Jack Straw Fortnightly*

as applied

So. The Supreme Court has decided *Kaestner Trust*, and contra Jack's predictions, the "dormant" commerce clause was mentioned only in passing, in a footnote saying we are not dealing with this just yet.

Because as it happens we can dispose of this case on the ground that a state statute purporting to tax income accumulations in a trust where a discretionary beneficiary is a resident does not afford a nonresident trustee due process. Under the particular facts of this case.[1]

Well, but which facts? the skeletal facts recited in the text of the opinion, or the more extensive facts that were developed in the trial court?

What Justice Sotomayor says in the closing paragraph of her opinion is that we are dealing only the particular circumstance in which "a beneficiary receives no trust income, has no right to demand that income, and is uncertain necessarily to receive a specific share of that income."[2]

Disregarding, in other words, any arrangements that had been made between the beneficiary and the trustee to withhold distributions that would otherwise have been taxed to her in North Carolina, but in the meantime to lend her a quarter million at three or four pct. so she and her husband could invest in "vanilla,"[3] and then "repay" the loan from the proceeds of a later distribution from a second trust --

-- into which the subject trust had in the meantime been decanted, with the beneficiary's consent, in order to forestall an outright distribution of the entire trust corpus to her at age forty.[4]

Those facts are not mentioned in the opinion, and Jack says some other trustee in some other case should not expect to skate. The *Kaestner Trust* decision is limited to a specified subset of its particular facts.

limited, we got limited

All nine justices joined this opinion, and Justice Alito wrote a brief concurrence, in which Chief Justice Roberts and Justice Gorsuch joined, emphasizing that we are not breaking new ground here, we are simply following existing precedent in *Brooke* and *Safe Deposit*,[5] and

again, the present decision is limited to the specific facts of the case. Which again are, quote,

> the resident beneficiary has neither control nor possession of the intangible assets in the trust. She does not enjoy the use of the trust assets. The trustee administers the trust and holds the trust assets outside the State of North Carolina[,]

end quote.

All of which is not to say that the beneficiary does not have enforceable rights against the trustee.[6] But for present purposes we are going to pretend she does not -- or that whatever those rights might be, they are somehow not sufficient to create due process "minimum contacts" between the state of her residence and a nonresident trustee.

To her credit, Justice Sotomayor stops just short of labeling the beneficiary's interest here as "contingent." In a lengthy footnote 10 on page 12 of the opinion, she puts the word in scare quotes, and says the Court is reserving the question "whether a different result would follow if the beneficiaries were certain to receive funds in the future," even if for the moment the trustee is accumulating income.

So the North Carolina statute is actually not unconstitutional on its face, but only "as applied" to a trust in which income is being accumulated by a nonresident trustee, the resident beneficiary has no right -- at least, not on paper[7] -- to demand distribution, and the accumulations may actually end up being distributed to some other beneficiary down the road.

where this leaves us

The decision may turn out to have limited value as a precedent.

Jack suggests we should not even infer that a court might not find in an essentially identical case -- nominally "absolute" discretion in the trustee to accumulate, no actual distributions -- that an agreement between the beneficiary and the trustee to defer taxable "distributions" and instead lend money to the beneficiary at a discounted interest rate, and then have her "repay" the loan from a later distribution, does give the state sufficient "contacts" with a nonresident trustee to justify imposition of an income tax on the accumulations.

Why not? because the Court chose not to mention any of these additional facts in its decision, or to explain why they did not create sufficient contacts. For purposes of citing *Kaestner Trust* as precedent, it is as though these facts did not exist.[8]

Responding to the state's argument that allowing the trust to escape state income taxation under these facts "will lead to opportunistic gaming of state tax systems," Justice Sotomayor says, well, "it is by no means certain" that this will actually happen. After all, we are talking about a trust in which the nominal beneficiaries have essentially no enforceable rights. A settlor seeking to take advantage here "[would] have to weigh the potential tax benefits of such an

arrangement against the costs to the trust beneficiaries of lesser [formal, legal] control over trust assets," she says.

