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Jeffrey Schoenblum*

With the maximum rate of federal income tax at 39.6 percent, the Medicare surtax on investment income of 3.8 percent, and some state income tax rates exceeding 9 percent, taxpayers in the highest brackets have been seeking to develop strategies to lessen the tax burden. One strategy that has been receiving increased attention is the use of a highly specialized trust known as the NING, a Nevada incomplete gift nongrantor trust, which eliminates state income taxation of investment income altogether without generating additional federal income or transfer taxes. A major obstacle standing in the way of accomplishing this objective, however, are the laws of a number of high-tax states. These laws assert taxing jurisdiction over trusts created by grantors who were resident in the state when the trust was created, even if the grantor has long since departed the state or if the trust has been continuously administered from out of state. Other high-tax states claim jurisdiction to tax the trust as long as there is a beneficiary resident in the state at the time that the income is being accumulated out-of-state or at the time a distribution is made. One state, New York, simply outlaws the NING technique. In order to overcome these state laws, tax planners have found an unlikely ally—federal constitutional law. This Article explores whether and how the Federal Constitution can be used to avoid state income taxation. As it makes clear, interpretations of the Federal Commerce and Due Process Clauses, though developed in other contexts, are proving to be powerful tools in neutralizing state jurisdiction to tax high-bracket taxpayers.

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taxpayers with substantial investment income and an out-of-state trust such as a NING.

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I. INTRODUCTION

Presently the maximum rate of federal taxation of taxable income is 39.6 percent.1 With the Medicare surtax on investment income of 3.8 percent,2 the federal tax rate can exceed forty-three percent. The state3 tax in states such as California4 and New York5 can easily exceed twelve percent. The combined federal-state share of taxable income can, thus, be fifty-five percent or more.6 Even when a state has a relatively benign rate of income taxation, a sale of a highly appreciated asset can result in a significant state tax burden in absolute dollars that is added to the federal tax due.7

In light of the foregoing, it should come as no surprise that taxpayers have been incentivized to pursue strategies that reduce or eliminate the overall take of Government. For the individual with investment income, one such option is the use of an out-of-state, nongrantor accumulation trust that avoids all states’ income taxes. In particular, a Nevada Incomplete Gift Nongrantor Trust (“NING”) has recently received considerable attention and actually garnered IRS approval.8

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3. All references in this Article to the states include the District of Columbia.
5. The maximum rate of New York State tax is 8.82 percent. See, e.g., N.Y. TAX LAW § 601(a)(1)(A) (McKinney 2013) (married individuals filing jointly and resident surviving spouse). New York City imposes its own tax at a maximum marginal rate of 3.876%. See id. § 1304(b)(1)(a) (married individuals filing jointly and resident surviving spouse). Thus, the combined rate of tax could exceed twelve percent.
6. The actual rate is effectively reduced somewhat to the extent that a deduction is claimed at the federal level for state and local income taxes paid. See I.R.C. § 164(a)(3). However, for purposes of the federal alternate minimum tax, state and local taxes are not permitted as a deduction. See id. § 56(b)(1)(A)(ii).
7. Unlike federal tax law, even long-term capital gains are typically taxed at the same rate as ordinary income under state tax laws.
The NING is designed to be an independent taxpayer for tax purposes, separate and apart from the settlor. This is crucial, because if the settlor retains certain strings of control, the trust is likely to be regarded as a “grantor trust.” In such case, the trust is ignored for income tax purposes—the settlor is deemed still in effective control. As a consequence, all income, even if accumulated in trust, will be attributed to the settlor.

The grantor trust rules set forth in the Internal Revenue Code have been, with just a few exceptions, enacted as part of state income tax laws. Accordingly, there will be no state tax savings if the trust is treated as a grantor trust. To avoid grantor trust status, the NING is drafted so that strings of control, notably the power to make distributions, are either held exclusively by beneficiaries with substantial interests, such as members of settlor’s family, or shared by the settlor and these beneficiaries. These beneficiaries are deemed “adverse parties” vis-à-vis the settlor under both the Code and state tax laws that mirror the Code’s grantor trust provisions. The assumption is that adverse parties, being economically self-interested, will not approve distributions to the settlor that have the effect of diminishing their own interests in the trust. Because of these adverse interests, the NING is a nongrantor trust rather than a grantor trust. On the other hand, in reality, the settlor retains practical control in many of these situations because adverse parties, especially younger family members, are likely to comply with the perceived or stated wishes of the settlor.

The nuanced drafting that avoids grantor trust status for income tax purposes is not the end of the story. The settlor’s retention of strings of control may also impact the NING’s treatment under the federal gift tax. Indeed, a properly crafted NING is something of a sleight of hand, a successful navigation of a Scylla and Charybdis of tax law—giving up income-tax states use out-of-state trusts to avoid such taxes and those high income-tax states’ responses.


10. The term “settlor” is used throughout this Article to refer to the person who creates the trust by transferring assets to the trustee. The Code uses the term “grantor,” which in most respects is interchangeable with the term “settlor.”

11. See I.R.C. § 672(a), which provides in relevant part: “For purposes of this subpart, the term ‘adverse party’ means any person having a substantial beneficial interest in the trust which would be adversely affected by the exercise or nonexercise of the power which he possesses respecting the trust…” Thus, an adverse party may also be another beneficiary of the trust other than the settlor.

12. The reasons that they would be on board are numerous and may vary from one trust to another. As an example, the settlor may have other wealth and the failure to cooperate may jeopardize receipt of the other wealth by inheritance or otherwise. Alternatively, they may have deep respect for a parent or grandparent settlor and willingly accede for that reason.
sufficient strings of control so the settlor is not taxed on the income, while not giving up too many strings of control so that the transfer of assets to the trustee is a taxable transfer under the federal gift tax.

Fortunately, a tax arbitrage opportunity exists for sophisticated planners. The federal income tax and the federal gift tax are not in pari materia on the question of the quantum of control that results in a transfer's being deemed complete or not. The NING capitalizes on this arbitrage opportunity by denying the settlor sufficient strings of control so that the trust is a nongrantor trust for federal income tax purposes, but preserves for the settlor certain strings of control that are only pertinent to the federal gift tax. These strings of control make the transfer incomplete and, thus, not a taxable gift for federal gift tax purposes.

Even then, the NING is not for everyone. At the federal level, the income taxation of a nongrantor accumulation trust is especially punishing. For example, income earned in 2014 by such trusts is subjected to the maximum 39.6 percent marginal rate of federal income taxation once taxable income exceeds $12,150. By way of contrast, assuming no trust, an individual taxpayer faces the maximum marginal rate of taxation only for taxable income for the year in excess of $406,750. Accordingly, the additional cost of using the trust when there is at least $406,750 of taxable income is $41,283.35 for taxable years beginning in 2014.

But that additional federal tax cost might be worth incurring if offset by even greater state income tax savings. In fact, under the proper circumstances, such state income tax savings greatly outweigh the additional federal tax cost. A simple example establishes this. Suppose the state tax rate is a flat ten percent. Securities having a value of $20 million are transferred into trust. The securities produce annual net income of eight percent, or $1.6 million. The tax each year would be $160,000. This amount is nearly four times the additional tax cost, $41,283.35, imposed under federal law for using a nongrantor

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13. This lack of congruence between the federal income tax and federal gift tax has long been recognized. See, e.g., Galt v. Comm'r, 216 F.2d 41, 44 (7th Cir. 1954); Farid-Es-Sultaneh v. Comm'r, 160 F.2d 812, 814–15 (2d Cir. 1947).
14. For a detailed discussion of the various types of strings of control that pass or do not pass muster and other technicalities associated with the NING, see infra Part III.
16. In the case of a married couple filing jointly in 2014, the maximum rate comes into play when taxable income exceeds $457,600. See I.R.C. § 1(a); Rev. Proc. 2013-35, 2013-47 I.R.B. 537. As for the 3.8 percent Medicare surtax on investment income, it kicks in at two hundred thousand dollars for a single taxpayer and two hundred fifty thousand dollars for joint filers. In other words, it works off the unadjusted rate table in I.R.C. § 1 without any cost-of-living adjustment.
accumulation trust. Even taking into account the administrative costs associated with the trust, the savings are substantial and translate into a meaningful increase in the net return on investment. Further, these savings can be reinvested each year to produce additional income that will not be subject to state tax either. Meanwhile, the federal tax cost of using a nongrantor trust each year effectively remains static.

Alternatively, suppose the taxpayer in the hypothetical transfers into trust the shares of a privately owned company, which shares have a zero basis. When it goes public, the trust realizes $100 million in exchange for its shares. The taxpayer avoids a total of $10 million in state income taxes. As this example establishes, the additional federal tax cost incurred in using the NING is insignificant compared with the state tax savings that the NING delivers.

But the NING is not the only vehicle for attaining significant state income tax savings. For example, assume that an individual establishes a revocable trust during his lifetime. There are any number of nontax reasons for doing so.\(^{17}\) Since the settlor typically has a power to revoke throughout the settlor’s lifetime, the trust is deemed a grantor trust for federal income tax purposes and trust income is reported as part of the gross income of the settlor individually.\(^{18}\) As noted, almost all states adhere to these grantor trust rules and therefore will not recognize the trust as a taxpayer separate from the settlor in this situation.

Notwithstanding the foregoing, upon the death of the settlor, the revocable trust becomes irrevocable; that is, the trust becomes a nongrantor trust, inasmuch as the settlor no longer exercises strings of control. The trust is now the taxpayer, and if established and administered in the settlor’s home state, its investment income may well be subjected to a high rate of taxation. By removing the trust to another state, one that will not tax the trust’s income, substantial savings may be available, as demonstrated by the examples previously discussed.\(^{19}\) Moreover, in this case, the gift tax concerns that dog the NING at its creation are not present. There is no gift during the settlor’s lifetime, as he or she maintained control. At the settlor’s death, however, the trust asset value is subjected to inclusion in the settlor-decedent’s gross estate.\(^{20}\) Having incurred the transfer tax cost, the focus can now be exclusively on reducing the state income tax cost.


\(^{18}\) See I.R.C. § 676.

\(^{19}\) See supra text accompanying note 16.

\(^{20}\) See I.R.C. § 2038.
A second nongrantor trust situation would be one in which an irrevocable trust was purposefully created, notwithstanding the taxable gift involved. The typical goal here is to remove assets from the estate early on and to transfer them to a separate taxpayer, the trust, before the assets significantly appreciate and thereby generate a higher estate tax at death than the gift tax the assets would have generated had they been transferred during life. In this case, avoidance of the gift tax is not a concern as in the case of the NING, since the goal is to complete the gift. While this may, in fact, reduce the transfer tax burden, it does not reduce the state income tax burden. Again, by situating the trust in an appropriate state or moving to that state, state income taxes can be eliminated altogether.\(^2\)

Regardless of whether a NING, a revocable trust turned irrevocable accumulation trust, or another nongrantor accumulation trust is involved, the fact that the trust has found a home in a state that does not tax is not the end of the story. For example, the state in which the settlor of the NING resides, or the state in which the settlor of a revocable trust resided when he or she died and the trust became a nongrantor trust, may seek to tax. But can the state do so?

At one level, the foregoing question can be answered by consulting the relevant state statute that sets forth the state’s taxing jurisdiction. At another level of analysis, however, there is the question of whether or not that state statute goes too far as a federal constitutional matter. The principal concern of this Article is this federal constitutional question and how it may facilitate the use of the NING and other trusts to avoid all state income taxation on investment income. Before delving into this question, the Article seeks to provide the reader with the relevant foundation.

\(^2\) But does nontax trust law permit an irrevocable trust established in one state to move freely to another, more tax-favorable state? In fact, the Uniform Trust Code § 108(d) permits a transfer without court approval, so long as “qualified beneficiaries” are notified and none object. This is the case even if the purpose of the move is “to secure a lower state income tax rate.” UNIF. TRUST CODE § 108 cmt. (amended 2010). Other states have similar laws so that a solid majority do not require judicial consent. Peter Gordon, Nonjudicial Transfer of Trust Situs Chart, ACTEC (July 9, 2012) http://www.actec.org/public/Documents/Studies/Gordon_Transfer_of_Situs_and_Governing_Law_July_2012.pdf, archived at http://perma.cc/37FU-DY4Q (the chart is an excellent starting point, but the law in each state must be confirmed on an ongoing basis). Hawaii is one state that requires such approval when there is no provision in the instrument and, very possibly, even if there is such provision. See HAWAII REV. STAT. ANN. § 560.7-305 (LexisNexis 2014).

Note that the Uniform Trust Code actually imposes a duty on the trustee “to administer the trust at a place appropriate to its purposes, its administration, and the interests of the beneficiaries.” This duty is “continuing.” UNIF. TRUST CODE § 108(b). The comment accompanying § 108 recognizes that changing circumstances may require a move. Indeed, the trust will need a specific provision to the contrary if the trustee is to be denied the power to move the principal place of trust administration. Id. cmt.
Part I of this Article explores how the structure and operation of an out-of-state nongrantor accumulation trust gives rise to contacts with multiple states and how this, in turn, may afford a basis for more than one state to tax the income of the trust. However, notwithstanding this potential of an out-of-state trust to breed multiple-state taxation, the reality is very different.

Indeed, Part II details the actual contacts that particular states rely upon to delimit their taxing jurisdiction consistent with federal constitutional requirements. In addition to organizing the states into ten categories based on the contacts they rely upon for exercising tax jurisdiction, this Part reveals a very critical conclusion that emerges from a comprehensive study of the state tax laws: in most instances, the states tend to delimit their taxing jurisdiction more than is constitutionally required. This phenomenon opens the way for their citizens to utilize out-of-state nongrantor accumulation trusts to avoid home-state taxation of investment income entirely and to sidestep taxation by other states as well.

But this is not true of all states. Part II reveals that several categories of states, in a determined effort to preserve their tax base, assert taxing jurisdiction rather aggressively. These states fall into two principal categories—(i) those that continue to tax even long after the settlor, beneficiaries, trustee, and assets have all departed the state; and (ii) those that seek to reach the income of an out-of-state trust due to the presence of resident beneficiaries at the time the income is earned by the trust or eventually distributed to those beneficiaries. As shall be seen, the federal constitutional validity of taxing based on these attenuated contacts has been challenged in court, sometimes successfully. Meanwhile, New York, arguably bypassing its own judicial precedent, has recently declared a NING a grantor trust for state income tax purposes at the very same time the Internal Revenue Service has been issuing private letter rulings to the contrary. The constitutionality of the New York statute is ripe for challenge.

Part III of the Article describes the basic design and operation of the NING version of the out-of-state nongrantor accumulation trust, which is being utilized to avoid state income taxes altogether. This Part also demonstrates how relatively uncomplicated it is for a nongrantor accumulation trust to change its “home” and, in the process, to escape another state’s taxing jurisdiction.

Part IV of the Article hones in on an especially troubling problem—the striking disparity in interpretation and application of federal constitutional law with respect to the limits of state taxing jurisdiction over out-of-state nongrantor accumulation trusts. It identifies a largely ignored statute—the Tax Injunction Act—as the
principal culprit. That statute essentially places exclusive jurisdiction in the states to decide the scope of their taxing powers. In so doing, it removes from federal courts the power to resolve conflicting state determinations as to the extent of state taxing jurisdiction. Part IV considers the extent to which this exclusion of federal courts has produced disarray in the constitutional doctrine.

