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February 22, 2010

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Re: Report Commenting on 2010-2011 New York State Executive Budget Proposal to Modify Income Taxation of New York Resident Trusts

Gentlemen:

We write with comments of the Tax Section of the New York State Bar Association¹ on certain provisions of the 2010-11 New York State Executive Budget contained in Revenue Article VII Legislation, Part G (the "Proposal") which, if enacted, would modify the income taxation of New York resident trusts.

¹ Opinions expressed in the report are those of the Tax Section of the New York State Bar Association, and do not represent those of the New York State Bar Association unless and until they have been adopted by the Association's House of Delegates or its Executive Committee.

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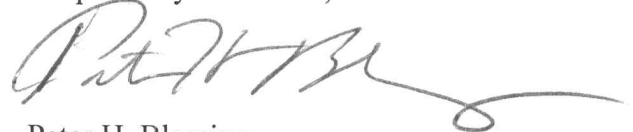
We recognize and acknowledge the concerns motivating the Proposal, but recommend that the Proposal in its current form be deleted from the pending budget legislation in light of the serious Federal constitutional questions it raises and the practical considerations discussed in the report.

We also recommend that a careful review of possible approaches to address the relevant concerns include, as one alternative, consideration of the possible application of “throwback rules” analogous to those in Federal and California income tax laws and, in certain respects, analogous to the treatment of New York shareholders of S Corporations in certain circumstances under current New York income tax law.

We respectfully suggest that further consideration of the Proposal take place in the broader context of considering, in addition to the potentially significant constitutional and practical issues discussed in the report: (i) whether tax distinctions drawn on the basis of the domicile of the creator of a trust continue to be meaningful in today’s mobile society; (ii) the constitutionality of the current rules for the income taxation of New York resident trusts, particularly those that may result in the New York income taxation of all of a resident trust’s taxable income solely by reason of its receipt of any New York source income; (iii) the economic impact of tax and other trust law rules on the creation and administration of trusts in New York and related economic activity; and (iv) whether alternative mechanisms of income taxation are available to address relevant concerns.

We appreciate your consideration of our recommendations and suggestions. Please let us know if you would like to discuss these matters further or if we can assist you in any other way.

Respectfully submitted,

A handwritten signature in black ink, appearing to read "Peter H. Blessing", with a long, sweeping underline that extends to the right.

Peter H. Blessing,
Chair

cc: Hon. Robert Megna, Budget Director, Office of the Governor
Hon. Jamie Woodward, Acting Commissioner, Department of Taxation and Finance

**NEW YORK STATE BAR ASSOCIATION
TAX SECTION**

**REPORT COMMENTING ON 2010-2011 NEW YORK STATE
EXECUTIVE BUDGET PROPOSAL TO MODIFY
INCOME TAXATION OF NEW YORK RESIDENT TRUSTS**

February 22, 2010

Table of Contents

	Page
I. INTRODUCTION	1
II. BACKGROUND	3
A. Scope of the Proposal	3
B. Income Taxation of Non-Grantor Trusts in General	5
C. Distinctions Drawn on Domicile of Trust Creator; <i>The Mercantile</i> Decision	8
D. Post <i>Mercantile</i> Developments in New York Law	10
E. Specifics of the Proposal	12
III. CONSTITUTIONAL ISSUE	14
A. In General	14
B. Difficulty in Categorizing Trusts	17
C. Post <i>Mercantile</i> Developments	19
IV. OBSERVATIONS REGARDING RETROACTIVITY	24
V. RECOMMENDATIONS	26
A. The Proposal	26
B. Throwback Rules	27

Appendix A, List of Significant Cases

**NEW YORK STATE BAR ASSOCIATION
TAX SECTION**

**Report Commenting on 2010-2011 New York State
Executive Budget Proposal to Modify
Income Taxation of New York Resident Trusts**

I. Introduction

This report¹ comments on certain provisions of the 2010-11 New York State Executive Budget contained in Revenue Article VII Legislation, Part G (the “Proposal”) which, if enacted, would modify the income taxation of New York resident trusts.

The report recognizes and acknowledges the concerns motivating the Proposal, but recommends that the Proposal in its current form be deleted from the pending budget legislation in light of the serious Federal constitutional questions it raises and practical considerations discussed below.

We also recommend that a careful review of possible approaches to address the relevant concerns include, as one alternative, consideration of the possible application of “throwback rules” analogous to those in Federal and

¹ The principal drafter of this report was Jeffrey N. Schwartz, with substantial contributions from Amy E. Heller and helpful comments from Kim Blanchard, Peter Blessing, Paul Comeau, Peter Connors, Sarah DeBergalis, Peter Faber, Maria Jones, Stephen Land, Carolyn Joy Lee, Carlyn McCaffrey, David Miller, Jeffrey Reed, Arthur Rosen, Michael Schler and Diana Wollman.

Opinions expressed herein are those of the Tax Section of the New York State Bar Association, and do not represent those of the New York State Bar Association unless and until they have been adopted by the Association’s House of Delegates or its Executive Committee.

California income tax laws and, in certain respects, analogous to the treatment of New York shareholders of S Corporations in certain circumstances under current New York income tax law.

We note that this report does not express a view as to the minimum constitutionally sufficient contacts or other requirements necessary for New York to impose an income tax on all or a portion of a trust's income, but rather attempts to explain why certain aspects of the Proposal may be subject to constitutional challenge given the New York Court of Appeals' decision in *Mercantile Safe-Deposit & Trust Co. v. Murphy*, 203 N.E.2d 490 (N.Y. 1964) discussed below, even after taking into consideration subsequent jurisprudence in the trust context. We express no view in this report as to broader trends in constitutional jurisprudence outside the trust context that might influence one's view as to the current relevance of the U.S. Supreme Court decisions cited in *Mercantile*. In this regard, we note that there may be disagreement as to the implications of those trends in analyzing issues relating to trusts.

We also note that this report does not take any position on whether the Proposal is appropriate as a policy matter, but instead attempts to highlight certain constitutional and practical, non-constitutional considerations which could influence one's view of the Proposal.

We also respectfully suggest that further consideration of the Proposal, and of potential modifications and alternatives to the Proposal, should take place in the broader context of considering, in addition to the potentially significant

constitutional and practical issues discussed below: (i) whether tax distinctions drawn on the basis of the domicile of the creator of a trust continue to be meaningful in today's mobile society; (ii) the constitutionality of the current rules for the income taxation of New York resident trusts, particularly those that may result in the New York income taxation of all of a resident trust's taxable income solely by reason of its receipt of any New York source income; (iii) the economic impact of tax and other trust law rules on the creation and administration of trusts in New York and related economic activity; and (iv) whether alternative mechanisms of income taxation are available to address relevant concerns. In this regard, and as indicated above, we believe that "throwback type rules" in the nature of those discussed below are an additional mechanism of income taxation that merits further consideration in addressing certain of the concerns that may have motivated the Proposal.

