MOVING A TRUST FROM MASSACHUSETTS TO NEW HAMPSHIRE TO AVOID CONTINUING STATE INCOME TAXATION

To What Extent Can Massachusetts Residents Continue to Serve the Trust in Non-Trustee Capacities without Jeopardizing the Trust's Non-Resident Status?

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A. Trusts that Stand to Benefit from Migrating North of the Border. The Commonwealth's definition of "resident trusts" that are subject to Massachusetts state income taxation on all of their income and gains is narrowly drawn to exempt the non-Massachusetts source income and gains of non-grantor, *inter vivos* trusts that have no Massachusetts resident trustees. This creates an opportunity for current resident non-grantor trusts to avoid any continuing state income tax obligations on their accumulated non-Massachusetts source income and capital gains. It can be accomplished by resignations or removals of their current Bay State resident trustees in favor of successor trustees residing in a state that will not tax the trusts. If the new trustee resides close-by in New Hampshire, the trust can avoid state income taxation entirely. New Hampshire has no broad-based income or capital gains taxes, and as of January 1, 2013, trusts are exempt from the New Hampshire interest and dividends ("I & D") tax.[1] The savings that can result by discontinuing the annual practice of sending to Beacon Hill a check for 5.6% on the trust's taxable income and capital gains can in short order justify any costs associated with the move of the trust's situs. A Massachusetts resident trustee may feel some obligation to at least consider resigning the trusteeship and changing the trust's situs in appropriate circumstances to save state income taxes. Some perhaps overzealous

commentators have suggested that trustees failing to consider this might subject themselves to surcharge. [2]

The ideal candidate for such a move: a substantially funded, long-term, non-grantor *inter vivos* trust, all or most of the beneficiaries of which are Massachusetts residents, that makes no or modest annual distributions to Massachusetts resident beneficiaries and has no or very few New Hampshire resident beneficiaries. The potential for significant state income tax savings exists primarily for non-grantor trusts treated under Subchapter J of the Internal Revenue Code as "complex trusts" that historically accumulate all or a substantial portion of their distributable net income ("DNI"). Massachusetts law incorporates the grantor trust rules of Code §671 *et seq*.[3] Therefore, changing the situs of a Massachusetts grantor trust will not secure any tax savings because the income and capital gains will continue to be taxed to the trust's settlor. For "simple trusts" that require mandatory income distributions to Massachusetts beneficiaries, and "complex trusts" that historically make substantial annual distributions and are likely to continue to distribute all or a substantial portion of their DNI to Massachusetts resident beneficiaries, a situs change can save taxes on capital gains but not ordinary income, as the Massachusetts resident beneficiaries' Federal K-1 income will continue be taxed in the Commonwealth. For those trusts, a relocation might be appropriate only if the trustee expects to realize substantial capital gains from anticipated sales of highly appreciated holdings.

So decamping to New Hampshire won't save state income taxes for all current Massachusetts resident trusts. Still, there remains a potentially large universe of Massachusetts trusts that might be good candidates. The current Massachusetts trustees

and the beneficiaries of the trusts they serve will often be interested in availing themselves of these opportunities without completely severing the relationship with the resigning Massachusetts resident trustees and other local advisors that the family may want to continue to actively participate in important settlor and beneficiary-facing discretionary powers relating to trust investments and distributions. Many families will want the New Hampshire resident trustees to perform as minimal a role as possible in the trust's administration to achieve the tax savings. Can the family's Massachusetts resident trusted advisors, be they current trustees, attorneys, accountants, investment advisors or family members, continue to perform important trust functions as non-trustees without risking the trust's continued taxation by the Massachusetts Department of Revenue ("DOR")? This article will attempt to provide some guidance for those families and Massachusetts resident advisors who are interested in having it both ways.

B. Applicable Massachusetts Trust Taxation Principles: Relevant Statutory, Common Law and Regulatory Authorities.

1. Statutory. The pertinent provisions are found in M.G.L. Ch. 62, particularly §10(a)-(e). The determination of the taxation of a trust with Massachusetts connections is a two-step inquiry.

First, is the trust a resident or non-resident trust? Resident trusts include: (i) testamentary trusts created under the will of Massachusetts decedents, and (ii) *inter vivos* trusts with at least one Massachusetts trustee if at least one grantor was a Massachusetts resident at the creation of the trust, at death, or during any part of the tax year at issue. M.G.L. Ch. 62, §10(a), (c). A non-resident trust is taxed only on Massachusetts source income. M.G.L. Ch. 62, §§5A,10(d).

Second, for a resident trust, are the beneficiaries Massachusetts residents? The share of the income of a Massachusetts beneficiary is taxed to the trust under M.G.L. Ch. 62, §10(a). A non-resident beneficiary's share of the income is taxed to the beneficiary. Unborn persons, ascertained members of a class, and persons with uncertain interests are treated as if they were residents of Massachusetts, and income accumulated for these persons is taxed to the trust. M.G.L. Ch. 62, §10(a). The rate of taxation is 12% for "Part A" taxable income, 5.6% for Part B taxable income, and 0% to 5% for Part C taxable income, depending on the holding period. Generally, most of a trust's ordinary income and capital gain will be taxed as Part B taxable income at the 5.6% rate.

