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## Asset Preservation and the Evolving Role of Trusts in the Twenty-First Century

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# Asset Preservation and the Evolving Role of Trusts in the Twenty-First Century

Jay A. Soled\*

Mitchell M. Gans\*\*

## *Abstract*

*For the vast majority of the twentieth century, trusts served two pivotal roles. The first was as a vehicle to help mitigate federal and state estate tax burdens, the rates of which could be quite significant. The second was to assist in asset preservation, safeguarding trust beneficiaries from their profligacy, former spouses, creditors, and the like.*

*At the start of the twenty-first century, Congress passed legislation that curtailed the impact of the federal estate tax, and many state legislatures have followed suit, either eliminating or significantly reducing their estate taxes. As a result of these legislative changes, trust instrument reliance to mitigate transfer tax burdens is no longer a commonplace objective. Instead, the role of trusts has shifted entirely toward asset preservation, buoyed by state legislative reforms that facilitate fulfillment of this role.*

*However, state legislative reform measures that are designed to strengthen the asset preservation element of trusts are replete with problems. In particular, they drain government coffers as they pit states against one another and the federal government; furthermore, insofar as they promote an aristocracy-like environment (where wealth cascades down from one generation to the next), they thwart economic mobility, an essential component of our nation's financial fabric.*

*Using three specific examples of states' aggressive efforts to attract trust formation within their borders, this analysis*

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*demonstrates the shortcomings associated with the evolving role of trusts in asset preservation and its corrosive effects. Because too much is at stake for this role to be left unchecked, this analysis recommends several viable reforms.*

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### I. Introduction

Over the past decade, Congress has devitalized the federal estate tax,<sup>1</sup> relegating it to almost complete obscurity. As currently formulated, it only burdens approximately 0.14% of the U.S. population.<sup>2</sup> Moreover, the vast majority of state governments has followed the lead of the federal government, in many instances even going a step further and entirely eliminating their estate taxes.<sup>3</sup> These actions by the federal

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1. See, e.g., Grayson M.P. McCouch, *The Empty Promise of Estate Tax Repeal*, 28 VA. TAX REV. 369, 370 (2008) (“The 2001 Act provides sizable income and estate tax cuts over a protracted phase-in period, culminating in 2010 with repeal of the estate tax and introduction of a modified carryover basis system for inherited property.”); Daniel W. Matthews, *A Fight to the Death: Slaying the Estate Tax Repeal Hydra*, 28 WHITTIER L. REV. 663, 665 (2006) (acknowledging that estate tax critics have been hugely successful in their campaign against the estate tax); Karen C. Burke & Grayson M.P. McCouch, *Estate Tax Repeal: Through the Looking Glass*, 22 VA. TAX REV. 187 (2002) (explaining how Congress, in 2001, greatly weakened the federal transfer tax system).

2. See Chye-Ching Huang & Nathaniel Frenzt, *Myths and Realities About the Estate Tax*, CTR. ON BUDGET & POLICY PRIORITIES (Aug. 29, 2013), <http://www.cbpp.org/archiveSite/estatetaxmyths.pdf> (indicating that in 2013 only 1.4 people out of 1,000 taxpayers endured the federal estate tax).

3. See Ashlea Ebeling, *Where Not to Die in 2014: The Changing Wealth Tax Landscape*, FORBES (Nov. 1, 2013), <http://www.forbes.com/sites/ashleaebeling/2013/11/01/where-not-to-die-in-2014-the-changing-wealth-tax-landscape/> (last visited Jan. 27, 2015) (indicating that only nineteen states and the District of Columbia still retain state estate taxes) (on file with the Washington and Lee Law Review). See generally Jeffrey A. Cooper, John R.

government and state legislatures have led to a fundamental shift in the estate planning landscape. Simply put, most taxpayers no longer need to retain legal counsel to circumvent estate taxes that in their heyday had tax rates—at least at the federal level—ranging as high as 77%.<sup>4</sup>

In the aftermath of the estate tax upheaval,<sup>5</sup> to stay relevant, the estate planning bar is struggling to reinvent itself. This is no easy task. Its membership has had to rethink the role of trusts and the objectives that they can achieve.<sup>6</sup> In the past, trusts were often employed as powerful shields to protect taxpayer wealth from the estate tax.<sup>7</sup> As the estate tax has waned at both the federal and state levels,<sup>8</sup> however, this objective has largely been rendered a nullity. Estate planners have thus had to reformulate the role of trust instruments, placing much greater emphasis on their second historical objective, namely, asset preservation.<sup>9</sup>

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Ivimey & Donna D. Vincenti, *State Estate Taxes After EGTRRA: A Long Day's Journey into the Night*, 17 QUINNIPIAC PROB. L.J. 90 (2003) (explaining how in the aftermath of congressional repeal of state death tax credit, many state legislatures simply let their estate taxes lapse); Joel Michael, *State Responses to EGTRRA Estate Tax Changes*, 103 TAX NOTES 1023 (2004) (cataloging state tax policy changes in the wake of the Economic Growth and Tax Relief Reconciliation Act of 2001).

4. See Darien B. Jacobson, Brian G. Raub & Barry W. Johnson, *The Estate Tax: Ninety Years and Counting*, 27 STAT. INCOME BULL., 118, 122 fig.D (Summer 2007), <http://www.irs.gov/pub/irs-soi/ninetyestate.pdf> (showing the top tax rates from 1916 to 2007).

5. See *infra* Part II (discussing the historical context of the estate tax and its current state, which shows the drastic change).

6. See, e.g., Jeffrey A. Cooper, *Interstate Competition and State Death Taxes: A Modern Crisis in Historical Perspective*, 33 PEPP. L. REV. 835 (2006) (describing the new estate tax landscape).

7. See *infra* Part II.A (discussing the estate tax prior to 2001).

8. See *infra* Part II.B (looking at the changes made in 2001 and developments since then).

9. See RESTATEMENT (SECOND) OF TRUSTS §§ 25–33 (1959) (discussing the creation of a trust); ERWIN N. GRISWOLD, SPENDTHRIFT TRUSTS § 1 (2d ed. 1947) (discussing trusts as a way to keep large estates intact); AUSTIN W. SCOTT & WILLIAM F. FRATCHER, THE LAW OF TRUSTS § 151 (4th ed. 1987) (describing the transfer of interest by means of a trust). See generally Lawrence M. Friedman, *The Dynastic Trust*, 73 YALE L.J. 547 (1964) (providing a history of trust law in the United States); George P. Costigan Jr., *Those Protective Trusts Which Are Miscalled "Spendthrift Trusts" Reexamined*, 22 CAL. L. REV. 471 (1934) (looking at the role of spendthrift trusts in the concentrated accumulation of wealth).

Consistent with achieving this objective, the estate planning bar has aggressively lobbied state legislatures to pass legislation that emphasizes trust asset preservation.<sup>10</sup> Many state legislatures have been compliant, enabling estate planners to design trusts to achieve numerous asset preservation goals, including the ability to mitigate and, in some instances, defeat state income taxes; safeguard assets within bloodlines for multiple generations; and offer significant shelter from creditors.<sup>11</sup> This emerging trend in the area of trust law has important, negative consequences for federal and state governments—consequences that require immediate attention.<sup>12</sup>

This analysis proceeds as follows. Part II provides estate tax historical background, including those events that over the past decade have gutted this tax.<sup>13</sup> Part III then details how, in the aftermath of the estate tax evisceration, the estate planning bar has responded by enlisting state legislatures to pass laws that facilitate trust asset preservation and then designing trusts that can fulfill this role.<sup>14</sup> Next, Part IV pinpoints the consequences associated with this emerging trend and suggests measures that the federal and state governments should institute to protect their tax bases from erosion and to secure other public policy objectives.<sup>15</sup> Finally, Part V concludes.<sup>16</sup>

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10. *See infra* Part III (“In particular, they are reexamining trust instruments and transforming the roles that such trusts can potentially play in the twenty-first century.”).

11. *See infra* Part III (examining how weaker estate taxes have frequently led to more onerous state income taxes).

12. *See infra* Part III (looking at how trusts can be used to avoid income taxation).

13. *See infra* Part II (providing relevant historical context to the forthcoming discussion of the estate tax).

14. *See infra* Part III (discussing the response to the weakening of the estate tax).

15. *See infra* Part IV (addressing the result of these changing policies and proposing a solution).

16. *See infra* Part V (concluding with a summary of the concerns regarding the use of trusts to circumvent estate and income taxes).

## II. Historical Background

The vibrancy of yesteryear's federal and state estate taxes compared with their current limited impact signifies how the estate planning landscape has changed.<sup>17</sup> Subpart A sets forth a short historical overview of the federal estate tax and its state law counterparts prior to 2001. Subpart B then details how legislative changes in 2001 and the years following have largely emasculated the federal and state estate taxes.

### A. Overview of the Pre-2001 Federal Estate Tax and State Law Counterparts

The federal estate tax owes its origin to the Revenue Act of 1916.<sup>18</sup> This legislation initiated what was then a modest tax.<sup>19</sup> With a \$50,000 exemption, it applied only to what were then the wealthiest estates.<sup>20</sup> Moreover, the applicable tax rates were graduated in nature, ranging from 1% on the first \$50,000 beyond the exemption amount to 10% on the portion exceeding \$5 million.<sup>21</sup>

To complement the estate tax and ensure the integrity of its base, Congress introduced the federal gift tax in 1924.<sup>22</sup> In 1926, Congress repealed this tax<sup>23</sup> but reintroduced it in 1932.<sup>24</sup> With a rate structure that was somewhat akin to that of the estate tax and a lifetime exclusion of \$50,000, this tax applied to inter vivos gratuitous transfers.<sup>25</sup> Congress also provided an annual

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17. See *infra* Part II.A (detailing the historical context of the estate tax, which serves to demonstrate how much it has weakened over time).

18. See Pub. L. No. 64-271, 39 Stat. 756 (providing for a tax on income received by estates).

19. See *id.* § 200 (setting the highest estate tax rate at 10%).

20. See *id.* (taxing estates under \$50,000 at just 1%).

21. See *id.* (providing estate tax rates for estates ranging from \$50,000 to over \$5 million).

22. See Revenue Act of 1924, Pub. L. No. 68-176, 43 Stat. 313 (providing for a tax on property received as a gift).

23. See Revenue Act of 1926, Pub. L. No. 69-20, 44 Stat. 126 (repealing the gift tax).

24. See Revenue Act of 1932, Pub. L. No. 72-154, 47 Stat. 169 (imposing a gift tax and setting forth calculations for that tax).

25. See Jeffrey A. Cooper, *Ghosts of 1932: The Lost History of Estate and*

exclusion, enabling taxpayers to transfer up to \$5,000 per donee free of gift tax or the use of their lifetime exclusion.<sup>26</sup>

Notwithstanding the estate tax's modest beginnings, the country's need for revenue and the Second World War led to a series of legislative initiatives resulting in the imposition of a more vigorous estate tax.<sup>27</sup> In 1932, Congress passed legislation that raised the highest estate tax rates from 20% to 45% and lowered the exemption amount from \$100,000 back to \$50,000.<sup>28</sup> In 1934, Congress passed legislation that again raised the highest estate tax rate, this time from 45% to 60%;<sup>29</sup> and in 1935, Congress raised the highest estate tax rate from 60% to 70% and even lowered the exemption amount to \$40,000.<sup>30</sup> Finally, in 1941, Congress passed legislation that raised the highest federal estate tax rate from 70% to 77% while maintaining the exemption amount at \$40,000.<sup>31</sup>

In 1976, the federal estate tax received a legislative complement in the form of the generation-skipping transfer (GST) tax.<sup>32</sup> This new transfer tax was designed to curtail

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*Gift Taxation*, 9 FLA. TAX REV. 875, 897 (2010) (discussing the effect of the Revenue Act of 1932, which exposed more estates to taxation).

26. The 1932 Act clarified that the exclusion was calculated on a per-donee, per-calendar-year basis. More specifically, Section 504(b) of the Act provided that "[i]n the case of gifts (other than future interests in property) made to any person by the donor during the calendar year, the first \$5,000 of such gifts to such person shall not, for purposes of subsection (a), be included in the total amount of gifts made during such year." Revenue Act of 1932, Pub. L. No. 72-154, 47 Stat. 169. Note that from 1943 through 1981, the annual exclusion amount was \$3,000. Revenue Act of 1942, Pub. L. No. 77-753, § 454, 56 Stat. 798, 953.

27. As Congress strengthened the estate tax, it also instituted measures designed to strengthen the gift tax. See DAVID JOULFAIAN, OFFICE OF TAX ANALYSIS, U.S. DEP'T OF THE TREASURY, OTA 100, THE FEDERAL GIFT TAX: HISTORY, LAW, AND ECONOMICS (Nov. 2007), <http://www.treasury.gov/resource-center/tax-policy/tax-analysis/documents/ota100.pdf> (describing changes taken by Congress).

28. See Revenue Act of 1932 § 403 (requiring a tax whenever the decedent's estate exceeds \$50,000).

29. See Revenue Act of 1934, Pub. L. No. 73-216, 48 Stat. 680 (providing estate tax rates).

30. See Revenue Act of 1935, Pub. L. No. 74-407, 49 Stat. 1014 § 201 (raising the estate tax rates and changing the criteria for exemption).

31. See Revenue Act of 1941, Pub. L. No. 77-250, 55 Stat. 687 § 401 (setting estate tax rates).

32. See generally A. MacDonough Plant & Lynn Wintriss, *Generation-*



taxpayers from gifting and devising assets to distant generations, outright or in trust, forestalling estate tax imposition for years and even decades.<sup>33</sup> On a going-forward basis, taxpayers who made gifts or bequests to so-called skip people (generally, grandchildren and more distant descendants)<sup>34</sup> beyond a statutory set exemption amount<sup>35</sup> had to pay, in addition to gift and estate taxes, the GST tax. The GST tax has a flat rate equal to the highest federal estate tax rate.<sup>36</sup>

As the federal estate tax (along with its gift and GST tax counterparts) gradually became broader based in nature, many state legislatures during this same time period took steps to augment their revenues, choosing a path similar to that of the federal government.<sup>37</sup> Consider the fact that in 1924 Congress enacted the so-called state death tax credit.<sup>38</sup> Up to certain dollar thresholds, this credit enabled taxpayers' estates to offset dollar-for-dollar their federal estate tax liability equal to amounts paid to state governments.<sup>39</sup> With this federal legislative framework in place, many state governments quickly enacted estate tax laws

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*Skipping Transfer Tax*, 17 U. BALT. L. REV. 271 (1988) (discussing legislative attempts to ensure that a tax is imposed on trusts at least once a generation); Joseph M. Dodge, *Generation-Skipping Transfers After the Tax Reform Act of 1976*, 125 U. PA. L. REV. 1265 (1977) (discussing the impact of the Tax Reform Act of 1976 on generation-skipping taxes). In 1986, Congress retroactively repealed the generation-skipping transfer tax, replacing it with the version currently in effect. See Tax Reform Act of 1986, Pub. L. No. 99-514, § 1431, 100 Stat. 2085, 2717–32 (1986).

33. See STAFF OF JOINT COMM. ON TAXATION, 94TH CONG., 2D SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976, at 564–65 (Comm. Print 1976) (discussing the motivations for changing the federal estate tax law).

34. See I.R.C. § 2613(a) (1988) (defining a skip person for purposes of a generation-skipping transfer).

35. See *id.* § 2631(c) (setting forth exemptions from a generation-skipping transfer).

36. See *id.* § 2641(a) (setting the applicable rate equal to the highest federal estate tax rate).

37. See E.M. Perkins, *State Action Under the Federal Estate Tax Credit Clause*, 13 N.C. L. REV. 271, 280 n.33 (1934) (discussing state laws providing for an estate tax).

38. See Revenue Act of 1924, Pub. L. No. 68-176, § 301(b), 43 Stat. 253, 304 § 216 (providing tax credits to a surviving spouse in the year following his or her spouse's death).

