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 TAX LAW PROFESSORS AS *AMICI CURIAE* IN SUPPORT OF PETITIONER

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STATEMENT

This case presents a narrow but significant question at the intersection of state tax law and federal

[1] Pursuant to this Court's Rule 37.3(a), *amici* state that all parties have granted blanket consent to *amicus* briefs. Pursuant to this Court's Rule 37.6, *amici* state that this brief was not authored in whole or in part by counsel for any party, and that no person or entity other than *amici* or their counsel made a monetary contribution intended to fund the preparation or submission of this brief.

constitutional law: whether the Due Process Clause of the Fourteenth Amendment prohibits a state from taxing its residents' proportionate share of the accumulated nonsource income of a nongrantor trust whose trustee resides in another state. That framing—though a mouthful—highlights several important aspects of the issue facing this Court.

First, only the taxation of *nongrantor* trusts is in dispute. If the grantor of a trust retains any one of several powers over the trust (*e.g.*, the power to revoke), and if the grantor can exercise that power without the approval of others who hold substantial beneficial interests in the trust, then the trust is treated as a "grantor trust" under federal tax law, and the grantor is treated as the "owner." *See* 26 U.S.C. §§ 672(a), 674-677. The trust's income and deductions are then included in computing the owner's taxable income. *Id.* § 671. In effect, the trust is "ignored" for income tax purposes. *See, e.g.*, *United States v. Buttorff*, 761 F.2d 1056, 1061 (5th Cir. 1985). North Carolina, like most other states, follows the federal grantor trust rules. *See* N.C. Gen. Stat. §§ 105-153.3(1), 105-153.4 (using federal tax law to calculate taxable income); N.C. Dep't of Revenue, *Grantor Trust Returns No Longer Required*, https://perma.cc/2G2J-F843 (explaining that grantor trusts need not file North Carolina income tax returns because their income is reported on the grantors' returns). The respondent trust is not a grantor trust because the grantor relinquished all relevant powers over the trust to the trustee. *See* App. 69.

Second, only the taxation of a trust's *nonsource* income is at issue. North Carolina, like other states with comprehensive income taxes, draws a distinction between income from in-state sources and all other income. A nongrantor trust's North Carolina source income—which includes income from real or tangible personal property inside the state, as well as income from a business, trade, profession, or occupation carried on in the state—is subject to North Carolina income tax regardless of whether the trust's beneficiaries are North Carolina residents. *See* N.C. Gen. Stat. § 105-160.2. For all other income, North Carolina taxes only its resident beneficiaries' proportionate share. *See id.* To protect against duplicative taxation of a trust's non-North Carolina source income, North Carolina allows a credit for income taxes paid to another state or country on income from sources in that jurisdiction. *See id.* § 105-160.4.[2] The respondent trust does not challenge North Carolina's authority to tax trust income from in-state sources, and it does not charge that North Carolina's system for crediting taxes paid to other jurisdictions is unfair or unconstitutional.

Third, the present controversy concerns only the taxation of a trust's *accumulated* income. When a trust earns income, it can either distribute the income to the beneficiaries immediately, or accumulate the income and add it to the trust principal. *See, e.g.*, *United States v. O'Malley*, 383 U.S. 627, 629 (1966). This Court decided nearly a century ago that the Due Process Clause permits a state to tax trust income distributed to a resident beneficiary, even when the

[2] For example, if a trust whose beneficiaries are all North Carolina residents pays a tax to New York on rental income that the trust derives from a New York office building, the trust can claim a dollar-for-dollar credit against North Carolina income tax up to the amount of tax that North Carolina would otherwise impose on that income. *See* N.C. Gen. Stat. § 105-160.4(b).

trustee resides elsewhere and the income is from an out-of-state source. *See Maguire v. Trefry*, 253 U.S. 12, 17 (1920). The question in this case is whether the Due Process Clause requires a different result when, instead of distributing the income immediately, the trust accumulates the income for future distribution to the taxing state's residents.

The narrowness of this question should not obscure its importance. As of 2014, the most recent year with available data, more than 1.4 million "complex trusts" in the United States filed tax returns. *See* Internal Revenue Serv., Statistics of Income Div., *Fiduciary Income Tax Returns, Income Source, Deductions, and Tax Liability, by Type of Entity, Filing Year 2014* (Oct. 2015), https://www.irs.gov/pub/irs-soi/14fd02.xlsx. (A trust that accumulates income is a "complex trust."[3]) These trusts reported more than $90 billion in income from the previous year. *Id.* But even that figure understates the stakes, because a ruling for the respondent trust would encourage high-net-worth individuals to transfer many more billions of dollars to nongrantor trusts to avoid state income taxes. For that reason, this may well be the most important state income tax case that the Court has decided in decades, and its ramifications for state tax regimes will likely be felt for decades to come.

