THE CALIFORNIA THROWBACK TAX APPLICABLE TO DISTRIBUTIONS OF PREVIOUSLY UNTAXED ACCUMULATED TRUST INCOME TO CALIFORNIA RESIDENT BENEFICIARIES

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I. INTRODUCTION

When an irrevocable, non-California resident, non-grantor trust distributes current net income to a California beneficiary, that beneficiary generally pays income tax on that income—both federal tax and California tax, up to the amount of the trust's distributable net income ("DNI"), and any undistributed net income in excess of DNI is accumulated and not currently taxable by California. If the trust later distributes the undistributed net income to a California resident beneficiary, that beneficiary will not owe federal tax on that income. However, the beneficiary will owe California tax on the income if: 1) the beneficiary was also a California resident during the year that the income was accumulated; and 2) the income was not previously taxable by California because the resident beneficiary had a contingent interest in the trust (i.e., in the accumulated income). This tax on distributions of accumulated income is known as the "throwback tax," because California is effectively "throwing" the income back to the prior period in which it was accumulated, or deemed to have been accumulated, for the benefit of a California beneficiary.

This article focuses on the California throwback tax, which is not widely understood by practitioners or trustees and beneficiaries of trusts.[1] The Franchise Tax Board (FTB) regulations do not give guidance on how to determine the amount of accumulated income taxable to the beneficiary. Although the California Fiduciary Income Tax Return (Form 541) and instructions do address the throwback tax, the form and instructions do not fully determine the application of the throwback tax law. In this article, we explain our interpretation of the intent and application of that law, suggest a methodology for tracking accumulated income in non-California resident trusts to implement the application of the law, and explore opportunities to plan around the tax.

II. CALIFORNIA TAXATION OF TRUSTS AND THEIR BENEFICIARIES FOR CURRENT INCOME

To understand the application of the throwback tax, we begin with a brief overview of California's system of taxation of trust income.[2] Unlike many other states, California taxes the current non-California source income of a trust based on the residence of the fiduciaries and the non-contingent beneficiaries. The residence of the settlor and the law governing the administration of the trust are irrelevant for California income tax purposes.

A. Taxation Based on Fiduciaries and Beneficiaries in California

California follows the federal rules for non-grantor trusts generally, so that any of the trust's current net income that is distributed (or required to be distributed) to a beneficiary is taxable to the beneficiary and deductible by the trust. However, California's tax rate schedule applicable to the undistributed net income of trusts (as well as estates) is the same as the schedule applicable to single individuals and married individuals filing separately; there are no compressed tax-rate brackets, unlike those applicable to trusts and estates under federal law.[3] California taxes both short-term and long-term net capital gains at the same rates as ordinary income, both for trusts and beneficiaries.

All the trust's undistributed net income is taxable by California: (1) if it is California-source income (*e.g.*, rent from California real property);[4] (2) if all the fiduciaries are California residents, in which case all the trust's non-California sourced undistributed net income is taxable; or (3) if at least one, but not all, the fiduciaries is a California resident, in which case the non-California sourced income is taxable in proportion to the number of the fiduciaries who are California residents to the total number of fiduciaries.[5] For this purpose, 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.[6]

In the case of a California-resident beneficiary, all or part of the trust's remaining undistributed net income is taxable by California if one or more California resident beneficiaries have a non-contingent (*i.e.*, vested) interest in the trust.[7] If all the beneficiaries with non-contingent interests are California residents, all the undistributed net income is taxable by California. If at least one, but not all, the beneficiaries with a non-contingent interest is a California resident, only the portion of the undistributed net income allocable to beneficiaries who are California residents is taxable by California.

Although there is no clear authority on the definition of contingent and non-contingent interests, in our view, a beneficiary should be treated as having a non-contingent interest in all or a portion of a trust if all or a portion of its undistributed net (accumulated) income will, sooner or later, be distributed to or for the benefit of the beneficiary or to the beneficiary's estate, or the creditors of either. We believe that beneficial interests in the remaining accumulated income should be treated as contingent. In our view, whether a beneficiary's interest in a discretionary trust is contingent or non-contingent should be determined by the nature of the beneficiary's interest as set forth in the terms of the trust instrument, and should not change from year to year based on the distributions from the trust to a beneficiary in any particular year. Therefore, although a discretionary beneficiary, of course, has a non-contingent interest in any net income distributed to him or her, that does not make him or her a non-contingent beneficiary of the trust with respect to the trust's undistributed net income. Good examples of trusts with non-contingent beneficial interests are: (1) "administrative trusts" (*i.e.*, revocable trusts that have become irrevocable as a result of the death of the settlors) and other so-called "terminating trusts"; (2) trusts for the benefit of minors that qualify for the gift tax annual exclusion[8]; and (3) trusts for the benefit of "skip persons," structured to qualify for the GST tax annual exclusion.[9]

B. Determination of Residency of Fiduciaries and Beneficiaries

The residence of an individual fiduciary or beneficiary is determined in the same manner as an individual taxpayer.[10] A California "resident" includes an individual who is: (1) in California for other than a temporary or transitory purpose; or (2) domiciled in California and outside the state for a temporary or transitory purpose.

