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Kaestner Fails: The Way Forward

Mitchell M. Gans

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Recommended Citation

Mitchell M. Gans, *Kaestner Fails: The Way Forward*, 11 Wm. & Mary Bus. L. Rev. 651 (2020)

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KAESTNER FAILS: THE WAY FORWARD

MITCHELL M. GANS*

ABSTRACT

This past term, the Supreme Court applied the Due Process Clause to prevent the states from closing down a tax strategy that employs out-of-state trusts. Many had hoped that the case would serve as a vehicle for the Court to overrule taxpayer-friendly precedents that make the strategy possible. But it failed. The question that emerges is whether the decision leaves the states with a path to address the strategy and thereby prevent it from being used to exacerbate issues of inequality. After examining the decision, this Article considers the options available to the states and then suggests a way forward.

* Mitchell M. Gans is a professor at the Maurice A. Deane School of Law at Hofstra University, where he is the Rivkin Radler Distinguished Professor in Taxation. He is also an adjunct professor at NYU School of Law. He is the Academic Editor of the *ACTEC Journal*. He participated in drafting the ACTEC amicus brief in *Kaestner*. Brief for American College of Trust and Estate Counsel as Amici Curiae Supporting Neither Party, *N.C. Dep't of Revenue v. Kimberly Rice Kaestner Family Tr.*, 139 S. Ct. 2213 (2019) (No. 18-457), 2019 WL 1057910. He also served on the New York State Bar Association Committee that formulated legislation enacted in New York to address the out-of-state trust strategy. He wishes to acknowledge the efforts of Professor Ashleigh Gough, whose assistance was invaluable.

TABLE OF CONTENTS

INTRODUCTION	653
I. THE OUT-OF-STATE TRUST STRATEGY (OR PROBLEM)	656
II. EXAMINATION OF <i>KAESTNER</i>	659
A. <i>Kaestner Facts</i>	659
B. <i>Court's Decision</i>	661
1. <i>Narrow Holding</i>	661
2. <i>No New Ground</i>	661
3. <i>Analyzing Contacts in Trust Context</i>	662
4. <i>Majority Provides Some Concrete Guidance</i>	663
C. <i>Concurring Opinion</i>	665
III. AVAILABLE OPTIONS	666
A. <i>Wealth Tax</i>	667
B. <i>Founder's Principle</i>	670
1. <i>High Watermark</i>	671
2. <i>"Low Watermark:" Principle Unequivocally Rejected</i>	672
3. <i>Fault Line in Supreme Court: Stare Decisis</i>	674
4. <i>Impact on the Founder's Principle</i>	676
5. <i>Borrowing Jurisdictional Considerations</i>	678
6. <i>Founder's Principle v. Situs and Jurisdictional</i> <i>Considerations</i>	679
C. <i>Grantor Trust: Taxing the Grantor on the Trust's</i> <i>Income</i>	680
1. <i>Background</i>	680
2. <i>New York Expands Grantor Trust Concept</i>	682
3. <i>Grantor Control: How Much Is Necessary to Satisfy</i> <i>Due Process?</i>	684
4. <i>Grantor Trust on Kaestner Facts</i>	687
5. <i>Grantor-Trust Concept: Its Limitations</i>	688
D. <i>Throwback</i>	689
IV. ELIMINATING DUE PROCESS AS A CONSTRAINT: EMPOWERING CONGRESS	691
CONCLUSION	693

INTRODUCTION

In *North Carolina Department of Revenue v. Kimberly Rice Kaestner 1992 Family Trust*,¹ decided this past term, the Supreme Court held that the Due Process Clause² precluded North Carolina from taxing the income of an out-of-state trust even though a beneficiary resided in the state. Two facts were critical to the Court's holding: the trust was under administration in another state, where the trustee was located, and no distribution of trust income had been made to the beneficiary.³ North Carolina, in short, lacked sufficient contacts with the trust to justify its tax.⁴

In recent years, a planning strategy designed to reduce state income tax, similar to the one employed by the Kaestner family, has proliferated—surprisingly abetted by the Internal Revenue Service.⁵ The strategy exploits the due process limitations the states encounter when they seek to tax transactions or activity occurring beyond their borders. When the Court granted certiorari in *Kaestner*, many had hoped that the Court would take the opportunity to sweep away the limitations, or at least minimize them, in order to diminish the strategy's effectiveness—similar to a step it had taken the previous term in an analogous context.⁶

These hopes were unfortunately dashed. *Kaestner* turned out to be a poor vehicle for, in essence, two reasons.

First, the case was not a compelling one. North Carolina's connection to the trust's income was particularly weak.⁷ After all, no distribution had been made to the beneficiary, and it was possible that she would never receive one given the trustee's discretion under the trust instrument.⁸ Thus, in seeking to tax the income, North Carolina had to overcome a well-established tax

¹ 139 S. Ct. 2213 (2019).

² U.S. CONST. amend. XIV, § 1 (“No State shall ... deprive any person of life, liberty, or property, without due process of law ...”).

³ *Kaestner*, 139 S. Ct. at 2216.

⁴ *Id.*

⁵ *South Dakota v. Wayfair, Inc.*, 138 S. Ct. 2080, 2088 (2018).

⁶ The Court overruled a Commerce Clause precedent in the sales tax context, explaining its concern that the precedent had created “market distortions” and that it “has come to serve as a judicially created tax shelter.” *Id.* at 2094.

⁷ *Kaestner*, 139 S. Ct. at 2218.

⁸ *Id.*

norm: the imposition of the income tax generally requires either receipt or, at the very least, a legal entitlement.⁹ Indeed, the majority emphasized the narrowness of its holding and the possibility of a different outcome had additional contacts with the state been present.¹⁰ The upside, if there is one, is that, in adopting a narrow holding, the Court has reserved wide latitude to address more compelling cases in the future.

Second, the decision may reflect a fissure among the Justices on the application of *stare decisis*. Key precedents favored the taxpayer. And reading between the lines, one can discern a hesitation among at least some of the Justices in the majority to “normalize” the overruling of precedent in the constitutional setting given the impending battle over abortion and other issues. So, to the extent that North Carolina’s position hinged on the overruling of these key precedents, this larger battle may have cast a critical shadow.

Perhaps because of this tension over *stare decisis*, finding a more compelling vehicle may prove to be difficult. Indeed, one week after its decision in *Kaestner*, the Court denied a certiorari petition in a case where the contacts between the trust and the state were much more substantial, permitting a state supreme court decision upholding the strategy to stand.¹¹

What, then, is the way forward for the states? Much is at stake. For states that impose an income tax, designed to achieve a more progressive distribution of the tax burden, taxing investment income is critical. Failure to eliminate the strategy will certainly exacerbate inequality. Although the *Kaestner* decision is problematic, it does, as it will be argued, leave a legislative path for the states.

Part I provides an explanation of the out-of-state trust strategy.¹² It provides a brief policy critique of the strategy, demonstrating that states would be able to easily close it down were they not constrained by the due process limitations the Court has imposed.

⁹ *Comm’r v. Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955).

¹⁰ *Kaestner*, 139 S. Ct. at 2221.

¹¹ *Fielding v. Comm’r*, 916 N.W.2d 323 (Minn. 2018), *cert. denied*, *Bauerly v. Fielding*, 139 S. Ct. 2773 (2019). For a discussion of the possible motivations for denying certiorari in *Fielding*, see *infra* Section III.B.

¹² *Infra* Part I.

Part II examines the *Kaestner* facts and the Court's analysis.¹³ Although, as suggested, the majority sought to limit its holding, it did provide some concrete guidance, which is briefly explored. The three-Justice concurring opinion argued that no aspect of two taxpayer-friendly precedents should be reconsidered. The majority's refusal to embrace these precedents on such an expansive basis reflects, as will be argued, the tension among the Justices over *stare decisis*.

Part III explores three options available to the states in the face of *Kaestner*¹⁴: a wealth tax based on the value of the beneficiary's interest in the trust; use of what is referred to as the founder's principle, under which the trust is taxed in the state where the grantor resides at its inception; and an expanded application of the grantor-trust concept, which is currently employed on a more limited basis at the federal level to tax the grantor on the trust's income.¹⁵

Concluding that the first two options are questionable in terms of validity or effectiveness, Part III suggests that the states consider legislation that would embrace the grantor-trust approach. Under this approach, a taxpayer who conveys assets to an out-of-state discretionary trust for the benefit of family members would remain taxable on all of the trust's income. This would largely, if not entirely, eliminate the strategy. Part III also examines a fourth option available to the states, suggesting the adoption of a throwback principle, referenced in *Kaestner*, to prevent any remaining abuse that might escape the grantor-trust concept.

Part IV briefly argues against due process in the tax setting at a more fundamental level.¹⁶ If the precedents limiting the states' ability to tax out-of-state transactions (including *Kaestner*) were overruled, the Commerce Clause could do the work that federalism requires in this context. This would not only give the states more room to address abusive strategies but also give Congress the regulatory role it needs to establish uniform, sensible tax policy across the country.

This Article concludes in the last few paragraphs.¹⁷

¹³ *Infra* Part II.

¹⁴ *Infra* Part III.

¹⁵ Under I.R.C. section 671, trusts are ignored for federal tax purposes if they meet certain conditions. The Code refers to such trusts as "grantor trusts." *Id.*

¹⁶ *Infra* Part IV.

¹⁷ *Infra* Conclusion.

I. THE OUT-OF-STATE TRUST STRATEGY (OR PROBLEM)

To illustrate the out-of-state trust problem, consider this scenario: Taxpayer resides in a state that imposes an income tax on its residents. Taxpayer has substantial investment assets and would like to avoid paying state tax on the income those assets generate. Perhaps, in addition, Taxpayer anticipates selling an appreciated investment asset and would also like to avoid paying state tax on the appreciation.

How might Taxpayer accomplish her objectives? She could transfer the investment assets to a trustee located in a state without an income tax, with trust administration to occur in that state (the situs state). If the trust instrument does not mandate distribution to the beneficiaries, but instead gives the trustee discretion regarding distributions, the income earned by the trust, as well as any appreciation generated on the trust's sale of the assets, could be accumulated in the trust free of state income tax.

The trust itself would not be required to pay any tax given that the situs state does not impose an income tax. The beneficiaries, even if they live in a state with an income tax, would not be subject to tax on the trust's income if no distribution is made to them. And the grantor would, as a general matter, not be required to report the trust's income on her state tax return. Note that the effectiveness of the strategy hinges on the selection of an out-of-state trustee: had Taxpayer instead selected an in-state trustee, all the trust's undistributed income could be taxed in the Taxpayer's state.

In 2017, Congress enacted legislation that simultaneously makes the out-of-state trust strategy both more attractive and easier to accomplish.¹⁸ First, in terms of attractiveness, the 2017 changes limit the amount of state income tax that is deductible on a federal return.¹⁹ If a taxpayer is not permitted to fully deduct (or deduct at all) her state income tax, the after-federal tax cost of the state income tax is of course increased.²⁰ The increased

¹⁸ Tax Cuts & Jobs Act, Pub. L. No. 115-97, 131 Stat. 2054 (2017).

¹⁹ I.R.C. § 164(b)(6) (limiting deductions for state and local income and other taxes to \$10,000 for years 2018 through 2025).

²⁰ *Briefing Book: The State of State (and Local) Tax Policy*, TAX POL'Y CTR., <https://www.taxpolicycenter.org/briefing-book/how-does-deduction-state-and-local-taxes-work> [<https://perma.cc/R3NZ-ALEV>].

cost, in turn, creates greater incentive for taxpayers to engage in strategies designed to reduce the amount of state income tax.²¹

Second, in terms of ease of accomplishment, in the past, the federal gift tax served as a deterrent: taxpayers who made gifts, whether in trust or outright, exposed themselves to gift tax liability.²² Thus, before adopting an out-of-state trust strategy, taxpayers had to consider the cost of the gift tax. Although taxpayers found creative, complicated ways to implement the strategy while sidestepping gift tax liability—surprisingly with some assistance from the Internal Revenue Service in the form of taxpayer-friendly private letter rulings²³—the 2017 legislation increased gift exemptions to a level that make the gift tax irrelevant as a practical matter to almost all taxpayers.²⁴ With the gift tax thus no longer as much of a deterrent, the out-of-state trust strategy is less difficult to implement.

As a policy matter, the strategy is indefensible. As is the case with most tax strategies, it results in inequity and inefficiency. Consider first the question of inequity. Horizontal equity requires that two similarly situated taxpayers make the same contribution to the cost of government.²⁵ If a taxpayer is permitted to avoid state income tax by adopting the strategy, she makes less of a contribution to the cost of state government than other similarly situated taxpayers who opt against the strategy.

