Ed Morrow, David Berek, and Raj Malviya on the North Carolina Supreme Court’s Affirmation of Kaestner and Its Impact on both North Carolina and Other States’ Abilities to Tax Trust Income

“Kaestner represents another unsuccessful attempt by a state to capture state level fiduciary income tax revenue from a ‘minimally connected’ trust. In a growing trend, taxpayers have been challenging the sufficiency of state “minimum contacts” that purport to reach an increasingly mobile taxpayer environment. Given the right fact pattern as in Kaestner, a traditional constitutional analysis may be necessary for practitioners to evaluate the appropriateness and extent of a trust’s minimum contacts with the state taxing jurisdictions.

In The Kimberly Rice Kaestner Trust v. North Carolina Department of Revenue, the North Carolina Supreme Court upheld the North Carolina Court of Appeals’ and lower court’s holding that the North Carolina statute (NCGS 105-160.2), which sought to tax a trust’s accumulated income, was unconstitutional as applied to the trust at issue. The holding was based on the grounds that taxing a trust on the sole basis of the North Carolina residency of the trust beneficiaries violates the Due Process Clauses of the U.S. Constitution and the North Carolina Constitution.

Kaestner is an important case for Constitutional analysis. At least ten other states have beneficiary residency as a critical factor under their taxing statute (or administrative interpretation of it) – Alabama, California, Connecticut, Georgia, Michigan, Missouri, North Dakota, Ohio, Rhode Island and Tennessee. However, the court’s reasoning and analysis also exposes potentially Constitutionally-defective features in the statutes of many other states that incorporate the residency of the settlor as a crucial factor. Because this decision is from a state’s highest court on a federal constitutional issue (and was shortly thereafter followed by the Minnesota Supreme Court’s similar decision in Fielding v. Dept. of Revenue), it may have persuasive—although not controlling—impact on many other states’ constitutional nexus jurisprudence.
The court’s holding continues a taxpayer-friendly trend in the state fiduciary income tax area. The most obvious and immediate impact of Kaestner is on existing irrevocable non-grantor trusts that are now paying North Carolina income tax merely due to the residency of their beneficiaries. Trusts paying North Carolina income tax due to situs of trust administration and/or location of assets may be able to sever trust nexus from the state in order to avoid paying North Carolina income tax.

Beyond this, Kaestner may impact high-income North Carolina residents who now have greater tax planning options for their estate plans, and who may even establish intervivos non-grantor trusts to avoid North Carolina income tax on non-source income. This is further explored in a forthcoming companion LISI newsletter by the same authors on State Income Tax Planning with Intervivos Trusts After Kaestner and Fielding.”

Ed Morrow, David Berek, and Raj Malviya provide members with analysis of the North Carolina Supreme Court’s affirmation of Kaestner and its impact on both North Carolina and other States’ abilities to tax trust income.

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Now, here is Ed’s, Dave’s, and Raj’s commentary:

EXECUTIVE SUMMARY:

In The Kimberly Rice Kaestner Trust v. North Carolina Department of Revenue, the North Carolina Supreme Court affirmed the Business Court’s (lower court) and Court of Appeals’ holding that the North Carolina statute (N.C.G.S. 105-160.2), which taxes an estate or non-grantor trust if a trust benefits a North Carolina resident (i.e., a beneficiary is a resident of North Carolina),² is unconstitutional as applied to the Kimberly Rice Kaestner Trust. Taxing the trust on the sole basis of the North Carolina residency of the trust beneficiaries violates the Due Process Clauses of the U.S. Constitution and Article I, Section 19 of the North Carolina Constitution.³

The case continues a taxpayer-friendly trend in this area (see listing and summary of recent cases in Ed Morrow on Fielding: Yet Another Case Where State Income Taxation of Nonresident Trusts Ruled Unconstitutional, LISI Income Tax Planning Newsletter #117 (August 31, 2017)). Because this decision is from a state’s highest court on a federal constitutional issue (and was shortly thereafter followed by the Minnesota Supreme Court’s similar decision in Fielding v. Dept. of Revenue), it may have persuasive—although not controlling—impact on many other states’ constitutional nexus jurisprudence.