An individual who spends in the aggregate more than nine months of the taxable year within California is presumed to be a resident, but this presumption can be rebutted by satisfactory evidence that he or she is in California for a temporary or transitory purpose.[11] However, presence within California for less than nine months of the taxable year does not create a presumption of nonresidency, unless the individual is present for less than six months as a seasonal visitor, tourist, or guest and is permanently domiciled outside of California.[12] Any person who is domiciled in California is also a resident regardless of the period of time he or she spends in the state. Domicile is the one location where an individual has his or her principal home without any present intention of permanently leaving, and to which place he or she has, whenever absent, the intention of returning.[13]

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.[14] Given the national presence of many corporate fiduciaries, it is often unclear where the major portion of a corporate fiduciary's administration of a trust takes place. Even the California FTB has conceded that the law does not provide guidance as to what specific administrative activities will be considered in making this determination.[15]

C. Alternative Tax on Receipt by Beneficiaries of Taxable Income if Taxes Not Paid by the Trust

If tax is imposed on a portion of the trust's accumulated net income, but the tax is not paid when due and remains unpaid when that income is later distributed to a California-resident beneficiary, or if such income is distributable to the beneficiary before the taxes are due, such income is taxable to the beneficiary.[16]

III. ORIGIN OF CALIFORNIA'S THROWBACK TAX AND ITS APPLICATION

The throwback tax applies when a trust that has accumulated income, all or some of which has not been taxed by California, makes a distribution of such accumulated income to a California-resident beneficiary who also was a California resident when the income was accumulated. To understand and apply the rules that tax distributions of previously untaxed accumulated income, it is helpful to review the historical origin of the throwback tax.

A. Origin of California's Throwback Tax Law

Consider, first, this example of the problem that the throwback tax is designed to solve: The John Smith Trust was established in Nevada[17] by John's parents for the benefit of John Smith, a California resident who pays federal tax at the highest rate of 39.6% and California state tax at the highest rate of 12.3%. The trust was an irrevocable non-grantor trust with no California fiduciaries and John is a contingent beneficiary. Over a five-year period, the trust had taxable income of $100,000. If it had distributed the income currently to John, he probably would have paid federal and state income tax of about $50,000. Instead, the trust accumulated the income and paid federal tax during that period of about $35,000, but no state tax. In the sixth year, the trust terminated and distributed the trust estate, including the accumulated income of about $65,000, to John. But for the California throwback tax, the income earned by the trust and accumulated for the benefit of a California resident beneficiary would go untaxed. California does not have jurisdiction to tax the trust on its undistributed income currently,[18] but it does have jurisdiction to tax the beneficiary on the accumulated net income when it is later distributed to the beneficiary so long as the beneficiary is a California resident at that time and also was a California resident during the year of accumulation.[19] In effect, the throwback tax applies to net income that was accumulated in the trust and would have been taxable if it had been distributed to John currently.

California first adopted its throwback tax in 1963, to impose a tax on a California resident beneficiary (such as John Smith in the hypothetical above) who received a distribution of accumulated income of a non-California resident trust that would make up for the tax the beneficiary would have paid if the income had been distributed to him or her during the years in which the trust accumulated the income.[20] However, it was not until 1983, 20 years later, that California law was amended to provide that California would not follow the federal throwback rules under IRC sections 665 through 668.[21]

B. Application of the California Throwback Tax

In brief, the throwback tax provides that, if no taxes have been paid by a trust on its current or accumulated non-California source net income because the California resident beneficiary's interest was contingent, such income is taxable to the beneficiary when distributed to him or her, if he or she (a) is then a California resident and (b) also was a California resident during the year of accumulation.[22] The portion of the income taxed by California because it is either California source income or there are one or more resident fiduciaries is not subject to the throwback tax because it will be taxed currently to the trust.[23]

The amount of the throwback tax is the aggregate of the taxes that would have been paid with respect to the accumulated income had it been included in the beneficiary's gross income ratably for the year of the distribution and the five preceding taxable years (or for the period that the trust accumulated or acquired income for that contingent beneficiary if shorter than that period).[24]

The amount of the accumulated income that is taxable to the beneficiary under the throwback tax seemingly should exclude any federal income taxes attributable to that income paid or payable by the trust (because that amount is not available to be accumulated and distributed later). Any income taxes paid or payable to another state by the trust with respect to that income should not be excluded, but the amount thereof should be allowed as a credit against the California tax.[25] Although California law does not specify these details of the throwback computation, the principles are partly derived from the more robust federal throwback provisions,[26] and are consistent with the overall goal of the California throwback tax to roughly approximate the tax that would have been paid by the beneficiary had the trust income been distributed currently.