SUMMARY OF ARGUMENT

The Fourteenth Amendment's Due Process Clause prohibits a state from taxing the income of an

[3] *See* 26 C.F.R. § 1.651(a)-(1). A trust also may be a "complex trust" if it distributes principal or makes charitable contributions. *See id.*; *compare* 26 U.S.C. § 651 (governing simple trusts), *with* 26 U.S.C. § 661 (governing complex trusts).

entity that has no connection to the state's residents. The Due Process Clause does not, however, prevent a state from taxing the income of an entity that directs all of its activities at the state's residents and that itself benefits from the state's protection and services. The court below misconstrued the Due Process Clause to do the latter, thereby transmogrifying the provision from a vital safeguard of fundamental rights into a recipe for avoidance of state income tax. Nothing in the text of the Fourteenth Amendment nor the century and a half of this Court's precedents construing it requires or recommends that result.

What the Due Process Clause does require are at least "minimum contacts" between a state and the object of its taxes. *See Quill Corp. v. North Dakota*, 504 U.S. 298, 307 (1992). "Minimum contacts" exist when the taxpayer's efforts are "purposefully directed" toward residents of the taxing state. *Id.* at 308 (internal quotation marks omitted). That is true here. The respondent is a trust, so *all* its efforts must be purposefully directed toward its beneficiaries, who are residents of North Carolina. *See* Restatement (Third) of Trusts § 78 (2007). It would be anomalous to say that a state has "minimum contacts" with a corporation that makes less than 0.5% of its sales to the state's residents, *see Quill*, 504 U.S. at 302, 308, but that a state lacks that requisite connection with a trust whose efforts must, by law, be aimed entirely at benefitting the state's residents.

This outcome accords with the "traditional notions of fair play and substantial justice" undergirding the Court's due process jurisprudence. *Quill*, 504 U.S. at 307 (internal quotation marks omitted). Here, North Carolina facilitates the respondent trust's accumulation of income by providing a wide range of services to the trust's beneficiaries, thereby alleviating the trust's burden to pay for those same services itself. Meanwhile, a contrary holding that allowed a state to tax a nongrantor trust on its accumulated income only when the trustee is an in-state resident or the trust is administered inside the state would open a wide door to avoidance of state income tax. Financially sophisticated individuals who live in the 43 states that tax income could avoid current-year taxation of capital gains, dividends, and interest by transferring financial assets to nongrantor trusts in states that do not tax income, or in states that do not tax trust income on the basis of trustee residence or in-state administration. Those trusts could then strategically time their distributions to beneficiaries so as to minimize or eliminate any state-level taxation.

Perhaps this unattractive result would be acceptable—or at least inevitable—if it were a necessary prophylactic to protect interstate trusts from excessive taxation. But it is not. If this Court reverses the decision below, grantors and trustees still will be able to ensure that trust income is not subject to duplicative taxation on both the basis of beneficiary residence and the basis of trustee residence. And the Court's dormant Commerce Clause precedents establish additional guardrails that prevent states from taxing more than their fair share of trust income. *See, e.g.*, *Comptroller of the Treasury of Md. v. Wynne*, 135 S. Ct. 1787, 1803 (2015). The rigid rule applied by the court below—which prohibits a state from taxing any portion of a trust's nonsource income based on the in-state residence of trust beneficiaries—is gratuitous in light of these protections that interstate trusts already enjoy.

ARGUMENT

I. The Due Process Clause permits a state to tax income accumulating in a nongrantor trust for the benefit of its residents.

In a series of cases culminating in *Quill v. North Dakota*, this Court developed a two-pronged test to determine whether a state's exercise of its power to tax satisfies the Fourteenth Amendment's Due Process Clause. First, there must be "some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax." *Quill*, 504 U.S. at 306 (quoting *Miller Bros. Co. v. Maryland*, 347 U.S. 340, 344-345 (1954)). This "definite link" requirement tracks the "minimum contacts" test familiar from the Court's personal jurisdiction cases. *See Int'l Shoe Co. v. Washington*, 326 U.S. 310, 316 (1945). Second, the "income attributed to the State for tax purposes must be rationally related to values connected with the taxing State." *Quill*, 504 U.S. at 306 (internal quotation marks omitted).

These two prongs allow the Court to assess "whether the taxing power exerted by the state bears fiscal relation to protection, opportunities and benefits given by the state." *MeadWestvaco Corp. v. Ill. Dep't of Revenue*, 553 U.S. 16, 25 (2008) (quoting *ASARCO Inc. v. Idaho Tax Comm'n*, 458 U.S. 307, 315 (1982)). They can be reduced to one "simple but controlling question": "whether the state has given anything for which it can ask return." *Wisconsin v. J. C. Penney Co.*, 311 U.S. 435, 444 (1940).

Whether this Court applies *Quill*'s two-pronged test or *J. C. Penney*'s one-question approach, the same answer emerges: The Due Process Clause permits a state to tax its residents' proportionate share of the accumulated nonsource income of a nongrantor trust.

A. A state tax on residents' proportionate share of trust income satisfies the "minimum contacts" and "rational relationship" requirements.

The court below concluded that North Carolina's application of its income tax to the respondent trust failed to meet the first prong of *Quill*: "minimum contacts" between the taxpayer and the taxing state. Pet. App. 10a, 18a. That conclusion was mistaken. In fact, the tax here satisfies both prongs of *Quill*.