Building upon the first four parts of this article, Part V comes to grips with the constitutional doctrine itself. In particular, consideration is given to several critical state court decisions of quite recent vintage. Tax avoiders using out-of-state trusts have succeeded in overturning longstanding state tax jurisdiction statutes on Commerce Clause and Due Process grounds. This Part of the Article analyzes in some detail the constitutional arguments that have prevailed. These decisions, however, have clustered around a certain set of facts. There remain other circumstances that have received less thorough consideration and remain open questions.

Part V, therefore, also considers how constitutional doctrine should be applied in three situations that are currently being vigorously disputed—(i) when the state taxes income on the basis that the settlor was domiciled, or a resident there when the trust was created, or became irrevocable; (ii) when the only contact with the state is that there is a resident beneficiary; and (iii) when a statute, like the one in New York, categorically reclassifies a NING or similar trust as a grantor trust.

Part V of the Article also delves into the federal constitutional limitations on the enforcement of one state’s tax judgment in another state. While the Full Faith and Credit Clause is often assumed to require enforcement of other state judgments, there are limits. Thus, even if a state has constitutionally sound taxing jurisdiction, it may find itself severely hobbled in seeking to enforce a judgment against a trust no longer resident in the state and without beneficiaries resident in or valuable assets situated in the state.

Finally, Part V notes another critical contributor to the constitutional disarray that exists—the failure of the U.S. Supreme Court to resolve these issues. Indeed, the Court has not issued an opinion bearing on the jurisdictional limits of state power to tax the income of an out-of-state trust for more than seventy years.

The Article ends with the Conclusion. The Conclusion summarizes the key points derived from the prior Parts and considers in broader perspective the role that federal constitutional law plays. In particular, the Federal Constitution’s role is increasingly one of facilitating the avoidance of all state income taxes via use of the out-of-state nongrantor accumulation trust.
II. Why a Trust Is a Potential Breeder of Multiple State Tax Liability

A nongrantor trust created during the life of the settlor invariably holds the potential to breed multiple state tax liabilities. A simple example reveals why. Suppose a settlor creates a nongrantor trust while domiciled in state A. He transfers publicly traded securities, interests in mutual funds, and an art collection situated in state A into trust. The trustee is a trust company with offices in state C, from which it administers the trust. The beneficiaries are the settlor’s spouse, who also resides in state A, as well as his children and grandchildren, some of whom are minors and reside with their parents at the situs of the creation of the trust in state A. Other beneficiaries are scattered throughout the United States, residing in states B, D, E, F, and G.

Based on the foregoing, there are as many as seven states—A, B, C, D, E, F, and G—that can claim varying degrees of contact with the trust. These contacts can be classified as residence of settlor, residence of beneficiary, situs of assets, and situs of administration of the trust. With respect to this last contact, if a trust is administered from state C, but the trustee has its worldwide headquarters in state X, the trust’s tax residence is likely to be held to be the place from which the trust is primarily administered during the taxable year and not the trustee’s worldwide headquarters.22

With respect to the settlor and the beneficiaries, what are their “residences” for tax purposes? Often, albeit not always, the tax statute will offer a definition comprised of two alternatives: (i) the traditional concept of domicile, and (ii) statutory residence hinging on the number of days during the year that the taxpayer was present in the state. The satisfaction of either will result in classification as a resident.

A problem of multiple taxation can arise if two different states determine that an individual is a tax resident. Especially since many factors can enter into a determination of domicile, each state can decide the individual is a domiciliary. Alternatively, one state may tax on the basis of domicile and the other on the basis of physical residence in the state for the requisite number of days during the year. As long as each state has made a reasonable determination, each can tax on the basis of residence status, notwithstanding the double taxation. In particular,

22. But see N.Y. TAX LAW § 605(b)(3)(D) (McKinney 2013), which treats a trust as nonresident if all of the trustees are domiciled outside of New York.
the Supreme Court has refused to intervene and resolve the conflicting state determinations of tax residence.\(^{23}\)

The foregoing contacts may alter and may even extend to new states over time. For example, suppose the settlor departs from state A and settles in state H. Almost all of the art collection is removed from state A to state H. The beneficiaries, especially as they attain adulthood, scatter even further across the country. During this period their stakes in the trust also change. Initially, some of the beneficiaries were contingent or discretionary beneficiaries, but with the death of the grantor’s spouse, certain interests vest in the children—for example, a mandatory share of annual net income followed by a principal distribution at a specified age.\(^{24}\)

The changing array of state contacts detailed above, upon initial consideration, ought to deter the less-than-committed client and his planner from resorting to an out-of-state nongrantor accumulation trust. There seem to be just too many contacts to avoid, and the risk of multiple state taxation looms too large. Many of these contacts are beyond the client’s control, as they involve lifestyle decisions of other family members, who may not be prepared to defer to the settlor. Nevertheless, the considerable self-restraint shown by most states with respect to the exercise of taxing jurisdiction, plus federal constitutional doctrine, assures that concerns about multiple taxation can, in most instances, be addressed successfully.

One potential fly in the ointment ought to be income derived from intangible investment assets. As a federal constitutional matter, more than one state can tax intangibles. This was the holding of the Supreme Court in *Curry v. McCanless*,\(^{25}\) which based its holding on the fact that an intangible has no obvious and solitary situs. A state may tax the intangible if it affords some benefit, protection, or power to a person who has an economic interest in the intangible. At a bare minimum, an intangible asset can, therefore, be taxed by the owner’s

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\(^{23}\) Although arising in the estate tax context, the language of the Court would seem to apply as well to the income tax. See, e.g., *Cory v. White*, 457 U.S. 85, 89 (1982) (stating that an earlier decision, *Worcester County Trust Co. v. Riley*, 302 U.S. 292 (1937), held that “there could be no credible claim of a violation of federal law since it was clear from prior cases that inconsistent determinations by the courts of two states as to the domicile of a taxpayer did not raise a substantial federal constitutional question”); see also *Tamagni v. Tax Appeals Tribunal*, 659 N.Y.S.2d 515 (App. Div. 1997), aff’d, 673 N.Y.S.2d 44 (N.Y. 1998) (holding that New York could tax income from intangibles based on statutory residence, even though the owner of the intangibles was actually domiciled in New Jersey).

\(^{24}\) The nature of the beneficiary’s interest may prove critical for purposes of state income tax jurisdiction. For example, California seeks to tax at least a portion of the income of an out-of-state nongrantor accumulation trust that has a beneficiary resident in California but not if the beneficiary’s interest is contingent. See *Cal. Rev. & Tax Code § 17742(a)* (West 2013).

domicile. The benefits and protections afforded by the domicile state are always deemed sufficient to justify the taxation of the owner. Presumably other states, such as the state where the underlying entity that has issued the intangible asset is organized, could also tax.

Curry v. MeCanless was a transfer tax case. In the context of state income tax, there has been an interesting and crucial development—virtually every state now has a constitutional or statutory provision that treats intangibles, at least in the income tax setting, as situated exclusively at the owner’s domicile or statutory residence, except when used in a trade or business operating locally. This assures that only one state will exercise taxing jurisdiction over the income derived from the intangible investment asset, assuming no dispute over domicile.

In the case of an out-of-state nongrantor accumulation trust, such as a NING, the ownership and strings of control over the intangible investment assets are shifted to the trustee, who is a resident of a state that does not tax the income from the assets. The ability to change the situs of intangible investment assets by shifting ownership to the trustee of an out-of-state trust is a central component of the tax avoidance strategy considered in this Article.

In sharp contrast to investment income derived from intangibles, constitutional principles have long confirmed that income earned through the provision of services is taxable wherever it is earned, that is, its source. The same is true for trade and business income and rents and royalties from real property and tangible personal property. This does not mean that the state of actual domicile or statutory residence of the owner is itself foreclosed from taxing such

26. Interestingly, the case involved a trust administered in Alabama. When the settlor, a domiciliary of Tennessee, died, she exercised a general power of appointment that altered the terms of the trust. Accordingly, Tennessee included the trust property subject to the power in her estate. Alabama also taxed the property on the theory that it was being administered in an Alabama trust at the time of her death. Id. at 361.

27. See, e.g., N.Y. CONST. art. XVI, § 3 (“Moneys, credits, securities and other intangible personal property within the state not employed in carrying on any business therein by the owner shall be deemed to be located at the domicile of the owner for purposes of taxation . . .”).


[T]he very fact that a citizen of one state has the right to hold property or carry on an occupation or business in another is a very reasonable ground for subjecting such nonresident, although not personally, yet to the extent of his property held, or his occupation or business carried on therein, to a duty to pay taxes not more onerous in effect than those imposed under like circumstances upon citizens of the latter state.; see also Zelinsky v. Tax Appeals Tribunal, 801 N.E. 2d 840, 844 (N.Y. 2003) (holding that New York could tax the compensation of a law professor who lived in Connecticut but taught in New York, as long as the tax was fairly apportioned based on days worked in the state during the tax year).
The risk of multiple state taxation looms large. However, this problem of multiple taxation is averted in the case of income derived from intangible investment assets.

III. STATE JURISDICTIONAL BASES FOR TAXATION OF INTER VIVOS IRREVOCABLE TRUSTS

As a by-product of federalism, each state is able to design its own tax laws, to determine the extent of its own taxing jurisdiction, and to compete for capital from other states. Consequently, there is considerable variety in state tax laws. This patchwork of rules rewards the opportunistic states, as well as the individuals who choose to shift the situs of ownership of their capital to such states via the trust vehicle.

As has already been discussed, a trust may have substantial contacts with any number of states. Nevertheless, many states have chosen to delimit their own taxing jurisdiction to well within constitutional confines, thereby encouraging efforts to avoid the state’s tax through a variety of techniques such as the use of an out-of-state nongrantor accumulation trust. For the citizens of most states, then, tax avoidance with respect to investment income through the use of the out-of-state accumulation trust mechanism is easily achievable. The following analysis demonstrates this proposition.

1. No tax under any circumstances: Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming. There is no reason to use an out-of-state nongrantor accumulation trust since no tax is imposed on residents of these states.

2. No tax as long as there is no resident trustee and/or no trust administration in the state: Arizona, Colorado, Hawaii, Indiana, Iowa.

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29. See, e.g., Cohn v. Graves, 300 U.S. 308, 313 (1937) (holding New York could tax the rental income of a New York resident derived from New Jersey realty); Lawrence v. State Tax Comm’n, 286 U.S. 276, 280–81 (1932). Certiorari was granted by the Supreme Court earlier this year in a case that raises the issue whether the county of residence must afford a credit for taxes imposed by the source state under constitutional principles, especially the Commerce Clause. See Md. State Comptroller of the Treasury v. Wynne, 64 A.3d 453 (Md. Ct. App. 2013), cert. granted, 134 S. Ct. 2660 (May 27, 2014) (No. 13-485).

30. See supra Part II.

31. See Shaffer, 252 U.S. at 50.

32. See supra Part II.

33. Iowa’s law is a bit more intricate. See IOWA ADM. CODE r.701-89.3 (2014). The tax can be sidestepped if the trustee is not resident in the state, the trust is not being administered in the state, and evidence of ownership of intangibles is not kept in the state.
Kansas, Kentucky, Mississippi, Montana, New Mexico, New Jersey, Oregon, South Carolina, and Utah. In these states, an out-of-state nongrantor accumulation trust thus readily avoids home-state tax on investment income.

3. No tax as long as there is no resident trustee and/or no trust administration in the state. However, this is true only if state law is not designated by the trust instrument as the governing law: Louisiana.

4. No tax if there is no administration of the trust in the state, and there is no real or tangible personal property situated in state: Idaho.  

5. No tax, as long as a beneficiary is not resident in the state: Delaware, Georgia, New Hampshire, North Carolina, Rhode Island, and Tennessee. Accordingly, there is no need for an out-of-state nongrantor accumulation trust, assuming no resident beneficiary. Who is a “resident” beneficiary? In Delaware, a beneficiary would have to maintain a place of abode in the state and also spend more than 183 days in the state during the taxable year.


35. Idaho actually has a multi-factor trust. The trust is a resident if three of the following factors are present: domicile or residence of the grantor; Idaho governing law is designated for the trust; trust property with a situs in the state; domicile or residence of the trustee in the state; and administration of the trust in the state. IDAHO ADMIN. CODE r. 35.01.01.035 (2014) There is no clear indication that the grantor and the trustee have to be domiciled or resident in Idaho, for example, when the trust is created or in the taxable year. See id.

36. The tax is limited to dividend and interest income. See N.H. REV. STAT. ANN. § 77:10 (2014).


38. Residency of the beneficiary is determined at the close of the trust’s taxable year. If income is being accumulated for a group of beneficiaries, the trust is resident if anyone is a resident beneficiary, to the extent of “accumulated income pertaining to the resident beneficiary or beneficiaries.” 46-050 R.I. CODE R. § 910 (2014). How this is to be determined is set forth in a series of examples that need to be carefully considered in drafting a trust that will have a Rhode Island beneficiary. In addition there is a throwback rule. Id.

39. The tax is imposed only on dividends from stock and interest from bonds. See TENN. CODE ANN. § 67-2-102 (2014).

40. See DEL. CODE ANN. tit. 39, § 1103(2) (2014). If the beneficiary of a resident trust is a nonresident, income distributed to such beneficiary or set aside for future distribution to the beneficiary is deductible from what would otherwise be the taxable income of the trust. See id. §§ 1635(a)-1636.
number of days to avoid that status. Of course, most beneficiaries will not be residents of the state in any event, so that, effectively, Delaware will not tax trust income.

6. No tax, as long as a beneficiary is not a resident of the state, and there is no resident trustee or trust administration in the state: California\textsuperscript{41} and North Dakota.\textsuperscript{42} Accordingly, an out-of-state nongrantor accumulation trust generally works, subject to the caveat regarding a resident beneficiary. As a practical matter, the concern about resident beneficiaries may not be all that troublesome. First, under California law, the tax is not imposed, even if the beneficiaries are resident, if they are "contingent beneficiaries."\textsuperscript{43} A discretionary interest in a trust would constitute a contingent interest and not be taxable as long as there was no actual distribution.\textsuperscript{44} Making beneficial interests discretionary is common in trust drafting and often highly desirable entirely apart from income tax planning.\textsuperscript{45}

However, upon receipt of a distribution, the beneficiary will be taxed if resident in California during the year. There are two critical provisions that make tax avoidance more difficult. First, residence is presumed if the person is a resident of California during accumulation, leaves the state within twelve months of the distribution, and returns within twelve months of the distribution.\textsuperscript{46} This makes it considerably more difficult to dodge the California tax by timing one's presence in the state during the year of distribution, as is possible in Delaware.

