WYOMING AS A FAVORABLE TRUST SITUS FOR CALIFORNIA RESIDENTS:

A CASE STUDY

LONG REIMER WINEGAR BEPPLER LLP

ALL RIGHTS RESERVED

Calvin Californian ("Calvin") is a California resident and has been for the last twenty years. Calvin surfs every morning, drinks only cone-drip coffee, and is a vegan. That said, Calvin isn't completely against the idea of leaving California for more tax-friendly climes—people road-trip to Burning Man from places other than California, after all.

Calvin is the sole owner of Consultants-R-Us (the "Company"), a very successful S corporation organized under California law. The Company provides consulting services across the nation, including to the 20% of its client-base located in California. Calvin foresees selling his interest in the Company, though the time frame of that sale is uncertain.

I. CALVIN'S CALIFORNIA STATE TAX OBLIGATIONS AS A RESIDENT:

California residents pay California state income tax on income from all sources.[1] In addition, California imposes one of two taxes on S corporations: corporate franchise tax if the entity is "doing business" in California, or corporate income tax if the entity receives income from California sources but is not "doing business" in California.[2] A company is doing business in California if (1) it is organized or commercially domiciled in the state; (2) its sales in California exceed the lesser of $500,000 or 25% of the company's total sales; (3) the company's real property and tangible personal property in California exceed the lesser of $50,000 or 25% of the company's total real property and tangible personal property; or (4) the amount of

[1] CAL. REV. & TAX. CODE § 17041(a).

[2] *Id.* §§ 23151, 23153, 23501, 23802; STATE OF CALIFORNIA FRANCHISE TAX BOARD, GUIDE FOR CORPORATIONS STARTING BUSINESS IN CALIFORNIA 2-3 (2012). S corporations are not subject to the Alternative Minimum Tax. JOHN CHIANG ET AL, CAL. FRANCHISE TAX BD., CALIFORNIA FORMS & INSTRUCTIONS 100S: 2012 S CORPORATION TAX BOOKLET 6 (2012). The California tax treatment of S corporation sand their shareholders is determined in accordance with Subchapter S of Chapter 1 of Subtitle A of the Internal Revenue Code. CAL. REV. & TAX. CODE § 23800 (incorporating I.R.C. §§ 1361 through 1379). For California purposes, an S corporation may not be included in a combined report under Cal. Rev. & Tax. Code § 25101. CAL. REV. & TAX. CODE § 23801(d). However, if it is determined that the income or loss of a group of commonly owned or controlled entities which includes an S corporation does not reflect the correct income or loss, the Franchise Tax Board may apply methods of unitary combination. *Id.*§ 23801(e).

compensation paid by the company in California exceeds the lesser of $50,000 or 25% of the total compensation paid by the company.[3]

While income from S corporations is only taxed at one level by the IRS, the California Franchise Tax Board treats pass-through entities differently and taxes S corporation income at the corporate level as well as at the shareholder level.[4] The corporate franchise or income tax for an S corporation is 1.5% (but not less than $800) as opposed to 8.84% for corporations that have not made the election.[5]

For entities that do business in California as well as in other states, the company's income is apportioned according to the source of the income, and taxes are assessed accordingly.[6] Starting with tax year 2013, California no longer apportions a business's income according to a combined property, payroll, and double-weighted sales calculation but uses only a single sales factor.[7] Different rules govern the sourcing of tangible personal property versus intangible property, including services.

Sales of tangible property are considered California source if either of two prongs are met. First, if the property is delivered or shipped to a purchaser in California, it is a California source sale.[8] This rule applies even in a situation where property is delivered to a purchaser in California and immediately transported to branch stores in other states.[9] On the whole, California's regulations source to California every round-about sale whose ultimate destination is within the state as well as those whose ultimate destination may be outside the state but have some temporary connection with California.[10] The second instance in which sales of tangible property are considered California source occurs when property is shipped from a warehouse,

---

[3] CAL. REV. & TAX. CODE § 23101. For the purposes of determining whether an entity is "doing business" in California, sales of tangible goods are sourced according to the Cal. Rev. & Tax. Code § 25135; sales of series and intangibles are sourced under § 25136(b). Sales are defined in Cal. Rev. & Tax. Code § 25120(e) and (f).

[4] CAL. REV. & TAX. CODE § 23802; CAL. FRANCHISE TAX BD., GUIDE FOR CORPORATIONS STARTING BUSINESS IN CALIFORNIA 2 (2012).

[5] CAL. REV. & TAX. CODE §§ 23802, 23151, 23800.5.

[6] *Id*. § 25101. The sourcing rules apply both to California corporate income and franchise tax.

[7] Proposition 39 (adding CAL. REV. & TAX. CODE § 25128.7). Proposition 39 applies to tax years beginning January 1, 2013. This paper does not discuss pre-2013 sourcing and filing options. Some commentators argue that Proposition 39 does not repeal the apportionment method under the terms of the Multistate Tax Compact, Cal. Rev. & Tax. Code § 38006, which allows for a three-factor, single-weighted sales factor, with cost-of-performance sourcing for sales other than sales of tangible personal property. Brian W. Toman et al., *California's Proposition 39: Not-so-Mandatory Single Sales Factor*, JDSUPRALAWNEWS (Nov. 14, 2012), http://www.jdsupra.com/legalnews/californias-proposition-39-not-so-mand-85519/; Ligia Machado et al., *California Proposition 39: Single sales factor for most taxpayers and market-based sourcing for all taxpayers*, MYSTATETAXOFFICE: A WASHINGTON NATIONAL TAX SERVICES (WNTS) PUBLICATION (Dec. 3, 2012), http://www.pwc.com/en_US/us/state-local-tax/newsletters/mysto/assets/pwc-california-proposition-39.pdf.

"The sales factor is a fraction, the numerator of which is the total sales of the taxpayer in this state during the taxable year, and the denominator of which is the total sales of the taxpayer everywhere during the taxable year." CAL. REV. & TAX. CODE § 25134.

[8] CAL. REV. & TAX. CODE § 25135(a)(1).

[9] CAL. CODE REGS. tit. 18, § 24135(a)(3).

[10] *See id*.

factory, or place of storage in California and (1) the purchaser is the U.S. government or (2) the purchaser lives in a state that does not impose a tax on the selling company.[11] This tax is referred to as the "throwback" tax.[12] As long as the company is not taxable in the state where the retailer or individual purchaser receives the property, that sale is "thrown back" to California and considered a California sale. The California point of origin for the sale is broad—an office, store, warehouse, factory, or other place of storage in the state.[13]

Companies whose product is a service rather than tangible property are subject to newly-adopted market-based sourcing rules in apportioning sales between California and other states.[14] In 2012, the California Franchise Tax Board released regulations providing guidance for the market-based sourcing rules.[15] The guidance begins with the general rule that a sale of anything other than tangible property is sourced to California if the apportioning taxpayer's market is in California.[16] Utilizing a set of defined terminology, the regulation proceeds to set forth a series of cascading rules for determining the market source of a sale. The rules cover both sales of services as well as sales, or transfers, of variously defined intangibles.[17]

In the sale of services[18] realm, the regulation sets out two avenues of sourcing rules—one for sales to individuals and another for sales to business entities.[19] For sales to customers who are

---

[11] CAL. REV. & TAX. CODE § 25135(a)(2). A company is taxable in another state if "(a) in that state it is subject to a net income tax, a franchise tax measured by net income, a franchise tax for the privilege of doing business, or a corporate stock tax, or (b) that state as jurisdiction to subject the taxpayer to a net income tax regardless of whether, in fact, the state does or does not." *Id.*§ 25122.

[12] This is one of a number of state and federal taxes referred to in this paper, all of which have been given the moniker "throwback."