The strategy is also offensive as a matter of vertical equity, which inquires whether differently situated taxpayers are required to make an appropriately different contribution to the cost of government.²⁶ Wealthier taxpayers, almost by definition, have more investment assets than the less wealthy. To the extent they can use

²¹ *Id.*

²² I.R.C. § 2501(a)(1) (2012).

²³ See 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, 1963–67 (2014) (discussing the strategy and favorable Internal Revenue Service private rulings making the strategy possible).

²⁴ I.R.C. § 2505 (2018); Rev. Proc. 2018-57 (federal gift tax exemption of \$11,400,000 in 2019).

²⁵ See, e.g., Paul R. McDaniel & James R. Repetti, *Horizontal and Vertical Equity: the Musgrave/Kaplow Exchange*, 1 FLA. TAX REV. 607, 607–08 (1993).

²⁶ See, e.g., *id.*

the strategy to avoid paying income tax on the dividends, interest, and gains these assets produce, they undercut the progressive objectives the state income tax is designed to achieve. Moreover, they tend to be better advised and will likely find the cost and inconvenience of creating and maintaining an out-of-state trust to be insignificant relative to the potential tax savings. All of this will, as a practical matter, result in the wealthy disproportionately implementing the strategy—permitting them to make a reduced contribution to the cost of state government that is inappropriate relative to the contribution required of others.

Vertical equity is a significant issue at the state level.²⁷ Those states that are somewhat successful in making their tax system less regressive (or perhaps more progressive) rely on the income tax to achieve this outcome.²⁸ To the extent, however, that these states are constitutionally required to permit taxpayers to use the out-of-state trust strategy and thereby avoid income tax on their investment returns, the states' ability to redress inequality is of course undermined—thus exacerbating vertical equity issues.²⁹

As for inefficiency, tax strategies, in general, encourage behaviors that have no purpose other than reduction in tax liability. Taxpayers who implement the out-of-state trust strategy are required to create and maintain trusts that otherwise serve no constructive purpose. In that sense, they are inefficient.³⁰

Given this policy critique, the only question is how to eliminate the problem—in other words, to close down the out-of-state trust as a tax-saving strategy. Absent constitutional constraints,

²⁷ See, e.g., *Who Pays: A Distributional Analysis of the Tax Systems in All 50 States* (6th ed. 2018), INST. TAX'N & ECON. POL'Y, <https://itep.org/whopays/> [<https://perma.cc/QK4Y-EZQL>].

²⁸ See *id.*

²⁹ Achieving a progressive tax structure at the state level is difficult enough on its own terms. See, e.g., Kirk J. Stark, *Fiscal Federalism and Tax Progressivity: Should the Federal Income Tax Encourage State and Local Redistribution?*, 51 UCLA L. REV. 1389, 1410 (2004). The out-of-state trust makes it even more difficult to achieve. *Id.*

³⁰ Cf. Lawrence Zelenak, *For Better and Worse: The Differing Income Tax Treatments of Marriage at Different Income Tax Levels*, 93 N.C. L. REV. 783, 794 (2015) (referencing Professor Bittker's observation that inefficiency results to the extent tax-incentive strategies are utilized and therefore impact behavior and that inequity results to the extent they are not).

the solution would be straightforward. The strategy would fail to work if the state in which the taxpayer resides could impose its income tax on any trust created by one of its residents—or if, as in *Kaestner*, the state in which the beneficiary resides could tax the trust. But the difficulty is that the trustee would argue, as did the *Kaestner* trust,³¹ that the Due Process Clause precludes the state from taxing income in the absence of a sufficient contact with the state. This argument was, of course, successful in *Kaestner*.³²

Before turning to a consideration of the options available to the states given *Kaestner*, a careful examination of the case is first necessary.

II. EXAMINATION OF *KAESTNER*

A. *Kaestner Facts*

Almost 30 years ago, Joseph Rice III, a New York domiciliary, created a trust for the benefit of his children.³³ He named a New Yorker as trustee and made New York law controlling.³⁴ He continued to reside in New York.³⁵ The trustee moved to Florida in 1995, continuing to administer the trust until his retirement in 2005.³⁶ At that time, he was replaced by a new trustee, who was domiciled in Connecticut and who has administered the trust in the years since his appointment.³⁷

At the trust's inception, no beneficiary resided in North Carolina.³⁸ But, in 1997, Mr. Rice's daughter, Kimberly Kaestner,³⁹ moved to North Carolina and lived there during the relevant years

³¹ N.C. Dep't of Revenue v. Kimberly Rice Kaestner 1992 Family Tr., 139 S. Ct. 2213, 2216 (2019).

³² *Id.*

³³ *Id.* at 2218.

³⁴ *Id.*

³⁵ *Id.*

³⁶ Brief for Petitioner at 10, N.C. Dep't of Revenue v. Kimberly Rice Kaestner 1992 Family Tr., 139 S. Ct. 2213 (No. 18-457), 2019 WL 949892, at *10.

³⁷ *Kaestner*, 139 S. Ct. at 2218 n.2.

³⁸ *Id.* at 2218.

³⁹ While the trust, as originally created, was for the benefit of Rice's children, it was later divided into three subtrusts. As a result, a subtrust for the benefit of Kaestner and her children was created with the same terms as the original trust. This subtrust is the taxpayer before the Court. *Id.* at 2218.

with her minor children.⁴⁰ Under the terms of the trust, the trustee was given “absolute discretion” to distribute the trust assets to the beneficiaries “in such amounts and proportions” as the trustee might determine.⁴¹ At age 40, Kaestner would become entitled to receive the trust assets outright.⁴² Under New York law, subject to statutory limitations, a trustee may decant a trust and thereby in effect amend its terms.⁴³ And, in fact, after the tax years under consideration, the trustee used this authority to extend the term of the trust to eliminate Kaestner’s right to receive the asset at age 40.⁴⁴ He did so “after consulting with Kaestner and in accordance with her wishes.”⁴⁵

As North Carolina conceded, the beneficiaries’ residence in the state was its only connection to the trust.⁴⁶ The trust’s records were maintained in New York.⁴⁷ And the trust’s asset custodian was located in Massachusetts.⁴⁸ During the years in question, only two meetings between Kaestner and the trustee occurred, both held in New York.⁴⁹ Kaestner did receive trust accountings,⁵⁰ which were presumably sent to her home.

Although the trust enjoyed significant income in the years at issue, the trustee made no distribution.⁵¹ North Carolina sought to tax the trust on its undistributed income, arguing that the beneficiaries’ residence was a sufficient connection to the State to overcome the due process argument made by the trust.⁵² The North Carolina Supreme Court agreed with the trust, concluding that the imposition of the income tax on the trust’s undistributed income was inconsistent with due process⁵³ (but the court did not reach the Dormant Commerce Clause issue⁵⁴).

⁴⁰ *Id.*

⁴¹ *Id.*

⁴² *Id.* at 2219.

⁴³ N.Y. EST., POWERS AND TRUSTS § 10-6.6(b) (McKinney 2019).

⁴⁴ *Kaestner*, 139 S. Ct. at 2219.

⁴⁵ *Id.*

⁴⁶ *Id.* at 2220.

⁴⁷ *Id.* at 2218.

⁴⁸ *Id.*

⁴⁹ *Id.* at 2218 n.3.

⁵⁰ *Id.*

⁵¹ *Id.* at 2220.

⁵² *Id.*

⁵³ *Kimberly Rice Kaestner 1992 Family Trust v. N.C. Dep’t of Revenue*, 814 S.E.2d 43, 50–51 (N.C. 2018).

⁵⁴ *Id.* at 47.

B. Court's Decision

1. Narrow Holding

Ruling for the taxpayer, the Court adopted a narrow holding: that, as a matter of due process, the presence of the beneficiaries in North Carolina does not, in and of itself, permit the state to impose its income tax on the trust's undistributed income where the beneficiaries have no right to demand the income and are uncertain about receiving it in the future given the trustee's discretion.⁵⁵ As will be discussed, the concurring opinion makes the narrowness of the majority's holding even more apparent. Justice Alito, joined by the Chief Justice and Justice Gorsuch, argued in the concurring opinion that no aspect of two key taxpayer-friendly precedents (*Brooke v. Norfolk*⁵⁶ and *Safe Deposit & Trust Co. of Baltimore v. Virginia*⁵⁷) should be open for re-examination. But the majority resisted such a wholesale endorsement of these precedents, instead limiting its holding and thus leaving itself wide latitude in terms of future cases involving other factual permutations.⁵⁸

2. No New Ground

The Court does not break new ground. It instead applies the now-familiar standard for assessing due process limitations on state taxes and adheres to several key precedents. It reiterates that, in applying the standard, a two-pronged inquiry is required: first, quoting *Quill Corp. v. North Dakota*,⁵⁹ the Court asks whether there is “some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax;” and second, again quoting *Quill*, it asks whether “the income attributed to the

⁵⁵ *Kaestner*, 139 S. Ct. at 2221. Later in the opinion, the Court intimates that taxation in the state where the beneficiary resides would be permissible where the beneficiary can “control, possess, enjoy, or receive trust assets.” *Id.* This is somewhat inconsistent with the Court's expressly stated holding, which appears to suggest that such a tax would only be appropriate where the beneficiary has the right to demand and receive the income. *See id.*

⁵⁶ *See* 277 U.S. 27, 28–29 (1928).

⁵⁷ *See* 280 U.S. 83, 92–93 (1929).

⁵⁸ *See Kaestner*, 139 S. Ct. at 2226.

⁵⁹ 504 U.S. 298, 306 (1992).

state for tax purposes” is “rationally related to ‘values connected to the taxing state.’”⁶⁰ It then concludes that the state was unable to satisfy the first prong, obviating the need to examine the second one.⁶¹

Quoting from *International Shoe Co. v. Washington*,⁶² as well as *Quill*, the Court elaborates that the first prong requires “certain minimum contacts” with the state so that the tax “does not offend traditional notions of fair play and substantial justice.” If someone does not “derive ‘benefits and protection[s]’ from associating with a State,” she should not be subject to the state’s taxing power.⁶³

3. Analyzing Contacts in Trust Context

Applying these principles in the context of the *Kaestner* trust, the Court does not focus on the trust as a distinct entity.⁶⁴ Had it done so, its focus would have necessarily been limited to the contacts between the trustee and the state, making the grantor’s or the beneficiaries’ contacts with the state irrelevant. Instead, the Court takes a more global approach, asking whether the contacts of any of the trust’s “constituents” (trustee, grantor or beneficiary)⁶⁵ are sufficient to justify the tax. In the language of the Court, contacts between the trust’s “constituents” and the state may be considered “alone or in combination.”⁶⁶ Questions will inevitably arise about how to determine whether distinct contacts are sufficient when considered in combination with each other.

Consideration will also need to be given to the relevance of contacts other than the presence of an in-state beneficiary. Indeed, as will be discussed,⁶⁷ one week after the *Kaestner* decision, the

⁶⁰ *Kaestner*, 139 S. Ct. at 2220 (quoting *Quill*, 504 U.S. at 306).

⁶¹ *See id.* at 2223–24.

⁶² 326 U.S. 310, 316 (1945).

⁶³ *Kaestner*, 139 S. Ct. at 2220 (quoting *Int’l Shoe Co.*, 326 U.S. at 319).

⁶⁴ Citing its decision in *Greenough v. Tax Assessors of Newport*, 331 U.S. 486 (1947), the Court does, however, acknowledge that a trust is generally treated as a separate entity for federal income tax purposes. *Kaestner*, 139 S. Ct. at 2218 n.1.

⁶⁵ *See id.* at 2220.

⁶⁶ *Id.*

⁶⁷ *See infra* Section III.B.

Court denied certiorari in *Fielding v. Commissioner of Revenue*,⁶⁸ where the Supreme Court of Minnesota held the state's tax on a trust unconstitutional despite the presence of multiple contacts in addition to the presence of an in-state beneficiary: the grantor's residence in the state both at inception and during the tax year; a provision in the trust instrument designating the state's law as controlling; a trust investment in a corporation having property physically located within the state; and the grantor's use of an in-state law firm to draft the trust instrument.⁶⁹ The relevance and weight of such contacts will need to be considered in the lower courts, if not eventually in the Supreme Court.

4. Majority Provides Some Concrete Guidance

While the Court does not go beyond its conclusion that the mere presence of an in-state beneficiary is an insufficient contact, it does give some concrete guidance. First, citing *Maguire v. Trefry*,⁷⁰ it reiterates that where a distribution is made to the beneficiary, the state where the beneficiary resides is permitted to tax it as income.⁷¹

Second, citing *Greenough v. Tax Assessors of Newport*,⁷² it points out that the state in which the trustee resides is permitted to tax the trust.⁷³

Third, citing *Hanson v. Denckla*,⁷⁴ it indicates that the state in which the trust is administered, its situs, is permitted to tax the trust.⁷⁵

Fourth, the Court explains that, in assessing a contact between an in-state beneficiary and an out-of-state trust, the Court has focused on the "beneficiary's right to control, possess,

⁶⁸ 916 N.W.2d 323 (Minn. 2018), *cert. denied*, *Bauerly v. Fielding*, 139 S. Ct. 2773 (2019).

