Kaestner: Tax, Estate Planning, and Trust Administration Implications

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Kaestner: Tax, Estate Planning, and Trust Administration Implications

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Kaestner Case

Facts

- Joseph Lee Rice III formed a trust for the benefit of his children in his home State of New York.
- Rice appointed a fellow New York resident as the trustee.
- The trust instrument gave 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 divided Rice’s initial trust into three separate sub-trusts including the Kimberley Rice Kaestner 1992 Family Trust (Trust).
- The Trust agreement provided that the Kaestner Trust would terminate when Kaestner turned 40, after the time period relevant here. After consulting with Kaestner and in accordance with her wishes, however, the trustee rolled over the assets into a new trust instead of distributing them to her.

Facts

- During the tax years in issue Kaestner had no right to, and did not receive, any distributions.
- The Trust was subject to New York law.
- The grantor was a New York resident.
- No trustee lived in North Carolina.
- The trustee kept the Trust documents and records in New York.
- The Trust asset custodians were located in Massachusetts.
- The Trust maintained no physical presence in North Carolina, made no direct investments in the State, and held no real property there.
- There were only two meetings between Kaestner and the trustee in those years, both of which took place in New York.

Facts

- The taxation of the trust was based on a North Carolina 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.
- North Carolina taxed the Trust formed for the benefit of Kaestner and her three children.
- The state courts holding was that the Kaestner’s in-state residence was too tenuous a link between the State and the Trust to support the tax.

Kaestner Case

Summary

- The Supreme Court of the United States published its decision in North Carolina Department of Revenue v. Kimberley Rice Kaestner 1992 Family Trust (*Kaestner*) June 21, 2019.
- It holds that, by reason of the due process clause of the Fourteenth Amendment of the Constitution of the United States, a state may not impose its income tax on undistributed income of a trust merely because a beneficiary, who was eligible to receive but did not receive any distribution from the trust in the years in question, was a resident of that state.

Unanimous Decision?

- The decision was unanimous.
- But Justice Alito filed a concurring opinion, in which Chief Justice Roberts and Justice Gorsuch joined.
- That concurring opinion may temper certain statements made in the court's opinion.

Due Process Limits State's Right to Tax

- The 14th Amendment to the Constitution provides in part: "No state shall make or enforce any law which shall abridge the privileges or immunities of citizens of the United States; nor shall any state deprive any person of life, liberty, or property, without due process of law; nor deny to any person within its jurisdiction the equal protection of the laws."
- 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.
- 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.

Due Process Limits State's Right to Tax

- That "minimum connection" inquiry is "flexible" and focuses on the reasonableness of the government's action. Id., at 307. Pp. 5–6.
- "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.
- Comment: What might this vague minimum connection mean to other contacts?
- Quill was overturned in part last year by South Dakota v. Wayfair, Inc., 585 U. S. ___ (2018).

Commerce Clause Not Addressed

- The *Kaestner* decision was based solely on due process.
- Another attack on a state imposing its income tax on undistributed trust income is the commerce clause contained in Article I, Section 8, Clause 3 of the Constitution.
- That was not addressed by the Court even though the trial court in North Carolina found that that too foreclosed income taxation of the trust's undistributed income.
- Previously the Supreme Court in the Quill case analyzed the distinction between the minimum contacts for nexus required under the Due Process Clause and the substantial nexus required by the Commerce Clause. Quill Corp. v. North Dakota (91-0194), 504 U.S. 298 (1992).

Holding Limited in Scope

- The decision is limited to the facts of the case. It means that a state, such as North Carolina, may not impose its income tax on undistributed trust income merely because a beneficiary who resides in the state is eligible to receive trust distributions. The decision does not provide the parameters of when a state may so impose its tax. But it is filled with significant discussion of the issue. That discussion may inform states on how to rig their state income tax laws so they can impose their state income tax on undistributed income of trust. It also should inform practitioners on how to try to structure and trustees how to administer trusts to avoid a state tax.