The federal throwback tax rules expressly do not apply to these distributions of accumulated income for California purposes.[27] However, California provides no guidance regarding the application of the California throwback tax rules. In our view, many of the federal rules are sensible and could be helpful if applied to the California throwback tax. For example, the federal rules specify a first-in, first-out method for determining the years to which accumulated income should be attributed,[28] and how to treat accumulation distributions from one trust to another trust.[29] In the absence of any other guidance, we believe it is reasonable to follow the federal rules where appropriate.

However, not all the rules applicable to the federal throwback tax should be applied for California throwback purposes. For example, the California rule does not provide for interest to be imposed on the tax attributable to accumulation distributions, whereas federal law expressly imposes an additional charge to approximate interest for the period of the accumulation.[30] More generally, the entire amount of an accumulation distribution to a beneficiary is taxable under the federal throwback rule, regardless of whether that person was alive and a U.S. resident at the time the income was accumulated, whereas the California rule is more limited in its scope (given the federalism restrictions on state taxation) and applies only to a distribution of income accumulated in years in which the beneficiary was both alive and a California resident.[31]

There also are issues on which neither the federal nor California rules are entirely clear: For example, it is unclear whether income accumulated before the beneficiary reached age 21 is taxable as to that beneficiary. The federal statute provides that the amount of accumulated income subject to the throwback tax "shall not include amounts properly paid, credited, or required to be distributed to a beneficiary from a trust (other than a foreign trust) as income accumulated before the birth of such beneficiary or before such beneficiary attains the age of 21."[32] Since almost no U.S. trusts are subject to the federal throwback rule, the exclusion for accumulations while the beneficiary is under age 21 would appear to have almost no application.[33] Nevertheless, the federal form for reporting the throwback tax instructs the beneficiary to subtract "distributions of income accumulated before you were born or reached age 21" from the total accumulation distribution subject to the throwback tax.[34]

The California statute is entirely silent on the treatment of accumulations before a beneficiary reaches age 21, and the California forms are inconsistent on this point. The instructions to the fiduciary income tax form expressly state that "California does not conform to federal law to exempt from taxation those accumulations occurring prior to a beneficiary turning age 21."[35]

However, as pointed out in the previous paragraph, that federal exclusion apparently has almost no application. In addition, the form required to be completed by a beneficiary who receives a distribution of accumulated income instructs the beneficiary to deduct the income accumulated before the beneficiary attained age 21 from the total amount to which tax is applied.[36]

IV. PRACTICE TIP: TRACKING AND ESTIMATING ACCUMULATED INCOME

One of the most challenging aspects of the throwback rule is keeping records of the trust's accumulated net income over time to facilitate the application of the tax. We have attached a set of schedules as Exhibits to this article, illustrating the application of the California throwback tax and suggesting a format for maintaining records relating to a trust's accumulated net income. We have applied a first-in, first-out methodology to the distribution of accumulated income in the example trust in those schedules, which we believe to be a sensible methodology, notwithstanding that California has not adopted this approach for purposes of determining the throwback tax.

At the end of the article, we have included an example of a completed schedule for a hypothetical trust (the "Smith Family Trust"), established before or during 1995, that: (1) accumulated varying amounts of income every year from 1995 through 2015, (2) made discretionary distributions of $100,000 of accumulated income every year from 2007 through 2015, (3) distributed all its remaining accumulated income in 2016, and (4) never paid any income taxes to another state (see "*Exhibit A*"). Next, we have included a completed schedule which illustrates the way the Smith Family Trust's income that was accumulated from 1995 through 2015 would be deemed to be distributed to the beneficiary or beneficiaries of the trust, applying the first-in, first-out method of taxing accumulation distributions, during the years 2007 through 2016 (see "*Exhibit B*").

In many cases, the trustee of an irrevocable non-California resident trust, whether or not it files California fiduciary income tax returns, may not keep track of the trust's accumulated income that may be subject to the California throwback tax in future years. However, if copies of the trust's federal fiduciary income tax returns[37] are available, the amount of that accumulated income should be readily determinable. If the returns are not available, it still may be possible to determine the total amount of a trust's accumulated income prior to the earliest year for which the trust's fiduciary income tax returns and/or other records are available, but it may not be possible to determine the amount that was accumulated each year.

For example, if the income tax basis of all a trust's assets initially transferred to a trust can be determined (*e.g.*, from the settlor's gift or estate tax returns reporting the establishment of the trust and any additions to it), then the trust's accumulated income prior to the earliest year for which the trust's fiduciary income tax returns or other records are available will generally be the difference between the income tax basis of all the trust's assets at the end of that earliest year and the income tax basis of all its assets initially transferred to the trust.

