



BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
C. PARDEE ERDMAN)

Appearances:

For Appellant: Antonio R. Romasanta
and Robert H. Schwab, Jr,
Attorneys at Law

For Respondent: Jack E. Gordon
Counsel

O P I N I O N

This appeal is made pursuant to section 18594 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of C. Pardee Erdman against proposed assessments of additional personal income tax in the amounts of \$2,474.50 and \$39,258.55 for the years 1959 and 1960, respectively.

Appellant C. Pardee Erdman and his late wife, Eleanor Donnelley Erdman, became California residents in 1946. Mrs. Erdman was the beneficiary for life of the income from two trusts which had been created by her father, Reuben H. Donnelley, a resident of Illinois. Trust #6087 was an irrevocable inter vivos trust established in 1924, and Trust #10881 was a testamentary trust which became operative in 1929. The trustees of the two trusts were the Northern Trust Company and the First National Bank of Chicago, respectively, both of which did business only in Illinois during the years in question. That state was also the location of the trust assets.

Each trust instrument granted Mrs. Erdman a general testamentary power of appointment over the trust

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corpus. If these powers were not exercised, the trust instruments provided that the corpus of Trust #6087 was to be distributed to Mrs. Erdman's heirs at law and the corpus of Trust #10881 was to be distributed one-third to her husband if he survived her, and the other two-thirds (or all if her husband predeceased her) in equal parts per stirpes to her descendants. In 1943 Mrs. Erdman executed a partial release of each general power, retaining only a power to appoint the corpus to her spouse, her descendants, her father's descendants (other than herself), spouses of such descendants, and certain public, charitable, and religious entities.

Mrs. Erdman periodically received the net income from the trusts and reported it for California personal income tax purposes. However, In accordance with the terms of the trust instruments, the capital gains earned by each trust were accumulated and added to corpus. California fiduciary income tax returns were not filed on behalf of the trusts. Mrs. Erdman died on December 30, 1959, without having exercised the retained powers of appointment. Consequently the corpus of each trust was distributed pursuant to the above described default clauses of the trust instruments. Appellant received \$69,288.43 from Trust #6087 and \$4,476,572.61 from Trust #10881.

After audit of appellant's 1960 return the Franchise Tax Board determined that he had incurred transferee liability, under section 17745 of the Revenue and Taxation Code, for personal income taxes owed by the two trusts with respect to the capital gains which the trusts had accumulated since 1946 and then had distributed to the appellant. Whether this determination was correct is the sole issue of this appeal. The above board also audited appellant's 1959 return and disallowed deductions for certain charitable contributions and interest expenses claimed by appellant. The correctness of those 1959 adjustments has been conceded by appellant.

The following sections of the Revenue and Taxation Code present the basic statutory scheme relevant to the above issue during the year in question.

17731. (a) The taxes imposed by this part on individuals shall apply to the taxable income of estates or of any kind of property held in trust, including--

(1) Income accumulated in trust for the benefit of unborn or unascertained persons or persons with contingent interests, and

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income accumulated or held for future distribution under the terms of the will or trust;

(2) Income which is to be distributed currently by the fiduciary to the beneficiaries, and income collected by a guardian of an infant which is to be held or distributed as the court may direct;

(3) Income received by estates of deceased persons during the period of administration or settlement of the estate; and

(4) Income which, in the discretion of the fiduciary, may be either distributed to the beneficiaries or accumulated.

(b) The taxable income of an estate or trust shall be computed in the same manner as in the case of an individual⁹ except as otherwise provided in this chapter. The tax shall be computed on such taxable income and shall be paid by the fiduciary.

* * *

17741. For purposes of Articles 1 to 6, inclusive, the term "beneficiary" includes heir, legatee, devisee.

* * *

17742. Except as otherwise provided in Articles 1 to 6, inclusive, of 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 a trust, if the fiduciary or beneficiary is a resident, regardless of the residence of the settlor.

* * *

17744. Where the taxability of income under Articles 1 to 6, inclusive, of this chapter depends on the residence of the beneficiary and there are two or more beneficiaries of the trust, the income taxable under Section 17742 shall be apportioned according to the number and interest of beneficiaries resident in this State pursuant to rules and regulations prescribed by the Franchise Tax Board.