Kaestner is an important case for Constitutional analysis. At least ten other states have beneficiary residency as a critical factor under their taxing statute (or administrative interpretation of it) – Alabama, California, Connecticut, Georgia, Michigan, Missouri, North Dakota, Ohio, Rhode Island and Tennessee. However, the court’s reasoning and analysis also exposes potentially Constitutionally-defective features in the statutes of
many other states that incorporate the residency of the settlor as a crucial factor.

The most obvious and immediate impact of *Kaestner* is on existing irrevocable non-grantor trusts that are now paying North Carolina income tax merely due to the residency of their beneficiaries. Trusts paying North Carolina income tax due to situs of trust administration and/or location of assets may be able to sever trust nexus from the state in order to avoid paying North Carolina income tax.

Beyond this, *Kaestner* may impact high-income North Carolina residents who now have greater tax planning options for their estate plans, and who may even establish intervivos non-grantor trusts to avoid North Carolina income tax on non-source income. This is further explored in a forthcoming companion L\$\$ newsletter by the same authors on State Income Tax Planning with Intervivos Trusts After *Kaestner* and *Fielding*.

**COMMENT:**

This newsletter will summarize the facts of the *Kaestner* case, examine how the North Carolina trust residency and taxing statute applies, and examine how the North Carolina Supreme Court applied federal Constitutional law to suppress its own state’s ability to tax trusts. It will then examine how this analysis may influence interpretation and limitation on other states’ abilities to tax trusts, including which states are the most vulnerable to attack. A forthcoming companion newsletter entitled *State Income Tax Planning with Intervivos Trusts After Kaestner and Fielding* will explore potential estate planning opportunities for both North Carolina residents and potentially for those residing in other states with similar statutes that may be equally Constitutionally-deficient.

**The Kimberly Rice Kaestner Trust**

The *Kaestner* case concerned an irrevocable trust established by Joseph Lee Rice III in 1992 for his three children and their families with substantial ties to New York. Joseph was a resident of New York, created the trust in New York, and the initial trustee was a resident of New York. However, upon the initial trustee’s resignation, the individual successor trustee was a resident of Connecticut. In addition, the trust was governed by New York law, the tax compliance and trust accountings were prepared in New York, and the trust’s financial, tax and legal books and records were located in
New York. The custodians of the Trust accounts, however, were located in Massachusetts.

Upon Joseph’s death, the trust was divided into separate trusts for each beneficiary. The *Kaestner* case, however, concerned only one of the three trusts—the trust established for Joseph’s daughter, Kimberly Rice Kaestner (the “trust”). Mrs. Kaestner was a discretionary beneficiary under the trust. The only contact Mrs. Kaestner had with North Carolina was her residency when she moved her family there in 1997.

The trust had been paying significant North Carolina state income tax based on the following statute that imposes income tax on undistributed income in trusts:

*The tax is computed on the amount of the taxable income of the estate or trust that is for the benefit of a resident of this State*, or for the benefit of a nonresident to the extent that the income (i) is derived from North Carolina sources and is attributable to the ownership of any interest in real or tangible personal property in this State or (ii) is derived from a business, trade, profession, or occupation carried on in this State.4

*Kaestner* only concerned the first part of the above sentence since there was no North Carolina “source income” at issue. There was, however, significant dollars at stake for the *Kaestner* family, as the trust paid over $1.3 million in North Carolina income tax and interest for tax years 2005-2008, the years at issue in the case. In contrast, the trust did not pay New York or any other state income tax.

During those years, Mrs. Kaestner and her family were the sole primary beneficiaries of the trust and were North Carolina residents. That said, they did not receive any distributions from the trust during the tax years in question, though the trustee was afforded the discretion to make distributions. There were two loans, but both loans were repaid in full with interest at the applicable federal rate. The Court ultimately found the loans to be irrelevant.