Even where the income tax basis of all a trust's assets initially transferred to the trust cannot be determined (*e.g.*, where the settlor's gift or estate tax returns are unavailable), it still may be possible to estimate the initial basis of all those assets. Assuming that the trust distributes all income currently, the fair market value at the time of funding could be estimated by determining the net fair market value of the trust assets for the earliest year for which records are available and projecting that value back to the date on which the trust was funded, based on the average growth of a typical trust corpus from that time to the earliest year for which the net fair market value of the trust assets is available.

For example, suppose that: (a) the current net fair market value of all the assets of an irrevocable non-California resident testamentary trust at the end of 2015 (the earliest year for which records are available) is $10,000,000; (b) the amount of its cash plus the income tax basis of all its other assets—readily marketable securities consisting of about 60% equities and 40% fixed-income investments—was then $6,000,000; (c) the trust was established with the residue of the estate of the settlor who died near the end of 1975 (about 40 years earlier); (d) the trust is required to distribute all its net income currently; (e) the trust had never distributed any principal; and (f) similar trusts holding similar readily marketable securities would have been worth about $1,000,000 in 1975. A reasonable estimate of the amount of the trust's accumulated income as of the end of 2015 would be $5,000,000 ($6,000,000 minus $1,000,000).

V. PLANNING OPPORTUNITIES TO MINIMIZE THE APPLICATION OF THE THROWBACK TAX

Given the current dearth of guidance on the application of the California throwback tax rules, there are a variety of situations as to which it is unclear how those rules should be applied. Based on our views of an appropriate method for calculating the throwback tax, certain situations enable trustees to anticipate and plan for the throwback tax.

A. Discretionary Accumulation Trusts

For example, discretionary accumulation trusts with multiple beneficiaries may make distributions to beneficiaries residing both in California and in other states. By applying the first-in, first-out method of taxing accumulation distributions, as discussed above, the accumulated income is treated as being distributed to the extent of the money or the basis of other property distributed to a beneficiary, whether he or she is a California resident or not, the same as for current distributable net income.[38] For example, if a trust has substantial accumulated income and three beneficiaries, one of whom is a California resident and two of whom are not, the trustee may be able to distribute the accumulated income to the non-California resident beneficiaries first and distribute principal in a later year to the California resident beneficiary. In this way, the trustee may be able to minimize the amount of future throwback tax liability for the California resident beneficiary.

B. Trust to Trust Distributions

For trusts with significant accumulated income, it may be possible to reduce the amount of California throwback tax liability by making distributions of some or all the accumulated income to another non-California trust. This possibility is based on the application of certain federal regulations to the California throwback tax.[39] Although, as noted in Subpart B of this Part III, above, the California statute provides that the federal throwback rules do not apply, the instructions to California's fiduciary income tax return expressly advise trustees to refer to the federal treasury regulations under IRC sections 665 through 668 with respect to reporting accumulation distributions from one trust to another. These regulations provide that a distribution from one trust to another trust is generally an accumulation distribution, regardless of whether: (1) the distribution is to an existing trust or to a newly created trust; and (2) the trust to which the distribution is made was created by the same person who created the trust from which the distribution is made or by a different person.[40]

1. Distributions to a California Resident Trust

If we apply the federal regulations to a distribution from Trust A (a non-California resident trust) to Trust B (a California resident trust[41]), we would conclude that this distribution is treated as an accumulation distribution and, therefore, that at least part of that distribution would be subject to California's throwback tax. For example, assume that Trust B also was a California resident trust during the years in which the income was accumulated. In that case, one-sixth of the accumulation distribution received from Trust A would be included in Trust B's gross income for the current year and subject to tax in that year, and one-sixth of that distribution would be treated as having been included in its gross income for each of its prior five taxable years. Trust B's increased tax liability attributable to the inclusion of a portion of the accumulated income in each of those years would be payable by Trust B in the current year.

How would the throwback tax be calculated if Trust B had *not* been in existence during the prior five tax years? The federal regulations answer this question by providing that "[i]f a beneficiary was not in existence on the last day of a preceding taxable year of the trust with respect to which a distribution is deemed made under IRC section 666(a) [relating to the allocation of accumulation distributions to prior years on a first-in first-out basis]," certain assumptions shall be made, including, among other things, that the beneficiary: (1) was in existence on the last day of the prior taxable years; and (2) had no income other than any other amounts thrown back to those years.[42] The examples in the regulations expressly state that these rules also should apply to distributions to trusts: "If A [the beneficiary] were a trust or estate created after 1973 [the first year to which the accumulated income would be thrown back], the same assumptions would apply…."[43]

