Department of Finance and Administration

Legislative Impact Statement

Bill: HB1911 **Amendment Number: H1**
Bill Subtitle: TO AMEND THE INCOME TAX ACT OF 1929 CONCERNING WHO SHALL BE TREATED AS THE OWNER OF A PORTION OF A TRUST.

Basic Change :

Sponsor: Rep. M. Gray

House Amendment 1 --- The amendment adopts 26 U.S.C §§ 671-679 as in effect on January 1, 2019. HB1911, as originally introduced, adopted 26 U.S.C §§ 671-679 as in effect on January 1, 2018. The bill also changes the effective date of the bill to provide that the adoption of the federal code sections would be effective for the 2020 and following tax years. As originally introduced, the bill would have been effective for the 2019 and following tax years.

The amendment also adds the following two sections that are not to be codified:

- The first additional section provides a statement of legislative intent to provide that 26 U.S.C. §§ 671-679, as in effect on January 1, 2019, be adopted prospectively. In addition, this additional section states that the General Assembly recognizes that the Income Tax Act of 1929, § 26-51-101, et seq, has not previously addressed the issue of taxation of trusts and their beneficiaries that are grantor trusts for federal income tax purposes.

- The second additional section provides that Director of the Department of Finance and Administration (DFA) shall repeal Comprehensive Individual Income Tax Rule 4.26-51-102. This section states that the Director did not have authority to adopt 26 U.S.C. §§ 671-679 and the related federal regulations and the “Comprehensive Individual Income Tax Regulation 4.26-51-102 is inconsistent with 26 U.S.C. §§ 671-679 and the related federal regulations.”

Original Bill --- HB1911 amends § 26-51-201 by adopting federal law, 26 U.S.C. §§ 671-679 as in effect on January 1, 2018. The federal income tax laws are adopted for purposes of determining whether the grantor or another person shall be treated as the owner of a portion of a trust. These changes will clarify that Arkansas taxpayers will have the same rules for both federal and state income tax purposes.

Revenue Impact :

FY2020 $20 Million Reduction in State General Revenue

[Revenue impact is based upon current pending tax cases and inquiries of $6.2 Million. Matters going back three years that could be subject to an amended return and request for refund could total over $20 Million.]

Taxpayer Impact :

26 U.S.C. §§ 671-679, as in effect on January 1, 2019, will be adopted prospectively for the 2020 and following tax years for income tax purposes. Taxpayers with current pending grantor trust cases or tax inquiries involving the DFA may argue DFA was without authority to promulgate Rule 4.26-51-102. Certain taxpayers that reported income as a grantor trust in the last three years would possibly amend their returns and request refunds.

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Resources Required :

None.

Time Required :

Adequate time is provided for implementation.

Procedural Changes :

None.

Other Comments :

None.

Legal Analysis :

Amendment 1 to HB1911 amends the bill as originally introduced and contains two sections that are not to be codified. These sections provide a statement of legislative intent and a directive to the Director of the Department of Finance and Administration ("DFA") to declare that the Director did not have the authority to promulgate Rule 4.26-51-102 of the Comprehensive Individual Income Tax Regulations (the "Rule"). The Rule states as follows:

> **4.26-51-102 Grantor Trust**
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> A trust whereby the grantor retains control over the income or corpus (trust property) or both, to such an extent that the grantor will be treated as the owner of the property and its income for income tax purposes. The general result is that the income from a grantor trust is taxable to the grantor, as "owner" of the trust, and not to the fiduciary. In determining whether a trust is a grantor trust, the grantor's degree of control over the trust must be analyzed.
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> If a grantor is considered to be the owner of the entire trust, the grantor computes his own personal income tax by taking into account all trust income, deductions and credits as though the trust did not exist. However, where a grantor is treated as owner solely because of his interest in trust income, the grantor takes into account only his share of trust items that would be reported by a current income beneficiary. IRC Reg. 1.671-3.
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> The grantor of a trust is treated as its "owner" and is generally taxed on its income if:
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> a) The grantor reserves the power to take back title to (that is, revoke) trust funds for himself where the grantor can exercise this power alone, or it can be exercised only by another who is regarded as a nonadverse party or it can be exercised by both the grantor and nonadverse party together;

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*b) The trust income is distributed actually or constructively to the grantor or the grantor's spouse;

*c) The trust income is held or accumulated for future distribution to the grantor or the grantor's spouse;

*d) The trust income is applied to pay premiums on life insurance policies taken out on the life of the grantor or the grantor's spouse.