Reasoning of the Court

Minimum Connection

- The Supreme Court of the United States agreed with the decision of the Supreme Court of North Carolina that the state could not impose its tax on the undistributed income of the trust because the state “lacks the minimum connection with the object of its tax that the Constitution requires.”
- The court found that North Carolina’s only connection to the trust in the tax years in question was the state residency of the trust beneficiaries.
- The Trust had no physical presence in North Carolina, made no direct investments in the State, and held no real property there.
- The trustee chose not to distribute any of the income, and the trustee’s contacts with beneficiary were “infrequent.” The trustee kept the trust documents and records in New York, and the Trust asset custodians were located in Massachusetts.

Income Taxation of Trusts and Their Beneficiaries

Background Discussion

Federal Income Taxation of Trusts

- For Federal income tax purposes, trusts and their beneficiaries are taxed on trust income under a unique set of rules, unlike corporations and their shareholders (including so-called S corporations) or partnerships and their partners or any other tax entities and their beneficiaries or owners.
- Section 641(b) provides that trusts and decedents' estates are to be taxed as individuals except as otherwise provided in the Code.
- Section 641(c) provides that they will be taxed as individuals except as provided in Subchapter J. However, sections outside of Subchapter J provide some of the unique treatment of trusts and decedents' estates. Example: Section 167 provides for the treatment of deprecation on property held by a trust and for an estate and the treatment for those entities is somewhat different.

DNI and Kaestner

- A key difference between the taxation of an individual and a trust or estate is that a trust or estate is entitled to an income tax deduction for its distributable net income (DNI) that is distributed or treated as distributed to a beneficiary who must include the DNI in income.
- Sections 651-652 and 661-662. Section 643(a) defines DNI.
- To the extent an estate or trust is not entitled to a distribution of its DNI, the income will be taxed to the estate or trust. The issue dealt with in *Kaestner* was the ability of a state to tax such undistributed income.

Other Trust Taxation Schemes

- Most states tax on the basis of the Federal income tax rules. But at least two do not: Pennsylvania and Tennessee. Hence, the issue of the right of those states to tax trust income may be somewhat different than it might be in other states, such as North Carolina.
- Grantor trusts have their income, deductions and credits against tax attributed to the trust's grantor, or to someone who has certain powers to demand the income or corpus of the trust. See Sections 671-679.

Court's Comments on State Taxation of Trust Income

Kaestner Discussion of Factors Supporting Taxation

- Although the court limited its holding to the precise facts before it, many of its statements may be informative of when a state might impose its income tax on income that is not attributed to a beneficiary.
- Even if several additional factors would weigh in favor of allowing a state to impose its tax on the trust (e.g., settlor was domiciled in the state when the trust became irrevocable, one or more trustees resided in the state or the trust held assets in the state), North Carolina presumably could not have imposed its tax because the tax was premised on only one factor: a North Carolina resident was a beneficiary to whom the trustee could make distributions.
- North Carolina imposed its tax even if the trust had no relationship with the state other than one or more beneficiaries resided there. If the grantor had resided there or North Carolina law governed the trust, the result might have been different.
- In other words, in determining if the state could impose its tax, one first must see what the basis for the tax under that state's law.

When State Taxation May be Imposed

- The Court has already held that a tax on trust income distributed to an in-state resident passes muster under the Due Process Clause. Maguire v. Trefry, 253 U. S. 12, 16–17 (1920).
- A tax based on a trustee's in-state residence is valid. Greenough, 331 U. S., at 498.
- A tax based on the site of trust administration is constitutional. See Hanson v. Denckla, 357 U. S. 235, 251 (1958); Curry v. McCanless, 307 U. S. 357, 370 (1939)."

Resident Beneficiary

- The Kaestner 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.”
- But the court adds “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.”
- The court adds (footnote 10) “We have no occasion to address, and thus reserve for another day, whether a different result would follow if the beneficiaries were certain to receive funds in the future.”

