

The State of Exemptions for Resident Trusts

By Jay D. Waxenberg and Nathaniel W. Birdsall

Faced with a daunting budget shortfall, Governor David A. Paterson's 2010 executive budget bill proposed in January to dramatically increase the number of New York resident trusts subject to state income taxation. While the Legislature did not adopt this proposal in the budget that passed this August, resident trusts remain on the state's radar as a potential source of increased tax revenue.

Starting with the 2010 tax year, most New York resident trusts not subject to income taxation in New York will, for the first time, be required to file a state income tax return for information purposes. These fiduciary returns will, presumably, provide the state with a precise estimate of the revenue it forgoes under the current tax law, providing ammunition for future attempts to expand New York taxation of resident trusts.

Resident Trust Basics

A New York "resident trust" includes any trust created under the will of a New York domiciliary and any inter vivos trust that, while the settlor was a New York domiciliary, was created as an irrevocable trust, became irrevocable, or was created as a revocable trust and has not yet become irrevocable.¹ If a trust meets any of these criteria, it remains a New York resident trust even if its administration is thereafter conducted entirely in another state.

For the 2010 and 2011 tax years, if a New York resident trust is subject to income taxation by New York, the maximum personal income tax rate is 8.97 percent on taxable income over \$500,000, increasing to a cumulative 12.618 percent if the trust is also subject to taxation by New York City.²

Not every New York resident trust is subject to state income taxation, since New York courts have discerned constitutional limits on the state's ability to tax resident trusts. In a 1964 case, *Mercantile-Safe Deposit & Trust Co. v. Murphy*, the New York Court of Appeals concluded that since the due process clause prohibits states from taxing property beyond their jurisdiction, New York cannot impose an income tax on resident trusts with which it has only minimal contact.³

At issue in *Mercantile* was New York's ability to tax the accumulated income of an inter vivos trust created by a New York settlor for the benefit of a New York beneficiary, but which was administered in Maryland by a Maryland trustee. In addition, all of the trust's assets were located in Maryland, since intangible assets (such as cash and securities) are deemed located where the trustee is domiciled.⁴

The Court of Appeals concluded that even though the trust met the statutory definition of a New York resident trust, its connection with New York was too tenuous to justify income taxation in this state. The Court did not posit any bright line test for judging when a trust had a nexus with New York sufficient to justify taxation, but the decision at least holds that the New York domicile of the settlor and beneficiary is not sufficient by itself to justify income taxation by New York.

Mercantile was followed in 1981 by *Taylor v. State Tax Comm'n*, in which the Appellate Division, Third Department, extended *Mercantile's* holding to testamentary trusts, concluding that the mere fact that the decedent died a New York domiciliary was an insufficient basis for New York to tax Florida real property sold by the trust, given that neither the beneficiaries nor those trustees authorized to act in respect of the sale were New York domiciliaries.⁵

Tax Exemption

In response to the constitutional concerns expressed in *Mercantile* and *Taylor*, in 1992 the Department of Taxation and Finance amended its regulations to specify that some resident trusts would not be taxed by New York.⁶ In 2003, these regulations were incorporated into the New York tax code as New York Tax Law §605(b)(3)(D), which provides that the income of a resident trust is not taxable in New York as long as three criteria are met: (1) all of the trustees are domiciled outside of New York, (2) the entire corpus of the trust, including real and tangible property, is located outside of New York and (3) the trust has no gain or income derived from New York sources.

This three-prong test, besides bringing the law into line with *Mercantile* and *Taylor*, provided a boon to New York's legal industry by minimizing the incentive for a wealthy New Yorker to change

domicile to a state (such as Florida) that does not impose an income tax on resident trusts. Instead, the client could retain his or her New York domicile and employ New York lawyers to draft resident trusts that met the three requirements listed above. The test is also in alignment with other New York policies that favor local legal and financial institutions, such as New York's decision (unlike California or Delaware) not to impose a tax on non-resident trusts solely because a trustee (such as a corporate trustee headquartered in New York City) is domiciled in New York.

Existing resident trusts may also take advantage of this three-prong test and avoid future state income taxation by replacing New York trustees with trustees domiciled in other states, liquidating any real property in New York, and moving tangible property out of the state. Arguably, trustees of trusts that are currently subject to income taxation in New York may even have a duty to take these actions, if avoidance of unnecessary taxation is interpreted as part of their fiduciary duty to preserve trust property.⁷

June Advisory Opinion

The literal language of New York Tax Law §605 states that "all income and gains" of a resident trust must be from non-New York sources, if the trust is to avoid state income taxation. This has commonly been interpreted to mean that a single dollar of New York source income renders the entirety of a resident trust's income and gains for the year (from whatever source) taxable by New York. While the constitutionality of this "one-dollar rule" may be debatable,⁸ trustees have to date been disinclined to challenge its application, preferring instead to monitor any pass-through entities and hedge funds in which the trust has an interest, to make certain they do not hold assets that will produce unexpected New York income.

