

Trustee's Duty to Minimize State Income Taxes

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Take-Away: A trustee has a duty to change the situs of the Trust it administers to minimize, or completely avoid, the imposition of state income taxes on the Trust's accumulated income. While other factors also need to be considered when selecting the law that governs a Trust, minimizing state income taxes should be a major consideration.

Background: The past few years has brought a lot of attention to the topic of a Trust's obligation to pay state income taxes. First, the U.S. Supreme Court in *North Carolina Department of Revenue v. Kaestner 1992 Family Trust* June 21, 2019) held that the state could not tax an irrevocable Trust with few, if any, contacts with the state. Then the strategy of INGs, or incomplete non-grantor trusts, gained nationwide attention, which seeks to avoid state income taxes on income that is accumulated in a non-grantor Trust, where neither the trustee nor the trust beneficiaries are in that state. We often refer to them as DINGs, for Delaware Incomplete Non-Grantor Trusts, which were aggressively used to avoid New York's high state income tax on Trusts. But then a couple of high state income tax states, e.g., New York and California, responded with statutes that effectively negate the state tax-savings results of an ING Trust. Alaska, Florida, Nevada, South Dakota, Texas, and Wyoming do not have state income taxes. And in Delaware, the trustee of a Delaware Trust created by a nonresident does not have to file Delaware returns or pay Delaware income tax if there are no Delaware resident beneficiaries. [30 Del Code Ann. Tit. 30, Sections 1605(b), 1636.] So, there may be a lot of states that could be used to avoid, or minimize, the incidence of state income taxes on a Trust's undistributed income.

Questions: This recent activity surrounding the state income taxation of Trusts prompts the questions:

- (i) Does a trustee have an affirmative fiduciary duty to minimize state income taxes about its Trust?

- (ii) If there is such a duty, must the trustee move the situs of a Trust to a jurisdiction to minimize, or possibly avoid, the imposition of state income taxes on the Trust's accumulated and undistributed Income?

Michigan Trust Code: Like 36 other states, Michigan adopted various provisions of the Uniform Trust Code (UTC), including Section 108(b). MCL 700.7108(2) provides: *"A trustee is under a continuing duty to administer the trust at a place appropriate to its purposes, its administration, and the interests of the qualified trust beneficiaries."* This continuing duty is supplemented in the Michigan Trust Code (MTC) at MCL 700.7802(1) which provides that the trustee *"shall administer the trust solely in the interests of the trust beneficiaries."*

Affirmative Duty? While UTC section 108(b) does not impose an affirmative duty on a trustee to re-situs its Trust to a jurisdiction to avoid state income taxes, it is interesting to note that the various states that adopted the UTC, but not all of the language of Section 108(b), omitted some UTC language reasoning that it, in fact, the omitted language implied a duty that the trustee must consider the laws of all conceivable jurisdictions to which the situs of a Trust may be moved and established and re-established. [e.g., Pennsylvania; North Carolina. Perhaps which prompted this concern is the Comment to UTC 108 which observes:

- UTC Comment: *"Locating a trust's principal place of administration will ordinarily determine which court has primary if not exclusive jurisdiction over the trust. It may also be important for other matters, such as payment of state income tax or determining the jurisdiction whose laws will govern the trust. Subsections (c)-(f) provide a procedure for changing the principal place of administration to another state or country. Such changes are often beneficial. A change may be desirable to secure a lower state income tax rate, or because of relocation of the trustee or beneficiaries, the appointment of a new trustee, or a change in location of the trust investments."* [UTC Section 108 Comment.]

Restatement of Trusts: The Restatement (Third) of Trusts also refers to the trustee's duty to administer the Trust in accordance with its terms and applicable law. Section 76 of this Restatement provides the following comment:

“A trustee’s duty to administer a trust includes an initial and continuing duty to administer it at a location that is reasonably suitable to the purposes of the trust, its sound and efficient administration, and the interests of its beneficiaries...Under some circumstances the trustee may have a duty to change or to permit (e.g., by resignation) a change in the place of administration. Changes in that place of administration by a trustee, or even the relocation of beneficiaries or other developments, may result in costs or geographic inconvenience serious enough to justify the removal of the trustee.” Restatement (Third) of Trusts Section 76, (2003).

Conclusion: It would appear from these legal authorities that a trustee has a continuing legal duty to minimize state income taxes. These objective benefits both current and future trust beneficiaries, particularly if it leads to more assets held in the Trust, and more future income produced by those additional assets. By designating the law of another state to govern their irrevocable Trust, like Delaware, a settlor can retain local advisers and escape Michigan income taxes, except on Michigan-based income, if any.