Resident Beneficiary – Concurring Opinion

- Justice Alito in his concurring opinion may have indicated that the court's opinion may suggest a ground for a state to impose its tax on undistributed income beyond what he sees as precedent. For example, in the sole footnote to his opinion he states, in part, that *Brooke v. Norfolk*, 277 U. S. 27 (1928) held that "even if the children had a right [to all the trust income], it would not, alone, justify taxing the trust corpus."
- Unfortunately, the footnote does not indicate whether it is intended to mean that income attributed to corpus (such as capital gain in the "normal case") could not be taxed or it means something else.

Trustee Residence, Trust Administration, Investments

- In Kaestner, the trustee resided out of State, trust administration was split between New York (where the Trust's records were kept) and Massachusetts (where the custodians of its assets were located).
- In Kaestner, the trustee made no direct investments in North Carolina.
- Do these statements mean that if some trust administration occurred in North Carolina and/or there had been a direct investment there that the state could impose its income tax on the trust's undistributed income?

Accountings and Legal Advice

- The court also mentions that the trustee also gave the beneficiary accountings of trust assets and legal advice concerning the trust.
- It seems somewhat curious that the court mentions the foregoing factors because the North Carolina statute does not look to such factors in its statute to impose its tax on trust income.
- Why are they mentioned?
- Perhaps, it is saying that states cannot add those factors (e.g., giving accountings and legal advice to the beneficiaries) to another or other factors to permit the state lawfully to impose its income tax. It simply seems uncertain.

Trustee and Beneficiary Meetings

- The court mentions in footnote 3 that there were only two meetings between the beneficiaries and the trustee in the tax years in question, both of which took place in New York.
- Does this suggest that if there had been several meetings with the beneficiary that took place in North Carolina that its decision would have been different.
- What about web meetings?

Residence of Settlor

- The court also mentions that the settlor did not reside in North Carolina. Many states use the settlor's domicile as the factor or a factor in imposing its tax on undistributed trust income although it seems appropriate to note that many state courts have held that the settlor's domicile alone cannot provide the premise for taxation of the trust.
- See, e.g., *Mercantile-Safe Deposit and Trust Company v. Murphy*, 15 N.Y.2d 579 (N.Y. 1964).

5 Factors Used by States to Tax Trusts

5 Basis States Use to Tax Trusts

- States impose their income tax on trusts on a variety of factors.
- See Nenno, *Bases of State Income Taxation of Nongrantor Trusts, State Survey*, American College of Trust and Estate Counsel (ACTEC), updated February 21, 2019 (State Survey), a summary of which is provided on the webinar console.
- According to the Nenno article "All of the taxing states tax a non-grantor trust based on one or more of the following five criteria: (1) If the trust was created by the Will of a testator who lived in the state at death; (2) if the trustor of an inter vivos trust lived in the state when he or she placed assets in the trust or when the trust became irrevocable; (3) if the trust is administered in the state; (4) if one or more trustees live or do business in the state; or (5) if one or more beneficiaries live in the state."

Governing Law as a Basis of Taxation

- Louisiana taxes an inter vivos trust if the trust specifically provides that Louisiana law governs, but it does not tax such a trust if the trust specifies that the law of another state applies.
- Idaho and North Dakota consider the designation of its law as a factor in determining whether a trust is a Resident Trust.
- Otherwise, the designation of a state's law to govern a trust has no bearing on its classification.
- It might be that governing law could be an important factor in allowing the state to impose its tax on the trust income, as apparently Louisiana, Idaho and North Dakota do.
- In fact, if the law of a state governs the trust, that may allow access to that state's courts to resolve legal issues related to the trust.

Governing Law and Kaestner

- The Supreme Court in *Kaestner* did not pass on the issue of governing law.
- *Kaestner* may suggest, because it did not list governing law as a factor that might be considered, that a state may not tax such income merely because the trust is governed by the law of that state.
- It would not be simple, however, to avoid having a state resident create the trust if the grantor, in fact, lives there when the trust is created (or becomes irrevocable). Probably, the easiest way is to have no trustee in the state.

