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BOARD OF EQUALIZATION

STATE OF CALIFORNIA

In the Matter of the Appeal of:	**REHEARING SUMMARY**
	FRANCHISE AND INCOME TAX APPEAL
PAULA TRUST	Case No. 759422

Claim for Refund

Year	Amount
2007	$150,655.00[1]

Representing the Parties:

For Appellant: Edwin P. Antolin, Antolin Law Group

For Franchise Tax Board: Sonia Woodruff, Tax Counsel III[2]

QUESTION: Whether appellant Paula Trust was subject to California income tax on all of its income as California source income, as contended by respondent Franchise Tax Board (FTB), or, alternatively, whether appellant's amended return correctly apportioned 50 percent of its income to California on the basis that only one of its two fiduciaries was a California resident.

[1] There are 171 other appeals, with over $27 million at issue, deferred pending the resolution of this matter.

[2] Respondent's counsel was formerly known as Sonia C. Deshmukh.

HEARING SUMMARY

Background

Paula Trust is an irrevocable trust created in 1971. During the year at issue, the trust had two co-trustees. One of the trustees was a California resident and the other was a resident of another state. The trust has a single beneficiary, who is a California resident.[3] The trustees have the authority to distribute net income or principal to the beneficiary as they deem to be in her best interests. (App. Op. Br., pp. 1-2; FTB Reply Br., p. 2.)[4]

During the 2007 tax year, Paula Trust recognized a substantial amount of income as a result of the sale of stock in Century Theatres, Inc. by a partnership in which it was a limited partner. It also recognized income from the sale in its capacity as a shareholder in an S corporation that served as the general partner of that same partnership. (App. Op. Br., pp. 2-3; FTB Reply Br., pp. 2-3.)

In its reply brief prior to the original hearing, appellant stated that, for purposes of this appeal, it has agreed not to dispute whether all of its income was from a California source. (See App. Original Hearing Reply Br., p. 7, fn. 4; FTB Reply Br., pp. 3-4.)

On its original 2007 California income tax return (Form 541), Paula Trust apportioned all of its income to California.[5] In 2012, appellant filed an amended tax return that apportioned only half of

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[3] On the death of the beneficiary, distributions may be made to descendants of the beneficiary. Respondent's brief notes at page two that Paula Trust was one of several trusts created by a December 23, 1971 trust agreement.

[4] Unless otherwise noted, all references to briefs and exhibits refer to briefs and exhibits submitted during the rehearing briefing process. Briefs and exhibits submitted prior to the first oral hearing can be found by Board staff in the materials for the September 23, 2014 Board meeting.

[5] It appears to staff that appellant's original California income tax return does not indicate whether its income was from a California source. It lists one California beneficiary, one nonresident trustee, and one resident trustee. (App. Op. Br., Ex. C, p. 3 [Side 3 and Schedule G of the return].) The Form 541 instructions state that contingent beneficiaries "are not relevant in determining the taxability of a trust[,]" and instruct the taxpayer to list only noncontingent beneficiaries. (2007 California Fiduciary Income Tax Return Form 541 & Instructions [hereinafter "Form 541 Booklet"], p. 14.) Consistent with these instructions, appellant's original tax return appears to report the beneficiary as a noncontingent beneficiary (or at least as noncontingent in part) and to report that appellant's entire taxable income is taxable by California on that basis rather than on the basis of all income being from a California source. However, appellant's amended tax return states that its original tax return "incorrectly reported" a stock gain as "solely California source income." (App. Op. Br., Ex. D, p. 6 [Explanation of Changes, p. 2].) In a letter dated January 21, 2014 to Appeals Division staff and the FTB, appellant stated that "[o]n its original return, [it] reported 100% of its income as California source." At the hearing, appellant should be prepared to explain its original reporting position and its current position with regard to the source of its income.

its income to California on the ground that only one of its two fiduciaries resided in California.[6] This amended tax return sets forth the refund claim at issue in this appeal. (App. Op. Br., pp. 2-3, Ex.'s C [original return] & D [amended return]; FTB Reply Br., p. 3.)

On August 30, 2013, appellant filed this timely appeal pursuant to Revenue and Taxation Code[7] (R&TC) 19331 on the basis that its refund claim should be deemed denied as respondent had not mailed a notice of action on the refund claim within six months after the claim had been filed. (App. Op. Br., p. 3.)

On September 23, 2014, the Board held an oral hearing and determined that appellant was subject to California income tax on all of its income.[8] Therefore, it denied appellant's appeal.

Appellant filed a timely petition for rehearing, and the parties provided briefing on the petition for rehearing. On July 28, 2015, the Board granted appellant's petition for rehearing. The parties then filed briefs on rehearing, which are summarized in this Rehearing Summary.

Contentions

Appellant's Opening Brief

In its introduction, appellant notes that the FTB contends that a two-step methodology set forth in California Code of Regulations, title 18, section (Regulation) 17743 applies.[9] In this two-step methodology, the FTB first applies the nonresident individual sourcing rules contained in Chapter 11 of the Revenue and Taxation Code and then, with respect to non-California source income, applies an apportionment rule based on the state of residence of fiduciaries and noncontingent beneficiaries under Chapter 9. However, appellant contends, "given the precise terms of the regulation," the regulation does not apply. Appellant further contends that the FTB's methodology is contrary to the statutes governing

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[6] Appellant states that the return also corrected "computational errors" relating to tax-exempt interest income, income from an S Corporation, and an Electing Small Business Trust tax schedule. It appears to staff that these corrections are not at issue in this appeal.

[7] Unless otherwise noted, references to the Revenue and Taxation Code refer to provisions in effect for the year at issue, 2007.

[8] Members Runner and Steel voted against sustaining the FTB's action. The Hearing Summary prepared for the original hearing is available at: www.boe.ca.gov/meetings/pdf/hearingsummaries/2014/B_Paula_Trust_759422_Sum_092314.pdf .

[9] The Applicable Law section of this Hearing Summary includes excerpts from various statutes and regulations referenced by the parties in their contentions.

the taxation of trust income, which are set forth in Chapter 9, and which were changed "a long time ago to eliminate the first step of the [FTB's] methodology." (App. Op. Br., pp. 1, 5.)

Summarizing its argument, appellant argues that the FTB, "recognizing the risks inherent in relying on the regulation, . . . also argues that there is a statutory basis for applying its two-step approach." However, appellant contends, the Revenue and Taxation Code does not say that the nonresident sourcing statutes in Chapter 11 apply to trusts. Appellant asserts that the "FTB is asking this Board to rewrite the statutes, but this is prohibited by law." Appellant further asserts that tax imposition statutes must be strictly construed in favor of the taxpayer and, as there is no express statute applying the sourcing statutes to trusts, that such statutes cannot be applied to trust income. Appellant argues that, under the "plain language of the statutes and their legislative history, the trust income taxable by California is determined only by the apportionment rules in Chapter 9 (Sections 17743-17744)." (App. Op. Br., pp. 1, 5.)

Appellant contends that, under the "plain language" of the statutes, California can only tax one-half of its income. Appellant argues that R&TC section 17041, subdivision (e), provides the "starting point" for determining the income tax of a trust. Appellant further argues that it "provides that trust taxable income is subject to tax" by stating "There shall be imposed for each taxable year upon the taxable income of every estate, trust, or common trust fund taxes equal to the amount computed under subdivision (a) for an individual having the same amount of taxable income." Next, appellant contends, R&TC section 17731 provides that trust income shall be computed in the same manner as for federal income tax purposes, subject to California modifications. (App. Op. Br., p. 3.)

Appellant argues that, once the trust's "total California apportionable income" is computed, then "the portion of that income that is taxable by California is determined pursuant to Sections 17742, 17743, and 17744 as follows." Appellant explains that these statutes provide as follows: if all fiduciaries or all noncontingent beneficiaries are California residents then, under R&TC section 17742, the entire taxable income of the trust is taxable by California; if some of the fiduciaries are residents and some are nonresidents, as is the case for Paula Trust, then taxable income is apportioned to California under R&TC section 17743 according to the number of fiduciaries resident in California pursuant to rules and regulations prescribed by the FTB; and, if the trust has both a resident

beneficiary and a nonresident beneficiary, then taxable income is apportioned by R&TC section 17744 and taxed "according to the number of and interest of noncontingent beneficiaries resident in this state pursuant to rules and regulations prescribed by the [FTB]." Appellant argues that, under the foregoing statutes, as it has no noncontingent beneficiaries, and one resident fiduciary and one nonresident fiduciary, California can only tax one-half of its income. (App. Op. Br., pp. 4-5.)

Appellant contends that, contrary to the FTB's argument that a "two-step method" applies in which California source income is first taxed, "no statute provides that the nonresident individual sourcing rules in Chapter 11 apply to trust income." In support, appellant advances three arguments. (App. Op. Br., pp. 5-12.)

First, appellant contends that, "under settled rules of statutory construction, the nonresident sourcing rules do not apply to trusts . . . ." Appellant emphasizes that "California may not tax income unless the Legislature expressly says so." Appellant adds that "[i]t is a bedrock principle of statutory construction that tax imposition statutes must be construed strictly against the state and in favor of the taxpayer and must be 'clear and explicit' when imposing a tax[,]" quoting *Whitmore v. Brown* (1929) 207 Cal. 473, 482-483 (*Whitmore*) and citing additional authorities. Appellant provides the following quotation from *In re Estate of Potter* (1922) 188 Cal. 55, 64: "[l]aws imposing taxes are strictly construed, and doubts are resolved in favor of the taxpayer. . . . Duties are never imposed upon a citizen upon vague or doubtful interpretations." Appellant also quotes language from *Microsoft Corp. v. FTB* (2006) 39 Cal.4th 750, 759 (*Microsoft*), in which the court states "[t]o the extent the language is ambiguous, we generally will prefer the interpretation favoring the taxpayer." (App. Op. Br., p. 6. See also App. Reply Br., pp. 1-2.)

Appellant further contends that, when interpreting a statute, courts seek to, in the words of *Hoechst Celanese Corp. v. FTB* (2001) 25 Cal. 4th 508, 519 (*Hoechst*), "ascertain the intent of the Legislature so as to effectuate the purpose of the law." Further quoting *Hoechst*, which cites additional cases, appellant contends that one begins with the words of the statute, and if the statute "is clear and unambiguous, then we need go no further." (App. Op. Br., p. 7.)

Appellant notes that the FTB argues "that the nonresident individual sourcing statutes contained in Chapter 11 (Sections 17951-17955) apply to trusts." However, appellant observes that the

statutes "do not expressly state that they apply to trusts." Appellant notes that R&TC section 17951 provides that "in the case of *nonresident* taxpayers [appellant's emphasis]" only California-source income is included in gross income. Appellant notes that "nonresident" is defined by R&TC section 17015 as an "individual" which is defined by R&TC section 17005 as a "natural person." Thus, appellant argues, "by their terms and under the principles of strict construction, the nonresident individual sourcing statutes do not apply to trusts." (App. Op. Br., p. 7.)

After addressing the nonresident individual sourcing statutes in Chapter 11, appellant contends, as its second argument, that "[t]here is no other statutory basis for applying the nonresident statutes in Chapter 11 to trusts." Appellant argues that the "starting point" for taxing individuals and trusts is R&TC section 17041 as it imposes tax on individuals, trusts, and estates. Appellant observes that subdivisions (a)(1) and (c) tax full-year residents, while subdivisions (b) and (d) tax nonresident and part-year residents. Appellant reiterates that "nonresident" and "resident" are defined to include only individuals and natural persons and therefore exclude trusts. (App. Op. Br., pp. 7-8.)

Appellant notes that R&TC section 17041, subdivision (e), imposes on "the taxable income of every estate, trust, or common trust fund taxes equal to the amount computed under subdivision (a) for an individual having the same amount of taxable income." Appellant argues that, for full-year resident individuals and trusts, "the starting point for computing taxable income is federal taxable income[,]" citing R&TC section 17071 for resident individuals and R&TC section 17731 for trusts. (App. Op. Br., p. 8.)