[13] CAL. REV. & TAX. CODE § 25135(a)(2).

[14] CAL. CODE REGS. tit. 18, § 25136-2. This market-based sourcing regulation was approved by the California Office of Administrative Law in February of 2012, published in March of the same year but applies retroactively to taxable years beginning on or after January 1, 2011. *Id*. While this regulation was recently adopted, Proposition 39, which imposes a single sales factor for apportioning income, passed after the regulation. The regulation is currently in force and unchanged.

[15] CAL. CODE REGS. tit. 18, § 25136-2.

[16] *Id*. § 25136-2(a).

[17] The definition of "intangible property" includes, but is not limited to, "patents, copyrights, trademarks, service marks, trade names, licenses, plans, specifications, blueprints, processes, techniques, formulas, designs, layouts, patterns, drawings, manuals, trade secrets, stock, contract rights including broadcasting rights, and other similar intangible assets." *Id*. § 25136-2(b)(4). A "marketing intangible " includes, but is not limited to, "the license of a copyright, service mark, trademark, or trade name where the value lies predominantly in the marketing of the intangible property in connection with goods, services, or other items." *Id*. § 25136-2(b)(4)(A). A "non-marketing and manufacturing intangible" includes, but is not limited to, "the license of a patent, a copyright, or trade secret to be used in a manufacturing or other non-marketing process, where the value of the intangible property lies predominantly in its use in such process." *Id*. § 25136-2(b)(4)(B). A "mixed intangible" includes, but is not limited to, "the license of a patent, a copyright, service mark, trademark, trade name, or trade secrets where the value lies both in the marketing of goods, services, or other items as described" as a marketing intangible and "in the manufacturing process or other non-marketing purpose as described" as a non-marketing and manufacturing intangible. *Id*. § 25136-2(b)(4)(C).

[18] The definition of a "service" is "a commodity consisting of activities engaged in by a person for another person for consideration. The term 'service' does not include activities performed by a person who is not in a regular

individuals, the rules begin with a rebuttable presumption that sales will be sourced based on the customer's billing address.[20] If this presumption is overcome, either by the taxpayer or by the Franchise Tax Board, alternate sourcing methods are available, including basing the benefit of the service on information in the contract between the parties or upon information contained in the taxpayer's records.[21] If the presumption is overcome but an alternate method cannot be determined based on the aforementioned sources of information, the benefit of the service shall be "reasonably approximated."[22] A series of examples in the regulation illustrate the Franchise Tax Board's concept of reasonable approximation.

For sales to business entity customers, the rules begin with a rebuttable presumption that sales will be assigned to the state where the customer receives the benefit of the service based on information in the contract between the taxpayer and the business entity customer and other books and records kept in the taxpayer's normal course of business.[23] The billing address of the customer is not determinative at this point. If the presumption is overcome by a preponderance of the evidence, the regulation sets out a series of steps for determining source based on a reasonable approximation of the location of the benefit of the service.[24] Finally, if neither the contracts and records of the taxpayer nor a reasonable approximation determination can be made, the sale will be presumed to be California source if the customer placed the order for the service from a location in California.[25] In a case where all of these methods of determination fail, the benefit of the service will be determined by the taxpayer's billing address.[26] The regulation provides extensive examples to illustrate these rules.

For both sales to individuals as well as to business entities, once a taxpayer or the Franchise Tax Board settles on an alternate method to source the receipt of the benefit of the service or use of intangible property, the taxpayer must continue to use that method unless and until it receives permission from the Franchise Tax Board otherwise.[27] In addition, unlike the sourcing rules for tangible personal property, the rules governing sales of services and other intangibles do not include a throwback provision for sales made to jurisdictions that do not otherwise tax the sale.[28]

---

trade or business offering its services to the public, and does not include services rendered to another member of the taxpayer's combines reporting group. . . ." CAL. CODE REGS. tit. 18, § 25136-2(b)(6).

[19] *Id*. § 25136-2(c).

[20] *Id*. § 25136-2(c)(1)(A).

[21] *Id*.

[22] *Id*. §§ 25136-2(c)(1)(B), (b)(5).

[23] *Id*. § 25136-2(c)(2).

[24] *Id*. § 25136-2(c)(2)(B).

[25] *Id*. § 25136-2(c)(2)(C).

[26] *Id*. § 25136-2(c)(2)(D).

[27] *Id*. § 25136-2(g)(2)(A).

[28] *See generally id*. § 25136-2. In addition, note that a number of special industry rules are not incorporated into this regulation: CAL. CODE REGS. tit. 18, § 25137(c)(1)(C) (Special Rules / Sales Factor); the throwback provision in CAL. CODE REGS. tit. 18, § 25137-3 (Franchisors); the income-producing activity, costs of performance, and throwback provisions in CAL. CODE REGS. tit. 18, § 25137-4.2 (Banks and Financials); the throwback and sales

In Calvin's situation, his personal income (which includes all of the Company's income as he is the sole shareholder of a pass-through entity) places him in the highest California tax bracket, resulting in a personal income tax rate of 13.3%.[29] In addition, the Company is assessed a 1.5% corporate franchise tax on its California source income. Because the Company sells its services, the portion of its income apportioned to California will be based on the market-based sourcing rules discussed earlier. Assuming that Calvin's figure of 20% California-based clients is also an accurate assessment of the California source of the company's service sales, while Calvin himself will pay 13.3% California state income tax on the entire income of the Company, the Company's 1.5% corporate franchise tax obligation will only be assessed against 20% of the Company's income.

II. CALVIN'S CALIFORNIA STATE TAX OBLIGATIONS AS A NONRESIDENT:

Calvin moves out of the Golden State, abandoning all intent to return, and takes up residency in a state that doesn't impose income tax—Wyoming. Calvin exchanges his surf board for a snowboard, learns how to make his own drip coffee, and develops a taste for elk and venison. As a result, the California Franchise Tax Board indeed recognizes that Calvin is no longer a California resident.[30]

---

factor inclusion of property shipped from California provisions in CAL. CODE REGS. tit. 18, § 25137-12 (Print Media); and the throwback provision in CAL. CODE REGS. tit. 18, § 25137-14 (Mutual Fund Service Provider). *Id*. § 25136-2(g)(3).

[29] Proposition 30, passed in November of 2012, results on an increase in the tax rate on households making more than $250,000 a year.

[30] Becoming a non-resident for California tax purposes is not as simple as it sounds. A California resident is anyone (1) in the state for other than a transitory or temporary purpose; or (2) whose "domicile" is in California but who is outside the state for a transitory or temporary purpose. CAL. REV. & TAX. CODE § 17014(a). California takes an aggressive approach in applying this definition.

Whether a person's purpose in being inside or outside of California is temporary or transitory depends on that person's subjective intent, resulting in the application of a facts and circumstances test to each situation. CAL. CODE REGS. tit. 18, § 17014(b) ("The underlying theory of § 17014 is that the state with which a person has the closest connection during the taxable year is the state of his residence."); *see* Noble v. Cal. Franchise Tax Bd., 118 Cal. App. 4th 560 (Cal. Ct. App. 2004) (finding a couple had not relinquished their California residency after an examination of facts that included California vehicle registration, California driver's licenses, memberships in California clubs, and California bank accounts). The *Noble* decision is helpful in providing guidance for individuals attempting to change their California residency status; in general, the factors that are weighed in determining whether the person is out of the state temporarily or permanently include the location of the person's permanent residence, where his business interests are situated, where her children go to school, where he belongs to clubs, registers a car and does banking, and where she is located physically during the taxable year. In addition, records should be kept documenting the change of residency. *See* In re Hardie, No. 127537 (Cal. State Bd. of Equal. Dec. 19, 2002) (stating that a "scarcity of documentation of a person's whereabouts for a stretch of eight to nine consecutive months" worked against the taxpayer's allegation that he had permanently moved out of California).

