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FIDUCIARY ISSUES IN 1041s

Estate Planning in recent years has shifted in many ways from Federal Estate Tax Planning to income tax planning for capital gains tax and state income tax. The game has often been to try and eliminate capital gains through utilization of a second step-up at the surviving spouse's death or other methods of estate inclusion for former credit shelter trusts that are in desperate need of a basis step-up before proceeding to the next generation. The federal estate tax credit has been plentiful and portability has allowed for significant capital gains planning without sacrificing federal estate tax.

As capital gains techniques were honed, the additional frontier of achieving optimal state income tax treatment of trusts was embraced by planners eager to additionally reduce a trust's tax burden by shifting situs of a trust to states that have no state income tax.

In light of potential changes to capital gains tax treatment, and the already existing push to get trusts into states with no or low state income tax rates, it is worthwhile to take a look at what fiduciaries need to be thinking about regarding minimizing taxes and considerations of governing jurisdictions.

I. THINKING ABOUT FIDUCIARY DUTIES AND STATE INCOME TAX

There is at least one commentator who believes that there is a fiduciary "duty" to minimize the state income tax of trusts.[1] For this proposition, the commentator cites to § 76 of the Third Restatement of Trusts which contains 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 the 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 removal of the trustee.[2]

The discerning reader would note that nowhere within that citation appears the word "tax". Having stated that, one could imagine an aggressive beneficiary coopting the above language in an effort to argue that a particular state's tax laws are not "suitable to the purposes of the trust." Given the appellate court in Iowa's fairly frequent citation to the Restatement (Third) of Trusts this is not a line of argument that is entirely dismissible out of hand. If there is potential line of attack under the Restatement (Third) of

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[1] Richard Nenno, *From Sea to Shining Sea: Understanding the Landscape of the State Income Taxation of Trusts and Planning to Minimize Tax* Exposure, ACTEC Virtual Meeting, March 2021, Page 150.
[2] Id. Citing to Restatement (Third) of Trusts § 76 cmt. b(2) (2003) .

Trusts as a supposed restatement of the common law that is in existence, are there elements of Iowa's statutory trust law that help clarify things for fiduciaries in Iowa concerned that they have to move all irrevocable trusts to South Dakota.

Iowa Code 633A.6105 contains the Iowa Trust Code's statutory consideration of appropriate trust jurisdiction.

633A.6105 Transfer of jurisdiction.

1. The court may transfer the place of administration of a trust to or from this state or transfer some or all of the trust property to a trustee in or outside this state if it finds that the transfer of the trust property to a trustee in this or another jurisdiction, or the transfer of the place of administration of a trust to this or another jurisdiction, **will promote the best interests of the trust and those interested in it, taking into account the economical and convenient administration of the trust and the views of the qualified beneficiaries.**

2. A new trustee to whom the trust property is to be transferred shall be qualified, willing, and able to administer the trust or trust property under the terms of the trust.

3. If the trust or any portion of the trust property is transferred to another jurisdiction and if approval of the transfer by the other court is required under the law of the other jurisdiction, the proper court in the other jurisdiction must have approved the transfer in order for the transfer to be effective.

4. If a transfer is ordered, the court may direct the manner of transfer and impose terms and conditions as may be just, including a requirement for the substitution of a successor trustee in any pending litigation in this state. A delivery of property in accordance with the order of the court is a full discharge of the trustee with respect to all property specified in the order.

5. If the court grants a petition to transfer a trust or trust property to this state, the court shall require the trustee to give a bond, if necessary under the law of the other jurisdiction or of this state, and may require bond as provided in section 633A.4102.

6. **Without precluding the right of the court to order, approve, or disapprove a transfer, the trustee, in furtherance of the trustee's duty to administer the trust at a place appropriate to its purpose or administration, and the interests of the beneficiaries, may transfer the trust's principal place of administration to another state or to a jurisdiction outside the United States**.

Iowa Code 633A.6105 (emphasis added)

The above language certainly does not stand for the proposition that every trustee has a duty to now set up a blind irrevocable trust in the Cayman Islands ("jurisdiction outside the United States") to reduce trust income taxes to the lowest possible rate. Importantly, Iowa Code 633A.6105 notes that the court is take into account the "views of the qualified beneficiaries" along with "convenient administration of the trust."

All lawyers and professionals have made suggestions that would save clients money and taxes, and then had those clients reject such suggestions in favor of things like simplicity and convenience among others. All this to say that the "views of the qualified beneficiaries" may be that they already like trust administration in its current convenient local form, even if there could be savings gained from moving

trust administration to a different state or country. Therefore, if the beneficiaries are happy and informed, 633A.6105 does not seem to indicate that a trustee has a duty to move a trust to a different jurisdiction if the beneficiaries are already happy.

