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Constitutionality of tax on 'foreign' trusts challenged

■ AMY STEVENS

amy.stevens@nclawyersweekly.com

A recent North Carolina Business Court decision may have a ripple effect on how what the court calls "foreign" trusts are taxed within the state. The court denied the NC Department of Revenue's motion to dismiss a plaintiff's claim that the state tax statute at issue is unconstitutional based on the Due Process Clause and Commerce Clause.

Section 105-160.2 of the North Carolina code allows the revenue department to tax the portion of a foreign trust's income that is for the "benefit of a North Carolina resident." At issue is the Kimberly Rice Kaestner Trust, the plaintiff in the action, which was created in 1992 in New York and is governed by New York state laws. The trust was set up as a "discretionary trust" – meaning beneficiaries could not make demands of the trust's assets or property.

In 2005, when the trust's beneficiaries moved to North Carolina, the trust was required to pay taxes in both New

York and North Carolina. The trust paid taxes for three years before filing a North Carolina state refund request, which was denied.

The plaintiff initially brought an action before the Office of Administrative Hearings, arguing that the trustee of the Kimberly Rice Kaestner Trust never resided in North Carolina, and that the trust had never made a distribution to the beneficiaries living in North Carolina. The action was dismissed, citing lack of jurisdiction because the sole matter was the constitutionality of the tax statute. The case then moved to Business Court.

"The issue in this case is whether North Carolina can tax income accrued and held by an out of state trust whose only connection with the state is the location of its beneficiaries," said Neil Bloomfield of Moore & Van Allen in Charlotte, who represents the plaintiff. "If the statute is upheld, it would be the first time in the country that a court has found that a state is entitled to tax a trust based solely on the location of its beneficiaries."

There is no current case law in North Carolina which upholds the constitutionality of the foreign trust taxation statute. Additionally, the court pointed out there is no binding law from any jurisdiction that seems to fit this particular question of law. For this reason Judge John R. Jolly Jr. ruled the court had "no reason to deny that the plaintiff's constitutional claims on their face must fail as a matter of law" and will allow the case to continue.

"If held to be constitutional, this statute presents serious challenges to out of state trusts that generally have no control over the location of their beneficiaries," said Tom Myrick, also of Moore & Van Allen.

Despite the state's request for Jolly to rule on the constitutionality of the statute, the judge declined, citing the need for more evidence. The case is set for trial.

The 7-page decision is *Kimberly Rice Kaestner 1992 Trust v. North Carolina Department of Revenue* (Lawyers Weekly No. 13-15-0157).

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Tom Myrick, Charlotte attorney