

Trusts

## INSIGHT: North Carolina Supreme Court Declares Tax on Accumulated Trust Income Unconstitutional

### BNA Snapshot

Richard Fox of Buchanan Ingersoll discusses a North Carolina court ruling that the state couldn't tax the accumulated income of a New York trust based on a beneficiary's North Carolina residency.



By Richard L. Fox

The constitutional restraints on a North Carolina statute seeking to impose income tax on the undistributed income of a trust on the basis of the trust's sole tie to the state being the residency of a trust beneficiary has been the subject of litigation in The Kimberly Rice Kaestner 1992 Family Trust since 2015.

Now, on June 8, 2018, the North Carolina Supreme Court, in *The Kimberley Rice Kaestner 1992 Family Trust v. North Carolina Dep't of Revenue*, No. 307PA15-2, 2018 BL 202913 (6/8/18), has affirmed lower court decisions declaring unconstitutional a state statute imposing income tax on a trust based solely on the residence of the beneficiary of the trust. The statute in question in this case is N.C. General Statutes Section 105-160.2 (2005), allowing taxation of trust income by the State of North Carolina of a trust "that is for the benefit of a resident of this State." In holding that the imposition of income tax under provision this was unconstitutional, the North Carolina Supreme Court agreed with earlier decisions by the North Carolina Business Court on April 23, 2015, and by the North Carolina Court of Appeals on July 5, 2016, holding that the connection of a beneficiary's residence to the State of North Carolina alone is insufficient to allow income taxation of the accumulated income of the trust under the due process clause of the U.S. Constitution.

The trust, the plaintiff in this case, asserted that N.C. Gen. Stat. Section 105-160.2 was "both unconstitutional on its face and as applied to the plaintiff." The North Carolina Supreme Court emphasized, however, that its opinion was limited to an "as applied" standard, meaning the court looked only "to whether the statute was unconstitutional in the limited context of the facts of the case before us." In this regard, the North Carolina Supreme Court noted the presumption that "any act passed by the legislature is constitutional" and an 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.'" Given that the trust presented only evidence relevant to its particular situation, the North Carolina Supreme Court did not consider whether the statute was unconstitutional on its face and only considered whether the statute was "unconstitutional as applied to plaintiff to collect the taxes at issue."

The statute struck down as unconstitutional in North Carolina is similar to statutory provisions in other states where a trust that is created and becomes irrevocable while the settlor has his or her permanent legal residence in the state is automatically deemed a resident trust of the state and the undistributed income of the trust is, under the provisions of the statute, thereafter subject to the state income tax. The applicable taxing authority in Pennsylvania, for example, subjects to Pennsylvania income tax the undistributed income of any trust that was created by a person who was a Pennsylvania resident of the trust at the time of the trust's creation. 72 Pa. Consolidated Statutes Section 7302(a). Therefore, the statute purports to create a broad application of the tax based on the trust's sole tie to the Commonwealth of Pennsylvania being the residency of the settlor. In *McNeil v. Commonwealth*, 67 A.3d 185 (Pa. Commw. Ct. 2013), however, the Pennsylvania Commonwealth Court held that,

notwithstanding the broad application on the statute on its face, it was unconstitutional to impose Pennsylvania tax on undistributed trust income of a Pennsylvania resident trust where the only contact of the trust to Pennsylvania was the residence of the settlor. Similar to *The Kimberley Rice Kaestner 1992 Family Trust* case, the statute was determined to be unconstitutional as applied to the trust, as opposed to a determination that the statute was unconstitutional on its face.

### **Facts in The Kimberley Rice Kaestner 1992 Family Trust**

The facts in *The Kimberley Rice Kaestner 1992 Family Trust* were not disputed. The trust was created in 1992 by a Joseph Lee Rice, III, a New York resident settlor, for the benefit of his descendants and a New York resident was named as the initial trustee. In 2005, a new trustee was named, who resided in Connecticut during the entire period relevant to this case. The trust was governed by the law of New York. No party to the trust resided in North Carolina until the settlor's daughter, Kimberly Rice Kaestner, a primary beneficiary of the trust, moved to North Carolina in 1997. The trust was subsequently divided into separate share sub-trusts, one of which was formed for the benefit of Kimberly Rice Kaestner and her three children, all of whom were residents of North Carolina during the tax years at issue.

Other than the beneficiaries of the trusts being residents of North Carolina, all functions and administration of the trust took place outside of North Carolina. All financial books and records and legal records of the trust were maintained in New York. The tax returns and accountings for the trust were prepared in New York. Meetings with the trustee were held in New York. The trustee did not make any distributions to any beneficiary of the trust and no beneficiary could compel the trustee to make a distribution from the trust.

During the years 2005 through 2008, the state of North Carolina, in accordance with N.C. Gen. Stat. Section 105-160.2, taxed the trust on income accumulated each year, regardless of whether any income was distributed to any of the North Carolina beneficiaries. The trust then sought a refund of those taxes totaling more than \$1.3 million for such years. The state of North Carolina denied the refund request on Feb. 11, 2011.

### **Holding**

In its holding, the North Carolina Supreme Court emphasized that it has long been settled that a trust has a separate existence from its beneficiary, and the taxable existence is critical to the outcome of the case because a taxed entity's minimum contacts with the taxing state cannot be established by the contacts of a third party, i.e., a beneficiary of a trust, with the taxing state. Therefore, the court stated that because the trust and the trust's beneficiaries are separate legal entities, due process must be satisfied from the trust's contacts with North Carolina, not the beneficiaries.

In determining whether the taxing statute at issue was constitutional, as applied to the trust, the North Carolina Supreme Court evaluated the requirements of the due process clause, specifically that the trust against which tax is sought must purposefully avail itself of the benefits of the taxing state and of the privilege of conducting activities within the taxing state, thus invoking the benefits and protections of its laws. Here, the Supreme Court of North Carolina stated that it was the trust's beneficiaries, not the trust, "who reaped the benefits and protections of North Carolina's laws by residing here," and because the trust and the trust's beneficiaries "are separate legal entities, due process was not satisfied from the beneficiaries' contacts with North Carolina." Mere contact with a North Carolina beneficiary does not suffice. In conclusion, the North Carolina Supreme Court stated:

"For taxation of a foreign trust to satisfy the due process guarantee..., the trust must have some minimum contacts with the State of North Carolina such that the trust enjoys and benefits and protections of the State. When, as here, the income of a foreign trust is subject to taxation based on its beneficiaries' availing themselves of the benefit of our economy and the protections afforded our laws, those guarantees are violated. Therefore, we hold that N.C.G.S. §105-160.2 is constitutional as applied to collect income taxes from plaintiff for tax years 2005 through 2008."

As indicated above, the opinion is limited to an "as applied" standard, such that the statute was not declared unconstitutional on its face given that an 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.'" Here, if the trust itself had sufficient contacts with North Carolina to pass due process muster, the imposition of a tax on the trust under the challenged statute presumably would survive.

Richard L. Fox is a shareholder in the Philadelphia office of Buchanan, Ingersoll & Rooney, PC. He concentrates his practice in the areas of estate planning, trusts and estates, philanthropic planning, and tax-exempt organizations, specializing in tax issues in these areas.