Kaestner's Final Chapter: North Carolina Abandons Beneficiary-Based Fiduciary Income Taxation

By Carl L. King

Note: This article will be published in the August/September 2026 issue of the North Carolina Bar Association's publication, The Will and the Way.

On July 2, 2026, Governor Josh Stein signed Session Law 2026-31. Section 1.3 of the Act fundamentally rewrites North Carolina's fiduciary income tax regime. Effective for taxable years beginning on or after January 1, 2026, North Carolina no longer attempts to tax the accumulated income of trusts merely because that income may benefit a resident beneficiary. Instead, North Carolina now focuses principally on income derived from North Carolina sources.

This development concludes a debate that has spanned more than a decade and has generated four separate legislative proposals, multiple refund controversies, substantial audit activity, decisions by the North Carolina Business Court, the North Carolina Supreme Court, and ultimately the United States Supreme Court in *North Carolina Department of Revenue v. The Kimberley Rice Kaestner 1992 Family Trust*, 139 S.Ct. 2213 (2019).

This article is the fourth installment in a series of Will and the Way articles examining North Carolina fiduciary income taxation. The first article discussed the 2015 Business Court decision in Kaestner. The second evaluated the North Carolina Supreme Court's affirmance. The third analyzed the United States Supreme Court's decision and its practical consequences. This final article examines the General Assembly's response and the significant planning issues that remain.

THE END OF THE BENEFICIARY-RESIDENCE REGIME

For nearly four decades, North Carolina employed a fiduciary income tax structure atypical among most states. Former G.S. Section 105-160.2 imposed tax on:

"The taxable income of the estate or trust that is for the benefit of a resident of this State."

The constitutional vulnerability of that language became increasingly apparent as beneficiaries became more mobile and as modern trust administration became increasingly interstate in character. Ultimately, in Kaestner, the United States Supreme Court held:

"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." 139 S.Ct. at 2221.

The Supreme Court's opinion resolved the constitutional issue for the Kaestner trust and similarly situated taxpayers. However, it did not rewrite North Carolina's statutory law. Consequently, fiduciaries, advisors, and auditors have spent the last seven years attempting to determine precisely which beneficiary interests were sufficiently substantial to support taxation under North Carolina's beneficiary-based statute.

Significantly, on July 2, 2026 (effective January 1, 2026) the General Assembly abandoned that inquiry.

As amended, G.S. Section 105-160.2 provides:

"The tax is computed on the amount of the taxable income of the estate or trust that (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 business, trade, profession, or occupation carried on in this State."

Note that the revised statute has removed references to estates and trusts benefiting residents or nonresidents.

The amended statute further provides that multistate income is apportioned and allocated under G.S. Section 105-130.4 (concerning the allocation and apportionment of income for *corporations*).

This conceptual shift is significant. The former statute attempted to identify a "resident trust" through the presence of resident beneficiaries. The amended statute now focuses primarily on whether ***income itself*** has a sufficient connection to North Carolina. In practical terms, North Carolina has largely moved from a beneficiary-nexus regime to a source-income regime.[1]

THE GENERAL ASSEMBLY ULTIMATELY ACCEPTED THE PRACTICAL CONSEQUENCES OF KAESTNER

An interesting aspect of the legislation is what it does not do.

Following *Kaestner*, policymakers considered several alternative jurisdictional models.

- In 2015, Senate Bill 468 would have relied upon a combination of a resident beneficiary and a North Carolina principal place of administration.
- In 2020, the Department of Revenue circulated a probably unconstitutional proposal that purported to create the broadest fiduciary income tax base in the country: relying upon resident beneficiaries together with several additional connections, including trustee residency, trust administration, and retained powers of a resident grantor.
- In 2021, a draft proposal supported by members of the banking industry, focused on where trusts were administered: specifically, where investment and distribution decisions were being made.
- In 2022, the Department of Revenue formally proposed taxation of trusts based on administrative activities of trustees in North Carolina.

Following a final proposal by the North Carolina Department of Revenue, the General Assembly ultimately adopted none of these approaches.

Instead, rather than attempting to identify a constitutionally sufficient definition of a "resident trust," the legislature largely shifted its attention to source income. That outcome is noteworthy.

While Section 1.3 of Session Law 2026-31 never expressly endorses Kaestner, the legislation reflects the profound difficulties associated with taxing accumulated trust income based solely upon beneficiary residence. Also, the legislation reflects a practical acceptance of the competitive economic needs of the fiduciary services industry in North Carolina (i.e., such that resident trustees and trust administration activities do not attract taxation) and the challenges of identifying where trust administration decisions are made in a modern, highly decentralized economy.

1 When it has the opportunity to issue updated instructions to 2026 Form D407, practitioners reasonably can expect the NC Department of Revenue to confirm the plain reading that North Carolina solely is taxing fiduciaries on Source Income under the new statute.

THE NEW FRONTIER: WHAT CONSTITUTES NORTH CAROLINA SOURCE INCOME?

While *Kaestner* largely resolved the constitutional debate, Session Law 2026-31 inaugurates a new analytical challenge. The principal question for fiduciaries is no longer:

> "Is this trust or estate taxable because it has a North Carolina beneficiary?"

Instead, the critical question becomes:

> "Does this trust or estate have North Carolina source income?"

For many trusts and estates, the answer will be straightforward.