2. Common Law. Harrison v. Commissioner of Corps. and Taxation, 272 Mass. 422, 172 N.E. 605 (1930), stands for the proposition that the state of residence of the creator of a testamentary trust may establish a permanent situs for taxation in that state, and if it does so no other state may also tax the trust income. At issue was the ability of Massachusetts to tax capital gains of a testamentary trust of a New York decedent with Massachusetts resident trustees, where the gains were also subject to New York tax. The SJC held that under principles of interstate comity, the trust had insufficient current contacts with the Commonwealth to justify the assertion of the DOR's taxing jurisdiction:

> We think that it is within the competency of New York to require that the intangible personal property of one its deceased residents, whose will has been allowed by its court acting as the court of the domicil of the decedent, in the custody of fiduciaries appointed by such court to hold and administer that intangible personal property according to the will of the deceased resident and being so held and administered by such fiduciaries with responsibilities for accounting to that court, shall have and continue to have a situs for

> taxation within its jurisdiction…That conclusion …rests on the power of the State to establish a situs for purposes of taxation over a testamentary trust fund created by its deceased residents in intangible personal property being administered by appointees of its own court, under its laws, and thus for practical purposes within its jurisdiction all control over the trust and especially control for purposes of taxation. The conclusion rests also upon interstate comity which except in unescapable circumstances would not permit taxation in this Commonwealth of property thus within the jurisdiction of another state.

The case also involved a Massachusetts income tax imposed on a District of Columbia testamentary trust on the basis of the residence of one (of three) trustees. Unlike the New York testamentary trusts the SJC considered, over which the Court held New York had established exclusive taxing jurisdiction, no such showing was made with respect to the District of Columbia trust. Nonetheless, the Justices held that all the income could not be taxed in Massachusetts on the basis of the residence of one of three trustees. "Otherwise …if the state of residence of each trustee exerted to the full its taxing power, the entire income of the trust would be subject to three different taxes in each of three States." The Court also declined to accept the DOR's invitation to construe the statute as taxing only a *pro rata* portion (one-third) of the income, since "…the words [of the statute] are not susceptible of that construction."

Although Harrison is somewhat dated, it does have some precedential value for the SJC's unwillingness to give the DOR and the legislature a blank check to overreach in a strained construction of statutory language.

3. Regulatory.

a. DOR Regulations. These are found in 830 CMR 62.10.1. Subsection (1)(a) describes the DOR's taxing jurisdiction over testamentary trusts, and (1)(b) covers *inter vivos* trusts. Testamentary trusts created on the death of a

Massachusetts resident "…are subject to the tax and jurisdiction of Massachusetts with respect to all of their taxable income from whatever source derived". *Inter vivos* trusts of which at least once trustee resides in Massachusetts will be subject to taxing jurisdiction if at least one trustee resides in Massachusetts, and in addition at least one of three conditions listed in subsection (1)(b)1.a.-c. exist: a. the grantor was a Massachusetts resident at the time of the creation of the trust, defined "ordinarily" as "…a declaration of trust has been made and property delivered by the grantor to the trustee"; b. during any part of the year for which the income is computed the grantor (or any one of several grantors) resided in Massachusetts, and c. the grantor (or any one of several grantors) died a resident of Massachusetts. Subsection (1)(b)2. defines a non-resident trust as any *inter vivos* trust other than a resident trust, and indicates that such trusts are subject to taxing jurisdiction "…only to the extent of income derived by the trustee from the carrying on of a profession, trade or business within Massachusetts."

Subsection (4)(b) of 830 CMR 62.5. A.1 exempts from Massachusetts taxation income from intangibles realized by a non-resident trust if that income is:

> …purely of a passive investment character, not related to the operational functions of a business, and not related to employment or business activity in Massachusetts or the sale or exchange of Massachusetts real or tangible personal property or of an interest in a business, and not related to a partnership interest in a partnership to the extent the partnership holds an interest in real property located in Massachusetts.

Section (10) makes clear that a non-resident trust is taxable on Massachusetts source income, and subsection (11)(d) requires the trustee of a non-resident trust deriving Massachusetts source income to file Massachusetts Form 2, Fiduciary Income Tax Return, and all other required forms.

b. Form 2 Instructions. In the "Definitions" section of the instructions for Form 2, a "non-resident trust" is a trust that:

> …earns Massachusetts source income and that is (1) a trust under the will of a decedent who is a non-Massachusetts resident at death, (2) a trust all of whose trustees are non-residents, or (3) a trust all of whose grantors are non-residents at the time of the creation of the trust or at any time during the year for which the income is computed. These conditions must be met in order to subject the trust to the taxing jurisdiction of Massachusetts.

A "resident trust" may be one of two types: a "testamentary trust", meaning a trust under the will of a decedent who died a Massachusetts resident, or an "*inter vivos* trust" that is created during the life of the grantor. The instructions go on to say that:

> [t]o subject an *inter vivos* trust to the taxing jurisdiction of Massachusetts, the following conditions must exist: the trustee or other fiduciary, or at least one of them, is a Massachusetts resident, and (1) the grantor, or at least one of them, was a Massachusetts resident when the trust was created; or (2) the grantor, or at least one of them, resided in Massachusetts during any part of the year for which the income is computed; or (3) the grantor, or at least one of them, died a Massachusetts resident.

c. DOR Letter Rulings. In Letter Ruling 84-13, January 24, 1984, a New York bank serving as trustee of a number of trusts created by Massachusetts residents requested a ruling on the Massachusetts income tax liability and filing requirements for, *inter alia*, a trust that is a grantor trust with respect to the Massachusetts resident settlor during his lifetime, and will upon the settlor's death create two new non-grantor trusts. The bank was to serve as corporate trustee with no co-trustee residing in Massachusetts. After listing the applicable statutory provisions, the DOR ruled that:

> as a non-Massachusetts corporate trustee of certain trusts having no Massachusetts resident trustees, the Bank is subject to

> Massachusetts income tax on (i) trust income allocated to Massachusetts beneficiaries under any testamentary trusts where the testator died inhabitant of Massachusetts, and (ii) trust income from sources within the Commonwealth.

