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TERRITORY OF HAWAII

DEPARTMENT OF THE ATTORNEY GENERAL

HONOLULU

July 1, 1958

Honorable Earl W. Fase
Tax Commissioner
Territory of Hawaii
Honolulu, Hawaii

Attention: Mr. James I. Nishikawa
Asst. Tax Commissioner

Dear Sir:

Reference is made to the letter of May 29, 1958 from the Assistant Tax Commissioner requesting advice as to the taxability of a nonresident beneficial of a resident trust.

A letter from the taxpayers' representative states the facts as to three trusts. Each is stated to have been "created under the laws of the Territory of Hawaii". It is our understanding that each is being administered in Hawaii, by a resident trustee. It further is our understanding that the trustee of each of these trusts has the usual powers of control and management, though as a matter of policy there may be consultations by the trustee with the nonresident beneficiary. (This latter information was transmitted to us orally.)

The three trusts involved are as follows:

"Trust A is an irrevocable trust created on December 28, 1927 by the transfer of various assets to a local trustee to be held in trust to pay the grantor the net income for his life with various supplemental provisions for distributions after his death. At present the entire income of the trust is distributable to the grantor, who has been a resident of the State of California for many years. The trust owns no real property and the present income is made up of the following:

Dividends - From Hawaii corporations
From Mainland corporations

Interest - From U. S. Treasury bonds, et cetera
From municipal bonds
From mortgage loans to individuals in Hawaii

"Trust B is a testamentary trust created under the will of a decedent who died in 1924. At present income is distributable in various proportions to nine individuals, two of whom are non-residents of the Territory (one a resident of New Jersey and the other a resident of New York). The trust owns real property in Hawaii as well as corporate stocks, municipal bonds, and other personality. Its present income distributable to said beneficiaries consists of the following:

Dividends - From Hawaii corporations
From Mainland corporations

Interest - From municipal bonds
From mortgage loan secured by Hawaii realty
From agreements of sale on prior disposition of Hawaii real estate by the trustees
On delinquent rents
On certificates of deposit

Rents - From real estate located in Hawaii

"Trust C is a revocable trust created on May 10, 1955, by a grantor who gave up her Hawaii residence in 1956 and is now a resident of the State of Texas. The property of the trust in the hands of a local trustee consists only of corporate stocks of Hawaii and mainland corporations, and the income derived therefrom which is all taxable to the grantor is made up of the following:

Dividends - From Hawaii Corporation
From Mainland corporations

Capital gains - From sale of rights and possible sales of stock

Our conclusions as to these three situations are as follows:

(a) The nonresident grantors and beneficiaries, as well as the residents, are taxable upon:

(1) The dividends from the stocks, both stocks of Hawaii corporations and stocks of mainland corporations.

(2) The interest from the mortgage loans, agreements of sale, delinquent rents, and certificates of deposits.

(3) The capital gains from sale of stock rights and stocks.

(4) The rents from real estate located in Hawaii.

(b) Pursuant to section 103 of the Internal Revenue Code, which is applicable, interest upon the obligations of a State, Territory or political subdivision is not taxable.

(c) Under section 121-5(a)(1) interest upon obligations of the United States is not taxable.

In order to explain the foregoing conclusions we will use a hypothetical example as follows: Assume that a trust company organized and doing business under the laws of Hawaii is the fiduciary of a trust, the beneficiaries of which are California residents, and the corpus of which includes California real estate, Hawaiian real estate, and stocks in California and Hawaiian corporations. The trustee has the usual powers, and the administration of the trust is carried on in Hawaii. Assume further that under the terms of the trust three-fourths of the income is required to be distributed currently and one-fourth is required to be accumulated by the trustee.

This hypothetical case most closely resembles Trust B. Trusts A and C are governed by subpart E of Subchapter J of the Internal Revenue Code, which has to do with grantors and others treated as substantial owners. However, as will appear from the discussion below, the conclusions are the same as to trusts which fall under subpart E, except of course that under subpart E the trust itself is not taxable on the portion treated as owned by the grantor or other person (see I below).

I. Paragraph (1) of subsection (e) of section 121-3 provides that "the income of a resident * * * trust shall be computed without regard to source in the Territory." Section 121-1, 19th paragraph, defines "resident trust" as follows: "'Resident trust' means a trust of which the fiduciary is a resident of the Territory or the administration of which is carried on in the Territory."

Therefore in the hypothetical case above set out the entire income, including the income from the California real estate, must be included in the gross income of the trust. Since the trust instrument required one-fourth of the income to be accumulated the trust has taxable income, after giving effect to the deductions provided by section 661 of the Internal Revenue Code, and the trust as a resident trust is taxed on this taxable income even though it includes income from real estate located outside the Territory.