II. Background

A. Scope of the Proposal

The Proposal would modify the income taxation of New York "resident trusts," a term generally defined in the New York Tax Law as any trust (or portion of a trust) consisting of property transferred to it by a New York domiciliary without regard to the location of the administration of the trust or its trustees or beneficiaries.²

² New York Tax Law § 605(b)(3) defines a resident estate or trust as follows:

"(3) Resident estate or trust. A resident estate or trust means:

(...continued)

The Proposal would not modify the income taxation of “non-resident trusts,” which term generally refers to a trust created by a non-New York domiciliary without regard to the location of the administration of the trust or its trustees or beneficiaries.³

The Proposal also would not modify the income taxation of resident trusts that are treated as so called “grantor trusts” for Federal income tax purposes.⁴ Accordingly, unless otherwise indicated, the references in this report to resident trusts are to resident non-grantor trusts.

The specifics of the Proposal are discussed in I.E. below.

(continued...)

(A) the estate of a decedent who at his death was domiciled in this state;

(B) a trust, or portion of a trust, consisting of property transferred by will of a decedent who at such decedent’s 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 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 revert 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.”

³ See N.Y. Tax Law §605(b)(4).

⁴ Under the grantor trust rules, the creator of the trust, or other person possessing specific powers with respect to the trust property, is treated as the owner of the trust property and all income and deductions of the trust (including capital gains and losses) are included on that person’s income tax return and taxed to him or her. See I.R.C. §§ 671-679.

B. Income Taxation of Non-Grantor Trusts in General

While the Proposal is itself focused only on the income taxation of New York resident trusts, *i.e.*, trusts funded by New York domiciliaries, if one assumes based upon *Mercantile* that distinctions in the income taxation of non-grantor trusts based upon the domicile of the original creator or funder of the trust are constitutionally insignificant, the broader tax policy issue implicated by the Proposal is the selection of appropriate circumstances under which New York may and should tax the undistributed income of a non-grantor trust, whether the non-grantor trust is created by a New York domiciliary or created by a non-New York domiciliary.

A non-grantor trust, whether or not created by a New York domiciliary, is generally treated for Federal and New York income tax purposes as both a separate taxable entity and as a conduit.

The trust itself is potentially subject to Federal and New York income tax each year on its undistributed taxable income, while the trust beneficiaries are taxed on their share of the trust income that is distributed, or deemed distributed, to them.

For example, if a non-grantor trust has \$100 of taxable income in a current tax year and makes distributions which, under the relevant rules, causes \$30 of taxable income to be passed out to the trust beneficiaries, the trust beneficiaries would be subject to tax on \$30 and the trust would be subject to tax on \$70. Specific tax rules govern how capital gains and other types of taxable income may

or may not be passed out of the trust by reason of distributions to trust beneficiaries.

In this report, the undistributed income of a non-grantor trust represented by the \$70 in the above example (and the \$100 mentioned below) is referred to as “Undistributed Income.”

If permitted under the terms of the trust’s governing instrument, the \$30 distribution in the above example might instead be accumulated within the trust (in which case the Undistributed Income would be \$100) and be subject to Federal, but (if the trust is a non-resident trust or a resident trust qualifying for the exception mentioned below) not New York, income tax.

If no New York income tax is imposed on Undistributed Income at the trust level, the net amount remaining in trust after the payment of Federal income tax could be reinvested at the trust level to generate additional income which, if distributed on a current basis, may be subject to tax in the hands of the trust beneficiaries. Annual distributions to a beneficiary in excess of the maximum amount of that year’s taxable income that may be carried out to that beneficiary under the applicable rules, however, generally are not subject to income tax when received by the beneficiary. Thus, the original \$70 of Undistributed Income (and the additional \$30, if accumulated) could potentially be distributed to a New York

beneficiary in a subsequent tax year without the imposition of any New York income tax.⁵

Unless the current rules are modified, imposition of a tax at the trust level is the last opportunity for New York to tax Undistributed Income subsequently distributed to a New York beneficiary and, even if the rules were modified to include “throwback rules” of the nature described below, is likely the last opportunity to impose a New York tax on Undistributed Income subsequently distributed to a non-New York beneficiary.

As indicated below, a non-resident trust, *i.e.*, a trust created by a non-New York domiciliary, is currently subject to New York income tax only on the portion of its Undistributed Income constituting “New York source income.”⁶

A resident trust, *i.e.*, a trust (or the portion of a trust) consisting of property transferred to it by a New York domiciliary, is subject to New York

⁵ Obviously, a number of different factors, including the terms of the trust, the needs of the beneficiary, the interests of other beneficiaries, creditor protection issues and the Federal income tax bracket of a beneficiary relative to that of the trust, would also impact upon a trustee’s decision to accumulate or distribute funds in any particular year.

⁶ Section 631 of the New York Tax Law defines New York source income generally as including income attributable to intangible personal property, including annuities, dividends, interest and gains from the disposition of intangible personal property, but only to the extent that such income is derived from a “business, trade, profession or occupation” carried on within New York. New York source income also comprises income attributable to (i) ownership of any interest in real or tangible property in New York, (ii) New York lottery winnings in excess of \$5,000, (iii) the sale, conveyance or other disposition of shares in a cooperative housing corporation owning real property in New York in connection with the grant or transfer of a proprietary leasehold interest by its owner, and (iv) payments made to an athlete or entertainer in connection with the broadcast or other transmission of an event occurring in New York State, but only to the extent the broadcast or transmission is received or exhibited in New York. *See* N.Y. Tax Law § 631.

income tax on all of its Undistributed Income unless the exception described in I.D. below is applicable for the relevant tax year.

C. Distinctions Drawn on Domicile of Trust Creator;
The *Mercantile* Decision

The current general rule under the New York Tax Law is that, while a resident trust may be subject to tax on all of its Undistributed Income, a non-resident trust is only subject to tax on Undistributed Income constituting New York source income.⁷

As indicated above, the term “resident trust” is not defined by reference to the location of the administration of the trust in New York or the residence of the trustees in New York, two factors which would clearly support the imposition of a current New York income tax on a trust’s Undistributed Income, but is instead defined by reference to the domicile of the individual who funded the trust at the time the trust became irrevocable.⁸

Presumably, the use of this domicile of the settlor approach towards the income taxation of non-grantor trusts rather than the domicile or residence of the trustees or the location of trust administration was intended to increase the relative attractiveness of New York to non-domiciliaries as a jurisdiction within which to establish a trust, thereby permitting New York to benefit from increased activity in New York trust creation, administration and related activities, including in its

⁷ N.Y. Tax Law §§ 601(e), 633.

⁸ As indicated above, if an individual funds an irrevocable trust while domiciled in New York and makes an addition to the trust while domiciled outside of New York, or vice versa, a portion of the trust is a resident trust and the other portion is a non-resident trust.

financial, banking and legal industries. For example, under this approach, non-New York domiciliaries, whose income and assets would normally not be subject to New York income tax, are not deterred from establishing trusts in New York on the basis that the trust's income will be subject to a tax that could be avoided by establishing the trust in another jurisdiction. In fact, relative to other jurisdictions, New York may in some instances be a tax favored, as opposed to a merely tax neutral, jurisdiction for the creation of a trust by a non-New York domiciliary settlor.

