Selected Issues Concerning The State Income Taxation Of Nonresident Trusts And Estates

BY GREGORY A. BERGMANN, TAX PARTNER, DELOITTE TAX LLP
ERIC L. JOHNSON, TAX PARTNER, DELOITTE TAX LLP
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STATE & LOCAL TAXES
by Gregory A. Bieganek, CPA, J.D., and Eric L. Johnson, CPA, CFP, MST
Published September 01, 2011

Editor: Harlan J. Kwiatik, CPA, J.D., LL.M.

Trusts have played a significant role in serving affluent families for centuries, and the basic federal statutory landscape for taxing trusts and their beneficiaries has remained relatively intact for about the past 50 years. However, the state income taxation of trusts has become an increasingly complicated and challenging task for trustees and their tax advisers in carrying out their responsibilities to both trust settlors and beneficiaries.

Some of these challenges are simply inherent in the nature of trusts. For example, at least two aspects of trusts make them distinctive from other taxpayers. First, for income tax purposes, trusts operate as flowthrough entities to the extent that current distributions are made to beneficiaries and as separate taxpayers with regard to undistributed amounts retained at the trust level. Second, a lack of integration exists between the two principal conventions governing the operations of trusts: fiduciary accounting and income taxation.

Other challenges have arisen due to changes in societal and marketplace conditions. Financial markets have dramatically evolved, and there are more investment products and strategies available than ever before. Trust portfolios have moved from traditional "stock and bond" allocations to investments in real estate, private equity, venture capital, and hedge funds. This migration toward more sophisticated investment holdings has increased the complexity of federal and state income taxation and related tax return preparation. Simple investment statements and Forms 1099 have been replaced with complicated Schedules K-1, many of which include pages of supplemental state tax information.

Coadically, and particularly noticeable over the past five years, the federal tax compliance environment for taxpayers (including trusts) has become increasingly complex, mainly as a direct result of the implementation of the Foreign Account Tax Compliance Act (FATCA). The IRS and other governmental agencies have been building in because the state uses federal adjusted gross income or federal taxable income as the starting point for the state tax calculation.

This potential shifting of the liability for the tax payment is accomplished by the trust’s distributing income to its beneficiaries and the allowance of an income distribution deduction (IDD). Most states follow federal tax treatment and allow the trust an IDD. Likewise, most states tax beneficiaries on the income associated with the IDD. In many states, the adoption of the federal system is built in because the state uses federal adjusted gross income or federal taxable income as the starting point for the state tax calculation.

However, most states tax nonresident trusts and nonresident beneficiaries only on the income sourced to the state. Most states also allow a nonresident trust an IDD in computing taxable income. California Code Regs. Section 17742 is fairly typical and provides a simple illustration.

Exhibit 1

Example:

Trust T is invested in three partnerships; each operates in a different state. Partnership A reports $10,000 of New York-source ordinary income. Partnership B reports $15,000 of California-source ordinary loss. Partnership C reports $7,000 of Illinois-source ordinary income. C, an Illinois partnership, distributes $12,000 of cash to a nonresident trust. A (New York) and B (California) do not make any distributions. T distributes $10,500 in cash to the beneficiary. T has $500 of federal distributable share of income (DDNI). As reflected on the federal Schedule K-1, the beneficiary receives $500 of DDNI.


In most states, there is little or no guidance for determining the trust’s share of the state-sourced income when that income exceeds the federal income. Illinois is an example of one such state. The Illinois Schedule NR is used to compute a nonresident trust’s Illinois income. Amounts from Form 1041 are reported in column A, the trust’s portion of column A is reported in column B, and the Illinois portion of the trust’s share is reported in column C. In the example, the ordinary income and loss are netted: $2,000 is reported on Form 1041, line 5, and is then reported on the Illinois Schedule NR, column A, line 6a. The trust’s share of the $2,000 is $1,500 ($2,000 of total income less the $500 that was distributable to the beneficiary), which is reported in column B, line 6b. The instructions to the form do not provide clear guidance to determine the Illinois-source amount to be reported in column C, line 6c. Under the heading “Column C, Illinois Portion,” the instructions state, “Write the portion of Column B, Federal Income Tax, that was taxed by Illinois.” However, it is not clear that this amount can be summarized in another source column, cannot exceed the amounts in columns A or B. See Exhibit 2.

