No. 18-457

In the

Supreme Court of the United States

NORTH CAROLINA DEPARTMENT OF REVENUE,

Petitioner,

v.

THE KIMBERLEY RICE KAESTNER 1992 FAMILY TRUST,

Respondent.

On Writ of Certiorari to the Supreme Court of North Carolina

BRIEF OF *AMICUS CURIAE* THE NEW YORK STATE BAR ASSOCIATION IN SUPPORT OF RESPONDENT

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INTEREST OF *AMICUS CURIAE*

The New York State Bar Association ("NYSBA") is the largest voluntary state bar association in the United States, with more than 72,000 members.[1] NYSBA's members live and practice in every town, city and county in the State of New York, and its membership also includes non-resident lawyers around the nation and throughout the world.

NYSBA has 26 sections dedicated to discrete areas of the law, including the Trusts and Estates Law Section, which consists of more than 3,000 members. With the assistance of its sections, as well as more than 60 committees, NYSBA drafts and supports legislation, sponsors conferences, seminars and institutes, and makes policy recommendations to bodies including the United States Congress, the New York State Legislature, and the New York State Office of Court Administration.

NYSBA previously has submitted *amicus curiae* briefs to the Supreme Court of the United States. NYSBA respectfully submits this brief in support of respondent, the Kimberley Rice Kaestner 1992 Family Trust ("Respondent"), and to assist the Court concerning the practical and policy implications of this case for the

1. NYSBA respectfully submits this brief, pursuant to the blanket-consent letters that the parties filed with the Court. Pursuant to Rule 37.6 of the Court's Rules, *amicus* affirms that no counsel for a party authored this brief, in whole or in part; that no such counsel or party has made a monetary contribution intended to fund the preparation or submission of this brief; and that no person other than *amicus* and its counsel made such a monetary contribution.

trusts and estates bar, as well as the grantors, trustees, and beneficiaries of trusts.

SUMMARY OF ARGUMENT

NYSBA respectfully submits this *amicus curiae* brief in support of Respondent. The court below correctly found that an out-of-state trust that did no business in North Carolina, had no assets in North Carolina, and distributed no income to anyone in North Carolina had no connection or substantial nexus with that state, which unconstitutionally taxed Respondent on its undistributed income. This accords with generally accepted trusts and estates law, which draws a distinction between a trust's trustee and its beneficiaries, and does not treat a trust as a vehicle to serve at the beneficiaries' behest.

With that in mind, NYSBA respectfully submits that North Carolina's argument that a beneficiary is "the central figure" in a trust is a mischaracterization of well-settled trusts and estates law. Pet. Br. at 2. Contrary to North Carolina's contention, the central figure in a trust is the trustee, who is the taxpayer, the fiduciary, and the owner of legal title in the trust's property. This distinction is all the more apparent here, where the trustee has absolute discretion to make (or not make) distributions, and the beneficiaries' rights are contingent upon that absolute discretion.

Given the nature and purpose of trusts, North Carolina's tax impermissibly violates the Due Process Clause of the Fourteenth Amendment to the United States Constitution, as well as the Commerce Clause contained in the Constitution, by taxing trustees who have no relationship with North Carolina. The tax violates the Due Process Clause because it does not require that a trustee have the requisite "minimum connection" with the state, nor does it require the existence of a rational relationship between North Carolina and the income it seeks to tax. As to the Commerce Clause, the tax fails the four-part test set forth in *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977), as there is no nexus between Respondent and North Carolina, and the tax is neither internally consistent nor externally consistent. Hence, the decision below should be affirmed.

ARGUMENT

I. A Trust Is Separate and Distinct from Its Beneficiaries, and Should Be Treated as Such for Purposes of State Income Taxation of Undistributed Trust Income.

To justify the state income tax that it assessed against Respondent, North Carolina effectively argues that no legal distinction exists between a trust and its discretionary beneficiaries. North Carolina's contention flatly contradicts the governing trusts and estates law, which this Court should apply in rejecting North Carolina's position.

A trust "is a fiduciary relationship with respect to property, subjecting [the person] by whom the title to property is held, to equitable duties to deal with the property for the benefit of another person, which arises as a result of a manifestation of an intention to create it." Restatement (Second) of Trusts § 2. The trust relationship has three essential requirements: (1) "an expression of intent that property be held, at least in part, for the benefit of one other than the settlor;" (2) "at least one beneficiary for whom the property is to be administered by the trustee;" and (3) "an interest in property which is in existence or is ascertainable and is to be held for the benefit of the beneficiary." George T. Bogert, *Trusts* § 1 (6th ed. 1987) ("Bogert on Trusts"); *Brown v. Spohr*, 73 N.E. 14 (N.Y. 1904).