39. See I.R.C. § 2011(a) (2002) (providing tax credits for estate taxes paid to a state).

designed to absorb this credit because it came at no added cost to their constituents.<sup>40</sup>

While exemption amounts and tax rates fluctuated prior to 2001,<sup>41</sup> federal and state estate taxes remained a salient part of the tax landscape.<sup>42</sup> Beyond the applicable exemption amount (which from 1942 to 1976 stayed constant at a modest \$60,000),<sup>43</sup> the combined federal and state estate tax rates consistently exceeded 50%, claiming significant portions of wealthy taxpayers' estates.<sup>44</sup> The modest exemption amount combined with the severity of such federal and state estate tax rates constituted a constant driving force toward comprehensive estate planning for many taxpayers.<sup>45</sup>

Naturally, the estate planning bar did whatever it could to keep transfer tax severity in the public limelight and to emphasize taxpayers' need for legal counsel.<sup>46</sup> Estate planners routinely warned clients that improperly planned estates had the potential for significant estate tax exposure.<sup>47</sup> Indeed, these planners routinely exploited examples of assets inuring to the benefit of grandchildren that triggered multiple-transfer-tax application (i.e., both the estate and GST taxes) and resulted in an aggregate transfer tax rate as high as 90%.<sup>48</sup> Whether these

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40. See Perkins, *supra* note 37, at 280 n.33 (detailing those states that adopted an estate tax in the aftermath of federal legislation).

41. See Jacobson, Raub & Johnson, *supra* note 4, at 122 (providing estate tax rates from 1916 to 1977).

42. See *id.* at 122–24 (providing historical context of the estate tax).

43. See *id.* at 122 (providing estate tax rates from 1916 to 1977).

44. See *id.* (showing that, despite fluctuations, the top rate was almost always above 50%).

45. See *id.* at 121–24 (discussing past estate tax regimes, under which many more estates were exposed to taxation).

46. See AMERICAN BAR ASS'N, ESTATE PLANNING 4, [http://www.americanbar.org/content/dam/aba/migrated/publiced/practical/books/family\\_legal\\_guide/chapter\\_16.authcheckda.pdf](http://www.americanbar.org/content/dam/aba/migrated/publiced/practical/books/family_legal_guide/chapter_16.authcheckda.pdf) (encouraging the use of an attorney in estate planning).

47. See *id.* at 27–28 (discussing the potential for estate tax exposure, including the methods of asset valuation upon death).

48. See generally *Top Four Reasons You Need an Estate Planning Attorney*, FOWLER ST. CLAIR (Nov. 15, 2013), <http://www.fowlerstclair.com/top-four-reasons-need-estate-planning-attorney/> (last visited Jan. 27, 2015) (listing one reason to see an estate planning attorney as having “enough assets to worry about the so-called ‘death tax’”) (on file with the Washington and Lee Law Review); Evelyn Zawatasky, *Ten Reasons You Need to See an Estate Planning*

frightful scenarios would actually materialize was irrelevant; they motivated taxpayers to act.

Because of the high stakes, taxpayers were often willing to dedicate a lot of resources in the form of legal fees to safeguard their estates from transfer tax. Tax counsel accordingly developed a plethora of tax-saving techniques, the vast majority of which employed trust utilization.<sup>49</sup> Some of these tax-saving techniques involving trusts could be employed during taxpayers' lifetimes and were designed to keep insurance proceeds out of their estates,<sup>50</sup> maximize valuation discounts,<sup>51</sup> and leverage their annual exclusions;<sup>52</sup> some of these tax-saving techniques involving trusts were testamentary in nature and, among other things, were

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*Attorney*, ZAWATSKY LAW (Feb. 9, 2014), <http://www.zawatskylaw.com/10-reasons-need-see-estate-planning-attorney/> (last visited Jan. 27, 2015) (including the possibility of estate taxes as a reason to see an estate planning attorney) (on file with the Washington and Lee Law Review).

49. See, e.g., C. Daniel Yates & Michael O. Chenoweth, *Estate Planning: The Use of Irrevocable Insurance Trusts*, 23 IND. L. REV. 517, 517 (1990) (discussing the use of trusts in estate planning).

50. See, e.g., *id.* ("An irrevocable trust funded with life insurance provides the opportunity to create wealth for the benefit of the settlor's family without the imposition of federal estate tax and to provide liquidity for the estate of the settlor."). For a historic examination of the early use of irrevocable life insurance trusts, see Note, *Federal Taxation of Personal Life Insurance Trusts*, 44 YALE L.J. 1409, 1415–21 (1935) (looking at the use of trusts in avoiding estate taxation).

51. See James R. Repetti, *Minority Discounts: The Alchemy in Estate and Gift Taxation*, 50 TAX L. REV. 415, 431–32 (1995) (discussing ways that valuation methods might be used to lower estate and gift taxes); Mary Louise Fellows & William H. Painter, *Valuing Close Corporations for Federal Wealth Transfer Taxes: A Statutory Solution to the Disappearing Wealth Syndrome*, 30 STAN. L. REV. 895, 913 (1978) (looking at a case that addressed valuation as a way to reduce gift taxes); Alan L. Feld, *The Implications of Minority Interest and Stock Restrictions in Valuing Closely-Held Shares*, 122 U. PA. L. REV. 934, 947 (1974) (addressing the impact of valuation on fixed estate taxes).

52. See John G. Steinkamp, *Common Sense and the Gift Tax Annual Exclusion*, 72 NEB. L. REV. 106, 116–25 (1993) (providing an overview of the exclusion and limitations on that exclusion); Robert B. Smith, *Should We Give Away the Annual Exclusion?*, 1 FLA. TAX REV. 361, 401 (1993) (arguing that exclusions make it easy to avoid paying estate taxes); Louis S. Harrison, *The Strategic Use of Lifetime Gifting Programs to Reduce Estate Taxes in Light of Recent Congressional and Internal Revenue Service Antipathy Towards Transfer Tax Reduction Devices*, 40 DEPAUL L. REV. 365, 375–77 (1991) (looking at exclusion gifts as "an effective means to reduce eventual estate taxes").

designed to maximize taxpayers' use of their federal and state exemption amounts<sup>53</sup> and the estate tax marital deduction.<sup>54</sup> The trust utilization area of the law blossomed and remained vibrant.<sup>55</sup>

*B. Overview of 2001 Legislative Changes and Current Status of the Law*

For years prior to 2001, many commentators and politicians called for estate tax repeal.<sup>56</sup> They labeled the estate tax as the "death tax" and claimed that it was summarily destroying small businesses and farms.<sup>57</sup> While their pleas for repeal gained traction in Congress, primarily due to the sympathies of Republican Party members,<sup>58</sup> the

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53. See, e.g., Henry M. Ordower, *Trusting Our Partners: An Essay on Resetting the Estate Planning Defaults for an Adult World*, 31 REAL PROP. PROB. & TR. J. 313, 347 (1996) (outlining the rationale behind unified credit shelter trusts); Larry W. Gibbs, *Basic Federal Gift and Estate Taxation*, 17 ST. MARY'S L.J. 809, 834 (1986) (describing in detail how credit shelter trusts are designed to operate).

54. See, e.g., Wendy C. Gerzog, *The New Supercharged PAT (Power of Appointment Trust)*, 48 HOUS. L. REV. 507, 529–34 (2011) (describing marital trust use in the estate planning sphere); Joseph M. Dodge, *A Feminist Perspective on the QTIP Trust and the Unlimited Marital Deduction*, 76 N.C. L. REV. 1729, 1729 (1998) (exploring the history of the unlimited estate tax marital deduction and how it gave rise to marital deduction trusts).

55. See generally Gerzog, *supra* note 54 (discussing the power of appointment trusts in the context of estate planning).

56. See Joel C. Dobris, *A Brief for the Abolition of All Transfer Taxes*, 35 SYRACUSE L. REV. 1215, 1216 (1985) (calling for a repeal of the estate and gift tax).

57. See *id.* at 1222 (referring to the estate tax as a death tax); John E. Donaldson, *The Future of Transfer Taxation: Repeal, Restructuring and Refinement, or Replacement*, 50 WASH. & LEE L. REV. 539, 545–49 (1993) (discussing the unfairness of the estate tax); Charles O. Galvin, *To Bury the Estate Tax, Not to Praise It*, 52 TAX NOTES 1413 (1991) (arguing that the income tax should be increased to make up any deficit caused by a repeal of the estate tax); Robert B. Smith, *Burying the Estate Tax Without Resurrecting Its Problems*, 55 TAX NOTES 1799 (1992) (calling for the repeal of the estate tax). *But see* Michael J. Graetz, *To Praise the Estate Tax, Not to Bury It*, 93 YALE L.J. 257, 274–78 (1983) (discussing the benefits of progressive taxation versus regressive taxation).

58. See Floyd Norris, *The 'Death Tax' Lives on Despite Senate Republican Efforts to Kill It*, N.Y. TIMES, June 11, 2006, at C3 (discussing the failure of a bill that would have repealed the estate tax); Jackie Calmes, *Republicans Discover*

estate tax remained largely intact during the 1980s and 1990s.<sup>59</sup>

But in 2001 everything changed. In a hotly contested presidential election, George W. Bush narrowly prevailed over Al Gore, and the Republicans commanded a majority in the House and a tie in the Senate.<sup>60</sup> While the Republicans harbored antipathy for the income tax, they expressed even greater disdain for the estate tax.<sup>61</sup> Within a few months of taking office, with the balance of power in Republican hands, the Bush administration sought to torpedo the estate tax.<sup>62</sup>

Congress accordingly enacted sweeping legislation that fundamentally changed the estate tax and set it on a trajectory toward obsolescence. Among other things, the Economic Growth and Tax Relief Reconciliation Act of 2001 (2001 Act)<sup>63</sup> gradually raised the estate tax exemption amount, gradually reduced the estate tax rate, and suspended the tax in its entirety for a one-

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*Appeal of Killing the 'Death Tax': Good Times Make It Politically Acceptable to Support Repeal*, WALL ST. J., Feb. 2, 2000, at B2 (looking at the appeal of repealing the estate tax to those Americans whose estates would not likely be affected by such a tax); *President George W. Bush's Weekly Radio Address*, 37 WKLY. COMPILATION PRESIDENTIAL DOCUMENTS 12, at 463–508 (Mar. 17, 2001) (“On principle, every family, every farmer and small business person should be able to pass on their life’s work to those they love. So we abolish the death tax.”); Press Release, Sen. Charles E. Grassley (Mar. 15, 2001), *available at* LEXIS, FEDTAX library, TNT file (“Repealing the federal death tax is critical to the financial well-being and survival of family farms and small businesses.”).

59. See generally Dobris, *supra* note 56 (calling for the repeal of the estate tax in the 1980s); Donaldson, *supra* note 57 (calling for the repeal of the estate tax in the 1990s).

60. See *Party Division in the Senate, 1789–Present*, U.S. SENATE, [https://www.senate.gov/pagelayout/history/one\\_item\\_and\\_teasers/partydiv.htm](https://www.senate.gov/pagelayout/history/one_item_and_teasers/partydiv.htm) (last visited Jan. 27, 2015) (listing the majority party in Congress) (on file with the Washington and Lee Law Review).

61. For a complete compendium of the Republicans’ current arguments against the estate tax, see KEVIN BRADY, JOINT ECON. COMM. REPUBLICANS, COST AND CONSEQUENCES OF THE FEDERAL ESTATE TAX, AN UPDATE 15–18 (July 25, 2012), [http://www.jec.senate.gov/republicans/public/?a=Files.Serve&File\\_id=bc9424c1-8897-4dbd-b14c-a17c9c5380a3](http://www.jec.senate.gov/republicans/public/?a=Files.Serve&File_id=bc9424c1-8897-4dbd-b14c-a17c9c5380a3).

62. See *President George W. Bush's Weekly Radio Address*, 37 WKLY. COMPILATION PRESIDENTIAL DOCUMENTS 12, at 463–508 (Mar. 17, 2001) (discussing reasons for getting rid of the estate tax).

63. See Pub. L. No. 107-16, 115 Stat. 38 (codified as amended in scattered sections of 26 U.S.C.).

year period in 2010.<sup>64</sup> Due to budgetary constraints,<sup>65</sup> in 2011 the estate tax was scheduled to revert to its original 2001 status;<sup>66</sup> however, the vast majority of politicians suspected that once taxpayers were accustomed to the higher estate tax exemption amounts (and even a one-year tax suspension), replication of the “2001 estate tax world” would be a virtual impossibility.<sup>67</sup> The 2001 Act also repealed the state estate tax credit, replacing it with a deduction;<sup>68</sup> on a going-forward basis, if states were to levy an estate tax, it would come at an additional cost to their taxpayers.<sup>69</sup>

Late in 2010, with the clock ticking toward reversion to the 2001 estate tax world, Congress enacted legislation that once again sucked vitality from the estate tax.<sup>70</sup> With the imprimatur of a Democratic president, namely, Barack Obama, Congress “temporarily” raised the 2009 estate tax exemption amount over 40% from \$3.5 million to \$5 million; raised the gift tax exemption amount 500%, from \$1 million to \$5 million; raised the GST tax exemption amount over 40%, from \$3.5 million to \$5 million; indexed these exemption amounts for inflation; and significantly lowered the highest estate tax rate from 45% to 35% (its lowest

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64. See *id.* tit. V (reducing the estate tax and changing the exemption amount so that fewer estates are subject to the tax); Sergio Pareja, *Estate Tax Repeal Under EGTRRA: A Proposal for Simplification*, 38 REAL PROP. PROB. & TR. J. 73 (2003) (explaining the details of this legislation).

65. For an excellent overview of how these constraints operate and how politicians seek to circumvent them, see George K. Yin, *Temporary Effect Legislation, Political Accountability, and Fiscal Restraint*, 84 N.Y.U. L. REV. 174, 228 (2009) (describing how Congress can avoid restraints while still appearing to comply with such restraints).

66. See Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, § 901, 115 Stat. 38 (sunsetting the legislation after December 31, 2010).

67. See, e.g., William G. Gale & Samara R. Potter, *An Economic Evaluation of the Economic Growth and Tax Relief Reconciliation Act of 2001*, 55 NAT'L TAX J. 133, 138 (2002), available at <http://ntj.tax.org/> (“Virtually no one believes the bill will sunset as written.”).

68. See Economic Growth and Tax Relief Reconciliation Act of 2001, § 531(a)(1)–(3) (replacing the state estate tax credit with a deduction).

69. See *id.* (providing that taxpayers would no longer receive a credit for state estate taxes levied against an estate).

70. See Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312, 124 Stat. 3296 (codified as amended in scattered sections of 26 U.S.C.) (providing relief from the estate tax).

rate since 1932).<sup>71</sup> Another feature that Congress added to the Internal Revenue Code (Code) was portability of the estate tax exemption amount between spouses.<sup>72</sup> This new feature would enable a surviving spouse to capitalize on the decedent spouse's unused estate tax exemption amount without going through the tiresome and expensive exercise of establishing so-called bypass trusts that, for decades, were instrumental in preserving a decedent spouse's unused exemption amount.<sup>73</sup> (Bypass trusts had been the darling technique of the estate planning industry, often constituting a major justification for expensive estate planning fees.)<sup>74</sup>

Congress last revisited the estate tax in the waning days of 2012.<sup>75</sup> While Congress had the opportunity to allow the estate tax to revert to its historical roots (the estate tax exemption was again scheduled to return to \$1 million), it chose a different path.<sup>76</sup> The estate, gift, and GST exemption amounts were instead made "permanent" at the \$5 million threshold (indexed for inflation), and the concept of portability was likewise made permanent.<sup>77</sup> The only gasping effort that Congress made to keep the transfer tax system "alive" was increasing the estate, gift, and GST tax rates from 35% to 40% (not counting the two-year interval of 2011–2012, still the lowest estate tax rate since 1932).<sup>78</sup>

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71. *See id.* (offering lower rate and exemptions to more estates).

72. *See id.* § 303(a)(4) (offering greater flexibility to a surviving spouse in preserving more of the inherited estate).

73. *See id.* (providing a way for a surviving spouse to keep more of the inherited estate).

74. *See* Ordower, *supra* note 53, at 347 (explaining the reasoning for using trusts in estate planning); Gibbs, *supra* note 53, at 834 (describing how trusts operate).

75. *See* American Taxpayer Relief Act of 2012, Pub. L. No. 112-240, 126 Stat. 2313 (codified as amended in scattered sections of 26 U.S.C.) (setting the maximum estate tax rate at 40%).

76. *See id.* (keeping the higher estate tax exemptions rather than exposing more estates to taxation).

77. *See id.* (continuing to allow spouses to capitalize on available exemptions).

78. *See id.* § 101(c) (setting the maximum estate tax rate at 40%).

