NEBRASKA INCOME TAX: ESTATES AND TRUSTS

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I. INTRODUCTION

As in the case of taxation of individuals, the Nebraska income tax upon estates and trusts is directly related to the federal tax thereon. Thus, before one can comprehend the computation of the Nebraska tax, one must be somewhat familiar with the general principles of federal taxation of estates and trusts set forth in the Internal Revenue Code.[1]

Generally speaking, for federal purposes each estate is considered to be a separate taxpayer and is required to pay a tax upon its entire income other than that which is either distributed or distributable during each taxable year. The same rules generally apply to trusts, except that all the income of a revocable inter vivos trust is deemed to be taxable to the grantor, and all or part of the income of an irrevocable inter vivos trust may be taxable to the grantor if he has retained certain "strings attached" to the trust.[2]

For federal income tax purposes, each estate or trust is treated as a "conduit" with regard to items of income and deductions which were either distributed or distributable by the estate or trust during the taxable year. Moreover, all distributions of money and property are deemed to be distributions first of income, with a few exceptions, which the estate or trust may deduct. A pro rata share of distributed or distributable items is included in the gross income of each beneficiary, and unless local law or the governing instrument provides otherwise, each distribution is deemed to include a pro rata share of each type of income and deduction received by the trust. It should be noted that each such item maintains its identity in the hands of the beneficiary.[3] For Nebraska income tax purposes, it is doubly important that identity of items of income be maintained, first, because interest on federal obligations is exempt from the Nebraska income tax, and second, because the portion of each distribution to a nonresident beneficiary which is income "derived from" Nebraska must be identified.[4]

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1. INT. REV. CODE of 1954, §§ 643-92.

2. See INT. REV. CODE of 1954, §§ 671-78 for rules pertaining to "grantor trusts."

3. *See* INT. REV. CODE of 1954, §§ 651, 652, 662.

4. *See* NEB. INCOME TAX REG. TC 23-3(g) (1968).

II. RESIDENCY OF ESTATES AND TRUSTS

Many doubts and questions are raised by the statutory language defining resident estates and trusts.[5] The situation is further obfuscated by the Regulations published by the Nebraska tax commissioner.[6] It is clear that every decedent's estate is a "resident estate" if the decedent was domiciled in Nebraska at the time of his death. Similarly, a testamentary trust is a "resident trust" if the testator was domiciled in Nebraska at the time of his death. Under a strict reading of the language of the Act and the Regulations, an ancillary estate[7] is not a "resident estate." However, income from such an estate does not escape Nebraska taxation, whether such income is accumulated by the estate or by a testamentary trust created by the decedent, and notwithstanding that it is distributed to nonresident beneficiaries.

Most of the questions raised by the language of the Act and Regulations concern inter vivos trusts. The Act provides that "an inter vivos trust created by, or consisting of property of, a person domiciled in this state" is a resident trust.[8] The Regulations amplify this language, stating that the domicile of the grantor on the date of creation of the trust is the key to whether or not the trust is a "resident trust." A subsequent change of domicile by the grantor will not affect the taxability of the trust.[9]

If the Regulations are to be followed literally, curious results will follow. The tax commissioner states that an inter vivos trust created by a Nebraska resident will always be subject to Nebraska tax, "unless and until a person not domiciled in Nebraska contributes property to the trust."[10] The contrary is said to be true in regard to inter vivos trusts originally created by nonresident individuals. Thus, a million-dollar trust created by a resident of Nebraska will escape the Nebraska income tax, except as to income derived from sources within Nebraska, if a resident of any other state contributes as little as one dollar to the trust. On the other hand, a literal following of the Regulation would subject a million-dollar trust created by an Iowan to the Nebraska income tax, if a Nebraskan subsequently were to contribute one dollar to the trust. Furthermore, an inter vivos trust created by a Nebraskan would be exempt

5. NEB. REV. STAT. § 77-2718 (Supp. 1967).
6. *See* NEB. INCOME TAX REG. TC 25-1, -2 (1968).
7. Generally, an estate is ancillary when the decedent was a nonresident of Nebraska at the time of death, but owned real estate in Nebraska.
8. NEB. REV. STAT. § 77-2718 (Supp. 1967).
9. NEB. INCOME TAX REG. TC 25-1 (1968).
10. NEB. INCOME TAX REG. TC 25-1 (1968).

from the Nebraska tax, should the grantor of the trust move to another state, but only if he or some other nonresident subsequently contributes one dollar to the trust. A more logical rule would be to impose the Nebraska income tax upon the proportionate part of the income attributable to property contributed to the trust by a Nebraska resident, where other property has been contributed to the trust by a nonresident, whether or not the nonresident is the same person as the original grantor of the trust. The rule suggested would avoid the undesirable consequences noted above.

The basic rules for estates and trusts with regard to filing returns and paying the tax follow the rules applicable to individuals. In other words every "resident" estate or trust must file Nebraska income tax returns and must pay tax on all its taxable income. Every "nonresident" estate or trust is exempt from the Nebraska tax and need not file a return except with regard to income derived from sources within Nebraska, such as income from Nebraska real estate and income from a going business in Nebraska.

III. PREPARATION OF NEBRASKA FIDUCIARY INCOME TAX RETURNS

With a few exceptions, estates and trusts are taxed in basically the same manner as individuals. Thus, each estate or trust, whether resident or nonresident, will have a Nebraska income tax liability based upon a percentage of its federal income tax liability, as if the entity were an individual. For obvious reasons neither an estate nor a trust is allowed the food sales tax credit allowed to individuals.

