John O. Johnson
Tax Counsel III
Board of Equalization, Appeals Division
450 N Street, MIC: 85
PO Box 942879
Sacramento, CA 95814
Tel: (916) 323-3140
Fax: (916) 324-2618

Attorney for the Appeals Division

BOARD OF EQUALIZATION

STATE OF CALIFORNIA

In the Matter of the Appeal of:	**HEARING SUMMARY**
	PERSONAL INCOME TAX APPEAL
ROBERT W. HOLMAN AND	Case No. 856805
MARGARET E. HOLMAN	

Year	Proposed Assessments
2004	$182,376

Representing the Parties:

For Appellants: John B. Mulligan, Esq., McDonald Carano Wilson, LLP

For Franchise Tax Board: Sonia D. Woodruff, Tax Counsel III

QUESTIONS: (1) Whether appellants have shown that respondent's proposed assessment is barred by the statute of limitations because the notice of proposed assessment (NPA) was sent to appellants and not to the Holman Charitable Remainder Unitrust 02 (the Trust).

(2) Whether appellants have shown error in respondent's determination that appellants are liable for tax on the capital gain based on respondent's finding that the Trust was not a qualified charitable trust.

///

NOT TO BE CITED AS PRECEDENT - Document prepared for Board review. It does not represent the Board's decision or opinion.

STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

HEARING SUMMARY

Background

Appellants established a charitable remainder trust (i.e., the Trust) on December 16, 2002. (Resp. Op. Br., exhibit A.) On the same day, appellants transferred real property in Carmel, California, from the Quantum Group Limited Partnership, an Oregon partnership of which appellants were the general partners, to themselves as joint tenants, and then again to themselves as trustees of the Trust. (*Id*. at pp. 2-3 & exhibit B.) Appellants claimed a charitable contribution deduction of $821,750[1] on their federal and California returns for 2002 based on this transference of the property. (*Id*. at exhibit D, p. 3.) The Trust had no other assets and appellants acted as the sole co-trustees at all times during the administration of the Trust. (*Id*. at p. 1 & exhibit A.)

The Trust provided that appellants were entitled to annual payments equal to the lesser of the trust income for the taxable year under Internal Revenue Code (IRC) section 643(b) or 7.1 percent of the net fair market value of the assets of the Trust as of the first day of each taxable year. The Trust was set up as a net income with make-up charitable remainder trust (NIMCRUT), meaning that for any year in which the annual payment is less than 7.1 percent of the net fair market value of the trust assets (i.e., the annual payment is based on trust income instead), the difference between the actual payment and what the payment would have been (had it equaled 7.1 percent of the net fair market value of the trust assets) can be "made up" in subsequent years as an addition to any annual payments, based on 7.1 percent of the net fair market value of the trust assets in those future years. (Resp. Op. Br., p. 2 & exhibit A, p 1.) The Trust terms provided that appellants would receive these annual payments for the duration of their lives and, upon the death of the surviving spouse, the remaining assets would pass to their charitable foundation. (*Id*. at exhibit A, pp. 1-2.)

Appellants lived in the home for the first seven months of 2003, claiming at protest that they paid the Trust $12,000 per month in rent during this time. (Resp. Op. Br., exhibit E.) Appellants state that the residence was rented to non-related parties during the summer and fall of 2003, and stayed

[1] Respondent indicates that this amount was determined by appellants based on the stated fair market value of the remainder interest in the Trust, which would ultimately be conveyed to a qualified charity under the provisions of the Trust. (Resp. Op. Br., p. 3.)

NOT TO BE CITED AS PRECEDENT - Document prepared for Board review. It does not represent the Board's decision or opinion.

vacant from the beginning of 2004 to the date it was sold to an unrelated party in April of 2004.[2] (App. Op. Br., p. 2.) The Trust deducted cleaning expenses of $50,306, legal fees of $1,000, insurance of $5,111, repairs of $2,180, taxes of $39,284, other expenses of $4,936 and depreciation of $87,121 for the home in 2003. (Resp. Op. Br., exhibit F, p. 3.)

Appellants, as co-trustees of the Trust, sold the home in April of 2004 for $8,225,000, with a resulting capital gain amount of $3,195,301. (Resp. Op. Br., exhibit G.) The Trust paid no tax on the sale of the residence. (Resp. Op. Br., p. 3.) Appellants state that the proceeds from the sale were invested in a money market account and later invested in stocks and bonds. (App. Op. Br., p. 2.) Appellants then made the first distribution from the Trust to themselves in the amount of $1,168,769. It is uncertain whether this distribution was made in 2004 or 2005.[3] This amount is reportedly comprised of $570,857 for the 2004 year, plus $597,912 of cumulative make-up amounts distributed pursuant to the NIMCRUT provisions of the Trust.[4] (Resp. Op. Br., exhibit H, p. 2.) In 2008, appellants terminated the Trust, causing the Trust to distribute $5,225,904.38 to appellants as the present value of their "Income Interest" in the Trust. The remaining $2,189,565.91 (i.e., the present value of the remainder interest in the Trust) was distributed to "Parasol," an organization designated as tax-exempt

///

///

///

---

[2] In a subsequent brief, appellants contend that the house was rented to unrelated persons for "over a year," contrasting with their statements here. (App. Reply Br., p. 5.) Appellants should be prepared to explain the actual amount of time they occupied the residence (including any time the residence was occupied by their family or other related individuals), the span of time when it was occupied by unrelated renters, and the amount of time it was vacant, from the time the Trust was created through to the date the property was sold.

[3] Respondent treats the payment as being made in 2004, as reported on appellants' and the Trust's tax information return documents. (Resp. Reply Br., pp. 3-4.) Appellants contend that this distribution was not made until April 11 or 12, 2005, nearly a full year after the sale of the residence. (App. Supp. Br., p. 4; App. Reply Br., p. 5.)

[4] The Trust's California Form 541-B for 2004 calculated a unitrust amount of $570,857 by multiplying the 7.1 percent fixed percentage by a reported total assets amount of $8,040,240. (Resp. Op. Br., exhibit H, p. 2, ln. 50b.) The form reports total accrued distributions from previous years as $597,912, which when added to the unitrust amount of $570,857 equals the distribution amount of $1,168,769. (*Id*. at exhibit H, p. 2, ln. 52.) Respondent also mentions a cumulative make-up amount of $24,899, which is not reflected on this form, though appellants also state on appeal that there was a make-up payment from 2002, which could be this amount and might be already incorporated in the total $597,912 accrued distributions amount reported on this form. (*Id*. at p. 4; App. Reply Br., p. 5.) The record does not indicate whether there were any annual payments for years 2006, 2007, or 2008.