California Taxation Base on Trustees

- California (and other states) impose tax on the undistributed income of the trust if there is a California resident trustee even if no other state factor which might be used as a factor to impose its tax (e.g., the grantor lived in California when the trust was created) is present.
- For this purpose, the residence of a corporate fiduciary of a trust means the place where the corporation transacts the major portion of its administration of the trust. Calif. Revenue and Tax Code Sec. 17742. Where the taxability of income under this chapter depends on the residence of the trustee and there are two or more trustees for the trust, the income taxable under Section 1772 shall be apportioned according to the number of fiduciaries resident in California.
- The California statute imposes the tax if there is a California trustee even if the grantor was never there and there is no other connection to the state.

California Taxation Base on Beneficiaries

- The California statute also imposes its tax if there are one or more non-contingent trust beneficiaries who resides there.
- The meaning of "non-contingent beneficiary" is not entirely certain but it does not appear to include a person who is merely eligible but who does not receive a distribution from the trust.
- CA defines a contingent beneficiary as one whose 'interest is subject to a condition precedent,' meaning a condition must be satisfied in order for the beneficiary's interest in the trust to vest or become noncontingent. Conversely, a beneficiary whose interest is vested is a noncontingent beneficiary. California Code of Regulations Title 18, Section 17742(b).
- A beneficiary whose interest is subject to the trustee's sole and absolute discretion has a contingent interest until the trustee decides to distribute the property. FTB Technical Advice Memorandum 2006-0002.

Connecticut Taxation Based on Grantor Residence

- Connecticut imposes its income tax if the grantor resided there when the trust became irrevocable and if the trustee could distribute income to a Connecticut beneficiary.
- This applies even if the beneficiary is contingent, apparently meaning one who is eligible to receive a distribution, even if the beneficiary does not receive one. This is in contrast to California where a beneficiary's residence can trigger state income tax only if he or she is non-contingent.
- *Kaestner* indicates that this latter factor alone is insufficient to allow a state to impose its income tax although, perhaps, coupled with the grantor being a Connecticut resident might be sufficient.

Evaluating Various Factors in Light of Kaestner

Evaluating the 5 Factors in Light of Kaestner

- Although *Kaestner* did not specify what factors would be sufficient for a state to impose its income tax on the undistributed income of a trust, states may decide to change their statutes to provide a list of factors, which if present, will serve as the basis to tax.
- A state statute imposing its tax if all the factors listed by the Nenno are present may be sufficient constitutionally to impose the tax, but it would provide a relatively easy way for a trust to avoid the state income tax.
- For example, not having trustee in the state would limit the choice of trustees but, perhaps, that could be overcome by having an out-of-state entity (e.g., an S corporation) owned by a state resident.
- That may not "work" if the state may constitutionally use another or an alternative factor, such as if trust administration occurred in the state.

Factors Cited by Kaestner Court

- The three factors that the court seems to indicate might be sufficient for a state to impose its tax on undistributed taxable income are
  - the presence of an in-state trustee.
  - significant administration of the trust in the state.
  - or the beneficiaries residing in the state have control, possession, or the enjoyment of the trust.
- Justice Alito states in his concurring opinion: “In the case of intangible assets held in trust, we have previously addressed whether a resident of the State imposing the tax has control, possession, or the enjoyment of the asset. See Greenough v. Tax Assessors of Newport, 331 U. S. 486, 493–495 (1947); Curry, supra, at 370–371; Safe Deposit & Trust Co. of Baltimore v. Virginia, 280 U. S. 83, 93–94 (1929); Brooke v. Norfolk, 277 U. S. 27, 28–29 (1928).