A trust may be created for any lawful purpose, N.Y. E.P.T.L. § 7-1.4, but the most common reason for establishing a trust is to separate the control of trust assets from its beneficiaries. Restatement (Second) of Trusts § 59, cmt. b. As a result, legal title to trust property vests in the trustee, not in a beneficiary. *Stephens v. Tipton*, 268 P. 1014, 1015 (Or. 1928). The bifurcation of legal and beneficial title to trust assets is fundamental to the very existence of a trust; for if legal and beneficial title are not separated (such that legal and beneficial title to trust property rest in the same individual or entity), no trust arises. *Id.*

Beneficiaries are not "owners" of trust assets in the common sense of the word. On the contrary, because a trustee is a fiduciary, and fiduciaries and beneficiaries are separate entities, *Abell v. Tait,* 30 F.2d 54, 55 (4th Cir. 1929) (citing, *e.g.*, *Merchants' Loan & Tr. Co. v. Smietanka*, 255 U.S. 509 (1921)), *cert. denied,* 279 U.S. 849 (1929), a trust beneficiary's interest in trust assets is "non-possessory." Bogert on Trusts, § 38.

A trustee has legal ownership of trust assets, at least until trust distributions are made. The trustee's legal ownership of trust assets typically carries with it the power to sell trust assets, to invest trust property, and to collect the income earned on trust property. Bogert on Trusts, § 88. A beneficiary has no such powers. In fact, a beneficiary's rights with respect to trust property are derivative, not direct, and are subject to the possessory rights that a trustee has as to trust assets. *Western R.R. Co. v. Nolan*, 48 N.Y. 513, 518-19 (N.Y. 1872). For example, in order to assert a cause of action on behalf of a trust, the trustee, not a beneficiary, must commence an action, even though that action ultimately may inure to the beneficiary's benefit. *Noel v. Liberty Bank of Ark.*, No. 3:10-CV-00107, 2012 WL 13027498, at *8 (E.D. Ark. Nov. 27, 2012).

Given the foregoing, and the nature of the trustee-beneficiary relationship, it logically follows that a beneficiary's right to distribution of trust assets is subject to limitations. It is governed by the terms of the trust instrument, pursuant to which the trust is created. Bogert on Trusts, § 38. As memorialized in the trust instrument, the settlor's intentions are entitled to great latitude in fixing beneficiaries' interests in a trust, and not all trust beneficiaries are created equal. The trust instrument may direct that a beneficiary's equitable interest in trust assets is subject to a definite period of trust administration, or that the trust's administration shall continue indefinitely. *Id.*; Wis. Stat. § 700.16. Likewise, the trust instrument may provide that a trust beneficiary's interest is contingent or vested; is in trust income or principal; is subject to a condition precedent or subsequent; or is possessory or non-possessory. Bogert on Trusts, § 38.

A settlor may direct that a trustee make certain distributions to specific beneficiaries (whose rights are "mandatory"), or may "authorize the trustee to do or refrain from doing a certain act, or use his [or her] judgment as to when or how a power should be used." Bogert on Trusts, § 89. Put another way, a settlor may vest the trustee with partial or absolute discretion to make trust distributions. *Id.* In general, a trustee's exercise of discretion in making trust distributions (or refraining from doing so) will only be disturbed, by courts or otherwise, upon a showing that the trustee did not act in good faith. *Id.*; *In re Harmon*, 900 N.Y.S.2d 761, 764 (N.Y. App. Div. 2010). The trustee's exercise of discretion in distributing trust assets is entitled to tremendous deference, regardless of the wishes of trust beneficiaries (and, oftentimes, much to beneficiaries' chagrin). *Id.*

Further demonstrating the dichotomy that exists between trusts and their beneficiaries is the fact that courts typically will not require trustees to exercise their discretion to make trust distributions in a manner that would allow for beneficiaries' creditors and assignees to gain access to trust assets. *Lineback by Hutchens v. Stout*, 339 S.E.2d 103, 106 (N.C. Ct. App. 1986). Indeed, courts have explained that, under a "discretionary trust, the trustee may withhold the trust income and principal altogether from the beneficiary and the beneficiary, as well as the creditors and assignees of the beneficiary, cannot compel the trustee to pay over any part of the trust funds." *Id.*

In order to justify the unconstitutional state income tax that it seeks to levy against Respondent, North Carolina argues that a beneficiary is "the central figure in a trust." Pet. Br. at 2. North Carolina's contention overlooks well-settled trust law, which establishes that three figures are essential to a trust: the settlor, the trustee, and the beneficiaries. The trust's beneficiaries are not, as North Carolina argues, more important to the trustee-beneficiary relationship than the trustee.

In fact, for the purpose of determining the legal ownership of assets that are held in trust, the beneficiaries are less important to the trust relationship than the trustee is. During the relevant tax years, the beneficiaries' ability to receive income distributions was subject to the trustee's absolute discretion. Joint Appendix ["App."] 45-47. As he was permitted to do under the terms of Respondent trust, the trustee did not exercise his discretion to distribute income to the beneficiaries during the 2005, 2006, 2007, or 2008 tax years. *Id.* at 12.

Legal title to trust assets, including its income, remained with the trustee, rather than the trust's beneficiaries. Because legal title to the trust's income remained with the trustee, and the beneficiaries had neither access to, nor control over the income, the trust and its beneficiaries are separate and distinct from each other, and should be treated as such for purposes of state income taxation of undistributed trust income.

