Where Does Your Trust Live?

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Presents

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By:

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I. Difference Between "Principal Place of Administration" and "Resident Trust"

If the context is state trust law, a trust's place of residence is its "situs" or "principal place of administration." The Uniform Trust Code ("UTC") does not explicitly define "principal place of administration" – probably because the term appears to be largely self-defining. A trust's principal place of administration would seem to be the place where most of the trust's administrative acts are carried out, which in most cases (at least those involving an individual sole trustee or a predominant individual co-trustee) would be where the Trustee resides. Other relevant factors include the place where the trust records are kept or trust assets held or, in the case of an institutional Trustee, the place where the trust officer responsible for supervising the account is located. Section 108 of the UTC allows the terms of a trust to designate the principal place of administration if a Trustee's principal place of business is located in or a Trustee is a resident of the designated jurisdiction or all or part of the administration occurs in the designated jurisdiction.

If, however, the context is state income tax law, the status of a nongrantor trust as a resident, or not, of a given state may have nothing to do with where it is administered or where the Trustee resides. To assume otherwise could be a potentially serious mistake. In those relatively few states whose laws do not impose income tax on nongrantor trusts, the concept of a trust's residency for income tax purposes is meaningless. Regarding the remaining states, whether a nongrantor trust is treated as a resident for income tax purposes often determines whether the trust's undistributed income and realized capital gains will be subject to income tax in one or more of such states and generally depends on the presence of one or more of the following factors:

- If the trust was established by will, whether the testator resided in the state at his death;
- If the trust was established by an *inter vivos* instrument, whether the settlor resided in the state at the time the trust was established (if the trust was irrevocable from the moment of establishment) or at the time the trust became irrevocable (if the trust, at the time of establishment, was revocable);
- The location of the trust property;
- Whether the trust is administered in the state;
- Where the Trustee resides;
- Where the beneficiaries reside; and
- Whether the trust instrument provides that the trust is to be governed by the law of the state.

II. Whether a State's Imposition of Trust Income Tax Is Subject to Challenge

A. Constitutional Challenges to a State's Taxation of Trusts

There is a long history of case law addressing whether, under either the Due Process Clause or the Commerce Clause, or under both such clauses, a state may be justified in imposing income tax on a trust where the trust's only contact with the state is the fact that the settlor was a resident of the state at the time of the trust's creation. This question is of particular importance for a client seeking to create a trust in a jurisdiction providing more favorable tax treatment than the client's home jurisdiction or seeking to avoid state income taxation on the trust altogether.

1. Due Process Clause

a. <u>In General</u>. The Due Process Clause requires "some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax." *Miller Brothers Co. v. Maryland*, 347 U.S. 340, 344-345 (1954). A link or connection could exist even without physical presence in the state if the entity being taxed substantially benefited from the state's economic activity and legal infrastructure. In applying this rationale to trusts, courts have based their decisions on whether a state has sufficient "minimum contacts" with the testator or settlor, the Trustees, the trust property and/or the beneficiaries.

In *Chase Manhattan Bank v. Gavin*, 733 A.2d 782 (Conn. 1999), the court considered five trusts created by a Connecticut resident, four testamentary (the "Testamentary Trusts") and one *inter vivos* (the "*Inter Vivos* Trust") (together, the "Trusts"). Connecticut law imposed income taxes on the Trusts for the tax year at issue, 1993, based on the residency in Connecticut of the testator at death or the settlor when property was transferred to the trust if the trust was then irrevocable. CONN. GEN. STATS. § 12-701(a)(4)(C) & (D)(i). The Trustee paid those taxes and then brought a claim against the state seeking refunds, claiming that the Connecticut taxation scheme violated the Due Process Clause (as well as the Commerce Clause; the *Gavin* holding with respect to the Commerce Clause is discussed below). At the relevant time:

- Chase Manhattan Bank ("Chase"), a New York corporation, was the Trustee of all the Trusts.
- Both the current beneficiary and the remainder beneficiaries of the *Inter Vivos* Trust were Connecticut residents. With respect to two of the Testamentary Trusts, Connecticut residents held interests as current beneficiaries and as remainder beneficiaries and, with respect to the other two Testamentary Trusts, no beneficiaries were Connecticut residents.
- All the assets of all the Trusts were outside of Connecticut.
- Chase, as Trustee, had not been subject to any judicial or administrative proceeding in Connecticut, other than in connection with accountings filed with the probate court for three of the Testamentary Trusts.

