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 Petition For A Writ Of Certiorari
To The Supreme Court Of North Carolina

BRIEF IN OPPOSITION TO THE NORTH CAROLINA DEPARTMENT OF REVENUE'S PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

Did the North Carolina Supreme Court correctly apply settled due process principles to the unique facts of this case, in which the State sought to tax the worldwide income of a trust to which it had no connection based solely on the existence of a discretionary in-state beneficiary?

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INTRODUCTION

This case presents a unique, fact-bound dispute that does not raise any significant question of federal law. The North Carolina Supreme Court correctly followed the well-established due process analysis from this Court and applied it to the unique facts of this action. This Court should deny the petition for three principal reasons.

First, the decision below does not conflict with the decision of any other state court on any question of federal law. The cases the Department cites as establishing a purported conflict present different factual circumstances from one another and from this case that explain their different outcomes. The Department has identified only two states whose highest courts held that the state could tax the accumulated income of an out-of-state trust. The trusts in those cases had more connections with the taxing state than the residence of an in-state beneficiary. In fact, all of the cases relied upon by the Department involve connections to the taxing state other than the residence of the beneficiary; two do not involve a beneficiary residing in the taxing state; and one does not even involve the taxation of a trust. The Department has identified no decision in which a state has attempted, much less succeeded in, the taxation of an out-of-state trust based solely on the presence of a beneficiary. There is no conflict that a decision by this Court would resolve.

Second, this case presents a poor vehicle for addressing the Constitutional implications of state taxation of out-of-state trusts because it is limited to its facts and the arguments heard by the lower court. This case does not impact the taxation of all trusts. Instead, it relates to the taxation of an out-of-state trust where the only purported connection is the in-state presence of a beneficiary. In the almost 100 years that the North Carolina law has been in existence, no similarly situated trust has filed a challenge. Only four states have similar statutes to North Carolina that even would permit taxation on these facts. And of those four states, none have seen a challenge by a similarly situated trust. In addition, the North Carolina trial court recognized that taxing the trust in these circumstances would violate the Commerce Clause, but the two North Carolina appellate courts found it unnecessary to reach this issue because they held that the tax failed under the Due Process Clause. Because of the unaddressed Commerce Clause implications, a decision by this Court may not finally resolve even this specific litigation. These limitations on both the facts and the law make a review by this Court unwarranted.

Third, the North Carolina Supreme Court correctly reached its decision based on the application of long established precedent of this Court applied to the particular set of facts presented. Due Process demands that where a state seeks to tax, it must have provided some benefit. There is no connection between North Carolina and the trust in this case. And there is no cause for this Court to devote its limited resources to reviewing the application of settled due process principles to a unique factual circumstance.

The petition for certiorari should be denied.

STATEMENT OF THE CASE

I. Background

The Joseph Lee Rice, III Family 1992 Trust (the "Family Trust") was created in New York under an agreement dated December 30, 1992 (the "Trust Agreement") between Joseph Lee Rice III as Settlor (the "Settlor") and William B. Matteson as trustee (the "Initial Trustee"). App. 2a. The Family Trust is governed by New York law. App. 2a. At the Family Trust's creation there were no connections to North Carolina:

- The Settlor was a resident and domiciliary of New York, App. 44a;
- The Initial Trustee was a resident and domiciliary of New York, App. 44a;
- The primary beneficiaries of the Family Trust were the Settlor's descendants, none of whom were residents of North Carolina, App. 44a;
- The contingent beneficiaries of the Family Trust were the Settlor's spouse and sister, none of whom were residents of North Carolina, App. 44a–45a;
- All of the assets of the Family Trust were located outside of North Carolina, App. 3a; and

- The Family Trust was a separate tax paying entity subject to all applicable New York income tax, App. 3a.

Ultimately, pursuant to Section 1.2 of the Trust Agreement, the Family Trust was divided into three separate share trusts, including the Kimberley Rice Kaestner 1992 Family Trust (the "Kaestner Trust"). App. 3a. The separate share trusts continued to be administered by the Trustee under the terms of the Trust Agreement. App. 45a–46a.

The beneficiary of the Kaestner Trust is Kimberley Rice Kaestner. She was a resident of North Carolina during the tax years at issue after moving to the state in 1997. App. 2a. The contingent remainder beneficiaries of the Kaestner Trust were residents of New York (the Settlor's other children and the Settlor's spouse) and Connecticut (the Settlor's sister). *See* App. 44a–45a. Ms. Kaestner has since moved to California; during the time she resided in North Carolina, she received no distributions from the trust.

None of the beneficiaries had any right to withdraw the assets because distributions were made at the sole discretion of the Trustee. App. 3a. No funds were distributed from the Kaestner Trust during the relevant tax years. App. 3a. The beneficiaries also had no role in the management of the Kaestner Trust's assets; the Trustee had and exercised sole discretion to make all investment decisions. App. 46a.

The facts are undisputed. The Department "concedes that the only 'connection between the [Kaestner]

Trust and North Carolina in the case at hand is the residence of the beneficiaries.'" App. 54a.