Accordingly, it strains credulity to dispute that the trust was separate and distinct from its beneficiaries, and North Carolina's contentions to the contrary are devoid of merit.

II. Due Process Does Not Permit a State to Tax Undistributed Trust Income Based Solely on the Residence of a Discretionary Trust Beneficiary in the State.

The Question Presented addresses the extent to which the Due Process Clause permits North Carolina to tax undistributed income earned by a trust that is administered, and maintains all of its assets, books, and records, outside of North Carolina, based solely upon the North Carolina residence of discretionary trust beneficiaries to whom no trust distributions were made during the relevant tax years. As the Due Process Clause does not permit such state income taxation, the Court should affirm the decision of the court below.

Under the Due Process Clause, "[n]o State shall . . . deprive any person of life, liberty, or property, without due process of law[.]" U.S. Const. amend. XIV, § 1. The Court has interpreted the Due Process Clause to limit states' authority to tax, requiring a state to satisfy two jurisdictional prerequisites in order to impose tax on a prospective taxpayer. *Quill Corp. v. North Dakota*, 504 U.S. 298, 306 (1992), *overruled in part by South Dakota v. Wayfair, Inc.*, 138 S. Ct. 2080, 2099 (2018). First, a state must show a "definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax". *Miller Bros. Co. v. Maryland*, 347 U.S. 340, 344-45 (1954). Second, the state must establish the existence of a rational relationship between income that the state seeks to tax and "values connected with the taxing [s]tate." *Quill*, 504 U.S. at 306; *F.W. Woolworth Co. v. New Mexico*, 458 U.S. 354, 365 (1982). Absent those two jurisdictional prerequisites, a state cannot tax a prospective taxpayer in a manner that passes Due Process Clause-based muster.

Although a state may, at times, tax a prospective taxpayer that does not have a physical presence within the state's borders in a constitutionally-permissible manner, the state's authority to do so is subject to limitations. *Oklahoma Tax Comm'n v. Chicksaw Nation*, 515 U.S. 450, 463 n.11 (1995). One such limitation is the requirement that the prospective taxpayer "purposefully avail . . . itself of the benefits of an economic market in the forum [s]tate." *Quill*, 504 U.S. at 307. The underlying rationale is that a prospective taxpayer's purposeful availment puts the prospective taxpayer on notice that its "activity may subject [it] to the jurisdiction of a" state in which it does not have a physical presence. *Id.* at 308. The foregoing principles apply regardless of whether (a) the prospective taxpayer is an individual, a business entity, or a trust, or (b) the tax concerns income or sales tax.

In order for a state to tax income earned by a trust in a manner that comports with the Due Process Clause, the state must establish that the trust has a "definite link" and "minimum connection" to the state, and that a rational relationship exists between the trust income that the state seeks to tax and the values that the state provides. *Linn v. Ill. Dep't of Revenue*, 2 N.E.3d 1203, 1208 (Ill. App. Ct. 2013); *Residuary Tr. A v. Dir., Div. of Taxation*, 27 N.J. Tax 68, 72-76 (N.J. Tax Ct. 2013), *aff'd*, 28 N.J. Tax 541 (N.J. App. Div. 2015) (affirming on the basis of statutory construction, rather than the Due Process Clause). Failing such a showing, the Due Process Clause will bar state income taxation of a trust. *Linn*, 2 N.E.3d at 1208; *Fielding v. Comm'r of Revenue*, 916

N.W.2d 323, 329 (Minn. 2018), *petition for cert. pending*, No. 18-664 (filed Nov. 15, 2018).

A. A Discretionary Trust Beneficiary's Residence In a State Does Not Justify That State's Taxation of Undistributed Trust Income That Is Earned In Another State.

A state's taxation of undistributed income earned by a trust that is administered in another state, based solely on the presence of a trust beneficiary within the taxing state, is hardly a novel concept. *Brooke v. City of Norfolk*, 277 U.S. 27, 28-29 (1928). In fact, for the past 80 years, this Court has rejected states' efforts to tax undistributed trust income earned in another state where the taxing state's sole connection to the trust is the residence of a trust beneficiary in that state. *Id.*; *Safe Deposit & Tr. Co. v. Virginia*, 280 U.S. 83, 92 (1929). The Court has reasoned that a trust and its beneficiaries, though related, are not one and the same. *Safe Deposit*, 280 U.S. at 92 (explaining that, where the trustee of a trust owned legal title to trust securities in Maryland, and none of the trust beneficiaries located in Virginia had a "present right to their enjoyment or power to remove them," the "securities did not and could not follow any person domiciled in Virginia"); *cf. United States v. One Parcel of Prop. Located at Route 27, Box 411 (Patterson Road), Montgomery Cnty., Alabama*, 845 F. Supp. 820, 823-24 (M.D. Ala. 1993) (in rejecting the federal government's argument that a trust beneficiary's knowledge should be imputed to the trust's trustee in a forfeiture proceeding concerning the beneficiary, the court noted that a trustee's ownership of trust property "is independent of the beneficiary," and oftentimes requires the trustee to protect "the beneficiary from his or her own improvidence or incapacity").

