SUPREME COURT TO RULE ON STATE TAXATION OF TRUST INCOME

BY BRANDON D. HAMM & MITCHELL D. HIATT, KOLEY JESSEN

Last year's landmark decision in Wayfair had widespread impact on remote retailers' sales and use tax collection responsibilities. This year, in North Carolina Department of Revenue v. Kaestner Family Trust, the Supreme Court will address the issue of whether a trust beneficiary's residence is sufficient for a state to tax the trust's income. With nearly $120 billion of U.S. income being attributable to trusts, the Supreme Court's decision will have widespread impact on state laws governing trust income taxation, including potentially Nebraska's own laws on this issue.

In Kaestner Family Trust, an out-of-state trust brought an action against the North Carolina Department of Revenue arguing that the statute imposing income tax on it violated the Due Process and Commerce Clauses of the U.S. Constitution. The North Carolina statute at issue states that income of a trust that is for the benefit of a North Carolina resident beneficiary is subject to North Carolina income tax. This means that regardless of where the trust is created, where the trustee resides, or whether any trust assets can be found in the state, so long as a single trust beneficiary resided in North Carolina, a portion of the trust's income would be subject to North Carolina income tax.

The trust at issue in Kaestner Family Trust was created by a New York resident with a Connecticut resident serving as trustee. The assets of the trust are comprised of various financial investments, whose custodian is located in Massachusetts. The only connection that the trust has with North Carolina is that the beneficiaries of the trust are North Carolina residents. The North Carolina Supreme Court ruled that the Due Process Clause requires some minimum contacts with a state before the state may impose income tax on a trust, and taxation based purely on the residence of the beneficiaries did not constitute sufficient minimum contacts for that purpose. The Supreme Court has remained relatively silent on this issue since the early 1900s, leaving state courts with little guidance and ultimately leading to a split amongst the states.

Although Nebraska does not impose income tax on trusts based on the residence of beneficiaries, the decision in Kaestner Family Trust may still impact Nebraska law. Nebraska imposes its income tax on trusts considered to be "resident trusts." A resident trust is defined under Nebraska law as:

(1) A trust created by a will of a decedent who was domiciled in Nebraska at the time of his/her death; or

(2) A trust whose settlor is domiciled in Nebraska at the time the trust becomes irrevocable.

Two years prior to the North Carolina Supreme Court's decision in Kaestner Family Trust, a Pennsylvania court struck down Pennsylvania's statute, which was similar to Nebraska's current law, as a violation of the Commerce Clause. In that case, the court found that the residency of either the settlor or the beneficiaries alone were insufficient contacts for the state to impose income tax on the trust at issue. This case was one in a line of several cases leading up to the Supreme Court's decision to hear Kaestner Family Trust. Based on the similarity with the Pennsylvania statute, Nebraska's own statute may be called into question or even determined to be unconstitutional per se depending on the breadth of the Supreme Court's ruling in Kaestner Family Trust.

The Supreme Court's decision in Kaestner Family Trust will have a widespread impact beyond just North Carolina and the trust beneficiaries involved in the case. The Supreme Court could affirm the states' ability to tax trust income based merely on the residence of the beneficiaries or strike these types of statutes down as unconstitutional. This would impact not only the states with similar statutes to North Carolina, but may also call into question the validity of other states' law, including potentially Nebraska. ◀

For more information, contact Brandon Hamm or Mitchell Hiatt at Koley Jessen at brandon.hamm@koleyjessen.com or mitchell.hiatt@koleyjessen.com. Hamm and Hiatt serve as trusted advisors to some of the region's most prominent individuals, families, and business owners and assist them with the accumulation, management, protection, and transfer of their wealth.