Letter Ruling 82-3, January 4, 1982, is another cryptic ruling requested by a New York bank as successor trustee of two irrevocable *inter vivos* trusts created by a Massachusetts resident. The bank served together with an individual resident of Connecticut as co-trustee. The co-trustees had succeeded Massachusetts resident trustees, and the bank requested a ruling that the trusts, which had been subject to Massachusetts taxation, were no longer resident trusts. The DOR ruled that "…since the two irrevocable *inter vivos* trusts now have no Massachusetts resident trustees, they are subject to Massachusetts income tax only on their items of gross income from sources within the Commonwealth. Any Massachusetts resident who receives, is entitled to, or to whom income is available from the trust is subject to Massachusetts income tax upon such income, according to the nature of the income received by the Trustees."

4. The "Sham Transaction" Doctrine. A codification of the "sham transaction rule", as set forth at G.L. c. 62C, §3A, "…permits the Commissioner, in his discretion, to disallow the asserted the tax consequences of a transaction by asserting that it is a sham transaction; in such cases the taxpayer has the burden of proving by clear and convincing evidence that it is not a sham transaction, as fully described in G.L.c. 62C, §3A."

The DOR promulgated 830 CMR 62.5 A.1 effective on January 1, 2006. It is captioned "Non-Resident Income Tax". Section (2) provides "Definitions", listed in alphabetical order. "Sham transaction" is defined as "…a transaction that does

not have (i) a valid, good faith business purpose other than tax avoidance; and (ii) economic substance apart from the asserted tax benefit."

5. Summary: A Massachusetts Resident *Inter Vivos* Trust Must Have at Least One Massachusetts Resident "Trustee". Thus, Massachusetts taxes the non-Massachusetts source income and gains of a testamentary trust created by a Massachusetts resident irrespective of the residence of its trustees. It will tax a non-grantor *inter vivos* trust created by a Massachusetts resident if the trust has at least one resident trustee *and* at least one resident beneficiary. Accordingly, a non-grantor *inter vivos* trust created by a Massachusetts resident that has at least one non-resident beneficiary will not be subject to Massachusetts taxation of its non-Massachusetts source income if the trust has no Massachusetts resident trustee.[4] The DOR and the courts have available the sham transaction doctrine, and general principles of statutory construction, to attack any structuring deemed to be abusive that comports with the letter, and not the spirit, of these rules.

C. To What Extent Might Massachusetts Resident Agents, Trust Protectors and Advisors Serving a New Hampshire Resident Trustee Allow the DOR to Assert Its Continuing Massachusetts Tax Jurisdiction? Having at least one Massachusetts resident trustee of a non-grantor *inter vivos* trust created by a Massachusetts resident grantor is therefore an indispensable trigger for determining resident trust status. Nowhere in the statute, regulations or common law, however, is there a definition of "trustee". The statutory definition that focuses on the residence of trustees was enacted before state trust law evolved to allow for an unbundling of critical fiduciary functions among multiple non-trustee participants such as "trust advisors" and "trust protectors" who may be

serving in fiduciary or non-fiduciary capacities. There is no indication whether such Massachusetts resident participants in a trust's administration, or the actions of other parties residing in the Commonwealth who serve the non-resident trustees as agents, will be considered by the DOR or the courts to be constructive co-trustees. In these situations the non-resident trustee holds legal title to the trust assets and performs at least some administrative duties outside Massachusetts.

1. Possible Legal Theories to Support the DOR's Continued Exercise of Jurisdiction: The Rockefeller Trusts Ruling. There is no direct legal support, however, under Massachusetts law for construing the word "trustee" to cover those situations. In Harrison, the SJC demonstrated some inclination to reign-in the DOR when the Court feels that the agency exceeds its statutory authority in seeking to tax non-resident trusts outside the strict parameters of M.G.L. Ch. 60.

DOR audit and collection personnel might, however, look outside the state for legal theories that they could co-opt. They need not look very far. On November 12, 2004, the New York State Department of Taxation and Finance (the "Department") issued Advisory Opinion TSB-A-04(7) (the "Rockefeller trusts ruling"). This ruling is the only published authority that the author has found from any other state that attempts to define a resident trust by reference to the "domicile" of the trustee, and dealt with the question whether the activities of resident advisors, agents and other non-trustee participants who reside in the taxing state could justify New York's assertion of taxing jurisdiction.

a. Factual Context. The Department considered the questions of the domicile of a corporate trustee and how broadly the concept of a trustee will

extend. It issued the Opinion in response to a Petition from J.P. Morgan Chase Bank. The bank requested rulings relating to trusts established by John D. Rockefeller, Jr., of which the bank's New York affiliate was trustee. The trustee was subject to the directions of a "Committee" of five individuals, including two New York residents, with respect to trust investments, distributions, and other matters. The bank's New York affiliate proposed to resign and be succeeded by a JP Morgan Chase subsidiary chartered and doing business exclusively in Delaware. The two New York resident Committee members likewise proposed to resign and be replaced by two non-New York resident members. The ruling request indicated that the former New York resident Committee members may (but may not) serve as non-voting advisory members of the Committee.

b. Expansive "Nerve Center" Definition of "Domicile" as Possible Basis for Assertion of Continued Jurisdiction Over Corporate Trustee With Multi-Jurisdictional Footprint. As regards the non-New York "domicile" of the proposed Delaware successor trustee, the Department held that "…the domicile of a corporation is the principal place from which the trade or business of the corporation is directed or managed," i.e., "where the corporation manages, conducts or directs its business…where the main and regular meeting place of the board of directors is located." The ruling characterizes this issue as a question of fact. The Department refused to rule on the issue, noting that it would only rule on questions of law. However, from the facts stated it appears that the bank's Delaware subsidiary would be domiciled exclusively in Delaware even based on the broad nerve center test of corporate domicile that the ruling cites as the proper standard.[5] Those facts included, *inter alia*, four of seven directors being as Delaware residents, 14 of 18 officers Delaware residents, 900 fiduciary accounts

managed from Delaware headquarters, and Directors' meetings and day to day operations conducted in Delaware.

