CALIFORNIA FRANCHISE TAX BOARD

Legal Ruling No. 290

April 23, 1965

PARTNERSHIP TRUSTS: DEDUCTIONS OF INCOME DISTRIBUTED TO SUBSIDIARY TRUSTS

Syllabus:

On January 3, 1955, A, as grantors, created two trusts naming their minor daughter, as the primary beneficiary of one trust and their minor son, as the primary beneficiary of the other trust. On the same date B, as grantors, also created two trusts naming their minor daughter, as the primary beneficiary of one trust and their minor son, as the primary beneficiary of the other trust. C was named as the trustee for the four trusts. For convenience's sake, these four trusts will hereafter be referred to as the "primary" trusts.

Under the respective trust instruments, each trust was given an undivided 12 1/2% interest in a business. The trustee represented the trusts as a limited partner in the business. The general partners consisted of A and B, each of whom possessed a 25% interest in the partnership. The trusts were to be terminated upon the primary beneficiary attaining a specified age. The trust instruments specifically provided that the trusts were irrevocable.

Broad discretionary powers were granted to the trustee as to the distribution of the income. Among the provisions relating to the distribution of the income, the trust instruments provided that the trustee shall have complete discretion to distribute in case of emergency "all or any part of the available income, including the available share of the income from the business or its successors or assigns, to any one or more trusts then in existence for the primary benefit of the primary beneficiary."

On December 28, 1955, the grantors created five more irrevocable trusts for each primary beneficiary named in the primary trusts; i.e., five additional trusts were created naming daughter of A as the primary beneficiary, five additional trusts were created naming the son of A as the primary beneficiary, etc. C was named the trustee for all of these trusts. These trusts will hereafter be referred to as "subsidiary" trusts.

The terms of the trust instruments creating these subsidiary trusts are identical with the exception of the termination date. The termination date differs by one year. As in the case of the primary trusts, the instruments grant to the trustee broad discretionary power as to the distribution of the income. the instruments, however, did not grant the trustee power to distribute the income to other trusts as in the case of the primary trusts. The Board seeks to disallow the deductions of income distributed to the subsidiary trusts.

(1) Whether the "investment" trusts can be considered as beneficiaries of the "primary" trusts.

(2) Whether the distributions from the "primary" trusts to the subsidiary trusts qualify as distributions of "income" under the provisions of the trust instruments.

We have before us two of the most technical and involved fields of tax law, i.e., family partnerships composed of general and limited partners and subsidiary or overflow trusts. Both of which offered to the taxpayers herein substantial income tax savings.

(1) Recognition of Trusts as Partners

In a 24-page opinion Judge Graven in the Iowa District Court in Hanson v. Birmingham, 92 Fed. Supp. 33, came to the conclusion that the concept of a trust as a partner was unknown under the common law and therefore, absent legislation, a trust does not have the legal capacity to become a member of a partnership. This notion was expressly repudiated by a majority of the Tax Court in Theodore Stern, 15 T.C. 521, primarily on the ground that Code Section 3797(a)(2) (PITL 17007, 17008) contained its own definition of what should be recognized as a partnership and that this definition was sufficiently broad in its scope to include a trust as a member of a joint venture, which in turn would make the trust a member of a partnership for tax purposes. In view of amendments to the law and the long line of court decisions recognizing that trusts may be valid members of a partnership, it is not believed that taxpayer's plan is open to question from this standpoint.

Where a multiple trust scheme on its face appears to be a pure unadulterated tax avoidance device the scheme should be examined with particular care to determine whether the multiple trusts are in substance one taxable entity. In other words, form must yield to substance.

In the recent Boyce case (109 F. Supp. 950, affd. 296 F. (2d) 731) there were 90 identical trusts created by the same grantor for the same beneficiary and they were treated as a single trust. Court relies upon admission that sole purpose of multiple trusts was to decrease taxes and upon failure to prove that trusts were separately maintained.

In cases where the same trustee or trustees serve for different trusts, different beneficiaries and maintain separate accounts and in similar factual situations but maintain a single capital account with each beneficiary having an undivided interest in the single account and in other such situations, we are protected taxwise but when a ridiculous number of trusts are created for the same beneficiary with the same trustee or trustees, particularly where the estate is not large, the scheme bears close scrutiny.

(2) Subsidiary or Overflow Trust

Where distribution of all, or a specified portion, of the trust income is subject to the discretion of the trustee, the taxation of that income is dependent upon how the trustee exercises his discretion.

It has been held that income distributable to subsidiary trusts is not taxable to the primary trusts. (Lynchburg Trust & Savings Bank v. Com., 68 Fed. (2d) 356, cert. den. 292 U.S. 640; George G. Allen, 40 B.T.A. 351.) If the income so distributed is to be further accumulated by the subsidiary trusts, such trusts and not the beneficiaries thereof are taxable upon the income. (Angier B. Duke, 38 B.T.A. 1264.) Such was the case of both primary and subsidiary trusts.

The distributions to the subsidiary trusts as beneficiaries of the primary trusts are considered as paid or credited to a beneficiary (Section 17761(a)(2)) because these terms are broad enough to include those to whom income was paid or credited in trust. (Duke v. Com., supra.)

The amount paid or credited would be deductible by the primary trusts and constitute income taxable to the subsidiary trusts as beneficiaries of the primary trusts. Taxpayers as beneficiaries of subsidiary trusts receiving income from the primary trusts there would be no crediting of income to them in the absence of a right of election on their part to receive it from the trustees of the subsidiary trusts. Such a right did not exist in the trust instruments.