

Tax Section

Comments Regarding the Throwback Tax Proposal, Part I of Revenue Article VII Legislation

Tax #1

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By: BUDGET
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Senate Committee: Finance
Assembly Committee: Ways and Means

This document¹ provides comments on a proposal to tax New York trust beneficiaries on their receipt of certain trust distributions (the “Throwback Tax Proposal”) contained in Revenue Article VII, Part I of the 2014-15 New York State Executive Budget (“Part I”).²

Adoption of a throwback tax would mark a significant change in the New York income taxation of New York trust beneficiaries, and would make New York one of two states to impose this type of tax.³ As described below, we believe that the Throwback Tax Proposal (as proposed) would raise a variety of technical, structural and constitutional issues and that it is extremely important for certain of the issues to be addressed before the Throwback Tax Proposal becomes effective. Moreover, we believe that additional issues are likely to emerge as the tax department and tax practitioners further consider the Throwback Tax Proposal. As a result, we recommend that consideration be given to delaying the effective date (or perhaps enactment) of the Throwback Tax Proposal until certain issues identified to date have been addressed and to give some more time for the tax department and tax practitioners to consider whether other issues should be addressed.

¹ The principal drafter of this document was Jeffrey N. Schwartz. Significant contributions were made by Alan S. Halperin, Amy E. Heller, Stephen Land, Carlyn S. McCaffrey, Arthur Rosen, David Schnabel and Joseph Septimus. This document reflects solely the views of the Tax Section of the New York State Bar Association and not those of its Executive Committee or House of Delegates.

² Although not within the direct scope of this document, we note that a proposal in Revenue Article VII, Part X relating to the inclusion of the value of lifetime gifts in the gross estates of decedents for New York estate tax purposes could similarly benefit from additional consideration and possible modification to most appropriately address the specific concern raised in the related provisions of the Memorandum in Support related to “deathbed gifts.”

³ California is the only other state that has a throwback tax, but its tax may not cover all of the corresponding distributions received by California beneficiaries from its equivalent of exempt resident trusts. We also note that the Federal throwback tax rules discussed below were effectively repealed with respect to U.S. domestic trusts in 1997. Those rules remain in effect with respect to distributions received by U.S. beneficiaries from foreign trusts.

Background

The Throwback Tax Proposal would tax New York beneficiaries of trusts created by non-New York domiciliaries (referred to in Part I as “non-resident trusts”), and of certain trusts created by New York domiciliaries that have no trustee domiciled in New York, no trust property located in New York and no New York source income (referred to in Part I as “exempt resident trusts”),⁴ on their receipt of certain distributions of accumulated income. The proposal would not subject distributions from non-exempt resident trusts to this treatment, presumably because non-exempt resident trusts are subject to New York income tax on all of their income on a current basis.

Technical Issues

Under the current Throwback Tax Proposal, distributions from non-resident trusts and exempt resident trusts of amounts originally transferred in trust (as opposed to only the undistributed earnings on those amounts) would be subject to tax when received by a New York beneficiary. We expect that these results were not intended. The issue arises because the proposal refers to the inclusion in income of “the amount of any accumulation distribution as described in [Section 665(b)]” of the Internal Revenue Code of 1986, as amended (the “IRC”).

Section 665(b) of the IRC contains a trigger for when a current distribution in excess of a specified amount is deemed an “accumulation distribution” potentially subject to tax as a distribution of accumulated income. Related provisions that distinguish between the portions of an accumulation distribution consisting of earnings and amounts originally contributed to the trust are found in other sections of the IRC. More specifically, section 666 of the IRC contains provisions that limit the portion of an accumulation distribution that is includible in the recipient’s income to “undistributed net income.”

⁴ Under current New York law, the classification of a trust as a non-resident trust or a resident trust depends entirely on the domicile of the creator of the trust at the time the trust became irrevocable, as opposed to any characteristics relating to the ongoing administration of the trust or the location of its income producing activities or assets. Non-resident trusts and exempt resident trusts generally are not subject to New York income tax. Non-resident trusts are subject to New York income tax on their New York source income. The relevant statute provides for the taxation of all of an exempt resident trust’s income for any year in which it has any New York source income. If a non-resident trust, exempt resident trust or other resident trust is disregarded for Federal income tax purposes as a so-called “grantor trust” because of a living grantor’s, or other living person’s, possession of certain interests or control over the trust, the grantor, and not the trust, is treated as the owner of the trust property for Federal income tax purposes. In such circumstances, the trust is also effectively disregarded for New York income tax purposes. If the grantor of a grantor trust is a New York domiciliary at the relevant point in time (*e.g.*, the grantor creates an irrevocable grantor trust while domiciled outside of New York and subsequently moves to New York), the grantor will be subject to New York income tax on the trust’s income, including capital gains, so long as the trust continues to be treated as a grantor trust for Federal income tax purposes.

