CALIFORNIA INCOME TAXATION OF TRUSTS AND ESTATES

By Richard S. Kinyon, Esq., Kim Marois, Esq.,** and Sonja K. Johnson, Esq.***[1]*

Reprinted with the permission of The American College of Trust and Estate Counsel.

California's income taxation of trusts has unpleasantly surprised many trust fiduciaries and beneficiaries. Its unique method of taxation, based on the residence of the trust's fiduciaries and beneficiaries (and regardless of the residence of the settlor), may affect trustees and beneficiaries (as well as their lawyers and other advisors) far beyond the California borders.

For example, consider an irrevocable, non-grantor trust[2] established by an Illinois resident that is administered by two co-trustees, one of whom is an Illinois resident while the other resides in California. All beneficiaries of the trust also reside in Illinois. Despite the predominantly non-California connections, and even if the Illinois co-trustee is more actively involved in the administration of the trust, *half* of the trust's undistributed net income is currently taxable by California.

Alternatively, consider another irrevocable, non-grantor trust, this time with a New York settlor. In this case, the trust is administered in New York by a New York resident serving as the sole trustee. However, the trust's sole beneficiary is a California resident with a vested (i.e., non-contingent) interest in the trust property. Despite the trust's New York origin and administration, *all* of the trust's undistributed net income is currently taxable by California.

California acknowledges other state laws regarding taxation of trust income and will allow a credit for taxes paid to another state, but only if the trust is considered to be a resident by both states *and* taxes are actually payable to both states.[3] The credit is effective where the taxes paid to the other state are levied on the same income and at the same rates as those of California. In the examples above, if the trusts are taxed on the same income at lower rates in Illinois or New York than in California, the additional taxes paid to California (which are not offset by the credit for taxes paid in the other states) will represent additional taxation that will deplete the trust estate.

Given that California taxes net capital gains at the same rates as ordinary income—with a maximum rate of 12.3 percent (or 13.3 percent with respect to taxable income in excess of $1,000,000)—an otherwise out-of-state trust may have significant California income tax liabilities. If the tax is not paid by the trust for the year in which the income is received and if that income is subsequently distributed to a California resident beneficiary, that beneficiary will be taxable on that income. Moreover, even where a trust has not had a prior obligation to pay California income tax, a later distribution of accumulated net income to a California beneficiary is subject to the California throwback rules, which are somewhat similar to the now largely repealed federal throwback rules (under IRC sections 666-668).[4] Thus, even if a non-California resident establishes a trust that is always administered outside of California by non-California trustees, and even if the trust's California beneficiaries only have contingent, non-vested interests (for example, where *all* distributions are fully discretionary), California may *still* ultimately tax the trust's income when and to the extent it is later distributed to a California resident beneficiary.

The broad reach of California's fiduciary income tax laws is an important consideration for trustees, beneficiaries and advisors, where either a trustee or beneficiary resides in California or is contemplating a move to California. This article provides an in-depth analysis of the principles of California fiduciary taxation and the manner in which they are applied. Although its focus is on the treatment of irrevocable, non-grantor trusts, it includes a brief overview of California's taxation of the income of estates and administrative trusts, as well as a technical guide to complying with California income tax reporting and withholding requirements.

I. STATUTORY OVERVIEW

The California laws governing the income taxation of estates, trusts, beneficiaries and decedents are in the California Revenue and Taxation Code.[5] (All subsequent statutory references are to the California Revenue and Taxation Code, unless specified otherwise.) Section 17731 provides that the federal rules relating to such taxation (IRC sections 641-692) apply for California purposes, except as otherwise provided.

The elections under IRC section 645(a) (treating a "qualified revocable trust" as part of the deceased settlor's probate estate for income tax purposes), IRC section 663(b) (treating discretionary distributions in the first sixty-five days of the taxable year of an estate or trust as having been made on the last day of the preceding taxable year), and IRC section 663(c) (treating separate shares of an estate or trust as separate estates or trusts for the sole purpose of determining the amount of distributable net income taxable to the beneficiaries) are also effective for California purposes. Any of these elections not made for federal purposes cannot be made separately for California purposes.

II. CALIFORNIA TAXATION OF ESTATES, ADMINISTRATIVE TRUSTS, REVOCABLE AND OTHER GRANTOR TRUSTS

In considering California's unique approach to the taxation of irrevocable, non-grantor trusts, it is useful to understand and compare its treatment of other similar entities, including probate estates, administrative trusts, revocable trusts, and other grantor trusts.

A. Probate Estates

The undistributed net income of a probate estate of a California decedent is taxable by California regardless of the residence of its beneficiaries, the personal representative or any other fiduciary. If part of a California decedent's estate (such as out-of-state real estate) is subject to ancillary probate administration in another state, California presumably would allow a credit for the income taxes paid to the other jurisdiction.[6] If a California non-resident decedent owned assets (such as real estate) situated in California that produce California source income, that income will be taxed by California regardless of the residence of its beneficiaries, the personal representative or any other fiduciary.[7]

B. Administrative Trusts

While an "administrative trust" of a California decedent (i.e., a revocable trust that has become irrevocable because of the death of the settlor) is functionally the same as a probate estate (except that it is not subject to mandatory court supervision), its undistributed net income is not taxable by California in the same manner as that of a California decedent's probate estate. Instead, it is taxed by California as an irrevocable, non-grantor trust—unless an IRC section 645(a) election is made.

An election under IRC section 645(a) to treat and tax a "qualified revocable trust" (i.e., a typical administrative trust) as part of the deceased settlor's probate estate for federal income tax purposes is treated as an election for California income tax purposes as well. If such an election is not made for federal income tax purposes, it cannot be made for California income tax purposes.[8] Making an IRC section 645(a) election could have a substantial impact on a qualified revocable trust's income tax liability to California. For example, if the deceased settlor of a revocable trust was a California resident but all of the trustees and beneficiaries are non-residents of California, all of the trust's undistributed net income will be taxable by California if the IRC section 645(a) election is made. In comparison, none of the trust's income (except for California source income)[9] will be taxable by California if the election is not made, because California's unique irrevocable trust taxation laws exclude the income from taxation in California. Conversely, if the deceased settlor was a non-resident of California but all of the trustees or all of the beneficiaries are residents of California, none of the trust's non-California source income will be taxable by California if an IRC section 645(a) election is made because the trust will be taxed as a non-California estate—whereas all of the income will be taxable by California if that election is not made because California's irrevocable trust rules will apply.

C. Revocable and Other "Grantor Trusts"

California treats property of a "grantor trust" (i.e., a trust subject to the grantor trust rules in IRC sections 671-679) as owned by and taxable to its settlor (or grantor) for income tax purposes. Therefore, its income, deductions and credits generally are included in computing the tax liability of the grantor, and the trust itself is disregarded for both federal and California income tax purposes.[10]

III. IRREVOCABLE, NON-GRANTOR TRUSTS

A. Overview[11]

While many states tie the income tax liability of an irrevocable, non-grantor trust to its settlor's residence, California disregards this consideration altogether.[12] Instead, California employs a unique analysis that considers (1) the source of the trust's income, (2) the residence of its trustees,[13] and (3) the residence of the trust's beneficiaries. Consistent with the tax laws of most states, California taxes all of a trust's income attributable to California sources (e.g., rental income from property located in California).[14] What makes California unique is that it also taxes all of a trust's taxable income if all of its trustees are California residents *or* if all of its beneficiaries are California residents with "non-contingent" (i.e., vested) interests in the trust.[15]

Where some, but not all, trustees or vested beneficiaries are California residents, California taxes a fractional amount of the trust's taxable income.[16] For example, where two of three trustees are California residents (and there is no California source income and none of the beneficiaries are California residents with vested interests), California will tax two-thirds of the trust's taxable income. If a trust has no California trustees, but has a California resident beneficiary with a vested interest in 50% of the trust estate and the rest of the trust estate is not vested or is vested in non-California beneficiaries, California will tax 50 percent of the trust's taxable income. California applies a two-step formula to determine the portion of the trust's taxable income subject to California tax.[17] This formula first defines the income taxable to California on the basis of the number of California trustees to total trustees; any income not allocated to California because there are one or more non-resident trustees is then allocated on the basis of vested California beneficiaries to total beneficiaries.