Second, California enforces a throwback rule with respect to out-of-state trusts.\textsuperscript{47} A throwback rule works by altering normal trust accounting. Ordinarily, a beneficiary is taxed for the current year on

\begin{footnotes}
\footnote{41. In the case of a corporate trustee, residence is where the major portion of the administration of the particular trust takes place. See \textit{CAL. REV. \& TAx CODE} § 17742(b) (West 2013).
}
\footnote{42. Also, North Dakota law must not be the designated governing law and there must not be trust assets with a situs in North Dakota. See \textit{N.D. ADMIN. CODE} § 81-03-02.1-04(2) (2014).
}
\footnote{43. See \textit{CAL. REV. \& TAx § 17742(a)}.
}
\footnote{44. See, e.g., Cal. Franchise Tax Board Tech. Adv. Memo. 2006-0002 (Feb. 17, 2006). See \textit{generally CAL. REV. \& TAx § 17745(b)}. If no taxes have been paid on the current or accumulated income of the trust because the resident beneficiary's interest in the trust was contingent, such income shall be taxable to the beneficiary when distributed or distributable to him or her.
}
\footnote{45. The reasons for doing so is to assure that creditors of the beneficiary cannot reach the assets and to control distributions to a beneficiary based on demonstrated maturity and ability to act responsibly over time. See \textit{DUKEMINER \& SITKOFF, supra} note 17, at 9-10, 688-94.
}
\footnote{46. See \textit{CAL. REV. \& TAx § 17745(e)}.
}
\footnote{47. The source of the rule is I.R.C. § 667 (2012), which no longer applies with respect to domestic trusts. The throwback rule set forth in the Internal Revenue Code was designed to eliminate the benefit of accumulations in trust when the rate of taxation imposed on a trust was less onerous than on individuals. In contrast, the throwback rule is used by California to tax income accumulated out-of-state and not taxed there or not taxed as much once it is brought back into the state for the benefit of a resident Californian.
}
the net income deemed distributed to the beneficiary. If the beneficiary receives a distribution in excess of the trust's net income, then the rest of the distribution is considered to be principal and not subject to income taxation. The California throwback rule changes this. It treats the "principal" portion of the distribution as first constituting income accumulated in prior years in the out-of-state accumulation trust, where it went untaxed.

In applying the throwback rule, accumulations for the five preceding years can be considered. They will be taxed as if received ratably over the five-year-or-shorter accumulation period, but there is no interest charged for the theoretical late payment. One offsetting benefit is that tax liability is prorated based on the relative amount of net income eventually to be distributed to the resident beneficiaries. This is a rather ambiguous measure. However, in a quite typical case of equal shares, it may avoid considerable taxes. For example, if only one of four equal income beneficiaries is resident in California at the time of the distribution, then only one-fourth of the income is subject to income taxation upon distribution to the four beneficiaries.

7. No tax as long as the settlor of the trust was not domiciled or resident in the state at time the trust became irrevocable and no beneficiary is domiciled in the state in the current tax year: Alabama, Missouri, and Ohio. Inasmuch as the first requirement could not likely be avoided, the second is crucial. Essentially, the same beneficiary issues discussed in categories 5 and 6 would have to be confronted.

8. No tax as long as the settlor of the trust did not have a domicile and/or residence in the state either at the time the trust became irrevocable due to death of the settlor or otherwise, or at the time additional property was donated to the irrevocable trust: Arkansas, Connecticut, District of Columbia, Maine, Massachusetts, Minnesota,
Nebraska, Oklahoma, Vermont,\textsuperscript{54} Virginia,\textsuperscript{55} West Virginia,\textsuperscript{56} and Wisconsin.

This requirement is the most difficult to avoid. Essentially, the trust is “forever tainted” if the settlor was domiciled/resident at the time it became a nongrantor trust. Even if there are no resident beneficiaries, trustees, or assets in the state and the settlor himself or herself has long since departed from the state, the tax will continue to be imposed and efforts will be made by the state to collect it.

The harshness of this jurisdictional standard has stimulated a spate of recent and not-so-recent cases challenging its constitutionality under the Due Process and Commerce Clauses of the Federal Constitution. Indeed, Illinois’s law recently has been held unconstitutional.\textsuperscript{57} The same is true of similar laws in Michigan\textsuperscript{58} and Pennsylvania.\textsuperscript{59} In each of these states, however, no substitute jurisdiction statute has been enacted, thus leaving the jurisdictional bases for taxing a nongrantor accumulation trust administered out-of-state entirely unresolved. This uncertainty regarding whether there are valid jurisdictional contacts for imposing tax (and, if so, what they are) prevents taxpayers with existing trusts from making enforceable claims for refunds for taxes paid based on unconstitutional grounds in prior years.

\textsuperscript{54} The Instructions to FI-161 indicate that a trust is also taxable as a resident trust, even if it previously became irrevocable in another state, if the settlor was a resident of Vermont at the time of his death. See VERMONT FIDUCIARY RETURN OF INCOME (2013), available at http://www.state.vt.us/tax/pdf.word.excel/forms/income/2013/2013FI-161-fillin.pdf, archived at http://perma.cc/KCW7-6W78 (“Resident Estate means the estate of a decedent who was domiciled in Vermont at the time of death.”). The statute indicates, however, that the trust would have to become irrevocable on account of the settlor’s death. See VT. STAT. ANN. Tit. 32 § 5811(11)(B) (2013) (stating when a trust qualifies for residency in Vermont).

\textsuperscript{55} VA. CODE ANN. § 58.1-302 (2014) provides for taxation of a trust created with property “of a person domiciled in the Commonwealth” but, unlike some other states, does not appear to require domicile at the time of creation. Thus, a person who moves to Virginia after creating a trust could be subject to tax since it would then consist of property of a domiciliary. On the other hand, when the person changes domicile from Virginia to another state the tax would cease. The trust is also subject to tax if being administered in Virginia. See 23 VA. ADMIN. CODE § 10-115-10(2) (2014).

\textsuperscript{56} The language used is similar to Virginia’s in its ambiguity, see supra note 55, as to when the settlor has to be domiciled in the state in order for the tax to be imposed.

\textsuperscript{57} See Linn v. Dept of Revenue, 2 N.E.3d 1203, 1208 (Ill. App. Ct. 2013) (holding unconstitutional the taxation of a trust with no contacts to the state of Illinois).

\textsuperscript{58} See Blue v. Dep’t of Treasury, 462 N.W.2d 762, 764–65 (Mich. Ct. App. 1990) (declaring imposition of a state tax on a trust without minimum contacts to the state to be a violation of the Due Process Clause of the Fourteenth Amendment).

9. No tax as long as the settlor is not a resident during the current taxable year: Maryland.\(^60\) If the settlor is not prepared to change “residence,” then he or she will face considerable difficulty in avoiding tax, much as in the case of a settlor in a category 8 state. However, the Maryland tax-jurisdiction statute is both more and less expansive. A settlor who creates a trust while resident in Maryland, but then leaves the state, would not continue to be subject to tax. Nor would the trust. On the other hand, the income of the trust would be subject to tax in the case of a person who was not resident when the trust was established but is resident in a year in which the trust has investment income, even though the trust was administered out of state and without resident beneficiaries.

10. The NING is treated as a grantor trust, despite being classified as a nongrantor trust for federal tax purposes: New York.\(^61\) By categorizing the NING as a grantor trust, New York has eliminated its utility as a tax-avoidance technique.\(^62\) This dramatic measure, taken in response to rising concerns about the impact it could have on revenues, was not the only attack on out-of-state trusts. New York has also now introduced a throwback rule, largely modeled on California’s law,\(^63\) when a distribution is made to a New York resident beneficiary. Prior to these changes, nongrantor accumulation trusts could successfully avoid New York taxation if the trustee was not domiciled in the state, there were no assets of the trust in the state, and all income and gains were derived from or connected with sources outside the state, which would include intangible investment assets held in the trust.\(^64\)

Based on the foregoing analysis, it should come as no surprise that the most controversial statutes, constitutionally speaking, are (i) those that allow taxation even though all contacts with the state have

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\(^{60}\) See MD. CODE ANN., TAX-GEN. § 10-101(k)(1)(ii)(2) (LexisNexis 2014) (declaring fiduciary of a trust as a resident if “the creator or grantor of the trust is a current resident” of Maryland). Thus, it is possible to avoid the tax after trust creation by the settlor changing state residence. However, if the trust is administered in Maryland, it will be subject to tax. See id. § 101(k)(1)(ii)(3) (stating a fiduciary of a trust is a “resident,” thus subject to state tax, if the trust is primarily administered by the state). As for residence, a change could prove difficult, since it would exist if the settlor is domiciled there on the last day of the year or maintained a place of abode for more than six months during the year. See id. § 10-101(k)(1)(ii) (defining residency for an individual).

\(^{61}\) See N.Y. TAX LAW § 612(b)(41) (McKinney 2013) (accounting for income from an “incomplete gift non-grantor trust”—a NING—in the same manner “as a grantor trust for federal tax purposes”).

\(^{62}\) See id. § 612(b) (adding income from an “incomplete gift non-grantor trust” to the calculation of “federal adjusted gross income” for taxing purposes); infra Part VI.C.3.

\(^{63}\) See N.Y. TAX LAW § 612(b)(40).

\(^{64}\) See id. § 605(b)(3)(D) (providing the conditions under which a resident trust is not subject to taxation).
since terminated, followed by (ii) those statutes that base taxation on the residence of a beneficiary in the state in the year of receipt by the trustee or year of distribution by the trustee to the beneficiary, and finally, (iii) the New York legislation, highlighted in category 10 above.

IV. THE NING

Estate planners and other tax advisors relentlessly seek to develop and employ techniques that allow the client and his or her successors in interest to maximize returns on investment by reducing the cost of taxes. Even a 0.5 percent increase in return on an annual basis, compounded yearly and perpetually free of state tax, is significant. This is precisely what the NING is designed to accomplish.65

The NING is created in a nontax state and then is administered by a trustee there who has no connections with the taxing home state. The settlor escapes taxation by the home state, inasmuch as the settlor no longer owns the assets that produce the taxable income. Meanwhile, the new owner—the trust—also escapes taxation at its home.66

The NING is designed to insulate from all state income taxation investment income derived from intangible assets such as securities. It cannot accomplish the same with respect to income from tangible assets, such as rental income, or gains from the disposition of real estate or tangible personal property, such as works of art. Income from tangible property can be taxed at the situs of the property.67

But why does an incomplete gift nongrantor trust have to be established in Nevada, ergo, the NING? While there are any number of states, in addition to Nevada, that do not impose a state income tax,68


66. Under the laws of states that impose an income tax, a trust is typically regarded as an entity, capable of having its own tax residence, just as under federal tax law. In contrast, under classical nontax, state-trust common law, the trust is not a distinct entity. See, e.g., RESTATEMENT (THIRD) TRUSTS § 2 (2003) (defining a trust as a "fiduciary relationship" between a person and property).


That rights in tangibles—land and chattels—are to be regarded in many respects as localized at the place where the tangible itself is located for purposes of the jurisdiction of a court to make disposition of putative rights in them, for purposes of conflict of laws, and for purposes of taxation, is a doctrine generally accepted.

One possible solution with respect to an asset like real estate, which cannot be moved, is to convert it to intangible property by placing ownership in an entity, such as a limited liability company, that is organized outside of the state, possibly in Nevada as well. However, there are a number of non-income-tax reasons why this may prove unfeasible.

68. See supra Part II.1.
they are not suitable. The reason is that they do not have an appropriate asset protection trust statute.

The conundrum for the settlor of the NING is that he or she not only wants to avoid all state income taxes but also wants to retain some access to the trust estate during the trust’s existence. In other words, the NING is not designed to constitute a complete transfer involving a total relinquishment of the settlor’s interest. Basically the settlor wants to have his cake and eat it too. The problem with retaining this interest in the trust is that under the common law of trusts, as well as under the Uniform Trust Code now adopted by more than one-half of the states, creditors of the settlor can reach trust assets if the settlor retains access to the trust estate. Even if the settlor is only a discretionary beneficiary, the creditors of the settlor can reach the maximum that the trustee is empowered to distribute to the settlor in the exercise of the trustee’s discretion, whether or not a distribution is actually made. The fact that creditors of the settlor can reach the trust estate is considered an economic benefit to the settlor, since the settlor’s individual liabilities can be satisfied and the settlor thereby has more resources available to him.

Under the grantor trust rules of the Internal Revenue Code, the possibility that trust assets can be accessed to cover claims of creditors of the settlor make the trust a “grantor trust,” that is, one deemed owned by the settlor. The income of a grantor trust is included in the income of the settlor for the taxable year. Since almost all states follow the grantor trust rules, a trust that is a grantor trust for federal purposes will also be one for state-law purposes. Thus, the trust’s income will be deemed the settlor’s individual income and will be taxable based on his residence in the state.

How, then, can the settlor avoid the grantor trust rules? One obvious way is to retain absolutely no rights or powers with respect to the trust. In that case, the settlor’s current or future creditors could not reach the assets of the trust. The problem with this approach is that the

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69. See Unif. Trust Code § 505(a)(2) (amended 2010), available at http://www.uniformlaws.org/shared/docs/trust_code/utc_final_rev2010.pdf, archived at http://perma.cc/S6G7-NMGM (stating creditors have the ability to access “the maximum amount that can be distributed to or for the settlor’s benefit” from a trust).


71. See Rush Univ. Med. Ctr. v. Sessions, 980 N.E.2d 45, 52 n.3 (Ill. 2012) (“This rule has a 500-year lineage.”).


73. However, there are certain states that do not do so. These would include D.C., Pennsylvania, and Tennessee. See Schoenblum & Schoenblum, supra note 65, at 24–37.
settlor views the NING as an income tax play. The settlor actually is not prepared to give up all access to the assets in trust or their income. At a minimum, the settlor will seek to retain an interest in income and/or principal as a discretionary beneficiary. In order to retain this interest and still not have the trust classified as a grantor trust, the settlor must identify a state that allows settlors to retain such interest without access being granted to their future or hypothetical creditors. This would be a dramatic deviation from the common law and the Uniform Trust Code.

Nevada presently is the one state that affords a reliable solution. Its statute bars claims of all creditors, including those claiming spousal maintenance or support, alimony, and child support. That is not to say that other states do not also afford asset protection through special trust legislation. There are actually an increasing number of such states. However, these states’ statutes do not exclude all claims, notably those for child support. For this very reason, there is some doubt whether the Delaware alternative to the NING, appropriately named the DING, can assure nongrantor trust status for federal and state income tax purposes.

But even with respect to the NING, there is another problem. Recall that the NING is a vehicle used to avoid state income tax. The problem is that the very transfer of investment assets by the settlor to the NING trustee could result in a federal taxable gift. That does not mean necessarily that federal gift tax will be due. There is a combined gift and death transfer exclusion equal to $5.34 million in 2014. This amount is also protective of generation-skipping transfers. The settlor, in creating the NING, does not intend to exhaust this transfer tax exclusion—that would simply offset the benefit of the NING, especially since those using NINGs are likely to have transfer tax

74. See supra text accompanying notes 69–70; see also DUKEMINIER & STIKOFF, supra note 17, at 703.
77. See supra text accompanying notes 12–14.
78. See Rev. Proc. 2013-35, 2013-47 I.R.B. 537 (Section 3.32 provides: “For an estate of any decedent dying during calendar year 2014, the basic exclusion amount is $5,340,000 for determining the amount of the unified credit against estate tax under § 2010.”).
79. See I.R.C. § 2631(c) (2012) (stating the exemption amount for a GST—generation-skipping transfer). Unlike the estate tax and gift tax applicable exclusion amounts, the GST exemption amount applied to particular assets expands with the value of those assets and in that respect over time can exempt value greatly in excess of the amount originally claimed.
exposure at some point and will need to use the exclusion. Moreover, the amounts involved in a transfer may exceed the $5.34 million exclusion, or whatever portion of the exclusion still remains after the taxpayer's prior taxable gifts. Thus, the transfer of intangible investment assets to the NING might generate an actual liability to pay gift tax. This is a highly undesirable result from the standpoint of the settlor, who has turned to the NING in order to save taxes, not to generate them.

