

Opportunities for Saving State Income Taxes on Trusts Expanded with Kaestner Trust Decision

U.S. Supreme Court Holds Presence of Resident Discretionary Beneficiaries Does Not Justify North Carolina Income Taxation of Nonresident Trustee

Richard W. Nenno, Esquire

Senior Trust Counsel and
Managing Director

Wilmington Trust Company

When determining whether a trustee of a nongrantor trust must pay a particular state's income tax on retained ordinary income and capital gains, the practitioner should resist the impulse to consult the governing-law clause in the Will or trust instrument. Instead, she should analyze how that state defines "resident trust" for income-tax purposes in its statutes, regulations, and/or tax-return instructions. Although North Carolina does not formally define "resident trust," the state provides a functional definition of the term by taxing trustees—resident and nonresident—"on the amount of the taxable income of the . . . trust that is for the benefit of a resident of this state . . ."¹

In North Carolina Department of Revenue v. The Kimberly Rice Kaestner 1992 Family Trust,² the U.S. Supreme Court held unanimously on June 21, 2019, that the Due Process Clause of the U.S. Constitution³ prohibited North Carolina from taxing a nonresident trustee on the accumulated ordinary income and capital gains of a nongrantor trust based exclusively on the existence of resident discretionary beneficiaries, saving the trustee over \$1.3 million. The decision enhances tax-saving opportunities in North Carolina, Georgia, Maryland, and elsewhere, and highlights the importance of continuing to take advantage of planning opportunities in California, New Jersey, New York, Oregon, Pennsylvania, and other states.

Facts

- **1992**—New York settlor created irrevocable inter vivos trust for his children naming New York individual trustee and designating New York law to govern
- **1997**—One of settlor's children moved to North Carolina
- **December 30, 2002**—Trustee divided trust into equal shares for settlor's children, including share for North Carolina resident and her children
- **2005–2008**—Trustee was Connecticut resident; trust investments consisted of financial assets; custodian was in Boston; tax returns, accountings, and other records were prepared and kept in New York; no distribution was made to North Carolina resident

Continued



- **February 11, 2011**—North Carolina Department of Revenue denied trustee’s requests for refunds of North Carolina income taxes paid for 2005–2008
- **2015–2018**—Business Court Division of Superior Court of Wake County, North Carolina, Court of Appeals of North Carolina, and Supreme Court of North Carolina held for trustee⁴
- **January 11, 2019**—U.S. Supreme Court granted North Carolina Department of Revenue’s petition for certiorari⁵
- **April 16, 2019**—U.S. Supreme Court conducted oral arguments

Supreme Court holding

Justice Sotomayor wrote the opinion for a unanimous Court in favor of the taxpayer.⁶ The opinion concluded:⁷

We hold 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. In limiting our holding to the specific facts presented, we do 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.

Following the Kaestner decision, a nonresident trustee should not have to pay North Carolina income tax on the nonsource undistributed ordinary income and capital gains of a nongrantor trust with North Carolina resident discretionary beneficiaries.

Planning enhanced in Georgia and Maryland

Georgia’s tax statute imposes the Georgia income tax on resident and nonresident fiduciaries “[m]anaging funds or property for the benefit of a resident of the state.”⁸ Because Georgia’s approach is so similar to North Carolina’s framework, nonresident trustees should no longer need to pay Georgia tax in Kaestner-like trusts.

Maryland defines “resident trust” as a trust that is created by a Maryland testator or settlor or that is administered in Maryland.⁹ But, Maryland gives trustees a deduction for intangible personal property held in trust for nonresidents.¹⁰ It’s nice that Maryland provides this deduction, but the Kaestner decision confirms that the presence of resident beneficiaries should be irrelevant in determining whether it is constitutional for Maryland to tax a nonresident trustee.

Planning should continue in California, New Jersey, New York, Oregon, and Pennsylvania

Kaestner does not affect existing opportunities to reduce California income tax on nonsource income through the appointment of Delaware trustees because nonresident trustees already don’t have to pay California income tax currently on trusts having discretionary beneficiaries under the following statute:¹¹

The tax applies . . . to the entire taxable income of a trust, if the . . . beneficiary (other than a beneficiary whose interest in such trust is contingent) is a resident, regardless of the residence of the settlor.

In addition, efforts to minimize tax should continue in New Jersey, New York, and Oregon, where the rules for escaping tax already are clear and the presence of resident beneficiaries is

Continued

Figure 1

Potential reduction on \$1 million long-term capital gain incurred by trustee, select states

State	Potential Savings
California	\$108,220
Georgia	\$59,729
Maryland	\$87,868
New Jersey	\$74,484
New York State (not including New York City)	\$68,479
New York State (including New York City)	\$107,102
North Carolina	\$54,974
Oregon	\$96,944
Pennsylvania	\$30,706

not germane in determining resident-trust status,¹² and in Pennsylvania, which already says that the residence of a beneficiary is not a factor in determining taxability.¹³

Although Floridians and Texans don't have a state income tax, they still might want to consider Delaware for perpetual trusts, asset-protection trusts, and other estate-planning purposes.