⁶⁹ *Id.* at 330, 334.

⁷⁰ 253 U.S. 12, 16–17 (1920).

⁷¹ The Court also cites *Guaranty Trust Co. v. Virginia*, 305 U.S. 19, 21–23 (1938), for this proposition.

⁷² 331 U.S. 486 (1947).

⁷³ *N.C. Dep't of Revenue v. Kimberly Rice Kaestner 1992 Family Tr.*, 139 S. Ct. 2213, 2220 (2019).

⁷⁴ 357 U.S. 235 (1958).

⁷⁵ *Kaestner*, 139 S. Ct. at 2220.

enjoy or receive trust assets.”⁷⁶ While this principle is consistent with well-accepted tax norms,⁷⁷ questions may arise about its implementation.

For example, if the beneficiary has the right to select the people, other than herself, who will eventually be entitled to the accumulated income (through what is known as a special power of appointment⁷⁸), would this constitute sufficient control? Or what if the beneficiary has no present right to receive the accumulated income but does have a right to receive it at some designated point in the future?⁷⁹ Implementing the Court’s rights-based principle will require that these variations, as well as others, be addressed.

Fifth, citing *Curry v. McCanless*⁸⁰ and *Graves v. Elliot*,⁸¹ the Court observes that the grantor’s control over trust assets under

⁷⁶ *Id.* at 2221.

⁷⁷ *Cf.* *Comm’r v. Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955) (stating “taxpayers [must] have complete dominion” before income is realized for federal income tax purposes).

⁷⁸ For a discussion of special powers of appointment, see RESTATEMENT (THIRD) OF PROP.: WILLS AND DONATIVE TRANSFERS § 17.3 (AM. LAW INST. 1999).

⁷⁹ In *Kaestner*, as the record reflects, the beneficiary had such a special power of appointment. 139 S. Ct. at 2218–19. But the Court does not make reference to it, perhaps because it was eliminated through the decanting of the trust. And, in *Safe Deposit*, the beneficiary was entitled to receive the accumulated income at the age of 25, but his descendants would instead receive it if he failed to reach that age. *Safe Deposit & Trust Co. of Baltimore v. Virginia*, 280 U.S. 83, 89–90 (1929). Consider whether necessary control would be present if in a case like *Safe Deposit* if the beneficiary’s estate, rather than his descendants, would be entitled to receive the accumulated income upon a failure to reach age 25.

In *Chase Manhattan Bank v. Gavin*, a Connecticut domiciliary was entitled to receive the out-of-state trust’s income. 733 A.2d 782, 788 (Conn. 1999). In addition, she was entitled to receive the trust’s assets upon reaching the age of 48. *Id.* In the event of an earlier death, she could control the disposition of the assets through a special power of appointment (limited to her descendants). *Id.* While the parties agreed that the income to which she was entitled was subject to Connecticut tax, there was disagreement about the trust’s undistributed capital gain (to which the beneficiary was not presently entitled). *Id.* at 788 n.8. The court rejected the trust’s constitutional argument and upheld the tax on the undistributed capital gain, concluding that *Safe Deposit* should no longer be followed. But given *Kaestner*, the question remains whether the beneficiary’s rights in *Gavin* gave her sufficient control to justify the Connecticut tax. For further discussion of *Gavin*, see *infra* Section III.B.1.

⁸⁰ 307 U.S. 357 (1939).

⁸¹ 307 U.S. 383 (1939).

administration in another state can serve as a basis for tax in the state where the grantor resides.⁸²

Sixth, citing *Quill*, it explains that it “borrows” from its adjudicative jurisdiction cases in deciding the due process limitations on state taxation,⁸³ although it refuses to decide whether the jurisdictional principles established in *Hanson v. Denckla* are controlling in the tax context.⁸⁴

C. Concurring Opinion

Although the concurring opinion’s analysis is very similar to the majority’s, it appears to suggest a willingness to enforce due process limitations on state taxing power more stringently than the majority. Three aspects of the opinion suggest a basis for such an inference.

First, as indicated, the opinion begins with a caution to the effect that no points resolved in two pro-taxpayer precedents (*Brooke* and *Safe Deposit*) are open for reconsideration.⁸⁵ While the majority cites these cases and integrates them into its analysis, it does not go as far as the concurring opinion’s caution about the extent to which they are binding.⁸⁶

Second, unlike the majority opinion, the concurring opinion does not reference the cumulative approach to contacts adopted by the majority. So, while the majority opinion may be read to contemplate the possibility of considering, say, a grantor contact in combination with a beneficiary contact in determining whether the necessary connection to the taxing state exists,⁸⁷ the concurring Justices would likely find this objectionable. Indeed,

⁸² In *Curry*, the grantor had retained, in the Court’s words, the “power to dispose” of property in an out-of-state trust in the form of a general power of appointment. The Court upheld the estate tax on the trust assets imposed in the state where the grantor had resided. Similarly, in *Graves*, the grantor had created an out-of-state trust subject to retained control in the form of a revocation power, and the Court again upheld the estate tax imposed by the state of residence.

⁸³ *Kaestner*, 139 S. Ct. at 2220; see also *Miller Bros. v. Maryland*, 347 U.S. 340, 342 (1954) (stating that jurisdiction is necessary before state can exercise taxing power or judicial authority).

⁸⁴ *Kaestner*, 139 S. Ct. at 2224 n.11.

⁸⁵ *Id.* at 2226 (Alito, J., concurring).

⁸⁶ *But see id.* at 2221–22.

⁸⁷ *Id.* at 2220.

as will be discussed, the *Safe Deposit* Court, in finding insufficient contacts, did not take the grantor's connection to the taxing state into account—and, as indicated, the concurring Justices are unwilling to reconsider any aspect of this precedent.⁸⁸

Third, the concurring Justices' discussion of the decision in *Brooke* is telling—pointing out that the *Brooke* Court had characterized the beneficiary as a mere “stranger” vis-à-vis trust assets and thus revealing their view that a discretionary beneficiary bears an attenuated relationship to trust assets.⁸⁹ Moreover, under *Brooke*, the concurring Justices emphasize, even if an in-state beneficiary is legally entitled to receive income, that is not a justification for taxing an out-of-state trust's assets.⁹⁰ Although the majority Justices appear to agree with this characterization of *Brooke*,⁹¹ it is less clear that they are prepared to treat this aspect of the decision as binding.

In sum, while the majority seeks to retain wide latitude in terms of future cases, the concurring Justices do not want the decision to be understood as inviting or permitting arguments that would call into question any aspect of *Safe Deposit* or *Brooke*.

III. AVAILABLE OPTIONS

Given *Kaestner*, what options are available to the states? Four are considered: a wealth tax; the founder's principle; an expanded application of the grantor-trust concept; and a throwback rule. Neither the wealth tax nor the founder's principle would be an ideal solution—the former because it would likely be ineffective as a practical matter and the latter because it would raise constitutional questions. The other two options are more appealing. The *Kaestner* Court, it will be suggested, left a discernible path for an enhanced grantor-trust concept. And it explicitly signaled that the states could adopt a throwback rule to address the problem. Implemented together, the grantor-trust concept and the throwback principle could provide an effective and constitutionally permissible solution.

⁸⁸ See *infra* Section III.C.4.

⁸⁹ *Kaestner*, 139 S. Ct. at 2227 (Alito, J., concurring).

⁹⁰ *Id.* (citing *Brooke v. Norfolk*, 277 U.S. 27, 28–29 (1928)).

⁹¹ *Id.* at 2221 (describing *Brooke* and *Safe Deposit* in a manner that is consistent with the description in the concurring opinion).

A. Wealth Tax

Does *Kaestner*—along with its reaffirmance of *Safe Deposit*—suggest that the state where the beneficiary resides is entirely precluded from taxing the beneficiary with respect to the trust in the absence of additional contacts? A close reading of *Safe Deposit* suggests otherwise. In *Safe Deposit*, Virginia, where the beneficiary resided,⁹² sought to impose a tax on the entire trust corpus,⁹³ which was in the possession of the trustee in Maryland.⁹⁴ In finding the tax objectionable on due process grounds,⁹⁵ the Court indicated that the tax did not target the value of the beneficiary’s equitable interest in the trust but rather the entire corpus.⁹⁶ And because the assets were located in Maryland, the tax was invalidated.⁹⁷

In a concurring opinion, Justice Stone emphasized that Virginia had failed to limit the tax to the value of the beneficiary’s equitable interest in the trust, implying that the tax would have been upheld had it been so limited.⁹⁸ In *Commonwealth v. Stewart*,⁹⁹ cited in *Kaestner*,¹⁰⁰ the court embraced this implication, upholding a tax imposed by the state in which the beneficiary resided based on the value of the beneficiary’s equitable interest, even though the trust was under administration

⁹² *Safe Deposit & Tr. Co. v. Virginia*, 280 U.S. 83, 91 (1929).

⁹³ *Id.* at 90.

⁹⁴ *Id.* at 91.

⁹⁵ *Id.* at 94.

⁹⁶ *Id.* at 92 (“The power of Virginia to lay a tax upon the fair value of any interest in the securities actually owned by one of her resident citizens is not now presented for consideration.”).

⁹⁷ *Id.*

⁹⁸ *Id.* at 95 (Stone, J., concurring) (“... the question whether the Fourteenth Amendment forbids a tax on the beneficiaries, in Virginia, where they are domiciled, measured by their equitable interests, seems to me not to be presented No attempt was made by Virginia to tax the equitable interests of the beneficiaries of the trust. That the thing taxed or the measure of the tax is different from the equitable interests of the beneficiaries, as affected by the specified contingencies, sufficiently appears from the fact that the one may well have been of different value than the other. In fact, the securities seem to have been assessed at their full value, although the equitable interests of the beneficiaries are less than the whole.”).

⁹⁹ 12 A.2d 444 (Pa. 1940), *aff’d.*, 312 U.S. 649 (1941).

¹⁰⁰ *N.C. Dep’t of Revenue v. Kimberly Rice Kaestner 1992 Family Tr.*, 139 S. Ct. 2213, 2223 n.10 (2019).

in another state.¹⁰¹ And, in *Kaestner* itself, the Court describes *Safe Deposit* and *Brooke* in terms suggesting that a wealth tax would be permissible, indicating that “[i]n each case the challenged tax fell on the entirety of a trust’s property, rather than on only the share of trust assets to which the beneficiaries were entitled.”¹⁰² All of this is consistent with the principle that, as a general matter, the state in which the taxpayer resides is permitted to tax all of her property.¹⁰³

¹⁰¹ Somewhat analogously, in the corporate context, the Court has upheld a tax imposed by the state in which the shareholder resided based on the value of shares. *First Bank Stock Corp. v. Minnesota*, 301 U.S. 234, 241 (1937) (“But we have recently had occasion to point out that enjoyment by the resident of a state of the protection of its laws is inseparable from responsibility for sharing the costs of its government, and that a tax measured by the value of rights protected is but an equitable method of distributing the burdens of government among those who are privileged to enjoy its benefits.”). Similarly, in *Blodgett v. Silberman*, distinguished in *Safe Deposit*, the Court upheld the Connecticut estate tax on the value of a partnership interest owned by the decedent, who had been domiciled in the state, even though some of the partnership’s assets were located elsewhere. 277 U.S. 1, 12 (1928); *see also* *Norfolk & W. Ry. Co. v. Mo. State Tax Comm’n*, 390 U.S. 317, 325 (1968) (“Any formula used must bear a rational relationship, both on its face and in its application, to property values connected with the taxing State.”).

¹⁰² *Kaestner*, 139 S. Ct. at 2221. Note also that the concurring opinion, in its only footnote, explains that, in *Brooke*, the beneficiary had a right to income but not trust corpus and that the Court had held that taxing the beneficiary on the corpus was not permissible. *Id.* at 2227 (Alito, J., concurring). This would suggest the concurring Justices would not find a wealth tax on the value of the beneficiary’s entitlement to be problematic.