II. Procedural History

At every level, North Carolina courts were confronted with the same issue—whether the Constitution prohibited the state from taxing a foreign trust based solely on the presence of an in-state beneficiary. *See* App. 1a; App. 27a; App. 41a. And at every level, the North Carolina courts correctly held that the State's tax of a foreign trust was unconstitutional.

The North Carolina Business Court held that the State's attempt to tax the Kaestner Trust violated the Due Process Clause. The Business Court did not take an outdated, formalistic approach as the Department alleges. In citing this Court's decision in *Quill Corp. v. North Dakota*, the Business Court held that where a party is not physically located in the taxing state, the taxed entity must "'purposefully avail[]' itself of the benefits, economic and otherwise, and the laws of North Carolina." App. 53a. The Business Court further concluded under the second prong of the *Quill* due process analysis that the income attributed to North Carolina—all of the Kaestner Trust's worldwide income—was not rationally related to the connection to the state. App. 57a. The Business Court then followed this Court's holding in *Complete Auto Transit, Inc. v. Brady* in holding that the State's tax also violated the Commerce Clause. App. 67a–68a.

The Court of Appeals unanimously affirmed the Business Court. The Court of Appeals relied on this Court's decision in *Brooke v. Norfolk* in holding that the Due Process Clause prohibited North Carolina from taxing a foreign trust based solely on the residence of a beneficiary. App. 38a–40a; *see also Brooke v. Norfolk*, 277 U.S. 27, 28–29 (1928). The Court of Appeals did not reach the Commerce Clause challenge because it was unnecessary.

The North Carolina Supreme Court affirmed the decision of the Court of Appeals. Like the lower courts, the North Carolina Supreme Court considered whether the State could tax the Kaestner Trust "solely based on the North Carolina residence of the beneficiaries during the tax years 2005 through 2008." App. 2a. The court cited this Court's decision in *Anderson v. Wilson* for the proposition that a trust is a separate entity for income tax purposes. App. 12a; *see Anderson v. Wilson*, 289 U.S. 20, 27 (1933). It then relied on this Court's decision in *Walden v. Fiore* and *Hanson v. Denckla* to conclude that the trust cannot satisfy the minimum contact requirements based on the activity of a third party. App. 13a; *see Walden v. Fiore*, 571 U.S. 277, 284–85 (2014); *Hanson v. Denckla*, 357 U.S. 235, 253 (1958). Finally, the North Carolina Supreme Court distinguished *Gavin* and *McCulloch* in favor of this Court's analysis in *Quill* in deciding that North Carolina's taxation of the Kaestner Trust violated Due Process. App. 14a–17a.

REASONS FOR DENYING THE PETITION

This Court should deny the Petition because, contrary to the Petitioner's efforts to inflate its significance, the case presents only the narrow question of whether a state's attempt to tax a foreign trust based solely on the presence of an in-state beneficiary violates the Due Process Clause. The case is not a part of any split of authority. North Carolina is the only state to address the validity of a statute that provides for the taxation of a foreign trust based solely on the in-state residence of a beneficiary. This is a fact-bound case that was correctly decided below and would have limited precedential value because of the unique facts and the limitations on the arguments ruled upon. This Court's review is not warranted.

I. *Kaestner* Is Not Part of a Conflict Among the Courts of Different States

The Kaestner Trust is unique. No case cited by the Department or by the courts below addressed a trust where the only possible connection to the state for minimum contacts analysis was the in-state presence of a beneficiary. The cases the Department does cite are inapposite. The two cases emphasized by the Department throughout this litigation and the six cases it has added to their argument to manufacture a split of authority all address the due process rights of trusts that have connections to the taxing state that do not exist here. Five of these cases have held that the tax violates the Constitution and therefore do not support review.

The three remaining cases all involve multiple connections to the taxing state.

A. The North Carolina Supreme Court's Decision Is Based on a Unique Set of Facts

The North Carolina Supreme Court held that Section 105-160.2 of the North Carolina General Statutes, as applied to the Kaestner Trust, violated the Due Process Clause of the Fourteenth Amendment because the Trust did not have sufficient minimum contacts with North Carolina. In considering the Kaestner Trust's "as applied challenge . . . [the court] look[ed] to whether the statute is constitutional in the limited context of the facts of the case before" them. App. 9a. The court considered whether the Department could tax the Kaestner Trust's income "solely based on the North Carolina residence of the beneficiaries during tax years 2005 through 2008." App. 2a.

No court has been confronted with the stark fact pattern presented here. The Kaestner Trust has no connection to North Carolina. The Family Trust was created in 1992 when both the Settlor and the initial trustee were New York residents. App. 43a–44a. The Family Trust was created under New York law and the Trust Agreement provides that New York law governs the trust in all respects. App. 2a. In 1997, five years after the Family Trust was created, the beneficiary moved to North Carolina. App. 2a. She has since moved to another state.