Avoiding federal gift tax is easy. The settlor could retain a host of controls that would make the transfer incomplete. The problem is retaining such controls while still making the transfer complete for income tax purposes, so that the trust is not a grantor trust and the trust's income is not imputed to the settlor. Here, federal tax law provides a pathway, accounting for the introduction of a number of highly nuanced permutations into the trust. Precisely because the federal gift tax law and federal income tax law are not in pari materia when it comes to the question of the settlor's retained control, the possibility exists of the trust being complete for income tax purposes and incomplete for gift tax purposes—an ideal result from the standpoint of the settlor and a disaster from the standpoint of state taxing authorities.

This design ordinarily results in a structure where one or more committees, of which the settlor is a member, determine distributions. The other committee members may be family members who are also beneficiaries. Rather than being regarded as pawns of the settlor, these beneficiaries are deemed adverse precisely because they are beneficiaries and would have their own interests diminished by approving a distribution to the settlor. After years of uncertainty, the IRS has recently issued several private letter rulings concluding that the creation of the NING, if properly designed, is a complete transfer for income tax purposes, and that the NING thereby avoids grantor trust status. On the other hand, the transfer into trust is incomplete for gift tax purposes, and therefore incurs no offsetting transfer tax cost. But for this best-of-both-worlds series of private letter rulings by the IRS.

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80. Initially, the IRS ruled favorably on DINGS, that is, incomplete gift nongrantor trusts administered in Delaware. See Jeffrey Schoenblum & Neil Schoenblum, Avoid State Income Tax with the Right Kind of Trusts, EST. PLAN., May 2014, at 29–30. (noting the routine approval of DINGS in the past). Then, in I.R.S. News Release IR-2007-127 (July 9, 2007), the Service called into question its own analysis. The release sought comments, and the Service received many. Nevertheless, no further ruling, opinion, or comment was issued for approximately five years thereafter, thus effectively terminating the use of this sort of trust except for those with no risk aversion. Schoenblum & Schoenblum, supra, at 30. Further concerns were raised with the issuance of I.R.S. CCA 201208026 (Feb. 24, 2012).
IRS, the NING would be quickly removed from the sophisticated estate planner's toolkit and fade into oblivion.\textsuperscript{81}

Finally, regardless of whether it is a NING or other irrevocable trust, the out-of-state trust must be an accumulation trust. In other words, the trustee principally must retain the earned investment income in the trust, rather than distributing it to beneficiaries. While there may be distributions planned for years down the road, or perhaps as a result of emergency needs, routine distributions would undermine the tax benefits of the trust. The reason is that if the beneficiary is in a state that taxes income, the receipt by the beneficiary will almost certainly be deemed income and will be taxed. As such, routine distributions, rather than accumulations, will simply shift the incidence of taxation from the trust to the beneficiaries and will generally not eliminate all state income taxes. Accordingly, there is no point in resorting to a NING if the settlor intends to make routine distributions. Likewise, there is no point in transferring the principal place of administration of a more traditional irrevocable trust to a nontax state if routine distributions are likely to be made to a beneficiary residing in a state that taxes income.\textsuperscript{82}

V. THE PROCEDURAL ASPECTS OF CONSTITUTIONAL CHALLENGES TO STATE TAX JURISDICTION

As has already been discussed in Part II, there are important federal constitutional law questions regarding the contacts relied on by some states to justify taxing out-of-state nongrantor accumulation trusts. Critically, these questions will almost certainly not be resolved in the federal courts. These matters, in fact, have been reserved exclusively to the state courts.

The controlling statute disabling federal court jurisdiction is the Tax Injunction Act.\textsuperscript{83} It provides: “The district courts shall not enjoin, suspend or restrain the assessment, levy or collection of any tax under State law where a plain, speedy and efficient remedy may be had in the

\textsuperscript{81} See I.R.S. Priv. Ltr. Ruls. 2013-10-002 to 2013-10-006 (Mar. 8, 2013) (determining that transfer to a NING trust is an incomplete gift and that a NING is not a grantor trust). These rulings were followed by I.R.S. Priv. Ltr. Ruls. 2014-10-001 to 2014-10-010 (Mar. 7, 2014) (holding that distribution committees could be comprised of minor children represented by their guardians, without undermining the status of the NING).

\textsuperscript{82} Note that the jurisdiction to tax a resident beneficiary as an individual is quite distinct from the jurisdiction to tax the out-of-state nongrantor accumulation trust based on the residence of a beneficiary in the taxing state. The latter is subject to serious constitutional concerns. See supra Part II.5-7 and infra Part V.C.1.

In large part, the statute was enacted to prevent federal courts from intervening in a vital function of the states: the raising of revenue through taxation.\(^8\) Thus, as long as the state affords an adequate remedy for a taxpayer to challenge an assessment, levy, or collection of tax by the state, the Tax Injunction Act proscribes federal court jurisdiction.\(^8\)

All such decisions by state courts are reviewable by the U.S. Supreme Court. Certainly, the Supreme Court has granted petitions for certiorari and issued opinions regarding the power of states to tax interstate and international business profits under the Commerce and Due Process Clauses. Nonetheless, the facts and circumstances of those cases, typically involving business activity, do not closely match those involving the taxation by one state of an out-of-state trust that earns passive income on investment assets. The jurisprudential task of determining which contacts with a state suffice to justify taxation has been made more difficult by the failure of the Supreme Court to consider the constitutional aspects of taxing out-of-state trusts for more than seventy years.

What are the implications of the Tax Injunction Act in terms of the development of a coherent constitutional jurisprudence regarding the power of a state to tax an out-of-state trust, its settlor, or its beneficiaries? One might have expected that constitutional arguments denying a state’s power to tax would receive a hostile reception in that state’s courts. Indeed, there has been a checkered history, with courts in certain, traditionally high-tax states, rejecting federal constitutional arguments that would deny the state the jurisdiction to tax out-of-state trusts linked to an in-state settlor or beneficiaries. More recently, however, several state courts have risen remarkably above provincial

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84. Id.
85. See Peter Enrich, Federal Courts and State Taxes: Some Jurisdictional Issues, with Special Attention to the Tax Injunction Act, 65 Tax Law. 731, 744 (2012) (explaining that the Tax Injunction Act was grounded on the imperative of limiting federal court jurisdiction over the local concern of tax collection).
86. A second purpose for enactment of the law was to put local taxpayers on a par with out-of-state taxpayers who, but for the Tax Injunction Act, might be able to rely on federal diversity jurisdiction when injunctive relief is sought. See id. at 743–44 (noting that large intrastate businesses, prior to the Act, frequently used federal courts to enjoin the collection of local taxes). While there would be diversity jurisdiction, but for the Tax Injunction Act, in the case of local taxes, there would typically not be jurisdiction in the case of state taxes, as a state cannot be a citizen of a state. See id. at 736 (explaining the potential unavailability of diversity jurisdiction for state tax actions). Arguably, however, if diversity is based on the citizenship of a state officer, the requirements for diversity of citizenship could be satisfied. See id. at 735–36 ("[T]he state generally is not considered the party in interest in cases seeking injunctive relief against a state officer so diversity jurisdiction arguably may be appropriate in such cases."); see also Ex parte Young, 299 U.S. 123, 184–85 (1908) (the state officer is the real party in interest).
interests and held their own state revenue authorities’ attempts to tax out-of-state trusts violative of the Federal Constitution. Indeed, in the past two years, important decisions in Illinois and Pennsylvania have confirmed a strong trend to rule, on Commerce Clause and Due Process grounds, against longstanding statutes authorizing expansive exercise of state jurisdiction to tax. The Illinois and Pennsylvania decisions follow similar decisions in New York and Michigan.87

VI. CONSTITUTIONAL DIMENSIONS OF STATE INCOME TAXATION OF TRUSTS

Decisions addressing the constitutionality of a state’s power to tax the income of an out-of-state nongrantor accumulation trust have principally referenced two provisions—the negative Commerce Clause and the Due Process Clause of the U.S. Constitution.88 The jurisprudence with respect to each of these provisions is considered below.

A. The Commerce Clause

If every state could tax income based on any contact with the state, no matter how minimal, this “would have drastic consequences for the national economy, as businesses could be subjected to severe multiple taxation.”89 As a federal constitutional matter, a state can be barred from imposing tax that would interfere with “commerce . . . among the several States . . . .”90 From these statements, which situate the power to regulate interstate commerce affirmatively in the federal government, the courts implied the dormant or negative Commerce Clause. This implied constitutional limitation prevents a state from discriminating in favor of in-state economic activity.91 This is the case even when no affirmative federal regulation is present, as is

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87. For a discussion of these cases, see infra Part VI.
88. Occasionally, consideration is given to the Privileges and Immunities Clause. See, e.g., Shaffer v. Carter, 252 U.S. 37, 53 (1920) (holding that the Privileges and Immunities Clause protects a citizen from discriminatory taxes in a nonresident state but does not entitle that citizen to tax immunity in that nonresident state). However, it has played a minimal role, especially if a nonresident taxpayer is taxed within the state on source income and entitled to deductions associated with the income taxed as would be residents.
90. U.S. CONST. art. I, § 8, cl. 3 (negative Commerce Clause).
91. See Ronald D. Rotunda & John E. Nowak. TREATISE ON CONSTITUTIONAL LAW-Substance and Procedure § 11.5 (5th ed. 2013) (noting the “negative implication” of the Commerce Clause as restricting state laws that serve anti-competitive purposes by shifting costs of local benefits to out-of-state persons).
the case with state taxation of income.\textsuperscript{92} The overriding concern is “to avoid tendencies toward economic Balkanization . . .”\textsuperscript{93}

Importantly, the negative Commerce Clause has never been applied to limit the authority of a state to tax its own residents’ worldwide income,\textsuperscript{94} although the issue now is under consideration by the Supreme Court.\textsuperscript{95} The Commerce Clause “protects markets and participants in markets, not taxpayers as such.”\textsuperscript{96} This can be especially problematic for trusts. If a trust is resident in a state, that state will be able to exercise taxing power over the trust, even with respect to income sourced and taxed beyond its boundaries.\textsuperscript{97} This is true despite the fact that another state is also taxing the income. The trust would have to show that “there is a risk of multiple taxation which places a burden on interstate commerce that is not also borne by intrastate commerce.’”\textsuperscript{98} In the case of a trust, the mere earning of income and realization of gains in various jurisdictions, as opposed to engagement in business activity, simply does not implicate the Commerce Clause.\textsuperscript{99}

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92. See Wardair Can., Inc. v. Fla. Dep’t of Rev., 477 U.S. 1, 7–8 (1986):

[W]e have acknowledged the self-executing nature of the Commerce Clause and held on countless occasions that, even in the absence of specific action taken by the Federal Government to disapprove of state regulation implicating interstate or foreign commerce, state regulation that is contrary to the constitutional principle of ensuring that the conduct of individual states does not work to the detriment of the nation as a whole, and thus ultimately to all of the states, may be invalid under the unexercised Commerce Clause.”


94. See Goldberg v. Sweet, 488 U.S. 252, 266 (1989) (“It is not a purpose of the Commerce Clause to protect state residents from their own state taxes.”).

95. See Md. State Comptroller of the Treasury v. Wynne, 64 A.3d 453, 457 (Md. Ct. App. 2013) (raising the issue of whether a state is barred under the dormant Commerce Clause from taxing “pass-through” income generated by a Subchapter S corporation in other states), cert. granted, 134 S. Ct. 2660 (May 27, 2014) (No. 13-485). See supra note 29 and infra text accompanying note 182.


97. See Zunamon v. Zehnder, 719 N.E.2d 130, 137–38 (Ill. App. Ct. 1999) (Commerce Clause provides no bar on taxing a resident’s income sourced in another state); see also Luther v. Comm’r, 588 N.W.2d 502, 511–12 (Minn. 1999) (holding that income from intangible assets in a nonresident state may be taxed by resident state). In Tamagni v. Tax Appeals Tribunal, 695 N.E.2d 1125, 1130 (N.Y. 1998), the New York Appellate Division held that New York is not required to afford a credit for tax imposed on a “resident,” who was also a domiciliary of New Jersey and taxed there. The court held that no Commerce Clause issue was involved since tax can be imposed constitutionally based on presence in the state “without regard to any specific commercial or economic transaction or activity.” Id. Further, the negative Commerce Clause does not apply when the state is regulating evenhandedly, with only incidental effects on interstate commerce. Id. at 1131–32; see also City of New York v. State, 730 N.E.2d 920, 930–31 (N.Y. 2000) (tax only on out-of-state commuters is a violation of negative Commerce Clause).

98. Zunamon, 719 N.E.2d at 138.

99. Id.
Of course, a NING or other trust that has left a state in order to avoid state income taxes will not be resident in a state that taxes it. The more controversial question is whether the settlor's former or current state of residence can tax. At no time has the Supreme Court addressed the application of the Commerce Clause to the taxation of trusts. Accordingly, the constitutional jurisprudence has developed entirely in the state courts.\(^{100}\) What little state court jurisprudence there is appears to be in conflict.

The decisions have dealt with the situation in which the settlor establishes an out-of-state trust and is then taxed by his or her home state on the basis that he was domiciled in the state when the trust was established or became irrevocable. The leading case cited in support of the exercise of taxing jurisdiction in these circumstances is *Chase Manhattan Bank v. Gavin.*\(^ {101}\) In that case, the out-of-state trustee, Chase Manhattan Bank, argued that the taxation of the income of the inter vivos trust violated the Commerce Clause. The trustee contended that such taxation discouraged the retention of out-of-state trustees because doing so could generate a second tax on the income in the state of residence of the trustee, in addition to taxation by the settlor's domicile at death, thereby unconstitutionally promoting in-state trustees. The Connecticut Supreme Court rejected this argument. While agreeing "that there are such incentives and risks, we conclude that they are too remote and speculative to constitute a dormant commerce clause violation."\(^ {102}\)

The holding of the Connecticut Supreme Court in *Chase Manhattan Bank v. Gavin* was a rather conclusory one with respect to the Commerce Clause. It really did not give careful consideration to the U.S. Supreme Court jurisprudence. In particular, because the trustee did not raise the issue, the court failed to consider the requirements of *Complete Auto Transit, Inc. v. Brady.*\(^ {103}\) In *Complete Auto*, the U.S. Supreme Court set forth a four-prong test to determine that a state tax is not violative of the negative Commerce Clause: (1) the taxpayer has a substantial nexus with the taxing state, (2) the tax is fairly apportioned, (3) the tax does not discriminate against interstate commerce, and (4) the tax is fairly related to the services provided by

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100. The federal courts have not had a role due to the Tax Injunction Act. See *supra* text accompanying note 83.
101. 733 A.2d 782, 805 (Conn. 1999).
102. *Id.; see also* WALTER HELLERSTEIN, *STATE TAXATION ¶ 20.09* (3d ed. 2012) (asserting that, contrary to the position of the Connecticut Supreme Court, a serious dormant Commerce Clause issue exists that needs to be addressed by the Supreme Court).
the state.\textsuperscript{104} The Supreme Court proceeded in \textit{Quill Corporation v. North Dakota}\textsuperscript{105} to hold that in order to satisfy the first of these requirements, the taxpayer had to have a physical presence in the state.