1. A trust has more than "minimum contacts" with a state when all its activities are "purposefully directed" toward the state's residents.

A state's application of its tax satisfies the "minimum contacts" criterion when the taxpayer's "efforts are *purposefully directed* toward residents of [the taxing] State." *Quill*, 504 U.S. at 308 (emphasis added; internal quotation marks omitted). When a taxpayer purposefully directs its efforts toward residents of a particular state, the taxpayer cannot complain that it lacked "fair warning" of its possible obligations to that state. *See id.* And, in this case, there is no doubt that the respondent trust has purposefully directed its efforts toward residents of North Carolina.

The respondent trust, like any private (*i.e.*, noncharitable) trust, exists to benefit its beneficiaries. *See* Restatement (Third) of Trusts § 27 cmt. b (2003). The trustee "has a duty to administer the trust solely in the interest of the beneficiaries." *Id.* § 78(1). This duty applies to "all matters involving the administration of the trust and its property." *Id.* § 78 cmt. a; *accord*

Moeller v. Superior Court, 947 P.2d 279, 285 (Cal. 1997) ("A trustee must always act *solely* in the beneficiaries' interest."); George Gleason Bogert et al., *The Law of Trusts and Trustees* § 543 (2018) (trustee must "administer the trust solely in the interest of the beneficiary"). When, as here, all of the beneficiaries of a trust are residents of North Carolina, *see* Pet. App. 3a, it follows that the trust's activities are—and, by law, must be—"purposefully directed" toward residents of the state.

This conclusion aligns with the Court's due process cases. In *Quill*, there was "no question" that a company selling office equipment and supplies had "purposefully directed its activities at North Dakota residents" when it made less than 0.5% of its annual sales to North Dakota customers. *See* 504 U.S. at 302, 308. It would be anomalous to reach a different conclusion for the respondent trust when 100% of its activities are directed toward North Carolina resident beneficiaries.

This Court has likewise held that due process permitted a state to exercise jurisdiction over an out-of-state nonprofit membership association that provided sick benefits to the state's residents because the association "create[d] continuing relationships and obligations" with the state's citizens. *Travelers Health Ass'n v. Virginia*, 339 U.S. 643, 647 (1950); *see also Burger King Corp. v. Rudzewicz*, 471 U.S. 462, 472-73 (1985) (citing *Travelers Health* as a case in which the purposeful direction requirement was satisfied). Here, by its nature, the respondent trust has "continuing relationships and obligations" with its North Carolina resident beneficiaries. Indeed, not unlike the membership association in *Travelers Health*, the trust in this case undertakes a duty to provide for the health of its beneficiaries, among other ongoing obligations to ensure their well-being. App. 51.

Thus, as in *Quill*, there is "no question" that the taxpayer here has "purposefully directed" its activities toward residents of the taxing state, and that a "minimum connection" therefore exists between the taxpayer and that state. *Quill*, 504 U.S. at 306, 308; *see also id.* at 308 ("So long as a commercial actor's efforts are purposefully directed toward residents of another State, we have consistently rejected the notion that an absence of physical contacts can defeat personal jurisdiction there." (quoting *Burger King*, 471 U.S. at 476)). North Carolina's application of its income tax to the respondent trust therefore satisfies the first prong of *Quill*.

2. A tax on residents' proportionate share of trust income is "rationally related" to values connected with the taxing state.

A state satisfies *Quill*'s second prong—a rational relationship between the income attributed to the state and values connected with the state, *see* 504 U.S. at 306—when, as here, the state taxes only the portion of a trust's income that is held for the benefit of in-state beneficiaries.

This Court "has refused to impose strict constitutional restraints on a State's selection of a particular formula" for attributing income to the state. *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 273 (1978). States instead have "wide latitude" on this issue. *Id.* at 274.

To be sure, states do not enjoy carte blanche: The Court will strike down an apportionment formula when the "income attributed to the State is in fact out of all appropriate proportion" to the values connected with the state, or the state's approach "has led to a grossly distorted result." *Moorman*, 437 U.S. at 274 (internal quotation marks omitted). But there is no such problem here. North Carolina's approach for attributing trust income falls well within the "wide latitude" granted by the Court's due process cases.

North Carolina taxes trusts on "the amount of the taxable income of the estate or trust that is for the benefit of a resident" of the state. N.C. Gen. Stat. § 105-160.2. In other words, it attributes to itself the portion of the trust's nonsource income that corresponds to the interest of beneficiaries who reside in North Carolina. That means when, as here, all of the trust's beneficiaries reside in North Carolina, the state taxes 100% of the trust's nonsource income. *See* Pet. App. 3a. But if, for example, only 50% of a trust's beneficiaries reside in North Carolina, the state taxes only 50% of the trust's nonsource income.[4]

This attribution method is rationally related to values connected with North Carolina. *See Quill*, 504 U.S. at 306. Indeed, given that North Carolina taxes the non-North Carolina source income of a nongrantor trust only on the basis of beneficiary residence, it is difficult to imagine a more rational approach than also apportioning trust income based on the residence of the trust's beneficiaries. This approach attributes trust income to North Carolina on the same theory that permits North Carolina to tax trust income in the

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[4] The percentage of trust income subject to North Carolina tax should not be confused with the *rate* at which trust income is taxed. North Carolina's tax rate—for individuals as well as trusts—was 5.499% in 2017 and 2018, and 5.25% starting in 2019. *See* N.C. Gen. Stat. §§ 105-153.7(a), 105-160.2.

first place: the state's connection with the trust's beneficiaries.