At all relevant times after the Kaestner Trust was formed as a separate share trust, the beneficiary did not receive any distributions of funds, including during the period when she resided in North Carolina. App. 3a. All of the Kaestner Trust's assets were located outside of North Carolina. App. 3a. All of the business of the Kaestner Trust took place in New York—its attorneys were located in New York; its financial books and records were located in New York; the custodian of the trust's assets was in Massachusetts, and its tax returns and accountings were prepared in New York. App. 45a–46a. The Trustee generated income exclusively from investments outside of North Carolina. App. 65a.

The Trustee made all the decisions for the Kaestner Trust. App. 46a. The beneficiary had no control over the management of the Kaestner Trust or the distribution of its funds. App. 46a. In fact, the beneficiary was not even aware of its existence until nine years after she had moved to North Carolina.

In 2005 through 2008, the Department taxed all of the accumulated, worldwide income of the Kaestner Trust on the sole basis that Ms. Kaestner, a discretionary beneficiary of the trust, was a North Carolina resident during the tax years at issue. App. 4a.

Every other state that sought to tax a trust in the cases cited by the Department had a connection to the trust that does not exist here.

B. No Court Has Held that a Beneficiary's Presence Is Sufficient to Tax the Undistributed Income of a Foreign Trust

The cases invoked in the Petition do not establish any split of authority with this case. Two of these cases do not present a conflict because, even with the presence of connections to the taxing state that are not present here, the courts concluded that the tax was unconstitutional. Three of the cases are decisions of lower level state courts that all similarly concluded that taxation was unconstitutional. Of the remaining three cases, all are distinguishable because they (i) are not decided based on a state statute permitting taxation based solely on the residency of the beneficiary, (ii) the trusts have connections with the taxing state that are not present here, and (iii) one involves taxation of funds held by the in-state beneficiary.

1. The *Fielding* and *Mercantile-Safe Deposit* Courts Found Taxation of a Foreign Trust Violates the Due Process Clause Despite the In-State Presence of a Beneficiary and Grantor

The Minnesota Supreme Court in *Fielding v. Commissioner of Revenue* and the Court of Appeals of New York in *Mercantile-Safe Deposit & Trust Co. v. Murphy* both held that the state's taxation of the trust violated the Due Process Clause of the Fourteenth Amendment. *Fielding*, 916 N.W.2d 323, 334 (Minn. 2018), petition for cert. filed, *Comm'r of Rev. v. Fielding*, No. 18-664 (Nov. 15, 2018); *Mercantile-Safe Deposit & Tr. Co.*, 203

N.E.2d 490, 581 (N.Y. 1964). Both courts concluded that Due Process prohibited taxation even though, unlike in this case, the trusts had connections to the taxing state beyond an in-state beneficiary.

The relevant statute in *Fielding,* Section 290.01 of the Minnesota Statutes, defines a resident trust as "an irrevocable trust, the grantor of which was domiciled in this state at the time the trust became irrevocable." Minn. Stat. § 290.01, subd. 7b.(a)(2). Unlike this case, the grantor of the trusts was a resident of the taxing state when the trusts became irrevocable, and some of the *Fielding* trusts' income was derived from sources in Minnesota. *Fielding*, 916 N.W.2d at 330. Despite these additional connections, the Supreme Court of Minnesota held that the trust "lack[ed] sufficient relevant contacts with Minnesota during the applicable tax year to be permissibly taxed consistent with due process." *Id.* at 325.

The *Mercantile-Safe Deposit* court had to determine whether New York could tax "a nonresident trustee of an *inter vivos* trust created in Maryland by a resident of New York." 19 A.D.2d 765, 765 (N.Y. App. Div. 1963), *aff'd*, 203 N.E.2d 490 (N.Y. 1964). Both the grantor of the trust and the trust's beneficiary were New York residents. *Id.* Despite the in-state presence of the grantor and the beneficiary, the New York Court of Appeals held that the state could not tax the accumulated income of the trust. 203 N.E.2d at 581.

2. Three Lower Courts Found that Taxation of a Trust Violates the Due Process Clause Despite the In-State Presence of the Grantor

The Department cites three lower court decisions from Illinois, Michigan, and New Jersey, none of which supports the petition for this Court's review. Each of those decisions rejected taxation of trusts that had connections to the taxing state that are not present here. None of the relevant statutes permitted taxation based solely on the in-state presence of a beneficiary. None of the non-contingent beneficiaries resided in the taxing state. And even if these cases were on point, which they are not, these are cases decided by a trial court and two intermediate state appellate courts; the highest courts of these states should be permitted to address the issue before review by this Court may be warranted or appropriate.

In *Linn v. Department of Revenue*, the issue before the Appellate Court of Illinois was whether the state could tax a trust whose only connections to the state was that the *grantor* was a resident of Illinois at the time the trust was made irrevocable. 2 N.E.3d 1203, 1209–11 (Ill. App. Ct. 2013). The beneficiaries of the trust did not reside in Illinois. *Id.* at 1210. The Illinois statute at issue provides that an irrevocable trust is a resident of Illinois, and thus can be taxed pursuant to 35 Ill. Comp. Stat. § 5/201(a), when "the grantor [of the trust] was domiciled in this State at the time such trust became irrevocable." *Id.* at 1208 (quoting 35 Ill. Comp. Stat. § 5/1501(a)(20)(D) (2006)). The *Linn* court held that Illinois could not tax a trust where the trust's only connection with the state was the fact that the grantor of the trust resided in Illinois. *Id.* at 1211. *Linn* therefore did not even address the question that the Department seeks to present here.