Until recently, it was uncertain whether a mid-year replacement of a New York trustee with an out-of-state trustee would immediately render a resident trust non-taxable in New York, or whether, similar to the one-dollar rule, a single day with a New York trustee rendered the trust susceptible to taxation by the state for the entire tax year.

On June 8, however, the Department of Taxation and Finance issued Advisory Opinion TSB-A-10(4)I, which sheds some light on the mid-year change in the taxable status of a New York resident trust. The advisory opinion discusses the potential taxation of inter vivos resident trusts that held no real property or tangible personal property in New York. Each trust had the same two trustees, only one of whom was a New York domiciliary. When the New York domiciliary trustee died in the middle of the tax year, the trusts met all of the tax exemption requirements, since they had no New York domiciliary trustees and all of their intangible assets and income were deemed located in the out-of-state domicile of the remaining trustee.

The advisory opinion concluded that the trusts became non-taxable by New York immediately upon satisfying the three prongs of New York Tax Law §605(b)(3)(D). While this is welcome news, the more tantalizing aspect of the advisory opinion is its erosion of the one-dollar rule, since it is the first evidence that New York source income does not always taint other income earned by the trust in the same tax year. However, it is still an open question whether the advisory opinion is limited to situations involving a change of trustees, or whether trusts that fail the three-prong exclusion test solely because of New York source income can now avoid state taxation for the remainder of the year by jettisoning the asset giving rise to the income.

This advisory opinion may be the final incentive that trustees and practitioners need to take the (often simple) steps required to render a resident trust non-taxable by New York.

Paterson Proposal

In the briefing book for Governor Paterson's proposed 2010-11 Executive Budget, the tax exemption for New York resident trusts with minimal contacts with New York is described as a "loophole" that, if closed, would provide the state with \$25 million in extra revenue in the 2011-2012 tax year.⁹

The accompanying budget bill proposed, as of the 2010 tax year, to eliminate the three-prong test under New York Tax Law §605(b)(3)(D) and impose an income tax on all testamentary trusts created by a decedent domiciled in New York.¹⁰ In addition, an inter vivos New York resident trust with no income derived from or connected with New York sources would nonetheless be subject to partial income taxation by New York, if it had one or more New York beneficiaries. Such inter vivos trusts would be taxed based on the percentage of the trust's "ascertainable beneficiaries" who are residents of New York, and the residence of the trustees would be irrelevant.

The governor's proposals were opposed in memorandums by both the Trusts and Estates Law Section and the Tax Section of the New York State Bar Association,¹¹ and the proposals were removed from the Senate and Assembly versions of the budget bill.

The most obvious objection to the governor's proposed tax regime is that it violates the holdings of *Mercantile* and *Taylor*, namely, that taxing authority cannot be based solely on the domicile of the settlor and the beneficiaries. The governor's memorandum in support of the legislation posits that this new tax regime would nonetheless survive judicial scrutiny, since similar tax regimes had been upheld by "recent state and federal appellate decisions."¹²

The cases most likely referred to are *Chase Manhattan Bank v. Gavin*, a 1999 case decided by the Connecticut Supreme Court,¹³ and *District of Columbia v. Chase Manhattan Bank*, a 1997 case decided by the District of Columbia Court of Appeals.¹⁴ These cases conclude that income taxation of testamentary resident trusts is justified by the benefits provided to the decedent (and his or her estate) by the court system of his or her domicile, which maintains an ongoing supervisory relationship with the trusts.¹⁵ The court in *Chase Manhattan Bank v. Gavin* also concluded that Connecticut could impose an income tax on an inter vivos trust whose settlor and beneficiary were Connecticut domiciliaries, since each enjoyed the protections and benefits of that state's judiciary system.

As pointed out in the state bar opposition memorandums, New York courts are under no obligation to reach the same conclusions as the courts in Connecticut or the District of Columbia, and Governor Paterson's proposed bases of taxation are arguably broader than those authorized by the above cases. For instance, the proposed taxation of testamentary resident trusts would not depend upon New York's maintaining ongoing supervision of those trusts. Thus, if a Surrogate's Court approves an out-of-state transfer of the situs of such a trust (and gives up jurisdiction), the trustees or beneficiaries may no longer receive any constitutionally sufficient New York benefit.

Another issue discussed in the opposition memorandums is the broad scope of the proposed statute's definition of "ascertainable beneficiary," which would include any living beneficiary who has a present or future interest in the trust, even if that interest is subject to a condition precedent. The proposed statute would also look through any partnership, LLC or S-corporation designated as a beneficiary, treating each partner, member or shareholder as a separate beneficiary.

This equal treatment of beneficiaries, regardless of the varying size or nature of their interests, may, similar to the one-dollar rule, result in taxation disproportionate to New York's actual contact with the trust. For instance, if a trust has two beneficiaries, only one of whom is a New York domiciliary, New York would tax half of the trust's income, even if the New York beneficiary possesses an interest in only 1 percent of the trust principal, or, due to a power of appointment held by a preceding beneficiary, is virtually assured of receiving no benefit at all. This arrangement may also be susceptible to abuse, since a settlor can minimize the percentage of taxable income by giving a vested interest (and a power of appointment) to a single New York beneficiary, and then appointing dozens of contingent out-of-state beneficiaries.

