The California Taxation of Non-California Trusts
with California Resident Beneficiaries

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INTRODUCTION

In 2012, California claimed the dubious notoriety as the state with the highest income tax rates. As a result, many Trustees and trust beneficiaries are exploring ways to move trusts out of the state of California. However, re-situsing a trust to low- or no-income tax jurisdictions will not necessarily achieve the desired result if the trust has (a) California source income; (b) a California trustee or co-Trustee; or (c) a California beneficiary. This outline focuses on this last element; that is, the California taxation of non-California non-grantor trusts with California resident beneficiaries.

I. California Taxation of Trusts Generally. Under California Revenue & Tax Code (“CR&TC”) § 17742, some or all of the income of a non-grantor trust is subject to California income tax if any non-contingent beneficiary is a California resident.1 (All of the income of a grantor trust, whether or not distributed, is taxable to the grantor for California purposes.2)

A. What makes a California beneficiary contingent or non-contingent? A contingent beneficiary is one whose interest is subject to a condition precedent, meaning a condition must be satisfied in order for the beneficiary’s interest in the trust to vest or become non-contingent.3 Conversely, a beneficiary whose interest is vested is a non-contingent beneficiary. Thus, the determination of whether a beneficiary is a contingent or non-contingent will depends primarily on the distribution standards and rights of the beneficiary under the trust agreement and the trustee’s exercise of discretion in administering the trust subject such standards.

1 CR&TC § 17742(a).
2 CR&TC § 17731.
3 Title 18 of the California Code of Regulations (“18 CCR”) § 17742(b). The regulation defines “noncontingent beneficiary” as one whose interest is not subject to a condition precedent.
As a general rule, a beneficiary whose beneficial interest is subject to the trustee’s sole and absolute discretion (for example a discretionary distribution standard over trust income and principal pursuant to which a Trustee may make distributions for a beneficiary’s health, education, maintenance, support, care, comfort, etc.) constitutes a contingent interest until such property is actually distributed. On the other hand, a beneficiary’s interest will become non-contingent if a trustee exercises the discretion to distribute, or if the terms of the trust agreement subsequently remove a condition to the beneficiary’s enjoyment of trust income or principal, such as a trust that provides for the distribution of all trust income after a certain age, provides a stipend to the beneficiary, or allows the beneficiary a withdrawal right, such as a 5-or-5 power.

B. **Is a beneficiary who “shall receive distributions for HEMS as the Trustee determines necessary” a contingent beneficiary?** Typically, the inclusion of a term such as “shall” would mandate a particular action. In the context of a trust distribution standard, such usage would suggest a non-contingent interest. However, the interest of a beneficiary who “shall” receive distributions for their health, education, maintenance and support (“HEMS”) as determined by the trustee, would still be subject to the trustee’s discretion in determining whether a distribution for the beneficiary’s HEMS was appropriate. The Franchise Tax Board (“FTB”) may attempt to characterize such beneficiary’s interest as non-contingent given the mandatory connotations of the term “shall.” However, there is no authority, statutory or otherwise, that we are aware of that compels a Trustee to make any distribution when considering a beneficiary’s HEMS. Instead it seems that the beneficiary would only receive a distribution if the trustee deems the distribution to be necessary for the support, health, maintenance, and education of the beneficiary. That is, only upon this exercise of discretion “shall” the beneficiary receive a distribution. Thus, the best argument would appear to be that the beneficiaries’ interest remains subject to the condition that the trustee exercises such discretion in determining whether a distribution is necessary, rendering their interests contingent.

**Observation:** The Franchise Tax Board (“FTB”) may attempt to characterize a beneficiary’s interest in a trust as non-contingent, even though distributions to the beneficiary were completely discretionary under the trust agreement, if the trustee makes regular and substantial distributions to a beneficiary such that the beneficiary effectively has the power to access trust property. If the FTB’s argument is successful, the trust would be subject to California income tax.

