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Trust Us: New York's Residency Rules For Trusts Are Complicated

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In this edition of Noonan's Notes, the authors discuss New York's residency rules for trusts including the three different trust residency categories, the three-prong test for exempt resident trusts, and the state's efforts to push back against them through a 2014 change in the law.

As we have outlined in this column many times before, the New York tax department has one of the most sophisticated and aggressive residency audit programs in the nation. The rules are complex as well, leading to many difficult audits and some interesting litigation. For the most part, much of the action — and hence most of our commentary — surrounds those rules in the individual income tax context. But did you know that New York has a completely separate regime for determining the residency status of a trust? And did you know that there have been significant changes in this area over the past couple years?

Right, we didn't think so! For your reading pleasure, in this article we'll outline the sometimes convoluted residency rules that apply in the trust area. And if recent experience is a guide, we can expect to see more of those issues arising in audits and litigation.

I. Background

First, some basics. Because we're dealing with trusts, we're in the realm of fiduciary income taxation. And under those rules, trusts are divided into three categories: resident, nonresident, and so-called exempt resident.[1] A resident trust is subject to New York income tax on just one thing: *everything*.[2] A nonresident trust, on the other hand, is only subject to New York income tax on its New York source income.[3] The taxation of an exempt resident trust is much more nuanced: While the trust itself is not subject to New York income tax, under a 2014 change to the law, the New York beneficiaries may be taxed on later distributions from the trust.[4] The taxation of those distributions is discussed below.

For individual income tax purposes, we deal with resident and nonresident categories too, but the tests are much different. Under the personal income tax, a taxpayer is treated as a resident if he is domiciled in New York or maintains a permanent place of abode in New York and spends more than 183 days here (statutory residency).[5] Anyone not taxed as a resident is a nonresident, but there is also a similar type of exempt resident as well, applying to domiciliaries who meet either the 30-day rule or the 548-day rule.[6]

II. Trust Residency Rules

The trust residency inquiry is significantly different and examines where the transferor was domiciled when property was transferred to the trust.

That plays out differently in numerous situations, depending on when and how the trust was created. If a trust is created under a will, the trust is a resident trust if the decedent was domiciled in New York *at the time of her death*. If property was transferred to a trust during the transferor's lifetime, the trust is a resident trust if the transferor was domiciled in New York *at the time of the transfer*, and the trust was either irrevocable at the time of the transfer or

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[1] N.Y. Tax Law section 605(b).
[2] N.Y. Tax Law section 618.
[3] N.Y. Tax Law section 633.
[4] N.Y. Tax Law sections 605(b)(3)(D), 612(b)(40).
[5] N.Y. Tax Law section 605(b).
[6] *See* Noonan and Andrew W. Wright, "The Nuts and Bolts of New York's 548-Day Rule," *State Tax Notes*, Mar. 7, 2011, p. 725.

Summary of New York State Trust Income Tax Rules	
Fact Pattern	**Residency Result**
Property transferred to trust by will of New York domiciliary	Resident trust
Property transferred to irrevocable trust while transferor is New York domiciliary	Resident trust
Property transferred to revocable trust while transferor is New York domiciliary and the trust is still revocable	Resident trust
Property transferred to revocable trust while transferor is New York domiciliary and the trust becomes irrevocable while the transferor is still a New York domiciliary (either because transferor dies or because transferor gives up right to revoke)	Resident trust
Property transferred to revocable trust while transferor is New York domiciliary and the trust becomes irrevocable when transferor is no longer a New York domiciliary	Nonresident trust
Property transferred to a trust under will of Massachusetts domiciliary for benefit of New York beneficiaries	Nonresident trust
Property transferred to an irrevocable trust by a Florida domiciliary, and trust has a New York trustee	Nonresident trust
Property transferred to trust under will of New York domiciliary, but trustee is a Florida domiciliary, all assets are intangibles, and the only income received by the trust is non-New York source	Exempt resident trust

revocable at the time of the transfer and remains revocable. Also, if an individual transfers property to a revocable trust, and the trust *becomes irrevocable while the individual is domiciled* in New York, the trust will also be considered a New York resident trust.[7] For ease of reference, we've also outlined those rules in the table.