However, appellant contends, the tax treatment of trusts and resident individuals then diverges, with R&TC section 17041, subdivision (a), taxing resident individuals on their "entire taxable income" while R&TC sections 17742 through 17744 of Chapter 9 determine the portion of income taxed by California based on the residence of the trust's noncontingent beneficiaries and fiduciaries Appellant emphasizes that "[n]o part of Chapter 9 states that the nonresident sourcing statutes in Chapter 11 apply to trusts. [appellant's emphasis]" (App. Op. Br., p. 8.)

Appellant contrasts the above treatment of trusts with R&TC section 17041's treatment of nonresident and part-year resident individuals. Appellant argues that, since nonresident individuals and part-year resident individuals cannot be taxed on their "entire" taxable income, R&TC section

17041, subdivision (b)(2), determines the "taxable income of every nonresident or part-year resident" through the application of R&TC section 17041, subdivision (i). R&TC section 17041, subdivision (i), then "expressly provides" that the "taxable income of every nonresident or part-year resident" includes California source income. (App. Op. Br., pp. 8-9.)

Appellant argues that, "[b]y its terms, Section 17041, subdivision (i), does not apply to trusts[,]" and it does not "purport to define the taxable income of trusts." Instead, appellant argues, R&TC section 17041, subdivision (i), "expressly defines the income of nonresidents and part-year residents[,]" who are defined as individuals. (App. Op. Br., p. 9.)

Thus, appellant contends, "when Section 17041 is read as a whole and in context with related [R&TC] provisions, it is plain that the Legislature intended for the taxable income of resident individuals, trusts/estates, and nonresidents/part-year resident individuals to be determined in different ways." Appellant argues that "[t]his is underscored by the fact that the Legislature" set forth the rules for resident individuals and trusts, and nonresident/part-year resident individuals, in different chapters, with Chapter 9 providing the rules for determining the taxable income of a trust and Chapter 11 providing the rules for determining the taxable income of a nonresident. (App. Op. Br., pp. 9-10.)

As its third argument against the FTB's statutory interpretation, appellant contends that the FTB's position is refuted by the legislative history of R&TC sections 17742-17744. Appellant argues that these statutes unambiguously provide that trusts with nonresident and resident fiduciaries determine their taxable income by apportionment. Thus, appellant argues, "there is no need to look beyond the text of the statutes to determine the Legislature's intent[,]" citing *Hoechst, supra*, 25 Cal. 4th at 519. (App. Op. Br., p. 10.)

However, appellant contends, "if there were any doubt as to the proper application of the Rev. & Tax. Code, the legislative history of the trust income tax statutes confirms Appellant's interpretation." Appellant observes that Section 12(b) of the original income tax act, which was enacted in 1935, expressly taxed trusts based both on income from California sources and on the basis of the residence of the trust's fiduciaries. Appellant notes that, in 1937, Section 12 was amended in a way that

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"deleted the sourcing method, but left in place the apportionment method."[10] Appellant contends that "[t]he 1937 amendment establishes that the Legislature intended only the apportionment method to apply to the taxation of trust income[,]" citing *Eu v. Chacon* (1976) 16 Cal.3d 465, 470, and several additional cases indicating that amendments to a statute are presumed to be intended to change the meaning of the statute. (App. Op. Br., pp. 10-11. See also App. Reply Br., p. 5.)

Appellant next argues that Regulation 17443 "does not support the FTB's approach." Appellant argues that "by its express terms" the regulation does not apply because it states it applies when there are both nonresident and resident fiduciaries "*and all the beneficiaries are nonresidents . . . .* [appellant's emphasis]" Appellant argues that, as appellant's sole beneficiary is a California resident, the regulation does not apply by its own terms. Appellant further argues that the examples in the regulation confirm that the regulation "means what it expressly says" by providing that "all beneficiaries [must be] nonresidents[,]" as both examples address situations in which all of the beneficiaries are nonresidents. (App. Op. Br., pp. 12-13. See also App. Reply Br., p. 14.)

Appellant further argues that, "[i]f Regulation 17743 could be read as applying in this case, it is invalid to the extent it conflicts with Section 17743." Appellant argues that the regulation "applies the nonresident individual sourcing rule to trust income[,]" while, in contrast, R&TC section 17743 provides that taxable income will be apportioned based on the number of fiduciaries resident in California. Appellant contends that, to the extent the regulation conflicts with R&TC section 17743, "it is void[,]" citing Government code section 11342.2 and *Nortel Networks, Inc. v. SBE* (2011) 191 Cal.App.4th 1259, 1276-78, and other cases. (App. Op. Br., pp. 13-14. See also App. Reply Br., p. 14.)

In addition, appellant argues that the FTB's regulation "completely ignores the 1937 Amendment." Appellant notes that the original statute was enacted in 1935, and the FTB's predecessor issued its regulation in 1936. The regulation applied both sourcing rules and apportionment rules to trust income. Appellant contends that, while the Legislature amended the statute in 1937 "to omit the sourcing rule[,]" new regulations were issued in 1938 that did not reflect the statutory changes and still applied the sourcing rule to trust income. Thus, appellant argues, "it is clear the original trust regulation was not updated after the 1937 amendment." (App. Op. Br., pp. 14-15.)

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[10] The 1935 and 1937 versions of Section 12 are attached as Exhibits F and G, respectively, of appellant's opening brief.

Appellant notes that R&TC section 17743 provides the FTB with the authority to issue regulations to implement the statute, which provides that "the income taxable under Section 17742 shall be apportioned according to the number of fiduciaries resident in this state *pursuant to rules and regulations prescribed by the Franchise Tax Board.* [appellant's emphasis]" However, appellant contends, the FTB's authority is limited to issuing regulations "to implement the apportionment of trust income according to the residence of fiduciaries." Appellant argues that "[t]here is no statutory authority for the FTB by regulation to expand the statute, or to add different sourcing or apportionment methods, especially sourcing methods the Legislature deleted from the statute." (App. Op. Br., pp. 15-16.)

Appellant disputes the FTB's argument that the Legislature has "tacitly approved" the regulation. Appellant argues that, even if the Legislature could be charged with knowledge of the 1936 regulation when it enacted the 1937 amendment, "such knowledge establishes that the Legislature disapproved of the California sourcing rules in the regulation because it deleted those rules from the statute." (App. Op. Br., p. 16.)

Appellant also disputes the FTB's argument that its trustees, rather than the trust, "should be treated as the true taxpayers." Appellant argues that the FTB erroneously asserts that the trustees hold an equitable interest in the trust assets. Appellant provides quotations from *Steinhart v. County of Los Angeles* (2010) 47 Cal.4th 1298, 1319 and *Reilly v. City and County of San Francisco* (2006) 142 Cal.App.4th 480, 489, which indicate that beneficiaries hold equitable and beneficial interests in trust property while trustees only hold legal title. (App. Op. Br., pp. 16-17.)

Appellant argues that the FTB's "novel argument finds no support in the statutes, and FTB cited no legal authority in support of its argument." Appellant further argues that the Legislature "has expressly provided that a trust is a separate taxable entity[,]" noting that R&TC section 17742, subdivision (a), states that: "Except as otherwise provided in this chapter [chapter 9], *the income of an estate or trust is taxable to the estate or trust*. [appellant's emphasis]" Appellant notes that, in *McCulloch v. FTB* (1964) 61 Cal.2d 186 (*McCulloch*), 191, the California Supreme Court stated that California's taxation system treated "the trust as a separate economic entity." (App. Op. Br., pp. 17-18.)

Appellant also disputes the FTB's argument that it is the trustees, and not Paula Trust,

that hold appeal rights. Appellant argues that, pursuant to R&TC section 17041, subdivision (e), the trust income is taxable to the trust, and, per R&TC section 17004, the term "taxpayer" includes a trust. Appellant also cites the *Appeal of Ury Family 1978 Residual Trust*, 96-SBE-005, decided March 14, 1996, in which the Board treated a trust as a separate entity and separate taxpayer from the trustee. Appellant summarizes that "the separate existence of the trust cannot be ignored as FTB contends, and the trust's income cannot be taxed as if earned by the trustees." (App. Op. Br., p. 18.)

Appellant's final argument is that, even if one assumed that R&TC section 17743 was ambiguous, "FTB's reading of the statute should be rejected to preserve its constitutionality and avoid violating the U.S. Constitution[,]" citing *People v. Roder* (1983) 33 Cal.3d 491, 505. Appellant argues that a state may not tax value earned outside of its borders, citing *Container Corp. of America v. FTB* (1983) 463 U.S. 159, 164. Appellant then asserts that, while a state has flexibility in determining what income is earned in the state and may be taxed, "[o]nce that method is applied, the income that is deemed to be earned outside of the state's reach and [is] not constitutionally taxable." (App. Op. Br., p. 19.)

Appellant asserts that the FTB's "two-step methodology improperly taxes income earned outside California" because it first divides income into California source income and non-California source income but it then "applies the apportionment method to the trust's non-California source income, which under step one has already been identified as income outside of the constitutional reach of the state."[11] Appellant further asserts that "[b]y definition, the income to which the FTB would apply the second apportionment method is non-taxable, extraterritorial income in violation of the Due Process and Commerce Clauses." (App. Op. Br., pp. 19-20.)

Respondent's Brief

In its introduction, the FTB argues that the proper appellants are the trustees of Paula

[11] It is not clear to staff that there would be a constitutional bar to a method of taxation that relies on both sourcing and residency principles. California frequently taxes taxpayers based both on source and on residence. For example, if a part-year resident sold a California property while she was a nonresident and an Arizona property while she was resident, California would tax income from the California property based on its source and would also tax income from the Arizona property due to the taxpayer's residence in California. The fact that the gain from the Arizona property had been identified as coming from a source outside of California would not cause that gain to be deemed to be constitutionally outside of the reach of California.

Trust rather than Paula Trust itself.[12] The FTB further argues that appellants "challenge California's statutory scheme for taxing California-source income when the income is earned by a trust with one California resident trustee and one non-resident trustee."[13] (FTB Reply Br., p. 1.)

The FTB contends that individuals, estates, and trusts are all taxed "based on both residency and source of income" with residents taxed on all of their income and nonresidents taxed "only on income from a California source." The FTB argues that "[t]rusts are treated no differently." Thus, the FTB argues, ". . . a trust with two trustees would be taxed based on the residency of any California resident trustee and based only on source for any non-resident trustee."[14] The FTB contends that "[a]ppellants, the co-trustees of the Paula Trust . . . , contend that the source of the income should be ignored and trust income taxed only based on the residence of the trustees, even though this treatment contradicts the express language of the relevant statutes and the taxation of all other taxpayers under Part 10 of the Revenue & Taxation Code ("Part 10")." (FTB Reply Br., p. 1.)

The FTB provides the example of a nonresident individual or an estate of a nonresident decedent that sells California real property. In each of those situations, each of those taxpayers "clearly pay tax on the resulting income because the income was derived from a California source." The FTB argues that, under appellants' view, "if the very same California real property were held in trust by one resident trustee and one nonresident trustee and sold, California may only tax one-half of the resulting income."[15] The FTB contends that "[t]his absurd result finds no support in the existing statutes." The FTB concludes that "California's long history of taxing trusts based on both residency and source is not only clearly prescribed by the Legislature, and internally consistent with the way that all other taxpayers

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[12] In footnote 2 of its brief, the FTB "objects to the trust being named as an appropriate party to bring this appeal because [R&TC] section 19512 requires fiduciaries to assume all of the duties, rights and privileges of the taxpayer on whose behalf they act." The FTB states that it "will proceed as if the appeal named the correct parties, the co-trustees of the Trust." The FTB reiterates this argument at page 8 of its brief.

