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# Trust Planning and the Washington State Capital Gains Tax

*J. M. Coppieters\**

## INTRODUCTION

On April 25, 2021, the Washington state legislature enacted a new state capital gains tax.<sup>1</sup> Prior to the enactment of the new state capital gains tax, Washington had been one of the few states that did not impose a tax on either income or capital gains. The limitations imposed by the Washington state constitution<sup>2</sup> have forced the legislature to characterize the tax as an excise tax, rather than treat it as an income tax as would the federal government and every other state. Based on the statute's structure and its presentation as an excise tax, whether intentionally or unintentionally, the legislature appears to have excluded both the trustees and beneficiaries of non-grantor trusts from being subject to the tax.

Part I of this Article summarizes the history of the new capital gains tax and its key provisions. Part II reviews the history and law regarding grantor and non-grantor trusts, analyzes the new law as applied to non-grantor trusts, and concludes that neither the trustee nor the beneficiaries of a non-grantor trust appear to be subject to the tax. Given the apparent discrepancy, whether it is because of legislative oversight or an unavoidable consequence of constitutional limitations, Part III explores tax strategies that planners and clients might consider pursuing in the wake of the new tax.

## I. THE NEW WASHINGTON STATE CAPITAL GAINS TAX

"A capital gains tax has long been a goal of Washington state progressives, who have criticized the regressive nature of the state's tax

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1. Capital Gains Tax, ch. 196, 2021 Wash. Sess. Laws 1229.

2. See WASH. CONST. art. VII, § 1 (mandating tax uniformity); WASH. CONST. art. VII, § 2 (limiting property tax percentage).

structure.”<sup>3</sup> A capital gains tax has been introduced in each session of the Washington house of representatives since 2012<sup>4</sup> and senate since 2015.<sup>5</sup> Washington state Governor Jay Inslee incorporated the 2015 house proposal into his 2017–2018 budget proposal, hoping to partly counteract the regressive nature of Washington’s tax system and noting that Washington is one of the few states without a tax on capital gains.<sup>6</sup> His proposal recommended a 7.9% tax on capital gains above \$25,000 (\$50,000 for joint filers).<sup>7</sup>

Governor Inslee presented the same proposal again in his 2019–2021 budget proposal (increased to 9%)<sup>8</sup> and 2021–2023 budget proposal.<sup>9</sup> In 2021, the Washington senate introduced the Governor’s proposal with a few amendments.<sup>10</sup> The senate amended the bill to: (1) reduce the rate from 9% to 7%; (2) increase the exclusion from \$25,000 to \$250,000; (3) exempt sales of real estate; and (4) change the prior bill’s exemption for sole proprietorship businesses to a more robust, small family-owned business exemption.<sup>11</sup> The bill passed the house after amendments and adjustments. A brief deadlock between the house and senate was then

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3. Paul Jones, *Washington State Democrats Include Capital Gains Tax in Budget Proposals*, TAX NOTES (Mar. 31, 2021), <https://www.taxnotes.com/tax-notes-today-state/capital-gains-and-losses/washington-state-democrats-include-capital-gains-tax-budget-proposals/2021/03/31/4c5sl> [<https://perma.cc/7P4C-ZYJ4>]; see also *An Act Relating to Enacting an Excise Tax on Gains from the Sale or Exchange of Certain Capital Assets: Hearing on S.B. 5096 Before the S. Comm. on Ways & Means*, 2021 Leg., 67th Sess. (Wash. 2021) [hereinafter *Senate Hearing Jan. 14, 2021*] (statement of Scott Merriman, Legislative Liaison, Office of Financial Management) (“The Governor has put [this bill] before [the Washington legislature] several times [as] a way to help balance the regressive tax code that we’re all familiar with.”).

4. See H.B. 2563, 62nd Leg., Reg. Sess. (Wash. 2012) (5% tax); H.B. 1484, 64th Leg., Reg. Sess. (Wash. 2015) (7% tax); H.B. 2224, 64th Leg., Reg. Sess. (Wash. 2015) (5% tax); H.B. 2186, 65th Leg., Reg. Sess. (Wash. 2017) (7% tax); H.B. 2967, 65th Leg., Reg. Sess. (Wash. 2018) (7% tax); H.B. 1172, 66th Leg., Reg. Sess. (Wash. 2019) (8% tax); H.B. 1496, 67th Leg., Reg. Sess. (Wash. 2021) (9.9% tax).

5. See S.B. 5699, 64th Leg., Reg. Sess. (Wash. 2015) (7% tax); S.B. 6102, 64th Leg., Reg. Sess. (Wash. 2015) (7% tax); S.B. 5929, 65th Leg., Reg. Sess. (Wash. 2017) (7% tax); S.B. 5314, 66th Leg., Reg. Sess. (Wash. 2019) (8% tax); S.B. 5096, 67th Leg., Reg. Sess. (Wash. 2021) (9% tax).

6. See JAY INSLEE, OFF. OF FIN. MGMT., 2017–19 BUDGET & POLICY HIGHLIGHTS 16 (2016).

7. *Id.*

8. See *9 Percent Capital Gains Tax on Individuals (2019-21 Proposal)*, OFF. OF FIN. MGMT. (Mar. 15, 2021), <https://ofm.wa.gov/budget/state-budgets/gov-inslees-proposed-2019-21-budgets/proposed-2019-21-budget-and-policy-highlights/revenue-changes/9-percent-capital-gains-tax-individuals> [<https://perma.cc/96MW-HNQB>].

9. See JAY INSLEE, OFF. OF FIN. MGMT., PROPOSED 2021–23 BUDGET & POLICY HIGHLIGHTS 63 (2020); *9% Capital Gains Tax on Individuals – 21–23 Budget Proposal*, OFF. OF FIN. MGMT., <https://ofm.wa.gov/budget/state-budgets/gov-inslees-proposed-2021-23-budgets/highlights-governor-inslees-2021-23-proposed-budget/revenue-changes-proposed-21-23-budget/9-capital-gains-tax-individuals-21-23-budget-proposal> [<https://perma.cc/5MNA-7BDF>].

10. See S.B. 5096, 67th Leg., Reg. Sess. (Wash. 2021).

11. Compare Engrossed Substitute S.B. 5096, 67th Leg., Reg. Sess. (Wash. 2021) [hereinafter E.S.B. 5096], with S.B. 5096, 67th Leg., Reg. Sess. (Wash. 2021).

resolved through a conference committee, with the final vote in the house at 52–44 and the final vote in the senate at 25–24.<sup>12</sup>

The new tax is apportioned based on the character of the underlying property (tangible vs. intangible) and the taxpayer's residence, which is determined by either (1) domicile (unless the taxpayer maintained a permanent place of abode outside the state) or (2) physical presence in the state over 183 days.<sup>13</sup> Dispositions of tangible property are taxable if the property is located in Washington, regardless of the taxpayer's residency.<sup>14</sup> Tangible property outside the state may still be taxable if the taxpayer resides in Washington and the property is or was located in the state in the current or prior tax year.<sup>15</sup> Capital gains from sales of intangible property are taxable if the taxpayer is domiciled in Washington as of the date of the sale.<sup>16</sup>

Tax returns are due at the same time as federal income tax returns—April 15 or October 15 with an automatic 6-month extension.<sup>17</sup> A 5% failure-to-file penalty is imposed for each month the return is late, up to a maximum of 25%.<sup>18</sup> Failure to pay by April 15 will also incur penalties and interest.

The bill contains several exemptions and deductions, the most important of which are discussed in this section. First, as mentioned above, there is a uniform standard exemption of the \$250,000 in gains. Interestingly, however, the increase in exclusion to \$250,000 does not appear to account for married couples filing jointly. The original bill provided for an exclusion of \$25,000, or \$50,000 for married couples filing jointly.<sup>19</sup> The amended statute simply provides a flat exclusion of \$250,000 for both single taxpayers and married couples filing jointly.<sup>20</sup>

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12. See S.B. 5096 Bill History, WASH. STATE LEGISLATURE, <https://app.leg.wa.gov/bills/billsummary?BillNumber=5096&Initiative=false&Year=2021> [<https://perma.cc/V8CE-AZA4>]; Larry Brant, *The Colorful and Continuing Journey of Senate Bill 5096—the New Washington State Capital Gains Tax*, FOSTER GARVEY (May 7, 2021), <https://www.foster.com/larry-s-tax-law/colorful-continuing-journey-washington-capital-gains-tax> [<https://perma.cc/SU35-4JM3>].

13. Capital Gains Tax Act, ch. 196, § 4(10)(a), 2021 Wash. Sess. Laws 1229, 1231.

14. Capital Gains Tax Act, ch. 196, § 11(1)(a), 2021 Wash. Sess. Laws 1229, 12235–36.

15. *Id.*

16. Capital Gains Tax Act, ch. 196, § 11(1)(b), 2021 Wash. Sess. Laws 1229, 1236.

17. Capital Gains Tax Act, ch. 196, § 12, 2021 Wash. Sess. Laws 1229, 1236–37. As with the federal return, the extension applies to the return due date, not the tax payment date.