NOT TO BE CITED AS PRECEDENT - Document prepared for Board review. It does not represent the Board's decision or opinion.

STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

in the termination agreement.[5] The termination agreement did not provide an explanation or reason for the termination other than appellants' desire to terminate the Trust early. (*Id*. at exhibit I.)

Respondent began its audit of the transactions at issue in September of 2007, ultimately resulting in a Notice of Proposed Assessment (NPA) being issued to appellants on February 24, 2011, for the 2004 tax year.[6] (App. Op. Br., exhibit G.) Respondent's auditor determined that the 2004 distribution was excessive under the terms of the Trust, which was a violation of the rules regarding charitable remainder trusts, and therefore treated the Trust as a grantor trust. Because grantor trusts are disregarded for tax purposes, respondent's auditor assessed appellants individually for the income from the 2004 sale of the Carmel property, finding $2,026,532 of additional gain for appellants and additional tax of $182,376.[7] (*Ibid*.) Appellants protested the proposed assessment and, after considering the protest, respondent issued a Notice of Action affirming its proposed assessment.[8] (Appeal Letter, exhibit B.) This timely appeal followed.

Contentions

The parties argue various theories as to whether respondent's proposed assessment is timely, made upon the correct taxpayer, and otherwise proper under the relevant statutes and regulations. These contentions are provided herein grouped by subject matter.

Statute of Limitations

Appellants' Contentions

Appellants contend that the Trust is a separate legal entity which was required by law to file a separate tax return (Form 541-B), which it did, and, under Revenue and Taxation Code (R&TC)

---

[5] On appeal, appellants provide additional information regarding the Parasol Tahoe Community Foundation ("Parasol"). (See App. Reply Br., p. 5 & exhibit 2.) Respondent does not address this entity's status as an approved charity foundation.

[6] Appellants' representative signed two year-long waivers extending the statute of limitations for proposing an assessment for the 2004 tax year to April 15, 2011. (Resp. Op. Br., exhibit J.) Respondent provides a copy of the first waiver, dated April 20, 2009, and signed April 29, 2009. (*Ibid*.) Appellants provide a copy of another waiver (including the 2005 tax year as well as 2004), also dated April 20, 2009, but with a signature date of April 21, 2009. (App. Op. Br., exhibit E.)

[7] The adjustments also allowed $50,316 in passive activity losses and $605 in itemized deductions, resulting in an additional income amount of $1,975,611. (Resp. Op. Br., exhibit K.)

[8] The NPA included an accuracy-related penalty of $36,475.20, which respondent determined not to apply after the consideration of appellants' protest. (Resp. Op. Br., p. 5 & exhibit K.)

NOT TO BE CITED AS PRECEDENT - Document prepared for Board review. It does not represent the Board's decision or opinion.

STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

section 19033, the Trust and its fiduciaries were entitled to a notice of any deficiency. Appellants assert that no such notice was provided to the Trust or its fiduciaries within four years from the date of the filing date of the return (citing R&TC section 19057). Appellants contend that the sale of the property and the treatment of the distributions was fully disclosed on its Form 541-B, and appellants were required to treat the distributions as reflected on their K-1s issued by the Trust under IRC section 6034A(c). (App. Op. Br., pp. 8-9.) Appellants also assert that the Internal Revenue Service (IRS) never challenged the Trust's reporting. (App. Reply Br., p. 4.) Appellants contend that at no point has respondent examined or proposed a change to the Trust's 2004 or 2005 Forms 541-B, and assert that the statutes of limitation for doing so have now expired. (App. Op. Br., p. 9.)

Appellants argue that respondent cannot attempt to change the Trust's 2004 or 2005 returns through the 2004 income tax return filed by appellants. (App. Op. Br., p. 9.) Appellants assert that the legal concept of transferee liability, relied upon by respondent, does not relieve respondent of its obligation to provide notice and to adjust the Trust's tax return within the statute of limitations. (App. Reply Br., p. 6.) Appellants contend that *McCulloch v. FTB* (1964) 61 Cal.2d 186 (*McCulloch*), does not state that trusts are abstractions and not entities, as respondent argues, but instead states that a trust should be treated as having a separate existence for income tax purposes with its own return filing requirement. Appellants assert that respondent provides no authority allowing notice to individual taxpayers to constitute notice to a tax-exempt charitable trust. Appellants contend that respondent never audited the Trust, requested an extension of time within which to issue an NPA to the Trust, or proposed an assessment against the Trust, and now the statute of limitations has expired for any such assessment. Appellants cite California Code of Regulations, title 18, section 23701, which provides that every exempt organization must make its records available to respondent to allow respondent to inquire into the organization's exempt status, and contend that these entities are separate entities entitled to proper notice within the statute of limitations under the law. (*Id*. at pp. 6-8.)

Appellants contend that, if respondent wanted to provide a proposed assessment against the Trust based on its activity and tax reporting, then respondent needed to issue an NPA that identified the appropriate taxpayer (the Trust) and the return being adjusted (Form 541-B). Instead, appellants continue, respondent issued NPAs to appellants as individuals, not trustees, and in relation to their joint

NOT TO BE CITED AS PRECEDENT - Document prepared for Board review. It does not represent the Board's decision or opinion.

STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

nonresident tax return. Appellants quote R&TC section 19057, subdivision (a), wherein it defines "return" to mean "the return required to be filed by the taxpayer and does not include the return of any person from whom the taxpayer has received" some tax credit.[9] Appellants contend that the plain language of the statute confirms that respondent is required to mail a notice of assessment to the Trust or its trustees regarding the Trust's return, not to appellants regarding their personal return. (App. Supp. Br., pp. 2-3.)

Appellants also assert that respondent cannot get around the four-year statute of limitations for proposing an assessment by relying on a waiver of the statute executed by a different taxpayer. Appellants contend that R&TC section 19067 requires the "taxpayer" to consent in writing before the expiration of the time prescribed for proposing an assessment, and, here, the only waiver was executed on behalf of appellant-husband, not the Trust. Appellants assert that, if the waiver was to be effective for the Trust, then it would have been listed as the taxpayer and signatures would have been provided on the lines for "Trustee" and "Co-Trustee." Further, appellants assert that the waiver signed on behalf of appellant-husband was signed more than four years after the Trust's 2004 return was filed, and therefore, even if it was executed on behalf of the appropriate taxpayer, it was not timely and therefore would still not comply with the statutory requirements. (App. Supp. Br., pp. 2-4.)

