

# Instructions for Estates and Trusts Income Tax Return

North Carolina Department of Revenue

The references to line numbers and form numbers on federal income tax forms were correct at the time of printing. If they have changed and you are unable to determine the proper line to use, please contact the Department of Revenue.

**Do not attach a copy of Federal Form 1041 or copies of K-1s to Form D-407. If copies are needed, the Department will request them at a later date.**

**(A) Who must file Form D-407?** A fiduciary must file North Carolina Form D-407 for the estate or trust if he is required to file a federal income tax return for estates and trusts and (1) the estate or trust derives income from North Carolina sources or (2) the estate or trust derives any income which is for the benefit of a resident of North Carolina.

**(B) Other returns to be filed by fiduciaries:**

**(1) Returns for decedents.** - A personal representative must file an individual income tax return, Form D-400, for the last taxable year of the decedent if the decedent had income that was sufficient to require the filing of an individual income tax return.

**(2) Returns for other individuals.** - A fiduciary, including the guardian of a minor (who has not filed a return) and the guardian of a mentally incompetent individual who has charge of the income of the individual, must file a return on Form D-400 if a return is required for such an individual.

**(C) Period to be covered by the return.** - Returns shall be filed for the calendar year 2001 or fiscal year beginning in 2001. If the return is filed for other than a calendar year, fill in the beginning and ending dates of the taxable year in the boxes at the top of page 1.

**(D) Time and place for filing.** - Returns must be filed with the N. C. Dept. of Revenue, P. O. Box 25000, Raleigh, North Carolina 27640-0645, on or before the 15th of April for an estate or trust filing on the calendar year basis, and on or before the 15th day of the fourth month following the close of the fiscal year for an estate or trust filing on a fiscal year basis.

**(E) Extensions.** - If Form D-407 cannot be filed by the due date, the fiduciary may apply for an automatic 6-month extension of time to file the return. **To receive the extension, the fiduciary must file Form D-410P, Application for Extension for Filing Partnership, Estate, or Trust Tax Return, by the original due date of the return.**

The fiduciary is not required to send a payment of the tax it estimates as due to receive the extension; however, it will benefit the estate or trust to pay as much as it can with the extension request.

A 10 percent late payment penalty will apply on the remaining balance due if the tax paid by the due date of the return is less than 90 percent of the total tax due. If the 90 percent rule is met, any remaining balance due, including interest, must be paid with the estate or trust return on or before the expiration of the extension period to avoid the late payment penalty. A fiduciary may file the return at any time within the extension period but it must be filed on or before the end of the extension period to avoid the late filing penalty.

**(F) Signature.** - The fiduciary or authorized representative must sign Form D-407. The return must also be signed by the person or in the name of the firm or corporation preparing the fiduciary's return for compensation. The daytime telephone number of the fiduciary should be shown so that he may be reached if additional information is needed to process the return. **For tax due returns only**, the preparer's facsimile signature is acceptable provided the preparer submits with the return a letter, manually signed by the preparer, identifying each return bearing the facsimile signature by taxpayer name and identifying number and a declaration under penalty of perjury that the facsimile signature on each return is the signature used by the preparer to sign the return.

**(G) When and to whom the tax must be paid.** - The tax of an estate or trust must be paid in full when the return is filed. If the balance due after all credits is less than one dollar, no payment is required. The tax may be paid by check or money order payable to the N. C. Dept. of Revenue or in cash at any local revenue office. Pay in U.S. currency only.

**(H) Penalties and interest.** - For failure to file a timely estate or trust return, the penalty is 5 percent of the tax per month with a \$5 minimum and a 25 percent maximum. Returns filed after April 15 without a valid extension are subject to a late payment penalty of 10 percent of the unpaid tax (minimum \$5). In addition, penalties are provided for fraud, for willful failure to file on time, and for willful attempt to evade or defeat the tax. Taxes also bear interest from the due date until the date paid. The rate is available at your local revenue office.

**(I) Copy of governing instrument.** - A copy of the decedent's will or the trust instrument is not required unless the Department of Revenue requests it. If the Department requests it, file a copy (including any amendments) with the following:

(1) A signed statement under affirmation that the copy of the will is true and complete.

(2) A statement listing the provisions of the will or the trust instrument that divides the income among the estate or trust, the grantor (if applicable) and the beneficiaries.