II. We next consider the situation of the beneficiaries. Sections 661 and 662 of the Internal Revenue Code provide that the amount of income required to be distributed by the trust is deductible by the trust and includable in the gross income of the beneficiaries. Under the definitions in section 121-1 of the Income

Tax Law of 1957, 7th and 8th paragraphs, and section. 121-2(a) and (b), these Internal Revenue Code provisions apply. This without more would mean that the beneficiaries, irrespective of their residence, were taxable on their share of the entire income.

However the statute says more. It says that taxable income shall be determined under the Internal Revenue Code "except as otherwise provided in this chapter."

Section 121-3 sets forth the rules as to the effect of residence and nonresidence upon taxability. These rules apply in lieu of the Internal Revenue Code provisions on this subject, this being an instance in which the Hawaii law has "otherwise provided".

One such rule is that a resident is taxable on his entire income computed without regard to source in the Territory, whereas in the case of a nonresident in order to tax the income from property it must be property "owned in the Territory". This is stated in subsections (a) and (b) of section 121-3.

As will appear from the discussion below, the words "property owned *** in the Territory" refer to the situs of the property. The meaning of this language was determined more than 30 years ago, and as stated in our letter of September 5, 1957, the words "property owned *** in the Territory" in the Income Tax Law of 1957 keep the meaning they had in the Income Tax Law of 1932 and the Income Tax Law of 1901.

It requires only brief consideration to reach the conclusion that the geographical source of income is not determined by the same rules as, under the Internal Revenue Code, determine whether income is from "sources within the United States". For example, the dividends from Hawaiian corporations are not from "sources in the Territory" unless the stocks have their situs here. Cf. Henley v. Franchise Tax Board, 264 P.2d 179, Calif. D.C.A., 2d District, 1953 and note the criticism of this case in Keyes v. Chambers, 307 P.2d 498. Ore. 1957. Had the legislature intended the words "source in the Territory" to have a different meaning from the meaning of these words in the Income Tax Law of 1932 it would have said so, or would have adopted the Internal Revenue Code provisions as to the effect of residence and nonresidence instead of enacting its own.

In applying the rules set out in subsections (a) and (b) to beneficiaries of trusts the following problem arises: A trust is a taxpayer within the meaning of the Internal Revenue Code and the Territorial income tax law. The beneficiaries also are taxpayers In setting up the trust as a taxpayer the law further provides for deductions to avoid double taxation. (See 6 Mertens, Zimet Revision,

sections 36.01, 36.11 and 36.28. Cf Wilder v. Hawaiian Trust Co., 20 Haw. 589.)

Since the beneficiaries each have their own income the application to them of the statutory provisions set out in subsections (a) and (b) requires determination, in the case of a nonresident beneficiary, as to whether the income is or is not from "property owned * * * in the Territory." If the statute had provided no guide as to how this is to be determined, difficulties would be presented. The income is from the beneficiaries' equitable interest in the property, and the question is whether this equitable interest is:

(1) Owned where the corpus of the trust is owned, or

(2) Owned both where the corpus of the trust is owned and also where the beneficiary has his domicile.

The second of these answers is indicated by Curry v. McCanless, 307 U.S. 357 and Commonwealth v. Stewart, 338 Pa. 9, 12 A.2d 444, affirmed 312 U.S. 649. The first was the result reached in Safe Deposit and Trust Co. v. Virginia, 280 U.S. 83 (1929) and Senior v. Braden, 298 U.S. 422 (1935).

It is not necessary to reconcile these cases, since the statute supplies its own guide. It says to ignore the equitable interest in determining the taxability of the income and treat the situation as if the income were "received directly by such person". That is, in determining the taxability of the income it must be deemed received not from the equitable interest but from the trust corpus itself. This is provided in paragraph (2) of subsection (e), section 121-3.

The provision as to treating the situation as if the income were "received directly" is contained in the second sentence of paragraph (2), the first sentence of which specifies that a beneficiary shall be taxed upon his income "irrespective of the taxability of the estate or trust". Hence, reading the two together, the taxability of the beneficiaries is to be determined by disregarding the peculiarities of the trust relationship.

The language if "received directly" contained in the second and third sentences of paragraph (2), section 121-3(e) is just the language of the Internal Revenue Service regulations section 1.671-2(c), which was adopted on December 19, 1956 by T.D. 6217. This last cited regulation has to do with grantors and others treated as owners under subpart E of subchapter J, Internal Revenue Code. Thus paragraph (2) of section 121-3(e) provides that in applying subsections (a) and (b) the trust relationship

shall be ignored as to beneficiaries of trusts not falling under subpart E, as well as grantors and others to whom subpart E applies. See also the language "as if such item were realized directly", contained in section 702(b) of the Internal Revenue Code having to do with partnerships.

