New York State Releases its Throwback Tax Form (and it is Unduly Complex)

Kevin Matz, Esq., CPA, LL.M. (Taxation)[1]
Trusts and Estates Lawyer, Tax Attorney and Certified Public Accountant
White Plains, New York
kmatz@kmatzlaw.com; 914-682-6884
www.kmatzlaw.com

The New York State Department of Taxation and Finance (the "NYSDTF") has posted on its website Form IT-205-J, New York State Accumulation Distribution for Exempt Resident Trusts ("Schedule J"), together with accompanying instructions, for computing the throwback tax applicable to "exempt resident trusts:" https://www.tax.ny.gov/pdf/current_forms/it/it205j_fill_in.pdf and https://www.tax.ny.gov/pdf/current_forms/it/it205ji.pdf Given the complexity of this area of the tax law, it should not be surprising that this form will be very difficult for practitioners to complete. Moreover, in a measure that was likely intended by the NYSDTF to be helpful to taxpayers by excluding from tax certain distributions to New York resident beneficiaries that are matched up against (*i.e.*, thrown back to) undistributed net income attributable to tax years beginning prior to January 1, 2014, practitioners when applicable will also be required to track down information pertaining to trusts and their beneficiaries going back to the year *1969* (the year that Man first walked on the Moon!) to determine the existence of prior years' undistributable net income to which such distributions could be applied. Unfortunately, the NYSDTF has *not* permitted trusts to use a simplified "default calculation" for throwback purposes in conjunction with this -- similar to that employed by the Internal Revenue Service in Part III of the IRS Form 3520 – in order to better achieve this objective. To its credit, the form does also clarify that capital gains will not be subject to throwback except where the capital gains are part of federal distributable net income, such as where the trust is a foreign trust for federal income tax purposes.

Background

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

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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.[2] Many of the contours of the throwback tax, however, awaited clarification from the NYSDTF.[3]

Why The Throwback Tax Was Enacted and How It Works

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 (although potentially excluding in certain circumstances income from real estate, tangibles or businesses conducted outside of New York State[4]), 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" ("***exempt resident trusts***"). 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.[5]

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." 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.[6]

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.

The Throwback Tax Generally Does Not Apply to Capital Gains

One of the issues left open by the New York throwback tax legislation concerned the extent to which throwback applies to capital gains in addition to ordinary income. This uncertainty arose from 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.

The throwback tax form has resolved this question in a manner that is generally favorable to taxpayers. The starting point in this form for determining the applicability of the throwback tax is DNI as reported on the Form 1041, the Federal fiduciary income tax return. Under Section 643(a) of the Internal Revenue Code ("IRC § 643(a)"), capital gains will usually be excluded from DNI unless the trust is a foreign trust for federal income tax purposes. Accordingly, unless the governing instrument provides otherwise or the trustee has exercised discretion to include capital gains in DNI (such as for the purpose of minimizing trust exposure to the 3.8% tax on net investment income under IRC § 1411), capital gains generally will not be subject to the New York throwback tax.

The Form's Mechanics and Its Accompanying Instructions

The instructions to Schedule J provide that every exempt resident trust must file Schedule J for any tax year in which it makes an accumulation distribution to a beneficiary who is a New York State resident. A resident beneficiary receiving an accumulation distribution from an exempt resident trust (other than an incomplete gift nongrantor trust) must include the accumulation distribution in his or her New York adjusted gross income, ***unless***:

- The accumulation distribution is thrown back to a tax year for which the trust was subject to New York State tax, or a tax year starting before January 1, 2014;
- The accumulation distribution is thrown back to a tax year prior to when the beneficiary first became a New York State resident, or a tax year before the beneficiary was born or reached age 21; or
- The income was already included in the beneficiary's gross income.

A resident beneficiary includes the accumulation distribution in his or her New York adjusted gross income by using Part 4 of the Schedule J. The trust must provide the resident beneficiary with a copy of Part 4 of the Schedule J.

Part 1 of this form determines the amount of the accumulation distribution for the current taxable year. The instructions to Schedule J (at page 1) define an "accumulation distribution" as "the excess of amounts properly paid, credited, or required to be distributed (other than income required to be distributed currently) over the distributable net income of the trust reduced by the income required to be distributed currently. To have an accumulation distribution, the distribution must exceed the accounting income of the trust."

