



BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of }
JOHN R. HAYNES (now deceased) }

Appearances:

For Appellant: Chas. F. Hutchins and Harold J. Cashin,
Attorneys at Law.
For Respondent: James J. Arditto, Franchise Tax Counsel.

O P I N I O N

This appeal is made pursuant to Section 19 of the Personal Income Tax Act (Chapter 329, Statutes of 1935, as amended) from the action of the Franchise Tax Commissioner in overuling the protest of John R. Haynes to a proposed assessment of additional tax in the amount of \$2,857.81 for the taxable year ended December 31, 1935.

Dora Haynes, the wife of Appellant, by her will left a portion of her estate to a charitable foundation **subject** to the reservation that all of the income therefrom be paid to Appellant during his lifetime. Dora Haynes died within six months of making her will and accordingly it was necessary to scale down the charitable devise to one-third of the estate of the testatrix (Probate Code, Sections 40 to 43). The Appellant and the foundation agreed that the value of the right to the income from the **one-third** of the estate was \$32,571.89 and pursuant to this agreement there was distributed to him by the decree of distribution in the Estate of Dora Haynes, actual assets equal to the said value of his interest in the future income. The remainder of the one-third was distributed to the foundation free from any interest given to Appellant by the will.

Section 7-b of the Personal Income Tax Act of 1935 provides in part:

"(b) The following items shall not be included in gross income and shall be exempt from taxation under this act:
(3) The value of **property acquired by gift, bequest, devise, or inheritance (but the income from such property shall be included in gross income) . . .**"

Respondent contends that the property received by Appellant pursuant to the said agreement was an advance payment of future taxable income and that it was not received by bequest or devise but was received pursuant to the agreement. Respondent has included

Appeal of John R. Haynes (deceased)

this amount in the proposed assessment and has overruled Appellant's protest to his action.

In Lyeth v. Hoey, 305 U.S. 188 (this case is discussed at some length. in Mertens, Law of Federal Income Taxation, Section 6.05), it was held that assets received by an heir pursuant to a compromise agreement were property subject to the exemption set forth in Section 22(b)(3) of the Revenue Act of 1932, exempting from the income tax "The value of property acquired by gift, bequest, devise, or inheritance?" This heir and others had started to contest the will of decedent and the contest was settled by the compromise agreement. We are in agreement with the reasoning of the Lyeth case and it is our opinion in the instant appeal that these assets were acquired by Appellant by bequest or devise.

The next question relates to the application of the exception to the exemption whereby "the income from such property shall be included in gross income." While the assets were received by Appellant in lieu of income, we fail to see how those assets can be regarded as "income from" any "property" which was "acquired" by Appellant "by gift, bequest, devise or inheritance." If the assets are the "property" to which Section 7(b)(3) relates, they cannot at one and the same time be income from that property. If the assets were to be considered as "income" they would not be income from any property acquired by bequest or devise.

If the agreement had not been entered into, the future income would have been taxable over a period of years to the recipient of the income, the recipient being the Appellant during his lifetime. **But** under the agreement and decree of distribution the Appellant received a portion of the corpus and the foundation received another portion. The income from the Appellant's share of the corpus is subject to taxation as and when it is received. If the tax were to be applied in the manner for which Respondent contends, the Appellant's share of the corpus would be taxed as income, together with a similar burden on the income from this share as and when it is received. In our opinion, the Legislature did not intend that both the income and corpus should be taxed and Section 7(b)(3) does not require nor warrant a construction that would tax both the corpus and the income.

It is worthy of note that the Federal administrative officers conceded that these assets were not taxable as income and that their decision was approved by the U. S. Board of Tax Appeals, 40 BTA 1344.

In Lyeth v. Hoey, supra, the Supreme Court of the United States held that it was not bound by local law in construing the exemption in the Federal act. Respondent cites Estate of Rossi, 169 Cal. 148, in support of his position that the assets received by Appellant were received by agreement rather than by devise or bequest. It is also his position that the local and federal law are not the same. That case involved the California inheritance tax. It was held that the right of the State to receive that tax vested upon the death and could not be affected by any subsequent arrangement that might be made by the heirs. We do not think it to be in, point.

Appeal of John R. Haynes (deceased)

Respondent cites Irwin v. Gavit 268 U.S. 161, which holds that income received pursuant to a bequest of income is taxable when received. Appellant did not, however, receive upon the distribution any income as such. He merely received some of the corpus in lieu of income which had not yet been earned. If that income were taxed to Appellant prior to the time it was earned, would it again be taxable when earned or would it be exempt on the ground that already it had been taxed? It would, in our opinion, be contrary to the legislative intention to tax it twice. In lieu of taxing it twice, the simpler and more practical method appears to be to tax it once when the income is earned and received rather than to tax it indirectly by taxing the corpus which has been received in lieu of income. The Legislature has not indicated any intention to tax the corpus.

While the foregoing is the basis of our decision, it may also be noted that under Section 7(d) of the Personal Income Tax Act of 1935, as in effect for the taxable year of 1935, any tax on the exchange of property received by devise or bequest would be measured by the excess received over "the fair market value at time of acquisition." In this case Appellant exchanged his right to receive future income for a portion of the corpus and it appears that the value of each was the same. Therefore, no tax should be imposed on account of the exchange.

The foregoing disposes of all but \$32.84 of the proposed assessment. There is no dispute with reference to the amount of \$32.84.

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 that the action of Chas. J. McColgan, Franchise Tax Commissioner, in overruling the protest of John R. Haynes (now deceased) to his proposed assessment of additional tax in the amount of \$2,857.81 for the taxable year ended December 31, 1935, under the Personal Income Tax Act (Chapter 329, Statutes of 1935, as amended) be and it is hereby modified as follows:

The Commissioner is hereby directed to exclude from the measure of the assessment the said amount of \$32,571.89. In all other respects the action of the said ~~Commissioner~~ is hereby affirmed.

Done at Sacramento, California, this 14th day of October, 1943, by the State Board of Equalization.

R. E. Collins, Chairman
Wm. G. Bonelli, Member
Geo. R. Reilly, Member
J. H. Quinn, Member

ATTEST: Dixwell L. Pierce, Secretary