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Commentary on Jeffrey Schoenblum, *Strange Bedfellows: The Federal Constitution, Out-of-State Nongrantor Accumulation Trusts, and the Complete Avoidance of State Income Taxation*[1]

I. INTRODUCTION

Are INGs rightfully the next big thing? Professor Schoenblum presents an artful argument as to why an ING—an incomplete nongrantor trust sited in a state with favorable local tax laws—can produce significant income tax savings and should be defensible from a constitutional perspective.[2] Diplomatic in tone, Professor Schoenblum

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1. Jeffrey Schoenblum, *Strange Bedfellows: The Federal Constitution, Out-of-State Nongrantor Accumulation Trusts, and the Complete Avoidance of State Income Taxation*, 67 VAND. L. REV. 1945 (2014).

2. Schoenblum, *supra* note 1, at Part V. Professor Schoenblum focuses primarily on the NING—the Nevada incomplete nongrantor trust—because of Nevada's superior creditor protection statutes. *See id.* at Part III ("[D]escrib[ing] the basic design and operation of the NING version of the out-of-state non-grantor accumulation trust, which is being utilized to avoid state income taxes altogether."). I instead use the broader term ING in my Comment, to recognize the possibility of other jurisdictions developing competitive alternatives.

describes the technique without expressly endorsing it.[3] Should estate planners be following this trend, or walking away?

Given its docile position in Private Letter Ruling 2013-10-002,[4] which sanctions the technique from a federal income tax and gift tax perspective, the IRS is seemingly not to be feared. The U.S. Treasury, after all, has economic incentives aligned with the taxpayer here. If a taxpayer avoids state income tax by use of a trust, and the corpus of that trust grows over time (including the forgone state tax), larger amounts of income will be subject to federal income tax at the trust level or upon distribution to beneficiaries. The taxpayer wins, the federal government wins, and the state loses.

The states, whose already-strapped budgets take another hit from this technique, have an incentive to fight. New York is fighting mad already. A recent Bloomberg news article reported that New York's state tax commission, led by former Comptroller Carl McCall, was looking for solutions to stop the tax bleed.[5] The article quotes a commission member, James Wetzler: "The only purpose of setting up these trusts, near as far as we can tell, is avoiding state tax. . . . I'm literally at a loss to understand why [the IRS] would issue these rulings."[6] These were the drum beats of tax war.[7] New York recently responded aggressively to the technique by enacting a statute declaring an ING to be a grantor trust for state law purposes, even though an ING is a nongrantor trust for federal law purposes.[8] Professor Schoenblum argues that this new statute is "purely an effort to staunch the loss of revenue resulting from the movement of capital to other

3. Professor Schoenblum's other work does seem to promote the use of the technique. *See* Jeffrey Schoenblum & Neil Schoenblum, *Avoid State Income Taxes with the Right Kind of Trusts*, EST. PLAN., May 2014, at 19.

4. *See* I.R.S. Priv. Ltr. Rul. 2013-10-002 (Mar. 8, 2013), *available at* http://www.irs.gov/pub/irs-wd/1310002.pdf, *archived at* http://perma.cc/W2Z7-7KTS. Private letter rulings, of course, are not binding authority, so there is some risk that this position could change and there would be no right to rely upon it.

5. *See* Richard Rubin, *Wealthy N.Y. Residents Escape Tax with Trusts in Nevada*, BLOOMBERG NEWS (Dec. 18, 2013), *available at* http://www.bloomberg.com/news/2013-12-18/wealthy-n-y-residents-escape-tax-with-trusts-in-nevada.html, *archived at* http://perma.cc/K5CC-JCGV ("[Tax avoidance] maneuvers are getting fresh scrutiny from officials . . . .").

6. *Id.*

7. As one commentator has noted, "Given the perpetual desperation of most states for tax revenue, this may be one of the tools with a limited life." Gordon Schaller, *The 13.3% Solution: Of DINGs, NINGs, WINGs and Other ThINGs*, LISI EST.PLAN. NEWSL. (Leimberg Info. Servs.), Feb. 5, 2014.

8. *See* N.Y. TAX LAW § 612(b)(41) (McKinney 2014) (enacting a throwback rule).

states" that is incompatible with Due Process Clause and negative Commerce Clause jurisprudence—so the battle persists.[9]

Until the conflict is resolved, though, practitioners are well-advised to consider Professor Schoenblum's diagnosis of the risks and rewards of the technique, contemplating not just tax consequences but the constitutional landscape that lets a hundred tax flowers bloom. In response to his article, I would like to make two major points. First, I offer a suggestion as to how to make the technique of using an ING work better. Second, I explain why it might be better if an ING didn't work at all.