With the reduction of rates from 77% in 1941 to 40%, where it is today,<sup>79</sup> the function of the estate tax has radically changed. No longer concerned with breaking up concentrated wealth, it now merely adds an element of progression to the income tax system—and, indeed, does so rather modestly given its flat 40% rate.<sup>80</sup>

As the federal government gutted the estate tax, state legislatures did not stand idly by.<sup>81</sup> Once the federal government repealed the credit for state estate taxes, many states immediately eliminated their estate taxes entirely.<sup>82</sup> Other states retained their estate taxes but followed the federal model of significantly raising their exemption amounts.<sup>83</sup> A few states, such as New Jersey,<sup>84</sup> retained their estate taxes essentially in their 2001 form.<sup>85</sup> Nevertheless, only eighteen states still levy an estate tax, and pressure continues to mount even within those states to eliminate their estate taxes or drastically increase their exemption amounts lest their income-tax-paying populaces move out of state.<sup>86</sup>

On a going-forward basis, absent change, the nation's federal and state estate tax systems will remain anemic.<sup>87</sup> On the whole, the vast majority of taxpayers have no federal or state estate tax

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79. See *id.* (describing the maximum estate tax rate).

80. See generally THOMAS PIKETTY, *CAPITAL IN THE TWENTY-FIRST CENTURY* (2013) (discussing economic factors and policies driving inequality).

81. See Ebeling, *supra* note 3 (discussing changes to state estate laws).

82. See *id.* (addressing the changes to estate taxes by state legislatures).

83. See *id.* (providing a summary of changing exemption policies in certain states).

84. See N.J. STAT. ANN. § 54:38-1 to -16 (West 2002) (detailing that the New Jersey estate tax uses as an exemption threshold a decedent's federal estate tax liability as if the person died on December 31, 2001).

85. See *id.* (keeping the estate tax law nearly the same as in 2001).

86. See Paul Sullivan, *Some States Are Moving to Loosen Their Estate Taxes*, N.Y. TIMES (Jan. 24, 2014), <http://www.nytimes.com/2014/01/25/your-money/cold-facts-about-estate-taxes.html> (last visited Jan. 27, 2015) (looking at the motivations for some states to change their estate tax laws to mirror the less onerous federal estate tax) (on file with the Washington and Lee Law Review).

87. See IRS STATISTICS OF INCOME, ESTATE TAX STATISTICS FILING YEAR TABLE 1 (last updated Sept. 12, 2013), <http://www.irs.gov/uac/SOI-Tax-Stats-Estate-Tax-Statistics-Filing-Year-Table-1> (last visited Jan. 27, 2015) (revealing how little revenue is brought in by the estate tax) (on file with the Washington and Lee Law Review).



exposure.<sup>88</sup> Evidence of this proposition abounds. In 2012, for example, the number of federal taxable estate tax returns totaled 3,738, affecting approximately 0.1% of the number of 2012 decedents.<sup>89</sup> Consider, too, that the nation's transfer tax system historically collected approximately 1% to 2% of the nation's overall revenue;<sup>90</sup> under the radically transformed transfer tax system, this percentage amount will no doubt decline precipitously.<sup>91</sup>

### *III. Emerging Trends in the Use of Trust Instruments*

With the federal estate tax emasculated and the majority of state legislatures eliminating their estate tax systems,<sup>92</sup> estate planning bar members must confront significant relevancy challenges. No longer can taxpayers be induced to retain professional advice on the basis of ominous estate tax clouds perched on the horizon. What makes the relevancy challenge particularly acute is that taxpayers generally want to ignore their own mortality and, moreover, tend to view the future through Pollyannaish crystal balls that, in their minds, portend further estate tax reductions. The combination of the foregoing leaves estate planning bar members in an unenviable situation: they possess a great wealth of knowledge in an area of the law (namely, estate taxes) that has little or no bearing on the vast majority of taxpayers.<sup>93</sup>

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88. *See id.* (showing how few estates were subject to an estate tax in 2012).

89. *See id.* (displaying the data compiled by the IRS).

90. *See* CONG. BUDGET OFFICE, FEDERAL ESTATE AND GIFT TAXES (Dec. 19, 2009), [cbo.gov/sites/default/files/cbofiles/ftpdocs/108xx/doc10841/12-18-estate\\_gifttax\\_brief.pdf](http://cbo.gov/sites/default/files/cbofiles/ftpdocs/108xx/doc10841/12-18-estate_gifttax_brief.pdf) (“Federal transfer taxes have historically made up a relatively small share of total federal revenues—accounting for 1 percent to 2 percent of total revenues for the past 60 years.”).

91. *See, e.g.*, CONG. BUDGET OFFICE, THE BUDGET AND ECONOMIC OUTLOOK: FISCAL YEARS 2012 TO 2022, at 85 (2012), [http://www.cbo.gov/sites/default/files/cbofiles/attachments/01-31-2012\\_Outlook.pdf](http://www.cbo.gov/sites/default/files/cbofiles/attachments/01-31-2012_Outlook.pdf) (estimating that the federal estate tax will generate only \$14 billion of revenue in 2013—less than 1% of the nation's overall revenue).

92. *See supra* Part II.B (providing an overview of 2001 legislative changes and the current status of the law).

93. *See* IRS STATISTICS OF INCOME, ESTATE TAX STATISTICS FILING YEAR TABLE 1 (updated Sept. 12, 2013), <http://www.irs.gov/uac/SOI-Tax-Stats-Estate->

Because of the radical transformation of the estate tax laws, members of the estate planning bar have been scurrying to reinvent themselves, attempting to regain relevancy among the members of the general public. In particular, they are reexamining trust instruments and transforming the roles that such trusts can potentially play in the twenty-first century.

Below, we document three emerging trends in the area of trust law: (A) the employment of trusts to minimize or eliminate state income tax burdens,<sup>94</sup> (B) the utilization of dynasty trusts to preserve wealth within family units,<sup>95</sup> and (C) the establishment of trusts to protect taxpayers' wealth from potential creditors.<sup>96</sup>

#### *A. Minimizing or Eliminating State Income Tax Burdens*

Since 2001, as the federal estate tax has diminished in importance<sup>97</sup> and state estate taxes have largely disappeared,<sup>98</sup> state income taxes have generally become more onerous.<sup>99</sup> As state income taxes have increased in significance,<sup>100</sup> estate

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Tax-Statistics-Filing-Year-Table-1 (last visited Jan. 27, 2015) (showing that very few estates were subject to an estate tax in 2012) (on file with the Washington and Lee Law Review).

94. See *infra* Part III.A (discussing challenges to the residency-by-birth method and the establishment of ING trusts).

95. See *infra* Part III.B.3 (discussing the emergence of perpetual dynasty trusts).

96. See *infra* Part III.C (discussing the elimination of the self-settled trust rule and the effectiveness of the self-settled trust strategy).

97. See *supra* Part II.B (providing an overview of 2001 legislative changes and the current status of the law).

98. See *supra* notes 81–86 and accompanying text (discussing state reactions to the federal government's repeal of the credit for state estate taxes).

99. See Joseph D. Henchman & Christopher L. Stephens, *Playing Fair: Distribution, Growth, and Fairness in Federal and State Tax Debates*, 51 HARV. J. ON LEGIS. 89, 103–06 (2014) (discussing recent measures that states have enacted, including several “millionaire taxes,” that were designed to keep their budgets solvent); LIZ MALM & GERALD PRANTE, ANNUAL STATE-LOCAL TAX BURDEN RANKING FY-2011 (Apr. 2, 2014), <http://taxfoundation.org/article/annual-state-local-tax-burden-ranking-fy-2011> (last visited Jan. 27, 2015) (“Nationally, average state-local tax burdens . . . on average, rose from 2000 to 2010, followed by a decrease in 2011.”) (on file with the Washington and Lee Law Review).

100. See, e.g., CAL. REV. & TAX CODE §§ 17041, 17043 (West 2014) (declaring that the highest marginal income tax rate in the state of California is currently

planners have devised strategies to minimize their impact. Achieving such tax savings, however, requires technical expertise and circumspection. In this subpart, we explore how estate planners establish trust situs in low-tax jurisdictions.

But before exploring those techniques that estate planners recommend to establish trust situs in low-tax jurisdictions, a framework is necessary. States generally treat trusts as if they were individual taxpayers and, accordingly, classify trusts as either resident or nonresident in nature.<sup>101</sup> For those trusts that are identified as being resident, taxpayers are generally taxed on all of their income; in contrast, for those trusts that are identified as being nonresident, taxpayers are generally taxed only on income that is sourced within the state seeking to impose tax.<sup>102</sup>

The rules that define trust residency vary from state to state.<sup>103</sup> For example, some states claim that a trust is a resident if at least one trustee is a resident of the state;<sup>104</sup> other states claim that a trust is a resident based on where the majority of fiduciary decisions are made.<sup>105</sup> Historically, however, the most common method for determining trust residency has been based upon the residency of the individual taxpayer who established the trust during life or upon death (known as the residency-by-birth method).<sup>106</sup>

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13.3%).

101. See source cited *infra* note 102 (examining the statutory approaches to both resident and nonresident trusts).

102. See generally Warren R. Calvert & Sylvia Z. Gaspar, *State Taxation of Accumulated Trust Income: Statutory Approaches and Constitutional Considerations*, 5 ST. & LOC. TAX LAW 73, 76 (2000) (examining statutory approaches to the income taxation of accumulated trust income and discussing the constitutional considerations that govern the validity of more common schemes).

103. See *infra* notes 104–107 and accompanying text (detailing various state approaches to determining trust residency).

104. See, e.g., ARIZ. REV. STAT. ANN. § 43-1301(5) (West 2011) (“If a trust has more than one fiduciary, the trust is a resident trust if at least one of the fiduciaries is a resident of this state.”).

105. See, e.g., OR. REV. STAT. § 316.282(1)(d) (2013) (“In the case of a fiduciary that is a corporate fiduciary engaged in interstate trust administration, the residence and place of administration of a trust both refer to the place where the majority of fiduciary decisions are made in administering the trust.”).

106. See, e.g., CONN. GEN. STAT. § 12-701(4) (2012) (“Resident trust or estate” means (A) the estate of a decedent who at the time of his death was a resident of

Most states declare that any trust not identified as a resident trust is, by default, classified as a nonresident trust.<sup>107</sup>

### 1. Challenges to the Residency-by-Birth Method

Over the last several decades, the residency-by-birth method has been the target of numerous constitutional challenges.<sup>108</sup> This is because, once established, the trust in question may have little or no subsequent nexus with the state actually claiming jurisdiction.<sup>109</sup>

In *Quill Corp. v. North Dakota*,<sup>110</sup> the U.S. Supreme Court indirectly issued guidance in this area of the law. In *Quill*, via mail order, a taxpayer made sales to North Dakota residents, and the state sought to collect use tax from the taxpayer.<sup>111</sup> The question before the court was as follows: Under the Constitution's Commerce and Due Process Clauses, did North Dakota have a right to force the taxpayer, who had no physical presence in the state, to collect use tax?<sup>112</sup> Regarding the Commerce Clause issue, the court ruled that requiring the taxpayer to collect use tax in North Dakota and throughout the country would unduly burden interstate commerce and, as such, was impermissible.<sup>113</sup> On the due process clause issue, however, the court ruled that only "minimum contacts" were necessary to justify jurisdiction; and because the taxpayer had a targeted marketing campaign of mailing advertising catalogs to North Dakota residents, the threshold had been met.<sup>114</sup>

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this state . . .").

107. See, e.g., N.Y. TAX LAW § 605(b)(4) (McKinney 2009) ("A nonresident trust means a trust which is not a resident or part-year resident.").

108. See *infra* notes 110–127 and accompanying text (discussing several of these constitutional challenges).

109. See *infra* notes 116–120 and accompanying text (discussing the lack of nexus with the state as grounds for a constitutional challenge to the state treating a trust as resident for taxation purposes).

110. 504 U.S. 298 (1992).

111. *Id.* at 302–03.

112. See *id.* at 304 (outlining the procedural posture of the case).

113. *Id.* at 309–17.

114. *Id.* at 306–08.

In *Quill*'s aftermath, some state courts have continued to uphold residency-by-birth statutes.<sup>115</sup> Consider the facts of *Chase Manhattan Bank v. Gavin*.<sup>116</sup> A Connecticut resident established two trusts, one inter vivos and the other testamentary in nature.<sup>117</sup> The question before the Connecticut Supreme Court was whether it was constitutional for Connecticut to treat each as being a resident trust despite the fact that neither trust had any continuing nexus with Connecticut (i.e., all trust beneficiaries, trustees, and investments were located out of state).<sup>118</sup>

Insofar as the testamentary trust was concerned, the Connecticut Supreme Court held in favor of the state.<sup>119</sup> More specifically, it ruled that there was no due process violation because the Connecticut probate court had continuing jurisdiction over the trust to settle its accounts and the like, and therefore the "minimum contact" threshold that *Quill* had established had been met.<sup>120</sup> Likewise, there was no violation of the Commerce Clause because Connecticut's tax imposition would not likely dissuade a taxpayer from selecting out-of-state trustees based upon the fear that another state's income tax might be imposed.<sup>121</sup>

Insofar as taxation of the inter vivos trust was concerned, the Connecticut Supreme Court ruled that this, too, was constitutionally permissible.<sup>122</sup> While acknowledging that resolution of this issue was a closer constitutional call, the court claimed that there was a "critical link" between the trust and Connecticut because the trust's primary beneficiary was a Connecticut resident.<sup>123</sup>

Even in the aftermath of the *Quill* decision, the constitutionality of state taxing statutes that are entirely based

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115. See *infra* notes 116–123 and accompanying text (outlining a Connecticut case that upheld a residency-by-birth statute).

116. 733 A.2d 782 (Conn. 1999).

117. *Id.* at 786.

118. See *id.* at 785–86 (listing the issues before the court).

119. See *id.* at 786 (affirming the trial court's judgment in favor of the state).

120. *Id.* at 791–93.

121. *Id.* at 804–07.

122. *Id.* at 801–03.

123. *Id.* at 801 ("There must be some 'definite link, some minimum connection between' the state and the income that it seeks to tax.").

on the residency-by-birth method remains suspect.<sup>124</sup> Indeed, several state courts have struck down such statutes.<sup>125</sup> Many state legislatures have therefore undertaken initiatives to ensure the constitutionality—and clarity—of their resident trust statutes.<sup>126</sup> Under the laws of many states, a so-called resident trust not only must be established by a resident of that particular state but also there must be some other nexus with the state—that is, the trustee, the beneficiary, or trust property must be located in the state.<sup>127</sup>

## 2. Establishment of ING Trusts

With the basic framework for the state income taxation of trusts in mind, estate planning attorneys have been creating strategies designed to minimize their clients' state income tax burdens.<sup>128</sup> A few of the techniques that they recommend are fairly basic;<sup>129</sup> others are more aggressive. One popular technique

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124. See *infra* note 125 and accompanying text (detailing multiple states that struck down residency-by-birth statutes).

125. See, e.g., *Mercantile-Safe Deposit & Trust Co. v. Murphy*, 203 N.E.2d 490 (N.Y. 1964) (addressing an inter vivos trust); *In re Swift*, 727 S.W.2d 880 (Mo. 1987) (addressing testamentary trusts); *Westfall v. Dir. of Revenue*, 812 S.W.2d 513 (Mo. 1991) (addressing a testamentary trust); *Blue v. Dep't of Treasury*, 462 N.W.2d 762 (Mich. Ct. App. 1990) (addressing a resident trust); *Pennoyer v. Taxation Dir.*, 5 N.J. Tax 386 (N.J. Tax Ct. 1983) (addressing a testamentary trust); *Potter v. Taxation Div. Dir.*, 5 N.J. Tax 399 (N.J. Tax Ct. 1983) (addressing an inter vivos trust).

126. See *infra* note 127 and accompanying text (discussing the laws of many states that require a resident trust to have a nexus with the state, i.e., be located in the state).

127. See, e.g., MO. REV. STAT. § 143.331 (2014) (declaring that a trust will be deemed a Missouri resident only if it is created by a Missouri resident and at least one income beneficiary is a Missouri resident).

128. See *infra* note 129 and accompanying text (discussing some basic techniques employed by attorneys for minimizing their clients' state income tax).

129. Some of the basic techniques require action items prior to trust establishment. For example, one easy way to avoid state income taxation on a trust is for the trust settlor to move from a high-tax jurisdiction, such as California, to a low-tax jurisdiction, such as Florida (which does not levy a state income tax), and then establish a trust. Prudent trustee selection is also critical (i.e., avoiding the selection of a trustee domiciled in a state that predicates taxation based upon a trustee's residency). See, e.g., ARIZ. REV. STAT. ANN. § 43-1301(5) (West 2011) (providing trust situs dependent upon residency of trustee).

involves locating so-called incomplete nongrantor (ING) trusts in a state (e.g., Delaware) that does not impose an income tax. The goal of establishing an ING trust is straightforward: the elimination of state income tax on the investment income generated by the assets conveyed to the trust. Actually achieving this goal, however, requires technical sophistication.