Well, yeah. And/or select a trustee who will cooperate with her.[9]

Jack is thinking in particular about the "incomplete nongrantor trust," for which we have yet another batch of letter rulings this week, PLRs 201925002 through 010, again identical verbatim.

Part of the design here is to have a corporate trustee resident in a zero tax state, but to strip the trustee of discretion in making distributions, instead lodging that power with a committee comprised of beneficiaries whose interests are nominally "adverse" to the exercise.

But even IRS will not give an advance ruling on the question whether the settlor might have reserved "administrative" powers that would trigger "grantor" trust status under section 675. These are facts and circumstances that would be explored on audit.[10]

No single beneficiary of an ING has a right to demand income, and none is absolutely certain of receiving a specific share of accumulations. To paraphrase *Kaestner Trust*. But the entire operation is a matter of ~~complicity~~ coordination among individuals who share an interest in avoiding the imposition of a state income tax on undistributed income.

final regs on SALT cap workarounds

On June 13, the Treasury and IRS published final regs treating a state or local tax credit for a contribution to an exempt org as a *quid pro quo*, reducing the amount allowable as an income tax charitable deduction. Seventy pages of preamble and not quite four pages of regulatory text.

The final regs track the proposed regs, published last August 27, pretty closely, with only a couple of "clarifying and technical" changes.

We are keeping the basic *quid pro quo* analysis. And we are keeping the exception for credits aggregating no more than fifteen pct. of the value transferred.

And although we acknowledge the distinction between credits and deductions, we are extending the rule to reduce the charitable deduction where the taxpayer receives or expects to receive state or local deductions in excess of the value transferred.

Also, we are extending the entire analysis to deductions claimed by a decedent's estate or a nongrantor trust under section 642(c).

But what really makes TD 9864 a fun read is the preamble, where the Treasury and IRS take on some of the objections commenters had raised to the proposed regs and sketch out some issues on which we might expect further guidance in the future.

Why we went with *quid pro quo* when we said in Notice 2018-54 we were looking at substance over form, etc.

Of particular interest is the discussion of the fifteen pct. exception, which as some commenters pointed out creates a "cliff effect," where a taxpayer who receives credits

aggregating more than fifteen pct. of the value transferred gets zero benefit from the exception.

The response from the Treasury and IRS is, this is not intended to be a *de minimis* exception, it is intended to effect a rough justice, "ensur[ing] that taxpayers in states offering state tax deductions and taxpayers in states offering economically equivalent credits are treated similarly."

In other words, the fifteen pct. peg is meant to approximate the combined benefit of state and local tax deductions at what are understood to be the highest marginal rates currently in effect.

One item they decided needed immediate attention was the question whether, if a portion of the claimed charitable deduction is being disallowed because of an offsetting state credit, the taxpayer can claim that amount as a deductible tax payment, assuming we are not already over the $10k cap.

And Notice 2019-12, issued the same day as the final regs, says yes -- in the year in which the credit is actually applied, but only if the taxpayer is an individual, and only if the contribution was made in cash.

parthian shot

After eighteen years in the position, national taxpayer advocate Nina E. Olson will be retiring at the end of July. In her final "objectives" report to Congress, released June 20, Ms. Olson identified a dozen "areas of focus" the advocate will be pursuing in coming months.

One of these, item eight, recounts the ongoing saga with respect to the inadequacy of the "short form" 1023-EZ as a tool for determining the exempt status of small orgs, and the inadequacy of IRS review processes to identify applicants whose organizing documents were obviously defective.

Back in 2016, the taxpayer advocate actually issued a directive requiring TE/GE to revise the 1023-EZ to require a narrative statement of the applicant's exempt purpose, copies of its organizing documents, and at least some summary financial information, and --

-- and to change its procedures "to require review of these materials prior to making a determination."

The present report says, okay, the agency did revise the form, but they have done nothing to improve their review procedures.