Similarly, the provisions of the IRC that allocate current and prior distributions of accumulated income to particular tax years are not contained in Section 665 of the IRC. While the Throwback Tax Proposal (as modified after introduction) excludes from taxation distributions of income accumulated prior to a beneficiary reaching age 21, prior to a beneficiary becoming a New York resident and prior to 2011,⁵ the proposal does not include any mechanism for a trustee or beneficiary to allocate current and prior distributions of accumulated income to particular tax years. Such a mechanism is necessary for beneficiaries to determine whether a distribution represents a distribution of income accumulated prior to that beneficiary reaching age 21, prior to that beneficiary becoming a resident of New York or prior to 2011.

We note that an individual may be or become a resident of New York in a given year, become a non-resident in a succeeding year and then return to New York at a later date. Accordingly, the exclusion of income accumulated prior to a beneficiary becoming a New York resident should exclude distributions of income accumulated at any time the recipient was not a New York resident, as opposed to excluding only accumulations prior to the beneficiary first becoming a New York resident.⁶

Under the Federal rules, the amount of an accumulation distribution (to the extent of the aggregate amount of all years' accumulated income remaining on hand) is treated as a distribution of the accumulated income from the earliest year in which there is accumulated income, moving forward until the amount of the distribution, or the aggregate amount of remaining accumulated income, has been exhausted. To the extent there may be a desire to follow these Federal tax rules, which are highly complex, we note that, for purposes of these rules, a throwback distribution consists of two separate parts: (i) an "accumulation distribution" that cannot exceed the amount of a trust's accumulated "distributable net income" less Federal taxes previously paid in respect of that net income (referred to as "undistributed net income"); and (ii) a separate deemed distribution of the Federal taxes allocable to the accumulation distribution. This separation is necessary for further Federal tax computational purposes, and may pose drafting challenges if the intention is for these rules to be incorporated by reference. To the extent that the relevant Federal rules are tied to concepts of "distributable net income", drafters attempting to incorporate those rules into a state level throwback tax should note that the Federal rules differentiate between domestic and foreign trusts as to whether capital gains are automatically includible in distributable net income.⁷

⁵ These changes to the scope of the Throwback Tax Proposal were made during the 21 day technical corrections period generally applicable to provisions of the 2014-15 New York State Executive Budget.

⁶ During the correction period, a corresponding change was made to provisions of the Throwback Tax Proposal amending the New York City income tax under the Administrative Code. While this corresponding change refers to New York State residence, we believe it likely was meant to exclude distributions of income accumulated prior to the recipient becoming a New York City resident. This provision also should be modified to exclude distributions of income accumulated at any time the recipient is not a New York City resident.

⁷ The Federal throwback rules, because they effectively no longer apply to domestic trusts for purposes of calculating a beneficiary's taxable income, also may not be fully reflective of developments in applicable state law that permit certain adjustments between income and principal for trust accounting purposes. This may be another issue meriting further consideration.

Structural Issues

The current Throwback Tax Proposal applies only to non-resident and exempt resident trusts. It does not, for example, contemplate the possibility of a trust created by a New York resident accumulating income as an exempt resident trust (i.e., during the period it has no trustee domiciled in New York, no trust property located in New York and no New York source income) and then becoming a non-exempt resident trust prior to making a distribution (e.g., through the appointment of a New York trustee). This issue could be addressed by expanding the scope of the Throwback Tax Proposal to include any resident trust that was an exempt resident trust in a prior tax year, but to continue to exclude from the throwback tax income accumulated during the period the resident trust was not an exempt resident trust. In the alternative, the scope of the current Throwback Tax Proposal could be expanded to cover all resident trusts.⁸ In any case, there should be a credit for all state level taxes paid at the trust level (including to New York) in respect of the relevant income taxed under the throwback tax.⁹