Got that? Good, because it gets a little more complicated after this. For instance, what happens if the person making contributions to the trust moves during the existence of the trust? If a trust creator makes annual gifts to an irrevocable trust for five years while the transferor is domiciled in New York, the trust is a New York resident trust. But if the transferor then moves to California and continues to make gifts to the trust, the tax department has taken the position that the portion of the trust that was funded after the move to California will be treated as a nonresident trust.[8] Similarly, if a New York domiciliary decedent leaves a will directing that property be distributed to a preexisting nonresident trust, the portion of the property that passed under the will is considered a resident trust, and the preexisting nonresident portion should remain nonresident. Needless to say, determining the proper income taxation of such trust would be challenging. Presumably, the New York resident portion and the nonresident portion would be determined using a fraction in which the numerator is the addition to the trust and the denominator is the entire value of the trust immediately after the contribution.

Despite that unusual circumstance involving dual resident trusts, normally a trust is stuck with its residency status. An irrevocable trust is either resident or nonresident from day one, and, unlike an individual, it cannot switch back and forth between the two categories. However, that leads us to the even more interesting discussion involving the ever-popular exempt resident trust.

III. Exempt Resident Trusts: The Basics

While a resident trust can never become nonresident, it can become an exempt resident trust if it meets the three-prong test found in New York Tax Law section 605(b)(3)(D). To meet the three-prong test, the trust must not have any New York domiciliary trustees, New York situs assets, or New York source income.

Though that rule is codified in New York law, it finds its genesis in old constitutional case law decided in 1964. In *Mercantile-Safe Deposit & Trust Co.*, New York's highest court struck down provisions of the tax law which attempted to levy income tax against a trust created by a New York decedent that had no New York trustees, assets, or income.[9] The court affirmed that the trust was wholly beyond the tax jurisdiction of New York state, and therefore the law was an unconstitutional violation of due process.

A. Prong 1: Trustee Domicile

The analysis of the first prong of the test is often straightforward. If the trustee is not domiciled in New York, the first prong has been satisfied. But if the trust is a directed trust, which has become popular over the last decade, the analysis becomes more complicated. In a directed trust, the trustee may be stripped of the trustee's historical powers to invest trust assets and to make decisions regarding distributions to beneficiaries. Instead, those powers are given to trust advisers, and the trustee is bound to follow their decisions. The tax department has indicated that if those advisers act in a trustee-like capacity, they may be considered to be trustees for purposes of the three-prong test.[10] As a result, a well-advised client will carefully choose which powers to give to New York advisers, shying away from allowing a New York domiciliary to have ultimate control over trustee-like decisions.

B. Prong 2: No New York Assets

The second prong of the exempt resident trust test requires that all of the trust assets be sitused outside New York. All of the trust's intangible assets, such as stock and bonds, are deemed to be sitused at the domicile of the trustee. To an

[7]N.Y. Tax Law section 605(b)(3).
[8]TSB-A-11(4)I (July 27, 2011).

[9]*Mercantile-Safe Deposit & Trust Co. v. Murphy*, 15 N.Y.2d 579 (1964).
[10]TSB-A-04(7)I (Nov. 12, 2004).

extent, the first and second prong go hand in hand. If the first prong has been satisfied because the trustee is domiciled outside New York, then all of the trust's intangible assets are deemed sitused outside New York. So long as the trust does not have any hard assets in New York, such as real property, cars, or antiques, the second prong will also be satisfied.

C. Prong 3: No New York Source Income

Finally, the third prong requires that the trust not receive any New York taxation. When analyzing this prong, special attention must be given to flow-through income received by the trust. If the trust receives a Schedule K-1 with even $100 of New York tax on source income, it may be enough to blow the third prong for that tax year and subject the entire trust to New York source income. Interestingly, there is no authority on whether New York source income should be analyzed as a gross or net amount. For instance, if the trust receives a Schedule K-1 showing $100 of New York source income and $150 of New York source loss, can the amounts be netted with the end result that the trust does not have New York source income? For now, that remains a gray area.

Of course, significant life changes rarely occur exactly on December 31. For instance, the sole New York domiciliary trustee may move to Florida, resign, or pass away midyear. In such a case, the tax department has indicated that if the trust otherwise meets the three-prong test, the trust can switch to an exempt resident trust midyear, with the result that the trust will only be taxed on income received during the first part of the year.[11] The same analysis should apply when the trust disposes of its New York situs assets midyear or ceases to receive New York source income midyear.