II. IMPROVING INGS

Professor Schoenblum pinpoints two risks with using INGs: the unreliability of federal constitutional law and the unreliability of state law. Although both bodies of law permit the technique to flourish for the time being,[10] if either of these moving pieces shifts, the structure becomes vulnerable.

Potential changes to the federal constitutional landscape are difficult to predict and probably impossible to plan around. The primary cases on point, *Quill Corporation v. North Dakota*[11] and *Complete Auto Transit, Inc. v. Brady*,[12] provide the structure for determining whether Due Process and Commerce Clause concerns are satisfied when a state taxes income.[13] As Professor Schoenblum points out, under these cases, the ING seems workable.[14] Although state law jurisprudence on the matter is thin and inconsistent, a proper analysis under existing federal constitutional law standards should support the effectiveness of the ING technique.[15] However, the Supreme Court could determine that these cases are not appropriate for determining tax liability in the trust

9. *See* Schoenblum, *supra* note 1, at 1994 (noting that the true issue is not whether NING-like vehicles are being used to avoid taxes, but rather if the taxation itself comports with the standards of the Commerce Clause precedent).

10. Federal constitutional law, paired with the careful selection of situs to ensure supportive state law, provides a legal environment in which the ING can succeed.

11. 504 U.S. 298, 318–19 (1992).

12. 430 U.S. 274, 288–89 (1977).

13. *See* Schoenblum, *supra* note 1, at Part VI.B.1 (discussing "The *Quill* Approach" to the Due Process Clause).

14. *See id.* at 1972–75 (describing how the specific provisions of the Nevada ING under discussion appear to pass the constitutionality tests prescribed in *Complete Auto* and *Quill*).

15. *See id.* (criticizing the Connecticut court's decision in *Chase Manhattan Bank v. Gavin*, 733 A.2d 782, 805 (Conn. 1999), and endorsing the Pennsylvania approach in *Robert L. McNeil, Jr. Trust ex rel. McNeil v. Commonwealth*, 67 A.3d 185 (Pa. Commw. Ct. 2013)).

context, and choose instead to develop a different test.[16] Furthermore, the Tax Injunction Act,[17] which enables this patchwork of laws, purportedly intends to facilitate the collection of state and local taxes.[18] Perhaps then it would not be surprising if the federal government did decide to craft a definitive rule settling whether settlors may use the ING technique to avoid state taxes.[19] There are also a variety of state-law approaches that would satisfy the Due Process and Commerce Clause tests as structured but would be less favorable to those seeking to avoid taxation of INGs.[20]

Changes to the state tax law landscape also create risk in using the ING technique, but it is here that practitioners could take some steps to design a sturdier plan. The primary risk is that the "best" state for using the ING technique could change.[21] The decision whether to have a generous tax statute that permits trusts to escape tax is driven largely by a state's calculation as to whether the increased trust business drawn to the state by forgoing the tax outweighs the revenue lost by taxing. As the data coming into this calculation changes—such as by competing states enacting similar laws—the decision to tax could change as well. Taxpayers could gain new states with favorable tax laws

16. In fact, the Supreme Court has granted certiorari on a tax case that may have bearing on this issue. *See* Md. State Comptroller of the Treasury v. Wynne, 64 A.3d 453 (Md. 2013), *cert. granted*, 134 S. Ct. 2660 (2014) (addressing whether, under constitutional principles, the county of residence must grant credits for imposed source state taxes). For further discussion on the implications of *Wynne*, see Brannon P. Denning & Norman R. Williams, Wynne*: Lose or Draw?*, 67 VAND. L. REV. EN BANC 245 (2014).

17. 28 U.S.C. § 1341 (2012). Professor Schoenblum cites the Tax Injunction Act as the prime statutory constraint on federal interference with state tax law. Schoenblum, *supra* note 1, at 1967.

18. *See* Peter Enrich, *Federal Courts and State Taxes: Some Jurisdictional Issues, with Special Attention to the Tax Injunction Act*, 65 TAX LAW. 731, 743 (2012).

