Despite 'Wayfair,' SCOTUS Declares That 'Quill' Lives On

August 5, 2019 | by Einhorn Barbarito

As published in the New Jersey Law Journal on August 2, 2019.

Last year, the United States Supreme Court issued a landmark state taxation decision in South Dakota v. Wayfair, 585 U.S. ___ (2018), overturning the “physical presence” test under Quill Corp. v. North Dakota, 504 U.S. 298 (1992). On June 21, 2019, the one-year anniversary of Wayfair, SCOTUS held that part of Quill lives on. In N.C. Dep’t of Revenue v. The Kimberly Rice Kaestner 1992 Family Trust, 588 U.S. ___ (2019), the court unanimously upheld the “minimum contacts” test under Quill as it applies to state taxation of income earned by a trust.

The facts of Kaestner are fairly straightforward. In 1992, Joseph Lee Rice III, a New York resident, established a trust for the collective benefit of his three children. Rice initially appointed a New York trustee who, in 2002, divided the trust into separate shares, or “sub-trusts,” for each child. In 2005, the New York trustee was replaced by a Connecticut trustee. In 2006, the new trustee severed the sub-trusts and established three separate and distinct trusts. As a result, the Kimberly Rice Kaestner 1992 Family Trust was established for Rice’s daughter, Kimberly Rice Kaestner, a North Carolina resident, and her children.

The provisions of the Kaestner trust granted the trustee broad power and authority to make distributions of income and/or principal in the trustee’s sole discretion. During the trust term, the trustee was not required to distribute any income or principal, and the beneficiaries had no right to demand a distribution or withdraw funds from the trust. The trust was to terminate on Kimberly Rice Kaestner’s 40th birthday in 2009, at which time she would receive a distribution of the entire then remaining corpus. Although not relevant to the court’s decision, it should be noted that the trustee decanted the trust in 2009 under New York law into a new trust that did not terminate on Kaestner’s 40th birthday.

From 2005 through 2008, the trust assets were comprised of investments in equities, mutual funds and partnership interests. The trust earned income during those years, none of which was derived from assets located within Kaestner's home state of North Carolina since the trust did not own any assets located there. Nevertheless, the trust was required to pay North Carolina income tax during those years in excess of $1.3 million pursuant to a North Carolina law which imposed an income tax on a trust based solely upon the residency of a beneficiary within the state, notwithstanding the fact that no income was ever distributed to a North Carolina resident beneficiary. Believing such law was unconstitutional, the trust filed for a refund, which was denied by the North Carolina Department of Revenue in 2011. As a result, the trust sued the North Carolina Department of Revenue in the state's Superior Court seeking a declaration that the tax law was unconstitutional and refund of the taxes paid.

As the case made its way up the North Carolina court system, the trust prevailed at each level with the courts finding that the tax violated the Due Process Clause of the Fourteen Amendment to the United States Constitution. The lower court also held the tax violated the Commerce Clause, but that argument was not reached by any subsequent court. After losing at North Carolina's highest court, the Department of Revenue petitioned for and was granted certiorari by the United States Supreme Court.

In writing for the unanimous court, Justice Sotomayor focused her opinion on whether the North Carolina tax met the "minimum connection" test, more commonly referred to as "minimum contacts," under Quill. Specifically, Quill held that a state tax will comply with the Due Process Clause if there is "some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax." In Kaestner, however, based upon all standards of measurement, the trust had no connection to North Carolina. The grantor's residence, the trustee's residence, the situs of administration and the location of assets were all out-of-state. In the case of the Kaestner trust, North Carolina clearly imposed a tax on the trust based solely upon the in-state residence of the beneficiaries.