A statutory presumption of residency exists for a person who is in California for more than nine months of the year. CAL. REV. & TAX. CODE § 17016. A presumption of non-residency exists when an individual domiciled outside of California spends six months or less in California, so long as that person maintains a permanent residence in the state where he is domiciled. *See* CAL. CODE REGS. tit. 18, § 17014(b) (stating that "an individual may be a seasonal visitor, tourist or guest even though he owns or maintains an abode in California or has a bank account here for the purpose of paying personal expenses or joins local social clubs.").

As a nonresident, Calvin's income is subject to California income tax only to the extent it is California source income.[31] In the case of a nonresident who is a shareholder of an S corporation that does business both within and without California, the business's income is apportioned at the corporation level, but only the nonresident shareholder's distributive share of the business income apportioned to California is considered California source income and taxed.[32] As a result, while the Company's corporate franchise tax liability has not changed under this scenario, Calvin's has. The Company will continue to pay 1.5% tax on the 20% of its income apportioned to California. Rather than having his entire income subject to California income tax, now only 20% of Calvin's distributive share of Company income will be subject to California income tax.

III. AS A NONRESIDENT, CALVIN SELLS THE COMPANY:

The clear air of the Mountain West helps Calvin focus—he decides to sell the Company. He has an interested buyer willing to be flexible in structuring the sale. Now Calvin needs advice on how to deal with the transaction in a way that will result in the least California tax being imposed.

The sale of a shareholder's interest in an S corporation may be accomplished via a sale or exchange of stock, treating the sale of stock as a sale of assets, or an actual sale of company assets. The way in which Calvin relinquishes his interests in the Company will determine whether and to what extent California may assess personal income tax and corporate franchise tax on the gain. While making a final decision in a situation like this requires a more in-depth look at the facts than there is time for here, this paper will review the wider-picture tax implications of the various structuring options.

For the purposes of determining gain or loss on a sale or exchange of S corporation stock, California generally conforms to Subchapter C of the Internal Revenue Code[33] and has adopted

---

[31] CAL. REV. & TAX. CODE §§ 17301.3(b), 17591(a), 17954 ("For purposes of computing 'taxable income of a nonresident . . . ' gross income from sources within and without this state shall be allocated and apportioned under rules and regulations prescribed by the Franchise Tax Board"). For taxable years beginning on or after January 1, 2002, a nonresident's California tax is determined by multiplying California taxable income by an effective tax rate which is the California tax on all income as if you were a California resident divided by total taxable income. CAL. REV. & TAX. CODE § 17041. The Franchise Tax Board expresses it like this:

$$\text{Prorated tax} = \text{CA taxable income} \times \frac{\text{Tax on total taxable income}}{\text{Total taxable income}}$$

STATE OF CAL. FRANCHISE TAX BD., TAXATION OF NONREISDENTS AND INDIVIDUALS WHO CHANGE RESIDENCY (2012) ("California taxes your distributive share of partnership, S corporation and trust income derived from California sources if you are a nonresident of California").

[32] CAL. CODE REGS. tit. 18, § 17951-4(f).

[33] There are, however, differences between the I.R.S.'s treatment of S corporations and California's; for additional details on California's tax law regarding S corporations, see Cal. Rev & Tax. Code §§ 23800–24203.

I.R.C. Sections 61 and 62.[34] In addition, the federal income tax rule that gain or loss realized is recognized unless a nonrecognition provision applies is applicable in California.[35] Except for corporate reorganizations, which will not be discussed in this paper, most nonrecognition provisions do not apply to the sale or exchange of S corporation stock.

While the California rules regarding the taxation of a nonresident's distributive share from an S corporation are clear, California's jurisdiction over nonresident shareholder gains and losses from the sale of S corporation shares turns on whether there is a viable nexus between the shares and the state.[36] Gain from the sale of an S corporation interest by a nonresident is treated as gain on the sale of intangible personal property.[37] As a result, the gain is allocable to the state where the selling shareholder resides so long as the intangible asset has not obtained business situs in California.[38] If the S corporation interest has acquired a business situs in California, then the gain from its disposition is entirely sourced to California.[39] A California business situs may be acquired by, for example, the intangible asset being used as capital in California or used in connection with a business in California to the extent that it is considered an asset of that business.[40] The regulation gives as an

---

[34] CAL. REV. & TAX. CODE §§ 17072; 17072(a).

[35] CAL. CODE REGS. tit. 18, § 18031; I.R.C. § 1001(c).

[36] *Cf.* Valentino v. Franchise Tax Bd., 105 Cal Rptr. 2d 304 (Cal App. 2001).

[37] CAL. CODE REGS. tit. 18, § 17952(b). This case study focuses on Calvin, as an individual, selling the shares. If, instead, the S corporation stock being sold was held by another business entity, the regulation governing market sourcing rules for sales of intangibles would apply. *Id*. § 25136-2(b)(7), (d)(1)(A)1, (d)(1)(A)1.a, b. The regulation refers to "the complete transfer of all property rights." *Id*. § 25136-2(d)(1). The "complete transfer of all property rights" is a transfer of all property rights associated with owning intangible property as opposed to the rights granted in a licensing situation, where the licensor retains some ownership rights in connection with the licensed property. As such, a complete transfer does not require that the seller sells *all* of his stock or interests in a particular entity, just that the seller retains no property rights with respect to those that have been sold. *Id*. § 25136-2(b)(3). In general, intangible property sales are sourced to California "to the extent" they are used in California. *Id*. § 25136-2(d). In a situation where stock or interests in a pass-through entity are transferred, the regulation states that the location of the use of intangible property, and therefore its market source, is the location of the use of the underlying assets of business entity being sold. *Id*. § 25136-2(b)(7). Currently, the regulation states that the "location of use" is determined as follows: if 50% or more of the assets of the business entity being sold consist of real and/or tangible personal property, the sourcing will be determined by averaging the payroll and property factors for the most recent taxable year unless the sale occurs more than halfway through the taxable year in which case the average from the current taxable year's payroll and property factors shall be used. *Id*. § 25136-2(d)(1)(A)1.a. Alternatively, if more than 50% of the interests consist of intangible property, the sourcing will be determined based on only the sales factor for either the preceding taxable year, or the current year if the sale occurs more than six months into the current year. *Id*. § 25136-2(d)(1)(A)1.b. If these methods do not result in a determination of sourcing or the presumption is overcome, a reasonable approximation shall be used. *Id*. § 25136(d)(1)(B). If this method, too, is not determinative, then as a last resort the sale will be source to California if the billing address of the purchase is in California. *Id*. § 25136(d)(1)(C).

[38] CAL. CODE REGS. tit. 18, § 17952.

[39] *Id*.