California incorporates the federal definition of gross income,[18] so that a California beneficiary will be taxed on the receipt of all distributions of current trust income. In addition, California imposes a tax on California beneficiaries who receive trust distributions of accumulated income if (a) the trust has been non-compliant in paying California income taxes previously due[19] or (b) the beneficiaries' interest in that income was previously contingent. A distribution results in the beneficiary's interest becoming vested, at least to the extent of the distribution, under California law.[20] For example, if a beneficiary's interest is unvested because the trustee has complete discretion over distributions, an actual distribution will result in the beneficiary's becoming vested in the amount distributed. These provisions effectively hold beneficiaries accountable for the trust's failure to pay income tax previously owed to California and (with some notable, but limited, exceptions discussed below) for income taxes that would have been due to California if the beneficiary had a vested interest in the trust when the accumulated income was earned.

B. Trustee-Based Taxation of Trusts: Understanding Corporate Residency

As described above, a key factor for determining California's income taxation of a trust is the residency of the trust's fiduciaries. However, such determinations often are not straightforward. Most of the problematic issues pertain to corporate fiduciaries. Many corporate fiduciaries have a national presence, and might consider themselves residents of the state(s) in which they are incorporated or headquartered. Nonetheless, for purposes of California income taxation of trusts, the key determinant of an institution's residency is the location where it administers the trust.

Section 17742, subdivision (b), provides that "the residence of a corporate fiduciary of a trust means the place where the corporation transacts the major portion of its administration of the trust." Thus, a corporate fiduciary's residence for these purposes is tied to its activities with respect to a particular trust, rather than to its state of incorporation or other general factors. California law does not provide guidance as to what constitutes the "major portion" of trust administration activities.

Notably, the California Franchise Tax Board itself has indicated that California law is unclear in this respect, stating that "[t]he law does not provide guidance as to what specific activities of 'administration' will be considered in determining whether a corporate fiduciary of a trust is transacting the majority of the administration of the trust in California under section 17742(b)."[21] In its 1998 proposal to change the manner in which California taxes trust income, the Franchise Tax Board stated that "[t]here is uncertainty regarding what factors, and their relative weights, should be considered in determining where trusts are administered. This uncertainty is compounded by the changing nature of corporate trust administration from local (one state only) to interstate or national,"[22] concluding as a result that, "[c]urrent law providing the rules to determine when a trust's taxable income is subject to California tax is seriously outdated and needs to be modified to conform to modern trust administration practices."[23] However, the Franchise Tax Board's accompanying proposal for an alternative approach to the income taxation of trusts has yet to be adopted into California law.

A relatively recent California State Board of Equalization opinion commented on the intent of the "major portions" provision, stating:

> The "major portions" test represents a clear public policy to impose tax only on trust income to the extent from quantifiable activities of fiduciaries that are transacted in California. The test is also consistent with the fundamental tax law doctrine that substance must prevail over form. E.g., Microsoft Corp. v. Franchise Tax Board, 39 Cal. 4th 750, 760 (2006). The rule notably results in a higher percentage of income apportioned to California to the extent that the main business affairs of the trust are substantively conducted within the State, without regard to whether the trustee may technically be a resident of another jurisdiction.[24]

That opinion did not set forth the specific factors to be considered with respect to a corporate fiduciary's residence. Thus, although corporate fiduciaries are not provided with any detail as to what activities would constitute a "major portion" of trust administration, this opinion provides some guidance as to how the State Board of Equalization approaches the issue. Without more specific guidance, the determination of corporate residency presumably depends on the particular circumstances of the applicable trust's administration.

C. Beneficiary-Based Taxation of Trusts: "Non-Contingent" Interests

In addition to trustee residence and source income, the final basis for California's taxation of a trust's undistributed net income is the residence of its vested trust beneficiaries.[25] The case of *McCulloch v. Franchise Tax Board* established that California may tax the accumulated income of an otherwise non-resident trust where a resident of California is or becomes a vested (non-contingent) beneficiary of the trust.[26] Thus, where a trust has no California fiduciaries but does have a California beneficiary, the trust's liability for California income tax generally hinges on whether its California beneficiary has a non-contingent interest in the trust. Whether the beneficiary's interest is contingent or non-contingent is generally a fact-based question, the answer to which even the Franchise Tax Board acknowledges is often difficult to ascertain.[27]

The relevant statutes and cases do not specifically describe the conditions or circumstances required for a beneficiary's interest to be vested. However, a logical analysis of the established principles of vesting indicates that a beneficiary is only vested if he or she has an absolute right to receive the accumulated income in the future. In addition, the Franchise Tax Board may assert that a beneficiary has a vested interest where accumulated income will be distributed to the beneficiary's estate, or where the beneficiary has a general power of appointment over the accumulated income at his or her death. Thus, apparently a beneficiary's interest is contingent if a condition must be met (and that condition is not assured) before a beneficiary would be entitled to receive the accumulated income and the beneficiary does not have a general power of appointment, or the property is not payable to the beneficiary's estate following his or her death, i.e., someone other than the beneficiary, his or her appointees, or his or her estate might receive the accumulated income.

The Ninth Circuit in *Urquhart v. Commissioner*[28] adopted a similar view of contingency for federal income tax purposes. In that case, a trust instrument provided that a beneficiary was to receive accumulated trust income and corpus upon reaching the age of 30. If the beneficiary died prior to that time, the accumulated income and corpus was to pass to his lawful issue or to the other contingent remainder trust beneficiaries if he died without issue. The court stated that the beneficiary had "no dominion over the income accumulated for his benefit, nor [did] he have any testamentary right over it unless and until he attain[ed] the age of thirty years . . . [I]t cannot be said therefore that [the beneficiary had] a present vested interest in the accumulations."[29] Although *Urquhart* is an old federal case and more recent cases do not provide such direct analysis, the cases allowing California to tax trust income on the basis of vested resident beneficiaries are consistent.

In the Matter of the Appeal of C. Pardee Erdman[30] is a case where the California resident transferee of a deceased California resident beneficiary of trusts (with an Illinois trustee) who received income from the trusts and paid taxes to California with respect to that income was taxable on an accumulation distribution that included the trusts' capital gains for which no taxes had been previously paid to California. The court rejected the contention that the beneficiary should not be taxed on the accumulation distribution because the beneficiary's interest was contingent when the gains were accumulated. The holding in *Erdman* is consistent with the holding in *McCulloch*, in that a beneficiary's residence was sufficient nexus for California to impose income tax on an accumulation distribution.[31]

D. Taxation of Beneficiaries Receiving Trust Distributions

1. Overview

As noted previously, the Revenue and Taxation Code is structured so that California may levy income tax with respect to a trust's undistributed net income via two different avenues. First, the trust itself is subject to income taxation in California based on its California source income, trustees and non-contingent beneficiaries, as described above.[32] This income tax is a liability of the trust and is reportable and payable on an annual basis in accordance with normal reporting requirements. Second, where a California resident beneficiary receives an accumulation distribution from (a) a trust that has not satisfied all of its income tax liabilities to California because the taxes were not paid when due,[33] or (b) a trust in which the California resident was a contingent beneficiary and therefore the accumulation distribution was not previously taxable by California,[34] the state exacts its tax from the California beneficiary upon his or her receipt of the accumulation distribution from the trust.

