

New York State and City Income Taxation of Nongrantor Trusts: Rules and Opportunities

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INTRODUCTION

Executors and trustees pay a lot of New York State and City income taxes!

At the macro level, in 2009, 38,033 resident estates and trusts paid approximately \$157 million of New York income tax.² Given that, as covered below, the rules for avoiding tax are clear in many situations, one

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² N.Y. State Department of Taxation and Finance, Office of Tax Policy Analysis, *Analysis of 2009 Personal Income Tax Returns* at 89 (June 2012), available at http://www.tax.ny.gov/pdf/stats/stat_pit/pit/analysis_of_2009_personal_income_tax_returns.pdf. For an analysis of the constitutional limitations on New York's ability to tax trustees based on the residence of the testator or trustor, see Nenno & Zaritsky, "Proposed New York Fiduciary Income Tax Changes: Let My Trustees Go!" 35 *Tax Mgmt. Est., Gifts & Tr. J.* 147 (5/13/10) (hereafter "Nenno & Zaritsky"). That analysis is relevant in Alabama, Arkansas, Connecticut, Delaware, the District of Columbia, Idaho, Illinois, Iowa, Louisiana, Maine, Maryland, Massachusetts, Michigan, Minnesota, Missouri, Ne-

wonders how much of that tax could have been escaped.

At the micro level, if a nongrantor trust, which was created by a New York City resident and was subject to New York State and City tax, incurred a \$1 million long-term capital gain in 2011, had no other income, and paid its New York State and City income tax by year-end, the trustee would have owed \$127,189 of New York State and New York City tax on December 30, 2011, and \$149,655 of federal income tax on April 17, 2012. If the trust had been structured to avoid New York tax, however, the trustee would have owed no state or city tax and the same \$149,655 of federal income tax. Under the Internal Revenue Code of 1986, state income tax is deductible for federal purposes,³ but the deduction is worthless in the above example due to the alternative minimum tax ("AMT"). Even if the AMT did not apply, the state income tax deduction would have been of limited value because it is a deduction — not a credit — and because, in 2011, the maximum tax rate on long-term capital gains was 15%, therefore providing only a 15% federal tax offset for the state income taxes paid.⁴

This article summarizes the development of the income taxation of trustees in New York and describes the current rules in New York State and New York City, including a clear-cut exemption that is available to trustees of numerous trusts. The article then samples pertinent cases and rulings and alerts readers to the perils of source income. Finally, the article offers some planning ideas.

CLIFFSNOTES VERSION

New York long has defined "Resident Trust" as a trust established by a New York resident testator or

braska, New Jersey, Ohio, Pennsylvania, Rhode Island, Utah, Vermont, Virginia, West Virginia, and Wisconsin, which also tax trustees of trusts created by resident testators and trustors. We would like to thank Laura M. Twomey, Esq., Simpson Thacher & Bartlett LLP, New York, N.Y., for her assistance in the preparation of this article.

³ §§164(a)(3), 641(b).

⁴ §1(h)(1).

trustor. Following the *Mercantile-Safe Deposit & Trust Co. v. Murphy*⁵ and *Taylor v. State Tax Comr.*⁶ decisions, the New York State Department of Taxation and Finance adopted a regulation in 1992 confirming their holdings (i.e., that the trustee of a trust created by a New York testator or trustor is not taxable if the trust has no New York trustees, assets, or source income).⁷ We refer to a trust that satisfies the foregoing requirements as a “Nonresident Resident Trust.” Subsequently, the State of New York Division of Tax Appeals rendered two decisions and the Technical Services Division of the State of New York Department of Taxation and Finance issued several advisory opinions indicating that Nonresident Resident Trusts were not taxable⁸ and the Department of Taxation and Finance announced that trustees of such trusts did not have to file tax returns.⁹ The Nonresident Resident Trust exemption was codified in 2003, effective January 1, 1996.¹⁰

In 2010, Governor Paterson proposed to repeal the exemption for Nonresident Resident Trusts,¹¹ but his proposal was not enacted. Later, though, the New York State Department of Taxation and Finance announced that, effective January 1, 2010, new and existing Nonresident Resident Trusts must file informational returns.¹²

⁵ 19 A.D.2d 765 (3d Dept. 1963), *aff'd*, 15 N.Y.2d 579 (1964). See *Nenno & Zaritsky* at 157.

⁶ 445 N.Y.S.2d 648 (3d Dept. 1981). See *Nenno & Zaritsky* at 157.

⁷ N.Y. Comp. Codes R. & Regs. tit. 20, §105.23(c).

⁸ *In the Matter of Joseph Lee Rice III Family 1992 Trust*, DTA No. 822892, 2010 N.Y. Tax Lexis 268 (N.Y. Div. Tax App. 2010), available at <http://www.nysdta.org/Determinations/822892.det.pdf>; *In the Matter of the Petition of the John Heffer Trust*, DTA No. 820351, 2006 N.Y. Tax Lexis 124 (N.Y. Div. Tax App. 2006), available at <http://www.nysdta.org/Determinations/820351.det.pdf>; N.Y. TSB-A-11(4)I, 2011 N.Y. Tax Lexis 181 (July 27, 2011), available at http://www.tax.ny.gov/pdf/advisory_opinions/income/a11_4i.pdf; N.Y. TSB-A-10(4)I, 2010 N.Y. Tax Lexis 196 (June 8, 2010), available at http://www.tax.ny.gov/pdf/advisory_opinions/income/a10_4i.pdf; N.Y. TSB-A-04(7)I, 2004 N.Y. Tax Lexis 259 at 1 (Nov. 12, 2004), available at http://www.tax.ny.gov/pdf/advisory_opinions/income/a04_7i.pdf; N.Y. TSB-A-00(2)I, 2000 N.Y. Tax Lexis 118 (Mar. 29, 2000), available at http://www.tax.ny.gov/pdf/advisory_opinions/income/a00_2i.pdf; N.Y. TSB-A-96(4)I, 1996 N.Y. Tax Lexis 528 (Oct. 25, 1996), available at http://www.tax.ny.gov/pdf/advisory_opinions/income/a96_4i.pdf; N.Y. TSB-A-94(7)I, 1994 N.Y. Tax Lexis 310 (Apr. 8, 1994), available at http://www.tax.ny.gov/pdf/advisory_opinions/income/a94_7i.pdf. See below.