The residency of the beneficiaries alone does not meet the "minimum contacts" test. Borrowing from Safe Deposit & Trust Co. of Baltimore v. Virginia, 280 U.S. 83 (1929), and Brooke v. Norfolk, 277 U.S. 27, (1928), Justice Sotomayor writes that the constitutionality of such a tax necessarily turns on whether the beneficiaries had any rights to "possess, control or enjoy" the trust assets. In Kaestner, the court found no such rights existed. The beneficiaries neither received a distribution of income in the tax years in question, nor could they demand or count on a distribution of income from the trustee. The power to make distributions was vested solely in the trustee and could only be carried out in the trustee's discretion. Moreover, the beneficiaries had no rights to control or manage the assets. All decisions regarding the assets, including the nature of the investments, were again vested solely in the trustee who was not resident in North Carolina. The court held the beneficiaries' connection to the trust, as purely discretionary beneficiaries with no other rights or interests, was too tenuous to meet the "possession, control or enjoyment" test and, as such, the tax as imposed on the Kaestner trust violated the Due Process Clause.

The State's arguments did not carry much weight with the court. First, the court plainly rejected the State's overly broad contention that based upon the sheer nature of a trust, a beneficiary and a trust itself are "inextricably intertwined" so that a beneficiary's residence alone is enough of a minimum contact to comply with the Due Process Cause. Second, the court noted that its decision will not undermine numerous state taxation regimes, as North Carolina is one of only a handful of states that tax a trust based solely upon the in-state residence of a beneficiary. Finally, the court rejected the premise that a beneficiary could game the state tax system by forgoing distributions until he or she moves to state with a lower income tax or none at all. While that is certainly a possibility, Kaestner had no power to control distributions as such authority was vested in the trustee.

Based upon the facts and circumstances presented in Kaestner, the court's holding is extremely narrow. In fact, the court went out of its way to specifically limit its application. Justice Sotomayor writes:

[W]e address only the circumstances in which a beneficiary receives no trust income, has no right to demand that income, and is uncertain necessarily to receive a specific share of that income. Settlors who create trusts in the future will have to weigh the potential tax benefits of such an arrangement against the costs to the trust beneficiaries of lesser control over trust assets.

Her language here lends valuable insight into how the court will undertake future Due Process analyses of state taxation laws; namely on a case-by-case basis. Indeed, in the context of a trust, the different permutations of the relevant factors (i.e., grantor's residence, trustee's residence, beneficiary's residence, distribution powers, withdrawal rights, location of assets, situs of administration, etc.) can be endless.

Of course, the constitutionality of a state tax law initially depends on the language of the law itself. Unlike North Carolina, New Jersey does not tax a trust based upon the residency of the beneficiary. Rather, New Jersey imposes a tax on income earned by a "resident trust," which is defined as a testamentary or inter vivos trust which contains property transferred (1) under the will of a New Jersey domiciliary, or (2) by a New Jersey domiciliary during his or her life. See N.J.S.A. 54A:1-2(o)(2)–(3). A resident trust is not subject to New Jersey income tax if the trust does not have any of the following: (1) tangible assets located in New Jersey, (2) income from New Jersey sources, and (3) trustees who reside in New Jersey. See New Jersey Division of Taxation Tax Topic Bulletin GIT-12. If, however, income is distributed to a New Jersey beneficiary, then the trust will issue a Schedule K-1 to the beneficiary who will be required to report the income on his or her individual New Jersey income tax return.

Although the holding of Kaestner may not be directly precedential in a Due Process challenge to New Jersey's trust taxation law, it is certainly persuasive. First, the decision notes that the residence of a trustee is a permissible basis upon which to tax a trust. Second, Justice Alito's concurring opinion in Kaestner rightfully acknowledges a state's power to tax a tangible asset located within the state. Third, income derived from a source located within a state (e.g., a business) would appear to meet the minimum contacts test. On its face, New Jersey's trust tax likely passes constitutional muster. However, as we saw in Kaestner, despite the language of a law, its constitutionality necessarily depends on how it is applied to a given set of facts and circumstances, and whether there are "minimum contacts" between the trust and the taxing state to satisfy Quill.

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