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17745. If, for any reason, the taxes imposed on income of a trust which is taxable to the trust because the fiduciary or beneficiary is a resident of this State are *not* paid when due and remain unpaid when such income is distributable to the beneficiaries, or in case the income is distributable to the beneficiaries before the taxes are due, if the taxes are not paid when due, such income shall be taxable to the beneficiaries when distributable to them except that in the case of nonresident beneficiaries such income shall be taxable only to the extent ~~it is~~ derived from sources within this State.

Appellant first contends that the trusts did not incur any California personal income tax liability with respect to the capital gains and therefore he did not incur *any* transferee liability under section 17745. The alleged lack of trust liability, is based upon the fact that during the period when the capital gains were accumulated appellant possessed only a contingent interest with respect to this income, and therefore the trustees were unable to determine whether all or a portion of it would ultimately be distributed to him. Appellant states that this uncertainty created the following dilemma for the trustees. They could estimate appellant's share of the capital gains, pay California taxes accordingly and, if they erred, face possible civil liability to the actual recipients and criminal liability for supplying false information under section 19401 of the Revenue and Taxation Code. If they chose not to file returns they might again face criminal liability under the above statute. Appellant concludes that in order to avoid this dilemma the term "beneficiary" in section 17742 must be construed to exclude persons whose income interests are contingent. Such a construction would eliminate the trusts' and therefore appellant's liability.

The California Supreme Court considered a very similar contention in the case of McCulloch v. Franchise Tax Board, 61 Cal. 2d 186 [37 Cal. Rptr. 636, 390 P.2d 412], appeal dismissed, 379 U.S. 133 [13 L.Ed. 2d 333], which was also concerned with the tax consequences of a terminal distribution of corpus and accumulated income. During the years of accumulation the taxpayer's interest in this income was subject to two conditions: he had to survive to age 40, and he had to satisfy the trustees that he could capably manage the funds. Mr. McCulloch argued that this interest, whether described as contingent or vested subject to divestment, was so uncertain that he could not be characterized as a "beneficiary" under the predecessors

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of sections 17731 and 17744. (Appellant's Opening Brief, pp. 19-25, McCulloch v. Franchise Tax Board, supra, 61 Cal. 2d 186 [37 Cal. Rptr. 636, 390 P.2d 412], appeal dismissed, 379 U.S. 133 [13 L. Ed. 2d 3333.]) However the court held that under the identically worded predecessor of section 17745 the taxpayer was liable for the taxes owed by the trust. The court stated in part:

... 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.... (Footnote omitted and **emphasis** added.) (61 Cal. 2d 186, 191.)

* * *

Nor can we accept plaintiff's position that California cannot properly subject the beneficiary to any tax liability whatsoever on the income accumulation. Plaintiff contends that until he received the final distribution of trust assets at age 40, he held only a defeasible interest which could not support the imposition of the tax. **Yet,** as the condition of plaintiff's survival without mental incapacity was annually fulfilled, he continued to enjoy his right to the advantages flowing from additional accumulations of income in the trust. Plaintiff's survival to age 40 is material only to his personal liability for payment of the tax liability of the trust as a transferee of the assets under the terms of section 18106 [the predecessor of section 17745].... (61 Cal. 2d 186, 193.)

* * *

Indeed, to hold that California could not levy this tax **upon the** beneficiary when the trust is distributed to him would expose this state to serious impediments in the collection of its taxes. The purpose of section 18106 of the Revenue and Taxation Code in Imposing upon the beneficiary at the time of the trust distribution his personal obligation to pay taxes due, but

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unpaid, by the trust is to avoid the difficulties which the state might otherwise encounter in attempting to enforce tax collection directly against foreign trustees. (See Hanson v. Denckla (1957) 357 U.S. 235, 250-255 [78 S.Ct. 1228, 2 L. Ed. 2d 1283, 1295-1299], and Atkinson v. Superior Court (1957) 49 Cal. 2d 338 [316 P.2d 9603 .) The transferee tax thus levied assures this state that resident beneficiaries of the trusts administered elsewhere obtain no special advantage over California taxpayers. (Footnote omitted.) (61 Cal. 2d 186, 197.)