B. A state's tax on its residents' share of trust income is justified by the benefits that the state provides to the trust.

The Court can arrive at the same result by applying the "simple" test of *J. C. Penney Co.*: "whether the state has given anything for which it can ask return." 311 U.S. at 444; *see also MeadWestvaco Corp.*, 553 U.S. at 24-25 (stating that the "broad inquiry" of *J. C. Penney* is "subsumed" in the *Quill* test). North Carolina "has given"—and continues to give—much to the respondent trust for which it can "ask return."

First, North Carolina makes possible the respondent trust's accumulation of income. The trust instrument here directs the trustee "to meet the needs of the Beneficiaries, including, without limitation, to provide for their health, education, and welfare." App. 51. Other trust instruments commonly invoke the phrase "health, education, support, or maintenance." *See, e.g.*, Bogert, *supra*, § 229 n.1; *id.* § 543 nn.31, 51; *see also* Restatement (Third) of Trusts § 50 cmt. d (2003). Under either of these formulations, the frequency and amount of a trust's distributions to the beneficiary depend inversely on the protections and services provided by the beneficiary's home state. For example:

- When a state provides world-class public universities and offers tuition discounts to its residents—as North Carolina does through the University of North Carolina, *see* N.C. Gen. Stat. §§ 116-1, 116-4, 116-144—the trust may be able to distribute less income to the beneficiary for her education than it otherwise would.

- When a state facilitates first-rate health care for its residents—which North Carolina does, among other ways, by establishing public health care entities such as the University of North Carolina Health Care System, *see* N.C. Gen. Stat. § 116-37—the trust may be able to distribute less income to the beneficiary for her health than if she had to travel to another state for care.
- When a state provides for the safety and security of its residents through police forces, fire departments, and emergency services, the state spares the trust the cost of attempting to replicate those protections and services for the beneficiary.

Second, North Carolina provides a forum in which certain trust-related disputes can be litigated. In *Greenough v. Tax Assessors of Newport*, 331 U.S. 486 (1947), this Court held that Rhode Island could—consistent with due process—tax the corpus of a trust where one of the trust's two trustees was a Rhode Island resident. The Court reasoned that the beneficiaries of the trust might have needed to proceed against the trustee in Rhode Island court, and that the trustee might have needed to invoke the jurisdiction of state courts on trust-related matters. *See id.* at 495. The Court therefore concluded that Rhode Island offered "benefit and protection through its law to the resident trustee," which was sufficient to support the state's tax. *See id.* at 496-97.

The reasoning of *Greenough* applies with similar force here. Just as Rhode Island's courts were open to the resident trustee, North Carolina courts are available to the constituents of the trust to resolve trust-related disputes.

For example, the trustee might need to invoke the jurisdiction of North Carolina courts to recover amounts improperly paid to a resident beneficiary. *See* Restatement (Second) of Trusts § 254 (1959); Restatement (Third) of Trusts § 104 cmt. g(3) (2012). Likewise, the North Carolina courts may be called upon to enforce the terms of a loan from the trust to a resident beneficiary. *See* Restatement (Second) of Trusts § 255 (1959); Restatement (Third) of Trusts § 104 cmt. d. And North Carolina courts may be the site of litigation when the trust or one of its beneficiaries alleges that another beneficiary has participated in a breach of trust. *See* Restatement (Third) of Trusts § 104 cmt. f.

Greenough observed that "[t]here may be matters of trust administration which can be litigated only in the courts of the state that is the seat of the trust." 331 U.S. at 495. But not all trust-related matters fall into that category, and the beneficiary's home state will be the appropriate forum for at least some cases. If the possibility that Rhode Island's courts would be called upon to adjudicate trust-related disputes was sufficient to justify a tax on the trust in *Greenough*, then the possibility that North Carolina's courts may be called upon to do the same is sufficient for tax jurisdiction here.

Third, the protection and services that North Carolina provides to its resident beneficiaries enhance those beneficiaries' present and future enjoyment of trust income—and therefore advance the respondent trust's purpose of benefitting the beneficiaries. That is undoubtedly true when the trust distributes income to the beneficiaries. *See Maguire*, 253 U.S. at 17. But it is also true when the trust accumulates income for the beneficiaries. For example:

- The trust may lend accumulated funds to a beneficiary on more favorable terms than the beneficiary could secure from a commercial lender. *Cf.* App. 100 (testimony by trustee that he lent funds to Ms. Kaestner and her husband at "a low interest rate" so that they could "invest in vanilla").
- Knowing that the trust has accumulated income for her health, education, and welfare may allow a beneficiary to pursue business and investment opportunities that—if not for the fallback provided by the trust—would be too risky.
- Likewise, the financial security provided by the trust may allow a beneficiary to save less year-to-year—and to allocate more of her own income toward consumption—than if she lacked the safety net that the trust supplies.