⁹ N.Y. TSB-M-96-(1)I (July 29, 1996), available at http://www.tax.ny.gov/pdf/memos/income/m96_1i.pdf.

¹⁰ N.Y. Tax Law §605(b)(3)(D)(i).

¹¹ 2009 N.Y. S.B. 6610, Part G.

¹² N.Y. TSB-A-11(4)I, 2011 N.Y. Tax Lexis 181 (July 27, 2011), available at http://www.tax.ny.gov/pdf/advisory_opinions/

CURRENT RULES

New York State

General

New York State treats a trust as a grantor trust if the trust is classified as a grantor trust for federal purposes,¹³ and the state permits a distribution deduction.¹⁴ In 2011, New York State taxed trustees on the New York taxable income (including accumulated ordinary income and capital gains) of nongrantor trusts at rates up to 8.97% on such income over \$500,000.¹⁵ In 2012, the top rate is 8.82% on such income over \$1 million.¹⁶ New York State defines “Resident Trust” as a trust that is created by a New York State testator or trustor as follows:¹⁷

(B) a trust, or a portion of a trust, consisting of property transferred by will of a decedent who at his death was domiciled in this state, or

(C) a trust, or portion of a trust, consisting of the property of:

(i) a person domiciled in this state at the time such property was transferred to the trust, if such trust or portion of a trust was then irrevocable, or if it was then revocable and has not subsequently become irrevocable; or

(ii) a person domiciled in this state at the time such trust, or portion of a trust, became irrevocable, if it was revocable when such property was transferred to the trust but has subsequently become irrevocable.

For the purposes of the foregoing, a trust or portion of a trust is revocable if it is subject to a power, exercisable immediately or at any future time, to revest title in the person whose property constitutes such trust or portion of a

income/a11_4i.pdf; N.Y. TSB-M-10(5)I, 2010 State Tax Today 145-10 (July 23, 2010), available at http://www.tax.ny.gov/pdf/memos/income/m10_5i.pdf.

¹³ See N.Y. Tax Law §§611(a), 612(a); instructions to 2011 N.Y. Form IT-205 at 6.

¹⁴ See N.Y. Tax Law §618; N.Y. Comp. Codes R. & Regs. tit. 20, §118.1; instructions to 2011 N.Y. Form IT-205 at 7.

¹⁵ N.Y. Tax Law §601(c)(1-a); instructions to 2011 N.Y. Form IT-205 at 10.

¹⁶ N.Y. Tax Law §601(c)(1)(A).

¹⁷ N.Y. Tax Law §605(b)(3)(B)-(C). See N.Y. Comp. Codes R. & Regs. tit. 20, §105.23(a)-(b).

trust, and a trust or portion of a trust becomes irrevocable when the possibility that such power may be exercised has been terminated.

A “Nonresident Trust” is a trust that is not a “Resident Trust.”¹⁸

New York State taxes trustees on all New York taxable income of Resident Trusts¹⁹ but only on New York-source income of Nonresident Trusts.²⁰ In New York State, trustees must make estimated tax payments for trusts.²¹

Nonresident Resident Trust Exemption

Importantly, as just mentioned, the New York Tax Law was amended in 2003, effective for tax years beginning in 1996, to codify an exemption for a Nonresident Resident Trust. Hence, a Resident Trust is not subject to tax if there are no New York State trustees, assets, or source income as follows:²²

(D)(i) Provided, however, a resident trust is not subject to tax under this article if all of the following conditions are satisfied:

(I) all the trustees are domiciled in a state other than New York;

(II) the entire corpus of the trusts, including real and tangible property, is located outside the state of New York; and

(III) all income and gains of the trust are derived from or connected with sources outside of the state of New York, determined as if the trust were a non-resident trust.

Regarding (I) above, the Technical Services Division of the State of New York Department of Taxation and Finance has issued guidance on how to determine the residence of a corporate trustee and the circumstances in which resident advisors, protectors, and committee members will be treated as resident trustees.²³

¹⁸ N.Y. Tax Law §605(b)(4).

¹⁹ N.Y. Tax Law §618. See N.Y. Comp. Code R. & Regs. tit. 20, §118.1.

²⁰ N.Y. Tax Law §§631, 633; instructions to 2011 N.Y. Form IT-205 at 2. See N.Y. Tax Bull. TB-IT-615, 2011 State Tax Today 244-15 (Dec. 15, 2011), available at http://www.tax.ny.gov/pdf/tg_bulletins/pit/b11_615i.pdf.

²¹ N.Y. Tax Law §685(c)(6); instructions to 2011 N.Y. Form IT-205 at 5.

²² N.Y. Tax Law §605(b)(3)(D)(i). See N.Y. Comp. Code R. & Regs. tit. 20, §105.23(c); instructions to 2011 N.Y. Form IT-205 at 2.

²³ N.Y. TSB-A-04(7)I, 2004 N.Y. Tax Lexis 259 (Nov. 12, 2004), available at http://www.tax.ny.gov/pdf/advisory_opinions/income/a04_7i.pdf. See below.

Regarding (II) above, the New York tax law provides:²⁴

(ii) For purposes of item (II) of clause (i) of this subparagraph, intangible property shall be located in this state if one or more of the trustees are domiciled in the state of New York.

Thus, if a trust only has nonresident trustees and intangible assets (e.g., stocks and bonds), the trust will meet the exemption. If a trust holds New York tangible personal property and/or real property, the trustee might consider placing it in an FLP or an LLC to convert it into intangible personal property. Guidance on the circumstances in which this approach will succeed is discussed below regarding source income.

