

THE  
NATIONAL LAW REVIEW

---

## A Movable Feast - State Taxation of CRT Distributions for Beneficiaries Who Move from California to Another State

---

Friday, March 29, 2019

MSK private clients sometimes move from California, the state with the highest maximum individual income tax rate in the US – 13.3%! — to states like Nevada and Wyoming that have no income tax at all. Some of these clients are income beneficiaries of large charitable remainder trusts. How are distributions from those CRTs taxed once the income beneficiaries are no longer California residents?

First things first: remember how CRT distributions are characterized for tax purposes. Under Internal Revenue Code §664, distributions are treated as coming first, from the current and accumulated ordinary income of the trust (Tier One); second, from capital gains (Tier Two); third, from tax-exempt interest (Tier Three); and fourth, from corpus (Tier Four). Within each tier, distributions are treated as coming first from income taxed at a higher rate – for example, gain from the sale of collectibles, taxable at 28% before gain from the sale of stock, taxable at 20%. This requires careful record keeping by the trustee, to track the various types of trust receipts in the various sub-tiers, especially for NIMCRUTs that may make no distributions for several years.

Now we need to add a new task for trustees that track the types of income earned by a CRT with California beneficiaries in order to accurately characterize distributions to its beneficiaries if and when those beneficiaries move to another state, namely, what is the *source* of income earned by a CRT under California tax law. The reason is that if a resident of another state receives a trust distribution of California source income, that income remains taxable in California, while distributions of non-California source income are free from California income tax, even if the transaction by the trust that gave rise to the income took place while the beneficiary was a California resident.

The California Franchise Tax Board has a very helpful internal procedures manual, available online at [www.ftb.ca.gov](http://www.ftb.ca.gov), the Residency & Sourcing Technical Manual, to help determine if an individual is a resident or nonresident of California, and whether income earned by individuals is from California sources. The Manual cites California Revenue & Taxation Code §17953, which provides that trust income distributed to a nonresident beneficiary is income from California sources only if distributed from income of the trust derived from California sources. Under the source rules, gain from the sale of California real estate is sourced in California, while gains from the sale of stock is not from California sources.

*Illustration 1:* Bob is planning to move from California to Wyoming to retire. In preparation for his move, in Year One he funds a NIMCRUT with highly appreciated California real estate. The property is sold by the NIMCRUT, and Bob moves to Wyoming at the end of Year One. No distributions are made by the NIMCRUT in Year One or Year Two. In Year Three, after Bob is clearly nonresident in California, the NIMCRUT makes a distribution to him under the terms of the trust, which the trustee attributes to the gain from the sale of the California real estate under the tier system described above. This distribution retains its character as California source, and is subject to California tax. Bob is frustrated: he loves the wide open spaces of Wyoming, but was hoping he was done paying California taxes.



Article By  
[David Wheeler Newman](#)  
[Mitchell Silberberg & Knupp LLPMSK Blog](#)

[Estates & Trusts](#)  
[Tax](#)  
[California](#)

*Illustration 2:* Jane has been an angel investor for years, helping California start-up companies. She hits a real home run, when one of the companies goes public. To diversify her portfolio, she transfers her shares in the newly-public company to a NIMCRUT, which promptly sells the shares and reinvests the proceeds in a diversified portfolio. Jane packs her bags and moves to Nevada. Three years later, Jane receives her first distribution from the NIMCRUT, attributable to gain from the sale of the shares. Since gain from the sale of stock is not treated as California source, the distribution is not subject to California tax. Jane is delighted.

How do these state tax rules affect CRT planning? First, trustees will want to take these source rules into account when investing trust assets to determine whether a particular asset could result in tax to nonresidents of California. Second, if a client is thinking about moving out of state sometime after funding a CRT, thought should be given to which assets are used to fund the trust: if Bob and Jane are married, perhaps we fund two NIMCRUTs rather than one, to make sure that distributions from Jane's CRT remain free of California tax. Finally, the trustee will need to have a system to keep track of California source income of the trust under the tier system summarized above.

© 2019 Mitchell Silberberg & Knupp LLP

**Source URL:** <https://www.natlawreview.com/article/movable-feast-state-taxation-crt-distributions-beneficiaries-who-move-california-to>