19. It is unclear, however, whether the resolution of the conflict in *Wynne*—the extent to which the Dormant Commerce Clause protects against double taxation and so requires states to credit taxpayers for sums paid to other jurisdictions—has direct bearing upon the situation that exists when a tax haven is created though an ING and no double taxation is threatened. *See Wynne*, 64 A.3d at 461–62; Schoenblum, *supra* note 1, at Part VI.C.1.

20. For example, the Commerce Clause concern seems easily satisfied through the use of a sponge tax—a tax that applies to trust income only to the extent no other state taxes it. So long as the state had some sufficient nexus to the trust to satisfy due process, a sponge tax statute would allow a state to soak up forgone tax without producing double taxation, ameliorating Commerce Clause concerns.

21. *Cf.* Schoenblum, *supra* note 1, at 1957. While Professor Schoenblum identifies the diversity of state tax regimes as a land of opportunity for careful planners, he also identifies one of the driving factors that may make those opportunities elusive in the long run—while certain states certainly will compete to attract more and more financial capital, others will fight to prevent its flight to neighboring jurisdictions. *See supra* notes 5–9 and accompanying text.

or lose existing ones that abandon the strategy. The best situs is a moving target.[22]

It is in responding to this risk of the ING—failing to pick the right state—that I suggest a strategy for improvement. Estate planners are accustomed to moving targets, after years of shifting estate tax exemption amounts. A similar solution, the use of formula clauses or algorithms in forum selection, could prove useful here. Rather than stating that a particular state shall be the situs of the trust, the situs could be determined with reference to outside information: "The situs of this trust shall be the state that produces the lowest total net tax liability, taking into account taxes on the grantor, the beneficiaries, and the trust." Alternatively, language shifting the trust's situs could enlist fiduciary discretion: "The situs of this trust shall be the state that, in the discretion of the trustee [or trust protector], provides the most favorable tax environment, taking into account taxes on the grantor, the beneficiaries, and the trust." And if the trustee became the problem—if it were the residence of the trustee triggering the tax—that trustee could be removed by formula clause as well: "Any trustee whose residence causes the income of the trust to be subjected to a tax in a state which would otherwise not assess a tax shall be removed and replaced by a successor institutional trustee selected by a majority of the qualified beneficiaries of the trust."

Overall, Professor Schoenblum ably points out the variability and vulnerability of INGs from a state law perspective.[23] I suggest that this risk might be mitigated by incorporating more formula clause drafting.

III. OPPOSING INGS

Despite Professor Schoenblum's convincing argument that an ING can flourish in the existing constitutional law and state law landscape, I'd like to take the position that all this ING-ing may not be a good thing(-ing) for many clients, for the trusts and estates discipline, or for the status of the law as a whole.

The growing emphasis on INGs and other techniques focusing exclusively on tax minimization interferes with the core mission of an estate planner: to counsel a client in planning to die and to share the wealth that has been accumulated over a life. At its center, estate

22. Trusts in Uniform Trust Code states, or those with similar statutes, may already be able to chase a better tax situs under Uniform Trust Code § 108(d), but generally only with notice and consent of qualified beneficiaries. *See* UNIF. TRUST CODE § 108(d) & cmt. (amended 2010).

23. *See* Schoenblum, *supra* note 1, at 1957–63 (discussing ten discrete categories of state law approaches).

planning is about two important and powerful things: dying and giving. It is about the fact that we are all going to die, and, after that, we have very limited opportunities to explain how we would like things to operate in our absence. At its best, the practice of trusts and estates can provide a sort of immortality in which clients can create systems of support for people or causes that they cannot bear to leave behind. It is a recognition of our own fragile humanity. The fact that you can't take it with you[24] presents an opportunity to be giving—to think about how you want the world to go on without you and to give it a push in the direction you think is best.

It is the unquantifiable outcomes of estate planning that are the most important.[25] Imposing some control over death, the great uncontrollable, and finding peace in taking care of loved ones—these core missions of estate planning should not be overshadowed by the quest for more, more, more money. There is too much emphasis on growing the pie without acknowledging that dead people don't eat pie. Instead, the emphasis should be on sharing the pie.

In recent years, the trusts and estates discipline has lost sight of those core values and shifted to being about something less: "wealth management." Lawyers promote elaborate contraptions where you can put money in and get more money out—never mind that you lose control over the assets or how they are used or your connection with the people whom they are supposed to benefit. The goal is to have the biggest number at the end of the day, and other goals are marginalized. When we chase these tax tricks, we lose sight of what is most important: how dying people want to leave things behind.