Taxation of accumulated income under section 17745, subdivision (a), is somewhat confusing in that the income is currently taxable to the trust by California under section 17742, subdivision (a). If the trust does not pay the tax, the Franchise Tax Board would have difficulty collecting it if there is no California trustee and no trust property situated in California. However, instead of providing that the taxes owed but not paid by the trust are payable by the beneficiary as a transferee of that accumulated income, as contemplated by the court in *McCulloch*,[35] section 17745 taxes that accumulated income in the year distributable to the beneficiary, as the taxpayer and not as a transferee, if he or she is a California resident at that time. Presumably, California would not be able to tax that income to the beneficiary under section 17745 and also collect the tax owed by the trust from the beneficiary as a transferee under the traditional concept of transferee liability.[36]

Equally significant, but substantially more complex, is California's "throwback" taxation of trust distributions pursuant to section 17745, subdivision (b). This provision allows California to tax a resident beneficiary on distributions of accumulated income when the trust had not been required previously to pay income tax to California, because only its California beneficiaries' interests in the trust were contingent. "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."[37] Under section 17745, subdivision (d), the accumulated net income earned while the beneficiary's interest in the trust was contingent that is included in an accumulation distribution is taxed as though it had been included in the income of the beneficiary receiving the distribution ratably in the year of distribution and the five preceding years (or if the income has been accumulated for a shorter period, during such period).

Since California's income tax law was conformed to the federal income tax law in 1983,[38] distributions of accumulated income by a trust to a resident California beneficiary generally have been subject to both federal and California income tax in accordance with the throwback rules under IRC sections 665-668. However, section 17779 provides that those sections are inapplicable to distributions described in section 17745, subdivision (b), quoted in the previous paragraph. Therefore, it appears that the California throwback rules in section 17745, subdivision (d), and not the rules under IRC sections 665-668, generally are applicable to an accumulation distribution received by a resident California beneficiary unless the trust is also subject to federal tax on that distribution under IRC section 667 (as discussed in the last paragraph of section III.D.2 of this article, *post*).

2. *Limitations on Income Subject to "Throwback" Tax*

One important limitation on the amount of accumulated income subject to tax under section 17745 is that the income must have been earned by the trust while the beneficiary was a California resident. As discussed previously, the purpose of section 17745, subdivision (b), is to hold a resident beneficiary liable for income tax that otherwise would have been taxable, had the beneficiary's interest not been contingent.[39] Before such beneficiary became a California resident, the income would not have been taxable by California (regardless of whether the beneficiary's interest was contingent or non-contingent) because there was no connection to California. Thus, income earned in years when the beneficiary was not a California resident is not included in the amount taxable under the California throwback rules.

This principle is supported not only by the Revenue and Taxation Code itself, but also by the courts and the Franchise Tax Board's application of income tax rules to trust beneficiaries. As the court in *McCulloch* explains, for example, taxation of the plaintiff beneficiary upon distribution was constitutionally supported because the "[beneficiary] in the instant case has, in his role as beneficiary *during the years of his residence in this state*, enjoyed the protection accorded by California for his eventual receipt of these assets."[40] By the same token, taxation of a beneficiary on income accumulated before he or she was born or for periods during which he or she was not a California resident (and hence derived no benefits from it) would be inappropriate and perhaps unconstitutional. The Franchise Tax Board appears to employ this approach as well, based on its description of the assessment of income tax upon trust beneficiaries. Discussing the calculation of a credit for income tax paid in another state, the Franchise Tax Board, in one ruling, stated:

> [T]he credit shall be based upon the tax on the income accumulated by the trust since the [beneficiary] taxpayers became California residents until the date of distribution. One-sixth of that amount shall be added to the taxpayers' income for the year of distribution and for each of the five preceding years to determine the California tax attributable to the trust income.[41]

Thus, depending on the duration of a beneficiary's California residence, this limitation may help to limit the amount of accumulated income that is taxed upon distribution.

In addition to residency, a beneficiary's age while income accumulates may also limit the amount taxable upon a distribution that is also subject to the tax on accumulation distributions under IRC section 667 (i.e., with respect to a foreign trust and certain domestic trusts).[42] One consequence of California's general adherence to the federal throwback rules with respect to such distributions is that a beneficiary is not taxed on income that accumulated before he or she reached age 21.[43] This rule is embodied in the Specific Instructions of Form 541, Part I of Schedule J, which provide that "[g]enerally, the beneficiary may exclude amounts accumulated before the beneficiary becomes age 21."[44] Consistently, Part I (Tax on Accumulation Distribution under IRC section 667), Section A, line 2, of Form 5870A,[45] used by a beneficiary to report accumulation distributions under IRC section 667, provides for the deduction of income accumulated before the beneficiary reached age 21. Because of section 17779 (discussed above), it appears that California might not exclude from taxation a distribution of income that was accumulated while the beneficiary was a California resident before becoming age 21 if that income is subject to the tax on accumulation distributions under section 17745, subdivision (b), rather than IRC section 667.[46] However, the absence of regulations under section 17745, subdivision (b), or other Franchise Tax Board guidance to provide any alternative method for calculating accumulation distributions under section 17745 has caused substantial uncertainty.

3. *Special Considerations Regarding Beneficiary Residence*

Finally, it is important to note that beneficiaries may not avoid California's throwback tax on trust distributions simply by briefly leaving the state. Section 17745, subdivision (e), implements a rule of "deemed residency," which provides as follows:

> In the event that a person is a resident beneficiary during the period of accumulation, and leaves this state within twelve months prior to the date of distribution of accumulated income and returns to the state within twelve months after distribution, it shall be presumed that the beneficiary continued to be a resident of this state throughout the time of distribution.[47]

Even when a beneficiary leaves the state for the requisite period of time to avoid California taxation of an accumulation distribution, it is possible that California will consider the beneficiary to have been a California resident at the time of distribution based on its general rules for identifying residents. As this article's Appendix A describes in detail, terminating California residency is not nearly as simple as physically leaving the state and living elsewhere, or even taking basic steps such as registering to vote and obtaining a driver's license in another state. Instead, California considers a myriad of factors in determining whether an individual is a California resident.[48] Trust beneficiaries who have physically left California must carefully assess their remaining connections with the state to determine whether an accumulation distribution will be taxable by California.

IV. ILLUSTRATIONS OF MISCELLANEOUS CALIFORNIA PROVISIONS

The following scenarios illustrate the somewhat unpredictable results under California law in several typical fact patterns. In each scenario, it should be assumed that the trust in question is an irrevocable, non-grantor trust.

A. Minor's Trust with General Power of Appointment

> **Scenario #1**: Assume that a non-resident of California is the sole trustee of an irrevocable trust, established for a California minor resident beneficiary. The minor beneficiary may receive discretionary payments of income and principal and is to receive an outright distribution of all of the remaining trust property upon reaching age 21, at which time the trust terminates. If the beneficiary dies before reaching age 21, the trust assets are to be distributed to the beneficiary's issue, per stirpes, or if there is none, to other beneficiaries; however, the beneficiary is given a general testamentary power of appointment over the trust assets on attaining age 18.

> **Question 1(a): Does a general power cause a beneficiary to be vested?**

Because the distributions are discretionary, the beneficiary's interest is contingent, at least until age 18. Upon reaching age 18, when the beneficiary acquires a general testamentary power of appointment over the trust assets, the Franchise Tax Board is likely to assert that the general testamentary power of appointment is sufficient to cause the interest to become vested (non-contingent). However, vesting as a result of a general power is less clear than vesting as a result of gaining the absolute right to receive accumulated income in the future. In this case, the beneficiary has a contingent interest until age 18 and most likely has a vested interest from and after age 18.

> **Question 1(b): Is the undistributed net income of the minor's trust taxable by California?**

A trust that has only non-resident fiduciaries and a contingent California beneficiary would not be responsible at any point for paying tax on its accumulated income, absent California source income. Under the facts presented, the minor's trust would be responsible for paying annual income tax to California only with respect to income earned after the beneficiary reaches age 18, assuming the general testamentary power of appointment is deemed sufficient to cause the beneficiary's interest to become vested (non-contingent) at age 18.