C. **Is a beneficiary who is entitled to receive a small annual payment relative to the entire trust a non-contingent beneficiary as to the entire trust?** California income tax law provides that a California beneficiary’s interest in the trust must be non-contingent in order for California to tax the trust. The statute does not qualify this standard by

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4 FTB TAM 2006-0002.
5 CR&TC § 17742(a).
specifying the extent to which the beneficiary’s interest is non-contingent, nor does it provide for the apportioning of the trust’s income based on the extent to which the beneficiary’s interest is non-contingent. As a result, if a resident beneficiary is entitled to, for example, one-third of the trust income, the entire trust, not one-third of the trust, will be subject to California income tax. If the non-contingent beneficiary is both the sole beneficiary and a resident of California, the trust must then report all its income and gains for California income tax purposes. The tax burden associated with such income will be assigned under general income taxation principles applicable to trusts and beneficiaries, which will depend in part on the amounts distributed (or distributable) and accumulated by the trust.

Example 1: The terms of a Delaware non-grantor trust (“Trust”) provide that the trustee shall distribute to the beneficiary, B, one-third of the trust income annually for her lifetime. B is the sole beneficiary of the Trust and is a California resident at all relevant times. Because the trustee is required under the terms of the Trust to distribute trust income, B is entitled to such amounts and her interest is not subject to a condition. As a result, B is a non-contingent beneficiary regardless of the fact that she is entitled to just one-third of the trust income. Because B is the sole non-contingent beneficiary of the Trust and a resident of California, the Trust will be subject to California taxation. The Trust would then have to report all its income for California income tax purposes. Ultimately, B will be taxable on the income distributed to her, while the Trust will bear the burden on the remaining income.

D. If a beneficiary will receive a distribution of 1/3 of the trust principal upon attaining three successive ages and is subject to a discretionary distribution standard otherwise, is the beneficiary contingent in each period between distributions? If the trust agreement provides that the beneficiary is entitled to principal distributions at prescribed ages, for example thirty (30), thirty-five (35) and forty (40), the beneficiary is a non-contingent beneficiary in the year in which the beneficiary attains those ages as the interest is no longer subject to a condition precedent (i.e. attaining the specified age). Accordingly, the trust will be subject to California income tax in the years that a California resident beneficiary attains the prescribed ages. The California income taxation of the trust in the interim years will depend on the distribution standards and rights of the beneficiary under the trust agreement and also whether distributions are actually made to the beneficiary, as the taxability of the trust is determined on a year by year basis. If the sole beneficiary’s interest is subject to a discretionary standard in the interim years, and no distribution are made pursuant to that standard, then the

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6 This is, of course, distinguished from the apportionment required where a trust’s beneficiaries include non-residents.
7 CR&TC § 17742(a).
8 Note that California has adopted the separate shares rules under Code 663(c).
beneficiary has a contingent interest and the trust will not be subject to California income taxation in those years.

Observation: In the above example, to the extent that the principal required to be distributed under the Trust Agreement continues to be held in trust after the indicated ages, that portion of the trust will be treated as a grantor trust, as to the distributable principal, under § 678 of the Internal Revenue Code (“Code”). California income tax law adopts the federal treatment of grantor trusts. Accordingly, any income will be taxed to the beneficiary/owner of such grantor trust regardless of the trustee’s discretion to distribute income or principal and whether such income or principal is actually distributed.

II. Accumulation of Gain by a Non-California Trust and Subsequent Distribution of Proceeds. A non-California trust with contingent California beneficiaries will not be subject to tax in California so long as no distributions (or any other events rendering the beneficiary non-contingent) occur.9 Under the general federal income taxation principles of trust and beneficiary taxation, distributions of accumulated income by domestic trusts do not result in taxation to the beneficiary. If California were to adopt this principle, deferred distributions could provide significant California income tax benefits. In order to mitigate such benefits, California imposes a “throwback” tax on an otherwise contingent beneficiary, as opposed to the trust.10 Thus, California beneficiaries will not escape California income taxation by reason of a trustee’s decision to accumulate income or realized gain for distribution in a subsequent year.

To impose the throwback tax, California law overrides general tax principles by providing that accumulated income continues to be “income” even though the trust’s terms provide that accumulated income (whether ordinary or capital) is added to corpus.11 Thus, even if the trust recognizes gain on the sale of stock in one year, accumulates and pays federal tax on such gain in that year, such accumulated income will be subject to California income tax when it is distributed to a California beneficiary in a subsequent year. Accordingly, the accumulation of any gain realized by the trust on the sale of appreciated assets12 will be subject to California taxation upon distribution under this principle of California income tax law.

