

When is an irrevocable trust's income taxable in California?

Certain rules apply to California, but each applicable state's rules will need to be reviewed.

By Richard B. Malamud, J.D., LL.M., CPA
Guest Contributor

When a California resident with a revocable living trust dies, what was once a grantor trust taxable to the resident becomes an irrevocable trust with future income reported on a fiduciary return. The income from the trust assets is either taxable to the trust or to the beneficiary.

Often, the trust becomes an administrative trust until the beneficiaries receive their inheritance or trusts established by the living trust are funded, such as a QTIP, an exemption trust, or a trust for the children or grandchildren. How are these irrevocable trusts and others trusts taxed by California?

Trustees

In general, California provides that all of the trust's taxable income (the income not distributed to the beneficiaries) is taxable in California if the trustees are all California residents. If there are multiple resident and non-resident trustees, California taxes all California-source income, plus the percentage of other income based on the ratio of the number of California trustees to the total number of trustees.¹

COMMENT: In the case of a corporate trustee, its residence is the place where the corporation transacts the major portion of its administration of the trust.² The Franchise Tax Board sought legislation to repeal this, due to the complexity of determining the location of a multistate corporate trustee. It unsuccessfully proposed to simply tax trusts based on the residence of the beneficiaries.³

Beneficiaries

If none of the trustees are California residents, California will tax the trust's California-source income, plus all the other taxable income if all *non-contingent* beneficiaries are California residents.⁴ If there are multiple resident and nonresident non-contingent beneficiaries, California will tax the California-source income plus the percentage of other income based on the ratio of California non-contingent beneficiaries to total non-contingent beneficiaries.⁵

A non-contingent or vested beneficiary is someone who has an unconditional interest in the trust income or corpus. A resident beneficiary of a discretionary trust has a non-contingent interest if the distribution is at the trustee's discretion.⁶

COMMENT: If all the income is distributed to the beneficiaries, the beneficiaries pay tax on the income. Resident beneficiaries pay tax on income from all sources. Nonresident beneficiaries are taxable on income sourced to California.

Unlike some other states, the domicile of the decedent does not determine California situs. Thus, where a California resident dies and there is both a nonresident trustee and nonresident beneficiary, unless the trust contains California property (usually real estate or a business), the trust would not be subject to filing and payment of tax to California. Capital gains retained by the trust would not be taxable in California unless the gain is from the sale of California real or tangible personal property.

EXAMPLE 6-6: Bill, a Nevada resident, is the trustee and beneficiary of a trust his California resident mother established for him. The only assets the trust contains are publicly traded stocks. The trust will not be a California trust and any income retained by the trust will not be subject to any state's tax (since Nevada does not have an income tax).

Although there is no case law or guidance from the FTB, a common situation occurs when a California surviving spouse who is both the sole trustee and sole beneficiary of the predeceased spouse's QTIP or exemption trust dies and the successor trustee/beneficiary is not a California resident. There is simply no guidance if they are considered two trustees and two beneficiaries for the year, or if the year-end determination is made based on their status at that time.

In the case of a grantor trust that became irrevocable on the death of the grantor, only the successor trustee probably should be counted. In the case of an existing exemption trust in the year the trustee/beneficiary dies, both trustees should be counted.

Residents and nonresidents trustees and beneficiaries

As stated above, if all the trustees are California residents or all the non-contingent beneficiaries are California residents, then all the trust's income is taxable in California. It is far more complicated when there are both resident and nonresident trustees and beneficiaries. This was addressed by FTB Legal Ruling No. 238 (October 27, 1959), which provides the method for allocating non-California source income where there is a mixture of California resident and nonresident fiduciaries, and California resident and nonresident non-contingent beneficiaries.⁷

Form 541, Schedule G must be completed to determine what percentage of the trust's income is taxable in California. The trust's taxable income does not include amounts distributed to a beneficiary who pays tax. The allocation of the trust's California taxable income is best explained by using an example and the chart from Schedule G (see box below).

How to allocate non-California-source income

Total taxable income of the trust is \$90,000 that is not sourced to California. There are three trustees, one of whom is a resident of California and two non-contingent income beneficiaries, one of whom is a resident of California. There was no distribution of income to the beneficiaries. The amount of income taxable by California is calculated in the following steps:

First, the \$90,000 income is allocated to California based on the ratio of California trustees to total trustees: \$30,000 (1/3 of \$90,000).