Relying upon this Court's well-reasoned precedent, other courts (including state courts) have held that, under the Due Process Clause, the presence of a trust beneficiary in a particular state, without more, is insufficient to establish minimum contacts to justify the state's taxation of undistributed trust income that is earned in another state. *Mercantile-Safe Deposit & Tr. Co. v. Murphy*, 242 N.Y.S.2d 26, 28 (N.Y. App. Div. 1963) ("We find no merit . . . in their thesis that since the resident beneficiaries of the trust could be taxed on income distributed the nonresident trustee can be taxed on income accumulated."), *aff'd*, 203 N.E.2d 490, 491 (N.Y. 1964). For example, in *Mercantile-Safe Deposit & Trust Co. v. Murphy*, New York sought to tax the undistributed income earned by a trust administered in Maryland, by a corporate trustee based in Maryland, solely because a trust beneficiary resided in New York. *Id.* Citing to *Safe Deposit*, New York's Appellate Division and Court of Appeals rejected the state's argument, and held that regardless of the beneficiary's residence in New York, the tax violated the Due Process Clause. *Id.*[2]

A similar result is warranted when a state's only connection to a trust is a discretionary trust beneficiary's

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2. The holding the New York courts reached in *Mercantile-Safe Deposit & Trust Co.* is consistent with the one that this Court articulated in *Hanson v. Denckla*. In *Hanson*, this Court found that the presence of trust beneficiaries in Florida did not confer on that state jurisdiction over the trustee of a trust who had no other Florida connections. *Hanson v. Denckla*, 357 U.S. 235, 254 (1958). While North Carolina argues that *Hanson* has no application here because personal jurisdiction in litigation and tax jurisdiction are distinct concepts, this Court has recognized that adjudicative jurisdiction and tax jurisdiction are comparable with each other. *Quill*, 504 U.S. at 307-08.

residence within the state. Under such circumstances, insufficient contacts exist between the state and the trust to justify the state's taxation of the trust's undistributed income. *Potter v. Taxation Div. Dir.*, 5 N.J. Tax. 399, 405 (N.J. Tax Ct. 1983). This is because the discretionary trust beneficiary has "no right to the undistributed trust income." *Id.* Absent an exercise of discretion by the trustee, the discretionary trust beneficiary cannot access such undistributed trust income, direct that it be paid to (or for the benefit of) the beneficiary, or otherwise exercise control over it. Restatement (Second) of Trusts § 128, cmt. d.; *but cf. Linser v. Office of Attorney Gen.*, 672 N.W.2d 643, 646 (N.D. 2003) (explaining that a discretionary beneficiary's interests in a trust are too remote to warrant treating the trust's undistributed assets as belonging to the beneficiary).

Recognizing that the presence of discretionary trust beneficiaries within North Carolina was the only connection that the trust had to that state, the court below correctly concluded that the trust lacked sufficient minimum contacts with North Carolina to justify its tax on all of the income the trust earned during the 2005 to 2008 tax years. *Kimberly Rice Kaestner 1992 Family Tr. v. North Carolina*, 814 S.E.2d 43, 51 (N.C. 2018). The trustee resided in Connecticut. App. 40-41. The trustee maintained the trust's books and records in New York. *Id.* at 41. All of the trust's assets were in Massachusetts. *Id.* The trustee did not make distributions to any beneficiaries that were located in North Carolina, earn income within that state, or otherwise transact business in North Carolina. *Id.* at 41-42.

Simply put, since neither the trust nor the trustee engaged in any affairs in North Carolina, it cannot be said that Respondent purposefully availed itself of any benefits associated with North Carolina. What is more, because the trust's discretionary beneficiaries did not have a right to access or control the trust's assets or income, and those beneficiaries did not receive any trust distributions during the relevant tax years, the mere presence of Respondent's discretionary beneficiaries in North Carolina during those years is insufficient to establish the requisite minimum contacts to justify that state's tax on Respondent's undistributed trust income during the relevant tax years.

Putting aside, for argument's sake only, that the mere presence of a discretionary beneficiary of a trust in a particular state is insufficient to establish minimum contacts to justify that state's taxation of undistributed trust income that is earned outside of the state, such undistributed trust income also bears no relationship, rational or otherwise, to the values that the state in which the discretionary trust beneficiary resides provides to the trust. *Blue v. Dep't of Treasury*, 462 N.W.2d 762, 764 (Mich. Ct. App. 1990). Since none of the trustee, the trust's assets or the trust's income is located within North Carolina, the state provides "no ongoing protection or benefit to the trust." *Id.* The state is essentially a stranger to the trust, regardless of the state's relationship to a discretionary trust beneficiary. *Cf. Allied-Signal, Inc. v. Dir., Div. of Taxation*, 504 U.S. 768, 778 (1992) (noting that, to satisfy the Due Process Clause, "there must be a connection to the activity itself, rather than a connection only to the actor the [s]tate seeks to tax"). Consequently, the Due Process Clause does not permit North Carolina to tax the trust on undistributed income that the trust earned outside of North Carolina's borders.

