

Appeal of Proctor P. and Martha M. Jones

The sole **issue for** resolution is whether respondent's determination that one-half of each class of the distributable net income of an Ohio trust was allocable to appellants for California tax purposes **was correct.**

Appellants, husband and wife, filed a joint return for the years in question. For clarity, **appellant-**husband Proctor P. Jones is hereafter referred to as appellant.

Appellant is one of two income beneficiaries of a trust established in 1945 by his grandfather, **Proctor Patterson.** The other beneficiary is appellant's sister, who resides in Arizona.

The original trust corpus consisted of 2,652 shares of common stock in the W.S. Tyler Company (Tyler) of Cleveland, Ohio. The trustees were directed to pay' the net income of the trust as follows: first, to Mr. Patterson for his life; second, to **appellant's parents,** appellant, and his sister in equal shares for their lives; and, finally, to the surviving "needy and deserving" employees of Tyler. After this class ceased to exist, the corpus was to be distributed to St. Vincent's Charity Hospital **of** Cleveland.

In **1969,** when appellant and his sister were the only surviving life income beneficiaries, Tyler merged with Combustion Engineering Co. (Combustion). The trust received 154,715 shares of Combustion stock in exchange for its Tyler stock, and two officers, of Combustion became trustees. The merger resulted in two lawsuits involving appellant, his sister, their families, and the charitable remaindermen. After lengthy negotiations, the litigants agreed on a settlement of the matter, which resulted in **the appointment** of The National City Bank **of Cleveland** as 'successor trustee and provided for the orderly liquidation of the trust's holdings of Combustion stock. Separately, the bank committed itself to reinvesting the corpus, in substantial part, in tax-exempt bonds, and appellant and his sister each irrevocably directed the bank to annually pay over to the charitable remaindermen an amount equal to five percent of the trust's tax-exempt income. The settlement agreement was approved by the Cuyahoga County, Ohio, Court of Common Pleas in April **1971.**

By late 1974, the trustee had sold the Combustion stock and reinvested the proceeds as follows: approximately one-third of the corpus consisted of California **municipal** bonds: one-third consisted of Arizona municipal bonds; and

Appeal of Proctor P. and Martha M. Jones

one-third was invested in other tax-exempt and taxable securities. In 1975 and 1976, the years under appeal, the bank paid all of the California bond income to appellant, all of the Arizona bond income to his sister, and distributed the remaining income, after deducting the payments to the remaindermen, between appellant and his sister, as necessary to equalize their annual distributions from the trust.

On their California returns for 1975 and 1976, appellant and his wife did not report any of the California bond income received from the trust, because it was tax exempt, or any of the Arizona bond income, because all of that had been distributed to appellant's sister. Appellant did report his share of the other income received from the trust. After an audit, respondent determined that, for tax purposes, appellant should have had allocated to him one-half of each class of income received by the trust. Proposed assessments were issued based on the inclusion in appellant's income of one-half of the Arizona bond income and other income, and the exclusion of one-half of the California bond income.

Following discussions concerning this matter, and as directed by respondent, appellant filed a motion in the Court of Common Pleas, General Division, Cuyahoga County, Ohio, requesting that the court issue an Order Clarifying Judgment. On October 20, 1981, appellant obtained an order from the court clarifying the original settlement agreement and ordering that the terms of the settlement agreement be amended and the following language inserted in paragraph 6(a), nunc pro tunc:

In order to provide a reasonable after-tax income for the beneficiaries of the Trust, as long as either of the income beneficiaries are entitled to receive income from the trust, and as long as they have different states of residence, the successor Trustee is required to allocate the principal of the Trust into portions **attributable to** each income beneficiary.

Respondent contends that appellant has failed to sustain his burden of proving that the determination in question is in error. Respondent argues that Revenue and Taxation Code section 17752 controls in the instant case because appellant has failed to show that the trust in question had a charitable set-aside which would take it out of the purview of section 17751 of the Revenue and Taxation Code. Respondent contends that the express terms

Appeal of Proctor P. and Martha M. Jones

of the trust- provide that the income from **the** trust is to be paid in equal shares and, thus, under section 17752 and its interpretive regulation 17752(d) (Former Cal. Admin. Code, tit. 18, reg. 17752(d) (repealer filed Jan. 15, 1982, Register 82, No. 3)), one-half of the total income received from the trust is allocable to appellant. Finally, respondent submits that, in accordance with its well-established policy, the board should decline to rule on the equal protection arguments put forth by appellant because of the absence of any specific statutory authority which would allow respondent to obtain judicial review of such a matter.

Appellant contends that Revenue and Taxation Code section 17752 is inapplicable to the instant case because it applies only to trusts described in Revenue and Taxation Code section 17751 which do not provide for payment of any amounts for the purposes specified in section 17734, relating to deductions for charitable purposes. Appellant also contends that even if Revenue and **Taxation Code** section 17752 applies, the trust's terms and Ohio law require the allocation of **California** municipal bond income to appellant. Appellant also contends that the allocation of trust income had an economic effect independent of the income tax consequences. Appellant also argues that respondent's interpretation of section 17752 violates appellant's rights under the equal protection clause of the United States Constitution because there is no rational basis why appellant, as an income beneficiary of a trust, should be treated differently than an individual who, independent of a trust, receives tax-exempt income from California municipal bonds.