Potential tax savings

The tax savings achievable by structuring a trust to eliminate state income tax are not inconsiderable. For example, the potential reduction on a \$1 million long-term capital gain incurred by a trustee in 2018 for states covered earlier in this article are shown in Figure 1.

There's more

Like North Carolina's and Georgia's tax statutes, Tennessee's Hall Income Tax, which applies only to interest and dividends and which will sunset on December 31, 2020,¹⁴ purports to tax trustees solely because there are resident beneficiaries. The pertinent statute provides:¹⁵

Trustees, . . . who receive income taxable under this chapter for the benefit of residents of Tennessee shall be required to make returns under this chapter and to pay the tax levied by this chapter.

Nonresident trustees should no longer need to pay tax in Tennessee in situations like [Kaestner](#). The decision also should have no bearing in Connecticut, Iowa, and Nebraska, which, like Pennsylvania, already say that the residence of beneficiaries is irrelevant in determining resident-trust status.¹⁶

Several states, in addition to Maryland, consider the presence of resident beneficiaries as one of multiple criteria. [Kaestner](#) suggests that beneficiary residence should be a nonfactor in those states as well.

In Alabama, a trust established by a resident testator or settlor is a resident trust if:¹⁷

For more than seven months during such taxable year, a person, . . . who either resides in or is domiciled in Alabama is . . . a beneficiary of the trust to whom distributions currently may be made.

Connecticut defines "resident trust" as a trust that is created by a Connecticut resident testator or settlor.¹⁸ Nevertheless, for inter vivos trusts, Connecticut apportions tax based on the number of resident and nonresident noncontingent beneficiaries.¹⁹ The tax return instructions define "noncontingent beneficiary" to include "every individual to whom a trustee of an inter vivos trust during the taxable year . . . may, in the trustee's discretion, distribute income or corpus, or both."²⁰

Continued

Delaware defines “resident trust” as a trust that is created by a Delaware domiciliary testator or settlor or that has one or more Delaware resident individual or corporate trustees.²¹ But, Delaware allows trustees of resident trusts to deduct taxable income set aside for future distribution to nonresidents.²²

In Hawaii, “resident trust means a trust of which the fiduciary is a resident of the State or the administration of which is carried on in the State.”²³ However, Hawaii allows trustees of resident trusts to exclude taxable income attributable to nonresidents.²⁴

Massachusetts defines “resident trust” to include testamentary and inter vivos trusts created by Massachusetts residents, provided that an inter vivos trust has a resident trustee.²⁵ Nonetheless, Massachusetts generally taxes trustees of resident trusts only on income attributable to resident beneficiaries.²⁶

In Michigan, a trust created by a resident testator or settlor is a “resident trust.”²⁷ But, the tax return instructions specify that an inter vivos trust created by a Michigander will not be treated as a “resident trust” if three conditions are satisfied, one of which is that “[t]he beneficiaries are all nonresidents.”²⁸

Missouri defines “resident trust” as a trust created by a testator or settlor domiciled in Missouri that “has at least one income beneficiary who, on the last day of the taxable year, was a resident of this state.”²⁹

In Montana, the factors that are assessed in determining whether a trust is a “resident trust” include the beneficiaries’ domiciles.³⁰

A North Dakota regulation contains a nonexclusive list of factors to be used in determining whether a trust is a “resident trust.”³¹ The factors include whether “[a] beneficiary of the trust . . . is a domiciliary or resident of this state.”³²

Ohio taxes an irrevocable inter vivos trust only if a “qualifying beneficiary is domiciled in Ohio for all or a portion of the trust’s taxable year.”³³ The term “qualifying beneficiary” generally “has the same meaning as ‘potential current beneficiary’ as defined in section 1361(e)(2) of the Internal Revenue Code,”³⁴ which, in turn, says that:³⁵

[T]he term ‘potential current beneficiary’ means, with respect to any period, any person who at any time during such period is entitled to, or at the discretion of any person

may receive, a distribution from the principal or income of the trust (determined without regard to any power of appointment to the extent such power remains unexercised at the end of such period).

