

Appeal of Jack Kelly and Mary (Buckley) Kelly

interest. The note was to be secured by a trust deed on the real property of the business., Mrs. Kelly kept her personal effects and jewelry. Appellant received the business known as Kelly's Cleaning Service, including real property and improvements, machinery and equipment, and accounts receivable. He also received an automobile and his personal effects.

Mrs. Kelly obtained an interlocutory decree of divorce in September 1947, which later became final. The value of the community property, as set out in the pleadings in the divorce case, was approximately \$50,000.

Appellant and **Mrs.** Kelly were remarried on April 24, 1950. By that date, only \$6,000 of the \$30,000 due to her under the 1947 agreement had been paid. Mrs. Kelly treated the balance as satisfied and ordered the trustee to reconvey the property that had secured Mr. Kelly's note. During the period of the second marriage, **Mrs.** Kelly again worked in the business. In 1950 she and appellant both signed an application for a bank loan to improve and expand the business, **On** their personal income tax return for 1950, **they** reported the income from the business as community property.

Appellant and Mrs. Kelly separated again on March 5, 1951. The net worth of the business as of May 1951, according to a financial statement accompanying an application by appellant for a bank loan, was \$77,155.47. On this statement, the real property was valued at \$69,505.13, including \$25,000 for land. and \$44,505.13 for improvements, The realty was shown to be **subject** to a-lien for \$15,648.28.

On **June** 11, 1951, Mrs, Kelly and appellant executed a new instrument entitled "Property Settlement Agreement," It provided that future acquisitions were to be separate property and that each party accepted the provisions of the agreement in full satisfaction of their respective rights in the community property and their rights to support and maintenance. Appellant agreed to pay **Mrs.** Kelly \$75,000 "in full satisfaction of her right to alimony, support and maintenance" and to execute a promissory note for that amount payable at the rate of \$300 per month, without interest, The note was to be secured by a deed of trust on the real property of the business. There was no provision for cessation of the monthly **payments** upon Mrs. Kelly's death or remarriage, In the event **that** appellant sold or mortgaged the business, Mrs. Kelly was to receive one-half of the proceeds and the note was to be reduced by the amount received. Mrs, Kelly also received two insurance policies with a total face value of \$7,500, upon which she was to pay future premiums.

Mrs. Kelly obtained an interlocutory decree of divorce in September 1951, The decree contained the provision for payment by appellant of the \$75,000 and stated that the community property had been divided and that all property then standing in appellant's name was his separate property,

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Appellant paid Mrs. Kelly \$3,600 per year on the note in each of the years 1952-1954. Appellant deducted the amounts as alimony on his tax returns but the amounts were not reported by Mrs. Kelly as income.

Respondent audited the returns of appellant and Mrs. Kelly for the years in question, Among other things, Mrs. Kelly stated that the business was worth \$150,000 since a third party had offered to buy it for that amount, Respondent concluded that the \$75,000 note represented consideration for her share of the community property and disallowed the deduction by appellant of the amounts he had paid to her,

Our statutes provide for inclusion in the gross income of a wife divorced from her husband amounts received in discharge of "a legal obligation which, because of the marital or family relationship is imposed on or incurred by the husband., ." (Rev. & Tax. Code, § 17081, formerly 17104,) Such payments are deductible by the husband. (Rev. & Tax. Code, § 17263, formerly 17317.5.)

As stated by the Committee on Ways and Means with respect to the federal statute upon which the above section 17081 is based: "This section applies only where the legal obligation being discharged arises out of the family or marital relationship in recognition of the general obligation to support, ..." (H.R. Rep. No. 2333, 77th Cong., 2d Sess., p. 72 [1942-2 Cum. Bull, 428].) If the payments were consideration for the release of Mrs. Kelly's community interest in the business, they were not deductible by appellant, (John Sidney Thompson, 22 T.C. 275.) The question of whether the payments were consideration for property turns upon the facts and not upon labels attached by the parties, (Ann Hairston Ryker, 33 T.C. 924.)

It is undisputed that Mrs. Kelly had a community interest in the business prior to 1947, when she and appellant entered into the first of their property settlement and support agreement: Pursuant to the 1947 agreement, the business became the separate property of appellant. However, subsequent facts demonstrate that the parties, after remarriage, again treated all of the property as community, These facts were that Mrs. Kelly released appellant from his obligation under the agreement, the parties treated the business income as community income for tax purposes and both signed for a loan from a bank to expand the business. An oral agreement is sufficient to change separate property into community property and the agreement may be either express or implied from the conduct of the parties. (Estate of Cummins, 130 Cal, App. 2d 821 [280 P.2d 128]; Lawatch v. Lawatch, 161 Cal. App. 2d 780 [327 P.2d 603].) We conclude that the assets of the business constituted community property immediately prior to the execution of the 1951 agreement.

The best evidence of the value of the business at the time the parties entered into the 1951 agreement is the financial

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statement which appellant submitted to a bank one month before that agreement was executed. The financial statement showed a value of \$77,155.47, substantially less than the offer of \$150,000 which Mrs. Kelly stated was made by a prospective purchaser. We conclude that the financial statement was accurate and that the value of Mrs. Kelly's community interest was \$38,577.74.

Upon giving up her substantial rights in the community property, Mrs. Kelly received two insurance policies and a note in the face amount of \$75,000.

Appellant has not assigned any value to the insurance policies nor has he given us any facts upon which to base a finding of their value at the time Mrs. Kelly received them. We must assume, accordingly, that their value was only nominal.

The \$75,000 note that appellant executed was payable over a period of almost 21 years and yet it bore no interest. In addition, the underlying security was valued at less than the face amount of the note and was subject to a prior lien. In view of these facts, the note was worth an amount far under its face value at the time it was delivered. Discounted at an interest rate of 6 percent, a very conservative rate under the circumstances, the note was worth \$42,756 when it was received by Mrs. Kelly.

The value of the note so closely approximates the value of Mrs. Kelly's community interest that we are led to conclude that the note represented the consideration for her property. The slight variation we attribute to the fact that Mrs. Kelly regarded the community property as more valuable than we have found to be the case and that she bargained on that basis,

As agreed at the oral hearing before this board, respondent shall allow appellant to make such adjustments in the basis of the business property as are justified by our findings and to deduct such additional amounts for depreciation as may be appropriate for the years in question,

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 18,595 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Jack and Mary (Buckley) Kelly against proposed assessments of additional personal income tax in the amounts of \$36.00, \$36.00 and \$54.04 for the years 1952, 1953 and 1954, respectively, be modified in accordance with the opinion on file herein.

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Done at Sacramento, California, this 13th day of
November, 1962, by the State Board of Equalization.

_____, Chairman
John W. Lynch, Member
Paul R. Leake, Member
Richard Nevins, Member
_____, Member

ATTEST; Dixwell L. Pierce, Secretary