A beneficiary is in a position to invest and consume in these ways, and thus to enjoy the benefits of the trust's accumulated income, only because her home state provides basic protections for her health, safety, and welfare, including "police and fire departments," "public roads and municipal services," and "sound local banking institutions." *See South Dakota v. Wayfair, Inc.*, 138 S. Ct. 2080, 2096 (2018) (internal quotation marks omitted). A tax on the trust's accumulated income therefore "bears fiscal relation to protection, opportunities, and benefits given by the taxing state." *MeadWestvaco*, 553 U.S. at 25; *ASARCO*, 458 U.S. at 315; *J. C. Penney*, 311 U.S. at 444.

C. None of the Court's previous trust taxation cases bars a state from taxing its residents' share of trust income.

Contrary to respondent's argument in opposing certiorari, *see* Opp. 29, the Court did not resolve the question presented by this case in *Safe Deposit & Trust Co. v. Virginia*, 280 U.S. 83 (1929). *Safe Deposit* concerned a tax assessed by Accomac County, Virginia, on personal property held by a trustee in Maryland for beneficiaries in Virginia. *See* 280 U.S. at 90-91 & n.1, 93-94. *Safe Deposit* did not concern an *income* tax, and thus did not address the question here: whether a state can tax income accumulated by a trust for the benefit of the state's residents.

An analogy illustrates the point. Connecticut towns impose an annual tax on motor vehicles. Conn. Gen. Stat. § 12-71(f). The tax is based on the vehicle's location: The tax is due to the town "where such vehicle in the normal course of operation most frequently leaves from and returns to or in which it remains." *Id.* § 12-71(f)(2)-(3). Connecticut also imposes a tax on the income of its residents, regardless of where that income is earned. Conn. Gen. Stat. §§ 12-700, 12-701(1), (19), (20).

Now imagine that a resident of Greenwich, Connecticut, owns a fleet of New York City taxi cabs, all of which operate inside New York City limits. The Town of Greenwich would not impose its motor vehicle tax on those cabs (and, as a constitutional matter, probably could not do so),[5] but the State of Connecticut could and would impose its income tax on the Greenwich resident's income from the cabs.

Safe Deposit pertains to the imposition of property tax on a trust's out-of-state personal property. As applied to this example, it would mean that Connecticut towns could not impose their motor vehicle tax on a trust's New York City-based taxi cabs. The question that would be analogous to the actual question before the Court in this case, in contrast, would be whether Connecticut could apply its income tax to a trust's earnings from its New York City taxi cab business. *Safe Deposit* does not address that question.[6]

For the same reasons, the North Carolina Court of Appeals erred in concluding that *Brooke v. City of Norfolk* "controls the analysis and outcome" of this

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[5] Most glaringly, the tax would—without further modification—flunk the Court's "internal consistency" test unless the state offered relief to residents who pay motor vehicle taxes to other jurisdictions or to nonresidents who own vehicles in Connecticut. *See Wynne*, 135 S. Ct. at 1805-06.

[6] North Carolina persuasively argues that this Court's subsequent cases have repudiated *Safe Deposit*. *See* Br. of Pet'r 27-28 & n.12. *Amici*'s argument is not that *Safe Deposit* should be reaffirmed; it is, rather, that *Safe Deposit* is inapposite. As a practical matter, the limits imposed by *Safe Deposit* on a state's authority to tax a trust's out-of-state property are much less relevant today than 90 years ago because personal property taxes comprise a dwindling share of state tax revenue. *See* John L. Mikesell, *Patterns of Exclusion of Personal Property from American Property Tax Systems*, 20 Pub. Fin. Q. 528, 530 (Sage 1992). Meanwhile, more than half of the states have adopted income taxes in the years since *Safe Deposit*. *See* Scott Drenkard & Richard Borean, *When Did Your State Adopt Its Income Tax?*, Tax Found. (June 10, 2014), https://perma.cc/C3V3-LACK.

case. *See* Pet. App. 38a-39a (citing *Brooke v. City of Norfolk*, 277 U.S. 27 (1928)). *Brooke* presented the same basic question as *Safe Deposit*: whether the City of Norfolk could apply a personal property tax to property held by a trustee in Maryland—in fact, the same trustee as in *Safe Deposit*—for a beneficiary in Virginia. *See* 277 U.S. at 28. In *Brooke*, the city attempted to collect the property tax from the beneficiary, *see id.*, whereas in *Safe Deposit*, the county attempted to collect the property tax from the trustee, *see* 280 U.S. at 90, 93. But that distinction made no difference to the result—*Brooke* also held that the Virginia property tax could not be imposed on property in Maryland. *See* 277 U.S. at 28.

Because *Brooke*, like *Safe Deposit*, concerned a tax on a trust's out-of-state property, it did not address the question presented here: whether a state can apply its income tax to trust income held for an in-state beneficiary. The Court of Appeals was therefore mistaken in reading *Brooke* to be outcome-determinative.