See IRC Sec. 671 et seq.

*The income is not taxable to the grantor if the application of the income to any of these purposes requires the approval of an adverse party (such as a beneficiary).

The Arkansas Income Tax Act of 1929 defined “gross income” broadly to include "gains or profits and income derived from any source whatever." In conjunction with this broad definition, the Arkansas General Assembly delegated to the Director of the DFA broad authority to promulgate necessary rules for the administration of the tax. In particular, when the Arkansas General Assembly set forth the definition of "gross income", it did not state what interests in a source of income are sufficient to require a person to report the income. To address this question, the Director promulgated several rules that state when a person is required to report income derived from various beneficial interests in property. Rule 4.26-51-102, which is at issue in Amendment 1 to HB1911, is an example of one such rule.

The Director promulgated this Rule to provide a reasonable answer to the specific question of when the creator (or "grantor"), rather than the trustee, of a kind of trust called a "grantor trust" is liable for the tax. Under the Rule, a grantor trust is "[a] trust whereby the grantor retains control over the income or corpus (trust property) or both, to such an extent that the grantor will be treated as the owner of the property and its income for income tax purposes". If a trust is a grantor trust, its income is taxable to the grantor, as "owner" of the trust, and not to the trustee. In determining whether the grantor is liable for the tax, the Rule states that the grantor's degree of control over the trust must be analyzed. To aid in this analysis, the Rule utilizes the circumstances described in IRC § 671 et seq to identify when the grantor has retained such control.

These are the same federal statutes that the original version of HB1911 would have clarified for the public have been adopted in Arkansas.

As the Arkansas Supreme Court has stated, an agency's "administrative interpretation is to be regarded as highly persuasive," and it should "not be disregarded unless it is clearly wrong." *See Macsteel, Parnell Consultants v. Arkansas Ok. Gas Corp.*, 363 Ark. 22, 210 S.W.3d 878 (2005). A court will not attempt to substitute its judgment for that of the administrative agency. *Arkansas Health Services Commission v. Regional Care Facilities, Inc.*, 351 Ark. 331, 338, 93 S.W.3d 672 (2002). The Rule at issue in Amendment 1 it is not "clearly wrong". Control over the trust property is a reasonable basis for evaluating whether an interest in a property is sufficient to make a grantor of a trust subject to tax, and this standard does not contravene any statute.

Further, while it is correct that "when the state seeks to impose a tax under the terms of a state tax law, then the statute imposing the tax shall be strictly construed in limitation of the imposition of the tax," § 26-18-313; however, the Director's authority to promulgate the Rule did not come from the statute that imposes the income tax. It came from the Arkansas Tax Procedure Act, which does not itself impose a tax. For these reasons, the DFA disagrees with the legal conclusion in the “Do Not Codify” sections of Amendment 1 to HB1911.

Finally, Amendment 1 to HB1911 would create serious unintended consequences. Under Amendment 1, for all years prior to 2020, a taxpayer may argue that all gains on property held by an out-of-state trustee but for the benefit of an Arkansas resident would not be subject to income tax even if the trust was completely revocable and the grantor of the trust had complete control over the trust property. The legislature clearly did not intend for such a result, and the Arkansas Supreme Court has held that it "does not engage in interpretations that defy common sense and produce absurd results." *Green v. Mills*, 339 Ark. 200, 205, 4 S.W.3d (1999).