

Taxation of Trust Income Deemed Unconstitutional: NC Supreme Court Decision in *Kaestner*

Tax Section



By [John G. Hodnette](#)

On June 8, the North Carolina Supreme Court affirmed the 2016 decision of the North Carolina Court of Appeals in *Kimberly Rice Kaestner Family Trust v. North Carolina Department of Revenue* holding that N.C.G.S. § 105-160.2 is unconstitutional under the due process clauses of both the U.S. Constitution and the North Carolina Constitution where taxation of the trust is based solely on the beneficiary residing in North Carolina. The Court of Appeals had in turn affirmed the 2015 decision of the North Carolina Business Court, which ruled on the same grounds.

The trust in this case was a New York trust. The trustee of the trust resided in Connecticut. The assets of the trust were located in Massachusetts. No distributions were made by the trust to the North Carolina beneficiary in the years in question. The North Carolina statute purported to tax the income of the trust based solely on the residence of the beneficiary in North Carolina. This case was brought after a denied request for refund for trust income taxes in the amount of \$1.3 million for 2005-2008.

Only irrevocable trusts subject to income taxation under Subchapter J of the Internal Revenue Code (and thus required to file a Form 1041) are affected by this taxpayer friendly ruling—and even then only a subset of those trusts. Trusts which by the terms of their trust agreements are required to distribute their current income to their North Carolina beneficiary or trusts whose trustees decide to make a discretionary distribution to such North Carolina beneficiary will still be subject to North Carolina income taxation, although the Subchapter J mechanism of distributable net income will most often move the burden of taxation to the beneficiary. However, where a North Carolina resident client is a beneficiary of an out-of-state trust that has made no distributions and has no other connection to North Carolina, the trust should file for refunds from the North Carolina Department of Revenue for open tax periods where income tax was paid. Also, the trust's filing a North Carolina return is no longer necessary under the holding of *Kaestner*.

John G. Hodnette, JD, LL.M. is an attorney with Culp, Elliott, & Carpenter in Charlotte.