COUNSELOR'S CORNER

U.S. SUPREME COURT RULES AGAINST STATE IN TRUST TAX CASE

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In a recent case, the U.S. Supreme Court unanimously ruled against the state of North Carolina and in favor of the taxpayer, determining that a trust beneficiary's residence alone is insufficient for the state to tax the trust's undistributed income. The ruling in the case is too narrow to apply to the taxation structure Nebraska imposes on trusts, but it does shed light on how a legal challenge to the Nebraska law taxing trusts might be interpreted. At a minimum, it highlights that practitioners should be discussing state taxation of trusts with their clients and potential planning for lessening that tax burden.

In North Carolina Department of Revenue v. Kimberley Rice Kaestner 1992 Family Trust, the U.S. Supreme Court ruled that North Carolina violated the Due Process Clause of the 14th Amendment of the U.S. Constitution, which provides "[n]o state shall . . . deprive any person of life, liberty, or property, without due process of law."[1]

Mr. Rice had created a trust for the benefit of his children in his home state of New York. He appointed a trustee who was a New York resident; the successor trustee was a Connecticut resident. The trust agreement provided that the trustee had absolute discretion to distribute the assets of the trust to the beneficiaries of the trust. After he created the trust, his daughter, Kimberley Rice Kaestner, moved to North Carolina. The trustee then divided the trust into three separate subtrusts, including the trust formed for the benefit of Kaestner and her three children.

North Carolina attempted to tax Kaestner's trust, under a law authorizing the state to tax any trust income that is for the benefit of a state resident. The Department of Revenue assessed $1.3 million in income taxes on the proceeds that the trust accumulated from 2005 through 2008.

Upon challenge, the North Carolina courts held that the taxation of the trust violated the beneficiaries' Due Process rights because there was not a strong enough link between the trust and the state to support the tax. The U.S. Supreme Court granted certiorari and explained that the state must have "some definite link, some minimum connection, between a state and the person, property, or transaction it seeks to tax."[2] In Kaestner, the only connection North Carolina had was the residence of the beneficiaries. However, the Court determined that was insufficient, explaining 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."[3]

Nebraska imposes a state income tax on all income of resident trusts and on Nebraska-sourced income of nonresident trusts.[4] Resident trusts are defined to include: (1) a trust created by a will of a decedent who was domiciled in Nebraska at the time of his/her death; and (2) a trust whose settlor is domiciled in Nebraska at the time the trust becomes irrevocable.[5] Nebraska law also states:

> If the settlor of a trust is domiciled in Nebraska when the trust becomes irrevocable, the trust will be considered a resident trust for the entire life of the trust. Such a trust is a resident trust even though the situs of the trust, the property held in trust, or the trustee are located in another state.[6]

This Nebraska regulation provides: once a resident trust, always a resident trust. Would this Nebraska law be determined to have "some definite link, some minimum connection, between a state and the person, property, or transaction it seeks to tax" once the settlor passes away, the beneficiaries move out-of-state, and the trustee is out of state managing investments that are out of state? The Kaestner opinion was written too narrowly to apply to Nebraska law, but does beg the question as to how courts would rule on a legal challenge to the Nebraska law with the right set of facts.

Even without a legal challenge to Nebraska law, the issue Kaestner brings forth for discussion by advisors with their clients is the impact state income tax can have on a trust's investment returns and the long-term growth of trust assets. Advisors should be reviewing whether a trust could be created in another state, or after creation, moved to another state, potentially resulting in lower state income tax. ◀

[1]North Carolina Department of Revenue v. Kimberley Rice Kaestner 1992 Family Trust, 588 U.S. ___ (2019).
[2]Id. at 5.
[3]Id. at 7.
[4]150 NEB. ADMIN. CODE, CH. 23 §§ 004.01, 004.02.
[5]150 NEB. ADMIN. CODE, CH. 23 § 001.01.
[6]150 NEB. ADMIN. CODE, CH. 23 § 001.03 (emphasis added).

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