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State Taxation of Non-Grantor Trusts Following the Supreme Court's Ruling in *Kaestner*

Practitioners in the field of estate planning have countless reasons to recommend the execution of trusts to their clients. Presumably, the advisor would be well versed in the various benefits and implications of all types of trusts. However, they must not only be aware of the legal consequences of the recommended plan, but they must also be aware of the tax consequences that the grantor, trustee, and beneficiaries of the trust may face.

Specifically, when utilizing non-grantor trusts, practitioners must consider the state income tax implications of the trusts when making recommendations. Similarly, trustees should be educated on how they can properly administer the trust assets in order to reduce the impact of state income taxation. Failure to take income taxes into consideration could ultimately lead to a malpractice claim against the estate planner, or a breach of fiduciary duty against the trustee.

State Taxation of "Resident Trusts"

A majority of states tax the full income of any non-grantor trust that is treated as a resident for income tax purposes, which is referred to as a "Resident Trust." However, states have various methods of defining whether a trust qualifies as a Resident Trust, depending on the circumstances. This inevitably leads to inconsistent income tax treatment of the same trust, which may lead to multiple state income taxes being imposed on the same trust income.

Forty-three states impose state income tax on trust income. Of these taxing states, they each tax a non-grantor trust based on one or more of the following:

(1) the trust is a testamentary trust and the testator was domi-ciled in the state at death;

(2) the trust is an inter vivos trust and the grantor lived in the state;

(3) the trust is administered in the state;

(4) at least one trustee lives or does business in the state; or

(5) at least one beneficiary lives in the state.

Of the above-outlined criteria, some states require multiple factors to be met in order to categorize a trust as a Resident Trust, whereas some states may only require one. Additionally, the existence of a provision in the trust which expressly states which state's law governs may or may not be conclusive on the issue. For example, Louisiana determines whether a trust is a Resident Trust based solely on what the provisions of the trust declares as its situs. The existence of such a provision in Idaho, on the other hand, has no bearing on a trust's income tax classification without the addition of another one of the five factors.

As a result of the inconsistent classifications of Resident Trusts by the states, it is important for practitioners and trustees to review the statutes which govern the tax treatment. These discrepancies could lead to a trust being treated as a Resident Trust in multiple states, and therefore being imposed with state income tax more than once on the same income.

New York taxes all of the taxable income of a Resident Trust,[1] as well as any taxable income of a Non-Resident Trust sourced in New York.[2] In order for a trust to qualify as a Resident Trust in New York, the trust must be either (1) a testamentary trust and the testator was domiciled in New York at death, or (2) a lifetime trust whereby (a) the grantor was domiciled in New York at the time property was transferred to the trust, regardless of whether the trust was revocable or irrevocable, or (b) in the event of a revocable trust that subsequently became irrevocable, the grantor was domiciled in New York at the time the trust became irrevocable.[3] The most common way in which a revocable trust becomes irrevocable is upon the death of the grantor.

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Kaestner: Minimum Contacts Required

On June 21, 2019, the United States Supreme Court ruled on the constitutionality of a state's taxation of a trust's income when the state's only connection to the trust was the residence of a trust beneficiary. In *North Carolina Department of Revenue v. Kimber-ley Rice Kaestner 1992 Family Trust,*[4] Kimberley Rice Kaestner, a North Carolina resident, was one of the beneficiaries of a trust formed by her father that was governed by New York law. The trust agreement gave the trustee "absolute discretion" to distribute income to the trust beneficiaries, and no income was distributed to Ms. Kaestner during the years in question. The trust maintained no physical presence, made no direct investments, nor held any real property in North Carolina. As such, the trust's only connection to North Carolina was the domicile of Ms. Kaestner.

In its unanimous decision, the Supreme Court held that, under the Due Process Clause, "a State has the power to impose a tax only when the taxed entity has certain min-imum contacts with the State such that the tax does not offend traditional notions of fair play and substantial justice," and that only those who derive benefits and protection from associating with a State should have obligations to the State."[5]

As a result of the holding in *Kaestner,* a state is not authorized to tax a trust's income where the state's only contact with the trust is the residence of a trust beneficiary who received no income from the trust and had no right to demand income from the trust. As noted above, prior to this decision, some states defined a Resident Trust as one in which at least one beneficiary lived in the state. It is now apparent that this criterion alone does not constitute sufficient "minimum contact" with a state for its income to be taxed while satisfying the due process requirements.

The First Supreme Court Decision, But Likely Not the Last

Although this decision by the Supreme Court is an important one, there have also been determinations by various state and federal courts on this issue, which have focused both on the Due Process Clause, as well as the Commerce Clause. These rulings may cause more trustees to commence suits against taxing states in the event the trustee's contacts are minimal.

The earliest New York Court of Appeals case ruling on the Due Process Clause issue occurred in 1964 in *Mercantile-Safe Deposit & Trust Company v. Murphy.*[6] In that case, the state was attempting to tax the accumulated income of an inter vivos trust after the Grantor's passing. Although the beneficiary of the trust was a New York resident, the trust had no New York trustee, no New York assets, and no New York source income. The court held that the state was acting beyond its jurisdiction and therefore, such an imposition of tax would conflict with and violate the Due Process Clause.

Years later, the Appellate Division of the Supreme Court of New York elaborated on the ruling in *Mercantile Safe Deposit & Trust Company* with its holding in *Taylor* v. *State Tax Commission,*[7] regarding how the Due Process Clause may be violated in the context of a state's taxation of trusts. In that case, the trust was a resident trust, as the Grantor was domiciled in the state of New York. However, the main asset of the trust was real property located in Florida and therefore, New York's connection with the trust was minimal. Ultimately, the court found that the Grantor's domicile alone was not a sufficient nexus with the state and imposing a tax would violate the Due Process Clause.

While New York cases have focused predom-inantly on the Due Process Clause, other states have made similar findings utilizing an analy-sis of the Commerce Clause. In *McNeil v. Commonwealth,*[8] for example, a Pennsylvania court held that the state was prohibited from taxing the income of a trust that, although created by a Pennsylvania resident, there were no Pennsylvania trustees, assets, or source income. Although this is a similar holding to the above-referenced cases, the court used a different approach, by reviewing the constitutionality under the Commerce Clause.

When considering whether a trust will be subject to state income taxation, it is imper-ative for practitioners to first identify which states' tax statutes will apply. This is especially important in situations where there are trustees and/or beneficiaries residing in different states. Estate planners in New York must advise their clients as to any income tax consequences they could face. Additionally, during the term of the trust, trustees must be advised as to of whether their investment methods, or a change in domicile, could result in an unintended state income tax implication. Overall, because of the narrow scope of the holding in *Kaestner*, the Supreme Court opened the door to opine on other issues regarding state taxation of trusts, which could ultimately have an even broader impact nationwide.

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1. Tax Law § 618.
2. Tax Law § 631.
3. Tax Law §§ 605(b)(3)(B), –(C).
4. 588 U.S. ___, 139 S.Ct. 2213 (2019).
5. Id. at 2220.
6. 15 N.Y.2d 579 (1964).
7. 85 A.D.2d 821 (3d Dept. 1981).
8. 67 A.3d 185 (Pa. Commw. Ct. 2013).