North Carolina's reliance upon *Greenough v. Tax Assessors of City of Newport* for the proposition that "a trust constituent's residency in a state connects the trust to the state" is misplaced. Pet. Br. at 30. Although *Greenough* established that a state could constitutionally tax income earned by a trust based upon a trustee's presence within that state, *Greenough* does not support North Carolina's argument that a beneficiary's presence within the state provides the same jurisdictional basis. *Greenough v. Tax Assessors of City of Newport*, 331 U.S. 486, 493-96 (1947).

North Carolina's claim that *Greenough* is at odds with *Safe Deposit* is incorrect. First, it is worthy of note that the Court cited to *Safe Deposit* in *Greenough*, recognizing that the two cases involved different jurisdictional issues. *Greenough*, 331 U.S. at 496-97. On the one hand, the Court answered the jurisdictional question in *Safe Deposit* – whether the presence of trust beneficiaries in Virginia permitted that state to tax the trust's assets, even though the trustee, and the trust's assets, were located in Maryland – in the negative. *Safe Deposit*, 280 U.S. at 89-94. On the other hand, however, the Court answered the jurisdictional question in *Greenough* – whether the presence of a trust's trustee in Rhode Island authorized that state to tax the trust's intangible assets – affirmatively. *Greenough*, 331 U.S. at 488-98. Collectively, they provide that the presence within a state of a trust's trustee, but not a trust's beneficiary, is sufficient to establish minimum contacts with the state. Hence, *Safe Deposit* and *Greenough* are consistent with each other.

Finally, Petitioner's reference to *District of Columbia v. Chase Manhattan Bank*, *Chase Manhattan Bank* *v. Gavin*, and *McCulloch v. Franchise Tax Board* is misplaced. All but one of the trusts in question in *District of Columbia* and *Gavin* were testamentary trusts, which were created pursuant to decrees that issued from courts in the jurisdictions that imposed tax. *District of Columbia v. Chase Manhattan Bank*, 689 A.2d 539, 545 (D.C. 1997); *Chase Manhattan Bank v. Gavin*, 733 A.2d 782, 795-99 (Conn. 1999). Although *Gavin* also concerned an inter vivos trust, the beneficiary thereof – whose presence in Connecticut was found to justify that state's taxation of the trust's undistributed income – had more significant vested rights in the *Gavin* inter vivos trust (including the right to receive the trust's corpus at age forty-five, and to direct how the trust's corpus would be distributed, if she died before attaining forty-five years of age) than Respondent's discretionary beneficiaries did in the trust established for their benefit. *Gavin*, 733 A.2d at 802. In *McCulloch*, California taxed the California-resident beneficiary of a Missouri testamentary trust for income earned during the last five years of the trust's administration, at a point when the trust already had terminated and its assets had been distributed to the beneficiary, which is readily-distinguishable from the present matter (in which Respondent's assets remained in trust during, and after, the relevant tax years). *McCulloch v. Franchise Tax Bd.*, 390 P.2d 412, 414-21 (Cal. 1964).

In light of the foregoing, the Due Process Clause does not permit a state to tax the undistributed income that a trust earns in another state, based solely upon the presence of a discretionary trust beneficiary within the taxing state. The court below correctly concluded as much in ruling for Respondent.

B. The Analysis of the Court Below Is Neither Formalistic Nor Rigid and Comports With the Due Process Clause.

Since deciding *International Shoe Co. v. Washington*, the Court has eschewed formalistic Due Process Clause tests that "focused on a [party's] 'presence' within a [s]tate in favor of a more flexible inquiry into whether [the party's] contacts with [a state] made it reasonable, in the context of our federal system of Government," to be taxed by the state. *Quill*, 504 U.S. at 307. Regardless of that flexibility, however, the Court has declined to abandon "the requirement that, in the case of a tax on activity, there must be a connection to the activity itself . . . " *Allied-Signal, Inc. v. Dir., Div. of Taxation*, 504 U.S. 768, 778 (1992). The Court has recognized that the Due Process Clause requires a connection to the activity that is taxed, not merely "to the actor [that] the [s]tate seeks to tax." *Id.*

North Carolina and certain *amici* assert that the North Carolina Supreme Court's holding was overly formalistic and rigid, in a manner that contravenes this Court's Due Process Clause precedents. Pet. Br. at 21-22; Br. for Minnesota and Nineteen Other States and the District of Columbia as Amicus Curiae Supporting Petitioner (hereinafter, the "States Amicus Br.") at 3-6. However, that argument fails because the income tax that North Carolina seeks to impose upon the trust's undistributed income bears no connection to activities that took place, or income earned, within North Carolina's borders. In effect, North Carolina impermissibly seeks to tax the trust based upon a connection not to the trust or the trustee, but rather to its beneficiaries, whose rights to access trust assets during the relevant tax years were subject to the trustee's absolute discretion. App. 42.