[13] In footnote 3 of its brief, the FTB states that "[t]he parties appear to agree that non-California source income will be taxed based on [the] residency of the trustees pursuant to [R&TC] sections 17742 through 17744." However, on pages 12-14 of its brief, the FTB argues that ". . . the trust is taxable . . . based on the residency of the sole current beneficiary whose interest in the Trust is fully vested and not contingent." At the hearing, the FTB should be prepared to clarify its position.

[14] Staff notes that, per R&TC sections 17742 and 17744, a trust can also be subject to tax on non-California source income based on the residence of its beneficiary or beneficiaries.

[15] The example appears to assume that the trust had no noncontingent California beneficiaries.

are treated under Part 10, it is the only correct reading of the existing statutes." (FTB Reply Br., p. 1.)

In its description of the background, the FTB states that "the Trust was created pursuant to the Trust Agreement Establishing RJS Family Trusts (the 'Trust'), dated December 23, 1971." The FTB states that "[t]he Trust provides for the creation of separate trusts for seven named beneficiaries."[16] The FTB asserts that "[t]he Trust has one beneficiary with a current, vested interest in the Trust assets." It agrees that the beneficiary is a California resident. (FTB Reply Br., p. 2.)

The FTB argues that the Trust instrument "requires distributions to be made to the beneficiaries during their lifetime from income or principal as the trustee deems to be in the 'best interests' of each beneficiary." The FTB further argues that "Article VII of the Trust provides additional guidance regarding the exercise of the trustee's discretion in making distributions." The FTB contends that, "[w]hile . . . distributions are to be made in the 'sole absolute discretion of the Trustee,' the instrument continues to define the 'best interests' of a beneficiary in relatively specific terms." The FTB states that "Paragraph 7.2 . . . provides that a trustee shall contemplate distributions 'necessary for support' of the beneficiary and also distributions necessary for her 'comfort and convenience.'" (FTB Reply Br., p. 2. See also FTB Reply Br., pp. 12-13.)

Respondent notes that it requested a deferral of the appeal to complete an ongoing audit of related trusts and to determine whether the trust had received income from a California source. Respondent states that, after a phone conference with appellants' counsel and Appeals Division staff, it "agreed not to defer the appeal based on the understanding that appellants had conceded the question of whether the Trust's income was from a California source." Respondent quotes from a portion of appellants' reply brief in the original proceeding in which appellant stated that that it had agreed not to dispute, for purposes of this appeal, whether 100 percent of the trust's income was from a California source, but further stated that the "FTB has mischaracterized Appellant's position in stating that it agreed that 100% of the income was from a California source." The FTB argues that "appellants' position on the source of the Trust's income is not clear." Respondent states that it did not brief this

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[16] It appears to staff that Paula Trust is one of the seven separate trusts created pursuant to the terms of the trust agreement, and that only the income and beneficiaries/trustees of Paula Trust are at issue in this appeal.

issue because of its "belief that appellants had conceded this issue."[17] (FTB Reply Br., pp. 3-4.)

The FTB argues that R&TC section 17041 is the "general tax imposition statute of Part 10, which imposes a tax on the entire net income of California residents and the California-source income of non-residents." The FTB argues that "Part 10 reflects California's dual jurisdiction to tax individuals, fiduciaries, estates or trusts, based on residency and source." (FTB Reply Br., pp. 4-5.)

The FTB contends that subdivision (e) of R&TC section 17041 "provides the general tax imposition statute for estates and trusts . . . ." The FTB argues that subdivision (e) "expressly states that taxes will be imposed upon estates and trusts under subdivision (a) in an amount 'equal to the amount computed under subdivision (a) for an individual having the same amount of taxable income.'" The FTB contends that, while "[a]ppellants argue that subdivision (e) only pertains to the tax rate imposed on the trust[,]" subdivision (e) actually "reflects the Legislature's intent to tax trusts under Part 10 in the same manner as individuals." (FTB Reply Br., p. 5.)

The FTB argues that Chapter 9, beginning with R&TC section 17731, presents "additional specific rules" for trusts. The FTB states that R&TC section 17331[18] conforms to Internal Revenue Code (IRC) section 641, which is "the general tax imposition statute for federal purposes for trusts and estates." The FTB notes that subsection (b) of IRC section 641 states:

> The **taxable income of an estate or trust shall be computed in the same manner as in the case of an individual**, except as otherwise provided in this part. The tax shall be computed on such taxable income and shall be paid by the fiduciary. For purposes of this subsection, a foreign trust or foreign estate shall be treated as a nonresident alien individual who is not present in the United States at any time. [FTB's emphasis]

Based on IRC section 17731, the FTB argues that ". . . California incorporates the federal rule of taxing trusts in the same manner as individuals." Thus, the FTB contends, this same rule

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[17] In footnote 12 of its brief, respondent states that, "[i]f appellants do not concede the issue of [the] source of the income, respondent renews its request that the appeal be deferred in order to provide adequate time to complete the audit of the Trust and related entities" and further states that "[a]t a minimum, respondent should receive additional time to brief the issue of whether the income was from a California source, if appellants do not concede the issue." It appears to staff that, at least for purposes of this appeal, appellants have clearly conceded the source of the income. Staff notes that, in a letter dated January 21, 2014 to Appeals Division staff and the FTB, appellant stated that, if it loses on the legal issue on appeal, it will follow its original return position which sourced 100 percent of its income to California.

[18] R&TC section 17731, subdivision (a), provides "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."

"applies the general tax imposition statute of section 17041 to trusts just as it applies to individuals." (FTB Reply Br., p. 5.)

The FTB notes that R&TC section 17041, subdivision (a), "imposes tax upon the entire taxable income of every resident of this state." The FTB explains that paragraph (1) of subdivision (b) "imposes tax upon the taxable income of every nonresident or part-year resident, while subdivision (i) clarifies that the 'taxable income of a nonresident or part-year resident' includes 'gross income and deductions derived from sources within this state.'" Thus, the FTB argues that "subdivision (i) makes clear that the taxable income of any nonresident will include income from a California source, while IRC section 641(b) requires trusts to compute taxable income in the same manner as individuals." Accordingly, the FTB argues that appellants err by contending that subdivision (i) only applies to individuals, because ". . . IRC section 641(b) requires trusts to be taxed in the same manner as individuals." (FTB Reply Br., pp. 5-6.)

The FTB observes that "[i]ndividuals are taxed on two jurisdictional bases: residency and source[,]" with residents taxed on their "entire taxable income, regardless of source, while nonresident individuals are taxed upon all income from a California source." The FTB argues that "[t]rusts with nonresident fiduciaries are treated like nonresident individuals pursuant to IRC section 641 and section 17041." The FTB therefore concludes that ". . . all trusts are taxed on California-source income, regardless of the residency of the fiduciaries." (FTB Reply Br., p. 6.)

The FTB argues that IRC section 641(b) is similar in that it states that "a foreign trust or foreign estate shall be treated as a nonresident alien individual who is not present in the United States at any time." The FTB argues that this treatment "precisely mirrors California's treatment of trusts with nonresident trustees; they will be treated like nonresident individuals and taxed upon all California-source income." (FTB Reply Br., p. 6.)

The FTB disputes appellants' contention that R&TC sections 17742 through 17744 "contain the only relevant statutes for taxing trusts." The FTB argues that trusts "are subject to the general tax imposition statutes of Part 10[,]" and that fiduciaries are "also expressly subject to all of the provisions of Part 10[,]" citing R&TC section 18509. (FTB Reply Br., p. 6.)

The FTB contends that R&TC sections 17742 through 17444 "contain the rules for

determining *residency* status for trusts and how non-California source income . . . [is] taxed under a residency theory is to be apportioned based on such status. [FTB's emphasis]" The FTB further contends that these provisions are not the exclusive provisions applicable to trusts. In support, the FTB points to the first clause of R&TC section 17743 which begins with "[w]here the taxability of income under this chapter depends on the residence of the fiduciary and there are two or more fiduciaries . . . ." The FTB argues that this language sets forth rules for taxing non-California source income "since it is clear from the [FTB's] analysis . . . that California already taxes all California source income of a trust." The FTB argues that if appellants were correct then this language would be unnecessary and "[t]here would never be a scenario when the taxability of income did *not* depend on the trustee's residence, under appellants' interpretation." The FTB contends that R&TC section 17443 only addresses the taxation of non-California source income and California source income is taxed under R&TC sections 17041 and 17951. (FTB Reply Br., pp. 6-7.)

The FTB argues that its interpretation of the relevant statutes is both constitutional and sensible because it applies the same rules to trusts that are applied to individuals. The FTB explains that, "[a]lthough the law appears to treat a non-grantor trust as an entity, allowing a separate return . . . , a trust is actually a relationship between the trustees, who are the legal owners of trust assets, and the beneficiaries, who have a beneficial interest in the trust assets." The FTB asserts that R&TC section 19512 recognizes this fact as it requires any person acting in a fiduciary capacity to "assume the duties, rights and privileges of the taxpayers in respect of any tax, additions to tax, penalties and interest. . . ." (FTB Reply Br., pp. 7-8.)

The FTB argues that "[t]he trustees, rather than the 'trust,' hold the powers and duties to manage and administer the trust[,]" and to pursue actions on behalf of the trust. The FTB further argues that, "[b]ecause trustees are the legal owners of trust assets, the law looks to them, in their representative capacity, to determine the taxability of all trust income based on residence."[19] (FTB Reply Br., p. 8.)

The FTB contends that its statutory construction is both "longstanding," consistent with the taxation of California-source income throughout the Personal Income Tax Laws, and supported by

[19] At the hearing, the FTB may wish to also address how taxation based on the residence of beneficiaries, as set forth in R&TC sections 17742 and 17744, fits into its legal analysis.

the legislative history. The FTB argues that "California correctly applied both residency and sourcing rules to tax trust income in the same manner for 80 years." The FTB further argues that the Board has afforded "significant weight and respect to a longstanding statutory construction by the agency charged with enforcement of the statute[,]" quoting the *Appeal of Apple Computer*, 2006-SBE-002, decided November 20, 2006. The FTB also notes that the *Appeal of Apple Computer* states "the Legislature is presumed to be aware of longstanding administrative practice and its failure to enact change is evidence that the administrative practice is consistent with legislative intent." (FTB Reply Br., p. 8.)

The FTB argues that "[a]ppellants mischaracterize the 1937 amendments . . . ." The FTB notes that "[S]ection 12, subsection (b) of the Personal Income Tax Act of 1935 (the '1935 Code') previously stated that 'the taxable income of an estate or trust shall include the following . . .'" and then listed the types of income that would be included as taxable income, including California-source income. The FTB further notes that the 1937 amendment removed this language. However, the FTB argues that "[t]he new relevant language in Section 12, subsection (c) stated '[w]here the taxability of income under this *subsection* depends on the residence of the fiduciary and there are two or more fiduciaries for the trust, the income taxable under this *subsection* shall be apportioned . . . .' [FTB's emphasis]" Thus, the FTB argues, the provision's application is limited to income taxed under Section 12, subsection (c). Thus, the FTB argues that "[t]he new subsection apportioned income taxed on a residency basis while subsection (a) imposed tax upon trusts by stating that '[t]he taxes imposed by this act upon individuals shall apply to, and be imposed upon, the income of estates or of any kind of property held in trust . . . .'" (FTB Reply Br., p. 9.)

The FTB contends that, by stating that the same taxes imposed on individuals will apply to trusts, Section 12(a) taxed trusts on California source income just as California taxed individuals on California source income. Thus, the FTB argues, the 1937 amendments did not change the fact that trusts were taxed on California source income just as individuals were. (FTB Reply Br., p. 9.)