[40] *Id*. § 17952(c). What constitutes "business situs" was argued before the State Board of Equalization in the *Matter of the Appeals of Amyas and Ames*, 87 SBE 042, June 17, 1987. In this case, a partnership owned real estate located in California and the Franchise Tax Board argued that the sale of partnership interests should be sourced to California because the operation of the partnership itself was in California. The State Board of Equalization disagreed, holding that the partnership interests had not acquired a business situs in

example the situation of a nonresident who pledges stock as security for the payment of a loan incurred in connection with a business in California—such intangible property obtained a business situs in California.[41] Without more connection to California, the taxable situs of a nonresident's interests in a business entity doing business in California should be its owner's state of residence.[42]

As a result, if Calvin is a nonresident and sells his interests in the Company, so long as nothing ties that intangible property to California, Calvin's gains on the sale of his S corporation interests will not be subject to California income tax. If, however, Calvin has at any point used his shares in the Company to secure a business loan, or in any other way established a business situs for the stock in California, all of the gain from the sale will be taxable by California.[43]

California allows the sale of stock to be treated as a sale of assets if the shareholders make an Internal Revenue Code § 338(h)(10) election.[44] In this situation, the S corporation's sale of stock is recharacterized as a sale of assets. When the buyer purchases the assets directly or the sale of stock is treated as an asset sale, the buyer receives a stepped-up basis in the purchased assets.[45] In turn, the S corporation generally distributes the proceeds of the sale to the shareholders.[46] Because the S corporation is deemed to liquidate upon making the election, all of the gain on the deemed asset sale will be recognized.[47] This results in tax implications on two levels—for the shareholders and for the company. First the company calculates the S corporation's gain or loss from the sale of assets and, second, it computes the shareholder's gain or loss from the liquidation. For California purposes, Internal Revenue Code Subchapter C rules generally apply when an S corporation is liquidated.[48] The result is substantially the same if the company undertakes an actual asset sale, the main difference being that under a deemed asset

---

California and therefore the gain on the sale was not taxable by California. While this case determines the situs of partnership interests, because S corporations are a similar type of pass-through entity, it is reasonable to conclude that the same conclusion would likely be made in an analogous situation involving an S corporation.

[41] CAL. CODE REGS. tit. 18, § 17952(c). The regulation also notes that the source of gains or losses from sales or exchanges of intangibles are determined at the time of the disposition. *Id*. § 17952(d). This becomes relevant in installment sales involving intangibles, which will not be discussed in this paper. *Id*.

[42] *See Matter of the Appeals of Amyas and Ames*, 87 SBE 042, June 17, 1987.

[43] For basis purposes, if a person becomes a nonresident of California, their basis in a pass-through entity will need to be restated as if they had been a nonresident of California for all prior years. STATE OF CAL. FRANCHISE TAX BD., TAXATION OF NONRESIDENTS AND INDIVIDUALS WHO CHANGE RESIDENCY 30 (2012). *See also*, CAL. REV. & TAX. CODE §§ 18031–18049.

[44] CAL. REV. & TAX. CODE § 23806.

[45] I.R.C. §§ 338; 1060 To qualify for the asset sale treatment under California Tax law, a valid election must also be made for federal purposes under Section 338 of the Internal Revenue Code. CAL. REV. & TAX. CODE § 23806.

[46] I.R.C. § 331(a); Treas. Reg. § 1.338(h)(10)-1(d)(4). Installment sales may come into play here, though this paper will not discuss the additional considerations in such a situation.

[47] CAL. REV. & TAX. CODE § 24672.

[48] I.R.C. §§ 1361–1379; CAL. REV. & TAX. CODE § 17321.

sale, the sale will be treated as a stock sale for the sales and use tax, with the result that the buyer in a deemed asset sale will avoid paying sales and use tax on the acquired tangible assets.[49]

For an S corporation doing business both within and without the state of California, the treatment of gain from either a liquidating sale of company assets or a deemed sale of assets will turn on whether the gain is considered business income (which is apportioned among the jurisdictions in which the company does business) or nonbusiness income (which is allocated to a specific situs). Business income is defined as:

> income arising from transactions and activities in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of that taxpayer's regular trade or business operations.[50]

California regulations provide additional guidance:

> [T]he critical element in determining whether income is "business income" or "nonbusiness income" is the identification of the transactions and activity which are the elements of a particular trade or business. In general, all transactions and activities of the taxpayer which are dependent upon or contribute to the operations of the taxpayer's economic enterprise as a while constitute the taxpayer's trade or business and will be transactions and activity arising in the regular course of, and will constitute integral parts of, a trade or business.[51]

A company's income is presumed to be business income unless it is clearly classifiable as nonbusiness income.[52] California applies two tests to distinguish between the two: a transactional test and a functional test.[53] If under either test the income is business income, it will be considered business income.[54] The focus in the transactional test is the nature of the income-producing transaction.[55] Income will be classified as business income if the income-generating transaction is carried out in the regular course of business. A complete liquidation or cessation of business cannot result in business income under the transactional test[56] with the result that the second test—the functional test—will be

---

[49] CAL. FRANCHISE TAX BD., INTERNAL PROCEDURES MANUAL: 15.0 S-CORPORATION LIQUIDATIONS 2 (Dec. 2007).

[50] CAL. REV. & TAX. CODE § 25120.

[51] CAL. CODE REGS. tit. 18, § 25120(a).

[52] *Id*. § 25120. *See* Appeal of Borden, Inc., SBE-XXII021, 77-SBE-007 (Cal. St. Bd. of Equal. 1977).

[53] Hoechst Celanese Corp. v. Franchise Tax Bd., 25 Cal. 4th 508, 520 (Cal. 2001).

[54] *Id*.

[55] *Id*. at 526.

[56] *Id*. at 526–27 (citing Uniroyal Tire Co. v. Dept. of Finance, 779 So.2d 227, 230 (Ala. 2000)). Note that this scenario focuses on an individual's sale of a business, the income from which will not be business income for business being sold. However, if a business entity owns a subsidiary, the sale of the subsidiary can constitute business income to the business entity owner, though not for the subsidiary itself. *See Times Mirror Co. v. Franchise Tax Board*, 102 Cal. App. Ed 872 (Cal. App. 1980).

controlling for a determination of whether the sale constitutes business or non business income.

The focus of the functional test is the income-producing property and its relationship with the taxpayer's business operations.[57] In situations where a company liquidates a subsidiary or a unitary business[58], the gain will generally be treated as business income pursuant to section 25120(a) and apportioned to the states in which the company did business prior to the sale.[59] The treatment of the gain is less clear in a situation where a single business is liquidating via a deemed or actual asset sale. The California Franchise Tax Board has stated that "[a]s a general rule liquidating activities such as paying debts, collecting accounts receivable and pursuing tax refund claims do not constitute doing business because the purpose of financial or pecuniary gain is missing."[60] However, both *Hoechst Celanese Corp. v. Franchise Tax Board* and *Jim Beam Brands Co. v. Franchise Tax Board*, while focusing on the sale of a subsidiary by a parent company, suggest that the circumstances under which assets are sold are not relevant to the functional test.[61] Instead, the relevant inquiry is whether the property being sold had been used in the normal and regular course of business.[62] As a result, to the extent that assets being sold, or deemed sold, have been used in the course of business, the gain from the sale will be considered business income.[63]

In the event that the gain, or a portion of it, is considered nonbusiness income, it is allocated as follows:[64] Nonbusiness capital gains and losses from the sale of real property are California source if the property is located in California.[65] Nonbusiness gains from the sale of tangible real property are allocable to California if the property had a situs in California at the

---

[57] *Id*. at 527.

[58] A unitary business is generally defined as two or more business entities that are commonly owned and integrated in a way that transfers value among the affiliated entities. Citicorp North America, Inc. v. Franchise Tax Bd. 83 Cal. App. 4th 1403, 1411 (2000).

[59] *See, e.g.*, *Hoechst Celanese Corp*. 25 Cal. 4th 508; Jim Beam Brands Co. v. Franchise Tax Bd., 133 Cal. App. 4th 514 (2005); Appeal of Borden, Inc., SBE-XXII-21, 77-SBE-007 (Cal. St. Bd. of Equal. 1977); *Appeal* of Triangle Publications, Inc., SBE-XXXI-477, 84-SBE-096 (Cal. St. Bd. of Equal. 1984); Cal. Franchise Tax Bd., Legal Ruling No. 2006-03 (May 5, 2006) (specifically addressing gains under the IRC § 338 election).