Based on the principles set forth in \textit{Complete Auto}, as amplified in \textit{Quill}, the decision in \textit{Chase Manhattan Bank v. Gavin} is severely flawed. One need only consider the clear failure in \textit{Chase} to satisfy the first prong, as the trustee (the taxpayer) did not have an actual physical presence in the state. Similarly, with regard to the second prong, the tax was arguably not fairly apportioned. The Connecticut revenue authorities imposed a tax on the entire income of the trust purely on the basis of the residence of the sole beneficiary, despite the non-residence of the trustee and the fact that no assets producing income were situated in Connecticut. As for the third and fourth prongs, their application to this trust is far from clear but still deserving of analysis.\textsuperscript{106} Rather than using the four-prong test, the Connecticut Supreme Court preferred to emphasize that many factors would enter into the settlor's decision when choosing a trustee, urging that this established the Connecticut law was not driving settlers away from nonresident trustees, which would interfere with interstate commerce. At the other extreme, the dissent emphasized that “the risk, and not only the actuality, of multiple state taxation suffices to establish such a constitutional violation [under the Commerce Clause].”\textsuperscript{107}

\textit{Chase Manhattan Bank v. Gavin}, notwithstanding its flawed Commerce Clause analysis, has stood as the principal authority on the issue. Most recently, however, the Commonwealth Court of Pennsylvania, the statewide court of appeals, held that a similar statute, in fact, did violate the Commerce Clause.\textsuperscript{108} \textit{Complete Auto} and

\begin{itemize}
  \item \textsuperscript{104} \textit{Id.}
  \item \textsuperscript{105} 504 U.S. 298, 317–19 (1992).
  \item \textsuperscript{106} Indeed, even in a more recent decision by the Commonwealth Court of Pennsylvania, Robert L. McNeil, Jr. Trust \textit{ex rel. McNeil v. Commonwealth}, 67 A.3d 185, 192–198 (Pa. Commonw. Ct. 2013), that did consider the prongs, the third prong was not discussed at all. \textit{See infra} note 115.
  \item \textsuperscript{107} \textit{Chase Manhattan Bank}, 733 A.2d at 808 (McDonald, J., dissenting) (citing Goldberg v. Sweet, 488 U.S. 252, 261–62 (1989)); BORRIS BITTKER, REGULATION OF INTERSTATE AND FOREIGN COMMERCE \textsection{8.07}, at 8–23 (1989); J. HELLERSTEIN & W. HELLERSTEIN, STATE TAXATION \textsection{108}[ii][a], at 4–39 (3d ed. 1998). In fact, multiple state taxation per se is not a violation of the negative Commerce Clause and the authorities cited do not so hold. Rather, they express the principle that each state should only tax its fair share of interstate commerce. The real controversies are what is a “fair share” and how should it be determined.
  \item \textsuperscript{108} \textit{See Robert L. McNeil, Jr. Trust}, 67 A.3d at 198 (finding imposition of Pennsylvania income tax to all income from out-of-state inter vivos trusts unconstitutional). This statute, 72 PA. CONS. STAT. ANN. \textsection{7301(a)(2)} (West 2014), has not yet been repealed, and there is no indication in the codification that the provision has been held unconstitutional as applied.
\end{itemize}
Quill provided the foundation for the Pennsylvania court’s holding in Robert L. McNeil, Jr. Trust ex rel. McNeil v. Commonwealth. The Robert L. McNeil, Jr. Trust decision involved a number of inter vivos nongrantor trusts administered out of state by nonresident trustees. All records were kept out of state. The trusts were governed by Delaware law and earned no income from Pennsylvania sources. While the beneficiaries were residents of the state, Pennsylvania nevertheless sought to tax on the statutory basis that the settlor had been a resident of Pennsylvania when he created the trusts. The Commonwealth Court held the law unconstitutional, exclusively on negative Commerce Clause grounds.

In reaching its decision, the court focused on the Quill physical-presence add-on to the first requirement of Complete Auto. It concluded that the requisite physical presence did not exist. Neither the residence of the settlor at the creation of the trust nor the residence of the beneficiaries in the taxable year satisfied the requirement. The discretionary beneficiaries of the trust were likened to the North Dakota customers in Quill who were purchasing products by mail from a company outside the state. The Commonwealth Court made clear that the focus must be on the trust itself. Moreover, unlike Chase Manhattan v. Gavin, the beneficiaries in Robert L. McNeil, Jr. Trust were all discretionary and might never have received anything. The trustee was not obligated to ever make a distribution to any of them, although distributions had been made to one beneficiary. The court held that the settlor’s residence in Pennsylvania forty-eight years prior to the taxable year was the type of “slightest presence” rejected as insufficient by the Supreme Court in Quill.

The Commonwealth Court’s decision is both sweeping in its significance and precise in its reasoning. It stands in stark contrast to the conclusory language of Chase Manhattan Bank v. Gavin. On the
other hand, the opinion is not necessarily a wholesale rejection of the Pennsylvania statute and similar statutes elsewhere. In particular, the holding is ambiguous as to whether a different result might have been arrived at if one or more resident beneficiaries had not been discretionary beneficiaries, but had held vested interests. Indeed, it iterates and reiterates that not only were the beneficiaries all discretionary beneficiaries, but that they had no right to a vested remainder.

As for the other three requirements set forth in *Complete Auto*, the Commonwealth Court found that requirement (2) was also not satisfied. The attempt to tax the trust’s *entire* income did not comport with the minimal contact with the state that the trust had. As for requirement (4), \(^{115}\) the court held again that the trust had not received benefits and protections from the state and, thus, that the tax was not “fairly related.” While there were discretionary beneficiaries resident in the state, any benefits they had received from the state were not relevant. They were not the taxpayer—the trust itself was. “[I]mportantly, as discretionary beneficiaries, they have no present or future right to distributions from the trusts.” \(^{116}\) The settlor was also not receiving benefits, as he was actually deceased in the taxable year. \(^{117}\)

There would seem to be two open questions as a result of the Commonwealth Court’s opinion. First, will any sort of future, but vested, interest of a beneficiary resident in the state during the current tax year allow for taxation of the *entire* income of the trust, compatible with the negative Commerce Clause? While this question is discussed later in this Article, \(^{118}\) suffice to say that the out-of-state nongrantor accumulation trust is designed exclusively with discretionary interests. As long as a vested remainder is not held by a current resident, the trust is free of tax under *Robert L. McNeil, Jr. Trust*. A cautious planner will not provoke the unsettled constitutional question as to the impact of a remainder vested in a resident of the state.

The second question is whether a tax on the entire income of the trust can be assessed if the settlor continues to reside in the state or has only recently departed. The court emphasized in its opinion that the settlor had been gone from the state for forty-eight years prior to the tax year—thus, he had “the slightest presence.” But what if the

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\(^{115}\) The court’s analysis bypasses requirement (3), as the trusts did not contend that requirement (3) was not satisfied. *Id.* at 192.

\(^{116}\) *Id.* at 198.

\(^{117}\) Because its decision was based exclusively on negative Commerce Clause grounds, the court did not address federal due process and equal protection arguments or the argument that the tax violated the uniformity clause of the state constitution. *Id.* at 198 n.17.

\(^{118}\) See infra text accompanying note 134.
settlor had not left, as would be true of many settlors relying upon a tax avoidance trust? There is simply no way, short of other judicial opinions, to know the outcome in such a circumstance or one where, for example, the settlor remained in the state for years after the trust was created or has been out of state only a few years when the state imposes a tax. While language in the opinion indicates that the residence of the settlor is irrelevant, the other language referenced above suggests that the “presence” test is a continuum, which could possibly be satisfied when fewer years have transpired.

The bottom line is that negative Commerce Clause jurisprudence, as it relates to out-of-state trusts, is thin. The two major decisions can be harmonized, but only when the settlor has long since departed the taxing state and there are no vested beneficiaries resident in the current taxable year.

B. The Due Process Clause

1. The Quill Approach

As noted, in addition to the Commerce Clause limitation on a state's ability to impose taxes, including income taxes, the states are restricted by another federal constitutional provision, the Due Process Clause.\footnote{U.S. Const. amend. XIV, § 1.} The relevance of this clause in matters of taxation was addressed in Quill.\footnote{504 U.S. 298, 306–08 (1992).} In Quill, the U.S. Supreme Court explained that the function of the Due Process Clause, in contrast to the Commerce Clause, is to assure fairness through “‘notice’ or ‘fair warning.’”\footnote{Id. at 312.} A state’s tax does not violate the Due Process Clause when a taxpayer should have safely assumed that the state would exert authority over it.

In Quill, a company had deluged the state of North Dakota with sales catalogues, so that, according to the Supreme Court, it should have expected the state to impose sales or use tax on its in-state customers, requiring Quill to collect that tax. This was the case even though the company had no physical presence in the state and, on that basis, could not be taxed under the negative Commerce Clause. Left unanswered, post-Quill, was how the Due Process Clause applies to trusts—specifically, what contacts, past and present, should put the trustee on notice about potential liability for taxation?
2. The Greenough Approach

Importantly, Quill departed from a body of decisions that had applied the Due Process Clause to the state income taxation of trusts from a different analytical perspective. The continuing authority of such case law is now uncertain post-Quill. The reasoning of these authorities may have been displaced by Quill. On the other hand, they continue to be cited and may stand as a second, alternative branch of due process analysis that survives as a complement to the Quill line of analysis.

The leading pre-Quill decision is Greenough v. Tax Assessors, an opinion that considered whether Rhode Island could impose an ad valorem tax on intangible assets administered in a testamentary trust established under a New York probate, where none of the trust beneficiaries were domiciled or resided in Rhode Island and none of the trust estate was situated in that state. Crucially, there was a Rhode Island cotrustee, although all actions were taken by the New York cotrustee.

Following the reasoning of an earlier decision regarding state taxing power under the Due Process Clause, the Supreme Court rejected the argument that Rhode Island had no additional basis to tax. Several key points stand out in the Court’s opinion. First, unlike the later Quill opinion, the Greenough opinion presented the due process question in terms of whether the state affords any protections or benefits for which it can seek taxes in return. Second, the Court made clear that those protections and benefits need only be potential ones to justify taxation. Thus, the Court stated that “although nothing appeared as to any specific benefit or protection which the trustee has actually received, [the Rhode Island Supreme Court] concluded that the state was ‘ready, willing and capable’ of furnishing either ‘if requested.’” For example,

when testamentary trustees reside outside of the jurisdiction of the courts of the state of the seat of the trust, third parties dealing with the trustee on trust matters or beneficiaries may need to proceed directly against the trustee as an individual for matters arising out of his relation to the trust. Or the resident trustee may need the benefit of the Rhode Island law to enforce trust claims against a Rhode Island resident. As the trustee is a citizen of Rhode Island, the federal courts would not be open to the trustee for such causes of action where the federal jurisdiction depended upon diversity. The citizenship of the trustee and not the seat of the trust or the residence of the beneficiary is the controlling factor. The trustee is suable like any other obligor. There is no provision of the

federal Constitution which forbids suits in state courts against a resident trustee of a trust created under the laws of a sister state. Consequently, we must conclude that Rhode Island does offer benefit and protection through its law to the resident trustee as the owner of intangibles.\(^{124}\)

In the abstract, the due process standard set forth in Greenough is more expansive than the Quill test of due process. But in terms of the out-of-state nongrantor accumulation trust, it is of little consequence. True, the residence of a single trustee in the state suffices to justify state taxation of the trust.\(^{125}\) But this principle poses no obstacle to the formation of the tax-free trust under discussion in this Article, since all trustees would be from nontaxing states.\(^{126}\)

3. The Impact of the Testamentary Trust Decisions

Although this Article is concerned with federal constitutional dimensions of taxing jurisdiction over certain inter vivos trusts, the more extensive constitutional jurisprudence concerning testamentary trusts needs to be considered. While the U.S. Supreme Court has not addressed the matter, a number of state courts have done so. What has emerged is a serious division of opinion. On the one hand, some courts have found their own state laws unconstitutional. However, other courts have found these contacts sufficient, from a constitutional standpoint, to justify continued taxation as long as the trust is in existence.

The first line of cases is represented by In re Swift.\(^{127}\) The Missouri Supreme Court applied a multifactor balancing test in holding that Missouri did not have jurisdiction to tax, notwithstanding the fact that the testamentary trust was that of a Missouri decedent. Despite the decedent's Missouri domicile, all other contacts deemed critical by the court pointed elsewhere—the trustees, the situs of administration

\(^{124}\) Greenough, 331 U.S. at 495–96 (footnote omitted).

\(^{125}\) In Greenough, the tax was apportioned between resident and nonresident trustees. Id. at 488. The Court also cited prior state decisions, all either permitting proportional taxation or no tax at all. Id. at 497 n.27. No case was cited allowing the taxation of the entire income of the trust. Under the law of California, jurisdiction to tax arises from the residence of a trustee in the state during the tax year. See CAL. REV. & TAX. CODE § 17742 (West 2013). If there is more than one trustee, the law apportions tax liability if there is a resident and nonresident trustee. Id. § 17743. The income is apportioned based on the number of resident trustees, assuming that there are no resident beneficiaries. See id. As for the computation when there are also some resident and some nonresident beneficiaries, see CAL. FRANCHISE TAX BD., LEGAL RULING NO. 238 (Oct. 27, 1959). See also CAL. FRANCHISE TAX BD., 2013 INSTRUCTIONS FOR FORM 541, sched. G. (summarizing relevant statutes and providing examples).

\(^{126}\) See supra Part IV. Greenough does make clear that its protections and benefits due process analysis justifies state income taxation in certain circumstances, even if the result is multiple state taxation. 331 U.S. at 496–97.

\(^{127}\) 727 S.W.2d 880 (Mo. 1987) (en banc).
of the trust estate, and the beneficiaries were all outside the state. In light of the prevalence of these “foreign” factors, the balancing, in the opinion of the court, weighed against taxation. This was the case even though (1) there was a continuing probate administration, (2) without such administration under Missouri law there would have been no trust, (3) the statute very clearly provided for taxation, and (4) the U.S. Supreme Court had not ever held the Missouri nexus for taxing to be constitutionally infirm. Nevertheless, the Missouri Supreme Court overturned the imposition of the tax on the ground that Missouri law was “providing no present benefit or protection to the subject trusts, their beneficiaries, trustees, or property.”

In contrast to In re Swift, the same Missouri Supreme Court did hold that there was jurisdiction to tax in a later decision, Westfall v. Director of Revenue. However, in this case a number of other elements were present: some trust-owned real property had a situs in Missouri; under certain contingencies set forth in the trust instrument, Missouri charities could become beneficiaries; and under certain circumstances, a Missouri bank could become a successor trustee.