Similarly, in *Potter v. Taxation Division Director*, the New Jersey Tax Court addressed whether the state's taxation of the accumulated income of the trust based on the residency of the grantor violated the Due Process Clause. 5 N.J. Tax 399, 404–05 (N.J. Tax Ct. 1983). The New Jersey statute provides that the state can tax the accumulated income of a trust if the grantor resided in the state at the time the trust became irrevocable. N.J. Stat. § 54A:1-2. In *Potter*, the settlor of the trust resided in New Jersey. 5 N.J. Tax at 402. But the trustee and non-contingent beneficiaries resided outside the state.[1] *Id.* at 403. The New Jersey Tax Court held that the state did not have sufficient contacts to tax the trust when the only relationship between the trust and the state was that the grantor was a New Jersey resident. *Id.* at 404–05.

In *Blue v. Department of Treasury*, the Michigan Court of Appeals addressed whether the state could lawfully tax the accumulated income of a trust where the trust was created by a Michigan settlor, but had no other connections to the state. 462 N.W.2d 762, 763 (Mich. Ct. App. 1990). The Michigan statute provides

[1] The New Jersey Tax Court noted that the contingent beneficiaries resided in New Jersey, but did not consider that as a connection between the trust and the state. *Id.* at 405.

that the state may tax a trust that was created by a Michigan resident. Mich. Comp. Laws § 206.18(1)(c); *see also Blue*, 462 N.W.2d at 763. Neither the beneficiary nor the trustee was a resident of Michigan. *Blue*, 462 N.W.2d at 763. The Michigan Court of Appeals held that the trust did not have sufficient contacts with the state when the trust's only connection to the state was that the settlor was a Michigan resident. *Id.* at 764.

These decisions are inapposite and are not by the highest courts of these states and therefore do not provide a reason for this Court to review the unique facts of this case.

3. The Remaining Three Cases from California, Connecticut, and Missouri Reject Due Process Challenges But the Taxpayers All Have Connections to the Taxing State that Do Not Exist Here

The remaining three cases on which the Department relies present fundamentally different facts. The Department has repeatedly emphasized the Supreme Court of California's decision in *McCulloch v. Franchise Tax Board* and the Connecticut Supreme Court's decision in *Chase Manhattan Bank v. Gavin*. *McCulloch*, 390 P.2d 412 (Cal. 1964); *Gavin*, 733 A.2d 782 (Conn. 1999). The North Carolina Supreme Court correctly distinguished these cases. App. 14a–17a. The Department now also cites *Westfall v. Director of Revenue*, 812 S.W.2d 513 (Mo. 1991), an almost 30-year-old case which it has never previously relied upon and which does not assist it here. Each of these cases involved statutes that did not permit taxation based solely on the beneficiary's residence and the trusts at issue had contacts with the taxing state that are not present here.

As the North Carolina Supreme Court noted, *McCulloch v. Franchise Tax Board* is distinguishable from the instant case on a number of grounds—(i) California taxed the distribution in the hands of the in-state beneficiary, not the out-of-state trust and (ii) the California resident beneficiary was also a trustee. *See* 390 P.2d at 414.

The statute at issue in *McCulloch* provides that a resident beneficiary—not the trust—may be taxed for income accumulated by the trust and distributed to the beneficiary.[2] *See* 390 P.2d at 416; *see also* Cal. Rev. &

[2] The Supreme Court of California did not address the constitutionality of the separate California statute providing that a trust may be taxed on its accumulated income when the trustee *or* beneficiary is a resident of the state. Cal. Rev. & Tax Code § 17742 (providing that the state can tax the entire taxable income of a trust "if the fiduciary or beneficiary (other than a beneficiary whose interest in such trust is contingent) is a resident, regardless of the residence of the settlor") (emphasis added). But at least one justice deciding *McCulloch* was aware of the potential constitutional challenges a state would face when directly taxing a foreign trust. Justice Roger Traynor recognized that taxation of a trust based on the residency of a beneficiary would be difficult. *See* Roger John Traynor, *State Taxation of Trust Income*, 22 Iowa L. Rev. 268, 278 (1936-1937). Justice Traynor concluded that to tax accumulated income of a trust, a state should tax the income after it was distributed to the in-state beneficiary. *Id.* at 275,

Tax Code § 17745(a). In *McCulloch*, the Supreme Court of California acknowledged that "[t]he purpose of section 18106 of the Revenue and Taxation Code," the statute at issue, "is to avoid the difficulties which the state might otherwise encounter in attempting to enforce tax collection directly against foreign trustees." 390 P.2d at 420. The Supreme Court of California held that "California can constitutionally tax the beneficiary at the time he receives the accumulated income." *Id.* at 414.

