

ANALYSIS OF ORIGINAL BILL

Author: Harman Analyst: John Pavalasky Bill Number: SB 454
 Related Bills: See Legislative History Telephone: 845-4335 Introduced Date: February 21, 2007
 Attorney: Daniel Biedler Sponsor: _____

SUBJECT: Trust Income Exempt From Tax If Trust Has No California Source Income, No Resident Beneficiaries, and No Resident Trustees

SUMMARY

This bill would limit California's ability to tax the income of certain trusts.

PURPOSE OF THE BILL

According to the author's office, this bill is intended to exempt from California taxation the income of a trust having a trust fiduciary that is a California resident when the trust has no California source income and the trust beneficiaries all reside outside of California.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective immediately and apply to taxable years beginning on or after January 1, 2007.

POSITION

Pending.

SUMMARY OF SUGGESTED AMENDMENTS

Substantive amendments are necessary to resolve the implementation and policy considerations discussed in this analysis. Department personnel are available to help resolve these considerations as the bill moves through the legislative process.

ANALYSIS

FEDERAL/STATE LAW

Under federal and state law, trusts are generally treated as separate taxpayers and, with some important exceptions relating to "grantor trusts," are taxed in the same way as individuals. If a person creates several or "multiple" trusts, each trust is generally treated as a separate taxpayer. Several separate trusts may be created even though there is only one trust instrument and only one trustee.

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Trust income is normally reported by the trust itself, if retained by the trust, or by the beneficiary, if distributable to the beneficiary (whether or not actually distributed). Where the trust distributes income to the beneficiary, the trust deducts the distributed income taxable to the beneficiary.

California source income

A nonresident of California is taxed by California only on income having a California source during the period when the taxpayer is a nonresident, including any California source income of a “grantor trust” created by that nonresident.

Income having a California source includes:

- Trade, business, or professional income from a taxpayer’s trade or business that is conducted in this state.
- Income from real or tangible personal property located in California, such as rental property.
- Any gain resulting from the sale or exchange of real or tangible personal property located in California.
- Any other type of income from the ownership, control, or management of real or tangible personal property located in California, regardless of whether the income arose in connection with a trade, business, or profession in California.
- The California source income of a partnership (including a limited liability company classified as a partnership) or S corporation retains its character as California source income in the hands of a nonresident partner or shareholder of an S corporation.

Income from intangibles

Income from intangible personal property such as stocks, bonds, and notes is generally taxed by the state of residence of the owner, unless the property has acquired a business situs in California. Thus, this type of intangible income is not treated as having a California source.

California residency rules applied to trusts

California has evolved a comprehensive system for the taxation of trust income patterned upon the federal tax structure that treats a trust as a separate taxpayer, unless the trust is a “grantor trust.”

As under federal law, California requires the trust to report the taxable income of the trust, including income that the trust accumulates or holds for future distribution to a beneficiary. If either the trustee (fiduciary) or beneficiary is a resident of California, the entire taxable income of the trust must be reported to California. That is because long-standing case law holds that California has nexus to tax the entire taxable income of a trust based on the protection afforded to the trust, trustee, or beneficiary by the state of California. If both the fiduciary and beneficiary are non-residents of California, only the income from California sources is reportable to California. Special rules pro-rate the trust income (other than California source income) when a trust has multiple trustees or beneficiaries (or both multiple trustees and multiple beneficiaries) and some of them are nonresidents of California.

Grantor trusts

A “grantor trust” is a trust where the grantor retains the power to revoke the trust (sometimes also called a revocable trust), retains a substantial reversionary interest, or gives another person substantial control over the trust property or income. “Grantor trusts” are not treated as a trust for tax purposes (i.e., the trust is disregarded for tax purposes and the income must be reported by the grantor as their own).

Examples of “grantor trusts” include estate planning trusts, commonly called “living” trusts, that do not become irrevocable until the death of the grantor, and “family estate” trusts where an individual transfers tangible and intangible property and the right to receive income in exchange for units of beneficial interests that are essentially the right to enjoy the property.

Where the grantor is a California resident, the entire taxable income of a “grantor trust” (even when the beneficiaries, trustees, and assets of the trust are located in another state) is taxed to the grantor because a resident is taxed on all income, regardless of the source of that income.

