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 FOR SOUTH DAKOTA AND ALASKA, NEVADA, AND TEXAS AS *AMICI CURIAE* IN SUPPORT OF RESPONDENT

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March 25, 2019

WILSON-EPES PRINTING CO., INC. – (202) 789-0096 – WASHINGTON, D. C. 20002

QUESTION PRESENTED

May states, consistent with Due Process, tax the accumulated, undistributed gains of an out-of-state trust's assets because a trust beneficiary is a resident of the taxing state?

TABLE OF CONTENTS

TABLE OF AUTHORITIES

TABLE OF AUTHORITIES—Continued

Page(s)

TABLE OF AUTHORITIES—Continued

INTEREST OF *AMICI CURIAE*

In a federal union, some states, a rural state such as South Dakota in particular, may find comparative economic advantage in not taxing personal and corporate income in the hope of attracting businesses to employ residents and support local communities through property and sales taxes. Admittedly, an incident of such a tax system is a favorable environment for trust location. Opening trusts to nationwide and multiple taxation will inevitably burden such interstate commerce by compelling trust constituents to confine their domiciles to one state whenever possible. Nationwide and multiple taxation also will subject resident South Dakota trusts to litigation in distant and inconvenient forums as states with resident grantors or beneficiaries sue one another over competing claims to their perceived taxable share of the trust *res.*

States have ways and means of taxing trust income without offending either Due Process or the Commerce Clause. A resident beneficiary may be taxed when a distribution is made; a resident trustee may be taxed for undistributed income; trust income may be taxed to the extent it is sourced to property or activity in the taxing state; or "throwback" provisions. As the plaintiff in *Wayfair*, South Dakota's *amicus curiae* interest is in seeing that further evolution of taxation jurisprudence remains tethered to legal and practical principles of Due Process.

SUMMARY OF ARGUMENT

Recently, *South Dakota v. Wayfair*, 138 S.Ct. 2080 (2018), abrogated the requirement that out-of-state retailers have a "physical presence" in a state in order to subject sales within that state to taxation. In today's digital economy, where out-of-state retailers can establish an online "virtual presence"[1] anywhere and generate substantial sales to the detriment of local retailers, *Wayfair* dispatched the physical presence rule as a formalism of a bygone-era, overtaken by technology allowing out-of-state retailers to compute taxes due without burdening interstate commerce. Dispensing with physical presence essentially aligned the nexus component of Commerce Clause jurisprudence with Due Process concepts of minimum contacts.

North Carolina now invokes *Wayfair* to argue for abrogation of certain "formalisms" which prevent states from taxing accumulated, undistributed gains held in out-of-state trusts. The obstructing "formalisms" are a trust's independent legal identity and the assignment of the taxable situs of intangible assets to the jurisdiction where they are held. North Carolina proposes to dispense with these "formalisms" so that states may, in effect, pierce the fiduciary veil to directly tax in-state beneficiaries for undistributed gains realized by an out-of-state trust over which these beneficiaries exercise no control.

But this proposal demands more than dispensing with "obsolete formalisms." This proposal entails overturning at least two prior decisions of this Court and relaxing requisite Due Process contacts well below traditional minimums . . . to the end simply of substituting new formalisms – a grantor's or beneficiary's residence – for existing ones. These new formalisms, could not be adopted and applied to the trust industry without wholly abrogating customary constraints upon extraterritorial exercises of *in personam* or *in*

[1] *Wayfair*, 138 S.Ct. at 2095.

rem jurisdiction. The trust industry, unlike the retail sector, has not experienced systemic structural changes warranting such radical reformulation of Due Process principles.

ARGUMENT

To paraphrase *Hanson v. Denkla*, 357 U.S. 235, 246 (1958), "[i]t is a mistake to assume that [*Wayfair*] heralds the eventual demise of all restrictions on the personal jurisdiction of state courts" over non-resident trust personnel or property. *Wayfair* simply relieved North Carolina of any need to demonstrate the Kaestner Trust's physical presence within its borders for purposes of meeting the substantial nexus component of the *Complete Auto*[2] test – *if* the Kaestner Trust's activities are interstate commerce. If not, North Carolina must satisfy *Quill's*[3] minimum contacts test. The North Carolina Supreme Court's *Kaestner* decision[4] and other briefing in this case ably describe why the Kaestner Trust's contacts with North Carolina satisfy neither test.