18. Capital Gains Tax Act, ch. 196, § 12(6)(a), 2021 Wash. Sess. Laws 1229, 1237..

19. S.B. 5096, 67th Leg., Reg. Sess. (Wash. 2021).

20. Capital Gains Tax Act, ch. 196, § 7, 2021 Wash. Sess. Laws 1229, 1234. The plain language of the statute is clear that married couples face a penalty, despite the claim of senate staff that the amendment “just lifts [the exemption] up to \$250,000 uniformly for all taxpayers.” *Senate Hearing Jan. 14, 2021*, *supra* note 3 (statement of Jeffrey Mitchell, Senior Fiscal Counsel, Revenue Coordinator, S. Comm. on Ways & Means).

Second, sales of real estate are exempt, as are sales of business entities to the extent of their directly owned real estate, which is intended to be covered by the state real estate excise tax (REET) system.<sup>21</sup>

Third, there is a small charitable deduction available for charitable gifts over \$250,000 in a tax year.<sup>22</sup> The deduction is capped at \$100,000—that is, after \$350,000 in donations<sup>23</sup>—and the charity must be “[p]rincipally directed or managed within the state of Washington.”<sup>24</sup>

Fourth, there is a deduction for sales of all or substantially all (*i.e.*, more than 90%) of an interest in a Qualified Family-Owned Small Business (QFOSB) in which the taxpayer or a family member “materially participates” in at least five of the preceding ten years.<sup>25</sup> The taxpayer and their family must own (1) 50% of the QFOSB; (2) 30% of the QFOSB, if the business is owned at least 70% by two families; or (3) 30% of the QFOSB, if the business is owned at least 90% by three families.<sup>26</sup> The taxpayer must have owned the interest for at least five years before the sale or disposition.<sup>27</sup> Eligibility is restricted to businesses with less than \$10 million in worldwide gross revenue in the past twelve months.<sup>28</sup>

Fifth, Section 7(2) of the bill also provides a deduction for “[a]mounts that the state is prohibited from taxing under the Constitution of this state or the Constitution or laws of the United States.”<sup>29</sup> Such language has been present in almost all the capital gains tax bills introduced in the Washington legislature. The provision presumably intends to offer relief to taxpayers in the event the tax is ruled unconstitutional by the courts.

Because of Washington’s unique constitutional provisions regarding taxes, the legislature has been forced to characterize the tax as an excise tax.<sup>30</sup> Due to the tax’s structure and characterization, a dramatic and irresolvable anomaly results between grantor and non-grantor trusts: while a trust with a Washington-domiciled grantor is subject to the tax, a similarly situated non-grantor trust is not subject to the tax even if the settlor, trustee, and beneficiaries are all Washington domiciliaries.

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21. Capital Gains Tax Act, ch. 196, § 6(1)–(2), 2021 Wash. Sess. Laws 1229, 1232.

22. Capital Gains Tax Act, ch. 196, § 9(1), 2021 Wash. Sess. Laws 1229, 1235.

23. Capital Gains Tax Act, ch. 196, § 9(2), 2021 Wash. Sess. Laws 1229, 1235..

24. Capital Gains Tax Act, ch. 196, § 9(4)(b)(ii), 2021 Wash. Sess. Laws 1229, 1235.

25. Capital Gains Tax Act, ch. 196, § 8(2)(d)(ii), 2021 Wash. Sess. Laws 1229, 1234.

26. Capital Gains Tax Act, ch. 196, § 8(2)(f), 2021 Wash. Sess. Laws 1229, 1234–35.

27. Capital Gains Tax Act, ch. 196, § 8(2)(d)(ii), 2021 Wash. Sess. Laws 1229, 1234.

28. Capital Gains Tax Act, ch. 196, § 8(2)(d)(iii), 2021 Wash. Sess. Laws 1229, 1234.

29. Capital Gains Tax Act, ch. 196, § 7(2), 2021 Wash. Sess. Laws 1229, 1234.

30. *See infra* Section II.B.3.c.

## II. THE DISCREPANCY BETWEEN GRANTOR AND NON-GRANTOR TRUSTS

*A. Two Flavors of Trust (for Income Tax Purposes):  
Grantor Trusts and Non-Grantor Trusts*

For federal income tax purposes, the income generated by assets within a trust are treated as owned either by the trustees of the trust (a non-grantor trust) or by another person or persons (a grantor trust). The “grantor” is typically the person contributing assets to the trust. However, the grantor can be any person holding powers sufficient to cause the trust income to be attributable to them.

Taxpayers with high marginal income tax rates have long sought to shift their income to other persons or entities with lower marginal tax rates. In the early twentieth century, trusts became a popular vehicle to reduce and eliminate income tax; by dividing assets between several trusts, a taxpayer could lower the overall income tax on the assets because each trust would be treated as its own taxpayer.<sup>31</sup> The result did not go unnoticed by Congress or the courts: “By the creation of trusts, incomes [have] been so divided and subdivided as to withdraw from the government the benefit of the graduated taxes and surtaxes applicable to income when concentrated in a single ownership.”<sup>32</sup>

The Supreme Court took up the issue in several cases, each time focusing on the taxpayer’s control over assets purportedly given away, rather than ownership of legal title.<sup>33</sup> The culmination was *Helvering v. Clifford*, in which the taxpayer had established a trust for his wife’s benefit for a term of five years.<sup>34</sup> Income was to be distributed to her (either during the term of the trust or at the end), and the principal was to revert to the taxpayer after the termination of the trust.<sup>35</sup> The taxpayer named himself as trustee, which reserved the absolute discretion to distribute or accumulate income, and purchase, sell, and manage all trust assets.<sup>36</sup> Based on the broad definition of income in the Code, the Court held that the trust’s income was taxable to the taxpayer because he retained almost complete dominion and control over the property:

Since the income remains in the family and since the husband retains control over the investment, he has rather complete assurance that the

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31. See Laura E. Cunningham & Noël B. Cunningham, *Tax Reform Paul McDaniel Style: The Repeal of the Grantor Trust Rules 4–6* (Cardozo Legal Stud., Working Paper No. 328, 2011).

32. *Burnet v. Wells*, 289 U.S. 670, 675 (1933).

33. *Id.* at 677–79; see also *Corliss v. Bowers*, 281 U.S. 376, 378 (1930); Abraham S. Guterman, *The New Clifford Regulations*, 1 TAX L. REV. 379, 381–85 (1946); Jay A. Soled, *Reforming the Grantor Trust Rules*, 76 NOTRE DAME L. REV. 375, 378–85 (2001).

34. *Helvering v. Clifford*, 309 U.S. 331, 332 (1940).

35. *Id.*

36. *Id.* at 332–33.

trust will not effect any substantial change in his economic position. It is hard to imagine that respondent felt himself the poorer after this trust had been executed or, if he did, that it had any rational foundation in fact. For as a result of the terms of the trust and the intimacy of the familial relationship respondent *retained the substance of fully enjoyment of all the rights which previously he had in the property*.<sup>37</sup>

After *Clifford* and the resulting deluge of litigation, the Treasury Department promulgated bright-line regulations delineating when grantor trust status would apply.<sup>38</sup> Congress eventually codified the grantor trust rules in its 1954 overhaul of the Code as Sections 671 to 679, which are summarized below.

Although historically grantor trust status was a quasi-punishment imposed to attribute income to a taxpayer, trusts are now commonly drafted to intentionally trigger grantor trust status.<sup>39</sup> There are three primary benefits to grantor trust status. First, trust income tax brackets progress more quickly than the brackets for individuals and the maximum marginal income tax rate (37%) for trusts applies to income over \$13,050. Most individuals are subject to lower marginal income tax rates, so grantor trust status provides income tax savings. Second, by allocating income taxes to the grantor, grantor trust status permits the assets in the trust to grow more quickly. The grantor's payment of income taxes is not treated as an additional gift to the trust.<sup>40</sup> Third, sales, loans, and transactions between a grantor trust and the grantor are generally disregarded for income tax purposes. Thus, estate planners can—and do—structure transactions that are respected as *bona fide* for gift and estate tax purposes but result in no change for income tax purposes.<sup>41</sup>

The types of interests causing grantor trust status under the Federal Code are:

- o reversionary interests in either principal or income;<sup>42</sup>

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37. *Id.* at 335–36 (emphasis added).

38. See T.D. 5488, 1946-1 C.B. 19–25, amended by T.D. 5567, 1947-2 C.B. 9–13; Soled, *supra* note 33, at 386–87.

39. Soled, *supra* note 33, at 397 (“Although tax advisors were at one time careful to avoid the ‘trap’ of grantor trust status, today the opposite is true. In a major role reversal, many tax advisors are using the same care on behalf of some of their clients, but this time to ensure that the trusts their clients establish are ‘defective’ for tax purposes.”).

40. See Rev. Rul. 2004-64, 2004-2 C.B. 7.

41. See Jay A. Soled & Mitchell Gans, *Sales to Grantor Trusts: A Case Study of What the IRS and Congress Can Do to Curb Aggressive Transfer Tax Techniques*, 78 TENN. L. REV. 973, 985 (2011).

