

Corporate Fiduciaries, Advisors and Other “Co-Trustees”—Perhaps Your Trust Isn’t Exempt from New York State Income Tax

By Paul Comeau and Jack Trachtenberg

The New York State Department of Taxation and Finance (the “Department”) recently issued an advisory opinion, *Petition of JPMorgan Chase Bank* (the “Advisory Opinion”),¹ that raises serious concerns for certain taxpayers who are currently treating their New York resident trusts as exempt from New York State income tax. In particular, the Advisory Opinion indicates that the Department may treat certain out-of-state corporate fiduciaries as New York trustees, and may consider certain advisors, committee members and other non-fiduciaries to be co-trustees. Both of these potentialities could cause a New York resident trust that was once thought to be exempt from New York income tax to be taxable. Though the reasoning of the Advisory Opinion is questionable in many respects, it raises new issues that must be considered in trust tax planning and administration.

Introduction: The Taxation of New York Resident Trusts

Certain resident trusts (i.e., trusts created by individuals while domiciled in New York) have long been exempted from New York’s fiduciary income tax. The exemption applies if: (1) all of the trustees are domiciled in a state other than New York; (2) the entire corpus of the trust, including real and tangible property, is located outside of New York; and (3) all of the income and gains from the trust are derived from or connected to sources outside of New York.² This three-part test was derived from the Court of Appeals decision in *Mercantile-Safe Deposit and Trust Co. v. Murphy*,³ where it was held that New York could not constitutionally impose its income tax on a resident trust that lacked certain minimum connections to the state. The three-part test was first put forth in regulations promulgated by the Department, and in October 2003, it was codified by the New York State Legislature in Tax Law § 605(b)(3)(D).

For years, this exemption has provided a useful planning tool for taxpayers wishing to minimize or avoid New York State fiduciary income tax, especially where the trust’s assets consist entirely of intangibles, such as cash, securities or government obligations. In such cases, the intangible assets are treated as being located at the domicile of the trustee, regardless of the actual physical location of the

assets.⁴ This rule, first established by the Department in *Petition of Charles B. Moss Trust*,⁵ was also codified in October 2003 in Tax Law § 605(b)(3)(D)(ii). Consequently, taxpayers have had the option to exempt such resident trusts from New York State income tax by simply appointing a non-New York individual or trust company as trustee. The Advisory Opinion, however, has brought a cloud of uncertainty over the taxability of such trusts.

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The Advisory Opinion

The issue in the Advisory Opinion was whether certain New York resident trusts would be subject to New York State and City income taxes if: (1) the existing New York corporate trustee was replaced by a Delaware trust company; and (2) a committee established by the grantor to advise the trustee replaced its two New York domiciled members with individuals domiciled outside of New York.

The trusts in the Advisory Opinion were formed in 1934 by John D. Rockefeller. The trust agreements name The Chase National Bank as trustee (the “Trustee”), and establish a committee of five individuals to oversee the Trustee (the “Committee”). The Trustee has broad powers over the trusts’ assets, subject to direction by the Committee should it decide that a particular course of action should be taken or avoided. Since Mr. Rockefeller was domiciled in New York at the time he created the trusts, and since the existing corporate Trustee is incorporated and domiciled in New York State, the trusts are New York resident trusts subject to the state’s fiduciary income tax.

In order to eliminate New York income taxes, it was proposed that the existing Trustee would be replaced by its affiliate, J.P. Morgan Trust Company of Delaware (the “Successor Trustee”).⁶ The Successor

sor Trustee, which was incorporated in Delaware, would take title to and become the custodian of the trusts' assets. To administer the trusts, the Successor Trustee would purchase certain services from its affiliate, J.P. Morgan Chase Bank, a New York State banking company. These services could include tax preparation, client support, processing and other ministerial services, and would be provided in accordance with the terms of an existing agency agreement. Occasionally, the Successor Trustee would also retain certain non-Delaware service providers, such as accountants, investment managers, and legal counsel.

It was also proposed that two members of the Committee who are domiciled in New York State would resign. They would be replaced by individuals domiciled outside of New York. At times, the Committee would meet in New York, and it would continue to retain one or more non-member advisors who may be domiciled in the state. These advisors could include one or both of the committee members who resigned.