Question 1(c): Assuming that the beneficiary remains a California resident and receives a termination distribution at age 21, how will California tax any accumulated income?

Consistent with tax laws of most states, beneficiaries who reside in California are taxable on trust distributions to the extent of the trust's distributable net income ("DNI"), as reported on the Schedule K-1 of the Form 1041.[49] However, under California law, to the extent of accumulation distributions received by the beneficiary, the beneficiary generally will be subject to California tax on all accumulated trust income that was not previously taxed by California. As discussed above, the termination distribution to the beneficiary could be taxed to the beneficiary under section 17745, subdivision (a), if the trust did not pay taxes to California when it was required to do so, and/or as an accumulation distribution subject to the throwback rules under sections 17745, subdivisions (b) and (d).

In the case of this minor's trust, if the trustee determined that the beneficiary's interest vested upon attaining age 18 (when the beneficiary obtained the general power of appointment) and *thereafter paid income taxes to California* on accumulated income, the beneficiary would become liable, if at all, only for income taxes on the income earned by the trust prior to reaching age 18, as provided in sections 17745, subdivisions (b) and (d).

If, in the case of this minor's trust, the trustee *did not pay income taxes to California* following the beneficiary's acquisition of a general power of appointment at age 18, either because the trustee believed that the power of appointment was not enough to cause the beneficiary to become vested or because the trustee was unaware of California's requirements, the Franchise Tax Board could assert that the income accumulated after the beneficiary reached age 18 is taxable to the beneficiary under section 17745, subdivision (a).

B. Discretionary Accumulation Trust With Several California Resident Beneficiaries

Scenario #2: Assume that a non-resident of California is the sole trustee of a trust with several California resident beneficiaries. The primary beneficiary and his or her issue may receive payments of income and principal for their health, education, maintenance or support, in the sole discretion of the trustee. The primary beneficiary also holds a limited (non-general) testamentary power of appointment.

Question 2(a): Are the beneficiaries' respective interests contingent or non-contingent?

As in Scenario #1, the question is whether any of the beneficiaries has either a current right to trust property or an assured testamentary right to, or general power of appointment over, trust property.

With respect to current distributions, the trustee may, but is not required to, make distributions for certain needs of these beneficiaries. Because such distributions are solely at the discretion of the trustee, the beneficiaries cannot assert any current rights to trust funds and may never receive them. Thus, none of the beneficiaries has a vested interest based on a present right to trust property.

With regard to testamentary rights, the primary beneficiary has a limited testamentary power of appointment. A limited testamentary power does not ensure that the beneficiary will receive or enjoy the trust property, and does not have the effect of causing the beneficiary to become vested, as might be the case with a testamentary general power of appointment.

Because none of the beneficiaries is guaranteed any current or future rights to trust property, they are all contingent beneficiaries.

Question 2(b): Are the beneficiaries' interests still contingent if the trust makes distributions to any of the beneficiaries?

Any distributions to the beneficiaries under Scenario #2 will result in vesting as to the distributed amounts, which will be taxable to the California beneficiaries under section 17731 (with respect to current distributable net income) or section 17745, subdivision (b) (with respect to accumulated net income). Except with respect to an actual distribution, however, the status of a beneficiary as contingent with respect to undistributed net income would not change, because the current distribution in and of itself would not guarantee any further rights to trust distributions or property.

C. Distributions to Current or Former California Residents

Scenario #3: Assume the following additional facts regarding Scenario #2: The trust has been in existence for fifty years, and all beneficiaries during the term of the trust have been California residents (except as provided below with respect to the sole remaining beneficiary). Under the terms of the trust instrument, the trust will terminate soon and distribute to the sole remaining beneficiary.

Questions: Will the trust or sole remaining beneficiary be taxed by California on the accumulated income earned during the term of the trust upon distribution under the following circumstances:

3(a). The sole remaining beneficiary remains a California resident through and including the date of distribution?

3(b). The sole remaining beneficiary ceases to be a California resident two years before the date of distribution?

3(c). The sole remaining beneficiary ceases to be a California resident six months before the date of distribution?

In this scenario, because the sole trustee is a non-resident of California and all of the California beneficiaries have contingent interests,[30] the trust is not taxable by California (except with respect to any California source income of the trust), pursuant to the general taxation principles of sections 17742 through 17744. Under section 17745, subdivision (b), any prior distributions made to a beneficiary of this trust would have been taxable to the beneficiary. Because there is now one remaining beneficiary and this beneficiary has been a California resident throughout his or her lifetime (except surrounding the time of the distribution, as described below), 100 percent of any accumulation distribution which was not previously taxed by California will be taxable to this beneficiary.

Question 3(a) is straightforward because the beneficiary is a California resident prior to and at the time of the trust distribution. As such, the beneficiary will be taxed on the accumulation distribution to the extent the trust's income was not previously taxed by California. To calculate this tax, one-sixth of the accumulated income will be added to the beneficiary's gross income for the year of distribution and for each of the five preceding years, and the hypothetical additional tax liability for each of these years will be added together to determine the total amount of tax to the beneficiary.[31]

In Question 3(b), the contingent beneficiary resides in California until two years prior to the trust distribution. As described previously, section 17745, subdivision (e), was implemented to preclude California residents from avoiding income tax on a trust distribution by leaving the state for a short period of time surrounding the distribution.[32] If a beneficiary leaves within 12 months before the distribution and returns within 12 months following it, he or she will be treated as if his or her California residency were continuous for this period and will be taxed upon the distribution. The Revenue and Taxation Code does not extend the scope of this provision, however, beyond the two specified twelve-month periods. Thus, if a beneficiary moves his or her residency out of California *more than* 12 months before a distribution, the distribution would not be taxable in California under section 17745, even if the beneficiary returns to California immediately after the distribution. Here, two years well exceeds this time frame, so neither the beneficiary nor the trust would be subject to California income tax, regardless of whether or when the beneficiary returns to California following the distribution.[33]

Question 3(c) varies this scenario with a sole remaining beneficiary who has moved his or her residence out of California only six months prior to the distribution. Because this change in residency falls within the twelve-month period prior to the distribution, the beneficiary could be treated as a California resident at the time of distribution under section 17745, subdivision (e). If the beneficiary resumes California residency within 12 months following the distribution, he or she will be treated as a California resident for these purposes and will be taxed upon the distribution as if he or she never left the state. If not, the beneficiary may avoid California income tax on the distribution depending on all the relevant facts and circumstances.

D. Discretionary Accumulation Trust with No California Beneficiaries

__Scenario #4__: Assume that a California non-resident is the sole trustee of a trust with several beneficiaries, none of whom currently resides in California. The beneficiaries may receive payments of income and principal for their health, education, maintenance, or support, and they have limited (non-general) testamentary powers of appointment. At the time the trust was established, the settlor and the beneficiaries all resided in California.

__Questions__: Should the trust continue to file California fiduciary income tax returns after all of the beneficiaries no longer reside in California? Does this requirement change if the trust makes distributions to the beneficiaries?

Under this scenario, the only connection to California is the residence of the settlor and beneficiaries when the trust was created. As explained previously, the residency of the settlor at the time a trust was created (or became irrevocable) does not bear on whether California will impose income tax on that trust.[24] Thus, the fact that the settlor was a resident of California when the trust was created does not expose the trust to California income tax.

As described in Scenario #3 above, section 17745, subdivision (e), provides that a beneficiary will be treated as a California resident—and a distribution to him or her will be subject to California income tax—if he or she resides in California while trust income accumulates, leaves California within 12 months before a distribution is made, and then returns to California within 12 months after that distribution. Thus, if any of the trust beneficiaries leaves California within 12 months prior to the distribution, receives a trust distribution, and then returns to California within 12 months after the distribution, he or she will be subject to California income tax. In this case, it is advisable for the trust to file a fiduciary income tax return as long as this possibility exists (i.e., for one year following the last beneficiary's departure from California).

