

BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
ESTATE OF MICHAEL KARPEN, DECEASED)

Appearances:

For Appellant: Chandler P. Ward, Attorney at Law

For Respondent:, Burl D. Lack, Chief Counsel;
 John S. Warren, Associate Tax Counsel

O P I N I O N

This appeal is made pursuant to Section 18593 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of the Estate of Michael Karpen to a proposed assessment of additional personal income tax in the amount of \$7,348.95 for the year ended June 30, 1952.

Prior to 1922 Michael Karpen bought stock in an Illinois corporation, S. Karpen & Bros. His purchase of the stock was financed by interest-bearing obligations to the corporation, secured by pledge of his stock. He became a California resident in 1922 and remained a resident until his death on June 30, 1950. During administration of the decedent's estate and in the year ended June 30, 1952, S. Karpen & Bros. was liquidated. The corporation paid the estate a net liquidating dividend for the decedent's stock after first offsetting the principal and interest due on decedent's stock purchase obligations.

Appellant estate reported the gain on the liquidating dividend as a gain on the sale or exchange of a capital asset, using as a basis the fair market value of the stock on the date of decedent's death. It took into account as taxable only 30% of the gain as it considered the stock to have been held from the date decedent acquired it, a period of more than ten years. The Franchise Tax Board determined that 80% of the gain should be taken into account, as gain from a capital asset held since the death of Michael Karpen, a period of more than one year but not more than two years.

The amount of interest due the corporation, which was offset in paying the liquidating dividend to the estate, was \$138,965.72. Appellant claimed the full amount as a deduction. The Franchise Tax Board disallowed the deduction of \$63,128.09 as being that portion of the interest accrued prior to 1922

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when decedent became a California resident. Both decedent and his estate kept their books and made returns on a cash basis.

During the year in question Section 17712 of the Revenue and Taxation Code (now Section 18151) provided:

"In the case of any taxpayer, only the following percentages of the gain or loss recognized upon the sale or exchange of a capital asset- shall be taken into account in computing net income:

80 percent if the capital asset has been held for more than 1 year but not for more than 2 years;

30 percent if the capital asset has been held for more than 10 years."

Appellant argues that a decedent's estate cannot have a new holding period separate from that of the decedent, because under the property law of this State an estate is not an entity, and neither it nor its representative acquires title to the decedent's property. Appellant further points to Section 17253 of the Revenue and Taxation Code (now Section 17833) as indicating that income in the hands of the estate should be considered to have the same character as it would have had in the hands of the decedent if he had lived to receive it.

It is necessary to recognize that Section 17253 applied by its terms only to a restricted type of income; namely, "income in respect of a decedent." That phrase has been construed as intending "to cover into income the assets of decedents, earned during their life and unreported as income" (Commissioner v. Linde, 213 Fed. 2d 1, 5). The liquidating dividend here in question may be attributable in part to earnings of the corporation during Mr. Karpen's life, but it may not be considered as earned by him and does not fall in the category of "assets of decedents, earned during their life" (Estate of Putnam v. Commissioner, 324 U.S. 393, 400).

Regardless of the concept of an estate that may prevail under general property law, the tax statutes of this State leave no room to doubt that an estate is an entity for income

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tax purposes. Section 17004 of the Revenue and Taxation Code provides that, a taxpayer includes an estate. Section 18101 (now Section 17731) provided that the taxes upon individuals apply to the income of estates, Section 18102 (now Section 17742) stated that income of an estate is taxable to the estate, Section 17746 (now Sections 18044 and 18045), dealing with the basis for determining gain or loss, provided:

"If the property was acquired by bequest, devise, or inheritance, or by the decedent's estate from the decedent, the basis shall be the fair market value of the property at the time of its acquisition* . . ."
(Emphasis added.)

It is abundantly clear that the estate as a taxable entity "acquires" property from the decedent and then as a taxpayer it "holds" the property. Under our income tax law, as under the Federal income tax law from which ours is derived, the period of holding for an estate begins when the estate acquires an asset, which is the date of death (Herbert Tutwiler, 28 BTA 495; Estate of Hall, 38 BTA 1145).

H. Tutwiler
28 BTA

The next issue is whether interest accrued against the decedent prior to his becoming a California resident in 1922 is allowable as a deduction to his estate when paid by it in 1952 by means of offset against the liquidating dividend of S. Karpen & Bros. The Franchise Tax Board allowed a deduction to the estate for only so much of the interest paid in 1952 as had accrued after the decedent became a resident of California.

In 1952, Section 17566 (now 17596) of the Revenue and Taxation Code provided:

"When the status of a taxpayer changes from resident to nonresident, or from nonresident to resident, there shall be included in determining income from sources within or without this State, as the case may be, *income* and deductions accrued prior to the change of status *even though not otherwise includible* in respect of the period prior to such change, but the taxation or deduction of items accrued prior to the change shall not be affected by the change."

This provision was first added to the law in 1941 as Section

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16(g) of the Personal Income Tax Act.

The deduction in question relates to interest which had accrued against the decedent prior to his death. It is allowable to the estate by virtue of Section 17254 (now 17835) of the Code only as a "deduction in respect of" the decedent. The amount allowable, under the terms of Section 17566, supra, accordingly, turns on the status of the decedent as a resident or nonresident of this State during the period in which the interest accrued.

Appellant, however, points out that Mr. Karpen became a resident of California prior to the enactment of Section 17566 and contends that its application to the deduction in question would be to give to the section an invalid retroactive effect. The basis of this contention is that on the effective date of Section 17566 Karpen, as a resident of this State, had acquired a "vested right ... to use the cash receipts accounting method and to deduct when thereafter paid, interest therefor incurred". As respects a cash basis taxpayer, however, it is settled law that an accrued liability does not create any rights to a deduction until he makes payment (Helvering v. Price, 309 U.S. 409). Furthermore, it is equally well established that the extent to which deductions shall be allowed is a matter of legislative grace (New Colonial Ice Co. v. Helvering, 292 U.S. 435).

The cases of Dillman v. McColgan, 63 Cal. App. 2d 405, and Cullinan v. McColgan, 80 Cal. App. 2d 976, relied on by Appellant, do not aid its position. Those cases, taken together, held that items received or paid by a cash-basis taxpayer after the effective date of the Personal Income Tax Act were by its terms includible in or deductible from income, without regard to whether they accrued before or after the effective date of the act. Thus, the rationale of the cases is that, as respects a cash basis taxpayer, the taxation of income or the allowance of an item of deduction is governed by the law in effect at the time of its receipt or payment.

O R D E R

Pursuant to the views expressed in the Opinion of the Board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to Section 18595 of the Revenue and Taxation Code, that the

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action of the Franchise Tax Board on the protest of the Estate of Michael Karpen to a proposed assessment of additional personal income tax in the amount of \$7,348.95 for the year ended June 30, 1952, be and the same is hereby sustained.

Done at Sacramento, California, this 15th day of September, 1959, by the State Board of Equalization.

Paul R. Leake _____, Chairman

John W. Lynch _____, Member

Richard Nevins _____, Member

George R. Reilly _____, Member

_____, Member

ATTEST: Dixwell L. Pierce _____, Secretary