



a movable feast

MSK Client Alert

March 28, 2019

State Taxation of CRT Distributions for Beneficiaries Who Move from California to Another State

MSK private clients sometimes move from California, the state with the highest maximum individual income tax rate in the US – 13.3%! -- to states like Nevada and Wyoming that have no income tax at all. Some of these clients are income beneficiaries of large charitable remainder trusts. How are distributions from those CRTs taxed once the income beneficiaries are no longer California residents?

First things first: remember how CRT distributions are characterized for tax purposes. Under Internal Revenue Code §664, distributions are treated as coming first, from the current and accumulated ordinary income of the trust (Tier One); second, from capital gains (Tier Two); third, from tax-exempt interest (Tier Three); and fourth, from corpus (Tier Four). Within each tier, distributions are treated as coming first from income taxed at a higher rate – for example, gain from the sale of collectibles, taxable at 28% before gain from the sale of stock, taxable at 20%. This requires careful record keeping by the trustee, to track the various types of trust receipts in the various sub-tiers, especially for NIMCRUTs that may make no distributions for several years.

Now we need to add a new task for trustees that track the types of income earned by a CRT with California beneficiaries in order to accurately characterize distributions to its beneficiaries if and when those beneficiaries move to another state, namely, what is the *source* of income earned by a CRT under California tax law. The reason is that if a resident of another state receives a trust distribution of California source income, that income remains taxable in California, while distributions of non-California source income are free from California income tax, even if the transaction by the trust that gave rise to the income took place while the beneficiary was a California resident.

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