If it has been more than 12 months since the last beneficiary left California, however, any future trust distributions would not be subject to California income tax (assuming that the trust does not have any California source income). Thus, unless at least one beneficiary returns to California and receives a discretionary distribution of income, or the trust has California source income, it does not appear necessary for the trust to continue filing fiduciary income tax returns in California.

E. Distributions to New California Residents

Scenario #5: Regarding Scenario #4, assume the following alternate facts: The trust has been in existence for 50 years and none of the beneficiaries during the term of the trust has been a resident of California (except as provided below with respect to the sole remaining beneficiary). Under the terms of the trust instrument, the trust will terminate soon and the assets will be distributed to the sole remaining beneficiary.

Questions: Will the sole remaining beneficiary be taxed by California on the income accumulated during the term of the trust upon distribution under the following situations:

5(a). The beneficiary becomes a California resident two years before the date of distribution?

5(b). The beneficiary becomes a California resident one week before the date of distribution?

Questions 5(a) and 5(b) should be considered under section 17745, subdivisions (a) and (b).

As previously discussed, a California resident beneficiary will be taxed under section 17745, subdivision (b), upon distribution from a trust when income tax attributable to that beneficiary's share has not been paid by the trust because of the beneficiary's contingent status. Nowhere does the Code state that a beneficiary must have been a California resident for any minimum amount of time for this tax to apply. Because Questions 5(a) and 5(b) both involve a beneficiary who is a California resident at the time of distribution, that beneficiary will be subject to California income tax upon distribution in both cases, regardless of how long the beneficiary has been a California resident. (Because this beneficiary's interest is contingent, however, the trust itself will not be subject to California income tax.)

Where the timing of the beneficiary's arrival in California will have an impact is in the calculation of *how much* (rather than whether) income tax will be due. Thus, with respect to Questions 5(a) and 5(b), although the beneficiary would be subject to tax upon distribution, it appears that the amount subject to tax would be limited to the income earned after the beneficiary became a California resident. The beneficiary in Question 5(a) would be subject to California income tax on all of the undistributed net income earned for the two years preceding the distribution and would be allowed a credit for taxes paid by the trust to other states on the same income. Similarly, the beneficiary in Question 5(b) would be subject to California income tax only on the undistributed net income earned in the one week preceding the distribution.

With respect to the distribution in Question 5(b), the amount of income accumulated during the one week of the beneficiary's California residence is likely to be nominal. If so, the adoption of California residence immediately prior to a distribution is unlikely to create significant income tax liability with respect to the accumulation distribution. Where this action could have quite an impact is in the case of a trust that has failed to satisfy its California income tax liabilities. In that event, two years' or even a weeklong residence in California could subject the beneficiary to income tax liability with respect to the distribution under section 17745, subdivision (a) (which, as described previously, allows California to tax a resident beneficiary receiving a distribution for a pro rata share of amounts previously due and unpaid by the trust).

A final issue regarding the scenarios in both Questions 5(a) and 5(b) is the manner in which the total amount subject to tax is allocated for purposes of calculating the amount of tax due. In situations involving the throwback rules of section 17745, subdivisions (b) and (d), the standard throwback allocation of one-sixth of the income to each of the present and five preceding years is normally used to calculate the beneficiary's tax liability. However, section 17745, subdivision (d), specifically states that the untaxed income should be included either in this manner, "or for the period that the trust accumulated or acquired income for that contingent beneficiary, whichever period is shorter."[15] Thus, it appears likely that the throwback period would only include the time during which the beneficiary was a California resident and held a contingent interest. In Scenario #5, for purposes of calculating the beneficiary's income tax liability under the throwback rules, the trust income would be allocated ratably as if it had been included in the beneficiary's income for the two-year period (with respect to Question 5(a)) or the one-week period (with respect to Question 5(b)) during which the beneficiary was a California resident, rather than over the five years preceding the distribution.

V. COMPLIANCE

The primary purpose of this article is to raise awareness of California's unique approach to income taxation and to help fiduciaries, beneficiaries, and advisors with California connections understand how these laws are applied. However, it is also important to understand the practical implications of California's income tax rules. The last portion of this article therefore discusses the nuts and bolts of complying with the California law relating to the income taxation of trusts and estates. California Form 541 (California Fiduciary Income Tax Return) and the schedules thereto are generally similar to the federal income tax Form 1041 and its schedules, but with important differences. The relevant forms and schedules can be accessed from the Franchise Tax Board's website at http://www.ftb.ca.gov/.

A. Form 541 and Related Schedules

California decedents' estates, as well as resident and "non-resident" trusts, file FTB Form 541 (California Fiduciary Income Tax Return)[16]. California does not publish a separate non-resident fiduciary income tax return. California's Form 541 was clearly derived from the federal Form 1041 (U.S. Income Tax Return for Estates and Trusts),[17] as the line items on the face of the return (income and deductions) appear in the same order and only vary because of differences in the applicable state and federal laws (e.g., the reference to qualified dividends on the federal return, as California has a single rate schedule applicable to all dividends and capital gains). Both returns require that pertinent questions be answered under a section entitled "Other Information" and both include Schedule A ("Charitable Deduction") and Schedule B ("Income Distribution Deduction").

An important difference between Form 541 and Form 1041 is the use of Schedule G. Schedule G of Form 541, entitled "California Source Income and Deduction Apportionment," is used to compute the tax due with the return by non-resident estates and trusts to identify the amounts taxable by California. The amounts identified on Schedule G are carried forward to the taxable income computation on the first page of Form 541 and completed by reference to Form 1041. Form 541 first separates the trust's income between California source income (all of which is taxable by California) and non-California source income. The non-California source income is then apportioned to California on the basis of the percentage of trustees residing in California and the remaining non-California source income, if any, is apportioned to California on the basis of the percentage of non-contingent beneficiaries residing in California. Schedule G also directs the trustee to report the trust's deductions and to identify those allocable to California. A copy of pages 1 and 2 of Form 1041 is required to be attached to the Form 541.

Schedule K-1 of Form 541 reports the information on the Schedule K-1 of Form 1041, lists the California adjustments to determine the income reportable for California, and identifies California source income and credits. Importantly, Schedule K-1 of Form 541 separately states the California source income on which non-resident beneficiaries are required to pay tax in California.

Schedule J of Form 541, entitled, "Trust Allocation of an Accumulation Distribution," is a separate form used to report and compute accumulation distributions by domestic complex trusts and certain foreign trusts. The instructions to Schedule J of Form 541 acknowledge California's conformity to the repeal of the federal throwback rules, but state: "However, if the trust did not pay tax on the beneficiary's interest because the beneficiary was contingent, the income that would have been taxed is included by the beneficiary in the year it is distributable or distributed; see California Revenue and Taxation Code Section 17745(b)."

FTB Form 5870A, entitled, "Tax on Accumulation Distribution of Trusts," is used by a beneficiary to report and pay the tax on an accumulation distribution and is to be attached to the beneficiary's California individual income tax return.[58] If the federal throwback rules apply, Part I of Form 5870A allows a beneficiary to exclude income accumulated before the beneficiary "[was] born or reached age 21." However, as discussed above, the federal throwback rules are generally inapplicable to domestic trusts.