Minnesota, nineteen other states, and the District of Columbia advocate for the Court to adopt the Missouri Supreme Court's six-pronged test for determining whether a state can tax income earned by a trust. States Amicus Br. at 4. The six factors enumerated by the Missouri Supreme Court are: (1) "the domicile of the settlor"; (2) "the state in which the trust is created"; (3) "the location of the trust property"; (4) "the domicile of the beneficiaries"; (5) "the domicile of the trustees"; and (6) "the location of the administration of the trust." *Westfall v. Dir. of Revenue*, 812 S.W.2d 513, 514 (Mo. 1991). Under that test, when only one or two of the six factors are satisfied, the Due Process Clause cannot be met. *In re Swift*, 727 S.W.2d 880, 882 (Mo. 1987) (finding that Missouri could not impose income tax against a trust, even though the trust's settlor was domiciled in that state, and the trust was created there).

The test for which *amicus* advocates would not justify reversal here. Without more, the mere presence of a discretionary trust beneficiary in a particular state is insufficient to satisfy the Due Process Clause's requirement that a state have minimum contacts with a trust before taxing the trust's undistributed income. The presence of a trust beneficiary in a state is neither the dispositive factor that North Carolina claims it to be, nor one that warrants reversal here.

Contrary to the claims of North Carolina and certain *amici*, the North Carolina Supreme Court did not apply an antiquated, formalistic, or rigid Due Process Clause test in this matter. On the contrary, the court below properly recognized that North Carolina's efforts to tax undistributed trust income based solely upon the presence of discretionary trust beneficiaries within its borders did not satisfy the Due Process Clause's requirement for minimum contacts.

C. The Court Below Did Not Create A Tax Shelter.

The states have adopted divergent approaches for taxing trust income. Seven states (Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming) do not tax trust income at all. Kevin R. Ghassomian, *Eliminate State Tax On Trust Income: A Comprehensive Update on Planning with Incomplete Gift Non-Grantor Trusts*, 39 ACTEC L.J. 317, 322 (Winter 2013). Although the remaining forty-three states and the District of Columbia do tax trust income, those jurisdictions apply different criteria in taxing income accumulated by trusts.

Only four states (California, Georgia, North Carolina, and Tennessee) tax income earned by trusts based upon the residence of a trust beneficiary within their borders. Cal. Rev. & Tax Code § 17742(a); Ga. St. § 48-7-22(a)(1)(c); N.C. Gen. St. § 105-160.2.; Tenn. Code Ann. § 67-2-110(a). Among the states in that small minority, Tennessee has repealed its state income tax, which will be fully phased out effective January 1, 2021. Tenn. Dep't of Rev., *2018 Guidance for Tennessee's Hall Income Tax Return* (July 12, 2017).

While the states are free to enact tax legislation of their choosing, that power is subject to limitations. *Greenough*, 331 U.S. at 493-95 ("But our question here is whether or not a provision of the Constitution forbids the tax. Neither the expediency of the levy nor its economic effect on the economy of the taxing state is for our consideration."). At the very least, the states must comport with the Due Process Clause in enacting taxation legislation, which North Carolina failed to do here.

The Due Process Clause provides states with a wide array of options that do not raise constitutional concerns. Those options include: (1) taxing trust income that is derived from property and activity that takes place within a state; and (2) imposing tax on undistributed trust income earned by a trustee who is located in a state. Mich. Comp. Laws § 206.110; Ark. Code Ann. § 26-51-203(a)(1).

Yet another constitutionally-permissible option is available to states. States may tax accumulated trust income at the time that it is distributed to beneficiaries who are located within their borders, regardless of where the income is earned. N.Y. Tax Law § 612(b)(40); Cal. Rev. & Tax Code § 17745(b). When doing so, states receive the benefit of taxing resident trust beneficiaries, who receive trust distributions, for the accumulated income that the trusts earn during the years before distributions occur. Regardless of the contacts (or lack thereof) that the states have to trusts that are administered outside of their borders, states possess the minimum required contacts with trust beneficiaries who reside in the states and can tax such trust beneficiaries on accumulated trust income that is distributed to them without violating the Due Process Clause.

In light of the alternatives that are available to the states, it strains credulity to suggest that the analysis of the court below creates a tax shelter. Instead, as the North Carolina Supreme Court correctly recognized, a state can tax trust income, so long as the state satisfies the Due Process Clause's minimum contacts-based test, which can be met by establishing that the trust's income arose from property or activities that occurred within the state, the trust's trustee was located in the state, or the trust's income was distributed to trust beneficiaries who resided within the state. Absent such a minimal showing, a state's taxation of trust income violates the Due Process Clause.