In 2009, the trustee filed for refunds of the more than $1.3 million in income tax and interest paid for tax years 2005-2008. The refund was denied, and in 2012 an action was filed in state court to recover this money. In the suit,
the trustee argued that North Carolina’s broad trust income tax reach violated the U.S. Constitution’s Due Process and Commerce Clauses. In 2015, the North Carolina Business Court issued an opinion and order for the trustee on cross motions for summary judgment, finding that North Carolina could not tax the income of the trust for the years in question. The appellate court upheld the decision in 2016 and now the North Carolina Supreme Court has upheld it as well.\(^5\)

**Court’s Analysis of the Commerce Clause and the Due Process Clause**

The constitutional attacks on the North Carolina statute under the Commerce and Due Process Clauses was consistent with the reoccurring approach by state courts in other jurisdictions in dismantling similar taxing statutes. The lower court examined both constitutional attacks and held that the statute violated the Due Process and Commerce Clauses. However, the North Carolina Court of Appeals did not address the Commerce Clause attack, so it was not examined in the North Carolina Supreme Court’s opinion. While the North Carolina Supreme Court focused on the Due Process Clause, it is important to briefly understand the lower court’s analysis of the Commerce Clause.

**Commerce Clause Analysis**

In general, the Commerce Clause gives Congress the sole power to regulate commerce among the states.\(^6\) The U.S. Supreme Court has used the Commerce Clause as a negative sweep to strike down or place significant limitations on state taxing schemes that place an undue burden on interstate commerce. In *Complete Auto Transit v. Brady*,\(^7\) the Supreme Court articulated a four-part test to determine if a state tax violates the Commerce Clause:

1. Nexus: there must be a sufficient connection between the taxpayer and the state to warrant the imposition of state tax authority;

2. Fairly Apportioned: the state must not tax more than its fair share of the income of a taxpayer;

3. Non-Discrimination: the state must not treat out-of-state taxpayers differently than in-state taxpayers; and
4. Fairly Related to Services: the tax must be fairly related to services the state provides to its taxpayers.

The above four-prong test, also commonly cited as the “Complete Auto Test,” serves to protect the free flow of commerce from undue state regulation, including taxes that impede interstate commerce. Without the Commerce Clause, states would be free to use their taxing powers to benefit in-state businesses by burdening their out-of-state competitors. To pass constitutional muster, all four prongs must be satisfied, and the failure to meet any one of these requirements renders a tax unconstitutional.8

The Kaestner lower court focused on the fact that Mrs. Kaestner was only a discretionary beneficiary of the trust and she did not have the right to compel nor influence distributions. With no other contacts to North Carolina, her residency alone was an insufficient contact to justify taxation. Consequently, the lower court held that the first and fourth prongs of the Complete Auto Test were not satisfied. The lower court did not address the second or third prongs of the test.

Due Process Clause Analysis

As previously mentioned, the North Carolina Supreme Court focused its examination on the Due Process argument, since it was addressed on appeal. The Fourteenth Amendment to the U.S. Constitution provides that no state shall “deprive any person of life, liberty, or property, without due process of law.”9 Moreover, the North Carolina Constitution guarantees due process rights by providing that no person shall be “in any manner deprived of his life, liberty, or property, but by the law of the land.”10 The North Carolina Supreme Court has noted that “[t]he term ‘law of the land’ as used in Article I, Section 19, of the Constitution of North Carolina, is synonymous with ‘due process of law’ as used in the Fourteenth Amendment to the Federal Constitution.”11 Accordingly, the Kaestner Court analyzed the State and Federal Due Process challenge together.

The U.S. Supreme Court case consistently cited for Due Process Clause challenges is Quill v. North Dakota,12 which dealt with a Delaware mail order company that sold office equipment and computer software to out of state customers. At issue in Quill was whether North Dakota could collect a use tax on Quill Corporation merchandise that was sold via mail order to
North Dakota residents, even though the retailer maintained no physical presence in the state. The Court, after thoroughly analyzing the Due Process Clause when Internet and web based commerce were in their infancy, held that North Dakota could not collect a tax for sales to its residents without the mail order retailer having a physical presence in the state.\textsuperscript{13}