Conversely, under a domicile of the settlor approach for the income taxation of non-grantor trusts, there is no tax incentive for New York domiciliaries to establish trusts outside of New York since, irrespective of the location of the administration of the trust, the trust continues to be subject to New York income tax.⁹ In *Mercantile*, however, the New York Court of Appeals held that the fact that an inter-vivos trust met the definitional requirements for being a New York resident trust, *i.e.*, the fact that the trust was funded by a New York domiciliary, was insufficient, under the Fourteenth Amendment to the United States Constitution, to allow New York to impose an income tax on the trust's Undistributed Income where there was no present contact with New York other than the residence of beneficiaries. Under the particular facts at issue in

⁹ This approach, however, could provide an additional incentive for tax sensitive individuals to leave New York before establishing a trust. A New York or non-New York domiciliary might also choose to establish a trust outside of New York to avoid New York limitations on the maximum duration of trusts under the New York rule against perpetuities or because they wish to employ "directed trusteeship" structures that provide trustees with additional protection from fiduciary liability as compared to similar structures created under New York law.

Mercantile, a beneficiary resident in New York was eligible to receive current trust distributions, and the trustee was also authorized to accumulate income for future distribution to beneficiaries currently resident in New York.¹⁰

D. Post *Mercantile* Developments in New York Law

In 1981, the Court of Appeals' decision in *Mercantile* was extended by the New York Supreme Court Appellate Division, Third Department, to testamentary resident trusts, albeit in an unusual situation involving a separate trust of Florida real property whose trustees were appointed by a Florida court and whose beneficiaries were resident outside of New York.¹¹

¹⁰ In *Mercantile*, a New York resident had created a revocable *inter vivos* trust with a Maryland trust company; at all times the trust's assets were held in Maryland, and the trust was administered in Maryland. The New York resident died without exercising his power of revocation over the trust, and, in his Will, he bequeathed additional property to the trust. The trust provided that, after the donor's death, income was payable to his widow for life, subject to power in the trustee in its discretion to accumulate income and add it to principal. Upon her death, the trustee was empowered to accumulate income or distribute it among the donor's descendants *per stirpes*. The donor was survived by his widow who was a resident of New York. In addition, he was survived by two sons, who were residents of New York. The trustee accumulated income and did not file New York State income tax returns, although the trust was a resident trust under the New York tax law and thus required by the tax law to file returns. The New York Court of Appeals held that, under the Fourteenth Amendment to the U.S. Constitution, New York could not constitutionally tax the accumulated income of the trust. The Court of Appeals stated: ". . . The lack of power of New York State to tax in this instant case stems not from the possibility of double taxation but from the inability of a State to levy taxes beyond its borders. Instead of overruling *Safe Deposit & Trust Co. v. Virginia*, *Guaranty Trust Co. v. Virginia* recognized its authority by citing it and stating that it went 'upon the theory that the taxing power of a state is restricted to her confines and may not be exercised in respect of subjects beyond them.' This confirmed rather than refuted the determination in *Safe Deposit & Trust Co.* that the imposition of a tax in the State in which the beneficiaries of a trust reside, on securities in the possession of the trustee in another State, to the control or possession of which the beneficiaries have no present right, is in violation of the Fourteenth Amendment." *Mercantile Safe-Deposit & Trust Co. v. Murphy*, 203 N.E.2d 490 (N.Y. 1964).

¹¹ *Taylor v. State Tax Commission*, 445 N.Y.S. 2d 648 (N.Y. App. Div. 1981).

Following this decision, section 105.23 of the New York State Personal Income Tax Regulations was amended in 1992 to provide as follows:

“(c) The determination of whether a trust is a resident trust is not dependent on the location of the trustee or the corpus of the trust or the source of income; provided, however, no New York State personal income tax may be imposed on such trust if all of the following conditions are met:

- (1) all the trustees are domiciled in a state other than New York State;
- (2) the entire corpus of the trust, including real and tangible property is located outside of New York State; and
- (3) all income and gains of the trust are derived or connected from sources outside of New York State, determined as if the trust were a nonresident.”¹²

Subsequent Advisory Opinions confirmed that, for purposes of the above regulations, intangible personal property (*e.g.*, stocks and bonds but not real estate) is located where a trustee is domiciled. *See, e.g.*, New York State Dep’t. of Taxation and Finance TSB-A-94 (7) I (Apr. 8, 1994).

In 2003, the above regulatory exception and administrative ruling were codified in Section 605(b)(3)(D) of the Tax Law, with certain additional provisions permitting New York resident trusts administered by non-New York banks to continue to qualify for an exception from the imposition of tax in the event the non-New York bank is acquired by a New York bank and thereby becomes a bank domiciled in New York.¹³

¹² N.Y. Comp. Codes R. & Regs. tit. 20, § 105.23. (2009).

¹³ See discussion in IV. below regarding one of the practical issues addressed by this exception.

Under current law as set forth in section 605(b)(3)(D)(i) of the New York Tax Law, a resident trust is not subject to New York income tax if all of the following conditions are met:

1. All the trustees are domiciled in a state other than New York;
2. The entire corpus of the trust is located outside the State of New York; and
3. 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.

Notably, the current rules regarding resident trusts indicate that, if a resident trust has *any* New York source income during a tax year, all of the trust's Undistributed Income for that year is subject to New York income tax, as opposed to only the portion constituting New York source income being subject to tax.

E. Specifics of the Proposal

The Proposal would repeal the exception described in I.D. above and modify the tax treatment of resident trusts so that:

1. A resident trust established under the Will of a decedent who died domiciled in New York (a "testamentary resident trust") is always subject to New York income tax on all of its Undistributed Income;
2. A resident trust established under a trust instrument executed during the settlor's lifetime (an "inter-vivos resident trust") is

subject to New York income tax on all of its Undistributed Income if it has *any* New York source income during the tax year; and

3. An inter-vivos resident trust that has no New York source income during the tax year is subject to New York income tax on a proportionate share of its Undistributed Income, with the proportion determined on the basis of the number of “ascertainable beneficiaries” resident in and outside of New York.

The term “ascertainable beneficiary” is not clearly defined but the intention appears to include a broad category of individuals, including current as well as future, contingent beneficiaries (*i.e.*, individuals who may in fact never be currently entitled to receive, or have the power to control the ultimate disposition of, Undistributed Income), and individuals who hold indirect beneficial interests through ownership of interests in pass through entities.¹⁴

¹⁴ The Proposal would amend New York Tax Law § 618(a), in relevant part, as follows:

“(4) For purposes of this section, ‘ascertainable beneficiary’ means a currently living ascertainable beneficiary who has a present or future interest in the trust, including a beneficiary whose interest has not vested because it is in a class subject to open, as defined in section 6-4.8 of the estates, powers and trusts law, and a beneficiary whose interest has not yet vested because it is subject to a condition precedent, as defined in section 6-4.10 of the estates, powers and trusts law.