Factors Cited by Kaestner Court

- Because a trustee is the legal owner of the trust assets and possesses the powers that accompany that status— such as the power to manage the investments, to make and enforce contracts respecting the assets, to litigate on behalf of the trust, etc.— the trustee's State of residence can tax the trust's intangible assets. Greenough [v. Tax Assessors of Newport, 331 U. S. 486 (1947).
- What does it mean for a resident to have control, possession and enjoyment of a trust? The beneficiary may be entitled to the entire trust at a later time (such as reaching a certain age), which may not be sufficient especially if the beneficiary would succeed to the asset only if alive at that time. In fact, in *Kaestner*, the beneficiary was to receive her share of the trust upon reaching age 40. But the trustees "decanted" the trust to last for her entire lifetime.

Protectors, Directors and Others

- Another factor a state might use is if a resident is a de facto trustee or holds powers similar to a trustee. In TSB-A-04(7)I, New York ruled that members of the trust committee were trustees for New York income tax state because they had responsibilities and powers of a trustee. That opinion, not official precedent even in New York, suggests that a trust protector or other (e.g., a so-called “director”) who can direct the trustee in carrying out fiduciary duties may also be treated as a trustee for New York income tax purposes. Perhaps, if the residence of a trustee is a sufficient ground under *Kaestner* for a state to tax the trust, then it seems somewhat likely that the residence of a director or trust protector with such or similar authority also would be sufficient.

What States May Do

Shoring up Taxing Authority May Happen

What Might North Carolina Do?

- North Carolina certainly must change the grounds upon which they seek to impose tax on undistributed trust income if they wish to collect such a tax.
- The state might seek to impose its tax only if a state resident created the trust and there is a state resident that acts as a trustee (or a similar capacity). Of course, that will make it relatively easy to avoid the state tax by not having an in-state trustee and would force the state to weigh certain matters carefully. By providing that the presence of an in state trustee will result in state income taxation, many taxpayers would avoid using an in state trustee. That means trust business in the state will diminish or entirely disappear. That means fewer people will be employed in the state in the trust industry.

What States Generally May Do?

- Might states adopt alternative tests to try to have a broad base tax but one that would withstand an attack on the grounds of lack of due process? (States also need to be concerned about violating the commerce clause as well as mentioned earlier).
- Note that California imposes its tax on alternative grounds: the presence of a non-contingent beneficiary or a California trustee. California's first leg might fall under *Kaestner* but its second might stand.
- So other states might adopt alternative tests: (1) one or more in state beneficiaries control, possess, enjoy, or are entitled to receive trust assets (2) the presence of an in state trustee (or anyone holding trustee like powers), or (3) the trust is administered in in whole or in part in the state, or (4) the trust has state source income or assets, with each of those under its statute providing a ground to tax.

What Trust Officers, CPA and Estate Planners Might Do

Inform Clients, Beneficiaries, and Trustees

Steps Practitioners Might Take for New Trusts

- Practitioners likely should inquire with clients who have or are planning to create trusts whether they wish the trusts to avoid state income tax.
- Some might decide the presence of a particular trustee is so important that paying state income tax on undistributed trust income is acceptable.
- There may be alternatives. For example, if an individual or institution is being chosen on account of investment acumen, perhaps merely having the trust hire that person might be sufficient. If it is not, the client (or the trust) could create a holding entity (e.g., such as a limited partnership) which would have the desired person as the general partner.

Steps Practitioners Might Take for New Trusts

- Other decisions, however, may be very personal, such as the decision on whether and how to bestow benefit to beneficiaries. Even that, however, might be accomplished by the desired person forming an out-of-state entity (perhaps, an S corporation) which would be trustee but ensuring little if any trust administration occurs in a state that would impose its tax if the trust is administered there.

Steps Practitioners Might Take for Meetings

- With communication systems such as Skype and others coming on line, true in person meetings probably can be minimized.
- Even holograms (persons appearing essentially in three dimensions through electronics) may soon be available.