Still, the Department's choice of an elastic standard for determining corporate domicile will cause concerns for any bank or trust company with a regional or national presence and New York affiliates or activities.[6]

c. In-State Activities of Resident Actors.

(1) Persons With Powers to Direct or Veto the Actions of Non-Resident Trustees. The Department analyzed the various New York resident persons and unaffiliated institutions that might assist the bank's Delaware subsidiary in the performance of its trustee duties. On the second of the requested rulings, the Department held that the members of the Committee would be treated as co-trustees under New York law because of their powers of direction. In reaching this result, the ruling relies on Matter of Rubin.[7]

Rubin was a decision of a New York appellate court that addressed the status of trustee advisors. In Rubin, the Appellate Division held that the designation of an advisor is a valid limitation on a trustee's powers. The Rubin court notes that other courts have generally considered an advisor to be a fiduciary, "somewhat in the nature of a co-trustee, 'quasi-trustee', or special trustee." The Rockefeller trusts ruling specifically quotes the Rubin court's statement that "since the relationship between the fiduciary and the advisor is that of a co-trustee, with the advisor having the controlling power, the fiduciary is justified in complying with the directives and will not generally be held liable for any losses", but also states that "…an advisor that does not have any powers under the terms of the trust agreement to direct or control a trustee in

the performance of some part or all of the trustee's functions and duties, and has not been invested with a form of veto power over particular actions of a trustee through the medium or device of requiring that those actions be taken only with the consent and approval of the advisor, will not be considered a co-trustee."

(2) Non-Fiduciary Agents Assisting the Non-Resident Trustee in the Performance of Trustee Functions With No Powers to Direct or Veto. The implications of the "power to direct or veto" portions of the Rockefeller trusts ruling are troublesome for anyone seeking certainty in this area of the law. Modern trusts employing multi-participant "open architecture" directed trust governance structures are of recent vintage but are becoming increasingly popular in New Hampshire and other states with common law or statutory default principles that expressly allow them. Even more unsettling, however, is the "agency" aspect of the ruling: the Department's discussion of the circumstances under which the activities of New York resident investment advisors, accountants, attorneys and others who are retained by the trustee or Committee as non-fiduciary agents might be imputed to a non-resident trustee.

As was the case with the requested ruling on the Delaware trustee's domicile, the ruling concludes that this is a factual matter "not susceptible of determination in this Advisory Opinion." The Department so held despite the bank's representations that make it clear that none of these advisors was anything more than an agent with no power of direction and control, and that therefore would not under Rubin be considered fiduciaries or co-trustees.

2. Alternative Strategies for Addressing the Implications of the Rockefeller Trusts Ruling. Especially for Massachusetts practitioners, some comfort can be taken in

the ruling's character as only the pronouncement of an administrative agency of another state that does not have the force of law even in New York. None of the Department's theories have been memorialized in any New York regulations or statute, or approved by any New York court in a contested matter involving state income taxation. Moreover, there is no indication that the Massachusetts DOR is aware of or would adopt the reasoning of the Rockefeller trusts ruling if it were confronted with similar facts.

Nonetheless, it would be prudent for any former Massachusetts trust leaving the Commonwealth for the more tax-friendly pastures of New Hampshire to attempt to structure around the issue because both Massachusetts and New York define resident trusts primarily by reference to the in-state residence of the "trustees". By a issuing the ruling the Department has given a roadmap for results-oriented, revenue-starved tax commissioners seeking to hold the line on the loss of tax revenues where in-state residents direct or assist the foreign trustees in the performance of their duties. The following will offer some thoughts on possible structuring options that might limit the audit risk.[8]

a. Avoiding the Use of Massachusetts Resident Agents is Almost Certain to be Unnecessary. The "agency" aspects of the Rockefeller trusts ruling have potentially open-ended implications. They have been justifiably criticized as a misreading of the law.

An agent of a fiduciary has no direct or indirect fiduciary relationship to the trust or its beneficiaries. The delegating fiduciary retaining the agent has duties to exercise reasonable care in the selection of the agent, defining the scope of the agent's responsibilities, and monitoring the agent's performance. The delegating

fiduciary, not the agent, will be liable to the beneficiaries should the agent's acts result in loss or damage to the trust estate. If the agency theory were to be carried out to its logical conclusion, it would subject to New York state income taxation an impossibly large number of trusts created by New York residents that have no New York trustees, but commonly contract with New York resident agents for assistance with trust administration, trust investments, legal services, and other activities. It is difficult to take the agency theory too seriously against that backdrop.

There is anecdotal evidence, however, that the Department's ruminations on resident agents have had some of its obviously desired chilling effect in New York. A few very cautious advisors have counseled their clients that even the non-New York domiciled trustee's continuation of professional relationships with New York-based accounting and law firms may provide an opening for the revenue authorities to continue to assert taxing jurisdiction based on the ruling's gratuitous *dictum* on this issue. It is unlikely that in most cases such excessive circumspection will be either practical or necessary in Massachusetts as there is no legal foundation for imputing the activities of resident non-fiduciary agents to a non-resident trustee.

b. Avoid the Implications of a Nerve Center Test of Corporate Domicile by Using New Hampshire Resident Individual or Professional Trustee With No Massachusetts Presence or Affiliation. The Department's broad definition of domicile for corporate trustees, based largely on the nerve center test for subjecting foreign corporations to personal jurisdiction, has encouraged some conservative advisors to avoid designating as successor non-resident trustees large national or regional banks and other

institutional fiduciaries with multi-state operations, including investment management and administrative "back office" operations located in New York. They instead favor individual trustees and independent community banks and trust companies with no affiliates or other presence in the Empire State. The malleability of the ruling's definition of corporate domicile creates so much gray area that it is virtually impossible for New York trusts and their advisors to draw any bright lines on these highly fact-sensitive issues. Conservative, audit-sensitive advisors to Massachusetts trusts relocating to New Hampshire might similarly do well to avoid institutional fiduciaries with affiliates or activities in Massachusetts, or at the very least use only the New Hampshire chartered subsidiary of a regional or national bank or trust company, not a branch office.[9]

c. Avoid or Limit the Authority of Massachusetts Resident Direction and Veto Powerholders. For trusts interested in having Massachusetts resident trust advisors and/or protectors direct or veto the actions of a New Hampshire trustee, "directed" or not, there are a few options to consider.

