The Limits of North Carolina Fiduciary Income Taxation After **Kaestner**: Making Do With Continued Uncertainty

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This article provides an in-depth treatment of the U.S. Supreme Court opinion in Kaestner intended for lawyers, state income tax practitioners, and trustees of trusts with North Carolina resident beneficiaries. It is the third in a series of articles written for The Will & the Way. For the first two articles, see Carl L. King, "Kaestner and the Future of North Carolina Fiduciary Income Taxation," The Will & The Way, June 2015, at 1, and Carl L. King, "Kaestner's Impact on NC Fiduciary Income Taxation," The Will & The Way, Aug. 2018, at 1.

Official U.S. Supreme Court Syllabus

"Certiorari to the Supreme Court of North Carolina. Joseph Lee Rice III formed a trust for the benefit of his children in his home State of New York and appointed a fellow New York resident as the trustee. The trust agreement granted the trustee "absolute discretion" to distribute the trust's assets to the beneficiaries. In 1997, Rice's daughter, Kimberley Rice Kaestner, moved to North Carolina. The trustee later divided Rice's initial trust into three separate subtrusts, and North Carolina sought to tax the Kimberley Rice Kaestner 1992 Family Trust (Trust)—formed for the benefit of Kaestner and her three children—under a law authorizing the State to tax any trust income that "is for the benefit of" a state resident, N.C. Gen. Stat. Ann. §105-160.2. The State assessed a tax of more than $1.3 million for tax years 2005 through 2008. During that period, Kaestner had no right to, and did not receive, any distributions. Nor did the Trust have a physical presence, make any direct investments, or hold any real property in the State. The trustee paid the tax under protest and then sued the taxing authority in state court, arguing that the tax as applied to the Trust violates the Fourteenth Amendment's Due Process Clause. The state courts agreed, holding that the Kaestners' in-state residence was too tenuous a link between the State and the Trust to support the tax. Held: 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 to receive it. Pp. 5-16.

(a) The Due Process Clause limits States to imposing only taxes that "bea[r] fiscal relation to protection, opportunities and benefits given by the state." Wisconsin v. J. C. Penney Co., 311 U. S. 435, 444. Compliance with the Clause's demands "requires some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax," and that "the 'income attributed to the State for tax purposes . . . be rationally related to "values connected with the taxing State,"'" Quill Corp. v. North Dakota, 504 U. S. 298, 306. That "minimum connection" inquiry is "flexible" and focuses on the reasonableness of the government's action. Id., at 307. Pp. 5-6.

(b) In the trust beneficiary context, the Court's due process analysis of state trust taxes focuses on the extent of the in-state beneficiary's right to control, possess, enjoy, or receive trust assets. Cases such as Safe Deposit & Trust Co. of Baltimore v. Virginia, 280 U. S. 83; Brooke v. Norfolk, 277 U. S. 27; and Maguire v. Trefry, 253 U. S. 12, reflect a common principle: When a State seeks to base its tax on the in-state residence of a trust beneficiary, the Due Process Clause demands a pragmatic inquiry into what exactly the beneficiary controls or possesses and how that interest relates to the object of the State's tax. Safe Deposit, 280 U. S., at 91. Similar analysis also appears in the context of taxes premised on the in-state residency of settlors and trustees. See, e.g., Curry v. McCanless, 307 U. S. 357. Pp. 6-10.

(c) Applying these principles here, the residence of the Trust beneficiaries in North Carolina alone does not supply the minimum connection necessary to sustain the State's tax. First, the beneficiaries did not receive any income from the Trust during the years in question. Second, they had no right to demand Trust income or otherwise control, possess, or enjoy the Trust assets in the tax years at issue. Third, they also could not count on necessarily receiving any specific amount of income from the Trust in the future. Pp. 10-13.

(d) The State's counterarguments are unconvincing. First the State argues that "a trust and its constituents" are always "inextricably intertwined," and thus, because trustee residence supports state taxation, so too must beneficiary residence. The State emphasizes that beneficiaries are essential to a trust and have an equitable interest in its assets. Although a beneficiary is central to the trust relationship, the wide variation in beneficiaries' interests counsels against adopting such a categorical rule. Second, the State argues that ruling in favor of the Trust will undermine numerous state taxation regimes. But only a small handful of States rely on beneficiary residency as a sole basis for trust taxation, and an even smaller number rely on the residency of beneficiaries regardless of whether the beneficiary is certain to receive trust assets. Finally, the State urges that adopting the Trust's position will lead to opportunistic gaming of state tax systems. There is no certainty, however, that such behavior will regularly come to pass, and in any event, mere speculation about negative consequences cannot conjure the "minimum connection" missing between the State and the object of its tax. Pp. 13-16."

Under the pragmatic inquiry into the rights of trust beneficiaries required by the U.S. Supreme Court in North Carolina Dep't. of Rev. v. The Kimberley Rice Kaestner 1992 Family Trust, 139 S. Ct. 2213 (2019), absent very unusual circumstances, is the trustee of any wholly-discretionary irrevocable trust for the benefit of North Carolina residents subject to North Carolina state income tax on annual non-source accumulated income under N.C.G.S. Section 105-160.2—a statute premised solely upon the residence of beneficiaries?

