BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeals of)	
CAROLYN I. EMMERSON, GEORGE EMMERSON AND MARK EMMERSON)	Nos. 82A-1189, 82A-1190, and 82A-1191-GO

Appearances

For Appellants. Donald E. Riewerts
Certified Public Accountant

For Respondent: Elleene K. Tessier
Counsel

O P I N I O N

These appeals are made pursuant to section 18593[1/] of the' Revenue and Taxation Code from the actions of the Franchise Tax Board on the protests of Carolyn I. Emmerson, George Emmerson, and Mark Emmerson against proposed assessments of additional personal income tax in the amounts and for the years as follows:

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

Appellants	Year	Proposed Tax
Carolyn I. Emmerson	1979	$2,497.83
	1980	406.18
George Emmerson	1979	3,588.37
	1980	406.84
Mark Emmerson	1979	2,656.60
	1980	406.22

Tne central issue presented in these appeals is whether respondent has properly determined the character of a trust's distributable net income as part ordinary income as opposed to entirely capital gain income. Because of the identity of facts, issue, and legal principles involved in each case, the three appeals are consolidated for the purposes of this opinion.

Appellants are each beneficiaries of one-third of the income of the R. H. Emmerson Trust (hereinafter **"Trust").** During the appeal period, the Trust's primary holding was a 37-percent interest in the L.T.E. partnership (hereinafter "partnership") which sold logs under the name of Elk River Timber Co. Pursuant to section 17711, the partnership elected to treat the cutting of timber during the appeal years as the sale or exchange of a capital asset.[2/] Accordingly, this election had the effect of transforming what normally would have been ordinary income into capital gain income. At the same time, the elimination of this ordinary income from the partnership's total income enabled it to report large operating losses for tax purposes. In accordance with the principles of partnership taxation, these capital gains and operating losses were passed through to the partners, including the Trust.

2/ Section 17711 is an elective provision which allows a taxpayer to treat the cutting of timber during a taxable year as a sale or exchange of a capital asset. When this election is made, gain or loss is recognized by the taxpayer in an amount equal to the difference between (1) the fair market value of the timber as of the first day of the taxable year in which such timber is cut, and (2) **the taxpayer's** adjusted basis for depletion of the timber.

In determining the character of its distributable net income (hereinafter "DNI"), the Trust concluded that it was entitled to offset the partnership losses first against its interest income, leaving only lower-taxed capital gains to be distributed to the beneficiaries, appellants herein.

However, since expense items directly attributable to one class of income must be first allocable to that class of income, upon audit, respondent concluded that the partnership iosses noted above were directly attributable to the capital gains arising from the timber activities. Since the partnership losses were absorbed by the capital gain income, part of the income distributed from the Trust to appellants would be characterized as ordinary income rather than entirely as capital gains.[3/] The result of such conclusion was that appellants were determined as having received some ordinary income from the Trust's distribution to them. Respondent thereupon issued the proposed assessments under review here and denial of appellants' protests led to these appeals.

The starting point for our inquiry here must be a brief review of trust income taxation principles. In general, beneficiaries of a trust are taxed on the income of the trust which has been distributed to them within the current year while the trust 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 a trust may claim as a deduction against its taxable income is limited by its DNI for that period. (Rev. & Tax. Code, § 17739, subd. (a).) For these purposes, DNI is defined as the taxable income of a trust, 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 function of DNI has been noted to be threefold: (1) it limits the amount of the distribution deduction of the trust: (2) it limits the amount on which beneficiaries can be taxed; and (3) it is the means of determining the character of amounts retained by the trust or distributed to the beneficiaries. (See Ferguson,

3/ Respondent has no objection with respect to the computation of DNI noted above, but only to the Trust's characterization that all of the distribution should be taxed as capital gains.

Freeland and Stephens, Federal Income Taxation of Estates and Beneficiaries, p. 303 **(1970).)**

The regulations interpreting the definition of DNI provide that capital gains are generally excluded from DNI. However, these regulations provide that capital gains are included in DNI if one of four requirements is satisfied. (Cal. Admin. Code, tit. 18, reg. 17739, subd. (d)(1).) Respondent has concluded that pursuant to the exceptions noted in those regulations, the subject capital gains are includible in the Trust's DNI. (See Resp. Br. at 8, fn. 1.) Appellants have made no argument and have presented no evidence which would indicate that the subject capital gains should not be so included in the Trust's DNI. Accordingly, we accept as correct respondent's determination that the subject capital gains are includible in the Trust's DNI.