After reviewing the applicable law, the Advisory Opinion declined to rule on whether the proposed changes would avoid New York taxation. First, the Advisory Opinion declared that the Successor Trustee could be treated as having a New York domicile, even though it was incorporated in Delaware. The Advisory Opinion recognized that the Tax Law and regulations do not define corporate domicile for personal income tax purposes, and noted that the Court of Appeals has ruled that the domicile of a corporation is the state in which it is incorporated. Nonetheless, the Department determined that the domicile of a corporation is the "principal place from which the trade or business of the corporation is directed or managed." Unfortunately, the Advisory Opinion does little to explain what this means. Moreover, the Department refused to definitively rule on whether the Successor Trustee would be considered a New York domiciled trustee under the "principal place of business" test.⁷

The Advisory Opinion goes on to determine that the trusts in question would be subject to New York State income tax if any member of the Committee was domiciled in the state. According to the Advisory Opinion, the Committee and its members should be treated as co-trustees because they have the power to direct and control the Trustee in the performance of its functions and duties. Similarly, the Advisory Opinion states that investment managers, the former committee members or other advisors could also be treated as a co-trustees depending on

the nature of their activities. Again, however, the Department refused to rule on whether the particular advisors in question would be treated as co-trustees for purposes of determining the trusts' taxability in New York.

Is the Advisory Opinion Correct?

While some support is seemingly provided, a taxpayer could certainly dispute the two fundamental legal conclusions that form the basis for the Advisory Opinion's determinations. Specifically, it is not clear that a corporation's domicile for New York State income tax purposes should be determined based on its "principal place of business." It is also questionable whether advisors, committee members and other non-fiduciaries should be treated as co-trustees for purposes of determining a resident trust's taxability in New York.

Two factors weigh against the conclusion that a corporate trustee's domicile should be based on its "principal place of business." First, the New York Court of Appeals has held that the domicile of a corporation is the state in which it is incorporated.⁸ Second, neither the Tax Law nor the regulations define corporate domicile for New York State personal income tax purposes.⁹ In the absence of such legislative or regulatory guidance, the Department may be exceeding its authority in sidestepping a ruling from New York's highest court and asserting a contrary theory of corporate domicile. And though the Advisory Opinion correctly notes that the "principal place of business" test has been employed by federal courts for purposes of determining whether federal diversity jurisdiction exists, the Advisory Opinion does not cite a single source where the same test was applied for New York personal income tax purposes.¹⁰ The Advisory Opinion also fails to explain that in these federal cases, the "principal place of business" test was one imposed on the courts by Congress pursuant to a statutory amendment.¹¹ No such statute exists in New York.

The assertion that the committee members and advisors should be treated as co-trustees for purposes of determining the trusts' tax status is also troubling. For this proposition, the Advisory Opinion relies entirely on *In re Rubin*,¹² a case in which the Nassau County Surrogate's Court addressed the propriety of designating advisors to direct the actions of individuals named as co-executors of a decedent's estate. While the Advisory Opinion correctly reads *In re Rubin* as holding that the designation of an advisor is a valid limitation on a fiduciary's powers, it goes too far in stating that the decision endorses the treat-

ment of such advisors as co-trustees for all purposes. In fact, the Advisory Opinion fails to mention two other cases, *Brown v. Spohr*¹³ and *In re Fontanella*,¹⁴ which indicate that advisors and similar individuals should not be treated as trustees at all.

In *Brown*, the Court of Appeals laid out the rule that “an essential element of a valid trust [is] . . . the actual delivery of the fund or other property, or of a legal assignment thereof to the trustee, with the intention of passing legal title thereto to him as trustee.”¹⁵ This principle was later employed by the Appellate Division in *Fontanella*, where it was determined that the decedent’s sister-in-law was not a trustee because title to the assets in question never passed to her.¹⁶ *Brown* and *Fontanella* remain good law, and were decided by higher-level courts than *Rubin*. Accordingly, it could be argued that committee members and advisors, such as those in the Advisory Opinion, should not be treated as trustees if the grantor never intended to pass, or did not actually pass, legal title over the trust assets to them.

What Should Taxpayers Do?

Taxpayers should recognize that the Advisory Opinion probably foreshadows the position that the Department would take in an audit of a similar New York resident trust that claims to be exempt from fiduciary income tax. While a taxpayer could challenge the legal underpinnings of the Department’s position, steps should be taken now to ensure that the exemption from tax is maintained under the Advisory Opinion. Given the Advisory Opinion’s holdings, several things should be considered.

In the case of a corporate trustee, thought should be given to where the corporation manages, conducts and directs its business. The location of corporate offices, the board of directors and employees should be reviewed. So should the location where director and shareholder meetings are held. It may even be important to think about the location where checks or other documents are signed on behalf of the company.

