

## Income taxation of trusts in California

A recent court case rejects the California Franchise Tax Board's long-standing approach to taxing trusts.

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For years, the California Franchise Tax Board (FTB) has taken the position that trusts are subject to California state income tax on all of their California-source income, and that non-California-source income is apportioned pro rata according to the number of California fiduciaries and noncontingent beneficiaries (see Cal. Code Regs. tit. 18, §17743).

Recently, in a closely watched case, the California Superior Court in San Francisco rejected the FTB's approach to the taxation of trusts and determined that all income, including California-source income, is subject to the apportionment formula set forth in California Revenue & Taxation Code Section 17743, *et seq.* (*Paula Trust v. California Franchise Tax Bd.*, No. CGC-16-556126 (Cal. Super. Ct. 3/7/18)). Should this decision be upheld, tax on California-source income could be deferred for years (i.e., until the income is distributed to the beneficiaries).

### ***Paula Trust* case**

*Paula Trust* involves a trust created by Raymond Syufy, founder of Century Theatres and a pioneer in the movie theater industry, for the benefit of his daughter Paula. In 1971, Mr. Syufy transferred a portion of his business interests to the Paula Trust. The trust agreement provided that the trustees had sole and absolute discretion to make distributions of income and principal to the beneficiary.

In 2007, the trust sold a portion of its assets, resulting in approximately \$2.8 million of California-source taxable income. At the time, the trust had two trustees; one was resident of California, the other was a resident of Maryland. Paula Syufy Medeiros, the sole beneficiary, was a resident of California. As the trustees did not make any distributions to Paula that year, Paula was considered to be a contingent beneficiary in 2007. The trust filed a tax return for 2007 and reported and paid tax on the entire \$2.8 million of capital gain from the sale of the business interest.

In 2012, after reviewing the applicable California law, the trustees filed a claim for refund and took the position that only 50% of the income was subject to California income tax under the apportionment formula set forth in Rev. & Tax. Code Section 17743 (i.e., the trustees apportioned the income pro rata based on the number of

resident and nonresident fiduciaries). The FTB denied the claim for refund on the basis that all of the income was California-source income and, therefore, not subject to the apportionment regime (see Cal. Code Regs. tit. 18, §17743). After exhausting its administrative remedies, the trust filed suit in California Superior Court.

While the proceeds from the sale of the interest in Century Theatres was indisputably California-source income, the taxpayer argued that Rev. & Tax. Code Section 17743 *et seq.* provides the exclusive basis for taxing trust income. Specifically, the taxpayer argued that the FTB's regulation was inconsistent with the plain reading of the statute as "[n]owhere in Section 17743 or in any other statute does it say that trust taxable income includes the income from property or business activity sourced in California" (Memorandum of Points and Authorities in Support of Plaintiff's Motion for Summary Judgment or Summary Adjudication, p. 8 (10/5/17)). In response, the FTB argued that Rev. & Tax. Code Section 17951 *et seq.* provides that nonresidents are subject to tax on their California-source income and that, therefore, the California-source income is not apportionable (Memorandum of Points and Authorities in Opposition to Plaintiff's Motion for Summary Judgment or Summary Adjudication, p. 15 (10/5/17)).

### **Superior Court decision**

The court agreed with the taxpayer and determined that the trust properly apportioned its California taxable income (including the California-source income) in accordance with Rev. & Tax. Code Section 17743. The court reasoned as follows:

- The sole beneficiary of the trust, Paula Syufy Medeiros, was a contingent beneficiary in the tax year at issue;
- "As a matter of law, Paula Trust's California taxable income is determined by apportioning its income pursuant to Rev. & Tax. Code § 17743"; and
- "Rev. & Tax. Code § 17041(i) and Rev. & Tax. Code § 17951 *et seq.*, which collectively define taxable income of nonresidents, do not apply to trusts because those statutes apply only to nonresidents" (Order Granting Plaintiff's Motion for Summary Judgment, p. 3 (2/6/18)).

The effect of this decision is that all of the Paula Trust's income, even the California-source income, is subject to the apportionment regime set forth in Rev. & Tax. Code Section 17743. In this case, the Paula Trust will report and pay tax on one-half of the California-source capital gain, and the other half of the California-source capital gain will be deferred until it is distributed to the beneficiary. Note that trust income is taxed to a resident beneficiary when it is distributed, regardless of source (i.e., the "throwback rule" under Rev. & Tax. Code Section 17745(b)), and taxed to a nonresident beneficiary when distributed, provided the income is from a California source. (Cal. Rev. & Tax. Code §17734). The trustees are required to keep track of the character of this income so that it can be properly accounted for upon distribution to the beneficiaries.

