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by Naomita Yadav

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Naomita Yadav is a partner at Withersworldwide LLP in San Francisco.

In this inaugural installment of (Tax) Matters of Life and Death, Yadav examines California's taxation of nonresident individuals and trusts.

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The pandemic changed the way we work in radical ways, and over the past two years, stories of a California "exodus" have abounded.[1] This article addresses a common misconception that by moving out of state, the taxpayer will reap the bounty of tax savings. In some cases, the savings may not be as material as expected, the practical/administrative costs may be too high, or the tax savings may not materialize at all. Unfortunately, as some may find out after spending much time and effort to "check out," the California Franchise Tax Board may never let you leave.

I. Keys to California Taxation: Residency and Source

As a general rule, California taxes both individuals and non-grantor trusts[2] on the basis of residency and source of income. California resident individuals and trusts are taxed on all taxable income regardless of source,[3] and nonresident individuals and trusts are taxed on income from California sources.[4] Therefore, to have no California income taxation, the individual or trust must (1) be a nonresident and (2) earn no California-source taxable income.

	California resident	California nonresident
California-source income	Fully taxable	Fully taxable
Non-California-source income	Fully taxable	No California tax

A. Income Tax Based on Residency

California Revenue and Taxation Code section 17014(a) defines an individual resident as one who is (1) in California for other than a temporary or transitory purpose; or (2) domiciled in California, but who is outside California for a temporary or transitory purpose. A search for cases dealing with residency brings up many results, which point to a number of takeaways for any individual considering terminating California residence:

- *Residency is "sticky" and may be presumed.* Any individual who spends in the aggregate more than nine months of the tax year in California is presumed to be a resident.[5] California domicile, once established, will often lead to the finding that any presence outside California is for temporary or transitory purposes. There are no bright-line rules for domicile and it hinges on the concept of a permanent home to which the taxpayer intends to return to when absent.[6]

[1] Dymond Green, "The California Exodus Continues as Residents Head South of the Border," CNBC.com, June 11, 2022.

[2] All references to "trust" assume the trust is a separate taxpayer, that is, a non-grantor trust.

[3] Cal. Rev. & Tax. Code section 17041(a) and (e).

[4] Cal. Rev. & Tax. Code sections 17041(i) and 17951.

[5] Cal. Rev. & Tax. Code section 17016.

[6] Cal. Code Regs. tit. 18, section 17014(c).

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- *Checklists are not sufficient.* Many clients may come across discussions of cases in which factors determining the residency outcome may be presented in a bullet-point fashion and walk away with the idea that there is a determinative checklist. This is not the case. The concept of temporary or transitory purpose is highly circumstantial and determined on a case-by-case basis. Aspects such as residence of a spouse and children,[7] maintaining a California home,[8] or even simply maintaining California bank accounts or taking the California bar exam,[9] have all been used to determine residency for individuals.
- *Be prepared to sever connections and stay gone.* Many clients inquire about when it is safe to resume activities and interactions in California. Still others point to an often-misunderstood six-month rule that states that a non-domiciliary who maintains a permanent abode outside California and whose presence in California does not exceed six months is considered to be in the state for temporary or transitory purposes provided any activities are limited to that of a seasonal visitor, tourist, or guest.[10] Unfortunately, the six-month horizon is not a bright-line test, nor is there any presumption of nonresidency — it merely states that if the taxpayer changes domicile (not easy, as discussed above) and thereafter keeps any in-state activities to the level of a tourist or guest, the taxpayer may claim nonresidency provided her in-state days do not exceed six months. The easiest trap to fall into is presuming that if the taxpayer is absent from the state for a year or two that she has necessarily broken domicile. There is no "days test" for domicile, and if the individual's actions indicate an intent to return, domicile would likely remain intact and the taxpayer's presence outside the state will also likely be deemed temporary and transitory.[11]

Compared with individuals, residency of trusts is somewhat simpler. A non-grantor trust is considered a California resident if "the fiduciary or beneficiary (other than a beneficiary whose interest in such trust is contingent) is a resident, regardless of the residence of the settlor."[12] Note, however, that a grantor trust is disregarded concerning the grantor; therefore, the residency of the grantor would control for those trusts (regardless of California residence of fiduciaries or beneficiaries).

