BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeals of)
)
LILLIAN RYAN FITZGERALD, INDIVIDUALLY)
AND AS ADMINISTRATRIX OF THE ESTATE)
OF GERALD FITZGERALD, DECEASED)

Appearances:

For Appellant: Edward F. Treadwell, Attorney at Law

For Respondent: James J. Arditto, Associate Tax Counsel

O P I N I O N

These appeals are made pursuant to Section 19 of the Personal Income Tax Act (Statutes of 1935, p. 1090, as amended) from the action of the Franchise Tax Commissioner in Overruling the protests of Lillian Ryan FitzGerald, as administratrix of the estate of Gerald FitzGerald, deceased, and Lillian Ryan FitzGerald, individually, to his proposed assessments of additional taxes for the years ended December 31, 1935, December 31 1936, and December 31, 1937, in the amounts of $1,470.00, $605.56 and $2,052.51, respectively.

The additional assessments involve the propriety of the Commissioner's action in treating as income of the estate of Gerald FitzGerald, deceased, the amounts of certain dividends paid by the Terminal Development Company to the Anglo-Californi National Bank and the sum of $2,000.00 received by the estate in compromise of a claim against the DePue Warehouse Company, and the propriety of his action in disallowing the deduction of the sum of $33,750.00 paid by Appellant as an attorney's fee in connection with certain litigation with the Anglo-California National Bank.

During his lifetime, Gerald FitzGerald, husband of the Appellant, engaged in buying, selling, reorganizing and operating various stevedoring, warehousing and terminal enterprises in California and other Pacific Coast states. These activities were carried on through corporations in which Mr. FitzGerald acquired controlling interests. In the course of the requisite financing, he borrowed large sums from the Anglo-California National Bank of San Francisco, eventually pledging to the bank as security for these loans all of his corporate stock.

In 1931, the business affairs of Mr. FitzGerald became involved, and the bank held a pledgee's sale, at which the stoc was sold to its nominee. This procedure was questioned by Mr. FitzGerald, who claimed that it was in violation of an agreement for extension of time on his indebtedness. Litigatio

was imminent when he died in November, 1933.

Following the appointment of Appellant as administratrix of the estate of Gerald FitzGerald, she instituted suit against the bank, seeking damages for the conversion of the stock. Thereafter, by agreement of December 31, 1934, this action was dismissed in return for the withdrawal of any claim against the estate by the bank and the granting of an option to Mrs. FitzGerald to purchase all of the stock within five years for the total amount of the indebtedness due the bank, less any amounts theretofore or thereafter received by it as dividends on the stock.

After crediting sums earlier received by the bank as dividends on the stock, the balance remaining was further reduced by the application of subsequent dividends, to the end that the amount due the bank was paid in full in 1936, and the stock transferred to the estate in pursuance of the option given to the administratrix.

In making her fiduciary returns for 1935 and 1936, during which years the dividends received by the bank were so applied, Mrs. FitzGerald did not include these amounts as income of the estate. Contending that in substance and practical effect the agreement between the administratrix and the bank was an extension of the right to redeem the stock from the pledge and recognition of the estate as the beneficial owner, the Commissioner ruled that payment of the dividends to the bank and their application against the agreed purchase price represented realization of taxable income by the estate.

In our opinion, this view must be sustained. The adoption of the amount of the indebtedness as the purchase price of the stock, the application of dividends received by the bank on the stock, both before and after the agreement, is satisfaction of that amount, the provision for interest on unpaid balances, the allegation in Appellant's suit against the bank that the pledgee's sale had been illegal, and the fact that within two years after the agreement the dividends were sufficient to result in the transfer of the stock to Appellant without any other outlay on her part, all point to the conclusion that the transaction was in actuality an extension of the right to redeem the stock from the pledge rather than an option to purchase.