42. See 26 U.S.C. § 673 (to the extent in excess of five percent of the principal or income).

- o powers to control the beneficial enjoyment of either principal or income without the approval or consent of an adverse party;<sup>43</sup>
- o powers to purchase, exchange, or otherwise deal with trust principal or interest for less than adequate and full consideration;<sup>44</sup>
- o powers to borrow from trust principal or income without adequate interest or security;<sup>45</sup>
- o actual borrowing of trust principal or income without adequate interest and security if the loan remains outstanding at the end of the taxable year;<sup>46</sup>
- o powers to revoke all or a portion of a trust;<sup>47</sup> and
- o if income is or may be distributed to the grantor or the grantor's spouse, held or accumulated for such future use, or paid for life insurance premiums insuring the life of the grantor or the grantor's spouse.<sup>48</sup>

However, the creator of a trust (*i.e.*, the settlor) is not always the grantor of a trust. Section 678 provides that a third party shall be treated as the owner of any portion of a trust over which he or she “has a power exercisable solely by himself to vest the corpus or the income therefrom in himself.”<sup>49</sup> Section 678 is a secondary attribution rule and does not apply if Sections 673–677 treat the settlor as the grantor over *income* of the trust.<sup>50</sup> The third party is also treated as the grantor of the trust even if they have released or modified such power *if* they have retained another power that would, if retained by the settlor, cause the settlor to be treated as the grantor under Sections 673–677.<sup>51</sup>

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43. See 26 U.S.C. § 674.

44. See 26 U.S.C. § 675(1).

45. See 26 U.S.C. § 675(2).

46. See 26 U.S.C. § 675(3). The three powers under Code Section 675 (*i.e.*, the power to deal with trust assets for less than full and adequate consideration, the power to borrow without adequate interest or security, and the actual borrowing without adequate interest and security) are referred to as “administrative powers.”

47. See 26 U.S.C. § 676.

48. See 26 U.S.C. § 677; see generally Maurice Alexandre, *A Case Method Restatement of the New Clifford Regulations*, 3 TAX L. REV. 189 (1947); Stephen R. Akers, Jonathan G. Blattmachr & F. Ladson Boyle, *Creating Intentional Grantor Trusts*, 44 REAL PROP. TR. & EST. L.J. 207, 258 (2009).

49. 26 U.S.C. § 678(a)(1).

50. See 26 U.S.C. § 678(b); see generally Jonathan G. Blattmachr, Mitchell M. Gans, & Alvina H. Lo, *A Beneficiary as Trust Owner: Decoding Section 678*, 35 ACTEC J. 106, 108 (2009). Subsection (b) also applies to a foreign trust or portion thereof over which a transferor is treated as being the grantor under Section 679, taking priority over a third party holding a power under Section 678(a). Code Section 678 was added to the tax law as a result of *Mallinckrodt v. Commissioner*, 146 F.2d 1 (8th Cir. 1945), in which the U.S. Court of Appeals for the Eighth Circuit held that the beneficiary of a trust could be taxed as the owner of trust because he could essentially direct the timing and amount of distributions from the trust. See Blattmachr, Gans & Lo, *supra* note 50, at 108.

51. See Treas. Reg. § 1.678(a)-1(a). Code Section 678 does not apply if the power is renounced or disclaimed within a reasonable time after the powerholder first became aware of its existence. See 26 U.S.C. § 678(d).



Although this Article refers generally to non-grantor trusts, note that estates are taxed identically for income tax purposes. Distributions of income from an estate to the beneficiaries are generally taxable to the beneficiaries and otherwise taxable to the estate if retained and undistributed. As a practical matter, there is (for now) a step-up in basis on an individual taxpayer's death, so little gain is likely to occur in most estates.<sup>52</sup>

### *B. Non-Grantor Trusts and the New Tax*

#### 1. Only (Certain) Individuals Are Subject to the Capital Gains Tax

"Only individuals are subject to payment of the [new capital gains] tax."<sup>53</sup> Furthermore, "[t]he tax imposed . . . applies to the sale or exchange of long-term capital assets owned by the taxpayer, *whether the taxpayer was the legal or beneficial owner of such assets at the time of the sale or exchange.*"<sup>54</sup> At first glance, the statute appears to apply to the trustee of a non-grantor trust (as the legal owner of the trust's assets), or alternatively to the beneficiaries of the non-grantor trust (as the beneficial owners of the trust's assets).

However, the structure and language of the new law suggest a different interpretation for three primary reasons. First, the history and structure of the statute's definitions suggest that trustees of non-grantor trusts may have been intentionally excluded. For purposes of the new tax:

An individual is considered to be a beneficial owner of long-term capital assets held by an entity that is a pass-through or disregarded entity for federal tax purposes, such as a partnership, limited liability company, S corporation, or grantor trust, to the extent of the individual's ownership interest in the entity as reported for federal income tax purposes.<sup>55</sup>

The initial budget proposal from Governor Inslee did not intend to tax trustees, although it did contemplate taxing beneficiaries if a distribution of capital gain was made.<sup>56</sup>

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52. See 26 USC § 1014.

53. Capital Gains Tax Act, ch. 196, § 5(1), 2021 Wash. Sess. Laws 1229, 1231.

54. Capital Gains Tax Act, ch. 196, § 5(4)(a), 2021 Wash. Sess. Laws 1229, 1232 (emphasis added).

55. Capital Gains Tax Act, ch. 196, § 5(4)(b)(i), 2021 Wash. Sess. Laws 1229, 1232.

56. See *Capital Gains Tax Proposal Q&A*, OFF. OF FIN. MGMT. (Mar. 15, 2021), <https://ofm.wa.gov/budget/state-budgets/gov-inslees-proposed-2021-23-budgets/highlights-governor-inslees-2021-23-proposed-budget/revenue-changes-proposed-21-23-budget/capital-gains-tax-proposal-qa> [https://perma.cc/U6UF-759E] ("Because a trust is not an individual subject to the Washington capital gains tax, no Washington capital gains tax would be due on gains retained by the trust. However, in some cases a non-grantor trust will distribute income that represents gain from the

Second, the express application of the tax to solely individuals leads to an anomaly between individual and institutional trustees, as stated in Section 5(1) of the bill. If the trustees of non-grantor trusts must pay the tax, a disparity would result between individual trustees and non-individual trustees. For instance, a Washington-chartered trust company serving as institutional trustee of a non-grantor trust would presumably owe no Washington capital gains tax on the sale of a long-term capital asset. To the author's knowledge, no other state exempts entities from their state-level taxes on income or capital gains, and therefore no other state has this apparent discrepancy.

Third, the language of the statute and state constitutional limitations suggest that the tax does not apply to trust beneficiaries, whether of a grantor or non-grantor trust, because they are not included in the enumerated list of beneficial owners. Under the new law:

An individual is considered to be a beneficial owner of long-term capital assets held by an entity that is a pass-through or disregarded entity for federal tax purposes, such as a . . . grantor trust, to the extent of the individual's ownership interest in the entity as reported for federal income tax purposes.<sup>57</sup>

Beneficiaries of a non-grantor trust are not considered to have an "ownership interest" in the trust "as reported for federal income tax purposes."<sup>58</sup> They may report taxable income or gain to the extent distributed by the trust, and the trustee will pay federal tax on the remainder of undistributed income or gain.<sup>59</sup> The Washington Supreme Court has affirmed the canon *expression unius est exclusio alterius*: "As a general rule, the expression of one thing in a constitution or statute excludes all others."<sup>60</sup> The canon implies that "[w]here a statute enumerates the persons or things to be affected by its provisions, there is an implied exclusion of others and the natural inference follows that it is not intended to be general."<sup>61</sup>

By excluding beneficiaries from the express definition of "beneficial owners," the legislature has apparently excluded beneficiaries of non-grantor trusts from being the intended payors of the tax. Furthermore, as

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sale of capital assets rather than retain the income. Individual beneficiaries will need to report distributed long-term capital gain income under the proposed Washington capital gains tax.").

57. Capital Gains Tax Act, ch. 196, § 5(4)(b)(i), 2021 Wash. Sess. Laws 1229, 1232.

58. *Id.* The exception is a beneficiary grantor trust, in which a settlor creates a trust with powers granted to one or more beneficiaries sufficient to cause the trust to be a grantor trust with respect to those beneficiaries under 26 U.S.C. § 678. See *infra* Part III.B.3.

59. See HOWARD M. ZARITSKY, NORMAN LANE & ROBERT DANFORTH, FEDERAL INCOME TAXATION OF ESTATES AND TRUSTS ¶ 1.02 (2001).

60. *State ex rel. Port of Seattle v. Dep't of Pub. Serv.*, 95 P.2d 1007, 1012 (Wash. 1939).

61. *Id.*

discussed in Section II.B.3.b below, there are serious state constitutional issues affecting the imposition of the capital gains tax on the beneficiaries of a non-grantor trust. To qualify as a permissible excise tax under the Washington state constitution, a tax must be imposed “upon the voluntary action of the person taxed in performing the act, enjoying the privilege[,] or engaging in the occupation which is the subject of the excise . . . .”<sup>62</sup> It is doubtful the actions of a trustee of an irrevocable trust (who may be domiciled in another state) will be considered the “voluntary action” of the beneficiaries. The entire premise of a trust is the existence of a person acting in a fiduciary capacity making decisions regardless of the consent or objection of the beneficiaries.<sup>63</sup>

With a grantor trust, one or more persons is the deemed owner of the trust’s assets for income tax purposes.<sup>64</sup> The application of the capital gains tax appears relatively simple for a grantor trust with a single grantor (over the entire trust). For example, a settlor retaining administrative powers—such as the power to borrow from the trust without adequate interest or security, or the power to substitute assets of equivalent value—would be deemed to be the grantor of the entire trust under Section 675. As the complete owner of the trust for federal income tax purposes, the settlor would owe Washington capital gains taxes on an applicable sale as if the trust assets were their own property. The application is less clear for grantors who are deemed to own only a portion of the trust for income tax purposes. For instance, under Section 675(3), if the grantor of a trust borrows trust corpus or income without adequate interest and security, and has not repaid the entire loan (including interest) before the end of a tax year, the trust is a grantor trust for that year with respect to the amount of the loan.<sup>65</sup> If a Washington-domiciled settlor borrowed 50% of the assets of a trust in a year without adequate interest and security, and the trustee made a sale in that same year triggering capital gains, presumably the settlor would be allocated 50% of the gains, as the one-half grantor of the trust. Without additional guidance from the Washington Department of

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62. *Covell v. City of Seattle*, 905 P.2d 324, 332 (Wash. 1995).