For purposes of easing administrative burdens on trustees to the extent possible, we would anticipate that trustees would report to a New York beneficiary the amount of a current distribution consisting of accumulated income allocable to each relevant source year. We further would anticipate that it would be the responsibility of the recipient beneficiary to determine whether the relevant source year of the related accumulated income was a year that could be excluded by the beneficiary for throwback tax purposes in its entirety, or a year in which the beneficiary turned 21 or became, or ceased to be, a New York resident, such that the beneficiary would be required to pro-rate that source year's accumulation distribution on a daily basis based upon the number of days in the relevant period of non-exclusion to the number of days in the full source year. However, it might still be the case, particularly with respect to non-resident trusts and contingent remaindermen, that a trustee will not recognize a need to maintain certain records because an individual (possibly someone not even eligible to receive a current distribution) has become a New York resident and might at some later date receive a trust distribution.

Further limiting the relevant look back period to some date prior to the date of the first distribution to a New York beneficiary might be one mechanism for partially addressing these types of concerns.

⁸ We note that subjecting all resident trusts to the regime might be preferable in that it would avoid any argument that the throwback tax was inappropriately designed to impose more onerous recordkeeping and related administrative burdens on any trust created by a New York resident that did not at all times continue to have at least one New York trustee.

⁹ As a related technical matter, we note that the proposed statutory language for credit computation purposes refers to a credit for taxes imposed by another state of the United States, a political subdivision thereof, or the District of Columbia, upon income "both derived therefrom and subject to tax [under the Throwback Tax Proposal]." Presumably, accumulated income of a trust with no New York trustee, no property located in New York and no New York source income would for these purposes be derived (i.e., sourced) both from the jurisdiction of administration and any other jurisdiction to which the income would be sourced under the normal rules. In the case of a trust whose accumulated income might be subject to tax by multiple jurisdictions, e.g., a New Jersey resident trust with two trustees, one resident in New Jersey and the other in California, a credit should be available for all state income taxes paid at the trust level. This treatment should be made explicit.

Another mechanism would be to include some applicable default rule in the event that a beneficiary is unable to obtain sufficient information to determine the portion of a distribution that might constitute an accumulation distribution, or the relevant source year, because of lost records or for some other reason.

An additional structural issue relates to whether some form of income averaging should be made available in the case of a large throwback distribution received in a particular tax year, such as a remainder beneficiary's receipt of trust principal (including accumulated capital gain) upon the death of an income beneficiary who may have been entitled to receive current distributions of trust accounting income, but not principal, for life.¹⁰

Constitutional Issues

The Throwback Tax Proposal includes a requirement that every non-resident trust and exempt resident trust file a New York return for any taxable year in which it makes an accumulation distribution to a New York resident. There is also a new requirement for exempt resident trusts to file returns each year substantiating their entitlement to exemption from New York income tax. Penalties are imposed for the failure to file these returns. Both types of returns also may request such other information as the Commissioner may require.

The application of these provisions to trusts with no New York activities may raise constitutional questions.¹¹ Limiting the application of the return and penalty provisions, and having default rules for the income taxation of beneficiaries who are unable to obtain information from trustees, may also help address concerns, if any, that a state level throwback tax could be characterized as an "undue burden" on interstate commerce and therefore unconstitutional.

Conclusion

If it would be of interest, we are happy to prepare another report on the Throwback Tax Proposal, or to provide further analysis of other tax matters which may be of interest to the Governor, the New York State Legislature, the Commissioner of Taxation and Finance and their staffs. In the meantime, we do not believe the Throwback Tax Proposal should become effective until after the concerns we have raised have been addressed. In this regard, the analysis and information contained in certain of our prior reports may also be helpful.¹²

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¹⁰ While the California throwback tax contains such a provision, the proposed Throwback Tax Proposal does not.

¹¹ For these purposes, disbursing funds to a New York resident may not in and of itself constitute a New York activity.

¹² See New York State Bar Association Tax Section, *Report on Certain New York State Resident Trusts, Report 1293*, November 18, 2013. <http://www.nysba.org/tax/> and New York State Bar Association Tax Section, *Report Commenting on the 2010-2011 New York State Executive Budget Proposal to Modify Income Taxation of New York Resident Trusts, Report 1205*, February 22, 2010. <http://www.nysba.org/tax>.