*75-SBE-016

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
S. STEVEN BASHARA)

For Appellant: George J. Cish
Certified Public Accountant

For Respondent: Crawford H. Thomas
Chief Counsel

Marvin J. Halpern
Counsel

O P I N I O N

This appeal is made pursuant to section 18594 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of S. Steven Bashara against proposed assessments of additional personal income tax in the amounts of $646. 99, $680.04 and $1,185.69 for the years 1965, 1966 and 1967, respectively.

Appeal of S. Steven Bashara

The issue is whether a portion of the income from three trusts is taxable to the grantor, where trust income was used, pursuant to directions in the trust agreements, to pay off a loan made to the grantor.

For some time prior to the years in question, appellant S. Steven Bashara owned certain income-producing property in downtown Los Angeles. On December 1, 1963, he borrowed $50,000.00 from the Crocker Citizens Bank (the Crocker loan), and as security gave the bank a deed of trust on the property. He repaid this loan in full on March 11, 1964, -from his personal funds.

On June 23, 1964, appellant borrowed $60,000.00 from the Security First National Bank (the Security loan), also secured by a deed of trust on the land. Three months later, on September 25, he placed-his interest in the property, still encumbered by this deed of trust, into three irrevocable trusts. While the record before us does not contain copies of the trust agreements, they apparently included instructions that the trustees pay the principal and interest on the Security loan out of the income from the trust property.

Appellant states that the proceeds of the Security loan were expended as follows: Approximately $l,OOO.OO was spent for legal and accounting fees relating to the trusts; a total of $23,714.31 was paid to the state and federal governments in gift taxes on the creation of the trusts; and $55,000.00 was retained by appellant to reimburse him for repaying the Crocker loan and for expenses he incurred in renovating the trust property. Appellant does not explain the discrepancy between the amount of the Security loan and the total expenditures.

During the appeal years the three trusts together paid $14,000.00 per year on the Security loan. Appellant did not report these amounts on his California personal income tax returns. After an audit respondent determined, among other adjustments,. that the loan payments were income to appellant, and accordingly issued the proposed assessments in question.

Revenue and Taxation Code section 17781 provides in part that where the grantor is treated as the owner of any portion of a trust, the income from that portion shall be included in

computing the grantor's taxable income. Section 17790 states:

> The grantor shall be treated as the owner of any portion. of a trust, .. whose income without the approval or consent of any adverse party is, or, in the discretion of the grantor or a nonadverse party, or both, may be--
>
> (a) Distributed to the grantor. ...

These provisions are substantially similar to sections 671 and 677 of the Internal Revenue Code of 1954. Roth the California and the federal regulations issued under these statutes explain that the grantor, in general, is considered the owner of any portion of the trust whose income is used to discharge his legal obligations. (Cal. Admin. Code, tit. 18, reg. 17790, subd. (d); Treas. Reg. § 1.677(a)-l(d).) This rule is based on the well-settled principle that, for tax purposes, the substance of a transaction takes precedence over its form, As the Supreme Court said in Douglas v. Willcuts, 296 U. S. 1 [80 L. Ed. 3]:

> We have held that income was received by a taxpayer, when, pursuant to a contract, a debt or other obligation was discharged by another for his benefit. The transaction was regarded as being the same in substance as if the money had been paid to the taxpayer and he had transmitted it to his creditor. (Citations.) The creation of a trust by the taxpayer as the channel for the application of the income to the discharge of his obligation leaves the nature of the transaction unaltered. (296 U. S. at 9.)

Appellant received the proceeds of the Security loan, spent them as he chose, and, to the extent of the payments made by the trusts, was relieved of the obligation to repay. In substance, it is as though the trust income was distributed to appellant and used by him to discharge his obligation. Appellant thus comes

squarely within the provisions, of section 17790 and the regulations issued thereunder. (Douglas v. Willcuts, supra; Helvering v. Blumenthal, 296 U. S. 552 [80 L. Ed. 390], rev'g 76 F. 2d 507; Clifton B. Russell, 5 T.C. 974; John T. McLane, T. C. Memo., Sept. 14, 1948.)

Hays' Estate v. Commissioner, 181 F. 2d 169, and Edwards v. Greenwald, 217 F. 2d 63? cited by appellant, do not aid his case. Hays' Estate involved an estate tax question, and is not'relevant here. In Greenwald, the grantors established the trusts on the same day they purchased the trust property, and the trust property was pledged to secure the purchase price. Under those circumstances it is clear that the grantors received no pecuniary benefit from the transaction. Here, the Security loan was not a purchase money loan made concurrently with the creation of the trusts.

For the above reasons, we hold that appellant is to be treated as the owner of those portions of the trusts-whose income is used to repay the Security loan, and that the, income from such portions is includible in computing his taxable income. (Rev. & Tax. Code, §§ 17790, 17781.) Accordingly, the action of the Franchise Tax Board must 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,

Anneal of S. Steven Bashara

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 S. Steven Bashara against proposed assessments of additional personal income tax in the amounts of $646.99, $680.04, and $1,185.69 for the years 1965, 1966 and 1967, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 18th day of March, 1975, by the State Board of Equalization.

John W. Lynch, Chairman

William G. Bennett, Member

Richard Nevins, Member

Paul Carrier, Member

_____, Member

ATTEST: Charles H. Ottoman, Acting Secretary