(5) If a beneficiary of a trust is a partnership (other than a publicly traded partnership as defined in section 7704 of the federal internal revenue code), subchapter K limited liability company, or S corporation for which an election has been made under subsection (a) of section six hundred sixty of this article, the trust shall, for purposes of determining the number of ascertainable beneficiaries of the trust who are residents, count each partner, member, or shareholder as a separate beneficiary and determine each individual partner’s, member’s or shareholder’s residence separately.”

III. Constitutional Issue

A. In General

The Proposal is clearly inconsistent with the conclusion reached by the New York Court of Appeals in *Mercantile* as to the minimum level of contacts with New York that are sufficient to permit New York to impose an income tax on an inter-vivos resident trust's Undistributed Income without violating the Due Process Clause of the Fourteenth Amendment. The Proposal is also potentially subject to challenge under the Commerce Clause.¹⁵ In *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), the U.S. Supreme Court explained the differences in the scope of analysis under the Due Process Clause and Commerce Clause as follows:

“Due process centrally concerns the fundamental fairness of governmental activity. Thus, at the most general level, the due process nexus analysis requires that we ask whether an individual's connections with a State are substantial enough to legitimate the State's exercise of power over him. We have, therefore, often identified ‘notice’ or ‘fair warning’ as the analytic touchstone of due process nexus analysis. In contrast, the Commerce Clause and its nexus requirement are informed not so much by concerns about fairness for the individual defendant as by structural concerns about the effects of state regulation on the national economy. Under the Articles of Confederation, state taxes and duties hindered and suppressed interstate commerce; the Framers intended the Commerce Clause as a cure for these structural ills. See generally *The Federalist* Nos. 7, 11 (A. Hamilton).”¹⁶

¹⁵ Such a challenge might be based on risks of double taxation and their impact on interstate commerce. See JEROME HELLERSTEIN & WALTER HELLERSTEIN, *STATE TAXATION*, ¶ 20.09[2][b](3rd ed. 2003).

¹⁶ *Quill Corp. v. North Dakota*, 504 U.S. at 312.

Attached hereto as Appendix A is a list of significant cases in various jurisdictions addressing the relevant constitutional issues in the trust context, the majority of which are consistent with *Mercantile*.¹⁷

Although it deals with the collection of use taxes by an out of state corporation on sales to in state residents, *Quill* is also included in Appendix A given its prominence in the two cases mentioned below and potential use as a dividing line in constitutional jurisprudence.

It should be noted that at least one treatise author has raised the issue of whether the U.S. Supreme Court's decision in *Safe Deposit & Trust Co. of Baltimore v. Virginia*, 280 U.S. 83 (1929) cited in *Mercantile*¹⁸ has been undermined by developments in Due Process Clause jurisprudence that no longer focus on risks of double taxation but rather, as explained in *Quill*, currently focus

¹⁷ For example, in *Potter v. Taxation Division Director*, 5 N.J. Tax 399 (1983), the Tax Court of New Jersey confronted facts similar to those at issue in *Mercantile*. *Potter* concerned a New Jersey domiciliary who had created an irrevocable inter-vivos trust, funded in part during her lifetime and in part under her Will following her death. From the inception of the trust, the trust's assets were located outside of New Jersey. The trust had no New Jersey source income, and the trustee was a non-New Jersey person. The beneficiaries of the trust, other than certain contingent beneficiaries, resided outside of New Jersey at all times from the inception of the trust. Citing *Mercantile*, the Tax Court of New Jersey held that under the Fourteenth Amendment of the United States Constitution, New Jersey could not constitutionally tax accumulated income of the trust. The court stated: "...The ability of the State of New Jersey to tax the undistributed income of this *inter vivos* trust depends on the existence of sufficient contacts and benefits to comply with constitutional due process requirements. The domicile of the settlor at the time of the creation of the irrevocable *inter vivos* trust is not in itself a sufficient contact to support taxation by New Jersey.... The fact that contingent beneficiaries reside in New Jersey does not alter this conclusion.... The fact that contingent beneficiaries are domiciled in New Jersey does not constitute a contact sufficient to empower New Jersey to tax undistributed trust income where the contingent beneficiaries have no right to the undistributed trust income." *Potter*, 5 N.J. Tax at 404-405.)

¹⁸ In *Safe Deposit & Trust Co.*, the U.S. Supreme Court held that Virginia could not impose an ad valorem property tax on intangible property of a trust established by an individual domiciled in Virginia, when intangibles were held and managed by an out-of-state trustee for the benefit of beneficiaries domiciled in Virginia who had no present right to enjoy the intangibles.

on whether a taxpayer's connections with a State are substantial enough to legitimate the State's exercise of power over the taxpayer.¹⁹ We do not express any view on this issue, but do note the U.S. Supreme Court's apparent reluctance in *Quill*, in the context of articulating a new Due Process Clause standard, to depart from its prior holding.²⁰ It also appears to be the view of at least one academic that, under the more modern approach towards Due Process Clause jurisprudence articulated in *Quill*, connections such as the residence of a settlor or beneficiary are not substantial enough to tax a resident trust administered in another jurisdiction by out of state trustees.²¹

¹⁹ See HELLERSTEIN, *supra* note 15 at 20-158 and 20-159. ("Our analysis proceeds from the premise that the U.S. Supreme Court's clear repudiation of the doctrine that the Due Process Clause bars double taxation substantially undermines the Court's decision in *Safe Deposit & Trust*. Accordingly, as we have suggested in the past, we believe it unlikely that the Supreme Court would hold today, on the weakened authority of *Safe Deposit & Trust* and in light of contemporary due process jurisprudence . . . [that a state may not tax a trust on the basis that it was created by a domiciliary of that state or has a beneficiary resident in that state.]").

²⁰ See *Quill*, 504 U.S. at 317-318. ("In sum, although in our cases subsequent to *Bellas Hess* and concerning other types of taxes we have not adopted a similar bright-line, physical-presence requirement, our reasoning in those cases does not compel that we now reject the rule that *Bellas Hess* established in the area of sales and use taxes. To the contrary, the continuing value of a bright-line rule in this area and the doctrine and principles of *stare decisis* indicate that the *Bellas Hess* rule remains good law. For these reasons, we disagree with the North Dakota Supreme Court's conclusion that the time has come to renounce the bright-line test of *Bellas Hess*.")

