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#### QUESTION PRESENTED:

What is required by the phrase "held in trust" as used in Revenue and Taxation Code section 23701t(a)(4)?

#### CONCLUSION

The "held in trust" requirement in Revenue and Taxation Code section 23701t(a)(4) is satisfied by a homeowners' association holding amounts received as membership dues, fees, and assessments in a bank account and restricting the use of the funds to the stated purpose, that is the management, maintenance, and care of association property and common areas. A separate trust entity is not required by Revenue and Taxation Code section 23701t(a)(4).

#### ANALYSIS AND DISCUSSION

Revenue and Taxation Code section 23701t(a)(4) provides:

(a) A homeowners' association organized and operated to provide for the acquisition, construction, management, maintenance, and care of residential association property [may be exempt from taxes in accordance with Revenue and Taxation Code 23701] if all of the following apply:

\* \* \*

(4) Amounts received as membership dues, fees, and assessments not expended for association purposes during the taxable year are transferred to and held in trust to provide for the management, maintenance, and care of association property and common areas. (Emphasis added.)

California Probate Code provides:

Section 15002. Except to the extent that the common law rules governing trusts are modified by statute, the common law as to trust is the law of this state.

Section 15200. Subject to other provisions of this chapter, a trust may be created by any of the following methods:

\* \* \*

(b) A transfer of property by the owner during the owner's lifetime to another person as trustee.

\* \* \*

(e) An enforceable promise to create a trust.

Section 15201. A trust is created only if the settlor properly manifests an intention to create a trust.

Section 15202. A trust is created only if there is trust property.

Section 15203. A trust may be created for any purpose that is not illegal or against public policy.

Section 15204. A trust created for an indefinite or general purpose is not invalid for that reason if it can be determined with reasonable certainty that a particular use of the trust property comes within that purpose.

Section 15205.

(a) A trust, other than a charitable trust, is created only if there is a beneficiary.

(b) The requirement of subdivision (a) is satisfied if the trust instrument provides for either of the following:

(1) A beneficiary or class of beneficiaries that is ascertainable with reasonable certainty or that is sufficiently described so it can be determined that some person meets the description or is within the class.

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In *Abrams v. Crocker-Citizens Bank* (1974) 41 Cal.App.3d 55, 59, the Court of Appeal provided the following discussion of trusts:

A voluntary trust is created by acts or words of the trustor which indicate (1) an intention to create a trust and (2) the subject, purpose, and beneficiary of the trust. (Civ. Code section 2221.) The trustor's manifestations of trust are to be accompanied by the trustee's acts or words expressing (1) his acceptance of the trust, or his acknowledgement, made upon sufficient consideration, of its existence, and (2) the subject, purpose, and beneficiary of the trust. (Civ. Code section 222.)

The payment of money may create either a debt or a trust, depending upon the intention of the parties. "If the intention is that the money shall be kept or used as a separate fund for the benefit of the payor or a third person, a trust is created. If the intention is that the person receiving the money shall have the unrestricted use thereof, being liable to pay a similar amount whether with or without interest to the payor or a third person, a debt is created." (Rest.2d Trust, § 12, com. g, p. 37.) The intention of the parties is to be ascertained from their words and conduct in light of the circumstances surrounding the transaction. Circumstances that may be helpful are: (1) the presence or absence of an agreement to pay interest; (2) the amount of money paid; (3) the time to elapse before the payee must perform his agreement; (4) the relative financial positions of the parties; (5) the relationship between the parties; and (6) the custom in similar transactions. (*Ibid.*) The view expressed in the Restatement has been generally adopted in California. (See *Bank of America v. Board of Supervisors* (1949) 93 Cal.App.2d 75, 80.)

Section 2 of the Restatement Second of Trusts provides:

When not designated as "charitable," "resulting" or "constructive," a trust is "a fiduciary relationship with respect to property, subjecting the person by whom the title to the property is held to equitable duties to deal with the property for the benefit of another person, which arises as a result of a manifestation of an intention to create it.

Revenue and Taxation Code section 24311 was adopted in 1975, and excluded from taxable income amounts received as contributions, assessments or dues from owners or shareholders of a condominium project, cooperative housing project, or members of a real estate housing project, if the amounts were transferred to and "held in trust" in a capital expansion fund or if transferred to and "held in trust" in a repair and maintenance fund, and used for capital, repair or maintenance projects.

For federal purposes, Internal Revenue Code section 528 was adopted as part of the Tax Reform Act of 1976.<sup>1</sup> This section provided an exclusion from taxable income for all membership dues, fees, and assessments, provided 60% of gross income consisted solely of amounts received as membership dues, fees, and assessments, and 90% or more of the expenditures were for the acquisition, construction, management, maintenance, and care of association property.

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<sup>1</sup> Internal Revenue Code section 528 was adopted retroactively to include taxable years beginning after December 31, 1973.

In 1977, California adopted Revenue and Taxation Code section 23701t. This section provides modified conformity with Internal Revenue Code section 528. Revenue and Taxation Code section 23701t(a)(4) continued the requirement from former section 24311 to "hold funds in trust." As stated in the memo from James Giroud, Manager, Exempt Organization Section, dated February 7, 1977, "Our proposal includes a provision that unexpended funds must be set aside in trust and are to be used only for the associations' exempt purposes. This will enable us to retain the trust concept for such income and thereby repeal Section 24311 of our code." The memo also discussed other aspects of modified conformity to IRC section 528. The memo does not specify the type of trust required to meet the "hold funds in trust" provision.

In the *Matter of the Appeal of Charter Point Homeowners Association*, 96-SBE-004, the issue was the characterization of interest earned as the result of the investment of funds received by Charter Point Homeowners Association as a result of construction defect litigation. The settlement funds were considered to be a return of capital for the individual homeowners. The homeowners' association considered its position with respect to the settlement funds as holding the funds in trust for the individual homeowners and the State Board of Equalization upheld the position of the homeowners' association in this appeal.

## DISCUSSION

No reported court opinion or opinions of the State Board of Equalization have been discovered which refer to or discuss the "held in trust" phrase used in Revenue and Taxation Code section 23701t(a)(4).

Focusing on the common law trust elements:

Funds (trust property) held by the homeowners' association have been provided to the homeowners' association by the individual homeowners as membership dues, fees, and assessments; for the management, maintenance, and care of association property and common areas (trust purpose); and by law are to be held in trust (trust intent), for the benefit of the association property and common areas (trust beneficiary.) It is clear that the dues, fees, and assessments are to be kept or used as a separate fund for the benefit of the association property.

California Probate Code, section 15002, provides that the common law as to trusts is the law of California. In the case of the homeowners' association, the funds referred to in Revenue and Taxation Code section 23701t(a)(4) as "held in trust" have the requisite elements to create a trust. The individual homeowners have transferred membership dues, fees, and assessments to the homeowners' association to act as trustee of the funds and use the funds for the management, maintenance, and care of association property and common areas.

## CONCLUSION

Based on a review of the files of the Franchise Tax Board regarding the adoption of Revenue and Taxation Code sections 24311 and 23701t, the definition of trust under California law, and the consistent and long standing practice of the staff of the Franchise Tax Board to accept homeowners' association funds held in a separate bank account as fulfilling the "held in trust" requirement, it is concluded that such practice will satisfy the requirements of the "held in trust" requirement of Revenue and Taxation Code section 23701t(a)(4).

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