i. New Hampshire Directed Trustee, Massachusetts Resident Fiduciary Trust Advisor or Protector. New Hampshire has comprehensive directed trust legislation defining the roles, responsibilities and liabilities of trustees and the "trust advisors" and "trust protectors" that are empowered to direct their actions.[10] These non-trustee participants may direct a trustee as to fiduciary distribution and/or investment functions, or approve or veto proposed trustee actions. Each non-trustee participant is presumed to exercise the participant's veto, approval or direction powers as fiduciaries if the document is silent on this issue. A directed trustee must execute the direction given by the empowered party without any duty to inquire whether the direction

exceeds the scope of the director's powers or would constitute a breach of fiduciary duty by the directing party. As an "excluded fiduciary", a directed trustee is absolved from liability for any losses incurred by the trust estate's executing party resulting from a breach of the advisor's duties.

Assume that the individual trustee of a Massachusetts resident trust resigns and, as authorized in the trust document, appoints a successor New Hampshire resident directed trustee. The terms of the governing trust document, a binding Massachusetts non-judicial settlement agreement or court order approves a change of the trust's situs to New Hampshire and designates the Massachusetts former trustee as trust advisor with powers to direct the New Hampshire trustee concerning trust investments and distributions.[11] The trust holds only intangible personal property that by law has its exclusive situs in the state of residence of the title-holding trustee. The governing law of the trust is changed, and the trust incorporates all of the New Hampshire statutory directed trustee principles. The Massachusetts resident trust advisor continues most of his practices and procedures concerning trust administration that he followed as trustee, and orchestrates all distributions and investments as he did prior to the change of trustees, except that he must now act through the New Hampshire directed trustee. The only substantive difference after the move is that there is no longer, strictly speaking, a Massachusetts resident "trustee".

This form of directed trust would be considered a non-resident trust based on a literal reading of the Massachusetts statute, regulations and Form 2 instructions. It appears that the New Hampshire resident directed trustee could in good faith and based on substantial authority discontinue filing Massachusetts Forms 2

beginning on the date the Massachusetts resident trustee's resignation became final when the New Hampshire directed trustee accepted its appointment.[12] The Massachusetts DOR cannot cite a case like Rubin, as the New York taxing authority did in the Rockefeller trusts ruling, for the proposition that the Massachusetts resident trust advisor is in substance a co-trustee or quasi-trustee. And, if the New Hampshire directed trustee is a New Hampshire resident individual or a New Hampshire bank or nondepository trust company with no activities in Massachusetts, the DOR would have a harder time finding Massachusetts corporate domicile than the New Yorkers did with the J.P. Morgan Chase Delaware subsidiary based on its affiliates' activities in New York.

ii. New Hampshire Resident Directed Trustee, but Each Massachusetts Resident Trust Advisor and Protector Serves in Non-Fiduciary Capacity. Still, having Massachusetts resident fiduciary trust advisor is aggressive because two traditional trustee functions - - trust investments and distributions - - are being directed from Massachusetts. Unlike agents retained by trustees, such advisors and protectors have fiduciary duties and are directly accountable to the trust's beneficiaries. As indicated earlier, the New Hampshire directed trust statute *presumes* that an advisor and protector serves as a fiduciary. Making fiduciary status a default rule leaves the door open to allocating to a trust advisor investment and/or distribution duties exercisable in a *non-fiduciary* capacity. This begs the question: would a provision in a directed trust's governing document stating that the Massachusetts resident trust advisor is a non-fiduciary weaken the DOR's case for continuing taxing jurisdiction?

Even if the answer is "yes", the non-tax related implications of this approach would raise nettlesome questions. If a "trust advisor"

handling a critical trust function such as exercising discretionary powers over investments or beneficiary distributions is not a fiduciary with direct accountability to the trust beneficiaries and a New Hampshire probate court, then what is he? A mere agent? If the advisor is not a fiduciary as to the investment or distribution function and the directed trustee is an excluded fiduciary as to the exercise of the advisor's powers, then who will bear the surcharge liability risk and make the beneficiaries whole for the advisor's negligence or willful misconduct? Will a court simultaneously recognize both the non-fiduciary (and judgment-proof) status of the Massachusetts resident director, and the excluded fiduciary status and liability protection that would otherwise be allowed under the New Hampshire directed trust statute for the New Hampshire resident directed trustee, if to do so would leave the aggrieved beneficiaries without recourse? It is difficult to imagine that a court would refuse to find that someone, whether the trust advisor as quasi fiduciary or the directed trustee based on a breach of duty to monitor the activities of the trust advisor as the trustee's actual or constructive agent, would be liable in the event of an egregious breach causing significant loss to the trust estate.

If challenged by the Massachusetts DOR, the New Hampshire directed trustee and the Massachusetts resident advisor would have the burden to prove by clear and convincing evidence that the governing document's characterization of the advisor as a non-fiduciary was not a sham. The DOR might assert that the form of the arrangement does not comport with its substance. It could make a particularly compelling argument that the Massachusetts resident trust advisor was more a "fiduciary" than the New Hampshire directed trustee who enjoys statutory excluded

fiduciary immunity for following the directions of the empowered Massachusetts resident trust advisor.