The Court's Commerce Clause-based analysis in *South Dakota v. Wayfair, Inc.* does not compel a contrary result. In *Wayfair*, the Court rejected the efforts of businesses that maintained no physical presence in particular states, but sold their goods and services to consumers located in those states via the internet, to avoid paying any sales tax to those states. In stark contrast to *Wayfair*, none of the parties to this proceeding argues that undistributed trust income is absolutely exempt from state income taxation in the absence of a physical presence of a trust within a state.

Rather, to the extent that a state's only connection with an out-of-state trust is a discretionary beneficiary's residence within the state, the state must await the beneficiary's receipt of trust distributions in order to tax trust income. Such a result fairly balances the state's interest in maximizing its tax revenues and the Due Process Clause's minimum-contacts analysis, by which all states are bound.

In light of the foregoing, North Carolina's tax on Respondent during the 2005 to 2008 tax years, which was predicated upon the residence of Respondent's discretionary trust beneficiaries in that state, violates the Due Process Clause. The Court should, therefore, affirm the North Carolina Supreme Court's decision.

III. North Carolina's Tax Violates the Commerce Clause.

Although the Question Presented concerns whether North Carolina's tax violates the Due Process Clause, Respondent argued below that the tax also violates the Commerce Clause. *Kimberly Rice Kaestner Family Trust v. North Carolina Dep't of Revenue*, 12-CVS-8740, 2015 WL 1880607 (N.C. Super. Ct. Apr. 23, 2015), *aff'd*, 789 S.E.2d 645 (N.C. Ct. App. 2016), *aff'd*, 814 S.E.2d 43 (N.C. 2018). While the North Carolina Business Court ruled that the law violated both the Due Process Clause and the Commerce Clause, North Carolina's Court of Appeals and Supreme Court only ruled that the statute violated the Due Process Clause. *Id.*, 814 S.E.2d at 47. Should the Court consider North Carolina's tax vis-à-vis the Commerce Clause, it should find that it is unconstitutional, or in the alternative, remand the matter.

A. The Four Factors For the Dormant Commerce Clause Analysis Cannot Be Met.

A state tax will survive scrutiny under the Dormant Commerce Clause so long as it: "(1) applies to an activity with a substantial nexus with the taxing State, (2) is fairly apportioned, (3) does not discriminate against interstate commerce, and (4) is fairly related to the services the State provides." *South Dakota v. Wayfair*, 138 S. Ct. 2080, 2091 (2018) (citing *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977)).[3] An analysis of the tax under the

3. In finding that the tax ran afoul of the Commerce Clause, the North Carolina Business Court held that the tax did not satisfy the first or fourth prong, and did not address the other two prongs.

Complete Auto Transit test shows that North Carolina's tax does not fulfill any of these requirements, much less all of them.

The substantial nexus requirement commands that there be "some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax." *Miller Brothers Co. v. Maryland*, 347 U.S. 340, 344-45 (1954). For example, in the wake of *Wayfair*, Pennsylvania's intermediate appellate court rejected a Commerce Clause challenge to a Pennsylvania personal income tax upon non-resident taxpayers because the underlying entity derived its income from real property owned in Pennsylvania, which created a substantial nexus with the state. *Andrews v. Commonwealth of Pennsylvania*, 196 A.3d 1090, 1098 (Pa. Commw. Ct. 2018).

The operative activity – Respondent accumulating undistributed income – and the taxpayer (the trustee) did not create a nexus with North Carolina, much less a substantial nexus. The trustee did not live or work in North Carolina, none of the income was earned in North Carolina, and the trust did not own any assets in North Carolina. Nor was a cent distributed from the trust to anyone in North Carolina. The presence of discretionary beneficiaries in the State of North Carolina was incidental to the taxpayer's activities.

Kimberly Rice Kaestner Family Trust, 2015 WL 1880607, at *9. Specifically, the Business Court held that the discretionary beneficiaries' presence in North Carolina was "some contact" but hardly a "substantial nexus." Likewise, it found the taxpayer (the trustee) had no presence within the state.

Wayfair does not change this analysis. *Wayfair* dispensed with the physical presence requirement, dubbing it "artificial, anachronistic . . . unsound and incorrect." *Wayfair*, 138 S. Ct. at 2099. But this does not alter the outcome, as the state still must show that the tax is applied to an activity with a substantial nexus with the taxing state and that the taxpayer availed itself of the "substantial privilege" of conducting business in the jurisdiction. *Wayfair*, 138 S. Ct. at 2099. This is not the case here, as North Carolina's tax is designed to capture all income earned by a trustee, regardless of whether the trustee used or profited from any of North Carolina's services.[4]

Nor is the tax fairly apportioned. This prong of the *Complete Auto Transit* test serves to "ensure that each [s]tate taxes only its fair share of an interstate transaction." *Oklahoma Tax Com'n v. Jefferson Lines, Inc.*, 514 U.S. 175, 184 (1995). Doing so requires analyzing whether the tax is both internally consistent and externally consistent. Internal consistency is achieved "when the imposition of a tax identical to the one in question by every other [s]tate would add no burden to interstate commerce that intrastate commerce would not also bear." *Jefferson Lines, Inc.*, 514 U.S. at 185. This Court described utility of this test three years ago in *Comptroller of Maryland Treasury v. Wynne*:

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4. For this reason, tax practitioners and commentators have speculated that *Wayfair* would have a minimal impact on state taxation of trusts. Richard W. Nenno, *Minimizing or Eliminating State Income Taxes on Trusts*, Koren Estate, Tax, and Personal Financial Planning Update (August 2018 ed.).