Income of non-grantor trusts is taxable in California in a cascading fashion:

- *Determine all California-source income; that amount is fully taxable in California.*[13]
- *Apportion all non-California income based on the residence of fiduciaries.* When there are multiple fiduciaries, some California residents and others non-California residents, Rev. & Tax. Code section 17743 (and regulations thereunder) require apportionment of non-California-source income based on the number of resident fiduciaries.
- *Apportion any remaining non-California income based on the residence of non-contingent beneficiaries.* A beneficiary has a contingent interest in a trust when the trustee holds sole and absolute discretion to distribute to the beneficiary.[14] Or, stated differently, a contingent beneficiary cannot compel the trustee to give him any portion of trust assets.[15] When the trustee's discretion is restricted or the beneficiary enjoys the ability to demand distributions, the interest would be non-contingent. FTB Legal Ruling No. 238 (Oct. 27, 1959) provides an example

[7] *Appeal of Collins*, California State Board of Equalization, Case No. 80317 (May 31, 2001).

[8] *Appeal of James*, BOE, Case No. 596166 (Feb. 26, 2013).

[9] *Appeal of Narayan*, BOE, Case No. 79538 (Apr. 19, 2001).

[10] Cal. Code Regs. tit. 18, section 17014(b).

[11] Cal. Rev. & Tax. Code section 17014(d) does provide a special rule for California domiciliaries who may be considered nonresident, but the threshold is high, including absence for at least 546 consecutive days under an employment contract.

[12] Cal. Rev. & Tax. Code section 17742(a).

[13] While this was a long-held position, it was recently confirmed in *Steuer v. Franchise Tax Board*, No. A154691 (Cal. Ct. App. 1st Dist. June 29, 2020, commonly referred to as the *Paula Trust* case).

[14] California Franchise Tax Board, Technical Advice Memorandum 2006-0002 (Feb. 17, 2006).

[15] *Id.*

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of the double bite at non-California-source income when there is at least one California resident fiduciary and one non-contingent beneficiary. It states that for a trust with non-California-source taxable income of $90,000, with three trustees (one of whom is a resident) and two non-contingent beneficiaries (one of whom is a resident), California is able to tax $60,000 of this income.

- *Beware throwback taxes.* When a trust has only non-California fiduciaries and any California resident beneficiaries are contingent, income earned by that trust is not immediately taxable by California. However, the moment a distribution is made from such earned but untaxed income to a California resident beneficiary, the beneficiary is considered non-contingent up to the amount of that distribution and it could be taxable in California at the time of distribution.[16] This is the lurking throwback tax. There are two factors for throwback tax to apply — first, there must be a distribution to a California resident beneficiary, and second, there must have been previously accumulated untaxed income starting from the point the contingent beneficiary became a California resident. If the beneficiary was resident in California but moves out of state before a distribution, it may be possible that throwback tax does not apply provided residency is terminated and the beneficiary does not reestablish California residency within a year of the distribution.[17]

In short, for a non-grantor trust to be nonresident, no fiduciary or non-contingent beneficiary can be a California resident, and no distributions should be made to a California resident contingent beneficiary. One practical issue that often arises is that California-based settlors do not have close family or friends outside the state who they can name in fiduciary roles, and they do not feel comfortable with third-party corporate trustees — not to mention the costs associated with corporate trustees.

B. Income Tax Based on Source of Income

Going back to our checkout process, and as noted in the prior section, the source of income is the other crucial aspect because even nonresident individuals and trusts are subject to California tax on California-source income. The character of income usually dictates how it will be sourced.

