

BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
ESTATE OF **CARMA** ISRAEL,)
DECEASED, **SECURITY** PACIFIC) No. **81A-135**
NATIONAL BANK, EXECUTOR)

For Appellant: Ralph Mitzenmacher
Attorney at Law

For Respondent: Jean Ogrod
Counsel

O P I N I O N

This appeal is made pursuant to section **18593¹** of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Estate of **Carma** Israel, Deceased, Security Pacific National Bank, Executor, against a proposed assessment of additional personal income tax in the amount of **\$51,352.96** for the year ended May 31, 1980.

1 Unless otherwise specified, all section references are to sections of the Revenue and Taxation Code as in effect for the year in issue. In addition, all references to regulations are to the California Administrative Code as in effect for the year in issue.

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The sole issue presented is whether respondent correctly determined that appellant was precluded from including certain capital gains in the computation of its distributable net income for the taxable year in issue,.

The estate was created on December 7, 1978, upon the death of **Carma** Israel. By court order dated February 16, 1979, Letters Testamentary were issued to Security Pacific National Bank as Executor of the Will. Appellant operates on a tax year ending May 31, and for the tax-year ended May 31, 1980, appellant filed a fiduciary income tax return claiming a \$703,377 deduction for distributions to beneficiaries.. As **indicated** in **greater** detail below, deductions by, an estate for distributions to beneficiaries are limited by the amount of the estate's distributable net **income (hereafter "DNI")**. In support of its **\$703,377** deduction for distributions to its beneficiaries, appellant had computed its **DNI** for the same taxable period to be \$703,377.

Upon audit, respondent determined that \$565,866 of the capital gains incurred by appellant was not **includible** in the computation of its DNI, thereby resulting in the disallowance of \$565,866 of the deduction for distributions to beneficiaries which it had claimed. Respondent thereupon issued the proposed assessment under review here and denial of appellant's protest led to this **appeal**.

In general, beneficiaries of estates are taxed on the income of the estate which has been distributed to them within the **current** year while the estate is taxed on income which has not been distributed within the current year. (See Rev. & Tax. Code, **§§ 17761, 17762**.) The amount of distributions to beneficiaries which an estate may **claim** as a deduction against its taxable income is limited by its **DNI** for **that** period. (Rev. & Tax. Code, 5.17739, subd. (a).) **For** these purposes, DNI is defined as the taxable income, of an estate, excluding, **inter alia**, capital gains, which are allocated to corpus and not "paid, credited, or required to be **distributed** to any beneficiary during: the taxable year . . ." (Rev. & Tax. Code, **§ 17739, subd. (b)(1)**.) The regulation **interpreting this definition** provides that capital gains are excluded from DNI unless at least one of four requirements is satisfied. The requirement involved in **this** appeal is **that** capital gains be "**[a]llocated** to corpus and **actually distributed** to beneficiaries during the taxable year." (Cal. Admin. Code, tit. 18, reg. 17739(d), **subd. (1)(B)**.) Respondent, in reliance upon the cited

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regulation, contends that it is necessary to trace distribution payments to capital gains in order to show actual distribution of such gain.

Mrs. Israel's will was silent on the question of whether capital gains were to be allocated to income or corpus. Consequently, the gains involved in this appeal were properly allocable to corpus. (Civ. Code, § 730.03, subd. (b)(8); Estate of Davis, 75 Cal.App.2d 528, 538 [171 P.2 463] (1946).) Respondent maintains, therefore, that they were excluded from DNI because appellant provided no documentation establishing that the capital gains in question were actually distributed to beneficiaries during the taxable year.

Appellant first argues that tracing distribution payments to capital gains in order to show actual distribution of such gain is not necessarily required. (App. Br. at 8.) However, as we held in Appeal of Estate of Ray Murphy, Deceased, Dorothy D. Walton and Adrian -- Arendt, Executors, decided June 29, 1982, such tracing is required to show actual distribution. Next, appellant contends that even if tracing is required, we must presume that appellant actually did distribute all such capital gains to the beneficiaries since it must be presumed, in the absence of contrary evidence, that the assets were sold and distributed in the best interests of the estate. (App. Br. at 4.) Apparently, appellant concludes that such a distribution to the beneficiaries was in the best interest of the estate and, therefore, such a distribution must be presumed. However, it is well settled that the taxpayer has the burden of showing that the subject capital gains were actually distributed to the beneficiaries. (Aaron v. Commissioner, 22 T.C. 1370, 1374 (1954).) Accordingly, we must hold that appellant cannot rely upon any presumption and that appellant's second contention is mistaken.