North Carolina faults the *Kaestner* court for reasoning that the trust's independent legal identity and situs of the trust's intangible assets in New York were critical to the disposition of that case.[5] To North Carolina, the trust's independent legal identity and taxable situs under traditional rules are archaic formalisms on a par with the physical presence rule

[2] *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 285 (1977).

[3] *Quill v. North Dakota*, 504 U.S. 298 (1992).

[4] *Kaestner 1992 Family Trust v. North Carolina Dept. of Revenue*, 814 S.E.2d 43 (N.C. 2018).

[5] *Kaestner*, 814 S.E.2d at 49.

which should be abrogated as well. In lieu of these "old formalisms," North Carolina proposes a new formalism – taxation of a trust's accumulated gains by the beneficiary's state of residence (even if the beneficiary has no control over either the trust or its assets and has not realized any income from its accumulated gains). Other states pursue taxation through a different new formalism – the grantor's residency at the time of the trust's formation. North Carolina and other states take *Quill* and *Wayfair* to an extreme not warranted by currently applicable measures of extraterritorial jurisdiction, minimum contacts or traditional notions of justice and fair play.

Thus, there is significantly more at issue here than North Carolina's prescriptive jurisdiction to tax,[6] for prescriptive jurisdiction is hollow without the adjudicative jurisdiction to enforce it.[7] The "old formalisms" obstructing North Carolina's adjudicative jurisdiction exist to enforce constitutional constraints on extraterritorial exercises of *in personam* and *in rem*[8] jurisdiction, themselves rooted in imperatives of

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[6] *Quill*, 504 U.S. at 319-20 (Scalia, J., concurring)("It is difficult to discern any principled basis for distinguishing between jurisdiction to regulate and jurisdiction to tax"); Petitioner's Brief at 21 n. 9.

[7] *Safe Deposit & Trust Co. v. Commonwealth of Virginia*, 280 U.S. 83, 92 (1929)(prescriptive jurisdiction question ignored when taxing jurisdiction could not exercise adjudicative jurisdiction).

[8] *Connecticut General Life Ins. Co. v. Johnson*, 303 U.S. 77 (1938)("As a general principle, a state may not tax value earned outside its borders"); *Safe Deposit*, 280 U.S. at 93 ("A statute of a state which undertakes to tax things wholly beyond her jurisdiction or control conflicts with the Fourteenth Amendment . . . . [P]roperty permanently located beyond the owner's domicile may not be taxed at the latter place").

fundamental fairness. Precedent reveals that dispensing with these "old formalisms" likely would create "as many tax injustices as [this Court] would avoid."[9]

When, in *Brooke*, this Court recognized a trust's independent legal identity *vis-à-vis* a state's effort to directly tax a trust beneficiary it noted Fourteenth Amendment concerns with taxing trust property "to which she [wa]s a stranger" because, as here, the property was "not within the [taxing] state, d[id] not belong to the petitioner and [wa]s not within her possession or control."[10] *Greenough* reaffirmed that "[t]he legal interest of the trustee in the *res* is a distinct right."[11] And in *Hanson*, the "acts of the trustee," distinct and apart from those of the beneficiary, were determinative of jurisdiction. To the extent subsequent decisions have condoned certain exceptions to the general principle that a trust has an independent legal identity, they did so in response to circumstances not present here, such as one-time *estate* taxation in dual jurisdictions where a donor retained certain controls over the trust property,[12] or a taxed entity that was a "trust" in name only.[13]

When, in *Safe Deposit*, this Court assigned the taxable situs of intangible trust assets to the state where the assets were held in trust, it recognized the out-of-state trustee as "the holder of legal title" and the legal and physical separateness created by that

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[9] *Curry v. McCanless*, 307 U.S. 357, 373 (1939).

[10] *Brooke v. City of Norfolk*, 277 U.S. 27, 28 (1928).

[11] *Greenough v. Tax Assessors of City of Newport*, 331 U.S. 486, 495-96 (1947).