¹⁰³ Under several precedents, the Court makes a distinction between income tax and property tax. Resident taxpayers are taxable on income derived from all sources, including out-of-state sources. *Okla. Tax Comm’n v. Chickasaw Nation*, 515 U.S. 450, 462–63 (1995). On the other hand, in the case of a property tax, an important limitation applies: tangible property located in another state is not taxable in the state of the taxpayer’s residence. *Greenough v. Tax Assessors of Newport*, 331 U.S. 486, 492 (1947). In the case of intangible personal property, the state of the taxpayer’s residence is permitted to tax it even if located in another state. *Id.* An amicus brief in *Kaestner* sought to distinguish *Safe Deposit* on the ground that it involved a tax on out-of-state property, whereas *Kaestner* involved a tax on income. Brief of Tax Law Professors as Amici Curiae Supporting Petitioner at 16, *Kaestner*, 139 S. Ct. 2213 (2019) (No. 18-457), 2019 WL 1093046, at *16. But because the property in *Safe Deposit* was intangible, the limitation on the state’s taxing power with respect to property was inapplicable—thus placing *Kaestner* and *Safe Deposit* on an equal footing in the sense that in neither case was the property-tax limitation relevant. *See Greenough*, 331 U.S. at 492. For an argument critiquing

To be sure, a wealth tax imposed on the value of a beneficiary's equitable interest is a possible response to the out-of-state trust problem. But given that, in a case like *Kaestner*, it could constitutionally target only the value of the beneficiary's equitable interest, rather than the value of the assets in the trust, it would be less than an ideal solution. Faced with such a tax, advisers could draft out-of-state trusts on a discretionary basis (as the *Kaestner* trust was drafted) in order to minimize the value of the beneficiary's equitable interest and thereby substantially reduce—or practically eliminate—the tax. For if the beneficiary had no entitlement to receive trust assets but only the hope that the trustee might exercise discretion in her favor, valuing the beneficiary's interest would require taking into account the possibility that the trustee might decide to distribute to other beneficiaries or to withhold distributions entirely.¹⁰⁴

Professor Carla Spivack argues that the *Kaestner* beneficiaries' residence in North Carolina should have been a sufficient

the property-tax limitation, see Boris I. Bittker, *The Taxation of Out-of-State Tangible Property*, 56 YALE L.J. 640 (1947).

¹⁰⁴ See *Safe Deposit & Tr. Co. v. Virginia*, 280 U.S. 83, 95 (1929) (Stone, J., concurring); *Commonwealth v. Stewart*, 12 A.2d 444, 449 (Pa. 1940) (acknowledging potential difficulty in valuing equitable interest); cf. Rev. Rul. 67-370, 1967-2 C.B. 324 (acknowledging the difficulty in valuing an interest subject to the control of another).

Note that, in *Kaestner*, the Court, in its parenthetical description of *Stewart*, muddies things by including a quotation from the decision to the effect that the *Stewart* beneficiary had a "right to the income." *Kaestner*, 139 S. Ct. at 2223 n.10. Reading this would suggest that it would be impermissible for the state of the beneficiary's residence to tax the value of a discretionary interest under a wealth tax and would be difficult to reconcile with basic principles. See *supra* text accompanying note 102. The Court muddied the issue even further in its discussion of the inability of the *Kaestner* beneficiary to voluntarily transfer her interest. While emphasizing the language in the trust instrument prohibiting such transfers, *Kaestner*, 139 S. Ct. at 2223, the Court goes on to state that the question whether a different outcome would be appropriate in the absence of such a prohibition is not resolved. *Id.* at 2223 n.9. To be sure, the beneficiary's inability to transfer her interest in the trust would certainly be relevant in valuing the interest under a wealth tax. But it would be wrong to read *Kaestner* as precluding the states from imposing a wealth tax on such an interest. After all, the Court was focusing on the level of the beneficiary's control over the trust's undistributed income, not whether the beneficiary had a valuable interest that could be subjected to a wealth tax. See *id.* at 2223.

constitutional justification for the imposition of North Carolina's income tax on the trust's undistributed income (or perhaps a tax on the beneficiaries based on the trust's undistributed income).¹⁰⁵ She argues that the beneficiaries' equitable interest in the trust constitutes a property interest that is an appropriate subject of taxation in their state of residence.¹⁰⁶ This is consistent with the general rule that the state in which a taxpayer resides is permitted to tax all property owned by the taxpayer.¹⁰⁷ But, given *Kaestner* as well as *Safe Deposit*, this does not justify the imposition of an income tax on the undistributed income of an out-of-state trust. As suggested, it would justify a wealth or property tax on the value of the beneficiary's equitable interest in the trust, which, as Professor Spivack indicates, is a property interest.¹⁰⁸

Although initially attractive, Professor Spivack's theory—that a beneficiary's equitable interest is a property interest that confers taxing authority on the state of residence—does not support her conclusion—that this property interest justifies an income tax on the trust's undistributed income.¹⁰⁹ Indeed, North Carolina did not argue that its income tax could somehow be defended as a property tax on the beneficiary's equitable interest. More important, even assuming North Carolina had imposed a property tax on the beneficiary, rather than its income tax on the trust, the value of the equitable interest, as suggested, would have likely proven to be insignificant once the trustee's discretion was taken into account. All of which is to say that a wealth tax is not a sufficient solution to the out-of-state trust problem.

B. Founder's Principle

Some state tax statutes focus on the residence or domicile of the grantor at the time of the trust's creation.¹¹⁰ Under these

¹⁰⁵ Carla Spivack, *Due Process, State Taxation of Trusts and the Myth of the Powerless Beneficiary: A Response to Bridget Crawford and Michelle Simon*, 67 UCLA L. REV. DISC. 46, 54 (2019).

¹⁰⁶ *Id.*

¹⁰⁷ See *Greenough*, 331 U.S. at 492 (permitting the state of residence to tax even out-of-state non-tangible property).

¹⁰⁸ See, e.g., *Blair v. Comm'r*, 300 U.S. 5, 13 (1937) (equitable interest in trust is property); *United States v. Harris*, 854 F.3d 1053, 1056 (2017) (beneficiary's discretionary interest in trust is property).

¹⁰⁹ See Spivack, *supra* note 105, at 54.

¹¹⁰ See, e.g., MINN. STAT. § 290.01, subd. 7b(a)(2) (2019).

statutes, the trust is treated as if it were a resident and is therefore taxed on all of its income—not just in-state income—if the grantor was domiciled or resided in the state at the trust’s inception.¹¹¹ Hence, the term “founder’s principle” is used. If constitutionally valid, the principle could largely eliminate the out-of-state trust problem: the state of the grantor’s residence would be permitted to tax the trust on an ongoing basis.¹¹²

In *Fielding v. Commissioner of Revenue*,¹¹³ however, the Supreme Court of Minnesota concluded that the principle is inconsistent with *Safe Deposit* and therefore violates due process. One week after its decision in *Kaestner*, the Court denied Minnesota’s certiorari petition in *Fielding*,¹¹⁴ raising questions about the extent to which the principle retains viability.

1. High Watermark

The principle perhaps reached its high watermark in the Connecticut Supreme Court decision in *Chase Manhattan Bank v. Gavin*.¹¹⁵ Under the Connecticut statute, an inter vivos trust is treated as a resident trust if the grantor was a resident when the trust became irrevocable—though it is treated otherwise if there is no current Connecticut beneficiary.¹¹⁶ In *Gavin*, the grantor created an inter vivos trust at a time when he was a Connecticut domiciliary.¹¹⁷ During the tax year, a beneficiary resided in the state, although the grantor had previously died.¹¹⁸

The facts in *Safe Deposit*, where the Court invalidated Virginia’s tax, were strikingly similar: the grantor in *Safe Deposit* created an inter vivos (revocable) trust in Maryland while domiciled in Virginia for the benefit of a beneficiary in Virginia.¹¹⁹ After the

¹¹¹ *Id.*

¹¹² Steve R. Akers, *ACTEC 2018 Annual Meeting Musings*, BESSEMER TR. (Mar. 2018), https://www.bessemertrust.com/sites/default/files/2018-07/ACTEC%202018%20Annual%20Meeting%20Musings_WEBSITE.pdf [https://perma.cc/4JG2-HF22].

¹¹³ *Fielding v. Comm’r of Revenue*, 916 N.W.2d 323, 330–32 (Minn. 2018), *cert. denied*, *Bauerly v. Fielding*, 139 S. Ct. 2773 (2019).

¹¹⁴ 139 S. Ct. 2773 (2019).

¹¹⁵ 733 A.2d 782 (Conn. 1999).

¹¹⁶ *Id.* at 789–90.

¹¹⁷ *Id.* at 801–03.

¹¹⁸ *Id.*

¹¹⁹ *Safe Deposit & Tr. Co., v. Virginia*, 280 U.S. 83, 89–92 (1929).

grantor's death, Virginia imposed a tax on the trust at a time when the beneficiary still resided in Virginia.¹²⁰ The Court held that the tax violated due process, concluding that there were insufficient contacts with Virginia to justify it.¹²¹ Unable to distinguish *Safe Deposit*, the *Gavin* court determined that *Safe Deposit* had been undermined by later Supreme Court decisions and that it should therefore no longer be followed.¹²² Finding no due process violation, the court sustained the Connecticut tax on all of the trust's income, leaving open the question whether the founder's principle is available where there is no in-state beneficiary.¹²³

2. "Low Watermark:" Principle Unequivocally Rejected

If, as suggested, the principle reached a high watermark in *Gavin*, it reached a "low watermark"—or its nadir—in *Fielding*. Under the Minnesota statute,¹²⁴ as in the case of the Connecticut statute, a trust is treated as a resident trust if the grantor was domiciled in the state at inception or when the trust later becomes irrevocable.¹²⁵ All of a resident trust's income, even if derived from out-of-state sources, is taxable in Minnesota.¹²⁶ If, on the other hand, the trust is treated as a non-resident, it is taxable only on income from in-state (Minnesota) sources.¹²⁷

In *Fielding*, a Minnesota domiciliary created an out-of-state trust in 2011.¹²⁸ Three years after the trust became irrevocable, in 2014, when the grantor was still domiciled in the state, Minnesota sought to tax the trust on income from out-of-state sources.¹²⁹ Ruling for the trust, the Minnesota Supreme Court held that the mere fact that the grantor was domiciled in the state at inception was an insufficient contact for due process purposes.¹³⁰

The court reasoned that the tax was not imposed on the grantor, but rather on the trust, and that he no longer had control

¹²⁰ *Id.*

¹²¹ *Id.* at 94.

¹²² *Gavin*, 733 A.2d at 802.

¹²³ *Id.* at 786.

¹²⁴ MINN. STAT. § 290.01, subd. 7b(a)(2) (2019).

¹²⁵ *Fielding v. Comm'r*, 916 N.W.2d 323, 328 (Minn. 2018).

¹²⁶ *Id.*

¹²⁷ *Id.*

¹²⁸ *Id.* at 326.

¹²⁹ *Id.*

¹³⁰ *Id.* at 330–31.

over the trust assets in 2014.¹³¹ The focus, according to the court, must be on the relationship between the taxpayer—the trust, which the court treats as an entity separate from the grantor and the beneficiaries—and the state.¹³² The grantor’s contact with the state at the trust’s inception did not count for due process purposes, under the court’s analysis, given that he no longer had control over the trust assets in 2014.¹³³ Nor, parenthetically, did the existence of a beneficiary in Minnesota through 2014 count.¹³⁴ Relying in part on *Safe Deposit*, the court rejected the founder’s principle.¹³⁵

Although this reading of *Safe Deposit* is certainly a reasonable one, consider an alternative one. As indicated, the grantor in *Safe Deposit* had died before New York sought to tax the trust.¹³⁶ It is therefore possible to read *Safe Deposit* narrowly: whatever the status of the founder’s principle as a general matter, it could not be invoked once the grantor had died. Even if, in other words, the grantor’s residence in the taxing state at inception could be a sufficient contact, it ceased to be relevant in *Safe Deposit* at the grantor’s death.

¹³¹ *Id.*

¹³² *Id.* Contrast this with the *Kaestner* Court’s conclusion that a trust “is not a distinct legal entity.” N.C. Dep’t of Revenue v. Kimberly Rice Kaestner 1992 Family Tr., 139 S. Ct. 2213, 2218 (2019) (quoting *Americold Realty Tr. v. Conagra Foods, Inc.*, 136 S. Ct. 1012, 1016 (2016)).

¹³³ *Fielding*, 916 N.W.2d at 330–31. Note, however, that the court’s treatment of the grantor’s connection to the trust as irrelevant is not consistent with *Kaestner*, where the Court indicates that connections between the state and (i) the grantor, (ii) the trustee, and/or (iii) the beneficiaries are to be considered alone or in combination with each other in determining the sufficiency of the contact with the taxing state. *Kaestner*, 139 S. Ct. at 2220.

¹³⁴ *Fielding*, 916 N.W.2d at 331.