Whether for these reasons, or because of fears that wealthy New Yorkers would decamp to other states to avoid New York taxation, the governor's resident trust proposals did not gain much visible traction in 2010. However, there are indications that the taxation of resident trusts is still a topic of interest in Albany.

July Memorandum

On July 23, the Office of Tax Policy Analysis issued memorandum TSB-M-10(5)I, which reversed the long-standing policy that New York resident trusts that were not subject to income taxation by New York did not need to file a state fiduciary income tax return.¹⁶ Effective as of the 2010 tax year, the memorandum requires a New York resident trust to file a fiduciary income tax return in any year in which it is required to file a federal income tax return or has any New York taxable income.¹⁷

In addition, any New York resident trust that is exempt from state income taxation under the three-prong test at New York Tax Law §605(b)(3)(D) is required to attach to its return a new form, Form IT-205-C, New York State Resident Trust Nontaxable Certification. This form is not yet finalized or publicly available, but a draft version provided to the authors by the Department of Taxation and Finance would require the disclosure of the names, addresses and Social Security numbers of all trustees, along with an attestation that the trust meets the three exemption requirements.

One likely motive for this new filing requirement is to assist in identifying resident trusts that have failed to pay New York income taxes, even though they do not meet the requirements for tax exemption. However, collection of these returns will also allow the state to calculate with precision

the amount of revenue forgone under the current resident trust tax regime. Given the avidity for trust creation among wealthy New Yorkers (and their attorneys), it is possible that the governor's estimate of \$25 million in annual forgone tax revenue from resident trusts is understated (although any such estimate would have to factor in potential revenue losses from a diaspora of wealthy New Yorkers to other states).

This evidence of quantifiable, untapped revenue may prove enticing to the Legislature and to Governor Paterson's successor, particularly if the state's economic condition fails to improve. While future proposals to expand taxation of resident trusts may differ from those presented in Governor Paterson's proposed budget (and may be more narrowly tailored to minimize constitutional challenges), the governor's proposals may be regarded as the beginning of a new era of scrutiny of New York's taxation of resident trusts.

Jay D. Waxenberg is a partner at Proskauer Rose and the chair of its personal planning department. **Nathaniel W. Birdsall** is an associate at the firm and a member of its personal planning department.

Endnotes:

1. New York Tax Law §605(b)(3)(C).
2. New York Tax Law §601(c)(1).
3. 203 N.E.2d 490 (NY 1964), relying on the due process requirements set forth by the U.S. Supreme Court in *Safe Deposit & Trust Co. of Baltimore, MD. v. Virginia*, 280 U.S. 83 (1929).
4. See New York Tax Law §605(b)(3)(D)(ii); N.Y. State Dept. of Taxation and Finance Advisory Opinion TSB-A-94(7)I, April 8, 1994.
5. *Taylor v. State Tax Comm'n*, 445 N.Y.S.2d 648 (1981).
6. 20 NYCRR 105.23.
7. For a discussion of this potential fiduciary duty (along with an excellent overview of the constitutional issues surrounding the taxation of New York resident trusts), see Richard W. Nenno and Howard M. Zaritsky, "Proposed New York Fiduciary Income Tax Changes: Let My Trustees Go!" 35 Tax Mgm't Est., Gifts and Tr. J. 147 (May 2010).
8. See, e.g., Henry Christensen III & Erica J. Goldberg, "Provisions Codified on Making Trusts Non-Resident for Income Tax Purposes," 231 NYLJ, 9 (March 1, 2004).
9. This briefing book is available online at <http://www.nysenate.gov/files/pdfs/GovBudgetBriefingBook.pdf>.
10. S. 6610, Part G (N.Y. 2010); A. 9710, Part G (N.Y. 2010), available online at <http://publications.budget.state.ny.us>.
11. Memorandum from the Tax Section of the New York State Bar Assoc. to Governor Paterson et al (Feb. 22, 2010); Memorandum from the Comm. on Taxation of the Trusts and Estates Law Section of the New York State Bar Assoc. (March 25, 2010), both available online at www.nysba.org.
12. 2010-11 New York State Executive Budget Revenue Article VII Legislation—Memorandum in Support, Part G, available online at <http://publications.budget.state.ny.us>.
13. 733 A.2d 782 (CT 1999).
14. 689 A.2d 539 (DC 1997).
15. Each case relies on the U.S. Supreme Court's re-examination of due process in *Quill Co. v. North Dakota*, 504 U.S. 298 (1992).
16. This policy had been in effect since at least 1996. See TSB-M-96-(1)I, July 29, 1996.
17. A resident trust must also file a return if it had tax preference items for minimum income tax purposes in excess of the specific deduction or is subject to a separate tax on lump-sum distributions.