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Trusts May Unknowingly Owe Income Taxation in California: California's Unique Rules for the Income Taxation of Trusts

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It's no secret that the State of California is suffering its own budgetary crises and is in desperate need of cash for the state. The **California Franchise Tax Board (FTB**) is aggressively pursuing **income tax on large trusts** that may unknowingly owe tax to the state because California's rules for taxing trusts are complex and unique. Penalties for failing to report income tax to California are severe and failure to file tax returns in California keeps the statute of limitations open for audit. This *GT Alert* provides a brief overview for trusts that may have a California filing obligation.

Unlike many other state income taxation rules, the grantor's residence is of no consequence in determining whether a trust must file an income tax return annually in California. A trust will be subject to taxation by the State of California if a fiduciary or non-contingent beneficiary is a resident of California, regardless of the settlor's place of residence. This comes as a surprise to many estate planners who are unaware that the incidence of California state taxation can depend on the residence of the fiduciary. To avoid unexpected California tax liability or the imposition of significant penalties, estate planners should be mindful of the California rules when selecting fiduciaries or considering the impact of future distributions.

When is a Trust Subject to Taxation in California?

Under California law,[1] a trust's income is taxable to the trust. A trust will be subject to taxation in California if: (i) the fiduciary is a resident of California; or (ii) a beneficiary whose interest in such trust is non-contingent is a resident of California. (In addition, if *accumulated* income is distributed to a contingent resident beneficiary, it is also subject to California's throw-back rule which prorates income over the period of accumulation (with a six year limit.))

The rule applies regardless of the residence of the trust's settlor. Under California's Code, an individual is deemed to be a resident of California for tax purposes where: (i) she is in the state for other than temporary or transitory purposes; or (ii) she is domiciled in the state but is outside of the state for temporary or transitory purposes. The residence of a corporate fiduciary is determined according to where the corporation performs the majority of its administrative functions with respect to a trust.

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, is taxable by California. Where a trust has multiple fiduciaries, the income taxable to California is apportioned according to the number of fiduciaries who are California residents. For example, if a trust has two fiduciaries and one fiduciary is a California resident, California will tax one-half of the trust income.

The incidence of taxation for trusts may also depend on the residence of the beneficiaries. A non-contingent beneficiary is one whose interest in the trust is not subject to a condition precedent, such as survivorship beyond a life in being or attaining the age of majority. A resident beneficiary whose interest in a trust is subject to the sole and absolute discretion of the trustee is deemed to have a contingent interest in the trust. A contingent resident beneficiary is treated as having a non-contingent vested 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 distributable income. This means that a distribution to a California resident beneficiary can trigger a filing requirement in California for a trust that would otherwise be treated as a non-California trust.

The rules regarding contingent vs. non-contingent interests are complex and, therefore, the trust instrument should be examined carefully to determine whether there is a non-contingent California resident beneficiary when the trust is drafted. According to the law in California, where a trust has multiple beneficiaries, the income is apportioned according to the number and respective interests of beneficiaries that are California residents. Special ordering rules apply where a trust has multiple fiduciaries and multiple beneficiaries, some of which are California residents. Consequently, it would make sense to draft the terms of a trust instrument to avoid California income tax and planners should carefully navigate California's rules to avoid negative tax implications.

When is a California Trust Obligated to File a Return and What Are the Consequences for Failing to File and Pay the California

Tax Liability?

A California trust is required to file an income tax return in California if the trust: (i) has net income from all sources in excess of $100; or (ii) has gross income from all sources in excess of $10,000, regardless of the amount of net income.[2] The failure to file a California tax return can result in the imposition of significant penalties, including, but not limited to, the failure to file and failure to pay penalties. The FTB charges interest from the due date of the return until the time the tax is paid. If a trust fails to file a tax return in a particular year, the statute of limitations for assessment will remain open indefinitely until a return is filed and severe penalties will likely be asserted by the FTB.

Potential Remedies for Non-Compliance

The FTB is aware that there is a significant amount of non-compliance in the income taxation of trusts. The FTB Trust & Estate Audit Team was expanded in recent years and it is actively trying to identify delinquent trust taxpayers. Among other tools, the FTB is using new databases to identify California resident fiduciaries and beneficiaries. People serving as fiduciaries should consult their tax advisor if there is any question as to whether a trust is subject to income taxation in California.

California has established a mechanism for delinquent California trusts to voluntarily come forward and get into compliance, possibly with reduced penalties. The FTB established a voluntary disclosure program to provide relief for trusts that voluntarily come forward regarding their California income tax deficiencies. To be eligible for the voluntary disclosure program, the trust must establish that: (i) the trust has never filed an income tax return with the FTB; (ii) the fiduciaries only performed inconsequential administrative services in California; (iii) the trust did not have any non-contingent California resident beneficiaries within the last six years; (iv) the trust has never been the subject of any inquiry by the FTB regarding franchise or income tax liability; (v) the trust makes the disclosure voluntarily prior to contact by the FTB; and (vi) the trust has never registered with the Secretary of State.

If the trust is accepted into the FTB’s voluntary disclosure program, it will be required to file tax returns for each of the six years preceding the signing date of the written voluntary disclosure agreement and pay any tax, interest or applicable penalties. The primary benefit of entering the voluntary disclosure program is that the FTB has the discretion to waive most penalties for the six-year voluntary disclosure period and it will waive the right to make any assessments for the years preceding the six-year voluntary disclosure period.

In establishing a new trust, it is important for trust fiduciaries and estate planners to carefully consider potential California income tax implications. The FTB is aggressively pursuing delinquent trust taxpayers in order to obtain much needed tax revenue. Fiduciaries of existing trusts who believe that a trust may not be in compliance with California tax laws should consult their tax advisors to evaluate the possibility of making a voluntary disclosure.

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[1]Cal. Rev. & Tax. Code § 17742(a).

[2]Cal. Rev. & Tax. Code § 18505.