¹³⁵ See also *Linn v. Dep’t of Revenue*, 2 N.E.3d 1203, 1210 (Ill. App. Ct. 2013) (indicating the state could cite “no cases finding a grantor’s in-state residency is a sufficient connection for due process with an *inter vivos* trust” and concluding tax on out-of-state trust’s undistributed income was constitutionally impermissible); *Blue v. Dep’t of Treasury*, 462 N.W.2d 762, 764 (Mich. Ct. App. 1990) (tax on undistributed income constitutionally impermissible even though grantor resided in the state when she created the revocable trust and when it became irrevocable at her death); *Residuary Tr. A v. Dir.*, 27 N.J. Tax 68, 76 (2013) (rejecting *Gavin*’s use of settlor’s domicile as a sufficient basis to tax out-of-state trusts); *Mercantile-Safe Deposit & Tr. Co. v. Murphy*, 203 N.E.2d 490, 491 (N.Y. 1964) (rejecting New York’s argument that, because grantor was domiciled in the state when his revocable trust became irrevocable at his death, it could tax its undistributed income).

¹³⁶ *Mercantile-Safe Deposit*, 203 N.E.2d at 491.

Whether this narrow reading is correct was important in *Fielding*, where the grantor was still alive and residing in Minnesota when the tax was imposed. Under a more expansive reading, adopted by the *Fielding* court, *Safe Deposit* rejected the founder's principle in its entirety, making the grantor's residence in the state, either at inception or during the tax year, an insufficient contact. Which reading is correct—or, more accurately, which one will ultimately prevail—is of course an open question. But to the extent the *Fielding* reading is correct, states will not be able to employ the founder's principle as a solution to the out-of-state trust problem.

3. *Fault Line in Supreme Court: Stare Decisis*

Why didn't the Court grant Minnesota's certiorari petition in *Fielding* to resolve which of these readings is correct? Had it done so, it would have had an opportunity to address not only the validity of the founder's principle but also other issues *Kaestner* left unresolved. Why, therefore, did the petition fail to secure the necessary (four) votes? Although of course necessarily speculative, the answer may lie in the tension among the Justices over stare decisis.

The *Kaestner* majority stressed the narrowness of its holding: to the extent a state seeks to justify a tax on the undistributed income of an out-of-state trust *solely* on the basis of the beneficiary's residence, it violates due process unless the beneficiary has control over the income.¹³⁷ And in rejecting North Carolina's argument that *Safe Deposit* had been implicitly overruled, the majority maintained that "[t]he aspects of the case noted here are consistent with the pragmatic approach reflected in" other cases.¹³⁸ The majority was, in other words, anxious to avoid overruling *Safe Deposit* while leaving for future consideration as much of the case as possible. This of course leaves the status of aspects of *Safe Deposit* not implicated in *Kaestner* unresolved.

The concurring Justices, on the other hand, twice indicate in the course of a rather short opinion that every aspect of *Safe Deposit*, as well as *Brooke*, remains binding—and further indicate that nothing in the majority opinion should be read to suggest otherwise.¹³⁹ Perhaps the four liberal Justices, who formed part of the majority, refused to vote in favor of Minnesota's certiorari

¹³⁷ See *supra* notes 55–58 and accompanying text.

¹³⁸ *Kaestner*, 139 S. Ct. at 2221 n.6.

¹³⁹ *Id.* at 2226–28 (Alito, J., concurring).

petition out of concern that a decision in *Fielding* to overrule any aspect of *Safe Deposit* (or *Brooke*) would be cited by the other side in a battle over abortion and the validity of *Roe v. Wade*.¹⁴⁰ So, plausibly, from the vantage point of the four liberal Justices, the safer strategy was to embrace as little of *Safe Deposit* and *Brooke* as necessary in *Kaestner* and to avoid the fuller examination of these cases that a grant of certiorari in *Fielding* would have entailed.¹⁴¹

In short, it may well be that the denial of certiorari in *Fielding*, together with the decision in *Kaestner*, has more to do with stare decisis than state taxing power. As suggested, the concurring Justices in *Kaestner* were explicit about their unwillingness to reconsider any aspect of *Safe Deposit*, a precedent on which the *Fielding* court relied.¹⁴² And at least some of those in the majority may not have wanted to take a position in *Fielding*, or *Kaestner*, that would “normalize” the overruling of precedent given the dispute over abortion, as well as other issues, that is perhaps on the horizon. So the denial of certiorari in *Fielding*, together with the decision in *Kaestner*, may simply reflect the fault line developing in the Court over stare decisis.¹⁴³

¹⁴⁰ 410 U.S. 113 (1973); see also *Planned Parenthood v. Casey*, 505 U.S. 833 (1992) (reaffirming *Roe*).

¹⁴¹ An additional dynamic may also help explain the tension among the Justices: the typical conservative-liberal divide over economic issues. See, e.g., NEAL DEVINS & LAWRENCE BAUM, *THE COMPANY THEY KEEP: HOW PARTISAN DIVISIONS CAME TO THE SUPREME COURT* 4–5, n.10 (2019). Whereas the liberal Justices may have been concerned about distributive implications and the resulting inequity, the conservative Justices who wrote or joined in the concurring opinion may have been more sensitive to a different set of issues: the need to minimize government intervention, concern about the scope of the states’ taxing power and the related question of federalism. *But see* *South Dakota v. Wayfair, Inc.*, 138 S. Ct. 2080, 2094 (2018) (conservative Justices (but not Chief Justice Roberts) voting to permit the states to adopt legislation designed to close down a “judicially created tax shelter”).

¹⁴² It is not without irony that, on the very same day *Kaestner* was decided, the three concurring Justices joined (or wrote) the majority decision in *Knick v. Township of Scott*, 139 S. Ct. 2162 (2019), which overruled a 1985 precedent under the Fifth Amendment’s Takings Clause (*Williamson County Regional Planning Commission v. Hamilton Bank of Johnson City*, 473 U.S. 172 (1985)). While thus willing to overrule a 1985 precedent, the three concurring Justices simultaneously declared that 1928 and 1929 due process precedents are beyond re-examination, in effect peremptorily announcing their views on cases involving different fact patterns that may eventually come before the Court.

¹⁴³ A similar dynamic could play out should a wealth tax be enacted. In *Pollock v. Farmers’ Loan & Trust Co.*, 158 U.S. 601, 618 (1895), the Court held

4. *Impact on the Founder's Principle*

Where does this leave the founder's principle? None of the six Justices in the majority makes their thinking explicit about whether *Safe Deposit's* rejection of the principle should be modified or overruled. There was no need for the majority to do so given that the *Kaestner* grantor resided in New York, not North Carolina, when he created the trust.¹⁴⁴ Resolving the issue before the Court, i.e., determining whether North Carolina could tax the trust based solely on the residence of an in-state beneficiary, did not require a more extensive examination of *Safe Deposit*.

But if, for example, a case with *Fielding*-type facts—an in-state beneficiary *and* a grantor residing in the state at inception and during the tax year as well—were to come before the Court,

that a tax on income from property was a direct tax and was therefore unconstitutional because not apportioned as required in Article I, section 9, clause 4—the Court having earlier held that a tax on real property was also a direct tax. *Springer v. United States*, 102 U.S. 586, 602 (1881). If this aspect of *Pollock* remains viable, a wealth tax would likely fail as an unapportioned direct tax. Arguing in support of a wealth tax, some maintain, however, that *Pollock* should be overruled in favor of the Court's earlier approach in *Hylton v. United States*, 3 U.S. 171, 175 (1796), under which the direct-tax concept was given narrow scope. See, e.g., Bruce Ackerman, *Taxation and the Constitution*, 99 COLUM. L. REV. 1 (1999). The adoption of the Sixteenth Amendment, the argument goes, undermined *Pollock* entirely. *Id.* at 5. In *National Federation of Independent Business v. Sebelius*, however, Chief Justice Roberts intimated that a critical aspect of *Pollock* remains intact, observing that the Court had applied the *Pollock* principle that income from property is a direct tax even after the Sixteenth Amendment was adopted. 567 U.S. 519, 571 (2012) (citing *Eisner v. Macomber*, 252 U.S. 189, 218–19 (1920)). While this point was made only by the Chief Justice, one could easily imagine that the liberal justices—concerned about the impact on *Roe v. Wade*—would be unwilling to declare *Pollock* dead, just as they were unwilling to overrule *Safe Deposit & Trust Co. of Baltimore v. Virginia*, 280 U.S. 83 (1929) and *Brooke v. Norfolk*, 277 U.S. 27 (1928). If this proves to be the case, an unapportioned wealth tax would likely be declared unconstitutional, not only by the conservative justices who refused to revisit these pro-taxpayer precedents in *Kaestner*, but also by the liberal justices.

Parenthetically, a wealth tax could plausibly be saved from constitutional challenge by giving taxpayers an election: voluntarily choose to pay the wealth tax or instead be subject to a higher income tax rate (or perhaps a higher estate tax rate). See *Nat'l Fed'n of Indep. Bus.*, 567 U.S. at 574 n.11 (upholding a tax on those who chose not to comply with the individual mandate in Obamacare even though Congress lacked the constitutional authority to impose the mandate directly).

¹⁴⁴ *Kaestner*, 139 S. Ct. at 2218.

the Justices in the majority would need to undertake such an examination. In doing so, they could, for example, decide that the grantor's residence at inception, in conjunction with an in-state beneficiary, is a sufficient contact. Or they could decide that, even if there is no in-state beneficiary, the grantor's residence at inception is a sufficient contact in itself. In either case, they would need to overrule *Safe Deposit*. Or they might decide not to overrule it but to read it narrowly, limiting it to its facts and thus making it permissible for the state to impose its tax where both the grantor and a beneficiary continue to reside in the state during the tax year.¹⁴⁵

On the other hand, the three concurring Justices, having concluded that every aspect of *Safe Deposit* remains binding,¹⁴⁶ would surely reject the founder's principle. Thus, in a case where the state seeks to tax a trust solely on the basis of the grantor's residence at the trust's inception, the concurring Justices would undoubtedly find a violation of due process. And even if there were, in addition, an in-state beneficiary at the time the tax was imposed, they would presumably reach the same conclusion given the presence of such a beneficiary in *Safe Deposit*. Thus, in a case like *Gavin*, where there was an in-state beneficiary and the deceased grantor had resided in the state at inception, the concurring Justices would likely invalidate the tax (contrary to the *Gavin* court's holding).¹⁴⁷ But in a case where the grantor was still alive, as

¹⁴⁵ The majority indicates that, in assessing the grantor's connection to the trust, the grantor's level of control over the trust assets is the critical determinant. *Id.* at 2222. And while the majority does go on to say that it does not decide what level of control would suffice to justify a tax on the trust imposed by the state of the grantor's residence, *id.* at 2222 n.7, the clear implication is that some level of control would be essential. *See id.* This would appear to be inconsistent with the founder's principle, which does not depend on continuing control. But whether continuing control would be required where the grantor resided in the state at inception (and perhaps still lives in the state) and where there is also an in-state beneficiary is not clear.

¹⁴⁶ *See supra* notes 55–58 and accompanying text.

¹⁴⁷ Although the facts in *Gavin* are very similar to those in *Kaestner*, one factual distinction makes it difficult to predict how the Justices in the *Kaestner* majority would view a case like *Gavin*. In *Kaestner*, the beneficiary's residence in North Carolina was the only basis for imposing the tax. 139 S. Ct. at 2218. The grantor did not reside in North Carolina at inception or otherwise. *Id.* In *Gavin*, in contrast, the grantor did reside in the taxing state

in *Fielding*, whether the concurring Justices would adopt an expansive or narrow reading of *Safe Deposit* remains unclear—although one could reasonably speculate that they would opt for the former given their emphatic embrace of all aspects of the decision.

5. *Borrowing Jurisdictional Considerations*

The validity of the founder's principle could possibly also be influenced by jurisdictional considerations. As suggested, *Kaestner* indicates that the Court borrows from its adjudicative-jurisdiction cases in applying due process in the tax context.¹⁴⁸ In *Hanson v. Denckla*,¹⁴⁹ a foundational jurisdiction case, cited in *Kaestner*,¹⁵⁰ the Court determined that a Florida court lacked jurisdiction over a Delaware trustee even though the person who created the trust, as well a beneficiary, resided in Florida at the time of the litigation.¹⁵¹

If *Hanson* were applied on a parallel basis in the tax context, it could possibly cut against the founder's principle. For if the courts in a state where the grantor resides at the time of litigation are not permitted to exercise jurisdiction over an out-of-state trustee on that basis, a tax imposed on a trust by the state where the grantor resided when it was created might similarly fail for lack of connection between the trustee and the taxing state.¹⁵² The founder's principle might therefore be vulnerable to

(Connecticut) at inception. 733 A.2d 782, 787 (Conn. 1999). Given the apparent willingness of the Justices in the majority to combine different contacts, *Kaestner*, 139 S. Ct. at 2220, it is possible that they would treat the grantor's residence in Connecticut at inception, in conjunction with the residence of a beneficiary in the state during the tax year, as a sufficient basis for taxing the trust.

¹⁴⁸ *Id.* at 2224 n.11.

¹⁴⁹ 357 U.S. 235 (1958).

¹⁵⁰ *Kaestner*, 139 S. Ct. at 2220, 2224 n.11.