The basic problem with the non-fiduciary trust advisor approach is that if neither the directed trustee nor the directing trust advisor is a fiduciary as to the most critical trust functions, does a valid trust arrangement exist? The defining feature of the trust relationship is the fiduciary duty. This is the means by which beneficiaries can enforce the terms of the trust and protect their interests. The DOR could assert that because no one exercises the critical trust investment and/or distribution questions as a fiduciary, the arrangement is a sham. In the event of a breach, the Massachusetts resident advisor or protector must remain on the hook as a quasi fiduciary despite the self-serving language in the governing documents purporting to absolve the advisor or protector of any fiduciary responsibility.

iii. <u>"Delegated" Trust Arrangement</u>. A more conservative alternative that seeks to avoid this risk involves establishing a non-fiduciary agency relationship with the Massachusetts resident service provider. (Choosing this option assumes, as all but the most conservative of advisors will, that the law does not support the agency aspects of the Rockefeller trusts ruling). The Massachusetts resident trustee will resign in favor of a New Hampshire trustee. That trustee will delegate investment and/or distribution authority to the Massachusetts resident agent. The New Hampshire delegating trustee will be responsible for exercising due care in defining the scope of the Massachusetts agent's authorities, monitoring the performance of his duties to ensure that he remain within the scope of the delegation, and intervening to prevent a

breach.[13] The New Hampshire delegating trustee will retain fiduciary surcharge exposure for breaches of these duties.

The cost of choosing a delegated trust, versus a directed trust, arrangement: the delegating New Hampshire trustee is likely to charge a greater "surcharge premium" to reflect the increased agent oversight responsibilities and risks over and above those that a directed trustee would undertake over trust advisors in light of that trustee's excluded fiduciary status. The New Hampshire resident delegating trustee's fee might, for example, go from a directed trustee fee of 15-35 basis points, to 65-100 basis points or more. Before resigning and accepting the new role as agent, the Massachusetts resident trustee must consider any additional costs in the form of the New Hampshire delegating trustee's fees and determine whether the potential Massachusetts state income tax savings outweigh the additional administrative costs. This delegated trust solution would therefore deny the trust the benefit of the lower "all-in" fees that would be available under the pure directed trust alternative. Forfeiting the advantages of New Hampshire's robust directed trust statute and excluded fiduciary protection will be a great sacrifice for many alternative situs seekers, and will likely be a deal-breaker for any given trust.

iv. New Hampshire Resident Trustee Directed by Massachusetts Resident Managers of a New Hampshire "Special Purpose Entity" ("SPE"). How then can one arrange for a *true* directed trusteeship that avoids that risk? The SPE structure offers a possible solution.

(A) The SPE as Fiduciary Trust Advisor. Attorneys in Delaware and South Dakota have been working for years now to assist trusts

moving to those states from high tax states with relatively narrow definitions of resident trusts such as New York and Massachusetts. Both states have both a robust directed trust statute and either no state income taxation of resident trusts (South Dakota), or, in the case of Delaware, an exemption from state income tax for trusts with Delaware directed trustees but no Delaware resident beneficiaries. Some attorneys in those states have implemented structures under which the fiduciary trust advisor's duties that would otherwise be performed by an individual in the high tax state instead be handled in Delaware or South Dakota by a "special purpose" LLC of the type sanctioned in another Advisory Opinion from New York, TSB-A-00(2)I (Mar. 29, 2000).

If such an arrangement were to be implemented for a directed trust migrating from Massachusetts to New Hampshire along the lines described in that Opinion, the New Hampshire LLC's one percent managing member (or the non-member manager) will be the former Massachusetts resident trustee. The 99% (or 100%) non-managing member will be the former Massachusetts resident trust that now has a New Hampshire resident directed trustee. The trust assets, all of which are intangible personal property, will have been contributed to the LLC by the former Massachusetts trust in exchange for the 99% (or 100%) member interest. All of those assets will be owned by the LLC and managed by the Massachusetts resident manager. That manager might be subject to removal without cause by the New Hampshire resident directed trustee. The manager can also be given authority to direct or veto distributions in his capacity as manager, not as an individual resident of the Commonwealth. A more risky structure would be to have a single member non-member managed LLC of which the New Hampshire trust is the sole member, with the LLC's

affairs managed by a Massachusetts resident non-member manager. This would allow the LLC to be treated as a disregarded entity that need not file a partnership tax return.

(B) Risks and Uncertainties. There are two potential problems with using the SPE.

(1) Sham Transaction? First, it might be perceived as "too cute by half", and therefore be vulnerable to the DOR's sham transaction challenge. This risk is particularly acute in the case of a single member LLC.[14] The New Hampshire trustee can defend the structure by arguing that the LLC was formed not solely or primarily to avoid Massachusetts income tax, but rather for the legitimate business purposes of helping secure liability and errors and omissions insurance coverage that might not otherwise be available to an individual trust advisor, and protecting the individual manager from the liability exposure he would encounter if he were an individual trust advisor or agent.[15]

(2) Possible New Hampshire Regulatory Sanctions. A second risk is that the New Hampshire Banking Department asserts that the LLC was engaging in the regulated activity of providing fiduciary services without a trust charter or regulatory oversight. The Department may issue a "cease and desist" order and pursue civil sanctions. Unlike South Dakota,[16] New Hampshire has no legislation that recognizes a regulatory exemption for SPEs that serve as fiduciary trust advisors. Unlike Massachusetts,[17] there is no common law support for an unregulated entity providing fiduciary services. The former Massachusetts individual trustee may consider this and decide not to proceed with this solution without receiving a no-action letter or some formal ruling from the New Hampshire Banking Department that the LLC will not be

engaging in a regulated activity and is therefore exempt from regulatory oversight. The request would assert that the essence of the regulated activity is the legal ownership of a trust's assets as trustee, not directing the performance of a fiduciary function, and that by explicitly allowing for non-trustee advisors and trust protectors to perform fiduciary functions, the New Hampshire legislature has implicitly authorized them to do so under the regulatory radar.