Since the \textit{Kaestner} holding was based on a violation of the Due Process Clause, it is important to briefly examine its components. As analyzed in \textit{Quill}, when a state seeks to impose a tax, the Due Process Clause requires: (1) “some definite link, some minimum connection, between a state and a person, property or transaction it seeks to tax;” and (2) “that the income attributed to the State for tax purposes . . . be rationally related to values connected with the taxing state.”\textsuperscript{14}

When analyzing the first requirement, courts consider whether a taxed entity’s “connections with a State are substantial enough to legitimize the State’s exercise of power over” it.\textsuperscript{15} Importantly, where the taxed entity has no physical presence in a state, the entity must “purposefully avail itself of the benefits of an economic market in the forum state.”\textsuperscript{16} This requirement ensures that the taxed entity is given “fair warning that its activity may subject it to the jurisdiction of a foreign sovereign.”\textsuperscript{17} The courts then analyze the second component and assess “whether the taxing power exerted by the state bears fiscal relation to protection, opportunities and benefits given by the state.”\textsuperscript{18}

The \textit{Kaestner} Court carefully analyzed the first component of the Due Process Clause under the \textit{Quill} lens. It also applied recent precedent in North Carolina standing for the proposition that “a finding of minimum contacts to satisfy due process will vary with the quality and nature of the [party’s] activity, but it is essential in each case that there be some act by which the [party] purposefully avails itself of the privileges of conducting activities within the forum State, thus invoking the benefits and protections of its laws.”\textsuperscript{19}

\textbf{The Kaestner Court held that the trust did not satisfy the “minimum contacts” component of the Due Process Clause in North Carolina based solely on Mrs. Kaestner’s and her family’s presence in North Carolina.} The Court focused on the following key factors in reaching its holding:
1. A non-grantor trust is a separate entity to which income is separately attributed, and tax is paid by the fiduciary or trustee. As a discretionary beneficiary of a non-grantor trust, Mrs. Kaestner had no directive or involvement as to the trust’s income and tax liability associated with it.\(^\text{20}\)

2. The property owned by the trust was not physically located in North Carolina. While there may have been other minimum contacts to be considered in North Carolina under *Quill*, the Court recognized that the trust and the trust beneficiary are independent legal entities, and the property of the trust does not belong to the beneficiary and is not within the beneficiary’s possession or control.\(^\text{21}\) Consequently, if the *Kaestner* Court were to assess tax on the trust in North Carolina, it would essentially be holding Mrs. Kaestner liable on an interest to which she is a stranger.\(^\text{22}\)

3. In the same vein, the independent significance analysis led the *Kaestner* Court to a critical component of its holding, which is that given the trust and its beneficiaries having legally separate taxable existences, the taxed entity’s (trust) minimum contacts within the taxing state cannot be established by a third party’s (discretionary beneficiary) minimum contacts with the taxing state.\(^\text{23}\) In other words, it was Mrs. Kaestner and her family—not the trust—who benefitted from the protections of North Carolina law, and the state cannot use the beneficiaries to create minimum contacts for the trust.\(^\text{24}\) This component may also help distinguish the *Kaestner* Court’s holding from the subsequently decided U.S. Supreme Court decision, *South Dakota v. Wayfair, Inc.*\(^\text{25}\)

4. As separate legal entities, it is the trust’s contacts within North Carolina—not the beneficiaries who reside there—that must suffice to establish minimum contacts. Consequently, the trust would have needed to purposefully avail itself of the benefits and protections offered by the state. The facts were undisputed that the trust did not benefit from North Carolina’s laws. Simply communicating with the North Carolina resident beneficiaries a few times a year was insufficient to constitute purposeful availment by the trust.

**Impact of *South Dakota v. Wayfair, Inc.***
As noted above and reported in a recent LISI newsletter (in Larry Katzenstein & Jeff Pennell—How Does South Dakota v. Wayfair Impact a State's Ability to Tax Undistributed Trust Income?, LISI Income Tax Planning Newsletter #148 (July 12, 2018) only weeks after the Kaestner Court's decision, the U.S. Supreme Court issued its opinion on South Dakota v. Wayfair, Inc., reversing its own fifty year precedent ruling under Quill Corp. v. North Dakota, which necessitated a business to have physical presence in the state before the state could require the collection and remittance of sales tax. In a 5-4 decision, with Justice Kennedy delivering the opinion, the U.S. Supreme Court declared that the physical-presence rule was "unsound and incorrect", and that Quill and its 1967 predecessor decision, National Bellas Hess Inc. v. Illinois, were overruled.