When establishing an ING trust, estate planning attorneys' objectives are generally twofold. First and foremost, they want to ensure that the trust in question is treated as a nonresident trust in the client's home state.<sup>130</sup> They therefore take important

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Another strategy that estate planning attorneys routinely recommend to those clients who are considering establishing trusts and who have children who are domiciled in different states is that instead of establishing one trust for the benefit of all of their children (which might subject the entirety of the trust's income to taxation in those states that predicate taxation based upon the residency of the trust beneficiaries, *see, e.g.*, N.J. STAT. ANN. § 54A:1-2 (West 2004) (declaring that trust situs is dependent upon the residency of the beneficiaries)), they should establish a separate trust for the benefit of each child to capture the benefits of those states that impose little or no income tax. A final technique that may avoid state income taxation is to make the terms of the trust entirely discretionary in nature; the absence of any trust beneficiary with a vested interest can negate taxation in those states that utilize beneficiaries' domicile as a metric to determine trust residency. *See* McNeil v. Commonwealth, 67 A.3d 185, 198 (Pa. 2013) (holding a residency-by-birth statute unconstitutional when applied to a discretionary inter vivos trust with residency beneficiaries but no trustees, assets, or income located in Pennsylvania). *See generally* 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, 25-27 (2006) (discussing techniques to avoid state income taxation of trust beneficiaries).

Even after the trust is established, estate planners may utilize other planning strategies to circumnavigate the imposition of state income taxes. For example, if trust situs is based upon the trustee's state of residency (which is located in a state that imposes a high state income tax), the trust beneficiaries can request that the trustee resign. If, instead, trust situs is based upon the location of trust property, *see, e.g.*, Westfall v. Dir. of Revenue, 812 S.W.2d 513, 517 (Mo. 1991) (holding that owning a small parcel of Missouri real property was a sufficient basis upon which the state could justify its taxation of trust income), then the trustee should consider moving such property; if this is not possible because it engenders title to real property, a solution would be selling such property and reinvesting the proceeds in property located outside of that particular taxing jurisdiction.

130. *See, e.g.*, N.Y. TAX LAW § 605(b)(3)(B) (McKinney 2014) (describing nonresident trusts). Note, however, that New York has enacted legislation that would limit the advantages of using an out-of-state trust. Under the legislation, when distributions are made by the trust to New York beneficiaries, they are taxable under a so-called "throwback rule." N.Y. TAX LAW § 612(b)(40).

precautions with respect to such trusts. These precautionary steps include installing out-of-state trustees, mandating that trust property be located outside the client's home jurisdiction, and requiring that the trust itself have no vested beneficiaries.

Second, estate planners craft the trust terms to ensure that trust contributions do not result in a completed gift and that, for income tax purposes, the trust is treated as a nongrantor trust.<sup>131</sup> It is important to avoid making a completed gift so that a gift tax liability is not imposed in connection with the trust's creation.<sup>132</sup> It is likewise important to avoid grantor-trust status because, in the case of a grantor trust, all of its income is taxed to the grantor for state, as well as federal, income tax purposes.<sup>133</sup> Thus, with a grantor trust, all of the trust's income would be taxed to the grantor in his or her home state, defeating the purpose of the strategy.<sup>134</sup> To fulfill these objectives, ING trusts often have several special attributes.

In multiple private letter rulings, the IRS initially ruled that trust contributions to such trusts were incomplete and that the trust terms did not cause them to be grantor trusts.<sup>135</sup> These private letter rulings essentially sanctioned the use of these trusts as gift-tax-free devices that enable taxpayers to avoid income in their home state on the assets conveyed to the trust.<sup>136</sup> But several years after issuing the aforementioned favorable taxpayer private letter rulings, the IRS began to question its own

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131. See *id.* § 612(b)(41) (describing incomplete gift nongrantor trusts).

132. See I.R.C. § 2501(a) (2012) ("A tax . . . is hereby imposed for each calendar year on the transfer of property by gift during such calendar year by any individual resident or nonresident.").

133. See *id.* § 671 (describing grantor trusts and tax liability).

134. See *id.* (describing the tax liability).

135. See I.R.S. Priv. Ltr. Rul. 2001-48-028 (Nov. 30, 2001) (ruling that trust contributions to ING trusts were incomplete and that the trust terms did not cause them to be grantor trusts); I.R.S. Priv. Ltr. Rul. 2002-47-013 (Nov. 22, 2002) (same); I.R.S. Priv. Ltr. Rul. 2005-02-014 (Jan. 14, 2005) (same); I.R.S. Priv. Ltr. Rul. 2006-12-002 (Mar. 24, 2006) (same); I.R.S. Priv. Ltr. Rul. 2006-37-025 (Sept. 15, 2006) (same); I.R.S. Priv. Ltr. Rul. 2006-47-001 (Nov. 24, 2006) (same); I.R.S. Priv. Ltr. Rul. 2007-15-005 (Apr. 13, 2007) (same); I.R.S. Priv. Ltr. Rul. 2007-29-025 (July 20, 2007) (same); I.R.S. Priv. Ltr. Rul. 2007-31-019 (May 1, 2007) (same).

136. See I.R.S. Priv. Ltr. Rul. 2001-48-028 (Nov. 30, 2001) (determining that ING trusts were incomplete and that the terms did not cause them to be grantor trusts).



analysis in these rulings.<sup>137</sup> More recently, in response to a somewhat different drafting approach, the IRS has again endorsed the strategy, ruling that the trust terms in question would neither trigger a taxable gift nor be categorized as a grantor trust.<sup>138</sup>

Evident by the amount of time, energy, and resources that estate planning attorneys have devoted to ING trust development, there is little doubt that they must achieve significant tax savings.<sup>139</sup> Over the last decade and half, the estate planning bar has reconceived the role of the trust from that of an estate tax savior to that of an income tax savior.<sup>140</sup> By redesigning the role of trust instruments, the estate planning bar has been able to resurrect its relevancy.

### *B. Preserving Wealth Within Family Bloodlines*

The trust evolution did not stop with income tax minimization or elimination. In seeking to develop methods of trust utilization to appeal to its expanding client base, the estate planning bar designed dynasty trusts to preserve wealth within family bloodlines.<sup>141</sup>

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137. See Press Release, Internal Revenue Serv., Chief Counsel Seeking Comment on Gift Tax Consequences of Trusts Employing Distribution Committee (July 9, 2007) (No. 2007-127) (questioning its own prior sanctions of the use of ING trusts as gift-tax-free devices).

138. See I.R.S. Priv. Ltr. Rul. 2013-10-002 (Nov. 12, 2013) (showing that the taxpayer established an irrevocable trust). With the taxpayer's consent, principal and income distributions could be made to the taxpayer or issue (but only with the approval of a distribution committee comprised of the taxpayer and the taxpayer's sons); without the taxpayer's consent, principal and income distributions could be made to the taxpayer or issue (but only with the unanimous approval of the distribution committee members, excluding the taxpayer); in a nonfiduciary capacity, the taxpayer could make principal distributions among the grantor's issue for their health, education, maintenance, and support; and the taxpayer retained a limited testamentary power of appointment. *Id.*

139. See Richard W. Nenno, *Planning to Minimize or Avoid State Income Taxation on Trusts*, 34 ACTEC J. 131, 146 (2008) (presenting an excellent summary of how properly established trusts in the "right jurisdictions" can yield tremendous state income tax savings).

140. See *id.* (summarizing how properly established trusts can yield tremendous state income tax savings).

141. See *infra* Part III.B.3 (discussing the emergence of perpetual dynasty

### 1. *The Rule Against Perpetuities and the GST Tax*

For centuries, what is known as the rule against perpetuities placed timing limits on the vesting of property interests.<sup>142</sup> In essence, the rule required that vesting had to occur within twenty-one years of a life (or lives) in being.<sup>143</sup> Its purpose was to prevent the negative economic and interpersonal consequences that would ensue were the property subject to restrictions of a problematic duration.<sup>144</sup>

Application of the rule against perpetuities often meant that trust property would vest at least once every one hundred years or so. Consider the following fact pattern: Assume that under the terms of a decedent's will, the decedent established a trust for the lifetime benefit of his descendants. Assume further that, at the time of the decedent's death, the youngest of his descendants was his one-year-old grandchild. Properly drafted, the trust would terminate twenty-one years after the death of this grandchild, which, assuming the grandchild died at the age of eighty, would enable the trust to remain intact for 101 years.

Aside from the rule against perpetuities, the GST tax was designed to eliminate the estate tax advantages offered by long-term trusts, which defer estate tax imposition.<sup>145</sup> The GST tax is a tax that applies in addition to federal gift and estate taxes.<sup>146</sup>

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trusts).

142. See *infra* note 143 and accompanying text (discussing the function of the rule against perpetuities (RAP)).

143. See Stewart E. Sterk, *Jurisdictional Competition to Abolish the Rule Against Perpetuities: R.I.P. for the R.A.P.*, 24 CARDOZO L. REV. 2097, 2098–99 (2003) [hereinafter Sterk, *Judicial Interpretation*] (discussing reaction to the abolishment of the RAP) (quoting JOHN CHIPMAN GRAY, RULE AGAINST PERPETUITIES 191 (4th ed. 1942) (“No interest is good unless it must vest, if at all, not later than twenty-one years after some life in being at the creation of the interest.”)).

144. See Heather M. Marshall, *Instead of Asking “When,” Ask “How”: Why the Rule Against Perpetuities Should Not Apply to Rights of First Refusal*, 44 NEW ENG. L. REV. 763, 766 (2010) (providing background information regarding prohibitions against restraints on property rights and the right of first refusal); Lewis M. Simes, *The Policy Against Perpetuities*, 103 U. PA. L. REV. 707, 708–12 (1955) (discussing the public policy reasons behind the RAP).

145. It seems logical, therefore, to expect the enactment of the GST tax to diminish interest in creating such long-term trusts. Ironically, just the opposite has occurred.

146. See *supra* note 32 and accompanying text (noting that the GST was a

As noted earlier, the Code triggers its application when property passes to or for the benefit of so-called skip persons, i.e., generally, people two or more generations removed from the transferor, such as a grandchild or a great-grandchild.<sup>147</sup> Designed to act as a surrogate for the estate tax that would otherwise be imposed on the children's generation, the GST tax seeks to prevent taxpayers from circumventing the principle that the estate tax should be imposed once per generation and thereby safeguards the integrity of the estate tax.<sup>148</sup> The GST tax rate has always been flat, equal to the highest marginal federal estate tax rate.<sup>149</sup>

To illustrate GST tax application, consider a case where the decedent establishes a testamentary trust for the benefit of his children, after which the trust corpus passes in further trust for the benefit of his grandchildren and great-grandchildren. At the death of the decedent's last surviving child, the trust experiences what the Code identifies as a taxable termination and, as such, would be subject to GST tax.<sup>150</sup> However, if the decedent had allocated his entire GST tax exemption of \$5.34 million (the current exemption amount) to the trust and if the value of the assets transferred to the trust did not exceed this amount, the trust would remain permanently free of GST tax. Thus, even if the trust were to remain intact for, say, five hundred years, no

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complement to the federal estate tax).

147. See I.R.C. § 2613(a) (2012) ("For purposes of this chapter, the term 'skip person' means . . . a natural person assigned to a generation which is 2 or more generations below the generation assignment of the transferor . . .").

148. See *supra* note 32 and accompanying text (noting that the GST was a complement to the federal estate tax designed to protect its integrity); Estate of Gerson v. Comm'r, 127 T.C. 139, 142–43 (2006) ("The public policy underlying the GST tax is to bring uniformity and consistency to Federal transfer taxes (estate, gift, and generation-skipping) by imposing a transfer tax upon all transfers whether directly to an immediate succeeding generation or to generations further removed from the transferor."), *aff'd*, 507 F.3d 435 (6th Cir. 2007).

149. See I.R.C. § 2641(a)(1) ("For purposes of this chapter, the term 'applicable rate' means, with respect to any generation-skipping transfer, the product of . . . the maximum Federal estate tax rate, and . . . the inclusion ratio with respect to the transfer.").

150. See *id.* § 2612(a) ("For purposes of this chapter, the term 'taxable termination' means the termination (by death, lapse of time, release of power, or otherwise) of an interest in property held in a trust . . .").

GST tax would ever be imposed. And, if properly drafted, the trust's assets would likewise not be subject to tax in the estates of any of the descendants. The longer the trust remained in existence, the greater the tax savings the exemption would produce.

## 2. *The Downfall of the Rule Against Perpetuities and the GST Tax*

To optimize the tax savings, therefore, it was necessary to locate such GST-exempt trusts in jurisdictions permitting perpetual trusts. Thus began the search for jurisdictions willing to eliminate the rule against perpetuities. The estate planning bar found state legislatures extraordinarily receptive.<sup>151</sup> Why did a rule that appeared so deeply engrained in the law's fabric become unwoven so quickly? With the promise that rule against perpetuities elimination would attract massive amounts of capital investment, state legislatures readily jumped on the repeal bandwagon.<sup>152</sup> Once one state repealed its rule against perpetuities, other states, fearful of losing capital investments, quickly followed suit.<sup>153</sup> Today, the vast majority of states have either repealed or greatly curtailed their rule against perpetuities.<sup>154</sup>

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151. See *infra* notes 152–154 and accompanying text (discussing the overwhelming cooperation by states in eliminating the RAP from estate planning).

152. See Max M. Schanzenbach & Robert H. Sitkoff, *Perpetuities or Taxes? Explaining the Rise of the Perpetual Trust*, 27 CARDOZO L. REV. 2465, 2474 (2006) (discussing the multiple states that followed Delaware in its repeal of the RAP as applied to interests in trusts); Robert H. Sitkoff & Max M. Schanzenbach, *Jurisdictional Competition for Trust Funds: An Empirical Analysis of Perpetuities and Taxes*, 115 YALE L.J. 356, 404 (2005) (“Within the timeframe of our sample, 17 states abolished the RAP with a resulting average increase of \$6 billion in trust assets per state.”).

153. See *supra* note 152 and accompanying text (noting the domino effect among states to repeal the RAP as applied to interests in trusts).

154. See, e.g., Robert H. Sitkoff, *Trusts and Estates: Implementing Freedom of Disposition*, 58 ST. LOUIS U. L.J. 643, 668 (2014) (“Most strikingly, as a consequence of the competition across the states for trust business, more than half the states have abrogated the Rule to allow for a *perpetual trust*.” (emphasis added)).

For two reasons, the GST tax has likewise lost its vibrancy. First, like the federal estate tax applicable exclusion amount,<sup>155</sup> the GST exemption amount has increased vastly in size from \$1.5 million (in 2005) to \$5.34 million (in 2014)<sup>156</sup> and is annually adjusted upward for inflation.<sup>157</sup> This bountiful GST exemption amount enables married couples to transfer massive amounts of wealth into trusts that are entirely insulated from any transfer tax for generations to come. Second, federal estate tax rates have changed from graduated to flat.<sup>158</sup> Historically, federal estate tax rates have been steeply graduated and the GST tax rate has always equaled the highest federal estate tax percentage,<sup>159</sup> routinely dissuading long-term trust creation. Now, however, because the federal estate tax rate is flat (currently set at 40%),<sup>160</sup> GST tax imposition often inflicts no greater financial burden than had the federal estate tax itself been imposed.

### 3. *The Rise of Dynasty Trusts*

With the rule against perpetuities eliminated in many states and the application and impact of the GST tax neutered, the estate planning bar has begun to tout so-called dynasty trusts.<sup>161</sup>

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155. See I.R.C. § 2010(c)(2) (2012) (declaring that the applicable exclusion amount is at least \$5 million).

156. See *id.* § 2631(c) (explaining that the GST exemption amount “shall be equal to the basic exclusion amount” used to calculate the federal estate tax applicable exclusion amount).

157. See Rev. Proc. 2013-15, § 2.13 (confirming that the basic exclusion amount against estate tax for an estate of any decedent dying during calendar year 2013 is \$5.25 million, proving that it continues to be indexed for inflation).

158. See *infra* note 160 and accompanying text (noting that the federal estate tax rate is now flat and currently set at 40%).

159. See *supra* note 36 and accompanying text (noting that the GST tax has a flat rate equal to the highest federal estate tax rate).