Now, assume that Trust B is a newly formed California resident trust (*e.g.*, a trust established in the year Trust A distributes accumulated income to it). Under the federal regulations, it is presumed that Trust B: (1) was in existence on the last day of prior taxable years; and (2) had no income other than any other amounts thrown back to those years. Should we also presume that Trust B was a California resident trust in the years during which the income was accumulated? The federal regulations do not provide any guidance on this point. On the one hand, we might treat Trust B like a California resident trust in those years if its initial trustee is a California resident and was a California resident in the years with respect to which the income was accumulated, even though the trust was not yet in existence. Under this approach, Trust B would compute the throwback tax due in the year of the distribution by including the additional tax due in the prior five years as a result of the inclusion of a portion of the accumulated income in each year. However, we might also take the position that a non-existent trust cannot be presumed to be a resident of California (or any other state), and therefore that Trust B should not be treated as a California resident trust. In that case, Trust B would include a portion of the accumulated income in its current year income, but would not incur throwback tax on the portion of the accumulated income attributable to the prior five years.

2. Distributions to a Non-California Resident Trust

If Trust B is a non-California resident trust, then the accumulation distribution received from Trust A would not be taxable to Trust B by California in the year of the distribution. No throwback tax would be due at the time of the distribution to Trust B, but would the accumulation distribution retain its character as accumulated income for California purposes, or would it be "cleansed" such that it would be treated as principal at the time of a future distribution to a beneficiary? We believe that the California throwback rule should be applied to determine the treatment of the accumulation distribution received by Trust B for the purpose of taxing that income if later distributed by Trust B to a California resident beneficiary.

As noted above, California determines the tax liability with respect to an accumulation distribution by treating the amount of the distribution as though it had been received by the beneficiary evenly over the year of the distribution and the beneficiary's prior five tax years and adding the aggregate amount of the beneficiary's additional tax liability attributable to the prior five tax years to the beneficiary's tax liability for the year of the distribution. Thus, Trust B would treat one-sixth of the accumulation distribution received from Trust A as though it had been received by Trust B in the year of the distribution and in each of Trust B's prior five tax years (whether or not Trust B was in existence during those prior five years). This treatment would effectively result in including one-sixth of the distribution from Trust A in the gross income of Trust B for the year of distribution. That distribution would retain its character as income of Trust B. Thus, if any part of that one-sixth portion of the distribution is accumulated and later distributed to a California resident beneficiary who also was a California resident in that year, it would be carried out to the beneficiary as an accumulation distribution and subject to California's throwback tax at that time. The remaining five-sixths of the accumulation distribution received by Trust B from Trust A (which were thrown back to Trust B's prior five tax years), would not be taxable by California because Trust B is a non-California resident trust. Therefore, this five-sixths of the accumulation distribution would be treated as corpus of Trust B and not be subject to the California throwback tax when later distributed to a California resident beneficiary.[44]

C. Anti-Avoidance Rules

The Franchise Tax Board could take the position that a trust-to-trust distribution is not effective to reduce the throwback tax payable by the beneficiary of the non-California resident second trust, if the primary purpose of the distribution from the first trust to the second trust was to avoid the California throwback tax.

The federal regulations governing trust-to-trust distributions expressly provide that they will be treated as accumulation distributions if the purpose of the distribution is to avoid tax. In particular, the regulations state that "a distribution made from one trust to a second trust will be deemed an accumulation distribution *by the first trust to an ultimate beneficiary of the second trust* if the primary purpose of the distribution to the second trust is to avoid capital gain distribution provisions."[45] Although the referenced capital gain distribution provisions have been repealed, such a distribution might nevertheless be deemed an accumulation distribution by the first trust to an ultimate beneficiary of the second trust if the primary purpose of the distribution to the second trust is tax avoidance.[46]

If the distribution from Trust A to Trust B is triggered by an act of independent significance, it would seem that it could not be for tax avoidance purposes. For example, Trust A might make a distribution of all its remaining assets to Trust B upon the death of the income beneficiary of Trust A. However, a discretionary distribution to Trust B by the trustee of Trust A, or a distribution to Trust B resulting from the exercise of a special power of appointment over Trust A, might not be treated as an act of independent significance if the primary purpose of the distribution or appointment is to avoid the California throwback tax.

Alternatively, the Franchise Tax Board could argue that a trust-to-trust distribution is not effective on the theory that the second trust is merely an intermediary between the first trust and the beneficiary. Under the federal throwback regulations, certain payments from a foreign trust to a U.S. person that are made through intermediaries will be deemed to be direct distributions from the foreign trust to the U.S. person in applying the throwback rule if the intent of the parties was to "circumvent the purposes for which the [throwback rule] was enacted."[47] Based on this regulation, an accumulation distribution by a non-California resident trust (Trust A) that is routed through a non-California intermediary, either a non-resident individual or other trust, to a California resident beneficiary of Trust A, might be deemed to be a direct distribution from Trust A to the California resident beneficiary in applying the California throwback rule, if the intent of the parties was to circumvent the purpose for which that rule was enacted.