[12] *Curry*, 307 U.S. at 369 (1939).

[13] *Americold Realty Trust v. Conagra Foods, Inc.*, 136 S.Ct. 1012, 1016 (2016).

relationship.[14] *Safe Deposit* reasoned that it was the law of the situs state that "protected" the assets and that for a state to exercise *in rem* jurisdiction over trust property not subject to the control of the beneficiary and "wholly beyond [its] jurisdiction or control conflicts with the Fourteenth Amendment."[15] Such extraterritorial *in rem* jurisdiction in the trust context "would 'involve possibilities of an extremely serious character' by permitting double taxation, both unjust and oppressive."[16]

Today's "[f]lexible standards" of extraterritorial jurisdiction do not abrogate constraints on *in personam* or *in rem* jurisdiction over out-of-state trustees or trust property; these constraints must be overcome by a proper showing of sufficient minimal contacts between the legal titleholder of the trust *res* and a taxing state before an out-of-state trustee and trust property may be subject to extraterritorial taxation.[17] If overcoming these constraints was as easy as some "'random,' 'fortuitous,' or 'attenuated' contact" with a taxing state via the "unilateral activity" of a grantor or beneficiary in choosing to reside there,[18] operative protections of Due Process would lose all force in the trust context . . . and not just in regard to taxation.

The possibilities of tax injustices from unconstrained long-arm taxing statutes are manifold. As

[14] *Safe Deposit*, 280 U.S. at 93.

[15] *Safe Deposit*, 280 U.S. at 92.

[16] *Safe Deposit*, 280 U.S. at 93.

[17] *Hanson,* 357 U.S. at 250-52.

[18] *Burger King v. Rudzewicz,* 471 U.S. 462, 475 (1985); *Hanson,* 357 U.S. at 250-52 (grantor's relocation to Florida after formation of trust not sufficient to create *in personam* jurisdiction over out-of-state trustee).

applied to trust beneficiaries, the term "undistributed income" is an oxymoron; trust gains are not "income" until they are paid to the beneficiary. A gain in a trust asset, *e.g.* a mutual fund, one year may be wiped out the next year. If taxed on this "gain" before it is paid as income, a beneficiary suffers the dual injustices of being taxed on a "gain" that subsequently evaporates and being forced to deplete the principal of the trust to pay the tax. Oppressive double or triple taxation could occur if, as here, a grantor created a trust in one state,[19] the trustee holds and manages the assets in another state, and a beneficiary lives in a third state – particularly if *each* state "tax[es] the entire net income of the trust" without apportionment for taxes imposed on other "trust constituents" in their respective states.[20] Such opportunities for multiple taxation inevitably will have a chilling effect on interstate commerce as trusts and beneficiaries consider consolidating their activities and holdings within a single state. Some states tax an out-of-state testamentary trust's income in perpetuity simply because the testator was domiciled in that state at the time of death years or decades

[19] *District of Columbia v. Chase Manhattan Bank*, 689 A.2d 539 (D.C.Ct.App. 1997)(statute permitting taxation of trust by District of Columbia because grantor formed the trust in the District of Columbia prior to his death); *Chase Manhattan Bank v. Gavin*, 733 A.2d 782 (Conn. 1999)(statute permitting taxation of trust by Connecticut because grantor formed trusts in Connecticut prior to his death).

[20] *McCulloch v. Franchise Tax Bd.*, 390 P.2d 412 (Cal. 1964) (statute permitting taxation of out-of-state trust by California because beneficiary was a California resident); *Fielding v. Commissioner of Revenue*, 916 N.W.2d 323 (Minn. 2018)(statute permitting taxation of out of state trust by Minnesota because beneficiary was a Minnesota resident); *District of Columbia*, 689 A.2d at 545 (asserting right to "tax the entire net income of the trust" because grantor died in the District over 50 years earlier).

ago.[21] Once grantor and beneficiary states begin suing each other for their perceived proportionate share of an out-of-state trust's annual accumulated gains, non-resident trustees inevitably will be haled into court in inconvenient forums in states that have provided no infrastructure or legal protection of service to the growth of trust assets.