**(J) Specific Instructions for Form NC K-1.** - Schedule NC K-1 for Form D-407 is used by an estate or trust to report each beneficiary's share of income, adjustments, tax credits, etc. Prepare and give a Schedule NC K-1 to each person who was a beneficiary of the estate or trust at any time during the year. Schedule NC K-1 must be provided to each beneficiary on or before the day on which the estate or trust return is required to be filed.

**Line-by-Line Instructions**

**Line 1** - Enter on Line 1 the federal taxable income from Federal Form 1041, Line 22.

**Line 2** - Additions to taxable income - Determine the amount to enter on Line 2 by completing Schedule A, Lines 1 through 5, and allocating the additions between the beneficiaries and the fiduciary in Schedule B, Line 3. Enter on Line 2 the amount from Line 3, Fiduciary Column of Schedule B.

**Line 4** - Deductions from taxable income - Determine the amount to enter on Line 4 by completing Schedule A, Lines 6 through 14 and allocating the deductions between the beneficiary and the fiduciary in Schedule B, Line 4. Enter on Page 1, Line 4 the amount from Line 4, Fiduciary Column of Schedule B.

**Line 6** - If none of the federal taxable income, as adjusted (Line 5), is from dividends, interest, gains, losses, other intangibles, or from sources outside North Carolina for the benefit of a nonresident beneficiary, the total income of the estate or trust is taxable to the fiduciary and you should enter zero on Line 6. If there are nonresident beneficiaries and Line 5 includes any income from interest, dividends, gains, losses, other intangible property, or from sources outside North Carolina for the benefit of a nonresident beneficiary, enter the amount of such income for the benefit of nonresident beneficiaries on Line 6. The determination of the amount of federal taxable income (as adjusted) which is from intangible property or from sources outside North Carolina for the benefit of a nonresident beneficiary is based on the income beneficiary's state of residence on the last day of the taxable year of the estate or trust. In the case of both resident and nonresident income beneficiaries, the determination of the amount of federal taxable income (as adjusted) which is from intangible property or sources outside of North Carolina for the benefit of nonresidents is made on the basis that the nonresident beneficiaries' income interests for the taxable year relate to the income interests of both resident and nonresident income beneficiaries for the taxable year.

**Line 9** - Complete Form D-407TC, Estates and Trusts Tax Credit Summary to determine the fiduciary's share of any tax credits. Enter on Line 9 the amount from Form D-407TC, Line 10.

**Line 10** - If Form D-410 was filed to request an extension of time to file Form D-407, include any tax paid with the extension on Line 10.

**Line 11** - No estimated tax is required of a fiduciary; however, if the fiduciary makes any prepayments of tax, include the prepayment on Line 11. If filing an amended return, include on this line any amount paid with the original return.

**Line 12** - If tax was paid by a partnership or S corporation enter the amount paid and include with the return a copy of the information furnished by the partnership or S corporation to verify the payment.

**Line 15** - Enter the total of any penalties and interest due. [See (H) Penalties and interest above.]

**Line 16 - Pay this Amount** - Add lines 14 and 15 and enter the total. The total tax, penalties, and interest due must be paid by the fiduciary responsible for administering the estate or trust.

**Line 17 - Amount to be Refunded** - If the amount on Line 8 is less than the amount on Line 13, subtract and enter the amount to be refunded.

**Schedule A - North Carolina Fiduciary Adjustments**

Schedule A is provided for the computation of the North Carolina fiduciary adjustments. The following additions and deductions are required by North Carolina law as adjustments to the federal taxable income of the estate or trust.

Additions to federal taxable income, to the extent the amounts are not included in federal taxable income:

**Line 1** - Enter on Line 1 any interest received from bonds or obligations of a state or its political subdivisions other than North Carolina if not included in federal taxable income.

**Line 2** - Enter on Line 2 any state, local, or foreign income tax that was deducted from federal gross income.

**Line 3** - Enter on Line 3 any amount allowed as a deduction from federal gross income because of electing to exclude a lump-sum distribution from a qualified pension, profit sharing, or stock bonus plan in the regular tax computation and to compute the tax separately using the favorable ten-year or five-year forward averaging rules.

**Line 4** - Enter on Line 4 any other additions required, such as the following:

- Amounts that were included in the cost basis of property under federal law but not under State law prior to January 1, 1989. These amounts must be added to taxable income in the year that the income includes a gain or loss from the sale or other disposition of the property.
- A loss or deduction incurred or paid in a tax year prior to January 1, 1989, that is carried forward and deducted in taxable years after January 1, 1989, for federal income tax purposes.
- The amount of federal estate tax that is attributable to income in respect of a decedent and that is deducted under Section 691(c) of the Internal Revenue Code.