¹⁵¹ *Hanson*, 357 U.S. at 251–52.

¹⁵² In *Hanson*, in concluding that the Florida courts lacked jurisdiction over the Delaware trustee, the Court indicates that the grantor resided in Pennsylvania, not Florida, when she created the trust. *Id.* at 252. To the extent this can be read to imply that the Pennsylvania courts would have had jurisdiction over the Delaware trustee, it would lend support to the founder's principle. It would, however, ordinarily be inconsistent with the parties' expectations (trustee and grantor)—and perhaps therefore inconsistent with due process principles—to allow the courts in the state where the grantor resides at inception to exercise adjudicative jurisdiction over the trustee solely on that basis. See RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 267 cmt. c. (AM. LAW INST. 1977) (“reasonable

attack not only on the basis of how *Safe Deposit* is read—or indeed whether it is partially overruled—but also on the basis of a “borrowing” from the adjudicative-jurisdiction analysis in *Hanson*.

6. *Founder’s Principle v. Situs and Jurisdictional Considerations*

Jurisdictional considerations may account for what would otherwise be a subtle distinction between the founder’s principle and the concept, endorsed in *Kaestner*, permitting the state where the trust is under administration (the trust’s situs) to impose its tax.¹⁵³ Consider, for example, a testamentary trust, typically having its situs in the state where the decedent was domiciled and her will admitted to probate.¹⁵⁴ Courts in the situs state have jurisdiction over the trustee and all beneficiaries concerning matters of administration, even if they have no other contact with the situs state.¹⁵⁵ Permitting the situs state to exercise such jurisdiction is perhaps driven by practical necessity: were it otherwise, in the case where beneficiaries reside in different states, no one forum would be available to resolve with finality all trust-related disputes. And because the situs state offers its courts as such a forum, *Kaestner* sensibly permits taxation in the situs state.¹⁵⁶

If, however, the trust was to change its situs to another state, the original state could no longer rely on situs as a justification for imposing its tax. Income earned in years after the change would cease to be taxable, in other words, in the original state. Under the founder’s principle, in contrast, the state of the

to infer in most situations that the testator or settlor expected the trustee to administer the trust at his or its place of business or domicil [sic]—although comment d. indicates that trustees may be subject to jurisdiction of other courts where there is an appropriate basis); *Burger King Corp. v. Rudzewicz*, 471 U.S. 462, 474 (1985) (discussing whether it was reasonably foreseeable defendant would be required to litigate in forum state is critical to due process analysis).

¹⁵³ *Kaestner*, 139 S. Ct. at 2220 (“tax based on the site of trust administration is constitutional”).

¹⁵⁴ See, e.g., *District of Columbia v. Chase Manhattan Bank*, 689 A.2d 539, 545 (D.C. 1997) (testamentary trust has situs in state of decedent’s domicile and, therefore, state is constitutionally permitted to impose its tax given the benefits it offered of “continuing, principal jurisdiction” over the trust).

¹⁵⁵ *Mullane v. Central Hanover Bank & Tr. Co.*, 339 U.S. 306, 313 (1959).

¹⁵⁶ *Kaestner*, 139 S. Ct. at 2220.

decedent's domicile might be permitted to continue taxing the trust indefinitely even if, during the tax year, there was no other contact to justify the tax.¹⁵⁷ Thus, the reach of the founder's principle is potentially more expansive and, as a result, perhaps more difficult, unless cabined, to defend constitutionally.

In the end, whether or not the founder's principle remains viable as an effective solution to the out-of-state trust problem remains unclear. To be sure, the *Kaestner* Court did not address the question. But the lack of a single vote to overrule any aspect of *Safe Deposit*, along with the denial of certiorari in *Fielding*—a compelling case for application of the principle¹⁵⁸—is telling.¹⁵⁹

C. Grantor Trust: Taxing the Grantor on the Trust's Income

1. Background

In a series of private letter rulings,¹⁶⁰ the IRS has approved a technique that enables taxpayers to use an out-of-state trust more

¹⁵⁷ In *Linn v. Department of Revenue*, the state made just such a claim, but the court rejected it. 2 N.E.3d 1203, 1210 (Ill. App. Ct. 2013); see also *Blue v. Dep't of Treasury*, 462 N.W.2d 762, 764 (Mich. Ct. App. 1990) (rejecting founder's principle, invoked by state, where "no ongoing protection or benefit to the trust"); *Fielding v. Comm'r*, 916 N.W.2d 323, 333 (Minn. 2018) ("existing relationship" between trust and state required).

¹⁵⁸ In *Fielding*, not only was the grantor domiciled in Minnesota at the trust's inception, he continued to be domiciled in the state when the trust became irrevocable and during the tax year in question. 916 N.W.2d at 330. In addition, a beneficiary was also domiciled in the state. *Id.* And the trust owned stock in a Minnesota Subchapter S corporation (i.e., a corporation that passes its income through to its shareholders, here the trust), which in turn owned property physically located in the state. *Id.* at 331. Finally, a Minnesota law firm drafted the instrument, which made the state's law controlling. *Compare id.*, with *Burger King Corp. v. Rudzewicz*, 471 U.S. 462, 482 (1985) (choice-of-law provision, although not determinative, not to be ignored).

¹⁵⁹ Were a case to arise where the only contact was the grantor's residence at inception, it seems unlikely that any of the Justices in the majority would find this a sufficient contact. For, in the case of grantor-based contacts, the majority indicated that the grantor's level of retained control should be the focus. *Kaestner*, 139 S. Ct. at 2222 n.7. While the majority indicated that the necessary level of control remains an open question, a requirement of some level of continuing control is apparently contemplated. *Id.*

¹⁶⁰ Many such rulings have now been issued. For a sample of recent ones, see I.R.S. Priv. Ltr. Rul. 2019-25-006 (June 21, 2019); I.R.S. Priv. Ltr. Rul. 2019-25-005 (June 21, 2019); I.R.S. Priv. Ltr. Rul. 2019-08-005 (Feb. 22, 2019);

easily.¹⁶¹ Under the technique, a taxpayer in a state that imposes an income tax conveys investment assets to a trust.¹⁶² The trust is drafted to make sure that it does not constitute a grantor trust for federal tax purposes.¹⁶³ If it were a grantor trust, all of the trust's income would be taxable for federal purposes on the grantor's tax return.¹⁶⁴ But if the trust is drafted to make it a non-grantor trust, its income is not taxable to the grantor for federal purposes.¹⁶⁵ And to the extent that the state follows federal law, the trust's income would not be reported on the grantor's state income tax return either.¹⁶⁶ If, as is always the case, the trust is located in a state without an income tax, the trust's undistributed income is not subject to state income tax—thereby permitting the grantor to avoid her home state's income tax on investment income.¹⁶⁷

Prior to the private letter rulings, the difficulty with the technique had been the federal gift tax. Typically, when assets are conveyed to a non-grantor trust, gift tax liability is triggered, resulting in a cost that would ordinarily deter taxpayers from adopting the technique.¹⁶⁸ But, surprisingly unconcerned about the impact on the states, the IRS approved a structure in the rulings under which the trust is treated as a non-grantor trust for income tax purposes even though the creation of the trust did not result in a completed gift for gift tax purposes or any gift tax liability.¹⁶⁹ Thus, taxpayers using this technique could freely (i.e., without paying gift tax¹⁷⁰) transfer investment assets to a

I.R.S. Priv. Ltr. Rul. 2019-08-004 (Feb. 22, 2019); and I.R.S. Priv. Ltr. Rul. 2019-08-003 (Feb. 22, 2019).

¹⁶¹ For a discussion of the strategy, see Schoenblum, *supra* note 23, at 1963–67.

¹⁶² *Id.*

¹⁶³ *Id.*

¹⁶⁴ See Rev. Rul. 85-13, 1985-1 C.B. 184 (“grantor takes into account in computing the grantor’s income tax liability all items of income, deduction, and credit to which the grantor would have been entitled had the trust not been in existence”).

¹⁶⁵ See Schoenblum, *supra* note 23, at 1963–67.

¹⁶⁶ Most states follow the federal grantor-trust rules. *Id.* at 1964.

¹⁶⁷ *Id.*

¹⁶⁸ See *Abusive Trust Tax Evasion Schemes—Questions and Answers*, IRS (Jan. 16, 2020), <https://www.irs.gov/businesses/small-businesses-self-employed/abusive-trust-tax-evasion-schemes-questions-and-answers> [<https://perma.cc/FJ6C-H5JC>].

¹⁶⁹ See *supra* notes 160–61 and accompanying text.

¹⁷⁰ The making of a completed gift does not necessarily result in gift tax liability given the gift tax exemption, under which no gift tax is payable until

non-grantor trust and thereby avoid paying state tax on income the assets generated while held in the trust.

2. *New York Expands Grantor Trust Concept*

In 2014, New York, a state which imposes an income tax, sought to close down this technique.¹⁷¹ It amended its tax statute to provide that, if a taxpayer used this technique, the trust would be treated as a grantor trust for state tax purposes even though it would be treated as a non-grantor trust for federal purposes.¹⁷² More specifically, under the amendment, where a grantor makes a contribution to a trust that is not a completed gift for federal gift tax purposes,¹⁷³ the trust is treated as a grantor trust for New York income tax purposes—requiring the grantor to report all of the trust’s income on her state tax return.¹⁷⁴

In broad terms, a trust is treated as a grantor trust for federal tax purposes where the grantor has certain powers over, or interests in, the trust.¹⁷⁵ The premise is that, in such a case, the grantor has not fully relinquished control over the trust assets and should therefore be treated for income tax purposes as if the trust did not exist. And, as indicated, states that impose an income tax typically follow the federal grantor trust rules,¹⁷⁶ treating the income of a grantor trust as taxable to the grantor for state tax purposes.

The New York amendment severed the connection between the federal and state rules, treating all so-called incomplete gift trusts (trusts structured so that transfers to it are not a completed gift) as grantor trusts for state purposes.¹⁷⁷ Under the amendment,

the taxpayer makes aggregate gifts during her life in excess \$11,400,000 (under current law). I.R.C. § 2505 (2012). But even though no gift tax is due on account of the exemption, whether or not a completed gift has occurred is nonetheless consequential: all completed gifts are in effect included in the donor’s estate tax calculation at the time of death. I.R.C. § 2001(b) (2012).

¹⁷¹ See N.Y. TAX LAW § 612(b)(41) (McKinney 2019).

¹⁷² *Id.*

¹⁷³ For the rules that enable a person making a contribution to a trust to render the gift incomplete for gift tax purposes, see Treas. Reg. § 20.2511-2 (as amended in 1999).

¹⁷⁴ N.Y. TAX LAW § 612(b)(41) (McKinney 2019).

¹⁷⁵ See, e.g., I.R.C. §§ 673–76, 678.

¹⁷⁶ See Schoenblum, *supra* note 23, at 1964.

¹⁷⁷ *Id.*

if a New York taxpayer creates an incomplete gift trust, all of the trust's income must be reported on the taxpayer's state return even if the trust is a non-grantor trust for federal purposes.¹⁷⁸

The New York model, if expanded, could possibly go a long way toward solving the out-of-state trust problem. To illustrate, assume New York (or any state that imposes an income tax) amended its tax statute to provide that a trust created by a resident where the grantor retains control, de facto or otherwise, is to be treated as a grantor trust for state tax purposes regardless of the trust's status as a non-grantor trust for federal purpose. All of the trust's income would then be reportable on the grantor's New York return, even though the income would be reportable for federal purposes on the trust's return, and the out-of-state trust would no longer provide an escape from New York income tax.¹⁷⁹

Would such an expanded grantor trust concept violate due process? Note first the difference between this concept and North Carolina's position in *Kaestner*. Whereas North Carolina sought to tax the *trust* on its undistributed income based on the beneficiary's contact with the state (residence), the grantor-trust approach would enable the state where the grantor resides to tax the *grantor* on the trust's income. While rejecting North Carolina's position, the Court explains and tacitly reaffirms two precedents upholding an estate tax in the grantor's estate on assets in an out-of-state trust.¹⁸⁰

The Court's discussion of these precedents suggests that the due process analysis in the case of a tax imposed on a grantor

¹⁷⁸ *Id.* Parenthetically, as a result of 2017 federal tax legislation, Tax Cuts & Jobs Act, Pub. L. No. 115-97, 131 Stat. 2091 (2017), under which the gift tax exemption has been substantially increased; I.R.C. § 2505; 26 C.F.R. § 601.602 (federal gift tax exemption of \$11,400,000 in 2019), the New York amendment has lost much of its force. New York taxpayers are now able to make completed gifts to their out-of-state trusts without as much concern about gift tax liability because of the increased gift tax exemption.