Respondent's Contentions

Respondent contends that the Trust terminated in 2008, resulting in a total distribution of all Trust property, and appellants as trustee distributed a substantial portion to themselves as income beneficiaries. Respondent asserts that this means appellants are now individually liable for the unpaid taxes of the Trust because they are the transferees of the Trust property, citing the *Appeal of Ruby Loyal*, 66-SBE-043, decided August 1, 1966. Respondent asserts that it may assess the beneficiaries of a trust who receive income from a trust when the trust failed to pay taxes due on that income. (Resp. Op. Br., p. 5; Rev. & Tax. Code, §§ 19071, 19073.) Respondent cites R&TC section 19074, subdivision (d), which provides that the statute of limitations for assessing additional tax against a transferee or fiduciary may be completed at any time before the period agreed upon by both the

[9] Although appellants only list "tax credit" in their brief, R&TC section 19057, subdivision (a), actually provides ". . . an item of income, gain, loss, deduction, or credit."

NOT TO BE CITED AS PRECEDENT - Document prepared for Board review. It does not represent the Board's decision or opinion.

STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

Franchise Tax Board (FTB) and the transferee or fiduciary. Respondent asserts that appellants' representative signed waivers extending the statute of limitations, and the subsequent NPA was issued within that extended statute of limitations. (Resp. Op. Br., p. 6.)

Respondent contends that appellants are incorrect in their assertion that the Trust is entitled to notice. Respondent asserts that a trust is an abstraction, a legal relationship, and not an entity as alleged by appellants. Respondent contends that appellants were trustees with the powers and duties to manage and administer the Trust, which included paying taxes on trust income, and were entitled to receive notices on behalf of the Trust, which they did. Respondent asserts that, even if the notices were somehow defective in that they lacked the word "trustee" after appellants' names, appellants have not shown that the notices misled them or caused a prejudicial delay in proceedings. Respondent asserts that the notices were properly served and that the assessments were issued within the statute of limitations. (Resp. Op. Br., pp. 6-7.) Respondent contends that, even if the Trust had not been terminated, R&TC section 19512 provides that "any person acting in a fiduciary capacity shall assume the duties and, upon giving notice to the [FTB], shall assume the rights and privileges of the taxpayers in respect of any tax, additions to tax, penalties, and interest imposed by Part 10." Respondent asserts that all claims against a trust must be asserted by proceeding against the trustee in their representative capacity, and therefore appellants were the appropriate parties to receive notice, and they did receive notice beginning in 2007 that the Trust was being examined. (Resp. Reply Br., pp. 2-3 & exhibits N, O; Prob. Code, § 18004.)[10]

Respondent references R&TC section 19516, which imposes a personal liability upon fiduciaries who make any distributions of trust assets before the satisfaction and payment of taxes. Respondent asserts that appellants were the sole trustees of the Trust, and therefore became personally liable for California taxes when they made distributions from the Trust before paying all required taxes. Therefore, respondent asserts, it correctly assessed appellants individually for the liability incurred by their actions as co-trustees of the Trust. Respondent asserts that appellants are also liable as transferees

[10] Probate Code section 18004 states that actions may be brought against a trust by proceeding directly against the trustee in his capacity as trustee if the claim is based on a contract entered into by the trustee, an obligation arising from the ownership or control of trust property, or a tort committed in the administration of the trust. Respondent may wish to clarify whether a tax liability would be included in the types of actions covered by this section.

NOT TO BE CITED AS PRECEDENT - Document prepared for Board review. It does not represent the Board's decision or opinion.

STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

because they were the only non-charitable beneficiaries of the Trust. (Resp. Reply Br., pp. 2-3.)

Year at Issue

Appellants' Contentions

Appellants assert on appeal that the appropriate year at issue, if any, would be the year in which the large distribution occurred. Appellants contend that the distribution was issued in 2005, not 2004.[11] (App. Op. Br., p. 8.) Appellants assert that any penalty for self-dealing would be imposed for an "act" of self-dealing in the appropriate taxable period. Appellants contend that a future distribution cannot retroactively cause a trust to lose its tax-exempt status for previous years. (App. Supp. Br., p. 4.) Appellants contend, as discussed further below, that the remedy for any infraction in the operations of a tax-exempt trust, particularly a one-time infraction, is not a retroactive loss of its tax-exempt status. (App. Reply Br., pp. 8-9.) Appellants assert that the Trust was a valid charitable remainder trust in full compliance with any and all application rules and regulations in 2004 when the sale of the property occurred. (App. Op. Br., p. 8.)

Respondent's Contentions

Respondent asserts that appellants raise for the first time on appeal the contention that the distribution at issue was actually made in 2005 rather than 2004. Respondent contends that this argument lacks merit, pointing out that appellant-husband, as co-trustee of the Trust, reported the excessive distribution of $1,168,769 on the Trust's 2004 California information return and appellants individually reported the distribution on their 2004 California income tax return. (Resp. Reply Br., pp. 3-4 & exhibits P, Q.) Respondent contends that, if the distributions actually happened in 2005, then the Trust would have failed in 2004 under IRC section 664(d)(3) for the failure to make a distribution when it had distributable net income of $129,591 in 2004. (*Id*. at p. 4.)

Whether the Trust Conformed to the Legal Requirements for a NIMCRUT

Appellants' Contentions

Appellants contend that California probate law provides for a presumption that a trustee has complied with IRS regulations, and respondent must do more than simply assert that there has been

[11] Appellants appear to acknowledge that the distribution was reflected on 2004 tax returns, but assert that the proper year at issue is the year of the act and not the year of the tax return. (App. Supp. Br., p. 4.)

NOT TO BE CITED AS PRECEDENT - Document prepared for Board review. It does not represent the Board's decision or opinion.

STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

self-dealing or a violation of state or federal law. (App. Reply Br., p. 10; App. Supp. Br., p. 5; Prob. Code, § 21540.) Appellants assert that the IRS has never challenged the validity of the Trust, the charitable deductions generated by appellants' gifting of the property to the Trust in 2002, the tax-exempt treatment of the sale of the property in 2004, the 2005 distribution, or the distribution upon the termination of the Trust in 2008. (App. Reply Br., p. 4.)