63. However, in practice, it is curious the extent to which beneficiaries and friendly trustees “collude.” In the most egregious circumstances, the trustee is merely a formality. The IRS has attacked several estate planning techniques based on a “prearranged plan or understanding” between the parties to a trust. See Donald P. DiCarlo, Jr., *What Estate Planners Need to Know About the Step Transaction Doctrine*, 45 REAL PROP. TR. & EST. L.J. 355, 355 (2010). Ideally, a trustee is not merely a “potted plant,” but the extent to which trustees serve as an actual check on beneficiary demands is worthy of further empirical study.

64. See *supra* Section II.A.

65. See Rev. Rul. 85-13, 1985-1 C.B. 184–86 (explaining a settlor who borrowed trust corpus in exchange for a promissory note was treated “as the owner of *the portion* of [the trust] represented by [his] promissory note.” (emphasis added)).

Revenue, the treatment of the other half of the trust's income and gains is uncertain.

## 2. The Intent of the Washington Legislature

The initial proposal from Governor Inslee did not intend for this discrepancy between grantor and non-grantor trusts to exist. A "Q&A" from the 2019–2021 budget proposal stated:

Because a [non-grantor] trust is not an individual subject to the Washington capital gains tax, no Washington capital gains tax would be due on gains retained by the trust. However, in some cases a non-grantor trust will distribute income that represents gain from the sale of capital assets rather than retain the income. Individual beneficiaries will need to report distributed long-term capital gain income under the proposed Washington capital gains tax.<sup>66</sup>

This approach would have been straightforward and logical: "States typically impose tax on a beneficiary in the year in which the beneficiary receives the income from the trust."<sup>67</sup> Deferral that might otherwise benefit taxpayers who delay trust distributions could have been addressed via "throwback taxes" on the trust's accumulated income. For example, both New York and California impose a throwback tax on distributions to a resident beneficiary based on income accumulated within the trust in prior years.<sup>68</sup>

## 3. The Logistical and Constitutional Complications of Applying the Tax to Trustees and Beneficiaries

The logistics of imposing the capital gains tax on the beneficiaries of a non-grantor trust can be complicated. As an example, assume the trustee of a non-grantor trust sells an interest in a Washington LLC, triggering long-term capital gain, and distributes none of the proceeds. As a complex trust, the trust will pay federal capital gains tax in the year of the sale. If

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66. *Capital Gains Tax Q&A (2019-21 Proposal)*, OFF. OF FIN. MGMT. (Mar. 15, 2021), <https://ofm.wa.gov/budget/state-budgets/gov-inslees-proposed-2019-21-budgets/proposed-2019-21-budget-and-policy-highlights/revenue-changes/capital-gains-tax-qa> [<https://perma.cc/G89P-KC7F>]; *accord Capital Gains Tax Proposal Q&A*, OFF. OF FIN. MGMT. (Mar. 15, 2021), <https://ofm.wa.gov/budget/state-budgets/gov-inslees-proposed-2021-23-budgets/highlights-governor-inslees-2021-23-proposed-budget/revenue-changes-proposed-21-23-budget/capital-gains-tax-proposal-qa> [<https://perma.cc/U6UF-759E>]. Identical language was present in the 2017–19 FAQs. See OFF. OF FIN. MGMT., PROPOSED WASHINGTON CAPITAL GAINS TAX 3 (2015).

67. Brief Amicus Curiae for the American College of Trust and Estate Counsel in Support of Neither Party at 14, *North Carolina Dep't of Revenue v. Kimberley Rice Kaestner* 1992 Fam. Tr., 139 S. Ct. 2213 (2019) (No. 18-457) [hereinafter ACTEC Brief].

68. *Id.* at 15–17; see N.Y. TAX LAW § 612(b)(40) (McKinney 2021); CAL. REV. & TAX. CODE § 17745 (West 2021).

the beneficiaries are Washington domiciliaries, should they be required to realize Washington capital gains in the year of the sale, despite the fact they have received no distributions? Or, if the trustee distributes the proceeds of the sale in a later year, should the beneficiaries be required to pay then? What if some beneficiaries are no longer domiciliaries of Washington at that time? Alternatively, assume the trustee sells an interest in a Delaware LLC and distributes the proceeds of the sale five years later to the beneficiaries, one of whom is a Washington domiciliary. Should the Washington beneficiary pay tax on the capital gain in the year of receipt? What if the beneficiary was domiciled in Oregon in the year of the sale, but then moved to Washington by the year of the distribution—or vice versa?

These questions also implicate federal and state constitutional questions. While such a discrepancy is probably not a violation of the Equal Protection Clause of the Fourteenth Amendment,<sup>69</sup> there are serious Due Process Clause concerns. The Due Process Clause “requires some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax.”<sup>70</sup> “A statute of a [s]tate which undertakes to tax things wholly beyond her jurisdiction or control conflicts with the Fourteenth Amendment.”<sup>71</sup> The Court explains:

In sum, when assessing a state tax premised on the in-state residency of a constituent of a trust—whether beneficiary, settlor, or trustee—the Due Process Clause demands attention to the particular relationship between the resident and the trust assets that the State seeks to tax. Because each individual fulfills different functions in the creation and continuation of the trust, the specific features of that relationship sufficient to sustain a tax may vary depending on whether the resident is a settlor, beneficiary, or trustee.<sup>72</sup>

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69. Tax statutes are almost always upheld under the federal Equal Protection Clause. The U.S. Supreme Court has given states broad power to enact tax classifications:

This Court has often admonished against such interferences with the State’s fiscal policies under the Equal Protection Clause: “... [T]he passage of time has only served to underscore the wisdom of that recognition of the large area of discretion which is needed by a legislature in formulating sound tax policies.... It has... been pointed out that in taxation, even more than in other fields, legislatures possess the greatest freedom in classification.... [T]he presumption... can be overcome only by the most explicit demonstration that a classification is a hostile and oppressive discrimination against particular persons and classes . . . .”

San Antonio Indep. Sch. Dist. v. Rodriguez, 411 U.S. 1, 40–41 (quoting *Madden v. Kentucky*, 309 U.S. 83, 87–88 (1940)).

70. *Miller Bros. Co. v. Maryland*, 347 U.S. 340, 344–45 (1954).

71. *Safe Deposit & Trust Co. of Baltimore v. Virginia*, 280 U.S. 83, 92 (1929).

72. *North Carolina Dep’t of Revenue v. Kimberley Rice Kaestner 1992 Fam. Tr.*, 139 S. Ct. 2213, 2222 (2019)

There are also Commerce Clause limitations on state taxation. The standard, set by the Court in *Complete Auto Transit, Inc. v. Brady*, is whether “the tax is applied to an activity with a substantial nexus with the taxing State, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services provided by the State.”<sup>73</sup> “Substantial nexus” runs parallel to the Due Process Clause’s “minimum contacts” requirement, and requires that the taxpayer “avail[] itself of the substantial privilege of carrying on business in that jurisdiction.”<sup>74</sup>

*a. Constitutional Limitations on the Taxation of Trustees*

States imposing taxes on trusts generally do so based on the residence of the settlor or trustees.<sup>75</sup> Numerous state courts in the late nineteenth and early twentieth century confronted the issue of tax jurisdiction with application to trustees; most concluded that a trust could be subject to tax in the state where a trustee resided, including one case from the Washington Supreme Court.<sup>76</sup> The U.S. Supreme Court “has never denied the constitutional power of the trustee’s domicile to subject them to property taxation . . . . On the contrary, [the] Court . . . has declared that both the decedent’s domicile and that of the trustee are free to tax.”<sup>77</sup>

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73. *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977).

74. *Valdez Tankers, Inc. v. City of Valdez*, 557 U.S. 1, 11 (2009) (internal quotation marks omitted).

75. See ACTEC Brief, *supra* note 67, at 5.

76. See *City of Walla Walla v. Moore*, 47 P. 753, 754 (1897). The issue of whether multiple states can tax a trust based on the various residences of the trust’s multiple trustees has not been directly addressed by the Supreme Court. The Supreme Court has upheld a state’s valid taxation of a trust’s income based on the residence of the trustee and the simultaneous taxation by another state on distributions received by a trust beneficiary, even though such a conclusion clearly resulted in double taxation. See *Guaranty Trust Co. of N.Y. v. Virginia*, 305 U.S. 19, 22–23 (1938); Charles L. B. Lowndes, *The Tax Decisions of the Supreme Court, 1938 Term*, 88 U. PA. L. REV. 1, 12–13 (1939).