160. See I.R.C. § 2001(c) (detailing the rate schedule for the federal estate tax).

161. See, e.g., JESSE DUKEMINIER & ROBERT H. SITKOFF, WILLS, TRUSTS, AND ESTATES 897 (2013) (reproducing an advertisement from a South Dakota trust company, highlighting the fact that South Dakota has repealed its rule against perpetuities). See generally Joshua C. Tate, *Perpetual Trusts and the Settlor’s Intent*, 53 U. KAN. L. REV. 595, 602–26 (2005) (examining perpetual dynasty trusts through the lens of settlor intent); Joel C. Dobris, *The Death of the Rule Against Perpetuities, or the RAP Has No Friends—An Essay*, 35 REAL PROP.

The terms of these trusts are unprecedented in the field of trust law: they are designed to last generations to come and, depending upon GST exemption allocation, will escape transfer tax application over this same period of time.<sup>162</sup> Aside from the transfer tax benefits that such trusts offer, the estate planning bar flaunts the fact that the establishment of such trusts can serve as a viable mechanism to essentially immortalize the settlor.<sup>163</sup>

Because of the elongated time period that such trusts are supposed to remain in existence, the estate planning bar has engrafted such trusts with an immense amount of flexibility.<sup>164</sup> Common trust provisions include lifetime and testamentary special powers of appointment bestowed on trust beneficiaries, the ability of the trustee to change trust situs, and designation of trust protectorates to ensure ample investment oversight.<sup>165</sup> Made out of whole cloth, dynasty trusts constitute an innovative new offering unique to a world in which trusts have always been of limited duration.

### *C. Protecting Assets from Creditors*

In general, creditors of a trust beneficiary cannot reach trust assets when the instrument or a statutory default rule confers spendthrift protection on the trust.<sup>166</sup> However, under an important exception—known as the “self-settled trust rule”<sup>167</sup>—

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PROB. & TR. J. 601, 614–21 (2000) (analyzing the RAP’s decline as society’s attitudes toward aggregations of wealth in perpetual trusts have grown more favorable); Note, *Dynasty Trusts and the Rule Against Perpetuities*, 116 HARV. L. REV. 2588, 2595–609 (2003) (offering a framework for assessing both the impact and the desirability of getting rid of the RAP, and discussing dynasty trusts).

162. See *supra* note 161 (discussing the attributes of perpetual dynasty trusts).

163. See *supra* note 161.

164. See *supra* note 161.

165. See *supra* note 161.

166. See, e.g., RESTATEMENT (THIRD) OF TRUSTS § 58 (2003) (setting forth the spendthrift concept).

167. See Stewart E. Sterk, *Asset Protection Trusts: Trust Law’s Race to the Bottom?*, 85 CORNELL L. REV. 1035, 1043 (2000) [hereinafter Sterk, *Asset Protection Trusts*] (discussing the self-settled trust rule).

the settlor's creditors are permitted to reach trust assets to the extent of the settlor's interest in the trust.<sup>168</sup>

Common law,<sup>169</sup> as well as statutory law in some states,<sup>170</sup> sets forth the parameters of the self-settled trust rule. This rule essentially provides that if the terms of a trust give the trustee discretion to distribute the entire trust to the settlor, the settlor's creditor could reach all of the trust's assets even if the trustee were unwilling to exercise discretion in favor of the settlor or the creditors; on the other hand, if the trust terms permit only the trust's income to be distributed to the settlor, a creditor could only reach the trust's income and not its principal.<sup>171</sup> Not only does the self-settled rule pose creditor-protection issues, it is also problematic from another perspective: under the federal estate tax, because creditors have direct access to the assets of self-settled trusts, such access causes the trust's assets to be treated for estate tax purposes as if owned by the settlor, resulting in estate tax inclusion of all of the posttransfer appreciation.<sup>172</sup>

### *1. Elimination of the Self-Settled Trust Rule*

In the 1990s, the estate planning bar recognized that if the self-settled trust rule were eliminated, self-settled trusts could

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168. See, e.g., GRISWOLD, *supra* note 9, § 282.1 ("It is almost universally held that a person cannot create an effective spendthrift trust for his own benefit . . .").

169. See RESTATEMENT (SECOND) OF TRUSTS § 156 (1959) (denying creditor protection in the case of a self-settled trust); RESTATEMENT (THIRD) OF TRUSTS § 60 cmt. f (2003) (same).

170. See, e.g., N.Y. EST. POWERS & TRUSTS LAW § 7-3.1 (2005) (codifying the common law approach).

171. See RESTATEMENT (THIRD) OF TRUSTS § 60 cmt. f (2003) (indicating that the creditors could reach the maximum amount that could be distributed to the settlor).

172. See Treas. Reg. § 20.2036-1(b)(2) (requiring inclusion in the gross estate where assets transferred in trust could be used as a matter of state law to discharge the settlor's legal obligation); Rev. Rul. 76-103, 1976-1 C.B. 293 (finding a gift incomplete for tax purposes based on the ability of the settlor's creditors under state law to reach the assets of a self-settled trust); Estate of Paxton v. Comm'r, 86 T.C. 785 (1986) (applying I.R.C. § 2036 to include assets in a self-settled trust in the settlor's gross estate based on the self-settled trust rule under applicable state law).

possibly provide two valuable strategic advantages.<sup>173</sup> First, a settlor concerned about the possibility of future creditors could establish a self-settled trust without having to surrender permanent and unequivocal access to the assets, which is ordinarily the case when an outright gift is used for creditor-protection purposes.<sup>174</sup> Second, a self-settled trust could offer an ability to minimize estate tax liability while still allowing the settlor to retain indirect control of his or her assets.

In light of these strategic advantages, starting in Alaska, the estate planning bar—along with other professionals, particularly from the banking industry—mobilized and successfully lobbied for legislation that would overrule the self-settled trust rule.<sup>175</sup> By designating an Alaskan trustee, making the trust irrevocable, inserting a spendthrift provision, and invoking choice-of-law provision making Alaskan law controlling in the trust instrument, nonresidents could seek to avoid the self-settled trust rule in their home state.<sup>176</sup> Thus, for example, a person residing

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173. See, e.g., Sterk, *Asset Protection Trusts*, *supra* note 167, at 1035–40 (discussing the earlier use of such trusts in an offshore context and their later evolution in the domestic context).

174. All outright gifts as well as gifts in trust can be set aside by creditors if the gift constitutes a fraudulent conveyance or transfer. See Uniform Fraudulent Transfer Act, 7A pt. 2 U.L.A. 4, prefatory n. (2006) (setting out this rule). Thus, if the gift or transfer in trust is made at a time when claims have already been asserted, the creditor may well be able to collect from the transferee. Yet, if no claim is pending or foreseeable at the time of the gift/transfer, it is unclear whether such a transfer constitutes a fraudulent conveyance. The applicability of these statutes is unclear. Courts have nonetheless found transfers/gifts invalid when made to hinder or delay a future creditor. See, e.g., *United States v. Chapman*, 756 F.2d 1237, 1241 (5th Cir. 1985) (indicating that where a gift/transfer is made with the intent to “shield the property from debts thereafter to be incurred,” it can be set aside as fraudulent); Charles D. Fox IV & Michael J. Huft, *Asset Protection and Dynasty Trusts*, 37 REAL PROP. PROB. & TR. J. 287, 303–06 (2002) (discussing fraudulent conveyance claims); Robert T. Danforth, *Rethinking the Law of Creditors’ Rights in Trusts*, 53 HASTINGS L.J. 287, 312 (2002) (discussing fraudulent conveyance claims under Alaska law).

175. See Amy Lynn Wagenfeld, *Law for Sale: Alaska and Delaware Compete for the Asset Protection Trust Market and the Wealth That Follows*, 32 VAND. J. TRANSNAT’L L. 831, 850 (1999) (indicating that Alaska was the first state to enact such legislation and that Delaware did so shortly thereafter); Danforth, *supra* note 174, at 312–18 (recounting the history of state action overruling the self-settled trust rule).

176. See Wagenfeld, *supra* note 175, at 852–55 (outlining Alaska’s choice-of-law provision).



in a common law state who wanted to establish a self-settled trust that provided creditor protection could create the trust with spendthrift protection in Alaska. Under the Alaskan legislation,<sup>177</sup> as well as conventional conflicts-of-law analysis,<sup>178</sup> there would be sufficient contacts with the state of Alaska to make application of its law appropriate. As noted, this would permit the settlor to retain access to the assets conveyed to the trust while hopefully creating a shield that would provide not only creditor protection but also negate estate tax inclusion issues (i.e., because the settlor's creditors would have no access to the trust's assets, for estate tax purposes there would be no state law predicate for treating the settlor as the de facto trust asset owner).<sup>179</sup>

Other states quickly began to follow suit, unleashing a race among the states to create trust legislation that would be effective in attracting nonresidents.<sup>180</sup> Even today, this race

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177. See ALASKA STAT. § 13.36.035(c) (2008) (providing that such a choice-of-law provision is conclusive if, among other requirements, some part of the trust's assets is deposited in Alaska and part or all of the administration occurs in Alaska); Danforth, *supra* note 174, at 312 (discussing the requirements of the Alaska statute for securing creditor protection under its legislation); DEL. CODE ANN. tit. 12, § 3570 (2005) (requiring a Delaware trustee and a designation in the instrument that Delaware law is controlling).

178. Compare RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 270 (1971) (indicating that a choice-of-law provision in a trust instrument is to be respected in terms of the trust's validity if there is a substantial relation to the state), with *Franchise Tax Bd. v. Hyatt*, 538 U.S. 488, 494–95 (2003) (indicating that a state can constitutionally apply its laws only if there are sufficient contacts with the state).

179. Compare I.R.S. Priv. Ltr. Rul. 2009-44-002 (July 15, 2009) (concluding that the assets of a self-settled trust settled by an Alaskan in Alaska would not generally be included in the settlor's gross estate unless there was an understanding, express or implied, under which the settlor would be entitled to receive distributions), and Rev. Rul. 2004-64, 2004-2 C.B. 7 (July 6, 2004) (indicating that express or implied understanding is sufficient to trigger inclusion under I.R.C. § 2036), with I.R.S. Priv. Ltr. Rul. 98-37-007 (June 10, 1998) (refusing to address the inclusion issued under I.R.C. § 2026 in the context of a self-settled trust located in a state that had overruled the common law self-settled trust rule after first concluding that the gift to the trust was complete for gift tax purposes).

180. See David M. English, *The Impact of Uniform Laws on the Teaching of Trusts and Estates*, 58 ST. LOUIS U. L.J. 689, 693 (2014) ("But beginning with Alaska in 1997, fourteen U.S. states have enacted what are known as Domestic Asset Protection Trust (DAPT) statutes."); John K. Eason, *Policy, Logic and Persuasion in the Evolving Realm of Trust Asset Protection*, 27 CARDOZO L. REV.

shows no signs of abating as more and more states rush to join the self-settled asset protection trust bandwagon.<sup>181</sup>

## 2. Effectiveness of the Self-Settled Trust Strategy

Notwithstanding the fact that many self-settled asset protection trusts have been established in the states that have eliminated the self-settled rule,<sup>182</sup> salient questions remain about the effectiveness of the self-settled trust strategy. First, it is not clear that a settlor who resides in a common law state can, through the simple expedient of including a choice-of-law provision in the trust instrument, sidestep the home-state common law approach.<sup>183</sup> If the choice-of-law provision is found to violate the home state's strong public policy, courts will generally refuse to enforce it.<sup>184</sup> Second, in 2005, Congress amended the Bankruptcy Code to create a federalized self-settled trust rule:<sup>185</sup>

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2621, 2622–24 (2006) (reviewing the history of asset protection legislation and indicating that many other states began to follow the lead of Alaska and Delaware).

181. See Adam S. Hofri-Winogradow, *The Stripping of the Trust: From Evolutionary Scripts to Distributive Results*, 75 OHIO ST. L.J. 529, 542–43 (2014) (describing the rapid spread of state legislation sanctioning the use of asset protection trusts).

182. See Sitkoff & Schanzenbach, *supra* note 152, at 380–85 (documenting the migration of trusts to states that have enacted settlor-friendly legislation).

183. See *id.* at 412–14 (highlighting that there is not much information about the effects of statutory changes on the common law rules).

184. See *Rush Univ. Med. Ctr. v. Sessions*, 980 N.E.2d 45, 58 (Ill. 2012) (refusing to respect such a choice-of-law provision); *In re Huber*, 493 B.R. 798, 807–09 (Bankr. W.D. Wash. 2013) (disregarding Alaska law—where the trust had been established—and applying Washington law to find that the transfers to the trust were void as to creditors because Washington had the most significant relationship with the trust and Washington has a strong public policy against self-settled trusts); *In re Portnoy*, 201 B.R. 685, 696–97 (Bankr. S.D.N.Y. 1996) (applying New York law to permit creditors to reach a self-settled trust that was subject to the law of the Jersey Channel Islands); see also Gideon Rothschild, Daniel S. Rubin & Jonathan G. Blattmachr, *Self-Settled Spendthrift Trusts: Should a Few Bad Apples Spoil the Bunch?*, 32 VAND. J. TRANSNAT'L L. 763 (1999) (examining the public policy issue); RESTATEMENT (SECOND) OF CONFLICTS OF LAW § 270 (1971) (indicating that a choice-of-law provision will not be respected in terms of the validity of the trust if it violates a strong public policy of the state having the most significant relationship to the issue).

185. 11 U.S.C. § 548(e)(1) (2012). For a discussion of the history of the

transfers to a self-settled trust can be invalidated in bankruptcy where the transfer was made within ten years of the bankruptcy filing and with the intent to hinder, delay, or defraud creditors, even if the claim did not arise until after the creation of the trust.<sup>186</sup> Thus, even if the trust is located in a state that has overruled the self-settled trust rule, creditors can nonetheless reach the trust's assets if the requirements of this federal statute are satisfied.<sup>187</sup>

To the extent that trust assets can be reached by creditors, either because the choice-of-law provision is found to be inconsistent with the public policy of the settlor's home state or because of the Bankruptcy Code, the estate tax advantages that the self-settled trust are designed to offer may prove to be unavailable.<sup>188</sup> Indeed, it is arguable that the mere possibility that a creditor could use one of these theories to reach the trust's assets,<sup>189</sup> even if the settlor has no creditors, is sufficient to treat

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legislation, see Eason, *supra* note 180, at 2667–77; Gideon Rothschild, *Did Bankruptcy Reform Act Close the 'Loophole' for the Wealthy?*, 107 TAX NOTES 492 (2005).

186. See 11 U.S.C. § 548(e)(1)(D); *In re Mortensen*, No. A09-00565-DMD, 2011 WL 5025288 (Bankr. D. Alaska 2011) (invoking § 548(e)(1) of the Bankruptcy Code in the case of a self-settled trust located in Alaska). It is worth noting that the bankruptcy section carries the negative implication that it cannot be used to invalidate a transfer made to a self-settled trust established more than ten years before the bankruptcy filing.

187. Note that, under the Delaware statute, a person who becomes a creditor after the trust is established can reach trust assets if there is a showing that the settlor intended to hinder or delay that particular future creditor. Compare DEL. CODE ANN. tit. 12, § 3572(a) (2005) (indicating that a trust conveyance cannot be set aside “unless the qualified disposition was made with actual intent to defraud such creditor”), with 11 U.S.C. § 548(e)(1)(D) (explaining that the conveyance to the trust can be set aside if the settlor had such intent with respect to any future creditor).

188. See I.R.S. Priv. Ltr. Rul. 2009-44-002 (Oct. 3, 2009) (providing that assets are deemed includable in the settlor's gross estate if, as a matter of state law (or as a matter of federal bankruptcy law), creditors can reach the assets).

189. Some states that have overruled the self-settled trust rule provide exceptions that permit creditors with special statuses to reach the trust's assets. For example, in Delaware, certain divorce-related creditors are permitted such access. See, e.g., DEL. CODE ANN. tit. 12, § 3573(1) (providing divorce-related creditors the ability to access trust assets). It is arguable that if state law permits access to any creditor, even where the class of such creditors is narrowly circumscribed, the settlor should be treated as owning the trust's assets for estate tax purposes. See 26 C.F.R. § 20.2036-1(b)(2) (2014) (providing that trust assets are includable in the settlor's gross estate if a creditor, not all creditors,

the settlor as the owner of the trust's assets for estate tax purposes.<sup>190</sup>

Self-settled trust strategies nevertheless remain popular throughout the country. In terms of creditor protection, settlors justifiably believe that creditors seeking to penetrate the shield that the trust provides should bear a rather onerous burden.<sup>191</sup> Establishing that such a shield offends the strong public policy of the settlor's home state could prove to be difficult, particularly when one takes into account the fact that many states provide creditor protection for self-settled retirement accounts.<sup>192</sup> And in terms of the provision in the Bankruptcy Code, it can only be invoked if bankruptcy occurs within ten years of the trust's creation and, then, only if it is established that the settlor had created the trust with the requisite intent.<sup>193</sup> Furthermore, the IRS has sanctioned the self-settled-trust concept in one context implicitly<sup>194</sup> and, in another, explicitly,<sup>195</sup> suggesting that taxpayers' estate tax objectives are safely within reach using self-settled asset protection trusts.