Because of these elements, Westfall is distinguishable on factual grounds from In re Swift and thus does not represent a repudiation of In re Swift, but rather an indication of how Missouri’s balancing test can yield different outcomes. Moreover, other state courts have also rejected on constitutional grounds the state’s authority to tax a testamentary trust simply because of the domicile or residence of the decedent or settlor at the inception. The argument that there is a lack of continuing benefits and protections is especially compelling when the state court’s administration of a testamentary trust may be limited. For

128. Id. at 882. Without explanation, the court simply stated that certain other cases were distinguishable. Id. at 882–83. One of these cases was First National Bank v. Harvey, 16 A.2d 184 (Vt. 1940). In its opinion in that case, the Vermont Supreme Court had staked out the opposing position, holding that the trust could not have come into existence without the approval of the local probate court and that such property remained within the jurisdiction of the probate court. Harvey, 16 A.2d at 189–90. It should be noted that this decision rests on the premise that there is always continuing probate jurisdiction. See id. at 189. One way that Harvey may be distinguished is that not all states today maintain continuing probate jurisdiction or necessarily assert it at all with respect to some estates.

129. 812 S.W.2d 513, 514 (Mo. 1991) (en banc).

130. See, e.g., Taylor v. State Tax Comm’n, 445 N.Y.S.2d 648 (App. Div. 1981) (explaining that, although there was a New York cotrustee, it had no authority to act with respect to the property situated in Florida). It is not entirely clear whether this was the critical consideration for the court or whether its decision was based on the following broader conclusion: “The fact that the former owner of the property in question died while being domiciled in New York, making the trust a resident trust under New York tax law, is insufficient to establish a basis for jurisdiction.” Id. at 649. It is also not clear whether Greenough would permit taxation based on partial ownership of the assets by the cotrustee.
example, the court’s supervision under the law may be discretionary and presumably exercised only at the behest of beneficiaries, creditors, the trustee, and other interested parties. Even if a tax return is filed listing the trust’s residence as the state seeking to tax, this is likely to be regarded as a mere technical flaw, as is filing a “resident” tax return.

Several courts have endorsed the contrary approach, upholding the constitutionality of such a basis for state income taxation. For example, in District of Columbia v. Chase Manhattan Bank, a testamentary trust of a District resident whose will had been probated in the courts of the District of Columbia, was held to have a relationship to the District distinct from the relationship, if any, between the District and the trustee or trust assets. The District’s unquestioned power to resolve disputes over the trust, and to order accountings to protect trust corpus and beneficiaries from potential malfeasance by the trustee, represented the District’s justifiable, though not necessarily exclusive, jurisdiction over the trust itself. The court rejected contrary decisions by pointing out that they predated Quill. In reaching its decision, the court refused to address the numerous decisions holding otherwise, except to draw attention to some arguable conflicts in the reasoning of Swift and Westfall. In particular, the court honed in

131. Pennoyer v. Taxation Div. Dir., 5 N.J. Tax 386, 398 (1983). Note that in Pennoyer, the court did not require these additional elements to be present. Thus, it simply concluded that:
[C]reation of the trust in New Jersey and the resultant jurisdiction and availability of the New Jersey courts to enforce or interpret this trust are insufficient contacts with New Jersey to support the Director’s income tax assessment. The creation of the trust in 1971 through the probate process in New Jersey courts is an historical fact which, absent continuing contacts, is not a constitutional nexus justifying income taxation of undistributed income earned in 1979-80.

Id.; see also City of Augusta v. Kimball, 40 A. 666, 667–69 (Me. 1898) (rejecting the notion that the court has authority over the assets once the estate has been closed and the assets distributed to an out-of-state trustee). Similarly, in Bayfield County, v. Fishon, 156 N.W. 463, 463–64 (Wis. 1916), the court also held that Wisconsin could not tax the income of a testamentary trust of a Wisconsin testator once the property was in the hands of a nonresident trustee. However, this decision is based on the Wisconsin statute then in force and should not be relied upon as an authority on the constitutional issue.


133. 689 A.2d 539, 544 (D.C. 1997).

134. Id.; see also Chase Manhattan Bank v. Gavin, 733 A.2d 782, 795–99 (Conn. 1999) (listing state probate court’s responsibilities related to trust); Chase Manhattan Bank v. Comm’r of Revenue Sers., 716 A.2d 950, 957 (Conn. Super. Ct. 1997) (emphasizing that:
In creating these testamentary trusts, the settlors exercised and took advantage of a right or a privilege granted by Connecticut law. It is fair to say that the trusts owe their existence to Connecticut law. Like the individual domiciliary or Connecticut corporation, the resident trust may invoke the protection of Connecticut law and thus be responsible to share the costs of government.)
on Westfall's conclusion that the situs of only some trust property in Missouri gave it jurisdiction to tax the entire income of the trust. This would not be constitutionally permissible post-Quill. Thus, the Westfall court must have given weight to the additional factor that the trust was created in Missouri.

The court in District of Columbia v. Chase Manhattan Bank offered one other basis for taxing jurisdiction—a trust is a taxable entity, like a corporation, which can be taxed where it is organized, even if its operations are otherwise outside the state. Like a corporation, according to the court, a testamentary trust is a creature of the laws of the state where created and owes its existence to those laws. In fact, the case may be even stronger for the trust. Unlike a corporation, which can reincorporate in another jurisdiction, a testamentary trust typically cannot do so.

Most recently, in Residuary Trust A v. Director, Division of Taxation, the New Jersey Tax Court rejected this line of pro-taxation Due Process Clause cases. The Tax Court concluded that the law as set forth in Potter v. Taxation Division Director should continue to be observed and that there were simply two lines of cases in direct conflict as to what the Due Process Clause of the Constitution requires in the testamentary trust context. The New Jersey Tax Court held that Quill's Due Process holding in favor of taxation did not apply for two reasons: first, Quill involved a use tax and, second, the taxpayer in Quill

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135. In Quill Corp. v. North Dakota, 504 U.S. 298, 306 (1992), the Supreme Court, quoting from Moorman Manufacturing, Co. v. Bair, 437 U.S. 267, 273 (1978), stated that the Due Process Clause requires that "income attributed to the State for tax purposes must be rationally related to 'values connected with the taxing State.'" In other words, global taxation based on a relatively weak nexus with the state is not constitutionally permissible. Similar reasoning was applied in Complete Auto Transit, Inc. v. Brady, 430 U.S. 274, 279 (1977) (requiring that a tax be "applied to an activity with a substantial nexus with the taxing State, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services provided by the State").

136. 689 A.2d at 544–45; see, e.g., Cream of Wheat Co. v. Grand Forks, 253 U.S. 325, 328 (1920) (with respect to taxation of a corporation). The equation of a testamentary trust to a corporation as a justification for continuing taxation of a trust, though it has no connections with the state after its creation, was endorsed by the Connecticut Supreme Court in Gavin, 733 A.2d at 795 (noting that the United States Supreme Court has described a trust as something of an "abstraction" that may be dealt with as an "entity" (quoting Greenough v. Tax Assessors, 331 U.S. 486, 493–94 (1947)). See also Chase Manhattan Bank v. Commissioner of Revenue Services, 716 A.2d at 957 (holding that, for tax purposes, a trust is a distinct entity and can continue to be taxed for that reason alone).

137. Under current law this may actually be possible, such as by decanting. See Jeffrey A. Schoenblum, 2014 Multistate Guide to Trusts and Trust Administration tbl. 7 (2014) for an in-depth state-by-state analysis of decanting statutes.


was actively carrying on business, while the trust was simply a passive owner of stock.141 Future decisions of higher courts will determine whether these distinctions are sufficiently compelling. However, these distinctions would appear to have little relevance regarding an inter vivos trust, which is not a supervised trust, like the typical testamentary trust, and is not ordinarily the product of a judicial probate process at its inception.

4. The Due Process Clause and the “Forever Tainted Trust” Jurisdiction Statutes

a. The Pre-Quill Decisions

The constitutional legitimacy of a statute authorizing continued taxation of the investment income of a tax-avoidance trust when there is no contact with the state other than the residence of the settlor at the trust’s creation or when it becomes irrevocable, a so-called “forever tainted” statute, is extremely dubious. This is even true of a trust that is funded by a will pour-over. For example, in Mercantile-Safe Deposit & Trust Co. v. Murphy,142 the New York Appellate Division held that the state could not impose a tax on accumulated income of a trust, even though assets had poured over from a New York estate to an inter vivos trust pursuant to New York law, and the settlor and beneficiaries were all New York domiciliaries. Instead, the court emphasized that the trustee was a Maryland domiciliary and that the property was held and administered in Maryland.143

In Blue v. Department of Treasury,144 a later decision involving a revocable trust that had become irrevocable upon the settlor’s death, the Michigan Court of Appeals also held that the state had no jurisdiction to tax. The court emphasized as the crucial factors that

141. Id. at 75 n.11.
143. Id. at 28. But see Chase Manhattan Bank v. Gavin, 733 A.2d 782, 802–805 (Conn. 1999) (upholding constitutionality of taxation of inter vivos trust where the taxing state was the domicile of the settlor at creation and the beneficiaries currently were residents of the state).

With respect to pour-overs from an estate to a trust established during the lifetime of the settlor-testator, states have widely enacted the Uniform Testamentary Additions to Trusts Act, either the 1960 original version, enacted in 44 states, or the 1991 revision, incorporated as section 2-511(b) of the Uniform Probate Code. The 1991 version of the Act, section 1(b), provides that unless the testator’s will specifies otherwise, property devised to a trust established during the testator’s lifetime “is not held under a testamentary trust of the testator but it becomes part of the trust to which it is devised.” The 1960 version, section 1, states that the trust “shall not be deemed to be held under a testamentary trust of the testator but shall become a part of the trust to which it is given.”

neither the trustee nor the trust property was in the state and accordingly “conclude[d] that there [was] no ongoing protection or benefit to the trust.” 145 The court found the purported benefits and protections afforded by Michigan to the trust to be “hypothetical” and “illusory,” especially since the trust was registered and administered in Florida. 146 Under the facts, the only income that Michigan could tax constitutionally was income derived from local assets.

A third significant decision is Potter v. Taxation Division Director. 147 The New Jersey Tax Court held that there were insufficient contacts to tax, both with respect to property added to an irrevocable trust and also with respect to a pour-over from the estate of the settlor. The court made some interesting points in support of its holding. It stated that the required approval of the surrogate’s court with respect to the pour-over was inadequate to justify taxation, as was the fact that the trustee participated in an informal settlement of account and a release of the executrices during the subject year. The residence of contingent beneficiaries in New Jersey was also deemed an insufficient contact.

What remains uncertain from Potter is the court’s statement that:

[A]ny benefit to the trust from the laws of the State of New Jersey relative to the distribution of assets from the estate to the trust can be accounted for in terms of the inheritance tax paid to the State of New Jersey on the assets distributed and transferred to the trust.

This statement could mean that, without such payment, an income tax might be a legitimate alternative in light of benefits conferred. On the other hand, the statement could simply mean that the mere prospect of inheritance tax suffices, so that the income tax is not a valid substitute. Or, most likely, the statement is dicta that is not relevant to the question whether, from a constitutional perspective, there are sufficient contacts to impose an income tax. In this regard, a fundamental distinction is that the inheritance tax is based on a contact at the moment of death. In contrast, no such contact exists in the case of the income taxation of a nonresident trust when the tax is being imposed many years after the year of the settlor’s death or creation of the trust.

Indeed, as has already been noted,148 an inter vivos trust is not under continuing supervision, as will be the case with many, if not all, testamentary trusts. While every trust is organized under some state

145. Id. at 764.
146. Id.
147. 5 N.J. Tax 399 (1983).
148. See supra Part VI.B.3.
law, the governing law set forth in the trust instrument will likely be
other than that of the settlor’s domicile. The inter vivos trust generally
does not have to be registered, nor is it typically under the supervision
of a court, unless there is pending litigation. 149 While in some states
court approval would be necessary to depart the state, in the vast
majority of states no such approval would be required. 150

Notwithstanding the foregoing considerations, and as previously
discussed, 151 the Connecticut Supreme Court upheld the
constitutionality of a taxation scheme imposing tax on an inter vivos
irrevocable trust in Chase Manhattan Bank v. Gavin. 152 A closer look at
the relevant statute 153 in Connecticut, however, reveals a more complex
situation. The taxation of the trust, based on the residence of the settlor
when the trust became irrevocable, is further conditioned on the
presence in the tax year of a resident noncontingent beneficiary.
Moreover, if there are also nonresident, noncontingent beneficiaries,
then the income must be prorated and assigned based on the ratio of
Connecticut noncontingent beneficiaries to all noncontingent
beneficiaries.

Even under these circumstances, the Connecticut Supreme
Court acknowledged that “this is a closer case than with respect to
testamentary trusts.” 154 Nevertheless, in Gavin there was only one
beneficiary, a Connecticut noncontingent beneficiary for whom income
was being accumulated for eventual distribution to her. As she was
thereby enjoying all benefits and protections afforded by Connecticut,
“the state has given something for which it can ask return, and there is
a definite and sufficient link between the contact with the state and the
income sought to be taxed.” 155 Though decided post-Quill, the court
likened the situation to Greenough, in which the United States
Supreme Court allowed Rhode Island to tax since one of the trustees
was resident in the state and the testator had died domiciled in Rhode
Island.

149. Similar distinctions between a testamentary and inter vivos trust were noted in dictum in District of Columbia v. Chase Manhattan Bank, 689 A.2d 539, 547 n.11 (D.C. 1997). The distinctions drawn suggest that the D.C. courts might actually hold the local statute unconstitutional with respect to irrevocable inter vivos trusts. To date, however, no such case has been decided.
150. See supra note 21.
151. See supra text accompanying notes 101–02.
152. 733 A.2d 782 (Conn. 1999).
153. CONN. GEN. STAT. § 12-701a(4) (West 2014).
154. Gavin, 733 A.2d at 801.
155. Id. at 802.
This analogy, in fact, was specifically rejected in *Greenough.* 156 *Greenough* explicitly distinguished cotrustees from cobeneficiaries, and, in so doing, it cited to an earlier Supreme Court decision in *Safe Deposit & Trust v. Virginia.* 157 In *Safe Deposit,* the Supreme Court held unconstitutional under the Due Process Clause an attempt by Accomac County, Virginia, to impose a property tax on intangible assets constituting the whole corpus of a trust administered by a Maryland trustee. Equitable ownership of the assets of the trust was in Virginia, where all the beneficiaries were domiciled.

The Court essentially offered two reasons for its holding. First, it argued that the owner of legal title, the trustee, was resident in Maryland and also had actual possession and control158 of the assets. Second, to allow the domicile of the beneficiaries to tax the property would lead to “double taxation, both unjust and oppressive.” 159

The Court in *Safe Deposit* recognized that Virginia could tax “the fair value of any interest in the securities actually owned by one of her resident citizens,” citing *Maguire v. Trefry.* 160 *Maguire* had held that Massachusetts could tax income received by a Massachusetts beneficiary of a nonresident trust. Essentially, the income to which the beneficiary has legal title is like the property in *Safe Deposit.*

The Connecticut Supreme Court, in *Chase Manhattan v. Gavin,* questioned whether *Safe Deposit* is still good law in light of *Curry v. McCanless.* 161 Among other things, *Curry* rejected the argument that taxation by more than one state of the same property or income was constitutionally prohibited by the Due Process Clause. The Connecticut Supreme Court also cited *Guaranty Trust Co. v. Virginia,* 162 in which the Supreme Court held that the state in which a beneficiary is resident could tax income received from a nonresident trust, even though the income had also been taxed by the state in which the trust was resident.

