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## Opportunities to Save State Income Taxes on Nongrantor Trusts Expanded by U.S. Supreme Court's 'Kaestner' Decision

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When determining whether a trustee of a nongrantor trust must pay a particular state's income tax on retained ordinary income and capital gains, a 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 ..."<sup>1</sup>

In *North Carolina Department of Revenue v. The Kimberley Rice Kaestner 1992 Family Trust*,<sup>2</sup> the U.S. Supreme Court held unanimously on June 21, 2019, that the Due Process Clause of the U.S. Constitution<sup>3</sup> 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.

**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.**

<sup>1</sup> 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 Nenno, *Bases of State Income Taxation of Nongrantor Trusts for 2018* (Aug. 14, 2019), [www.actec.org](http://www.actec.org).

<sup>2</sup> 139 S. Ct. 2213 (2019).

<sup>3</sup> U.S. Const. amend. XIV, §1.

- 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.
- 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 trustee.<sup>4</sup>
- January 11, 2019 — U.S. Supreme Court granted North Carolina Department of Revenue’s petition for certiorari.<sup>5</sup>
- April 16, 2019 — U.S. Supreme Court conducted oral arguments.

## SUPREME COURT HOLDING

Justice Sonia Sotomayor wrote the opinion for a unanimous Court in favor of the taxpayer.<sup>6</sup> The opinion concluded:<sup>7</sup>

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.

In North Carolina, a taxpayer may request a refund until the later of three years after the due date of the

return or two years after payment of the tax.<sup>8</sup> A taxpayer who has filed a written notice of contingent event for a year that otherwise would be barred by the foregoing statute of limitations, must request a refund within six months after the contingent event concludes.<sup>9</sup> The North Carolina Department of Revenue has announced:<sup>10</sup>

The contingent event related to the *Kaestner* case concluded on June 21, 2019, the date of the United States Supreme Court’s decision. Therefore, taxpayers who believe that the *Kaestner* decision applies to their particular facts and circumstances and who filed a Notice of Contingent Event that met the requirements of N.C. Gen. Stat. §105-241.6(b)(5) must file an amended return with the Department on or before December 21, 2019.

Based on the *Kaestner* decision, North Carolina residents and nonresidents should create trusts elsewhere if there are North Carolina resident discretionary beneficiaries. Tax also might be eliminated in situations beyond the one addressed by *Kaestner*.

## PLANNING ENHANCED IN GEORGIA AND MARYLAND

### Georgia

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.”<sup>11</sup> 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. After the *Kaestner* decision, the Georgia Department of Revenue issued guidance regarding *Kaestner*’s impact on Georgia taxpayers.<sup>12</sup> The guidance acknowledged that Georgia may not tax a nonresident trustee of a trust in which:<sup>13</sup>

1. The beneficiaries did not receive any income from the trust during the years in question;
2. The beneficiaries had no right to demand trust income or otherwise control, possess, or enjoy the trust assets in the tax years at issue; and
3. Not only were the beneficiaries unable to demand distributions in the tax years at issue, but it was also uncertain whether they would ever receive any income from the trust in the future.

<sup>8</sup> N.C. Gen. Stat. §105-241.6(a).

<sup>9</sup> N.C. Gen. Stat. §105-241.6(b)(5)(a).

<sup>10</sup> N.C. Dep’t of Revenue, *Important Notice: Decision in the Kaestner Case* at 1 (July 2, 2019), [www.ncdor.gov](http://www.ncdor.gov).

<sup>11</sup> Ga. Code Ann. §48-7-22(a)(1)(C) (emphasis added).

<sup>12</sup> Ga. Dep’t of Revenue, Policy Bln. IT-2019-02, 93 Tax Notes State 861 (Aug. 13, 2019), [www.dor.georgia.gov](http://www.dor.georgia.gov).

<sup>13</sup> *Id.*

Affected taxpayers should file refund requests for open years. In this regard, the general statute of limitations is three years after the later of the date the tax was paid or the due date of the return.<sup>14</sup>

The guidance continued:<sup>15</sup>

Although the Department must follow the *Kaestner* decision, it is limited in scope to the facts in that case. Therefore, with respect to facts that are specifically like those in *Kaestner*, a nonresident trust fiduciary would not be subject to Georgia taxation. Otherwise, the fiduciary would be subject to taxation under O.C.G.A. §48-7-22 and must file a return.

With respect to filing a return, O.C.G.A. §48-7-50 when read together with §48-7-22 requires a return to be filed by a nonresident fiduciary when 48-7-22 applies provided *Kaestner* does not apply.

Notwithstanding the above pronouncement, imposition of tax might be unwarranted in non-*Kaestner*-like situations under several theories.

First, the tax return instructions distinguish between trusts having resident fiduciaries, which are taxed on all income, and trusts having nonresident fiduciaries, which are only taxed on Georgia-source income.<sup>16</sup> This dichotomy suggests that nonresident trustees are only taxable on source income in all circumstances.