This conclusion we believe to be compelled by a number of decisions of the courts of this State holding, on the basis of facts analogous to those involved herein, that deeds absolute on their face were in fact mortgages (Hickox v. Lowe, 10 Cal. 197; Couts v. Winston, 153 Cal. 686) or, with respect to personal property, that similar transactions constituted mortgages or pledges notwithstanding agreements purporting to recognize the creditor as the absolute owner of the property and to give the debtor merely an option to purchase (Peninsular, etc. Co. v. Pacific S.W. Co., 123 Cal. 689; Keifer v. Myers, 5 Cal. App, 668; Golden v. Fischer, 2'7 Cal. App. 271).

Appellant stresses, however, that the agreement provided, inter alia, for the withdrawal of the bank's claim against the

estate in return for express recognition of the bank as owner of the stock, as to which the Appellant's right was limited strictly to an option to purchase. This, it is said, is inconsistent with the survival of any creditor and debtor relationship between the parties, such as is essential to a pledge.

Since it appears that the only substantial assets of the estate were those rights which pertained to the stock or the banks alleged conversion of it, and since the administratrix dismissed her suit against the bank with prejudice, we cannot regard the withdrawal of the bank's claim as significant of any intention to consider itself as no longer a creditor of the estate. In effect, the bank recognized the futility of looking for repayment of its loan except through what could be realized from the stock and, in effect, the Appellant accepted the five year extension of the pledge in lieu of any claim which she might otherwise have asserted against the bank because of its conduct in the matter.

With respect to the other point advanced by Appellant, we believe it sufficient to point out that in the cases above cited pertaining to agreements relating to personal property, recitals that the creditors were the owners of the property were held not to be controlling in determining the purpose and effect of the agreements. Accordingly, we are drawn inescapably to the conclusion that theeffect of the agreement of December 31, 1934, was to recognize the continuance of the ownership of the estate in the stock during the existence of the "option to purchase." The estate thus being the beneficial owner of the stock, and the dividends therefrom being applied to release the stock from the pledge, we think that there can be no question that, in the absence of other considerations, these dividends constituted taxable income of the estate (Helvering v. Blumenthal, 296 U. S. 552, reversing 76 F. (2d) 507; Long v. United States, 66 Ct. Cls. 475).

Entirely independently, however, Appellant urges that, to the extent that the dividends were paid from the proceeds of a policy of insurance on the life of Mr. FitzGerald, they could not constitute a distribution made by a corporation to a shareholder out of its earnings or profits. Clearly, under Section 7 of the Act, corporate dividends are taxable income in the hands of the shareholder only if paid from earnings or profits.

Persuasive testimony was offered at the hearing in this matter concerning the importance of the personal direction given by Mr. FitzGerald to the success of his corporate enterprises. True, at the time of his death he had been divested of this control due to his difficulties with the bank, but there is evidence that the particular enterprise receiving the insurance proceeds owed its success almost entirely to his efforts. Consequently,it-seems logical to conclude that the receipt of the insurance proceeds by the company was not a receipt of "earnings or profits" but rather an indemnity for the loss sustained through the death of the man whose management was responsible for the success of the

enterprise. We are not prepared to say that this would generally be true in all instances where corporations insure the lives of their executives, but under the facts of this case, we are inclined toward the view that a contrary conclusion would disregard the realities.

This view may seem at variance with the decision of the United States Circuit Court of Appeals in Cummings v. Commissioner, 73 Fed, (2d) 477, but it does not appear that that case involved analogous facts. Moreover, it seems doubtful whether the court was actually called upon to rule with respect to the status of such insurance proceeds, since the Board of Tax Appeals (20 B.T.A. 1045) had disposed of the taxpayer's contention concerning the dividend by referring to an earlier case and saying that a similar contention had been rejected there, May v. Commissioner, 20 B.T.A. 282. In that earlier case, the Board had decided that it was unnecessary to determine whether the proceeds of life insurance distributed to stockholders as dividends would be taxable income of the stockholders for the reason that it did not clearly appear that the dividends in question were from that source. Thus, it may well be that what is said by the Court in the Cummings case is purely dictum.

