



SHARTSIS FRIESE LLP




California Fiduciary Income Taxation: Including the Infamous California Throwback Tax

Presented by: Richard S. Kinyon, Esq. & Elizabeth S. Sevilla, EA, ChFC, CLU



WE ARE AN INDEPENDENT MEMBER OF
THE GLOBAL ADVISORY
AND ACCOUNTING NETWORK



Learning Objectives

- Multi-state fiduciary income taxation rules
- Estates & non-grantor trusts subject to California fiduciary income taxation
 - California fiduciary income tax rules
 - California asset and income sourcing rules
 - State residency-based rules for fiduciaries and beneficiaries
 - Apportionment rules based on fiduciary and/or beneficiary – Form 541 Schedule G
 - Distinction between contingent and non-contingent beneficiaries
 - Potential throw-back tax issues



Multi-state Fiduciary Income Taxation

- Statutory bases for income taxation of trusts
 - ✓ “Situs” of Trust Administration/Fiduciary’s residency
 - ✓ “Residence” of settlor/trustor/testator/grantor
 - ✓ “Residence” of distributee/beneficiary
 - ✓ “Source” of income
- See attached [9th Annual Non-Grantor Trust State Income Tax Chart compiled by Steve Oshins](#)

California Fiduciary Income Tax Complexity

- California filing requirements are both complex and unique
 - The rule applies regardless of the residence of trust's settlor
 - May potentially cause multi-state filing requirements
- ***There is no such thing as a California “resident” trust, as taxation depends on:***
 1. Trust assets' situs and income sourcing
 2. Fiduciary's state of residency
 3. Beneficiary's current and history of residences in/out of California
 4. Trust provisions as to beneficiary's distribution rights and power of appointment, as well as trustee's income and principal distribution powers



Estates & Trusts Subject to California Income Tax

- Estates and trusts are subject to the California personal income tax on their Undistributed Net Income (“UNI”) and pay tax at the individual personal income rates. (Cal. Rev. & Tax. Code Section 17041(e))
- Any of the Distributable Net Income (“DNI”) that is distributed to trust’s or estate’s beneficiaries is taxable to them and deductible by the estate or trust
- California taxes the UNI of an estate if it is probated within the state.



Trusts Subject to California Income Tax on Their UNI

- CA taxes the UNI of a trust if it either
 - Has income from California sources (Cal. Rev. & Tax. Code § 17951);*or
 - Has California residency based on the California residence of a fiduciary or non-contingent beneficiary of the trust (Cal. Rev. & Tax. Code §§ 17742, 17743 and 17744

**Paula Trust vs CA FTB and NC Dept of Revenue vs Kaestner*



Trusts Subject to California Income Tax on Source

- California source income includes rental properties and operating businesses located from within the state
- Income from intangibles, such as interest and dividends from marketable securities are sourced in the taxpayer's resident state

Apportioning Rules Based on Residence of Fiduciary(s)

- If a trust has only one fiduciary, and that fiduciary is a California resident, then the entire taxable income of the trust, including accounting income and income attributable to corpus (e.g., capital gains), is taxable by California.
- The residence of a corporate fiduciary is determined based on where the majority of its administrative functions are performed



Apportioning Rules Based on Residence of Fiduciary(s)

- Where a trust has multiple fiduciaries, the income taxable to California is apportioned according to the number of fiduciaries who are California residents.
- Example: 2 trustees – one resident and one non-resident, California will tax one half of the trust non-California source income



Taxation Due to Beneficiary's Residence

- A California resident beneficiary whose interest in the UNI of a trust is **non-contingent** will subject the trust to tax in California
- A **non-contingent (vested)** beneficiary is one whose interest in the UNI of the trust is not subject to a condition precedent



Apportioning Rules Based on Residence of Beneficiary(s)

- Where a trust has multiple **non-contingent beneficiaries**, the income is apportioned according to the number and respective interests of beneficiaries who are California residents.





Examples of Trusts' Having Non-Contingent Beneficiaries

- Administrative trusts not treated as an estate
- Terminating trusts (e.g., following the death of the income beneficiary)
- Power of appointment marital deduction trusts – IRC Section 2050(b)(5) or 2523(e)
- An IRC Section 2503(c) minors trust
- An IRC Section 2641(c) GST tax direct-skip trust

Apportioning Rules & Ordering Rules

- Special ordering rules apply where a trust has multiple fiduciaries and multiple beneficiaries, some of which are California residents.
 - Example A:
 - A Non-CA resident trustee, and
 - 2 **non-contingent** beneficiaries – 1 non-CA and 1 CA resident, therefore
 - Only 50% of non-CA source income is taxed in California due to beneficiary
 - Example B:
 - 2 trustees – 1 CA and 1 non-CA resident AND
 - 2 beneficiaries – 1 CA and 1 non-CA resident, therefore
 - 75% of non-CA source income is taxed in California due to trustee and beneficiary

Example A: CA Form 541 Schedule G

Part I: If a trust, enter the number of:

1 a California resident trustees	●	
b Nonresident trustees	●	1
c Total number of trustees (line a plus line b)	●	1
d California resident beneficiaries	●	1
e Nonresident beneficiaries	●	1
f Total number of beneficiaries (line d plus line e)	●	2

Part II: Income Allocation. Complete column A through column F. Enter the amounts from lines 1-9, column F, on Form 541, Side 1, lines 1-9.