Regarding (III) above, we must stress that a single dollar of source income will prevent a trust from satisfying the Nonresident Resident Trust exemption. Hence, to minimize tax, the trustee of a trust that has source income should consider dividing it into separate trusts, one of which holds the source income and one of which holds the non-source income. We describe New York source income below.

In 2010, the New York State Department of Taxation and Finance announced a change in the filing responsibilities of trustees of Nonresident Resident Trusts as follows:²⁵

[U]nder the policy described in TSB-M-96(1)I, Resident Trusts, a resident trust that was not subject to tax because it met the conditions described in section 605(b)(3)(D) of the Tax Law was not required to file a return . . .

Effective for tax years beginning on or after January 1, 2010, the policy in TSB-M-96(1)I is revoked, and a resident trust that meets the conditions of section 605(b)(3)(D) of the Tax Law will be required to file a New York State fiduciary income tax return if it meets the filing requirements for resident trusts.

In 2011, that department clarified that the new filing requirement applies to trustees of Nonresident Resident Trusts that satisfied §605(b)(3)(D)(i)'s requirements before 2010:²⁶

As of tax year 2010, even though the Trusts meet the conditions set forth in Tax Law

²⁴ N.Y. Tax Law §605(b)(3)(D)(ii).

²⁵ N.Y. TSB-M-10(5)I, 2010 State Tax Today 145-10 (July 23, 2010), available at http://www.tax.ny.gov/pdf/memos/income/m10_5i.pdf. See instructions to 2011 N.Y. Form IT-205 at 3.

²⁶ N.Y. TSB-A-11(4)I, 2011 N.Y. Tax Lexis 181 at 4 (July 27, 2011), available at http://www.tax.ny.gov/pdf/advisory_opinions/income/a11_4i.pdf.

§605(b)(3)(D), they are required to file Form IT-205 Fiduciary Income Tax Return and attach Form IT-205-C New York Resident Trust Nontaxable Certification to Form IT-205.

New York City

New York City treats a trust as a grantor trust if the trust is classified as a grantor trust for federal purposes,²⁷ and the City permits a distribution deduction.²⁸ In 2011, the City taxed trustees on the city taxable income (including accumulated ordinary income and capital gains) of nongrantor trusts at rates up to 3.876% on such income over \$500,000.²⁹ It appears that the rates are the same in 2012. Like New York State, New York City defines Resident Trust as a trust that is created by a New York City testator or trustor as follows:³⁰

(c) City resident . . . trust. A city resident . . . trust means: . . .

(2) a trust, or a portion of a trust, consisting of property transferred by will of a decedent who at his death was domiciled in such city, or

(3) a trust, or a portion of a trust, consisting of the property of:

(A) a person domiciled in such city at the time such property was transferred to the trust, if such trust or portion of a trust was then irrevocable, or if it was then revocable and has not subsequently become irrevocable; or

(B) a person domiciled in such city at the time such trust or portion of a trust became irrevocable, if it was revocable when such property was transferred to the trust but has subsequently become irrevocable.

For the purposes of the foregoing, a trust or portion of a trust is revocable if it is subject to a power, exercisable immediately or at any future time, to revest title in the person whose

property constitutes such trust or portion of a trust and a trust or portion of a trust becomes irrevocable when the possibility that such power may be exercised has been terminated.

A Nonresident Trust is a trust that is not a Resident Trust.³¹

New York City taxes trustees on all City taxable income of Resident Trusts; it does not tax trustees of Nonresident Trusts.³² In New York City, trustees must make estimated tax payments for trusts.³³

Also, like New York State, New York City does not tax trustees of Nonresident Resident Trusts but requires them to file informational returns.³⁴

New York State and City

If a trust was a Resident Trust for New York State and New York City purposes in 2011, then the trustee was subject to tax at rates up to 12.846% on taxable income over \$500,000.³⁵ In 2012, the top rate is 12.696% on such income over \$1 million.³⁶

CASES AND RULINGS

Introduction

In addition to *Mercantile* and *Taylor*, New York courts and administrative agencies have issued numerous cases and rulings that involve the income taxation of trusts by New York State and New York City. Here is a sampling.

In the Matter of Joseph Lee Rice III Family 1992 Trust — Trustee Denied Refund for Closed Years Based on Change of Residence of Trustee

This 2010 decision of the New York State Division of Tax Appeals illustrates the importance of paying attention to detail.³⁷ In 1992, the trustor, who resided in New York City, created an irrevocable nongrantor trust in which he named his attorney, also a New York City resident, as trustee. The trust initially was subject to New York State and City income tax because of the

³¹ N.Y. Tax Law §1305(d); Admin. Code City of N.Y. §11-1705(b)(4).

³² N.Y. Tax Law §1303; Admin. Code City of N.Y. §11-1718.

³³ See N.Y. Tax Law §1301(b).

³⁴ Admin. Code City of N.Y. §11-1705(b)(3)(D)(i).

³⁵ N.Y. Tax Law §§601(c)(1-a), 1304(a)(3)(A), 1304-B(a)(1)(ii).

³⁶ N.Y. Tax Law §§601(c)(1)(A), 1304(a)(3)(A), 1304-B(a)(1)(ii).

³⁷ *In the Matter of Joseph Lee Rice III Family 1992 Trust*, DTA No. 822892, 2010 N.Y. Tax Lexis 268 (N.Y. Div. Tax App. 2010), available at <http://www.nysdta.org/Determinations/822892.det.pdf>.

²⁷ N.Y. Tax Law §1303; Admin. Code City of N.Y. §§11-1711, 11-1712.

²⁸ See N.Y. Tax Law §1303.