Generally, estates and trusts are subject to the same additions and transitional adjustments allowed to individuals; therefore, see the North Carolina Individual Income Tax Instructions for a more detailed explanation of any applicable adjustments.

**Line 5** - Enter the total of Lines 1 through 4 on Line 5. The total additions should be apportioned between the beneficiaries and the fiduciary on Schedule B, Line 3.

Deductions from federal taxable income, to the extent the amounts are included in federal taxable income:

**Line 6** - Enter on Line 6 any interest income which was received from obligations of the United States, United States' possessions, or the State of North Carolina.

**Line 7** - Enter on Line 7 the taxable portion of any Social Security or Railroad Retirement benefits included in federal taxable income.

**Line 8 - (Important):** The following instructions apply if an estate receives retirement benefits on behalf of a decedent because the decedent was a former employee of the State of North Carolina or any of its local governments or if a decedent was a former employee of the federal government and the decedent did not have five years of service with the government as of August 12, 1989, or if the decedent's estate received retirement benefits because the decedent was a former employee of another state. (Otherwise, see the line instructions for Line 13.) If the estate or trust received retirement benefits during the year from one or more federal, state, or local government retirement plans, enter on Line 8 the amount received or \$4,000, whichever is less.

**Line 9** - If the estate or trust received retirement benefits during the year from one or more private retirement plans other than federal, state, or local government retirement plans, enter on Line 9 the amount received or \$2,000, whichever is less.

**Line 11** - Enter the amount from Line 10 or \$4,000, whichever is less. (If retirement benefits were received from both a governmental plan and a private plan, the maximum deduction on Line 11 is \$4,000.)

**Line 12** - Enter on Line 12 any state, local, or foreign income tax refund that was reported in federal taxable income.

**Line 13** - Enter on Line 13 any other deductions required, such as the following:

- As a result of the North Carolina Supreme Court's decision in *Bailey v. State of North Carolina*, North Carolina may not tax certain retirement benefits received by retirees (and their beneficiaries and estates) of the State of North Carolina and its local governments or by United States government retirees (and their beneficiaries and estates), including military retirees. The exclusion applies to retirement benefits received from certain defined benefit plans, such as the North Carolina Teachers' and State Employees' Retirement System, the North Carolina Local Governmental Employees' Retirement System, the North Carolina Consolidated Judicial Retirement System, the Federal Employees' Retirement System, or the United States Civil Service Retirement System, if the retiree had five or more years of creditable service as of August 12, 1989. The exclusion also applies to retirement benefits received from the State's §401(k) and §457 plans if the retiree had contributed to the plan prior to August 12, 1989. Benefits from other State, local, and federal retirement plans may or may not be excluded depending on rulings in the *Bailey* case. The exclusion does not apply to retirement benefits paid to former teachers and state employees of other states and their political subdivisions. An estate entitled to exclude retirement benefits from North Carolina income tax should claim a deduction on Line 13 for the amount of excludable retirement benefits included in federal taxable income. A copy of Form 1099-R received from the payer must be attached to the return to support the deduction.
- As a result of the North Carolina Supreme Court's decision in *Faulkenbury v. Teachers' and State Employees' Retirement System*, certain disabled retirees (and their beneficiaries and estates) received retroactive benefits from the North Carolina Teachers' and State Employees' Retirement System and the North Carolina Local Governmental Employees' Retirement System. As a result of *Bailey*, an estate receiving a direct payment of an award under *Faulkenbury* may deduct the amount of the payment on Line 13. Evidence of the amount of the direct payment must be attached to the return to support the deduction. A recipient electing to roll over all or part of

the award into an IRA may not deduct any future distributions from the IRA; distributions from an IRA are includable in North Carolina taxable income to the same extent includable for federal income tax purposes.

- Amounts that were included in the basis of property under State law but not under federal law prior to January 1, 1989, should be deducted from taxable income in the year that the income includes a gain or loss from the sale or other disposition of the property.

Generally, estates and trusts are subject to the same deductions and transitional adjustments allowed to individuals. See the North Carolina Individual Income Tax Instructions for a more detailed explanation of any applicable adjustments.

