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This Technical Advice Memorandum responds to your request for clarification of California Revenue and Taxation Code ("Rev. & Tax. Code") section 17742.

### **QUESTION(S) PRESENTED**

1. Does a resident beneficiary who receives a current income distribution from a trust have a contingent or non-contingent interest in a trust if the distribution is at the trustee's discretion?
2. Is the possibility of a resident beneficiary receiving a distribution that may be allocated as income or corpus relevant to applying Rev. & Tax. Code section 17742?
3. Will the answer to question 1 be different if the trustee may or does distribute corpus (capital gains) to the current beneficiary?

### **CONCLUSION(S)**

1. A resident beneficiary of a discretionary trust has a non-contingent, vested interest in the trust as of the time, and to the extent of the amount of income the trustee decides to distribute.
2. Income that has been accumulated is taxable to the trust when it is distributed or distributable to a resident beneficiary pursuant to Rev. & Tax. Code section 17742.
3. The answer to question 1 does not differ if the trustee may or does distribute corpus (capital gains) to the current beneficiary.

## ANALYSIS AND DISCUSSION

**Rev. & Tax. Code Section 17742(a)**--Except as otherwise provided in this chapter, the income of an estate or trust is taxable to the estate or trust. The tax applies to the entire taxable income of an estate, if the decedent was a resident, regardless of the residence of the fiduciary or beneficiary, and to the entire taxable income of a trust, if the fiduciary or beneficiary (other than a beneficiary whose interest in such trust is contingent) is a resident, regardless of the residence of the settlor.

**Title 18, California Code of Regulations, Section 17742(b)**--A noncontingent beneficiary is one whose interest is not subject to a condition precedent.

*McCulloch v. Franchise Tax Board* (1964) 61 Cal.2d 186, 192, states in pertinent part:

California taxes the trust on that *portion* of the annual income which the trust holds for eventual distribution to the California resident beneficiary. (Italics added.)

1. A resident beneficiary whose interest in a trust is subject to the sole and absolute discretion of the trustee holds a contingent interest in the trust. The exercise of the trustee's discretionary power is a condition precedent<sup>1</sup> that must occur before the beneficiary obtains a vested interest in the trust. Once the trustee decides to distribute income in a specified amount, the beneficiary has a non-contingent, vested interest<sup>2</sup> in the trust, but only for that amount. At that time, the trust is taxable on the distributable income pursuant to Rev. & Tax. Code section 17742. The

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<sup>1</sup> **condition precedent.** An act or event, other than a lapse of time, that must exist or occur before a duty to perform something promised arises. If the condition does not occur and is not excused, the promised performance need not be rendered. The most common condition contemplated by this phrase is the immediate or unconditional duty to performance by a promisor. [Cases: Contracts, 221 C.J.S. *Contracts* §§ 356, 444-445, 450.] Black's Law Dictionary (8<sup>th</sup> Ed., p. 312).

<sup>2</sup> **vested, adj.** Having become a completed, consummated right for present or future enjoyment; not contingent; unconditional; absolute <a vested interest in the estate>. [Cases: Estates in Property, 1 C.J.S. *Estates* §§ 2-5, 8, 15-21, 116-128, 137, 243.]

"A future interest is vested if it meets two requirements: first, that there be no *condition precedent* to the interest's becoming a present estate other than the *natural expiration* of those estates that are prior to it in possession: and second, that it be *theoretically* possible to identify who would get the right to possession if the interest should become a present estate *at any time*." Thomas F. Bergin & Paul G. Haskell, *Preface to Estates in Land and Future Interests* 66-67 (2d ed. 1984).

**vested in interest.** Consummated in a way that will result in future possession and use. • Reversions, vested remainders, and any other future use or executory devise that does not depend on an uncertain period or event are all said to be vested in interest. [Cases: Wills 628-638 C.J.S. *Wills* §§ 1320-1379, 1551.]

Black's Law Dictionary (8<sup>th</sup> Ed., p. 1595).

