# Paula Trust

**(original trust formed in 1971)**

| | | |
|---|---|---|
| Alan S.<br>CA Resident | Stafford S.<br>MD Resident | **Trustees** |
| Paula Trust | | **Trust** |
| Paula M.<br>CA Resident | | **Contingent Beneficiary** |

STATE BOARD OF EQUALIZATION
Appeal Name: Paula Trust
Case ID: 759422
Date: 8/30/16 Exhibit No: 8.3 ITEM #: 81
FTP FTB DEPT PUBLIC COMMENT

**TAXPAYER EXHIBIT**
**B1**
**August 30, 2016**
**Paula Trust**
**759422**

# The Issue is what rule applies for determining the amount of Paula Trust's income taxed by California.

# What is the Paula Trust's Argument?

That the Statute is the **only** applicable authority and it requires apportionment based on the residency of the trustees (fiduciaries).

"Where the taxability of income under this chapter depends on the residence of the fiduciary and there are two or more fiduciaries for the trust, the income taxable under Section 17742 shall be **apportioned according to the number of fiduciaries resident in this state** pursuant to rules and regulations prescribed by the Franchise Tax Board."

**(Rev. & Tax. Code Sec. 17743)**

# History of Trust Sourcing Rules

## 1935

**Statute**

- Sourcing
- Apportionment

**Consistent with:**

**Regulation**

- Sourcing
- Apportionment

## 1937–Today

**Statute**

- ~~Sourcing~~ (repealed)
- Apportionment

**...NOT consistent with:**

**Regulation**

- Sourcing
- Apportionment

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**Added Statute**

- Non-Resident Beneficiaries taxed on Source Income

# What is the FTB's Argument?

FTB argues the sourcing rules for nonresident individuals apply to Paula Trust because:

- Regulation 17743
- Other statutes impose those rules on trusts
- It is absurd not to apply those rules to trusts

# Regulation 17743 Does Not Apply to Paula Trust

Reg. 17743 Language relied on by FTB:

" If there are two or more fiduciaries of a trust, and one or more are residents and one or more are nonresidents, and **all the beneficiaries are nonresidents**, the trust is taxable upon . . . "

# The Various Statutes Cited by FTB Do Not Impose the Nonresident Sourcing Rules on Trusts

First, there is no statute that clearly and expressly imposes those rules on trusts.

- "Tax laws are strictly construed in favor of the taxpayer and against the state."
- "A statute will not be held to have imposed a tax unless it is clear and explicit." *Whitmore v. Brown*, 207 Cal. 473 (1929)

Second, when the Legislature intends to impose the nonresident sourcing rules, it does so clearly:

- Section 17041(i)(1)(B) (providing that nonresident individuals are taxed on "income from sources within this state, determined accordance with . . . Chapter 11 . . . .")
- Section 17734 (providing that a nonresident beneficiary of a trust is taxable on income derived by the trust "from sources within this state")

Third, FTB's rule renders Section 17734 superfluous.

# The Various Statutes Cited by FTB Do Not Impose the Nonresident Sourcing Rules on Trusts

- Fourth, in other areas of commerce, the Legislature explicitly adopts apportionment/ sourcing rules.
- Partnerships:
  - o Incorporates federal law (IRC, subchapter K) to compute income. Rev. & Tax. Code § 17851.
  - o Applies express apportionment/sourcing rules to nonresident partners. Rev. & Tax. Code § 17951 (and regulations thereunder).
- Corporations:
  - o Incorporates federal law (IRC § 61) to compute income. Rev. & Tax. Code § 24271.
  - o Applies the apportionment and allocation rules in the Uniform Division of Income for Tax Purposes Act. Rev. & Tax. Code § 25120-25139.

# Apportionment under Section 17743 Is Not Absurd

1. Apportionment of income is a widely used and sensible method to source income.
2. Imagine that the Paula Trust assets sold here had been in Maryland. California still gets to tax 50% of the gain even though the property has no connection with the state, and there is only one trustee in California.
3. There is no tax avoidance because California will tax the income when distributed to the beneficiary. Rev. & Tax. Code § 17734, 17745, and 17953.

# FTB's Regulation Violates Internal Consistency Requirements

- The Statute is valid, but the regulation clearly violates the Commerce Clause internal consistency test.
  - o If the regulation applied to Paula Trust, it would violate the internal consistency test.
  - o The internal consistency test assumes all states apply the FTB's regulation. On our facts, California would tax 100% of the trust's income and Maryland would tax 50% of the trust's income, resulting in 150% of the trust's income being taxed. That is a violation of internal consistency because more than 100% of the income is taxed by the states.

| Paula Trust Argument | FTB Argument | Why FTB Argument Fails |
| --- | --- | --- |
| **The Statute is the ONLY applicable authority**<br><br>" Where the taxability of income under this chapter depends on the residence of the fiduciary and there are two or more fiduciaries for the trust, the income taxable under Section 17742 shall be **apportioned according to the number of fiduciaries resident in the state** pursuant to rules and regulations prescribed by the Franchise Tax Board."<br><br>(R&TC Sec. 17743) | **Regulation 17743 Applies** | **Regulation is not applicable** |
| | **Other statutes apply non-resident sourcing rules to trusts** | **1. Not "clear and explicit" here**<br><br>**2. Where intended, legislative application of non-resident sourcing to trusts is very clear**<br><br>**3. Legislature is clear in other areas of commerce** |
| | **Not applying these rules leads to absurd result** | **Apportionment is widely used and sensible approach** |