	(A) California Source Income	(B) Non-California Source Income	(C) Apportioned Income $\frac{\# \text{ CA Trustees}}{\# \text{ Total Trustees}} \times \text{B}$	(D) Remaining Non-California Source Income Col. B – Col. C	(E) Apportioned Income $\frac{\# \text{ CA Beneficiaries}}{\# \text{ Total Beneficiaries}} \times \text{D}$	(F) Income Reportable to California (Col. A+C+E)
1 Interest	●	●				
2 Dividends	●	● 250,000		250,000	125,000	125,000
3 Business income	●	●				
4 Capital gain	●	● 500,000		500,000	250,000	250,000
5 Rents, royalties, etc.	● 250,000	●				250,000
6 Farm income	●	●				
7 Ordinary gain	●	●				
8 Other income	●	●				
9 Total income	● 250,000	● 750,000		750,000	375,000	625,000

Example B: CA Form 541 Schedule G

Part I: If a trust, enter the number of:

1 a California resident trustees	●	1
b Nonresident trustees	●	1
c Total number of trustees (line a plus line b)	●	2
d California resident beneficiaries	●	1
e Nonresident beneficiaries	●	1
f Total number of beneficiaries (line d plus line e)	●	2

Part II: Income Allocation. Complete column A through column F. Enter the amounts from lines 1-9, column F, on Form 541, Side 1, lines 1-9.

Type of Income	(A) California Source Income	(B) Non-California Source Income	(C) Apportioned Income $\frac{\# \text{ CA Trustees}}{\# \text{ Total Trustees}} \times \text{B}$	(D) Remaining Non-California Source Income Col. B – Col. C	(E) Apportioned Income $\frac{\# \text{ CA Beneficiaries}}{\# \text{ Total Beneficiaries}} \times \text{D}$	(F) Income Reportable to California (Col. A+C+E)
1 Interest	●	●				
2 Dividends	●	● 250,000	125,000	125,000	62,500	187,500
3 Business income	●	●				
4 Capital gain	●	● 500,000	250,000	250,000	125,000	375,000
5 Rents, royalties, etc.	● 250,000	●				250,000
6 Farm income	●	●				
7 Ordinary gain	●	●				
8 Other income	●	●				
9 Total income	● 250,000	● 750,000	375,000	375,000	187,500	812,500

California Resident Beneficiary Contingent Interest

- A California resident beneficiary whose interest in the UNI of a trust is subject to (1) a condition precedent, e.g., a HEMS standard, or (2) the discretion of the trustee, is deemed to have a contingent interest in the trust
- Contingent beneficiaries are not considered in the count in the beneficiary apportionment.



Distribution to a Contingent Beneficiary

- A contingent California resident beneficiary is treated as having a California taxable interest in the trust at the time he or she receives a distribution, ***but only to the extent of the value of that distribution.***
- In this case, the trust will be taxable on the current distributable income. This means that a distribution to a California resident beneficiary will trigger a filing requirement in California for a trust that would otherwise be treated as a non-California trust.
- However, the beneficiary will be taxable on that income if the trust does not pay the tax when due, or the income is distributable to the beneficiary before the taxes are due. R&TC Section 17745(a).

Distribution to a Contingent Beneficiary

- If prior year California untaxed accumulated income is distributed to a California contingent resident beneficiary, that distribution is also subject to the California's throw-back rule which taxes income to the beneficiary.



California Throwback Rule

- Requires that a California resident beneficiary pay tax on a distribution of accumulated income if the trust did not pay the tax on accumulated income while the beneficiary was a resident (*Section 17745 (b) – (d)*)
 - ✓ *For example, California beneficiary was contingent during accumulation phase and later receive a distribution of accumulated income that was accumulated during years that the beneficiary also was a California resident*
 - ✓ *If the trust distribution exceeds the trust's DNI, the excess is treated as an "accumulation distribution" and throwback tax will apply at rates applicable to the years of accumulation the beneficiary is deemed to receive that distribution.*
- Trust files Form 541 Schedule J – **Trust Allocation of an Accumulation Distribution** and provides detail to beneficiary
- Trust beneficiary may use Form FTB 5870A – **Tax on Accumulation Distribution of Trusts**

Example A: Trust Allocation of an Accumulation Distribution- CA Schedule J (541)

Name of trust Example A - Assume California resident beneficiary is contingent		FEIN
---	--	------

Part I Accumulation Distribution

For definitions and special rules, see the federal Treasury Regulations under Internal Revenue Code (IRC) Sections 665–668. See the instructions for federal Form 4970, Tax on Accumulation Distribution of Trusts, for certain income minors may exclude and for special rules for multiple trusts.

1	Enter amount from 2022 Form 541, Schedule B, line 10	1	1,625,000
2	Enter amount from 2022 Form 541, Schedule B, line 7	2	375,000
3	Enter amount from 2022 Form 541, Schedule B, line 9	3	
4	2022 distributable net income. Subtract line 3 from line 2. If line 3 is more than line 2, enter -0-	4	375,000
5	2022 accumulation distribution. Subtract line 4 from line 1	5	1,250,000



California Taxation of Contingent Beneficiaries Distribution

- If the trust does not file a California return and/or does not provide the beneficiaries with the Form 541 Schedule J, California will treat the entire trust accumulation income distributed to the beneficiary as fully taxable and is reported on the California personal income tax return, California Adjustments.