Second, the remainder, \$60,000 (\$90,000 - \$30,000) is then allocated based on the ratio of the number of California non-contingent beneficiaries to the total number of non-contingent beneficiaries: \$30,000 (1/2 of \$60,000).

This produces income taxable by California of \$60,000 (\$30,000 + \$30,000).

Income Allocation						
	A	B	C	D	E	F
Type of Income	CA Source	Non-CA Source	$\frac{\text{CA Trustees}}{\text{Total Trustees}} \times B$	Remaining Non-CA source = B - C	$\frac{\text{CA Beneficiaries}}{\text{Total Beneficiaries}} \times D$	CA Income A + C + E
\$90,000 of interest		\$90,000	$1/3 \times \$90,000 = \$30,000$	$\$90,000 - \$30,000 = \$60,000$	$1/2 \times \$60,000 = \$30,000$	$\$0 + \$30,000 + \$30,000 = \$60,000$

California trust and a nonresident beneficiary

Whenever there is a trust, there are two potential taxpayers: the trust and at least one beneficiary. Beneficiaries are taxed on the amounts paid to them (or required to be paid to them) during the year. The trust receives a distribution deduction in the same amount. The trust's taxable income is limited to the amount not distributed. If the trust is a simple trust (such as a QTIP trust), all income is required to be distributed each year and therefore the trust's taxable income would be limited to the capital gains for the year. This is the case for most simple trusts where all "income" is taxed to the beneficiary, but capital gains are not distributed. Just because a California trust distributes income to a beneficiary does not mean it will be subject to tax in the state. A nonresident beneficiary of a California trust is only taxed on California-source income and is not taxed on non-California-source income, such as interest and dividends.⁸

EXAMPLE 6-7: Bill's mother established a simple trust for him naming his sister, a California resident, as the trustee. Bill is a resident of Nevada. If the trust has \$25,000 of interest income and \$35,000 of capital gains, Bill will receive \$25,000 of interest income that will be federally taxable but not subject to California tax. The trust will have \$35,000 of income taxed to California because its trustee is a California resident.

California's Other State Tax Credit

If a California trust has income from another state, such as rental real estate income that is taxed both to the state where the property is located and to California, the trust may claim a credit against its California tax, based on the net income tax paid to other states by the estate or trust on Schedule S. Given the lack of state uniformity, the credits may not totally offset the double income tax.⁹

Throwback rule is (unfortunately) alive and well in California

California has, in effect, a retroactive tax on California beneficiaries who receive trust distributions if:

- The trust has been non-compliant in paying California income taxes previously due; or
- The beneficiary currently receives income that was not previously taxed in California because the beneficiary had a contingent interest at the time it was accumulated.¹⁰

The accumulated net income is taxed over the shorter of the accumulation period or five years. The tax is calculated on Form 541, Schedule J.

Possible to avoid accumulation?

Why not accumulate income in a non-California trust and then, in the year of distribution, have a California resident leave the state to avoid the California tax? To prevent that, the statute provides that if a resident beneficiary leaves California within 12 months prior to the date of distribution of accumulated income and returns to California within 12 months after distribution, they are presumed to be a California resident at the time of the distribution.¹¹

Other states

Other states do not follow the same rules as California. A trust can therefore be taxable in more than one state, as the rules overlap. State tax provisions for determining if a trust is a resident trust in other states fall within several broad categories:

1. Will of a resident;
2. Trust of a resident;
3. Trust administered in the state;
4. Resident trustee;
5. Resident beneficiary;
6. Owning assets in the state (state-sourced income); and
7. State law is listed in the trust as the governing law.

Determination of the residence of the trustee varies. Some states use the date the trust was established, while others use the date the trust became irrevocable. Administration of the trust is often difficult to determine when a corporate bank or a professional advisor is used, as the office of the contact representative may be in a different state than the operations.

Moving the trust to save state taxes

California is unique in that it first taxes a trust if the trust has a California trustee; if not, it then looks to the residence of the non-contingent beneficiaries.

California tax on a trust's income can be reduced if a trust with some or all non-resident beneficiaries has a non-resident trustee.