The Schedule NR instructions direct the taxpayer to “calculate the amount of net loss or gain you (the trust) received from partnerships or subchapter S corporations as directed by Illinois Schedule K-1-P.” Partner’s Shareholder’s Share of Income, Deductions, Credits, and Recapital. The K-1-P instructions simply say to “[i]nclude your fiduciary’s share of this total amount on your Schedule NR, Step 3, Line 6, Column C.” The instructions do not explain how the fiduciary’s share or the beneficiary’s share are determined for Illinois tax purposes. Likewise, the instructions for completing Schedule K-1-T, Beneficiary’s Share of Income and Deductions, which is used to report to the beneficiary his or her share of Illinois income and deductions, are no more helpful: “If you (the trust) are a beneficiary of another trust or estate, a partner in a partnership, or a shareholder in an S corporation, you need to complete a pro forma Schedule K-1-T that identifies each beneficiary’s share of your share of items received from that entity.” The instructions do not provide any additional guidance as to how the trust should do this.


New York provides more guidance on how the New York-source income should be divided between the trust and the beneficiary. In most situations, that income is allocated based on the percentage of federal DNI going to the trust and each beneficiary. Using this method in the example, all the New York income is allocated to the beneficiary because the beneficiary received all the $850 federal DNI. In situations where the trust has no federal DNI, the New York income is allocated based on the percentage of the respective allocation of income between the trust and the beneficiary. The New York law and regulations also provide for alternative methods when these allocation methods result in “inequity which is substantial both in amount and in relation to the amount of the New York modifications.”

Finally, Fiduciary Allocation Form IT-205-A says, “do not complete Form IT-205-A if none of the income distributable to the nonresident beneficiaries is derived from New York State sources, even if other income is distributable to those beneficiaries.” This was not the case in the example because there was $10,000 of distributable income from A, the New York partnership, even though it did not distribute any cash. However, this provision would apply in situations where the New York income was a type of income that was not distributable to the beneficiary (e.g., when the corporation when the trust was made an elected small business corporation election).

To further complicate matters, some states may have special rules that alter or disallow the I&I. For example, California disallows the I&I for amounts taxable to nonresident beneficiaries if the estate fails to obtain a tax clearance certificate from the Franchise Tax Board. In addition, rules related to certain types of income or loss, such as passive activity losses (PALs) and net operating losses (NOLs), can complicate the calculations even further.

PAL Rules

As separate taxpayers, trusts are subject to the federal PAL rules. Generally, passive losses can only offset passive income, with any net passive loss disallowed and carried forward to the trust’s future tax years. The extent to which the trust has passive income in a subsequent tax year, such passive income would offset passive loss carryovers first and only the net amount included in DNI, which then could be passively distributed. As an extension to the example, if all three partnerships were considered passive and the trust had a $5,000 PAL carryover into the year, that carryover would offset the net passive income from the partnerships, resulting in no DNI. Thus, no income would be distributable and taxable to the beneficiary on his or her Schedule K-1.

Further, where the trustee and/or trust employees participate in the operations of the activity (e.g., partnership generating the loss), the PAL rules may not apply.

Most states adopt the federal PAL rules but provide little guidance as to how nonresident trusts and nonresident beneficiaries should apply these rules. In many states, the federal PAL rules are built in because the states use federal adjusted gross income or federal taxable income as the starting point for the state tax calculation. There are also states that do not adopt the PAL rules or have their own system for limiting losses (e.g., Pennsylvania and New Jersey). In the states that adopt the federal PAL rules, there are different methods for applying those rules to nonresidents. Some states, such as New York, require the nonresident taxpayer to apply the PAL rules to the state-sourced income as if that were the only income (i.e., these states apply the state sourcing rules first and then apply the PAL rules to the state-sourced income). Other states, such as Illinois, require to look which types of income or loss included in federal adjusted gross income are sourced to their state (i.e., they apply the PAL rules first and then the state sourcing rules). Under either method, applying the PAL rules to nonresidents adds an extra layer of complication and traps for unwary taxpayers.

NOL Rules

For federal income tax purposes, trusts follow individual taxpayer rules and can generate an NOL if business deductions exceed income in a given tax year. Trusts are allowed to carry back an NOL for 2 years (by filing either Form 1045, Application for Tentative Refund, or an amended Form 1041) or, alternatively, carry forward an NOL (by election) for up to 20 years by including the NOL in the computation of taxable income for the years the NOL is carried or applied. The treatment varies by state and does not necessarily match that for federal purposes. Some states allow NOLs to be carried back following the federal rules, whereas other states, such as Illinois, and Kansas only allow losses to be carried forward. In some states, such as Illinois, NOLs are combined with the federal rules for trusts.

