

BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
) No. 90R-0940
Ury Family 1978 Residual Trust)
)

Representing the Parties:

For Appellant: Lauren Cesare, Attorney at Law

For Respondent: Douglas K. Powers, Counsel

Counsel for Board of Equalization: Charles D. Daly, Staff Counsel

OPINION

This appeal is made pursuant to section 19057, subdivision (a), (renumbered as section 19324, subdivision (a), operative January 1, 1994) of the Revenue and Taxation Code from the action of the Franchise Tax Board in denying the claim of the Ury Family 1978 Residual Trust for refund of personal income tax in the amount of \$50,058.51 for the year 1986.

There are two issues presented for our resolution in the instant matter.¹ One is whether Community Psychiatric Centers (Community) had, for purposes of former section 18162.5, subdivision (f)(1), disqualifying amounts of “tainted” receipts, primarily dividends, in the income year immediately preceding the appeal year. The other is whether appellant Ury Family 1978 Residual Trust “acquired” Community stock, for purposes of section 18162.5, subdivision (e)(3), when it was created as an irrevocable trust on the death of Mr. Ury. Because our resolution of the second issue disposes of the appeal, we need not consider the first issue here.

Melvin and Janice Ury, who were husband and wife, were among the founders of a corporation in 1962 whose name was later changed to Community. The corporation was formed to purchase and modernize a psychiatric hospital in Belmont Hills, California. The Community stock acquired by the Urys as founders was their community property, and the parties have stipulated that the Ury’s Community stock qualified as “small business stock” when they acquired it. Community expanded over the next several years, and its stock became listed on the American Stock Exchange in 1971.

On July 7, 1978, the Urys created a revocable living trust to which they transferred their Community stock. The revocable trust was a typical “A-B” trust which was drafted so that, upon the death of the first trustor to die, it would divide into two trusts, a “survivor’s trust” and a “residual trust.” The survivor’s trust would include the surviving spouse’s interest in the trustors’ community property, the surviving spouse’s separate estate, and an amount equal to the maximum marital deduction allowable in the deceased spouse’s estate for federal estate tax purposes. The residual trust consisted of the balance of the trust estate, including Mr. Ury’s community property share of the Community stock at issue here.

Mr. Ury died on August 15, 1978, and appellant was created on that date as the residual trust. Under the terms of the trust agreement, appellant was required to pay to Mrs. Ury, as the surviving spouse, its net income at least quarter-annually and to pay to Mrs. Ury or their children as much of the principal of the residual trust as the trustee considered necessary for their “health, maintenance, support and education.” The trustee could also apply any remaining net income and principal for the “health, maintenance, support and education” of the issue and surviving spouse of any deceased child of the Urys. The issue of the Urys and charities selected by the trustee had remainder interests in the trust that would become effective on the death of Mrs. Ury. Mrs. Ury was the sole trustee of both the survivor’s trust and the residual trust. Unlike the survivor’s trust, which allowed her

¹ Respondent also raises the issue of whether small business stock acquired before September 17, 1981, qualified for the tax preference exclusion of former section 17063.11. This board in the Appeal of Magnus F. and Denise Hagen, decided on April 9, 1986, held that the benefits of that statute were available for small business stock purchased at any time if all other requirements were met. The California Supreme Court reached essentially the same conclusion in Lennane v. Franchise Tax Board, 9 Cal.4th 263 [36 Cal.Rptr.2d 563] (1994).

to revoke the trust and receive its assets and otherwise to alter or amend its provisions, the residual trust could not be revoked, altered, or amended.

On December 31, 1986, appellant sold the Community stock that it had held. On its 1986 California tax return, appellant reported a portion of the gain on the sale under former section 18162.5, subdivision (a), and excluded from preference tax the unrecognized portion of the gain in reliance upon former section 17063.11. Former section 17063.11 provided an exclusion from items of tax preference for capital gains on the sale of “small business stock,” as defined in former section 18162.5. After review of appellant’s 1986 tax return, respondent concluded that the Community stock which appellant sold did not qualify as “small business stock” and issued a Notice of Proposed Additional Tax (NPA). In its Notice of Action (NOA) denying appellant’s protest against the proposed assessment of additional tax, respondent relied upon subdivision (f)(1) of former section 18162.5 to disqualify appellant’s Community stock as “small business stock.” Appellant paid the proposed assessment of tax and filed a claim for refund. After respondent rejected appellant’s refund claim, this timely appeal followed.

At the hearing, respondent continued to assert that appellant’s Community stock was disqualified under former section 18162.5, subdivision (f)(1), but placed its primary reliance upon former section 18162.5, subdivision (e)(3). Former section 18162.5, subdivision (e)(3), disqualified stock from “small business stock” status if, at the time of its acquisition by the taxpayer, the outstanding stock of the corporation was listed on the New York Stock Exchange, the American Stock Exchange, or the National Association of Securities Dealers Automated Quotation system. Stating that our opinion in the Appeal of Bauer Stock Trust, Edward Landry and James Hassan, Trustees (92-SBE-003), decided on April 23, 1992, should be considered controlling on the issue, respondent argues that appellant acquired the Community stock on the date that the residual trust was created and contends that appellant’s Community stock was disqualified as small business stock on that date because Community was then listed on the American Stock Exchange. Appellant contends that the small business stock status of its Community stock continued after Mr. Ury’s death and argues there is no justification for retesting the small business stock status of their Community shares merely because a new trust was created upon his death. Relying upon our opinion in the Appeal of David G. And Helen Mendelsohn, decided on November 6, 1985, appellant also argues that disqualification of its Community stock under former section 18162.5, subdivision (e)(3), is a “new matter” for which the burden of proof has shifted to respondent. We agree with respondent’s contention and disagree with that of appellant.

