CALIFORNIA FRANCHISE TAX BOARD

Legal Ruling No. 201

June 17, 1957

TRUSTS: ALLOCATIONS BETWEEN INCOME AND CORPUS

Syllabus:

In the case of an irrevocable trust created prior to September 13, 1941, dividends are to be allocated to income only to the extent that they are earned by the paying corporation after the creation of the beneficiary's life estate, unless the testator clearly expresses his intention to the contrary.

On December 18, 1936, X placed 2155 shares of stock of the S Co. in an irrevocable trust. Her son, Y, was named life beneficiary of the trust, with remainder to his children. The earned surplus of the S Co. on December 18, 1936 was $875,798.47. On December 31, 1953, the earned surplus had been reduced to $767,357.04.

During the year 1954 the S. Co. earned net income of $41,260.74 of which $20,634.91 was attributable to the trusts ownership. Dividends of $90,240.00 were paid the trust during 1954, but the trustees only distributed $20,634.91 to the life beneficiary retaining the balance as trust corpus. The trust paid a tax on the retained portion.

The trust instrument provides that the trustees have conclusive authority to determine what constitutes principal and income from the trust estate. All income of the trust is currently distributable. Advice has been requested as to whether the life tenant is taxable on the entire dividend paid the trust or only on the $20,634.91 distributed to him. Held: the life tenant is taxable only on the amount distributed to him.

Prior to the adoption of the Uniform Principal and Income Act in 1941, the California courts established the rule that the allocation of dividends between principal and income depends on when the earnings from which it was paid were accumulated. If the earnings were accumulated before the commencement of the life estate the entire dividend is awarded to corpus. If paid from earnings accumulated partly before and partly after the creation of the life estate it is apportioned between income and corpus. Estate of Duffill, 180 Cal 48, Estate of Gartenlaub, 185 Cal 375. Since in the instant case only $20,634.91 was paid from earnings accumulated after the life estate was created, under this rule the balance of the dividend was properly treated as corpus by the trustee.

Section 730.15 of the Uniform Principal and Income Act provides, that cash dividends irrespective of source are awarded to income. Under Section 730.02, however, the Act does not apply to irrevocable trusts created before September 13, 1941, and since the instant trust was created on December 18, 1936 as an irrevocable trust, the rule of the Duffill and Gartenlaub cases is controlling. Consequently it is held that the trustee properly exercised its discretion and that the life tenant is taxable on the $20,634.91 distributed to him and not on the entire dividend.