

WILSON, ELSER, MOSKOWITZ, EDELMAN & DICKER LLP

677 Broadway - 9th Floor, Albany, New York 12207-2996 Tel: (518) 449-8893 Fax: (518) 449-8927

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MEMORANDUM IN OPPOSITION

February 11, 2010

Part G of A9710 / S6610 (Governor's Revenue Budget Bill)

AN ACT to amend the tax law, in relation to taxation of certain resident trusts; and to repeal subparagraph (D) of paragraph 3 of subdivision (b) of section 605 of such law relating thereto

This memorandum in *opposition* is written on behalf of our client, the New York Bankers Association. The Association is comprised of the community, regional and money center commercial banks and thrift institutions doing business in New York State. In aggregate, members of the Association employ approximately 250,000 New Yorkers and hold more than \$9 trillion in assets. Almost all of the corporate trustees authorized to engage in the trust business in New York are members.

This provision would revise the taxation of New York resident trusts, by bifurcating the tax on the basis of whether a trust was established by will (testamentary trust) or inter vivos (living trust). **If enacted, this provision is likely to drive residents out of the State; fall most heavily on the middle class; and is unconstitutional. Additionally, it will not generate the revenue anticipated in the Executive Budget.**

Currently, to be subject to New York State fiduciary income tax (part of the personal income tax article of the Tax Law), trusts must 1) have a New York resident grantor or creator and have a New York-domiciled trustee; 2) have some income from sources based in New York, or 3) have some real or personal property located in New York. Intangible property, such as stocks and bonds, is considered located where the trustee is located. This test was established as a result of a 1964 New York State Court of Appeals decision, *Mercantile-Safe Deposit and Trust Company v. Murphy*, which has not been overridden and which, in fact, was codified as recently as 2003.

The Budget proposes to repeal this three-part test. Under the proposal, all testamentary trusts established by a New York grantor who was a resident of the State at the time of his or her death would be fully taxable. Inter vivos trusts with a New York grantor would be subject to bifurcated taxation as follows: Resident non-testamentary trusts with New York source income would be fully taxable, but resident non-testamentary trusts with no New York source income would be taxed on the basis of the percentage of their beneficiaries resident in New York. That is, a resident non-testamentary trust with five beneficiaries, two of whom were New York residents, would pay tax on 40% of its accumulated income.

This change would be effective January 1, 2010. The Budget estimates that enactment of this provision would raise \$25 million per year effective April 1, 2011.

For a number of years, the New York Bankers Association has raised with the Tax Department concerns about the discriminatory effect of the fiduciary income tax for New York trustees. Because the Tax Law requires that a trust have both a New York grantor and New York fiduciary to be subject to the

income tax, grantors need only choose a non-New York trustee in order to avoid tax. In addition, in recent years a growing number of New York trustees have resigned in favor of out-of-State trustees in order to avoid the fiduciary income tax. New York surrogates, in a number of decisions, have explicitly approved minimizing tax as a valid reason for the resignation of a New York trustee in favor of an out-of-State trustee.

As a result of the fiduciary income tax and other factors, **while the trust business nationwide has been increasing, New York's personal trust business has been declining.** This provision would eliminate the discrimination in the law against New York trustees. Logically, therefore, the organization representing the largest corporate trustees in the State should favor the bill. However, **this provision would create an enormous incentive for both trustees and beneficiaries to relocate outside New York,** potentially draining the State of far greater revenues, in the form of the income, sales, withholding and other taxes paid by these trustees and beneficiaries, than could be generated by the tax.

Avoiding the tax created by this provision would be relatively simple for wealthy individuals. So long as an individual did not create a testamentary trust, or was not a domiciliary of the State when his or her inter vivos trust became irrevocable (and his or her trust earned no income in the State), there would be no liability due under this proposal. Whereas the current law contains no incentive for wealthy grantors or beneficiaries to leave the State, **this provision would potentially induce flight by any retiree and by wealthy individuals of less than retirement age contemplating creating a trust.** In addition, for beneficiaries of existing inter vivos trusts residing in New York, the proposal would encourage relocation in order to increase the annual earnings on their trusts by the amount of New York State income tax that would otherwise be due – a not inconsiderable sum for a larger trust.

