



TECP Alert: U.S. Supreme Court Clarifies the Minimum Connection for the Taxation of Trusts

June 21, 2019

Ruling that the state law taxing all income of an irrevocable trust based only on the residence of a beneficiary in the state is unconstitutional, the U.S. Supreme Court affirmed the North Carolina courts in *North Carolina Dept of Revenue v. Kaestner*. The details matter and should be studied, but this is an important ruling on the limits of a State's power to tax the income of an irrevocable trust. Here is some additional detail.

The North Carolina statute imposes a tax on any trust income that is "for the benefit of" a North Carolina resident. The statute has been interpreted to mean that the trust owes income tax to North Carolina whenever its beneficiaries live in the state, even if the beneficiaries did not receive the income during the tax year and could not demand distribution of the income. The Court agreed the State Court ruling that the tax is unconstitutional when assessed in that type of situation because the State lacks the minimum connection with the taxpayer, which is constitutionally required under the Due Process Clause.

The Court confirmed that many other contacts with a trust do provide a minimum connection. Income distributed to an in-state resident and also income tax based on the trustee's residence both pass the Due Process Clause minimum connection requirements. However, in *Kaestner*, the trustee resided out of State and the trust administration occurred out of state. The Court limited its holding to the following: "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."

This is another important change in the state taxation of trusts. In 2018, the Minnesota Supreme Court ruled in *Fielding* that the trustor's residence at the time a trust became irrevocable was not a sufficient minimum connection and that, as a result, the application of the statute as applied to the trusts in that case was unconstitutional. Trustee's should consider to evaluate where to file fiduciary income tax returns in the future. In addition, consideration should be given to whether any claims for income tax refund should be made. Let us know when you are ready for us to help.

Reach out to the Gray Plant Mooty Trust, Estate, and Charitable Planning Practice Group if you have any questions.