II. A ruling for the respondent trust would open up a "judicially created tax shelter" of *Quill*-like proportions.

As emphasized in Part I, North Carolina has the better of the doctrinal argument here, and that is all that the Court need consider in resolving this case. If the doctrine were in any doubt, however, the unappealing practical consequences of the rule advocated by the respondent trust should give the Court pause before adopting it.

Different states use different standards to determine a trust's residence for income tax purposes, but all states that tax trust income use at least one of four criteria: the residence of the beneficiary, the residence of the grantor (*i.e.*, the testator of a testamentary trust or the settlor of an *inter vivos* trust), the residence of the trustee, or the place of trust administration. *See* Richard W. Nenno, *Minimizing or Eliminating State Income Taxes on Trusts—Part One*, West's Est., Tax, & Pers. Fin. Plan., at 7 (May 2018) ("Nenno, *Part One*"), https://perma.cc/BJ4K-NWHZ. A majority of these states tax trust income on the basis of grantor residence, beneficiary residence, or some combination of the two. *See id.* at 7-10. Respondent argues here that the Due Process Clause prohibits a state from taxing trust income on the basis of beneficiary residence, and it has argued previously that taxation of trust income on the basis of grantor residence would violate the Due Process Clause as well. *See* App. 78. That leaves the trustee's state of residence and the situs of trust administration as the remaining bases upon which respondent's approach would allow a state to tax a trust's nonsource income.

These criteria—the residence of the trustee and the place of trust administration—are the easiest for taxpayers and their advisors to manipulate. *See* Richard W. Nenno, *Minimizing or Eliminating State Income Taxes on Trusts—Part Three*, West's Est., Tax, & Pers. Fin. Plan., at 10 (July 2018) ("Nenno, *Part Three*"), https://perma.cc/BJ4K-NWHZ; *see also Greenough*, 331 U.S. at 493 ("The trustee of today moves freely from state to state."). Indeed, respondent's rule would make it straightforward for individuals to escape state income tax on capital gains, dividends, and interest. An individual could set up a trust with a provider in one of the seven income-tax-free states—or any other state that does not tax trust income on the basis of trustee residence or place of administration—and then transfer assets to that trust.

If the trust already exists and is administered in a state with an unfavorable tax regime, the grantor or beneficiaries could choose a new trustee in a more tax-friendly jurisdiction. By sharing control over the trust with family members, the grantor would ensure that the trust is treated as a nongrantor trust. *See* Jeffrey Schoenblum, *Strange Bedfellows: The Federal Constitution, Out-of-State Nongrantor Accumulation Trusts, and the Complete Avoidance of State Income Tax*, 67 Vand. L. Rev. 1945, 1948 (2014). Capital gains, dividends, and interest generated by trust assets would vanish from the tax base of the grantor's and beneficiaries' home states.

Few barriers would stand in the way of taxpayers seeking to execute this state tax avoidance strategy. The grantor's transfer of assets to the trust would not trigger gift tax in 49 out of 50 states.[7] Transfers of up to $11.4 million for an individual ($22.8 million for a married couple) would not result in federal gift tax under current law. *See* 26 U.S.C. § 2505(a) (same exclusion applies to estate tax and *inter vivos* gifts); Internal Revenue Serv., Rev. Proc. 2018-57, § 3.41 (Nov. 17, 2018) (estate tax exclusion for 2019 is $11.4 million). For transfers above that amount, the taxpayer could establish an "incomplete gift nongrantor trust," which is treated as a nongrantor trust for income tax purposes but as part of the grantor's estate for gift and estate tax purposes. *See* Schoenblum, *supra*, at 1963-67. In practice, a motivated taxpayer could eliminate income tax in her home state on virtually all capital gains, dividends, and interest income. All the while,

[7] Connecticut is the only state that imposes a comprehensive gift tax. *See* Bogert, *supra*, § 300.

the trust could issue low-interest-rate loans to beneficiaries, allowing them to benefit from the trust's accumulated income without paying state income tax. The trust could defer repayment until the beneficiary relocates to a tax-free state or moves into a lower tax bracket, at which point the trust could make a distribution to the beneficiary equal to the amount owed.

The revenue consequences for state governments would be profound. The taxpayers most likely to shift assets into nongrantor trusts under a ruling for the respondent trust are the ones with the highest incomes, for whom the potential state tax savings justify the administrative expenses. The assets that they are most likely to shift are those that generate capital gains, dividends, and interest, which in most cases will be treated as nonsource income. In filing year 2017, according to Internal Revenue Service statistics, the roughly 9000 households in North Carolina with more than $1 million in adjusted gross income reported a total of $8.1 billion in capital gains, dividends, and taxable interest. *See* Internal Revenue Serv., Statistics of Income Div., *Individual Income Tax Data, by State and Size of Adjusted Gross Income, Tax Year 2016: North Carolina* (Aug. 2018), https://www.irs.gov/pub/irs-soi/16in34nc.xls. These sources accounted for more than a third of all income reported by that group. *See id*. With a flat state tax rate at the time of 5.499%, *see* N.C. Gen. Stat. § 105-153.7(a), those taxpayers would have paid more than $440 million on that income.