THIS BILL

This bill would exempt from California taxation the income of a trust when the trust has no California source income, none of the beneficiaries are residents of California, and none of the trustees are residents of California. This bill would expressly provide that this exemption from California taxation of the income of a trust applies “notwithstanding any other law to the contrary.” Thus the exemption would apply to any trust, regardless of whether the trust is revocable or irrevocable, even when the grantor would otherwise be taxed on that “grantor trust” income as a resident of California.

IMPLEMENTATION CONSIDERATIONS

The department has identified the following implementation concerns. Department staff is available to work with the author’s office to resolve these and other concerns that may be identified:

- It could be argued that use of the term “notwithstanding any other law to the contrary” means that this bill would allow a resident of California to create a “grantor trust” to avoid being taxed on the income from intangible assets such as stocks, bonds, notes, capital gain, or rights to receive income that are otherwise taxable to that resident. That “grantor trust” under this argument would be taxable only on income from California sources as a nonresident of California if it had only nonresident trustees and nonresident beneficiaries, even when the “grantor” retains the power to revoke the trust or has substantial control over the trust property or income. The author may wish to clarify that the bill would apply only to trusts where the separate existence of the trust is not disregarded under the “grantor trust” rules of current law.
- This bill also does not provide rules regarding the taxation of a California beneficiary receiving a distribution of accumulated income from the trust when that beneficiary was a nonresident in some of the years that the trust accumulated the income. That is, what rules does the California beneficiary use to determine the amount of tax to pay in the year of distribution whether the trust has paid California tax or not upon the accumulated trust income that is being distributed?

LEGISLATIVE HISTORY

SB 1017 (Perata, 2001/2002) would have restricted California taxation of a trust's entire taxable income to instances where the trust was created by a California resident. That bill was held in the policy committee.

AB 36 (Hannigan, Stats. 1983, Ch. 488) adopted federal law by reference while retaining specific rules relating to taxability of a trust with a resident fiduciary or beneficiary.

OTHER STATES' INFORMATION

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York*. These states were selected due to their similarities to California's economy, business entity types, and tax laws.

Florida does not impose an income tax on individuals but does impose an intangible personal property tax. If the grantor retains an unlimited right to revoke a trust, he or she is considered the owner of the property for tax purposes (i.e., the separate existence of the trust is disregarded). A Florida-domiciled grantor of a trust who retains ownership, management, or control of trust assets is subject to tax on intangibles held as items of trust principal. The Florida Attorney General has held that a Florida resident grantor of an out-of-state trust is subject to tax, even if the trust property is subject to tax in the other state.

Illinois, Massachusetts, Michigan, Minnesota, and New York, like California, conform to the federal grantor trust rules and require all items of income and deductions from the trust to be included in the grantor's tax return as though the property were owned outright by that resident (i.e., the separate existence of the trust is disregarded).

FISCAL IMPACT

If the implementation considerations addressed in this analysis are resolved, the department's costs are expected to be minor.

ECONOMIC IMPACT

Revenue Estimate

Based on data and assumptions discussed below, this provision would result in the following revenue losses.

Estimated Revenue Impact of SB 454 Effective for Tax Years BOA 1/1/2007 Assumed Enactment Date After 7/1/07 \$ in Millions)		
2007/08	2008/09	2009/10
Footnote A*	Footnote A*	Footnote A*

*Footnote A: The revenue loss could potentially be in the tens of millions of dollars.

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this bill.

Revenue Discussion

Under current law, in general, the income of a trust without California source income and without resident beneficiaries or trustees is not reported to California; however, if the grantor of a “grantor trust” is a California resident, the trust’s income, regardless of source, is reported on the grantor’s personal income tax return and taxed by California. The exemption from California tax in this bill would apply to the income of any trust even when the grantor would otherwise be taxed on that “grantor trust” income as a resident of California. Thus, this bill would allow a resident of California to create a “grantor trust” outside of California to avoid being taxed on the income from intangible assets such as stocks, bonds, notes, capital gain, or rights to receive income that are otherwise taxable to that resident.

The revenue impact is driven by the current amount of taxes paid on income of “grantor trusts.” The revenue loss would include the amount of taxes forgone by reclassifying taxable income as nontaxable income through the creation of “grantor trusts” outside of California.

As “grantor trusts” are treated as disregarded entities and the trust’s income is reported on the grantor’s personal income tax return, the amount of taxes currently paid on this income is unknown. Because of this and the uncertainty in the level of altered behavior, the revenue impact of this proposal is unknown. However, based on a review of currently reported taxable income that could be placed in “grantor trusts” outside of California (interest income, capital gains, and dividend income), the revenue loss could potentially be in the tens of millions of dollars.

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