The FTB notes that ". . . appellants incorrectly replace 'subsection' with 'section' in their Opening Brief on Rehearing[,]" referring to page 11 of the brief. The FTB argues that "[t]his error is significant because the language of the new 1937 subsection (c) expressly limited itself to the income taxed under that subsection and not to the entire Section 12, which imposed tax on trusts and estates

generally." The FTB observes that, rather than defining taxable income, as the original language of subsection (c) did, the new language of subsection (c) "carved out a new rule applicable to the income to be taxed on a residency basis, while leaving the general tax imposition language of subsection (a) to tax the California source income of a trust." (FTB Reply Br., pp. 9-10.)

In sum, the FTB argues that the 1937 amendments had "no effect on California's taxation of California source income . . . ." The FTB further argues that the amendments "formed the basis" for California's current system "in which the general tax imposition statute taxes trusts based on residency and source and the specific trust statutes define how a trust will be taxed based on residency when there are multiple trustees or beneficiaries." (FTB Reply Br., p. 10.)

The FTB also contends that the taxation of trusts on California-source income is "well established, accepted and recognized as obviously correct in the scholarly and tax practitioner literature[,]" citing and attaching supporting authorities. The FTB argues that the statutory basis for taxing California source income "clearly exists in sections 17041 and 17951." The FTB further contends that "virtually all other states that impose an income tax on trusts impose tax on the income from sources derived within that state." (FTB Reply Br., pp. 10-11.)

The FTB argues that ". . . even if appellants were correct that [Regulation 17743] does not apply to them, and they are not, they would still be taxable under the existing statutory framework." The FTB contends that the regulation "merely clarifies existing law." (FTB Reply Br., p. 11.)

The FTB asserts that appellants are arguing that California's taxation of trusts violates the United States Constitution and that the Board "may not consider constitutional arguments." The FTB cites in support Board Rule 5412, subdivision (b)(1), article III, section 3.5 of the California Constitution, and prior decisions of the Board. (FTB Reply Br., p. 11.)

As an alternative argument, the FTB argues that Paula Trust "may also be taxable based on the residency of the beneficiary." The FTB notes that R&TC section 17742 taxes a trust on its entire income if it has a contingent beneficiary who is a California resident. The FTB argues that, here, "[t]he sole vested, current beneficiary of the trust is a California resident." (FTB Reply Br., p. 12.)

The FTB asserts that the trust instrument "requires that distributions be made in the 'best interests' of each beneficiary[,]" and then in Article VII "defines the 'best interests' of the beneficiaries

in specific terms" which provide that the trustee "shall make distributions 'necessary for the support' of said beneficiary . . . and also distributions necessary for her 'comfort and convenience.'" The FTB argues that "[t]his language creates a defined standard that a trustee must adhere to in making distributions[,]" and that the distributions "may not be considered discretionary when the trust instrument contains such a standard." (FTB Reply Br., p. 12.)

The FTB notes that, in *Estate of Miller* (1964) 230 Cal.App.2d 888 (*Miller*), the court found that "[w]here the trust provision directs the trustee to disburse portions of the principal for a given purpose, the trustee's authority to pay is not discretionary but is merely conditional upon the existence of a reasonable necessity for the disbursement to accomplish the purpose." The FTB states that, in *Miller*, the trust "required" the trustee to make payments for support and maintenance in the trustee's "sole discretion." The FTB further states that the court found that the term "support" included expenses such as education and maintenance of family and that the use of this language showed that the distributions were not discretionary. The FTB argues that the situation here is similar and that the trust would therefore be taxable under R&TC section 17742 on the basis of its resident beneficiary, even if its income did not arise from a California source. (FTB Reply Br., pp. 12-13.)

The FTB notes that the Trust actually did distribute $752,000 to the beneficiary in 2007. The FTB argues that, "[n]ot only did the terms of the Trust require distributions to be made in accordance with an ascertainable standard, but the trustees actually did make a distribution to the beneficiary." On this basis, the FTB argues that the beneficiary is not contingent. (FTB Reply Br., p. 13.)

The FTB also argues that appellants' interpretation of the statute "would produce absurd results and encourage abuse." In support, respondent provides the following quotation from *McCulloch*, *supra*, 61 Cal.2d 186, 197: "while the complexity of the trust itself and the relations of the parties thereto complicates the problem of effective taxation, it should not obstruct the claims of a state to tax trust income, so far as possible, as it would in the absence of a trust." Thus, respondent argues, "the mere existence of the trust should not alter the way that the income is taxed." (FTB Reply Br., p. 13.)

The FTB argues that under appellants' interpretation ". . . the Trust would not be taxed in California on income that would be taxed if the very same income was directly received by an individual

or an estate, or indirectly received [through a partnership]." The FTB asserts that the Board has "long found that an estate of a nonresident decedent is still taxable in California on its California source income, even when none of the beneficiaries reside in California[,]" citing the *Appeal of the Estate of Marilyn Monroe*, 75-SBE-032, decided April 22, 1975 (*Monroe*) and the *Appeal of Jolke Jernberg*, 86-SBE-187, decided November 19, 1986. The FTB notes that in *Monroe* the Board found that if the individual had received the income directly then she would have been subject to tax and that the nonresident estate should not be "allowed to escape tax when it is the recipient." The FTB argues that appellants' interpretation of the statute would result in the type of "windfall tax break" that the Board sought to avoid in *Monroe*. The FTB further contends that appellants' interpretation would allow abuse as it would allow nonresidents to avoid tax on gains from California real property simply by placing the property in a trust with a nonresident trustee or trustees. (FTB Reply Br., pp. 13-14.)

Appellant's Reply Brief

Appellant introduces its reply brief by arguing that "[t]he sole issue on rehearing is whether the nonresident sourcing rules at Section 17951 *et seq.* apply to trusts." Appellant argues that there is no statutory basis for imposing the sourcing rules on trust income and further contends that, while the law used to impose such sourcing rules on trusts, the Legislature repealed the relevant provisions. (App. Reply Br., p. 1.)

Appellant further reiterates and emphasizes its argument, made in its original brief on rehearing, that "[a] bedrock principle of statutory interpretation is that California may not tax income unless the Legislature enacts a statute that expressly says so." Quoting *Whitmore*, *supra*, 207 Cal. 473, 482-483 and citing additional authorities, appellant argues that statutes imposing a tax must be "clear and explicit" in order for the tax to be applied. (App. Reply Br., pp. 1-3.)

Appellant argues that the FTB "ignores the rules of statutory construction, legislative history, and the absence of any express statutory authority in arguing that the nonresident sourcing rules apply . . . ." Appellant further argues that the FTB, in its original appeal briefing, admitted that the sourcing rules were, in the words of the FTB, "not explicitly stated in the statute . . . ." Appellant contends that the FTB "stitches together at least five statutory provisions to make its statutory argument[,]" and through this "circuitous route. . . demonstrates the absence of a 'clear and explicit'

statute on point and dooms FTB's position." (App. Reply Br., pp. 2-3.)

Appellant contends that neither R&TC section 17041, subdivision (e) or (a), "reflects any intent to apply the nonresident sourcing rules to trusts." Appellant notes that the FTB asserts that subdivision (e) "reflects the legislature's intent to tax trusts . . . in the same manner as individuals." Appellant observes that subdivision (e) states as follows:

> There shall be imposed for each taxable year upon the taxable income of every estate, trust, or common trust fund taxes equal to the amount computed under subdivision (a) for an individual having the same amount of taxable income.

Appellant argues that subdivision (e) "does not say that trust taxable income is determined in the same manner as California residents." Instead, appellant contends, ". . . subdivision (e) provides only that the tax rates on trust income are equal to the tax rates imposed on income of California residents." In support, appellant points to legislative history showing that, prior to 1987, subdivision (e) expressly included a tax rate table, and, in 1987, it was amended to replace the tax rate table with a reference to subdivision (a). (App. Reply Br., pp. 3-4.) Appellant argues that the FTB's "reliance on subdivisions (e) and (a) also fails because subdivision (a) only imposes income tax on California residents, and California residents are not subject to the nonresident sourcing rules." Appellant observes that "Subdivision (a) does not state that the nonresident sourcing rules apply to any taxpayers." (App. Reply Br., p. 4.)

Appellant contends that "[i]f the Legislature had intended Section 17041 to apply the nonresident sourcing rules to trusts, it would have expressly said so, as it did in the case of nonresidents." In support, appellant notes that R&TC section 17041, subdivision (b), expressly states that the taxable income of a nonresident or part-year resident is "defined in subdivision (i)[,]" which then expressly states that source rules apply. Appellant argues that, "[b]y expressly stating that the nonresident sourcing rules apply to nonresident individuals in Section 17041, and not saying the same thing for trust *in the same statute*, the Legislature expressed a clear intent not to apply those rules to trusts[,]" citing *Gikas v. Zolin* (1993) 6 Cal. 4th 841, 852. (App. Reply Br., pp. 4-5.)

Appellant further contends that R&TC section 17731 "does not impose the nonresident sourcing rules on trusts." Appellant argues that the FTB contends that R&TC section 17331, IRC

section 641 and R&TC section 17041, subdivision (i), can be "read together to support its position." However, appellant contends, the cited statutes are not "clear and explicit." Appellant argues that R&TC section 17041, subdivision (i), "only applies to *nonresident individuals*, not trusts." Appellant disputes the FTB's contention that R&TC section 17731 and IRC section 641 cause the trust to be treated as an individual. Appellant argues that R&TC section 17731 "merely states that the federal income tax statutes for computing a trust's total income apply for California income tax purposes." Appellant further argues that IRC section 641 provides in part that the federal taxable income of a trust "shall be computed in the same manner as in the case of an individual." Appellant contends that R&TC section 17731 and IRC section 641 only indicate "that the starting point for computing a trust's California taxable income is federal taxable income." Appellant further contends that these statutes and related Internal Revenue Code provisions regarding the computation of federal taxable income are "not relevant" to the issue here, which is "what rules apply for determining how much of Appellant's income is taxable by California." (App. Reply Br., pp. 5-6.)

Appellant argues that the "FTB overlooks the fact that the Rev. & Tax. Code expressly defines the term 'individual' to mean a 'natural person[,]' which does not include a trust[,]" citing R&TC section 17005. Appellant contends that R&TC section 17731 and IRC section 641 are "unrelated to the rules for sourcing and apportioning income" and "cannot override clear California law applying the nonresident sourcing rules to nonresident *individuals* and defining *individuals* as natural persons." Appellant further contends that the FTB essentially contends that R&TC section 17731 and IRC section 641 "somehow repealed" the definition of "individual" in R&TC section 17005. Appellant asserts that this argument implies the repeal of the statutes and there is a strong presumption against such an implied repeal of a statute, citing *W. Oil & Gas Assn. v. Monterey Bay Unified Air Pollution Control Dist.* (1989) 49 Cal.3d 408, 419. (App. Reply Br., pp. 6-7.)

Appellant argues that "[a]t bottom, FTB is arguing that the residence of a fiduciary should determine which tax imposition rules apply to trusts." Appellant disputes this argument, arguing that R&TC section 17041, which is the tax imposition statute, provides "separate tax schemes for trusts, residents, and nonresidents." Appellant argues that trust income is taxable under Chapter 9 (R&TC section 17731 *et seq.*, while residents and nonresidents are taxed under different chapters (Chapter 3,

R&TC section 17071 *et seq.*, for residents; and Chapter 11, R&TC section 17951 *et seq.*, for nonresidents). Appellant contends that trusts are "separate taxable entities" and "taxpayers." Appellant further contends that the FTB's argument is "nonsensical because a trustee can also be a corporation." Appellant asks rhetorically, "[w]ould trusts with corporate fiduciaries be taxed like corporations?" Appellant argues that "[p]lainly, the taxation of a trustee's income and a trust's income must be viewed separately, . . ." pointing to R&TC section 17041, subdivision (e), (imposing tax on trusts) and R&TC section 17731 *et seq.* (providing rules for computing and apportioning trust income). (App. Reply Br., pp. 7-8.)