- *Compensation.* As a general rule, the source of compensation income is determined by examining the location where services are performed, without regard to a taxpayer's state of residency.[18] Complications arise in cases of split residency — two common fact patterns involve deferred compensation and community property.
  - The first fact pattern involves a California resident who terminates residence and thereafter receives some manner of deferred compensation. In this case, the income must be apportioned between California and other states to allocate to California that portion of the total compensation that is "reasonably attributable to personal services performed in California."[19] What constitutes a reasonable apportionment is a facts and circumstances determination and may be affected by aspects such as vesting schedules or if there is a "busy" versus "off" season, but a generally used allocation method is based on California work days over the total work days during which the compensation income arose.[20]
  - Community property can add another layer of complexity to sourcing of income. The community property nature of wages and compensation (or, indeed, any other personal property) is determined by the domicile of the earning spouse.[21] Therefore,

[16] Cal. Rev. & Tax. Code section 17745(b).

[17] Cal. Rev. & Tax. Code section 17745(e) provides that a beneficiary is presumed to be resident in California if they leave within 12 months prior to the distribution and return within 12 months after the distribution.

[18] *See Appeal of Thomas*, 55-SBE-006 (Apr. 20, 1955); *Appeal of Perelle*, 58-SBE-057 (Dec. 17, 1958); *Appeal of Rule*, 76-SBE-099 (Oct. 6, 1976); and *Appeal of Seltzer*, 80-SBE-154 (Nov. 18, 1980).

[19] Cal. Code Regs. tit. 18 section 17951-5(b).

[20] *See Appeal of Perelle*, 58-SBE-057.

[21] *Schecter v. Superior Court*, 49 Cal. 2d 3, 10 (1957); and *Rozan v. Rozan*, 49 Cal. 2d 322, 326 (1957).

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if the earning spouse is domiciled in another community property state (for example, Texas) and the nonearning spouse is a California resident, half the income will still be taxable in California. Conversely, if the earning spouse is a California resident and the nonearning spouse is resident in a separate property state, the taxpayer will not save on any California income taxes because the income will be deemed 100 percent California-source.[22]

- *Capital gains from sale of stock.* Income from sale of stocks and other intangible personal property is sourced to the situs of the domicile of the owner but may treated as California-source income if it acquires a business situs in California.[23] That can occur if the nonresident buys or sells intangible personal property in California, or places orders with brokers in California to buy or sell intangible personal property on such a regular, systematic, and continuous basis as to constitute doing business in California; or if the nonresident employs the intangible personal property as capital in California; or the possession and control of the property is localized in connection with a business, trade, or profession in California, so that its substantial use and value attach to and become an asset of the business, trade, or profession.[24]

Whether an intangible has acquired business situs in California has been raised often by the FTB in cases when the nonresident seller was selling interests in an entity that was engaged in business activities in California (and the interests were not in a publicly traded company). The nonresident taxpayers in *Venture Communications*[25] and *Amyas*[26] sold limited partnership interests and prevailed against the FTB's contention that the partnership interest had acquired a business situs in California. However, the sale of an intangible — specifically goodwill — was recently treated as business income and was apportioned under Rev. & Tax. Code section 17951.[27] The court went further in this case and noted that even if the transaction was treated as the sale of an intangible, it had acquired California business situs because the management and disposition of such goodwill was an integral part of the seller's regular trade or business.[28]

- *Income derived from real property.* Rents or gains from the sale of real or personal tangible property located in California are treated as California income regardless of the location of the sale or whether a trade or business is carried on within the state.[29] Of course, in "Hotel California" the converse is not always true — income from real property outside California paid to a nonresident may still become taxable in California. For example, this can occur if the real property is owned in another community property state, and the nonresident is married to a California resident. This could cause the rental income to be treated as half-owned by the California resident and taxable in California.

II. Checking Out . . . Without Leaving

Any existing connections with California must be analyzed carefully to determine where and how income tax exposure is arising to find the best strategy for any client situation. Many practitioners have commented on the nuances of terminating California residence for individuals[30] — but even if they accomplish that, taxpayers may be surprised to find they have not yet escaped California income taxes.