Regarding the Testamentary Trusts, relying on *Quill Corporation v. North Dakota,* 504 U.S. 298 (1992), the court found that, because Connecticut provided benefits to the Testamentary Trusts such as the laws that allow for the creation of wills and trusts and their administration, as well as a forum for the litigation of disputes concerning wills and trusts, Connecticut had a sufficient connection to the Testamentary Trusts to tax them under the Due Process Clause. *See also*, *District of Columbia v. Chase Manhattan Bank*, 689 A.2d 539 (D.C. App. 1997) (upholding the District of Columbia's taxation of a testamentary trust due the court's "continuing supervisory jurisdiction over the trust since its inception").

Regarding the *Inter Vivos* Trust, the court held that the existence of a Connecticut beneficiary of the trust constituted a sufficient connection to support Connecticut's taxation thereof, because the Connecticut domiciliary "enjoyed all of the protections and benefits afforded to other domiciliaries." Thus, although the court considered this issue a closer one than its consideration of the tax imposed on the Testamentary Trusts, the court held that the tax on the *Inter Vivos* Trust did not violate the Due Process Clause.

Courts hesitate to enforce imposition of income taxes assessed against *inter vivos* trusts where the only connection to the state is the settlor's residence at the time it was created. *See Linn v. Department of Revenue*, 2 N.E.3d 1203 (Ill. App. Ct. 2013), and the discussion of the *Kaestner* and *Fielding* cases below.

b. *Fielding v. Commissioner of Revenue*, 2018 WL 3447690 (Minn. July 18, 2018), *aff'g*, 2017 Minn. Tax LEXIS 28 (Minn.T.C. 2017). Reid V. MacDonald ("Grantor") formed four grantor trusts in 2009 (the "Trusts"), while domiciled in Minnesota. The Trusts were funded with shares of common stock in Faribault Foods, Inc., a Minnesota Subchapter S corporation. The Trustee, trust administration, and all but one of the beneficiaries of the Trusts were always located outside of Minnesota.

In 2011, the Grantor relinquished the power to substitute trust assets, and the Trusts became irrevocable. Under Minnesota Statute § 290.01, subd. 7b(a)(2), Minnesota law defined a "resident trust," in part, as "an irrevocable trust, the grantor of which was domiciled in this state at the time it became irrevocable." At the time the Trusts became irrevocable, the Grantor was domiciled in Minnesota.

In 2014, the trusts received income from investments as well as gains from the sale of stock. The Minnesota Commissioner of Revenue took the position that the trusts were "resident trusts" under Minnesota's statutory definition of "resident trust." The Trustee's view was that Minnesota's statutory definition of "resident trust" violated the due process provisions of the Minnesota and United States Constitutions.

The Supreme Court of Minnesota observed that due process analysis imposes two constraints on state taxation. There must be both "a minimum connection" between the state and the person, property or transaction subject to the tax and a rational relationship between the income subject to the tax and the benefits conferred on the taxpayer by the State. The court found that Minnesota's "resident trust" definition failed the due process analysis for three reasons.

First, the court held that the Grantor's residence at the time the Trusts became irrevocable was "not relevant to the relationship between the Trusts' income that Minnesota seeks to tax and the protection and benefits Minnesota provided to the Trusts' activities that generated that income. The relevant connections are Minnesota's connection to the trustee, not the connection to the grantor who established the trust years earlier." Thus, the court looked largely to each Trust's independence as a legal entity, separate from the Grantor or beneficiary. *See Greenough v. Tax Assessors of Newport*, 331 U.S. 486 (1947).