VI. CONCLUSION

As our society becomes more mobile and long-term trusts continue to proliferate, we expect that the application of California's throwback tax (and similar taxes in other states) will become a more common challenge for trustees and trust beneficiaries. California practitioners who understand the rules and who have encouraged trustees to keep good records may find themselves ahead of the game.

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Exhibit A

Hypothetical Tracking Schedule

TRUST NAME: The Smith Family Trust
EIN: 00-00000000

Year	Current Year Accumulated Income*	Current Year Accumulation Distribution**	Total Accumulation Distributions	Cumulative Accumulated Income Remaining	Income Tax Paid To Another State***
1995	$10,000	$0	$0	$10,000	$0
1996	$12,000	$0	$0	$22,000	$0
1997	$50,000	$0	$0	$72,000	$0
1998	$7,000	$0	$0	$79,000	$0
1999	$10,000	$0	$0	$89,000	$0
2000	$70,000	$0	$0	$159,000	$0
2001	$14,000	$0	$0	$173,000	$0
2002	$80,000	$0	$0	$253,000	$0
2003	$100,000	$0	$0	$353,000	$0
2004	$75,000	$0	$0	$428,000	$0
2005	$80,000	$0	$0	$508,000	$0
2006	$45,000	$0	$0	$553,000	$0
2007	$60,000	$100,000	$100,000	$513,000	$0
2008	$70,000	$100,000	$200,000	$483,000	$0
2009	$900,000	$100,000	$300,000	$1,283,000	$0
2010	$60,000	$100,000	$400,000	$1,243,000	$0
2011	$40,000	$100,000	$500,000	$1,183,000	$0
2012	$35,000	$100,000	$600,000	$1,118,000	$0
2013	$50,000	$100,000	$700,000	$1,068,000	$0
2014	$45,000	$100,000	$800,000	$1,013,000	$0
2015	$35,000	$100,000	$900,000	$948,000	$0
2016	$0	$948,000	$1,848,000	$0	$0

* The trust's "Current Year Accumulated Income" should be net of all taxes paid by the trust and reflect undistributed income that was not currently subject to California tax but would have been taxable by California if the trust had been a California resident. Any undistributed income that would have been excludable from the trust's California gross income or was currently taxable by California (e.g., because one or more fiduciaries was a California resident) should not be included in Current Year Accumulated Income.

** The "Current Year Accumulation Distribution" is the amount by which the amount of the money and the lesser of the income-tax basis and fair market value of any other assets distributed to the beneficiaries in that year (whether California residents or not) exceeds the greater of the trust's distributable net income and its trust accounting income for that year.

*** California resident beneficiaries are entitled to a credit against their throwback tax liability for the amount of any taxes paid by the trust to another state that would have been allowed if the trust income had been distributed to the beneficiary currently. The credit should be applied ratably (equally) in: (a) the year of the distribution of the income that was accumulated in the year any such taxes were paid; and (b) each of the five years preceding the year of the distribution. See CA FTB Legal Ruling No. 375, dated 1/11/1974.

Exhibit B

Illustration of Deemed Distributions of Accumulated Trust Income

TRUST NAME: The Smith Family Trust

EIN: 00-00000000

Year	Current Year Accumulated Income*	Current Year Accumulation Distribution**	Total Accumulation Distributions	Remaining Accumulated Income	Income Tax Paid To Another State***
1995	$10,000	$0	$0	$10,000	$0
1996	$12,000	$0	$0	$22,000	$0
1997	$50,000	$0	$0	$72,000	$0
1998	$7,000	$0	$0	$79,000	$0
1999	$10,000	$0	$0	$89,000	$0
2000	**$11,000**	$0	$0	$0	$0
2000	**$59,000**	$0	$0	$159,000	$0
2001	$14,000	$0	$0	$173,000	$0
2002	**$27,000**	$0	$0	$0	$0
2002	**$53,000**	$0	$0	$253,000	$0
2003	**$47,000**	$0	$0	$0	$0
2003	**$53,000**	$0	$0	$353,000	$0
2004	**$47,000**	$0	$0	$0	$0
2004	**$28,000**	$0	$0	$428,000	$0
2005	**$72,000**	$0	$0	$0	$0
2005	**$8,000**	$0	$0	$508,000	$0
2006	$45,000	$0	$0	$553,000	$0
2007	**$47,000**	$0		$0	$0
2007	**$13,000**	$100,000	$100,000	$513,000	$0
2008	**$70,000**	$100,000	$200,000	$483,000	$0
2009	**$17,000**			$0	$0
2009	**$100,000**			$0	$0
2009	**$100,000**			$0	$0
2009	**$683,000**	$100,000	$300,000	$1,283,000	$0
2010	$60,000	$100,000	$400,000	$1,243,000	$0
2011	$40,000	$100,000	$500,000	$1,183,000	$0
2012	$35,000	$100,000	$600,000	$1,118,000	$0
2013	$50,000	$100,000	$700,000	$1,068,000	$0
2014	$45,000	$100,000	$800,000	$1,013,000	$0
2015	$35,000	$100,000	$900,000	$948,000	$0
2016	$0	$948,000	$1,848,000	$0	$0

* The trust's "Current Year Accumulated Income" should be net of all taxes paid by the trust and reflect undistributed income that was not currently subject to California tax but would have been taxable by California if the trust had been a California resident. Any undistributed income that would have been excludable from the trust's California gross income or was currently taxable by California (e.g., because one or more fiduciaries was a California resident) should not be included in Current Year Accumulated Income.