The increase in exemption rates has heightened the pressure to defend legal fees in terms of tax dollars saved. Lawyers need to do a better job marketing the value of their services as more than simply paying money to save money.[26] Estate planning is so much more than that.

INGs are also potentially oversold in that they may be too risky for some clients or might require the surrender of too much control for others. The risks involved in an ING are discussed above, so here I will focus on control. For an ING to work, the client must part with a precise

24. In Frank Capra's film version of the Kaufman & Hart play of the same name, Grandpa Vanderhof quips, "Maybe it'll stop you trying to be so desperate about making more money than you can ever use? You can't take it with you, Mr. Kirby. So what good is it?" YOU CAN'T TAKE IT WITH YOU (Columbia Pictures 1938); *see also* 1 *Timothy* 6:7 ("[W]e have brought nothing into the world, and so we cannot take anything out of it.").

25. *See* Mark Glover, *A Therapeutic Jurisprudential Framework of Estate Planning*, 35 SEATTLE U. L. REV. 427 (2012).

26. On the shortcomings of how lawyers market estate planning, see Michael R. McCunney & Alyssa A. DiRusso, *Marketing Wills*, 16 ELDER L.J. 33 (2008).

amount of control—retaining enough that the gift is incomplete but giving up enough to eliminate grantor trust status.[27] To accomplish this, the client must surrender independent control over who will receive the trust property, sharing that right with a group.[28] The trust cannot have an ascertainable standard, or else the beneficiary could be considered vested. Instead, the client must cede broad discretion to the trustee. The client must also choose the trustee based on location (and likely future location), as opposed to cost or quality of fiduciary administration. For some clients, this may "sell" too much control for tax benefits. It may be worth forgoing the tax savings to allow the client increased flexibility in determining how to use the trust's assets.

Finally, INGs are detrimental to society in that they require an ugly state-law landscape to work. For the ING technique to be successful, we need the intersection of several state laws. Policy questions surrounding these laws are not exclusive to the ING context.

An ING needs a state that does not claim any tax hold on trust income based upon the residence of its trustees. From a policy perspective, is it better to have states tax trust income or gather the revenue elsewhere, such as higher rates on earned income or higher sales tax? An ING also requires a ruthless asset protection trust ("APT") statute, otherwise the trust would be attributed to the grantor and taxed through the grantor. Do we want to promote the strictest of APT statutes, where even truly sympathetic creditors, like babies owed child support by deadbeat dads, are denied an invasion right? Is it worth drafting APT statutes in a way that might have rotten policy fallout, just so the ING technique can endure?

Assuming many states reach the same conclusion, deciding that it's worth forgoing the tax and structuring APTs in ways that may be less fair, do we then have a race to the bottom? Drawing on Professor Sitkoff's work with Professor Schazenbach on jurisdictional competition for trust funds, that is what we would see.[29] Is the ING the future we want?

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27. *See* Schoenblum, *supra* note 1, at 1948 (noting that if "the settlor retains certain strings of control," grantor trust status is triggered and the technique will fail). The control factors are discussed in more detail in Part III of his article.

28. The right to make distribution decisions is generally held by beneficiaries with a substantial adverse interest to the grantor. *See id.* The hope is that despite surrendering actual control, the grantor will still have practical control, largely because of voluntary cooperation of the beneficiaries. *Id.* Not all families are prone to voluntary cooperation. *See, e.g.*, Janine Rayford Rubinstein, *Why Kim Kardashian Has 'No Sympathy' for Brother Rob*, PEOPLE (July 21, 2014, 3:10 PM), http://www.people.com/article/kim-kardashian-rob-kardashian-weight-vacation.

29. Robert H. Sitkoff & Max Schanzenbach, *Jurisdictional Competition for Trust Funds: An Empirical Analysis of Perpetuities and Taxes*, 115 YALE L.J. 356 (2005).

IV. CONCLUSION

Professor Schoenblum illuminates an interesting possibility for tax planning and illustrates why it should be defensible from a constitutional law standpoint. INGs may very well be a good strategy for a limited number of clients, and practitioners could take steps, such as drafting formula clauses, to improve the way such trusts are structured. Nonetheless, there are many drawbacks to the technique as well, not only for the client but also for society at large, through the ING's negative impact on state law and the trusts and estates practice area. Overall, despite Professor Schoenblum's excellent explanation of the technique, it is far from clear that an ING is a good thing.