Rhode Island defines “resident trust” to include trusts established by resident testators and settlors.³⁶ But, it treats a trust as a “resident trust” only to the extent that it has resident beneficiaries.³⁷

Minnesota classifies an inter vivos trust created or first administered in Minnesota after 1995 as a “resident trust” if the settlor was domiciled in Minnesota when the trust became irrevocable.³⁸ But, in Fielding for MacDonald v. Commissioner of Revenue,³⁹ the Minnesota Supreme Court held that Minnesota’s imposition of income tax on the nonresident trustee of four trusts would violate the Due Process Clause of the U.S. Constitution even though the settlor of all four trusts and the current discretionary beneficiary of one of the trusts were domiciled in Minnesota. The court concluded that “[e]ven when the additional contacts the Commissioner cites [which included the Minnesota residence of a discretionary beneficiary] are considered in combination, the State lacks sufficient contacts with the Trusts to support taxation of the Trusts’ entire income as residents consistent with due process.”⁴⁰ The Kaestner decision suggests that the residences of beneficiaries should be a nonfactor even if courts may consider nonstatutory criteria. In any event, the Minnesota Commissioner of Revenue’s petition for certiorari to the U.S. Supreme Court is pending.

Conclusion

Do the trustees of your clients’ nongrantor trusts pay state income tax? If so, the U.S. Supreme Court’s decision in North Carolina Department of Revenue v. The Kimberly Rice Kaestner 1992 Family Trust is one more reason to explore reducing or eliminating that tax. Your Wilmington Trust Relationship Manager will be glad to discuss the tax-savings opportunities that the decision offers.



Richard W. Nenzo, Esquire

Senior Trust Counsel and Managing Director
Wilmington Trust Company
302.651.8113
rnenno@wilmingtontrust.com

Dick is a senior trust counsel and managing director in Wealth Management at Wilmington Trust Company. He has more than 40 years of estate-planning experience and is admitted to the practice of law in Delaware and Pennsylvania. He is a Fellow of the American College of Trust and Estate Counsel, a member of the Advisory Committee of the Heckerling Institute on Estate Planning, a Fellow of the American Bar Foundation, a member of the Bloomberg BNA Estates, Gifts, and Trusts Advisory Board, and a Distinguished Accredited Estate Planner.

Dick is a cum laude graduate of Princeton University with an A.B. degree from the Woodrow Wilson School of Public and International Affairs, and earned his JD from Harvard Law School. Dick is a published authority on estate-planning issues and is recognized as a national speaker, having presented at many of the industry's most highly respected conferences and forums.

SOURCES

- ¹ N.C. Gen. Stat. § 105-160.2 (emphasis added). For a compilation of the tax approaches of all 50 states and the District of Columbia, see Nenzo, “Bases of State Income Taxation of Nongrantor Trusts” (Feb. 28, 2019), www.actec.org
- ² 2019 WL 2552488 (U.S. June 21, 2019).
- ³ U.S. Const. amend. XIV, § 1.
- ⁴ 2015 WL 1880607 (N.C. Sup. Ct. Apr. 23, 2015), [aff'd](#), 789 S.E.2d 645 (N.C. Ct. App. 2016), [aff'd](#), 814 S.E.2d 43 (N.C. 2018).
- ⁵ 139 S. Ct. 915 (2019).
- ⁶ 2019 WL 2552488 (U.S. June 21, 2019).
- ⁷ 2019 WL 2552488, at *5.
- ⁸ Ga. Code Ann. § 48-7-22(a)(1)(C) (emphasis added).
- ⁹ Md. Code Ann., Tax-Gen. § 10-101(k) (1) (iii). See instructions to 2018 Md. Form 504 at 1.
- ¹⁰ Md. Code Ann., Tax-Gen. § 10-207(o). [See](#) instructions to 2018 Md. Form 504 at 4-5.
- ¹¹ Cal. Rev. & Tax Code § 17742(a) (emphasis added). Appointing Delaware trustees might also make it possible to reduce or eliminate California income tax on source income ([see Paula Trust v. California Franchise Tax Board](#), No. CGC-16-556126 (Cal. Super. Ct. Feb. 6, 2018)).
- ¹² [See](#) instructions to 2018 Form NJ-1041 at 1; N.Y. Tax Law § 605(b) (3)(D)(i); Or. Rev. Stat. § 316.282(1)(d).
- ¹³ [See](#) 61 Pa. Code § 101.1 (“The residence of . . . the beneficiaries of the trust shall be immaterial”).
- ¹⁴ Tenn. Code Ann. § 67-2-102.
- ¹⁵ Tenn. Code Ann. § 67-2-110(a) (emphasis added). [See](#) instructions to 2018 Tenn. Form INC 250 at 3.
- ¹⁶ [See](#) Instructions to 2018 Form CT-1041 at 6 (“The residence of the . . . beneficiary does not affect the status of a trust . . . as resident or nonresident”); Iowa Admin. Code r. 701-89.3(2) (“The residence of the beneficiaries of a trust is also not relevant in determining situs”); 316 Neb. Admin. Code § 23.002.03 (“Neither the residences of the beneficiaries . . . nor the situs of the trust . . . shall be determinative as to the residence or nonresidence of the trust . . .”).
- ¹⁷ Ala. Code § 40-18-1(33)(b) (emphasis added).
- ¹⁸ Conn. Gen. Stat. § 12-701(a)(4)(C)—(D). [See](#) Conn. Agencies Regs. § 12-701(a)(4)-1; instructions to 2018 Form CT-1041 at 6.
- ¹⁹ Conn. Gen. Stat. § 12-701(a)(4). [See](#) instructions to 2018 Form CT-1041 at 6, 8.
- ²⁰ Instructions to 2018 Form CT-1041 at 6. The nonresident trustee of a [Kaestner](#)-like trust might not be subject to Connecticut income tax notwithstanding the Supreme Court of Connecticut’s decision in [Chase Manhattan Bank v. Gavin](#), 733 A.2d 782 (Conn. 1999), where the current beneficiary had more significant interests.