[22] *See, e.g.*, *Appeals of Cremel and Koeppel*, 2021-OTA-222P (May 18, 2021).

[23] Cal. Code Regs. tit. 18, section 17952(b) and (c); and *Holly Sugar Corp. v. Johnson*, 18 Cal. 2d 218, 223 (1941).

[24] *Id. See also Appeal of Venture Communications Inc.*, Docket No. 141641, 140415 (Feb. 5, 2003).

[25] *Id.*

[26] *Appeal of Amyas and Ames*, 87-SBE-042 (June 17, 1987).

[27] *The 2009 Metropoulos Family Trust v. FTB*, No. D078790 (Cal. Ct. App. May. 27, 2022).

[28] *Id.*

[29] Cal. Code Regs. tit. 18, section 17951-3.

[30] *See, e.g.*, Michelle B. Graham and Vivienne King, "The California Exodus," *Daily Journal*, Oct. 9, 2019.

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- *Stumped by source.* Even as a taxpayer may begin to look into the feasibility of moving out of state, the tax professional should simultaneously undertake a detailed analysis of the taxpayer's income source. It would avoid wasting time and effort going down a path that would ultimately be futile from an income tax perspective if the taxpayer's income is predominantly California-source, regardless of the taxpayer's residence. For example, if income is predominantly rental income from real estate in California, relocating the owner — individual or trust — will not move the needle on California taxes. On the other end, if the income is predominantly portfolio income from sales of securities, changing the residence of the owner would result in maximum tax savings. In this case, the taxpayer may even consider funding non-grantor trusts[31] sitused outside California to benefit from significant savings without having to move himself.
- *Community property complexities.* As noted earlier, there are various situations in which split residence between spouses, with one spouse maintaining California connections, can result in inadvertent exposure to California income taxes. Continued residence in California of a spouse also increases the difficulty of the exiting spouse to terminate California domicile/residence, especially if no legal separation or divorce is underway. Additional measures such as a transmutation or post-nuptial agreement splitting assets into separate property may be required, which in turn have their own downsides such as the loss of full step-up in basis upon first death[32] allowed for community property assets.
- *Trust travails.* The most obvious aspect with existing irrevocable trusts is to ensure they are non-grantor if the grantor is going to remain situated in California. Converting a grantor trust to a non-grantor trust is rarely as simple as the grantor relinquishing overt powers such as the power to substitute assets. Too often, there are more insidious provisions, such as the ability to acquire life insurance on the grantor using trust income, that may require decanting to be removed. Thereafter, all fiduciaries (which may include power holders and not just trustees) should be changed to out-of-trust persons. Note, again, the choice of trustee may directly affect grantor status; for example, choosing an out-of-state trustee who is "related or subordinate" within the meaning of IRC section 672(c) may trigger grantor status. Then come the complex aspects:
  - *Determine if any California beneficiaries are non-contingent.* The most common instance of this issue is when beneficiaries have withdrawal rights or distribution standards are mandatory rather than discretionary. In this case, unless the beneficiaries are willing to move out of state, there is likely California income tax exposure. Some practitioners change distribution standards via a two-step decanting, but this strategy can carry its own federal and state tax exposures. It may be better, if adequate exemption is available, for the trusts to distribute completely and for the beneficiaries to settle new out-of-state trusts with discretionary standards.
  - *Inadvertent income tax exposure when converting to non-grantor trusts.* One often-overlooked item when converting to non-grantor trusts is income tax triggering events. The most common instance of this occurs if the trust owns an asset (usually a real estate partnership) that has debt in excess of basis.[33]

While successful income tax planning for California tax exposure is possible, a knee-jerk approach is likely to end up costing more than it saves, and the taxpayer might find herself embodying that famous lyric, of checking out without ever leaving![34] ■

[31] The conservative manner would be through a completed gift. Incomplete gift trusts are under heightened scrutiny in California.

[32] IRC section 1014(e).

[33] *See* Rev. Rul. 77-402.

[34] The author thanks the members of the Eagles for the theme song of this article!

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