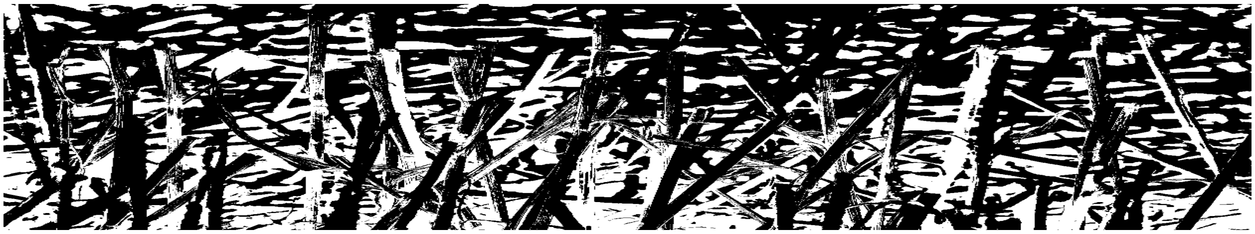

Jack Straw Fortnightly*

post mortem

We are not going to expend a lot of words analyzing the oral argument two weeks ago in *Kaestner Trust*. Well, okay, maybe a couple thousand.

Contra Jack's prediction, the phrase "dormant commerce clause" appeared not once in the transcript. But there were passing references to *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), and *South Dakota v. Wayfair, Inc.*, 138 S.Ct. 2080 (2018), both of which are commerce clause "nexus" decisions, and a fair amount of talk about allocating potential tax exposure among several states.

So at least this is on the radar. But to get to those questions you first have to get past due process.

There is a rather good summary on SCOTUSblog by Prof. Erin Scharff of Arizona State. As she notes, several justices seemed uncomfortable with the idea that North Carolina should be permitted to tax accumulations in a trust administered elsewhere for the benefit of a resident who might not actually ever receive any distributions.

So there were exactly two arguments the North Carolina solicitor general, Matthew W. Sawchak, had to make:

(1) a trust is not an entity, but a relationship among several parties, and due process analysis should not focus only on the trustee; and

(2) in the particular case, although the trustee had ostensibly unfettered discretion to withhold distributions from the settlor's daughter, her interest in the trust was not "contingent," but vested subject to defeasance.

And although some of the justices did not seem ready to hear this, he at least got some of the words out.

questions from the bench

Only Justice Kagan seemed to actually "get it." During the direct argument she created an opportunity for Mr. Sawchak to elaborate the second point, pages 16 and 17, and then she pressed the respondent's lawyer, David A. O'Neil of Debevoise & Plimpton, pretty hard, pages 34 to 38, on why it should make any sense to allow only the state in which the trust is being administered[1] to tax income accumulations, when these are ultimately benefiting the [current discretionary and vested remainder] beneficiary.

The settlor's daughter "[is] seeing a substantial asset of hers increase in value," Justice Kagan argued, "and even if she can't touch it right now, she's getting richer and richer because of it, and that's influencing her life choices because she knows she's eventually going to enjoy that money."

Well, maybe not, countered Mr. O'Neil, again suggesting the trustee's discretion was absolute.[2] And he was about to cite the ACTEC amicus brief, page 36, when Justice Kagan interrupted to clarify that he was using the word "contingent" to refer to the fact that outright distribution was delayed until the beneficiary attained age forty, and that the trustee had discretion to accumulate in the meantime.

Apart from Justice Kagan's questioning, probably the most interesting exchange came when Justice Gorsuch asked Mr. Sawchak if he was asking the court to overrule its prior decisions in *Safe Deposit Trust Company v. Virginia*, 280 U.S. 83 (1929), and *Brooke v. Norfolk*, 277 U.S. 27 (1928).

Mr. Sawchak first said the court might distinguish these on the ground that they dealt with property tax rather an income tax, but Justice Gorsuch was not having it. So then Mr. Sawchak said these decisions had been overruled already, albeit implicitly, by that portion of *Quill* that was not itself overruled by *Wayfair*.

"But assuming we thought those were still precedents," said Justice Gorsuch, page 29, "let's just spot me that for the moment."

Paren, "Laughter," close paren.

forum-directed activity by whom

So, what about it. If Justice Gorsuch is not satisfied with distinguishing these on the nature of the tax, do we need to overrule them, and/or has *Quill* already done this.