²¹ See Joseph W. Blackburn, *Constitutional Limits on State Taxation of a Nonresident Trustee: Gavin Misinterprets and Misapplies Both Quill and McCulloch*, 76 MISS. L.J. 1, 28-30. ("Could shareholder domicile states tax nonresident corporations that have no business or other contact with such state, or vice versa, as a result of attribution of state law benefits from a resident shareholder to such corporation? We know that answer to this rhetorical question—it is clearly No! In *Cannon Manufacturing Co. v. Cudahy Packing Co.*, the Supreme Court first held that corporate contacts cannot be attributed to shareholders of the corporation and vice versa. This principle has clearly been extended to a limited partnership and attribution of its contacts to limited partners. If general partners are agents acting on behalf of their partnership, contacts of the general partner can be attributed to the partnership. This is solely because the partner's actions as agent are actions of the partnership. However, beneficiaries as such, are not agents of the trustee. Clearly, the beneficiary and the trustee are distinct legal persons. In *Quill*, the Supreme Court looked to the taxpayer's direct contacts with and benefits derived from North Dakota. Indirect (...continued)

Based upon our research to date, we are not aware of any cases specifically addressing the ability of a State to tax all of an inter-vivos trust's Undistributed Income on the basis that a portion of the trust's Undistributed Income was sourced to that State (as opposed to a State imposing a tax only on the portion of Undistributed Income sourced to that jurisdiction).²²

B. Difficulty in Categorizing Trusts

Although treated as separate taxpayers, common law trusts are not separate juridical persons but are instead a relationship that is created when one person agrees to hold property in trust for the benefit of one or more other persons or charitable purposes. For example, unlike a corporation or limited liability company that is a separate juridical person, a common law trust cannot be sued. Instead, suit is brought against the person currently acting as trustee in his, her or its capacity as trustee (as opposed to being brought against that person in his, her or its individual capacity for some action taken by that person on his, her or its own behalf). Similarly, a trust does not own property and engage in income

(continued...)

benefits of North Dakota law to Quill's North Dakota customers or vendors which might be attributed to Quill were not even analyzed by the Court. To establish 'minimum contacts' for due process, the Supreme Court noted that Quill had mailed twenty-four tons of sales catalogs into the state and had made sales there of approximately one million dollars. As a result, Quill was found to have 'purposefully directed its activities at North Dakota...' Quill was not and could not be subjected to tax merely because North Dakota law applied to and benefited Quill's customers or vendors and thereby indirectly benefited Quill. Such state benefits were not and could not be attributed to Quill."(citations omitted).

²² In *Westfall v. Director of Revenue*, 812 S.W.2d 513 (Mo. 1991), the court did hold that a tax may be imposed on all of a resident testamentary trust's income when only part of the income was produced from property actually located in state. In that case, however, the testamentary trust appears to have been subject to primary supervision of the Missouri courts, a contact that in itself may support income taxation.

producing activities, but rather the person acting as trustee engages in those activities in his, her or its capacity as trustee. Furthermore, at least in the case of inter-vivos trusts, and unlike a corporation or limited liability company created by a filing and the issuance of a certificate of incorporation or other organizational document by a particular jurisdiction, the organizational document appointing a trustee is not typically filed with any governmental entity.

The rules governing the validity and administration of a trust at any particular time are also generally, in the first instance, those of the jurisdiction in which the trust is currently situated (in the case of an inter-vivos trust, generally the location where one or more of the trustees are resident and the administration of the trust is conducted), and not by the laws of the jurisdiction in which the settlor was domiciled or in which a beneficiary is resident, although special rules may apply with respect to real and tangible personal property (as opposed to intangible personal property such as stocks and bonds) held in trust and the laws of the jurisdiction in which a trust is currently situated also may (i) look to the laws of other jurisdictions to determine whether a trust was valid when originally created, (ii) have default choice of law rules that look to the laws of other jurisdictions in connection with certain trust matters, or (iii) permit the laws of another jurisdiction to control certain matters if so provided in the trust's governing instrument. Similarly, a trustee would typically petition a court located in the jurisdiction in which the trust is situated to rule on any matter relating to the administration of the trust, including to construe the trust instrument, to determine

whether the trustee has authority to engage in a particular course of action, and to be released from liability to trust beneficiaries. In any such judicial proceeding, process is generally served on out of state beneficiaries in accordance with the normal rules of the local court in which the petition is filed.

Under these circumstances, differences of opinion may arise as to the relative importance and significance of the legal protections afforded a settlor or beneficiary by any jurisdiction other than the jurisdiction in which the trust is currently situated for purposes of analyzing whether a particular jurisdiction may impose a tax on a trust's Undistributed Income.

In this regard, it is worth noting that the Proposal, in its present form, could result in the imposition of New York tax on the Undistributed Income of a resident trust administered outside of New York that could not be validly created in, or arguably continue to be validly administered if an attempt were made to move the trust's situs to, New York. One example of this type of trust is commonly referred to as a so called "perpetual trust", variations of which may be created in Delaware, Florida, New Jersey and certain other jurisdictions, but whose maximum duration may potentially extend beyond the applicable New York rule against perpetuities and is therefore invalid under New York law.

C. Post *Mercantile* Developments

As indicated by the legislative Memorandum in Support accompanying the Proposal and the cases listed in Appendix A, there have been developments since the New York Court of Appeals rendered its decision in *Mercantile* in 1964

that potentially could lead the Court of Appeals to reconsider its ruling that New York may not subject an inter-vivos resident trust to income tax when there is no present contact with New York other than residence of the beneficiaries. The two principal trust cases in this regard are *Chase Manhattan Bank v. Gavin, Comm'r of Revenue Services*, 733 A.2d 782 (Conn. 1999)(citing the United States Supreme Court's decision in *Quill* in support of its divergence from *Mercantile* and the decisions of other courts with holdings similar to *Mercantile*) and *District of Columbia v. Chase Manhattan Bank*, 689 A.2d 539 (D.C. 1997)(citing *Quill* in connection with its decision involving the income taxation of testamentary trusts, an issue not addressed in *Mercantile*).

It is unclear whether the New York Court of Appeals would be willing to adopt the views of the Connecticut Supreme Court in *Chase Manhattan* or of the D.C. Court of Appeals in *District of Columbia*.²³

Even if the New York Court of Appeals were willing to adopt the views of the Connecticut Supreme Court in *Chase Manhattan*, it is unclear how the Connecticut Supreme Court would have itself reacted to the apparent treatment in the Proposal of individuals who have only tenuous interests in an inter-vivos

²³ Although the decision in *Chase Manhattan*, which is not binding on the New York Court of Appeals, was appealed to the U.S. Supreme Court, the U.S. Supreme Court declined to hear the case. *Chase Manhattan Bank v. Gavin, Comm'r of Revenue Service of Connecticut*, 528 U.S. 965. See, also, Joseph W. Blackburn, *supra* note 21, at 3. (“[T]he Connecticut Supreme Court failed to honor the admonitions of *Quill* that a taxpayer must initiate its own due process contacts with the taxing jurisdiction. The [*Chase Manhattan*] opinion also gave little attention to the Supreme Court's Commerce Clause analysis which was essential to the Court's rejection of North Dakota's tax levy against *Quill*. To the limited extent [*Chase Manhattan*] addressed the Connecticut tax's discriminatory effect on interstate commerce, it misapplied *Quill*. The Connecticut justices also refused to follow a clear line of well-reasoned and authoritative cases that went clearly against their [*Chase Manhattan*] holding”).

resident trust, as compared to the comparable Connecticut statute, as beneficiaries for purposes of imposing and apportioning tax with respect to that trust.