After Kaestner, North Carolina state taxation of the annual accumulated income of wholly discretionary trusts appears to be unconstitutional under North Carolina's current statute, except in aberrant factual circumstances. This result appears to be true regardless of where the trust's trustees or grantor reside, and in spite of the principal place of administration of the trust, because the statutory scheme of taxation offered by N.C.G.S. Section 105-160.2 relies on none of those factors. This is not a cavalier expansion of the Kaestner holding; rather, it is a very conservative reading in light of a trustee's fiduciary duty not to remit taxes that are not owed.

Tax Nexus

Forty-two states across the United States choose to constitution-ally base their general jurisdiction to tax annual accumulated trust income on one or more of the following six connections, or points of nexus, with the state:

1. A resident grantor of inter vivos trusts,
2. A resident decedent of testamentary trusts, (State tax statutes described in 1 & 2 often are called "Founder" statutes.)
3. A resident beneficiary of a trust,
4. A resident trustee of a trust,
5. The location of the administration of the trust, and
6. In part, on a recitation in the trust agreement (Louisiana only).

Some state legislatures have chosen to use several of these fac-tors in combination (e.g., North Dakota, N.D. Admin. Code Section 81-03-02.1-04(2)). By contrast, many states use only one point of nexus for the authority to tax. See Richard W. Nenno, Bases of State Income Taxation of Nongrantor Trusts, ACTEC 1, http://www.actec.org/assets/1/6/Nenno_state_nongrantor_ tax_survey.pdf (last updated March 2019) (surveying all fifty states' respective trust income taxation regimes).

North Carolina's statute exclusively uses the residence of a beneficiary to provide the nexus to tax trust income. N.C.G.S. § 105-160.2. For purposes of Due Process, Kaestner holds that North Carolina only has jurisdiction to tax trustees on the trust income of trusts where a North Carolina resident holds beneficial interests having particularly narrow characteristics.

Scope

Following the Kaestner decision, commentators have wondered about the impact of the decision on the fiduciary income tax statutes of all forty-two taxing states. While the opinion will help shape the analysis of fiduciary income tax statutes in other states, the influence of Kaestner may be limited in that broader,

nationwide context. For trustees of trusts with North Carolina resident beneficiaries, though, the import of the Kaestner holding is difficult to overstate.

The Kaestner Court specifically "granted certiorari to decide whether the Due Process Clause prohibits States from taxing trusts based only on the in-state residency of trust beneficiaries." Kaestner, at 2219. Despite suggestions to the contrary in earlier lower court opinions in other cases and in professional and academic writings, the Court declined to hold that the Due Process Clause unequivocally prohibits states from taxing trusts based only on the in-state residency of any trust beneficiaries with all forms of equitable rights. Cf. In Re Swift, 727 S.W.2d 880, 882 (Mo. 1987) (en banc) (declaring as unconstitutional a statute based solely on domicile of the settlor of testamentary trusts, and suggesting that a state fiduciary income tax statute needs more than just one contact to be constitutional, e.g., more than merely the domicile of the grantor at death or the domicile of beneficiaries). So, in Kaestner, the Court has held that—only in very specific and limited legal or factual circumstances—the residence of the beneficiary, alone, may be enough to convey jurisdiction to tax a trustee on accumulated trust income. Kaestner, at 2221.

Importantly, for statutes such as N.C.G.S. Section 105-160.2—which bases North Carolina's power to tax solely on the residence of the beneficiary within that state—the Court clearly has limited the types of beneficial trust interests which create jurisdiction to tax. Specifically, the Court "[held] 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." Id. (emphasis added).

Stare Decisis

That the holding of the U. S. Supreme Court in Kaestner is "as applied" to the respondent trustee does not make the holding in-applicable to the annual accumulated income of other trusts with North Carolina resident beneficiaries. To the contrary, Kaestner is particularly pertinent to a wide range of trusts with North Carolina resident beneficiaries. It has far-reaching ramifications for trustee-taxpayers of trusts with North Carolina resident beneficiaries even though the opinion was rendered on an "as applied" basis. (A discussion of facial constitutional challenges to statutes, including Washington State Grange v. Washington State Republican Party, 552 U.S. 442 (2008), appears in the 2018 article in this series.)

The doctrine of stare decisis—i.e., following legal precedent in case law—is a primary foundation of American jurisprudence. At a fundamental level, the U.S. Supreme Court repeatedly has supported the doctrine of stare decisis, especially in constitutional matters. "In constitutional cases, the doctrine [of stare decisis] carries such persuasive force that we have always required a departure from precedent to be supported by some 'special justification.'" Payne v. Tennessee, 501 U.S. 808 (1991), citing Arizona v. Rumsey, 467 U.S. 203, 212 (1984); see Quill Corp. v. North Dakota, 504 U.S. 298 (1992) (concerning the application of stare decisis in the context of an un-constitutional state tax statute); c.f. Burnet v. Coronado Oil & Gas Co., 285 U.S. 393, 405 (1932) (Brandeis, J., dissenting).