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can reach the assets under state law).

190. *But see* United States v. Byrum, 408 U.S. 125, 149 (1972) (indicating that I.R.C. § 2036 should not apply where the settlor's ability to access trust assets is speculative); I.R.S. Priv. Ltr. Rul. 2009-44-002 (July 25, 2009) (refusing to apply Code § 2036 in the case of a self-settled trust located in Alaska in the absence of an implied understanding concerning distributions to the settlor).

191. *See* Christopher M. Reimer, *The Undiscovered Country: Wyoming's Emergence as a Leading Trust Situs Jurisdiction*, 11 WYO. L. REV. 165, 194 (2011) ("Combined with the advantages of spendthrift protection, self-settled trusts are fairly powerful when it comes to asset protection.").

192. *See, e.g.*, N.Y. EST. POWERS & TRUSTS LAW § 7-3.1 (2014) (stating that the same statute that renders self-settled trusts invalid in terms of the settlor's creditors creates an exception for certain self-settled retirement accounts). The legislative exception invites the argument that the general rule does not reflect a sufficiently strong public policy to warrant disregard of the law designated in the instrument.

193. *See supra* note 185 and accompanying text (creating a federalized self-settled trust rule).

194. *See supra* note 135 and accompanying text (assuming simply that creditors could not reach the trust's assets under state law because, in each ruling, the trust was located in a state that had overruled the self-settled trust rule).

195. *See* I.R.S. Priv. Ltr. Rul. 2009-44-002 (Oct. 20, 2009) (refusing to apply I.R.C. § 2036 on the basis of creditors' rights under state law, concluding instead that the section would only apply if there was an implied understanding that distributions would be made to the settlor).

In short, the self-settled-trust strategy remains attractive, both as a creditor-protection and an estate-tax-savings device. The estate planning bar has thus developed a sophisticated repertoire of trust offerings that have come at the expense of important societal interests.<sup>196</sup> Left unchecked, the types of trusts delineated in this section of the analysis can subvert states' income tax systems, undermine the remaining remnants of the federal estate tax system, and leave legitimate creditors shortchanged.<sup>197</sup>

#### *IV. Trust Evolution and Appropriate Governmental Responses*

Over the course of the last century, trusts established in the United States were typically designed with one of two purposes in mind: mitigation of transfer tax obligations<sup>198</sup> and conservation of property (i.e., protecting assets from being dissipated or wasted by profligate beneficiaries whose profligacy would make outright ownership detrimental).<sup>199</sup> But with the decimation of state and federal transfer taxes,<sup>200</sup> a significant motivating factor for trust formation now lies fallow. Trust settlors who once regularly formed qualified personal residence trusts,<sup>201</sup> grantor-retained annuity trusts,<sup>202</sup> and a whole array

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196. See *infra* Part IV.B.2 (discussing the generation-skipping transfer tax).

197. See *infra* Part IV.C (recommending solutions to maintain societal interests).

198. See *supra* notes 50–54 and accompanying text (discussing tax-saving techniques).

199. See *supra* note 9 (explaining that trusts have been used to maintain large estates).

200. See *supra* Part III.B (discussing how trusts preserve wealth in family bloodlines).

201. See Mitchell M. Gans, *GRIT's, GRAT's, and GRUT's: Planning and Policy*, 11 VA. TAX REV. 761, 851–58 (1992) (outlining how taxpayers could establish personal residence trusts). See generally Jonathan G. Blattmachr et al., *Partial Interests—GRATs, GRUTs, QPRTs*, TAX MGMT. (BNA) No. 836 (2014) (addressing transfers of partial interests in property); Jeremy T. Ware, *Using QPRTs to Maximum Advantage for Wealthy Clients*, 32 EST. PLAN. 34 (2005) (discussing how to create trusts in the best interests of wealthy clients); Ameet A. Ponda, *Using Qualified Personal Residence Trusts*, 67 TAX NOTES TODAY 947 (1995) (providing an overview of qualified personal residence trusts).

202. See Lawrence P. Katzenstein, *Running the Numbers: An Economic Analysis of GRATS and QPRTS*, SL078 ALI-ABA 779, 781 (2006) (“Grantor

of other trust instruments<sup>203</sup> now lack the incentive (i.e., estate tax exposure) to form such trusts. As the estate tax threat has receded, an entire branch of trust formation is atrophying, and the other branch—asset preservation—is attracting more attention and undergoing a radical transformation.<sup>204</sup>

This Part of the Article explores the shift from transfer-tax-centric trusts to those that are asset-preservation-centric in nature, discusses legislative measures designed to curtail the establishment of trusts containing problematic asset preservation features, and examines those mechanisms available to better align state interests between and among states and with the federal government.

#### A. Shift from Transfer-Tax- to Asset-Preservation-Centric Trusts

In the past, asset preservation trust formation was primarily geared toward safeguarding assets for the benefit of the settlor's surviving spouse and children.<sup>205</sup> So-called marital trusts were designed to ensure that a surviving spouse could not gift or bequeath a decedent spouse's assets to a new spouse or the offspring of a new relationship.<sup>206</sup> In the case of children, so-called

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retained annuity trusts ('GRATs') and qualified personal residence trusts ('QPRTs') have become standard weapons in the estate planner's arsenal." See generally Steve R. Akers, *IRS Blueprint for GRATs*, 7 PROB. & PROP. 48 (1993) (describing the use of grantor retained annuity trusts).

203. See *supra* notes 49–54 and accompanying text (discussing various types of trusts).

204. See *infra* Part IV.A (explaining the shift toward asset preservation trusts).

205. See, e.g., Bridget J. Crawford, *One Flesh, Two Taxpayers: A New Approach to Marriage and Wealth Transfer Taxation*, 6 FLA. TAX REV. 757, 760 (2004) (discussing the benefits of marriage under tax law and proposing the elimination of the marital deduction); Lauren B. Epstein, Note, *The QTIP Trust and the Elective Share Trust: Are They Really Parallel?*, 53 FLA. L. REV. 965, 970 (2001) (discussing whether the marital deduction should be allowed in QTIP trusts); Wendy C. Gerzog, *Symposium: The Illogical and Sexist QTIP Provisions: I Just Can't Say it Ain't So*, 76 N.C. L. REV. 1597, 1600 (1998) (discussing trust formation).

206. See sources cited *supra* note 205 (providing information on the marital deduction).

minor trusts were designed to ensure that the assets they housed could not be dissipated or wasted by a spendthrift child.<sup>207</sup>

Since the passage of the 2001 Act,<sup>208</sup> estate planning attorneys have discovered that trust versatility could take the asset conservation aspects of trusts to undiscovered heights and yield tremendous financial benefits: if trust situs could be selected or moved to a legal jurisdiction in which the laws were more accommodating, then it could be selected to seek a state without an income tax;<sup>209</sup> if a trust could be used to protect profligate surviving spouses and children from dissipating assets, then it could be structured to achieve the same goals for grandchildren, great-grandchildren, and more distant descendants;<sup>210</sup> and, finally, if a trust could protect its beneficiaries from pursuing a decadent lifestyle, then it could also be designed to protect trust settlors' assets from the reach of creditors.<sup>211</sup>

To facilitate the ability of trusts to conserve property, the estate planning bar enlisted the support of state legislatures. Arguments launched in favor of these legislative reforms focused on how these trust reforms would strengthen the ability of trusts to fulfill their historic role as asset conservators.<sup>212</sup> In the eyes of many state legislators, packaging of this sort proved compelling; as a result, numerous trust reform measures have been routinely passed and signed into law.<sup>213</sup> More specifically, over the course of the last several years, state legislatures have passed legislation

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207. See Eason, *supra* note 180, at 2622; Erwin N. Griswold, *Reaching the Interest of the Beneficiary of a Spendthrift Trust*, 43 HARV. L. REV. 63, 65 (1929) (providing a historical overview).

208. See *supra* note 64 (explaining the components of the legislation).

209. See *supra* Part III.A (discussing reductions of state income tax burdens).

210. See *supra* Part III.B (describing ways to maintain wealth within families).

211. See *supra* Part III.C (providing an overview of how to protect assets from creditors).

212. See, e.g., Wagenfeld, *supra* note 175, at 851–66 (exploring the underlying motivations of why states adopted asset preservation legislation and explaining that in Alaska the legislation was designed to attract trust protectors).

213. See *supra* Part III (discussing common trust reform measures).

facilitating trust situs establishment,<sup>214</sup> eliminating or emasculating the rule against perpetuities,<sup>215</sup> and enhancing asset protection.<sup>216</sup>

There did not appear to be anything nefarious motivating reform sponsors; to the contrary, they seemed intent on strengthening one of the historic linchpins of trust formation.<sup>217</sup> Members of state legislatures who have passed these “reforms” certainly appear to harbor no regrets and, in fact, on many occasions have issued prideful messages of their trust reform achievements.<sup>218</sup>

The combination of the recent legislative measures has fundamentally transformed the trust landscape. By offering clients the possibility of income tax savings, transfer tax elimination, and creditor protection, the estate planning bar can claim renewed value for its services.

### *B. Recommended State and Federal Reforms*

With the fiscal horizons of many states and the federal government marred by burgeoning deficits,<sup>219</sup> legislators must be vigilant about the challenges stemming from the recent evolution of trust instruments. The private enrichment that these newly

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214. See *supra* Part III.A (providing an overview of state tax deductions and eliminations).

215. See *supra* Part III.B (discussing the rule against perpetuities in conjunction with the generation-skipping transfer tax).

216. See *supra* Part III.C (outlining how to protect assets from creditors).

217. See, e.g., Wagenfeld, *supra* note 175, at 858 (explaining some of the Alaskan legislature’s motivations).

218. See, e.g., *id.* at 851 (“The drafters of Delaware’s legislation expressly stated their intent to maintain Delaware’s status as ‘the most favored domestic jurisdiction for the establishment of trusts.’”).

219. See, e.g., NAT’L GOVERNORS ASS’N & NAT’L ASS’N OF STATE BUDGET OFFICERS, THE FISCAL SURVEY OF STATES: AN UPDATE OF STATE FISCAL CONDITIONS, at vii (Spring 2012), <http://www.nga.org/files/live/sites/NGA/files/pdf/FSS1206.PDF> (leaving states to “solve a combined \$146.3 billion in budget gaps over the two year time period”); UPDATED BUDGET PROJECTIONS 2014–2024, CONG. BUDGET OFFICE (Apr. 14, 2014), <http://www.cbo.gov/publication/45229> (last visited Jan. 27, 2015) (projecting significant federal budget deficits for the foreseeable future) (on file with the Washington and Lee Law Review).



minted trusts offer often comes at tremendous financial costs to the public and thus warrants reform.<sup>220</sup>

In the sections below, this analysis describes specific legislative courses of action that state governments and the federal government can use to defeat suspect trust use.

### 1. *Safeguarding State Income Tax Coffers*

In an effort to mitigate their tax burdens, some taxpayers who reside in states that impose income taxes strategically park income-producing assets in trusts in those states that do not impose income taxes.<sup>221</sup> Utilization of this stratagem can produce revenue shortfalls in those states that levy an income tax.<sup>222</sup> To safeguard government coffers, either Congress or state legislatures should take steps to eradicate this problem.<sup>223</sup>

On the federal level, Congress can institute legislation that treats any contribution made into a trust—other than a grantor trust—as a completed gift. In 2001, in anticipation of the one-year federal estate tax suspension in 2010, Congress passed such legislation. Embodied in Code § 2511(c),<sup>224</sup> this legislation declared that all contributions into nongrantor trusts would constitute completed gifts. Had this legislation gone into effect,<sup>225</sup> it would have dampened taxpayers' willingness to contribute

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220. See *infra* Part IV.C (discussing proposed reforms).

221. See Lawrence W. Waggoner, *Congress Should Impose a Two-Generation Limit on the GST Exemption: Here's Why 2* (U. Mich. Pub. Law, Working Paper No. 205, 2010) (discussing how the GST exemption has allowed taxpayers to evade income taxes).

222. See *id.* (“The loss of tax revenue will become more and more significant as time goes along.”).

223. See Steve J. Horowitz & Robert H. Sitkoff, *Unconstitutional Perpetual Trusts*, 67 VAND. L. REV. 1769 (2014) (suggesting that another approach, on the basis of state constitutions, is to challenge judicially the recognition of perpetual trusts).

224. See Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, § 511, 115 Stat. 38 (codified as amended in scattered sections of 26 U.S.C.) (changing the effect of nongrantor trusts).

225. See Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312, § 302(e), 124 Stat. 3296 (repealing § 2511(c) and thereby dampening the ability of taxpayers to evade income taxes).

assets into trusts that are designed to effectuate income tax savings. The reason is twofold. As a result of the gift being deemed complete, depending on the dollar value of the trust contribution and the amount of the taxpayer's prior taxable gifts, there would have been the risk of immediate gift tax exposure.<sup>226</sup> Second, insofar as the tax basis of the transferred asset is concerned, the carryover tax basis rule would apply;<sup>227</sup> application of this rule enhances the risk that greater federal and state income taxes will be imposed upon the subsequent disposition of the transferred trust asset. However, when Congress decided to retain the federal estate tax, Code § 2511(c) was repealed.<sup>228</sup> This repeal left the door wide open for taxpayers to continue to park income-producing assets strategically in those trust jurisdictions that impose no income tax.

If Congress refuses to take remedial action, states that impose an income tax can take unilateral measures to try to protect the integrity of their tax bases. Consider the recent case of New York State.<sup>229</sup> In an attempt to safeguard its coffers, using the now-repealed Code § 2511(c) as a model, it fashioned legislation that identifies as grantor trusts all trusts into which incomplete gifts are made.<sup>230</sup> Because grantor trust status requires trust income to be included in the settlor's gross income, New York residents who now establish ING trusts will no longer be able to achieve their objective.<sup>231</sup>

Given the fact that Congress has no direct economic stake in how states vie for trust business, it is unlikely that it will enact universal reforms. However, as exemplified by New York, states

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226. See I.R.C. § 2501 (2012) (creating the federal gift tax).

227. See *id.* § 1015(a) (establishing the method to determine the value of the gift). This is far less favorable than the basis-equal-to-fair-market-value rule applicable upon death. *Id.* § 1014(a).

228. See Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act § 302(e) (revoking section 2511(c)).

229. See N.Y. TAX LAW § 612(b)(41) (McKinney 2014) (adjusting gross income of an individual resident).

230. See *id.* (establishing a broad definition of grantor trust).

231. See *id.* (treats ING trusts as grantor trusts for New York income tax purposes, thereby subjecting the grantors of such trusts to New York income tax).

can enact legislative measures to stymie other states' competitive tactics.<sup>232</sup>

## 2. Making the Generation-Skipping Transfer Tax Universal

The estate tax is supposed to be levied at each generational level. To achieve this goal, Congress designed the GST tax to eliminate the ability of taxpayers to defer estate tax imposition for decades to come by imposing a tax—in addition to gift and estate tax—on wealth transfers made to beneficiaries two or more generations removed from a taxpayer.<sup>233</sup> When Congress introduced the GST tax,<sup>234</sup> it also offered a modest \$1 million GST exemption.<sup>235</sup>

At the time, the adjective *modest* was a fitting description of the GST exemption amount because opportunities to leverage this exemption amount were limited: under the rule against perpetuities, which was then ubiquitous throughout the United States),<sup>236</sup> the wealth funding these trusts could not cascade down the generations for millennia to come, escaping transfer tax at every juncture along the way. Placing implicit reliance on the rule against perpetuities, Congress assumed that wealth transferred into a trust would generally vest with taxpayers' grandchildren or great-grandchildren and then, once again, face transfer tax exposure.

But from the time when the GST tax first came into existence, the legal landscape has dramatically changed. The GST exemption amount is currently \$5.34 million and is annually adjusted for inflation.<sup>237</sup> Given the size of this exemption and the

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232. See *id.* (stymieing the benefits of an ING trust).

