ABA Tax Section Fall Meeting 2019

Giving Due Process Its Due
Friday, October 4, 2019 – 4:15 p.m.

Reed Hollander
Nelson Mullins Riley & Scarborough, LLP
Raleigh, North Carolina
919.329.3816

Mike Shaikh
Baker & McKenzie, LLP
Palo Alto, California
650.251.5945
Due Process Is the Starting Point of Tax Constitutional Analysis

• The (dormant) Commerce Clause forms the basis for numerous challenges to SALT taxes.

• However, the starting point of any constitutional analysis of state tax power should be the 14th Amend. Due Process clause.

  o Remember: the 5th and 14th Amendments each contain a Due Process clause. Generally, the 5th regulates federal power; 14th regulates state power.

  o The 14th: “... nor shall any State deprive any person of life, liberty, or property, without due process of law.”
Two Forms of Due Process

- Procedural – Fundamental fairness of government processes
- Substantive – Balance between liberty and government power
- Our due process focus is on personal jurisdiction (a form of substantive due process). However, don’t overlook arguments based on the fundamental fairness requirement of procedural due process.
Nexus and Personal Jurisdiction

• Nexus: Does the state have a constitutionally sufficient (i.e. minimum) connection to the person, property, or transaction giving rise to the tax?

• Personal jurisdiction: Does the State taxing authority have power to enforce a tax against a nonresident entity? (Prescriptive jurisdiction)

• Personal jurisdiction: Do the State courts of the taxing state have the power to enforce the tax through adjudicative process against the nonresident entity? (Adjudicative jurisdiction)

• SCOTUS cases have considered these to be variations of the same due process question, but have varied in their consistency of application of due process concepts.
International Shoe – the essence of the modern rule


- A state may only exert personal jurisdiction over entity with sufficient minimum contacts with the forum state such that the exercise of jurisdiction “does not offend traditional notions of fair play and substantial justice.”

- Affirmed State of Washington’s power to impose privilege tax computed on salesmen’s salaries due to “systematic and continuous” activities purposefully directed into state by nonresident corporation’s sales agents through the years.
National Bellas Hess and Quill: Evolution of the Due Process Standard in Tax

National Bellas Hess, Inc. v. Department of Revenue of Ill., 386 U.S. 753 (1967)

- Review of Illinois statute imposing obligation on out-of-state mail order firm to collect use tax on sales into Illinois conducted solely by mail or common carrier.

- According to Quill, the holding in National Bellas Hess was that such a statute “violated the [14th Amend.] Due Process Clause and created an unconstitutional burden on interstate commerce.” Quill at *301.

- However, concluding lines of Bellas Hess focus on the Commerce Clause. Unclear how much cover exists in the DPC based on Bellas Hess (even before it was questioned/overruled in Quill and again overruled in Wayfair).
**National Bellas Hess and Quill: Evolution of the Due Process Standard in Tax**


- Clarified the difference between Due Process Clause requirements and Commerce Clause requirements, calling them “analytically distinct.”

- Due Process Clause requires “some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax” and that the “income attributed to the State for tax purposes must be rationally related to values connected with the taxing State.” *Quill* at *306.*

- Tax upheld under the Due Process Clause but not under Commerce Clause.
Did *Wayfair* Kill the Due Process Clause for SALT?

- At least for nexus, *Quill* killed the Due Process Clause.

- The *Wayfair* decision cites *Quill*, holding that Due Process does not require any physical presence.

- *Wayfair* eliminates any doubt that the Due Process standard is far lower than the Commerce Clause for purposes of jurisdiction to tax, but does not opine on other aspects of taxation.
The Practical Aftermath of *Wayfair* Illuminates Severe Due Process Concerns

- In the aftermath of *Wayfair*, states are not only taxing entities without physical presence in the state, they are taxing internet platforms that allow out-of-state sellers to operate in interstate commerce.
- These laws not only affect sellers of tangible personal property, but also service providers.
- The laws affect not only sales and use taxes, but also gross receipts and excise taxes.
- The laws not only affect state-level taxes, but also local taxes.
- All the problems with these new laws will largely be wrestled with under Commerce Clause analysis, not Due Process.
The Flickering Flame of SALT Due Process in *Kaestner Trust*

*North Carolina Dept. of Revenue v. The Kimberly Rice Kaestner 1992 Family Trust, 139 S.Ct. 2213 (June 21, 2019)*

- **Salient Facts**
  - New York settlor (deceased) of New York-based trust
  - Trust assets held in variety of places, but none in North Carolina.
  - Trust invested “absolute discretion” in trustee to make distributions to trust beneficiaries.
  - No beneficiary received a distribution during tax years at issue or while living in NC.
Challenge to North Carolina Tax on Trust Income

• North Carolina taxes any trust income that is “for the benefit of” a North Carolina resident. N.C. Gen. Stat. § 105-160.2.

• Trust beneficiaries Kimberly Rice Kaestner and her three children moved to North Carolina in 1997.

• Beneficiaries received no distributions from the Trust while living in North Carolina (although Kimberly received a $250,000 loan that was later repaid).