In any event, we are impressed by this language of the United States Supreme Court in United States v. Supplee-Biddle Hardware Co., 265 U.S. 189 at 195:

> "The benefit to be gained by death has no periodicity. It is a substitution of money value for something permanently lost, either in a house, a ship, or a life. Assuming, without deciding, the Congress could call the proceeds of such indemnity income, and validly tax it as such, we think that, in view of the popular conception of the life insurance as resulting in a single addition of a total sum to the resources of the beneficiary, and not in a periodical return, such a purpose on its part should be express, as it certainly is not here."

In the absence of any circumstances indicating that the corporation receiving the insurance proceeds on the life of Mr. FitzGerald did not sustain a commensurate loss in his death and in the absence of any express legislative intent that such proceeds should be considered invariably corporate earnings or profits, we are not prepared to say that the Commissioner was justified in rejecting the Appellant's claim that, insofar as the dividends in question were attributable to insurance proceeds, they were non-taxable income of the FitzGerald estate or of Mrs. FitzGerald.

Evidence has been submitted from which it appears that for the three years involved the dividends paid to the state or the widow (by application to the bank indebtedness or by direct payments) were derived from life insurance proceeds in the following amounts:

1935		$ 9,805.53
1936		8,794.17
1937		23,395.72
	TOTAL	$41,995.42

These sums should be excluded in the computation of the taxable income of the estate or of Mrs. FitzGerald, as the case may be.

Two other items are involved in the assessment for 1937. One is for net income of $2,000 and represents a payment made to the estate by DePue Warehouse Company in settlement of a claim for $14,000 arising out of contract whereby that company, which had employed Mr. FitzGerald as manager, was to pay his estate an amount equivalent to his compensation for the twelve months preceding his death. The DePue Warehouse Company denied liability by the controversy was eventually compromised through the $2,000 payment as settlement of a suit.

The Commissioner concedes that the rule is well established that, a decedent's claim or right to receive income is corpus to his estate and not income, but points out that the right may have a lesser value *or* no value as of the date of death and in that case any amount received in excess of its then value is income (Personal Income Tax Act, Section 7(d), as amended by Stats. 1937, p. 1834). It is the position of the Commissioner that the necessity for a lawsuit and the small amount for which the claim was compromised indicate its worthlessness at the time of Mr. FitzGerald's death.,

For the purpose of the State inheritance tax, the claim was appraised at nil. Under Section 7(d) of the Personal Income Tax Act, upon which the sale or other disposition of property acquired by a decedent's estate from the decedent the excess of the amount received over the fair market value at the date of death constitutes gross income. Article 7(d)-24(c) of the Regulations Relating to the Personal Income Tax Act provides that,

> ". . . ..the value of property as appraised for the purpose of the California inheritance tax, shall be deemed to be its fair market value at the time of the death of the decedent."

The validity of such a regulation is established, Williams v. Commissioner, 44 F. 2d 467, and since there is nothing in the record that overcomes the presumption of correctness which thus attached to the valuation fixed under the Inheritance Tax Act, this valuation must be accepted as representing the fair market value of the claim at the date of the decedent's death. The fact that $2,000 was paid several years later is not inconsistent with this conclusion, but on the contrary the compromise of the claim for only one-seventh of its total amount affirmatively indicates that its validity or collectibility was so doubtful and speculative that it may fairly be said to have had

no substantial market value at the date of death.

The other, and major item, involved in the 1937 assessment results from the disallowance by the Commissioner of a deductio of $33,750, claimed by the Appellant in the computation of taxable net income. This was the amount of attorneys' fee paid by her as administratrix in connection with the litigation with the Anglo-California National Bank, already mentioned,

The deduction was claimed by Appellant under Section 8 of the Act, which provides in part that:

"In computing net income there shall be allowed as deductions:

(a) All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. . ."