**Line 14** - Enter the total of Line 6 and 7 and 11 through 13 on Line 14. The total deductions on Line 14 should be apportioned between the beneficiaries and the fiduciary on Schedule B, Line 4.

### **Schedule B - Allocation of Adjustments**

In taxing estates and trusts, all income is taxable to the fiduciary or to the beneficiaries. The conduit rule for taxing estates and trusts is applicable for North Carolina income tax purposes. Under the conduit rules regardless of who is taxed, the income retains its same character as when received by the estate or trust. The additions and deductions to federal taxable income of an estate or trust must be apportioned between the estate or trust and the beneficiaries based on the distributions of income made during the taxable year. Unless the trust instrument or will creating the estate or trust specifically provides for the distribution of certain classes of income to different beneficiaries, the apportionment of additions and deductions to the beneficiaries is determined on the basis that each beneficiary's share of the income for regular tax purposes (from Line 8, Schedule K-1, Federal Form 1041) relates to adjusted total income (from Line 17 of Federal Form 1041). If the trust instrument or will specifically provides for the distribution of certain classes of income to different beneficiaries, any addition or deduction directly attributable to a particular class of income must be apportioned to the beneficiary to which that class of income is distributed. In apportioning the adjustments, the income for regular tax purposes (Line 8 of Federal Schedule K-1) must be adjusted for distributions to the beneficiary which are not reflected in the amount on Line 7. The adjusted total income (Line 17 of Federal Form 1041) must be adjusted (1) to exclude classes of income that are not part of the distribution to the beneficiary; (2) to include classes of income that are a part of the distribution to the beneficiary but are not included on Line 17; and (3) by any deduction treated differently for State and federal tax purposes that adjusts federal taxable income (see additions and deductions, Line 1 through 14 of Schedule A). The fiduciary may elect to apportion the federal deduction for State income tax to the estate or trust except in cases where the beneficiary's total distribution from the estate or trust has not been included in his federal taxable income because it exceeded the estate's or trust's federal distributable net income. In such cases, the addition for State income tax must be apportioned to the beneficiary to the extent his distribution exceeds the amount included in federal taxable income because of the State income tax deduction. After apportioning the additions and deductions to the beneficiaries, the balance is apportioned to the fiduciary.

Enter the full name and social security number of each beneficiary and determine the additions and deductions to be allowed to each beneficiary and to the fiduciary. Each beneficiary should be furnished a Schedule NC K-1 showing the applicable additions, deductions, tax credits, etc., to be reported on his North Carolina individual income tax return. A nonresident, in calculating the percentage of taxable income subject to North Carolina tax on Line 10b of Page 1 of the individual income tax return, must adjust his share of the income from North Carolina sources only by the additions and deductions attributable to the North Carolina income. The fiduciary's portion of the additions and deductions should be reported on Lines 2 and 4, respectively, on Page 1 of Form D-407.

### **Form D-407TC - Estates and Trusts Tax Credit Summary**

The tax credit for income tax paid to another state or country must be allocated between the fiduciary and the beneficiaries. Part 4 of Form D-407TC must be completed to determine the tax credit allowable to the fiduciary; however, before Part 4 can be completed, gross income (from Line 9, Federal Form 1041) on which such tax was paid must be allocated between the fiduciary and the beneficiaries.

The fiduciary's share and each beneficiary's share of the gross income on which tax has been paid to another state or country and the amount of tax paid on the income is determined by the governing instrument and such amounts should be entered on Lines 3 and 4 of the fiduciary and beneficiary's columns in Part 4, Section A. After allocating to the beneficiaries, enter the fiduciary's share of gross income taxed in another state or country on Line 1, Part 4, Section B. Enter on Line 2 the fiduciary's share of gross income from Federal Form 1041, Line 9. Complete the remaining Lines in Part 4, Section B to determine the fiduciary's share of the tax credit.

All tax credits allowed to individuals are allowed to estates and trusts with the following exceptions:

- (1) Tax credits for income taxes paid to other states by individuals
- (2) Credit for child care and certain employment-related expenses
- (3) Credit for the disabled
- (4) Credit for children
- (5) Credit for charitable contributions
- (6) Credit for long-term care insurance

Complete Form D-407TC, Estates and Trusts Tax Credit Summary, if the estate or trust claims any tax credits. Include the form when filing Form D-407. If additional tax credits are claimed, submit a separate schedule showing how the credits were determined and how they are allocated between the beneficiaries and the fiduciary.