66-SBE-064

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
ST. FRANCIS INVESTMENT COMPANY)

Appearances:

For Appellant: Edward L. Mulliner, Attorney at Law

For Respondent: Tom Muraki, Associate Tax Counsel

O P I N I O N

This appeal is made pursuant to section 25667 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protests of St. Francis Investment Company against proposed assessments of additional franchise tax in the amounts of $3,540.63, $5,669.69, $6,007.11, $11,029.20 and $9,064.77 for the income years 1956, 1957, 1958, 1959 and 1960, respectively.

Appellant, a California corporation organized in 1930, is principally engaged in the business of owning and renting commercial real properties. It also owns stock in various corporations. Twenty percent of appellant's capital stock is held by Jennie Crocker Henderson and the rest is held by her three adult children and trustees for her grandchildren.

On November 2, 1955, appellant and Jennie Crocker Henderson entered into an agreement whereby appellant acquired Mrs. Henderson's entire interest in a testamentary trust established by the will of her brother. Under the terms of, the trust provisions of the will, Jennie Crocker Henderson was to receive the net income from the trust property for her life, and upon her death the property was distributable to her issue. In consideration of her assignment of her beneficial interest .in the trust, appellant was to make quarterly payments to Jennie Crocker Henderson of $28,500, or a total of $114,000 per year, to continue for the remainder of her life.

The trust reported its income for tax purposes on the basis of a fiscal year ending September 30. After Its purchase of Mrs. Henderson's interest in the trust, appellant, a calendar year taxpayer, included in income those distributions received from the trust during the fiscal year of the trust ending with appellant's calendar year accounting period,

Among the assets held by the trust was' stock in the Crocker Estate Company, Cracker-Anglo National Bank, and various other corporations whose entire net income or a portion of it was included in the measure of their tax-under the California Bank and Corporation Tax Law (Rev. & Tax. Code, § 23001, et seq.}. In its returns for the years in question appellant claimed deductions for dividends received which had been declared and paid by these corporations from income which had been included in the measure of their tax. (Rev, & Tax. Code, § 24402.)

A portion of the divldends paid by the Crocker Estate Company to its stockholders, including the trust, during the years on appeal was from earnings and profits accumulated prior to March 1, 1913. To the extent that the distributions received by appellant from the trust arose from such sources they were not taxable to the trust (Rev, & Tax. Code, §§ 17323, 17381), and appellant excluded them from its gross income, (Rev. & Tax. Code, §§ 24453, 24495.)

The instant appeal arose from respondent's determination that: (1) appellant was not entitled to the dividends received deduction provided for in section 24402 of the Revenue and Taxation Code, and (2) the full amount of the distributions received by appellant from the trust was includible in appellant's gross income, whether or not that income had been includible in the trust's income. Both of these adjustments resulted from respondent's conclusion that the conduit principle of trust taxation, which causes trust distributions to retain the same character in the hands of the beneficiary as they had in the hands of the trust, and which was recognized and followed by appellant in claiming the above deductions and exclusions from gross income, is not applicable in this case.

Sect-ton 24271, subdivision (a)(12) of the Revenue and Taxation Code provides for the inclusion in a corporation's gross income of income from an interest In an estate or trust. Section 17752, subdivision (a) of the Revenue and Taxation Code states that the amount of income required to be distributed currently by a trust Is to be included in the gross income of the beneficiary. That rule is subject to the following modification:

> (b) The amounts specified in subsection (a) shall have the same character In the hands of the beneficiary as in the hands of the trust. (Rev. & Tax. Code, § 17752.)

This modification is the so-called "conduit rule," under which the trust is viewed as a conduit through which income flows to the beneficiaries, (6 Mertens, Law of Federal Income Taxation, §36.57, p. 159.)