The Commissioner does not deny that this expense was "ordinary and necessary" for the purpose it served, but his refusal to allow the deduction was based on the ground that the administratrix was not engaged in carrying on any trade or business.

In support of this view the Commissioner relies on the proposition that an administrator or executor is not engaged in a business merely because of his activities in marshalling the assets of the estate and protecting its income, no matter how extensive and burdensome such activities may be (United States v. Pyne, 313 U. S. 127; Meanley v. McColgan, 49 A.C.A. 251).

It seems to us, however, that this legal expense was incurred in such a way that the activity which it involved was more than merely marshalling the assets of the estate and protecting its income. Certainly, the authorities cited by the Commissioner do not stand for the proposition that an estate, or the administratrix thereof, cannot be regarded as carrying on a business when, as the personal representative of the decedent, the administratrix succeeds to his activity in the management of corporate enterprises in which he held controlling interests. It must be conceded that Mr. FitzGerald at the time of his death was carrying on the business described earlier in this opinion. True, his activities had been subject to interference because of the seizure of his business by the bank in the contested proceedings with respect to the pledged corporate stock, but at the time of his death he was engaged in preparations to force the return of this stock and thereafter Appellant, as the administratrix of his estate, pursued this activity, culminating in the transfer of the stock to her.

Manifestly, it would be unjust to hold that because a person might be temporarily ousted from the management of a corporate enterprise in which he held a controlling interest that the expense necessarily incurred by him in regaining that control should be denied as a deduction in computing net income because *he* was not engaged in carrying on the business. The evidence shows that until the bank's interference Mr. FitzGerald was actively engaged in the management of the

corporate enterprises that he controlled; that at the time of his death he had employed counsel to assist him in regaining that control; that following his death, Appellant, as his administratrix, continued this employment and that, when as the result of the efforts of her attorneys, she regained control of the stock, she immediately became a director of the corporations and took an active part in their management, becoming president of the companies. Under such circumstances, we believe that the expense involved in restoring the control of the enterprises to the estate is a legitimate deduction in the computation of net income. This was not a mere marshalling of assets, but rather the continuance to a successful termination of a fight begun by the decedent in the protection of his business from ruin incident upon the seizure of his properties by a creditor in reliance upon a pledge agreement which the decedent claimed had been violated to his prejudice. Accordingly, we conclude that the deduction should have been allowed.

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 Charles J. McColgan, Franchise Tax Commissioner, in overruling the protests of Lillian Ryan FitzGerald as Administratrix of the estate of Gerald FitzGerald, deceased, and Lillian Ryan FitzGerald individually, to proposed assessments of additional personal income taxes in the amounts of $1,470.00, $605.56 and $2,052.51 for the years ended December 31, 1935, December 31, 1936, and December 31, 1937, repsectively, be and the same is hereby reversed insofar as said action involves the inclusion of taxable income for said years of the amounts of $9,805.53, $8,794.17 and $23,395.72, in 1935, 1936 and 1937, respectively, it having been determined to the satisfaction of the Board that said sums, and the whole thereof, were derived from the proceeds of insurance on the life of Gerald FitzGerald not properly to be regarded as earnings or profits of the corporation paying such sums to said Appellant as dividends; that said action be and the same is hereby further reversed insofar as it involves the disallowance of a deduction of $33,750.00 claimed by Appellant in the computation of taxable net income for 1937, it having been determined to the satisfaction of the Board that said deduction was an ordinary and necessary expense paid during the taxable year in carrying on the business in which Appellant was engaged; it is further ordered that in all other respects the action of said Commissioner in overruling the protests of said Appellant be and the same is hereby sustained and that the Commissioner is hereby directed to proceed with the recomputation of said assessments in conformity with the views herein expressed.

Done at Sacramento, California, this 7th day of July, 1942, by the State Board of Equalization.

R. E. Collins,,Chairman
Wm. G. Bonelli, Member
George R. Reilly, Member
Harry B. Riley, Member

ATTEST: Dixwell L. Pierce, Secretary