Even if California had taxed the income in the hands of the trust, the case is distinguishable because the in-state beneficiary was also a trustee. The *McCulloch* court relied upon the well-established principle that a state may "tax the entire income of a discretionary trust administered by a resident trustee whether he elects to distribute any part of such income or not." *Id.* at 420–21 (citing *Guaranty Trust Co. v. Virginia*, 305 U.S. 19, 22 (1938)). Accordingly, the Supreme Court of California held that "[n]o possible doubt attaches to California's constitutional power to tax plaintiff as a trustee." *Id.* at 421. The *McCulloch* opinion contains a discussion of whether the beneficiary's residency on its own could establish a sufficient connection to tax the accumulated income of the trust, but this discussion is dicta because the *McCulloch* court taxed the beneficiary, not the trust and that beneficiary was also a trustee.

279–80. That is exactly what Section 18106, now codified at Cal. Rev. & Tax Code § 17745, allows.

The Department's reliance on *Chase Manhattan Bank v. Gavin* is also misplaced. 733 A.2d 782. In *Gavin*, the Connecticut Supreme Court addressed different statutory language applied to different facts. The Connecticut statute provides that a resident *inter vivos* trust is "a trust, or portion of a trust, consisting of the property of (i) a person who was a resident of this state at the time the property was transferred to the trust if the trust was then irrevocable. . . ." *Id.* at 789 (citing Conn. Gen. Stat. § 12-701(a)(4)(D)). The beneficiary and the settlor of the trust were residents of Connecticut. *Id.* at 787–88. Unlike the action here, the beneficiary's residency was not the sole contact relied upon by the Connecticut Supreme Court.

The Missouri Supreme Court's decision in *Westfall v. Director of Revenue* is also inapposite. 812 S.W.2d 513. The Missouri statute provides that the state can tax a trust if either the settlor or grantor of the trust is a resident of the state and at least one income beneficiary resides in the state.[3] *Id.* at 514. The *Westfall* trust had four contacts with the state—(1) the settlor resided in Missouri, (2) the trust was created in Missouri, (3) property generating income for the trust was located in Missouri, and (4) two contingent beneficiaries were located in Missouri. *Id.* at 514. The

[3] Mo. Rev. Stat. § 143.331 (defining a resident trust as a trust that was either (1) "created by will of a decedent who at his or her death was domiciled in this state" or (2) "created by, or consisting of property of, a person domiciled in this state on the date the trust or portion of the trust became irrevocable" and "[h]as at least one income beneficiary who, on the last day of the taxable year, was a resident of this state.").

Missouri Supreme Court's decision was based on all of these connections.

There is no split in authority among the states on the issue of whether the beneficiary's presence alone is sufficient to tax a foreign trust. There are no other cases. The cases cited by the Department simply underscore why review of the decision below would be unwarranted and inappropriate. Each of those cases turns on its particular set of facts, none of which is the same as the unique factual situation presented here.

II. This Case Is a Poor Vehicle for Addressing Constitutional Implications of State Taxation of Out-of-State Trusts and Would Have Limited Precedential Value

A decision on the facts of this case would provide limited guidance for courts addressing the taxability of trusts. First, as discussed above, the factual scenario in which the only purported connection between the taxing state and the out-of-state trust was the presence of the in-state beneficiary has never been litigated in any other state. Second, only five states, including North Carolina, have statutes that permit taxation based on the in-state presence of a beneficiary, which limits where this type of case could arise. Third, the North Carolina Supreme Court's analysis was limited to the Due Process Clause. Foreign-state taxation of a trust based on the contacts presented here also raises issues under the Commerce Clause, which were not briefed for or addressed by the North Carolina Supreme Court, and should not now be addressed by this Court.

A. This Case Presents a Unique Fact Pattern that Has Never Been Challenged

This case is limited to the North Carolina Supreme Court's decision addressing taxation in the unique situation where the trust's sole connection to the state is the in-state residency of the beneficiary. *See infra.* Section I.A. Contrary to the Department's assertions about the financial implications of this holding, the North Carolina court's decision is likely to have very little, if any, financial impact outside this litigation.

Only five states, including North Carolina, have statutes that as a theoretical matter would permit taxation solely on the basis of an in-state beneficiary. Even in those five states, there has not been a legal challenge by a similarly situated trust. Indeed, the Department observes that North Carolina's tax has not been challenged in the ninety-five years of its existence. That is almost certainly because most of the trusts paying taxes under the statute, unlike the Kaestner Trust, had some connection to North Carolina.

For another case to arise like this one, all of the following eight factors would need to be true: (1) the trustee is not a resident of the state; (2) the grantor or settlor of the trust is not a resident of the state; (3) the trust is administered outside the state; (4) there is at least one in-state beneficiary; (5) all of the trust's income is generated from sources outside the state; (6) all of the trust's assets are located out-of-state; (7) the trust is not governed by the state's laws; and (8) the trust has not distributed the income to the in-state beneficiary.

These factors have coalesced one time.[4] It is this case.