Recently, in the U.S. Supreme Court's October 2018 term, which ended June 30, 2019, the Court reiterated the boundaries of its stare decisis jurisprudence in Knick v. Township of Scott, Pennsylvania, 139 S. Ct. 2162, 2177 (2019) (overruling the state litigation requirement in the context of an uncompensated governmental taking). "The doctrine of stare decisis reflects a judgment 'that 'in most matters it is more important that the applicable rule of law be settled than that it be settled right.''" Id. (quoting Agostini v. Felton, 521 U. S. 203, 235 (1997), in turn quoting Burnet v. Coronado Oil & Gas Co., supra); see also Gundy v. U.S. at 55 (2019). In Kaestner itself, the principle was important enough to Justice Alito to file a concurring opinion: "I write separately to make clear that the opinion of the Court merely applies our existing precedent and that its decision not to answer questions not presented by the facts of this case does not open for recon-sideration any points resolved by our prior decisions." Kaestner, 139 S. Ct. at 2226 (Alito, J., concurring). Finally, in its petition to the North Carolina Supreme Court to review the Court of Appeal's decision in Kaestner, the state of North Carolina accurately observed "the potential widespread impact of the Court of Appeals' decision…." Petition in Kaestner, No. 307 P15-2, at 9 (N.C., July 22, 2016).

Accordingly, fiduciaries should not ignore he Kaestner holding as meaningless or inapplicable to the trusts they oversee merely because the holding was rendered "as applied" to the Kaestner Trust.

Degree of Beneficial Possession, Control, or Enjoyment Required for a State to Tax Under A Statute Premised on the Residence of a Beneficiary

In Kaestner, the Court "granted certiorari to decide whether the Due Process Clause prohibits States from taxing trusts based only on the in-state residency of trust beneficiaries." Kaestner, 139 S. Ct. at 2219. The Court answered this question by holding that, when tax residency of the trust is based on the residency of beneficiaries, only certain very narrow types of beneficial interests can give rise to a resident trust that is taxable under Due Process. See id. at 2222. For a tax year in question, if neither the trust terms nor distributions made from the trust convey those narrow, non-contingent types of taxable beneficial interests upon a North Carolina resident beneficiary, then the trust does not meet the prerequisite of being a resident trust. In particular, in a given tax year, the Constitution prohibits a state which predicates its tax solely upon the residence of a beneficiary within the state from taxing a resident beneficiary's interest (if any) in the accumulated income of a wholly-discretionary trust.

In contrast, in a given tax year, if trust income has been distributed to a resident beneficiary, if a resident beneficiary has the right to compel the distribution of the income, or if a resident beneficiary is certain to receive the accumulated income, then the resident beneficiary's interest rises to a level where the trustee is susceptible to taxation. Id. at 2222–24.

What Types of Trusts Remain Subject to North Carolina State Tax on Annual Accumulated Income?

In Kaestner, the Court helpfully defined the constitutional limits on a state's taxation of annual accumulated income. Specifically, the Court held that a tax statute based solely on the residence of beneficiaries did not meet the Due Process requirements under the following circumstances:

1. Income has not been distributed to the resident beneficiaries,
2. The resident beneficiaries have no right to demand that in-come, and
3. The resident beneficiaries are uncertain ever to receive the accumulated income.

Id. at 2224. In reaching this holding about North Carolina's constitutional authority to tax based on its current statute, the Court did not make further explicit observations about the existing application of well-established principles of trust taxation to those three special circumstances.

Tax Effect of Distributions. If a trustee distributes income to a beneficiary during the tax year in question, then I.R.C. Section 662 (or I.R.C. Section 652 for simple trusts) includes that income in the gross income of the beneficiary, and I.R.C. Section 661 (or I.R.C. Section 651 for simple trusts) provides a deduction to the trust for the distribution. In general, North Carolina follows these same rules. The first sentence of N.C.G.S. Section 105-160.2 states that "[t]he tax imposed by this Part applies to the taxable income of estates and trusts as determined under the provisions of the [Internal Revenue] Code except as otherwise provided in this Part . . ." So, while North Carolina has the constitutional authority to tax a trustee on trust income that is distributed to a resident beneficiary, it instead taxes that income to the distributee-beneficiary by the operation of basic principles of Subchapter J of the I.R.C., as incorporated by N.C.G.S. Section 105-160.2.

For years in which some, but not all, trust income is distributed to a resident beneficiary, unless the facts and circumstances indicate otherwise, and absent peculiar trust terms, the fact that the undistributed income was not distributed to the resident is compelling evidence that the accumulated income was not for the benefit of the resident in that tax year. In particular, even where a trustee might distribute some fiduciary accounting income to a beneficiary in a year, it does not follow that the state may tax 100% of the undistributed capital gain and income of the trust. The statute must meet muster under the Commerce Clause (fair apportionment, substantial relationship, etc.). See South Dakota v. Wayfair, Inc., 138 S. Ct. 2080, 2091 (2018) (citation omitted).

Tax Effect of Demand Rights. If a resident beneficiary has a right to demand accumulated trust income, then principles of existing tax law concerning general powers of appointment may impact the state income taxation of that income.

For example, in a given tax year, a lapsing Crummey right—if still outstanding at year-end—could be viewed as a right to "demand" or "compel" a small portion of accumulated income. See N.C.G.S. § 37A-3-303 (suggesting in the comments that a blanket power to withdraw trust property in general should be prorated between trust income and principal). Usually, each year trust income is small in proportion to trust principal, so a pending withdrawal right might create some minor North Carolina income tax liability to the trust under the second prong of the Kaestner exceptions. See Kaestner, 139 S. Ct. at 2223.