The reliance of the Connecticut Supreme Court on these cases was misplaced. *Safe Deposit* is a property tax case. *Chase Manhattan v. Gavin* is a trust income tax case. Supreme Court decisions like *Maguire*

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157. 331 U.S. at 496 (citing 280 U.S. 83 (1929)).
158. At the time, intangibles were often deemed situated where the evidences of title were physically located. Today, intangibles involving passive investment assets are, with a few exceptions, deemed to follow the domicile of the owner. See Crystal Commc’ns., Inc. v. Dep’t of Rev., TC 4769, 2008 WL 5182047, at *537–38 (Or. T.C. Dec. 10, 2008).
160. *Id.* at 92 (quoting 253 U.S. 12, 17 (1920)).
and *Guaranty*, as well as *Safe Deposit*, recognize that a trust can be taxed by its state of residence on its worldwide income, and that the state of residence of a beneficiary can tax income *received* by the beneficiary qua beneficiary. In each case, the tax is justified by the benefit and protection received with regard to the property legally owned. None of these decisions authorizes taxation of the nonresident *trust* based on the residence of the beneficiary. This is important because, in the case of an accumulation trust, the beneficiary has not *received* anything. Thus, the state of the beneficiary’s residence can hardly afford protection and benefit to a property interest that may never come to fruition. Arguably, the state could justifiably tax on the basis of the beneficiary’s equitable interest. However, this is practically and politically unfeasible, inasmuch as the beneficiary will likely not have the cash resources to pay the tax or will have to dip into other assets to satisfy the liability.

In sum, *Chase Manhattan v. Gavin*’s due process analysis is, indeed, flawed. Perhaps the vested, but undistributed, interest of the sole beneficiary of a nonresident trust is close enough economically to income actually received by a resident beneficiary so that, under the unique facts of the case, the trust is taxable without violating the Due Process Clause under pre-*Quill* constitutional analysis. Even if so, the decision is not particularly persuasive regarding the out-of-state nongrantor accumulation trust with its discretionary, contingent beneficiaries. Those beneficiaries do not have interests comparable to those of the noncontingent, vested beneficiary in *Chase Manhattan Bank v. Gavin*.

b. *The Illinois Court of Appeals Surrenders in Linn v. Department of Revenue*

The most recent decision on the applicability of the Due Process Clause to a state’s jurisdiction to tax an out-of-state trust has come in *Linn v. Department of Revenue*, a decision of the Illinois Court of Appeals. It is an especially important decision because the facts in the case involve a blatant attempt by a very wealthy family to re-situs existing trusts in order to avoid Illinois income tax.

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In *Linn*, the trustee of a Texas-administered inter vivos trust established by members of the hugely wealthy Pritzker family\(^{165}\) sought the return of an income tax payment made under protest. It argued that any payment by the trust, identified as the “Autonomy Trust 3,” was “unconstitutional as the trust had no connections with Illinois.”\(^ {166}\) The circuit court had granted summary judgment to the Department of Revenue. On appeal, the court of appeals reversed.

The court of appeals stated that, to comply with the Due Process Clause, there must be a minimum connection “between the state and the person, property or transaction it seeks to tax.”\(^ {167}\) Second, quoting *Quill*, “the income attributed to the state for tax purposes must be rationally related to values connected with the taxing state.”\(^ {168}\) The court equated the due process analysis for taxation to that for personal jurisdiction.

The Autonomy Trust 3 was described as a Texas trust governed by the laws of and administered in Texas. In the taxable year at issue (2006), the trustee, beneficiary, and trust protector\(^ {169}\) were all nonresidents of Illinois. Nevertheless, the Department of Revenue argued that (1) the trust owed its existence to Illinois and (2) the state provided the trust and beneficiary “with a panopoly of legal benefits and opportunities.”\(^ {170}\) In so doing, it echoed the pre-*Quill* due process analysis.

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165. The original trust was established in 1961 by A. N. Pritzker, the patriarch of the family. The family is known for founding Hyatt Hotels and the Marmon Group and claims several billionaires. See, e.g., Laura Baverman, *Billionaire Brothers Want More to Pritzker Name Than Hyatt*, UPSTART BUS. J. (Oct. 16, 2013), available at 2013 WLNR 26039913 (eleven members of the Pritzker family made the 2013 *Forbes’s* Wealthiest Americans list). One of the Pritzkers, Penny Pritzker, is currently the United States Secretary of Commerce.

166. 2 N.E.3d, at 1208.

167. Id.


169. A trust protector is a relatively new addition to the trust administrative structure. The position is authorized by Uniform Trust Code section 808(c). See UNIF. TRUST CODE § 808 cmt. (amended 2010) (“Subsections (b)–(d) ratify the use of trust protectors and advisers.”). Generally, the trust protector may exercise oversight with respect to the actions of the trustee and may have very broad powers, such as to amend or terminate the trust, or change the situs of trust administration and the governing law. There are many outstanding legal issues regarding the trust protector, as well as other trust advisers, who are also authorized by Uniform Trust Code section 808. One such critical issue is whether they are fiduciaries. A second issue is whether the trustee is bound to carry out their directions as to investments and distributions. The status of these advisers and the duty of the trustee to obey can have a critical impact on the state’s ability to tax. See supra text accompanying note 169.

170. 2 N.E.3d, at 1210.
In *Linn*, the court of appeals began its due process analysis by distinguishing *Chase Manhattan Bank v. Gavin*. It read that case as holding that the critical link between the state and the trust’s undistributed income “was the fact that the *inter vivos* trust’s noncontingent beneficiary was a Connecticut resident during the tax year in question.” As such, “the eventual receipt and enjoyment of the accumulated income were protected by Connecticut law so long as the beneficiary remained a beneficiary of the state.”

*Linn* emphasizes that the court’s reasoning in *Chase Manhattan Bank v. Gavin* regarding testamentary trusts is not pertinent. The permanent ties of testamentary trusts do not exist in the case of *inter vivos* trusts. Moreover, the Autonomy Trust 3 did not have a noncontingent beneficiary in Illinois. Most critically, the court explained: “Defendants cite no cases finding a grantor’s in-state residency is a sufficient connection for due process with an *inter vivos* trust.” In contrast, the court referenced *Blue and Mercantile-Safe Deposit Trust Company* for the proposition that “the grantor’s in-state residence is insufficient to establish a minimum connection.”

With respect to *Quill*, the *Linn* court noted that the Autonomy Trust 3 “had nothing in and sought nothing from Illinois.” Then, looking to the factors that would result in personal jurisdiction over the trust in Illinois litigation, the court emphasized that none of these gave jurisdiction under the facts of *Linn*: “the provisions of the trust instrument, the residence of the trustees, the residence of its beneficiaries, the location of the trust assets, and the location where the business of the trust is to be conducted.”

Notwithstanding the foregoing, at first glance, one could read the court’s language in the *Linn* opinion as implying that the income from assets pouring over from an estate can be subjected to taxation. The court explained that the Autonomy Trust 3 was not in existence when the settlor died and, thus, could not have been part of his probate estate. One could read this statement to suggest that the result might be different with respect to income from property that pours over from the estate to an inter vivos trust that is in existence.

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171. 733 A.2d 782 (Conn. 1999).
172. 2 N.E.3d at 1209.
173. *Id*.
174. *Id* at 1210.
175. *Id*.
176. *Id* at 1211.
178. *Id* at 1211.
A more thoroughgoing analysis of the text of the opinion strongly suggests that this is not the case. The trust in *Linn* was created by the exercise of a limited power of appointment by the trustee in 2002. The power had been created under the terms of a 1961 trust instrument. The opinion emphasizes that, even assuming that an Illinois court had validated the 1961 power, “what happened historically with the trust in Illinois courts and under Illinois law has no bearing in the 2006 tax year.” In short, the court of appeals seems to be saying that any state contacts must be present in the relevant tax year.

Based on the foregoing, *Linn* stands as the culmination of a series of cases that undermine the “forever tainted trust” statutes, holding them unconstitutional based on the Due Process Clause. While several states continue to tax on this basis, these statutes will likely be, and ought to be, overturned in the future upon federal constitutional challenge.

**C. Lingering Constitutional Issues**

1. If Taxation of a Trust Hangs on Residence of a Beneficiary, How Much Income Can Be Taxed?

This Article has already considered whether the residence of a trust beneficiary is enough of a contact to justify taxing a trust where the trustee is out of state, there are no trust assets in the state, and the settlor is no longer domiciled or resident there. The jurisprudence suggests that even if the settlor is still in state, there are not sufficient contacts to justify state taxation of an out-of-state trust.

If, however, the residence of a beneficiary is a constitutionally sufficient contact to permit the settlor’s home state to tax the income from investment assets held by an out-of-state nongrantor accumulation trust, precisely how much income constitutionally can be taxed? There is no definitive answer to the question. At one level, the reason for this is rather straightforward—there is no jurisprudence addressing this very practical question. At another level, there can never be a definitive answer—there is no objective, scientific metric. Ultimately, some judge or judges will decide whether and to what extent the presence of a resident beneficiary, noncontingent or contingent, suffices to justify taxation of the trust income.

What can be said with some assurance is that a hundred percent of the trust’s income cannot be taxed if there are any nonresident

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179. *Id.* at 1210.
beneficiaries. Likewise, no court to date has been prepared to endorse the imposition of tax on the basis that a beneficiary with a contingent, discretionary interest is a resident of the state. As a result, the out-of-state nongrantor accumulation trusts under consideration in this Article almost certainly cannot, as a federal constitutional matter, be taxed on account of a contingent, discretionary beneficiary’s state of residence. However, if the discretionary contingent beneficiaries do not count as such and there is a vested remainderman, one hundred percent of trust income may be subject to home-state taxation. Arguably, no apportionment need occur in this circumstance.

More generally, one might argue that the very fact that the settlor seeks to avoid all state taxation of income through use of the trust should circumscribe consideration of Commerce Clause issues, at a minimum. The fundamental concern from a Commerce Clause standpoint is whether interstate commerce is being discouraged by the state imposition. The principal question in the pending Supreme Court case Comptroller of the Treasury of Md. v. Wynne is whether a state or one of its subdivisions must credit income taxes paid to another state based on source, or whether the home jurisdiction can tax one hundred percent of the income based on the citizenship of the taxpayer. The concern is double tax and not total avoidance of tax. On the other hand, the criteria laid out in Complete Auto, refined in Quill, and applied to an out-of-state trust in Robert L. McNeil, Jr. Trust strongly suggests otherwise.

2. Can a Trust Be Taxed Based on the Application of the Throwback Rule?

Suppose an out-of-state trust has accumulated income over several years and then distributes the accumulated income as part of a distribution of some or all of the trust estate to the resident beneficiary. The beneficiary may seek to avoid the tax, first, on the ground that it was the trust’s income earned in the years when the trust was not resident, and second, that what was distributed to the beneficiary is principal under state trust accounting rules. Indeed, this was the claim made in the famous California Supreme Court decision of McCulloch v. Franchise Tax Board.

In McCulloch, the beneficiary was, nevertheless, held liable for the tax, apparently not individually on account of being a beneficiary,

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181. See supra text accompanying note 104, pertaining to the second prong of the Complete Auto test of constitutional validity under the Commerce Clause.
but rather on the basis of transferee liability. The enforcement of transferee liability against a California beneficiary assures that California will not lose out simply because the out-of-state trust itself was not subject to tax during the years of accumulation and could not be forced by the California revenue authorities to pay with the ease that a resident beneficiary can be compelled to pay.

The court also held that standard accounting rules are not controlling for income tax purposes. In the year of distribution, the standard characterization as principal can be ignored and the beneficiary’s tax burden can be determined as if income tax had been due as earned. This is essentially the same as the throwback rule historically applied to domestic accumulation trusts under I.R.C. § 667, prior to its repeal for distributions made in tax years beginning after August 5, 1997. The federal throwback rule was repealed because once the trust rates became more onerous than the individual rates, trusts could no longer produce lower taxes. Accordingly, no need remained for the complex throwback rules. The problem at the state level of taxation is different. The concern is that a beneficiary will receive income that is not taxed to the trust since it is not resident, and not taxed to the beneficiary because it was not received or owned by the beneficiary in the taxable year earned.

McCullough held that benefits and protections had been afforded the resident beneficiary during the accumulation period and, therefore, that the income could be taxed subsequently. But what benefits and protections exactly did residence in California offer? Had


185. Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 788 (1997); H.R. 2014, 105th Cong. § 507(b)(1) (1997); see also 2 BYRLE M. ABBIN, INCOME TAXATION OF FIDUCIARIES AND BENEFICIARIES 9–79 (2008). The federal throwback rule was repealed because once the trust rates became more onerous than the individual rates, trusts could no longer produce lower taxes. Accordingly, the complex throwback rules were no longer needed. See supra note 47 and accompanying text.

186. A state “throwback rule” is also implemented by about half the states in the case of cross-border sales with respect to “nowhere income.” This untaxed income results from an apportionment formula between the state from which sales are made and the state in which the purchase is actually made. If the producing state does not take account of sales and the state in which the sale occurred does not have sufficient nexus to tax, then the income can escape taxation. The throwback rule in this context has a very different meaning than as applied to out-of-state trusts and resident beneficiaries. It presumes that sales income was derived from the state of origin of the product sold. See UNIF. DIV. OF INCOME FOR TAX PURPOSES ACT §§ 160(b)2 (1957) (sales are considered to be in-state when they are not taxable in the state of the purchaser).
the beneficiary resided outside of California until the year of distribution, the trust would still have earned the income. Remember, the beneficiary is being taxed as a transferee, a proxy for the trust, to facilitate California’s collection of the tax.