** The "Current Year Accumulation Distribution" is the amount by which the amount of the money and the lesser of the income-tax basis and fair market value of any other assets distributed to the beneficiaries in that year (whether California residents or not) exceeds the greater of the trust's distributable net income and its trust accounting income for that year.

*** California resident beneficiaries are entitled to a credit against their throwback tax liability for the amount of any taxes paid by the trust to another state that would have been allowed if the trust income had been distributed to the beneficiary currently. The credit should be applied ratably (equally) in (a) the year of the distribution of the income that was accumulated in the year any such taxes were paid, and (b) each of the five years preceding the year of the distribution. See CA FTB Legal Ruling No. 375, dated 1/11/1974.

1 The federal throwback tax is beyond the scope of this article, but for a thorough discussion of the federal rules, see Mark Ascher, et al., Federal Income Taxation of Estates, Trusts & Beneficiaries (2018) (discussing the throwback tax at Chapter 9).

2 Rev. & Tax. Code, section 17014 (definition of "resident"), section 17041 (rates, etc.), sections 17731-17779 (estates, trusts, beneficiaries, and settlors/grantors), sections 18003-18005 (credits). Cal. Code Regs., tit. 18, chapter 25, subchapter 9, section 17014, sections 17742-17744, sections 17951-3, 17951-4, section 17952. Rev. & Tax. Code, section 17731 provides that IRC sections 641 through 692, relating to estates, trusts, beneficiaries, and decedents, apply for California purposes except as otherwise provided.

3 For 2019 the rates ranged from 1% on the first $8,809 of taxable income to 12.3% on taxable income over $590,742.

4 See Rev. & Tax. Code, section 17731 (California generally follows the federal law); IRC section 641(b) (trusts are generally taxed the same as individuals); Rev. & Tax. Code, section 17951, subd. (a) (non-resident individuals are taxable on California-source income); Cal. Code Regs., tit. 18, sections 17743 (noting that all California non-source income is taxable to a trust that is subject to taxation based on the residence of its fiduciaries), 17744 (applying the same rule to a trust that is subject to taxation based on the residence of the beneficiaries); *Steuer v. Franchise Tax Bd.* (2020) 51 Cal.App.5th 417.

5 See Rev. & Tax. Code, section 17731 (California generally follows the federal law); IRC section 641(b) (trusts are generally taxed the same as individuals); Rev. & Tax. Code, section 17951, subd. (a) (non-resident individuals are taxable on California-source income); Cal. Code Regs., tit. 18, sections 17743 (noting that all California non-source income is taxable to a trust that is subject to taxation based on the residence of its fiduciaries), 17744 (applying the same rule to a trust that is subject to taxation based on the residence of the beneficiaries); *Steuer*, *supra*, 51 Cal.App.5th 417.

6 Rev. & Tax. Code, section 17742, subd. (a). Rev. & Tax. Code, section 17006 provides as follows: "Fiduciary" means a guardian, trustee, executor, administrator, receiver, conservator, or any person, whether individual or corporate, acting in any fiduciary capacity for any person, estate, or trust.

7 Rev. & Tax. Code, section 17742, subd. (a).

8 IRC, section 2503(c).

9 IRC, section 2642(c)(2).

10 See generally, Rev. & Tax. Code, sections 17014-17016.

11 Rev. & Tax. Code, section 17016.

12 Cal. Code Regs., tit. 18, section 17014.

13 Treas. Reg. section 20.01-1(b)(l) provides in part as follows: "A person acquires a domicile in a place by living there, for even a brief period of time, with no definite present intention of later removing therefrom. Residence without the requisite intention to remain indefinitely will not suffice to constitute domicile, nor will intention to change domicile effect such a change unless accompanied by actual removal." See also Franchise Tax Bd. Publication 1031, section L ("Domicile is defined for tax purposes as the place where you voluntarily establish yourself and family, not merely for a special or limited person, but with a present intention of making it your true, fixed, permanent home and principal establishment. It is the place where, whenever you are absent, you intend to return. The maintenance of a marital abode in California is a significant factor in establishing domicile in California.").