²⁹ N.Y. Tax Law §§1304(a)(3)(A), 1304-B(a)(1)(ii); Admin. Code City of N.Y. §§11-1701, 11-1704.1; instructions to 2011 N.Y. Form IT-205 at 22. See N.Y. TSB-M-10(7)I, 2010 State Tax Today 161-19 (Aug. 17, 2010), available at http://www.tax.ny.gov/pdf/memos/income/m10_7i.pdf.

³⁰ N.Y. Tax Law §1305(c). See Admin. Code City of N.Y. §11-1705(b)(3).

trustor's and the trustee's New York City residences. In 1995, the trustee moved to Florida but continued to file tax returns using his law firm's Manhattan address and to pay State and City tax. Subsequently, it was discovered that the trustee should have ceased paying tax upon his move to Florida. The New York State Division of Taxation granted refunds for the open years — 2001–2003 — but the administrative law judge upheld the Division of Taxation's refusal to pay refunds for the closed years — 1996–2000.³⁸ The amount of tax was not disclosed, but the trustee and/or the accountant might face liability for the tax erroneously paid for those years.

In the Matter of the Petition of the Amauris Trust — Trusts Created at End of GRIT Term Not Resident Trusts

This 2008 decision of the New York State Division of Tax Appeals considered the taxation of two trusts that were funded at the expiration of the initial 10-year term of a grantor retained income trust ("GRIT").³⁹ The trustor was a New York resident in 1990 when he created the GRIT, but he resided in Connecticut at the end of the initial term in 2000. Because the trust had source income, the establishment of the trustor's residence determined whether the trusts were taxed on all income or on source income only. Several million dollars were involved. The administrative law judge concluded:⁴⁰

[S]ince the transfers were not effectuated until July 30, 2000, the ten-year anniversary of the Peterffy Trust, the Amauris and Niavius Trusts could not properly be taxed as resident trusts by the State of New York because, pursuant to Tax Law §605(b)(3), Thomas Peterffy was a Connecticut and not a New York domiciliary at the time the stock was transferred to these trusts. As such, since the Timber Hill, Inc., stock was not transferred to the Amauris Trust and the Niavius Trust until July 30, 2000, at a time that the grantor of the Peterffy Trust was a Connecticut domiciliary, it is hereby determined that the Amauris Trust and the Niavius Trust were not resident trusts as defined by Tax Law §605(b)(3)(C).

N.Y. TSB-A-04(7)I — Rules Set for Determining Residence of Corporate Trustee and for Evaluating Role of Advisor, Committee, Etc.

In 2004, the New York Technical Services Division considered whether proposed actions by a committee

acting under five irrevocable trusts entered into by John D. Rockefeller, Jr., and Chase National Bank in 1934 would enable the trustees to avoid New York State and City income tax as follows:⁴¹

The issue raised by Petitioner, JPMorgan Chase Bank, as Trustee of the 1934 Trusts, is whether the trusts, described below, will be subject to New York State or New York City income tax if (a) the Committee, described below, replaces the trustee with a trustee not domiciled in New York State, and (b) the two Committee members who are currently domiciled in New York State are replaced by individuals who are not domiciled in New York State.

First, the five-member committee, which directed the trustee on investment and distribution matters, proposed to replace the New York corporate trustee with its Delaware affiliate. The ruling stated that the residence of the proposed successor trustee should be determined as follows:⁴²

[F]or purposes of section 605(b)(3)(D) of the Tax Law and section 105.23(c) of the Regulations, the domicile of the Proposed Successor Trustee will be the state where its principal place of business is located, as set forth in the above guidelines for determining the domicile of a corporation.

However, the ruling declined to decide this issue for the following reason:⁴³

The determination of domicile is a factual matter that is not susceptible of determination in this Advisory Opinion. An Advisory Opinion merely sets forth the applicability of pertinent statutory and regulatory provisions to a specified set of facts.

Next, the two members of the committee who resided in New York proposed to resign. The ruling observed:⁴⁴

An advisor to a trustee has been interpreted by the courts to include not only a person who has been designated by particular terminology in the trust instrument but also any other individual who, by the terms of the trust instrument, has been given power to direct or control a trustee in the performance of some part or all of that trustee's functions and duties, or

³⁸ See N.Y. Tax Law §697(d).

³⁹ *In the Matter of the Petition of the Amauris Trust*, DTA No. 821369, 2008 N.Y. Tax Lexis 139 (N.Y. Div. Tax App. 2008), available at <http://www.nysdta.org/Determinations/821369.det.pdf>.

⁴⁰ 2008 N.Y. Tax Lexis 139 at 33–34.

⁴¹ N.Y. TSB-A-04(7)I, 2004 N.Y. Tax Lexis 259 at 1 (Nov. 12, 2004), available at http://www.tax.ny.gov/pdf/advisory_opinions/income/a04_7i.pdf.

⁴² 2004 N.Y. Tax Lexis 259 at 20.

⁴³ 2004 N.Y. Tax Lexis 259 at 20.

⁴⁴ 2004 N.Y. Tax Lexis 259 at 21–23 (citations omitted).

who has 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 such advisor.

It is well settled under New York law that a grantor of a trust may limit a trustee's powers. In *Matter of Rubin*, the court addressed the status of advisors. The court held that the designation of an advisor is a valid limitation on a trustee's powers, and noted that the courts have generally considered an advisor to be a fiduciary, somewhat in the nature of a co-trustee. Another term that may be employed, said the court, is quasi-trustee or special trustee. The court's statement "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," indicates a tacit acceptance of the characterization of the advisor as a trustee. However, an advisor that does not have any powers under the terms of the trust instrument to direct or control a trustee in the performance of some part or all of that 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.

Under the facts in this case, the Committee has been granted broad powers over the assets of the Trusts. For example, the Committee may direct the Trustee to take or refrain from taking any action which the Committee deems it advisable for the Trustee to take or refrain from taking. All of the powers of the Trustee under the Trust Agreements are subject to the directions of the Committee. Since the Committee is an advisor having the controlling power over the Trustee, following *Rubin*, supra, the members of the Committee are considered to be co-trustees of the Trusts. Therefore, for purposes of the first condition under section 605(b)(3)(D)(i) of the Tax Law and section 105.23(c) of the Regulations, the individuals comprising the Committee are considered to be trustees of the Trusts.

