Introducing the New York Throwback Tax

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On April 1, 2014, Governor Andrew Cuomo signed into law as part of the New York State Executive Budget several provisions affecting estate planning and trusts. Although most of the attention has focused on the New York estate tax law changes, the new law ushered in significant changes in the income taxation of trusts as well. The most far-reaching of these changes is New York's introduction of a "throwback tax" on certain distributions of prior year's taxable income to New York resident beneficiaries from trusts qualifying for the "New York Resident Trust Exception." The New York Resident Trust Exception applies to nongrantor trusts for which (1) all of the trustees are domiciled outside of New York State; (2) all real and tangible trust property is located outside of New York State; and (3) all trust income and gains is derived from sources outside of New York State.[1] Many of the contours of the throwback tax, however, still await clarification from the New York State Department of Taxation and Finance, which as of this writing has not yet issued a form or provided guidance on certain technical issues.[2]

Why The Throwback Tax Was Enacted and What We Know That It Does

The throwback tax was enacted by New York to address a perceived abuse in the case of nongrantor trusts qualifying for the New York Resident Trust Exception that accumulate income and distribute such income to New York resident beneficiaries in subsequent years effectively free of New York income tax. The perceived abuse resulted from the following circumstances. First, the starting point for the income taxation of trusts for New York fiduciary income tax purposes is the federal rules governing the income taxation of nongrantor trusts. Under the federal rules governing nongrantor trusts, a conduit regime of taxation prevails under which either the trust or the beneficiary is subject to income tax (but not both). The mechanism to accomplish this is "distributable net income" ("DNI"). DNI is essentially taxable income subject to certain adjustments, which can include the backing out of capital gains (which is the general rule subject to several exceptions). To the extent that DNI is distributed to beneficiaries, the trust in general gets an offsetting income distribution deduction, and the income tax liability is imposed upon the beneficiaries.

Against this federal income tax backdrop is superimposed the New York rules governing the income taxation of nongrantor trusts. There are two general categories of nongrantor trusts for New York income tax purposes – resident trusts and nonresident trusts. A resident trust is one that was created by a person who was a New York resident at the time the trust became irrevocable. In the case of a trust created while the grantor is living (an "inter vivos trust"), the trust would generally become irrevocable upon its creation, while in the case of a trust created under one's Will (a "testamentary trust"), the trust becomes irrevocable upon the person's death. If the trust is not a resident trust, then it is a nonresident trust. In general (and subject to a very important exception to be discussed below), resident trusts are taxed on their worldwide income, *excluding* income from real estate, tangibles or businesses conducted outside of New York State, while nonresident trusts are only taxed on income derived from New York real estate, tangibles or businesses.

An exception to the income taxation of New York resident trusts exists in the case of trusts qualifying for the "New York Resident Trust Exception." The New York Resident Trust Exception applies to nongrantor trusts for which (1) all of the trustees are domiciled outside of New York State; (2) all real and tangible trust property is located outside of New York State; and (3) all trust income and gains is derived from sources outside of New York State.[3]

If a New York resident trust qualifying for the New York Resident Trust Exception makes a current year distribution out of DNI to a New York resident beneficiary, then New York will impose income tax on the New York resident beneficiary. But a gap exists where the trust accumulates income and distributes the accumulated income in a subsequent tax year. In that case (at least under the law that existed prior to April 1, 2014), New York would not have any means to impose tax on the ***prior year's taxable income***.

To close this perceived loophole for New York resident trusts qualifying for the New York Resident Trust Exception, New York enacted a "throwback tax." Stated as a vast oversimplification, the throwback tax applies to income (1) of a trust qualifying for the New York Resident Trust Exception (2) which is distributed to a New York resident beneficiary (3) that was not previously taxed by New York and (4) that has been accumulated during taxable years beginning on or after January 1, 2014 for which there was a New York resident beneficiary who was at least twenty-one years of age.[4]

It should be noted that prior versions of the budget bill which enacted this statute would have applied the throwback tax to undistributed net income going back to trust inception, and moreover would have applied it to nonresident trusts as well. Fortunately, the statute as enacted limited its application to the form described above – *i.e.*, to income accumulated in taxable years beginning on or after January 1, 2014 and to resident trusts qualifying for the New York Resident Trust Exception. In addition, no interest charge is imposed by the New York statute even though the throwback tax applies to distributions of prior year's taxable income.

Open Questions Concerning the Scope of the Throwback Tax

The New York throwback tax is extraordinarily complicated both in its statutory formulation and in its daunting practical application.

First, to restate what we know: the throwback tax applies to income (1) of a trust qualifying for the New York Resident Trust Exception (2) which is distributed to a New York resident beneficiary (3) that was not previously taxed by New York and (4) that has been accumulated during taxable years beginning on or after January 1, 2014 for which there was a New York resident beneficiary who was at least twenty-one years of age.