[60] Cal. Franchise Tax Bd., Legal Ruling No. 038 (June 26, 1958).

[61] *Hoechst Celanese Corp*. 25 Cal. 4th at 530 ("[t]he extraordinary nature or infrequency of the income-producing transaction is irrelevant."); Jim Beam Brands Co. v. Franchise Tax Bd., 133 Cal. App. 4th 514, 526 (2005) (quoting the regulations drafted by the Multistate Tax Commission which provide "[i]ncome that is derived from . . . transactions made in liquidation or the winding-up of business, is business income, if the property is or was used in the taxpayer's trade or business operations" in support of California's treatment of income from liquidation events as business income).

[62] *Id*.

[63] Income from the sale of goodwill is considered business income for California tax purposes. *In re Imperial Inc.*, Nos. 472648 and 477927 (Cal. State Bd. of Equal. July 13, 2010).

[64] CAL. REV. & TAX. CODE § 25123 ("Rents and royalties from real or tangible personal property, capital gains, interest, dividends, or patent or copyright royalties, to the extent that they constitute nonbusiness income, shall be allocated as provided in Sections 25124 through 25127 of this act.").

[65] *Id*. § 25125(a).

time of sale, or if the company's commercial domicile[66] is California and the company is not taxable in state where property had situs.[67] Nonbusiness gains from the sale of intangible property are allocated to the state where the company is domiciled.

If some or all of the gain is considered business income, the sales-factor market-sourcing apportionment method discussed earlier applies for the purposes of California franchise tax.[68] The sourcing of income from the sale of intangibles, as opposed to income from the sales of services, is undertaken via another set of rules set out in the regulations.[69] The regulations begin with the general rule that sales from intangibles will be sourced to California to the extent the intangibles are used in California.[70] If 50% or more of the assets of the company being sold consist of real and/or tangible personal property, the sourcing of the ownership interests is calculated by averaging the property and payroll factors from the most recent taxable year before the year of the sale.[71] If, however, the sale occurs more than six months into the current taxable year, the current property and payroll factors will be averaged.[72] In a situation where 50% or more of the assets of the company being sold are made up of intangible property, the sales factor will be used to source the income based on either the previous taxable year or the current taxable year, depending on whether the sale occurs in the first or second six months of the current taxable year.[73]

With respect to the shareholder's individual income tax implications when an S corporation is liquidated pursuant to an actual or deemed asset sale, the Internal Revenue Code Subchapter C rules also apply.[74] According to IRC § 331(a), when an S corporation shareholder receives a distribution in complete liquidation, the distribution is treated as payment in full for the exchange or sale of stock to the corporation.[75] Even if a portion of the liquidating distribution is accumulated earnings and profits from prior years, the entire distribution is treated as part of the exchange for stock.[76] However, Internal Revenue Code § 1366(b) states that the character of the gain that flows through to a shareholder in a deemed sale of assets is decided at the corporate level. As a result, if the S corporation has California source income, that sourcing passes through to the shareholders. In the case of a deemed sale of assets (or an actual sale of assets), the gain is not treated as gain from the sale of an intangible asset, but instead is sourced and taxes payable

---

[66] "Commercial domicile" is defined as "the principal place from which the trade or business of the Taxpayer is directed or managed. *Id*. § 25120(b).

[67] *Id*. § 25125(b); Robert Half Intern.,, Inc. v. Franchise Tax Bd., 66 Cal. App. 4th 1020, 1023 (1998).

[68] CAL. REV. & TAX. CODE § 25128.7.

[69] CAL. CODE REGS. tit. 18, § 25136-2(d).

[70] *Id*.

[71] *Id*. § 25136-2(d)(1)(A)1.a.

[72] *Id*.

[73] *Id*. § 25136-2(d)(1)(A)1.b.

[74] CAL. REV. & TAX. CODE § 17321.

[75] Treas. Reg. § 1.331-1(b).

[76] I.R.C. § 331(b).

to California according to the same sourcing rules that govern the company's income.[77] As a result, if the income to the company is considered nonbusiness income, it is sourced according to California Revenue & Tax Code §§ 25124 through 25127, as described earlier.[78] If the income to the company is considered business income, the sales factor apportionment method applies as described in the previous paragraph.[79]

In Calvin's situation, the gain from the actual or deemed asset sale will likely be considered business income. Assuming that the assets being sold will consist primarily of goodwill and other intangibles, the sourcing for the income from the sale will be determined according to either the Company's previous year's single sales factor or the sales factor from the first six months of the current year, which, in Calvin's case, results in 20% of the sale of his interests in the Company being subject to California corporate franchise tax. In addition, Calvin will also be on the hook for California income tax against 20% of whatever liquidation gain, if any, that is passed through to him as a distribution.[80]

For the purposes of this case study, and assuming that Calvin's interest in the S corporation has not obtained a business situs in California, Calvin will be better off disposing of his interests in the Company via a sale of stock to a third party.

As a final note on Calvin's move out of California and subsequent sale of the company, there is a very high likelihood that the California Franchise Tax Board will not go gentle into that good night, especially if Calvin undertakes the sale within a year or two of moving out of the state. As a backup measure in case the California Franchise Tax Board wins a subsequent residency challenge, Calvin is advised to fund a WING (discussed in detail in the next section of this paper) with his S corporation shares to guard against California's after-the-fact assessment of tax on the sale of the Company.

IV. CALVIN STAYS IN CALIFORNIA WITH PLANS TO MOVE OUT OF STATE IN THE FUTURE:

> *Alternatively, Calvin visits Wyoming and decides that while it may be the perfect place to relocate in seven years or so, he's not ready now. Instead, he buys several pairs of custom boots, a belt buckle the size of a salad plate, and happily heads back to his beach-side oasis. He settles on a plan to move out in seven to ten years when he sells the Company and retires.*

In order to most effectively lower his California income tax burden under this scenario, Calvin should transfer his shares in the Company to a Wyoming Incomplete Gift Non-Grantor Trust (a "WING"). A WING is statutorily known as a Wyoming Qualified Spendthrift Trust,

---

[77] *Valentino v. Franchise Tax Appeal Bd.*, 87 Cal. App. 4th 1284, 1290 (2001); CAL. FRANCHISE TAX BD., INTERNAL PROCEDURES MANUAL: 16.0 SALE OF STOCK & ELECTION OF IRC § 338(H)(10) 32 (Dec. 2007).

[78] See the text corresponding to footnotes 64 through 67.

[79] CAL. REV. & TAX. CODE § 25128.7. See the text corresponding to footnotes 68 through 73.

[80] The value of the assets or deemed asset sale and Calvin's basis for California tax purposes may differ from those values for federal tax purposes, resulting in taxable income being distributed to Calvin as a result of the liquidation.

which is a type of self-settled spendthrift trust (also generically known as a domestic asset protection trust). Other than certain child support, fraudulent transfer, and secured claims, the assets held in such a trust will be protected from attachment by future creditors.[81] Twelve states currently permit settlors to create spendthrift trusts for their own benefit.[82] In this particular scenario, however, the many benefits of Wyoming's trust code come second to the fact that effectively drafted WINGs allow settlors living in states that impose tax on trust income to create trusts that will not be subject to such tax.[83]

Let's begin with an overview of how California taxes trust income. A trust is subject to California income tax if: (1) a fiduciary resides in California, (2) a non-contingent beneficiary resides in California, or (3) the trust has California source income.[84] Unlike many jurisdictions, California taxes trust income based on the residence of fiduciaries and non-contingent beneficiaries, regardless of where the settlor resides.[85] The trust's entire accumulated net income is subject to tax if all of the trustees or if all of its non-contingent beneficiaries are California residents.[86] If only some of the trustees or non-contingent beneficiaries are California residents, California takes a proportional approach to taxing the trust's accumulated net income.[87]

If a trust is subject to California tax based on the above, the tax is applied to all trust income derived from a California source.[88] In addition, California resident beneficiaries are liable for a "throwback" tax if they receive a distribution from a trust that (a) has not paid past-due California income tax, or (b) if the distribution causes the beneficiary's contingent interest in the trust to vest.[89] For example, if a beneficiary receives a distribution from a completely discretionary trust, that beneficiary's interest in the distributed portion of the trust becomes vested and therefore non-contingent. As a result, the accumulated net income from which the distribution was made will be taxed as though it had been included in the income of the

[81] *See* WYO. STAT. ANN. §§ 4-10-510(a), 4-10-520 (2010).