In deciding the McCulloch case, supra, the California Supreme Court considered a fact situation and contention closely analogous to those involved in the present appeal and discussed above. We think that the Supreme Court's decision forecloses the statutory interpretation urged by appellant and, therefore, appellant's contention must be rejected.

Appellant also argues that the term "income" as used in the phrase "income of a trust" in section 17745 refers to income in the trust accounting sense, and therefore does not include the capital gains at issue. Appellant argues that the McCulloch case, supra, and section 17740 of the Revenue and Taxation Code, support this position. During the period in question that statute provided:

For purposes of this article and Articles 2, 3, and 4, the term "income" when not preceded by the words "taxable," "distributable net," "undistributed net," or "gross," means the amount of income of the estate or trust for the taxable year determined under the terms of the governing instrument and applicable local law. Items of gross income constituting extraordinary dividends or taxable stock dividends which the fiduciary, acting in good faith, determines to be allocable to corpus under the terms of the governing instrument and applicable local law shall not be considered income.

Appellant points out that the trust instruments and applicable local law allocated capital gains to corpus.

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We cannot agree with this contention. In the Appeal of The First National Bank of Chicago, Trustee for Charles Errett Cord Trust, et al., Cal. St. Bd. of Equal., decided December 13, 1960, and the Appeal of the First National Bank of Chicago, Trustee for Virginia Kirk Cord Trust, et al., Cal. St. Bd. of Equal., decided June 23, 1964, we explicitly held that the income taxed by section 17742 and by its predecessor includes capital gains. The McCulloch case, supra, does not conflict with **these holdings.** The term "income" in section 17745 must be construed in the full context in which it is used, i.e., income of a trust which is taxable to the trust because the fiduciary or beneficiary is a resident of California. Such taxability is **created** by section 17742 which authorizes taxation on the entire "taxable income" of a trust and sections 17743 and 17744 which authorize taxation on an apportioned amount of the income taxable under section 17742,

Furthermore, the California trust provisions were based upon the federal Internal Revenue Code of 1954. Analysis of the legislative history of subdivision (b) of section 643 of that code, which is the federal counterpart of section 17740, indicates that it was enacted to eliminate difficulties which arose in reference to the provisions which are concerned with the common state and federal problem of **distributing** the tax burden between the trust and the beneficiaries (Rev. & Tax. Code, § 17751 through 17777), rather than in reference to section 17745 which is concerned with the more distinct state problem of enforcement of a foreign trust's tax liability. (H.R. Rep. No. 1337, 83rd Cong., 2d Sess. (1954) [vol. 3, 1954 U.S. Code Cong. & Ad. News, p. 4335].)

Alternatively, appellant challenges the constitutionality of sections 17742, 17744, and 17745, primarily on the ground that as applied in the present situation these statutes are so vague and uncertain that they deny due process of law. Appellant also argues **that** the instant assessments constitute "an ex post facto penal **imposition.**"

This board has a well established policy of abstention from deciding a constitutional question in an appeal involving proposed assessments of additional tax. This policy is based upon the absence of **any** specific statutory authority which would allow the Franchise Tax Board to obtain judicial review of a decision in a case of this type, and our belief that such review should be available for questions of constitutional importance.

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(Appeal of The First National Bank of Chicago, Trustee for Charles Errett Cord Trust, et al., supra, Cal. St. Bd. of Equal., Dec. 13, 1960.) This abstention policy properly applies to the instant case.

We must conclude that appellant was liable under section 17745 for the taxes which the trusts had not not paid with respect to the accumulated capital gains in question.

O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 18595 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of C. Pardee Erdman against proposed assessments of additional personal income tax in the amounts of \$2,474.50 and \$39,258.55 for the years 1959 and 1960, respectively, be and the same is hereby sustained.

Done at Sacramento California, this 18th day of February, 1970, ' by the State Board of Equalization...

John W. Lynch, Member
Paul R. Leake, Member
Philip W. B., Member
W. H. Kelly, Chairman

ATTEST: [Signature], Secretary