If the intended trustee is the family's attorney or best friend of the settlor, selecting an alternative out-of-state trustee may not be desirable, even if it does save state taxes.

This type of planning is best done when the trust is set up, but it can be accomplished later if the trust permits a change of trustee.

Similarly, because only non-contingent beneficiaries are counted in determining California taxation, state taxes may be reduced if the California beneficiaries are contingent. The problem is that the California beneficiaries may not receive the distributions that were intended, which is the reason they usually are not contingent in the first place.

To make them contingent, discretion must be given to the trustee and often that is a brother or sister who then decides not to make distributions to their California sibling. The reason isn't to avoid California tax but rather to deny the sibling a share of their parent's estate. This is why many trusts provide for equal distributions to each child.¹²

How much can be saved?

The chart below ("Tax on a Complex Trust, State-by-State") calculates the tax on a complex trust with state taxable income of \$100,000 of long-term capital gains. Given the graduated tax rates in most states, the percentage savings would be even higher if the income is greater than the amounts shown in the chart.

Tax on a Complex Trust, State-by-State (in dollars)

AL	3,767	KY	4,664	ND	1,818
AK	-	LA	3,405	OH	3,285
AZ	3,647	ME	7,302	OK	5,034
AR	3,819	MD	4,688	OR	8,201
CA	6,861	MA	5,250	PA	3,070
CO	4,625	MI	4,246	RI	5,868
CT	6,693	MN	6,977	SC	3,428
DE	5,637	MS	4,760	SD	-
DC	7,292	MO	5,469	TN	-
FL	-	MT	2,668	TX	-
GA	5,729	NE	6,480	UT	4,995
HI	6,922	NV	-	VT	8,251
ID	7,160	NH	8,500	VA	5,487
IL	1,485	NJ	4,180	WA	-
IN	3,397	NM	2,166	WV	5,336
IA	7,151	NY	6,164	WI	4,139
KS	4,610	NC	7,165	WY	-
				NY + NYC	9,690

Conclusion

In California, the residence of the trustee is the primary determination of the situs of a trust. Failing that, California next looks to the residence of the beneficiary. However, other states use alternative tests. Unfortunately, tax preparers must review the tax rules for each state in which there is a resident grantor, trustor, decedent, trustee, or beneficiary, or for the state where the trust is administered to determine the state's rules of residency of a trust. This can be both time consuming and difficult. The best place to start is the state's instructions to its equivalent of Form 1041. Here's hoping that either everyone lives in California or everyone lives in one of the few states that doesn't have an income tax.

About the author

Richard Malamud is a professor in the Department of Accounting and Finance at California State University Dominguez Hills, where he teaches federal income tax law. You may reach him at: rmalamud@csudh.edu.



- ¹ R&TC §17743
- ² R&TC §17742(b)
- ³ Legal Notice 98-12
- ⁴ R&TC §§17742-17745. *See Appeal of the First National Bank of Chicago* (1960) 60-SBE-039
- ⁵ R&TC §17744. *See McCulloch v. FTB* (1964) 61 Cal.2d 186. For a discussion of the relevant case law see, Richard W. Nenno "Selecting the Situs of a Trust: State Fiduciary Income Tax Implications" (2005) at: <http://apps.americanbar.org/tax/groups/salt/nasbts/2005/Selecting%20the%20Situs%20of%20a%20Trust.pdf>
- ⁶ Tech. Ad. Memo 2006-0002 at: www.ftb.ca.gov/law/Technical_Advice_Memorandums/2006/20060002.pdf
- ⁷ See FTB Form 541 Booklet 2013 (REV 01-14) p. 13-14 at: www.ftb.ca.gov/forms/2013/13_541bk.pdf
- ⁸ R&TC §17734
- ⁹ Charles A. Redd, *State Income Tax Issues with Trusts* (2011) p. 6 at: www.naepc.org/journal/issue08d.pdf
- ¹⁰ R&TC §17745(d)
- ¹¹ R&TC §17745(e)
- ¹² Carlyn S. McCaffrey and John C. McCaffrey "Rationalizing the State Income Taxation of Trusts – Chasing Quill Feathers in the Wind" (2010) p. 21-22 at: www.nycbar.org/pdf/report/uploads/20071955-HessLectureRationalizingtheStateIncomeTaxationofTrust.pdf



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