[82] *See* ALASKA STAT. § 34.40.110 (2010); DEL. CODE ANN. tit. 12, § 3570(11)(a) & (b) (2010); HAW. REV. STAT. § 554G (2010); MO. REV. STAT. § 456.5-505(3)(2) (2010); NEV. REV. STAT. § 166.040(1)(b) (2010); N.H. REV. STAT. ANN. § 564-D:1–18 (2010); OKLA. STAT. tit. 31, §§ 10–18 (2010); R.I. GEN. LAWS § 18-9.2-2(10) (2010); S.D. CODIFIED LAWS §§ 55-16-1 to 55-16-17 (2010); TENN. CODE ANN. §§ 35-16-101 to 35-16-112 (2010); UTAH CODE ANN. § 25-6-14(1)(a) (LexisNexis 2010); WYO. STAT. ANN. §§ 4-10-510.

[83] Wyoming trusts can be drafted with numerous favorable trust innovations, including the ability to protect wealth for up to 1,000 years. See generally Christopher M. Reimer, *The Undiscovered Country: Wyoming's Emergence as a Leading Trust Situs Jurisdiction*, 11 WYO. L. REV. 165 (2011) for a more detailed discussion of all of the advantages offered by Wyoming trusts.

[84] *See* CAL. REV. & TAX. CODE §§ 17742–17744, 17951.

[85] *Id*. § 17742(a). A "resident" is someone who is (1) in the state for anything other than a temporary or transitory purpose or (2) domiciled in the state but outside of it for a temporary or transitory purpose. *Id*. § 17014(a). A temporary absence will not end residency. *Id*. § 17014(c).

[86] CAL. REV. & TAX. CODE § 17742(a).

[87] *Id.* §§ 17743–17744; Cal. Franchise Tax Bd., Legal Ruling No. 238 (1959) (setting forth a formula to determine the portion of the trust to be taxed when some but not all of the trust's vested beneficiaries are California residents and some but not all of the trust's trustees are California residents).

[88] CAL. REV. & TAX. CODE § 17734.

[89] CAL. REV. & TAX. CODE § 17745.

beneficiary ratably in the year of distribution and all years during which the income had accumulated (limited to a total of six years).[90]

The federal throwback rules for the distribution of accumulated net income from foreign trusts govern how the tax is calculated.[91] Because the throwback tax only applies if and when a distribution is made, so long as no distribution is made from a discretionary non-California trust to a contingent California-resident beneficiary, the income-producing trust assets are allowed to grow California-tax-free.

A. Non-Grantor Trust

The first step in limiting the application of California tax is drafting a non-grantor trust. The Internal Revenue Code treats settlors who contribute property to certain kinds of trusts as the owners of some or all of such trusts. If a trust is classified as a grantor trust, any income attributable to the part of the trust to which the settlor is treated as the owner will be included in the settlor's taxable income.[92] If income is included in a California resident's federally taxable income, it will also be subject to California income tax.[93]

Generally, the settlor of a WING must avoid five pitfalls that will trigger grantor trust status:

(1) the settlor cannot retain a reversionary interest exceeding 5% of the trust's initial value;[94]

(2) the settlor cannot have the power to control the beneficial enjoyment of the trust's assets;[95]

(3) the settlor cannot have the power to revoke the trust;[96]

(4) the settlor cannot be able to receive impermissible distributions from the trust;[97] and

(5) trust assets must not be subject to claims by the settlor's creditors.[98]

Requiring a distribution committee composed exclusively of beneficiaries with substantial adverse interests in the trust to authorize distributions to the settlor should ensure a WING avoids grantor status.[99]

---

[90] *Id*. § 17731.

[91] *Id*. §§ 17745(d), 17731 (stating "Subchapter J of Chapter 1 of Subtitle A of the Internal Revenue Code, relating to estates, trusts, beneficiaries, and decedents, shall apply, except as otherwise provided"). *See* I.R.C. §§ 665–668; California Form 541 Schedule J, "Trust Allocation of an Accumulation Distribution" (2006).

[92] I.R.C. § 671 (2006).

[93] 38 CAL. JUR. 3D *Income Taxes* § 69 (2011 Supp.); *see also* CAL. REV. & TAX. CODE §§ 17731(a) (incorporating federal income tax laws as applied to trusts and estates unless an exception applies).

[94] I.R.C. § 673(a).

[95] *Id.* § 674(a).

[96] *Id.* § 676(a).

[97] Treas. Reg. § 1.677(a)-1(d) (1971).

[98] Other trust features can trigger grantor status, including impermissible administrative powers, I.R.C. § 675, and foreign trusts with U.S. beneficiaries, *id.* § 679.

1. Reversionary Interests (I.R.C. § 673)

A WING will receive grantor trust treatment if, at the trust's inception, the settlor has a reversionary interest exceeding 5% of the trust's initial value.[100] This raises the question of whether a settlor's ability to receive distributions at a trustee's discretion constitutes a reversionary interest. Code § 672 does not define the term "reversionary interest."[101] However, § 673 likely uses the term in its traditional sense, in which a reversionary interest is created when a person who owns a vested estate transfers a lesser vested estate to another person.[102] The part of the estate retained by the transferor constitutes the reversionary interest. From this perspective, the settlor of a properly drafted WING has no reversionary interest because he or she has transferred all of his or her legal interest to a third party trustee. The settlor's ability to receive distributions at the trustee's discretion is not a reversionary interest but a beneficial interest. Support for the argument that § 673 is using the term in this traditional sense—and thus does not describe a settlor's beneficial interest in a WING—can be found in I.R.S. guidance, case law, and the statute's legislative history.

In 1981, the I.R.S. issued a Technical Advice Memorandum considering whether the full amount of a taxpayer's recovery following termination of a trust should be included in the taxpayer's gross income.[103] As part of the memorandum, the I.R.S. determined whether the taxpayer's reasonable expectation of enjoyment of the trust property within ten years of the initial transfer created a reversionary interest. The I.R.S stated that it would not: "a reversionary interest is the interest a transferor has when less than his entire interest and property is transferred to a trust and which will become possessory at some future date."[104] The I.R.S. defined a reversionary interest in a similar fashion in a General Counsel Memorandum.[105] The memorandum concluded that a trust containing a provision deeming the trust void and returning assets to the grantors upon the I.R.S.'s disallowance of a deduction conflicted with § 676(a). Yet the memorandum defined reversionary interests in the traditional fashion, which would allow a properly drafted WING to avoid grantor trust status. The memorandum distinguished a reversionary interest from a possibility of reverter and stated, "the reversionary interest arises only when the transferor transfers an estate of lesser quantum than he owns."[106]

In *Crane v. Commissioner*, the United States Court of Appeals for the First Circuit addressed an unusual trust arrangement in which the settlor transferred stock to a trust.[107] Upon termination of the trust, the settlor would receive either the proceeds from the sale of the stock to

[99] *See* I.R.S. Priv. Ltr. Rul. 200612002 (Mar. 24, 2006); I.R.S. Priv. Ltr. Rul. 200502014 (Jan. 14, 2005); I.R.S. Priv. Ltr. Rul. 200247013 (Aug. 14, 2002); Priv. Ltr. Rul. 200148028 (Nov. 30, 2001).