In *Safe Deposit*, the court said a state could not, consistent with due process, impose a property tax on the corpus of a trust administered elsewhere, simply on the strength of the fact that the beneficiaries lived there.[3] The majority opinion cited *Brooke*, which had been decided just the previous term, to similar effect.[4] In each case, the court treated intangibles held in trust as having a situs where the trust was administered.

Sixty-odd years later, on a somewhat different page, *Quill* confirmed a trend in due process analysis in the context of adjudicative or regulatory jurisdiction, away from requiring a "physical presence" and toward a focus on whether the defendant has "purposefully directed" its activities toward residents of the state, but then said the commerce clause nonetheless requires a "substantial nexus" under the criteria established in *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977),[5] in order to impose a tax.

The *Wayfair* decision rejected this latter position, so apparently all we need now is purposeful direction.

Of course Mr. O'Neil argued, pages 63 to 64, that we do not have "forum-directed conduct" here, because the trustee is sitting quietly in

Connecticut while the beneficiaries move to North Carolina or wherever. But this again assumes that the trustee is the only relevant contact.

what was Justice Breyer on about

Throughout the argument, Justice Breyer wanted to talk about one or another hypothetical involving whether a state could properly tax realized, or even unrealized, appreciation on intangibles held elsewhere for the benefit of a resident, and if so, how you might discount the future value, etc.

In some instances, the conditions of the hypothetical were completely at odds with the facts of the present case. So it was difficult to see where he was going with this.

But having sat with this for a few days, Jack is coming around to the view that maybe Justice Breyer was laying the groundwork, however obscurely, for overruling *Safe Deposit* and *Brooke* by way of *Quill* and *Wayfair*.

Because in fact Mr. O'Neil did concede, page 53, responding to Justice Kagan, who was following up a line of questioning initiated by Justice Breyer, that a state could impose a wealth tax on intangibles held elsewhere for the benefit of a resident who had a "current, vested right," whatever exactly that might mean. As though maybe *Safe Deposit* and *Brooke* have in fact been overruled, or superseded, or what have you.

In making this concession, Mr. O'Neil mentioned a Pennsylvania supreme court decision, *Commonwealth v. Stewart*, 338 Pa. 912, A.2d 444 (1940), cited in the petitioner's brief, which rejected a due process challenge to a state property tax on the value of a resident beneficiary's life estate in a trust. The Pennsylvania court had distinguished *Safe Deposit* and *Brooke* on the ground that in those cases the tax was on the entire value of the trust corpus. And the supreme court affirmed without opinion, 312 U.S. 649 (1941).

The difference, said Mr. O'Neil, is that here the state is taxing the trustee, not the beneficiary directly. But Justice Kagan, as noted above, was suggesting that a tax on income accumulated at the trust level was in effect a tax on an "increase" in equity held by the beneficiary.

And then Justice Sotomayor made an interesting comment, page 55, sort of to the effect that she might be counting votes and could see Justices Kavanaugh, Alito, "and I assume Justice Kagan," might be ready to rule for the state if they were satisfied that the beneficiary here was in fact vested.

But this is reading tea leaves.

Jack says

Apparently a lot depends here on whether a majority of the court can accept the idea that a trustee can be given sufficiently broad discretion to accumulate income that she need not answer to the nominal beneficiary at all. This would seem to be fundamentally at odds with the common law understanding of what is a trust.

Justice Ginsburg came close to questioning this, page 41, when she asked whether the trustee did not need the consent of the settlor's daughter to effect the decanting that postponed the outright distribution that would have occurred when she attained age forty. Not under New York law, said Mr. O'Neil. Which is true on its face, but there is such a thing as a duty of impartiality among the beneficiaries, which the settlor cannot waive.

Absent a string of catastrophes that would bring in collateral heirs of the trust settlor, or the exercise by the daughter of her limited testamentary power to appoint, all of the potential distributees of this trust were residents of North Carolina during the years in question. And as Mr. O'Neil himself acknowledged, page 60, the trustee is under a duty to act in the "best interests" of the beneficiaries.

don't try this at home

An interesting thread on one of the listservs the other day about whether there might be some opportunity for post-mortem planning where a decedent's revocable trust was funded in part by distributions from qualified plan, and a fractional share of the residue was to be paid to charities. And although this was not made entirely clear, apparently the trustee did not have express authority to make non- pro rata allocations.