B. California Tax Withholding

California imposes backup withholding (generally at the rate of 7 percent) on distributions of income to non-resident beneficiaries where the payment consists of California source income.[59] Withholding is not required on distributions to non-resident beneficiaries of California source income totaling $1,500 or less in a calendar year.[60] The applicable California forms for withholding are:

592 Resident and Nonresident Withholding Statement;[61]

592-B Resident and Nonresident Withholding Tax Statement;[62] and

592-V Payment Voucher for Resident and Nonresident Withholding.[63]

California also imposes a three and one-third percent withholding tax on the gross proceeds from the sale of California real property (including installment sales), or the seller may elect to have the tax computed on the gain (at the highest applicable rates) withheld. If there is no gain on the sale, the seller may avoid the withholding requirement by electing the optional gain on sale method of withholding. The applicable California forms are:

593 Real Estate Withholding Tax Statement;[64]

593-C Real Estate Withholding Certificate;[65]

593-E Real Estate Withholding - Computation of Estimated Gain or Loss;[66] and

593-V Payment Voucher for Real Estate Withholding.[67]

C. Other State Tax Credit

California has complex rules regarding credits for taxes paid to other states that vary depending on whether the taxpayer is a resident, non-resident, individual, or a trust or estate.[68] California allows a credit for taxes paid to another state by an estate or trust where the estate or trust is considered to be a resident of both states.[69] California will also allow its resident beneficiaries of trusts or estates to claim a credit for income taxes paid by the trust or estate to another state.[70] In general, no credit is allowed if the other state allows California residents a credit for income taxes paid to California.[71] Non-residents of California may claim a credit only for net income taxes paid to California.[72] California Schedule S is used to claim this credit.

D. Voluntary Disclosure

California provides an Application for Voluntary Disclosure on FTB Form 4925.[73] As stated in its instructions:

> The purpose of the FTB's Voluntary Disclosure Program is to encourage qualified entities, qualified shareholders, qualified members, or qualified beneficiaries that have an unfulfilled California franchise/income tax return filing requirement and/or unpaid tax and/or fee liability to voluntarily come forward. In exchange, FTB is authorized by statute to limit the imposition of tax and/or fee liability to a six-year period immediately preceding the signing date of a voluntary disclosure agreement, and the discretion to waive penalties listed below under "Penalties Waived."

The requirements for participation in the Voluntary Disclosure Program are stringent and, therefore, of limited usefulness. In most situations, the applicant must have never previously filed a return with the Franchise Tax Board. If the entity is a trust, it must have never performed administration activities in California and had no resident beneficiaries (other than a beneficiary whose interest in that trust is contingent). A non-resident beneficiary must not have been a resident for six taxable years ending immediately preceding the date the Voluntary Disclosure Agreement is signed. In all cases, the applicant must not have been previously contacted by the Franchise Tax Board.

E. Additional Assistance from the FTB Legal Division

The Legal Division of the Franchise Tax Board is divided into five bureaus. The General Tax Law Bureau is responsible for taxation issues pertaining to trusts, and may be contacted by taxpayers or their representatives for assistance.

*Shartsis Friese LLP, San Francisco, California
**Clement, Fitzpatrick & Kenworthy, Inc., Santa Rosa, California
***Palo Alto, California

1 The authors acknowledge the valuable input to this article by Eric J. Coffill, Esq., of Morrison & Foerster LLP, Sacramento, California, and Danielle T. Zaragoza, of Shartsis Friese LLP, San Francisco, California.

2 Consistent with federal law, the assets of both revocable trusts and other so-called "grantor trusts" are treated as owned by the settlor for California income tax purposes. See discussion at Part II.C., *post*.

3 An estate or trust is considered a resident of the state which taxes its income irrespective of whether the income is derived from sources in that state. (Rev. & Tax. Code, section 18001.) Section 18004 allows a credit for California purposes for the "net income taxes" paid by an estate or trust to another state, provided the estate or trust is considered a resident of both states. The credit is limited in section 18004, subdivisions (a) and (b), to the proportion of taxes paid to the other state on the income taxable by both states to total income and to the proportion of California taxes. Section 18005 allows California resident beneficiaries a credit for taxes paid by the estate or trust to another state subject to limitations similar to those included in section 18004.

4 See IRC section 665(c). The federal throwback rules remain applicable to distributions of accumulated income to a U.S. beneficiary from a foreign trust and from a domestic trust that was formerly a foreign trust, and also to certain grandfathered trusts subject to the multiple trust rule under IRC section 643(f). (See IRC § 667(c)-(d).)

5 See Rev. & Tax. Code, sections 17731-17779, 18003-18005.

6 See Rev. & Tax. Code, section 18004.

7 Rev. & Tax. Code, section 17734.

8 Rev. & Tax. Code, section 17751, subd. (b).

9 California source income is always taxable by California. Rev. & Tax. Code, section 17951.

10 Rev. & Tax. Code, section 17731.

11 This overview of the law is drawn with permission from Johnson, Sonja K., LexisNexis (*California Income Taxation of Trusts: Pitfalls and Considerations for Settlors, Beneficiaries and Trustees*, LexisNexis (Aug. 3, 2010), <http://www.lexisnexis.com/legalnewsroom/tax-law/b/practitioners-corner/archive/2010/08/03/california-income-taxation-of-trusts-pitfalls-and-considerations-for-settlors-beneficiaries-and-trustees.aspx> (retrieved Sept. 17, 2015).

12 See Gutierrez, Jr., Max and Keydel, Fredprick R., *Study 6: State Taxation on Income of Trusts with Multi-State Contacts*, California section authored by Richard S. Kinyon, ACTEC Studies, Sept. 2001, at 6-1, 6-14.

13 See note 11, *ante*; Rev. & Tax. Code, sections 17742-17743, 17745 (referring to "fiduciary" rather than "trustee"). Therefore, any person acting in a fiduciary capacity with respect to a trust may be treated as a trustee for purposes of apportioning accumulated income to California.

14 See note 11, *ante*; Rev. & Tax. Code, section 17734.

15 While practitioners sometimes use the term "vested" to describe non-contingent interests subject to California income tax, the taxation of that income is not dependent upon whether the income is vested in the common-law sense of that word. Rather, taxation occurs when the beneficiary's right to receive the income is not subject to a contingency other than the passage of time. Rev. & Tax. Code, sections 17742-17744.

16 Rev. & Tax. Code, sections 17743-17744.

17 FTB Legal Ruling No. 238, Tr: Accumulated Income; Taxation When There Are Both Resident and Nonresident Trustees and Beneficiaries (Oct. 27, 1959), <https://www.ftb.ca.gov/law/rulings/active/lr238.shtml> (retrieved Sept. 17, 2015). These principles of taxation are included in the California Fiduciary Income Tax Return (Form 541) at Schedule G on side 3. *See* FTB, Form 541 Sched. G, California Fiduciary Income Tax Return (2012), <https://www.ftb.ca.gov/forms/2012/12_541bk.pdf> (retrieved Sept. 17, 2015).

18 See Rev. & Tax. Code, section 17071.

19 Rev. & Tax. Code, section 17745, subd. (a).

20 Rev. & Tax. Code, section 17745, subd. (b).

21 FTB Attachment to Legal Notice 98-12, <https://www.ftb.ca.gov/law/notices/1998/98_12att.shtml> (retrieved Sept. 17, 2015).

22 FTB Notice 98-12, Draft Legislation Symposium—Taxation of Trusts Resulting From The Trend Toward Nationwide Trust Administration, (Aug. 12, 1998), <http://www.ftb.ca.gov/law/notices/1998/n98_12.pdf> (retrieved Sept. 17, 2015).

23 FTB, Attachment to Legal Notice 98-12 (last visited Oct. 10, 2010), <https://www.ftb.ca.gov/law/notices/1998/98_12att.shtml> (retrieved Sept. 17, 2015).

24 See *Yolanda King Family Trust*, 2007 Cal. Tax LEXIS 406, at p. 242 (St. Bd. of Equalization Oct. 4, 2007).

25 See section I.D.3., *post* (determination of an individual beneficiary's residence, which in some cases is more straightforward than determining a corporation's residence, nonetheless involves some unusual factors).

26 *McCulloch v. Franchise Tax Bd.* (1964) 61 Cal.2d 186.

27 FTB Notice 98-12, note 22, *ante* ("[T]here is a continuing problem in determining whether an individual beneficiary is to be considered contingent or noncontingent (vested)").

28 *Urquhart v. Commissioner* (9th Cir. 1942) 125 F.2d 701.

29 *Id.* at p. 704.

30 1970 WL 2442, at p. 1 (Cal. St. Bd. Eq. Feb. 18, 1970).

