BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeals of)
)
JOHN PERRY COHN TRUST #1, ET AL)

Appearances:

For Appellant: Sidney J. Matzner
Certified Public Accountant

For Respondent: James T. Philbin
Supervising Counsel

O P I N I O N

These appeals are made pursuant to section 18594 of the Revenue and Taxation Code from the action Of the Franchise Tax Board on the protest of the John Perry Cohn Trust #1 against a proposed assessment of additional personal income tax in the amount of $14,776.00 for the year 1972; and from the action of the Franchise Tax Board on the protest of the John Perry Cohn Trust #2 against a proposed assessment of additional personal income tax in the amount of $9,704.20 for the year 1972.

Appeals of John Perry Cohn Trust #1, et al.

The issue is whether gains received by two trusts on the sale or exchange of capital assets, and thereafter distributed to the trusts' beneficiary, were includible in the trusts' distributable net income.

In 1950 Harry Cohn created two spendthrift trusts. His son, John Perry Cohn, was the sole beneficiary of each trust, except for contingent beneficiaries if John should not survive. Both trust agreements provided that trust income would be distributed to John in installments beginning on his twenty-fifth birthday, and that the corpus would be distributed to him in installments beginning on his thirtieth birthday. In addition, the agreements also provided that:

> If at any time or times during the existence of this trust, any beneficiary other than Joan Perry Cohn (but including the Trustor's son, John Perry Cohn and any other income participating beneficiary) shall be in want of additional monies for reasonable maintenance and support or for expenses of accident, illness, disability or other misfortune or, in case of a child, for his or her reasonable education including study at an institution of higher learning, in each such case of want, it shall be the discretionary duty of the Trustees, upon receipt by them of satisfactory evidence of such want, to pay to said beneficiary or his or her guardian, such part of the corpus of the trust estate or the accumulated and undistributed income as may be necessary to meet-said want. (Emphasis added.)

In 1972 the trustees sold some of the corpus Of each trust, realizing capital gains which were apparently allocated to corpus. Acting under the authority of the above quoted provision of the trust agreements; they distributed all or most of the gain from the sales. They then claimed deductions for the distributions on their California fiduciary income tax returns. Respondent determined, however, that the capital gains should be excluded from the trusts' distributable net income, and therefore disallowed the deductions.

Generally the amount of distributions which a trust may claim as a deduction is limited by the trust's "distributable net income" (DNI). (Rev. & Tax. Code, § 17751, subd. (b); § 17761, subd. (a).) DNI is defined as the trust's taxable income 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 the 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 construes this language to apply only where there is a distribution required by mandatory terms of the trust agreement upon the happening of a specified event.[1/]

The capital gains in question here were allocated to corpus and were actually distributed to the trusts' beneficiary. Respondent contends that they were excluded from DNI, however, because their distribution was a matter of discretion in the trustees. The trusts, on the other hand, contend that the capital gains were distributed under a mandatory direction in the trust agreements. This difference of opinion results from the contradiction inherent in the term "discretionary duty" as used in the previously quoted provision of the trust agreements. Does this term impose a duty on the trustees, or does it merely authorize them to distribute funds if they choose to do so?

1/ Revenue and Taxation Code section 17739 and the corresponding regulation are substantially identical to their federal counterparts. (Int. Rev. Code of 1954, § 643(a); Treas. Reg., § 1.643(a).) Respondent's interpretation of these sections, moreover, is based upon the construction given the federal law by the Internal Revenue Service. (See Rev. Rul. 68-392, 1968-2 Cum. Bull. 284.) Appellant does not object to this interpretation, and for purposes of this appeal we shall therefore assume that it is correct.

The answer to this question depends on the intention of the trustor as evidenced by the trust agreements. (Estate of Miller, 230 Cal. App. 2d 888, 908-909 [41 Cal. Rptr. 410] (1964).) In the agreements in question, most of the powers of the trustees are framed in clearly discretionary language. For example, the trustees have "full power" to manage the trust assets, to lease them "for any purpose", and to borrow money in their "sole discretion." Only the power to make distributions for maintenance and support is specifically described as a "duty," and except for the ad, jective "discretionary," the provision dealing with such distributions is drafted in imperative language. Moreover the trusts were spendthrift trusts created for' John Perry Cohn's benefit, and he was designated as both the income beneficiary and the remainderman. For these reasons it appears that the trustor intended to require the trustees to make any necessary distributions for John's maintenance and support, provided only that a need for such distributions be established.

In Estate of Greenleaf, 101 Cal. App. 2d 658, 662-663 [225 P.2d 945] (1951), the court said:

> Where 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 existance of a reasonable necessity for the distribution to accomplish the purpose. Upon proof of such a necessity, a court will compel the trustee to make the disbursement, and usually will direct him as to the amount to be paid. The question of necessity, as well as what it calls for to comply with the condition, is a judicial question. [Quoting from Annotation, Trust - Advances to Beneficiaries, 2 A.L.R. 2d 1383, 1395.1 (Emphasis added.)

Here the trustees were directed to pay amounts for maintenance and support upon the happening of a specified; event, namely, proof of need. Presumably acting in good faith (see Estate of Ferrall, 41 Cal. 2d 166, 177 [258 P.2d 1009] (1953)), the trustees actually made such distributions.

We hold that they did so, not as a matter of discretion, but under a mandatory direction in the trust agreements. The distributions were therefore not excluded from the trusts DNI. (Cal. Admin. Code, tit. 18, reg. 17739(d), subd. 1(B).) Accordingly, we reverse respondent's action.

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 John Perry Cohn Trust #1 against a proposed assessment of additional personal income tax in the amount of $14,776.00 for the year 1972; and the action of the Franchise Tax Board on the protest of the John Perry Cohn Trust #2 against a proposed assessment of additional personal income tax in the amount of $9,704.20 for the year 1972, be and the same are hereby reversed.

Done at Sacramento, California, this 26th day of July, 1977, by the State Board of Equalization.

_____, Chairman

_____, Member

_____, Member

_____, Member

_____, Member