Do the beneficiaries have to be consistently put on notice by the trustee of potential advantages in changing taxing jurisdictions in order for the qualified beneficiaries to be able to make informed "views" regarding taxing jurisdiction? In some ways, the trust document may help with this notice question. If the trust document has been provided to the beneficiaries, and the trust document contains a provision for how a trustee can be changed, it would not seem to be additionally necessary for a trustee to have the additional duty to specifically explain that some states have lower taxes and if the beneficiaries utilized the trustee change provisions of the trust they could achieve lower taxes by moving the trust to a trustee in another state. In this hypothetical, the beneficiaries have received the trust document and therefore are already on notice that they can change trustees (assuming such provisions which are in most every trust). In addition, differing tax rates in different states is commonly available knowledge that beneficiaries have their own access to. Obviously, if the trustee is specifically asked by the beneficiaries about changing the state income tax jurisdiction, the trustee will not be able to hide their knowledge of these kind of provisions. If the trustee reasonably believes that the beneficiaries put the convenience of the trust administration at a high value, the spirit of 633A.6105 seems to be that convenience can be recognized as such in seemingly superseding the factor of the lowest possible state taxes.

At this point it is obvious that not all trusts or beneficiaries are the same, let's walk through the following scenarios:

1) Beneficiaries never mention state income tax or changing to a different state, administration proceeds regularly, state taxes paid without beneficiary concerns, and it just has not come up. Does the Trustee have to bring up changing state tax jurisdictions if **a)** the beneficiaries can change trustees under the document; **b)** no trust provision for the beneficiaries to change trustees, but the trustee can change situs; **c)** a trust protector has been given the right to remove a trustee or change situs under new 633A.4804; **d)** the trust is completely silent about changing jurisdiction, but has a provision that says the trust is to be governed by Iowa law.

   1(a) This is a common situation. As indicated above, I want to presume the beneficiaries have the knowledge that they can change trustees because they received the trust document giving them the power to do so, and I want to presume their knowledge that there are other jurisdictions with lower taxes. I have hard time believing that it is a trustee's duty that beneficiaries need to be additionally told they can shop for a different trustee with lower fees, a better tax jurisdiction, etc. I want to give presume they have that knowledge, and that the beneficiary's rights in such situation are best explained by the beneficiaries' own counsel. Despite all that, would it be prudent to communicate annually that the trustee feels that Iowa is the most convenient place to continue administration, and that the trustee believes that the beneficiaries value that convenience over any other considerations? Of course, such communication bolsters the trustee's position as to informing the beneficiaries.

   1(b) In this situation the power to change situs is solely in the Trustee's hands, but there has been no inquiry by the beneficiaries about getting better state income taxes. In this scenario, there is the evidence of convenience vs. the beneficiaries never knowing it could be changed or how the trustee viewed the trustee's own use of their change of situs power. When we are talking about a trustee's use of its change of situs power under 633A.6105 we would not need

to utilize the court, and as anticipated under 633A.6105(6) the trustee's considerations of its own duty and power as to the proper jurisdiction would seem to take into account the same factors the court would consider earlier in 633A.6105. Therefore, in this scenario, where the power to change is centered in the trustee itself, it would seem prudent to at least annually communicate with the beneficiaries that the trustee feels that Iowa is the most convenient place to continue administration, and that the trustee believes that the beneficiaries value that convenience over any other considerations. This gives the beneficiaries an opportunity to correct the Trustee's understanding of the "views of the qualified beneficiaries" as to the appropriate jurisdiction.

1(c) In this situation, the power to change jurisdictions is not held by the Trustee or the beneficiaries, but by a trust protector governed by the new Iowa Code 633A.4804. It is important to note first the default provision of 633A.1101(24) that a Trust Protector "shall not be considered to be acting in a fiduciary capacity except to the extent the governing instrument otherwise provides." 633A.4207 indicates that the particular title of trust protector or trust director is not as important as the actual powers granted. So a trust protector could be given the power to change situs in a non-fiduciary capacity or a fiduciary capacity. If the trust protector's powers to change situs are given in a fiduciary capacity, it would seem clear that the trustee is an excluded fiduciary as to situs and therefore protected under 633A.4802 from liability and the trust protector takes on the role as to situs that we have been examining. If the trust protector's powers to change situs are non-fiduciary, then I would argue that the situation is akin to 1(b) above, where the trustee should presume that it is prudent to at least annually communicate with the beneficiaries that the trustee does not plan to engage the trust protector because the Trustee believes the beneficiaries continue to value convenience of administrating in Iowa above all else.

1(d) For what it is worth, if the document was completely silent as to changing jurisdiction, and all that one had to fall back on was the court changing jurisdiction under 633A.6105, the Trustee could continue to communicate that the Trustee believes the beneficiaries continue to value convenience of administrating in Iowa above all else.

I believe the above at least presents evidence that the trustee has tried to gauge the "views of the qualified beneficiaries in such situations" under 633A.6105.

Also note that a statement in the trust that Iowa law governs the trust is not controlling as to jurisdiction, but does at least provide some evidence of the grantor's intent for the jurisdiction of administration. Whether grantor's intent for a governing jurisdiction is similar to the direction to hold Kodak stock is not completely clear, but such a jurisdictional statement in a trust would not seem to be completely controlling.

Additionally see Iowa Admin Code 701-89.3(422)

701—89.3(422) Situs of trusts.

