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Can You Avoid California Tax Without Moving? Not Anymore

By Robert W. Wood

It is no secret that many people look for ways to avoid paying California taxes by moving out of state, usually shortly before a major income event. They don't always move to no-tax states like Nevada, Texas, Wyoming, Florida, and so on. But those tax havens are the usual suspects when Californians have tax wanderlust.

The state income tax they are trying to avoid might be triggered by the sale of a company or the settlement of a big lawsuit. For example, if you sell stock as a Texas resident, the highest federal capital gain tax rate is 20%, plus the 3.8% net investment income tax. California doesn't give a lower tax rate for capital gains, so you could pay up to 13.%.

There is also the federal Qualified Small Business Stock exclusion, that for the shareholders who qualify, can provide an up to a whopping $10 million exclusion from federal tax. California does not conform to federal law, which means you pay up to 13.3% tax on your gains. These are among the reasons that some people head for the exits as they eye a major income event.

Done carefully and with the right kind of income, properly moving out of California can reduce or eliminate the sting of California's top 13.3% tax rate. Yet even moving to avoid California taxes can be tricky. California may have a claim on some of the sales proceeds even if the move is well-timed, *bona fide,* and permanent. California can also dispute the move, arguing that a move in March really was not a move until July. In short, a residency audit from the state's notoriously aggressive Franchise Tax Board can sometimes mean that you didn't succeed in cutting your taxes after all.

And then there are all the hassles of a move, and the benefits of living in California that you would be giving up. Some people move to sell but move back quickly, which California may not respect as a bona fide move. Some Californians are simply unwilling to move, but still hope to skip California taxes. Let's say you can't move quite yet, so you wonder if a trust in another state might work?

Some history and tax lingo is relevant. The usual grantor trust (or so-called living trust) that you might form for estate planning purposes would not help. Living trusts help to avoid probate, but they have no income tax effect since the grantor must include the income on his or her personal tax return. Living trusts don't file a separate tax return. However, some trusts file their own returns and are separately taxed.

Up until recently, some taxpayers formed a special kind of Nevada, Delaware or Wyoming trust. The donor makes an incomplete gift (with some strings attached, so gift tax does not apply) to the trust, and the trust has an independent out of state trustee. The grantor is involved but not technically as the owner. The idea was to wall off assets from California's 13.3% tax rate via a 'NING', a Nevada Incomplete Gift Non-Grantor Trust. A 'DING' is its Delaware sibling. There is even a 'WING,' for Wyoming.

The idea is that the trust itself would be taxed, and since the trust is not in California, there should be no California tax. When these trusts took off in popularity in New York, New York State law was changed to make the grantor taxable on such trusts no matter what. But these trusts ramped up in California too, becoming a popular device.

For years, California's Franchise Tax Board said it was studying the issue, but California law has recently been changed to essentially follow New York's lead. That means under the new California law, income from these trusts will be taxed at the grantor level unless a limited exception applies. For tax years beginning January 1, 2023 and thereafter, the income of these trusts will be taxed as though it were a grantor trust. That means taxed to the grantor, the person still in California. See Cal. R&TC §17082.

Will this new California tax law be challenged in court? It could be, but even if it is, such a challenge may not succeed. That means if you have a NING, DING or WING, you should get some tax advice. Under the law, starting as of the beginning of 2023, these trusts are required to report the trust's income on the grantor's individual California income tax returns. Plus, the treatment of distributions from the trust remains subject to California's current tax treatment of trust distributions. See Cal. R&TC §17745.

Looking on the bright side, though, estimated tax underpayment penalties will not apply to any underpaid estimated tax payments for the 2023 tax year. Cal. R&TC §§19136, 19136.3. Next year, these taxpayers will not be so lucky. The larger question is whether existing trusts should be changed or undone. It seems likely that creative estate planners are already at work looking for ways to ameliorate the sting of this key change in California tax law. For one thing, the new law itself has limited exceptions. SB 131 allows such trusts to avoid California taxation as a grantor trust for a tax year in which all of the following apply:

1) The trust fiduciary makes a timely, irrevocable election on a California trust return to be taxed as a resident nongrantor trust in a time and manner to be determined by the FTB;
2) The ING trust is a nongrantor trust pursuant to R&TC §17731; and
3) At least 90% of the trust's distributable net income is distributed or treated as being distributed to an IRC §501(c)(3) charitable organization.

Most trusts are not going to meet this narrow exception. And it could mean that some elaborate trusts will be reformulated or even scuttled entirely where possible. It could even mean that more people will leave California over taxes, trying to avoid costly tax mistakes.

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