• Non-resident trustee filed trust income tax returns and paid under protest the NC tax ($1.3 million) for the periods 2005-2008, then sued for full refund based on argument that Due Process Clause bars taxation of the trust’s income.
State Court Procedural History

- Taxpayer prevailed in trial court, North Carolina Court of Appeals, and Supreme Court of North Carolina (6-1 decision). Each court found the State’s exercise of tax power to violate the Due Process Clause.

- “For taxation of a foreign trust to satisfy the due process guarantee of the Fourteenth Amendment and the similar pledge in Article I, Section 19 of our state constitution, the trust must have some minimum contacts with the State of North Carolina such that the trust enjoys the benefits and protections of the State. When, as here, the income of a foreign trust is subject to taxation solely based on its beneficiaries’ availing themselves of the benefits of our economy and the protections afforded by our laws, those guarantees are violated.” 814 S.E.2d 43, 51 (N.C. June 8, 2018).

- However – NC SCT relied heavily on Quill, and Wayfair was issued 13 days later (June 21). So the logic of the NCSCT opinion was attacked in the SCOTUS cert. petition.
SCOTUS Opinion in *Kaestner Trust*

- 9-0 decision (J. Sotomayor; Concurrence by J. Alito)
  - Core holding: “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.”
  - Why? Because “the Due Process Clause analysis in a trust beneficiary context focuses on the extent of the in-state beneficiary’s right to control, possess, enjoy, or receive trust assets.”
    - State based its tax on presence of in-state beneficiary, so inquiry must be focused on that beneficiary’s connection to the thing being taxed – the trust corpus.
SCOTUS Opinion in *Kaestner Trust*

- “The Constitution requires that the resident have some degree of possession, control, or enjoyment of the trust property or a right to receive that property before the State can tax the asset. Otherwise, the State’s relationship to the object of its tax is too attenuated to create the ‘minimum connection’ that the Constitution requires.”

- Beneficiaries
  - received no income from the Trust
  - had no right to demand income from the Trust
  - had no assurance that they would eventually receive a specific share of Trust income

- Therefore, beneficiaries’ residence could not “serve as the sole basis for North Carolina’s tax on trust income.”
Concurring Opinion in *Kaestner Trust*

- Alito concurrence (joined by C.J. Roberts and J. Gorsuch)
  - Emphasized that the 1920s-era precedents of *Safe Deposit & Trust Co. of Baltimore v. Virginia* and *Brooke v. Norfolk* were still reliable guideposts.
  - Those cases turned on whether a resident trust beneficiary had control or possession of intangible assets in a trust or enjoyed use of the trust assets, similar to the analysis undertaken in the principal *Kaestner* opinion.
  - Rejected State’s arguments that 1920’s precedents were based on a *Pennoyer*-era physical presence analysis.
The Narrowness of *Kaestner Trust*

- “As applied in these circumstances, the State’s tax violates the Due Process Clause...” Id. at *2217.

- “In limiting our holding to the specific facts presented, we do not imply approval or disapproval of trust taxes that are premised on the residence of beneficiaries whose relationship to trust assets differs from that of the beneficiaries here.” Id. at *2221.

- “Given these features of the Trust, the beneficiaries’ residence cannot, consistent with due process, serve as the sole basis for North Carolina’s tax on trust income.” Id. at *2224.

- “We express no opinion on the validity of [taxes that] ... consider the in-state residency of a beneficiary as one of a combination of factors, that turn on the residency of a settlor, or that rely only on the residency of noncontingent beneficiaries.” Id. at *2225.

- “[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.” Id. at *2226.
McIntyre is a U.K.-based machinery manufacturer. Its machine was sold in the U.S. via an uncontrolled U.S. distributor. Somewhere between 1-4 machines were sold in New Jersey.

Nicastro was injured by McIntyre’s machine in New Jersey. Suit brought against McIntyre in NJ. Distributor had become insolvent.

Issue: does NJ court have personal jurisdiction over McIntyre under the Due Process Clause?

Plurality opinion: No, because McIntyre did not purposefully avail itself of the privilege of conducting activities in NJ. Not enough that defendant “might have predicted” its goods will reach the forum state. Rejects imprecise “stream of commerce” language from Asahi Metals.
Current Due Process Rule – Purposeful Direction

- Not a sales tax vs. income tax distinction. (Contra pre-Wayfair)

- Lynchpin is purposeful availment/direction. Is the target of the tax purposefully availing itself of the state’s market or directing its activities into the state?
  - *Wayfair:* Yes, because the out-of-state merchant is purposefully directing business into the taxing state and engaging in transactions with in-state entities.
  - *McIntyre Machinery:* No, because the foreign manufacturer did not purposefully engage in conduct directed at New Jersey.
  - *Kaestner Trust:* No, because the trustee did not purposefully engage in trust business in North Carolina (no distributions made, no contacts of substance).
Purpose/Intent – What’s the Test?