This is a subject on which Chris Hoyt of UMKC Law speaks and writes with some frequency. One paper from 2015 posted to SSRN, and probably some more recent material posted to the NACGP website. But I want to pursue something else here.

Somewhere on the thread the idea came up, maybe it would possible to reform the trust to simply allocate items comprising income in respect of a decedent to the portion distributable to the charities. Y'know, like it shoulda been done in the first place. Which, I dunno, maybe, scrivener's error, bona fide controversy, depends on the facts.

But someone gave a cite to the 2018 decision by an intermediate appellate court in New York in Matter of Sukenik, 162 A.D.3d 564, 75 N.Y.S.3d 422 (Mem), reversing a decision of the surrogate's court that had denied a petition to reform not only the decedent's revocable trust but also an IRA beneficiary designation, so the account proceeds could fund a residuary gift to a private foundation and the surviving spouse could receive equivalent value in non-IRD assets.

The catch here was that the revocable trust plan was already in place when, as the surrogate's court put it, "the decedent himself thwarted the tax efficiency of his own estate plan by making petitioner the beneficiary of the IRA."

Nonetheless, the appellate division reversed, in a brief opinion citing some other surrogate's court decisions, including *Matter of Hicks*, 10 Misc 3d 1078(A), which involved a scrivener's error that would have disqualified both the marital and credit shelter trusts from holding S corporation stock.[6]

The problem here, as your correspondent immediately pointed out in the listserv thread, is that IRS is under no obligation to respect this reformation, and they have made it clear in letter rulings that they will not.

Examples include PLR 201628004 -- actually rather similar, a decedent mistakenly changing a beneficiary designation and undermining the plan --, and PLR 201021038, involving the reformation of a trust to remove provision for accumulations, so it could be treated as a conduit with respect to the decedent's IRAs.

Both rulings cited *Estate of La Meres v. Commissioner*, 98 T.C. 294 (1992), in which the court disallowed a claimed estate tax charitable deduction for the remainder of a nonqualified split interest trust, where the parties effected a nonjudicial reformation to terminate the trust early solely for the purpose of claiming the deduction.

lowered expectations

In Notice 2019-30, issued April 24, the Treasury and IRS have again invited the public, as they do every spring, to identify tax issues requiring formal guidance to which they should give priority in coming months.

In selecting projects to include in the fiscal 2020 plan, they say they will consider the usual factors, including whether the proposed guidance would resolve "significant issues" affecting a large number of taxpayers, whether it would "promote sound tax administration," etc.

But for a couple of years now, these notices have included some additional, limiting criteria: whether the proposed guidance "would be in accordance with" Executive Orders 13771 and 13777.

The former order requires that an agency issuing a regulation that increases "incremental costs" -- including not only direct budgetary outlays and net transfers, but also compliance costs incurred by the private sector -- simultaneously eliminate the costs associated with "at least two prior regulations." The latter order describes an enforcement mechanism to be implemented by the Office of Management and Budget.

Then last year they added yet another caveat. We are going to be pretty busy with guidance implementing the tax overhaul enacted in December 2017, the Notice said, and we do not expect to get to some of the items already identified in last year's plan until sometime next year. And of course some of those items had been carried for several years already.

And now they are lowering expectations yet further. "Due to resource limitations," the Notice says, "[we] also also expect that not all of the uncompleted projects will be carried over" to the fiscal 2020 plan, "and only a limited number of new non-TCJA guidance projects will be added to the plan." They are actually going to drop pending projects.

The current plan already does not include active projects for formal guidance on whether excess deductions on termination of an estate or trust will be deductible by distributees during the suspension of itemized deductions through 2025, see Jack Straw volume one, number nine, or on how the "grantor" trust rules will work after divorce with respect to powers once held by a former spouse, in light of the permanent repeal of section 682, see Jack Straw volume one, number six.