[100] I.R.C. § 673(a).

[101] *See id.* § 672.

[102] *E.g.*, 1 JOHN A. BARRON, JR. & LEWIS MALLALIEU SIMES, THE LAW OF FUTURE INTERESTS § 82 (3d ed. 2004); 2 HERBERT T. TIFFANY & BASIL JONES, TIFFANY ON REAL PROPERTY § 311(a) (2010).

[103] I.R.S. Tech. Adv. Mem. 8127004 (Feb. 25, 1981).

[104] *Id.*

[105] I.R.S. Gen. Couns. Mem. 36,410, at 5–6 (Sept. 11, 1975).

[106] *Id.* (citing Helvering v. Wood, 309 U.S. 344 (1940)).

[107] 368 F.2d 800, 803 (1st Cir. 1966).

the beneficiaries or a return of the stock.[108] The court considered whether the arrangement gave the settlor a reversionary interest in the trust. It applied the traditional definition of a reversionary interest and held that the settlor did have such an interest: "when we look at the obvious purpose of section 673(a), it must be to prevent a grantor from making a temporary transfer of assets in order to diminish, for a limited period, the receipt of taxable income therefrom."[109] By characterizing a reversionary interest as a temporary transfer, the court appears to have applied the traditional definition of a reversionary interest to § 673. The settlor's transfer of a lesser vested estate (the temporary transfer) left the settlor with a reversionary interest. A properly executed transfer to a WING is distinguishable from *Crane* because it is not a temporary transfer. While the settlor retains a beneficial interest in the property, full legal title to the property is transferred to the trustee.

The legislative history of § 673 also suggests that the statute applies the traditional definition of a reversionary interest. Congress enacted § 673 in 1954 with the intent of codifying § 39.22(a)-121(c) of Treasury Regulation 118.[110] According to that regulation, "[i]ncome of a trust is taxable to the grantor where the grantor has a reversionary interest in the corpus or income."[111] The regulation noted instances in which a reversionary interest arises, all of which use the traditional definition of a reversion. While the list is not exhaustive, it suggests legislative contemplation of the traditional definition.

Finally, several Private Letter Rulings from the I.R.S. appear to confirm that the ability to receive distributions from a WING will not cause a trust to be deemed a grantor trust. In 2002, the I.R.S. stated that it would not apply grantor treatment to a trust in which the settlor could receive distributions from the trust subject to the sole discretion of a distribution committee composed of potential recipients of trust distributions.[112] Taxpayers cannot rely upon or cite Private Letter Rulings as precedent. However, they indicate that the I.R.S. has accepted this interpretation in the past and may apply a similar analysis to a WING.

Drafters of WINGs seeking to avoid grantor trust status should be careful to ensure that a settlor's spouse not be entitled to a reversionary interest in the trust. This can complicate attempts to create marital trusts because the Internal Revenue Code treats a settlor as possessing any power or interest held by his or her spouse.[113] Yet the settlor may retain a testamentary limited power of appointment in favor of the spouse or a QTIP trust without retaining an impermissible interest.[114]

---

[108] *Id.*

[109] *Id.*

[110] H.R. Rep. No. 83-1337 (1954), *reprinted in* 1954 U.S.C.C.A.N. 4025, 4353. The two changes are unrelated to the definition of a reversionary interest.

[111] Treas. Reg. § 39.22(a)-121(c) (1953).

[112] I.R.S. Priv. Ltr. Rul. 200247013 (Aug. 14, 2002).

[113] I.R.C. § 672(e).

[114] *See id.* § 654(b)(3).

2. *Power to Control Beneficial Enjoyment (I.R.C. § 674)*

According to § 674,

> The grantor shall be treated as the owner of any portion of a trust in respect of which the beneficial enjoyment of the corpus or the income therefrom is subject to a power of disposition, exercisable by the grantor or a nonadverse party, or both, without the approval or consent of any adverse party.[115]

A WING can retain non-grantor status consistent with this provision even if it gives a trustee discretion to make distributions to the settlor, the settlor's spouse, or other beneficiaries. The trust agreement should specify that one or more members of a distribution committee must consent to distributions. All members of the distribution committee should be adverse parties. An "adverse party" is "any person having a substantial beneficial interest in the trust which would be adversely affected by the exercise or nonexercise of the power which he possesses respecting the trust."[116]

In 2002, the I.R.S. stated in a Private Letter Ruling that it would not treat a settlor as the owner of a trust because a distribution committee of a non-grantor trust consisting of members with substantial, adverse interests in the trust retained discretion over distributions and accumulations.[117] Each member of the distribution committee was eligible to receive distributions from the trust estate and had the nonfiduciary power to participate in deliberations and vote in favor of distributions. The ruling involved a distribution committee that exercised its powers by unanimous consent, although any member acting alone could direct a trustee to make a distribution after receiving the settlor's prior written consent. A planner may structure the distribution committee's decisionmaking process differently, so long as approval by one or more members with substantial adverse interests in the trust is required before making distributions. Again, these rulings are not binding and taxpayers cannot cite them as precedent. But it is likely that the I.R.S. would apply the same analysis to a WING.

None of the beneficiaries on the distribution committee should be California residents. Such residents' power to authorize distributions could make them non-contingent beneficiaries or even fiduciaries, risking application of California income tax.

3. *Power to Revoke (I.R.C. § 676)*

Section 676 triggers grantor status if the settlor or a non-adverse party has the power at any time to revest property in the settlor.[118] A WING is a type of irrevocable trust. Additionally, as with § 674, requiring consent by a distribution committee before any distribution to the settlor or settlor's spouse occurs should prevent grantor status under this section.

---

[115] *Id.* § 674(a).

[116] *Id.* § 672(a).

[117] I.R.S. Priv. Ltr. Rul. 200247013 (Aug. 14, 2002); *see also* I.R.S. Priv. Ltr. Rul. 200612002 (Mar. 24, 2006); I.R.S. Priv. Ltr. Rul. 200502014 (Jan. 14, 2005); I.R.S. Priv. Ltr. Rul. 200148028 (Nov. 30, 2001).

[118] I.R.C. § 676(a).

4. *Impermissible Income (I.R.C. § 677)*

Section 677 triggers grantor status if trust income, without approval or consent of an adverse party or at the discretion the settlor or a nonadverse party, may be distributed to the settlor or the settlor's spouse, held or accumulated for future distribution to the settlor or the settlor's spouse, or applied to pay life insurance premiums on the life of the settlor or the settlor's spouse.[119] As with §§ 674 and 676, distribution committee consent should prevent this section from causing grantor status.

5. *Creditor Claims (Treas. Reg. § 1.677(a)-1(d))*

A trust will receive grantor trust status if, under state law, the grantor's creditors may satisfy claims against the settlor out of the trust's assets.[120] This will ensure grantor status of self-settled trusts in the vast majority of states that adhere to the traditional rule against self-settled spendthrift trusts. However, Wyoming permits such trusts in the form of WINGs, which should prevent trust assets from being subject to creditor claims.[121] Accordingly, such trusts can avoid grantor trust status.