Appellants' opening brief addresses respondent's contention at protest that appellants' management of the Trust as its trustees did not comply with the law and thus the Trust must be treated as a grantor trust, whereby it would lose its tax-exempt privileges. Appellants contend that, even if there was a one-time excessive distribution made in reliance upon tax professionals, it would not cause the charitable remainder trust to suddenly become a grantor trust. (App. Op. Br., p. 6; App. Supp. Br., p. 1.) Appellants contend that respondent relies upon IRC section 677(a), which generally provides that the grantor shall be treated as the owner of any part of a trust where income may be distributed to the grantor or the grantor's spouse without the approval or consent of an adverse party. Appellants disagree with respondent's reliance on this statute, asserting that appellants could be potentially subject to personal liability as trustees for any violation of their fiduciary obligation to the charitable beneficiary, an adverse party to them in the Trust. More importantly, appellants contend, Treasury Regulations make it clear that the grantor's receipt of payments under the terms of a charitable remainder trust does not result in the trust being treated as a grantor trust for federal tax purposes, citing Treasury Regulation section 1.677(a)-1(g) example 1. (App. Op. Br., pp. 6-7.)

Appellants address respondent's contention that appellants improperly allocated capital gain on the sale of the Carmel property to income when it should have been allocated instead to corpus. However, appellants note that items allocable to corpus are specifically excluded from that portion of a trust which is treated as a grantor trust under Treasury Regulation section 1.671-3(b). (App. Op. Br., p. 7.)

Appellants assert that, if there was any self-dealing here, whether by an excessive distribution or by the use of the house as a personal residence for a short period, the only penalty would be a fine applicable to appellants and not a loss of the tax-exempt status for the Trust. Appellants contend that the penalty imposed by the IRS is a five percent excise tax, plus additional taxes if it is not

NOT TO BE CITED AS PRECEDENT - Document prepared for Board review. It does not represent the Board's decision or opinion.

STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

remedied, but only if such an alleged self-dealing act was willful and not due to reasonable cause. (App. Reply Br., pp. 9-10; App. Supp. Br., p. 6; Int.Rev. Code, §§ 4941(a)(2) & (b), 4947(a)(2).)

Appellants contend that there is a strong argument for reasonable cause here, noting that there is no evidence of intent by the trustees to make an excessive distribution, and asserting that their reliance on tax professionals to calculate a proper distribution should constitute reasonable cause.[12] Additionally, appellants contend that Probate Code section 21540 provides a presumption of compliance. (App. Reply Br., p. 10; App. Supp. Br., p. 6.) Appellants also assert that the charitable foundation (the Parasol Tahoe Community Foundation) ultimately received the appropriate distribution of ten percent of the value of the contribution, and therefore any excessive distribution in 2005 simply produced a timing difference with no harm to the charity, and certainly no basis for revoking the tax-exempt status retroactively to 2004. (App. Reply Br., p. 10.) Appellants contend that a judicial reform of the Trust is inappropriate, asserting that cases relied up by respondent involve major defects rather than a one-time inadvertent error. (App. Supp. Br. pp. 6-8.)

Respondent's Contentions

Respondent asserts that appellants failed to operate their trust in accordance with the strict rules applicable to charitable remainder trusts by making distributions to themselves exceeding allowable amounts by over $1,000,000, which they did not repay to the Trust or charitable remainder beneficiary, they engaged in acts of self-dealings in violation of federal and state law, they did not comply with the requirements of IRC section 664, and they inappropriately claimed income tax exemptions. Respondent contends that appellants terminated the Trust and distributed most of the assets to themselves, and are liable for the tax due. Respondent asserts that appellants already benefitted from a windfall by taking a large charitable contribution deduction in 2002 for the value of the remainder gift to charity, but cannot escape tax on the sale of the Carmel property when they failed to administer the trust correctly, to the detriment of the charitable remainder beneficiary. (Resp. Op. Br., pp. 14-15.)

Respondent contends that a multitude of statutory provisions have been enacted to

[12] Appellants also note that they reported and paid more than $113,000 in California tax in 2004 and $61,000 in 2005 based in part on the distribution to them from the Trust. (App. Reply Br., p. 5, fn. 1.)

NOT TO BE CITED AS PRECEDENT - Document prepared for Board review. It does not represent the Board's decision or opinion.

STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

ensure that private foundations and charitable trusts are operated exclusively to further charitable and other permissible purposes, rather than for the private purposes of their founders or family members. Respondent cites to IRC section 4941, which prohibits self-dealing, and asserts that appellants engaged in self-dealing. Respondent contends that appellants' use of the Carmel residence as their home for seven months after transferring the property to the Trust constitutes self-dealing, since disqualified persons (e.g., trustees) are not allowed to be provided personal living quarters by a trust without charge. Respondent notes that appellants assert that they paid $12,000 per month in rent, but have not provided any evidence of such payments. Respondent asserts that, even if fair rental value was paid, it is likely still self-dealing, since self-dealing also includes the exchange or leasing of property from a Trust to a disqualified person, and the Trust paid expenses such as cleaning, insurance, repairs, legal expenses, and taxes for the property on behalf of appellants. Respondent contends that the excessive distribution is also self-dealing. (Resp. Op. Br., pp. 11-12.) Respondent contends that engaging in self-dealing with regard to charitable trusts is against state and federal law, and, regardless of prescribed penalties, the fact that appellants engaged in self-dealing is evidence of their failure to comply with applicable state and federal laws. (Resp. Reply Br., p. 8.)

Respondent contends that there need not be a finding that the Trust was a grantor trust in order to be taxable to appellants, as discussed in appellants' opening brief. Respondent asserts that the Trust must comply with all of the specified requirements in order to be considered a valid charitable remainder trust, and if it does not, then it is not entitled to an exemption from income tax and accordingly becomes taxable. Respondent asserts that appellants cannot argue that an excessive distribution is not excessive if it is repaid, when appellants did not make any repayments to the Trust or charitable remainder beneficiary. (Resp. Op. Br., p. 13.) Respondent discusses various Private Letter Rulings (PLRs), noting that the PLRs are not citable or precedential, and finds that, in examples where charitable remainder trusts have defects, the IRS determined that the trusts were not disqualified because the trusts sought judicial reformation to correct the mistake, repaid excess distribution amounts with interest, gave notice to the charitable beneficiary and state attorney general, and sought approval from the IRS. Respondent contends that appellants did none of these things, and asserts that the failure to comply with the provisions of IRC section 664 and relevant regulations results in a loss of charitable

NOT TO BE CITED AS PRECEDENT - Document prepared for Board review. It does not represent the Board's decision or opinion.

STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

trust qualification. (Resp. Reply Br., pp. 5-8; *Estate of Atkinson v. Commissioner* (2000) 115 T.C. 26 (*Atkinson*); *Estate of Hall v. Commissioner* (1989) 93 T.C. 745 (*Hall*).)

Respondent contends that appellants erroneously cite Probate Code section 21540, which states that the provisions of a charitable trust instrument will be construed as complying with the Internal Revenue Code for purposes of qualifying for the charitable deduction. Respondent contends that appellants have already taken the charitable deduction in 2002, and that this deduction is not at issue here. Respondent asserts that this Probate Code statute only concerns the creation of the trust instrument, and respondent is not challenging the construction or intent of the Trust, but rather argues that appellants caused the disqualification of the Trust through their excess distribution. Respondent notes that appellants never attempted to remedy the excess distribution or give notice to the charitable beneficiaries of their actions, and therefore Probate Code section 21540 does not support appellants' position. (Resp. Reply Br., pp. 5-6.)

Treatment of Property Sale Proceeds and Calculation of the Distribution

Appellants' Contentions

Appellants contend that the 2005 distribution was an appropriate distribution under Nevada law as well as the FTB's and the IRS's rules and regulations. Appellants cite Nevada law, wherein it states that an adjustment between principal and income is allowable when a trustee deems it necessary to be fair and reasonable to the various beneficiaries, and contend that such an adjustment was allowable here. (Nev. Rev. Stat., § 164.795.) Appellants assert that they made an adjustment and treated some of the principal as income because the Trust had not earned sufficient income for several years to make proper payments. Appellants contend that there was nothing inappropriate about the distribution of the capital gain in order to comply with the "make-up" provision of the Trust. (App. Op. Br., pp. 9-11.) Appellants contend that the distribution of the capital gain was in accordance with Nevada law. (App. Supp. Br., p. 5; Nev. Rev. Stat., § 164.798(2).)[13]

Appellants assert that the Trust sold the Carmel house in April of 2004, and thereafter

[13] This Nevada statute was enacted in 2009, well after the year of the distribution. The statute provides a priority list of where payments must come from, beginning with income, then short-term capital gain, long-term capital gain, and finally the principal of the trust.

NOT TO BE CITED AS PRECEDENT - Document prepared for Board review. It does not represent the Board's decision or opinion.

STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

had assets of $8,225,000 in cash, stocks, and bonds. Contrary to respondent's contentions, appellants contend that the distribution of $1,168,769 was not excessive. Appellants assert that, even if the distribution was miscalculated, even to the point of self-dealing under the IRS rules, the appropriate remedy is a fine and not an automatic loss of the Trust's tax-exempt status. (App. Reply Br., p. 9.)

Respondent's Contentions

Respondent contends that the principal asset of the Trust was the Carmel residence appellants contributed in 2002 and, when the Trust sold it in 2004, a capital gain of $3,195,301 was generated. Appellants appear to have treated all of this gain as trust income, and made a large distribution in 2004 (or 2005) based on this treatment, but respondent asserts that, according to applicable law, the capital gain must be treated as corpus (i.e., principal) and not distributable income. Respondent contends that appellants should have allocated the capital gain to trust corpus and accumulated it for the remainder beneficiaries. Respondent cites Nevada Revised Statute section 164.840, which states that money or other property received from the sale of a principal asset shall be allocated to corpus rather than income. Respondent asserts that Treasury Regulation section 1.664-3(a)(1)(i)(b)(3) also provides that income from the sale of assets contributed to the trust by the donor must be allocated to principal and not income. Respondent contends that the proper reporting of Trust income shows that it had $129,591 of distributable net income, and the distribution of $1,168,769 exceeded the correct amount of distribution by over one million dollars. Respondent asserts that this excessive distribution was to the detriment of the charitable remainder beneficiary, because it improperly distributed trust corpus. (Resp. Op. Br., pp. 7-10.)

Respondent contends that appellants are incorrect when they allege that Nevada law allows for the distribution of capital gain as a distribution of trust income. Respondent asserts that appellants cite the statute granting trustees broad discretion in allocating between principal and income (Nev. Rev. Stat., § 164.795(3)(g)), but omit the language that prohibits such discretion when the trustees are also the trust beneficiaries, as is the case here. The law, as of 2003, precludes trustees who are also beneficiaries, from allocating discretionary amounts between principal and income, contrary to appellants' assertions. Respondent also asserts that Treasury Regulation section 1.664-3(a)(1)(i)(b)(3), which states generally that income from the sale of assets contributed to a trust by a donor must be

NOT TO BE CITED AS PRECEDENT - Document prepared for Board review. It does not represent the Board's decision or opinion.

STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

allocated to principal and not income, was in effect as of 1998. (Resp. Reply Br., pp. 4-5.) Respondent asserts that appellants make reference to Revenue Procedure 90-30 when asserting that trustees may need to invade corpus to make annual distributions, but respondent contends that this law only applies to standard unitrusts and not a NIMCRUT. (Resp. Op. Br., p. 14.)

Applicable Law

Statute of Limitations

R&TC section 19057, subdivision (a), provides that, in general, an NPA must be mailed to a taxpayer within four years after its return was filed. R&TC section 19067, subdivision (a), provides for an extension of time for issuing the NPA beyond the four-year period when "prior to the expiration of the time prescribed for the mailing of the notice of a proposed deficiency assessment, the taxpayer consents in writing to an assessment after that time."

R&TC section 19074, subdivision (a), provides, in pertinent part, that the period of limitation for the assessment of the liability of the initial transferee of the property of the taxpayer shall be one year after the expiration of the period of limitation for the assessment against the taxpayer. R&TC section 19074, subdivision (c), provides that the statute of limitations for fiduciaries is not later than one year after the liability arises or not later than the expiration of the period for the collection of the tax in respect of which the liability arises, whichever is later. R&TC section 19074, subdivision (d), allows for an extension of the time within which a proposed assessment may be issued with the transferee's or fiduciary's consent, similar to the extension allowed under R&TC section 19067. There is no requirement for the taxing agency to also acquire an extension of the statute of limitations from the taxpayer-transferor to preserve its rights to propose an assessment against a transferee when the taxpayer-transferor is insolvent. (*Coca-Cola Bottling Co. v. Commissioner* (9th Cir. 875) 334 F.2d 875, 880 (*Coca-Cola Bottling Co.*) IRC section 6901(g) provides that any notice of liability mailed to the person subject to the [transferee] liability at his last-known address shall be sufficient.