Specifically, the portion of the Connecticut statute at issue in *Chase Manhattan* with respect to the inter-vivos trust imposed a tax on the basis of there being a Connecticut “non-contingent beneficiary” with an interest not subject to a condition precedent.²⁴ The Proposal requires only that there be an “ascertainable beneficiary,” as broadly defined to include contingent, future beneficiaries.²⁵

²⁴ The Connecticut General Statutes define a “noncontingent beneficiary” as “a beneficiary whose interest is not subject to a condition precedent.” C.G.S.A. § 12-701(a)(4). The term is further defined in the agency regulation as follows: “For purposes of this subsection, ‘noncontingent beneficiary’ means every beneficiary whose interest is not subject to a condition precedent and includes every individual to whom a trustee of a nontestamentary trust during the taxable year (i) is required to distribute currently income or corpus (or both) or (ii) properly pays or credits income or corpus (or both) or (iii) may, in the trustee’s discretion, distribute income or corpus (or both). ‘Noncontingent beneficiary’ includes every beneficiary to whom or to whose estate any of the trust’s income for the taxable year is required to be distributed at a specified future date or event and every beneficiary who has the unrestricted lifetime or testamentary power, exercisable currently or at some future specified date or event, to withdraw any of the trust’s income for the taxable year or to appoint such income to any person, including the estate of such beneficiary. The provisions of this subsection also apply to a noncontingent beneficiary which is a trust or an estate, and wherever reference is made in this subsection to an individual who is a noncontingent beneficiary, such reference shall be construed to include a trust or estate which is a noncontingent beneficiary, but shall not be construed to include a corporation which is a noncontingent beneficiary.” Conn. Agencies Regs. § 12-701(a)(9)-1(b)(3).

²⁵ The legislative Memorandum in Support of the Proposal is correct that the relevant California, Connecticut, Delaware, Maryland and Rhode Island income tax statutes take into consideration the residence of trust beneficiaries, although it appears that the categories of beneficiaries to be taken into consideration under all but the Maryland statute may be more narrowly defined than in the Proposal and that, in the case of Maryland and Rhode Island, a tax could be imposed on all (or the non-capital gains portion) of a discretionary resident trust’s Undistributed Income if that income could be distributed to any in-state beneficiary. As indicated in Appendix A, it also appears that the California and Connecticut statutes (or earlier versions thereof) are the only statutes to have undergone significant judicial scrutiny. This is not surprising given that an out of state trustee administering a resident trust in its home jurisdiction may decide that the amount of tax at issue does not merit a constitutional challenge or given the current case law and the trustee’s limited contacts with the taxing jurisdiction, that there is a reasonable non-filing position consistent with the trustee’s fiduciary duties to the trust beneficiaries. In the case of California, we also understand that some practitioners may narrowly construe the California statute to include discretionary, current beneficiaries in the category of contingent beneficiaries on (...continued)

In addition to practical issues of administerability and potential abuse associated with the broader definition of ascertainable beneficiary,²⁶ this distinction is important because of the importance the Connecticut Supreme Court placed on the legal protections afforded a beneficiary as the basis on which an income tax could be imposed on a trust. The Connecticut Supreme Court explained that, in its view, “[j]ust as a state may tax all of the present income of a domiciliary, irrespective of its place or origin or the nature of its source, a state may, on the basis of the same justification, tax the income of an inter vivos trust that is accumulated for the ultimate benefit of a noncontingent domiciliary, *and that is subject to her ultimate power of disposition.*”²⁷ Again, even if one were to agree with this view of the Connecticut Supreme Court as to a state’s ability to tax Undistributed Income,²⁸ it is not at all clear from the opinion that the Court would have reached the same conclusion if the Connecticut Commissioner of Revenue Services had attempted to apply the statute to an inter-vivos trust whose Connecticut resident beneficiaries had had a lesser interest in, or control over, the

(continued...)

the basis that the interest is contingent on the trustee’s exercise of its discretion to make a distribution.

²⁶ For example, this approach could provide a greater opportunity for trust structures involving the designation of additional, remote, contingent beneficiaries residing outside of New York as a means of reducing the relative proportion of ascertainable beneficiaries residing in New York.

²⁷ *Chase Manhattan*, 733 A.2d at 802 (emphasis added).

²⁸ One might disagree with this view on the basis that the protections afforded a beneficiary are unrelated to the income producing investment activities of the trustee conducted outside of Connecticut, given the characteristics of common law trusts as described in III.B above, or for some other reason. *See supra* note 23.

trust's accumulated income. Under the specific facts at issue in *Chase Manhattan*, it was not merely the case that Undistributed Income might currently be distributed to a Connecticut beneficiary. Instead, the Connecticut beneficiary (i) was the sole current beneficiary, (ii) upon reaching age forty-eight, would receive any accumulated Undistributed Income outright, and (iii) if she died earlier than age forty-eight, had the ability to control the disposition of the trust property at her death (including accumulated Undistributed Income) pursuant to a testamentary power of appointment, in default of her exercise of which the property would pass to her descendants.²⁹

Similarly, we note that the testamentary trust at issue in the *District of Columbia* case mentioned above,³⁰ which dealt only with testamentary trusts, and the four testamentary trusts at issue in *Chase Manhattan*, appear to be testamentary trusts over which the District of Columbia and Connecticut, respectively, continued to exercise continuing supervisory authority. Accordingly, if the Proposal were to be enacted in its present form, we anticipate that a number of non-domiciliary trustees currently serving as trustees of New York resident testamentary trusts would petition the relevant New York Surrogate's Court for

²⁹ *Chase Manhattan*, 733 A.2d at 802. The Proposal's treatment of New York resident owners of pass through entities as indirect trust beneficiaries may be particularly problematic since the legal protections afforded the actual trust beneficiary would, in the first instance, be those afforded the pass through entity (which may be organized outside of New York) and not the indirect New York trust beneficiaries.

³⁰ While the legislative Memorandum in Support of the Proposal mentions recent state and federal appellate decisions, we note that the D.C. Court of Appeals is the equivalent of a state supreme court.

permission to transfer the situs of the administration of those trusts to their home jurisdictions, thereby causing the courts of their home jurisdictions to have primary trust supervisory authority over the trust and making it more difficult to differentiate, as a constitutional matter, between those trusts and inter-vivos resident trusts administered outside of New York. See *Matter of Block*, NYLJ, Jan.18, 2001, at 30, col 4 (authorizing for tax planning purposes both the appointment of a successor trustee domiciled outside of New York and the transfer of situs of administration outside of New York); and *Matter of Bush*, NYLJ, Jan. 7, 2004, at 28, col. 2. (authorizing appointment of successor trustee domiciled outside of New York for tax planning purposes but declining to transfer situs on the basis that 2003 amendments to the Tax Law had clarified that such a transfer was not needed to achieve the desired tax savings).³¹

IV. Observations Regarding Retroactivity

As indicated above, current New York law contains a special provision permitting New York resident trusts administered by non-New York banks to continue to qualify for an exception from the imposition of income tax in the event the non-New York bank is acquired by a New York bank and thereby becomes a bank domiciled in New York.

