CALIFORNIA FRANCHISE TAX BOARD

Legal Ruling No. 291

April 23, 1965

SOURCE OF TRUST INCOME: CORPUS CONSISTS OF INTANGIBLES

Syllabus:

The taxpayer is a California resident and the beneficiary of a testamentary trust established under the will of a resident of Hawaii. The trustee and the corpus of the trust, which consists of intangibles, are located in Hawaii.

During the year 1960, taxpayer received a distribution of income from the trust. An income tax on such income was paid to Hawaii and a tax credit therefore was claimed on taxpayer's California return. A notice of proposed assessment was issued on the grounds that the income was derived from sources within California, citing Miller v. McColgan, 17 Cal. 2d 432 (1941) which precluded the allowance of a tax credit.

The reasoning of the staff in disallowing the tax credit claimed by the taxpayer is substantially as follows. The practice has been to consider that the source of income received by a resident beneficiary from a nonresident trust, consisting of intangibles, is from sources outside this State in accordance with the decision in Appeal of Wilcox, Board of Equalization, (1939). However, Sections 17752 and 17763 provide that the character of the income is the same in the hands of the beneficiary as in the hands of the trust. If the character of the income is passed on to the beneficiary, so is the beneficial ownership of the intangibles which gave rise to the income. If that is the case, under the doctrine of mobilia sequuntur personam, the intangibles had a situs at the residence of the taxpayer, thus the income had its source in California. As a result, the taxpayer is not entitled to a tax credit since Section 18001(a) requires that the income have a source outside California.

The propriety of disallowing the tax credit on these grounds has been questioned.

(1) What effect does the character of income rule in Sections 17752 and 17763 have in determining the source of income received by a California resident beneficiary from an out-of-state trust distributing income derived from intangibles?

(2) Is a nonresident beneficiary subject to tax on income received from a California trust whose corpus consists of intangibles?
(1) Our understanding of the character of income rule applicable to trusts will be clearer if we first examine the problem of the source of income received

by a beneficiary of a trust whose corpus consists of intangibles.

The rule of mobilia sequuntur personam is applicable to the taxation of intangibles for income tax purposes. Under that rule, intangibles have their situs in the state or country wherein their owner resides unless the intangibles have acquired a "business" situs elsewhere. The source of income from the intangibles is, of course, at the situs of the intangibles.

In Miller v. McColgan, supra, it was held that income from intangibles owned by a California resident had its source in California even though the intangibles were physically located in the Philippine Islands. Similarly, where the intangibles are held in trust and trust income is distributed to the beneficiary, the source of such income is at the residence of the beneficiary. Robinson v. McColgan, 17 Cal. 2d 423 (1941).

It is noted that the mobilia rule applied in the Robinson case without comment by the court regarding the ownership of the intangibles which comprised the corpus of the trust. This was undoubtedly due to the prevailing view that the beneficiary is regarded as the real owner of the intangibles the trustee being merely the depositary of the legal title. Title Insurance & Trust Co. v. Duffill, 191 Cal. 629.

The facts in this case are substantially the same as those in Appeal of Wilcox, supra, in which the Board of Equalization held that the source of income received by a California resident beneficiary of a Hawaiian trust was Hawaii.

The stated reason for the holding was that "The testators and trustees were all residents of Hawaii, where the trust was managed and controlled and where the physical evidences of the intangibles constituting the trust res were located." It is our opinion that the Board's 1939 decision in Wilcox was overruled by the decision of the supreme court in 1941 in Robinson v. McColgan, supra, since it is clear from Wilcox that the intangibles were not employed as capital or used in a business in a manner which would constitute a business situs in Hawaii. See Reg. 17951-17954(f).

In the present case it is also clear that the trust res did not acquire a business situs in Hawaii. Therefore, under the mobilia rule the source of the beneficiary's income from the trust was California. Since a tax credit under Section 18001(a) is allowed only for taxes paid to the other state on income derived from sources within that state, the taxpayer is not entitled to the credit.

The above discussion relates to the question of jurisdiction to tax and source of income contemplated in Section 18001. However, the character rule in Section 17752 (simple trusts) and Section 17763 (complex trusts) is concerned only with the nature of distributions of trust income.

Our trust (and estate) provisions are in conformity with federal and are based upon the so-called "conduit" theory, that is, a trust primarily serves as a conduit through which income flows to the beneficiaries. Dovey v. U.S., 254 Fed. 2d 538. The Committee Reports make it clear that income ". . . shall have the same character in the hands of the beneficiary as in the hands of the estate or trust." is the statutory expression of the "conduit" rule which was codified in the Internal Revenue Code of 1954 and adopted by this State in 1955 (Sections 17752 and 17763). Thus, for example, if the income is exempt or a capital gain to the trust the income is also exempt or a capital gain to the beneficiary. House Report 1337, Senate Report 1662, pp. 4340, 4991, 1954 U.S. Code Cong. & Adm. News.

Accordingly, the rules governing jurisdiction to tax and the character (conduit) rule are entirely separate and distinct and have no relation to each other. As stated in Bank of America v. U.S., 203 Fed. Supp. 152 (1962) the conduit theory should be applied not to find tax liability, but to determine only the character of the amounts distributed for the purposes of assessing taxes after tax liability has been established.

(2) Section 17953 provides that income of nonresident beneficiaries is from sources within California only if distributed or distributable out of income of the trust which is derived from sources within California. In other words, as indicated in Reg. 17951-17954(f)(4), the income of a nonresident beneficiary derived from intangibles held by a resident trust is not income from sources within California and is therefore not taxable to the nonresident beneficiary unless the intangibles have acquired a business situs in California.

It will be noted that the last sentence in Section 17953 attributes ownership of the intangibles to the nonresident beneficiary. This sentence was added in 1943 and our historical records indicate it was intended to insure the treatment of income to a nonresident beneficiary as set forth in the regulations of 1941, Art. 7(f)-6(d). That regulation is now Reg. 17951-17954(f)(4) referred to above.