Charitable Remainder Trust Law

R&TC section 17731 conforms to IRC section 664 regarding charitable remainder

///

///

NOT TO BE CITED AS PRECEDENT - Document prepared for Board review. It does not represent the Board's decision or opinion.

STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

trusts.[14] These trusts must meet the definition of and function exclusively as a charitable remainder trust from the creation of the trust. (Treas. Reg., § 1.664-1(e)(4).) Charitable remainder unitrusts provide for mandatory annual payments of a fixed percentage of the net fair market value of the assets or the amount of trust income, whichever is less, to one or more beneficiaries for a set period of time less than twenty years or for their lifetime. Make-up payments can be allowed for prior years when payments were less than the fixed percentage amount described above. The remainder of the trust assets, upon the termination of the annual payments, is transferred to or set aside for the use of a charitable organization. At least ten percent of the initial net fair market value of all the contributed assets of the trust must go toward the remainder provided to a charitable organization. A charitable remainder trust receives tax-exempt status.[15] (Int.Rev. Code, § 664(d)(2) & (3); see also Treas. Reg., §§ 1.664-1 & 1.664-3.)

Strict rules apply to the categorization of trust assets, and which amounts constitute corpus, or principal, versus those that constitute income. Treasury Regulation section 1.664-3(a)(i)(1)(b)(3) provides that income carries the definition provided in IRC section 643(b), and specifically provides that "[p]roceeds from the sale or exchange of any assets contributed to the trust by the donor must be allocated to principal and not to trust income at least to the extent of the fair market value of those assets on the date of their contribution to the trust." (Treas. Reg., § 1.664-3(a)(1)(i)(b)(3); see also Nev. Rev. Stat., § 164.840.) Accordingly, if a charitable remainder trust is established with a principal donation of property, and that property is later sold, the proceeds of such sale constitute principal, i.e., corpus of the trust, and not income. This amount would then not be considered trust income when determining the appropriate annual payment amount for that year. Nevada Revised Statute section 164.795 provides that trustees may adjust between principal and income under specific circumstances, but the trustee is specifically barred from making any such

[14] Trusts, although abstractions, are treated for purposes of income tax law as having a separate existence with the requirement to file their own tax return under the hand of a fiduciary and claiming and receiving their own appropriate deductions. (*McCulloch*, *supra*, 61 Cal.2d at 191.)

[15] Grantors also receive a charitable deduction for assets contributed to a charitable remainder trust, and a grantor's intent to comply with the requirements for this charitable deduction are respected and cannot be impaired by the fiduciary. (Prob. Code, § 21540.)

NOT TO BE CITED AS PRECEDENT - Document prepared for Board review. It does not represent the Board's decision or opinion.

STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

adjustments if the trustee is also a beneficiary of the trust. (Nev. Rev. Stat., § 164.795(3)(g).)

IRC section 4941 prohibits self-dealing between a disqualified person (e.g., trustees) and a charitable remainder trust, and imposes a fine upon the disqualified individual involved in the self-dealing. Self-dealing includes: the leasing of property between a trust and a disqualified person; the furnishing of goods, services, or facilities between a trust and disqualified person; the reimbursement of expenses by a trust to a disqualified person; and the use of income or assets of a trust for the benefit of a disqualified person.

In *Atkinson*, *supra*, 115 T.C. 26, the settlor placed close to four million dollars of stock in a charitable remainder annuity trust. The trust terms stated that quarterly payments were to be made to the settlor equal to five percent of the trust value per year.[16] The trustee did not make any payments during the remaining approximately two years of the settlor's life. Upon the settlor's death, the IRS determined that the trust did not continue to function as a charitable remainder annuity trust based on the failure to pay the quarterly payments, and the IRS denied the charitable deduction taken by the estate. The court determined that, because the required payments were not made to the decedent, the trust did not meet the express annual payment requirement of the statute and could qualify for treatment as a charitable remainder trust. The court also discussed the possibility of reformation pursuant to IRC section 2055(e)(3), but noted that reformation is meant to address only those problems arising in the documentation of the trust, and was not helpful in this case because the trust was validly formulated, but failed based on operational failure.

In *Hall*, *supra*, 93 T.C. 745, the settlor established through her will a charitable remainder trust upon her death to provide all of the trust income to her son with the remainder of the principal going to charitable organizations. However, the settlor's Ohio probate form specifically indicated that the will did not contain a charitable trust. When charitable deductions pursuant to a remainder trust were claimed on settlor's tax return, the IRS requested a copy of the trust document.

[16] The trust also included a provision allowing for secondary beneficiaries that could elect to receive a five percent share of the trust upon the settlor's death if they agreed to pay certain tax liabilities. One secondary beneficiary elected to receive the distribution but refused to pay the tax liabilities based on a signed affidavit from the decedent, and ultimately the trustee distributed the funds without the requirement that the secondary beneficiary pay the applicable taxes. The IRS pursued an alternative argument that the trust failed based on the secondary beneficiary provisions and failure to adhere to them, but the court determined that the trust had already failed by this time and that it need not decide this issue.

NOT TO BE CITED AS PRECEDENT - Document prepared for Board review. It does not represent the Board's decision or opinion.

STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

The executor and trustee subsequently submitted a petition to the Ohio Attorney General's office to request a reformation and amendment to the charitable trust to limit the son's payments to an annual percentage of six percent and to amend the probate form so that it conformed to federal law, and the reformation was allowed. The only issue before the court was whether this reformation was timely commenced within the statutory deadline of 90 days of the date on which the federal estate tax return was required to be filed, and the court found that it was not. Therefore, the trust failed because its terms did not conform to the statutory requirements and it was not timely reformed.

Transferee and Fiduciary Liability

R&TC sections 19071 and 19073 authorize the assessment of tax against a taxpayer who is the transferee of the tax liability of another taxpayer. The law of the state where the transfer occurred governs. (*Fibel v. Commissioner* (1965) 44 T.C. 647, 657.) IRC section 6901, the federal equivalent of these Revenue and Taxation Code statutes, provides that a transferee includes, among other actors, a distributee. Transferee liability does not impose a new tax liability, but merely provides an alternative means to enforce an existing liability. The liability of a transferee may be enforced either at law or in equity.[17] (*Appeal of Howard Zubkoff and Michael Potash, Assumers and/or Transferees of Ralite Lamp Corporation, Taxpayer*, 90-SBE-004, Apr. 30, 1990 (*Appeal of Zubkoff*).) Regardless of whether the enforcement is sought under law or in equity, there are two fundamental elements to transferee liability: (1) there must be a transfer of the taxpayer's property to a third-party transferee; and (2) the taxpayer-transferor must be liable for the tax at the time of the transfer and at the time the transferee liability is asserted.