The impact of Wayfair on the broader question of a state's ability to tax trusts without an actual physical nexus point in the state is uncertain. However, the authors believe that there are several key factors in the Kaestner opinion that are distinguishable, even though Quill was one of the supporting cases cited in the Court's opinion. Importantly, Kaestner is a state income tax decision. Wayfair is a sales/use tax decision. These two categories of tax not only differ significantly in type, but also in the way they are derived, enforced, and collected. Also, the Kaestner opinion focused on the independent significance of a trust and rationalized how a third party's (beneficiary) minimum physical contacts within the state cannot be attributed to the taxed entity's (trust) contacts within the state. The parties affected in Wayfair were contracting parties each consenting in a sales transaction for the purchase of goods and services. This type of consenting relationship is very different than one of a Trustee/beneficiary, where the beneficiaries of a discretionary trust generally have no say or control over distributions made by the Trustee. In other words, regardless of the residency of a trust beneficiary, that beneficiary should not influence what distributions a Trustee with sole discretionary authority makes to the beneficiary. There are other key distinctions in the Kaestner opinion that warrant further analysis in a future article.

Summary of Which States Use Residency of Beneficiaries as Prong; Potential Impact on Case’s Constitutional Reasoning on States that Go Too Far
While North Carolina’s injection of taxing nexus based solely on a trust beneficiary's residency is aggressive (only a few states have a similar statute), several other states have given some weight to beneficiary residency in establishing a tax nexus. California and Connecticut are among the more extreme states, as both have taxpayer-adverse controlling case law providing that the in-state residency of beneficiaries may provide sufficient nexus for a state to tax a trust.

Where the potential persuasive impact of the Kaestner opinion may be the greatest is on the conclusion that only the contacts and actions of the trustee or the location of the assets matter for determining nexus. If the residency and contacts of the settlor do not matter, many more states’ statutes could be impacted. Most notably would be states known as "Founder States," which have statutes that largely or completely ignore the contacts of the trustee, but rather look to the residency of the settlor (even after a settlor is dead) to create the link for taxation.

Additionally, the fact pattern in Kaestner provides a further blueprint for how practitioners can evaluate their own client situations from a case study type perspective. The first question an advisor should always ask is: Why is the client trust paying tax in the particular state, and what is the state’s basis for taxing the trust? Next, the advisor should determine whether the state tax is calculated on the client trust under a statutory resident trust classification. If the statute as applied to the client trust seems unreasonable to subject the client trust to state taxation, the advisor should consider the number of constitutional minimum contacts between the state and the trust. Finally, if the contacts are questionable, the advisor should assess whether the client should challenge the statute through litigation, or whether there are other alternatives. The Kaestner decision provides a basis for this analysis.

Conclusion – Kaestner’s Impact on North Carolina Residents (and Beyond?)

North Carolina residents may now legitimately prevent North Carolina state income taxation on accumulated non-source income of irrevocable non-grantor trusts of which they are a beneficiary, provided proper attention is paid to trustees and administration. Important to note is that the North Carolina Department of Revenue has indicated it will appeal the Kaestner decision to the U.S. Supreme Court.
Beyond North Carolina, this case may put additional pressure on states with potentially Constitutionally-deficient taxing statutes -- and will provide incentive for taxpaying trusts to challenge them. Such states may not only include those which focus on residency of the beneficiaries, but potentially those which focus on the residency of settlors as a relevant factor, since the *Kaestner* court only deemed the trustee and location of assets/administration as relevant and saw the residency of “third parties”, such as settlors and beneficiaries, as irrelevant to determination of a trust’s nexus with a state.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

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**CITE AS:**


**CITATIONS:**
1 This newsletter represents the opinion of the authors and not of their respective organizations.

2 See N.C.G.S. 105-106.2.


4 North Carolina General Statutes (N.C.G.S.) Section 105-160.2.


6 See U.S. Const. at Article 1, Section 8, which gives Congress the authority to “regulate Commerce . . . among the several States.” For a thorough examination of the Commerce Clause, see Quill v. North Dakota, 504 U.S. 298 (1992).