**vested interest.** An interest the right to the enjoyment of which, either present or future, is not subject to the happening of a condition precedent. Black's Law Dictionary (8<sup>th</sup> Ed., p. 829).

beneficiary continues to have a contingent interest in the remaining current and/or accumulated income of the trust.<sup>3</sup>

2. A resident, contingent trust beneficiary of a discretionary trust may have a potential right to current income of the trust and no right to the corpus of the trust. In a discretionary trust if the trustee does not decide to distribute the current year income of the trust to the beneficiary, the income will be accumulated by the trust. This income will be taxable to the trust, pursuant to Internal Revenue Code section (IRC) 641(a) and Rev. & Tax. Code section 17742, in a subsequent taxable year when the trustee decides to distribute some portion of added portion of trust corpus accumulated income to the resident beneficiary. Once the trustee decides to make a distribution, however, the beneficiary has a vested and non-contingent interest in the accumulated income amount to be distributed.

3. A resident, contingent trust beneficiary of a discretionary trust may have a potential right to distributions of trust corpus. The trustee's decision (exercise of discretion) to distribute the proceeds from the sale of trust corpus in the current year gives the beneficiary a non-contingent, vested interest in the trust for that amount only. At that time, the trust is taxable on the gain from the disposition of the trust asset pursuant to Rev. & Tax. Code section 17742. If less than all of the sale proceeds are distributed or distributable, the gain should be prorated and the distributable portion is taxable. The beneficiary continues to have a contingent interest in the remaining corpus of the trust.

This technical advice memorandum presumes the trustee has complete, unfettered discretion whether and when to make a distribution. However, the trust document should be reviewed in each case to determine any limitations on the trustee's discretion to accumulate income rather than to distribute it to the beneficiary. Restatement 2d of Trusts, § 128 Extent of Beneficiary's Interest, states in pertinent part:

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<sup>3</sup> In a discretionary trust the beneficiary has no definitely ascertainable interest. He cannot compel the trustee to give him any portion of the income where the trust gives the trustee absolute discretion as to the amounts of income to distribute. See Scott on Trusts, Section 128.3 (2d ed., 1956). The beneficiary cannot be certain that he will ever enjoy any of proceeds of the trust. Consequently, where the extent of the interest of the beneficiary is dependent upon the exercise of discretion by the trustee, that interest is contingent. *Thomas v. Gregg* (1892) 76 Md., 169 [24 Atl., 418]; *Andrews v. Lincoln* (1901) 95 Me., 541 [50 Atl., 898]; *Moore v. Moore* (1860) 59 N. C. (6 Jones Eq.), 132; *Angell v. Angell* (1908) 28 R. I., 592 [68 Atl., 583]; *Denny v. Hyland* (1931) 162 Wash., 68 [297 Pac., 1083], English: *In re Vaux* (1939), Ch., 465; *In re Bernard* (1916), 1 Ch., 552; *In re Bleu* (1906), 1 Ch., 624. [\*6] Gray, Perpetuities, supra, Sec. 246; Restatement, Trusts (2d), Section 62q. Such interest does not vest until the trustee exercises his discretion (emphasis added).

Viewed in another way, the discretion in a trustee to distribute principal and income to any or all members of a designated class is tantamount to a special power of appointment. Simes and Smith, *The Law of Future Interests*, (cont. from previous page) 216, Section 1277 (2d ed., 1956); VI American Law of Property, Section 24.30 (1952). The exercise of the power is a condition precedent (emphasis added) to the vesting of any interest in a beneficiary of the trust. Simes & Smith, supra, Section 1274; Gray, Perpetuities, supra, Section 515. (*Thomas v. Harrison* (1962) 191 N.E.2d 862 [1962 Ohio Misc. LEXIS 284 (Ohio Misc.)]. (See also *Estate of Charles A. Canfield* (1947) 80 Cal. App. 2d 443, 451 - 452 [181 P.2d 732]; and *Estate of Ferrall* (1949) 92 Cal. App. 2d 712, 716.)

The extent of the interest of the beneficiary of a trust depends upon the manifestation of intention of the settlor....

COMMENTS & ILLUSTRATIONS: Comment:

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- d. Discretionary trusts.* By the terms of the trust it may be provided that the trustee shall pay to or apply for a beneficiary only so much of the income and principal or either as the trustee in his discretion shall see fit to pay or apply. In such a case it depends upon the manifestation of intention of the settlor to what extent the trustee has discretion to refuse to make such payment or application. If the settlor manifests an intention that the discretion of the trustee shall be uncontrolled, the beneficiary cannot compel the trustee to make any payment to him or application for his benefit, if the trustee does not act dishonestly or arbitrarily or from an improper motive . . .

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