The constitutional considerations attending exercises of extraterritorial *in personam* and *in rem* jurisdiction over out-of-state trustees and trust assets that animated this Court's decisions in *Safe Deposit, Greenough, Brooke* and *Hanson* are no less concerning now than then. At a minimum, these cases would have to be overruled in whole or in part, and a singular exception to general Due Process minimum contacts for trusts created, before North Carolina could visit any binding judgment on the New York trustee or trust assets in this case. But North Carolina has identified no "systemic and structural changes"[22] in the trust sector of the economy warranting such a radical reformulation of Due Process.

Indeed, the strained rationales required to sustain long-arm taxing statutes – which range from the merely paternalistic (beneficiary owes her "enjoy-

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[21] *District of Columbia*, 689 A.2d at 544, 545 (describing District of Columbia's "continuing jurisdiction" to tax NY trustee for income in 1987-1991 tax years because grantor was District resident in 1934 when he died); *Linn v. Department of Revenue*, 2 N.E.3d 1203, 1209 (Ill.App.4th 2013)(taxing trust created in 1961); *In re: Swift*, 727 S.W.2d 880 (Mo. 1987)(taxing trust created in 1942); *Gavin*, 733 A.2d at 787 (taxing trusts created in 1955 and 1968); *McNeil Trust ex rel. McNeil v. Commonwealth of Pennsylvania*, 67 A.3d 185 (Comm.Ct.Pa. 2013)(taxing trust created in 1959).

[22] *Wayfair*, 138 S.Ct. at 2097.

ment"[23] of life to the state) to the Orwellian (trust "owes its very existence"[24] to the state!!!) – reveal how "unacceptably grasping"[25] they are. The blessings of an orderly society bestowed by North Carolina on the Kaestners are not enjoyed by the Kaestner Trust or imputable to it for purposes of measuring the trust's contacts with the state.[26] *Wayfair* sustained South Dakota's sales tax because South Dakota had created a market in which Wayfair could operate and profit;[27] North Carolina's laws and markets contribute nothing to the Kaestner Trust's generation of income.[28] As in *Hanson*, "this suit cannot be said to be one to enforce an obligation that arose from a privilege [the Kaestner Trust] exercised in [North Carolina]" or any act by the trust to purposefully avail itself of the benefits and

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[23] *Gavin*, 733 A.2d at 802 ("social benefits" provided to beneficiary for "enjoyment" of her life in Connecticut, not trustee's connections to state, basis for directly taxing beneficiary for accumulated, undistributed trust gains); Petitioner's Brief at 36 (North Carolina make Kaestner's "lifestyle" possible).

[24] *District of Columbia*, 689 A.2d at 543; *Linn*, 2 N.E.3d at 1209 (fact that trust was formed under Illinois law – "owes its existence to Illinois" – more than 40 years earlier insufficient basis for taxation of out-of-state trustee).

[25] *Daimler AG v. Bauman*, 571 U.S. 117, 138 (2014); *Blue v. Department of Treasury*, 462 N.W.2d 762, 764 (Mich.App. 1990) (ostensible legal protections provided by state to non-resident trust "illusory").

[26] *Hanson*, 357 U.S. at 254 ("unilateral activity" of settlor in moving to Florida not imputed to defendant trustee).

[27] *Wayfair*, 138 S.Ct. at 2096; *Quill*, 504 U.S. at 328.

[28] *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450, 464 (1959)(taxes may be "levied only on that portion of the taxpayer's net income which arises from its activities within the taxing state"); *Quill*, 504 U.S. at 306 (taxed income must be rationally related to value provided by the taxing state).

protections of North Carolina's laws.[29] Rather, the Kaestner Trust's connections to North Carolina amount to nothing more than communicating with the beneficiary by mail or telephone while carrying out its general fiduciary responsibilities.[30]

Notions of fair play certainly have been abandoned when a state must accuse one of its citizens of freeloading to justify its aggressive taxing scheme. Petitioner's Brief at 34-36. It stands to reason that, since Kaestners took no distributions from the trust during the years in question, they earned their living from other income which North Carolina duly taxed as payment for the family's proportionate share of state services; the Kaestner Trust certainly made no quantifiable demands on North Carolina's infrastructure or resources. Thus, the *Wayfair* inequity of an out-of-state entity profiting from and consuming state resources without paying its fair share of taxes is not present here.[31]

Eleven states now have statutes or rules authorizing the taxation of trusts based on the residency of a beneficiary in the state.[32] Thirteen states authorize taxation based on the grantor's residency in the state.[33] Some courts have admirably held the constitu-

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[29] *Hanson*, 357 U.S. at 254; *Quill*, 504 U.S. at 307.