It is unclear whether those arguments would carry the day for the applicant if push came to shove with the Banking Department. Several SPEs have been created and are serving as fiduciary investment and distribution trust advisors to New Hampshire trusts. The author has surveyed attorneys and trustees involved in structuring and working with trust advisor SPEs, and none have reported that the issue has been raised in the course of any examinations or otherwise.

D. Conclusion. Can a former Massachusetts resident *inter vivos*, non-grantor trust seeking state income tax shelter in New Hampshire have its cake (avoid continuing Massachusetts income taxation of the trust by changing situs to New Hampshire), and eat it, too (allow its Bay State resident former trustee to continue to serve the trust in the most critical, beneficiary-facing discretionary functions of investment and/or distribution decisions and continue to receive all or a substantial portion of the associated fees)? As the foregoing illustrates, the answer remains a qualified "yes". With careful structuring, the advisors to the resigning Massachusetts resident trustee can proceed with the confidence that they have done their best to satisfy the duty to attempt to avoid the unnecessary payment of taxes, without forfeiting the

benefits of the meaningful participation from across the border for the mutual benefit of the resigning trustee and the beneficiaries that he or she has historically served.

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[1] On June 28, 2012, the New Hampshire General Court significantly changed the I & D tax rules for trusts as part of ongoing efforts to make New Hampshire more attractive for locating trusts. This legislation also eliminates the requirement of prior law that trusts administered in New Hampshire file state income tax returns, and repeals "throwback" rules that taxed interest and dividend income accumulated in a resident trust. Beneficiaries of nongrantor trusts who receive federal Schedules K-1 will be subject to I & D tax only to the extent that income reflected on the K-1 is taxed federally as interest or dividends. New Hampshire follows the federal rule that the existence of a grantor trust is ignored for New Hampshire I & D tax purposes. The Department of Revenue Administration Technical Information Release 2012-002 includes a brief discussion of these important tax changes.

[2] This is intended only to imply a remote theoretical risk of fiduciary surcharge liability under particularly egregious circumstances. The author is not aware of any cases in which a trustee was sued for failing to relocate a trust to save state income taxes. There have, however, been suggestions from various self-interested quarters that it is only a matter of time that such a claim will be made. These shrill voices from the "progressive" trust jurisdictions cite the general common law duty of a trustee to "use reasonable care and skill to preserve the trust property." Restatement (Second) of Trusts §176 (1959). This duty has been recognized in case law, see In Re: Joseph Heller Inter Vivos Trust, 613 N.Y.S. 2d 809 (Sur. Ct. N.Y. Co. 1994), in §7-305 of the Uniform Probate Code ("UPC") adopted in Massachusetts but with a delayed effective date, and in the Uniform Trust Code ("UTC") promulgated by the National Commission of Commissioners of State Laws ("NCCUSL"). NCCUSL's UTC's §108(b) recognizes a trustee's " … continuing duty to administer the trust at a place appropriate to its purposes, its administration, and the interests of the beneficiaries". UTC §108(c) allows (but does not direct) a trustee to further that duty by transferring the trust's principal place of administration to another state. The Official Comments to NCCUSL's Section 108 state that the change might be desirable "to secure a lower state income tax rate". Interestingly, the recently-enacted Massachusetts UTC, MGLA Chapter 203 E, excludes NCCUSL's Section 108(b). The report of the Ad Hoc Massachusetts Uniform Trust Code Committee responsible for drafting the text of the bill that introduced the Massachusetts UTC explains this omission as follows:

> The Committee specifically removed the duty of a trustee to evaluate if the trust was being administered in an appropriate place by deleting subsection (b) and made the decision of a trustee whether to transfer of the place of trust administration permissive, not mandatory. A trustee may still petition the courts with respect to this decision.

If a Massachusetts court addresses this issue in a surcharge action against a trustee (highly unlikely, in the author's opinion), it will be interesting to see if the court rules that under the new Massachusetts law the trustee had no duty (or had a diluted duty) to change situs to save state income taxes.

For some of the extreme commentary on these issues, *see generally*, Michael J. Myers and Rollyn H. Samp, *Essay*: South Dakota Trust Amendments and Economic Development: The Tort of "Negligent Trust Situs" at its Incipient Stage? 44 S.D. L. REV. 662 (1998/1999), and Mark Merric, Robert Gillan and Jane Freeman, Malpractice Issues and the Uniform Trust Code, Estate Planning (December, 2004).

[3] M.G.L. Ch. 62, §10(e).

[4] Importantly, Massachusetts will have tax and jurisdiction over any trusts created by a Massachusetts resident for any year in which at least one Massachusetts resident trustee was serving. This makes it impossible for a former Massachusetts resident trust to avoid taxation for any year during which one or more Massachusetts resident trustee resigned and are replaced by non-resident trustees.

[5] This is the standard for federal diversity jurisdiction over corporations adopted by the United States Supreme Court in Hertz Corp. v. Friend, 130 S.C.T. 1181 (2010). That test is applicable for determining the principal place of business of a corporation for diversity purposes. Under this standard, a corporation's principal place of business is "the place where a corporations officers direct, control and coordinate the corporation's activities". Id. 1192. The nerve center is not the state where the bulk of the corporation's activities can be measured, but rather the "center of overall direction, control and coordination". Id. at 1194. In practice, the nerve center "…should normally be the place where the corporation maintains its headquarters – provided that the headquarters is the actual center of direction, control and coordination[.]" Id. at 1192. It "…is not simply an office where the corporation holds its board meetings (for example, attended by directors and officers who have traveled there for the occasion)". Id.

