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Effect of *Kaestner* on Non-California Trusts With California Beneficiaries

On June 21, 2019, in a unanimous decision, the U.S. Supreme Court held as unconstitutional a North Carolina statute that had been interpreted by North Carolina to mean that a trust owed income tax to North Carolina whenever a beneficiary of the trust lived in the state, even if, in the relevant year, the beneficiary received no income from the trust, had no right to demand income from the trust, and could never count on receiving income from the trust. *N.C. Dep't of Revenue v. The Kimberley Rice Kaestner 1992 Family Trust*, 588 U.S. ___ (2019) (No. 18-457).

Summary of the Case

North Carolina taxes any trust income that "is for the benefit of" a North Carolina resident. N. C. Gen. Stat. Ann. §105-160.2. The North Carolina Supreme Court had interpreted the statute to permit North Carolina to tax a trust on the sole basis that a beneficiary resided in the state.

In *Kaestner*, Kimberley Rice Kaestner was the beneficiary of a trust established by her father, a New York resident. The trust was governed by New York law, and the trustee had "absolute discretion to distribute the trust's assets to the beneficiaries in such amounts and proportions as the trustee might from time to time decide." The dispute arose when, between 2005 and 2008, North Carolina required the trustee, a resident of Connecticut, to pay more than $1.3 million in taxes on income earned by the assets in the trust, solely because Kaestner was a resident of North Carolina at the time. During those years, the trustee had

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not distributed any of the income to Kaestner or her children, did not make any investment or hold real property in North Carolina, and did not maintain a physical presence in North Carolina.

The U.S. Supreme Court, in affirming the North Carolina Supreme Court, held that "presence of in-state beneficiaries alone does not empower a State to tax trust income that has not been distributed to the beneficiary, where the beneficiary has no right to demand that income, and is uncertain to ever receive it." In so holding, the U.S. Supreme Court relied on the lack of minimum contacts between the residence of the beneficiary in North Carolina and the assets of the trust, as defined in *International Shoe Co. v. Washington*, 326 U.S. 310 (1945). The Supreme Court focused on the extent of the in-state beneficiary's right to control, possess, enjoy or receive the trust assets (citing *Safe Deposit & Trust Co. v. Virginia*, 280 U.S. 83 (1929) and *Brooke v. Norfolk*, 277 U.S. 27 (1928)). It indicated that, to allow a state to base its tax on the residence of the beneficiary, the beneficiary needs to have some degree of possession, control, or enjoyment of the trust property or a right to receive that property before the state can tax the asset.

The Court found that, because Kaestner did not receive any income between 2005 and 2008, did not have a right to demand trust income or otherwise control, possess, or enjoy the trust assets during those years, and could not count on receiving any specific amount of income from the trust in the future, the minimum contacts required were lacking. Accordingly, North Carolina was precluded from taxing the trust assets solely on the basis of Kaestner's status as an in-state resident.

Impact on Drafting California Trusts

The U.S. Supreme Court specifically stated in *Kaestner* that the holding is limited to the facts presented and does "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." (at* 7). The Court's decision does not address, and reserves for another day, whether a different result would follow if beneficiaries were certain to receive funds in the future or whether state laws that rely only on the residency of non-contingent beneficiaries are constitutional.[1] (at* 15 + n.10). Therefore, it is difficult to assess whether this extremely narrow holding will have any impact on California's statute or the drafting of California trusts.

California trust law taxes "the entire taxable income of a trust if the fiduciary or beneficiary (other than a beneficiary whose interest in such trust is contingent) is a resident, regardless of the residence of the settlor." Cal. Rev. & Tax Code §17742(a). The statute authorizes the California Franchise Tax Board (FTB) to adopt regulations regarding apportionment of the income according to the number and interest of the beneficiaries in instances where there are beneficiaries with non-contingent interests, some who are residents and some who are non-residents. The FTB regulations state, in that case, the trust is taxable on its California source income (derived from real and tangible property in California and businesses conducted in California), and on the proportion of "all net income… from all other sources which eventually is to be distributed to the non-contingent beneficiaries who are residents of this State." 18 Cal. Code Regs. § 17744.

Unlike North Carolina, California limits the taxation of trust income based solely on the residency of the beneficiary to non-contingent beneficiaries.[2] A non-contingent beneficiary is one whose interest is not subject to a condition precedent, and therefore has a vested interest in the trust. 18 Cal. Code Regs.

[1] Justice Sotomayor emphasized that "today's ruling will have no such sweeping effect," mentioning a handful of state statutes that rely on the beneficiary's residency as the sole basis for taxation and distinguishing the North California statute from those of every other state.

[2] Only North Carolina and Tennessee tax trusts based on the residence of contingent beneficiaries. Tennessee is phasing out its income tax by 2021.

§17742(b). A resident beneficiary will be deemed to hold a contingent interest in a trust when his or her ability to receive distributions from the trust is subject to the sole and absolute discretion of the trustee. He or she may be deemed to have a non-contingent interest in a trust if the trustee's discretion is subject to a standard that the beneficiary can enforce. *See* Cal. FTB TAM 2006-0002 (Feb 17, 2006), *N.C. Dep't of Revenue v. The Kimberley Rice Kaestner 1992 Family Trust*, 588 U.S. ___, n.10 (2019) (citing *Fondren v. Commissioner*, 324 U.S. 18, 21 (1945)).

The fact that California limits the taxation of a trust based solely on the non-contingent beneficiaries' residence in the state, seems to require a closer connection between the beneficiary and the trust assets than was true of the North Carolina statute at issue in *Kaestner*. Because a non-contingent beneficiary has a vested interest in the trust, he or she has a present right to receive distributions of the assets (currently or at a later date) and thus can be said to have control, possession, or enjoyment of the assets. As indicated above, if the fiduciary has complete discretion to allocate or distribute the assets of a trust, the beneficiary would have a contingent interest and therefore insufficient access to the trust assets. Accordingly, the trust assets would not be subject to California income tax based solely on the residence of the beneficiary.

The above-referenced FTB regulation does, however, seem to provide that the trust may not be taxable on items of income that are not certain to be distributed to a resident beneficiary, even if the beneficiary has a vested interest in other items of income. For example, consider a trust that provides for mandatory distributions of some or all of the ordinary income to a California resident beneficiary, but requires capital gains to be held in trust for possible distribution to the beneficiary's descendants or other persons after his or her death. Under the regulations, it seems likely, though not certain, that the capital gains would not be currently taxable by California but that under the provisions of Section 17745 (the so-called California throwback rule), the California income tax could apply to later distributions. *Kaestner* may be a useful precedent that fiduciaries can cite if the FTB seeks to impose a tax on a trust's capital gain.

Given the uncertainties raised by the Supreme Court's decision in *Kaestner*, to the extent possible, it would seem advisable to draft trusts so that all beneficiaries' interests are contingent, and thereby minimize the possibility that current California tax would apply at the trust level. Of course, other considerations may outweigh this issue, e.g., qualifying the trust for the marital deduction.

Authors

This GT Alert was prepared by **Lawrence H. Heller, Linda B. Hirschson,** and **Norman H. Lane**. Questions about this information can be directed to:

- Lawrence H. Heller | +1 310.586.7709 | hellerl@gtlaw.com
- Linda B. Hirschson | +1 212.801.9342 | hirschsonl@gtlaw.com
- Norman H. Lane | +1 310.586.6539 | lanen@gtlaw.com
- Or your Greenberg Traurig attorney

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