• How is “purpose” or “intent” determined?
  o McIntyre intended to sell its machines in the U.S.
  o Did not prohibit its distributor from selling into NJ
  o But apparently its intent wasn’t specific enough to NJ to be “purposeful”

• Is there a de minimus level of intentional activity permitted under the DPC?
  o Yes – McIntyre (“None of the Court's precedents finds that a single isolated sale, even if accompanied by the kind of sales effort indicated here, is sufficient.... the relevant facts show no “regular ... flow” or “regular course” of sales in New Jersey.”) But see McGee v. Int’l Life Ins. Co., 355 U.S. 220 (1957) (predicating jurisdiction on single transaction in forum state)
  o Likely prevents states from contending that an isolated visit into the State or an isolated sale is sufficient contact under the DPC.
Purpose/Intent – Individualized Analysis

• Purposeful intent is an individualized analysis. Inquiry is whether the entity sought to be taxed is the one that purposefully availed itself of the forum state. Even attributional nexus cases like *Tyler Pipe* and *Scripto* rely on in-state activities of employees or agents of the taxed entity.

  o Does a seller/marketplace facilitator structure insulate seller from “purposeful availment” finding in the same manner as manufacturer/distributor structure in *McIntyre*?

  o Facilitating passage of title from seller to buyer through the marketplace may be sufficient to establish purposeful availment by seller.
Ongoing Issues

• Distinction between sellers who know where the buyers are located (Wayfair, International Shoe) and sellers who do not know/control the sale to the buyer in the forum state (McIntyre, World-Wide Volkswagen).

• Does holding intangible property in a state create sufficient connection to create nexus/personal jurisdiction (in personam, not in rem)?
  

  o But holding trust interest in North Carolina deemed insufficient connection to create nexus to tax income of the Kaestner Trust
Ongoing Issues

• Given the inconsistency between *Wayfair* and *McIntyre*, how does *Kaestner Trust* (narrow though it is) affect the balance?

  o Once beneficiary moved to NC and trustee continued to serve in that role, didn’t trustee “purposefully direct” his service as trustee to the benefit of the NC beneficiaries?

  o Or is the trustee’s service to the trust akin to *McIntyre*’s sale of its machines – agnostic to where the machine/beneficiary ends up?
In a Trust, Who is the “Actor” for Due Process Purposes?

- A “trust” is not a thing; it’s a relationship. Although it’s sometimes treated as having a separate existence – e.g. federal taxation.

- The trust relationship involves the separate interests of the beneficiary, who holds equitable interest in property -- and of the trustee, who holds legal interest in property.

- Whose activities are analyzed for due process purposes?

- When North Carolina taxes “trust income” – whose interest is being taxed?
  - Legally, it’s the interest of the trustee. Equitably, it’s the (inchoate expectancy) interest of the beneficiary.
  - Only the trustee can file the returns and pay the tax.
  - Only the trustee can be the target of enforcement efforts to collect the tax.
Ongoing Issues

• If beneficiary’s connection to the Trust is sufficient to create nexus (for example – beneficiary has some right to receive trust distributions), does that mean the State has jurisdiction over a non-resident trustee who otherwise lacks contacts? Could the State enforce a return filing requirement or to obtain a judgment against the trustee (as legal owner of trust assets) for the taxes owed?
  o Seems likely under *Kaestner Trust*

• But in *Hanson v. Denckla* – SCOTUS prevented Florida court from binding two non-resident trustees of a Florida beneficiary who was then receiving distributions, on grounds that non-resident trustees lacked minimum contacts with Florida. *Hanson* is a significant minimum contacts case cited numerous times by SCOTUS, including in *Kaestner Trust*. 
Squaring *Kaestner* and *Allied-Signal*

  - Recognizes limited power of a state to tax multi-state income of non-domiciliary corporation when there is no minimum connection between the interstate activities and the taxing State and the income is unrelated to activities in the State.
  - “In the case of a tax on an activity, there must be a connection to the activity itself, rather than a connection only to the actor the State seeks to tax.” *Id.* at 783, citing *Quill*.
  - Power to tax a corporation’s activities is justified by the “protection, opportunities and benefits” the state confers on those activities.
- Is the taxation of trust income taxation of an “activity”?
  - NJ tax was business corporation tax including gain of sale of Bendix stock.
Reed Hollander focuses his practice in the area of state and local taxation controversies, including property tax, sales and use tax, corporate and individual income tax, and excise taxes, and has spoken and published articles on state and local tax controversy issues regionally and nationally. He teaches state and local tax as an adjunct professor at the University of Miami Law School and is a member of the ABA Tax Section, the North Carolina Bar Association Tax Section, COST, and IPT. He was the principal author of the American College of Tax Counsel’s amicus brief in Kaestner Trust.

Mike Shaikh is a partner in the Tax Group of Baker McKenzie’s Los Angeles office. Mike counsels clients on tax matters related to administrative audits, corporate and personal income, property, payroll and business licenses. Mike has multistate tax experience and has extensive experience before California taxing agencies, including the California Franchise Tax Board, the California State Department of Tax and Fee Administration, California State Board of Equalization and the California Employment Development Department.