The Act[11] and Regulations[12] also provide for a "fiduciary adjustment," which refers to a credit against the Nebraska income tax in situations where a trust has accumulated income over a period of time and subsequently distributes all of its current year's income plus all or part of such accumulated income. Federal law concerned with this subject deals with "accumulation distributions"[13] and the "five-year throwback rule."[14] As in other areas, the basic federal rules with regard to such distributions apply to the Nebraska tax, except that no credit is available under Nebraska law where the income was accumulated by the trust prior to January 1, 1968 and thereafter distributed, because no Nebraska income tax has been paid thereon by the trust. In addition, the Nebraska Act provides

11. NEB. REV. STAT. §§ 77-2720, -2722 (Supp. 1967).
12. NEB. INCOME TAX REG. TC 25-4(1) (1968).
13. INT. REV. CODE of 1954, § 665(b).
14. INT. REV. CODE of 1954, § 666.

that no beneficiary's tax liability may be reduced by reason of the "fiduciary adjustment" below the tax liability such beneficiary might have been required to pay had he not received any distribution other than from current income of the trust.[15]

It should be noted, both for federal and Nebraska income tax purposes, that the rules pertaining to "accumulation distributions" and the "five-year throwback rule" apply only to trusts wherein the trustee has discretion to accumulate or distribute income. The rules do not apply to estates, nor to trusts from which all income is required to be distributed annually.

In preparation and filing of fiduciary returns for Nebraska income tax purposes, if the gross income of the estate or trust equals or exceeds $5,000, care should be taken that the fiduciary attaches to the return a statement expressing his opinion with regard to the taxability of the estate or trust and its various beneficiaries, quoting portions of the governing instrument in appropriate cases.[16] The purpose of this requirement is to help the tax commissioner determine whether the trust is "simple" or "complex" under federal law[17] and the extent to which actual distributions have been made by the fiduciary during the taxable year. Personal representatives and trustees are not required to file certified copies of wills or trust agreements with fiduciary income tax returns, but each is required to keep a certified copy thereof available for inspection by the commissioner upon request.[18]

IV. TAXABILITY OF BENEFICIARIES

Individual beneficiaries of estates and trusts, in effect, are taxed on income distributed or distributable to them as if the estate or trust entity did not exist, and as if the beneficiary received the income directly. The main principles to be considered by the fiduciary are first, that the income of a resident estate or trust is not per se Nebraska income when it is distributed to a nonresident beneficiary, and second, that all income and deductions of the estate or trust maintain their identity when distributed to the beneficiary. Thus, a nonresident beneficiary must pay Nebraska income tax only on the pro rata share of a distribution to him by a resident trust or estate of income derived from sources in Nebraska, such

15. NEB. REV. STAT. § 77-2722(2) (Supp. 1967).
16. NEB. INCOME TAX REG. TC 25-5 (1968).
17. A "simple" trust is one which is required to distribute all of its income currently, and a "complex" trust is one wherein the trustee either has discretion or is required to accumulate income. *See* Treas. Reg. § 1.651 (a)-3 (1956).
18. NEB. INCOME TAX REG. TC 25-5 (1968).

as rental income from Nebraska real estate. In addition, each beneficiary receiving income distributions is deemed to have received a pro rata share of interest income received by the fiduciary from federal obligations, which are exempt from the Nebraska income tax.

Should a trust become involved with the problems of "accumulation distributions" and the correlative "five-year throwback rule," then each beneficiary of the trust would receive a pro rata share of the credit, if any, for Nebraska income tax previously paid by the trustee on such income, since the income maintains its identity when distributed to the beneficiary.

V. TAXABLE YEARS OF ESTATES AND TRUSTS

Each estate or trust must use the same taxable year for Nebraska income tax purposes as for federal income tax purposes. Since each estate or trust is a separate taxable entity, each is allowed initially to determine its own taxable year, limited only by the requirement that the first taxable year terminate at the end of a calendar month which is not more than twelve months after the estate or trust was "created." An estate is deemed to commence on the date of death of the decedent, regardless of the duration of time until the personal representative is officially appointed.

The federal rules also apply with regard to the time of taxation of distributions by an estate or trust to beneficiaries. Each beneficiary is deemed to receive each distribution of income in his taxable year with which or within which the taxable year of the estate or trust ended.

VI. APPLICABILITY OF TAX RULES TO PLANNING

An attorney for an estate or trust should point out certain tax advantages to the fiduciary in the initial planning stages. For example, if the decedent died in February 1968, the attorney should point out that the first taxable year of the estate need not end until January 31, 1969. Distributions of income by the fiduciary from the estate would not then be taxable to the beneficiary until 1969, assuming the beneficiary paid taxes on a calendar year basis.

Distributions to residuary legatees of testate estates, to heirs in intestate estates, and to beneficiaries of "complex" trusts,[19] all may be planned with a view toward saving Nebraska income tax. If, for example, all the income of an intestate estate were constituted

19. The trustee of a "complex" trust has discretion to "spray" income or accumulate it. *See* note 17 *supra*.

of income from intangible property, none of it would be taxable to a nonresident of Nebraska. Thus, if the estate had two equal beneficiaries, one a resident of Nebraska and one a nonresident of Nebraska, the administrator and heirs might conclude that it would be advantageous to distribute substantially all the income of the estate to the nonresident beneficiary, thus avoiding Nebraska income tax thereon.[20] Other and more complex plans may be made by fiduciaries for the purpose of saving or at least deferring both federal and state income taxes.

20. For purposes of Nebraska probate law, the distribution would be treated as a partial distribution of the beneficiaries' share of the estate, but for purposes of income tax law, the entire distribution is deemed to be income to the extent of the taxable income of the estate.