233. See *supra* note 32 (discussing the generation-skipping transfer tax).

234. See Tax Reform Act of 1986, Pub. L. No. 99-514, §§ 1431–33, 100 Stat. 2712, 2717 (retroactively replacing the old GST tax, Tax Reform Act of 1976, §§ 2006–22, Pub. L. No. 94-455, 90 Stat. 1520, due to its complex nature).

235. See *id.* § 1431(a) (creating the GST exemption).

236. See STAFF OF JOINT COMM. ON TAXATION, 108TH CONG., OPTIONS TO IMPROVE TAX COMPLIANCE AND REFORM TAX EXPENDITURES 394 (Comm. Print 2005) (“When Congress originally enacted a tax on generation-skipping transfers, it noted that [m]ost States have a rule against perpetuities which limits the duration of a trust.”).

237. See IRS Rev. Proc. 2013-35, 2013-47, I.R.B. 537 (describing various tax

fact that many states have eliminated or greatly curtailed their rule against perpetuities,<sup>238</sup> taxpayers are now at liberty to establish trusts with significant amounts of wealth shielded from transfer tax imposition for many generations.<sup>239</sup>

Assuming that Congress wants to maintain the integrity of the federal transfer tax system and that perpetual trusts contravene achievement of this objective, there are at least three legislative measures that it should consider adopting.

First, Congress should prohibit generation-skipping exemption allocation to trust beneficiaries who are three or more generations below that of the taxpayer (e.g., great-grandchildren).<sup>240</sup> Allocation of the GST exemption to such distant generations magnifies the power of such an exemption in ways that Congress could never have envisioned. Presumably, Congress enacted the GST tax and the accompanying GST exemption to enable taxpayers to make modest gifts or bequests to their grandchildren without these recipients effectively having to bear two transfer taxes (i.e., an estate tax as well as the GST tax). The GST exemption was never intended to enable taxpayers to transfer wealth to more distant generations that taxpayers would presumably never know (great-great-grandchildren and more distant descendants).

A second legislative measure that Congress should consider adopting is a significant reduction of the GST exemption amount. Assuming that Congress does not want the vast majority of taxpayers to be subject to the estate tax, raising the applicable

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exemptions).

238. See RESTATEMENT (THIRD) OF PROPERTY: WILLS AND OTHER DONATIVE TRANSFERS, at ch. 27, intro. n. (2011) (cataloging state statutes).

239. See, e.g., Jesse Dukeminier & James E. Krier, *The Rise of the Perpetual Trust*, 50 UCLA L. REV. 1303, 1318 (2003) (describing problems associated with perpetual trusts); Grayson M.P. McCouch, *Who Killed the Rule Against Perpetuities?*, 40 PEPP. L. REV. 1291, 1295 (2013) (analyzing the relationship between the rule against perpetuities and federal transfer taxes); Schanzenbach & Sitkoff, *supra* note 152, at 2476 (concluding that the GST tax created an increase in perpetual trusts); Sterk, *Judicial Interpretation*, *supra* note 143, at 2099 (defining the rule against perpetuities); Angela M. Vallario, *Death by a Thousand Cuts: The Rule Against Perpetuities*, 25 J. LEGIS. 141, 148 (1999) (analyzing legislation abolishing the rule against perpetuities).

240. See Lawrence W. Waggoner, *Effectively Curbing the GST Exemption for Perpetual Trusts*, 135 TAX NOTES 1267 (2012) (calling for Congress to prohibit GST tax exemption allocation to trusts that endure past two generations).

exclusion amount (i.e., the amount that can pass free of estate tax) is imminently sensible. Yet, increasing the GST exemption to the same dollar amount as the applicable exclusion amount lacks any common sense: Congress should not incentivize taxpayers to make significant gifts and bequests to skip people—primarily grandchildren and more distant descendants—and thereby bypass transfer tax for an additional generation or generations to come.

A third alternative legislative measure for Congress to consider is the enactment of a federal rule against perpetuities. The Obama administration recently made such a proposal.<sup>241</sup> To date, however, this proposal has not gained any legislative traction.<sup>242</sup>

By not keeping the use of the GST exemption and its amount in check, Congress has allowed dynasty trusts to flourish.<sup>243</sup> Thus, as part of their repertoire, members of the estate planning bar routinely establish such trusts. But, down the road, havoc awaits. As explained by Professor Lawrence W. Waggoner, in the absence of a rule against perpetuities and a limited GST exemption amount, the number of beneficiaries that these dynasty trusts generate is stunning: for example, after 150 years, a dynasty trust “could have 450 beneficiaries; after 250 years, over 7,000 beneficiaries; after 350 years, 114,500 beneficiaries.”<sup>244</sup> Each beneficiary represents a lost opportunity for tax collection. Clearly, dynasty trusts represent an astronomical financial loss for the government.<sup>245</sup>

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241. See U.S. DEP'T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2013 REVENUE PROPOSALS 81–82 (2012) (proposing a ninety-year limit on GST exemption).

242. See Dennis I. Belcher et al., *Federal Tax Rules Should Not Be Used to Limit Trust Duration*, 136 TAX NOTES 833, 833 (2012) (arguing that trust duration is a state, not federal, law issue).

243. See *supra* Part III.B (discussing how dynasty trusts preserve wealth within family bloodlines).

244. Lawrence W. Waggoner, *Message to Congress: Halt the Tax Exemption for Perpetual Trusts*, 109 MICH. L. REV. FIRST IMPRESSIONS 23, 24 (2010).

245. See *id.* (discussing the number of beneficiaries generated by dynasty trusts in the absence of a rule against perpetuities).

### 3. *Eliminating Self-Settled Asset Protection Trusts*

While state law can generally be a critical predicate on which to base federal law,<sup>246</sup> problematic results can occur when Congress places too much reliance on state law.<sup>247</sup> In the self-settled trust context, in both the Internal Revenue and Bankruptcy Codes, Congress has made state law determinative.<sup>248</sup> As a result, settlors are free to locate their self-settled trusts in jurisdictions that enable them to accomplish their tax-and-creditor-related objectives, producing distortion and inequity. To remedy this distortion and restore equity, in determining the appropriate treatment of self-settled trusts, Congress should make state law considerations irrelevant.

#### *a. Estate Tax Considerations*

Recall that the estate tax treatment of self-settled trusts depends on their treatment under state law.<sup>249</sup> In general, if state law permits the settlor's creditors to reach the trust's assets, the trust is ignored for estate tax purposes, and all of the trust's assets are included in the settlor's gross estate under Code § 2036.<sup>250</sup> Conversely, if state law does not permit creditors access and there is no implied understanding between the settlor and trustee regarding future trust distributions, there is no estate tax inclusion provided the settlor retains no other access to, or control

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246. For example, in the estate tax context, the decedent's property rights under state law will often determine their estate tax treatment. *See, e.g.*, *Comm'r v. Estate of Bosch*, 387 U.S. 456, 465 (1967) (supplying the methodology for determining the content of state law for federal estate tax purposes); *Morgan v. Comm'r*, 309 U.S. 78, 80 (1940) (indicating that the estate tax is determined on the basis of rights under state law).

247. *See* Mitchell M. Gans, *Federal Transfer Taxation and the Role of State Law: Does the Marital Deduction Strike the Proper Balance?*, 48 EMORY L.J. 871, 876–83 (1999) (discussing the consequences of an overemphasis on state law).

248. *See, e.g.*, 11 U.S.C. § 541(c)(2) (2012) (“A restriction on the transfer of a beneficial interest of the debtor in a trust that is enforceable under applicable nonbankruptcy law is enforceable in a case under this title.”).

249. *See infra* notes 250–251 and accompanying text (discussing the consequences if state law does or does not allow creditor access to trust assets).

250. *See* *Estate of Paxton v. Comm'r*, 86 T.C. 785, 814–15 (1986) (applying I.R.C. § 2036 based, in part, on the right of the settlor's creditors to reach trust assets under state law).

over, the trust.<sup>251</sup> In thus linking the estate tax treatment of self-settled trusts to their state law treatment, Congress unintentionally sanctioned the self-settled trust tax strategy.

But Congress could easily defeat this strategy in the following manner. It could amend Code § 2036 to provide that whenever a trustee is given discretion to make distributions to the settlor, the trust's assets must be included in the settlor's gross estate. This change would constitute a significant expansion of this Code section's scope: inclusion would be required even if creditors did not have access to trust assets and even if there was no understanding regarding trust distributions to be made to the settlor.<sup>252</sup> If enacted, this proposed amendment would render the self-settled trust strategy ineffectual regardless of the state in which the trust were located, eliminating the distortion and inequity that stems from the ability of settlors to locate their trusts opportunistically in states with settlor-friendly legislation.<sup>253</sup>

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251. See, e.g., *Estate of McNichol v. Comm'r*, 265 F.2d 667, 673 (3d Cir. 1959) (concluding that an understanding that is not legally enforceable is nevertheless sufficient to trigger inclusion under the predecessor of I.R.C. § 2036 based on *Commissioner v. Estate of Church*, 335 U.S. 632 (1949)); Rev. Rul. 2004-64 (indicating that, in general, I.R.C. § 2036 will not apply if there is no implied or express understanding and if state law does not provide the settlor's creditors with access to trust assets).

252. This would have the salutary effect of eliminating litigation on the factual question of whether the settlor had an understanding with the trustee—an often nettlesome question for the judiciary to resolve. Traditionally, the estate bore the burden of proving the absence of an understanding, but under I.R.C. § 7491 the Tax Court has recently shifted the burden to the IRS. See *Estate of Van v. Comm'r*, 101 T.C.M. (CCH) 1077 (2011) (shifting the burden to the IRS on the question of an understanding).

253. The proposal would only affect I.R.C. § 2036(a)(1), not I.R.C. § 2036(a)(2). Under I.R.C. § 2036(a)(1), at present, inclusion is required if (i) the settlor had a legally enforceable right to the trust's income; (ii) the settlor could, as a result of state law, relegate creditors to the trust; or (iii) the settlor could receive trust distributions under an implied or express understanding with the trustee that need not be legally enforceable. In contrast, under I.R.C. § 2036(a)(2), inclusion is only appropriate if the settlor had a legally enforceable right to control trust assets. See *United States v. Byrum*, 408 U.S. 125, 136 (1972) (indicating that I.R.C. § 2036(a)(2) can only be applied if the settlor possessed a legally enforceable right).

*b. Creditor-Protection Considerations*

Congress should recognize the fact that even if Code § 2036 were amended to eliminate the self-settled trust as a tax strategy, self-settled trusts would continue to be used as a creditor-protection strategy.<sup>254</sup> In other words, settlors concerned about future creditors, not tax, would still be attracted to states with settlor-friendly legislation. As in the case of the estate tax, the ability of settlors to take advantage of such legislation is made possible by the linkage between federal (bankruptcy) and state law.<sup>255</sup>

Recall that common and statutory laws permit a settlor to confer spendthrift protection on a trust for the benefit of someone other than the settlor.<sup>256</sup> For example, a father might create a trust for the benefit of his son and include a spendthrift provision in the instrument based upon a concern about the son's ability to be financially prudent. The effect of the spendthrift provision is to prevent the son's creditors from reaching the trust's assets while the assets are in the hands of the trustee. Given the understandable desire of settlors to protect trust assets from beneficiaries' creditors, it is a rare trust that fails to include spendthrift protection. Indeed, in at least one state, under a statutory default rule, all trusts enjoy spendthrift protection.<sup>257</sup> Perhaps because the spendthrift concept is so well ingrained in state law, the Bankruptcy Code has embraced the concept, providing that assets in a trust entitled to spendthrift protection under state law are not available to the creditors of the bankrupt beneficiary.<sup>258</sup> Simply put, if spendthrift protection is available under state law, it is concomitantly available in the bankruptcy context.

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254. See Sterk, *Asset Protection Trusts*, *supra* note 167, at 1043 (discussing self-settled trusts).

255. See *infra* note 258 (noting the link between federal bankruptcy law and state law).

256. See sources cited *supra* note 9 (discussing trusts as a means for asset preservation).

257. See N.Y. EST. POWERS & TRUSTS LAW § 7-1.5 (McKinney 2014) (making spendthrift protection the default rule).

258. See 11 U.S.C. § 541(c)(2) (2012) (respecting, for bankruptcy purposes, spendthrift protection conferred under state law).



Historically, notwithstanding the esteem in which spendthrift provisions are held in the Bankruptcy Code, the settlor's interest in a self-settled trust could not be spendthrift protected under state law.<sup>259</sup> Even if the settlor explicitly provided in the instrument that her interest was entitled to spendthrift protection, the settlor's creditors could nonetheless reach the trust's assets.<sup>260</sup> Under state law, an important distinction was thus made between self-settled trusts and third-party trusts: spendthrift protection could only be secured in the latter case.<sup>261</sup>

This historic distinction between self-settled trusts and third-party trusts is absent in the Bankruptcy Code. Instead, the Bankruptcy Code simply defers to state law, sanctioning spendthrift provisions if they are respected under state law.<sup>262</sup> It is this failure that has made it possible for states to enact legislation that enables settlors to secure protection in bankruptcy for their interest in self-settled trusts. Put differently, had the language of the Bankruptcy Code made spendthrift provisions ineffectual in the case of self-settled trusts, state legislatures would have been rendered impotent to provide creditor protection in bankruptcy for such trusts.

In 2005, when Congress considered the bankruptcy implications of self-settled trusts, it left intact the existing spendthrift provision legislation,<sup>263</sup> making it possible for settlors to continue using these trusts for creditor-protection purposes. It did enact a new provision, however, under which transfers to a self-settled trust could be set aside if made within ten years of the filing of the bankruptcy petition and with the "intent to hinder, delay, or defraud" creditors.<sup>264</sup> But this was a modest attempt to

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259. *See supra* notes 168–170 and accompanying text (discussing spendthrift protection and self-settled trusts).

260. *Id.*

261. *See supra* notes 167–168 and accompanying text (describing the historical distinction between self-settled and third-party trusts).

262. *See supra* note 174 (discussing that outright gifts and gifts in trust can be set aside by creditors if the gift constitutes a fraudulent conveyance or transfer).

263. *See* 11 U.S.C. § 541(c)(2) (2012) ("A restriction on the transfer of a beneficial interest of the debtor in a trust that is enforceable under applicable nonbankruptcy law is enforceable in a case under this title.").

264. *Id.* § 548(e)(1).

eliminate the self-settled trust as a creditor-protection strategy.<sup>265</sup> Indeed, if a settlor does not file within ten years or, alternatively, is able to show a benign intent in establishing the trust, the trust's assets remain insulated from creditors in bankruptcy.<sup>266</sup>

As in the tax context, the linkage between federal and state law results in distortion and inequity, encouraging settlors to locate their self-settled trusts in settlor-friendly jurisdictions and giving such settlors an advantage over creditors. Congress should end this linkage: it should amend the Bankruptcy Code to deny spendthrift protection in the case of self-settled trusts without regard to their treatment under state law. The use of self-settled trusts would thereby come to a quick end.

#### 4. Alignment of Governmental Interests

Among the many things that this analysis highlights is the fact that states are constantly competing against one another and, to promote the economic well-being of their citizenry, are even willing to make legislative changes that are clearly detrimental to the well-being of the federal government—or even contrary to their own policy concerns.

This is not something new or novel: since the nation's founding, states have enacted measures designed to either promote their provincial economic interests or to safeguard their industries.<sup>267</sup> And the nation's courts routinely have had to examine whether these protectionist measures violate the U.S. Constitution's Commerce Clause, which gives Congress exclusive

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265. Other proposals would have more severely limited the use of self-settled trusts. For example, in the course of the debate over the 2005 legislation, Senator Charles E. Schumer proposed an amendment that would have set aside all transfers to self-settled trusts made within ten years of filing a bankruptcy petition “to the extent the aggregate amount of all such transfers exceeded \$125,000.” Eason, *supra* 180, at 2671–72.