The United States District Courts have struggled with the fact-intensive inquiry required under Hertz. The results in individual cases are often difficult to reconcile. Compare Brewer v. SmithKline Beechem Corp., 2011 W.L. 1103627(E.D. Pa. Mar. 24, 2011) and White v. SmithKline Beechem Corp., 2010 W.L. 3119926 (E.D. Pa. Aug. 5, 2010) (finding domicile and nerve center of defendant corporation in Pennsylvania and Delaware, respectively, based on very similar facts). These cases demonstrate that the nerve center test is anything but a bright-line rule; rather, it is a sliding scale. Commentators have urged corporations concerned about jurisdictional issues to take steps to ensure that sufficient parts of their "brain" are present at their preferred principal place of business. Suggested steps include, for example, maintaining reasonably large and functional offices to house employees and documents, and requiring that key decision-makers work from their new nerve center.

[6] See comments and suggestions described in the preceding footnote for building a record for avoiding or managing multi-jurisdictional litigation for corporations with activities in multiple states.

[7] 143 Misc. 2d 303, 540 N.Y.S. 2d 944 (N.Y. Surr., 1989).

[8] The least risky, most conservative and sure-fire approach would involve no participation in the trust's administration by a Massachusetts resident in any capacity. It is assumed, however, that the cure of sacrificing ongoing participation by one or more Massachusetts residents would be worse for the trust and its beneficiaries than the illness of continuing to pay Massachusetts state income taxes. Another option would be for the current Bay State trustee (corporate or individual) to charter a public nondepository trust company ("NDTC") in New Hampshire, resign as trustee, and appoint the New Hampshire resident NDTC as successor. The former Massachusetts resident trustee can then continue to administer the trusts as an employee of the new NDTC and not have to worry about Massachusetts taxes. Public records at the New Hampshire Banking Commission reveal that since 2006 when New Hampshire liberalized its trust and banking laws, a few Massachusetts firms whose Massachusetts resident principals served as individual private trustees. The MFO/RIA Private Trustee firm Loring, Wolcott and Coolidge, and the Boston law firm Hemenway and Barnes, have done so, presumably because the trusts that their principals were privately serving and the fees generated by those trusts were sufficiently large to justify the costs of chartering and continuing supervision. Most current Massachusetts resident trustees will not, however, have sufficient critical mass in trusts and trust assets to follow the lead of those firms, but will instead be looking for something less expensive and burdensome.

[9] An example of a separately-chartered New Hampshire subsidiary of a Massachusetts bank holding company is Cambridge Trust Company of New Hampshire, with a principal place of business in Manchester, NH, a subsidiary of Cambridge Trust Company of Boston, Massachusetts. An example of a trust office within a New Hampshire branch of a national bank is Bank of America's wealth management operations within its New Hampshire branches. Concord Trust Company, LLC and Perspecta Trust, LLC, both state-chartered NDTCs, are examples of stand-alone NDTCs without any presence or activities in Massachusetts.

[10] See generally N.H. RSA 564-B:12-1201 *et seq*. *See also* McDonald, Open Architecture Trust Designs Under New Hampshire Law Provide Flexibility and Opportunities, 49 N.H. Bar Jour. 34 (2008)

[11] The logistics of moving an existing irrevocable trust to New Hampshire from another state are described in McDonald, Migrating Trusts to New Hampshire: The "*Why*" and the "*How*" , 51 N. H. Bar.J. 34 (Winter, 2010). Now that Massachusetts has adopted its own version of the UTC, in the absence of a provision in the trust document permitting a change of situs, a situs change from Massachusetts to New Hampshire can be accomplished through a non-judicial settlement agreement entered into under M.G.L. Chapter 203-E, §111.

[12] The new Trustees should file a final Form 2 for the year in which Massachusetts resident trustee or trustees resign, marked "FINAL RETURN", with a cover letter indicating that the trust is no longer a Massachusetts resident trust because all Massachusetts resident trustees have resigned and have been replaced by one or more non-resident trustees.

[13] These duties applicable to "delegated trusts" are described in RSA 564-B §8-807(a).

[14] This is a theory similar to that applied by the Bankruptcy Court for the District of Colorado in In re: Ashley Albright, Debtor in allowing the Trustee of the bankruptcy estate of an LLC single member to reach the LLC's assets. The New York State Department of Taxation and Finance determined that a non-resident decedent sole shareholder's stock in a Florida S-corporation that owns New York real estate would not be treated as intangible personal property that is not subject to New York estate tax if its purpose is the equivalent of a business activity and not the ownership of a residence occupied by the shareholder. See TSB-A-08(1)M (October 24, 2008). That ruling would treat as an intangible not sitused in New York member interest as a single member LLC conducting a legitimate business activity only if the LLC is treated as a corporation under the "check-the-box" regulation of Treas. Regs. §§301.7701-1 through 301.7701-3.

[15] In most cases, individuals (except perhaps for attorneys and accountants) serving in fiduciary capacities find it difficult if not impossible to get liability insurance coverage. However, some insurance companies will provide insurance to directors and officers as well as errors and omissions insurance coverage to board members, officers and/or employees of SPEs established to perform a fiduciary function.

[16] S.D.C.L. 51A-6A-66, enacted in 2011.

[17] In Massachusetts not only may a plain-vanilla business corporation be in the business of serving as trustee of trusts if its articles of organization so provide, but if it is not a bank, the state banking commissioner has no authority to regulate its fiduciary activities. First Fiduciary Corp. v. Office of Comm'r of Banks, 43 Mass.App.Ct. 457, 684 N.B.2d 1 (1997). In that case, the Massachusetts appeals court held that "[t]here is no rational legislative objective in treating corporate fiduciaries differently from individuals or other business organizations performing the same function". Id., at 463, 5. This decision, although still good law in Massachusetts, has no counterpart in any other state. Every other state requires any form of limited liability business organization to be chartered and regulated to exercise trust powers.