[30] *Quill*, 504 U.S. at 307; *Hanson*, 357 U.S. at 252 (settlor's "bits of trust administration" in her resident state of Florida did not render Delaware trustee to the jurisdiction of Florida courts).

[31] *Wayfair*, 138 S.Ct. at 2096.

[32] Alabama, California, Connecticut, Georgia, Michigan, Missouri, North Carolina, North Dakota, Ohio, Rhode Island, Tennessee.

[33] Delaware, Illinois, Maine, Maryland, Michigan, Nebraska, Oklahoma, Pennsylvania, Vermont, Virginia, Washington, D.C., West Virginia, Wisconsin.

tional line against the possible inequity and overreach of such statutes as applied to out-of-state trusts.[34] But not all have,[35] creating a "tangled underbrush"[36] of disparate taxation schemes and conflicting constitutional interpretations in need of clearing. Piercing the fiduciary veil as provided in these statutes risks "enmeshing courts in the 'perplexing' business, 'so unfit for the judicial department,' of attempting to delineate 'what degree of taxation is the legitimate use, and what degree of taxation may amount to the abuse of power.'"[37] Equally perplexing for courts will be valuing benefits allegedly conferred by taxing states on resident grantors, beneficiaries, trust entities and trustees and apportioning to such states their piece of the pie. Formalisms such as a grantor's or beneficiary's residency bear no relation to, indeed are antithetical to, Due Process constraints upon the exercise of extraterritorial jurisdiction over a trustee or trust *res*. Core principles of Due Process, not opportunistic new formalisms, must continue to govern the measure of a state's extraterritorial jurisdiction.

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[34] *Kaestner*, 814 S.E.2d at 49; *Linn*, 2 N.E.3d at 1209; *Fielding*, 916 N.W.2d at 331-32; *Blue*, 462 N.W.2d at 764; *Swift*, 727 S.W.2d at 882; *McNeil*, 67 A.3d at 193-96; *Kassner Trust v. New Jersey Division of Taxation*, 27 N.J.Tax 68 (Tax Ct.N.J. 2013); *Mercantile-Safe Deposit Trust Co. v. Murphy*, 203 N.E.2d 490 (Ct.App.N.Y. 1964).

[35] *Gavin*, 733 A.2d at 802; *District of Columbia*, 689 A.2d at 543; *Legg Irrevocable Trust v. Testa*, 75 N.E.3d 184 (Ohio 2016); *McCulloch*, 390 P.2d at 418.

[36] *Wisconsin v. J. C. Penney Co.*, 311 U.S. 435, 445 (1940).

[37] *Dawson v. Steager*, 586 U.S. ____ (2019), quoting *McCulloch v. Maryland*, 4 Wheat. 316, 430 (1819).

CONCLUSION

While the fiduciary relationship may be an "abstraction," legal title to the property held by the trustee, and its power and control over assets bestowed by trust documents, are no mere legal fictions or "judicially-created tax shelters."[38] Hence, for jurisdictional purposes "[t]he citizenship of the trustee and not the seat of the trust or the residence of the beneficiary is the controlling factor." *Greenough*, 331 U.S. at 495-96. To pierce the fiduciary veil to directly tax a beneficiary on the undistributed gains of an out-of-state trust defeats all notions of fundamental fairness embodied in constitutional limits on the exercise of *in personam* and *in rem* jurisdiction over trustees and trust assets. This Court's retreat from the simple formalism of physical presence in *Wayfair* certainly did not portend such a radical departure from larger constitutional norms.

Respectfully submitted,

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March 25, 2019

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[38] *Greenough*, 331 U.S. at 493, 496-96 (legal interests of trustee distinct).

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