Second, the trusts owned no physical property in Minnesota that might serve as a basis of taxation. *See, e.g., Westfall v. Dir. of Revenue*, 812 S.W.2d 513 (Mo. 1991). The trusts owned interests in intangible property (the stock of a Minnesota company), but those intangible assets were held outside Minnesota.

Third, the court did not find relevant any contacts with Minnesota by the Grantor, the trusts or the beneficiaries, that occurred prior to the tax year at issue. Citing *Luther v. Commissioner of Revenue*, 588 N.W.2d 502 (Minn. 1999), the court stated that the facts relevant to evaluating the sufficiency of a taxpayer's contacts are drawn from the tax year at issue.

The Minnesota Commissioner of Revenue filed a petition for certiorari with the United States Supreme Court on November 15, 2018.

2. Commerce Clause

A tax does not violate the Commerce Clause so long as it: (a) is applied to an activity with a substantial nexus with the taxing state; (b) is fairly apportioned; (c) does not discriminate against interstate commerce; and (d) is fairly related to the services provided by the state. *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977). In *Quill*, *supra*, the Supreme Court differentiated the "minimum contacts" test from the "substantial nexus" test by stating that due process requirements address whether an individual's connections are substantial enough to legitimize the exercise of state power but that the Commerce Clause addresses structural concerns about the effects of state regulation on the national economy. Presence in the state can be one that is not related to the activity being taxed.

The *Gavin* court found that Connecticut did not violate the Commerce Clause by imposing its income tax on the trusts at issue because the risks associated with subjecting trusts to income tax imposed by multiple states on intangibles were too remote and speculative to constitute a violation of the Commerce Clause.

B. State Statute That Taxed Trust Income Solely Based on Residence of Beneficiary Violates Due Process Clause As Applied

Kimberly Rice Kaestner 1992 Family Trust v. North Carolina Dept. of Revenue, 814 S.E.2d 43 (N.C. June 8, 2018), *aff'g*, 789 S.E.2d 645 (N.C. App. 2016)

A trust was established in 1992 of which the settlor and the initial Trustee were both residents of the State of New York. The trust instrument provided that New York law was to govern. The successor Trustee of the 1992 trust and initial Trustee of three trusts resulting from a division, in 2002, of the 1992 trust was a Connecticut resident. In 1997, one of the beneficiaries, Kaestner, became a North Carolina resident. One of the trusts that came into existence in the 2002 division of the 1992 trust was for the benefit of Kaestner and her children, all of whom resided in North Carolina from 2005 to 2008, the tax years at issue.

From 2005 to 2008 the assets of the trust for the benefit of Kaestner and her children (the "Kaestner Trust") were held by a custodian in Boston, Massachusetts. The ownership documents pertaining to all trust assets, along with all the trust's financial books and legal records, were located in New York. Tax returns and trust accountings were prepared in New York. All distributions from the Kaestner Trust were to be made, if at all, by the Trustee in his discretion. Neither Kaestner nor her children received distributions from the Kaestner Trust between 2005 and 2008. Kaestner did receive proceeds of a loan from the Kaestner Trust in 2009. Kaestner and the Trustee twice met in New York during the tax years in question to discuss trust investments and whether Kaestner wished to receive distributions. In 2009, following a request from Kaestner, the Trustee transferred the Kaestner Trust's assets to a new trust, the KER Family Trust.

North Carolina law provides that the State may tax the income of a trust "that is for the benefit of a resident of [North Carolina]." N.C. GEN. STAT. § 105-160.2. Accordingly, each year, from 2005 to 2008, the Kaestner Trust paid North Carolina income tax. In 2009, the Trustee filed a claim for a refund of the taxes paid, which the North Carolina Department of Revenue denied in 2011. The Kaestner Trust then sued the Department of Revenue alleging the North Carolina statute imposing income tax on a trust for the benefit of a North Carolina resident was unconstitutional under the Due Process and Commerce Clauses of the United States Constitution as well as Article I, Section 19 of the North Carolina Constitution. The Commerce Clause argument wasn't addressed by the Court of Appeals of North Carolina and therefore wasn't addressed in the Supreme Court of North Carolina decision.

