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TAXABILITY OF INCOME TO ESTATES, TRUSTS OR BENEFICIARIES

(Replaces Revenue Administrative Bulletin 1988-19)

Pursuant to MCL 205.6a, a taxpayer may rely on a Revenue Administrative Bulletin issued by the Department of Treasury after September 30, 2006, and shall not be penalized for that reliance until the bulletin is revoked in writing. However, reliance by the taxpayer is limited to issues addressed in the bulletin for tax periods up to the effective date of an amendment to the law upon which the bulletin is based or for tax periods up to the date of a final order of a court of competent jurisdiction for which all rights of appeal have been exhausted or have expired that overrules or modifies the law upon which the bulletin is based.

RAB 2015-15. This Revenue Administrative Bulletin (RAB) explains the income tax treatment of income attributable to estates, trusts and beneficiaries.

Overview of the taxation of estates, trusts and beneficiaries.

Under the Michigan Income Tax Act, income received by an estate or trust will keep its character (interest, dividend, capital gain, business income, etc.) whether the income is retained by the estate or trust or is distributed to the beneficiaries. If income is retained by the estate or trust, the income will usually be taxed to the estate or trust. If the income is distributed to beneficiaries, the income will usually be taxed to the beneficiaries. The taxation of the income under the Michigan Income Tax Act depends on the residency of the taxpayer for certain types of income and on the source of the income for other types of income. The fiduciary of the estate or trust should provide a beneficiary with a federal Form 1041 Schedule K-1 that reports the income attributable to that beneficiary. The fiduciary should also provide supplemental information to a beneficiary identifying income that is attributable to Michigan.

Resident Estates or Trusts

The Michigan Income Tax Act defines a resident estate and a resident trust in MCL 206.18(b) and (c), respectively. Under subsection (b), the estate of a decedent is a resident estate if the decedent was domiciled in Michigan at the time of death. Under subsection (c), a trust is a resident trust if the trust was created by the will of a decedent who was domiciled in Michigan at the time of death. Resident trusts also include any trust created by, or consisting of property of, a person domiciled in this state at the time the trust becomes irrevocable.

Resident estates and resident trusts are subject to Michigan income tax on all income from any source, except for income that is attributable to another state according to the allocation or apportionment provisions of the Michigan Income Tax Act.¹ The taxable income of a resident estate or resident trust is federal taxable income subject to Michigan adjustments.²

Nonresident Estates or Trusts

A nonresident estate or trust is one that does not meet the definition of a resident estate or trust. In addition, a trust that meets the definition of a resident trust may nonetheless become a nonresident trust if all the following are true: the trustee is not a Michigan resident; the trust assets are not held, located or administered in Michigan, and; all of the beneficiaries are nonresidents.³

Nonresident estates and trusts are subject to Michigan income tax on income sourced to Michigan, including: income derived from real or tangible personal property located in Michigan; income from a business, trade, profession, or occupation conducted in Michigan; income from services performed in Michigan, and; income earned, received, or acquired in Michigan.⁴ Nonresident trusts and estates are taxed on the Michigan-sourced income that is not taxable to the beneficiaries.⁵

Grantor Trust

No fiduciary income tax return is required when the grantor is treated as the owner of the trust's assets under IRC 671-678. Instead, the grantor reports the trust's income, deductions, and credits on the grantor's individual Michigan income tax return.

Taxable Income of a Beneficiary of an Estate or Trust

Beneficiaries who are residents of Michigan are subject to Michigan income tax on all sources of income distributed from an estate or trust after adjustments.⁶ For income that is allocable based on residency, the allocation is based on the residency of the beneficiary regardless of the residency of the estate or trust.

Nonresident beneficiaries are subject to Michigan income tax on income distributed by an estate or trust if the income is allocated to or apportioned to Michigan. For example, rents and royalties from real or tangible personal property located in Michigan and capital gains and losses from sales or exchanges of those properties are allocated to Michigan. Royalty income from patents and copyrights are allocated to Michigan if they are used in Michigan. Business income is subject to allocation or apportionment.⁷ The net income from Michigan oil and gas wells is not subject to tax if the oil and gas is subject to Michigan severance tax. After 2012, income and expenses subject to the nonferrous metallic mineral extraction severance tax are not taxable. Nonresident beneficiaries are not subject to Michigan income tax on interest and dividends or on

¹ MCL 206.110(1).

² MCL 206.36.

³ *Blue v Michigan Department of Treasury*, 185 Mich App 406; 462 NW2d 762 (1990).

⁴ MCL 206.110(2).

⁵ MCL 206.110(3).

⁶ MCL 206.30 and MCL 206.110, for adjustments see MCL 206.30.

⁷ MCL 206.110-115.

capital gains or losses from the sale of intangible property even if the income is distributed from a Michigan estate or trust.

Allocation of Michigan Income Additions and Subtractions to Beneficiaries

The allocation of Michigan income additions and subtractions must be in proportion to the beneficiary's share of distributable net income of the estate or trust.⁸

If the distributable net income of an estate or trust is zero or less than zero, the share of each beneficiary's Michigan additions and subtractions is in proportion to each beneficiary's share of the income for that year (determined under local law or the terms of the instrument) which is required to be distributed currently, plus any other income distributed. Any balance of the Michigan additions and subtractions not allocable to any beneficiary is allocated to the estate or trust.

For example, a trust has income, for trust accounting purposes, of \$10,000, and the Michigan net rental income is \$5,000. Certain expenses paid by the trustee are chargeable to principal under the terms of the trust instrument but are nevertheless deductible for federal income tax purposes and have the effect of reducing distributable net income to zero.

The trust instrument requires that \$4,000 of income be distributed to the beneficiary. An additional \$3,000 is paid to the beneficiary under the discretionary authority of the trustee, and the remaining \$3,000 of income is accumulated by the trust. The beneficiary's \$7,000 share is 70% of the total income for trust accounting purposes, so that 70% of the adjustment (\$5,000 x 70% = \$3,500) is allocated to the beneficiary. The beneficiary will add \$3,500 to federal adjusted gross income to determine Michigan income. The remaining \$1,500 of the net adjustments belongs to the trust and is added to the federal taxable income of the trust to determine the trust's Michigan income.

⁸ MCL 206.36(2).