Appellant contends that the FTB "leans on [IRC section 641(b)] for the bold proposition that a trust itself can be a 'nonresident.'" Appellant notes that IRC section 641(b) provides that "[f]or purposes of this subsection, a foreign trust or foreign estate shall be treated as a nonresident alien individual who is not present in the United States at any time." Appellant contends that the FTB "argues *by analogy* that a domestic trust such as Appellant with a nonresident fiduciary should be treated as a nonresident for state income tax purposes. [appellant's emphasis]" Appellant argues that the FTB's argument fails because appellant "is not a foreign trust" and the tax imposition statutes cannot be extended to matters not expressly stated. Also, appellant argues that the FTB cannot "override the express statutory definition of 'nonresident' in Section 17015[,]" which defines a 'nonresident' as an 'individual' other than a resident. Appellant concludes that ". . . there is no authority in the Rev. & Tax. Code for the notion of a 'nonresident' trust." (App. Reply Br., p. 8.)

Appellant further contends that R&TC section 17743 does not support imposing the nonresident sourcing rules on trusts. Appellant disputes the FTB's contention that the first clause of R&TC section 17443 (which starts with "[w]here the taxability of income under this chapter depends on the residence of the fiduciary . . .") shows that the sourcing rules provide another basis for taxing trusts. Appellant argues that this clause is intended to distinguish taxation under R&TC section 17443 from taxation under R&TC section 17744, which imposes tax based on the residence of beneficiaries. Appellant argues that the FTB "misreads the statutes by reading snippets out of context and failing to take into account the whole statutory framework . . . [,]" citing to case law which indicates that statutes must be read in context. Summarizing its statutory argument, appellant argues that the FTB "has not

pointed to a single 'clear and explicit' statutory provision that states that the nonresident sourcing rules apply to trusts." (App. Reply Br., pp. 9-10.)

Appellant disputes the FTB's argument that former Section 12(a) shows an intent to apply sourcing rules to trusts. Appellant notes that Section 12(a) provides in part: "The taxes imposed by this act upon individuals shall apply to, and be imposed upon, the income of estates or any kind of property held in trust . . . ." Appellant argues that the FTB "focuses on the term 'individuals' in Section 12(a) and argues that means that trusts should be taxed as 'nonresidents.'" (App. Reply Br., p. 10.)

Appellant contends that "[t]his argument misreads the predecessor statutes and is essentially the same argument FTB makes with respect to Section 17041(a) and (e)." Appellant argues that former Section 12(a) "simply states that the income tax applies to trusts." Appellant further argues that the FTB "reads Section 12(a) in isolation" and "ignores" that Section 12 "also contained the various provisions for calculating a trust's taxable income, . . ." including the apportionment provisions. (App. Reply Br., p. 10.)

Appellant also notes that R&TC section 12(a) "was not added in 1937 when the Legislature repealed the nonresident sourcing rules applicable to trusts[,]" but "was enacted as part of the original income tax act in 1935, which also imposed the nonresident sourcing rules on trusts." Thus, appellant contends, "Section 12(a) was not intended to replace the nonresident sourcing rules because it was added to the code at the same time as the nonresident sourcing rules." Appellant argues it would be nonsensical for the Legislature to have repealed "clear and express statutory provisions in favor of a statute that, under FTB's reading, is completely unclear regarding the nonresident sourcing rules." (App. Reply Br., pp. 10-11.)

Appellant disputes the FTB's argument that the amended former Section 12(c) did not define taxable income for a trust as the prior language of Section 12(b) had. Appellant notes that, in the 1935 Act, Section 12(b) "provided that trust taxable income included California source income and California apportioned income." Appellant argues that, "[i]n 1937, the Legislature repealed Section 12(b) and replaced it with Section 12(c), which expressly provided that a trust's taxable income is based on the residence of the fiduciary or beneficiary and on apportionment depending on the residence of the fiduciaries or beneficiaries." On this basis, appellant argues that "Section 12(c) as enacted in [1937]

plainly defined that taxable income of a trust." (App. Reply Br., pp. 11.)

Appellant disputes the FTB's argument that it can tax all of appellant's income on the ground that appellant's beneficiary has a noncontingent interest. Appellant observes that, in FTB Technical Advice Memorandum 2006-002, dated February 17, 2006 (FTB TAM 2006-002),[20] the FTB stated that "[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." (App. Reply Br., pp. 11-12.)

Appellant argues that its beneficiary's interest is contingent because "[t]he fiduciaries are authorized to make distributions to the beneficiary as the fiduciaries deem to be in the best interest of the beneficiary, but they are not required to make any distributions." Appellant notes that Section 3.1 of the trust agreement authorizes the trustee to distribute "all or as much of the net income or principal . . . as the Trustee deems to be in the best interest of [the] beneficiary." Appellant further notes that Section 7.1 of the trust agreement provides that the authority of the trustee "may be exercised in the *sole absolute discretion of the trustee* . . ." and that the trustee's determination of the amount that is in the best interest or necessary for support "*shall be in the sole absolute discretion of such Trustee . . . .* [appellant's emphasis]." Appellant argues that under "the FTB's own interpretation" as set forth in FTB TAM 2006-0002 the trust's beneficiary is contingent because any distribution is, quoting FTB TAM 2006-0002, "subject to the sole and absolute discretion of the trustee." (App. Reply Br., p. 12.)

Appellant argues that *Miller*, *supra*, 230 Cal.App.2d 888, 913, is distinguishable from the facts in this appeal. Appellant states that, in *Miller*, the "will *directed* the executor to make distributions for her daughter's 'support and maintenance.' [appellant's emphasis]" Citing *Miller* at page 894, appellant argues that the executor "had discretion to determine the *amount* [appellant's emphasis] of the 'support and maintenance' distributions, but no discretion in whether to make such distributions." Appellant observes that, because the executor had made "almost no distributions to the daughter," the court determined that the executor failed to exercise discretion and ordered that distributions be made. (App. Reply Br., pp. 12-13.)

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[20] Available at www.ftb.ca.gov/law/Technical_Advice_Memorandums/2006/20060002.pdf. The FTB's website states that "TAMs are advice given by FTB Legal in response to a specific question from FTB Staff[,]" that they "may not be considered published guidance or published procedures within the meaning of the Revenue and Taxation Code[,]" and that they ". . . are informational only, and may not be used or cited as precedent."

Here, appellant argues, "the fiduciaries are not required to make any distributions for any purpose." Appellant contends that, instead of being required to make distributions, the trustees are "merely authorized to make distributions that the trustees deem to be in the best interest of the beneficiary." Appellant further contends that the FTB "apparently agreed that the beneficiary's interest was contingent in its original briefing because it did not argue this issue when this appeal was first considered by this Board." (App. Reply Br., p. 13.)

Appellant argues that the FTB's arguments concerning its "longstanding" practice and tax articles are irrelevant and cannot overcome "the absence of clear and express statutory authority" to impose sourcing rules on trusts. Appellant argues that ". . . even a longstanding FTB position cannot be upheld if it is contrary to law." (App. Reply Br., p. 14.)

Appellant disputes the FTB's contention that appellant is asking the Board to find a statute unconstitutional. Appellant explains that it "has only argued that the statutes should be construed in a manner that preserves their constitutionality . . . ." (App. Reply Br., p. 14.)

Appellant also disputes the FTB's contention that appellant's position would create absurd results or abuse. Appellant argues that "[t]rusts would not be treated more favorably than other 'similar' taxpayers because there are no similar taxpayers to trusts." Appellant reiterates its arguments that trust taxation is governed by Chapter 9 (R&TC section 17731 *et seq.*) rather than the chapters and provisions applicable to individuals. Appellant argues that "[i]n the end, any difference in taxation of trusts and other taxpayers is the result of policy decisions enacted by the Legislature[,]" which neither the FTB nor the Board can change. (App. Reply Br., p. 15.)

Appellant contends that *Monroe*, *supra*, should be distinguished. Appellant notes that Ms. Monroe had a right to contingent payments based on film earnings and, after her death, her estate continued to receive the contingent payments for her prior employment by California. Appellant states that a specific California statute "expressly provided that such payments were 'income in respect of a decedent' and provided that such income shall 'have the character which it would have had in the hands of the decedent if the decedent had lived and received such amount." Appellant argues that the Board held that the payments had a California source income because Ms. Monroe "earned the income while performing services in California . . ." and the income would have been California source income if

received by Ms. Monroe. Appellant argues that the case "has no relevance here because the income at issue here is not 'income in respect of a decedent.'" (App Reply Br., p. 15.)

With regard to the FTB's concerns of potential abuse, appellant contends "it is undisputed there was no abuse in this case." Further, appellant contends that the FTB assumes it can tax all of appellant's income and that tax avoidance exists if it cannot tax all of appellant's income. Appellant argues this is false and that ". . . in any event, whether or not taxpayers engage in tax planning does not give FTB or this Board power to override statutes enacted by the Legislature or, in this case, add back statutory provisions that have long been repealed." (App. Reply Br., p. 16.)

Applicable Law

General Trust Taxation Rules

In general, nongrantor trusts are subject to income tax. (See Int.Rev. Code, § 641; Rev. & Tax. Code, §§ 17731 & 17742.) As set forth below, the portion of trust income taxable in California depends upon whether beneficiaries and/or fiduciaries reside in California and, under respondent's regulations and tax return instructions, on whether the income is California source income. The bullet points below summarize the state of the law as it is interpreted in the FTB's regulations and tax return instructions. As noted above, appellant contests in this appeal whether the FTB has statutory authority to tax trusts based on the source of income.

- If all of the trust's fiduciaries or all of its noncontingent beneficiaries are California residents, then all trust income is taxable in California.[21]
- If there are no California noncontingent beneficiaries, but there is a mix of resident and nonresident fiduciaries, then California source income is taxable by California and the remaining income is apportioned based on the ratio of resident fiduciaries to nonresident fiduciaries.[22]
- If no fiduciaries or noncontingent beneficiaries are residents of California, then trust income

[21] Rev. & Tax. Code, § 17742, Cal. Code Regs., tit. 18, § 17742.

[22] See Rev. & Tax. Code, § 17743, Cal. Code Regs., tit. 18, § 17743; Form 541 Booklet [As noted in footnote 5, the Form 541 Booklet is available at: available at www.ftb.ca.gov/Archive/Forms/2007/07_541bk.pdf.]. See also, in the FTB's view, Rev. & Tax. Code, § 17041(a), (e), & (i), and §§ 17731 and 17951.

is taxable in California only to the extent that it is derived from a California source.[23]

- If all fiduciaries are nonresidents, and some noncontingent beneficiaries are California residents while others are nonresidents, California source income is taxable by California and remaining income is apportioned based on the ratio of resident noncontingent beneficiaries to nonresident noncontingent beneficiaries.[24]
- If the trust has a mix of both resident and nonresident fiduciaries, and resident and nonresident noncontingent beneficiaries, California source income is taxed, then non-California source income is allocated based on the ratio of California fiduciaries to nonresident fiduciaries, and then remaining non-California source income is allocated based on the ratio of resident noncontingent beneficiaries to nonresident noncontingent beneficiaries.[25]

Statutes and Regulations

The following are relevant excerpts from statutes and regulations discussed by the parties:

> *R&TC Section 17041*. (a) There shall be imposed for each taxable year upon the entire taxable income of every resident of this state who is not a part-year resident, except the head of a household as defined in Section 17042, taxes in the following amounts and at the following rates upon the amount of taxable income computed for the taxable year as if the resident were a resident of this state for the entire taxable year . . . : [tax brackets omitted]
>
> (b)(1) There shall be imposed for each taxable year upon the taxable income of every nonresident or part-year resident, except the head of a household as defined in Section 17042, a tax as calculated in paragraph (2).

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[23] Cal. Code Regs., tit. 18, § 17742, subd. (a); Form 541 Booklet, p. 14.