Continued

- ²¹ 30 Del. C. § 1601(8). See 2018 Del. Form 400-1 at 2.
- ²² 30 Del. C. § 1636(a). The combination of Delaware's small population and its favorable rule for determining the residences of future beneficiaries means that few trusts created by nonresidents pay Delaware income tax.
- ²³ Haw. Rev. Stat. § 235-1. See Haw. Regs. § 18-235-1-1.17; instructions to 2018 Haw. Form N-40 at 1.
- ²⁴ Haw. Rev. Stat. § 235-4.5(a). See Haw. Regs. § 18-235-4-03.
- ²⁵ Mass. Regs. Code tit. 830, § 62.10.1(1)(a), (1)(b)(1). See Mass. Gen. Laws ch. 62, § 10(c); instructions to 2018 Mass. Form 2 at 4.
- ²⁶ Mass. Regs. Code tit. 830, § 62.10.1(2)(b). See Mass. Gen. Laws. ch. 62, § 10(a).
- ²⁷ Mich. Comp. Laws § 206.18(1)(c).
- ²⁸ Instructions to 2018 MI-1041 at 2.
- ²⁹ RSMo § 143.331(2)(b), (3)(b).
- ³⁰ Instructions to 2018 Mont. Form FID-3 at 15-16.
- ³¹ N.D. Admin. Code § 81-03-02.1-04.
- ³² N.D. Admin. Code § 81-03-02.1-04(2)(a).
- ³³ Instructions to 2018 Ohio Form IT 1041 at 4.
- ³⁴ Ohio Rev. Code Ann. § 5747.01(I)(3)(c).
- ³⁵ IRC § 1361(e)(2).
- ³⁶ R.I. Gen. Laws § 44-30-5(c)(2)-(4). See instructions to 2018 Form RI-1041 at I-1.
- ³⁷ R.I. Gen. Laws § 44-30-5(c)(5). See 280-RICR-20-55-7.7; instructions to 2018 Form RI-1041 at I-1.
- ³⁸ Minn. Stat. § 290.01 Subd. 7b(a)(2).
- ³⁹ 916 N.W.2d 323 (Minn. 2018), aff'g, 2017 WL 2484593 (Minn. Tax Ct. May 31, 2017).
- ⁴⁰ 916 N.W.2d at 334 (footnote omitted).

This article, with commentary, is for informational purposes only and is not intended as an offer or solicitation for the sale of any financial product or service. It is not designed or intended to provide financial, tax, legal, accounting, or other professional advice since such advice always requires consideration of individual circumstances. If professional advice is needed, the services of a professional advisor should be sought.

IRS Circular 230 disclosure: To ensure compliance with requirements imposed by the IRS, we inform you that, while this article is not intended to provide tax advice, in the event that any information contained in this article is construed to be tax advice, the information was not intended or written to be used, and cannot be used, for the purpose of (i) avoiding tax related penalties under the Internal Revenue Code or (ii) promoting, marketing, or recommending to another party any matters addressed herein.

Wilmington Trust is a registered service mark. Wilmington Trust Corporation is a wholly owned subsidiary of M&T Bank Corporation. Wilmington Trust Company, operating in Delaware only, Wilmington Trust, N.A., M&T Bank, and certain other affiliates, provide various fiduciary and non-fiduciary services, including trustee, custodial, agency, investment management, and other services. International corporate and institutional services are offered through Wilmington Trust Corporation's international affiliates. Loans, credit cards, retail and business deposits, and other business and personal banking services and products are offered by M&T Bank, member FDIC.

Wilmington Trust Company operates offices in Delaware only. Note that a few states, including Delaware, have special trust advantages that may not be available under the laws of your state of residence, including asset protection trusts and directed trusts.

Investment and Insurance Products: • Are NOT Deposits • Are NOT FDIC Insured • Are NOT Insured By Any Federal Government Agency • Have NO Bank Guarantee • May Go Down In Value