SUMMARY OF CALIFORNIA FIDUCIARY INCOME TAX LAW

A. Current California Income Taxation of Estates and Non-Grantor Trusts and Their Beneficiaries

1. Scope of Presentation – California income taxation of non-grantor trusts and beneficiaries of non-grantor trusts receiving distributions of accumulated trust income (including net capital gains) that was not taxed by California currently. Our focus is on the California "throwback tax," but I'll first summarize the current California income taxation of trust income.

2. California generally follows the federal law with regard to the income taxation of estates and trusts, their grantors and their beneficiaries.

    a. An estate or trust's current net income is generally taxed to the estate or trust. However, if all or part of its Distributable Net Income (DNI), which may or may not include net capital gains, is currently paid to (or for the benefit of) one or more beneficiary, this income is deductible by the estate or trust and taxable to the beneficiaries.

    b. The U.S. can tax all of that income if the estate or trust and all of its beneficiaries receiving DNI are U.S. residents for income tax purposes. If the estate or trust is not a U.S. resident for income tax purposes, its undistributed net income, including net capital gain, generally can't be taxed currently by the U.S., but if a trust's accumulated undistributed net income is later distributed to a U.S. resident beneficiary, it is subject to tax under the federal throwback rules.

3. California's current taxation of an estate or non-grantor trust's undistributed net income depends on the source of the income, the place of administration of the estate and the residence of the trust's fiduciaries and beneficiaries, and whether a beneficiary of a trust has a contingent or non-contingent (i.e., vested) interest in that undistributed net income. The residence of the settlor and law governing the administration of a trust is irrelevant.

    a. California taxes all of a trust's California source income, e.g., rental from California situs real estate.

    b. Any remaining undistributed net income of a trust is first taxable by California to the trust in proportion to the number of the trust's fiduciaries who are California residents. (R&TC Sections 17742 & 17743)

        – A trust fiduciary generally is a person who owes a duty directly to the beneficiaries and can be sued by them for a breach of that duty, and typically includes trustees and other persons with fiduciary roles with respect to a trust.

c. Any remaining undistributed net income of a trust is taxable by California to the trust in proportion to the number of the trust's beneficiaries who have a vested interest in that income. (R&TC Sections 17742 & 17744)

– A vested interest for this purpose generally is one that can only benefit a particular beneficiary during his or her lifetime, and /any remaining portion of that interest will be subject to his or her general power of appointment.

– Examples of vested beneficial interests are:

- interests in administrative trusts (i.e., revocable trusts following the death of the settlor),

- interests in terminating trusts (e.g., following the death of the life beneficiary),

- the interest in an IRC § 2503(c) minor's trust and an IRC § 2641(c) GST tax direct-skip trust, and

- the interest in an IRC § 2056(b)(5) or 2523(e) power-of-appointment marital deduction trust.

d. Any remaining undistributed net income, less federal and other state income taxes, if any, attributable thereto, is accumulated and subject to the California throwback tax.

e. California's income tax brackets applicable to an estate or trust, unlike an estate or trust's federal income tax brackets, are not compressed and are the same as for an individual California resident.

4. Determination of Residency of Fiduciaries:

a. The residence of an individual fiduciary of a trust is the same as for an individual taxpayer. (*See* R&TC Section 17014)

b. The residence of a corporate fiduciary of a trust is the place where the corporation transacts the major portion of its administration of the trust. (R&TC Section 17742(b))

5. Alternative Tax payable by a vested beneficiary receiving previously accumulated undistributed net income with respect to which the trust failed to pay the tax imposed by R&TC Sections 17742-17744. (R&TC Section 17745(a) & (c)).

B. California Income Taxation of Distributions of Accumulated Undistributed Net Income – the "Throwback Tax" (R&TC Section 17745(b)-(d)).

1. If no California income taxes have been paid on the current or accumulated income of the trust because the California resident beneficiary's interest in the trust was contingent, that income is taxable to the beneficiary when distributed or distributable to him or her. (R&TC Section 17745(b))

2. The throwback tax on the accumulated undistributed net income is imposed on the (actual or constructive) receipt of that income by a California resident beneficiary who was a California resident beneficiary whose interest in that income was contingent when it was accumulated. (R&TC Section 17745(c))

3. The tax attributable to the inclusion of that accumulated net income in the gross income of the beneficiary from the year that income is distributed or distributable to the beneficiary is the aggregate of the taxes which would have been attributable to that income had it been included in the gross income of the beneficiary ratably for the year of distribution and the five preceding taxable years, or for the period that the trust accumulated the income for that contingent beneficiary, which is shorter. (R&TC Section 17745(d))

4. In the event that a California resident beneficiary during the period of accumulation leaves California within 12 months prior to the date of the distribution of the income and returns to California within 12 months after that date, it is presumed that the beneficiary continued to be a California resident throughout the time of distribution. (R&TC Section 17745(e))