An attempt by the Department of Revenue to collect revenue under this theory would be aggressive. The withdrawal right probably should not be elevated to a "mandatory income interest," i.e., "the right of an income beneficiary to receive net income that the terms of the trust require the fiduciary to distribute." N.C.G.S. § 37A-1-102(7). However, if a small portion of annual trust income truly can be "compelled" by a beneficiary to be distributed under the terms of the trust agreement, a counterargument might be made that the (unexercised) power also should be treated as a deemed distribution to that beneficiary of both distributable net income and fiduciary accounting income, and so the minor income tax liability would pass to the beneficiary.

Uncertainty Regarding Receipt of Future Distributions of Accumulated Income. For fiduciaries, advisors and the Department of Revenue, the question of whether beneficiaries are certain to receive accumulated income in the future may be the most salient inquiry in part III.B. of the Kaestner opinion.

As a threshold matter, absent special provisions, federal and state governments tax accumulated annual income only for the tax year in question.

"[W]ith income taxation, the focus of the due process analysis is on the tax year in question, which would be 2006 in this case." See Gavin, 733 A.2d at 802 (noting the connection for the inter vivos trust was the fact a noncontingent beneficiary was an in-state resident during the tax year in question); see also In re Swift, 727 S.W.2d 880, 882 (Mo. 1987) (addressing income taxation on a testamentary trust and stating, "An income tax is justified only when contemporary benefits and protections are provided the subject property or entity during the relevant taxing period")."

Linn v. Department of Revenue, 2 N.E. 1203, 1210 (Ill. Ct. App. 2013) (holding unconstitutional a state fiduciary income tax based on the residence of the grantor of an inter vivos trust who had died thirty years previously) (citing Chase Manhattan Bank v. Gavin, 733 A.2d 782 (Conn. 1999), In re Swift, 727 S.W.2d 880, 882 (Mo. 1987)). See also N.C.G.S. § 37A-1-102(1) (generally defining "Accounting Period" for fiduciary accounting purposes as a calendar year).

In a fiduciary income tax context, so-called "throwback" taxes might be assessed on a resident beneficiary (not on the trustee) in a subsequent tax year on income accumulated by trustees in prior years. California and New York each employ a form of throwback tax on resident beneficiaries. See Cal. Rev. & Tax Code § 17745; N.Y. Tax Law § 605(b)(3)(D). However, some anecdotal evidence from California suggests that its five-year throwback tax is easily avoided and very expensive for the California Franchise Tax Board to administer. North Carolina does not (and in the authors' opinions, in the future should not) employ a throwback tax.

Under wholly discretionary trusts containing typical spend-thrift provisions, resident beneficiaries are uncertain to receive distributions of accumulated income in the future. Applying general principles of trust law, that uncertainty may be either a matter of law or a matter of fact.

Analogizing a beneficiary's right to distributions from a wholly discretionary trust to a contingent interest under a will under traditional perpetuities jurisprudence suggests that the beneficiary's right to a discretionary distribution is uncertain as a matter of law.

For example, in Knox v. Knox, the North Carolina Supreme Court analyzed whether the remainder interest of a residuary, per stirpital beneficiary was vested where the beneficiary survived the testator but predeceased

the tenant for life. Knox v. Knox, 179 S.E. 610, 614 (N.C. 1935). In holding that the beneficiary's interest was vested because the beneficiary was a surviving brother and next of kin to the testator at the testator's death, the court reasoned that "[t]here must be a postponement not only of the right to enjoy, but also of the right to take an interest in order to make it either a contingent interest or a substitutional or alternative interest." Id. at 616 (emphasis added) (citation omitted). Conversely, the North Carolina Court of Appeals held that the interest of a remainder beneficiary was contingent where the beneficiary's interest was expressly conditioned on the beneficiary's survival of the life tenant—a hallmark condition precedent. Canoy v. Canoy, 520 S.E.2d 128, 131-32, 135 N.C. App. 326, 328 (1999) ("A remainder interest is not vested, but is contingent, 'when it is either subject to a condition precedent (in addition to the natural expiration of prior estates), or owned by unascertainable persons, or both.'") (quoting Hollowell v. Hollowell, 430 S.E.2d 235, 242 (N.C. 1993)).

The privilege of a trust beneficiary to receive a discretionary distribution is subject to the condition precedent that is the trustee's exercise of discretion to distribute trust property. Thus, the beneficiary's interest is contingent and, as a matter of law, uncertain to vest. See Thomas v. Harrison, 191 N.E.2d 862, 866 (Ohio Prob. Ct. 1962) (declaring a trust void under the rule against perpetuities because the trustee could conceivably exercise its "absolute discretion" to vest the trust property in the beneficiaries beyond the permissible period). The Court in Kaestner recognized the contingent nature of a beneficiary's interest in a discretionary trust. Kaestner, 139 S. Ct. 2213, 2223 n. 10 ("In light of these features, one might characterize the interests of the beneficiaries 'contingent' on the exercise of the trustee's discretion.").