³¹ Enactment of the Proposal could also be an additional factor in influencing individuals' decisions to leave New York (*e.g.*, so that any testamentary trusts created under their Wills will not be New York testamentary trusts forever subject to New York income tax and, if they are current or contingent trust beneficiaries, to reduce the number of ascertainable beneficiaries resident in New York).

One practical issue addressed by this exception arises in the situation in which an out of state bank may have assumed, on the basis of the Court of Appeals decision in *Mercantile* or otherwise, that a trust established with that institution by a New York domiciliary would never be subject to New York income tax and therefore, at the time the trust was established, that institution did not organize its records in a manner which would permit it to readily identify which inter-vivos trusts it administers are in fact inter-vivos trusts established by New York domiciliaries.

Absent the special exception mentioned above, a New York bank would face potential liability if it acquires, or has previously acquired, an out of state bank and it is subsequently determined that, from the date of acquisition going forward, a trust being administered by the merged entity is in fact a New York resident trust subject to tax by reason of having a trustee domiciled in New York.

If the Proposal is enacted in its present form, it would not only reverse the protections currently afforded in the situation described above but, unless it is given only prospective effect with respect to trusts created after some current date, could potentially exacerbate this type of problem by imposing an income tax on trusts currently being administered by out of state individual and corporate trustees who may lack sufficient records to readily identify where a settlor was resident at the time the trust was originally created. In this regard, trusts created by reason of the exercise of powers of appointment may involve further

complications (*i.e.*, whether the appointive trust should be treated as having been created by the original settlor or the person exercising the power of appointment).

V. Recommendations

A. The Proposal

We recommend that the Proposal in its current form be deleted from the pending budget legislation in light of the serious Federal constitutional questions it raises and the practical considerations discussed above.

We also respectfully suggest that further consideration of the Proposal, and of potential modifications and alternatives thereto, should take place in the broader context of considering, in addition to the potentially significant constitutional and practical issues discussed above: (i) whether tax distinctions drawn on the basis of the domicile of the creator of a trust continue to be meaningful in today's mobile society; (ii) the constitutionality of the current rules for the income taxation of New York resident trusts, particularly those that may result in the income taxation of a resident trust's entire Undistributed Income solely by reason of its receipt of any New York source income; (iii) the economic impact of tax and other trust law rules on the creation and administration of trusts in New York and related economic activity; and (iv) whether alternative mechanisms of income taxation are available to address relevant tax policy concerns.

In this regard, to the extent the Proposal is motivated by a concern that trustees of non-grantor trusts may assist New York trust beneficiaries in avoiding

New York income tax by accumulating income for future distribution in subsequent tax years, we note that this concern applies with respect to non-resident as well as to resident trusts. We also believe that the Federal income tax rules applicable to the income taxation of U.S. beneficiaries of foreign trusts described below may provide a useful framework for addressing this concern.³²

B. Throwback Rules

We recommend that a careful review of possible approaches to address the relevant concerns that may have motivated the Proposal include, as one alternative, consideration of “throwback rules” of the type discussed below.

Like a domestic non-grantor trust, a foreign non-grantor trust is potentially subject to Federal income tax each year on its Undistributed Income, while the trust beneficiaries are subject to tax on the trust’s current income required to be distributed or actually distributed. Unlike a domestic non-grantor trust, however, a foreign non-grantor trust is subject to Federal income tax only with respect to certain U.S. source income and income that is effectively connected with a U.S. trade or business.³³ Accordingly, absent the special rules mentioned below, income not falling within this narrow category could be accumulated within a foreign non-grantor trust without being subject to Federal income tax at the trust

³² At the same time, we respectfully note that the likelihood of a U.S. beneficiary of a foreign trust expatriating for purposes of avoiding Federal income tax may be significantly less than the likelihood of a New York resident deciding to move to another United States jurisdiction for tax planning purposes.

³³ I.R.C. §§ 641(b), 871. Like any other United States person, a domestic non-grantor trust is potentially subject to Federal income tax on its worldwide income.

level, and distributed to a U.S. beneficiary in a subsequent tax year without the imposition of a Federal income tax at the beneficiary level. As explained above, this is similar to the situation currently faced by New York with respect to non-resident trusts and certain resident trusts.

The relevant Federal income tax foreign non-grantor trust deferral and avoidance issues are addressed in the Internal Revenue Code and related Treasury Regulations through the application of a series of rules commonly referred to as the “throwback rules.” These rules generally require distributions in excess of a trust’s current year distributable income to be treated first as a distribution of accumulated Undistributed Income from prior years, until the trust ceases to have any accumulated Undistributed Income. These distributions to U.S. beneficiaries are included in the beneficiaries’ gross incomes as if distributed in the years during which the income had been accumulated (*i.e.*, the accumulated income is “thrown back”, and a current tax calculated based, in part, on what occurred during prior tax years).³⁴

For purposes of determining whether a trust is classified as a foreign trust under the Federal income tax rules, the residence and domicile of the trust’s settlor is irrelevant.³⁵ In addition, the Federal foreign trust classification rules do

³⁴ I.R.C. §§ 665-668.

³⁵ A trust is classified as a domestic trust if (1) a court within the United States is able to exercise primary supervision over the administration of the trust and (2) one or more U.S. persons have the authority to control all substantial decisions of the trust. A trust is classified as a foreign trust if it is not a domestic trust. I.R.C. §§ 7701(a)(30)(E) and (31)(B).

not create any meaningful tax disincentive to a foreign settlor's use of a domestic financial institution as trustee.³⁶

Interestingly, the Federal throwback rules appear to have their roots in a regime first proposed to address U.S. constitutional and practical considerations in connection with the state income taxation of trusts.³⁷ In a 1937 law review article titled "State Taxation of Trust Income"³⁸, Roger John Traynor, who later served as Chief Justice of the California Supreme Court, suggested that the troublesome practical and constitutional issues associated with the state income taxation of trusts could be resolved by a set of rules that would operate by subjecting beneficiaries who received distributions of accumulated trust income to tax by their states of residence, rather than by those states with minimal contacts to the trust attempting to subject the foreign trustees to tax. Rules similar to those described by Justice Traynor have been in effect in California for several decades

³⁶ It is understood that one of the objectives that was sought to be achieved in defining the terms "domestic trust" and "foreign trust" in the Internal Revenue Code and Treasury Regulations was to ensure that U.S. financial institutions would not be disadvantaged in securing the trust business of foreign persons. Because a trust will be a foreign trust if either condition (1) or (2) mentioned in the immediately preceding footnote is not satisfied, the Internal Revenue Code creates a strong statutory bias in favor of foreign trust status under which a foreign person, by designating a non-U.S. person whose concurrence is required with respect to any substantial trust decision, can relatively easily use a U.S. financial institution as trustee of a trust administered in the United States, including in New York, without creating a domestic trust that would be subject to U.S. federal income tax on its worldwide income.

