

May 5, 2016

Mr. Jerry Boone, Commissioner
Ms. Nonie Manion, Executive Deputy Commissioner
New York State Department of Taxation and Finance
W. A. Harriman Campus Bldg 9, Room 200
Albany, NY 12227

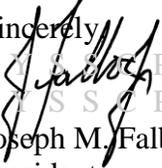
Via e-mail: jerry.boone@tax.ny.gov; nonie.manion@tax.ny.gov

**Re: Recommendations to the New York State Department of Taxation and Finance
Concerning Proposed Improvements to Form IT-205-J, New York State Accumulation
Distribution for Exempt Resident Trusts (Schedule J) and Accompanying Instructions**

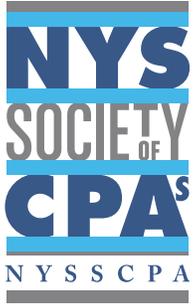
Dear Commissioner Boone and Executive Deputy Commissioner Manion:

The New York State Society of Certified Public Accountants (NYSSCPA), representing more than 28,000 CPAs in public practice, business, government and education, is pleased to offer its recommendations concerning Form IT-205-J, New York State Accumulation Distribution for Exempt Resident Trusts.

NYSSCPA's Trust & Estate Administration Committee has reviewed Form IT-205-J and its accompanying instructions and prepared the attached report detailing proposed improvements. If you would like additional discussion with us, please contact Melissa A. Abbott, Chair of the Trust & Estate Administration Committee, at (212) 695-7003, or Ernest J. Markezin, NYSSCPA staff, at (212) 719-8303.

Sincerely,

Joseph M. Falbo, Jr.
President

Attachment



**NEW YORK STATE SOCIETY OF
CERTIFIED PUBLIC ACCOUNTANTS**

**RECOMMENDATIONS TO THE NEW YORK STATE DEPARTMENT OF TAXATION
AND FINANCE CONCERNING PROPOSED IMPROVEMENTS TO FORM IT-205-J,
NEW YORK STATE ACCUMULATION DISTRIBUTION FOR EXEMPT RESIDENT
TRUSTS (SCHEDULE J) AND ACCOMPANYING INSTRUCTIONS**

May 5, 2016

Principal Drafter

Kevin Matz

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NYSSCPA Staff

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William R. Lalli

The New York State Society of Certified Public Accountants

Recommendations to the New York State Department of Taxation and Finance Concerning Proposed Improvements to Form IT-205-J, New York State Accumulation Distribution for Exempt Resident Trusts (Schedule J) and Accompanying Instructions

The New York State Society of Certified Public Accountants respectfully submits this comment letter setting forth its recommendations to the New York State Department of Taxation and Finance (“NYSDTF”) concerning proposed improvements to Form IT-205-J, New York State Accumulation Distribution for Exempt Resident Trusts (“Schedule J”) and its accompanying instructions: 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

Our principal concern is that this form is extremely difficult for practitioners to complete because it requires locating information pertaining to trusts and beneficiaries going back potentially to the year 1969 to determine the existence of prior years’ undistributed net income to which certain distributions could be applied. Although this requirement is helpful in theory to prevent tax from being imposed on income accumulated during taxable years beginning prior to January 1, 2014, (which income is excluded by N.Y. Tax Law § 612(b)(40)), in practice, records will frequently be unavailable to permit this exclusion to be invoked. This problem could be ameliorated to a large extent if the NYSDTF were to supplement Schedule J and its instructions to allow “exempt resident trusts” to use a simplified “default calculation” in tandem that is similar to the approach taken by the Internal Revenue Service (IRS) in Part III of the IRS Form 3520, Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts, (the “IRS Form 3520”).

Background

On April 1, 2014, Governor Andrew Cuomo signed into law as part of the New York State Executive Budget several provisions affecting the New York State estate tax and certain trusts. These provisions included 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 are derived from sources outside of New York State.¹ Many of the contours of the throwback tax awaited clarification from the NYSDTF.²

¹ See N.Y. Tax Law § 605(b)(3)(D).

² 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.

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 (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.

The New York rules governing the income taxation of nongrantor trusts are superimposed against this federal income tax backdrop. 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; 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 State³) 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 are derived from sources outside of New York State.⁴

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, New York will impose income tax on the New York resident beneficiary. 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*.

³ See *Taylor v. State Tax Commission*, 85 A.D.2d 821, 445 N.Y.S.2d 648 (N.Y. App. Div. 1981).

⁴ See N.Y. Tax Law § 605(b)(3)(D).

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.⁵

It should be noted that prior versions of the budget bill that enacted this statute would have applied the throwback tax to undistributed net income going back to trust inception and would have applied to nonresident trusts. This approach was ultimately rejected by the New York Legislature, and 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, the New York statute does not impose any interest charge.

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 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

⁵ 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.

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 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 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). 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. (IRC⁶ § 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.

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 great 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

⁶ All references to “IRC” are to the Internal Revenue Code of 1986, as amended.

follow the approach taken by the IRS in Part III of the IRS Form 3520⁷ 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, 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.

Our Recommendations

As discussed above, the instructions to Schedule J do not address circumstances in which the trustee might lack the records necessary to complete the form – a circumstance which can be expected to occur with great frequency given that the throwback year may be as long ago as 1969 if the trust was in existence during that year. While it seems 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 not practical.

The NYS DTF should follow the approach taken by the IRS, which in the late 1990s was confronted with very similar circumstances in administering the federal throwback tax that applies to foreign nongrantor trusts. The administrative solution reached by the IRS was to include within Part III of the IRS Form 3520 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. We believe that the NYS DTF should include a similar default calculation in its form, and we would be pleased to work together with the NYS DTF in revising Schedule J and its accompanying instructions to incorporate this.

⁷ Links to the 2015 IRS Form 3520 and its accompanying instructions follow: <https://www.irs.gov/pub/irs-pdf/f3520.pdf> and <https://www.irs.gov/pub/irs-pdf/i3520.pdf>.