[24] See Rev. & Tax. Code, § 17744; Cal. Code Regs., tit. 18, § 17744; Form 541 Booklet, p. 14. See also, in the FTB's view, Rev. & Tax. Code, § 17041(a), (e), & (i), and §§ 17731 and 17951.

[25] See Rev. & Tax. Code, §§ 17743, 17744; Cal. Code Regs., tit. 18, §§ 17743, 17744; Form 541 Booklet, p. 14; FTB Legal Ruling No. 238, Oct. 27, 1995 [1959 WL 1349, available at www.ftb.ca.gov/law/rulings/active/lr238.shtml]. See also, in the FTB's view, Rev. & Tax. Code, § 17041(a), (e), & (i), and §§ 17731 and 17951. The Form 541 Booklet provides an example of a trust with no California source income and $90,000 of non-California source income. One-third of its trustees are residents and one-half of its noncontingent beneficiaries are residents. First, one-third of its taxable income, or $30,000, would be allocated based on its trustees. Then, $30,000 of the remaining $60,000 of taxable income would be allocated to California because one-half of its nonresident trustees are based in California. Thus, a total of $60,000 of the trust's taxable income would be taxed by California.

(2) The tax imposed under paragraph (1) shall be calculated by multiplying the "taxable income of a nonresident or part-year resident," as defined in subdivision (i), by a rate (expressed as a percentage) equal to the tax computed under subdivision (a) on the entire taxable income of the nonresident or part-year resident as if the nonresident or part-year resident were a resident of this state for the taxable year and as if the nonresident or part-year resident were a resident of this state for all prior taxable years for any carryover items, deferred income, suspended losses, or suspended deductions, divided by the amount of that income.

. . .

(e) There shall be imposed for each taxable year upon the taxable income of every estate, trust, or common trust fund taxes equal to the amount computed under subdivision (a) for an individual having the same amount of taxable income.

. . .

(i)(1) For purposes of this part, the term "taxable income of a nonresident or part-year resident" includes each of the following:

(A) For any part of the taxable year during which the taxpayer was a resident of this state (as defined by Section 17014), all items of gross income and all deductions, regardless of source.

(B) For any part of the taxable year during which the taxpayer was not a resident of this state, gross income and deductions derived from sources within this state, determined in accordance with Article 9 of Chapter 3 (commencing with Section 17301) and Chapter 11 (commencing with Section 17951). . . .

R&TC Section 17014. (a) "Resident" includes: (1) Every individual who is in this state for other than a temporary or transitory purpose. . . .

R&TC Section 17015.5. "Nonresident" means every individual other than a resident.

R&TC Section 17005. (a) "Individual" means a natural person.

R&TC Section 17731. (a) 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. . . .

[Subchapter J, which is referenced above, includes IRC Section 641, which is set forth immediately below.]

IRC Section 641. (a) Application of tax. The [federal income tax] shall apply to the taxable income of estates or of any kind of property held in trust, including—
(1) income accumulated in trust . . .

(b) Computation and payment. *The taxable income of an estate or trust shall be computed in the same manner as in the case of an individual, except as otherwise provided in this part*. The tax shall be computed on such taxable income and shall be paid by the

fiduciary. For purposes of this subsection, a foreign trust or foreign estate shall be treated as a nonresident alien individual who is not present in the United States at any time. [emphasis added]

R&TC Section 17742. (a) Except as otherwise provided in this chapter, the income of an estate or trust is taxable to the estate or trust. The tax applies to the entire taxable income of an estate, if the decedent was a resident, regardless of the residence of the fiduciary or beneficiary, and to the entire taxable income of a trust, 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.
(b) . . . .

Regulation 17742. Taxability of Estates.

(a) . . . in the case of a trust, if the fiduciaries and noncontingent beneficiaries are all nonresidents of this State, only income from real or personal property located in this State (see Reg. 17951-3), business carried on within this State (see Reg. 17951-4), and intangible personal property having a business or taxable situs in this State (see Section 17952) is taxable.

In computing the taxable income from these sources, only the gross income from these sources is considered. From such gross income, the deductions allowed by the law are subtracted. See Sections 17301-17303 and Section 17734. The amount remaining is taxable income of the estate or trust to which the rates of tax specified in Section 17041 apply.

EXAMPLE. B is the executor of the estate of A, who was a nonresident of this State at the time of death. All the beneficiaries are likewise nonresidents. During the year 1980, the gross income of the estate from all sources amounted to $100,000, $50,000 of which was derived from real and personal property located, and from business transacted, in this State. The losses, depreciation, and depletion sustained with respect to the property in California, and the taxes, licenses, expenses, bad debts, etc., properly deductible from the California income amounted to $40,000. Thus, the income from California sources, prior to deducting amounts distributed to beneficiaries, amounted to $10,000. Of this amount, $6,000 was distributed to beneficiaries during the year pursuant to a partial distribution of the estate. The remaining $4,000 is the net income of the estate, as defined in Section 18411.

(b) A noncontingent beneficiary is one whose interest is not subject to a condition precedent.

(c) . . .

R&TC section 17743. Where the taxability of income under this chapter depends on the residence of the fiduciary and there are two or more fiduciaries for the trust, the income taxable under Section 17742 shall be apportioned according to the number of fiduciaries

resident in this state pursuant to rules and regulations prescribed by the Franchise Tax Board.

Regulation 17743. Taxability of Trust Dependent upon Residence of Fiduciary.

If there are two or more fiduciaries of a trust, and one or more are residents and one or more are nonresidents, and all the beneficiaries are nonresidents, the trust is taxable upon (a) all net income (less the deductions allowed under Article 1 of Chapter 9 (Section 17731 and following)) from business carried on within this State, from real or tangible personal property located in this State, and from intangible personal property having a business or taxable situs in this State (see Reg. 17952); and (b) that proportion of the net income (less the deductions allowed under Article 1 of Chapter 9 (Section 17731 and following)) from all other sources which the number of fiduciaries who are residents of this State bears to the total number of fiduciaries.

EXAMPLE (1). B, a resident, and C, a nonresident of this State, are the trustees of a trust created by A. All the beneficiaries are nonresidents. During the year 1980, the trust received $60,000 as rent from real and tangible personal property located in, and from business carried on in this State, from which expenses of $10,000 were deducted, $60,000 from real and personal property located, and business carried on, outside this State from which expenses of $10,000 were deducted, and $50,200 income from stocks and bonds, none of which had a business or taxable situs in this State. None of the income was paid or credited to the beneficiaries during the year. The $50,000 income from real and personal property located in, and business transacted in this State is taxable. Since there are two fiduciaries, one of which is a resident of this State, one-half of the balance of the income of the trust is likewise taxable to the trust. Thus, the taxable income amounts to $100,100 ($50,000 from property located in this State, plus one-half of $100,200 which is the remainder of the trust's income).

EXAMPLE (2). E, a resident, and F and G, nonresidents of this State, are the trustees of a trust created by D. All of the beneficiaries are nonresidents. The corpus of the trust consists entirely of stocks and bonds and property located outside this State. One-third of the income taxable under Section 17742 (i.e., net income less the deductions allowed under Article 1 of Chapter 9), which is the proportion of total income taxable which the number of fiduciaries who are residents of this State bears to the total number of fiduciaries, is taxable to the trust.

R&TC Section 17951. (a) For purposes of computing "taxable income of a nonresident or part-year resident" under paragraph (1) of subdivision (i) of Section 17041, in the case of nonresident taxpayers the gross income includes only the gross income from sources within this state.

Statutory Interpretation

In general, the goal of statutory construction is to determine legislative intent, and the first step in doing so is to look to the words of the statute. (*Ordlock v. FTB* (2006) 38 Cal.4th 897, 909 –

910; *Lennane v. FTB, supra,* 9 Cal.4th 263, 268; *Lungren v. Deukmejian* (1988) 45 Cal.3d 727, 737.) The words of the statute are given their ordinary meaning but considered in the context of the relevant statutory scheme. (*Ordlock, supra,* 38 Cal.4th at pp. 909-910 [citing *Lungren, supra,* at p. 735].) "If the statutory language is clear and unambiguous, then we need go no further." (*Hoechst, supra,* 25 Cal.4th 508, 557 [citing *Lungren, supra,* at p. 735]. See also *Lennane, supra,* 9 Cal.4th at p. 268.) In determining a statute's meaning, ". . . courts should, if possible, accord meaning to every word and phrase in a statute so as to better effectuate the Legislature's intent." (*Ste. Marie v. Riverside County Regional Park & Open-Space District* (2009) 46 Cal.4th 282, 289 (*Ste. Marie*).) "As a general proposition the courts have held that 'the very fact that the prior act is amended demonstrates the intent to change the pre-existing law . . . .' [citations omitted]" (*Eu v. Chacon, supra,* 16 Cal.3d 465, 470.)

While an agency's construction of a statute is reviewed independently, "significant weight" is given to long-standing agency constructions of a statute. (*Hoechst, supra,* 25 Cal.4th at p. 557 [citing *Agnew v. State Bd. of Equalization* (1999) 21 Cal.4th 310, 322 and other cases]. See *also Ste. Marie, supra,* 46 Cal.4th at pp. 292 – 293.) In *St. Marie,* the California Supreme Court explained that "'When an administrative interpretation is of long standing and has remained uniform, it is likely that numerous transactions have been entered into in reliance thereon, and it could be invalidated only at the cost of major readjustments and extensive litigation.'" (*St. Marie, supra,* at p. 293 [quoting *Whitcomb Hotel Inc. v. Cal. Emp. Com.* (1944) 24 Cal.2d 753, 757].)

In *Lungren v. Deukmejian* (1988) 45 Cal.3d 727, at page 737, the California Supreme Court explained as follows:

> Words used in a statute or constitutional provision should be given the meaning they bear in ordinary use. (*In re Rojas* (1979) 23 Cal.3d 152, 155; [additional citation omitted].) If the language is clear and unambiguous there is no need for construction, nor is it necessary to resort to indicia of the intent of the Legislature . . . .
>
> But the "plain meaning" rule does not prohibit a court from determining whether the literal meaning of a statute comports with its purpose or whether such a construction
>
> of one provision is consistent with other provisions of the statute. The meaning of a statute may not be determined from a single word or sentence; the words must be construed in context, and provisions relating to the same subject matter must be harmonized to the extent possible. (*Dyna-Med, Inc. v. Fair Employment & Housing*

> *Com.* (1987) 43 Cal.3d 1379, 1386-1387.) Literal construction should not prevail if it is contrary to the legislative intent apparent in the statute. The intent prevails over the letter, and the letter will, if possible, be so read as to conform to the spirit of the act. (*People v. Belton* (1979) 23 Cal.3d 516, 526; [additional citation omitted].) An interpretation that renders related provisions nugatory must be avoided (*People v. Craft* (1986) 41 Cal.3d 554, 561); each sentence must be read not in isolation but in the light of the statutory scheme (*In re Catalano* (1981) 29 Cal.3d 1, 10-11); and if a statute is amenable to two alternative interpretations, the one that leads to the more reasonable result will be followed (*Metropolitan Water Dist. v. Adams* (1948) 32 Cal.2d 620, 630-631).

In *Edison Cal. Stores v. McColgan* (1947) 30 Cal.2d 472, 476, the California Supreme Court observed that its prior decision in *Pioneer Express co. v. Riley* (1930) 208 Cal. 677, 687:

> . . . reiterated . . . that courts, in interpreting statutes levying taxes, may not extend their provisions, by implication, beyond the clear import of the language used, nor enlarge upon their operation so as to embrace matters not specifically included. In case of doubt, construction is to favor the taxpayer rather than the government.

In *Microsoft, supra*, 39 Cal.4th 750, the California Supreme Court stated that, to the extent that statutory language was ambiguous, it "generally will prefer the interpretation favoring the taxpayer[,]" citing *Edison Cal. Stores, supra*, 30 Cal.2d 472, 476.