### **Looking forward**

Unsurprisingly, the FTB has appealed the decision, so it remains to be seen whether trusts with nonresident fiduciaries or beneficiaries can apportion their California-source income. However, trusts with potentially apportionable California-source income should consult with a competent tax professional and consider filing a protective claim for refund to preserve their rights should the decision be upheld on appeal. Generally, the FTB will delay action on the refund claim until the litigation is resolved.

### **Understanding the apportionment formula**

To understand how you can help a client potentially benefit from the recent decision, it is important to have a working knowledge of California's apportionment regime.

In general, a trust's entire taxable income is subject to tax in California "if the fiduciary or beneficiary (other than a beneficiary whose interest in such trust is contingent) is a resident" of California. (Cal. Rev. & Tax. Code §17742(a)). In other words, if all of the trustees *or* all the noncontingent beneficiaries are California residents, all of the trust's income is subject to tax in California. California Code of Regulations Title 18, Section 17742(b), defines a contingent beneficiary as one whose "interest is subject to a condition precedent," meaning a condition must be satisfied in order for the beneficiary's interest in the trust to vest or become noncontingent. Conversely, a beneficiary whose interest is vested is a noncontingent beneficiary. While there is little authority on the subject, FTB Technical Advice Memorandum 2006-0002 provides that, generally, a beneficiary whose beneficial interest is subject to the trustee's sole and absolute discretion has a contingent interest until the trustee decides to distribute the property.

If a trust has a mix of California resident and nonresident fiduciaries or noncontingent beneficiaries, the trust's income is apportioned using the applicable two-tier apportionment formula. (See FTB Legal Notice 98-12).

First, where "there are two more fiduciaries for the trust, the income taxable under Section 17742 shall be apportioned according to the number of fiduciaries resident in this state" (Cal. Rev. & Tax. Code §17743). Second, "[w]here the income depends on the residence of the beneficiary and there are two or more beneficiaries of the trust, the income taxable under Section 17742 shall be apportioned according to the number and interest of beneficiaries resident in California pursuant to rules and regulations prescribed by the Franchise Tax Board" (Cal. Rev. & Tax. Code §17744).

Thus, under the two-tier approach, a trust's taxable income is first apportioned pro rata according to the number of resident fiduciaries, with the remaining amount apportioned pro rata according to the number of noncontingent beneficiaries. (See California Form 541, *California Fiduciary Income Tax Return*, Schedule G, *California Source Income and Deduction Apportionment*.)

The following example illustrates how the two-tier system operates:

**Example:** *T* sets up an irrevocable trust for the benefit of his two children, *A* and *B*. *A* is a California resident and *B* is a Wisconsin resident; both are noncontingent beneficiaries. *T* picks his personal attorneys to serve as trustees; one is a California resident, and the other is an Oregon resident. The trust has \$100,000 of non-California-source taxable income in 2017.

Under the first tier of California's apportionment formula, one-half of the income (or \$50,000) is allocated to California because one-half of the fiduciaries are residents of California (Cal. Rev. & Tax. Code §17743). Under the second tier, one-half of the remaining \$50,000 (or \$25,000) is allocated to California because one-half of the noncontingent beneficiaries are residents of California. In sum, \$75,000 of the trust's income is allocated to California under the apportionment formula. Note, that the trust will be required to file a California Form 541 and apportion its income on Schedule G accordingly.

**Potential effect of the *Paula Trust* case**

What if all of the income in the example above was California-source income? The FTB's historic position is that all California-source income is allocated to California and is not subject to the apportionment regime. (Cal. Code Regs. tit. 18, §17743). Under the regulations, the entire \$100,000 of the California-source income would be includible in the trust's income in tax year 2017.

However, applying the holding in *Paula Trust* to the example above, the \$100,000 of California-source income would also be subject to the apportionment regime, resulting in income to the trust of \$75,000 (i.e., the exact same answer as if the income was not from a California source). The remaining \$25,000 of California-source income would be subject to tax only upon distribution to a beneficiary (Cal. Rev. & Tax. Code §§17745(b), 17734). Thus, applying the apportionment formula to California-source income results in a deferral of California income tax until the income is distributed to a beneficiary.

### **More to come**

The FTB is understandably concerned that subjecting California-source income to the apportionment formula would provide an incentive for taxpayers to put their California property in a trust and potentially defer state income tax for decades. While the appeal may take years to resolve, practitioners who work in this area should keep a close eye on the case and advise their clients accordingly.

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