> By hypothetically assuming that every State has the same tax structure, the internal consistency test allows courts to isolate the effect of a defendant [s]tate's tax scheme. This is a virtue of the test because it allows courts to distinguish between (1) tax schemes that inherently discriminate against interstate commerce without regard to the tax policies of other [s]tates, and (2) tax schemes that create disparate incentives to engage in interstate commerce (and sometimes result in double taxation) only as a result of the interaction of two different but nondiscriminatory and internally consistent schemes. The first category of taxes is typically unconstitutional; the second is not.

Comptroller of Maryland Treasury v. Wynne, 135 S. Ct. 1787, 1802 (2015) (internal citations omitted).

If imposed nationwide, the North Carolina tax would discriminate against interstate commerce, as it would create double taxation upon any trust where the trustee resided in a state that taxed trust income, and a trust beneficiary, intentionally or not, resided in a different state.[5] In some instances, this would be unavoidable. As an illustration, consider a testamentary trust where the trustee had absolute discretion over distributing trust income, and a minor beneficiary resided in another state, and since she was a minor, could not relocate. Under the North Carolina law, the trustee would be subjected to

5. Subjecting interstate commerce "to the risk of a double tax burden to which intrastate commerce is not exposed" is forbidden by the Commerce Clause. *J.D. Adams Mfg. Co. v. Storen*, 304 U.S. 307, 311 (1938).

double taxation, and would be without recourse, as neither the trustee nor the beneficiary could relocate.[6]

This scheme would also create a sea change in trusts and estates practice for inter vivos trusts, as every time a beneficiary relocated to another state, grantors and trustees would be compelled to create a new trust (or decant a trust into a new trust) to avoid double taxation. Arguably, a trustee would be breaching its fiduciary duty if the trustee did not create a new trust (or decant).

The tax also fails to be externally consistent, which seeks "to discover whether a [s]tate's tax reaches beyond that portion of value that is fairly attributable to economic activity within the taxing [s]tate." *Jefferson Lines, Inc.*, 514 U.S. at 185. As none of Respondent's activity occurred within North Carolina, the tax reaches beyond its permissible scope.[7] Additionally, as noted above, a blanket application of North Carolina's law exposes the taxpayer (the trustee) to multiple taxation if the trustee is also paying income tax to the state in which she resides.[8]

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6. This is why the tax also fails the third prong of *Wayfair* and *Complete Auto Transit*, as it is plainly discriminates against interstate commerce; here, there are a trustee and a trust beneficiary in different states.

7. Similarly, the tax fails the fourth prong of *Wayfair* and *Complete Auto Transit*, which requires that the tax bear some relation to the services provided by North Carolina. The services that North Carolina and its *amici* claim the state is providing (such as public education) are to the beneficiary, not the taxpayer.

8. "The threat of real multiple taxation . . . may indicate a state's impermissible overreaching." *Jefferson Lines*, 514 U.S. at 185; *see also J.D. Adams Mfg. Co. v. Storen*, 304 U.S. 307, 311 (1938).

B. In the Alternative, the Matter Should be Remanded for Commerce Clause Consideration.

In the event the Court reverses on Due Process grounds and does not hold that North Carolina's tax is unconstitutional under the Dormant Commerce Clause, it should remand for further proceedings to develop a record concerning whether the tax violates the Commerce Clause. For example, a tax will not be externally consistent when the taxpayer demonstrates "by clear and cogent evidence that the income attributed to the [s]tate is in fact out of all appropriate proportions to the business transacted in that [s]tate."[9] *Container Corp. of America v. Franchise Tax Bd.*, 463 U.S. 159, 170 (1983) (citing *Hans Rees' Sons v. North Carolina*, 283 U.S. 123 (1931)). The parties should be permitted to develop a record to ascertain whether this was the case.

Additional findings of fact would also be necessary to ascertain if North Carolina's tax poses an undue burden and violates the balancing test set forth *Pike v. Bruce Church, Inc.*, 397 U.S. 137, 142 (1970). Indeed, this Court noted in *Wayfair* that *Pike* is one of several other aspects of Commerce Clause jurisprudence that can be used to ascertain a statute's constitutionality. *Wayfair*, 138 S. Ct. at 2098-99. The same is true as to whether North Carolina's tax impermissibly results in out-of-state taxpayers being subjected to double-taxation, whereas a domestic trust would not be. *See Wynne*, 135 S. Ct. at 1822.

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9. *Container Corp.* concerned an apportionment formula between two states. While this is not the case here, the overarching principle applies.

CONCLUSION

For the foregoing reasons, NYSBA respectfully submits that the decision below should be affirmed.

Respectfully submitted,

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