The main area that we don't know concerns the extent to which the throwback tax applies to capital gains in addition to ordinary income. This is so because of the way that this statute was enacted via an extensive incorporation by reference of Internal Revenue Code provisions that have been effectively repealed by Congress except in the case of foreign nongrantor trusts and certain trusts created prior to March 1, 1984. Specifically, the statute enacting New York's throwback tax provides as follows:

> **"(40) In the case of a beneficiary of a trust that, in any tax year after its creation including its first tax year, was not subject to tax pursuant to subparagraph (D) of paragraph three of subsection (b) of section six hundred five of this article (except for an incomplete gift non-grantor trust, as defined by paragraph forty-one of this subsection), the amount described in the first sentence of section six hundred sixty-seven of the internal revenue code for the tax year to the extent not already included in federal gross income for the tax year, except that, in computing the amount to be added under this paragraph, such beneficiary shall disregard (i) subsection (c) of section six hundred sixty-five of the internal revenue code;[5] (ii) the income earned by such trust in any tax year in which the trust was subject to tax under this article; and (iii) the income earned by such trust in a taxable year prior to when the beneficiary first became a resident of the state or in any taxable year starting before January first, two thousand fourteen. Except as otherwise provided in this paragraph, all of the provisions of the internal revenue code that are relevant to computing the amount described in the first sentence of subsection (a) of section six hundred sixty-seven of the internal revenue code shall apply to the provisions of this paragraph with the same force and effect as if the language of those internal revenue code provisions had been incorporated in full into this paragraph, except to the extent that any such provision is either inconsistent with or not relevant to this paragraph."**

> Unpacking this statutory provision requires very extensive analysis. The following language is most germane to the capital gains analysis:

> **"the amount described in the first sentence of section six hundred sixty-seven of the internal revenue code for the tax year to the extent not already included in federal gross income for the tax year"**

The first sentence of section 667 of the Internal Revenue Code, in turn, provides that "[t]he total of the amounts which are treated under section 666 [of the Internal Revenue Code] as having been distributed by a trust in a preceding taxable year shall be included in the income of a beneficiary of the trust when paid, credited, or required to be distributed to the extent that such total would have been included in the income of such beneficiary under section 662(a)(2) (and, with respect to any tax-exempt interest to which section 103 applies, under section 662(b)) if such total had been paid to such beneficiary on the last day of such preceding taxable year." The aforementioned section 666, in turn, incorporates the concept of "undistributed net income" ("UNI"), which, under section 665(a), is based upon the undistributed portion of DNI as adjusted for the amount of taxes imposed on the trust that is attributable to such undistributed portion of DNI. In the context of foreign nongrantor trusts, DNI includes capital gains under section 643(a)(6)(C), which stands in stark contrast to the general rule of section 643(a)(3) that will often exclude capital gains from DNI in the case of domestic trusts. So one reading of the statutory latticework would be to suggest that capital gains distributed in a subsequent tax year may be subject to the New York throwback tax if New York's statutory requirements for the imposition of this tax otherwise apply. That being said, the author is aware of other practitioners who have expressed the contrary view.

Planning to Avoid the New York Throwback Tax

The parameters of the New York throwback tax inform how it can be avoided with careful planning. The following techniques can be used by a trustee to avoid the New York throwback tax:

1. Distribute all DNI each year to beneficiaries, including to New York resident beneficiaries.

2. Minimize DNI (and thereby minimize UNI) by having the trust invest in low-income high-growth investments.

3. In any year in which there would otherwise be a throwback, do not distribute to any New York beneficiaries who were over age 21 and New York residents during the year of accumulation. Instead, consider "stripping out" UNI, for example, in December of "Year 1" by making distributions of UNI to non-New York beneficiaries and then distributing the "untainted income" to the New York resident beneficiaries in January of "Year 2."

4. Strip out DNI each year that is not needed for distributions to a separate "subtrust" that can be used in subsequent years to make distributions to beneficiaries other than those who were New York residents over age 21 in the year of accumulation.

5. Extend the trust as long as possible (via decanting or otherwise) to avoid having to make mandatory distributions in accordance with the terms of the trust's governing instrument.

6. Increase trust accounting income in the year of distribution. Under the last sentence in the flush language of section 665(b) of the Internal Revenue Code, if the total distributions from the trust do not exceed accounting income for that year then the distributions will not be deemed to include UNI even if the distributions exceed DNI. It may be possible to

increase trust accounting income by interposing an entity between the portfolio assets and the trust, because Section 11-A-4.1 of the New York Estates, Powers and Trusts Law (the "EPTL") generally allocates distributions from an entity to income (as opposed to principal) unless the distributions are in excess of twenty percent of the entity's gross assets.

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[1] *See* N.Y. Tax Law § 605(b)(3)(D).

[2] The new tax law also subjected New York grantors of so-called "incomplete gift nongrantor trusts" ("ING Trusts") qualifying for the New York Resident Trust Exception to New York income tax by treating such trusts as grantor trusts for New York income tax purposes**.** *See* N.Y. Tax Law § 612(b)(41). Section 9 to the budget bill which enacted this statute provides that this provision does not apply to income from a trust that is liquidated before June 1, 2014.

[3] *See* N.Y. Tax Law § 605(b)(3)(D).

[4] *See* N.Y. Tax Law § 612(b)(40). Section 9 to the budget bill which enacted this statute provides that this provision does not apply to income that is paid to a beneficiary before June 1, 2014.

[5] This provision of the Internal Revenue Code states that the throwback tax generally does *not* apply to most domestic trusts (as distinguished from foreign trusts).

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