[D]epending on the circumstances, a trust could easily satisfy one or more of the residency criteria of multiple states where the settlor, trustee, beneficiary, and assets have a nexus. This overlapping effect creates the problem of trusts that are treated as resident trusts in more than one state and thus the trustees of such trusts are potentially subject to multiple state income tax levies without an offsetting tax credit or other mechanism to allay the impact of double taxation. Although [the] Court has held that state taxation by multiple jurisdictions is federally constitutional in the transfer tax context, it has not addressed state residency-based income taxation by multiple jurisdictions.

ACTEC Brief, *supra* note 67, at 12–13. Presumably such a result would violate the Commerce Clause unless fairly apportioned between the states asserting tax authority. See generally Bradley W. Joondeph, *The Meaning of Fair Apportionment and the Prohibition on Extraterritorial State Taxation*, 71 FORDHAM L. REV. 149 (2002).

77. See *Curry v. McCanless*, 307 U.S. 357, 370, 373 (1939); Note, *State Power to Impose a Property Tax on the Interest of a Beneficiary of a Trust—A Problem in Double Taxation*, 30 COLUM. L. REV. 539, 539 n.1 (1930).

In *Greenough v. Tax Assessors of Newport*, the U.S. Supreme Court addressed the Due Process Clause regarding the taxation of trustees.<sup>78</sup> George Warren died testate in New York.<sup>79</sup> His will established a testamentary trust, and two trustees were appointed by the New York Surrogate's Court.<sup>80</sup> One trustee resided in New York and the other in Rhode Island. The sole asset of the trust consisted of shares in a New Jersey company. The City of Newport, Rhode Island, imposed a personal property tax against one-half of the trust's assets based on the proportionate residences of the trustees.<sup>81</sup> The Supreme Court upheld the tax, concluding that the courts of Rhode Island extended *some* benefit to the Rhode Island resident trustee:

The trustee of today moves freely from state to state. The settlor's residence may be one state, the seat of a trust another state and the trustee or trustees may live in still another jurisdiction or may constantly change their residence. . . . The legal interest of the trustee in the *res* is a distinct right. . . . The trustee as the owner of this legal interest in the *res* may incur obligations in the administration of the trust enforceable against him, personally. . . . [T]hird parties dealing with the trustee on trust matters or beneficiaries may need to proceed directly against the trustee as an individual for matters arising out of his relation to the trust. Or the resident trustee may need the benefit of the Rhode Island law to enforce trust claims against a Rhode Island resident. . . . Consequently, we must conclude that Rhode Island does offer benefit and protection through its law to the resident trustee as the owner of intangibles.<sup>82</sup>

*b. Constitutional Limitations on the Taxation of Beneficiaries*

In the context of taxation of trust beneficiaries, the due process analysis focuses on the extent of the in-state beneficiary's right to control, possess, enjoy, or receive trust assets. "When a State seeks to base its tax on the in-state residence of a trust beneficiary, the Due Process Clause demands a pragmatic inquiry into what exactly the beneficiary controls or possesses and how that interest relates to the object of the State's tax."<sup>83</sup>

The U.S. Supreme Court addressed the issue in a series of cases in the early twentieth century. In *Safe Deposit & Trust Co. v. Virginia*, a settlor domiciled in and resident of Virginia transferred securities to a

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78. See *Greenough v. Tax Assessors of Newport*, 331 U.S. 486 (1947).

79. *Id.* at 488.

80. *Id.*

81. *Id.*

82. *Id.* at 493–96.

83. *North Carolina Dep't of Revenue v. Kimberley Rice Kaestner* 1992 Fam. Tr., 139 S. Ct. 2213, 2221–22 (2019).

revocable trust established for the benefit of his two sons, naming Safe Deposit & Trust Co. of Baltimore, Maryland, as trustee.<sup>84</sup> The sons had no right to control the trust assets or receive the income from trust assets during the years in question.<sup>85</sup> Virginia sought to impose a tax on the trust's income, which the Virginia courts upheld.<sup>86</sup> On appeal, the U.S. Supreme Court held that the tax violated the Fourteenth Amendment, concluding that the securities had "acquired a situs separate from that of the beneficial owners."<sup>87</sup> In *Brooke v. Norfolk*, the Court rejected a similar attempt by Virginia to tax the entire trust corpus based upon a beneficiary's residence in Virginia when all the assets were held in Maryland (also by the Safe Deposit & Trust Co. of Baltimore).<sup>88</sup> By contrast, in *Maguire v. Trefry*, the Supreme Court upheld a tax on the beneficiary of a trust where income of the trust was distributed to her.<sup>89</sup>

In *North Carolina v. Kaestner*, the U.S. Supreme Court held that the mere physical presence of a beneficiary in a state is insufficient to subject the trust assets to income tax.<sup>90</sup> That is, a beneficiary's mere presence in a state did not give the trust sufficient minimum contacts with the state to justify taxation of the trust's assets under the Due Process Clause.<sup>91</sup> Therefore, it seems unlikely that Washington could assert its capital gains

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84. See *Safe Deposit & Trust Co. of Baltimore v. Virginia*, 280 U.S. 83, 89–90 (1929).

85. See *id.* at 91 ("[N]obody within Virginia has present right to [the securities'] control or possession, or to receive income therefrom, or to cause them to be brought physically within her borders."). The settlor's two sons were each entitled to take their half share after turning age 25. See *id.* at 89.

86. See *id.* at 89–90.

87. *Id.* at 93. Justices Stone and Brandeis, concluding in the judgment, would have stopped short of the Court's holding:

[T]he Virginia assessment was levied against a trustee domiciled in Maryland upon securities held by it in trust in its exclusive possession and control there, and so is forbidden as an attempt to tax property without the jurisdiction. *But the question whether the Fourteenth Amendment forbids a tax on the beneficiaries, in Virginia, where they are domiciled, measured by their equitable interests, seems to me not to be presented by the record and so, under the settled rule of decision of this Court, ought not now to be decided.*

*Id.* at 95 (Stone, J., concurring). Justice Holmes would have upheld the Virginia Court of Appeals' decision. See *id.* at 96–97 (Holmes, J., dissenting) ("To be sure the trustee having the legal title and possession of the bonds in Maryland may be taxed there. But that does not affect the right of Virginia by reason of anything that I know of in the Constitution of the United States.").

88. See *Brooke v. Norfolk*, 277 U.S. 27, 28–29 (1928). Interestingly, Justice Holmes delivered the opinion of the Court. Virginia may have taken heed from Holmes' dissent in *Safe Deposit* in their attempt to tax all the trust assets in *Brooke*. As the Court would later hold in *Kaestner*, Virginia's attempt to tax any of the trust's assets based on a beneficiary's mere presence in the state would also have been unconstitutional. See *infra* notes 90–93.

89. See *Maguire v. Trefry*, 253 U.S. 12, 16–17 (1920), *aff'g* *Maguire v. Tax Comm'r*, 230 Mass. 503 (1918).

90. See *North Carolina Dep't of Revenue v. Kimberley Rice Kaestner* 1992 Fam. Tr., 139 S. Ct. 2213, 2221 (2019).

91. See *id.* Without minimum contacts, the state also lacked substantial nexus required by the Commerce Clause. See *id.*



tax against a resident or domiciliary beneficiary unless the beneficiary had *some* ability to demand the trust income or to possess, control, or otherwise enjoy some portion of the trust assets.<sup>92</sup> Of course, if the beneficiaries in *Kaestner* had received income from the trust, it would have been taxable.<sup>93</sup>

### *c. State Constitutional Limitations*

Unique and special considerations apply to tax laws under the Washington State constitution. Article VII, Section 1 of the Washington constitution requires that “[a]ll taxes shall be uniform upon the same class of property within the territorial limits of the authority levying the tax . . . .”<sup>94</sup> Article VII, Section 2 provides that no property tax may exceed 1% of the fair value of the property.<sup>95</sup> The tax uniformity mandate and percentage limitation apply broadly to “property taxes” (including income taxes)<sup>96</sup> but do not apply to excise taxes.<sup>97</sup> An excise tax is imposed on “a particular use or enjoyment of property or the shifting from one to another of any power or privilege incidental to the ownership or enjoyment of property.”<sup>98</sup> “[T]he obligation to pay an excise is based upon the *voluntary action of the person taxed in performing the act*, enjoying the privilege or engaging in the occupation which is the subject of the excise, and the element of absolute and unavoidable demand, as in the case of a property tax, is lacking.”<sup>99</sup> Two distinct issues result from the intersection between Article VII, Section 1 of the Washington constitution and the Washington capital gains tax. First, the tax may be upheld as an excise tax but will face nearly insurmountable challenge if recharacterized as a property tax. Second, if interpreted as an excise tax, the law likely cannot permit the imposition of the tax against the beneficiaries of a non-grantor trust.

92. *Id.* at 2222–23.

93. *Id.* at 2223 (“If [the beneficiaries] had [received income from the trust], such income would have been taxable.”); *Maguire*, 253 U.S. at 17; *Guaranty Trust Co. of N.Y. v. Virginia*, 305 U.S. 19, 23 (1938).

94. WASH. CONST. art. VII, § 1; *see also* WADE J. NEWHOUSE, JR., CONSTITUTIONAL UNIFORMITY AND EQUALITY IN STATE TAXATION, 572–91 (1959) (discussing history of Washington’s uniformity requirement).