31 *Id.* at pp. 3-4.

32 See section III.A., *ante*.

33 Rev. & Tax. Code, section 17745, subd. (a).

34 Rev. & Tax. Code, section 17745, subd. (b).

35 "California taxes the trust upon that portion of the annual income which the trust holds for eventual distribution to the California resident beneficiary. If the trustee fails to pay the tax for the trust annually as it earns the income, the California resident beneficiary becomes liable for such tax [when] the previously earned income distributed to him." *McCulloch v. Franchise Tax Bd.*, *supra*, 61 Cal.2d at p. 192. "The purpose of . . . imposing upon the beneficiary at the time of the trust distribution his personal obligation to pay taxes due, but unpaid, by the trust is to avoid the difficulties in attempting to enforce tax collection directly against foreign trustees . . . . The transferee tax thus levied assures this state that resident beneficiaries of the trusts administered elsewhere obtain no special advantage over California taxpayers." *Id.* at p. 197.

36 Notably, the *McCulloch* court referred to the "transferee tax" (see the previous endnote); however, in rendering its decision, the court cited the predecessor to current section 17745, subdivision (a), which, as pointed out above, taxes the income directly to the beneficiary and not as a transferee.

37 Rev. & Tax. Code, section 17745, subd. (b).

38 Rev. & Tax. Code, section 17731 (effective July 28, 1983).

39 See endnotes 35-36 and accompanying text.

40 *McCulloch v. Franchise Tax Bd., supra*, 61 Cal.2d at p. 196 (emphasis added). Although the *McCulloch* court allowed taxation of the beneficiary for all years in which income had been earned by the trust, this was specifically permissible because the beneficiary had resided in California for this entire period. *Id.* at pp. 189-190.

41 FTB, Legal Ruling No. 375, Tax Credit for Accumulated Distributions Made by a Nonresident Trust to Resident Beneficiaries (June 11, 1974), <https://www.ftb.ca.gov/law/rulings/active/lr375.shtml> (retrieved Sept. 17, 2015) (holding that the taxpayer should be allowed a credit against California income taxes for taxes paid to Minnesota while residing in California).

42 IRC section 665(b).

43 IRC section 665(b).

44 FTB, Form 541 Sched. J, Trust Allocation of An Accumulation Distribution (2011), <https://www.ftb.ca.gov/forms/2011/11_541bk.pdf> (retrieved Sept. 17, 2015).

45 FTB, Form 5870A, Tax On Accumulation Distribution of Trusts (2012), <https://www.ftb.ca.gov/forms/2011/11_5870a.pdf> (retrieved Sept. 17, 2015).

46 FTB, Form 5870A, at Part II (Tax on Distributions of Previously Untaxed Trust Income Under Revenue and Taxation Code Section 17745 (b) and (d)).

47 Rev. & Tax. Code, section 17745, subd. (e).

48 See Appendix A.

49 Department of the Treasury, OMB No. 1545-0092, Form 1041 Sched. K-1, U.S. Income Tax Return for Estates and Trusts (2012), <http://www.irs.gov/pub/irs-pdf/f1041.pdf> (retrieved Sept. 17, 2015).

50 This characterization follows the traditional notion of a vested (non-contingent) interest. However, it is worth noting that the FTB has in certain recent instances attempted to characterize a beneficiary's interest as non-contingent—even though distributions to the beneficiary were completely discretionary—when a trustee made such regular and substantial distributions that the beneficiary was characterized as having the power in fact to access trust property as if the beneficiary had a right to it. Such cases are currently being contested and it remains to be seen both where such a line might be drawn and whether the Franchise Tax Board will be successful in applying this approach.

51 As discussed in Part III.D.2., in this article, *ante*, the absence of regulations under section 17745, subdivision (b), creates uncertainty as to how an accumulation distribution under this section should be calculated. If the federal throwback rules were used for this purpose, the beneficiary would be allowed to exclude any income accumulated before he or she reached age 21. See IRC section 665(b). However, the Franchise Tax Board could challenge this approach.

52 See Part III.D.3., *ante*.

53 Note, however, that care must be taken in assessing the beneficiary's state of residence given California's strict residency rules described above and in Appendix A.

54 See note 12, *ante*, and accompanying text.

55 Rev. & Tax. Code, section 17745, subd. (d).

56 FTB Form 541, California Fiduciary Income Tax Return (2014), <https://www.ftb.ca.gov/forms/2014/14_541.pdf> (retrieved Sept. 17, 2015).

57 Department of the Treasury, Form 1041, U.S. Income Tax Return for Estates and Trusts (2014), <http://www.irs.gov/pub/irs-pdf/f1041.pdf> (retrieved Sept. 17, 2015).

58 FTB, Form 5870A, Tax On Accumulation Distribution of Trusts (2012), <https://www.ftb.ca.gov/forms/2011/11_5870a.pdf> (retrieved Sept. 17, 2015).

59 Rev. & Tax. Code, sections 18662, 18664; California Code of Regulations, Title 18, sections 18662-1 through -3 (2009).

60 California Code of Regulations, Title 18, section 18662-2.

61 FTB, Form 592, Resident and Nonresident Withholding Statement (2015), <https://www.ftb.ca.gov/forms/2015/15_592.pdf> (retrieved Sept. 17, 2015).

62 FTB, Form 592-B, Resident and Nonresident Withholding Tax Statement (2013), <https://www.ftb.ca.gov/forms/2015/15_592b.pdf> (retrieved Sept. 17, 2015).

63 FTB, Form 592-V, Payment Voucher for Resident and Nonresident Withholding (2015), <https://www.ftb.ca.gov/forms/2013/13_592v.pdf> (retrieved Sept. 17, 2015).

64 FTB, Form 593, Real Estate Withholding Tax Statement (2015), <https://www.ftb.ca.gov/forms/2015/15_593.pdf> (retrieved Sept. 17, 2015).

65 FTB, Form 593-C, Real Estate Withholding Certificate (2015), <https://www.ftb.ca.gov/forms/2015/15_593c.pdf> (retrieved Sept. 17, 2015).

66 FTB, Form 593-E, Real Estate Withholding Computation of Estimated Gain or Loss (2015), <https://www.ftb.ca.gov/forms/2015/15_593e.pdf> (retrieved Sept. 17, 2015).

67 FTB, Form 593-V, Payment Voucher for Real Estate Withholding (2013), <https://www.ftb.ca.gov/forms/2015/15_593v.pdf> (retrieved Sept. 17, 2015).

68 See Rev. & Tax. Code, section 18001.

69 Rev. & Tax. Code, section 18004.

70 See Rev. & Tax. Code, section 18005. The credit California resident beneficiaries of trusts or estates can receive for income taxes paid by the trust or estate to another state is subject to conditions as outlined in section 18005, subdivisions (a) and (b).

71 Rev. & Tax. Code, section 18001, subd. (a)(2).

72 Rev. & Tax. Code, section 18002, subd. (a).

73 FTB 4925-C2, Application for Voluntary Disclosure, <https://www.ftb.ca.gov/forms/misc/4925.pdf> (retrieved Sept. 17, 2015); see also Rev. & Tax. Code, section 19191, subd. (a) (authorizing the Franchise Tax Board to enter into voluntary disclosure agreements).