14 Rev. & Tax. Code, section 17742, subd. (b).

15 Franchise Tax Bd. Notice 98-12 (Aug. 12, 1998).

16 Rev. & Tax. Code, section 17745, subd. (a). Note that any such income is directly taxable to the beneficiary in the year distributable to him or her and not as a transferee with respect to that income. A transferee would be indirectly liable for the trust's unpaid tax liability, including interest and possible penalties. Presumably any such beneficiary could not be directly taxable on that income and also be liable for the trust's unpaid tax liability as a transferee with respect to that income.

17 Nevada does not have a state income tax.

18 See *N.C. Dept. of Revenue v. The Kimberley Rice Kaestner 1992 Family Trust* (2019) 588 U.S. ______, 139 S.Ct. 2213.

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

20 Rev. & Tax. Code, section 17745, subds. (b)-(f), added by Stats. 1963, ch. 352, section 2. The Legislature expressly provided that the throwback tax would only apply prospectively. Thus "[w]hether or not the income of a trust which is or was accumulated or is or was accumulated and distributed or accumulated and distributable is taxable by California for the years prior to 1963 shall be determined as if Sections 17742 and 17745 had not been amended [by the 1963 statutes]." Rev. & Tax. Code, section 17745.1. Given that there was no other authority for subjecting accumulated income to California tax before 1963, it would seem that any income accumulated in a trust before 1963 could be distributed to a California beneficiary without imposition of the throwback tax. Also, income accumulated when the beneficiary was not a resident is not subject to the throwback tax.

21 Rev. & Tax. Code, section 17779, added by Stats. 1983, ch. 488, section 58.

22 See Rev. & Tax. Code, section 17745, subds. (b), (d). The California Supreme Court in the seminal case of *McCulloch v. Franchise Tax Board* (1964) 61 Cal. 2d 186, noted that taxation of the plaintiff beneficiary upon distribution was constitutionally supported because the "[b]eneficiary … 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." Rev. & Tax. Code, section 17745, subdivision (c) provides that if the beneficiary is a resident during the period of accumulation and leaves California within 12 months prior to the date of distribution of the accumulated income and returns within 12 months after the distribution, it is presumed that the beneficiary continued to be a resident throughout the time of the distribution. However, absence from California for more than either of those 12-month periods does not create the opposite presumption.

23 Rev. & Tax. Code, sections 17742(a), 17743.

24 Rev. & Tax. Code, section 17745.

25 Franchise Tax Bd. Legal Ruling No. 375 (June 11, 1974) (providing that a credit for income tax paid in another state "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").

26 IRC, sections 665-668.

27 Rev. & Tax. Code, section 17779.

28 IRC, section 666(a).

29 Treas. Reg. section 1.665(b)-1A.

30 IRC, section 668(a).

31 See endnote 19, *supra*.

32 IRC, section 665(b) (emphasis added).

33 Consistent with this conclusion, Treas. Reg. section 1.665(b)-1A(b)(2) provides that "[a] distribution of income accumulated during the minority of the beneficiary is generally an accumulation distribution," and Treas. Reg. section 1.668(b)-2A(a) sets forth an example of the treatment of a distribution to an individual beneficiary of income accumulated before that beneficiary was born.

34 Federal Form 4970 ("Tax on Accumulation Distribution of Trusts").

35 Schedule J to California Form 541 ("Trust Allocation of an Accumulation Distribution").

36 California Form 5870A ("Tax on Accumulation Distributions of Trusts").

37 IRS Form 1041.

38 Schedule J, line 13, to Form 541 instructs the trustee to allocate an accumulation distribution to the "earliest applicable taxable year" in which the trust had undistributed net income.

39 California Form 541, Schedule J ("Trust Allocation of an Accumulation Distribution").

40 Treas. Reg. section 1.665(b)-1A(b)(1).

41 A "resident" trust is one that is taxable in whole or in part in California.

42 Treas. Reg. section 1.668(b)-2A(a).

43 Treas. Reg. section 1.668(b)-2A(a) (flush language).

44 This analysis should be contrasted with the result of a distribution by Trust A directly to a non-California resident individual beneficiary. In that case, such a distribution presumably would draw out the accumulated income on a first-in, first-out basis but would not be subject to California throwback tax. However, if the beneficiary were a California resident at the time the distribution from Trust A was made, the distribution would be subject to throwback tax, but only to the extent that the income was accumulated during a period in which the beneficiary was alive and a California resident. See, endnote 19, *supra* and accompanying text in Part II.B, above.

45 Treas. Reg. section 1.665(b)-1A.

46 For rules relating to the computation of the beneficiary's tax under IRC section 668 by reason of an accumulation distribution from the second trust, see paragraphs (b)(1) and (c)(1)(i) of Treas. Reg. section 1.668(b)-1A and paragraphs (b)(1) and (c)(1)(i) of Treas. Reg. section 1.669(b)-1A.

47 Treas. Reg. section 1.665(c)-1A.