IV. Attacking Exempt Resident Trusts

For years, savvy tax advisers and trustees went to great pains to meet the three-prong test and remove a New York resident trust from the reach of New York income taxation. Trustees moved trusts to states with no state-level income tax, like Delaware, Florida, and Alaska, depriving New York state with a means to tax the income earned by New York resident trusts.

New York has taken steps to fight back. First, the tax department reversed its long-standing policy that exempt resident trusts do not need to file a New York tax return. For tax years beginning on or after January 1, 2010, all exempt resident trusts are required to file. Also, exempt resident trusts are required to attach Form IT-205-C to the return to certify its exempt status.[12] While it does not appear that New York has started a widespread three-prong test policing effort, Form IT-205-C gives the state the means to create a database to do so in the future, if desired.

Next, the New York Legislature got involved. It cannot get rid of the three-prong test, because it is grounded in the constitutional case mentioned above. Instead, it took sort of a sideways approach to recapturing what it perceives to be lost tax dollars by giving teeth to the exempt resident trust filing requirement. Now, the failure to file the return carries a penalty of $150 a month, not to exceed $1,500 for a given tax year.[13]

Even more significantly, New York has enacted an "accumulation distribution" regime for distributions from exempt resident trusts. Under the federal regime, each year of the trust stands alone, with the result that only current-year income can be carried out on a Schedule K-1 to a beneficiary, and prior-year undistributed income remains with the trust. Under New York's new regime, untaxed prior-year trust income can be carried out to a New York resident beneficiary and subject to tax in a subsequent year.[14] Generally, income for those purposes will include interest and dividends but not capital gains.

The implications of the new regime can best be illustrated with an example:

> Assume that Donald was a New York domiciliary at the time of his death. His will created a trust for the benefit of his three children, one of whom is a New York resident. From day one, the sole trustee has been domiciled in Florida. The trust does not own any New York situs assets and it has never received any New York source income (that is, it's an exempt resident trust).
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> In year 1, the trust earns $100 of interest income, which the trustee accumulates and adds to principal. In year 2, the trust earns $100 of interest income, which the trustee again accumulates and adds to trust principal. In year 3, the trust earns $10 of interest income. The trust had no expenses or deductions in the first three years, and in year 3 it has $200 of prior-year accumulated income.[15]
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> In year 3, the New York beneficiary requests a distribution from the trustee, so the trustee distributes $150 to the New York beneficiary.

Under the Internal Revenue Code, the $10 of interest income is carried out to the beneficiary on a Schedule K-1 and is includable in the beneficiary's gross income. It is also in the beneficiary's New York adjusted gross income, because the starting point for New York AGI is federal AGI.

Under the old New York regime, that would be the end of the analysis — only $10 of the $150 distribution would be in the beneficiary's income for both federal and New York tax purposes. But under the new accumulation distribution regime, the entire $150 is subject to New York income tax in year 3. The first $10 is in New York income because it's in

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[11] TSB-A-10(4)I (June 8, 2010).

[12] TSB-M-10(5)I (July 23, 2010).

[13] N.Y. Tax Law sections 658(f)(2), 685(h)(2).

[14] N.Y. Tax Law section 612(b)(40).

[15] For simplicity, in this example the trust's $100 annual exemption is being ignored.

federal gross income, and the next $140 is treated as a distribution of prior-year accumulated income, which is now a required New York addition to federal AGI.

There are some exceptions. An accumulation distribution will not be subject to tax if the trust's income:

- has already been subject to New York tax;
- was earned before January 1, 2014;
- was earned during a period when the beneficiary was not a New York resident; or
- was earned before the beneficiary turned 21.

In some cases, the New York beneficiary may be allowed a credit for taxes already paid on the accumulated income in New York, or for taxes imposed on the trust by another state on income sourced to that other state. The credit cannot be more than the percent of tax due determined by dividing the portion of the income taxable to the trust in the other jurisdiction and taxable to the beneficiary in New York by the beneficiary's total income.

V. Conclusion

We have not seen a huge amount of audit activity around residency issues for trusts, and because the accumulation distribution rules are so new, there have been no cases or rulings providing further guidance. But as enforcement efforts step up in general in New York, practitioners should expect inquiries in those areas; an understanding of the nuances of the trust residency rules is critical. Hopefully, this article gives you a head start. ■