Second, a practitioner notes an existing ambiguity in Georgia's tax framework:<sup>17</sup>

Wlodychak said that O.C.G.A. section 48-7-22, which imposes the state's tax on resident and nonresident fiduciaries, seems to conflict with section 48-7-50, which imposes the requirement to file tax returns.

Section 48-7-22 imposes the tax on fiduciaries "Receiving income from business done in this state; Managing funds or property located in this state; or Managing funds or property for the benefit of a resident of this state." But section 48-7-50 states that an income tax return must be filed by a "Nonresident estate or trust that has federal gross income from sources within this state:"

Wlodychak said that section 48-7-50 and the associated regulation seem to imply that a return is required only if the nonresident trust has income from sources in the state. Wlodychak wondered how the tax was supposed to be paid when no return was required to be filed.

<sup>14</sup> See O.C.G.A. §48-2-49(b).

<sup>15</sup> Ga. Dep't of Revenue, Policy Bltn. IT-2019-02, 93 Tax Notes State 861 (Aug. 13, 2019).

<sup>16</sup> Instructions to 2018 Ga. Form 501 at 6.

<sup>17</sup> Andrea Muse, *Georgia Issues Guidance for Nonresident Trusts After Kaestner*, 2019 Tax Notes Today State 159-1 (Aug. 16, 2019).

Third, some Georgia practitioners take the position that nonresident trustees are not subject to tax by analogy to a regulation that imposes tax withholding requirements on certain payors to "any trust that is being administered by a nonresident fiduciary if the gain from the sale will be taxed to the trust."<sup>18</sup>

## Maryland

Maryland defines "resident trust" as a trust that is created by a Maryland testator or settlor or that is administered in Maryland.<sup>19</sup> But, Maryland gives trustees a deduction for intangible personal property held in trust for nonresidents.<sup>20</sup> It's nice that Maryland and the other states mentioned below provide 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 non-California trustees because nonresident trustees already don't have to pay California income tax currently on trusts having discretionary beneficiaries under the following statute:<sup>21</sup>

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 not germane in determining resident-trust status,<sup>22</sup> and in Pennsylvania,

<sup>18</sup> See Ga. Comp. R. & Regs. r. 560-7-8-.35(1)(d).

<sup>19</sup> Md. Code Ann., Tax-Gen. §10-101(k)(1)(iii). See instructions to 2018 Md. Form 504 at 1.

<sup>20</sup> Md. Code Ann., Tax-Gen. §10-207(o). See instructions to 2018 Md. Form 504 at 4-5. The deduction is not allowed "if there are no remaindermen of the trust in being" (Md. Code Ann., Tax-Gen. §10-207(o)(3)).

<sup>21</sup> Cal. Rev. & Tax Code §17742(a) (emphasis added). Appointing non-California trustees might also make it possible to reduce or eliminate California income tax on source income (see *Paula Tr. v. Calif. Franchise Tax Bd.*, No. CGC-16-556126 (Cal. Super. Ct. Feb. 6, 2018)).

<sup>22</sup> 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).

which already says that the residence of a beneficiary is not a factor in determining taxability.<sup>23</sup>

## 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 the following table.

<u>State</u>	<u>Potential Savings</u>
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

## 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,<sup>24</sup> purports to tax trustees solely because there are resident beneficiaries. The pertinent statute provides:<sup>25</sup>

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.<sup>26</sup>

Several states, in addition to Maryland, consider the presence of resident beneficiaries as one of multiple

<sup>23</sup> See 61 Pa. Code §101.1 (“The residence of ... the beneficiaries of the trust shall be immaterial”).

<sup>24</sup> Tenn. Code Ann. §67-2-102.

<sup>25</sup> Tenn. Code Ann. §67-2-110(a) (emphasis added). See instructions to 2018 Tenn. Form INC 250 at 3.

<sup>26</sup> 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

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:<sup>27</sup>

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.<sup>28</sup> Nevertheless, for inter vivos trusts, Connecticut apportions tax based on the number of resident and nonresident noncontingent beneficiaries.<sup>29</sup> 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.”<sup>30</sup>

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.<sup>31</sup> But, Delaware allows trustees of resident trusts to deduct taxable income set aside for future distribution to nonresidents.<sup>32</sup>

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.”<sup>33</sup> However, Hawaii allows trustees of resident trusts to exclude taxable income attributable to nonresidents.<sup>34</sup>

Kentucky treats a trust having a Kentucky resident trustee as a resident trust.<sup>35</sup> Nevertheless, a Kentucky regulation states:<sup>36</sup>

A resident ... trust shall report and pay tax on all taxable income except ... that portion of the net income from intangible personal property *attributable to a nonresident beneficiary*.

trust...”).

<sup>27</sup> Ala. Code §40-18-1(33)(b) (emphasis added).

<sup>28</sup> 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.