In any event, most states require the taxpayer to file in the loss year in order to preserve the NOL. Yet many of those states lack tax forms or instructions to calculate a nonresident trust NOL. This lack of guidance often leaves taxpayers to their own devices, with logic as a guide, to prepare schedules documenting the NOL.

The unique five-year NOL carryback election available for tax years 2008 and 2009 enacted as part of the American Recovery and Reinvestment Act of 2009 further complicated the situation. Some states matched the federal carryback election period, but most states did not. Although the special election no longer applies for tax years after 2009, Congress has set a precedent, and there could be an extended NOL period again in the future.

In summary, taxpayers should pay attention to state-sourced NOLs, consider filing in loss years, and not miss an election deadline by assuming the states will follow the federal treatment.

Accumulation Distributions: The Federal Throwback Rule

Historically, federal accumulated distributions rules were designed to prevent the accumulation of trust income by a complex trust over several years, with distributions to the beneficiary in later years in which the beneficiary is in a lower income tax bracket. These rules served to carry back (or throw back) distributions in excess of the income in the distribution year, taxing the excess. The accumulated income distribution had to be made in the year of accumulation. The objective was to provide the extent of the taxes paid at the trust and beneficiary level was roughly equivalent to the tax that would have been paid had all DNI been distributed in the year in which it was earned by the trust.

For federal income tax purposes, these throwback rules are now ancient history for virtually all domestic trusts. The Taxpayer Relief Act of 1997 removed the accumulation distribution throwback provisions for all domestic trusts for distributions in tax years beginning after August 5, 1997, except as applied to multiple trusts defined in Sec. 643(f). Why? When the Tax Reform Act of 1986 reduced individual income tax rates and collapsed the marginal tax brackets, the benefit of allocating income between the trust and the beneficiary was reduced significantly. In fact, a trust that accumulated income typically paid more tax given the steep marginal income tax brackets for trusts.

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In some states, such as California, concepts similar to the throwback rule are alive and well as states seek to tax resident beneficiaries on distributed taxable income on which the trust has not paid tax to the state. The California throwback rule requires a beneficiary who is a California resident to pay tax on income if the trust did not pay the tax. That rule also applies when the trust is a nonresident income, eliminating much of the advantage of arguing that a California beneficiary is a contingent beneficiary. If no taxes have been paid on the current year’s income of the trust because the resident beneficiary’s interest in the trust was contingent such income shall be taxable to the beneficiary when distributed or distributed in a subsequent year. Under certain circumstances, the California throwback rule can even apply if the income, the trust, and the beneficiary are nonresident at the time of the distribution. The California law states, “In the event that a person is a resident beneficiary during the period of accumulation, and leaves [California] within 12 months prior to the date of distribution of income from that person’s interest, the income is taxable to that person as a resident beneficiary, even if the income is distributed to that person, after the income has accumulated, via a transfer outside of California or via a subsequent distribution to the person.”

These throwback rules may reduce potential planning opportunities but may also create additional complications and traps for unwary trustees, beneficiaries, and their respective advisers.

Grantor Trusts

A grantor is a trust in which the settlor or someone other than the settlor is treated as the owner of either a portion or the entire trust, as determined by the application of the grantor rules. As a result, the income, deductions, and credits earned by the trust are taxed to the grantor or his or her estate.

Most states follow the federal treatment of grantor trusts. However, there are some states that do not. For example, Pennsylvania requires grantor trusts (other than revocable trusts) to file Form PA-41, Pennsylvania Fiduciary Income Tax Return, and pay tax on Pennsylvania-source income not distributed to a beneficiary. This treatment can result in unexpected situations, such as a grantor retained annuity trust (GRAT) with Pennsylvania-source income owing tax in Pennsylvania, independent of the grantor trust rules taxing all trust attributable to the grantor for federal income tax purposes.

Reportable Transaction Disclosure Requirements

A reportable transaction is one that may have characteristics of a tax avoidance transaction and therefore requires additional federal reporting. Treasury regulations and instructions for Form 8886, Reportable Transaction Disclosure Statement, list various transactions that require additional disclosure. The federal government can assess penalties for failure to disclose a reportable transaction, so many taxpayers have opted for a “safe, not sorry” approach to disclosure. The owner of a thrift entity could be viewed as “participating” in a reportable transaction. The owner of a flowthrough entity could be viewed as “participating” in the transaction. Treasury has invested in sophisticated investment vehicles are faced with complex, time-consuming, and potentially duplicative disclosures at the trust level and possibly at the beneficiary level as well.