The Supreme Court of North Carolina noted that the Due Process Clause requires "some definite link, some minimum connection, between a state and a person, property or transaction [the government] seeks to tax." In addition, the court observed that "the income attributed to the State for tax purposes must be rationally related to values connected with the taxing State." The court stated further that "it is essential in each case that there be some act by which the [party] purposefully avails itself of the privilege of conducting activities within the forum State, thus invoking the benefits and protections of its laws." In its analysis, the court emphasized as "critical" that the Kaestner Trust and its beneficiaries have legally separate, taxable existences and that it was the beneficiaries, and not the Kaestner Trust, that were North Carolina residents and so reaped the benefits and protections of North Carolina's laws. The court therefore concluded that the beneficiaries' contact with North Carolina was insufficient to satisfy the requirements of due process and ruled that the statute at issue was unconstitutional as applied to the Kaestner Trust.

The United States Supreme Court granted certiorari on January 11, 2019. 139 S.Ct. 915 (Mem). Oral arguments occurred on April 15, 2019.

III. Selecting or Determining a Trust's Governing Law and Situs

A. Factors to be Considered Regarding Situs and Governing Law While Designing the Trust Instrument

When drafting a trust instrument, consideration should be given to the most suitable initial situs and governing law for the trust. This involves choosing which state's law will apply and analyzing the state law consequences of: (1) the Trustee designation; (2) the nature and location of the trust assets; and (3) the residence of the beneficiaries. Sager & Terebelo, "Down the Rabbit Hole and Through the Looking Glass: The Wonderland of Trust Situs and Governing Law," AMERICAN COLLEGE OF TRUST AND ESTATE COUNSEL, Annual Meeting (2019).

The settlor's intent is generally enforced by courts when determining a trust's situs and governing law. Thus, the trust instrument should include clear statements of the settlor's intent regarding both the situs and governing law of the trust. Regarding the designated state law that will govern the validity of the trust and construction of its terms, the practitioner should also ensure that the trust has sufficient contacts with that state.

Thus, determination of a trust's situs and governing law will usually begin with a consideration of the client's objectives. Some clients wish to prevent (or at least obviate the requirement of) diversification of a certain holding of stock, control the disposition of small business interests, keep the trust assets (or even knowledge of the trust) away from certain beneficiaries until they reach a certain age, etc. The practitioner should seek to ensure that the situs and governing law will promote these objectives. Delaware, therefore, will often be a favorable jurisdiction because trust provisions regarding those matters will be respected more often in Delaware than in most other states. 12 Del. C. § 3303(a). In contrast, as mentioned above, UTC jurisdictions and some other states allow beneficiaries to amend or terminate trusts in certain circumstances. *See, e.g.*, UTC § 411(b); Wash. Rev. Code § 11.96A.210-320. Once a favorable situs and governing law has been selected and designated in the trust instrument, it may be desirable to include additional language that would prevent a change in situs or governing law that would be contrary to the client's objectives. Kamin, "A Modern View of Settlor Intent," AMERICAN COLLEGE OF TRUST AND ESTATE COUNSEL, Annual Meeting (2019).

Because the duration of a trust can extend over several generations, it is important for the practitioner drafting the trust instrument to provide the Trustee with the ability to move the trust's situs or to grant the Trustee the power to make the laws of another jurisdiction applicable to the trust. The trust instrument should state, if the trust situs changes, whether that consequently causes a change in the governing law of the trust as well (or vice versa).

The practitioner should consider the trust's situs and governing law not only during the design phase but also when there are major changes in trust assets or a change in the domicile of a Trustee or beneficiary.