Part 2 of the form is a nightmare that requires the trust to go back potentially to the year *1969* to determine how much of the undistributed net income (UNI) attributable to prior tax years is available to absorb the current year's accumulation distribution on a year-by-year basis starting with the earliest preceding year in which the trust had UNI. This is the so-called "throwback." As the form illustrates, the UNI for a given year is the DNI for a given throwback year reduced by the trust's distributions to beneficiaries in that throwback year, and then further reduced by the taxes imposed on the trust for that throwback year (which, per Part 3 of the form, is computed based solely on the trust's ordinary income for that throwback year, with both short-term and long-term capital gains excluded from this computation). The instructions for line 13 then provide as follows:

> Allocate the amount on line 5 that is an accumulation distribution to the earliest applicable year first, but do not allocate more than the amount on line 12 for any throwback year. An accumulation distribution is thrown back first to the earliest preceding tax year in which there is undistributed net income (UNI). Then, it is thrown back beginning with the next

> earliest year to any remaining preceding tax years of the trust. The portion of the accumulation distribution allocated to the earliest preceding tax year is the amount of the UNI for that year. The portion of the accumulation distribution allocated to any remaining preceding tax year is the amount by which the accumulation distribution is larger than the total of the UNI for all earlier preceding tax years.

The instructions for line 13 then contain an exception for "simple trusts." A "simple trust" is a trust that (1) is required to distribute all of its income currently for the taxable year (whether or not distributions of current income are in fact made); (2) does not allow any amount to be paid or set aside for charitable contributions; and (3) does not in fact make any distributions other than of current income for such taxable year. (IRC § 651; Treas. Regs. § 1.651(a)-1) The instructions elaborate:

> A tax year of a trust during which the trust was a simple trust for the entire year is not a preceding tax year unless (a) during that year the trust received *outside income*, or (b) the trustee did not distribute all of the trust's income that was required to be distributed currently for that year. In this case, UNI for that year must not be more than the greater of the outside income or income not distributed during that year.
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> The term *outside income* means amounts that are included in the DNI of the trust for that year but not income of the trust as defined in IRC Treasury Regulations section 1.643(b)-1. Some examples of outside income are: (a) income taxable to the trust under IRC section 691; (b) unrealized accounts receivable that were assigned to the trust; and (c) distributions from another trust that include the DNI or UNI of the other trust.

Significantly, the instructions do not address what happens if the trustee lacks the records necessary to complete this form – which can be expected to occur with tremendous frequency given that the throwback year may be as long ago as *1969* if the trust was in existence during that year. Although it appears that this measure was intended to be helpful to taxpayers by providing a method to exclude from tax accumulation distributions that can be "soaked up" by UNI that is attributable to tax years starting before January 1, 2014, the recordkeeping aspect of this is totally unworkable. This problem could be ameliorated to some extent if the NYSDTF were to follow the approach taken by the Internal Revenue Service in Part III of the IRS Form 3520 and adopt an alternate "default calculation" that generally limits the throwback amount subject to tax to distributions for a given year that exceed 125% of

the average of the amounts distributed by the trust during the three preceding tax years.

The form instructs at the bottom of Part 2 that if the throwback year is a tax year that the trust was subject to New York State tax, or a tax year starting before January 1, 2014, then there is no New York State modification required for that year and, as a result, Part 4 of the form should not be completed for that year. The bottom portion of Part 2 further provides that Part 4 should not be completed *for the beneficiary* if the throwback year is a tax year prior to when the beneficiary first became a resident of New York State, a tax year before the beneficiary was born or reached age 21, or if the income was already included in the beneficiary's gross income.

Part 3 of the form, as noted above, computes the amount of the federal taxes imposed on the ordinary income portion of each throwback year's UNI for purposes of reflecting that information on line 9 in Part 2 of the form.

Finally, Part 4 of the form reports allocations to the New York resident beneficiary for whom Part 4 must be completed, and specifies that the beneficiary should enter the line 49 amount on Form IT-225 as addition modification "A-116." If the beneficiary received separate Schedule J Part 4's from multiple trusts, then the sum of the line 49 amounts from all Schedule J's gets entered on the Form IT-225. The instructions require that the New York resident beneficiary be provided with a copy of Part 4.

Planning to Avoid the New York Throwback Tax

Finally, given the complexity of the New York throwback tax, some discussion is warranted concerning 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 IRC § 665(b), 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 20% of the entity's gross assets.

[1] ©2016 Kevin Matz. All rights reserved. Mr. Matz is the managing attorney of the law firm of Kevin Matz & Associates PLLC, with offices in New York City and White Plains, New York. His practice is devoted principally to domestic and international estate and tax planning and he is a Fellow of the American College of Trust and Estate Counsel ("ACTEC"). Mr. Matz is also a certified public accountant (in which connection he is a past chairman of the Estate Planning Committee of the New York State Society of Certified Public Accountants), and writes and lectures frequently on estate and tax planning topics. He can be reached by email at kmatz@kmatzlaw.com, or by phone at 914-682-6884.

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

[3] The budget bill that enacted the throwback tax 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.

[4] *See Taylor v. State Tax Commission*, 85 A.D.2d 821, 445 N.Y.S.2d 648 (N.Y. App. Div. 1981).

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

[6] *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.