In Bauer Stock Trust, we concluded that stock given to an irrevocable, non-grantor trust² was to be retested for small business stock status on the date of the gift even though the stock had been small business stock in the hands of the donor. In justifying our conclusion, we reiterated our view stated in the Appeals of Diane L. Morris Trust, et al. (89-SBE-019), decided by this board on August 2, 1989, that the “plain meaning” of the term “acquired” was normally to be used in determining the date on which stock was acquired for small business stock purposes. We also followed Morris Trust in observing that “one would not generally acquire stock before one obtains ownership, possession, or control” over it. Appellant attempts to distinguish the instant matter from Bauer Stock Trust on the basis that Mrs. Ury had “ownership, possession, or control” over the Community stock both before and after the creation of the residual trust while the trustor in Bauer Stock Trust transferred the trust property to an independent, third-party trustee. Appellant also points out that Mrs. Ury was a beneficiary of the residual trust while the trustor in Bauer Stock Trust was not a beneficiary of the trust that he had created. Finally, appellant points out that Mrs. Ury, as the present income beneficiary, paid the tax on the income of the residual trust.

We think that the distinctions drawn by appellant are without a difference. Like the trust in Bauer Stock Trust, appellant was an irrevocable, non-grantor trust that is appropriately treated for small business stock purposes as a separate entity. If we agreed with appellant that the identity of the trustee should govern the tax consequences here, we would essentially be taking the position that Mrs. Ury was the true owner of the Community stock even after the creation of the residual trust and that the existence of appellant as a separate entity should be disregarded for small business stock purposes. Such a position would be unwarranted. Although it is true that Mrs. Ury had “ownership, possession, or control” of the Community shares after the residual trust was created, she held those shares in her capacity as trustee, and treating her as the true owner of the Community shares after the residual trust was created would ignore both that appellant was irrevocable upon its creation and that Mrs. Ury had fiduciary obligations to the other beneficiaries. Similarly, it would be unwarranted to disregard the existence of appellant for small business stock purposes merely because Mrs. Ury was a beneficiary of the residual trust.

² We did not define the term “non-grantor trust” in Bauer Stock Trust. Simply put, a “non-grantor trust” is a trust whose income is not taxed to the grantor (trustor) of a trust under the rules stated in Internal Revenue Code (IRC) sections 671 through 677 (the “grantor trust” rules). Directed at circumstances under which the grantor has retained the enjoyment or control of the trust property, the grantor trust rules disregard the existence of the trust for most income tax purposes by taxing the grantor as though he were still the owner of the property that he transferred to the trust. (Bittker & Lokken, Federal Taxation of Income, Estates, and Gifts, ¶ 81.1 (2nd ed. 1991).) For example, the grantor of a revocable trust is taxed on income from the property that he transferred to the trust because he has retained the right to revoke the trust and recover the trust property. (IRC §§ 671, 676.)

Finally, the fact that Mrs. Ury paid tax on the income of the residual trust is unhelpful to appellant because, as appellant itself has acknowledged, liability for tax on that income merely “passed through” to Mrs. Ury under IRC section 652(a). (App’s Reply Br. at 23.) IRC section 652(a) essentially provides that income of a trust that is required to distribute income currently to its beneficiaries is taxable to the beneficiaries rather than to the trust, while IRC section 651(a) allows the “passed through” income to be deducted by the trust. Apparently, the statutory purpose to be advanced by those two sections was the avoidance of double taxation of the trust income (Bittker & Lokken, Federal Taxation of Income, Estates, and Gifts, supra), and we see no reason why that federal income tax purpose should cause us to disregard the existence of the residual trust for small business stock purposes.

In view of the foregoing, we agree with respondent that Bauer Stock Trust, as amplified above, is controlling in this matter. Therefore, we must conclude that the Community stock sold by appellant was disqualified as small business stock because, on the date that appellant was created, Community was listed on the American Stock Exchange.³ We need not consider further appellant’s argument that the issue that we have just resolved is a “new matter” under Mendelsohn because, as our resolution of the issue makes clear, respondent has carried its burden of proof.

Accordingly, respondent’s action in this appeal must be sustained.

³ We note that the result here is consistent with the conclusion reached in Question 8 of respondent’s Legal Ruling 428, dated August 19, 1987.

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 19333 of the Revenue and Taxation Code, that the action of the Franchise Tax Board in denying the claim of the Ury Family 1978 Residual Trust for refund of personal income tax in the amount of \$50,058.51 for the year 1986 be and the same is hereby sustained.

Done at Sacramento, California, this 14th day of March, 1996, by the State Board of Equalization, with Board Members Mr. Klehs, Mr. Dronenburg, Mr. Andal, Mr. Sherman and Mr. Halverson present.

Johan Klehs _____, Chairman

Ernest J. Dronenburg, Jr. _____, Member

Dean F. Andal _____, Member

Brad J. Sherman _____, Member

Rex Halverson* _____, Member

*For Kathleen Connell, per Government Code section 7.9.