266. See 11 U.S.C. § 548(e)(1) (2012) (outlining the ten-year provision).

267. See, e.g., Kirk J. Stark & Daniel J. Wilson, *What Do We Know About the Interstate Economic Effects of State Tax Incentives?*, 4 GEO. J.L. & PUB. POL'Y 133, 134–35 (2006) (stating that soon after the Declaration of Independence was signed, “[t]hrough self-centered currency policies, impost duties, and other tariff measures, states sought to protect in-state industry and raise revenue through taxing measures that burdened out-of-state residents”).

powers over interstate commerce,<sup>268</sup> and decide whether to prohibit states from improperly burdening or discriminating against interstate commerce—a judicial doctrine proverbially known as the negative Commerce Clause or dormant Commerce Clause.<sup>269</sup> In some cases, courts have ruled that these protectionist measures do not interfere with the nation’s commerce in a material fashion; accordingly, they have withstood constitutional scrutiny.<sup>270</sup> In other cases, however, courts have

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268. See U.S. CONST. art. 1, § 8, cl. 3 (“To regulate commerce with foreign nations, and among the several states, and with the Indian tribes . . .”).

269. For exhaustive examinations of the dormant Commerce Clause, see generally Richard B. Collins, *Economic Union as a Constitutional Value*, 63 N.Y.U. L. REV. 43 (1988) (providing “an in-depth defense of the dormant commerce power doctrine”); Julian N. Eule, *Laying the Dormant Commerce Clause to Rest*, 91 YALE L.J. 425 (1982) (arguing for “a radically diminished role for both the dormant commerce clause and the Court as its interpreter”); Michael A. Lawrence, *Toward a More Coherent Dormant Commerce Clause: A Proposed Unitary Framework*, 21 HARV. J.L. & PUB. POL’Y 395 (1998) (“The Unitary Framework does just what its name suggests—it incorporates the various dormant-commerce-clause principles laid out by the Court and leading scholarly works and consolidates them into a hybrid unitary taxonomy suitable for use with both existing and prospective cases.”); Saul Levmore, *Interstate Exploitation and Judicial Intervention*, 69 VA. L. REV. 563 (1983) (“The major purpose of this article is to show that the distinction between ‘interferences’ and ‘exploitations’ has descriptive and normative value in understanding the judicial response to interstate trade barriers.”); Donald H. Regan, *The Supreme Court and State Protectionism: Making Sense of the Dormant Commerce Clause*, 84 MICH. L. REV. 1091 (1986) (“The claim I am most concerned to establish is my claim that in this area the Court is concerned and should be concerned only with preventing purposeful protectionism.”); Robert A. Sedler, *The Negative Commerce Clause as a Restriction on State Regulation and Taxation: An Analysis in Terms of Constitutional Structure*, 31 WAYNE L. REV. 885 (1985) (discussing the Commerce Clause as the source of constitutional limits on the power of the states to regulate and tax entities engaged in interstate commerce); Maxwell L. Stearns, *A Beautiful Mend: A Game Theoretical Analysis of the Dormant Commerce Clause Doctrine*, 45 WM. & MARY L. REV. 1 (2003) (explaining the relationship between the dormant Commerce Clause and the various forms of state law rent seeking); Mark Tushnet, *Rethinking the Dormant Commerce Clause*, 1979 WIS. L. REV. 125 (1979) (“[T]his article seeks to return the dormant Commerce Clause from its position of isolation and incoherence to be reintegrated with the rest of the Constitution.”); Jonathan D. Varat, *State “Citizenship” and Interstate Equality*, 48 U. CHI. L. REV. 487 (1981) (“Any effort to develop appropriate principles to govern [issues of interstate equality] should attempt to give each feature its due and should, therefore, be sensitive both to the character of state ‘citizenship’ and to the imperatives of interstate equality.”).

270. See, e.g., *United Haulers Ass’n v. Oneida-Herkimer Solid Waste Mgmt. Auth.*, 550 U.S. 330, 347 (2007) (holding that incidental burden on interstate

ruled that protectionist measures do materially interfere with the nation's commerce, and, accordingly, they have not withstood constitutional scrutiny.<sup>271</sup>

But state legislative measures designed to attract the type of capital that this analysis describes are of an entirely different ilk. Rather than erecting direct barriers to commerce, many states have instead adopted competitive legislative measures that sanction individual wealth preservation and eschew restrictions on its use.<sup>272</sup> Because the nature of these measures is only indirectly related to commerce—defined in *Black's Law Dictionary* as “[t]he exchange of goods, productions, or property of any kind; the buying selling, and exchanging of articles”<sup>273</sup>—they should not be protected at all by the Constitution.

Granted, the nation's founders promoted competition between and among the states.<sup>274</sup> Via such competition, public-sector innovations would supposedly arise as states sought to compete in the marketplace by offering favorable business

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commerce that resulted from application of county flow control ordinances was not clearly excessive in relation to public benefits provided in the form of increased recycling).

271. See, e.g., *City of Phila. v. New Jersey*, 437 U.S. 617, 629 (1978) (holding invalid New Jersey's Waste Control Act, which prohibited the importation of most “solid or liquid waste which originated or was collected outside the territorial limits of the State”); *Hunt v. Wash. State Apple Adver. Comm'n*, 432 U.S. 333, 353–54 (1977) (holding invalid a North Carolina law that sought to protect its apple growers); *Dean Milk Co. v. City of Madison, Wis.*, 340 U.S. 349, 356–57 (1951) (holding invalid a municipal ordinance requiring all milk sold in Madison to be pasteurized at an approved plant within five miles of the city). See generally Peter D. Enrich, *Saving the States from Themselves: Commerce Clause Constraints on State Tax Incentives for Business*, 110 HARV. L. REV. 377 (1996) (“In this Article, Professor Enrich argues that these state location incentives harm the states and their citizens, and that the Commerce Clause may present the only possible realistic restraint . . .”).

272. See N.Y. EST. POWERS & TRUSTS LAW § 7-1.5 (McKinney 2014) (making spendthrift protection the default rule).

273. BLACK'S LAW DICTIONARY 325 (10th ed. 2014).

274. See Michael W. McConnell, *Federalism: Evaluating the Founders' Design*, 54 U. CHI. L. REV. 1484, 1498 (1987) (“A consolidated national government has all the drawbacks of a monopoly: it stifles choice and lacks the goal of competition.”); H. Geoffrey Moulton Jr., *Federalism and Choice of Law in the Regulation of Legal Ethics*, 82 MINN. L. REV. 73, 132 (1997) (“In short, competitive federalism forces governments to be more efficient by improving services, reducing costs, and better assessing citizen preferences for public goods.”).

climates with low taxes and the support of important government services such as garbage removal and proper sewage treatment. In other words, state competition would incubate good ideas and cultivate economic efficiencies.<sup>275</sup> This philosophy, combined with the Tenth Amendment's delegation of certain rights and privileges to the states, makes it difficult to imagine the federal government establishing laws that are traditionally in the state realm (e.g., Congress defining the parameters of property ownership in the form of a federal rule against perpetuities).<sup>276</sup>

However, because the members of various state legislatures invariably are incapable of metaphorically holding hands with members of other state legislatures and making mutual concessions (there are simply too many state legislatures with different histories, agendas, and cultural fabrics), Congress sometimes does—and should—feel compelled to intervene.

By way of example, consider the history of state death taxes, which is emblematic of the difficulties associated with collective action between and among state legislatures. In the early part of the twentieth century, state death taxes were a revenue staple for many state governments.<sup>277</sup> However, this all changed when Florida repealed its state death tax and then ran a well-publicized campaign to attract retirees to the state.<sup>278</sup> Not to be outdone, other states then sought parity with Florida and repealed their state death taxes.<sup>279</sup> Because a large percentage of

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275. See, e.g., David L. Markell, *States as Innovators: It's Time for a New Look to Our "Laboratories of Democracy" in the Effort to Improve Our Approach to Environmental Regulation*, 58 ALB. L. REV. 347, 353–55 (1994) (stating that states, not the federal government, appear to be creating the most innovative regulatory regimes).

276. See, e.g., *Alden v. Maine*, 527 U.S. 706, 729 (1999) (noting that restraints on federal power are “fundamental postulates implicit in the constitutional design”). For a strikingly contrary view, see generally Calvin H. Johnson, *States' Rights? What States' Rights?: Implying Limitations on the Federal Government from the Overall Design*, 57 BUFF. L. REV. 225 (2009) (“In recent years, the Supreme Court has been finding and strengthening judicial doctrines constraining the federal government in favor of the states, in ways which have no specific justification in the constitutional text.”).

277. See Eugene E. Oakes, *Development of American State Death Taxes*, 26 IOWA L. REV. 451, 455–68 (1941) (describing tax measures in different states and motives for such measures).

278. See Perkins, *supra* note 37, at 271–72 (explaining the depth of this national campaign to attract wealthy retirees).

279. See, e.g., JAMES A. MAXWELL, *THE FISCAL IMPACT OF FEDERALISM IN THE*

states relied heavily on state death taxes as a revenue source and the threat of universal repeal loomed large, state leaders—in particular, William Bailey, president of the National Tax Association—convened a convention to discuss what could be done to salvage state death taxes.<sup>280</sup> What this convention—and two subsequent ones—decided was that congressional action was imperative to preserve the state tax revenue base.<sup>281</sup> The proposed solution was for the federal government to enact a state death credit as part of the federal estate tax to incentivize states to enact their own state death tax equal, at least, to the federal state death credit.<sup>282</sup> Implementing such state death taxes would not constitute an additional tax burden because the state death tax due would offset dollar-for-dollar the amount that would otherwise be due to the federal government. Most states, including even Florida, responded to this cue by enacting state death taxes equal to the federal state death tax credit.<sup>283</sup>

The effects of competition can also be corrosive beyond the realm of state death taxes. Certainly, in terms of asset preservation legislation related to trust instruments, this has been the case.<sup>284</sup> These “race-to-the-bottom” state legislative competitions put government coffers at risk while enriching those taxpayers who are economically well-to-do and who can afford the services of the estate planning bar. Indeed, trust asset preservation legislation is the exact antithesis of the kind of legislation that should be enacted—legislation such that “after balancing competing interests, it is determined that a societal

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UNITED STATES 333 (1946) (discussing the fact that in 1925 Nevada added an amendment to its constitution prohibiting the imposition of state death taxes).

280. See Jeffrey A. Cooper, *Interstate Competition and State Death Taxes: A Modern Crisis in Historical Perspective*, 33 PEPP. L. REV. 835, 851–52 (2006) (discussing the First National Conference on Inheritance and Estate Taxation).

281. See *id.* at 856–57 (providing the relevant recommendation of the Delano Committee Report from the First Conference).

282. See *id.* (describing these same recommendations).

283. See Oakes, *supra* note 277, at 469 (“The crediting device made it expedient for the states to adopt legislation which would absorb the full amount of the credit that a taxpayer could claim under the federal law.”).

284. See N.Y. EST. POWERS & TRUSTS LAW § 7-1.5 (McKinney 2014) (making spendthrift protection the default rule).

benefit can be achieved (beyond the mere transfer of wealth to a politically powerful group).”<sup>285</sup>

As this analysis demonstrates, aligning governmental interests is a daunting task. However, perseverance is critical. Admittedly, provincial state laws that come at the revenue expense of other states keep the estate planning bar bustling, but this is a slim justification to retain laws that produce inequities and benefit the wealthy, who can afford such services. State legislatures and Congress must defeat state legislation that is designed to enable one state to prosper largely at the expense of other states and the federal government. It is imperative that federal and state governments remain solvent so that essential government services are provided. Much is at stake; thus, action must be taken to align government interests or to force conformity.

### *C. Recommendations*

#### *1. State Action to Protect Against Other States’ Laws*

If the option is available, state legislatures can enact measures to protect themselves from the revenue-siphoning laws of other states. As a case study, consider the recent experience of the state of New York and how it has responded to its taxpayers establishing trusts in out-of-state jurisdictions that have no income tax. It enacted a law that classifies as a “grantor trust” any contribution into a trust that is incomplete for federal gift tax purposes.<sup>286</sup> This law erects a barrier that may dissuade taxpayers from engaging in this tax-circumvention strategy. The salient point is that, in the appropriate situations, state legislatures whose revenue base is at risk are not powerless to combat the actions of other state legislatures.

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285. Gans, *supra* note 201, at 882 n.44.

286. N.Y. TAX LAW § 612(b)(41) (McKinney 2014).

### 2. Congressional Action to Further Intrastate Conformity

When states cannot protect themselves from other states' internecine legislative measures and when such measures have the potential to harm the government and/or public (e.g., when critical funding for essential governmental services are at risk), Congress should institute legislation that spurs conformity between and among the states. Apparently, in the 1920s, this was the case with respect to the state death tax, which at the time was a vital funding mechanism of state governments.<sup>287</sup> With the solvency of several state governments in jeopardy, Congress took action and enacted a state death tax credit;<sup>288</sup> this generated a groundswell of uniformity between and among the state legislatures, which enacted state death taxes to match the federal state death tax credit.<sup>289</sup> The salient point here is that, in the appropriate situations, Congress is at liberty to prod state legislatures to bring state laws into conformity.

### 3. Congressional Action to Prevent Financially Threatening State Laws

In those instances when state legislatures take direct aim at the coffers of the federal government, Congress should pass measures that defeat these attacks. Consider those states that either eliminated or greatly curtailed the application of the rule against perpetuities.<sup>290</sup> The agenda of these state legislatures was simple: attract capital to their states, even though such legislation would clearly undermine the integrity of the federal estate tax.<sup>291</sup> To date, Congress has not responded, which has

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287. See Oakes, *supra* note 277, at 459–60 (noting that state death tax revenues steeply climbed from \$710,000 in 1886 to \$31 million by 1916).

288. See Revenue Act of 1924, Pub. L. No. 68-176, § 301(b), 43 Stat. 253, 304 (enacting the state death tax credit).

289. See Cooper, *supra* note 280, at 860 (“From coast to coast, states enacted new death taxes or modified their existing tax laws in order to fully absorb the available federal credit.”).

290. See Sitkoff, *supra* note 154, at 668 (“Today, every state has reformed the Rule in one way or another. Many of these reforms, such as the wait-and-see doctrine, are meant to honor the Rule's basic purpose, but not all.”).

291. See *supra* note 148 (highlighting that GST tax was meant to bring uniformity to federal transfer tax).



enabled wealthy taxpayers to continue to exploit this loophole and allowed billions of dollars to escape estate tax exposure, potentially for centuries to come.<sup>292</sup> Congress has the ability, however, to restore estate tax integrity by eliminating taxpayers' ability to allocate GST tax exemption to those trusts whose benefits inure to skip people three or more generations removed from the settlor.<sup>293</sup> The salient point that stems from this recommendation is that, in the appropriate situations, Congress holds a trump card in its hands in the form of measures that can defeat state laws that put the federal coffers at risk.

### V. Conclusion

As federal and state transfer taxes have ebbed in importance, the estate planning bar has been actively reconfiguring trusts to achieve a whole assortment of new goals. While these goals vary greatly in nature, the underlying denominator is asset preservation comprised of income tax minimization, trust perpetuation, and creditor protection. When properly designed and implemented, such specially designed trusts have proven extraordinarily adept at enabling trust settlors to preserve their wealth.

But as trusts have evolved, new and important public policy concerns have emerged. These concerns include whether trusts should afford trust settlors the opportunity to circumvent state income taxes, avoid the vestiges of the remaining transfer taxes, and shelter trust assets from the reach of all creditors.<sup>294</sup> In the prophetic words of one commentator, such trusts will “enable affluent people to provide their heirs with money and property largely free from taxes and immune to the claims of creditors . . . for generations in perpetuity—truly creating an American aristocracy.”<sup>295</sup>

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292. See *supra* Part III.B (discussing how dynasty trusts preserve wealth within family bloodlines).

293. See Waggoner, *supra* note 240, at 1267 (calling for Congress to prohibit GST tax exemption allocation to trusts that endure past two generations).

294. See *supra* Part III (discussing trends in the use of trust instruments).

295. Ray D. Madoff, *America Builds an Aristocracy*, N.Y. TIMES (July 11, 2010), [http://www.nytimes.com/2010/07/12/opinion/12madoff.html?\\_r=0](http://www.nytimes.com/2010/07/12/opinion/12madoff.html?_r=0) (last visited Jan. 27, 2015) (on file with the Washington and Lee Law Review).

The proper resolution of these public policy concerns will not be easily achieved; nonetheless, resolution is critical. As evidenced by this analysis, the estate planning bar has cleverly pitted states against one another and sought to leverage states' interests ahead of those of the federal government. This intense competition between and among governmental authorities makes the achievement of sound public policy objectives difficult. However, it is clear that such competition has wrought severe fiscal solvency issues; thus, state governments and Congress must take decisive actions to protect the public's interest. If no action is forthcoming, trust instruments will continue to evolve in ways that are detrimental to societal interests, besmirching their otherwise venerable nature.