B. There Are Only Four States with Similar Statutes that Could Possibly Have a Similar Case and None Have Decided this Issue

Forty-five states have chosen not to permit taxation of a trust based solely on a beneficiary's residence. The North Carolina statute provides that the state may tax "the amount of the taxable income of the estate or trust that is for the benefit of a resident of this State." N.C. Gen. Stat. § 105-160.2. Only four other

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[4] The Department states for the first time, and without any support in the record, that it has received "more than 450 contingent income-tax returns from trusts that are awaiting the outcome of this petition." (Pet. for Writ of Cert. at 13.) The Department provides no information about whether the referenced trusts remotely resemble the current trust, on what basis these returns were filed, and whether any particular return would be affected by the outcome of this case. This Court should disregard this vague outside-the-record assertion. *See* Sup. Ct. R. 14.1(g) (requiring that the statement of the case in a petition for certiorari rely on "specific portions of the record or summary thereof, with specific reference to the places in the record where the matter appears").

states[5] have statutes that provide for taxation of undistributed income of trusts based on nothing more than the residency of a beneficiary—California, Georgia, North Dakota[6], and Tennessee.[7] And none of these states have addressed whether the Constitution would permit taxation solely on that basis.

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[5] *See* Cal. Rev. & Tax Code § 17742 (explaining that "the entire taxable income of a trust" is taxable to the trust "if the fiduciary or beneficiary (other than a beneficiary whose interest in such trust is contingent) is a resident, regardless of the residence of the settlor"); Ga. Code Ann. § 48-7-22(a)(1)(c) (imposing an income tax upon resident fiduciaries and nonresident fiduciaries who are "[m]anaging funds or property for the benefit of a resident of this state"); N.D. Admin. Code § 81-03-02.1-04 (defining a resident trust as a trust that "has a relationship to the state sufficient to create nexus," including the fact that "[a] beneficiary of the trust or estate is a domiciliary or resident of this state"); Tenn. Code Ann. § 67-2-110 ("Trustees, guardians, administrators, executors, and other persons acting in a fiduciary capacity who receive income taxable under this chapter for the benefit of residents of Tennessee shall be required to make returns under this chapter and to pay the tax levied by this chapter.").

[6] Unlike North Carolina's statute, North Dakota does not explicitly provide that the state can tax solely based on the presence of an in-state beneficiary. Instead, North Dakota's statute suggests that the residence of a beneficiary may be sufficient on its own to create a nexus with the state; however, it also lists five other contacts that may be considered when assessing whether there is a nexus with the state. N.D. Admin. Code § 81-03-02.1-04. The language of the statute is ambiguous and has not been interpreted by the North Dakota Supreme Court.

[7] Unlike North Carolina, Tennessee only taxes "on incomes derived by way of dividends from stocks or by way of interest on bonds." Tenn. Code Ann. § 67-2-102. Further, Tennessee has enacted a bill that completely eliminates the income tax in 2022. *See* Tenn. Code Ann. § 67-2-124; Tenn. Pub. Acts 181 § 15.

The Supreme Court of California in *McCulloch* did not address this issue. Section 17742 provides that the state can tax "the entire taxable income of a trust, if the fiduciary or beneficiary . . . is a resident, regardless of the residence of the settlor." Cal. Rev. & Tax Code § 17742. But in *McCulloch*, the Supreme Court of California upheld a tax on the beneficiary—not the trust—under Section 18106, now codified at Section 17745. *McCulloch*, 390 P.2d at 416. There are no cases for the other three states that are remotely on point.

The other six states cited by the Department do not allow for the taxation of undistributed tax income based solely on the in-state residency of a beneficiary. Instead, those six states require both the in-state presence of at least one beneficiary *and* that the grantor of the trust was a resident of the state at the time the trust was made irrevocable.[8]

[8] *See* Ala. Code § 40-18-1 (defining a resident trust as a trust created "by a person who was an Alabama resident at the time such trust became irrevocable" and "either a fiduciary of the trust or a beneficiary of the trust to whom distributions currently may be made" resides in the state); Mont. Admin. R. § 42.30.101(16)(c) (defining resident trust to include "any irrevocable trust created by, or consisting of property of, a Montana resident on the date the trust or portion of the trust became irrevocable and has at least one income beneficiary who, for all or some portion of the trust's current taxable year, was a Montana resident"); Mo. Rev. Stat. § 143.331(3) (defining resident trust to include "[a] trust that: (a) [w]as created by, or consisting of property of, a person domiciled in this state on the date the trust or portion of the trust became irrevocable; and (b) [h]as at least one income beneficiary who, on the last day of the taxable year, was a resident of this state"); Ohio Rev. Code Ann. § 5747.01(I)(3)(a) ("A trust resides in this state for the trust's current taxable year to the extent . . . that the

C. This Case Is Limited to the Due Process Clause and Would Likely Return on Commerce Clause Grounds If the Department Was Successful

The Due Process Clause and the Commerce Clause "pose distinct limits on the taxing powers of the States," meaning "a State may, consistent with the Due Process Clause, have the authority to tax a particular taxpayer," but "imposition of the tax may nonetheless violate the Commerce Clause." *Quill Corp. v. North Dakota*, 504 U.S. 298, 305 (1992). This Court has explained that the Commerce Clause imposes limits upon a state's ability to tax interstate commerce and activity. *See Goldberg v. Sweet*, 488 U.S. 252, 259