¹⁷⁹ Under the grantor-trust approach, if the grantor were to move to another state without an income tax after having contributed investment assets to the trust, the trust's income would no longer be subject to state taxation. But this makes sense in that, had the trust not been created, the investment-asset income would have ceased to be taxable at the state level once the move was accomplished. The grantor-trust approach, in other words, works to close down the out-of-state trust strategy but does not place taxpayers in a worse position than if no trust had been created. See Schoenblum, *supra* note 23, at 1964.

¹⁸⁰ N.C. Dep't of Revenue v. Kimberly Rice Kaestner 1992 Family Tr., 139 S. Ct. 2213, 2225 (2019).

by the state where the grantor resides distills down to this question: whether the grantor has sufficient control over, or interest in, the trust to justify the tax.¹⁸¹ While the Court framed the issue analogously in assessing the validity of the tax imposed on the *Kaestner* trust—whether the beneficiary residing in North Carolina had sufficient control over, or interest, in the trust—it explicitly left open the question whether a lower level of control would suffice where a state seeks to justify a tax on the grantor.¹⁸²

3. Grantor Control: How Much Is Necessary to Satisfy Due Process?

In the first precedent, *Curry v. McCannless*,¹⁸³ the grantor had created an out-of-state trust and had retained complete control over the trust assets exercisable at his death (i.e., he had retained a general power of appointment) as well as the right to receive trust income during his life. The domicile state taxed the trust assets, treating the grantor as if he had owned the trust's assets. *Kaestner* explains that the decedent's control was sufficiently extensive to justify the tax.¹⁸⁴ In the second precedent, *Graves v. Elliot*,¹⁸⁵ the grantor again created an out-of-state trust and again retained control, but in this case the control was in the form of a revocation power.¹⁸⁶ *Kaestner* explains that, as in *Curry*, the grantor's control was sufficient to validate the domicile state's estate tax on the trust's assets.¹⁸⁷ It then observes that "the Court

¹⁸¹ Professor Schoenblum argues that the New York's grantor-trust concept is unconstitutional, emphasizing that the New York statute deviates from the definition of a grantor trust under federal law and from the definition under the law of every state that maintains a grantor-trust concept. Schoenblum, *supra* note 23, at 1993–94. He does, however, intimate that, where a grantor retains sufficient control over trust assets such that the trust should be ignored, it would be constitutionally permissible for the state to tax the grantor on the trust's income. *Id.* at 1990.

¹⁸² *Kaestner*, 139 S. Ct. at 2222 n.7.

¹⁸³ 307 U.S. 357, 360 (1939).

¹⁸⁴ *Kaestner*, 139 S. Ct. at 2222; *see also Curry*, 307 U.S. at 370 ("decedent's power to dispose of the intangibles was a potential source of wealth which was property in her hands").

¹⁸⁵ 307 U.S. 383, 384–85 (1939).

¹⁸⁶ *See also Bullen v. Wisconsin*, 240 U.S. 625, 626 (1916) (grantor's revocation power over trust permitted Wisconsin, where grantor resided, to impose an inheritance tax on out-of-state trust).

¹⁸⁷ *Kaestner*, 139 S. Ct. at 2222.

did not have occasion in *Curry* or *Graves* to explore whether a lesser degree of control by a settlor also could sustain a tax by the settlor's domicile¹⁸⁸ And, as indicated, the Court adds that "we do not today address that possibility"¹⁸⁹

Which raises the question: what is the necessary level of grantor control before a state can employ the grantor-trust concept to tax the grantor on the trust's income? For federal tax purposes, there is an implicit assumption underpinning the grantor-trust concept, as well as certain key estate tax provisions, in terms of grantor control: that the grantor's choice of trustee, in combination with the terms of the trust, can give the grantor sufficient control to justify treating the grantor as if she owned the trust assets.¹⁹⁰

¹⁸⁸ *Id.* at 2222 n.7.

¹⁸⁹ *Id.* The Court also indicates that its "decision does not address state laws that consider the in-state residency of a beneficiary as one of a combination of factors, *that turn on the residency of a settlor*, or that rely only on the residency of noncontingent beneficiaries" *Id.* at 2225 (emphasis added).

¹⁹⁰ For example, I.R.C. section 674(a) establishes a general rule under which the grantor is treated as owning the trust's assets where the trustee is given discretion regarding distributions. And while there are several important exceptions—applicable in general where the trust instrument constrains the trustee's discretion, where the discretion can only be exercised with the consent of a party with an adverse interest, or where the trustee is independent, as defined in section 674(c)—none undermines the underlying idea that a grantor who gives a friendly or non-adverse trustee sufficient discretion can be treated as having retained enough control to warrant the attribution of the trust's income to the grantor. Two other income-tax sections expand on this theme. Under section 679(a)(1), the grantor is treated as the owner of assets in a foreign trust, with no exceptions, where the trust designates a U.S. beneficiary. And under section 677(a)(1)–(a)(3), attribution of ownership/income is required where the trustee is given discretion to make distributions to the grantor or her spouse. In the estate tax context, sections 2036(a)(2) and 2038(a)(2) treat the grantor as owning trust assets where the grantor can exercise control by herself or "in conjunction with any person." In *United States v. O'Malley*, the grantor named himself and two others as trustees. 383 U.S. 627, 629, 634 (1966). Because his two co-trustees could outvote him, the grantor's control was limited. Yet the Court held, based on the "in conjunction with" language in the predecessor section to section 2036(a)(2), that the trust's assets should be included in the grantor's estate, reflecting the assumption underlying this language that the grantor's selection of a trustee can enable the grantor to enjoy continuing control. And while the outcome in *O'Malley* would have been different had the grantor not been a trustee based on the statutory language, the premise remains that attribution to the grantor based on an assumption of continuing control can be appropriate where the grantor gives discretion to her chosen trustee.

Although the Code is not explicit about this rationale, these income and estate tax provisions presumably reflect the psychological reality that a trustee chosen by the grantor will feel some sense of obligation to accommodate, and perhaps defer to, the wishes of the grantor in administering the trust and addressing the needs of the grantor's children and other family members. It is surely not likely that a grantor would choose a trustee she perceived to be potentially indifferent to her concerns; nor is it likely that the trustee would feel comfortable in frustrating those concerns. There is, in other words, a social contract between the grantor and trustee.

To be sure, the grantor's control over the trustee is not capable of legal enforcement. Indeed, abdicating to the wishes of the grantor could constitute a breach of the trustee's duty to the beneficiaries.¹⁹¹ But, as a practical matter, there is typically significant space for the trustee to exercise discretion with an eye towards the grantor's wishes without falling into a breach of duty.

A grantor who creates a trust for the benefit of family giving the trustee a measure of discretion has not, in substance, fully relinquished control. Indeed, at the federal level, as suggested, income and estate tax provisions reflect this reality. And if Congress were to broaden the grantor trust rules to include all discretionary trusts for the benefit of the grantor's family, with the states adopting a parallel approach, it is difficult to conceive of a viable constitutional challenge. Likewise, there is no justification for imposing a constitutional constraint on the states that would prevent them from broadening the grantor-trust concept without federal legislation.¹⁹² No extant precedent stands in the way—and, most critically, the only defense offered in support of the strategy is that the Constitution requires that it be permitted.¹⁹³

¹⁹¹ See *Estate of Wall v. Comm'r*, 101 T.C. 300, 312 (1993) (“trustee would violate its fiduciary duty if it acquiesced in the wishes of the settlor”).

¹⁹² Although Professor Schoenblum argues that New York's grantor-trust approach is unconstitutional, he does imply that he would reach a different conclusion if the scope of grantor-trust status were enlarged for federal purposes and New York simply followed the federal template. See Schoenblum, *supra* note 23, at 1993–94, 1997–98. He does not explain why a change in the federal statutory treatment of a trust should have an impact on the *constitutional* scope of the states' taxing power.

¹⁹³ For an early article exploring the modest use of the grantor-trust concept in the context of the out-of-state trust problem, see Roger John Traynor, *State Taxation of Trust Income*, 22 IOWA L. REV. 268, 284–85 (1937); see also

In short, until the grantor unequivocally surrenders control over investment assets via an outright gift, the state in which the grantor resides ought to be able to continue taxing her on the income those assets generate while held in trust—wherever the trust is located.¹⁹⁴

4. *Grantor Trust on Kaestner Facts*

Even on *Kaestner*-type facts, the grantor-trust concept could be helpful. Although the *Kaestner* beneficiary had not contributed assets to the trust or otherwise acted nominally as the grantor, North Carolina might have argued that, in substance, the resident beneficiary was the grantor based on her consent to extend the term of the trust (through its decanting). That is, where a beneficiary has a right to receive trust assets at the time of the trust's termination under the instrument but agrees to extend the term, it could be argued that the beneficiary in substance received the assets and then reconveyed them to a new trust. Although North Carolina did make reference to the fact that the beneficiary had consented to extending the trust's term in its brief, it did not connect this fact to a grantor-trust concept—understandably given the lack of such a concept in its statutes.¹⁹⁵

Joseph W. Blackburn, *Constitutional Limits on State Taxation of a Nonresident Trustee: Gavin Misinterprets and Misapplies Both Quill and McCulloch*, 76 MISS. L.J. 1, 12–13 (2006) (citing Roger John Traynor, *State Taxation of Trust Income*, 22 IOWA L. REV. at 268).

¹⁹⁴ There would surely be no constitutional impediment if a state were to attribute to a resident grantor the income of an in-state trust based on a theory of continuing control. Why should the constitutional analysis shift merely because an out-of-state trust is used instead?

¹⁹⁵ The concurring opinion maintains that, even absent the decanting, North Carolina would have been precluded from taxing the trust until the beneficiary reached age 40. *N.C. Dep't of Revenue v. Kimberly Rice Kaestner 1992 Family Tr.*, 139 S. Ct. 2213, 2227–28 (2019) (Alito, J., concurring). It points out that, in *Safe Deposit*, the Court similarly precluded Virginia from taxing the trust while the beneficiary residing there was under the age (25) designated in the trust instrument for termination and distribution. *Id.* And it goes on to indicate that no aspect of *Safe Deposit* should be open for reconsideration. *Id.* Contrast this with the majority's discussion of *Safe Deposit* as a binding precedent: "The aspects of the case noted here are consistent with the pragmatic approach reflected" in cases decided after *Safe Deposit*. *Id.* at 2221 n.6.

Thus, the grantor-trust concept could possibly be implemented not only by the state where the nominal grantor resides but also by the state where the beneficiary resides if the facts suggest that the beneficiary has acted, in substance, as a grantor.

5. Grantor-Trust Concept: Its Limitations

The grantor-trust concept has some inherent limitations. First, by its very nature, it ceases to be effective once the grantor has died. As a practical matter, the trust's post-death income must either be taxed to the trust or to the beneficiaries—no longer to the now-dead grantor. The federal grantor trust concept operates analogously, with post-death trust income taxed to the trust or the beneficiaries. Thus, if a grantor who resides in a state that imposes an income tax creates an inter vivos out-of-state trust, the grantor-trust concept will only be effective during the grantor's life. After the grantor's death, assuming that the trust continues to be located in a tax-free state, the out-of-state trust issue re-emerges.

Second, the concept is similarly limited in the case of a testamentary trust since the trust first becomes operative at the time of death, at which point it is again no longer possible to tax the grantor on post-death trust income. Here, again, the out-of-state trust issue can re-emerge after the grantor's death. Third, if the grantor moves to a state without an income tax after having created the trust, attributing the trust's post-move income to the grantor would not permit the grantor's state of residence at inception to reach the trust's income.

Do these limitations argue against the grantor-trust concept as a solution? Not at all. Once the grantor has died or moved, the policy argument in favor of permitting her state of residence at inception to continue taxing the trust's income weakens. The equity and efficiency objections to the out-of-state trust, in other words, dissipate considerably—if not disappear—once the grantor is no longer subject to tax by reason of death or a move to another state. For those who find this unsatisfactory, the founder's principle might be an attractive supplement. It would permit the grantor's state of residence at inception to continue taxing the trust income indefinitely. But, as indicated, the constitutional validity of the principle is in question.

D. Throwback

While *Kaestner* does not permit the beneficiary's state of residence to tax the out-of-state trust on its undistributed income and *Brooke* does not permit the state to tax the beneficiary on such income, there is no policy justification for permitting the beneficiary to escape taxation in her state of residence when the income is distributed to her in a later year. After all, the benefits the government makes available to a beneficiary and the corresponding obligation of residents to contribute to the cost of government do not depend on whether the income is immediately distributed or instead accumulated and distributed in a later year.¹⁹⁶

But if a state like North Carolina is to tax the beneficiary at the point of such later distribution, a statutory mechanism is needed, namely, a throwback rule. In fact, the *Kaestner* Court suggested that states seeking to combat the out-of-state trust strategy could adopt a throwback rule.¹⁹⁷ Indeed, North Carolina's failure to enact the rule presumably cut against its argument that the Court's precedents have created a tax shelter that the states are powerless to attack. The Justices apparently thought: why did the state fail to take advantage of a readily available remedy?