The deadline for submissions is June 07.

the continuing downward trend

And finally, in Rev. Rul. 2019-12, IRS announced the section 7520 rate for May will fall yet another twenty basis points -- sixty so far this year, eighty since December --, to 2.8 pct., the lowest rate since February 2018, when we were trending slowly up from a trough at 1.4 pct. in August and September 2016.

Good news for the small handful of people who are still leveraging GRAT remainders, but also for folks who might be using grantor CLATs to accelerate income tax charitable deductions into the current year.

As we have mentioned before, there is a tradeoff between the present value of the residuum of a gift annuity and the tax treatment of distributions over the expected return multiple. As the 7520 rate goes down, the present value of the annuity goes up, and the deduction goes down -- but the exclusion ratio goes up, so that a smaller portion of the payout is taxable to the annuitant.

graffiti

[1]

Not mentioned by anyone in the course of the argument, though this was made explicit in the record, was the fact that during the years in question, income accumulated in the Kaestner trust was not taxable -- or at least, was not taxed -- either in New York, where the settlor resided when he created the trust, nor in Connecticut, where the individual successor trustee resided.

The joint appendix includes an "explanation of changes" on a New York return for calendar 2005, recommending that the revenue department of that state "avoid [the] constitutional difficulties" we are slogging through here -- or more accurately, those presented in *Fielding*, the related case out of Minnesota, still pending cert --, and just refund the disputed tax.

For its part, Connecticut does not tax income accumulations in a trust where the only contact is a resident trustee. Note: the incumbent trustee is a successor; the initial trustee was a resident of New York, where the settlor resides. The scenario that is before the court has been carefully choreographed.

Also not mentioned during oral argument is the fact, stated at least twice in deposition excerpts also included in the joint appendix, that at least one meeting between the trustee and the settlor's daughter leading to the decision to decant to another trust that would not distribute outright to her at age forty after all occurred in New York City, at the offices of Devebois & Plimpton, where the trustee, though he may reside in Connecticut, is a partner. The investment advisor, although based in Connecticut, was also represented at that meeting.

So it is not quite true that the trust was "administered" entirely in Connecticut. Or even, really, at all.

[2]

Mr. O'Neil made the astonishing suggestion, pages 46 to 47, responding to Justice Kagan's point about "life choices," that the beneficiary here was in no different situation legally than if she happened to have "a wealthy parent in another state."

[3]

The terms of the trust were actually rather similar to what we have in *Kaestner*, accumulate income from a bond portfolio until each beneficiary attains age twenty-five.

[4]

The opinion in *Brooke* was authored by Justice Holmes and runs only three paragraphs. But then Justice Holmes wrote a dissent in *Safe Deposit*, not mentioning *Brooke*, but asserting that "hitherto the decisions have been confined to tangibles that in a plain and obvious way owed their protection to another [state]."

[5]

Without getting too deep into the "dormant commerce clause" weeds, suffice it to say that the *Complete Auto* test requires, in four parts, that the tax (1) is applied to an activity with a "substantial nexus" with the taxing state, (2) is fairly apportioned, (3) does not discriminate against interstate commerce, and (4) is fairly related to services provided by the state.

In *Quill*, the court found that a mail order house did not establish a sufficient nexus with the state simply by fulfilling orders for delivery through the postal system to require it to collect use taxes.

In *Wayfair*, the court overruled *Quill*, saying a state could require internet vendors delivering more than $100k in goods and services into the state to collect sales tax on those transactions. Justices Thomas and Gorsuch each wrote brief concurring opinions.

Chief Justice Roberts dissented, in an opinion joined by Justices Breyer, Sotomayor, and Kagan, arguing that, okay, *National Bellas Hess, Inc. v. Department of Revenue of Illinois*, 386 U.S. 753 (1967), which established the physical presence test, was wrongly decided. It was. But we refused to revisit this in *Quill* on the ground of *stare decisis*, and the entire internet market has grown up under these assumptions.

The whole idea of the "dormant commerce clause" is that Congress could act but has not yet chosen to do so. So we stepped in and set a rule in *Bellas Hess*, which maybe we should not have done, but now the impetus shifts to Congress to regulate or not.

[6]

The court in *Hicks* did allow the reformation as to the scrivener's error, but denied the surviving spouse's request to also remove language from both trusts limiting discretionary distributions of principal to her to an ascertainable standard.

Jack says, what are days for? to wake us up.