Respondent relied on sections 17751 and 17752 of the Revenue **and** Taxation Code in determining the amount of apportionable income attributable to appellant from the trust.

Revenue and Taxation Code section 17751 provides, in pertinent part, as follows:

(a) In the case of any trust the terms of which--

(1) Provide that all of its income is required to be distributed. currently; and

(2) Do not provide that any amounts are to be paid, permanently set aside, or used

Appeal of Proctor P. and Martha M. o n e s

for the purposes specified in Section 17734 (relating to deduction for charitable, etc., purposes),

there shall be allowed as a deduction in computing the taxable income of the trust the amount of the income for the taxable year which is required to be distributed currently.

Section **17752** of the Revenue and Taxation Code specifies that:

(a) Subject to subsection (b), the amount of income for the taxable year required to be distributed currently by a trust described in Section 17751 shall be included in the gross income **of the** beneficiaries to whom the income is required to be distributed, whether distributed or not. If such amount exceeds the distributable net income, there shall be included in the gross income of each beneficiary an amount which bears the same ratio to distributable net income as the amount of income required to be distributed to such beneficiary bears to the amount of income required to be distributed to all beneficiaries.

(b) The amounts specified in subsection (a) shall have the same character in the hands of the beneficiary as in the hands of the trust. For this purpose, the amounts shall be treated as consisting of the same proportion of each class of items entering into the computation of distributable net income of the trust, as the total of each class bears to the total distributable net income of the trust, unless the terms of the trust specifically allocate different classes of income to different beneficiaries. In the application of the preceding sentence, the items of deduction entering into the computation of distributable net income shall be allocated among the items of distributable net income in accordance with regulations prescribed by the Franchise Tax Board.

If it is determined that the trust in question has a valid charitable set-aside, the provisions of section 17752 do not apply. If this is the case, the amount and character of distributable trust income allocable to appellant is determined by **applying** the provisions of

Appeal of Proctor P. and Martha M. Jones

Revenue and Taxation Code sections 17762 and 17763 pertaining to complex **trusts**. Basically, the same analysis is **required to** determine the amount and character of distributable trust income allocable to appellant for both section 17752 and section 17763. We therefore find it unnecessary to address the question of whether the trust contained a valid charitable set-aside and will proceed to answer **the question** of whether there was an allocation of the principal of the trust into portions attributable to each beneficiary according to their place of residence.

If section 17752 is not applied, the applicable section is **17763**, which provides as follows:

The amounts determined under Section 17762 shall have the same character in the hands of the beneficiary as in the hands of the estate or trust. For this purpose, the amounts shall be treated as consisting of the same proportion of each class of items entering into the computation of distributable net income as the total of each class bears to the total distributable net income of the estate or trust unless the terms of the governing instrument specifically allocate different classes of income to different beneficiaries. In the application of the preceding sentence, the items of deduction entering into the computation of distributable net income (including the deduction allowed under Section 17734) shall be allocated among the items of distributable net income in accordance with regulations prescribed by the Franchise Tax Board. In the application of this section to the amount determined under Section 17762(a), distributable net income shall be computed without regard to any **portion** of the deduction under Section 17734 which is not attributable to income of the taxable year.

Former regulation 17752(d) (Former Cal. Admin. Code, tit', . 18 (repealer filed Jan. 15, 1982, Register 82, No. 3)) contained guidelines for determining the proper allocation of trust income under both sections 17752 and 17763. (See former Cal. Admin. Code, tit. 18, reg. 17763(a) and (b) (repealer filed Aug. 8, 1981, Register 81, No. 32).) Under former regulation 17752 (d), the character of the net income of a trust distributed to a beneficiary was in proportion to each class of items entering into the distributable net income of the trust as the total of each class bore to the total distributable

Appeal of Proctor P. and Martha M. Jones

net income. Former regulation 17752(d) cited two exceptions to this rule: (i) where the terms of the trust specifically provide otherwise, and (ii) where local law provides otherwise. The latter exception is not at issue in the instant case. It is therefore necessary to determine whether the first exception is applicable.

In discussing the first exception, former regulation **17752(d)(2)** provided as follows:

The terms of the trust are considered specifically to allocate different classes of income to different beneficiaries only to the extent that the allocation is required in the trust instrument, and only to the extent that it has an economic effect independent of the income tax consequences of the allocation.