Examples of "North Carolina source income" likely include:

- Rental income from North Carolina real estate.
- Gain from the sale of North Carolina real property.
- Timber operations conducted in North Carolina.
- Business income earned through operations physically conducted within North Carolina.
- Pass-through income allocable to North Carolina business activities

Difficult issues and fiduciary income tax planning opportunities arise when trust or estate assets consist of an ownership interest in a business and that ownership interest produces different types of income.

THE CONTINUING IMPORTANCE OF FIELDING

One of the most useful cases moving forward may be Fielding v. Commissioner of Revenue, 916 N.W.2d 323 (Minn. 2018), a parallel case moving through the court system at the same time as Kaestner.

Although Fielding is commonly viewed as a constitutional nexus case, its greater contribution may be its rigorous distinction between a Texas trustee's receipt of income from a Minnesota operating business as compared to capital gains derived from the sale of its ownership of equity of that same company–an intangible property interest.

That distinction becomes particularly significant under a source-income regime.

CONSIDER TWO EXAMPLES:

Example One: Operating Income

Suppose a trust owns stock in an S Corporation conducting manufacturing operations in North Carolina. To the extent annual distributions are derived from North Carolina operations, that income likely constitutes North Carolina source income.

Example Two: Sale of the Ownership Interest

Now assume the trust sells some or all of its partnership interest. The trust is no longer earning operating income. Instead, the trust has sold a partnership interest, which is an intangible asset. The investment asset sold is not inventory, machinery, real estate, or business operations.[2]

Historically, many states have distinguished between income generated by a business and gain realized from the sale of an intangible equity interest in that business. Under those authorities, gain from disposition of stock, partnership interests, and limited liability company interests often receives treatment different from income generated by the underlying enterprise. That distinction may become one of the most important fiduciary income tax issues in North Carolina in the coming decades.

2 Query whether the "hot asset" analysis applicable to entities taxed as partnerships affects simply the character of income—ordinary vs. capital gains—or might it affect whether such income is derived from a NC trade or business for state income tax purposes?

The distinction between business income and gain arising from the sale of an ownership interest is not merely theoretical. In *Fowler v. North Carolina Department of Revenue*, the Court of Appeals affirmed the trial court's determination that the taxpayers had established Florida domicile before the February 2006 sale of the majority interest in Commercial Grading, a North Carolina company. The controversy involved gain from the sale of the taxpayers' ownership interest rather than income generated by the company's ongoing operations. Although *Fowler* was a domicile case rather than a fiduciary income tax case, it highlights a concept likely to take on increased importance under amended G.S. § 105-160.2: ownership interests in corporations, partnerships, and limited liability companies are intangible assets, and gain from their disposition may require an analysis different from the sourcing of income earned by the underlying business itself.

PRACTICAL PLANNING IMPLICATIONS

For estate planners and fiduciary advisors, the legislative change presents both opportunities and responsibilities. First, trust situs planning remains important, but beneficiary residence becomes substantially less significant. Second, practitioners should review closely held business structures with renewed attention to sourcing consequences. Third, transactions involving partnership interests, LLC interests, family limited partnerships, carried interests, private equity structures, and installment sales deserve careful analysis. Fourth, trustees should avoid automatically assuming that all business-related income is North Carolina source income merely because a business operates in North Carolina. The nature of the asset generating the income remains critical.

The distinction between:

- Operating income
- Rental income
- Portfolio income
- Gain from the sale of tangible assets
- Gain from the disposition of intangible ownership interests may prove outcome determinative

CONCLUSION

In 2015, the North Carolina Business Court identified constitutional defects in North Carolina's fiduciary income tax system. This result was affirmed by the North Carolina Supreme Court (2018) and the United States Supreme Court (2019).

Between 2015 and 2026—with significant, active input from members of the Estate Planning and Fiduciary Law section throughout—legislators, financial institutions, fiduciaries, and tax practitioners debated multiple alternative approaches. Numerous legislative proposals attempted to define a constitutionally sufficient resident trust, but none ultimately prevailed.

Instead, the General Assembly chose a different path. With the enactment of Session Law 2026-31, North Carolina largely abandoned beneficiary-based fiduciary income taxation and embraced a source-income approach.

For fiduciaries and their advisors, the principal question is no longer whether a trust has a North Carolina beneficiary. Rather, the principal question is whether the trust has North Carolina source income. As a result, while nationally the impact of Kaestner is far-reaching, it may no longer define the future of North Carolina trust taxation. Rather, its lasting contribution may be that it forced policymakers to ask a different question entirely—and eventually led North Carolina to a different system of fiduciary income taxation altogether.

Carl L. King
Partner

+1 704.331.4940
carl.king@wbd-us.com

Carl L. King is a partner with Womble Bond Dickinson (US) LLP in its Charlotte office, where he helps lead the firm's Private Wealth team. Carl served as one of four principal drafters for the Amicus brief of the American College of Trust and Estates Counsel (ACTEC) to the U.S. Supreme Court in Kaestner. At ACTEC, Carl serves in a leadership role on the Fiduciary Income Tax substantive law committee. Carl is a member of the Executive Committee of the Council of the Estate Planning and Fiduciary Section of the NCBA, and he is a board-certified specialist in Estate Planning and Probate Law. Carl authored three prior articles about Kaestner and North Carolina's Fiduciary Income Tax in the Will and the Way on June 2015, August 2018, and March 2020.

Carl is deeply grateful to his fellow sub-committee members, Mike Godwin, Esq., and Edward Griggs for their valuable contributions to this article and to the legislation it discusses.