³⁷ See Joseph W. Blackburn, *Grantor Trusts, Trust Throwback Rules, and Their Application – or Not – by the States*, JOURNAL OF MULTISTATE TAXATION AND INCENTIVES (Aug. 2006).

³⁸ 22 IOWA L. REV. 268 (1937).

with respect to the income taxation of contingent trust beneficiaries.³⁹ There is also New York precedent in the S Corporation context for requiring New York taxpayers to “add back,” and be subject to additional tax, on income in situations in which they receive distributions that have not previously been subject to New York income tax.⁴⁰ Accordingly, we believe that throwback type rules may be useful in addressing certain of the concerns which may have motivated the Proposal.

If this approach is of interest, we would be happy to prepare another report on the subject, or to provide further analysis of other tax matters which may be of interest to the Governor, the New York State Legislature, the Commissioner of Taxation and Finance and their staffs.

³⁹ If a California resident is a contingent beneficiary of a trust with no other California contacts, no California tax is imposed on the trust. Rather, if accumulated income is ultimately distributed to such beneficiary, the income will be taxable to the beneficiary at the time of this later distribution. The California income tax attributable to the inclusion in the gross income of the beneficiary in the year of the distribution is the aggregate of the taxes which would have been attributable to the income had it been included in the gross income of the beneficiary ratably for the year of distribution and the five preceding taxable years, or for the period that the trust accumulated or acquired income for the contingent beneficiary, whichever period is shorter. Cal. Rev. & Tax. Cd. § 17745(c) and (d). A beneficiary who is subject to tax on a distribution of accumulated income is entitled to a credit for taxes previously paid to another jurisdiction by the trustee. Cal. Rev. & Tax. Cd. § 18005.

⁴⁰ See N.Y. Tax Law § 612(b)(20).

APPENDIX A

List of Significant Cases¹

Safe Deposit & Trust Co. of Baltimore v. Virginia, 280 U.S. 83 (1929)

Virginia could not impose an ad valorem property tax on intangible property of a trust established by an individual domiciled in Virginia, when intangibles were held and managed by an out-of-state trustee for the benefit of beneficiaries domiciled in Virginia who had no present right to enjoy the intangibles.

Guaranty Trust Co. v. Virginia, 305 U.S. 19 (1938)

Virginia could impose income tax on income received by a Virginia resident who was a beneficiary of a testamentary trust established under the Will of a New York decedent that was administered in New York by New York trustees, even though the trustees had been required to pay income tax in New York.

McCulloch v. Franchise Tax Board, 390 P.2d 412 (Cal. 1964), *appeal dismissed for lack of a substantial federal question*, 379 U.S. 133 (1964)

California could require a California resident beneficiary to pay tax with respect to funds received by the beneficiary from a testamentary trust, created by an individual who was not domiciled in California at death, calculated on the basis of the tax the trust was required to pay under the relevant California statute and did not pay on a current basis. In reaching its decision, the court commented that the trust itself could have been taxed on a current basis by reason of there being a California beneficiary, although, given the facts of the case, there may be some confusion regarding the importance of this statement for purpose of actually imposing a tax on the trust, as opposed to calculating the amount of tax payable by the beneficiary.

Mercantile Safe-Deposit & Trust Co. v. Murphy, 203 N.E.2d 490 (N.Y. 1964)

New York could not impose an income tax on an inter-vivos trust created by a New York domiciliary where there was no present contact with New York other than the residence of beneficiaries.

¹ This list of cases is intended to be indicative and not exhaustive, and reflects subjective determinations of significance. Additional cases and rulings are cited in the treatise and law review articles cited in the report to which this list is an appendix.

Taylor v. State Tax Commission, 445 N.Y.S.2d 648 (N.Y. App. Div. 1981)

New York could not tax gain on the sale of Florida real estate held in trust under the Will of a decedent who died domiciled in New York. Although a New York bank was appointed as trustee in New York, it could not serve as trustee of Florida real estate under Florida law. The relevant Florida court therefore appointed different, non-New York trustees to administer the Florida real estate.

Pennoyer v. Taxation Division Director, 5 N.J. Tax 386 (1983)

New Jersey could not impose an income tax on a testamentary trust created by a New Jersey domiciliary that was administered outside New Jersey and where the trustee, trust assets and beneficiaries were located outside New Jersey, notwithstanding that letters appointing the trustee were issued by a New Jersey court, the trustee was amenable to service of process in New Jersey and the New Jersey courts were available to resolve disputes relating to the trust.

Potter v. Taxation Division Director, 5 N.J. Tax 399 (1983)

New Jersey could not impose an income tax on an inter-vivos trust funded by New Jersey domiciliaries where the only continuing contact was that contingent beneficiaries resided in New Jersey.

Swift v. Director of Revenue, 727 S.W.2d 880 (Mo. 1987)

Missouri could not impose an income tax on a testamentary trust under the Will of a Missouri domiciliary where none of the beneficiaries or trustees of the trust had been or were currently Missouri residents and the trust property had been held, managed and administered in Illinois.

Blue v. Michigan Department of Treasury, 462 N.W.2d 762 (Mich. Ct. App. 1990)

Michigan could not impose an income tax on an inter-vivos trust created by a Michigan domiciliary where the current trustee and beneficiary were Florida residents and all assets were held in Florida with the exception of one non-income producing parcel of real estate held in Michigan.

Westfall v. Director of Revenue, 812 S.W.2d 513 (Mo. 1991)

Missouri could impose an income tax on a testamentary trust established by a Missouri resident decedent because of two additional facts not present in *Swift* above, the existence of trust assets in Missouri and the presence of contingent Missouri charitable beneficiaries.

Quill Corp. v. North Dakota, 504 U.S. 298 (1992)

North Dakota could not require a mail order retailer with substantial mail order business connections, but no physical presence, in North Dakota to collect use tax on sales shipped into North Dakota. The U.S. Supreme

Court articulated a new Due Process Clause legal standard but declined to depart from its precedent applying a bright line physical presence test with respect to use tax.

District of Columbia v. Chase Manhattan Bank, 689 A.2d 539 (D.C. 1997)

District of Columbia could impose income tax on testamentary trust created under Will of domiciliary of District of Columbia even though trustee, trust assets, and trust beneficiaries were located outside of the District of Columbia.

Chase Manhattan Bank v. Gavin, 733 A.2d 782 (Conn. 1999), *cert. denied*, 528 US 965 (1999)

Connecticut could impose an income tax on an inter-vivos trust created by a Connecticut domiciliary whose only other contact with Connecticut was a beneficiary resident in Connecticut and on four testamentary trusts created by Connecticut domiciliaries.