B. Aspects of Trust Administration Affected by Situs and Governing Law

A trust's situs and governing law affects many additional important issues that arise in estate planning, such as the following:

1. **State Estate Taxes.** Only 13 jurisdictions currently have some form of state estate or inheritance tax. Fox, "State Death Tax Chart," https://www.actec.org/resources/state-death-tax-chart (1/26/2019). Therefore, there are many states to which a client may transfer certain assets, or to which a client may change domicile, to avoid state estate tax. Typically, the state in which real property is located has exclusive jurisdiction to assess an estate tax on such property. Tangible personal property and intangibles are generally subject to the estate tax of the decedent's domicile but in some cases may be subject to tax in the state in which such property is located. Bogert, et al., 15 BOGERT'S THE LAW OF TRUSTS AND TRUSTEES (June 2018) § 287 (hereinafter "Bogert").

If a client lives in a state with no state estate tax and holds tangible personal property or intangibles with a situs in a state that does impose a state estate tax, the client and the client's advisor may consider transferring such assets into a revocable trust. This maneuver may change the situs of such assets to the state of the client's residence, especially if the trust instrument contains language designating the trust's situs. This same result can sometimes be accomplished by transferring assets to a limited liability company ("LLC"), a limited partnership ("LP") or a corporation. Similarly, real estate that is located in a state that does impose a state estate tax and is owned by an individual who is domiciled in a state that does not impose a state estate tax could be transferred to a LLC, LP or corporation. The owner will then hold an interest in an intangible, which will change the situs of the real estate. *See* Pratt & Stern, "Estate Planning Considerations for Migratory Clients," EST. PLN., Sept. 2007, at 16. Depending on the nature of the entity and other factors, this strategy may avoid imposition of a state death tax with respect to the real estate.

2. **Rule Against Perpetuities.** Which states have abolished the rule against perpetuities has a significant impact on dynastic planning. Several states have abolished the rule, including South Dakota (S.D.C.L. § 43-5-8), Idaho (Idaho C. § 55-111) and Delaware (25 Del. C. § 503). A client may be able to designate a trust's governing law for purposes of avoiding the rule against perpetuities without such designation's not being respected. RESTATEMENT (SECOND) OF CONFLICT OF LAWS §§ 269 cmt. d & f, 277, cmt. b.

3. **Privacy.** States also differ in the privacy protections given trust instruments. A South Dakota statute, for example, allows a Trustee, settlor or beneficiary to petition a court to seal trust instruments and related documents. Upon the filing of the petition, the statute requires these documents to be sealed. S.D.C.L. § 21-22-28.

4. **Asset Protection.** Asset protection is another common client objective that can vary from state to state. The practitioner should determine whether and to what extent spendthrift provisions are valid and, if valid, the extent to which they will protect trust interests from the claims of creditors under the law of the state of administration of the trust. In general, the law that determines whether creditors may reach a beneficiary's interest in a trust is the law designated by the trust instrument. RESTATEMENT (SECOND) OF CONFLICT OF LAWS §§ 273, 280.

State laws vary on their protection of assets from creditors' claims such as retirement benefits and life insurance proceeds. *See, e.g.*, NY EP&TL § 7-3.1 (retirement assets); FSA § 222.13 (life insurance proceeds). In addition, 17 states permit domestic asset protection trusts. Trustees might have an obligation to explore moving a trust to a jurisdiction that provides improved asset protection. *See, e.g.*, *In re Joseph Heller Inter Vivos Trust*, 613 N.Y.S. 2d 809 (1994).

5. **Trust Directors**. The settlor should also consider establishing a trust in a state that permits the settlor to designate a trust director, or trust protector, to be responsible for distribution, investment and/or administrative responsibilities. *See, e.g.*, Tex. Prop. Code Ann. § 114.0031; UTC § 808; *see also* Gordon, "It's Not My Fault! The Devil Made Me Do It. Fiduciary Liability Under the Uniform Directed Trust Act," AMERICAN COLLEGE OF TRUST AND ESTATE COUNSEL, Annual Meeting (2019).