Similar issues should be considered by advisors, committee members and others who may be treated as co-trustees. Their domicile and other contacts to New York should be reviewed. For instance, if the individual provides administrative, legal or other services for the trust in New York, it may serve as a basis for imposing income tax on the trust. Certainly, this is not an exhaustive list, and given the ambiguity of the Advisory Opinion, it is unclear precisely what the Department would review in making its determination.

Other issues that should be considered relate to the second prong of the three part test—i.e., the location of intangible assets owned by the trust. Assume, for instance, the use of a New York money manager who will maintain physical custody of, and manage, a resident trust’s intangible assets. Will this result in a determination that the property has a New York situs? Based on recent experiences, the authors believe that the answer could be yes. Specifically, we believe that the Department may deem an otherwise exempt resident trust (i.e., one with intangible assets and a trustee domiciled outside of New York) to have New York situs assets simply because those assets are in the “possession and control” of a New York-based brokerage firm, bank or trust company. If such a theory of trust taxation were to prevail, New York resident trusts with even the most minimal of connections to the state could lose their tax-exempt status.

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Conclusion

The Advisory Opinion has created a lack of certainty in the area of trust taxation in New York, a result the legislature attempted to avoid when it “clarified” the law in October 2003. Given the vague standards invoked in the Advisory Opinion, as well as the Department’s unwillingness to rule on the basis of represented facts, taxpayers are left with little guidance regarding their tax obligations. The Advisory Opinion may also have dramatic and adverse consequences for New York-based trustees, banks and businesses, as taxpayers may now be hesitant to employ their services in connection with resident trusts. For New York, the potential loss of business and jobs could not have come at a worse time. Surely, these uncertainties and negative economic outcomes could not have been intended when the legislature laid out the unambiguous three-part test in the Tax Law. Perhaps the legislature should consider clarifying the meaning of “domicile” and “trustee” for income tax purposes. In the meantime, taxpayers should carefully reassess the exempt status of their resident trusts.

Endnotes

1. TSB-A-04(7)I (Nov. 12, 2004).
2. N.Y. Tax Law § 605(b)(3)(D)(i); 20 N.Y.C.R.R. § 105.23(c).
3. 242 N.Y.S.2d 26, 19 A.D.2d 765 (3d. Dep't 1963), *aff'd*, 15 N.Y.2d 579.
4. N.Y. Tax Law § 605(b)(3)(D)(ii); *Petition of Charles B. Moss Trust*, TSB-A-94(7)I (Apr. 8, 1994).
5. TSB-A-94(7)I.
6. This change had already been approved by the New York County Surrogate in May 2002. *See Application for Judicial Approval of the Resignation of The Chase Manhattan Bank as Trustee and the Appointment of Chase Manhattan Bank USA, N.A.*, 2 Misc. 3d 554, 773 N.Y.S.2d 529 (Sur. Ct., New York Co. 2003).
7. The Department maintains that a determination of domicile is a factual matter that is not susceptible of determination in an advisory opinion. The Department has, however, ruled on such questions of fact in previous advisory opinion requests. *See, e.g.*, TSB-A-00(3)I (ruling that the taxpayer was domiciled in Virginia, as opposed to New York); TSB-A-98(23)S (declaring that the question of whether or not a particular improvement is a capital improvement constitutes a question of fact, but ruling that the pool improvements discussed in the advisory opinion were capital improvements); *see also*, TSB-A-04(4)I (ruling that the taxpayers home was not a permanent place of abode).
8. *Sease v. Central Greyhound Lines, Inc.*, 306 N.Y. 284 (1954).
9. *See* N.Y. Tax Law §§ 601, *et. seq.*
10. The existence of diversity jurisdiction permits the federal district courts to exercise original jurisdiction over controversies between "citizens of different states." 28 U.S.C. § 1332. The amount in controversy must also exceed \$75,000. *Id.*
11. *See* 28 U.S.C. § 1332; *see also Scot Typewriter Co. v. Underwood Corp.*, 170 F.Supp. 862 (S.D.N.Y. 1959), which was cited by the Advisory Opinion. This case explicitly relied on 28 U.S.C. § 1332 to justify the use of the "principal place of business" test.
12. 143 Misc. 2d 303, 540 N.Y.S.2d 944 (Sur. Ct., Nassau Co. 1989).
13. 180 N.Y. 201, 73 N.E. 14 (1904).
14. 33 A.D.2d 29, 304 N.Y.S.2d 829 (3d. Dep't 1969).
15. *Brown*, 180 N.Y. at 209.
16. *Fontanella*, 33 A.D.2d at 31.

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