To put these figures in perspective: A Government Accountability Office report cited by the Court in *Wayfair* estimated that, if *Quill*'s dormant Commerce Clause holding were overruled, North Carolina's potential revenue gain would have been between $223 million and $358 million in 2017. *See* U.S. Gov't Accountability Office, GAO-18-114, *Sales Taxes: States Could Gain Revenue from Expanded Authority, but Businesses Are Likely to Experience Compliance Costs*, app. II, at 48 (2017) (cited at *Wayfair*, 138 S. Ct. at 2088). Although a ruling for respondent here would not lead high-income households in North Carolina to shift *all* of their financial assets to nongrantor trusts administered in other states, the revenue consequences are potentially on the same order of magnitude as the stakes in *Quill*.

Beyond its revenue impacts, respondent's rule would have disturbing distributional implications. The winners would be the wealthy, who—again—can afford the fixed costs of establishing and maintaining nongrantor trusts and who hold financial assets that they can shift to those trusts. The losers would be lower- and middle-income taxpayers whose earnings come primarily from in-state sources such as salary, wages, and self-employment.[8] These taxpayers would likely end up shouldering more of the state income tax burden as wealthy households bore less. Funding for public schools, public health, law enforcement, and other essential state and local government services would suffer as well.

These consequences are far from hypothetical. Tax practitioners are already citing decisions such as the one below when describing ways for their high-

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[8] For North Carolina households with adjusted gross income under $1 million, the combination of salaries, wages, and business and professional income constitutes approximately 80% of total income, while capital gains, dividends, and taxable interest account for less than 5%. *See* Internal Revenue Serv., Statistics of Income Div., *Individual Income Tax Data, by State and Size of Adjusted Gross Income, Tax Year 2016: North Carolina*, *supra*.

net-worth clients to dramatically reduce state income tax liability. *See, e.g.*, Nenno, *Part Three* at 4-5 (citing *Kaestner*); Steve Hartnett, *State Income Taxation of Nongrantor Trusts*, Am. Acad. of Estate Planning Attys. (Feb. 5, 2019), https://perma.cc/L9XK-7F28 (same); Melissa M. Price, *Constitutional Challenges to State Income Taxation of Trusts*, Wealth Mgmt., 2019 WLNR 2546751 (Jan. 25, 2019) (same); Jordan D. Veurink, *Practical Pointers from Practitioners*, *Recent Resident Trust Rulings: Can Your Clients' Trusts Avoid State Income Tax?*, 33 Probate & Property 55 (Jan./Feb. 2019) (same). These practitioners are by no means skirting ethical lines by advising clients to pursue these strategies. They are simply guiding their clients through a loophole that decisions like the one below have opened.

To be sure, taxpayers have used trusts to reduce state income tax for decades. *See* Robert H. Sitkoff & Max M. Schazenbach, *Jurisdictional Competition for Trust Funds: An Empirical Analysis of Perpetuities and Taxes*, 115 Yale L.J. 356, 420 (2005). Yet three recent developments make the problem particularly acute today.

First, the doubling of the estate and gift tax exclusion as part of the December 2017 tax law means that individuals can now transfer twice as much wealth to trusts administered in other states before federal gift taxes even come into the picture. *See* Pub. L. No. 115-97, § 11061, 131 Stat. 2054, 2091 (2017) (amending 26 U.S.C. § 2010(c)).

Second, the IRS rulings that effectively allow taxpayers to make unlimited gift-tax-free transfers to certain nongrantor trusts were not issued until 2013. *See, e.g.*, Internal Revenue Serv., P.L.R. 201310002

(Mar. 8, 2013); Schoenblum, *supra*, at 1967 n.81 (compiling relevant rulings).

And *third*, the new $10,000 limit on the federal income tax deduction for state and local taxes—included in the December 2017 tax law—enhances the impetus for high-income taxpayers to reduce their state tax bills. *See* Pub. L. No. 115-97, § 11042, 131 Stat. at 2085-86 (amending 26 U.S.C. § 164(b)); Nenno, *Part One* at 5 ("Structuring a nongrantor trust to eliminate state income tax entirely can help an individual to preserve th[is] deduction.").[9]

Whatever one thinks of these developments individually, they interact with the decision below to make avoidance of state income tax through the use of nongrantor trusts both more feasible and more attractive. *See, e.g.*, Hartnett, *supra* (observing that "*Kaestner* could simplify th[e] process" for taxpayers who seek to "avoid state income taxation" through the use of nongrantor trusts).

Just last year, this Court recognized that its dormant Commerce Clause holding in *Quill* had "come to serve as a judicially created tax shelter" of multibillion-dollar proportions. *Wayfair*, 138 S. Ct. at 2088, 2094. *Stare decisis* notwithstanding, the Court shut that shelter down. *See id.* at 2096-99. It would be both ironic and unfortunate if only a year later, the

[9] The changes in the December 2017 law mean that top-bracket taxpayers who previously bore an after-federal-tax cost of 60.4 cents for every dollar they paid in state income tax now generally incur an after-federal-tax cost of 100 cents on the dollar. The all-in cost of state taxes (including the effect on federal income tax liability) has thus increased by approximately two-thirds.

