free to reach out to me if you would like to discuss further or have additional thoughts or ideas.

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[4] Id, citing Wisconsin v. J.C. Penney Co., 314 U.S. 325, 444, 61 S.Ct. 246, 85 L.Ed. 267.
[5] Id
[6] Safe Deposit & Trust Company of Baltimore v. Virginia, 280 U.S. 91 (1929)