IV. Mechanics of Establishing Trusts in a Jurisdiction or Moving to Another Jurisdiction

A. Changing a Trust's Situs and Governing Law

1. **Governing Law of a Trust.** Even if a trust's situs is moved, a change in the governing law is a separate question. The difference between the governing law of a trust and the situs of a trust is that the governing law is the particular legal system governing the validity, construction and effect of the trust instrument, while situs usually refers to the jurisdiction in which trust assets are physically located or where the trust is "grounded" or has its "foundation" or the principal place of its administration. The law of the situs generally governs trust administration matters (*e.g.*, Trustee liability, trust accountings, characterizing of beneficial interests and compensation). *See* Bogert, §§ 291, 295, 296, 297; *see also* UTC §§ 107 & Cmt., 108 & Cmt., 403 & Cmt.

Language in the trust instrument stating the governing law of the trust will usually be honored. RESTATEMENT (SECOND) OF CONFLICT OF LAWS §§ 268-270, 277. It may be beneficial for the trust instrument to specify that, if there is a change in situs, the laws of the transferee state will apply. If situs is transferred and the governing law is not transferred, if such a provision is not included, a conflict-of-laws analysis must be applied, which will depend on whether the issue involves a matter of trust validity, construction or administration, whether the trust is an *inter vivos* or testamentary trust and whether real property or personal property is involved. The primary factors in these determinations are often the jurisdiction designated in the trust instrument, the trust's connections with such jurisdiction and the location of any real property.

RESTATEMENT (SECOND) OF CONFLICT OF LAWS §§ 267-282; *see* Nenno, "Choosing and Rechoosing the Jurisdiction for a Trust," 40 PHILIP E. HECKERLING INSTITUTE ON ESTATE PLANNING (2006); Sparks, "Here Today, Gone Tomorrow: Trust Law Situs and Jurisdiction Considerations," AMERICAN COLLEGE OF TRUST AND ESTATE COUNSEL, 2006 Fall Meeting.

2. Moving the Situs of a Trust. To change a trust's situs from one jurisdiction to another, the practitioner must analyze the rules and procedures regarding trust situs in both jurisdictions. The steps that must be taken will be based on which characteristics of the trust need to be changed to fall outside the reach of the jurisdiction in which the trust originated.

The transfer of a trust's situs might be accomplished through a provision in the trust instrument, by statute or a court petition. A detailed governing instrument provision setting forth a procedure for the removal and replacement of a Trustee without a court proceeding may be all that is needed effectively to change the trust's situs. However, the situs with respect to real estate held by the trust may not be affected by this change. The trust instrument should also allow Co-Trustees to be appointed for the purpose of administering property that will be subject to the laws of another state. Nenno, "The Trust From Hell, Can it be Moved to a Celestial Jurisdiction?" PROB. & PROP., May/June 2008, at 60. If the trust instrument does not contain sufficient provisions regarding the removal and replacement of Trustees, or appointment of a Co-Trustee, to effect a change in trust situs, the Trustee may need to seek approval from a court to replace the Trustee or to appoint a Co-Trustee. Alternatively, if the governing instrument provides one or more beneficiaries with powers of appointment, the powers may be exercised in a manner that will move the trust's situs without court intervention.

If the settlor has designated a particular trust situs or the law of a particular state to govern the trust, courts have denied requests for the transfer of a trust situs. If no provision in the trust instrument prohibits the transfer, however, a court will usually grant the transfer of situs as long as the transfer will facilitate trust administration and will be in the beneficiaries' best interests. *See, e.g.*, *Estate of McComas*, 630 N.Y.S.2d 895 (1995); *Beardmore v. JP Morgan Chase Bank, N.A.*, 2017 Ky. App. LEXIS 60 (Ct. App. March 31, 2017); Bogert § 861; *but see Harold J. Allen Trust Number Three v. Brook*, 728 N.W.2d 60 (Iowa App. 2006) (trust provision allowing change of situs not upheld by court because allowing the attempted situs change to Canada in this case would frustrate grantor's overall intent).

