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SCOTUS Kaestner Ruling on State Trust Income Taxation: Key Considerations for Trusts and Estates Counsel

In-Depth Case Analysis, Income Tax Challenges for Nonresident Trusts, Planning Techniques

TUESDAY, OCTOBER 1, 2019

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

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U.S. Supreme Court's Kaestner Decision Is Good News for Georgia Taxpayers

BY: JULIAN FORTUNA
June 26, 2019

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Background

Most states have enacted statutes that impose income taxes on the income of a resident trust. Depending upon the particular statutory language, a trust is generally considered a resident trust when it meets one or more of the following criteria:

(1) the trust was created by the Will of a testator who lived in the state at death;

(2) the trustor of an *inter vivos* trust lived in the state;

(3) the trust is administered, or owns property, in the state;

(4) one or more trustees live or do business in the state; or

(5) one or more beneficiaries live in the state.

Because states define "resident trust" in several different ways, trusts are not taxed consistently from state to state. This often results in multiple state income taxes being imposed on the same trust income. [*See generally,* Nenno, *State Approaches to Taxation of Trust Income*, 51 Univ of Miami Law Center on Est Planning P 1501 (2018)].

The *Kaestner* Case

On June 21, 2019, the United States Supreme Court found that the presence of in-state beneficiaries alone did not empower the State of North Carolina to tax income accumulated in a trust. [*N.C. Dep't of Revenue v. Kimberley Rice Kaestner 1992 Family Trust*, 2019 U.S. LEXIS 4198.] In a unanimous decision, the court found that the beneficiaries' residence in North Carolina was too tenuous a link between the State and the trust to support the tax imposed on the income of fiduciary. Therefore, the Court held that the State's taxation of the trust violated the Due Process Clause of the Fourteenth Amendment.

Justice Sonia Sotomayor, writing for the majority, first acknowledged various precedents upholding as constitutional income taxes imposed on 1) income distributed to an in-state resident, 2) income accumulated by a trustee with an in-state residence, and 3) trust income with in-state trust administration. [*Kaestner*, 2019 U.S. LEXIS 4198 *citing Maguire v. Trefry*, 253 U. S. 12 (1920); *Greenough v. Tax Assessors of Newport*, 331 U. S. 486 (1947). *Hanson v. Denckla*, 357 U. S. 235 (1958); and *Curry v. McCanless* 307 U. S. 357 (1939)]. She next discussed various precedents in which the Court had previously upheld or overturned state statutes imposing taxes on trusts based upon beneficiary contacts, noting that in each of those cases it had evaluated the extent of the in-state beneficiary's right to "control, possess, enjoy, or receive trust assets." *[Kaestner, 2019 U.S. LEXIS 4198 citing Guaranty Trust Co. v. Virginia*, 305 U. S. 19 (1938*); Safe Deposit & Trust Co. of Baltimore v. Virginia*, 280 U. S. 83 (1929); *Brooke v. Norfolk*, 277 U. S. 27 (1928)].

In applying that analysis, the Court focused upon language in the *Kaestner* trust agreement which provided that 1) the decision of when, whether, and to whom the trustee would distribute the trust's assets was left to the trustee's "absolute discretion," 2) the trustee was explicitly authorized to distribute funds to one beneficiary to the exclusion of others, 3) the trustee and not the beneficiaries was authorized to make investment decisions regarding trust property, and 4) the beneficiaries were prohibited from assigning to another person any right they might have to the trust property. [*Kaestner*, 2019 U.S. LEXIS 4198].

Justice Samuel Alito, in a concurring opinion joined by Chief Justice John Roberts and Justice Neil Gorsuch, cautioned readers not to read too much into the decision which he said merely applied existing precedent to find that the connection between North Carolina and the trust was "unusually tenuous."

Impact in Georgia

Georgia imposes income taxes upon fiduciaries with beneficiaries residing in Georgia. However, unlike the North Carolina statute, the Georgia statute provides an exception whereby a fiduciary is not subject to tax on income that is "accumulated for, is distributed, or becomes distributable during the taxable year to a nonresident of this state and when the income was received from business done outside this state, property held outside this state, or intangible property, other than from the licensing for use of the property, held by a fiduciary, including, but not limited to, gains from the sale or exchange of the property." [O.C.G.A. § 48-7-22].

Based upon this statutory exception, it has long been the informal policy of the Georgia Department of Revenue not to tax a trustee on income sourced from outside the state which is accumulated for non-resident beneficiaries, regardless of whether the trustee is a resident or non-resident of Georgia. However, the statute provides no formula for apportionment of income between resident and non-resident beneficiaries and there are no court cases nor any publically available letter rulings or attorney general opinions interpreting the statutory exception.

The lack of formal guidance has led some fiduciaries to take a conservative approach and pay taxes in Georgia on all of the accumulated trust income even though not all of the beneficiaries are Georgia residents and the trust has no other connection to Georgia. This conservative approach, in essence, interprets the Georgia statute in a way similar to the North Carolina statute which has now been declared unconstitutional. Such an approach would seem to no longer satisfy the trustee's fiduciary duty to preserve corpus. Logically, income should be apportioned between resident and non-resident beneficiaries based upon their percentage interests in the trust, but in many cases, such as in *Kaestner*, the language of trust will give the trustee discretion as to which of multiple beneficiaries the accumulated income may be distributed.

Conclusion

Trustees who have been paying taxes in Georgia on accumulated fiduciary income may want to reevaluate that practice based upon the language of the Georgia statute and the Supreme Court decision on the *Kaestner* case. If the trust's only connection to Georgia is that one or more beneficiaries reside here, the trustee may be able to obtain full refunds of fiduciary taxes paid to Georgia in prior years provided that claims are filed before any statutes of limitations expire. If the trustee resides in Georgia and the trust has both resident and non-resident beneficiaries but no other connections to Georgia, the trustee should consider filing refund claims apportioning accumulated income among the beneficiaries using an apportionment method consistent with the language and administration of the trust.