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9 This assumes no California source income and no California trustees.
10 CR&TC § 17745(b). Note that the throwback tax also applies if the trust has been non-compliant in paying California income taxes previously due. CR&TC § 17745(a).
11 CR&TC §17745(c).
12 In general, trust income (as opposed to “gross” or “taxable income”) does not include gains from the sale of an interest in an entity (e.g. shares of stock). Cal. Probate Code § 16350(c)(2). Further, Code § 643(b) provides that the term “income” when not preceded by the words “taxable”, “distributable net”, “undistributed net”, or “gross” means trust or fiduciary income. Although California generally adopts the portion of the Internal Revenue Code relating to the income taxation of estates, trusts and beneficiaries, the term “income” as used in § 17745 of the CR&TC should not be construed to exclude gains from the sale of property as it appears to refer to California taxable income as opposed to the trust or fiduciary income.
A. **What is consequence of distribution of accumulated income a beneficiary that is a resident?** The throwback tax is imposed on the California resident beneficiary in the year that a trust distributes accumulated income including capital gain) to that beneficiary. In order to calculate the tax, the distribution of accumulated income is divided into equal shares by the lesser of six (6) or the number of years of accumulation.\(^\text{13}\) One share of such accumulated income is included in the beneficiary’s taxable income in the year of the distribution. Each of the remaining shares of accumulated income is added to the beneficiary’s California taxable income in each of the immediately preceding years of up to five years. This portion of the distribution is added to the beneficiary’s taxable income in prior years in order to determine the total incremental tax that would have been owed in the years covered by the accumulation period. The resulting incremental tax is determined by using rates applicable to those preceding years. The total incremental tax is then added to the beneficiary’s California income tax liability in the year of the distribution. The operation of these rules may best be illustrated by way of example:

**Example 2:** A Delaware non-grantor trust (“Trust”) sells stock and realizes capital gain of $12,000,000 in 2013. B is the sole contingent beneficiary of the Trust and is a California resident at all relevant times. The Trust accumulates (i.e., gain is not included in distributable net income) and pays federal income tax on the gain in 2013. In 2023, the trustee of the Trust exercises discretion and distributes all of the gain to B. Because the income has been accumulated for more than five years, the $12,000,000 is divided by 6 (the current year plus the maximum five preceding accumulation years). As a result, $2,000,000 is included in B’s California taxable income for 2023. Additionally, B must determine the incremental California income tax, net of credits, that would have resulted had $2,000,000 been included in each of 2018 through 2022 because the law requires the accumulated income to spread over a maximum of six years (including the current year). B determines his incremental increase in tax in 2018 through 2022 by using his taxable income and the rates in effect for each of those years. In determining B’s California income tax liability in 2023, he must add this incremental tax for those five prior years to the tax in the year of the sale in order to determine his total 2023 California income tax liability.

B. **What is consequence of distribution of accumulated income to a beneficiary that is currently a non-resident (but a former California resident)?** The California throwback tax also applies to non-residents who are formerly residents of California. However, the calculation of the incremental tax applicable to the period of accumulation only

\(^\text{13}\) For example, if the accumulated income had been accumulating for six or more years, it would be divided by six and each resulting share would be included in the beneficiary’s income in the year of distribution and the five preceding years. Alternatively, if the accumulated income had been accumulating for three years, it would be divided by four and each resulting share would be included in the beneficiary’s income in the year of distribution and the three preceding years.
applies for years in which the beneficiary was a resident. The portion of the accumulated income attributed to the year of the distribution is subject to California tax to the extent that it is derived from California sources.