In many cases, in long term "legacy" discretionary trusts, the beneficiaries may not receive current income from the trust during any years in question, they have no right to demand trust income or otherwise control, possess, or enjoy the trust assets in the tax years at issue, and they also have no expectation of receiving any specific amount of income from the trust in the future. When a grantor creates a long-term trust in one of a majority of states which have wholly or partially eliminated the rule against perpetuities, including North Carolina in 2007, a material purpose of the trust often is its longevity. N.C.G.S. § 41-23; Howard M. Zaritsky, The Rule Against Perpetuities: A Survey of State (and D.C.) Law, ACTEC, https://www.actec.org/assets/1/6/Zaritsky_RAP_Survey.pdf (last updated March 2012). With some regularity, grantors choose to create pairs of trusts: one for the immediate benefit of living family members, and second, a wholly-discretionary trust for the primary benefit of future generations, when needed.

Even under trust agreements giving the widest latitude to the trustee, a beneficiary may seek court review of the trustee's exercise of discretion. Determining whether a trustee has abused the trustee's discretion will depend on the findings of fact by the Department of Revenue or court in each case.

"Even with a pure discretionary trust in which the trustee's discretion is "sole and absolute," or "uncontrolled," and the trust is without standards, the beneficiary may obtain judicial review to determine whether the trustee has abused that discretion. If there were no judicial review, and the terms were taken literally, the trustee would, in effect, be the owner of the trust property and the settlor's trust terms would be precatory only." Discretionary trusts, Bogert The Law Of Trusts And Trustees § 228.

In a suit against the trustee, the beneficiary has standing to obtain judicial review in the jurisdiction in which the trustee resides and principal place of administration is conducted. In limited circum-stances, the beneficiary may have standing to obtain judicial review in the beneficiary's domicile depending on the substantiality of the trustee's contacts with that state. See Hanson v. Denckla, 357 U.S. 235, 251, 253 (1958). For many trusts with North Carolina resident beneficiaries, note that typically, the nature and scope of beneficia-ries' rights to future accumulated income are not governed by North Carolina law, but by the law of the state governing the administration of the trust, typically the domicile of the trustee. See id. at 255; see also N.C.G.S. § 36C-2-202 (jurisdiction over trustee and beneficia-ry). As a further complexity, where fiduciary authority is shared by multiple co-trustees residing in different states, the trustee charged with reporting income must assess which trustee or trustees hold distributive authority, administered in which state.

North Carolina, along with Arizona, Hawaii, and Louisiana, follow the Restatement (Second) of Trusts Section 187, and courts only will intervene if it is shown that an abuse of trustee discretion has taken place. Little v. Wachovia Bank & Trust Co., 113 S.E.2d 689, 708 (N.C. 1960) ("Where discretion is conferred upon the trustee with respect to the exercise of a power, its exercise is not subject to control by the court, except to prevent an

abuse by the trustee of his discretion.") (quoting Restatement (Second) of Trusts § 187 (1959)); Ivan Taback & David Pratt, When the Rubber Meets the Road: A Discussion Regarding a Trustee's Exercise of Discretion, 49 Real Prop. Tr. & Est. L.J. 491, 497 (2015); see N.C.G.S. § 36C-8-814(a) ("[A] trustee abuses the trustee's discretion in exercising or failing to exercise a discretionary power if the trustee acts with bad faith, acts dishonestly, acts with an improper motive, even though not a dishonest motive, or if the trustee fails to use the trustee's judgment in accordance with the terms and purposes of the trust and the interests of the beneficiaries."). "It should be noted that not one state in the United States allows a trustee truly uncontrolled discretion and . . . all states are willing to subject a trustee to some form of judicial review, regardless of the breadth of absolute discretion granted to a trustee." Taback & Pratt at 491, 511 (2015) (surveying the limits of trustee discretion under the laws of all fifty states); see Woody v. Christian, 172 S.E.210, 213 (N.C. 1934) ("When it appears that a trustee has exercised or proposes to exercise such discretion in good faith, and with an honest purpose to effectuate the trust, the courts will not undertake to supervise or control his actions."); Heyer v. Bullock, 186 S.E. 356, 362 (N.C. 1936) (North Carolina trusts are "subject to the control of the court at all times," affirming the lower court's decision to interfere with the trustee's exercise of discretion).

Despite the uncertainty of a beneficiary's right to a discretionary distribution from year to year as a matter of law, under Kaestner the existence or lack of a distribution in any one year should be a primary consideration in a pragmatic fact-based inquiry conducted by the trustee in fulfilling its duty to report income. See Kaestner, 139 S. Ct. at 2220; see also Richard C. Ausness, Discretionary Trusts: An Update, 43 ACTEC L.J. 231, 233 (2018) ("Discretion may be de-fined as the power or authority to choose among various alternatives."). While North Carolina's trust income tax statute lacks clarity for most discretionary trusts with resident beneficiaries, under Kaestner broad trustee discretion indicates that the state does not have a sufficient connection to the undistributed trust income to tax.

Under N.C.G.S. Section 105-160.2, Does the Residence of the Trustee Matter?