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trust consists . . . of assets . . . that were transferred . . . to the trust by . . . [a] person who was domiciled in this state for purposes of this chapter when the person directly or indirectly transferred assets to an irrevocable trust, but only if at least one of the trust's qualifying beneficiaries is domiciled in this state for the purposes of this chapter during all or some portion of the trust's current taxable year."); Conn. Gen. Stat. § 12-701(a)(4) (defining a resident trust to include an irrevocable trust "consisting of the property of (i) a person who was a resident of this state at the time the property was transferred to the trust if the trust was then irrevocable" or "a person who . . . was a resident of this state at the time the trust became irrevocable" and noting that the taxable income of the trust is modified if all the non-contingent beneficiaries do not reside within the state); R.I. Gen. Laws § 44-30-5(c)(4)(5) (defining a resident trust to include "[a]n irrevocable trust created by or consisting of property contributed by a person who is a resident individual in this state at the time the trust was created" and "the beneficiaries are Rhode Island resident individuals").

(1989); *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977).

This case does not present an opportunity to address the Commerce Clause. The validity of a state tax under the Commerce Clause is determined by the four-part test set forth by this Court in *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977). Under the *Complete Auto* test, a state complies with the Commerce Clause if: "the tax (1) is applied 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 provided by the State." *Quill Corp.*, 504 U.S. at 311 (quoting 430 U.S. at 279). If a tax does not satisfy all four elements of the *Complete Auto* test, then it must be struck down for violating the Commerce Clause. *Complete Auto Transit*, 430 U.S. at 279. Given the Kaestner Trust's lack of connection to North Carolina, it is unlikely that it could pass any of these four prongs, but it certainly could not pass all four.

There are cases where lower courts have ruled on both points. At least three of the eight cases cited by the Department in support of a purported split raised both Due Process and Commerce Clause challenges.[9]

[9] *Fielding v. Comm'r of Rev.*, 916 N.W.2d 323, 327 (Minn. 2018) ("Having decided the case on due process grounds, the Tax Court did not reach the Trusts' claims under the Commerce Clause."); *Linn v. Department of Revenue*, 2 N.E.3d 1203, 1211 (Ill. App. 2013) (explaining that the court did not need to address plaintiff's commerce clause argument because it found the taxation of the trust to violate the due process clause); *Chase Manhattan Bank v. Gavin*, 733 A.2d 782, 806 (Conn. 1999) (holding that

Other cases cited by the Department throughout this litigation have also asserted Commerce Clause challenges where the state taxed the undistributed income of a trust.[10]

Thus, a decision by this Court may not finally resolve even this fact-bound dispute. If the Court were to grant review and decide that that state's extraterritorial taxation does not violate the Due Process Clause, the litigation would continue and could return on Commerce Clause grounds.

D. This Case Does Not Present Issues of Federalism or an Opportunity to "Modernize" Trust Law

The Department's arguments based on federalism and the purported need to "modernize" trust jurisprudence lack merit. Federalism does not stand for the principle that one state should be able to exercise the power to tax over a resident of another state. Nor is review appropriate in order to "modernize" this Court's trust law jurisprudence; this is a solution looking for a problem. Trust law has been around since the 12th century and neither modern technology nor the facts of this case have done anything to cause this Court to

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"the incentives and risks have not been sufficiently established so as to result in a dormant commerce clause violation").

[10] *See, e.g.*, *McNeil v. Commonwealth*, 67 A.3d 185, 195 (Pa. Commw. Ct. 2013) (holding that Pennsylvania's taxation of the Trust's income violated the Commerce Clause where the trust's only purported connections to the state was the residency of the settlor and beneficiaries).

revisit and upset settled understandings about the relationship between a trust and beneficiary.

A state cannot invoke federalism principles to justify imposing a tax on an entity with no connection to that state. It is ironic that the Department cites *McCulloch v. Maryland* to support its argument that the North Carolina Supreme Court's decision challenges principles of federalism. In *McCulloch v. Maryland*, the Supreme Court prevented the state from taxing a federal institution within its borders because the state could claim no control over it. 17 U.S. 316, 430 (1819). What the Department attempts to do here—to reach outside its borders to tax an entity under control of and receiving the protection of another state—is far beyond what this Court rejected in *McCulloch v. Maryland*. This Court has continually imposed limits on a state's power to tax out-of-state entities without thwarting the general principle that states have the power to tax entities over which the state's sovereignty extends. *See, e.g.*, *Quill Corp.*, 504 U.S. at 305; *Complete Auto Transit*, 430 U.S. at 279; *Hanson*, 357 U.S. at 253; *Safe Deposit & Tr. Co. v. Virginia*, 280 U.S. 83, 92 (1929); *Brooke*, 277 U.S. at 28–29.

