

Supreme Court Rules Against North Carolina in *Kaestner* On State Income Taxation of Trusts: What Does This Mean for the District of Columbia, Virginia, and Maryland?

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A landmark Supreme Court decision decided last week calls into question the constitutionality of local (District of Columbia, Maryland, and Virginia) fiduciary income tax regimes. Many trusts that have been treated as “resident trusts” – and thus subject to tax in the state on all of the trust’s undistributed income, wherever sourced – because of the residence of the settlor, now have fertile grounds to challenge the constitutionality of the local taxation regimes.

On June 21, the Supreme Court unanimously decided in favor of the taxpayer in *North Carolina Department of Revenue v. Kimberley Rice Kaestner 1992 Family Trust*. The Kaestner Trust challenged North Carolina’s law taxing undistributed trust income on the basis of the beneficiaries’ place of residence. The Supreme Court held that “the presence of in-state beneficiaries alone does not empower a State to tax trust income that has not been distributed to the beneficiaries where the beneficiaries have no right to demand that income and are uncertain ever to receive it.” Slip Op. at 7. While the Supreme Court was careful to limit the holding to its facts, the Court’s analysis calls into question many state statutes for taxing the income of trusts, including our local regimes.

None of our local jurisdictions purport to tax trusts as residents due to the residence of the beneficiaries. Instead, the District of Columbia, Maryland, and Virginia all subject trusts to taxation based on the residency of the settlor, although the particulars vary among jurisdictions.¹

The *Kaestner* opinion does not specifically address taxation regimes based on the residence of the settlor. However, it does discuss such regimes in its analysis. The Court notes that “the Due Process Clause demands attention to the particular relationship between the [resident settlor] and the trust assets that the State seeks to tax.” Slip Op. at 10. The opinion notes that previous cases upholding the constitutionality of state taxation regimes based on the settlor’s residence had been decided on facts where the settlor’s relationship with the property included the “power to dispose of” or “revoke” the trust’s assets, such that they were “a potential source of wealth which was property in [the settlor’s] hands.” Slip Op. at 9.

The local taxation statutes are much broader than the facts in the cases cited by the Supreme Court: they would tax resident settlors’ trusts regardless of whether the settlor retained any control over the trusts (or, indeed,

¹ In addition, Maryland treats trusts “principally administered” in Maryland as resident trusts. Maryland-Tax General § 10-101(k)(1)(iii)(3). The constitutionality of this basis for taxation is not called into question by *Kaestner*. See Slip Op. at 6. Although Virginia has previously treated trusts “administered in the Commonwealth” as resident trusts, see Va. Code § 58.1-302, a new law effective July 1, 2019, removed this basis of taxation, see H.B. 2526. The District of Columbia’s only statutory basis for treating a trust as a resident trust is the residence of the settlor.

is even still living). These statutes may not pass constitutional muster in their current form, particularly as applied to trusts over which the settlor retains no control and that are not administered in the state claiming taxing authority. Several procedural options exist for challenging a state's taxing authority.

The *Kaestner* opinion can be found [here](#). Also of interest is Minnesota's pending petition for certiorari before the Supreme Court in *Bauerly v. Fielding*. In the decision being challenged, the Minnesota Supreme Court held that Minnesota could not constitutionally tax a trust based on the residence of the settlor in that state; the State appealed. We anticipate that the Court will remand *Fielding* for reconsideration in light of its *Kaestner* decision. The status of the certiorari petition in *Fielding* can be found [here](#).

If you have questions about how the *Kaestner* opinion affects the tax liability of a particular trust, please contact the authors of this alert or any member of Caplin & Drysdale, Chtd.'s [Private Client Group](#).

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