APPENDIX A

CALIFORNIA RESIDENCY DETERMINATIONS

Individual California tax residency cases are intensely factual in nature. Indeed, because the Franchise Tax Board views residency as a question of fact, not law, the Franchise Tax Board will not issue written advice on whether an individual is a resident for a particular period of time.[i] The legal analysis begins with the statute. California Code of Regulations section 17014(a) defines "resident" to include:

1. Every individual who is in this state for other than a temporary or transitory purpose; [or]
2. Every individual who is domiciled in this state who is outside the state for a temporary or transitory purpose.[ii]

Any individual who is not a resident is, by statutory definition, a non-resident.[iii] Presence within California for more than nine months of a taxable year creates a rebuttable presumption of California residence.[iv] However, presence within California for less than nine months does not create a presumption of non-residency.[v]

"Domicile" is a part of the definition of resident, but the concepts are not synonymous. Domicile has been defined by the courts as the "one location with which for legal purposes a person is considered to have the most settled and permanent connection, the place where he intends to remain and to which, whenever he is absent, he has the intention of returning ...."[vi] Similarly, the Franchise Tax Board regulations provide as follows:

> Domicile has been defined as the place where an individual has his true, fixed, permanent home and principal establishment, and to which place he has, whenever he is absent, the intention of returning . . . . Another definition of "domicile" consistent with the above is the place where an individual has fixed his habitation and has a permanent residence without any present intention of permanently removing therefrom.[vii]

Accordingly, domicile denotes the one location with which a person has the most settled and permanent connections and where the person intends to remain, while residence denotes any factual place of abode of some permanency; that is, "more than a mere temporary sojourn."[viii] A taxpayer may have several residences simultaneously for different purposes, as well as more than one residence for tax purposes. However, a taxpayer may have only one domicile at any given time.[ix] A domicile cannot be lost until a new one is acquired.[x] Once acquired, a domicile is presumed to continue until it is shown to have changed.[xi]

In order to change domicile, the California State Board of Equalization (which acts as a quasi-tax court in California for Franchise Tax Board matters) has required a showing that a taxpayer "(1) left the state without any intention of returning and (2) was located elsewhere with the intention of remaining there indefinitely."[xii] In determining the taxpayer's intent, the "acts and declarations of the party must be taken into consideration."[xiii]

The California courts recently confirmed the importance of the physical acts of the taxpayer, holding: "[t]o the extent residence and domicile depend upon intent, 'that intention is to be gathered from one's acts'."[xiv] The Court of Appeal has found that when "a person *actually removes to another place* with an intention of remaining there for an indefinite time and as a place of present domicile, it becomes his place of residence or domicile."[xv] With specific regard to domicile, the Court stated that "our courts have held that two elements are indispensable to accomplishing a change of domicile: *actual* residence in the new locality plus the intent to remain there."[xvi]

In most situations (and in most Franchise Tax Board audits), the same physical location is a person's domicile and residence. However, when domicile is an issue in a California tax residency case, domicile is always decided first. For California domiciliaries, the focus is upon whether the taxpayer is absent from California for a temporary or transitory purpose. If so, the taxpayer is a California resident. For non-California domiciliaries, the focus is upon whether he or she is in California for other than a temporary or transitory purpose. What constitutes a "temporary or transitory purpose" under California tax law is the same in either instance.[xvii]

Neither the California statutes, the Franchise Tax Board regulations, nor the decisional law provides an all-inclusive list of factors that are used to determine California residency status. No set of factors is conclusive. However, some of the factors commonly considered by the FTB in residency audits are the following: (1) the amount of time spent in California compared to the amount of time spent outside California; (2) the location of spouse, children, and relatives; (3) the location of all residences and of principal residence (and any homeowners property tax exemption taken); (4) where a driver's license is issued; (5) where vehicles (and watercraft and aircraft) are registered; (6) where the individual is registered to vote and his or her voting history; (7) the location of banks where accounts are maintained; (8) where financial transactions take place; (9) the location of professionals used, e.g., doctors, dentists, brokers, accountants, attorneys, veterinarians; (10) the location of church, temple, or mosque attended; (11) social ties and the location of social clubs, country clubs, and gyms of which the taxpayer is a member; (12) the location of real property (owned and rented by the taxpayer or related entities) and other investments; (13) the location of business interests; and (14) the location of tangible articles of a personal nature and any safe deposit box. A typical written determination in a Franchise Tax Board residency audit will organize these factors and other information into the categories of Tax Filing History (for California, federal and other states, for the years in issue and immediately preceding and subsequent years); Biographical History and Personal Profile; Real Property Interests; Personal Property Interests; Business Profile; and Financial Profile.[xviii]

As a general principle, a Franchise Tax Board audit determination is presumed correct and the taxpayer has the burden of proving it wrong.[xix] Unsupported assertions are not sufficient to satisfy the taxpayer's burden of proof.[xx] In the absence of "uncontradicted, credible, competent and relevant evidence" showing error in the Franchise Tax Board's determinations, they must be upheld.[xxi] The method by which one challenges an adverse audit finding is by filing a "protest" with the Franchise Tax Board within sixty days after the mailing by the Franchise Tax Board to the taxpayer of a notice of proposed deficiency assessment.[xxii]

i See FTB Publication 1031, Guidelines for Determining Resident Status, at 1 (2014), <https://www.ftb.ca.gov/forms/2014/14_1031.pdf> (retrieved Sept. 17, 2015).

ii See California Code of Regulations, Title 18, section 17014 (2015) (defines the term "resident" in same way as Rev. & Tax. Code, section 17014).

iii Rev. & Tax. Code, section 17015; California Code of Regulations, Title 18, section 17014.

iv Rev. & Tax. Code, section 17016; California Code of Regulations, Title 18, section 17016.

v *Christianson*, 1972 Cal. Tax LEXIS 24, at p. 9 (St. Bd. of Equalization Aug. 17, 1983).

vi *Whittell v. Franchise Tax Bd.* (1964) 231 Cal.App.2d 278, 284.

vii California Code of Regulations, Title 18, section 17014(c).

viii *Whittell*, *supra*, 231 Cal.App.2d at p. 284 (citing *Smith v. Smith* (1955) 45 Cal.2d 235, 239–240).

ix *Ibid.*

x See *Murphy v. Travelers Ins. Co.* (1949) 92 Cal.App.2d 582, 587; *Griffin v. Griffin* (1953) 122 Cal.App.2d 92, 98.

xi California Code of Regulations, Title 18, section 17014(c) (2013); *Murphy v. Travelers Ins. Co.*, *supra*, 92 Cal.App.2d at p. 588.

xii *Harrison*, 1985 Cal. Tax LEXIS 106, at p. 4 (St. Bd. Equalization, June 25, 1985); See also *In re Peter's Estate* (1932) 124 Cal.App. 75, 77.

xiii *Morgan*, 1985 Cal. Tax LEXIS 88, at p. 5 (St. Bd. Equalization, July 30, 1985), quoting *In re Phillips' Estate* (1969) 269 Cal.App.2d 656, 659; see also *Harrison*, *supra*, 1985 Cal. Tax LEXIS 106, at p. 5 (stating that "[i]t is the 'intent' of the person that determines domicile"); See also *Chapman v. Superior Court* (1958) 162 Cal. App.2d 421, 427.

xiv *Noble v. Franchise Tax Bd.* (2004) 118 Cal.App.4th 560, 567, quoting *Chapman*, *supra*, 162 Cal.App.2d at p. 426.

xv *Id.* at p. 568, quoting *In re Wood's Estate* (1898) 120 Cal. 634, 639 (italics in original, internal quotation marks omitted).

xvi *Ibid.*, quoting *DeMiglio v. Mashore* (1992) 4 Cal.App.4th 1260, 1268 (italics in original, internal quotation marks omitted).

xvii See California Code of Regulations, Title 18, section 17014 (2013).

xviii See FTB Publication 1031, *supra*.

xix See, e.g., *Myers*, No. 41792, 2001-SBE-001 at p. 5, (Cal. St. Bd. of Equalization May 31, 2001), <http://www.boe.ca.gov/legal/pdf/myers.pdf> (retrieved Sept. 17, 2015).

xx See, e.g., *Magidow*, 1982 Cal. Tax. LEXIS 44, at pp. 9–10 (St. Bd. of Equalization, Nov. 17, 1982).

xxi *Seltzer*, 1980 Cal. Tax LEXIS 27, at p. 7 (St. Bd. of Equalization, Nov. 18, 1980).

xxii Rev. & Tax. Code, section 19041, subd. (a); See generally Rev. & Tax. Code, section 19042.