<sup>29</sup> Conn. Gen. Stat. §12-701(a)(4). See instructions to 2018 Form CT-1041 at 6, 8.

<sup>30</sup> 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.

<sup>31</sup> 30 Del. C. §1601(8). See 2018 Del. Form 400-I at 2.

<sup>32</sup> 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.

<sup>33</sup> Haw. Rev. Stat. §235-1. See Haw. Regs. §18-235-1-1.17; instructions to 2018 Haw. Form N-40 at 1.

<sup>34</sup> Haw. Rev. Stat. §235-4.5(a). See Haw. Regs. §18-235-4-03.

<sup>35</sup> Ky. Rev. Stat. §141.030(1), §141.020(1).

<sup>36</sup> 103 Ky. Admin. Regs. 19:010, §4 (emphasis added). See instructions to 2018 Ky. Form 741 at 2; 2018 Ky. Form 741 at 1.

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.<sup>37</sup> Nonetheless, Massachusetts generally taxes trustees of resident trusts only on income attributable to resident beneficiaries.<sup>38</sup>

In Michigan, a trust created by a resident testator or settlor is a “resident trust.”<sup>39</sup> But, the tax return instructions specify that an inter vivos trust created by a Michigan resident will not be treated as a “resident trust” if three conditions are satisfied, one of which is that “[t]he beneficiaries are all nonresidents.”<sup>40</sup>

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.”<sup>41</sup>

In Montana, the factors that are assessed in determining whether a trust is a “resident trust” include the beneficiaries’ domiciles.<sup>42</sup>

A North Dakota regulation contains a nonexclusive list of factors to be used in determining whether a trust is a “resident trust.”<sup>43</sup> The factors include whether “[a] beneficiary of the trust ... is a domiciliary or resident of this state.”<sup>44</sup>

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.”<sup>45</sup> 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,”<sup>46</sup> which, in turn, says that:<sup>47</sup>

[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).

<sup>37</sup> Mass. Regs. Code tit. 830, §62.10.1(1)(a), §62.10.1(1)(b)(1). See Mass. Gen. Laws ch. 62, §10(c); instructions to 2018 Mass. Form 2 at 4.

<sup>38</sup> Mass. Regs. Code tit. 830, §62.10.1(2)(b). See Mass. Gen. Laws ch. 62, §10(a).

<sup>39</sup> Mich. Comp. Laws §206.18(1)(c).

<sup>40</sup> Instructions to 2018 MI-1041 at 2.

<sup>41</sup> RSMo §143.331(2)(b), §143.331(3)(b) (emphasis added).

<sup>42</sup> Mont. Admin. R. 42.30.101(16). See instructions to 2018 Mont. Form FID-3 at 15-16.

<sup>43</sup> N.D. Admin. Code §81-03-02.1-04.

<sup>44</sup> N.D. Admin. Code §81-03-02.1-04(2)(a) (emphasis added).

<sup>45</sup> Instructions to 2018 Ohio Form IT 1041 at 4 (emphasis added).

<sup>46</sup> Ohio Rev. Code Ann. §5747.01(I)(3)(c).

<sup>47</sup> I.R.C. §1361(e)(2).

Rhode Island defines “resident trust” to include trusts established by resident testators and settlors.<sup>48</sup> But, it treats a trust as a “resident trust” only to the extent that it has resident beneficiaries.<sup>49</sup>

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.<sup>50</sup> But, in *Fielding for MacDonald v. Commissioner of Revenue*,<sup>51</sup> 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.”<sup>52</sup> The *Kaestner* decision suggests that the residences of beneficiaries should be a nonfactor even if courts may consider nonstatutory criteria.

Unfortunately, this issue will remain unresolved for the time being because the Minnesota Commissioner of Revenue’s petition for certiorari to the U.S. Supreme Court was denied on June 28, 2019,<sup>53</sup> a development that the Minnesota Department of Revenue estimates will cost the state \$33.4 million of annual revenue (20% of estimated annual collections) as well as \$66.8 million (plus interest) of retroactive revenue loss.<sup>54</sup>

## 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 Kimberley Rice Kaestner 1992 Family Trust* is one more reason to explore reducing or eliminating that tax.

<sup>48</sup> R.I. Gen. Laws §44-30-5(c)(2)-(4). See instructions to 2018 Form RI-1041 at I-1.

<sup>49</sup> 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.

<sup>50</sup> Minn. Stat. §290.01 Subd. 7b(a)(2).

<sup>51</sup> 916 N.W.2d 323 (Minn. 2018), *aff’d* 2017 WL 2484593 (Minn. Tax Ct. May 31, 2017).

<sup>52</sup> 916 N.W.2d at 334 (footnote omitted).

<sup>53</sup> *Bauerly v. Fielding*, 139 S. Ct. 2773 (2019).

<sup>54</sup> Aaron Davis, *State Projects Shortfall After Losing Trust Taxation Case*, 93 Tax Notes State 867 (Aug. 26, 2019).