9 U.S. Const. amend XIV, § 1.

10 Article I, Section 19 of the Constitution of North Carolina.


13 Id.

14 Id.

15 Id. at 312.

16 Id. at 307.
17 Id. at 308.

18 Id.


21 Brooke v. City of Norfolk, 277 U.S. 27, 28 (1928).

22 Id. at 422.

23 See Walden v. Fiore, 134 S Ct. 1115, 1122 (2014) (holding that a unilateral activity of another party or a third person is not an appropriate consideration when determining whether defendants have sufficient contacts with a forum State).

24 The North Carolina Department of Revenue challenged the trust’s argument on this point by citing two out of state decisions, Chase Manhattan Bank v. Gavin, 249 Conn. 172, 204, 733 A.2d 802 (cert. denied 528 U.S. 965 (1999)) and McCulloch v. Franchise Tax Bd., 61 Cal. 2d 186, 196, 390 P.2d 412, 419 (1964), where the residence of the beneficiary was used to find minimum contacts within the taxing state. However, the Gavin case was distinguished because the state’s probate court was used to implement the trust at issue. Moreover, the Gavin Court failed to consider the separate legal existence of the trust and beneficiary, which is critical to determining whether minimum contacts are satisfied. The McCulloch case was distinguished because the Trustee in that case was a state resident, along with the beneficiary. In finding Gavin and McCulloch unpersuasive, the Kaestner Court indicated that other out of state jurisdictions applied similar reasoning in finding that minimum contacts test was not met. See Linn v. Dep’t of Revenue, 2 N.W. 3d 1203, 1211 (2013), appeal dismissed, 22 N.E. 3d 1165 (2014).


26 Alabama, California, Connecticut, Georgia, Michigan (not by statute but by administrative interpretation of case law), Missouri, North Dakota, Ohio (one factor), Rhode Island and Tennessee all consider beneficiary

27 McCulloch v. Franchise Tax Bd., 61 Cal. 2d 186, 196, 390 P.2d 412, 419 (1964) and Chase Manhattan Bank v. Gavin, 249 Conn. 172, 204, 733 A.2d 782, 802, cert. denied, 528 U.S. 965, 120 S. Ct. 401 (1999). The Kaestner court dismissed the McCulloch decision in large part because it was decided before the U.S. Supreme Court decision in Quill, which was itself recently reversed in part, see note 24 above.


29 The authors thank North Carolina attorney and fellow ACTEC Fellow, Carl King, of Culp Elliott & Carpenter, P.L.L.C., for his review and for this further history and update: A North Carolina Bar Association subcommittee of the Legislative Committee of the NCBA Estate Planning and Fiduciary
Law section (on which Carl serves) had previously drafted and proposed legislation to cure the apparent constitutional problems after the lower court’s decision in *Kaestner*. The proposed legislation was submitted to the General Assembly first in 2015 and again in 2017, but no legislation was passed. The crux of the proposed approach is to require both (a) a beneficiary in NC (income ratable over beneficial interests) AND (b) principal place of administration in NC. On July 26, 2018, from the podium at the NCBA Estate Planning and Fiduciary Law section annual meeting, Matt Cain, Esq., a presenter from the same law firm that represents the Kaestner Trust said that their litigators report that the state (North Carolina Department of Revenue) has indicated its intention to appeal the *Kaestner* decision to the U.S. Supreme Court.

The authors note that only a slim percentage of state supreme court decisions are granted *certiorari*, and an Ohio Supreme Court decision on somewhat similar constitutional issues was recently denied certiorari as recently as October 2, 2017 in *T. Ryan Legg Irrevocable Trust v. Joseph W. Testa, Tax Commissioner of Ohio*, 2016-Ohio-8418, cert denied 138 S. Ct. 222 (2017).