Having reached this conclusion, we must next decide the central issue presented: the character of the DNI in the hands of appellants. As indicated above, in addition to measuring the amount potentially taxable **to** beneficiaries, DNI serves as a qualitative measuring device within the distribution rules which fixes the character of amounts distributed to beneficiaries or retained by the trust. The method of determining how much of each item is included in a given distribution is explained in section 17752. In general, the net amount of each item is apportioned among the beneficiaries, on a simple proration basis.4/ The net amount of each item is described as the gross amount of the item less deductions allocable hereto. (P-H, **Federal Taxes,** 1985, Volume 6, § 28,131.)5/ Regulation 17752(e) provides in relevant part as follows:

> Allocation of Deductions. Items of deduction of a trust that enter into the computation of distributable net income are to be allocated among the items of income in accordance with the following principles:

4/ If local law or the trust instrument requires, a **different** allocation may be made. (Rev. & Tax. Code, § 17752.) However, no such allegation has been advanced by appellant.

5/ Section 17752 is substantially similar to Internal **Revenue** Code section 652.

> (1) All deductible items directly attributable to one class of income are allocated thereto. For example, repairs to, taxes on, and other expenses directly attributable to the maintenance of rental property or the collection of rental income are allocated to rental income. ... Similarly, all expenditures directly attributable to a business carried on by a trust are allocated to the income from such business. ... (Emphasis added.)

As indicated above, based on this provision, respondent concludes that since the partnership losses and the capital gains resulted from a single business carried on by the Trust (i.e., log sales), all partnership losses must first be allocated to the section 17711 capital gains derived from that business as opposed to other items of income such as interest income which are taxed at ordinary income rates.[6/]

On appeal, appellants make two arguments in rebuttal. First, they argue that the section 17711 election created two "classes" of income in the business, ordinary income and capital gain income, and that the partnership losses which are ordinary deductions presumably should not be first allocated to capital gain income, a different "class" of income. In other words, appellants argue that regulation section 17752(e) should be read as defining "different class" to mean "income of different character." However, no statutory or case authority for such reading has been advanced. Moreover, the best authority that we could discover which is even remotely close indicates. that appellant's argument is in error. In Revenue Ruling 77-466, 1977-2 C.B. 83, a trust generated tax-exempt interest income, interest and dividend income taxable at ordinary income rates, and capital gains and losses. The trust also incurred expense for trustee's commissions. While a deduction from ordinary income pursuant to Treasury Regulation section 1.652(b)-3, subd. (c), trustee's commissions are considered to be "not directly attributable to a specific class of income. ..." Revenue Ruling 77-466 held that such commissions were properly allocable to all three items of income noted above and thus were not allocated to only items of

6/ As indicated above, section 17711 transforms what ordinarily would have been ordinary income into capital gains income. Nevertheless, this capital gain is clearly income from that business (income from sale of inventory).

ordinary income. Accordingly, one might conclude that classifying income merely on the basis of character is erroneous under Internal Revenue Code section 652 and its California counterpart, 17752. Therefore, appellants' main argument appears to be misplaced.

Secondly, appellants appear to argue that respondent's reading of section 17752 undercuts the capital gains election made under 17711 and certain partnership conduit principles. While this may be true, the short answer to this argument is that we are here dealing with the taxation of trusts and the clear reading of the applicable statute--section 17752--and regulations thereunder requires that respondent's interpretation herein be upheld,

Accordingly, in light of the record presented this board, and after full consideration of appellants' arguments, we must sustain respondent's determination.

Appeals of Carolyn I. Emmerson, et al.

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 actions of the Franchise Tax Board on the protests of Carolyn I. Emmerson, George Emmerson, and Mark Emmerson against proposed assessments of additional personal income tax in the amounts and for the years as follows:

Appellants	Year	Proposed Tax
Carolyn I. Emmerson	1979	$2,497.83
	1980	406.18
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	1980	406.84
Mark Emmerson	1979	2,656.60
	1980	406.22

be and the same are hereby sustained.

'Done 'at Sacramento, California, this 4th day Of February, 1986, by the State Board of Equalization, with Board Members Mr. Nevins, Mr. Collis, Mr. Bennett, Mr. Dronenburg and Mr. Harvey present.

Richard Nevins, Chairman

Conwav H. Collis, Member

William M. Bennett, Member

Ernest J. Dronenburg, Jr., Member

Walter Harvey*, Member

*For Kenneth Cory, per Government Code section 7.9