95. WASH. CONST. art. VII, § 2.

96. “In a series of decisions dating back to 1933, the Washington Supreme Court has unequivocally held income is property, a tax on income is a tax on property, taxes on property must be uniformly levied, and a graduated income tax is not uniform. Therefore, the Washington Constitution bars any graduated income tax.” *Kunath v. City of Seattle*, 444 P.3d 1235, 1239 (Wash. Ct. App. 2019) (citing *Power, Inc. v. Huntley*, 235 P.2d 173, 175 (Wash. 1951)); *Apartment Operators Ass’n v. Schumacher*, 351 P.2d 124, 125 (1960) (“[A] tax on rental income is a tax on property, and not an excise tax.”); *see generally* Hugh D. Spitzer, *A Washington State Income Tax—Again?*, 16 PUGET SOUND L. REV. 515 (1993).

97. *See* *Dean v. Lehman*, 18 P.3d 523, 530–31 (Wash. 2001) (citing *Black v. State*, 406 P.2d 761, 763 (Wash. 1965)).

98. *Fernandez v. Wiener*, 326 U.S. 340, 352 (1945).

99. *Covell v. City of Seattle*, 905 P.2d 324, 332 (Wash. 1995) (emphasis added).

First, critics allege that the new capital gains tax is unconstitutional if properly recharacterized as a tax on income (*i.e.*, a property tax under Washington constitutional law). Two lawsuits have already been filed challenging the constitutionality of the tax.<sup>100</sup> The criticism is hardly new.<sup>101</sup> One Washington state representative has pointed out that the tax is based on the federal income tax return, and the IRS explicitly stated: “[C]apital gains are treated as income under the [federal] tax code and taxed as such.”<sup>102</sup>

The character of a tax—excise or property—is “determined by its incidents, not by its name.”<sup>103</sup> There are compelling arguments that the capital gains tax should be respected as an excise tax. For instance, the Washington Supreme Court has upheld estate and inheritance taxes as valid excise taxes on the right or privilege to transfer and receive property upon death.<sup>104</sup> But if considered a property tax, the 7% capital gains tax far exceeds the 1% limitation and fails to tax gains uniformly by excluding a taxpayer’s first \$250,000 in gain per year.

Second, if the new capital gains tax is treated as an excise tax, the tax cannot properly apply to the beneficiaries of a non-grantor trust. An excise tax may only constitutionally apply upon “the voluntary action of the person taxed.”<sup>105</sup> The engrossed senate bill stated that “[t]he excise tax on capital gains is a tax on the one-time, *voluntary* sale or exchange of a capital asset, not a tax on ownership of the asset itself. This excise tax is paid *only* by those individuals *who engage in voluntary* sales or exchanges of Washington capital assets . . . .”<sup>106</sup> This language was removed by the House before the law was passed. The beneficiaries of an irrevocable, non-grantor trust cannot reasonably be considered to have entered into a “voluntary action” if the trustees of the trust sell property triggering capital

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100. See *Quinn v. State*, No. 21-2-00075-09 (Wash. Sup. Ct., Douglas Cnty., Apr. 28, 2021); *Clayton v. State*, No. 21-2-00087-09 (Wash. Sup. Ct., Douglas Cnty., May 20, 2021).

101. “Democrats . . . propose the tax as a progressive source of new revenue . . . . Republicans and their allies attack it as a volatile and unconstitutional form of an income tax.” Austin Jenkins, *WA Democrats Push for Capital Gains Tax in a Year When ‘Tax’ Doesn’t Seem like a Bad Word*, NPR (Mar. 1, 2021), <https://www.kuow.org/stories/wa-democrats-push-for-capital-gains-tax-in-a-year-when-tax-doesn-t-seem-like-a-bad-word> [<https://perma.cc/4DQ7-LMAB>].

102. Letter from Paul Axelson, IRS Legis. Affs. Off., to Rep. Dan Newhouse (Sept. 25, 2018) (on file with the Dept. of Treasury).

103. *Harbour Vill. Apartments v. City of Mukilteo*, 989 P.2d 542, 544 (Wash. 1999).

104. See *In re Estate of Sherwood*, 211 P. 734 (Wash. 1922); *In re Estate of Ellis*, 14 P.2d 37, 39 (Wash. 1932) (“The charge is not on the property itself, although the value of the property determines the amount of the tax, but rather upon the right or privilege to transmit or receive the property.”).

105. See *Covell v. City of Seattle*, 905 P.2d 324, 332 (Wash. 1995).

106. See Engrossed Substitute S.B. 5096, 67th Leg., Reg. Sess. § 101(2) (Wash. 2021).

gains.<sup>107</sup> If the new tax were imposed on the beneficiaries of a non-grantor trust, there would be an unconstitutional disconnect between the incidence of the tax (the beneficiaries) and the voluntary action triggering the tax (by the trustee).<sup>108</sup>

It is uncertain whether the same limitation might apply to the grantor of a grantor trust. Presumably, much like the beneficiaries of a trust, the grantor also has no power to compel the trustees to sell or refrain from selling any particular asset.<sup>109</sup> Perhaps by retaining the powers sufficient to trigger grantor trust status for federal income tax purposes, the grantor has similarly retained sufficient beneficial powers to justify the imposition of the Washington capital gains tax as a matter of Washington constitutional law.

#### *d. The Inequity of the New Tax*

One of the fundamentals of tax policy fairness is the principle of horizontal equity, which “demands that similarly situated individuals face similar tax burdens.”<sup>110</sup> The newly enacted Washington capital gains tax fails to follow this fundamental principle.

The following two examples demonstrate the inequity created by the new capital gains tax. In one case, imagine a settlor establishes an irrevocable trust and retains grantor powers sufficient to cause her to be deemed the owner for income tax purposes under Code Section 671 (Trust A). Conversely, assume another settlor establishes an irrevocable trust over which he retains no grantor trust powers (Trust B). Each trust is established for the benefit of each settlor’s two children. The settlors of both trusts are Washington domiciliaries, as are all trustees and beneficiaries. Both trusts grant the trustee entirely discretionary distribution powers and are therefore complex trusts. Each settlor transfers to his or her trust a 100% interest in a Washington LLC with a basis of \$0 and a fair market value of \$10,000,000. The trustee of each trust sells each

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107. Consider *High Tide Seafoods v. State*, 725 P.2d 411, 413–14 (Wash. 1986), where the State imposed an excise tax on the “first possession” of fish and shellfish for commercial purposes after such fish or shellfish had landed. The court upheld the tax as a proper excise tax on the transfer of ownership from the fisherman to the first commercial owner. *Id.*

108. See Wash. Pub. Ports Ass’n v. Wash. Dep’t of Revenue, 62 P.3d 462, 469–70 (Wash. 2003).

109. The extent to which this presumption withholds empirical scrutiny is debatable, particularly in the case of grantors who nominate “friendly” trustees. The IRS has attempted to push against this tendency and estate planners have settled into the comfortable position of advising that trustees may exercise nearly discretionary distribution powers so long either: (1) the trustees are neither “related” or “subordinate,” within the meaning of Code Section 672, or (2) the distribution powers are limited to an “ascertainable standard.” See David Barbour & Barbara G. McComas, *Selecting a Trustee: Income Tax and Estate Tax Considerations*, 33 SW L.J. 635, 638, 646–47 (1979).

110. David Elkins, *Horizontal Equity as a Principle of Tax Theory*, 24 YALE L. & POL’Y REV. 43, 43–45 (2006).

LLC interest in August of Year 1 and distributes all the proceeds of the sale to the beneficiaries in February of Year 2. Assume the holding period of both LLCs (including the settlors' tacked-on holding periods) is more than one year. In Year 1, the settlor of Trust A will pay \$2,000,000 in federal capital gains tax<sup>111</sup> and \$682,500<sup>112</sup> in Washington state capital gains tax. The trustee of Trust B will pay the same \$2,000,000 in federal capital gains but no Washington state capital gains. In Year 2, when the trustee distributes the sale proceeds, the two beneficiaries of Trust A will each receive \$3,658,750, while the two beneficiaries of Trust B will each receive \$4,000,000.

### III. PLANNING AROUND THE TAX

The newly enacted Washington capital gains tax does not present difficulty for wealthy or sophisticated taxpayers. As described in Section III.A, traditional tactics to avoid state income taxes are available to all taxpayers, such as changing domicile (whether by the taxpayer or via trust), timing of realization to net losses against gains, or deferring gain recognition.

For ease of comparability, the strategies to avoid state taxes discussed in Part III are all premised on the following basic fact pattern:

Assume Taxpayer X, domiciled in Washington, owns an interest in Alpha LLC, a Washington limited liability company, worth \$10 million with a basis of \$0. X's interest in Alpha does not qualify as an interest in a "qualified family-owned small business" for purposes of the statute. Assuming a federal capital gains tax bracket of 20%, X would pay \$2 million in federal capital gains tax and \$682,500 in Washington capital gains tax if X sold the Alpha interest. The same result would occur if Taxpayer X transferred the Alpha interest to a grantor trust and the trustee sold the LLC.

Typically, Taxpayer X might take significant discounts on the value of Alpha as reported on his federal gift tax returns for lack of marketability or lack of control. For simplicity, the value of Alpha remains undiscounted in the discussion below.

#### *A. The Straightforward Options*

There are several relatively simple, straightforward techniques Taxpayer X might pursue to reduce or eliminate his Washington state capital gains tax. The topics in Section III.A are non-transferatory, in that they do not require the client to transfer ownership of their assets. Tactics

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111. Assuming a 20% federal capital gains tax bracket.