Currently nine states (California, Colorado, Illinois, Minnesota, New York, Oregon, Utah, West Virginia, and Wisconsin) have enacted legislation requiring taxpayers to disclose their participation in reportable transactions. Such disclosure generally involves attaching federal disclosure forms (Form 8886) to state income tax returns and in some cases mailing such forms to a separate state address. Some states, including California and New York, have identified state-specific reportable transactions. The state has more rules to track. In some cases, the state has more rules to track. The owner of a flowthrough entity could be viewed as “participating” in the transaction.

Other states may have also administratively required that taxpayers attach Form 8886 to the return, so advisors should give special attention to the applicable state instructions.

Estimated State Tax Payments and Withholding Requirements

For federal income tax purposes, a trustee can elect under Sec. 641(b) to treat any portion of estimated tax payments that the trust has made within the tax year as allocable to the beneficiary. The election deems the payments as made by the beneficiary as of January 15 of the following tax year (i.e., a fourth-quarter estimated tax payment). The election, made by filing Form 1041-T, Allocation of Estimated Tax Payments to Beneficiaries, by the 65th day after the close of the calendar year, gives trustees the ability to match estimated tax payments with the respective allocation of income between the beneficiary and the trust for which the estimated tax payments were made. In the event of an undistributed allocation that carries over to the next year.

DNI to a beneficiary, the ability to allocate estimated payments to the beneficiary is especially helpful to a beneficiary who otherwise may be underpaid. The trustee, meanwhile, avoids a free loan to the government, since the trust will receive an IDD for the distribution.

A few states, such as California, New York, and Hawaii, follow the Sec. 643(g) approach, but many others do not. As a result, a beneficiary may receive an allocation of state-sourced income in a state for which no estimated tax payments have been made, subjecting the beneficiary to underpayment and possibly late-payment penalties.

Similarly, many states, such as California, Illinois, and Indiana, now require trusts to withhold on state-sourced income distributable to nonresident beneficiaries. These withholding rules vary from state to state in terms of reporting requirements and when trusts must make the withholding payments to the state. In several states a distribution to the beneficiary can trigger a withholding payment to the state. For example, Indiana requires that a trust pay the withholding to the state by the 30th day of the month following the distribution to the beneficiary. This can create a number of issues for the trust. For example, if the state-sourced income was derived from a pass-through entity, the trustee may not know about the sourced income when making distributions and may inadvertently fail to meet the withholding requirements. Furthermore, as discussed above, determining how much of a distribution is from income sourced to a particular state can be complicated when the trust has income and losses from several states.

Conclusion

This column only briefly reviews some of the state income tax issues for nonresident trusts. There are a number of issues that are not covered, such as credits for taxes paid to other states. However, the issues summarized here highlight how the state income tax rules are evolving and changing as a result of marketplace, legislative, and regulatory activity. Trustees and tax practitioners are well advised to give special attention to state income tax matters for trusts with income and losses sourced to multiple states. This article does not constitute tax, legal, or other advice from Deloitte Tax LLP, which assumes no responsibility with respect to assessing or advising the reader as to tax, legal, or other consequences arising from the reader's particular situation. Copyright © 2011 Deloitte Development LLC. All rights reserved.

Authors’ note: The authors would like to acknowledge Hilary Carter Smith, a multistate tax manager, and Micaela Saviano, a private company services manager, in Deloitte LLP’s Chicago office for their contributions to this column.