Steps Practitioners Might Consider Regarding Beneficiary Control in Existing Trusts

- The Kaestner case notes: “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.”
- Does this suggest that any trusts that might have a 5/5 power, HEMS standard, or other provisions that might give the beneficiary any rights to demand trust income or otherwise control, or that terminate at a specified age, should be decanted now to remove those potential tax strings? Would a HEMS standard with an independent trustee be deemed control in the beneficiary merely because there is a definite standard? Perhaps. Note that in the Kaestner case the trust was decanted from the original trust that terminated at a specified age.
- Consider whether to perform a non-judicial modification that would curtail beneficiary control that might taint the result.

File Refund Claims for Existing Trusts

- Trustees and practitioners should evaluate filing state income tax refunds where it may be possible to claim that the trust should not have paid state income tax post-Kaestner.

Evaluate Converting Grantor to Non-Grantor Trusts (Carefully!)

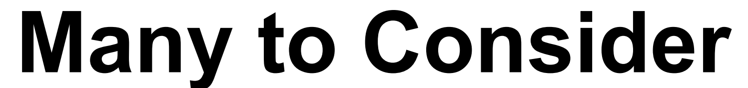
- Practitioners and trustees might consider reviewing the possible benefits of converting a grantor trust to a non-grantor trust to save state income taxes.
- Caution is important. What if the Sanders-type proposal of including grantor trusts in the grantor’s estate is eventually enacted? It might be wise to retain a grandfathered grantor trust (if that is feasible).
- Consider installment sales, negative basis, income tax consequences of conversion.
- Evaluate whether grantor trust status versus possible state income tax savings is preferable.

Evaluate Trustee Responsibility

- Does a trustee have a responsibility to resign if that trustee's presence is the link creating state income taxation of the trust?

Checklist of Factors Practitioners Should Evaluate

Many to Consider



Checklist of Factors

- Residence of grantor/settlor is an important factor in determining trust taxation by a state. But alone the mere fact that the person setting up the trust lived in the taxing state may not suffice to support jurisdiction.
- The trustee chose not to distribute any of the income to the beneficiary in the taxing jurisdiction. What might this mean if a person in a non-fiduciary capacity directed the trustee to make a distribution to a named person? Then the decision would not be in the trustee's discretion. Perhaps the recipient might not be deemed a "beneficiary" in a traditional sense. Might this change the analysis? Example: Your mom creates a trust for your descendants. You are not named a beneficiary of the trust. However, the trust states that your old college roommate holds a power, not in a fiduciary capacity, to direct the trustee to make a distribution to you. Under the Kaestner analysis you would have no authority to influence the trust, but it would not be the trustee choosing to make a distribution? How might this be treated?

Checklist of Factors

- The trustee has exclusive control over the allocation and timing of trust distributions. This was important in Kaestner as a clear theme of the opinion was that the beneficiaries living in North Carolina could not control their benefiting from trust income.
- The trust is subject to governing law of a different jurisdiction then the taxing jurisdiction. The Trust in Kaestner was subject to New York law, not North Carolina law. Decanting might cure this defect if your trust was formed under the laws of a taxing state.

Checklist of Factors

- The residence of individual trustees is a crucial factor. In the Kaestner case, no trustee lived in North Carolina. How will this apply in terms of an institutional trustee? Perhaps this suggests the benefit of using an institutional general trustee based in a tax friendly jurisdiction. That is an important planning step that too often is not used as those creating trusts tend to often name family members as trustees. The drawback of that is family members named may live in a taxing state. It may prove much less costly to name an institutional trustee in a no tax state and pay their annual fee. What does this criteria mean in terms of other trust positions?

Checklist of Factors

- The Kaestner Court did not address other common positions in a modern trust. What of a trust protector? Trust investment director? Various power holders? All of these positions, if the individuals named reside in a taxing state, might taint the trust as subject to that state's tax system? So, consider where the person you name as a trust protector resides. Perhaps a trust protector should act in a non-fiduciary capacity and/or reside in a state without a state income tax. Another option might be for the trust to name an entity, e.g. a limited liability company (LLC) formed in a tax friendly state (presumably the same tax friendly state where the trust is based) as trust protector (or investment advisor, etc.) and have the individual desired provide services as a manager of that LLC. Will that suffice to prevent a high tax state from taxing the trust?