The North Carolina Supreme Court's decision does not impose an "extraordinary imposition" on the state. Instead, it requires that the state comply with the well-established principles governing Due Process. To tax an out-of-state entity the state must demonstrate that the entity has some connections with the state and "that the 'income attributed to the State for tax purposes must be rationally related to values connected with the taxing State.' " *Quill Corp.*, 504 U.S. at 306 (quoting *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 273 (1978)).

The Department incorrectly states that this Court has not provided guidance concerning the taxation of trusts since the "*Pennoyer* era of due-process," which was decided in 1878. (Pet. for Writ of Cert. at i.) The Department contradicts the statement twice in its own petition—first, stating that it has been ninety years since the Court has addressed taxation of a trust, then changing the calculation to seventy years. (Pet. for Writ of Cert. at i, 15.)

Ultimately it is irrelevant how long it has been since the Court has addressed this issue. The correct question is whether there are "compelling reasons" to warrant the Court to readdress the issue. Sup. Ct. R. 10. This Court has noted that "any departure from the doctrine of *stare decisis* demands special justification." *Arizona v. Rumsey*, 467 U.S. 203, 212 (1984). The Department has failed to provide any compelling reason for this Court to grant its Petition or any justification for revisiting well-established precedent.

The Department suggests that the Due Process principles applicable to trusts should be "modernized," comparing the circumstances of this case to those in *Wayfair*. The comparison is inapt. In *Wayfair*, unlike in this case, the outcome of the case had significant implications. "Forty-one States, two Territories, and the District of Columbia" asked the Court to revisit the Commerce Clause physical presence rule as applied to sales tax. *South Dakota v. Wayfair, Inc.*, ___ U.S. ___, 138 S. Ct. 2080, 2086 (2018). The issue presented has only been addressed by North Carolina and at most this decision could impact only the five states with statutes permitting taxation of undistributed income of an out-of-state trust based solely on the residency of the beneficiary.

In *Wayfair*, this Court held that the Commerce Clause physical presence rule "must give way to the 'far-reaching systemic and structural changes in the economy' and 'many other societal dimensions' caused by the Cyber Age." *Id.* at 2097 (quoting *Direct Mkt. Ass'n v. Brohl*, 575 U.S. ___, 135 S. Ct. 1124, 1135 (2015) (Kennedy, J., concurring)). But there have been no changes or modernization of trusts that require a corresponding modernization of the Due Process analysis used to determine whether a state can tax an out-of-state trust. Further, unlike the Commerce Clause physical presence rule, the Due Process minimum contacts analysis has not been applied in formalistic and rigid manner dating back to at least *Quill* and its test for purposeful availment.

III. All of the North Carolina Courts Correctly Decided that the State's Tax Was Unconstitutional as Applied to the Kaestner Trust

There is no need to grant the petition to correct error in this case because there is none. The Due Process Clause prohibits a state from taxing the income of an entity, unless the entity has some minimum connection to the state and the tax is rationally related to the values the entity derives from the taxing state. *Quill Corp.*, 504 U.S. at 306. Longstanding precedent from this Court on the issue of due process prohibits taxation where, as here, the only contact is the presence of a resident beneficiary. A statute that seeks such a tax violates the Constitution.

The Kaestner Trust is a foreign entity. Its only connection to North Carolina is that a beneficiary moved to the state years after the Trust Agreement was executed. The presence of a beneficiary is not sufficient to tax a foreign trust's worldwide income. This Court reached that conclusion in *Safe Deposit & Trust Co. v. Virginia*, 280 U.S. 83 (1929). As in *Safe Deposit*, the North Carolina statute "undertakes to tax things wholly beyond [its] jurisdiction or control" and for that reason "conflicts with the Fourteenth Amendment." 280 U.S. at 92.

The Court provided additional guidance in *Quill* that dictates the same outcome. Under *Quill*, due process requires among other things "some definite link, some minimum connection between a state and the person, property or transaction it seeks to tax." *Quill Corp.*, 504 U.S. at 306. In the case of trusts, the connections must be to the trust. "[T]he law has seen fit to deal with this abstraction [i.e., a trust] for income tax purposes as a separate existence." *Anderson v. Wilson*, 289 U.S. 20, 27 (1933).

Where the only alleged connection is the residence of an in-state beneficiary, *Safe Deposit* and *Quill* align to stand for the proposition that the in-state residence of a beneficiary is not alone a sufficient definite link or minimum connection between a state and the trust it seeks to tax.

Even if the beneficiary were to constitute some minimum connection, which it does not, "the income attributed to the State for tax purposes . . . [must] be rationally related to 'values connected with the taxing State.'" *Quill Corp.*, 504 U.S. at 306 (quoting *Moorman Mfg. Co.*, 437 U.S. at 273); *see Hans Rees' Sons, Inc. v. North Carolina*, 283 U.S. 123, 134–35 (1931) (finding that taxing 80% of the taxpayer's income when only 17% was sourced within the taxing state was out of proportion to the business transacted within the state). There is no rational relationship here. The Kaestner Trust held all of its assets outside the state and all of its income was generated from sources outside of North Carolina. The Department taxed 100% of the trust's income while providing no opportunity to the Kaestner Trust to create that income.

CONCLUSION

The petition should be denied.

Respectfully submitted,

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