112.  $(\$10,000,000 - \$250,000) \times 7\%$ .

in Section III.B involve improved tax savings, but at the sacrifice of legal ownership.

### 1. Changing Domicile

The most straightforward answer to the imposition of a tax throughout history has simply been to leave. Jurisdictional tax arbitrage has, in the international arena, lead to what is called “base erosion.”<sup>113</sup> States historically have sought to keep corporate rates competitive (*i.e.*, low) to incentivize keeping corporate profits within their borders and disincentivize companies from moving profits to offshore low- (or no-) tax jurisdictions, which would otherwise “erode” their tax bases. The effort to counteract this international trend has proven difficult.<sup>114</sup>

A similar effect occurs sub-nationally within the United States, albeit to a lesser extent. Certain states have low (or no) income taxes, which draws individuals and entities with wealth and income that are able and willing to relocate.<sup>115</sup> For example, for individual income taxes, individuals working in New York City could relocate to New Jersey to avoid New York City local taxes and reduce state income taxes. Also, D.C. employees could relocate to Virginia or Maryland to avoid paying the higher D.C. income tax rate. The same sort of tax avoidance may occur with respect to estate taxes, with individuals fleeing high estate tax jurisdictions (*e.g.*, New York, Pennsylvania, Oregon, Washington) to states without estate or inheritance taxes (*e.g.*, Florida, Texas, Arizona).<sup>116</sup>

A taxpayer could simply change domiciles or residences and avoid the Washington capital gains tax. For income tax purposes, domiciliaries are always potentially subject to tax in the state of their domicile.<sup>117</sup> Residents of a state are also generally subject to income tax in that state.<sup>118</sup> “Residency,” for state income tax purposes, is frequently determined by a hard line test based on number of days spent in a given state.<sup>119</sup> The new

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113. See generally Jeffrey M. Kadet, *BEPS: A Primer on Where It Came from and Where It's Going*, 150 TAX NOTES 793 (2016).

114. See, *e.g.*, OECD, *OECD/G20 INCLUSIVE FRAMEWORK ON BEPS*; Rebecca M. Kysar, *Critiquing (and Repairing) the New International Tax Regime*, 128 YALE L.J.F. 339 (2018); Yariv Brauner, *What the BEPS*, 16 FLA. TAX REV. 55 (2014).

115. In the context of trusts, the states of Alaska, Delaware, Nevada, and South Dakota appear as having abolished or greatly reduced the common law rule against perpetuities, eliminated or reduced state income tax for non-residents, and offered strong creditor and spendthrift protections. See, *e.g.*, Jocelyn Margolin Borowsky, *A Comparison of the Leading Trust Jurisdictions*, 37 TAX MGMT. ESTS., GIFTS & TR. J. 233 (2012).

116. Although this may be attributable to a desire for warmer climates in retirement rather than true tax strategy.

117. See JEROME R. HELLERSTEIN & WALTER HELLERSTEIN, *STATE TAXATION* ¶ 20.03 (3d ed. 2001).

118. See *id.*

119. See *id.*

law defines “resident” as an individual who (1) is domiciled in Washington, unless they spent fewer than 31 days in Washington and their permanent place of abode is outside Washington, or (2) maintains a place of abode in Washington and was physically present for more than 183 days during the tax year.<sup>120</sup> Thus, going back to the previous example, Taxpayer X could change his domicile to Alaska and ensure that he spends no more than 183 days in Washington in the year Alpha is sold.

## 2. Netting Losses or Deferring Gain

A client may refuse to change domiciles and decline to transfer control of their assets over to an irrevocable trust.<sup>121</sup> However, such a client may be amenable to timing the sale of assets to net capital gains against various capital losses. The materials written on tax-loss harvesting are multitude.

Where tax cannot be easily avoided, the goal is to defer it to the extent possible. Under Internal Revenue Code Section 453, income from a sale of property with payments over one year is reported under the “installment method,” unless the taxpayer elects immediate gain recognition under Section 453(d).<sup>122</sup> If the circumstances of the deal permit, Taxpayer X could elect to sell Alpha in exchange for equal payments of \$1 million over a ten-year term. Each year, X would report \$1 million in federal taxable gain but only \$750,000 in Washington capital gains. Over ten years, this approach would exclude \$2.5 million from the capital gains tax, for a tax savings of \$175,000 (at a 7% Washington capital gains tax rate). Note that there may be interest charges associated with the installment method, which is discussed in greater detail in Section III.B.3. This approach is relatively inefficient, and it may prove difficult to structure sales of business interests over extended periods.

### *B. Planning Involving Trusts*

The strategies in Section III.B provide improved tax saving options over the straightforward options in Section III.A; however, the following methods critically depend on the client’s willingness to transfer their interest to an irrevocable trust. If the taxpayer cannot be persuaded to part with ownership of the assets, little more can be done aside from the straightforward options listed above.

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120. Capital Gains Tax Act, ch. 196, § 4(10)(a), 2021 Wash. Sess. Laws 1229, 1231.

121. A remarkably frustrating situation where the tax tail cannot seem to wag the dog.

122. 26 U.S.C. § 453.

### 1. Charitable Remainder Trusts

This option is not so much a technique to avoid the Washington capital gains tax as it is an estate planning strategy that avoids all federal and state income and capital gains taxes. Charitable remainder trusts are exempt from federal income taxation.<sup>123</sup> A charitable remainder trust is a “split interest” trust, in which the income interest is paid to one or more non-charitable beneficiaries for a term of years (up to 20 years) or for life, and the remainder interest is held for one or more charitable beneficiaries.<sup>124</sup> The present value of the charitable remainder interest must be at least 10% of the initial value of the property transferred to the trust.<sup>125</sup> The income interest can either be structured as a fixed annuity percentage (a Charitable Remainder Annuity Trust or CRAT) or a variable percentage of the trust assets (a Charitable Remainder Unitrust or CRUT).<sup>126</sup> In either case, the minimum payout percentage must be more than 5% and less than 50%.<sup>127</sup> For CRATs based on a lifetime annuity, the IRS also requires that the trust have less than a 5% chance of exhaustion based on the Section 7520 rate at the time of transfer.<sup>128</sup> Such trusts may avoid this test by including a trust provision that provides that the trust will terminate and transfer all assets to the charitable remainder beneficiary if the assets of the trust fall below 10% of the initial trust assets.<sup>129</sup>

Because almost every state bases its income tax on either federal adjusted gross income or federal taxable income as a starting point for calculating its own taxes, capital gains generated by a charitable remainder trust are also generally exempt from state taxation.<sup>130</sup> Although charitable remainder trusts are not subject to income tax, payments from charitable remainder trusts to the income beneficiaries are generally subject to income tax.<sup>131</sup> The Washington capital gains tax also uses federal capital gains as its starting point.<sup>132</sup> Therefore, in the example provided above, if

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123. 26 U.S.C. § 664(c)(1).

124. *See* Treas. Reg. § 1.664-1(a)(1)(i).

125. 26 U.S.C. § 664(d)(1)(D).

126. *See* 26 U.S.C. § 664(d)(1)–(2).

127. *See* 26 U.S.C. § 664(d)(1)(A), (2)(A).

128. *See* Rev. Rul. 77-374, 1977-2 C.B. 330–31.

129. *See* Rev. Proc. 2016-42, 2016-34 I.R.B. 269.

130. *See* 26 U.S.C. § 664(c)(1).

131. *See* 26 U.S.C. § 664(b). Note that charitable remainder trusts are “split interest” trusts and are treated as private foundations, subject to the restrictions on private foundations and potentially liable for taxes imposed on private foundations in Code Sections 4941, 4943, 4944, and 4945. *See* 26 U.S.C. § 4947(a)(2). All split interest trusts are required to file annual information reports with the IRS (Form 5227). *See* 26 U.S.C. § 6034.

132. *See* Capital Gains Tax Act, ch. 196, § 4(1), (13), 2021 Wash. Sess. Laws 1229, 1230–31. (“Washington capital gains” is based on an individual’s “adjusted capital gains,” which in turn is based on the individual’s “federal net long-term capital gain”).

Taxpayer X transferred his Alpha interest to a charitable remainder trust, the trust's subsequent sale of Alpha would not trigger federal or state taxes.

The annuity payable from the trust is based on the trust term or the annuitant's life expectancy (based on IRS actuarial tables) and the discount rate (based on the statutory rate published each month commonly referred to as the "Section 7520 rate"). Assuming Taxpayer X is age sixty-five and the Section 7520 rate for the month of transfer is 1.0%, X could transfer Alpha to a CRAT paying a 5% annuity for the remainder of his life (\$500,000 per year) and would be entitled to a charitable deduction of \$2,057,850.<sup>133</sup> The CRAT's subsequent sale of Alpha would not result in any federal income taxes or Washington capital gains tax. The annuity distributions would still be subject to federal tax, but would be below the \$250,000 Washington capital gains exemption (assuming the distributions are from trust income).