However, the determination of whether Petitioner or any other investment management firms or former Committee members that may be retained by the Proposed Committee to

provide investment advice or management services would also be treated as co-trustees of the Trusts for purposes of section 605(b)(3)(D)(i) of the Tax Law and section 105.23(c) of the Regulations is a factual matter that is not susceptible of determination in this Advisory Opinion.

Regarding New York State income tax, the ruling concluded:⁴⁵

In conclusion, Petitioner states that all real and tangible property included in the corpus of the Trusts, is located outside New York and all the income and gains of the Trusts are derived or connected from sources outside of New York State, determined as if the Trusts were a nonresident. Pursuant to section 605(b)(3)(D)(ii) of the Tax Law, any intangible property included in the corpus of the Trusts is located in New York State if any of the trustees are domiciled in New York State. Therefore, the determination of whether the Trusts will be exempt from New York State personal income tax for purposes of section 605(b)(3)(D) of the Tax Law and section 105.23(c) of the Regulations will depend on whether the Proposed Successor Trustee, any member of the Proposed Committee or any other investment advisor or manager that is considered to be a co-trustee is domiciled in New York State. The Trusts will meet the three conditions of section 605(b)(3)(D)(i) of the Tax Law and section 105.23(c) of the Regulations only if all of the trustees are domiciled outside of New York State. In the case of the Proposed Successor Trustee, pursuant to the concept of domicile with respect to an individual, the domicile of the corporation is the principal place from which the trade or business of the corporation is directed or managed. In the case of any member of the Proposed Committee or any other investment advisor or manager that is considered to be a co-trustee, pursuant to section 105.20(d)(1) of the Regulations, the domicile of an individual is the place which such individual intends to be such individual's permanent home.

Regarding New York City income tax, the ruling concluded:⁴⁶

The New York City personal income tax is similar to the New York State personal income tax and is administered by New York

⁴⁵ 2004 N.Y. Tax Lexis 259 at 23-25.

⁴⁶ 2004 N.Y. Tax Lexis 259 at 25.

State the same as Article 22 of the Tax Law. Accordingly, for the taxable years that the Trusts have not met the three conditions contained in section 605(b)(3)(D)(i) of the Tax Law and section 105.23(c) of the Regulations, New York State personal income tax is imposed on the Trusts, and if any of the trustees are domiciled in New York City, New York City personal income tax authorized under Article 30 of the Tax Law is imposed on the Trusts for those taxable years that a trustee is domiciled in New York City.

N.Y. TSB-A-03(6)I — Rules Set for Powers of Appointment

The New York State Department of Taxation provided guidance in 2003 on whether or not the donee of a power of appointment is the “transferor” to the appointive trust for New York income tax purposes in six situations.⁴⁷ The ruling concluded that:⁴⁸

[T]he residency of an appointive trust created by the exercise of a power of appointment is determined based on the domicile of the donor of the property who transferred the property to the trust. A person who transfers property held in trust to an appointive trust by the exercise of a general power of appointment over the trust property is considered the donor of the trust property for purposes of determining the residency of the appointive trust. Conversely, a person who transfers property held in trust to an appointive trust by the exercise of a special power of appointment over the trust property is not considered the donor of the trust property for purposes of determining the residency of the appointive trust. The donor of the special power of appointment is considered the donor of the trust property for purposes of determining the residency of the appointive trust.

Cases and Rulings Recognizing Nonresident Resident Trust Exemption

N.Y. TSB-A-94(7)I — Resident Trust Not Taxable Once Trustee Became Nonresident

In this 1994 ruling,⁴⁹ a New York City resident established an irrevocable complex inter vivos trust in

⁴⁷ N.Y. TSB-A-03(6)I, 2003 N.Y. Tax Lexis 313 (Nov. 21, 2003), available at http://www.tax.ny.gov/pdf/advisory_opinions/income/a03_6i.pdf.

⁴⁸ 2003 N.Y. Tax Lexis 313 at 12–13 (citation omitted).

⁴⁹ N.Y. TSB-A-94(7)I, 1994 N.Y. Tax Lexis 310 (Apr. 8, 1994),

1976. Although the sole individual trustee initially resided in New York City, he moved to Connecticut in 1985. During the years in question, the corpus consisted solely of intangible personal property (some of which was held by a New York financial institution), and the trust earned no source income.

Regarding New York State tax, the ruling stated:⁵⁰

[T]he Charles B. Moss Trust is a New York resident trust. However, since the three conditions contained in section 105.23(c) of the Personal Income Tax Regulations have been met, for the taxable years at issue, 1990, 1991 and 1992, no New York State personal income tax is imposed on such trust for said years.

Regarding New York City tax, the ruling concluded:⁵¹

The New York City personal income tax is similar to the New York State personal income tax and is administered by New York State the same as Article 22 of the Tax Law. Accordingly, since the Charles B. Moss Trust has met the three conditions contained in section 105.23(c) of the New York State Personal Income Tax Regulations and no New York State personal income tax is imposed on such trust for taxable years 1990, 1991 and 1992, no New York City personal income tax authorized under Article 30 of the Tax Law is imposed on such trust for such taxable years.

The tax preparer might have been at risk for the tax erroneously paid for the closed years — 1985–1989.

N.Y. TSB-A-96(4)I — Resident Trust Not Taxed on Capital Gain

The issue in this 1996 Technical Services Bulletin was whether the trustees of a trust created by a New York City resident in 1961 had to pay New York State and City income tax on a large capital gain.⁵² Initially, the two individual trustees were New York residents, but, by 1988, both trustees were nonresidents. Regarding New York State income tax, the ruling stated:⁵³

In this case, after 1988 the three conditions contained in section 105.23(c) of the Personal Income Tax Regulations have been met. First,

available at http://www.tax.ny.gov/pdf/advisory_opinions/income/a94_7i.pdf.