If the beneficiary were being taxed qua beneficiary, the beneficiary almost certainly could be taxed only on income received in the current taxable year. After all, the beneficiary had no right to income in prior years and the tax is imposed on income received or to which the taxpayer is entitled during the year.\textsuperscript{187}

Moreover, the court’s reasoning would appear to justify taxation of beneficiaries who are not resident in the state in the year of distribution. Suppose the beneficiary had been a resident of California during all the accumulation years but left in the year of distribution, never to return. Under the reasoning of \textit{McCulloch}, the beneficiary would be liable for the tax in light of the benefits and protections during the accumulation years. The only issue would be collection. Notwithstanding the foregoing, California only imposes tax liability on the beneficiary if the beneficiary is a resident in the year of distribution,\textsuperscript{188} so the throwback rule would not, in fact, be applied, and there would be no taxation, despite the benefits, on account of residence enjoyed by the beneficiary during previous years of income accumulation in California.\textsuperscript{189}

With respect to the out-of-state trust being taxed through the California beneficiary in \textit{McCulloch}, the terms of the trust instrument provided that the beneficiary’s interest terminated if he did not survive until age forty. In that circumstance, the distribution would go to his heirs, each of whom also purportedly benefitted from a California residence. But what if they had all resided out of state? The primary beneficiary would have had a contingent interest that might never have vested and the remaindermen would have had no connection with the state. Certainly in each of the years when the income was earned and accumulated, it could not have been known whether the beneficiary would survive. The ephemeral contact with California in each of those taxable years would be a highly dubious foundation for the exercise of state taxing jurisdiction on both Commerce Clause and Due Process grounds, as currently interpreted. Unless \textit{McCulloch} is read narrowly, it appears to go well beyond what other courts have subsequently

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{187} Cal. Rev. & Tax. Code § 17041 imposes a tax on a resident’s taxable income for the “taxable year.” \textit{Cal. Rev. & Tax. Code} § 17041(1) (West 2013).
\item \textsuperscript{188} \textit{See id.}
\item \textsuperscript{189} However, the beneficiary is presumed to have continued residence if the beneficiary left the state within twelve months of the distribution and returned within twelve months of the distribution. \textit{See id.} § 17745(e).
\end{itemize}
\end{footnotesize}
considered a constitutionally permissible exercise of taxing power with respect to out-of-state nongrantor accumulation trusts.

Regardless of the merits of McCullough's due process analysis, there is another problem with the decision and others resting on the beneficiary's residence in the state. The decision in Robert L. McNeil, Jr. Trust v. Commonwealth has already been discussed in some detail. Importantly, the Commonwealth Court in that case held quite explicitly that the presence of beneficiaries resident in the state is not a sufficient basis to satisfy the first prong of the negative Commerce Clause analysis—the substantial nexus/physical presence requirement. Assuming the Supreme Court meant to impose this requirement when it stated as much in Quill, McCulloch and the California throwback system is constitutionally suspect—indeed, almost certainly constitutionally invalid. Not only was McCulloch decided pre-Quill and pre-Safe Auto, but the opinion failed to consider the negative Commerce Clause altogether.

In this regard, one must draw a fundamental distinction between a statute like California's and one that imposes a tax on the beneficiary when the beneficiary receives certain current income. There is nothing unconstitutional about the latter, because the beneficiary must be a resident of the state and is being taxed on his ownership of income. Indeed, every state with an income tax would tax such receipt of trust income.

In taxing the beneficiary individually, very few states enforce a throwback rule. The effect of the throwback rule is to capture tax on income that was accumulated in trust and distributed in a year where the current income is substantially less than the total distributed, including income accumulated from prior years. Without the throwback rule, those prior years forever escape taxation. New York has enacted a throwback rule effective January 1, 2014. Modeled on the California throwback rule, the New York law carefully excludes “the income earned by such trust in a taxable year prior to when the beneficiary first became a resident of the state” from adjusted gross income. As written, the New York law would appear to permit taxation through its throwback rule on income earned by the trust in a year in which the beneficiary was not resident in New York if subsequent to the year in which the beneficiary “first” became a resident.

191. See supra text accompanying note 109.
193. Id. Most likely, a California beneficiary would only be taxed for the years in which resident in California, but there is not any authority addressing the matter and the law is not entirely clear. Cf. Kenyon supra note 184, at 189–90.
The following example demonstrates the problem constitutionally with the New York rule. Assume the beneficiary is a resident of New York in year one of income accumulation. The beneficiary then becomes a resident of New Jersey in years two and three. In year four, the beneficiary once again becomes a resident of New York. In year five the distribution is made. The throwback rule should only result in taxation of income attributable to years one and four and not years two and three. However, the New York law, at least on its face, is not so limited.

3. Is New York’s Statutory Classification of Incomplete Gift
Nongrantor Trusts as Grantor Trusts Violative of
the U.S. Constitution?

Is New York’s classification of a NING and other incomplete gift nongrantor trusts as “grantor trusts” an unconstitutional exercise of its taxing jurisdiction? One can make a strong argument that it is. To understand why this is the case, one must revisit New York jurisprudence with regard to the constitutionality of taxing “forever tainted” trusts. In particular, in Mercantile-Safe Deposit & Trust Co. v. Murphy, the New York Appellate Division held that a state would violate the Due Process Clause if it imposed a tax on the income of an accumulation trust where the trustee was administering the trust from beyond the confines of the state’s boundaries and, at all times, the trust assets were under its control out of state.

The decision required New York to amend its tax law. While such trusts were still deemed “resident” trusts, an exemption from income tax was introduced mirroring the Appellate Division’s holding. That exemption still appears in the statute. Simply providing now that a trust can be taxed because it will be treated as a grantor trust does not eliminate the constitutional infirmity identified by the New York Appellate Division. If the trust is being administered outside the state and the trust assets are out of state, the trust that would have been constitutionally exempt in 2013 must still be constitutionally exempt in 2014. For that reason, only a judicial reversal of Mercantile-Safe Deposit & Trust Co. v. Murphy would permit New York’s recent enactment to pass constitutional muster. But were that to occur, it would put New York courts at odds with the more recent decisions in

194. See supra text accompanying notes 142 and 172.
196. See N.Y. Tax Law § 605b(3)(D)(i) (“A resident trust is not subject to tax under this article if all [stipulated] conditions are satisfied . . . .”).
other states and would essentially acknowledge that the New York courts had gotten federal constitutional law wrong for a half century.

One might argue that the court of appeals decision did not consider at what point the settlor’s strings of control become so significant that the trust itself can be ignored and its income collapsed into that of the settlor. The problem with this reasoning is that New York has consistently followed the definition in the Internal Revenue Code, and continues to do so. New York has now departed from the venerable rules set forth in the Code and observed by every other state that recognizes grantor trusts.

The fact that the income tax rules and gift tax rules at the federal level are not in pari materia on the issue of ownership is entirely coherent in view of the different purposes served by the taxes. While one might be seduced by the argument that New York has a strong interest in having consistent rules for its income tax and gift tax, the problem is that New York has no gift tax.

The New York effort to outlaw incomplete gift nongrantor trusts is purely an effort to staunch the loss of revenue resulting from the movement of capital to other states. Not only would this appear to violate Mercantile-Safe Deposit & Trust Co. v. Murphy under the Due Process Clause, but it also represents a very direct violation of the negative Commerce Clause under the reasoning of Robert L. McNeil Trust. Under that reasoning, the original residence in the state and the presence of a beneficiary are not sufficient contacts for jurisdiction to tax. More fundamentally, in many cases the application of the statute may not result in a fair apportionment.

The argument might be made that the New York legislation is simply attacking those seeking to avoid all state income taxes through use of a NING-like vehicle. The problem is that the ultimate tax take of all states is beside the point. The issue is whether the taxation comports with the standards set forth in the Commerce Clause precedent. Moreover, with respect to the Due Process Clause, Mercantile-Safe Deposit & Trust Co. v. Murphy rejects the argument that the Due Process Clause only applies in the double or multiple state taxation context. The limitations on state taxing jurisdiction with respect to the income taxation of trusts is not based on fairness to the states, but on the limits placed on each state’s power to tax individuals and entities scattered throughout the United States.

197. See Robert L. McNeil, Jr. Trust ex rel. McNeil v. Commonwealth, 67 A.3d 185, 195-97 (Pa. Commw. Ct. 2013) (as trusts did not derive any income, benefits, or assets in Pennsylvania, taxation was externally inconsistent, that is, there was not a fair apportionment of interstate income so that Pennsylvania only taxed the portion attributable to intrastate activities); see also the discussion of the case beginning supra text accompanying note109.
4. As a Constitutional Matter, Must One State Facilitate the Enforcement of Another State’s Judgment Pertaining to State Income Tax?

Suppose one state, such as the state of residence of a beneficiary, wishes to collect tax from an out-of-state trust. Assume that its highest state court has held that nexus constitutional. Can it sue the trust in the state in which it is being administered to collect the tax? By the weight of authority, one state is not required, from a constitutional standpoint, to enforce a claim for taxes in its courts in favor of the taxing authorities of another state.\footnote{198} On the other hand, if the claim has been reduced to a money judgment, it must be enforced under the Full Faith and Credit Clause of the Federal Constitution, which requires giving credit to the judgments of the courts of other states even if those judgments run against the local state’s strong public policy.\footnote{199} In many cases, however, enforcing the judgment will not be possible. As the Supreme Court held in \textit{Baker v. General Motors Corporation}:\footnote{200}

\begin{quote}
Full faith and credit, however, does not mean that States must adopt the practices of other States regarding the time, manner, and mechanisms for enforcing judgments. Enforcement measures do not travel with the sister state judgment as preclusive effects do; such measures remain subject to the evenhanded control of forum law.\footnote{200}
\end{quote}

Essentially, the Supreme Court has made clear that, as a constitutional matter, full faith and credit involves issue and claim

\footnotesize{198. See Moore v. Mitchell, 30 F. 2d 600, 604 (2d Cir. 1929) (Hand, J., concurring), \textit{aff'd on other grounds}, 281 U.S. 18 (1930) (refusing to express an opinion on the question); Philadelphia v. Cohen, 184 N.E.2d 167, 169–70 (N.Y. 1962) (deferring to legislation dictating public policy rather than weighing pros and cons); P.H. Vartanian, \textit{Annotation}, \textit{Right to Maintain Action or Proceeding in One State or Country to Collect or Enforce Tax Due to Another State or Country or Political Subdivision Thereof}, 165 A.L.R. 796, III.a. (1946) ("The view that an action or proceeding may be maintained in the courts of one sovereignty to recover taxes due to another sovereignty has received scant support from the courts."). \textit{But see} Okla. \textit{ex rel. Okla. Tax Comm'n v. Neely}, 282 S.W.2d 150, 151 (Ark. 1955) ("In our opinion the oft-repeated dogma, that one sovereign does not enforce the revenue laws of another, is rapidly approaching a deserved extinction in those instances in which the dispute is not international but merely interstate."). In \textit{Milwaukee County v. M.E. White Co.}, 296 U.S. 268, 275 (1935), the Supreme Court called it "an open question." The Restatement (Second) of Conflict of Laws § 89 cmt. b (1971) decided to express no opinion on the issue, noting that the courts are divided.

199. See \textit{Milwaukee Cnty.}, 296 U.S. at 277, 279 ("[Full faith and credit] ought not lightly be set aside out of deference to a local policy. . . . [N]o state can be said to have a legitimate policy against payment of its neighbor's taxes, the obligation of which has been judicially established by courts . . .").

preclusion, that is, res adjudicata, and not the obligation of the executive officials of one state to enforce a judgment in the manner prescribed by the out-of-state judgment itself. Moreover, if a state is required to afford full faith and credit and the other party—the taxing state—believes the judgment is not being enforced, its only remedy is to seek relief from the United States Supreme Court.

As a statutory matter, the Uniform Enforcement of Foreign Judgments Act, which governs enforcement of sister state judgments and has been adopted by more than half of the states, does not have an exception for tax warrants and judgments. Thus, it is possible for a state to seek enforcement of a tax-related judgment, for example, where the trustee or the trust assets are. While there does not appear to be a definitive opinion on the Act’s application to the out-of-state trust setting, the principle has been recognized in other settings. Still, procedural impediments may hamper actual collection on a judgment involving a tax claim.

In sum, the matter is rather complex and the outcome unpredictable. A state can slow-walk enforcement by seeking to confirm that all jurisdictional requirements were satisfied before the judgment was issued. It may also raise statute of limitations issues on the ground that this is a matter of local procedure and enforcement. As a consequence of this procedural autonomy, even if state tax authorities can obtain a judgment that is otherwise constitutionally valid, enforcement of such judgment will be uncertain. No doubt, this will encourage acceptance by the taxing authorities of a deeply discounted settlement of the judgment or even a decision not to expend limited resources by seeking enforcement of it in the first place. This contributes further to the appeal of the out-of-state nongrantor

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201. As a result, the judgment will not be enforceable if the preconditions to claim preclusion, including personal jurisdiction, have not been satisfied.

202. See Adar v. Smith, 639 F.3d 146, 155–56 (5th Cir. 2011) (“The Court has expressly indicated that the only remedy available for violations of full faith and credit is review by the Supreme Court.”).


204. See, e.g., Watkins v. Conway, 385 U.S. 188, 190–91 (1966) (per curiam) (affirming judgment for defendant as state statute of limitation for plaintiff’s foreign judgment tolled); Grazer v. Jones, 294 P.3d 184, 197 (Idaho 2013) (affirming summary judgment for defendant as plaintiff’s foreign judgment lien had expired). As the discussion in these cases indicate, even the authority to rely on local procedural law is in dispute. Courts are also divided on the question whether the forum’s statute of limitations is applicable when the Uniform Enforcement of Foreign Judgments Act applies. Compare Wright v. Trust Co. Bank, 466 S.E.2d 74 (Ga. Ct. App. 1995) (forum’s statute of limitations not applicable), with Fairbanks v. Large, 957 S.W.2d 307 (Ky. Ct. App. 1997) (applicable).
accumulation trust for taxpayers and their estate planners. Once again, federal constitutional law contributes to private wealth transfer by curbing state power to enforce its tax judgments.

VII. CONCLUSION

The theme of this symposium is the role of federal law in private wealth transfer. One surprising and invariably neglected area in which federal law plays a huge role is state income taxation of trusts. Specifically, the interpretation of the Federal Commerce and Due Process Clauses has facilitated an extraordinary stratagem by which wealthy individuals are able to avoid all state income taxes on investment income through the use of a carefully crafted out-of-state trust. More strikingly, this interpretation and application of federal constitutional law has come from diverse state courts.

Admittedly, the constitutional jurisprudence as applied to trusts is sparse. Yet certain reasonably safe conclusions can be drawn. A state can tax the worldwide investment income of a trust that is being administered from the state. A state can also tax the income of an out-of-state trust that is sourced to the state, as in the case of net profits from a business conducted by the trust in the state. The same would be true of rental income derived from real or tangible personal property located in the state.

On the other hand, the Federal Constitution, at least as most recently interpreted, does not seem especially tolerant of taxation based solely on settlor's tax residence at the time of creation of the trust or when the trust became irrevocable. It also seems to bar a state from taxing an inter vivos, out-of-state nongrantor accumulation trust on the basis of residence of a beneficiary, at least with respect to a trust that has exclusively discretionary, contingent beneficiaries, even if those beneficiaries are locally resident. A state may seek to tax the receipt by a resident trust beneficiary of distributed income from an out-of-state trust. There is strong constitutional authority for such taxation, even if, as a result, there is double taxation. However, for reasons discussed in this Article, taxing a trust based on the residence of the beneficiary is, and ought to be, of dubious constitutional validity, at least under the Commerce Clause.

By paying careful attention to the nuances of federal constitutional jurisprudence, some very savvy planners are crafting trusts and situating them in state tax havens so as to eliminate all state-level income taxes on investment income. Even when a trust is created for the obvious purpose of tax avoidance, courts apply federal constitutional principles on the basis of federalism-structural and
liberty-fairness concerns, rather than on the basis of tax policy. That treatment has created an enormously rich opportunity to enhance the accumulation and eventual transmission of private wealth through the use of a specialized trust, the NING, or by changing the situs of certain preexisting irrevocable trusts.