Charitable remainder trusts may appear unsuitable for assets not currently generating sufficient cash flow, but CRUTs provide additional flexibilities. There are four varieties of CRUTs: (1) fixed-percentage CRUTs (the standard CRUT); (2) net-income CRUTs (sometimes called NICRUTs); (3) net-income with makeup CRUTs (sometimes called NIMCRUTs); and (4) "flip" CRUTs (which starts as a NICRUT or NIMCRUT but converts to a standard CRUT after a specified date or event).<sup>134</sup> A NICRUT and NIMCRUT pays the income beneficiaries a lesser of the trust's income or a percentage of the trust's assets.<sup>135</sup> There is not space here to discuss the nuances of these various types of CRUTs, but as a general matter, a "flip" CRUT would permit Taxpayer X to transfer Alpha to a NICRUT that converts after Alpha's sale to a standard CRUT. The CRUT would only be required to pay X net income from Alpha until Alpha's sale, after which it could pay X a fixed percentage of the trust assets for the remainder of X's lifetime. The value of charitable remainder trusts has been diminished recently due to low Section 7520 rates. However, charitable remainder trusts may be a valuable option depending on the circumstances of a particular client.

## 2. Gifting to a Non-Grantor Trust

The most viable option would be for Taxpayer X to gift his Alpha interest to a non-grantor trust. Each person has a unified federal estate and

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133. This transaction would not satisfy the 5% exhaustion test in Rev. Rul. 77-374, so the contingency provision in Rev. Proc. 2016-42 would be required.

134. See Robert I. Ury, *Charitable Remainder Trusts: An Overview and Selected Topics*, 5 J. TAX PRAC. & PROC. 21, 21-24 (2003); Wendy C. Gerzog, *The Times They are Not A-Changin': Reforming the Charitable Split-Interest Rules (Again)*, 85 CHI.-KENT L. REV. 849, 854-855 (2010).

135. See 26 U.S.C. § 664(d)(3).



gift tax exemption.<sup>136</sup> As of 2021, the exemption is \$11.7 million per person. Taxpayer X would file a U.S. Gift Tax Return (Form 709) reporting the transfer, utilizing \$10 million of X's available exemption. If married to a U.S. citizen, Taxpayer X and his spouse could elect under Section 2513 to treat the transfer as made one-half by each.

As discussed in Section II.B, neither the trustee nor the beneficiaries of a non-grantor trust are likely subject to the capital gains tax. If there are concerns the state may try to impose tax on the trustee, the settlor could name an institutional trustee or a non-Washington trustee (or a non-Washington institutional trustee). Suppose Taxpayer X gifted Alpha to a non-grantor trust managed by an Alaskan trust company. The trustee's subsequent sale of the stock would trigger only federal capital gains tax, taxable either to the beneficiaries (if distributed) or to the trustee (if retained). The trustee's distribution of the net proceeds of the sale to the beneficiaries would not trigger Washington capital gains, even if the beneficiaries are Washington domiciliaries or residents.

One major downside of gifting is that the transferee takes a "carryover" basis in the property received. For example, if Taxpayer X gifted Alpha interests to a non-grantor trust, X would report a taxable gift of \$10 million on their gift tax return and would correspondingly reduce their estate by \$10 million, but the trust would continue to have the same \$0 basis that Taxpayer X had in Alpha. The trustee's sale of Alpha stock in a later year would trigger massive capital gain. Instead, if Taxpayer X held the Alpha stock until his death, when it was worth \$10 million, X's beneficiaries would receive Alpha with a stepped-up basis of \$10 million and the entire built-in gain would be eliminated.

### 3. Installment Sale to Non-Grantor Trust

Rather than gifting Alpha to a non-grantor trust, Taxpayer X could sell the Alpha interest to the trust (*e.g.*, for cash, a promissory note, or a private annuity). If X sold all of the Alpha interest in one year, federal and state capital gains tax would be immediately due. However, if X elected to sell the Alpha interest over an extended period in exchange for installment payments, he could greatly reduce or eliminate his state capital gains tax liability. While it might not be feasible to structure a sale of a business interest to a third party over several years, sale of the company to a non-grantor trust over time may be possible, especially if coupled with gifting.

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136. "Unified" because taxable gifts made during life will reduce the remaining available exemption at death.

As discussed above, the sale of property with payments structured over one year is generally reported under the installment method of Section 453. If Taxpayer X has several years before being ready to consider selling Alpha, he could structure the sale of Alpha to a non-grantor trust in exchange for payments over an extended period. Each year, X would report federal capital gains but only Washington capital gains over the \$250,000 exclusion. Taxpayer X could also structure sales each year, but a single sale in the first year with payments extended over multiple years will shift the appreciation in Alpha over the term to the buyer. The trust's subsequent sale of Alpha will only result in federal capitals gain on any appreciation over the trust's cost basis (*i.e.*, purchase price) from Taxpayer X. However, if the trust sells Alpha before the installment payments to X are completed, all outstanding gain may be accelerated.<sup>137</sup>

The tax code imposes an interest charge for installment sales where the outstanding deferred tax liability exceed \$5 million each year.<sup>138</sup> The \$5 million threshold is doubled for married individuals.<sup>139</sup> The interest charge is based on the underpayment rate at the end of the taxpayer's taxable year.<sup>140</sup> Assuming a 20% capital gains tax rate, the deferred tax liability from Taxpayer X's sale of Alpha would be \$2 million. Therefore, there would be no Section 453A interest charge.

#### 4. Conversion Between Non-Grantor and Grantor Trust

Suppose Taxpayer X engages in one of the transactions described above by transferring his Alpha LLC interests to a non-grantor trust (whether by gift or sale). After the trust's subsequent sale of the Alpha interest—incurring federal capital gains tax, but no Washington capital gains tax—any subsequent income earned by the trust would be taxed at the trust income tax rates, which may be much higher than Taxpayer X's marginal income tax rate. However, it may be possible to convert the non-grantor trust into a grantor trust.

Several practitioners and IRS administrative decisions have addressed “togglng” between grantor and non-grantor status.<sup>141</sup> “[T]he

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137. See 26 U.S.C. § 453(e).

138. See 26 U.S.C. § 453A; Amy I. Kinkaid & Charles E. Federanich, *Application of Interest Charge for Installment Sale Obligations*, THE TAX ADVISOR (July 31, 2014), <https://www.thetaxadviser.com/issues/2014/aug/tax-clinic-06.html> [<https://perma.cc/7BDJ-7YF4>].

139. See TAM 9853002.

140. See 26 U.S.C. § 453A(c)(2).

141. See, e.g., Akers, Blattmachr, & Boyle, *supra* note 48, at 271–78; Howard M. Zaritsky, *Togglng Made Easy—Modifying a Trust to Create a Grantor Trust*, 36 EST. PLAN. 48 (2009); Laura H. Peebles, *Mysteries of the Blinking Trust*, TR. & ESTS., at 16 (Sept. 2008); David L. Case, *Conversion from Non-Grantor to Grantor Trust: Tax Issues*, 46 EST. PLAN. 11 (2019).

most popular method of conversion to a grantor trust is changing the trust by statutory modification or decanting to add a Section 675(4)(C) substitution-of-assets power . . . .”<sup>142</sup> The newly added substitution power will not, by itself, cause inclusion in the grantor’s estate so long as

the trustee has a fiduciary obligation (under local law or the trust instrument) to ensure the grantor’s compliance with the terms of this power by satisfying itself that the properties acquired and substituted by the grantor are in fact of equivalent value and further provided that the substitution power cannot be exercised in a manner that can shift benefits among the trust beneficiaries.<sup>143</sup>

The conversion to grantor trust status should not trigger income tax gain, although there may be little gain remaining after the trust’s sale of the Alpha interests.<sup>144</sup> This conclusion is not entirely immune from the step transaction doctrine.<sup>145</sup>

#### CONCLUSION

The Washington state legislature has sought for years to enact a capital gains tax and finally succeeded this spring. The Washington state constitution imposes a uniformity requirement on property taxes, including income taxes, but not excise taxes. If the legislature expects its characterization of the tax as an excise tax to be respected, the tax can only be applied to the voluntary actions of taxpayers under the state constitution. Based on the tax’s structure and the state definitional requirements of excise taxes, the new capital gains tax should not apply to either the trustees or beneficiaries of non-grantor trusts. The last part of this Article explored several techniques that clients and their advisors may pursue that might reduce or avoid the Washington capital gains tax. The extent to which the Washington state legislature will (or even can) correct these discrepancies remains to be seen.

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<sup>142</sup> See Case, *supra* note 141, at 13.

<sup>143</sup> Rev. Rul. 2008-22, 2008-16 I.R.B. 796; see also I.R.S. Priv. Ltr. Rul.200848006 (Nov. 27, 2008); I.R.S. Priv. Ltr. Rul.200848015 (Nov. 28, 2008); I.R.S. Priv. Ltr. Rul.200848016 (Nov. 28, 2008); I.R.S. Priv. Ltr. Rul.200848017 (Nov. 28, 2008).

<sup>144</sup> See Rev. Rul. 85-13, 1985-1 C.B. 184 (grantor taking a carryover basis in assets after conversion to grantor trust status); I.R.S. Priv. Ltr. Rul. 201730012 (May 1, 2017) (no income tax consequences resulting from agreement to modify non-grantor trust to provide third party with substitution powers causing grantor trust status); I.R.S. Chief Couns. Advice 200923024 (Dec. 31, 2008) (“The conversion of a nongrantor trust to a grantor trust is not a transfer for income tax purposes . . . that requires recognition of gain to the owner.”).

<sup>145</sup> See Case, *supra* note 141, at 14–15. Moreover, there is some risk that the conversion could cause recognition of gain because the beneficiaries’ interests are too substantially modified. See *id.* at 15.