Respondent concedes that if Jennie Crocker Henderson had retained her interest as life income beneficiary of the trust, the conduit rule would control in determining the character of the trust distributions in her hands, Respondent contends that that rule is not applicable in a situation such as this, however, where the trust is making distributions to the purchaser of an income interest in a trust, rather than to the named income beneficiary herself,

A life income beneficiary's interest in a trust is a vested property right, (Blair v. Commissioner, 300 U.S. 5 [81 L. Ed. 4651.) Under California law such a right Is assignable unless the trust Instrument itself makes it inalienable. (Title Insurance and Trust Co. v. Duffill, 191 Cal. 629 [218 P. 14]; Fatjo v. Swasey, 111 Cal. 628 [44 P. 225].) No restriction upon alienation Gas contained in the will creating the trust under which Jennie Crocker Henderson received her life income interest.

As a result of Mrs. Henderson's assignment to appellant of all her right, title and interest in the trust, appellant became the owner of Mrs. Henderson's beneficial interest in that trust and was entitled to all rights and remedies which would have been available to Mrs. Henderson as named income beneficiary. (Blair v. Commissioner, supra; Wright & Kimbrough v. Carly, 11 Cal. App. 325, 332 [104 P. 1009].) In Blair v, Commissioner, supra, the Court stated that:

> If under the law governing the trust the beneficial interest is assignable, and if it has been assigned without reservation, the assignee thus becomes the beneficiary and is entitled to rights and remedies accordingly, We find nothing in the revenue acts which denies him that status.

In support of its position respondent relies primarily on the reasoning In a series of federal cases dealing with the proper characterization of interest income received by cemetery corporations from the investment of perpetual care "trust" funds in tax-exempt bonds, and the availability of dividends received deductions to those corporations. (Monte Vista Burial Park, Inc. v. United States, 340 F.2d 595; Metairie Cemetery Ass'n v. United States, 282 F.2d 225; Memphis Memorial Park, Inc., T.C. Nemo, Dkt. No. 70313, July 17, 1959.) The courts there held that the income exclusions and deductions sought were not available to the cemetery corporations because the interest income received was in the nature of compensation for services rendered by the corporations in maintaining the cemetery lots. In United States v. Folckemer, 307 F.2d 171, also relied on by respondent, the court denied the applicability of the conduit theory because the taxpayer was not an income beneficiary of an estate but was merely the recipient of a money legacy. These cases are all clearly distinguishable on their facts from the case before us. None of them concerned an assignee of a beneficial interest in a trust.

Citing Commissioner v. P. G. Lake, Inc., 356 U.S. 260 [2 L. Ed. 2d 743], respondent also submits that the transaction in question was a tax avoidance scheme and as such should be governed by the total effect and not the form of the transaction. In the Lake case, the court found that assignments of portions of mineral payments were, in substance, assignments of rights to future income. The assignment of a beneficiary's entire interest in a trust was not involved, nor did the court state that its finding was based on the existence of tax avoidance motives. A tax avoidance motive does not in itself alter the tax effect of a transaction. (United States v. Cumberland Public Service Co., 338 U.S. 451 [94 L. Ed. 251]; Commissioner v. Brown, 380 U.S. 563 [14 L. Ed. 2d 75]; Ransom W. Chase, T.C. Memo., Dkt. Nos. 1320-63, 1369 to 1374-63, July 23, 1965.

We find no legal justification for denying appellant status as a beneficiary for the purpose of applying the conduit rule. We conclude, therefore, that respondent's action in this matter cannot be sustained.

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, Appeal of St. Francis Investment Company

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protests of St. Francis Investment Company against proposed assessments of additional franchise tax in the amounts of $3,540.63, $5,669.69, $6,007.11, $11,029.20 and $9,064.77 for the income years 1956, 1957, 1958, 1959 and 1960, respectively, be and the same is hereby reversed.

Done at Sacramento, California, this 6th day of October, 1966, by the State Board of Equalization.

_______________ Chairman

_______________ Member

_______________ Member

_______________ Member

_______________ Member

Attest: _______________, Secretary