At the federal level, a throwback concept has been utilized to undercut the tax advantage that an accumulation of income inside the trust provides. In essence, the idea is to tax the beneficiary when distribution is eventually made in a manner that forces her to disgorge the benefits that the accumulation created.¹⁹⁸ An interest charge is imposed to offset the advantages that stem from deferring the tax liability until the point of distribution.¹⁹⁹

When New York, in 2014, adopted its grantor-trust concept, it simultaneously adopted a throwback rule²⁰⁰ patterned after the federal rule.²⁰¹ Under this rule, New York imposes a tax

¹⁹⁶ See *Curry v. McCannless* 307 U.S. 357, 370 (1938) (suggesting "taxation is but a means of distributing the cost of government among those who are subject to its control and who enjoy the protection of its laws").

¹⁹⁷ *Kaestner*, 139 S. Ct. at 2225 n.13.

¹⁹⁸ Under current law, the throwback principle generally only applies in the case of a foreign trust. I.R.C. § 665(c) (1997).

¹⁹⁹ I.R.C. § 668 (1996).

²⁰⁰ N.Y. TAX LAW, § 612(b)(40) (McKinney 2019).

²⁰¹ As the *Kaestner* Court indicates, California also utilizes the throwback principle. CAL. REV. & TAX. CODE § 17745(b) (West 2019); *Kaestner*, 139 S. Ct. at 2225 n.13.

on a beneficiary residing in New York on a distribution of accumulated income as if, in rough terms, the beneficiary had received it when it was earned. States that enact the rule will need to consider whether to follow the interest-charge approach under the federal rule.

In essence, states seeking to attack the out-of-state trust strategy have three available effective weapons: the founder's principle, the grantor-trust concept, and the throwback rule. While the founder's principle (though constitutionally questionable) targets the trust, and the grantor-trust concept imposes the tax on the grantor, the throwback rule attacks the strategy from the beneficiary's side of the transaction.

If these weapons are adopted in tandem, some accommodation would be necessary to prevent double taxation. For example, if the state of the grantor's residence were to apply the grantor-trust concept and therefore required the grantor to report trust income on her return, subjecting the beneficiary to a throwback rule in her state of residence could produce double taxation: a tax in the grantor's state and a second tax in the beneficiary's state at the time of distribution. To the extent the states failed to prevent such an outcome, courts could possibly intervene under the Dormant Commerce Clause cases.²⁰²

To be sure, the throwback rule is not a panacea. As North Carolina argued, a beneficiary could move to a tax-free state before receiving a distribution and then move back in a post-distribution year.²⁰³ And while the rule could possibly be designed to prevent this kind of avoidance,²⁰⁴ supplementing it with the grantor-trust

²⁰² See Schoenblum, *supra* note 23, at 1994. *But see* Comptroller of Treasury of Md. v. Wynne, 135 S. Ct. 1787, 1802–04 (2015) (not every case of double taxation violates the Dormant Commerce Clause).

²⁰³ *Kaestner*, 139 S. Ct. at 2225–26.

²⁰⁴ Perhaps, a state could provide that, in the case of such a move, income accumulated while the beneficiary resided in the state would remain subject to its throwback rule even if the distribution were made after the taxpayer moved to another state on the theory that the beneficiary's right had accrued while she was a resident. While taxpayers would likely challenge the constitutionality of this approach, an accrual concept has been applied in analogous circumstances. For example, in *In re Schibuk*, the court held that payments the taxpayer received from a partnership in a post-move year had accrued while the taxpayer was still a New York resident and were therefore taxable in New York. 733 N.Y.S.2d 801, 803–04 (N.Y. App. Div. 2001). On the other hand, whether a beneficiary can be treated as having an accrued right before

concept (or, to the extent constitutionally permissible, the founder's principle) would certainly fortify the states' response to the strategy.²⁰⁵

IV. ELIMINATING DUE PROCESS AS A CONSTRAINT: EMPOWERING CONGRESS

An amicus brief in *Kaestner* suggested that the due process constraint on the authority of states to tax out-of-state trusts (or other taxpayers) be eliminated.²⁰⁶ Were this to occur, a state seeking to tax taxpayers or transactions having connections outside of its borders would still be subject to judicial control under the Dormant Commerce Clause and ultimately to Congress's control. There is much to be said for this approach. The federalism issues implicated in the tax context would be more easily amenable to solution through legislative regulation (with litigation under the commerce clause as a back-up).²⁰⁷ And,

the trustee unequivocally determines to exercise discretion in favor of the beneficiary is a debatable question.

²⁰⁵ In the personal jurisdiction context, some states have enacted legislation that is designed to be coterminous with the Due Process Clause: permitting the courts to exercise jurisdiction to the full extent that it is constitutionally authorized. *See, e.g.,* *Cowan v. First Ins. Co.*, 608 P.2d 394, 398–99 (Haw. 1980) (reach of long-arm statute to be determined by due process). Whether a tax statute could be drafted similarly—taxing all out-of-state trusts to the extent constitutionally permitted—is an interesting question. While such a statute would not appear to run afoul of the Due Process Clause—just as its analogue in the personal jurisdiction context is permitted—it would be problematic as a policy matter given the inevitable administrative difficulty. Neither taxpayers nor the state would be clear about the taxability of a trust until the courts ruled on the issue. On the other hand, the continuous need to litigate the question, together with the resulting uncertainty, might well deter taxpayers from utilizing the strategy.

²⁰⁶ Brief of Constitutional Law Scholars as Amici Curiae in Support of Neither Party at 8, *N.C. Dep't of Revenue v. Kimberly Rice Kaestner Family Tr.*, 139 S. Ct. 2213 (2019) (No. 18-457), 2019 WL 1112679, *8.

²⁰⁷ In *Quill Corp. v. North Dakota*, 504 U.S. 298, 298 (1992), the Court empowered Congress by removing the due process impediment to the tax at issue. In *South Dakota v. Wayfair, Inc.*, 138 S. Ct. 2080, 2084–86 (2018), freed from the constraint of due process by its decision in *Quill* and faced with Congressional inaction, the Court altered its Commerce Clause analysis in order to close down what it termed a “judicially created tax shelter.” Note also that, in *Comptroller of Treasury of Maryland v. Wynne*, Justice Scalia argued in dissent that the Dormant Commerce Clause cases should be overruled. 135 S. Ct. 1787, 1807–11 (2015) (Scalia, J., dissenting). This would leave Congress with

indeed, the two key cases limiting the taxation of out-of-state trusts, *Safe Deposit* and *Brooke*, are based on substantive due process principles, stemming from the now-discredited *Lochner*²⁰⁸ Era (one decided in 1928, the other in 1929).²⁰⁹

In short, the inequity and inefficiency inherent in out-of-state trusts could be effectively addressed by Congress—and, if necessary, the courts—were the due process constraint eliminated. But, unfortunately, *Kaestner* moves in the opposite direction, reaffirming and solidifying the constraint. Indeed, not a single Justice

the exclusive authority to regulate state taxing power under the Commerce Clause. *See also Wayfair*, 138 S. Ct. at 2100–01 (Gorsuch, J., concurring) (citing Justice Scalia and raising question about Dormant Commerce Clause cases).

²⁰⁸ *Lochner v. New York*, 198 U.S. 45, 45 (1905). To the extent *Kaestner* provides support for the out-of-state trust strategy and for the wealthy who employ it, it could be argued that it fits well within the spirit of *Lochner*. *See, e.g.*, ARCHIBALD COX, *THE COURT AND THE CONSTITUTION* 135 (1987) (“Lochnerian decisions flowed partly from the willful defense of wealth and power”). *But see* Herbert Hovenkamp, *The Political Economy of Substantive Due Process*, 40 STAN. L. REV. 379, 386–90 (1988) (acknowledging this view of substantive due process but arguing otherwise).

²⁰⁹ In rejecting the Virginia tax on due process grounds, the Court in *Safe Deposit* indicated that a different conclusion would “result in inescapable and patent injustice whether through double taxation, or otherwise.” 280 U.S. 83, 92 (1929). Such a focus on “injustice” reflects a substantive due process approach. *See Baldwin v. Missouri*, 281 U.S. 586, 595 (1930) (Holmes, J., dissenting) (explaining his disagreement with the majority in *Safe Deposit*, Justice Holmes indicates, “I cannot believe that the [Fourteenth] Amendment was intended to give us carte blanche to embody our economic or moral beliefs in its prohibitions.”); *see also Washington v. Glucksberg*, 521 U.S. 702, 721 (1997) (a primary feature of substantive due process is the protection it provides to liberty and rights the deprivation of which would result in a denial of justice). But, as the Court has indicated, its substantive due process precedents are based on a “restrained methodology”—a methodology that does not comfortably accommodate *Safe Deposit*. *Id.* On the other hand, note that *International Shoe Co. v. Washington*, 326 U.S. 310, 316 (1945), a seminal precedent from which modern tax and jurisdictional cases emanate, itself appeared to accept a substantive due process strand in its focus on “fair play” in the context of determining the presence of minimum contacts. *See* Stephen Goldstein, *Federalism and Substantive Due Process: A Comparative and Historical Perspective on International Shoe and its Progeny*, 28 U.C. DAVIS L. REV. 965, 976–77 (1995) (“fair play ... was attached in *International Shoe* to a new substantive due process test of minimum contacts”). In any event, neither the majority nor concurring opinion in *Kaestner* reveals a concern that *Safe Deposit* (or *Brooke*) is inconsistent with—or even in tension with—*Glucksberg*.

suggested that *Safe Deposit* or *Brooke* should be overruled—reflecting perhaps, as suggested, the looming battle over stare decisis.

CONCLUSION

No one defends the out-of-state trust strategy on policy grounds. Instead, those who defend it maintain that the Due Process Clause requires the states to permit it. *Kaestner* was the vehicle, many had hoped, that would eliminate constitutional constraints preventing the states from attacking the strategy. It failed. What now?

Perhaps the states need to find a more compelling vehicle. But given the key precedents that could be read to support the strategy and given the current state of affairs in the Supreme Court on stare decisis, finding the right vehicle may not be easy. Indeed, *Fielding* was surely a better vehicle than *Kaestner*, and yet the Court denied Minnesota's certiorari petition one week after deciding *Kaestner*.²¹⁰ Finding the right vehicle, at least in this judicial environment, will therefore be challenging.

Legislation is likely to be the more effective option. More specifically, if an expansive grantor-trust concept were adopted, one that is not tethered to its scope at the federal level, the trust's income would be reportable on the grantor's state return without regard to the trust's status for federal purposes.²¹¹ While *Kaestner* concluded that the presence of an in-state beneficiary was an insufficient contact to justify a tax on the undistributed income of an out-of-state trust, one can discern in the majority opinion a path left open for the states to tax the grantor, rather than the trust, on its income.

To be sure, the majority did observe that, in prior cases where such a tax was upheld, the grantor had control over the trust assets.²¹² But it also indicated that the required level of control in the context of a tax imposed on the grantor is an open question and that it may be appropriate to permit the states more leeway when they seek to tax an in-state grantor.²¹³

Where a grantor creates a discretionary trust for the benefit of her family, she will typically enjoy de facto control over

²¹⁰ See *supra* Section II.B.3.

²¹¹ See *supra* Section III.C.1.

²¹² See *supra* Section II.B.4.

²¹³ *Id.*

the trustee as a psychological matter.²¹⁴ This insight animates various federal provisions that tax the grantor on trust assets. Analogously permitting the states to tax an in-state grantor on trust income until control is fully surrendered—either by outright gift or by a gift to a nondiscretionary trust—would enable them to eliminate in large part the out-of-state trust strategy. No precedent stands in the way.²¹⁵ The battle over stare decisis lurking in the background of *Kaestner* should therefore not be an obstacle. The majority sent another signal—this one more explicit—to the states: that they are free to use a throwback rule to address the problem.²¹⁶ Supplementing the grantor-trust concept with a throwback rule would certainly be salutary.

Finally, a few words about what might be considered the ultimate question: should due process remain as a constraint in the tax context? Although the question is an academic one given *Kaestner*, it is nonetheless an important one. Had the Court overruled the taxpayer-friendly precedents and rejected due process as a constraint in this context, it would have empowered Congress to address the problem. And to the extent Congress failed to do so, the states would have been free to find their own solution—subject to the courts' control under the Dormant Commerce Clause. But the *Kaestner* Court chose a different path, fortifying the precedents and thereby constraining the states. And if the states are unable to find a solution, an abusive strategy disproportionately enjoyed by the wealthy will remain enshrined in the Due Process Clause.

²¹⁴ See *supra* Section III.C.3.

²¹⁵ See *supra* Section III.B.4.

²¹⁶ See *supra* Section III.D.