⁵⁰ 1994 N.Y. Tax Lexis 310 at 8.

⁵¹ 1994 N.Y. Tax Lexis 310 at 8.

⁵² N.Y. TSB-A-96(4)I, 1996 N.Y. Tax Lexis 528 (Oct. 25, 1996), available at http://www.tax.ny.gov/pdf/advisory_opinions/income/a96_4i.pdf.

⁵³ 1996 N.Y. Tax Lexis 528 at 6–7.

after 1988 all of the trustees have been domiciled outside of New York State. Second, the corpus of the Trust consists of intangible assets some of which are held by Lazard Freres & Co. located in New York City. Third, none of the assets of the Trust were employed in a business carried on in New York State and all income and gains of the Trust were derived from sources outside of New York State, determined as if the Trust were a nonresident. With respect to the second condition, the situs of the intangible assets of a trust is deemed to be at the domicile of the trustee. Therefore, the situs of the corpus of the Trust is deemed to be outside of New York State.

Accordingly, the Trust is a New York resident trust. However, for the taxable years that the three conditions contained in section 105.23(c) of the Personal Income Tax Regulations have been met, no New York State personal income tax is imposed on such trust for those years.

Regarding New York City income tax, it concluded:⁵⁴

The New York City personal income tax is similar to the New York State Personal income tax and is administered by New York State the same as Article 22 of the Tax Law. Accordingly, for the taxable years that the Trust has met the three conditions contained in section 105.23(c) of the New York State Personal Income Tax Regulations, no New York State personal income tax is imposed on the Trust, and no New York City personal income tax authorized under Article 30 of the Tax Law is imposed on the Trust for those taxable years.

N.Y. TSB-A-00(2)I — Resident Trust Not Taxable Even Though It Held Interest in LLC Managed by New York City Resident

Here,⁵⁵ a New York City resident created a Delaware LLC of which she was the managing member. She kept a 1% interest and contributed a 99% interest to a trust for the benefit of New York beneficiaries but appointed a nonresident individual as trustee.

The ruling identified the pertinent issues as follows:⁵⁶

3. Whether the Trust . . . or Trustee(s) . . . is subject to any New York State or New York

City tax law or filing requirements or fees (i.e., Fiduciary Income Tax Return).

4. Whether the domicile of the Trustee(s) or Beneficiary affects the tax status of the Trust.

The ruling found that the trustee was not taxable for the following reasons:⁵⁷

Issue 3 . . . In this case, the three conditions contained in section 105.23(c) of the Personal Income Tax Regulations have been met. First, the trustee is domiciled outside of New York State. Second, the corpus of the Trust consists of intangible assets. The situs of the intangible assets of a trust are deemed to be at the domicile of the trustee. Therefore, the situs of the corpus of the Trust is deemed to be outside of New York State. Third, none of the assets of the Trust are employed in a business carried on in New York State and all income and gains of the Trust were derived from sources outside of New York State, determined as if the Trust were a nonresident.

Accordingly, the Trust is a New York resident trust. However, for the taxable year that the three conditions contained in section 105.23(c) of the Personal Income Tax Regulations are met, no New York State personal income tax is imposed on such Trust for those years. Further, no New York City personal income tax authorized under Article 30 of the Tax Law is imposed on the Trust for those taxable years.

Issue 4

The domicile of the Trustee of the Trust does affect the taxable status of the Trust. If the Trustee is domiciled in New York State, the Trust would not meet the three conditions contained in section 105.23(c) of the Personal Income Tax Regulations, and the Trust would be subject to New York State personal income tax. In addition, if the Trustee is a resident of the City of New York, the Trust would be subject to the New York City personal income tax authorized under Article 30 of the Tax Law. The domicile of the beneficiary does not affect the taxable status of the trust.

The significance of this technical services bulletin is that a New York City resident could manage trust investments indirectly as the managing member of an LLC in which the trustee held an interest that she could not have managed directly as trustee without subjecting the trust to tax.

⁵⁴ 1996 N.Y. Tax Lexis 528 at 7–8.

⁵⁵ N.Y. TSB-A-00(2)I, 2000 N.Y. Tax Lexis 118 (Mar. 29, 2000), available at http://www.tax.ny.gov/advisory_opinions/income/a00_2i.pdf.

⁵⁶ 2000 N.Y. Tax Lexis 118 at 1.

⁵⁷ 2000 N.Y. Tax Lexis 118 at 13–15.

N.Y. TSB-A-04(7)I — Resident Trust Not Taxable if Corporate Trustee and Committee Members Are Not Residents

In this ruling summarized above,⁵⁸ the Technical Services Division recognized that the trusts under consideration would qualify as Nonresident Resident Trusts if the corporate trustee and the committee members were nonresidents.

In the Matter of the Petition of the John Heffer Trust — Resident Trust Not Taxable Once Resident Trustee Resigned in Accordance with Governing Instrument

This controversy⁵⁹ involved a trust that a New York City resident created in 1973 naming individual trustees. In 1981, the last New York resident trustee resigned and was replaced by a nonresident trustee as provided in the trust instrument but without a court proceeding. Nevertheless, the trustees continued to file returns and to pay tax. In 2004, the trustees filed amended returns seeking refunds for 2000 (about \$100,000), 2001 (about \$6,000), and 2002 (about \$100,000), which were denied by the Division of Taxation.

On appeal, the Division of Tax Appeals identified the issue as follows:⁶⁰

Whether the resignation of a New York domiciled trustee of a New York resident trust, without court approval, was sufficient to satisfy the requirements of 20 NYCRR former 105.23(c), such that petitioner trust was no longer subject to New York personal income tax and was entitled to a refund of taxes paid for the years 2000, 2001 and 2002.