Checklist of Factors

- The physical location of trust records. In the Kaestner case, the trustee kept the trust documents and records in New York, not in North Carolina. Where are your trust records kept? In a modern digital age how relevant will this be when most if not all records might consist of cloud based digital records? Will moving all records to the cloud solve the issue?
- Trust asset custodians were located in a state other than the taxing state. Is it relevant where a large institutional investment advisor is located as to the state taxation? Yet this seems to be a factor noted by the Court.
- No physical presence in the taxing state. The trust should not rent or own an office in the taxing state.

Checklist of Factors

- The trust should not have any direct investments in the taxing state. Might this suggest that any, even insignificant, investment in the taxing state might taint the entire trust? Might those administering trusts be advised to divide the trust with one component trust holding any investments in the state, and all other investments being bifurcated in a separate trust? Some states take the position that any active business in their state will taint the entire income of the trust as taxable. If that situation affects your trust try to divide the trust. Many trust documents permit the trustee to divide the trust for a variety of reasons. If not, state law might permit division. If that isn't the case, decanting may provide another possible way to cure this state tax issue.

Checklist of Factors

- The number of meetings between the trustee and beneficiary may be relevant. The Court noted: “the trustee’s contacts with Kaestner were “infrequent.” ” It is not clear what the import of this factor mentioned by the court is to the analysis. Might the Court be suggesting that the more meetings the more influence the beneficiary might be viewed as having over access to trust income? That would not seem appropriate as it is the terms of the trust and the powers not given to the beneficiary, not the number of meetings, that would seem to be the relevant factor. But in the Kaestner case, even if there were more (many more?) meetings then two, that would not affect the terms of the trust which in the instant case gave the trustee sole discretion as to distributions. But the language in Kaestner suggests that the beneficiary’s right to control is relevant. “the extent of the in-state beneficiary’s right to control, possess, enjoy, or receive trust assets.” Is this a suggestion that a large number of meetings might suggest a beneficiary’s right to control? This seems unlikely. But, what if there was an implied agreement found between the beneficiary and trustee suggesting that the beneficiary may have “control”?

Checklist of Factors

- The trust should not own real property in the taxing jurisdiction. What if the real property is held in an entity, such as a limited liability company or other disregarded entity, that would characterize the property as an intangible asset not real estate. Would that suffice to avoid the state taxation of the trust? Alternatively, as with a business activity in the state, consider segregating real property in a taxing state into a separate trust.
- Geographic location of trustee/beneficiary meetings was noted in Kaestner. What does this mean in an electronic age when web meetings are so common?
- The Kaestner Court noted that the trust did not terminate at a specified age distributing corpus to the beneficiary in the state in question. If it does, consider decanting the trust, which is what the Kaestner family did. If the trust distributes at age 25 all assets to the beneficiary, would that suffice to permit the state to tax the trust? What if the beneficiary is 1 year old and the trust distributed at age 75? Would that suffice for tax nexus? Although this is all unclear the more modern way to draft many trusts as long term or even perpetual is certainly a safer option.

Checklist of Factors

- What if the trust instrument permitted the trustee to loan funds to the beneficiary. Would a loan taint the beneficiary as taxable on trust income? What if it was not the trustee but another person, perhaps in a non-fiduciary capacity, that directed that a loan be made to the beneficiary? Would that taint the trust accumulated income as taxable?
- What if the trust owns personal use property, such as a home, and permits the beneficiary to use it? If the property is located in the taxing state that might suffice as sufficient nexus to tax undistributed income under the Kaestner Court's discussions. But if the property were located in a different state would the use of property permit a different state to argue that the beneficiary resident in its state received benefit from the trust even though no income was distributed?

Conclusion and Additional Information

Consider Action

Conclusion

- Kaestner at minimum is a strong reminder of the attention that should be given to planning with non-grantor trusts and endeavoring to minimize or avoid state income taxation of trusts.

Additional information

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