Example 3: Same facts as Example 2 above, except that B was a resident of California during 2018-2021 and of Kentucky during 2021 and 2023. For purposes of determining the incremental tax, the $2,000,000 ($12,000,000 gain divided by 6) is included in each of 2018 through 2023. However, the inclusion of the $2,000,000 in B’s 2022 taxable income is of no effect because any additional tax calculated in that year is excluded as B was a resident of Kentucky in that year. Thus, B determines his incremental increase in tax by summing the additional tax resulting from the inclusion of $2,000,000 in B’s taxable income in each of 2018 through 2022. In determining B’s California income tax liability in 2023, he must add this incremental tax to his tax on other income in order to determine his total 2023 California income tax liability. Further, in determining B’s tax, the $2,000,000 included in B’s California taxable income for 2023 is not taxable to him (unless it would otherwise be taxable income for the current year because it is derived from California sources).

Note: If the beneficiary in the example above was a California resident during any portion of the accumulation period, and left the state for any period of time during the 12 months prior to the date of distribution and returned to California within 12 months after the date of distribution, the taxpayer is presumed to have been a California resident throughout the time of distribution.

Observation: The example immediately above addresses instances where a trust accumulated income for a resident contingent beneficiary who subsequently receives a distribution of that income in a year that he is a non-resident. What if the trust accumulated income for a non-resident contingent beneficiary who subsequently receives a distribution of that income in a year that he is a California resident? It appears that income accumulated by a trust before a beneficiary becomes a California resident should not be subject to the California throwback tax. This is based on the language found in § 17445(b) of the CR&TC, which provides that the throwback tax applies if no California tax was paid on current or

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14 CR&TC § 17745(b) and Form 5870A.
15 CR&TC § 17745(a).
16 In determining whether income is derived from California sources, income from stocks and other intangible personal property is not California source income unless the property has acquired a business situs in California. Instead, the California Supreme Court has ruled that gains from the sale of shares of stock are sourced to the residence of its owner (i.e. the trustee). [CR&TC § 17952]. Thus non-resident beneficiaries would not be subject to California income tax on any income to the extent that the accumulated income constitutes gain from the sale of stock of corporation that has not acquired California business situs.
17 CR&TC § 17745(e).
accumulated income by reason of the resident beneficiary’s contingent interest in the trust.\textsuperscript{18}

C. **What is the consequence of the distribution of accumulated income to a resident beneficiary that was formerly a non-resident?** For purposes of determining the incremental tax that would have been owed in the years covered by the accumulation period, the incremental tax is only calculated for years in which the beneficiary was a California resident.

**Example 4:** Same facts as Example 2 above, except that B was a resident of Kentucky during 2018 and 2019. For purposes of determining the incremental tax, the $2,000,000 ($12,000,000 gain divided by 6) is included in each of 2018-2023. However, the inclusion of the $2,000,000 in B’s 2018 and 2019 taxable income is of no effect because B was a resident of Kentucky in those two years. Thus, B determines his incremental increase in tax by summing the additional tax resulting from the inclusion of $2,000,000 in B’s taxable income in each of 2020 through 2023. In determining B’s California income tax liability in 2023, he must add this incremental tax to his tax on other income in order to determine his total 2023 California income tax liability.

III. **California Residency Rules.** A California resident includes: (a) an individual who is in the state for other than “a temporary transitory purpose”, and (b) an individual domiciled in the state who is outside the state for “a temporary or transitory purpose.”\textsuperscript{19} All other individuals are non-residents. Whether or not the purpose for which an individual is in this State will be considered temporary or transitory in character will depend to a large extent upon the facts and circumstances of each particular case.\textsuperscript{20} However, California regulations provide that individuals who (a) are afflicted by illness of such a character as to require a relatively long or indefinite period to recuperate, (b) are present in California for business purposes which will require a long or indefinite period to accomplish, (c) are employed in a position that may last permanently or indefinitely, or (d) have retired from business and moved to California with no definite intention of leaving shortly thereafter, are in the state for other than “temporary or transitory purposes.”\textsuperscript{21} Although “domicile” and “residence” sometimes used interchangeably, they are not always the same place. California regulations generally define “domicile” as the place where an individual has his or her true, fixed, permanent home and principle establishment, to which, whenever absent, such individual has the intention of returning.\textsuperscript{22}

\textsuperscript{18} “If no taxes have been paid on the current or accumulated income of the trust because the resident beneficiary’s interest in the trust was contingent such income shall be taxable to the beneficiary when distributed or distributable to him or her.” (Emphasis added.) This position seems to be the position that the FTB has taken in Legal Ruling No. 375.