In addition to the constitutional questions, recent case law re-minds practitioners not to forget to apply basic principles of statutory analysis. In curtailing the reach of its holding, the Court ad-dressed North Carolina's authority to tax wholly discretionary beneficial trust interests under N.C.G.S. Section 105-160.2, a tax statute premised solely on the residence of the beneficiaries. When determining whether a trust is a North Carolina resident trust subject to taxation under that statute, the inquiry is limited to whether the basis for taxation set forth in the statute is present. Kaestner, 139 S. Ct. at 2222. The Court did not suggest that facts irrelevant to and outside the scope of the statute can be considered when evaluating taxation under N.C.G.S. Section 105-160.2.

In particular, practitioners should view the Kaestner Court's constitutional limitation in concert with its refusal (only a week after rendering the Kaestner opinion) to grant certiorari in Fielding v. Commissioner of Revenue, thereby letting stand the underlying Minnesota Supreme Court case. Fielding v. Commissioner of Revenue, 916 N.W.2d 323 (Minn. 2018), aff'g Fielding v. Commissioner of Revenue, 2017 WL 2484593 (Minn. Tax Ct. 2017), cert. denied, 139 S. Ct. 2773 (June 28, 2019) (holding unconstitutional under due process Minnesota's fiduciary income tax statute premised solely on original residence of the founder). In Fielding, the opinions of the Minnesota Tax Court and Minnesota Supreme Court contain outstanding discussions of the relevance or irrelevance of certain facts when assessing the application of a statute. The Minnesota Tax Court held:

We agree with the Commissioner that as-applied challenges are analyzed under all the relevant circumstances. See, e.g., Rew v. Bergstrom, 845 N.W.2d 764, 780 (Minn. 2014). The Commissioner simply assumes, however, that all the contacts between Minnesota and the Trusts are relevant when applying section 290.01, subdivision 7b(a)(2). We cannot agree…. Consequently, when analyzing the Trusts' s-applied challenge to the grantor-domicile rule, we will ask whether the domicile of the grantor—standing alone—is a sufficient connection upon which to justify taxing the Trusts as Minnesota residents…. We will not, as the Commissioner requests, consider other (nexus) factors such as the storage in Minnesota of trust instruments or the Minnesota domicile of a beneficiary."

Fielding v. Commissioner of Revenue, 2017 WL 2484593, at *24, *27 (emphasis added). In affirming the holding of the Minnesota Tax Court, the Minnesota Supreme Court refined the Tax Court's analysis, agreeing

that only relevant contacts should be considered when assessing the constitutionality of the tax statute on an as-applied basis. Suggesting that the residence of the trustee or activities of administration in the state might be relevant in some circumstances, that court stated:

"[W]e look beyond the statutory definition that identifies who is subject to a tax in order to evaluate the relationship between the income taxed and the benefits provided by the state. This analysis is not ... a matter of adding language to the statute. We are not redefining a resident trust; we are simply evaluating, as we have in other cases, all the relevant facts when considering whether the application of the statutory definition would be consistent with due process in this case."

Fielding v. Commissioner of Revenue, 916 N.W.2d at 329 (emphasis added).

The analysis required in Minnesota by its Supreme Court holding in Fielding is subtle and could be easily confused. So long as a court, commissioner, or fiduciary is assessing the state's authority to tax a resident trust as defined by a state tax statute (and circum-scribed by the Constitution), the court contended that it can weigh relevant extra-statutory facts, such as the residence of the trustee or activities of administration in the state, when determining the constitutional application of a tax. However, if a trust is not a "resident trust" under the statute—for instance, in Minnesota, if the grantor was not a resident when the trust was formed—then the tax does not apply and extra-statutory facts cannot be considered. A prerequisite to the applicability of an inquiry into extra-statutory facts is a determination of whether the trust is a resident trust under the statute.

When Kaestner was decided, the Court's decision on the petition for certiorari in Fielding—the case in which the Minnesota courts had struggled over the shape and extent of the relevancy analysis of a tax statute in as-applied constitutional challenges—was pending. The Kaestner Court added meaningfully to that constitutional jurisprudence, providing a clearer framework for analyzing the relevance of facts such as the residence of the taxpayer-trustee in situations where the state legislature did not base its fiduciary in-come tax statute on the location of the trustee-taxpayer. Part III. A. of the Kaestner opinion is critically important to the relevancy analysis in an as-applied Constitutional challenge to a tax statute un-der the Due Process clause.

"All of the foregoing cases reflect a common governing principle: When a State seeks to base its tax on the instate residence of a trust beneficiary, the Due Process Clause de-mands a pragmatic inquiry into what exactly the beneficiary controls or possesses and how that interest relates to the object of the State's tax.... When a tax is premised on the in state residence of a beneficiary, the Constitution requires that the resident [beneficiary] 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.... create the "minimum connection" that the Constitution requires."

Kaestner, 139 S Ct. at 2221–22 (citing Safe Deposit, 280 U. S., 83, 91 (1929), Quill, 504 U. S. 298, 306 (1992)). When a state relies solely on the residence of the beneficiary to justify taxation of annual accumulated non-source income, then this aspect of the statutory analysis focuses on the rights of the beneficiary and the beneficiary's connections to the state. Kaestner holds that the Due Process clause of the Constitution requires that a threshold pragmatic inquiry limit the scope of statutes like N.C.G.S. Section 105-160.2 only to trusts in which beneficiaries (a) actually receive a distribution of annual trust income, (b) have a right to demand annual trust income, or (c) obtain a right to receive a current trust income in the future. Id. at 2223. If a trust with resident beneficiaries does not fall within those exceptions, then constitutionally, it is not a resident trust.