The Division of Tax Appeals reversed the determination of the Division of Taxation and granted the refunds for the following reasons:⁶¹

The John Heffer Trust clearly prescribed procedures for the resignation of a trustee and the appointment of successor trustees which were carefully followed in accordance with the intent of the grantor, thereby giving legal effect to the resignation of Sidney J. Silberman on November 20, 1981.

Therefore, for the years 2000, 2001 and 2002, petitioner has established that it met the re-

⁵⁸ N.Y. TSB-A-04(7)I, 2004 N.Y. Tax Lexis 259 (Nov. 12, 2004), available at http://www.tax.ny.gov/pdf/advisory_opinions/income/a04_7i.pdf.

⁵⁹ *In the Matter of the Petition of the John Heffer Trust*, DTA No. 820351, 2006 N.Y. Tax Lexis 124 (N.Y. Div. Tax App. 2006), available at <http://www.nysdta.org/Determinations/820351.det.pdf>.

⁶⁰ 2006 N.Y. Tax Lexis 124 at 1–2.

⁶¹ 2006 N.Y. Tax Lexis 124 at 13.

quirements of 20 NYCRR 105.23(c) and was not subject to income tax.

Although the trustees obtained refunds for the open years — 2000, 2001, and 2002 — we wonder whether they, the tax return preparer, or their advisors were at risk for tax erroneously paid for the closed years, going all the way back to 1981.

In the Matter of Joseph Lee Rice III Family 1992 Trust — Resident Trust Not Taxable Once Trustee Became Nonresident

This 2010 decision of the Division of Tax Appeals summarized above⁶² recognized that a Resident Trust ceased to be taxable as soon as the sole resident individual trustee became a Florida resident.

N.Y. TSB-A-10(4)I — Resident Trust No Longer Taxable upon Death of Resident Trustee

This 2010 Technical Services Bulletin addressed the tax payment requirements of the surviving nonresident trustee of a New York Resident Trust due to the death of the New York resident individual co-trustee on August 1, 2008.⁶³ The ruling concluded:⁶⁴

Once a resident trust satisfies the conditions in Tax Law section 605(b)(3)(D)(i), it is no longer subject to further taxation by New York State so long as the trustee remains a non-domiciliary and the trust continues to meet the other conditions in section 605(b)(3)(D)(i). The Trusts must, however, accrue to the period of their taxable residence any income, gain, loss, deduction, items of tax preference or any ordinary income portion of a lump sum distribution accruing prior to the Trusts' change of tax status, regardless of the Trusts' method of accounting.

N.Y. TSB-A-11(4)I — Resident Trust No Longer Taxable when Resident Trustee Resigns

This 2011 Technical Services Bulletin considered the New York income tax consequences for Resident Trusts caused by changes of residences of the grantors and trustees.⁶⁵ The ruling concluded:⁶⁶

Based on the information submitted, the Trusts never owned and do not currently own

⁶² *In the Matter of Joseph Lee Rice III Family 1992 Trust*, DTA No. 822892, 2010 N.Y. Tax Lexis 268 (N.Y. Div. Tax App. 2010), available at <http://www.nysdta.org/Determinations/822892.det.pdf>.

⁶³ N.Y. TSB-A-10(4)I, 2010 N.Y. Tax Lexis 196 (June 8, 2010), available at http://www.tax.ny.gov/pdf/advisory_opinions/income/a10_4i.pdf.

⁶⁴ 2010 N.Y. Tax Lexis 196 at 4.

⁶⁵ N.Y. TSB-A-11(4)I, 2011 N.Y. Tax Lexis 181 (July 27, 2011), available at http://www.tax.ny.gov/pdf/advisory_opinions/income/a11_4i.pdf. Other cases upholding the Nonresident Resident Trust exemption are: *In the Matter of the Petition of the John*

any real or tangible property in New York and they have no New York source income. Therefore, the Trusts met the second and third requirements of Tax Law §605(b)(3)(D). However, because Trustee 1 was a New York resident, the Trusts did not meet the first requirement of Tax Law §605(b)(3)(D) and initially were subject to New York State income tax only on the New York resident portions of the Trusts. When Trustee 1 resigned as trustee, leaving only Trustee [sic] 2, a Connecticut resident, as the sole trustee, the Trusts met all the requirements of Tax Law §605(b)(3)(D). Accordingly, when Trustee 1 resigned as trustee, the Trusts were no longer subject to New York income tax.

SOURCE INCOME

Introduction

In New York, trustees of Nonresident Trusts are taxed on source income⁶⁷ and a single dollar of source income apparently will prevent a Resident Trust from meeting the Nonresident Resident Trust exemption.⁶⁸ The New York State Department of Taxation and Finance has announced that source income includes:⁶⁹

- real or tangible personal property located in New York State (including certain gains or losses from the sale or exchange of an interest in an entity that owns real property in New York State, see TSB-M-09(5)I);
- a business, trade, profession, or occupation carried on in New York State;
- your distributive share of New York State partnership income or gain;
- your share of New York State estate or trust income or gain;
- any gain from the sale, transfer, or other disposition of shares of stock in a cooperative housing corporation in connection with the grant or transfer of a proprietary leasehold, when the real prop-

erty comprising the units of the cooperative housing corporation is located in New York State;

- any income you received related to a business, trade, profession, or occupation previously carried on in New York State, including but not limited to covenants not to compete and termination agreements (see TSB-M-10(9)I); and
- a New York S corporation in which you are a shareholder.

That agency has stated that source income does not include:⁷⁰

- your income from annuities and pensions that meet the New York State definition of an annuity, unless the annuity is employed or used as an asset of a business, trade, profession, or occupation carried on in New York State;
- your interest, dividends, or gains from the sale or exchange of intangible personal property, unless they are part of the income you received from carrying on a business, trade, profession, or occupation in New York State; and
- your income as a shareholder of a corporation that is a New York C corporation.