Respondent argues that the trust instrument in question provides only that the income of the trust is to be paid to the two income beneficiaries "in equal shares" and that there is no further language specifically requiring the payment of a particular class of the trust income to a particular beneficiary. Respondent also contends that the settlement agreement does not provide any specifics as to the class or character of the trust income to be distributed to each beneficiary. While respondent notes that the settlement agreement does contain language which delineates "investment principles" to be adhered to by the trustee, the agreement does not, in the opinion of respondent, specify the manner in which the trust net income is to be distributed to the beneficiary. As such, respondent concluded that there was no allocation of different classes of income to different beneficiaries. In addition, respondent argues **that** even if the trust instrument is considered to allocate different classes of income to different beneficiaries, such allocation is only effective if the allocation is not based on income tax considerations. Respondent argues that this criterion has not been met because the allocation in question was only for income tax consequences.

Appellant argues that the trust and settlement agreement require the allocation of different classes of income to different beneficiaries and that this allocation had an economic effect independent of the income tax consequences in that it resulted in: (i) appellant and his sister agreeing to assign a portion of their annual income to the charitable remaindermen; (ii) the sale of the Combustion stock; and (iii) the purchase of a diversified

Appeal of Proctor P. and Martha M. Jones,

portfolio, including tax exempt municipal bonds. Appellant, therefore, submits that the requirements of former regulation 17752(d) are satisfied.

Paragraph 6(a) of the settlement agreement dated April 16, 1971, provides, in pertinent part:

[T]he respective interests of the principal beneficiaries and the income beneficiaries will be best served by investment in such securities as would be acquired by prudent men of discretion and intelligence in such matters who are seeking a reasonable after-tax income and the preservation of their capital and having regard for the desirability of diversification, the residence of the income beneficiaries and the effect of such residence on their federal, State and local taxes, and such other factors as may be relevant

On October 20, 1981, appellant obtained an Order Clarifying Judgment, nunc pro tunc, which provided that the April 19, 1971, judgment and settlement agreement be clarified to reflect the intent of the parties; and the court and incorporated the following language into paragraph 6(a) of the settlement agreement:

In order to provide a reasonable after-tax income for the beneficiaries of the Trust, as long as either of the income beneficiaries are entitled to receive income from the Trust, and as long as they have different states of residence; the Successor trustee is required to allocate the principal of the Trust into portions attributable to each income beneficiary.

It is well settled that a trust instrument may be modified by agreement of all the affected beneficiaries. (Heifetz v. Bank of America, 147 Cal.App.2d 776 [305 P.2d 979] (1957).) A court may take jurisdiction in order to assist in carrying out the trust and has the power to permit a deviation from the express terms of the trust. (Leonardini v. Wells Fargo Bank, 131 Cal.App.2d 9 [280 P.2d 81] (1955).)

The effect of a nunc pro tunc order is to correct the record of a judgment and not to alter the substance of a judgment actually rendered. (Estate of Careaga, 61 Cal.2d 471 [393 P.2d 415] (1964).) It is therefore necessary to examine the judgment, settlement

Appeal of Proctor P. and Martha M. Jones

agreement and Orders Clarifying Judgment to determine whether the trust can now be said to require: (i) allocation of different classes of income to different beneficiaries, and (ii) whether this allocation has an economic effect independent of the income tax consequences of the allocation as provided in Revenue and Taxation Code section 17763 and former regulation 17752(d)(2).

The plain language of the Order Clarifying Judgment requires the successor trustee to allocate the principal of the trust into portions attributable to each income beneficiary. We, therefore, conclude that the first requirement is satisfied. The more difficult question is determining whether the effect of the allocation has an effect independent of the income tax consequences. Appellant argues that the allocation of income according to the residences of the beneficiaries did have an independent economic effect in that it resulted in the investment in municipal bonds which increased the annual income from the trust for both appellant and his sister and satisfied the desire of the beneficiaries to switch from potentially volatile capital appreciating securities into income producing securities.

While we recognize that the repositioning of the trust's assets into two classes of municipal bonds and the allocation of tax-free income to each beneficiary was, in part, made because of the income tax consequences inherent in such action, appellant has offered credible evidence to demonstrate that the change was also to increase the income of the beneficiaries, an effect separate from the income tax consequences. Respondent has offered no persuasive argument or evidence with which to rebut appellant's claim. Under the plain language of the statute and regulation, there is no requirement that an allocation be entirely free of income tax consequences, just that there be an economic effect independent of the income tax consequences. We conclude that appellant has demonstrated that such an independent economic effect exists.

Accordingly, we must conclude that respondent's determination of the amount of trust income allocable to appellants was incorrect. Therefore, respondent's action **must be** reversed.

Appeal of Proctor P. and Martha M. Jones

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 Proctor P. and Martha M. Jones against proposed assessments of additional personal income tax in the amounts of **\$9,717.99** and **\$10,450.75** for the years 1975 and **1976**, respectively, be and the same is hereby reversed.

Done at Sacramento, California, this **15th** day of September , 1983, by the State Board of Equalization, with Board Members Mr. Bennett, Mr. **Collis**, Mr. Dronenburg, Mr. Nevins and Mr. Harvey present.

William M. Bennett , Chairman
Conway H. Collis - - , Member
Ernest J. Dronenburg, Jr. , Member
Richard Nevins , Member
Walter Harvey* , Member

*For Kenneth Cory, per Government Code section 7.9