California's income taxation of trusts has unpleasantly surprised many trust fiduciaries and beneficiaries. Its unique method of taxation, based on the residence of the trust's fiduciaries and beneficiaries (and regardless of the residence of
the settlor), may affect trustees and beneficiaries (as well as their lawyers and other advisors) far beyond the California borders.

For example, consider an irrevocable, non-grantor trust established by an Illinois resident that is administered by two co-trustees, one of whom is an Illinois resident while the other resides in California. All beneficiaries of the trust also reside in Illinois. Despite the predominantly non-California connections, and even if the Illinois co-trustee is more actively involved in the administration of the trust, *half* of the trust's undistributed net income is currently taxable by California.

Alternatively, consider another irrevocable, non-grantor trust, this time with a New York settlor. In this case, the trust is administered in New York by a New York resident serving as the sole trustee. However, the trust's sole beneficiary is a California resident with a vested (i.e., non-contingent) interest in the trust property. Despite the trust's New York origin and administration, *all* of the trust's undistributed net income is currently taxable by California.

California acknowledges other state laws regarding taxation of trust income and will allow a credit for taxes paid to another state, but only if the trust is considered to be a resident by both states *and* taxes are actually payable to both states. The credit is effective where the taxes paid to the other state are levied on the same income and at the same rates as those of California. In the examples above, if the trusts are taxed on the same income at lower rates in Illinois or New York than in California, the additional taxes paid to California (which are not offset by the credit for taxes paid in the other states) will represent additional taxation that will deplete the trust estate.

Given that California taxes net capital gains at the same rates as ordinary income--with a maximum rate of 12.3 percent (or 13.3 percent with respect to taxable income in excess of $1,000,000)--an otherwise out-of-state trust may have significant California income tax liabilities. If the tax is not paid by the trust for the year in which the income is received and if that income is subsequently distributed to a California resident beneficiary, that beneficiary will be taxable on that income. Moreover, even where a trust has not had a prior obligation to pay California income tax, a later distribution of accumulated net income to a California beneficiary is subject to the California throwback rules, which are somewhat similar to the now largely repealed federal throwback rules (under IRC sections 666-668). Thus, even if a non-California resident establishes a trust that is always administered outside of California by non-California trustees, and even if the trust's California beneficiaries only have contingent, non-vested interests (for example, where *all* distributions are fully discretionary), California may *still* ultimately tax the trust's income when and to the extent it is later distributed to a California resident beneficiary.

The broad reach of California's fiduciary income tax laws is an important consideration for trustees, beneficiaries and advisors, where either a trustee or beneficiary resides in California or is contemplating a move to California. This article provides an in-depth analysis of the principles of California fiduciary taxation and the manner in which they are applied. Although its focus is on the treatment of irrevocable, non-grantor trusts, it includes a brief overview of California's taxation of the income of estates and administrative trusts, as well as a technical guide to complying with California income tax reporting and withholding requirements.

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