If the trust is not a resident trust, then other potential nexus factors such as the residence of the trust's grantor, the location of the trustee's law firm or accountant, or the place of custody of the trust agreement—factors upon which North Carolina's tax statute is not premised—are not relevant. Just because a state could use a particular factor (and chooses not to) should not mean that the same state's department of revenue can pull irrelevant extra-statutory factors into the analysis.

North Carolina's General Assembly has compelling legislative reasons to closely draft its tax statutes to exclude factors that are against its public policy. As a critical aspect of the State of North Carolina's economic

policy, worldwide trust grantors readily can secure North Carolina as the principal place of administration of a trust without the challenges that some jurisdictions present. Some trust settlors may have a strong desire or tactical planning reason to con-tract with well-established trust companies with a proud history of dedication to their customers. North Carolina is home to a meaningful concentration of the largest and most well-staffed private banks and trust companies in the United States (indeed, in the world), as well as numerous excellent mid- and small sized trust companies. See Carolyn Duren & Armughan Khawaja, Charlotte, NC, outpacing nationwide growth in banking, set for further expansion, S&P Global (May 16, 2019), https://www.spglobal.com/marketintelligence/en/news-insights/trending/kdZchEwDkYSXozJJ7Z8gQA2. The head-quarters of Bank of America, housing the largest private banking operations in the United States, is in Charlotte, North Carolina. See Matt Barthel, Top 40 Wealth Management Companies, Wall Street J. (Sept. 24, 2018), http://online.wsj.com/public/resources/documents/Top40WealthManagementFirms2018.pdf?mom=article_in-line. Wells Fargo Bank (fourth-largest private bank operations) ad-ministers its East Coast operations out of North Carolina. Id. The trust department of Brown Brothers Harriman (twenty-sixth) is ad-ministered in North Carolina. Id. In February 2019, SunTrust Bank (twenty-fifth largest private bank) and Branch Banking and Trust Co. (BB&T; thirty-first) announced a $66 billion merger, "the world's largest bank merger in more than a decade" with headquarters in Charlotte, North Carolina. Id.; Hannah Levitt, BB&T to Buy Sun-Trust in Biggest Bank Merger in a Decade, Bloomberg (Feb. 7, 2019). The State of North Carolina strives to attract the business of the financial industry, and many North Carolina voters and stakeholders prioritize financial policy matters.

Where the North Carolina legislature has not acted to include certain bases for taxation in North Carolina's tax statutes—in particular, the residence of trustees and principal place of trust administration—the courts and Department of Revenue must adhere to legislative intent and limitations as set forth in those statutes. "The primary indicator of legislative intent is statutory language; the judiciary must give clear and unambiguous language its plain and definite meaning…. Tax statutes are to be strictly construed against the State and in favor of the taxpayer." Wal-Mart Stores East, Inc. v. Hinson, 197 N.C. App. 30, 42 (2009) (citing Proposed Assessments v. Jefferson-Pilot Life Ins. Co., 161 N.C. App. 558, 560 (2003)).

As a tangential observation, although N.C.G.S Section 105-160.2 is premised upon the presence of resident beneficiaries, because the instructions to the NC Form D-407 State Fiduciary Income Tax Re-turn are not clear, the duty to file a North Carolina fiduciary income tax return might apply in an important way to resident trustees who hold the duty to report a trust's income. If a non-resident trustee determines that a trust does not have resident beneficiaries within the scope of the Due Process clause (and assuming no North Carolina source income), then such trustee likely does not need to file a North Carolina state fiduciary income tax return at all, and North Carolina has no jurisdiction over such trustees. By contrast, because North Carolina almost certainly has personal jurisdiction over resident trustees, resident trustees, if they are responsible to report a trust's income, might have a duty to file and report information about a trust's income and expenses, even if that trust owes no tax. See Cal. Rev. & Tax Code § 17745(d) (implying duty of California resident trustees to report the annual accumulated income of trusts with contingent resident beneficiaries for calculating throwback tax).

Fiduciary Duty Not to Pay Taxes that Are Not Owed

Trustees can breach their fiduciary duties if they remit taxes that are not owed. Accordingly, they must proceed with extreme caution.

Case law establishes that overpayment of tax can be a breach of the trustee's fiduciary duty. See In re Estate of Ridl, 455 N.W.2d 188, 193 (N.D. 1990). The duty is more clearly breached when over-payment of tax is a result of fiduciary neglect rather than fiduciary caution. However, even where a fiduciary reasonably pays a tax out of caution, the fiduciary may still breach a duty by failing to file a claim for refund.