Contributing Tangible Personal Property or Real Property to an Entity to Escape Source-Income Classification

The trustee of a New York Nonresident Trust or of a Resident Trust that holds tangible personal property or real property might consider transferring the property into an FLP or LLC with the hope of converting it into intangible personal property that will not produce source income. In this regard, New York State treats the gain incurred upon the sale of interests in certain entities that hold New York real property as source income.⁷¹ Specifically, real property located in New York includes an interest in an entity (i.e., a partnership, limited liability corporation, S corporation, or non-publicly traded C corporation with 100 or fewer shareholders) that owns real property in New York having a fair market value that equals or exceeds 50% of all the assets of the entity on the date of sale or exchange of the taxpayer's interest in the entity.⁷² Only the assets that the entity owned for at least two years before the date of the sale or exchange of the taxpayer-

Heffer Trust, DTA No. 820351, 2006 N.Y. Tax Lexis 124 (N.Y. Div. Tax App. 2006), available at <http://www.nysdta.org/Determinations/820351.det.pdf>; N.Y. TSB-A-00(2)I, 2000 N.Y. Tax Lexis 118 (Mar. 29, 2000), available at http://www.tax.ny.gov/pdf/advisory_opinions/income/a00_2i.pdf.

⁶⁶ 2011 N.Y. Tax Lexis 181 at 3–4.

⁶⁷ N.Y. Tax Law §§633, 631.

⁶⁸ N.Y. Tax Law §605(b)(3)(D)(i)(III).

⁶⁹ N.Y. Tax Bull. TB-IT-615, 2011 State Tax Today 244-15 (Dec. 15, 2011), available at http://www.tax.ny.gov/pdf/tg_bulletins/pit/b11_615i.pdf.

⁷⁰ N.Y. Tax Bull. TB-IT-615, 2011 State Tax Today 244-15 (Dec. 15, 2011), available at http://www.tax.ny.gov/pdf/tg_bulletins/pit/b11_615i.pdf.

⁷¹ N.Y. Tax Law §631(b)(1)(A)(1).

⁷² N.Y. Tax Law §631(b)(1)(A)(1).

er's interest in the entity are to be used in determining the fair market value of all the assets of the entity on the date of sale or exchange.⁷³ The gain or loss derived from New York sources from the taxpayer's sale or exchange of an interest in an entity is the total gain or loss for federal income-tax purposes from that sale or exchange multiplied by a fraction, the numerator of which is the fair market value of the real property located in New York on the date of sale or exchange and the denominator of which is the fair market value of all the assets of the entity on the date of sale or exchange.⁷⁴ The New York State Department of Taxation and Finance has issued a Technical Services Bulletin that illustrates the operation of the provision. At the end of the bulletin, it covers applicability to trusts.⁷⁵

***In re Ittleson* — An Example of Source Income**

This case,⁷⁶ which did not involve a trust, illustrates source income. In 1986, a New York City married couple bought a Modigliani painting for about \$1.5 million and hung it in their Manhattan cooperative apartment. The owners moved to South Carolina in December 1996, but the painting remained in the apartment, where it stayed until March 1997 when it was turned over to Sotheby's for auction. Sotheby's sold the painting for about \$8.5 million in May 1997, producing roughly a \$7 million gain. The Tax Appeals Tribunal stated the issue at the outset:⁷⁷

Whether the Division of Taxation properly determined that the nonresident petitioners' gain from the sale of a painting was New York source income pursuant to Tax Law §631(b)(1)(A) and, therefore, subject to New York personal income tax under Tax Law §601(e).

⁷³ N.Y. Tax Law §631(b)(1)(A)(1).

⁷⁴ N.Y. Tax Law §631(b)(1)(A)(1).

⁷⁵ TSB-M-09(5)I, 2009 State Tax Today 91-26 (May 5, 2009), available at http://www.tax.ny.gov/pdf/memos/income/m09_5i.pdf.

⁷⁶ *In re Ittleson*, N.Y. DTA 819283, 2005 N.Y. Tax Lexis 199 (N.Y. Div. Tax App. 8/25/05), available at <http://www.nysdta.org/Decisions/819283.dec.pdf>.

⁷⁷ *In re Ittleson*, N.Y. DTA 819283, 2005 N.Y. Tax Lexis 199 at 1-2 (N.Y. Div. Tax App. 8/25/05), available at <http://www.nysdta.org/Decisions/819283.dec.pdf>.

In holding the gain to be taxable, the court concluded:⁷⁸

In the present case, the physical presence of the Painting in New York at the time of sale and for a substantial period of years before that clearly satisfies the requirement of a "minimal connection" with the state. In addition, the manifest benefits of the laws of New York attaching to petitioners' ownership and sale of the Painting clearly are rationally related to the gain on the sale of the Painting which the state seeks to tax. This is no less true because high-end art auctions attract bidders from all parts of the world. There may well be cases in which the presence of tangible personal property in the state would be too ephemeral to satisfy the requirements of due process but this is not such a case.

The surviving owner had to pay about \$500,000 of New York State and New York City income tax that probably could have been avoided if the Modigliani had left New York.

PLANNING

New York testators and trustors should plan their trusts to qualify as Nonresident Resident Trusts. If a trust will hold property that will generate source income, the testator or trustor might minimize tax by creating two trusts, one of which will hold assets that produce source income and the other of which will hold assets that do not generate such income. Residents of other states should consider creating trusts in New York because the state does not tax trusts created by nonresidents.

CONCLUSION

We hope that this article will guide attorneys planning trusts for New York residents as well as trustees of trusts that are paying New York tax to reduce or avoid such tax. Failure to plan often will cause trust assets to be reduced substantially without need and therefore expose attorneys, trustees, and other advisors to potential liability.

⁷⁸ *In re Ittleson*, N.Y. DTA 819283, 2005 N.Y. Tax Lexis 199 at 15 (N.Y. Div. Tax App. 8/25/05), available at <http://www.nysdta.org/Decisions/819283.dec.pdf>.