However, as noted above, courts have also held that, when reviewing a statutory interpretation, "significant weight" is given to long-standing agency constructions of a statute. (*Hoechst, supra*, 25 Cal.4th 508, 557 [citing cases]. See also *Ste. Marie, supra*, 46 Cal.4th at pp. 292 – 293.) In *Goldman v. FTB* (2012) 202 Cal.App.4th 1193, 1205, the court stated:

> [W]hile the ultimate interpretation of a statute is an exercise of the judicial power [citation], when an administrative agency is charged with enforcing a particular statute, its interpretation of the statute will be accorded great respect by the courts 'and will be followed if not clearly erroneous.' [internal citation omitted]

Evaluating the statutory interpretation at issue, the court in *Goldman* found that the proposed interpretation would "create opportunity for mischief" and construed the statute in a manner designed to avoid a "whipsaw" effect and implement the intent of the Legislature. (*Goldman, supra*, 202 Cal.App.4th at p. 1204.) Where there is a ". . . contemporaneous construction of a statute by an administrative agency charged with its enforcement, the [agency's] view is entitled to great weight." (*Western Oil & Gas Assn. v. Air Resources Board* (1984) 37 Cal.3d 502, 520 (*Western Oil*.)

Review of Agency Regulations

In *Yamaha*, *supra*, 19 Cal.4th at pages 10 to 13, the California Supreme Court explained as follows:

> . . . [Q]uasi-legislative rules--represents an authentic form of substantive lawmaking: Within its jurisdiction, the agency has been delegated the Legislature's lawmaking power. [citations omitted] Because agencies granted such substantive rulemaking power are truly "making law," their quasi-legislative rules have the dignity of statutes. When a court assesses the validity of such rules, the scope of its review is narrow. If satisfied that the rule in question lay within the lawmaking authority delegated by the Legislature, and that it is reasonably necessary to implement the purpose of the statute, judicial review is at an end.
>
> We summarized this characteristic of quasi-legislative rules in *Wallace Berrie & Co. v. State Bd. of Equalization* (1985) 40 Cal.3d 60, 65 . . . . "'[I]n reviewing the legality of a regulation adopted pursuant to a delegation of legislative power, the judicial function is limited to determining whether the regulation (1) is "within the scope of the authority conferred" [citation omitted] and (2) is "reasonably necessary to effectuate the purpose of the statute" [citation omitted].' [citation omitted] 'These issues do not present a matter for the independent judgment of an appellate tribunal; rather, both come to this court freighted with [a] strong presumption of regularity . . . .' [citation omitted] Our inquiry necessarily is confined to the question whether the classification is 'arbitrary, capricious or [without] reasonable or rational basis.' (*Culligan*, *supra*, 17 Cal.3d at p. 93, fn. 4 [additional citations omitted].)"
>
> [Footnote 4] In one respect, our opinion in *Wallace Berrie* may overstate the level of deference--even quasi-legislative rules are reviewed independently for consistency with controlling law. A court does not, in other words, defer to an agency's view when deciding whether a regulation lies within the scope of the authority delegated by the Legislature. The court, not the agency, has "final responsibility for the interpretation of the law" under which the regulation was issued. (*Whitcomb Hotel, Inc. v. Cal. Emp. Com.* (1944) 24 Cal.2d 753, 757; [additional citations omitted].)

Contingent Beneficiaries

Regulation 17742, subdivision (b), states that "[a] noncontingent beneficiary is one whose interest is not subject to a condition precedent."

The Restatement Third of Trusts (Restatement), section 49,[26] states that, "[e]xcept as provided by law or public policy (see § 29 [addressing, among other things, criminal acts and acts contrary to public policy]), the extent of the interest of a trust beneficiary depends upon the intention manifested by the settlor."

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[26] 2003 (updated to June 2016).

Section 50 of the Restatement explains:

> (1) A discretionary power conferred upon the trustee to determine the benefits of a trust beneficiary is subject to judicial control only to prevent misinterpretation or abuse of the discretion by the trustee.
>
> (2) The benefits to which a beneficiary of a discretionary interest is entitled, and what may constitute an abuse of discretion by the trustee, depend on the terms of the discretion, including the proper construction of any accompanying standards, and on the settlor's purposes in granting the discretionary power and in creating the trust.

In Comment (b), the Restatement further explains:

> A court will not interfere with a trustee's exercise of a discretionary power when that exercise is reasonable and not based on an improper interpretation of the terms of the trust. Thus, judicial intervention is not warranted merely because the court would have differently exercised the discretion.
>
> On the other hand, a court will not permit abuse of discretion by the trustee. . . .

In FTB TAM 2006-0002,[27] the FTB evaluated R&TC section 17742 and the issue of whether a resident beneficiary receiving an income distribution has a contingent or noncontingent interest if the distribution is made at the trustee's discretion. After considering the Restatement Second of Trusts and other authorities, the FTB concluded as follows:

> 1. A resident beneficiary of a discretionary trust has a non-contingent, vested interest in the trust *as of the time, and to the extent of the amount of income the trustee decides to distribute*. [staff's emphasis]
>
> 2. Income that has been accumulated is taxable to the trust when it is distributed or distributable to a resident beneficiary pursuant to Rev. & Tax. Code section 17742.
>
> 3. The answer . . . does not differ if the trustee may or does distribute corpus (capital gains) to the current beneficiary.

The TAM cautions, however, that its analysis "presumes the trustee has complete, unfettered discretion whether and when to make a distribution[,]" and states that the "the trust document should be reviewed . . . to determine any limitations on the trustee's discretion . . . ." In support, the TAM provides the following quote from the Restatement Second of Trusts, section 128:

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[27] As noted previously, the TAM is available at www.ftb.ca.gov/law/Technical_Advice_Memorandums/2006/20060002.pdf, and the FTB's website states that its TAMs ". . . are informational only, and may not be used or cited as precedent."

> The extent of the interest of the beneficiary of a trust depends upon the manifestation of intention of the settlor….
>
> COMMENTS & ILLUSTRATIONS: Comment:
> * * *
> d. Discretionary trusts. By the terms of the trust it may be provided that the trustee shall pay to or apply for a beneficiary only so much of the income and principal or either as the trustee in his discretion shall see fit to pay or apply. In such a case it depends upon the manifestation of intention of the settlor to what extent the trustee has discretion to refuse to make such payment or application. If the settlor manifests an intention that the discretion of the trustee shall be uncontrolled, the beneficiary cannot compel the trustee to make any payment to him or application for his benefit, if the trustee does not act dishonestly or arbitrarily or from an improper motive . . . .

McCulloch v. FTB (1964) 61 Cal.2d 186 (*McCulloch*)

In *McCulloch*, the California Supreme Court held that a resident beneficiary was liable for taxes that should have been paid by the trust in prior years. Mr. McCulloch was a California resident, beneficiary, and trustee of the trust. In addition, there were two other nonresident trustees. The Court noted that:

> California has evolved a comprehensive system for the taxation of trust income patterned upon the federal tax structure, which treats the trust as a separate economic entity. [footnote omitted] The statute requires the trustee to pay, on behalf of the trust, taxes due on the taxable income of the corpus; such income includes income, which the trust accumulates or holds for future distribution, whether the interest of the beneficiary is absolute, contingent, or vested subject to divestment. (*Id.* at p. 191.)
>
> As in effect for the year at issue in the case, R&TC section 18102 (which is the predecessor to R&TC section 17742), imposed tax "if the fiduciary or beneficiary is a resident."[28] (*Id.* at p. 192.)

The Court explained it saw no constitutional impediment to such taxation as the resident had enjoyed the protection of California laws. The Court stated in a footnote that if all residencies or fiduciaries were residents, then the entire income of the trust would be taxed, but if there was a mix of resident and nonresident trustees or beneficiaries, the tax would be apportioned according to the interest represented by the resident beneficiary or trustee. (*Id.* at p. 192 and fn. 5.) At page 197, the Court stated

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[28] Unlike the current version of R&TC section 17742, the statute in effect for the 1951 tax year did not state that the beneficiary had be noncontingent. The parenthetical excluding contingent beneficiaries, which is in the current statute, was added in 1963.

that imposing tax on the beneficiary as a transferee of the trust's liability "assures this state that resident beneficiaries of the trusts administered elsewhere obtain no special advantage over California taxpayers." Then, in a footnote to the preceding sentence (footnote 9), the Court quoted the following portion of a 1937 law review article of Roger Traynor (*Traynor Article*)[29]:

> (W)hile the complexity of the trust itself and of the relations of the parties thereto complicates the problem of effective taxation, it should not obstruct the claims of a state to tax trust income, so far as possible, as it [would in the absence of the trust][30]. Trust income is accorded protection in its production, receipt and enjoyment to the same extent as other income; it measures in like manner ability to pay. It measures in like manner ability far as possible upon the same basis. If the obstacles interposed by the trust device are to be circumvented, jurisdiction to tax should be found wherever substantial claims to tax are reinforced by effective power to compel payment.

<u>*Appeal of the Estate of Marilyn Monroe*, 75-SBE-032, decided April 22, 1975 (*Monroe*)</u>

Marilyn Monroe's estate received payments with respect to work she did on films prior to her death. She had been a resident of New York, and the executor was also a resident of New York. A portion of the payments, referred to as "percentage payments" were based on a percentage of earnings of the films, when such earnings accrued. The FTB determined that the percentage payments were "income in respect of a decedent" and further determined that all or a portion of other payments from her film work "were income attributable to a California source, viz. Miss Monroe's performance of her personal artistic services in California."

Reviewing the matter, the Board first noted that, as the payments arose from a California source, Miss Monroe would have been taxable on them if she had lived, citing R&TC section 17041 and Regulation 17951. The Board observed that R&TC section 17883 provided that income received by an estate will have the same character in the hands of the estate as if the decedent had lived. The Board noted that the courts had broadly interpreted when income "accrued" to fulfill the congressional purpose

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[29] Traynor, *State Taxation of Trust Income* (1937) 22 Iowa L.Rev. 268. The article is attached as Exhibit G of the FTB's Opening Brief prior to the original hearing. Mr. Traynor assisted in the drafting of the California trust regulations which were promulgated in 1936. He later served on the California Supreme Court, and he concurred in the *McCulloch* opinion, which was authored by Justice Tobriner.

[30] In the reproduction of the opinion on Westlaw, the court's clause reads: "so far as possible, as it income is accorded of a trust." However, the actual language of the article, reads as bracketed above. It is not clear to staff if the error arose in the Court's original opinion or later through the reporting service.

of taxing income of decedents. The Board stated that California's law was modeled on federal law and noted that, in *Commissioner v. Linde* (9th Cir. 1954) 213 F.2d 1, at page 5, the court stated that the federal provision was intended: ". . . to accomplish the general purpose of the internal revenue code that all income should pay a tax and that death should not rob the United States of the revenue it otherwise it would have had . . . ." Noting this, the Board stated:

> We have no doubt that our Legislature intended the comparable California provisions to fulfill the same general purpose. As we indicated above, the Personal Income Tax Law imposes a tax on all the income of a nonresident that is derived from a source within California. If Miss Monroe had lived to receive the percentage payments, they would have been taxable because they were derived from a California source. Therefore, in order to effectuate the legislative purpose behind [R&TC section 17831, appellant must be required to pay tax on the percentage payments . . . .

In reaching this conclusion, the Board rejected the estate's argument (among others) that the payments could not be taxed "because California has elected not to tax nonresident estates on personal service income." In support of its argument, the estate had noted that the FTB's trust regulations (Regulation 17742 *et seq.*) did not include any reference to taxation of personal service income. The Board found the argument "misplaced" and stated that it could not see why a nonresident estate "should be allowed to escape tax" or believe that the regulation was designed "to give nonresident estates any such windfall tax break." Accordingly, it ruled in favor of the FTB.