89.3(1) *Testamentary trusts.* The situs of a testamentary trust for tax purposes is the state of the decedent's residence at the time of death until the jurisdiction of the court in which the trust proceedings are pending is terminated. In the event of termination and the trust remains open, the situs of the trust is governed by the same rules as pertain to the situs of inter vivos trusts.

89.3(2) *Inter vivos trusts.* If an inter vivos trust is created by order of court or makes an accounting to the court, its situs is the state where the court having jurisdiction is located until the jurisdiction is terminated. The situs of an inter vivos trust which is subject to the grantor trust rules under 26 U.S.C. Sections 671 to 679 is the state of the grantor's residence, or the state of residence of the person other than the grantor deemed the owner, to the extent the income of the trust is governed by the grantor trust rules.

If an inter vivos trust (other than a trust subject to the grantor trust rules in 26 U.S.C. Sections 671 to 679) is not required to make an accounting to and is not subject to the control of a court, its situs depends on the relevant facts of each case. **The relevant facts include, but are not limited to: the residence of the trustees or a majority of them; the location of the principal office where the trust is administered; and the location of the evidence of the intangible assets of the trust (such as stocks, bonds, bank accounts, etc.)**. The residence of the grantor of a trust, not subject to the grantor trust rules under 26 U.S.C. Sections 671 to 679, is not a controlling factor as to the situs of the trust, unless the person is also a trustee. **A statement in the trust instrument that the law of a certain jurisdiction shall govern the administration of the trust is not a controlling factor in determining situs.** The residence of the beneficiaries of a trust is also not relevant in determining situs.

IA.Admin.Code 701-89.3(422)(emphasis added)

2) The previous hypothetical is great for the largely content set of qualified beneficiaries, but what if the beneficiaries are actively asking about the wisdom of changing tax jurisdictions to reduce the tax utilizing are same trust provisions of (a-d) referenced above?

2(a) in this case, the "views of the qualified beneficiaries" are seeking information about the pros and cons of such a change. In that situation the trustee can communicate about the potential tax benefits, but also the potential downsides of losing the existing convenience. The beneficiaries hold the power under the trust in this scenario and can decide from there.

2(b) again, the beneficiaries are seeking information, but in this scenario, the Trustee holds the power to change situs. In this scenario, the Trustee can explain the same pro/con list of changing jurisdictions, noting that if the decision is that convenience or other factors in keeping the jurisdiction status quo could be challenged with a petition by a beneficiary under 633A.6105 to forcibly change the jurisdiction and challenge the trustee's determination of its own power. Again, there is a line of cases that one does not have an affirmative duty to tell a beneficiary that they can challenge the trustee's determination.[3]

[3] *Sabin v. Ackerman*, 846 N.W.2d 835, 837-839 (Iowa 2014).

2(c) again, if the beneficiaries are seeking the information, and the trust protector has been given the situs changing power in a fiduciary capacity, then the trustee is excluded as to liability from that decision. If the power is non-fiduciary, then again the trustee is likely in the same position as outlined in 2(b), which would also seem to be the case for **2(d)**.

3) If the beneficiaries bring the matter to court under 633A.6105, how have courts interpreted such provisions?

   The Uniform Probate Code has had a similar provision 7-305 that has been interpreted by courts. Many states have some kind of variation on this kind of statute outlining the duties of trustees as to jurisdictional duties.

> A trustee is under a continuing duty to administer the trust at a place appropriate to the purposes of the trust and to its sound, efficient management. If the principal place of administration becomes inappropriate for any reason, the Court may enter any order furthering efficient administration and the interests of beneficiaries, including, if appropriate, release of registration, removal of the trustee and appointment of a trustee in another state. Trust provisions relating to the place of administration and to changes in the place of administration or of trustee control unless compliance would be contrary to efficient administration or the purposes of the trust. Views of adult beneficiaries shall be given weight in determining the suitability of the trustee and the place of administration. [4]

Our friends in Nebraska have a case dating back to 1982 that interpreted this provision in favorable manner as to trustees. *In re Zoellner Trust*, the Nebraska Supreme Court states that even if a place of administration is less convenient, less efficient, or less pleasant is not necessarily *inappropriate*, unless in combination with other factors, it actually *interferes* with proper administration of the trust.[5] Nebraska, its not for everybody, but as long as we don't interfere with you we're fine. Such a standard is clearly friendly to a trustee's position in such matters.

Even though Nebraska took a trustee friendly approach, courts in Alaska and Michigan took a more beneficiary centered approach and removed trustees in order to move the trust to a different jurisdiction.[6] One would hope that Nebraska's approach would be favored, but that case dates to 1982, far before the more recent cases that have forcibly changed jurisdiction.

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[4] Nenno, pg. 150.

[5] Page 3-14, *Changing the Situs of a Trust*, Hendrickson, Silverman, and Kaye (2003); *In re Zoellner Trust*, 325 N.W.2s 138 (Neb. 1982).

[6] *Marshall v. First Nat'l Bank Alaska*, 97 P.3d 830 (Alaska 2004); *In re Wege Trust*, 2008 WL 2439904 (Mich. Ct. App. June 17, 2008) in *Nenno,* pg. 150.