A change of situs and governing law may be part of a modification of the trust's terms. For example, a Trustee may be able to take advantage of the more liberal decanting rules of another state. In New York, a Trustee is prohibited from altering a mandatory income interest through a decanting. NY EP&TL § 10-6.6(n). If a Trustee of a New York trust wished to reduce a fixed income interest, the Trustee could decant the trust so that the trust will be governed by South Dakota law, which does allow a Trustee to decant a trust to reduce a fixed income interest. S.D.C.L. § 55-2-15 (as long as the fixed income interest is not part of a marital deduction trust, a charitable remainder trust or a grantor retained annuity trust). A second decanting could then take place to accomplish the Trustee's objective. U.S. Trust, Bank of America Private Wealth Management, "State Decanting Statutes," Practical Drafting (Jan. 2008).

3. Relevant Uniform Trust Code Provisions. As discussed above, the UTC provides for a trust's change of its "principal place of administration," which is defined as the Trustee's principal place of business or residence or the place where all or part of the trust's administration takes place. UTC § 108(a). UTC § 108(b) imposes a duty upon the Trustee to administer the trust "at a place appropriate to its purposes, its administration, and the interests of the beneficiaries." A Trustee has the power to move a trust, but such power may be subject to court approval. The Trustee must also provide qualified beneficiaries sixty days' notice of the proposed transfer. Such notice must state, among other items, the reason for the proposed transfer. The Trustee's power under this section to transfer the trust's principal place of administration terminates if a qualified beneficiary objects to the proposed transfer within the time period stated in the notice. UTC § 108(c)-(e). The Comment to this Section explains that the transfer of the principal place of administration will usually change the governing law as well, but only with respect to administrative matters and not with respect to the validity of the trust and the construction of its dispositive provisions. *See also* 5A Austin Wakeman Scott, William Franklin Fratcher & Mark L. Ascher, SCOTT AND ASCHER ON TRUSTS, Section 615 (5th ed. 2008).

The Comment to UTC § 108 also explains that "[d]esignating the principal place of administration should be distinguished from designating the law to determine the meaning and effect of the trust's terms, as authorized by Section 107." UTC § 107 allows a settlor to designate the governing law for the meaning and effect of the trust provisions unless the law selected is contrary to a "strong public policy of the jurisdiction having the most significant relationship to the matter at issue." *See, e.g.*, *Dahl v. Dahl*, 2015 UT 79, 2015 WL 5098249 (2015) (choice of law provision in trust instrument disregarded because of Utah's public policy regarding the equitable distribution of assets upon divorce). The Comment to UTC § 107 states that "[t]he jurisdiction selected need not have any other connection to the trust."

When the settlor's intent is not expressed or when there is the potential that the chosen state will be rejected on public policy grounds, the Comment to UTC § 107 establishes the following guidelines for determining which state has the most significant relationship to a trust and therefore will constitute its governing law:

> Factors to consider in determining the governing law include the place of the trust's creation, the location of the trust property, and the domicile of the settlor, the Trustee, and the beneficiaries. Other more general factors that may be pertinent in particular cases include the relevant policies of the forum, the relevant policies of other interested jurisdictions and degree of their interest, the protection of justified expectations and certainty, and predictability and uniformity of result.

As with many provisions of the UTC, several states have made significant changes to both UTC §§ 107 and 108. New Hampshire and Tennessee modified UTC § 108(e) to require a majority of the qualified beneficiaries to object to terminate the authority of the Trustee to transfer the place of administration. N.H. Rev. Stat. § 564-B:1-108; T.C.A. § 35-15-108. Oregon modified UTC § 108(a) to state that the principal place of administration as stated in the trust instrument is valid if "[o]ther means exist for establishing a sufficient connection with the designated state, county or other jurisdiction." O.R.S. § 130.022. Nebraska, concerned that the law of another state would be used to determine the governing law of real estate located in Nebraska, states in its version of UTC § 107 that "[t]he meaning and effect of the terms of a trust that pertain to title to Nebraska real estate are determined by the law of Nebraska." NE Stat. § 30-3807. Finally, Utah's statute provides for a completely different governing law provision, stating that the determination of the governing law for a trust primarily depends upon whether the trust is administered in Utah. U.C.A. § 75-7-107.