B. No California Resident Ffiduciaries

The second step in limiting the application of California tax is to have no California resident fiduciaries—a fairly easy process. California income tax will apply to any trust administered in the state by a California trustee, regardless of the location of the trust's assets, beneficiaries, or income source.[122] A trustee's place of business is the place where it "transacts the major portion of its administration of the trust."[123] Therefore, a trust company that transacts all of its administration outside of California will help prevent the application of California tax. Wyoming is one of the few states that allows private trust companies. It has no capital requirements and a very low cost of administration, thereby providing an avenue to further reduce the fees imposed on the trust and allow faster growth.

C. No California Resident Non-contingent Beneficiaries

Step three is to ensure any California resident beneficiaries are contingent. If the trust has non-contingent beneficiaries that reside in California, California imposes tax on the trust's income.[124] If the trust has multiple non-contingent beneficiaries, California law apportions income tax based on how many non-contingent beneficiaries reside in the state and the size of their interests, as determined by regulations.[125] A non-contingent beneficiary is "one whose interest is not subject to a condition precedent."[126] At common law, a beneficiary's interest in a trust is subject to a condition precedent if the "beneficiary is to take an interest in income or

---

[119] *Id.* § 677(a).

[120] Treas. Reg. § 1.677(a)-1(d) (1971).

[121] *See* WYO. STAT. ANN. § 4-10-510(a).

[122] CAL. CODE REGS. tit. 18, § 17744.

[123] CAL. REV. & TAX. CODE § 17742(b).

[124] *Id.* § 17742(a).

[125] *Id.* § 17744; CAL. CODE REGS. tit. 18, § 17744.

[126] CAL. REV. & TAX. CODE § 17742(b).

principal only on the happening of a designated event . . . ."[127] California courts follow the common law of trusts unless modified by statute.[128] Thus, a California trust administered by a non-California trust company will only be subject to California tax on its non-California source income if the trust has beneficiaries who are California residents and entitled to receive distributions not conditioned on any designated event.

The simplest means of ensuring a trust has no non-contingent California beneficiaries is to provide non-California trustees with complete discretion in making any distributions to such beneficiaries. The exercise of discretion by a third party trustee constitutes a condition precedent to the beneficiaries' ability to receive trust assets. As a result, a California resident's ability to receive current distributions would be contingent and would not subject the trust's income to California tax.[129] The California Franchise Tax Board confirmed this conclusion:

> A resident beneficiary whose interest in a trust is subject to the sole and absolute discretion of the trustee holds a contingent interest in the trust. The exercise of the trustee's discretionary power is a condition precedent that must occur before the beneficiary obtains a vested interest in the trust. Once the trustee decides to distribute income in a specified amount, the beneficiary has a non-contingent, vested interest in the trust, but only for that amount. At that time, the trust is taxable on the distributable income pursuant to Rev. & Tax. Code section 17742. The beneficiary continues to have a contingent interest in the remaining current and/or accumulated income of the trust.[130]

If the trust instrument provides the trustee with absolute, unfettered discretion to make distributions to California beneficiaries, the beneficiaries' residence will not subject the trust to California income tax until they receive distributions.[131]

To summarize, in order for a WING's non-California source income to avoid California income tax, (1) the trust must be non-grantor, (2) the trust must have no fiduciaries who reside in California, and (3) the trust's California resident beneficiaries must have only contingent interests in the trust. To avoid grantor status, a distribution committee composed of individuals with substantial, adverse interests in the trust, none of whom are the settlor or California residents, must approve any distributions from the WING to the settlor. To ensure that the WING has no California fiduciaries, a Wyoming trust company should be appointed as trustee. Finally, any

---

[127] RESTATEMENT (SECOND) OF PROP. § 128 cmt. k (1959). California courts apply a similar definition in the context of contract law: "a condition precedent is either an act of a party that must be performed or an uncertain event that must happen before the contractual right accrues or the contractual duty arises." *E.g.*, Platt Pacific, Inc. v. Andelson, 862 P.2d 158, 601 (Cal. 1993).

[128] CAL. PROBATE CODE § 15002.

[129] Richard W. Nenno, *Planning to Minimize or Avoid State Income Taxes on Trusts*, 352 PLI/EST 132, 164 (2009).

[130] Cal. Franchise Tax Bd. Tech. Adv. Mem. 2006-0002 (Feb. 17, 2006) (citing e.g., SCOTT ON TRUSTS § 128.3 (2d ed. 1956); Thomas v. Gregg, 24 A. 418 (Md. 1982)).

[131] It is important to draft the instrument ensure that beneficiaries do not retain excessive control over how the trustees exercise their discretion. *Id.*; *In re* Appeal of Yolanda King Family Trust & Mary L. Tunney Junior Trust, Case Nos. 357825 & 357829, 2007 WL 3275358, at *8–9 (Cal. St. Bd. Eq. Oct. 2, 2007) (discussing arguments regarding whether a beneficiary became non-contingent by retaining excessive control over the trustee).

distributions to California residents must be only at the trustee's discretion, unfettered by the direction of the trust's California beneficiaries. The income of a trust that adheres to these requirements will not be subject to California income tax, regardless of where the trust's settlors or beneficiaries reside.

As mentioned earlier, California resident beneficiaries of a WING will be liable for "throwback" tax if a distribution causes that beneficiary's contingent interest to vest.[132] With that in mind, the use of a WING is most beneficial for clients in three situations. First, like Calvin, if a person moves out of California, taking measures to establish residency in another state, and soon after disposes of assets considered partly or entirely non-California source. In this situation, a WING acts as an insurance policy if the California Franchise Tax Board challenges the person's revocation of his or her California residency and is successful. The WING will insulate the non-California source portion of the assets from California tax even if the person is deemed to have been a California resident when the trust sold the assets.

Second, as in Calvin's alternate life, a California resident plans to leave the state in the future and owns considerable assets that generate income partly or entirely sourced outside of California. So long as the person can put those assets in a WING and not need a distribution until he has moved out of California, no throwback tax will apply.[133]

Third, a California resident with no intention of ever leaving the state who has wholly or partly non-California source assets, the income from which she does not currently depend on, does not foresee needing, and plans to pass on to her children is also a good candidate. In this situation, the trust assets will be able to grow California income tax free to the extent they are non-California source and so long as the settlor takes no distributions.

V. RECENT UPDATES TO WYOMING'S TRUST LAW:

Recently-passed legislation has enhanced the flexibility of Wyoming's law and highlights the state legislature's responsive pro-business and pro-wealth posture. Taking effect in July of 2013, Wyoming trust law revisions include:

- Statutory decanting
- Streamlined "qualified beneficiary" rules with respect to consent and notice
- Confirmation that there is no separate perpetuities law limiting the duration of noncharitable purpose trusts
- Additional powers and interests a settlor can retain without threatening a self-settled asset protection trust's irrevocable status, including allowing reimbursement of income taxes attributable to the trust
- Narrower exceptions to transfers into self-settled asset protection trusts, known as Qualified Spendthrift Trusts
- Clear and convincing standard of judicial review applicable to whether a transfer to a self-settled asset protection trust violates the Uniform Fraudulent Transfer Act

---

[132] CAL. REV. & TAX. CODE § 17745.

[133] Note that if a beneficiary leaves California and takes a distribution within twelve months, and within twelve months of that distribution, returns to the state, the person will be presumed to have been a resident of California for the entire period, therefore subjecting the distribution to throwback tax. *Id*. § 17745(e).

- A new form of self-settled asset protection trust that provides self-settled creditor protection with no creditor exceptions so long as a regulated financial institution serves as trustee
- A new procedure to force a "will contest" before death[134]

[134] H.R.B. 139, 62nd Leg., 2013 Gen. Sess. (Wyo. 2013); H.R.B. 151, 62nd Leg., 2013 Gen. Sess. (Wyo. 2013); H.R.B. 201, 62nd Leg., 2013 Gen. Sess. (Wyo. 2013) (all effective July 1, 2013).