Sadly, middle class taxpayers without the wherewithal to establish second homes – and who create the majority of trusts in New York currently – would likely remain subject to tax under this provision. There is a misunderstanding that trusts are established only by the wealthy. **The majority of trusts by number in most corporate trustees' book of business are trusts established by the non-wealthy.** People look to trusts as a tax-favored estate planning tool and, if they have saved a decent nest egg over the course of their working lives, may be able to pass on \$1 million or more to their beneficiaries. The federal estate tax, before its temporary repeal, favored the creation of such smaller trusts through its generation-skipping features, which allow such sums to be passed tax free to future generations. It is the middle class whom this provision will tax. In effect, they will be taxed twice, once when they earn income, a second time when they attempt to pass it to their beneficiaries.

The Association believes that this provision will simply accelerate the flight of wealthy residents of the State to more tax-friendly jurisdictions. In addition, because the vast majority of taxes raised currently under the fiduciary income tax are paid by larger trusts, it will raise very little of the revenue that it anticipates. States which are cited in the Governor's memorandum in support as having adopted this form of taxation did so 20 years or more ago. Very few jurisdictions have moved to this form of trust taxation in the last few years because it cannot be demonstrated to raise the type of revenue anticipated by taxing authorities while demonstrably losing revenue under other articles of tax – the personal income tax, corporate income tax, sales and use tax, etc.

Finally, no court of competent jurisdiction in New York State has revisited the issues settled in the *Mercantile* case. In that case, the New York Court of Appeals ruled that, under the New York State Constitution, **it would be unconstitutional for the State to attempt to tax a trust based merely on the residence of the trust grantor.** Other State courts have upheld taxing mechanisms that mimic those in this provision, but none, of which we are aware, did so in the face of an adverse ruling by the State's highest court. The United States Supreme Court has been invited to review the constitutionality of this

type of taxing structure on at least two occasions, and has refused each time to hear the case. Adopting this provision, therefore, would fly in the face of settled precedent.

Recognizing that New York State is in need of significant revenue, the Association believes that there is a far better way to raise an amount that very well may be equivalent to the \$25 million revenue projection accompanying this proposal. The federal estate tax expired on January 1, 2010. There is no expectation that Congress will revive the tax in the near future, and the longer the tax remains un-re-enacted, the more likely that it will not be made retroactive to its repeal date. There are, NYBA believes, literally thousands of existing wills in New York State that contain what are called "formula clauses" tied to the applicable exclusion amount, unified credit, or GST exemption, under federal or State law. Because those exclusions or exemptions no longer exist, the wills, unless revised, will almost certainly lead to results not anticipated by the testator. For example, a typical formula clause might leave to a decedent's children the largest amount that can pass without Federal estate taxes, and leave the rest of the estate to the decedent's surviving spouse. Since there is no estate tax, there will be no residual amount for the surviving spouse who will, in effect, be disinherited.

Needless to say, courts will interpret these clauses differently, but the very uncertainty of the effect of current law will lead executors of estates to go to court for interpretations of what otherwise would be unexceptional testamentary documents. The resulting delay in the settlement of estates will significantly delay receipt of bequests by beneficiaries, leading to a potential slowdown in the State's tax revenue under the estate and income taxes. **By adopting a provision that provides a statutory interpretation that "formula clauses" should be interpreted as if the federal estate tax were still in effect, the Legislature could greatly speed settlement of estates, potentially accelerating payment of the taxes due on them and the income taxes that would be paid by beneficiaries receiving bequests under them.** It would not be surprising if the \$25 million in revenue anticipated by this provision would be realized through such a legislative interpretation.

For these reasons, the New York Bankers Association opposes this provision of and urges that it be dropped from the budget. NYBA would be pleased to work with the Legislature and Governor's Office on "formula clause" language such as we have suggested.

Respectfully Submitted,

WILSON, ELSER, MOSKOWITZ, EDELMAN & DICKER LLP