Transferee liability in equity is based upon the law of fraudulent conveyances. (*Appeal of Zubkoff, supra*.) To establish transferee liability in equity, respondent must prove the following elements: (1) the taxpayer-transferor transferred property to the transferee for less than full and adequate consideration; (2) at the time of the transfer and at the time transferee liability is asserted, the taxpayer-transferor was liable for the tax; (3) the transfer was made after the liability for the tax

[17] Transferee liability at law is generally found when transferees have expressly assumed the liabilities (i.e., pursuant to a contract or other legal instrument). There is a no evidence here of any such express assumption, and therefore only the equitable aspect of transferee liability shall be discussed herein.

NOT TO BE CITED AS PRECEDENT - Document prepared for Board review. It does not represent the Board's decision or opinion.

STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

accrued, whether or not the tax was actually assessed at the time of the transfer;[18] (4) the taxpayer-transferor was insolvent at the time of the transfer or the transfer left the taxpayer-transferor insolvent; and (5) respondent has exhausted all reasonable remedies against the taxpayer-transferor. (*Appeal of Howard Zubkoff and Michael Potash, Assumers and/or Transferees of Ralite Lamp Corporation, Taxpayer, supra*.) The requirement that recovery be sought first against the taxpayer-transferor is waived where it is apparent that proceeding against the transferor would be futile. For example, the taxing agency may proceed directly against a transferee in the case of an insolvent transferor. (See, e.g., *Commissioner v. Kuckenberg* (9th Cir. 1962) 309 F.2d 202 ["the government need not take futile assessment action against a taxpayer without assets"]; *Coca-Cola Bottling Co., supra*, 334 F.2d 875.)

Fiduciary liability may be imposed only where a fiduciary, in the exercise of his free choice, has chosen to pay a debt due from the entity for whom he acted in preference to a liability due to the government. A fiduciary need not personally benefit from these actions to be found liable. (*Grieb v. Commissioner* (1961) 36 T.C. 156.) Fiduciaries include trustees, and debts include a beneficiary's distributive share of an estate. (Int.Rev. Code, § 7701(a)(6); Treas. Reg., § 20.2002-1.) California law specifically provides that "[e]very fiduciary who . . . makes any distributions of the assets of [a] . . . trust, before satisfaction and payment of taxes . . . , is personally liable to the state for the taxes . . ." (Rev. & Tax. Code, § 19516.) Fiduciaries also assume the rights and duties in respect to taxes of the taxpayer upon giving notice to the FTB of their fiduciary status. (Rev. & Tax. Code, § 19512.) There is no reasonable cause exception to fiduciary liability, but a fiduciary's lack of knowledge that a debt was due to the government, or the lack of knowledge as would put the fiduciary on notice that such a liability existed, is a defense to an assertion of fiduciary liability. (*Leigh v. Commissioner* (1979) 72 T.C. 1105, 112-113.)

STAFF COMMENTS

Statute of Limitations

The question of whether respondent's proposed assessment at issue in this appeal is

[18] The *Appeal of Zubkoff* clarifies that a transferee is retroactively liable for the transferor's taxes in the year of the transfer and in prior years to the extent of the assets received from the transferor, even though the transferor's tax liability might be unknown at the time of the transfer, quoting *Leon Papineau v. Commissioner* (1957) 28 T.C. 54, 58.

NOT TO BE CITED AS PRECEDENT - Document prepared for Board review. It does not represent the Board's decision or opinion.

STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

timely within the appropriate statute of limitations depends on whether the NPA is deemed to be served upon appellants as individuals, appellants as transferees, or appellants as fiduciaries of the Trust.

If the NPA was served to appellants as individuals, then respondent had four years under R&TC section 19057 from when appellants filed their 2004 tax returns to issue the NPA. Appellants filed their 2004 return on October 15, 2005. (Resp. Reply Br., exhibit Q.) Appellants' representative signed two timely waivers, the first being signed on April 21 or 29, 2009, extending the statute of limitations for issuing an NPA to April 15, 2011. Respondent's NPA, issued February 24, 2011, was therefore timely if issued to appellants as individuals.

The statute of limitations for proposing an assessment against a transferee is one year after the expiration of the period of limitation for the assessment against the original taxpayer. In this case, the Trust filed its return on April 15, 2005, and therefore the statute of limitations for proposing an assessment against the transferee would be April 15, 2010 (i.e., one year beyond the standard four-year statute of limitations). The parties may wish to discuss whether the waivers signed on behalf of appellant-husband constitute a valid extension of time to propose an assessment under R&TC section 19074, subdivision (d).[19] If the waivers were valid extensions for this transferee assessment, then it appears the NPA was issued timely if the NPA was issued to appellants as transferees.

If the Board determines that the assessment is one made against appellants as fiduciaries, the parties should be prepared to discuss the applicable date the fiduciary liability arose and the expiration of the period for the collection of the tax in respect of which the liability arose to determine if respondent's proposed assessment was timely. The parties should consider that the fiduciary liability is a personal liability upon the fiduciary, rather than a transfer of the Trust's liability. The law also provides for an extension of the statute of limitations for fiduciaries through the signing of waivers.

Appellants also raise the related issue of whether respondent must first attempt to contact or propose an assessment against the Trust before proposing an assessment against appellants

[19] From the language of the waiver forms (trustee signature lines, instructions for fiduciaries, and a reference to the Probate Code), it appears that these statute of limitations waivers are intended for use with fiduciaries or in relation to trusts and similar entities, rather than for an individual in his or her own capacity. However, the account number and taxpayer's name belong to appellant-husband. The parties may wish to discuss the choice of waiver form used by respondent during the audit process, and whether it helps show which person or entity was the subject of the audit and under what theory the liability was being pursued.

NOT TO BE CITED AS PRECEDENT - Document prepared for Board review. It does not represent the Board's decision or opinion.

STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

under a fiduciary or transferee liability. However, case law appears to provide that respondent need not pursue an assessment against a terminated trust before proposing an assessment against appellants as transferees under these facts.