\textsuperscript{19} CR&TC § 17014.

\textsuperscript{20} 18 CCR § 17014(b).

\textsuperscript{21} Id.

\textsuperscript{22} 18 CCR § 17014.
Since all of the facts and circumstances must be considered when making determination as to residency, there is no easy rule of thumb for determining precisely when an individual is a resident of the state. However, in the *Appeal of Stephen D. Bragg, 2003-SBE-002 (2003)*, the California Board of Equalization enumerated the following list of non-exclusive factors indicative of an individual’s state of residency:

- the location of all of the individual’s residential real property, and the approximate sizes and values of each of the residences;
- the state wherein the individual’s spouse and children reside;
- the state wherein the individual’s children attend school;
- the state wherein the individual claims the homeowner’s property tax exemption on a residence;
- the individual’s telephone records (i.e., the origination point of individual’s telephone calls);
- the number of days the individual spends in California versus the number of days the individual spends in other states, and the general purpose of such days (i.e. vacation, business, etc.);
- the location where the individual files his tax returns, both federal and state, and the state of residence claimed by the individual on such returns;
- the location of the individual’s bank and savings accounts;
- the origination point of the individual’s checking account transactions and credit card transactions;
- the state wherein the individual maintains memberships in social, religious, and professional organizations;
- the state wherein the individual registers his automobiles;
- the state wherein the individual maintains a driver’s license;
- the state wherein the individual maintains voter registration, and the individual’s voting participation history;
- the state wherein the individual obtains professional services, such as doctors, dentists, accountants, and attorneys;
- the state wherein the individual is employed;
the state wherein the individual maintains or owns business interests;
the state wherein the individual holds a professional license or licenses;
the state wherein the individual owns investment real property; and
the indications in affidavits from various individuals discussing the individual’s residency.

In addition to the above enumerated factors, there is a presumption that an individual is a California resident when such individual spends, in the aggregate, more than nine months of the taxable year in California. Conversely, there is a presumption that an individual is not a California resident when such individual (a) spends, in the aggregate, less than six months in California, (b) is domiciled outside California, and (c) maintains a permanent abode in another state of domicile.

A. What are the rules for residency when a beneficiary moves in to California? Applying the above principals to an individual seeking to navigate the bounds of California residency without creating residency status, such individual must show that he or she has a closer connection to his or her home state than to California. Accordingly, such individual would be well advised to: (a) maintain his or her domicile in his or her home state by retaining a permanent principal residence in such state, (b) apply the Bragg factors, and maintain as many of the connections as possible to the home state while minimizing such connections to California; and (c) spend less than six months a year in California in order to avail themself of the presumption that such individual is a non-resident (recognizing that if such individual spends more than nine months in California a presumption will arise that the individual is a resident).

B. What are the rules for residency when a beneficiary moves out of California? For an individual trying to sever his or her California residency, such individual must show that he or she has a closer connection to a state other than California. To do so, such individual will need to: (a) change his or her domicile to another state by establishing a permanent principal residence in such state, (b) apply the Bragg factors, and sever as many connections as possible to California, and where possible replace such severed connections with connections to the other state; and (c) spend less than six months a year in California in order to avail themself of the presumption that such individual is a non-resident (recognizing that if such individual spends more than nine months in California a presumption will arise that the individual is a resident).

23 CR&TC § 17016.
24 18 CCR § 17014.
IV. **Tax Reporting and Compliance.** The calculation of accumulated income is prepared on Schedule J of California Form 541, which is prepared by the trustee. The trustee must furnish the Schedule J to the beneficiary, and the instructions to the form make clear that a beneficiary must contact the trustee if he or she does not receive Schedule J from the trustee. Note that a Delaware trustee must file a California Form 541 and the attendant Schedule J in the year of any distribution to a California beneficiary even if it has no California fiduciaries or California sourced income. The calculation of the incremental tax on the distribution of accumulated income is prepared on Part II of California Form 5870A, which is to be attached to the beneficiary’s California income tax return.

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