B. Changing a Trust's Residency to Avoid State Income Tax

At the outset of or during administration of a nongrantor trust, the Trustee may wish to think about whether a change in the place of administration (which will often require replacement of the existing Trustee) could enable the trust to avoid or minimize state income tax. The Trustee may conclude that, even if a change in the place of administration could enable the trust to avoid or minimize state income tax, there are real, meaningful, countervailing non-tax benefits, such as the Trustee's long-standing familiarity with and proximity to the beneficiaries, or the Trustee's special skills in dealing with unique trust assets, arising from retaining the trust's current place of administration. Moreover, if the trust was established by a testator or settlor who resided in a state whose laws impose trust income tax based on the testator's domicile upon death or the settlor's domicile upon the trust becoming irrevocable, avoidance or minimization of state income tax may not be possible in any event.

To change a trust's tax residency for state income tax purposes, the Trustee and his, her or its advisors must analyze the rules and procedures regarding trust tax residency in the existing and prospective jurisdictions of residence. In addition, the steps that must be taken will be based on which characteristics of the trust need to be changed to take the trust outside the scope of the resident state's taxation statute and establish it as having a tax residency in the target state. In addition, the Trustee should also determine whether the desired benefits available are significant enough to justify the costs and risks that will be incurred in connection with the change of tax residency.

States that tax trusts based on the tax residence of the Trustee, tax residence of the beneficiary or any other factor besides the tax residence of the individual who created the trust, provide much more flexibility in changing the tax residence of the trust for income tax purposes. *See* Michaels & Twomey, "How, Why, and When to Transfer the Situs of a Trust," 31 ESTATE PLANNING 28 (Jan. 2004) (hereinafter, "Michaels & Twomey"). For example, if a state's law requires a trust not to have a resident Trustee to avoid state income tax, such as California, Kentucky and Arizona, the practitioner must: (1) determine if the current Trustee is willing to resign or may be removed, (2) locate a suitable out-of-state Trustee and (3) coordinate the change of Trustees. This process will generally not involve a court proceeding, assuming the trust instrument or state law permits the resignation or removal of the Trustee and provides a non-judicial mechanism for the appointment of a successor Trustee.

The advisor must ensure that the steps taken to change a trust's tax residency do not inadvertently cause the trust to be subject to state income tax elsewhere. For example, the advisor would presumably seek to avoid designation of a new Trustee situated in, say, Colorado, whose laws subject a trust to income taxation if the trust has its place of administration there. Colo. Rev. Stat. § 39-22-103(10).

If for some reason a trust's tax residency cannot be transferred so that the trust is not subject to state income tax at all, a state that taxes trust income based on the residence of the testator or settlor at the trust's inception might be an appropriate state to which to transfer the tax residency of such trust because a trust created by a nonresident of such state will generally be subject to tax only on the income derived from sources in that state.

Trustees and their advisors should also consider dividing trusts to the extent allowable under the law of the applicable state (*see, e.g.*, Uniform Trust Code § 417) to minimize exposure to a state's income tax. Dividing a trust into separate trusts for each beneficiary may be more equitable to beneficiaries and preserve part of the trust against state income tax. For example, a trust is subject to Missouri income tax only if the trust has a resident income beneficiary on the last day of the taxable year. If a trust has two beneficiaries, one a Missouri resident and the other a resident of Texas (which does not impose an income tax on trusts), dividing the trust so that one share is held for the sole benefit of the Missouri beneficiary and other share is held for the sole benefit of the Texas beneficiary will preserve the trust for the Texas beneficiary from Missouri state income tax. Sherby, "It May Not be Broken, But it May Need Fixing: Techniques, Tools and Pitfalls in Changing the Trust (Selected Issues in Division, Merger, Change of Situs, Construction, Instruction, Reformation and Modification Actions)," FALL MEETING OF THE AMERICAN COLLEGE OF TRUST AND ESTATE COUNSEL, Fall Meeting (2009).

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