Distribution & Self-Dealing

Appellants state on appeal, possibly for the first time, that the distribution at issue was actually made in 2005, and not 2004. The parties should clarify at the hearing the date of the distribution and provide any evidence available to support their assertion. If the distribution was made in 2005, appellants should be prepared to explain why all tax reporting documents for the Trust and themselves individually show the distribution as being made in 2004. Appellants should also explain what the actual distribution amount was for 2004, if any. If there was no distribution for 2004, the parties should discuss whether this was a violation of the terms of the charitable remainder trust statutes, as respondent indicates there was other income received by the Trust in 2004 that should have been used to make the required annual distributions. (See *Atkinson*, *supra*, 115 T.C. 26.) If the Trust violated the statutes, and no timely attempt was made to remedy the violation, it appears as though the Trust might have lost its tax-exempt status in 2004, under the factual situation where the distribution at issue was made in 2005 and not 2004. (See *Atkinson*, *supra*, 115 T.C. 26; *Hall*, *supra*, 93 T.C. 745.) If the Trust lost its tax-exempt status in 2004, tax would be owed on the gain from the sale of the Carmel property, which occurred in 2004 regardless of when the distribution was made.

The parties should discuss whether the distribution at issue was properly calculated. Appellants appear to have either treated the gain from the sale of the Carmel property as income to the Trust, or determined that they were empowered with discretion as trustees to make distributions out of the Trust's principal as well as income. As discussed in the Applicable Law section above, gain on the sale of a trust's principal asset must be allocated to principal and not income. Therefore, the gain on the sale of the Carmel property, which was a principal donation to the trust, appears to constitute corpus of the Trust and not income. Accordingly, it should not have been included in any calculation for an annual distribution based on the amount of Trust income. The Applicable Law section above also shows that, under Nevada law, trustees who are also beneficiaries are not given discretion to make distributions to themselves from a trust's principal assets. Therefore, it does not appear as though the

NOT TO BE CITED AS PRECEDENT - Document prepared for Board review. It does not represent the Board's decision or opinion.

STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

large post-sale distribution was appropriate under the statutes and regulations governing charitable remainder trusts.

If the distribution was an act in violation of the applicable statutes and regulations, the parties should discuss what effect that has on the Trust's non-exempt status. Applicable regulations and case law shows that charitable remainder trusts are required to strictly adhere to the statutes and regulations, but also provide that noncompliance can be remedied. The parties should discuss whether any steps were taken to remedy this possible violation (e.g., paying back the distribution, petitioning the state attorney general, notifying the IRS or the applicable charitable organization, etc.). Appellants note that statutes provide that the penalty for violations, such as self-dealing, is a fine and an addition to tax. The parties should discuss whether these repercussions apply to the Trust itself, or whether these repercussions are intended only for the disqualifying individual that is party to the self-dealing, and whether the effect of unremediated noncompliance with the statutes and regulations is instead a loss of the tax-exempt status for the trust. If the consequence of failing to adhere to the statutes results in the Trust losing its tax-exempt status, the parties should be prepared to discuss whether this would happen in 2004, when the violation appears to have occurred, or some later year as proposed by appellants.

In addition to the alleged excessive distribution as noncompliance with applicable trust law, the parties should discuss implications of self-dealings, such as appellants' use of the Carmel residence for personal reasons during 2003, any payment by the Trust of repairs, maintenance, and other expenses related to the residence while appellants stayed there, and the fact that the alleged excessive distribution was made by appellants as trustees to themselves as beneficiaries and possibly to the detriment of the charitable organization. Appellants contend on appeal that they contributed funds to the Trust to pay for at least some of these property expenses without taking a charitable contribution deduction. (App. Reply Br., pp. 4-5.) The parties should be prepared to discuss whether these events constitute self-dealing, and what effect, if any, it has on the Trust's tax-exempt status. The parties may wish to discuss whether the Board has jurisdiction over appellants' individual liability for any self-dealing, depending on whether the proposed assessment at issue here is predicated on transferee or fiduciary liability, and therefore the Trust's original liability.

///

NOT TO BE CITED AS PRECEDENT - Document prepared for Board review. It does not represent the Board's decision or opinion.

STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

Transferee or Fiduciary Status

Respondent's proposed assessment was issued to appellants in their names as individuals, though the assessment has clearly been based on the actions of the Trust, with them as trustees and beneficiaries. Respondent should be prepared to explain at the hearing whether the liability is proposed as flow-through income to appellants individually, as a transferee liability upon appellants, or as a fiduciary liability upon appellants.[20] Respondent should also clarify whether it maintains any other options as alternative theories of assessment.[21]

The parties should be prepared to discuss whether the facts show appellants are liable for the Trust's tax liability under the transferee liability theory. The parties should discuss the elements listed in the *Appeal of Zubkoff*, noting that the "transfer" to be analyzed would be the distribution of the remaining trust assets in 2008 to appellants and Parasol upon the termination of the Trust (not the distribution in 2004 or 2005). Accordingly, it appears as though: (1) the distribution was made to appellants without adequate compensation in return; (2) the tax liability (arising from the sale of the Carmel property, and if found to be a valid liability) existed at the time of the distribution and remained outstanding after the distribution; (3) the distribution was made after the liability for tax accrued; (4) the Trust was terminated and therefore insolvent at the time of the distribution; and (5) respondent did not pursue action against the trust, but under the law is not required to pursue a futile action against an insolvent transferor before pursuing recovery from the transferee. Appellants note that they paid personal tax in 2004 and 2005, partly based on the distribution received, but the payment of a personal tax liability does not affect the transferor's tax liability. (*Appeal of Zubkoff*.)

Appellants, as co-trustees of the Trust, acted in a fiduciary capacity for the Trust. Appellants will have a fiduciary liability for any taxes owed by the Trust if they paid debts of the Trust or made distributions from the Trust instead of satisfying a liability due to the government that appellants knew or should have known existed. The record shows that, at the time of the Trust's

[20] Respondent should also be prepared to discuss whether the liability was based on a different theory at any previous time (e.g., audit, protest, etc.).

[21] For example, respondent might hold fiduciary liability as its primary theory, but still maintain that appellants would alternatively be liable under transferee liability.

NOT TO BE CITED AS PRECEDENT - Document prepared for Board review. It does not represent the Board's decision or opinion.

STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

termination, appellants were on notice that respondent was reviewing the Trust's accounts to determine if additional tax was due. The parties should discuss whether appellants' knowledge of respondent's ongoing audit constituted sufficient knowledge to put appellants on notice that additional tax was owed to the government. The parties should also discuss whether appellants should have otherwise known at any time prior to the termination and distribution in 2008 that the Trust had operated outside of the applicable trust law requirements, and thereby been aware that a tax liability would be due.

///

///

///

Holman_jj

STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

NOT TO BE CITED AS PRECEDENT - Document prepared for Board review. It does not represent the Board's decision or opinion.