The rule established by the above cited paragraph (2) is in accordance with the "character" rule set out in sections 652(b) and 662(b) of the Internal Revenue Code. This "character" rule is applied under the Internal Revenue Code in determining whether the income of a nonresident alien beneficiary is from "sources within the United States". Bence v. United States, 18 F. Supp. 848; I.T. 3495, C.B. 1941-2, p. 195. However, as above noted, section 121-3 sets forth the Hawaii rules as to the effect of residence and non-residence upon taxability, and these rules apply in lieu of the Internal Revenue Code provisions on this subject; the geographical source of income is not determined by the same rules as under the Internal Revenue Code. Therefore if section 121-3 had supplied no guide as to the application of the rules contained in subsections (a) and (b) of section 121-3 in the case of a trust beneficiary, the "character" rule in the Internal Revenue Code would have supplied the answer by the process of the following reasoning: The "character" rule applies under the Internal Revenue Code in determining the geographical source of income as well as its character, and the tax commissioner is to approach the problem in the same manner even though the Hawaii rules as to source of income are different. But it is unnecessary to resort to such reasoning, as this is spelled out in paragraph (2) of subsection (e).

What is the result in the hypothetical case set out above? As above stated, the statute lays aside the technicalities as to legal and equitable title and provides for disregarding the peculiarities of the trust relationship in determining the taxability of the beneficiaries. The statute does not call for any change in the facts as to the powers of management and control. These are not a peculiarity of the trust relationship and may exist without a trust. See, for example, the case of the life tenant involved in Cooke v. United States, 228 F.2d 667, (9th Cir.), aff'g 115 F.S. 830, U.S.D.C. Haw. More in point is the case of an agency for one who indisputably is the owner (see cases below cited).

Under the rule established by Carter v. Hill, 31 Haw. 264 (1930), aff'd 47 F.2d 869, certiorari denied 287 U.S. 625, the business situs of the intangibles is in the Territory and this is controlling as to where the property is "owned". Because of this business situs the intangibles are not "owned" at the place of domicile of the nonresident beneficiary.

To review--under paragraph (2) of section 121-3(e), Curry v. McCanless does not apply and the property is not "owned" both where the trust is managed and also at the domicile of the beneficiary.

The property has only one situs. Where there is a business situs due to provision having been made for activities at a place other than the domicile of the "owner", as here, the business situs is controlling and supplants the domiciliary situs. This was the holding in Carter v. Hill. See also New Orleans v. Stemple, 175 U.S. 309 and note at 44 L.Ed. 174; Safe Deposit and Trust Co. v. Virginia, supra. Cf. Ewa Plantation Co. v. Wilder, 26 Haw. 299, aff'd 289 F. 664, in which case there was no business situs under the particular circumstances.

III. What are the real changes as to trusts and beneficiaries brought about by subsection (e) of section 121-3 as compared with the prior law? The doctrine that "business situs" is controlling as to where property is owned is not a change. This doctrine has been followed ever since Carter v. Hill, as shown by the letters of the Special Deputy Attorney General to Deputy Tax Commissioner Fitzgerald, August 7, 1936 and August 27, 1936; letter of Deputy Attorney General to Deputy Tax Commissioner Fase, January 6, 1938; opinion of the Attorney General No. 1726, October 30, 1939; letter of Deputy Attorney General to Tax Commissioner, September 5, 1957.

There are two real changes:

(1) A resident trust, so far as it has taxable income after deductions, is taxed upon all the income without regard to source. Previously the trust was taxed only on the income from sources in the Territory.

(2) A resident beneficiary, unless he comes under the "age 65" provision of subsection (a), is taxed upon his income from a nonresident trust as well as that from a resident trust. Previously he was taxed only on the income from the trust property having a situs in the Territory. Now his income is computed without regard to source in the Territory. (As to the tax credits for resident taxpayers on account of taxes paid outside the Territory, see section 121-12")

IV. The following table sets out our conclusions in the hypothetical case which has been used for discussion purposes. T indicates "taxable" and NT indicates "nontaxable". For the purposes of this table we have assumed that there are resident as well as nonresident beneficiaries.

Case of Resident Trust

	1 Intangibles	2 Tangibles located in T.H.	3 Tangibles located outside T.H.
Trustee	T	T	T
Resident beneficiary not coming under "age 65" provision	T	T	T
Resident beneficiary coming under "age 65" provision	T	T	NT
Nonresident beneficiary	T	T	NT

V. For comparison there is set out the case of a non-resident trust with the usual powers of control and management, administered outside the Territory.

Case of Nonresident Trust

	1 Intangibles	2 Tangibles located in T.H.	3 Tangibles located outside T.H.
Trustee	NT	T	NT
Resident beneficiary not coming under "age 65" provision	T	T	T
Resident beneficiary coming under "age 65" provision	NT	T	NT
Nonresident beneficiary	NT	T	NT

APPROVED:

HERBERT Y. C. CHOY
Attorney General

Respectfully,

RHODA V. LEWIS
Deputy Attorney General