Court erected a new shelter—with proportions potentially similar to those in *Quill*, but with none of the same precedential pedigree.

III. Interstate trusts retain protection from unduly onerous tax burdens.

The practical consequences of ruling for North Carolina in this case would be far less troubling. Although allowing states to tax trust income on the basis of beneficiary residence could conceivably give rise to double taxation in some circumstances, trusts and their grantors would be able to shield themselves from duplicative state taxes in the mine run of cases.

First, any grantor can easily avert an outcome in which a trust that she settles is subject to tax on the basis of beneficiary residence in one state and trustee residence in another. She "can avoid piling on state income taxes" by choosing to have her trust administered in—and by a resident of—a state that does not tax trust income based on the place of administration or the residence of the trustee. *See* Sitkoff & Schazenbach, *supra*, at 386. Unsurprisingly, recent years have seen a migration of trust funds toward states that do not tax trust income on those bases. *See id.* at 420.

Second, as discussed above, prong two of the due process test in *Quill* requires a rational relationship between the income that a state taxes and the values connected to the state. *See Quill*, 504 U.S. at 306. And while that requirement is easily satisfied here, it would nonetheless stand in the way of a disproportionate state tax on trust income. For example, if a state sought to tax 100% of trust income based on the fact that 50% of the trust's beneficiaries were residents of the state, then the state's regime would clearly fail *Quill*'s second prong.

Third, almost all states with income taxes of their own follow the federal grantor trust rules. *See* Nenno, *Part One* at 7. In most cases, therefore, a grantor who establishes a grantor trust (*e.g.*, by retaining the power to revoke, *see* 26 U.S.C. § 676) can ensure that—at least during her own lifetime—trust income will be subject to state tax only once: in the grantor's home state.

Fourth and finally, the Court's dormant Commerce Clause cases impose constraints on state tax authority over and above the requirements of due process. *See Wynne*, 135 S. Ct. at 1799 (observing that the cases are "[l]egion" in which the Court has considered and sustained dormant Commerce Clause challenges to state taxes that otherwise satisfy the due process criteria). Perhaps most relevant to the issue of overlapping state taxation of trusts, the Court has held that state tax regimes must satisfy the requirement of "internal consistency." *See id.* at 1802-03 (collecting cases). "To be internally consistent, a tax must be structured so that if every State were to impose an identical tax, no multiple taxation would result." *Goldberg v. Sweet*, 488 U.S. 252, 261 (1989).

Consider, hypothetically, a state that taxes 100% of trust income when all the beneficiaries reside in the state *or* the trustee resides in the state. This tax would flunk the internal consistency test. If every state were to adopt this tax scheme, interstate trusts would be disfavored: A trust whose trustee and beneficiary reside in the same state would be taxed once, but a trust whose trustee and beneficiary reside in different states would be taxed twice. States must therefore choose between trustee or beneficiary residence as their basis for trust taxation—or, if they choose both, must allow a credit for trust income taxes paid to other states.

North Carolina's trust taxation regime appears to satisfy the internal consistency test because the state taxes the nonsource income of trusts only on the basis of beneficiary residence, not on the basis of grantor or trustee residence. And while North Carolina taxes all trusts on their income from in-state sources, it provides a corresponding credit for source taxes paid to other states. *See* N.C. Gen. Stat. §§ 105-160.2, 105-160.4. So if every state adopted North Carolina's regime, there would be no impermissible double taxation of trust income. The North Carolina Supreme Court did not reach respondent's dormant Commerce Clause challenge, however, and the case should be remanded so that the North Carolina courts can address that question in the first instance.[10]

In sum, the potential for overlapping taxes on trust income does not justify a ruling for respondent here. It is true that some amount of "double taxation" will occur at the state level unless this Court mandates that all states adopt identical tax bases. *See Moorman*, 437 U.S. at 279 ("The prevention of duplicative taxation . . . would require national uniform rules for the division of income."). But such "double taxation" does not itself violate the Due Process Clause, *see Curry v. McCanless*, 307 U.S. 357, 372-73

[10] The trial court did reach the dormant Commerce Clause challenge, and agreed with the respondent trust that North Carolina's tax violates the dormant Commerce Clause. But that conclusion was based on the trial court's determination that North Carolina neither had a sufficient connection to the trust nor provided any benefits to the trust. *See* Pet. App. 63a-68a. That determination is erroneous for the same reasons discussed in Part I of this brief.

(1939), or the dormant Commerce Clause, *see Wynne*, 135 S. Ct. at 1802, 1804. And, in any event, the remedies already available to trusts and their grantors considerably reduce the risk of duplicative tax burdens. Where the choice is between double taxation of a small slice of trust income and "nowhere taxation" of a massive chunk, concerns about occasional overlap among state tax claims should not drive the result.

CONCLUSION

The judgment of the Supreme Court of North Carolina should be reversed.

Respectfully submitted,

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