We still have a very high rate of approvals for noncompliant orgs, and now TE/GE is apparently pulling folks off of examinations in order to deal with the backlog in determinations --

-- thereby undermining the original premise that even if we let a lot of noncompliant orgs through on the "short form," we can weed them out in our shiny, new "post-determination compliance program."

rant, deferred

One of these days, Jack will probably want to sound off at length about how this whole problem is an artifact of

(a) the relentless reduction,

year over year for almost ten years, in the agency's operating budget, which has forced a sharp reduction in staffing, and of

(b) the continuing fallout from the so-called "targeting scandal," from which the takeaway seems to have been, get the approvals out quickly and let examinations worry about cleaning up the mess. A lot of these smaller orgs are going to fold quickly anyway, screw it.

For the moment, suffice it to say there are some in the Congress who seem to want the agency to fail, and for the moment they are getting their way.

afterthoughts

[1]

And another excellent writeup on SCOTUSblog by Prof. Erin Scharff of Arizona State.

[2]

On page 7, in introducing the substantive analysis, Justice Sotomayor disclaims that the present ruling implies anything about the validity of a statute -- apparently not even the very statute at issue here -- purporting to tax trust accumulations "premised on the residence of beneficiaries whose relationship to trust assets differs from that of the beneficiaries here."

At footnote 8 on page 10, she notes that while the beneficiaries here "do not have the requisite relationship with the trust property to justify the state's tax," the Court is not reaching the question "what degree of possession, control, or enjoyment would be sufficient to support taxation."

And at footnote 11 on page 13, she says there is no need to resolve the question whether under *Hanson v. Denckla* due process requires "minimum" contacts with the trustee, because "even if" the residence of a beneficiary might be a sufficient contact "in some circumstances," those circumstances -- whatever they might be -- are not present here.

Nowhere in either the principal opinion or the concurrence is there any mention of *Fielding*, still pending cert, in which the Minnesota statute purported to tax trust accumulations on the strength of the fact that the settlor was a resident at the time he toggled off the "grantor" status of the trust.

[3]

Plain vanilla. This detail was mentioned in a deposition of the trustee, see page 100 of the joint appendix.

[4]

The decision of the North Carolina state supreme court from which the petition for cert was taken treated these facts as having been established.

Jack is asking, at what point does this kind of collaboration between a nominally "discretionary" beneficiary and a nominally "independent" trustee arise to the "requisite relationship" justifying the imposition of a tax?

If you have a few minutes, Jack would urge you to peruse this article by Oklahoma City University law professor Carla Spivack in the current issue of the UCLA Law Review on "the myth of the powerless beneficiary."

[5]

These two decisions are discussed in slightly more detail in Jack Straw volume two, number six.

[6]

Jack is starting to wonder whether, if we strip the beneficiaries of any enforceable rights, we have a trust at all. Maybe these entities should be taxed as limited partnerships.

[7]

Or at least, not that she cares to enforce when it is to her long term advantage not to.

In some other case, a beneficiary might petition a court to force distribution, on the premise that the trustee's decision to withhold income was an abuse of his discretion.

In the particular case, the beneficiary had a pile of money of her own, which of course made it easier for her to cooperate in a plan to avoid state level taxation of trust accumulations.

[8]

As noted above, in footnote 10 on page 12, the Court reserved the question "whether a different result would follow if the beneficiaries were certain to receive funds in the future."

But in the present case, it was at least a practical certainty that the beneficiary would at some point receive a distribution sufficient to discharge the promissory note.

[9]

The record here also shows, page 98, that at one point the trustee decanted a portion of the trust into a "special assets trust" that was structured as a "grantor" trust as to the settlor, so that he could in effect make additional nontaxable contributions by way of paying income taxes on passthroughs from certain limited partnerships.

Why the state of New York caved on taxing this trust remains a mystery to Jack. See the discussion at footnote 1 in Jack Straw volume two, number six.

[10]

The IRS Data Book for 2018 shows 3.1 million 1041s filed for estates and trusts, of which only 1.5k were selected for examination, not even one-twentieth of one pct. About half of these were done by correspondence.

Statistics of Income data from 2014 suggest that not quite half of 1041s are filed by "complex" trusts, *i.e.*, nongrantor trusts that might accumulate income, but there is no further breakdown as between testamentary and *inter vivos* trusts.

Jack says, what's that big noise from the sky