Footnotes

1. The beneficiary could be the same person as the settlor in a self-settled trust.
2. Sec. 643(b).
3. This column does not address the fundamental aspects of trust accounting income that determine distributable net income (DNI) for federal income tax purposes. We caution readers to consider the trust accounting issues when preparing federal and state income tax returns for trusts. For a reference guide on this topic, consider Fiduciary/Trust Accounting: A Comprehensive Practice Guide (AICPA 2008) or Practice Guide for Fiduciary (Trust) Accounting: A Guide for Accountants Who Perform Fiduciary Accounting Services (AICPA 2007).
4. Regs. Secs. 1.651(b)-1 and 1.661(a)-2.
5. Sec. 661(a).
6. CA Code Regs. tit. 18, §17742(a).
7. IL 2010 Form IL-1041, Schedule NR, Nonresident Computation of Fiduciary Income (rev. 12/10).
8. NY Tax Law §§634(a)(3) and (b).
9. NY Tax Law §§634(b)(1). The phrase “trust income under local law” is not specifically defined in §634 or in NY Comp. Codes R. & Reg. §139.4. However, the phrase is also used in NY Comp. Codes R. & Reg. §119.2(b). Example 1 in §119.2(b) uses “income for trust accounting purposes,” indicating that trust income under local law means income for trust accounting purposes.
10. NY Tax Law §§634(b)(2); see NY Comp. Codes R. & Reg. §119.3.
12. Sec. 1361(e).
14. Sec. 469.
15. Matte K. Carter Trust, 256 F. Supp. 2d 536 (N.D. Tex. 2003). Generally, “passive activity” means any activity involving the conduct of a trade or business in which the taxpayer does not “materially participate” (Sec. 469(c)(1)).
18. NY Tax Law §631(b)(4).
20. Sec. 172.
21. 35 IL Comp. Stat. 5/207(a)(3).
23. 35 IL Comp. Stat. 5/207.
25. A complex trust, by definition, is any trust that does not qualify as a simple trust. A simple trust (1) requires that all income be distributed currently, (2) provides that no amounts be paid, permanently set aside, or used for charitable purposes, and (3) does not distribute any amounts allocated to trust corpus (Sec. 651).
27. Sec. 643(f) trusts are established with substantially the same grantor(s) and the same primary beneficiary (or beneficiaries) and have a principal purpose of tax avoidance (e.g., spreading income over a series of trusts to take advantage of lower marginal tax brackets and multiple personal exemptions).
29. CA Rev. & Tax. Code §17745.
30. California considers a trust to be a resident trust to the extent that a nonresident beneficiary is a California resident. As a result, some trusts take the position that a California beneficiary is a contingent beneficiary to avoid California taxation of the trust.
31. CA Rev. & Tax. Code §17745(b).
32. CA Rev. & Tax. Code §17745(c).
33. Secs. 673-679.
34. Sec. 671.
36. Sec. 6011; Regs. Sec. 1.6011-1.
Regs. Sec. 1.6011-4 (c)(3).

Sec. 643(g).

Sec. 643(g)(1)(b); Notice 87-32, 1987-1 C.B. 477, Q&A-12.

CA Rev. & Tax. Code §17731; see also California Form 541-T, California Allocation of Estimated Tax Payments for Beneficiaries.

NY Tax Law §685; see also New York Form IT-205-T, Allocation of Estimated Tax Payments to Beneficiaries.

See HI Form N-40T, Allocation of Estimated Tax Payments to Beneficiaries.

CA Rev. & Tax. Code §18662.

35 IL Comp. Stat. 5/709.5.

IN Code §6-3-4-15.

EditorNotes

Harlan Kwiatek is with Rubin Brown LLP in St. Louis, MO. Gregory Bergmann is a multi-state tax partner and Eric L. Johnson is a private company services partner with Deloitte Tax LLP in Chicago, IL. Mr. Kwiatek is chair and Mr. Bergmann is a member of the AICPA Tax Division’s State and Local Tax Technical Resource Panel, and Mr. Johnson is a member of the AICPA’s Trust, Estate and Gift Technical Resource Panel. For more information about this article, contact Mr. Bergmann at gbergmann@deloitte.com.
<table>
<thead>
<tr>
<th>Trust</th>
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<tbody>
<tr>
<td>New York-source ordinary income (A K-1)</td>
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<tr>
<td>California-source ordinary loss (B K-1)</td>
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<td>Illinois-source ordinary income (C K-1)</td>
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<td><strong>Total income of trust</strong></td>
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<td>Attorney and accountant fees</td>
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<td>Income distribution deduction</td>
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<td><strong>Taxable income of trust</strong></td>
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<td>Beneficiary's federal K-1: Ordinary income</td>
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### Exhibit 2: Illinois Schedule NR

**Step 3: Figure the Illinois portion of your federal taxable income**

See instructions for Columns A, B and C for each line item.

<table>
<thead>
<tr>
<th></th>
<th>A U.S. Form 1041</th>
<th>B Fiduciary's Share</th>
<th>C Illinois Portion</th>
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<td>Interest income</td>
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<td>1b_______ .00</td>
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<td>2</td>
<td>Dividends</td>
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<td>2b_______ .00</td>
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<td>3</td>
<td>Business income or loss</td>
<td>3a_______ .00</td>
<td>3b_______ .00</td>
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<td>4</td>
<td>Gain or loss on sales and exchanges</td>
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<td>4b_______ .00</td>
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<td>5</td>
<td>Net rent and royalty income</td>
<td>5a_______ .00</td>
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<td>6</td>
<td>Income from partnerships and subchapter S corps</td>
<td>6a_______ $2,000 .00</td>
<td>6b_______ $1,500 .00</td>
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<td>7</td>
<td>Income from trusts and estates</td>
<td>7a_______ .00</td>
<td>7b_______ .00</td>
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