STAFF COMMENTS

Authority to Tax California Source Income

For more than 80 years, the FTB's interpretation of the law has been that trusts are taxable on California source income, regardless of the residence of fiduciaries or beneficiaries.[31] Appellant's view is that there is no California statute imposing tax on trusts on the basis of source. Under this view, while a nonresident individual selling California property would recognize taxable gain, the same gain would not be taxed if the nonresident first places the property in a trust with nonresident fiduciaries and beneficiaries.

[31] To the best of staff's knowledge after extensive research, prior to this appeal and the related appeals filed by appellant's counsel, there have been no cases, appeals, or articles that have questioned the validity of the FTB's position that all California source income of trusts is subject to tax without apportionment based on the residence of fiduciaries or beneficiaries.

In support of its position, the FTB points to R&TC section 17731, which provides that California conforms to federal income tax provisions related to trusts, except as otherwise provided. IRC section 641(b) provides that "[t]he taxable income of an estate or trust shall be computed *in the same manner as in the case of an individual*, except as otherwise provided in this part. [emphasis added]" At the hearing, the parties should be prepared to discuss whether this provision, when read in context with other provisions, evidences a legislative intent to tax trusts on California source income just as individuals are taxed on California source income.

The FTB also points to R&TC section 17041, subdivision (e), which states as follows:

> There shall be imposed for each taxable year upon the taxable income of every estate, trust, or common trust fund taxes equal to the amount computed under subdivision (a) [which sets forth the tax rates for residents] for an individual having the same amount of taxable income.

The FTB argues that the above provision does not merely reflect an intent that trusts should be subject to tax at the same rate as individuals, but also reflects the intent to tax trusts in the same manner as individuals. At the hearing, the FTB should be prepared to address the legislative history provided in appellant's reply brief. The legislative history appears to show that, prior to its amendment in 1987, R&TC section 17041, subdivision (e), simply set forth tax rates applicable to trusts. However, it was amended in 1987 to remove the trust tax rates and state that taxes will be imposed on trusts in an amount computed under subdivision (a), which sets forth the tax rate for resident individuals. The FTB should also be prepared to address appellant's argument that subdivision (e)'s reference to subdivision (a) of R&TC section 17041 cannot provide a basis for taxing trusts on the basis of source because subdivision (a) addresses only residents, who are taxable on income regardless of its source, and does not address the taxation of income based on source. Staff notes that, even if the Board determines that subdivision (e) does not itself indicate that trusts are taxable on California source income, the fact that it imposes tax at the same rate as tax is imposed on individuals is consistent with an intent to treat individuals and trusts similarly, to the extent possible given the legal structure of trusts.[32]

The parties should be prepared to address whether the legislative history indicates that the

[32] See *McCulloch, supra*, 61 Cal2d 186, 197, fn. 9 [quoting Traynor Article to the effect that complexity of trust legal form should, insofar as possible, not allow income to escape taxation].

Legislature intended to, and did, remove the ability of California to tax trusts on the basis of their receipt of California source income.[33] Section 12(a) of the Personal Income Tax Act, both as originally set forth and as amended in 1937, stated that "[t]he taxes imposed by this act upon *individuals* shall apply to, and be imposed upon, the income of estates or of any kind of property held in trust . . . . [emphasis added]" This language seems similar to the existing language in IRC section 641(b), noted above, which states that "[t]he taxable income of an estate or trust shall be computed in the same manner as in the case of an individual, except as otherwise provided in this part." Similarly, both the original 1935 act, and the act as amended in 1937, stated that "[t]he *net income* of the estate or trust shall be computed in the same manner *and on the same basis as in the case of an individual* . . . . [emphasis added]"[34]

The parties should be prepared to discuss whether the 1937 amendments may have been primarily designed to remove superfluous language, rather than being designed to eliminate the ability of California to tax trusts on the basis of the source of their income. Such an interpretation would appear to be consistent with the fact that the Franchise Tax Commissioner subsequently issued regulations that did not revise the sourcing rule. When summarizing the 1937 amendments in his preface to issuing revised regulations, the Commissioner characterized the amendments to the trust provisions as "minor."[35] As noted previously, where there is a ". . . contemporaneous construction of a statute by an administrative agency charged with its enforcement, the [agency's] view is entitled to great weight." (*Western Oil, supra*, 37 Cal.3d 502, 520.)

The parties should be prepared to discuss whether it is plausible or likely that the Legislature's 1937 amendments were intended to stop the application of sourcing rules to trusts, but that the Franchise Tax Commissioner nevertheless disregarded that expressed intent, and the

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[33] Exhibits F and G of appellant's Opening Brief on Rehearing provide Section 12 of the Personal Income Tax Act of 1935, as originally enacted, and as amended in 1937. The entire original act, and the amended act, were attached as Exhibits A and B of the original Hearing Summary and can be found at: www.boe.ca.gov/meetings/pdf/hearingsummaries/2014/B_Paula_Trust_759422_Sum_092314.pdf .

[34] This language is set forth in Section 12(c) of the original act, and Section 12(d) of the amended act. Staff notes that both acts also impose a fiduciary filing requirement based on net income, which is calculated with reference to California source income. (See §§ 4 [filing requirement], 6 [net income], 7(f) [California source income].) Both acts state in Section 2 that the word "taxpayer" includes a fiduciary, estate, or trust subject to tax, and Section 7(f) of both acts states that in the case of "taxpayers" other than residents, gross income includes only California-source income.

[35] See App. Op. Br. on Original Hearing, Ex. H, p. 2.

Legislature then either did not notice in 1938 that the Commissioner had disregarded its intent or that the Legislature noticed but chose to take no action when the Commissioner and its successor the FTB continued to apply the regulations immediately following the statutory amendments and throughout subsequent decades. The Legislature's evident inaction in the face of the FTB's continued application of its source rules could suggest that the FTB's regulations and continued practice of taxing trusts on the basis of source were consistent with the intent of the 1937 amendments. (See *Yamaha, supra*, 19 Cal.4th 1, 22-23 (conc. opn. of Mosk, J.).)

Arguably, if the 1937 amendments had been designed to eliminate California's ability to tax trusts on a source basis, the amendments might have been drafted differently by removing clauses (1) and (2) of Section 12(b), which stated that taxable income included California source income, rather than removing the definition of "taxable income" set forth in that section. The parties may wish to discuss whether the definition of "taxable income" may have been removed because the statute already defined net income, stated that the tax imposed on individuals shall be imposed on trusts, and further stated that the net income of trusts shall be computed "in the same manner and on the same basis" as for individuals.

The amendments revised subsection (c) of Section 12 to state, in part, that the tax imposed on trusts will apply to the "entire net income" of trusts if the fiduciary or beneficiary was a resident. Subsection (c) was also revised to state that "[w]here the taxability of income under *this subsection* [i.e., subsection (c)] depends on the residence of the fiduciary and there are two or more fiduciaries . . . , the income [shall be apportioned] . . . ." As noted by the FTB, by its terms, this new language does not apply to all of Section 12, or all of the trust's income, it only applies to "income under this subsection [i.e., subsection (c)]." It thus arguably supports the FTB's argument that the apportionment methodology only applies to income that is not otherwise subject to tax on the basis of source.

Whether the Beneficiary is a Contingent

At the hearing, the FTB should be prepared to discuss the analysis and authorities set forth in TAM 2006-002. The FTB should be prepared to discuss whether the $752,000 in distributions by the Paula Trust during the year at issue indicates that the beneficiary's interest is entirely

noncontingent. On this point, the TAM states in part as follows:

> A resident beneficiary of a discretionary trust has a non-contingent, vested interest in the trust *as of the time, and to the extent of the amount of income the trustee decides to distribute*. [emphasis added]

While the TAM is not precedential, it cites and discusses cases and authorities supporting this position. It explains that:

> 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.[36]

The TAM states that its analysis assumes that the trustee has "complete, unfettered discretion."

Here, the terms of the trust agreement appear to provide very broad discretion.[37] Article 3.1 "authorizes" the Trustee to make such distributions "as the Trustee deems to be in the best interests of said beneficiary." (The Paula Trust has two trustees. Article 8.4 provides that the two trustees must act unanimously to take any action.) Article 7.1 states that the Trustee's authority "may be exercised in the sole absolute discretion of the Trustee, by distributions in cash or kind, at any time . . . , but *the existence of such authority shall not require the Trustee to make any distributions to any person*; such authority shall permit the Trustee to terminate such trust by such distributions." Article 7.1 further states that the determination of what amount is "in the best interests or necessary for the support of the beneficiary or beneficiaries of such trust shall be in the *sole absolute discretion* [emphasis added]" of the Trustee. Article 7.2 defines the "best interests" and states that it contemplates not only distributions "necessary for support . . . but also distributions for his comfort and convenience."[38] Although Article 7.2 provides examples and direction, it concludes by stating that "[t]his Section 7.2 is intended solely as a *precatory* guide to the Trustee and shall in no way be construed to alter, limit or enlarge the discretions and powers conferred upon the Trustee by any other provision hereof *nor to require the Trustee to make*

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[36] In footnotes, the TAM provides definitions of "condition precedent," "vested," and "vested interest."

[37] The trust agreement is attached as Exhibit A of appellant's Opening Brief on Rehearing.

[38] "Support" is defined in Article 7.3.

any distribution to any beneficiary. [emphasis added]"[39] At the hearing, the FTB should be prepared to address whether, under these terms, the exercise of the trustees' discretion is a condition precedent to distributions that causes the beneficiary's interest to be contingent.

The FTB cites *Miller*, *supra*, 230 Cal.App.2d 888 in support of its position that the beneficiary is a noncontingent beneficiary. In *Miller*, a trust beneficiary argued that the executor and trustee had failed to provide her with the rights she should have received under the trust. In relevant part, the trust stated that the trustee "*is to pay* from the income of the Trust to [the beneficiary] . . . such sums as my trustee, in his *sole discretion*, shall determine as necessary to supplement any other income or source of funds she may have, to provide for her support and maintenance. [emphasis added]" (*Miller*, *supra*, 230 Cal.App.2d 888, 894.) Reviewing the intent of the settlor, as shown by the trust terms, the court found that the settlor, the beneficiary's mother, wanted to provide support and maintenance to her daughter but also to limit her daughter's access to funds as the daughter's alcoholism made her unable to manage funds wisely. The court noted that the daughter was now completely rehabilitated (*Id.* at p. 897), yet the trustee had not paid sufficient funds "to keep [the daughter] alive, let alone to maintain her in the condition and situation to which she was accustomed." (*Id.* at p. 910.) The Court held that the trustee had "completely fail[ed] to exercise his judgment" and ordered that distributions be made in an amount sufficient for support. At the hearing, the FTB should be prepared to discuss whether the terms of the trust in *Miller*, and the general facts in *Miller*, are distinguishable from the terms of the trust and facts in this appeal.

Appellant should be prepared to explain in what circumstances the beneficiary might or might not receive distributions. Appellant should also be prepared to explain its original reporting position with regard to whether the beneficiary was a contingent beneficiary or a noncontingent beneficiary.

Other Related Appeals

As noted previously, there are 171 other appeals pending at the Board that involve similar

[39] It appears to staff that, pursuant to Article III of the trust agreement, any amounts that are not distributed prior to the beneficiary's death generally would be distributed to the beneficiary's descendants, or to any persons directed by the beneficiary pursuant to her exercise of a power of appointment.

issues and related facts. With the consent of the parties to those appeals, those appeals are currently deferred pending the outcome of this appeal. Each party should be prepared to provide its perspective with regard to how those appeals should be handled after the Board decides this appeal.

Additional Evidence

If either party has any additional evidentiary exhibits to provide, any such materials should be provided at least 14 days prior to the oral hearing pursuant to Regulation 5523.6, subdivision (b), in order to facilitate an orderly and productive hearing.

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