BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of	)	
	)	No. 81R-92-KP
SRELDON I. AND	)	
HELEN E. BROCKETT	)	

For Appellants: David E. Lundin
Attorney at Law

For Respondent: Patricia I. Hart
Counsel

O P I N I O N

This appeal is made pursuant to section 19057, subdivision (a),[1/] of the Revenue and Taxation Code from the action of the Franchise Tax Board in denying the claims of Sheldon I. and Helen E. Brockett for refund of personal income tax in the amounts of $997.04, $5,241.87, and $2,872.70 for the years 1973, 1974, and 1975, respectively.

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

The issue presented by this appeal is whether appellants have proven that respondent's reliance on federal income tax adjustments, based on the determination that appellants were owners of a trust corpus for the years at issue, was erroneous.

On July 2, 1973, appellants created a trust which was intended to be a "Clifford" trust. The grantor of a Clifford trust is not taxed on the income generated from the trust even though the-remainder reverts to the grantor upon termination of the trust, provided the trust is irrevocable and terminates more than 10 years after its creation. Due to an error, the Declaration of Trust provided that appellants' trust was to expire approximately 9 years and 11 months from its creation.

Some time after the trust's execution, appellants' attorney discovered the timing error. On December 26, 1975, with the consent of all of the parties involved, a document was executed which changed the termination date of the trust to July 6, 1983, thereby increasing the term of the trust to more than 10 years. Thereafter, the Internal Revenue Service (IRS) audited appellants' returns for the years at issue and determined that the corpus of the trust remained under appellants' control during the years at issue. Accordingly, the income generated by the corpus during those years was taxable to appellants rather than the trust. In reaching its determination, the IRS rejected appellants' argument that the 1975 reformation of the trust should have been given retroactive application. Appellants consented to the adjustments and paid the federal assessments.

Respondent was informed of the above events and issued its own assessments based on the federal determination. These assessments were also paid. Subsequent to the payment, appellants filed claims for refund. The claims were denied and this appeal followed.

Section 18451 provides that a taxpayer shall either concede the accuracy of a federal determination or state wherein it is erroneous. It is well settled that respondent's determination based on a federal audit report is presumptively correct, and the burden is on the taxpayer to prove that the determination is erroneous. (Appeal of Edward Benner, Cal. St. Bd. of Equal., Feb. 1, 1983; Appeal of Helen G. Gessele, Cal. St. Bd. of Equal., Apr. 8, 1980.)

A taxpayer is allowed to create a "Clifford" trust by virtue of section 17783, which states, in pertinent part:

> Reversionary interests. (a) The grantor shall be treated as the owner of any portion of a trust in which he has a reversionary interest in either the corpus or the income therefrom if, as of the inception of the portion of the trust, the interest will or may reasonably be expected to take effect in possession or enjoyment within 10 years commencing with the date of the transfer of that portion of the trust.
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> (c) Any postponement of the date specified for the reacquisition of possession or enjoyment of the reversionary interest shall be treated as a new transfer in trust commencing with the date on which the postponement is effected and terminating with the date Prescribed by the postponement. However, income for any period shall not be included in the income of the grantor by reason of the preceding sentence if such income would not be so includable in the absence of such postponement.

Section 17783 is based upon Internal Revenue Code section 673. Consequently, the determinations of the federal courts construing the federal statute are entitled to great weight in interpreting the state statute. (Meanley v. McColgan, 49 Cal.App.2d 203 [121 P.2d 45] (1942).)

Appellants argue that it was the intention of the parties involved to create an irrevocable trust for a period of 10 years and 1 day when the original trust instrument was signed in 1973. It was only due to a "scrivener's" mistake that the trust was designated to end 1 month shy of the necessary lo-year period. Appellants contend that the mistake was corrected "nunc pro tunc" by the voluntary execution of the 1975 reformation agreement, even as to taxing agencies.. In support of their position, appellants cite California Civil Code section 3399 which allows the revision of written contracts when those contracts, by mistake of the parties, do not express the true intention of the parties, so far as the revision can be done without prejudicing the rights

acquired by third parties, in good faith and for value. Further, appellants cite Flitcroft v. Commissioner, 328 F.2d 449 (9th Cir. 1964), for the proposition that a lower court's decree reforming a trust instrument on the grounds of mistake was binding as to the Commissioner where the Commissioner, through its agents, had full knowledge of the state court proceedings by virtue of being initially joined as a party in the lower court action. It is appellants' contention that the intention to create a Clifford trust from the inception of the agreement was evident to all of the taxing agencies involved as appellants filed the appropriate federal gift tax returns since the creation of the trust. Therefore, respondent and the IRS were not caught off-guard when appellants executed the reforming document. Under the doctrine set forth by the court in Flitcroft, appellants argue that respondent should be bound by the reformation and its retroactive application.

We disagree with appellants' analysis. As respondent has argued, Flitcroft is restricted to situations involving state court actions where two factors are present: "whether the federal tax authorities have notice of the state court action; and . .. whether the state court reached the correct result." (Flitcroft v. Commissioner, supra, 328 F.2d at 455.)

Here, there was no such court action; the reformation was simply an agreement between all of the parties involved. When faced with a similar situation where the parties to the trust, without a court decree, attempted to apply a reformation of the trust document retroactively, the court in Gaylor v. Commissioner, 153 F.2d 408, 415 (9th Cir. 1946) stated:

> Nor do we agree that the document signed [reforming the original trust agreement] changes the legal situation. During the taxable years here involved, it could not, by a process of retroactivity, defeat the effect and application of Federal tax laws. The fact remains that during the tax period here involved, the trust instrument was not reformed or revised. Furthermore, we do not agree that the gift tax returns ... had the effect of amending the trust declaration. These returns were simply a report to the Government required by law and did not purport to change the nature of the trust. Any effective changes had to be in the instrument itself. (Citations.)

This reasoning has been followed by this board when faced with "reformed" trust documents in past cases. In the Appeal of Title Insurance and Trust Co., Trustee, decided October 21, 1963, we noted that:

> The general rule is that as between parties to an instrument a reformation relates back to the date of the reformed instrument; however, even where the decree was specifically made nunc pro tunc, the reformation has not been accorded retroactive recognition for tax purposes. (Citation.) Reformation is not binding upon third parties who have acquired some legal rights which would be destroyed or injured by giving the remedy retroactive effect. (Citation.) Therefore, as to third parties who have acquired rights under the instrument, the reformation is effective only from the date thereof. (Citation.)
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> [As of the closing dates for the year in question], the tax ... became due and payable and the State of California acquired a vested right therein. (Citation.)

Consequently, absent a factual situation such as that presented in Flitcroft, the subsequent reformation of a trust instrument does not apply retroactively so as to affect respondent's ability to collect tax that is due and owing. Accordingly, we find that respondent's determination based on the IRS action is correct and that appellants have failed to sustain their burden of proving that the decision is erroneous. (Appeal of Edward Benner, supra; Appeal of Helen G. Gessele, supra.) For the above-stated reasons, respondent's action in this matter will be sustained.

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 19060 of the Revenue and Taxation Code, that the action of the Franchise Tax Board in denying the claims of Sheldon I. and Helen E. Brockett for refund of personal income tax in the amounts of $997.04, $5,241.87, and $2,872.70 for the years 1973, 1974, and 1975, respectively, be and the same is hereby sustained..

Done at Sacramento, California, this 18th day of June , 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

Conway H. Collis, Member

William M. Bennett, Member

Ernest J. Dronenburg, Jr., Member

Walter Harvey*, Member

*For Kenneth Cory, per Government Code section 7.9