For example, in In re Estes' Estate, an executor was surcharged for overpayment of estate tax resulting from inclusion of life insurance policies in the decedent's gross estate where the insurance policy was owned by the decedent's ex-wife. 654 P.2d 4 (Ariz. Ct. App. 1982). In the couple's separation agreement executed about

eight months prior to the decedent's death, the decedent had agreed to maintain the life insurance policies for the benefit of their children, and thus the decedent might not have had incidents of ownership at death. Id. at 11. However, the executor refused to file for a refund. Id. at 12–13. The Court of Appeals of Arizona held that the executor's inclusion of insurance proceeds in the gross estate without ascertaining the legal effect of the property settlement agreement and subsequent refusal to file a claim for refund was a breach of the executor's duty to preserve the property of the estate. Id. The court reasoned that even though the "case law establishe[d] a genuine question as to whether Mr. Estes retained sufficient incidents of ownership in the insurance policies," the executor's refusal to file for a refund was "inconsistent with its duty to minimize estate taxes where Mrs. Estes' challenge to the tax return was credible under the facts and the law." Id.

North Carolina law addresses the impact of a fiduciary's under-payment of property tax but not the impact of a fiduciary's erroneous or prudent overpayment of income tax. By statute, a trustee "who suffers property in his care or control to be sold by reason of his negligence in failing to pay the taxes thereon when available funds were in his hands shall be liable to his . . . cestui que trust for all actual damages incurred as a result of his neglect." N.C.G.S.§ 105-383(c). The North Carolina Supreme Court in Rose v. Bank of Wadesboro refused to surcharge a guardian for penalties incurred in failing to list the minor's property for local taxes because the penalties were lower than the tax would have been, and the minor "was not dam-aged thereby." 9 S.E.2d 2, 5 (N.C. 1940). N.C.G.S. Section 105-383(c) and Rose comport with the element of damages in a successful breach of fiduciary duty claim. See also Wilkins v. Safran, 649 S.E.2d 658, 662 (N.C. Ct. App. 2007) ("Breach of fiduciary duty is a species of negligence or professional malpractice."); In re Wills of Jacobs, 370 S.E.2d 860, 865 (N.C. Ct. App. 1988) ("[D]amages for breach of trust are designed to restore the trust to the same position it would have been in had no breach occurred.").

Conversely, a trustee can uphold its duties by making a good faith legal argument against trust tax liability. Newcomer v. National City Bank discusses a trustee's duty not to pay tax that is not owed. 19 N.E.3d 492 (Ohio Ct. App. 2014). One of the disputes in Newcomer was whether the trustee's failure to file tax returns and pay California state fiduciary income taxes constituted a breach of fiduciary duty. Id. at 511. California's income tax would not have ap-plied if the interest of the beneficiary was "contingent." Cal. Rev. & Tax Code § 17742(a); 18 Cal. Reg. § 17742(a)-(b). The Court of Appeals of Ohio affirmed the trial court ruling that the beneficiary's interest in the trust was contingent and did not create any California income tax liability. "Furthermore, given the existence of a good faith legal dispute on the issue with reasonable legal analysis supporting arguments on both sides of the California tax dispute, we conclude that, even were the resolution of the tax dispute otherwise, the trustee's failure to file tax returns and to pay California income taxes cannot be held to have been undertaken in bad faith, in willful default, or reckless indifference." Id. at 515 (emphasis added). A good faith, honest, reasoned determination, even if ultimately incorrect, may shield the trustee from surcharge. Note again that determining whether a trustee's erroneous payment of North Carolina's income tax constitutes a breach of trust will depend on the jurisdiction of the trust's principal place of administration.

Practice Tip: For trusts with a North Carolina resident beneficiary and which have a filing requirement, the trustee with the duty to report income should include a statement with the Form D-407. The statement should clarify whether or not the resident beneficiaries held any rights that would cause the trust to be treated as a resident trust under Kaestner's pragmatic inquiry.

Conclusion

The U. S. Supreme Court's decision in Kaestner reaffirmed the significant limits on the application of North Carolina's trust income tax that has existed since at least 2015, the year of the Business Court decision, and really since 1923, the inception of North Carolina's taxation of trust income based on the presence of in-state beneficiaries. Act of March 3, 1923, ch. 4, § 205, 1923 N.C. Sess. Laws 67, 128 (cited by the Department of Revenue in its March 9, 2017 brief to the North Carolina Supreme Court). Under Kaestner, if a North Carolina beneficiary does not receive income from the trust during the year in question, has no right to demand trust income or control trust assets, and is uncertain to receive trust distributions in the future, North Carolina cannot constitutionally tax non-source trust income that year. Kaestner, 139 S. Ct. at 2223. Where

discretionary trusts inherently entail uncertainty as to distributions, as the Court recognized by adopting a pragmatic test, uncertainty as to the trust's income tax is a necessary consequence when the state's fiduciary in-come tax is premised on the residence of trust beneficiaries.

The trustee must use its discretion to balance its twin duties to administer the trust for the benefit of the current beneficiaries and preserve the trust corpus. Each year, the trustee of a discretionary trust must review the North Carolina beneficiaries' relationship, if any, to income accumulated by the trustee. If the beneficiaries' interests in the annual accumulated income of the trust are remote and no trust distribution would be appropriate, then the trust income is not likely subject to tax in North Carolina. The trustee should also keep an ear to the ground for changes to N.C.G.S. Section 105-160.2, because changes could be coming soon, conforming the statute to the limits mandated by the Kaestner Court.

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