Lastly, appellant contends that even if actual distributions of capital gains may not be presumed, appellant can trace \$264,097 of the capital gains to distributions made to beneficiaries during the period at issue, so that at least this amount should be included in DNI. (App. Br. at 6-8.) Briefly, appellant notes that: (1) on September 8, '1979, the estate had cash on hand of \$235,952, (2) between September 8, 1979, and January 4, 1980, the estate sold assets from which it realized **\$2,713,623, \$2,391,119** of which was recovered basis and \$322,504 of which was capital gain, and (3) the distributions, approved by court order filed December 28, 1979,

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included **\$2,458,053** in cash to beneficiaries for the period at issue. Appellant concludes that **\$2,222,101** of the distributions made to beneficiaries can be traced to the amount realized from the sale of capital assets (i.e., **\$2,458,053** required to be distributed less cash on hand of \$235,952). Appellant then argues that the amount of the capital gains traceable to the beneficiaries from the total capital gains realized (i.e., \$322,504) must bear the same ratio as the total amount of proceeds so traceable to distributions to beneficiaries (i.e., **\$2,222,101**) over the total amount realized from the sale (i.e., **\$2,713,623**) or \$264,097. Respondent, on the other hand, contends that it is equally possible to attribute the distribution of **\$2,458,053** to cash on hand of \$235,952 and return of basis of **\$2,391,119** rather than to any part of the capital gains. Accordingly, respondent concludes that appellant has not properly traced the \$264,097 of the capital gains to distributions made to beneficiaries during, the year at issue. ^{2/}

Thus, in this appeal, we are asked to decide whether appellant has properly traced the subject \$264,097 of capital gains to the distributions made during the year at issue. Since the parties have cited no cases on this point and we are unable to locate any, this issue appears to be one of first impression. Nevertheless, commentators appear to have pondered this question and conclude that in order to be included in DNI, the fiduciary must, at least, indicate on his books or other records that the distribution was made out of capital gains. (See Ferguson, Freeland and Stephens, Federal Income Taxation of Estates and Beneficiaries, p. 328 (1970).) Indeed, one commentator concludes that an executor can "cause capital gains to be included in DNI merely by making a distribution to a beneficiary and noting on his books that it was a distribution of capital gains." (Hale, 302-2nd T.M., After-Death Tax Planning - Payments and Distributions, p. A-5 (1984).) Based on the record before us, we cannot find that appellant made such a notation. Indeed, appellant appears to concede that no notation has been made and only argues that tracing can be made "to the extent of the proportion of gains in the proceeds distributed." (App. Br. at 10.) We must conclude that there is no authority for such "proportional

^{2/} Respondent also appears to impugn the validity of appellant's figures. (Resp. Supp. Memo. at 4.) However, on review, we can find nothing erroneous about those figures.

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tracing" of capital gains. Accordingly, we must hold that appellant's last argument is also erroneous and that respondent's action here **must be** upheld.

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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 Estate of **Carma** Israel, Deceased, Security Pacific National Bank, Executor, against a proposed, assessment of additional personal income tax in the amount of **\$51,352.96** for the year ended May 31, 1988, be and the same is hereby sustained,

Done at Sacramento, . California, this 33th day of July , 1985, by the State Board of **Equalization**, with Board Members Mr. Dronenburg, Mr. Collis, **Mr. Bennett**, Mr. Nevins and Mr. Harvey present.

Ernest J. Dronenburg, Jr. , Chairman

Conway H. Collis , Member

William M. Bennett , Member

Richard Nevins , Member

Walter Harvey* , Member

*For Kenneth Cory, per **Government** Code section 7.9