BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
GRACE R. GLASER)

Appearances:

For Appellant: Nathan Schwartz, Attorney at Law.

For Respondent: W. M. Walsh, Assistant Franchise Tax Commissioner; 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 overruling the protest of Grace R. Glaser to a proposed assessment of additional tax in the amount of $357.96 for the year ended December 31, 1936.

Appellant in 1936 was the owner of 60 shares of capital stock of the Iroquois Investment Corporation, a California corporation, the remaining 40 shares of which were owned by her son, Caryl S. Fleming. Both were residents of California. In 1932 the Corporation had purchased from Appellant certain securities, real estate and other assets for $1,318,479.48, the consideration therefor being a promissory note, bearing interest at the rate of 2% per annum, and providing for annual installment payments of principal. The Corporation had also purchased certain assets of a value of $134,123.77 from Caryl S. Fleming on similar terms. Appellant rented a residence from the Corporation and in the year 1936 paid a rental of $6,000.00 therefor, the rental being credited against interest due her on the promissory note given her by the corporation in connection with the sale of the securities to it.

The Commissioner determined that the Corporationwas a personal holding company within the meaning of Section 2(o) of the Act and that its income for the year 1936 was taxable to its stockholders under Section 34, providing as follows:

> "For the purpose of this act a personal holding company whether or not organized under the laws of this State shall not be recognized as a legal entity separate and distinct from the shareholders thereof. Any such company having more than one shareholder shall be deemed a partnership."

Appellant contends that as the Corporation was subjected to

a tax measured by its net income for the year 1936 under the Bank and Corporation Franchise Tax Act, taxation of the corporate income to its stockholders under Section 34 of the Personal Income Tax Act is improper since it involves the recognition of the corporate entity under the Bank and Corporation Franchise Tax Act but the disregarding of that entity under the Personal Income Tax Act and the treating of the Corporation as a partnership under the latter Act.

There is, of course, no constitutional objection to the taxing to a shareholder of dividends even though the corporate income which is the source of the dividends is also taxed. Welch v. Henry, 305 U. S. 134, 143. The authority of the Legislature to impose an income tax on shareholders of a personal holding company on the basis of the undistributed profits of the company as provided by Section 34 of the Personal Income Tax Act, has already been upheld. McCreery v. McColgan, 17 Cal. (2d) 555. Nor does the Appellant's position fare any better on grounds of statutory construction. In the first place, the Commissioner's determinations respecting the tax liability of the Appellant herein and the Iroquois Investment Corporation are not necessarily inconsistent as a matter of law since Section 34 of the Personal Income Tax Act expressly states "For the purpose of this Act" a personal holding company shall not be recongized as a legal entity separate and distinct from its shareholders. Then, too, from the standpoint of the policies expressed in the Bank and Corporation Franchise Tax and Personal Income Tax Acts, there is no inconsistency *in* the Commissioner's actions. A franchise tax measured by net income applies to the income of the Iroquois Investment Corporation because it is engaged in doing business in this State and does not fall within the exemption accorded holding companies by the Act. (See Appeal of Iroquois Investment Corporation, decided this day.) A personal income tax measured by her share of the undistributed profits of that Corporation is due from the Appellant, in lieu of such tax as might be due from her on any dividends paid to her by Corporation, in view of the legislative determination, the validity of which was upheld in the McCreery case, that such a method of taxation was advisable as a means of preventing tax avoidance.

Although we have concluded that the Commissioner acted properly in determining that the Iroquois Investment Corporation was a personal holding company within the meaning of the Personal Income Tax Act, there remains the question of the correctness of his action in taxing to Appellant 90.76% of the adjusted net income of the Corporation, In computing Appellant's share of the undistributed net income of the Corporation the Commissioner disregarded her 60% stock ownership and, after adjusting that income through the exclusion of the $6,000 income and $8,772.79 expenses incident to the residential properties conveyed by the Appellant to the Corporation, regarded as her share of the adjusted net income that proportion thereof as the assets transferred by her to the Corporation bore to the total assets transferred to it by her and her son.

The Commissioner seeks to justify his action in this connection by Section 24 of the Act, which provides as follows:

> "In any case of two or more organizations, trades or businesses (whether or not incorporated, whether or not organized in the State of California, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Commissioner is authorized to distribute, apportion or allocate gross income or deductions between or among such organizations, trades, or businesses, if he determines that such distributions, apportionment, or allocation is necessary (1) in order to prevent evasion of taxes of any taxpayer taxable hereunder, or (2) clearly to reflect the income of any such organizations, trades, or businesses where the income of any taxpayer taxable hereunder is affected thereby in such manner as to permit evasion of taxes."

We have some doubt as to the applicability of this Section in this present case, since it appears to authorize only the reallocation by the Commissioner of income between or among two or more organizations, trades or businesses, whereas the Commissioner has herein merely determined the extent of the respective interests of Appellant and her son in the Iroquois Investment Corporation.

Irrespective of that Section, however, we are not prepared to say that the Commissioner acted unreasonably in looking to the total assets conveyed to the Corporation by Appellant and her son, rather than to their stock ownership, in determining their respective interests in the Corporation. He was entitled, in our opinion, to look into the realities of the situation to ascertain their real equitable interests in the personal holding company. See Gregory v. Helvering 293 U. S. 465; Higgins v. Smith, 308 U. S. 473. His conclusion as to the unrealistic character of the stock ownership as an indication of real ownership finds support in the action subsequently taken in 1938 pursuant to agreement between the Corporation and its two stockholders. That agreement provided for the transfer of the assets of the Corporation to the stockholders in proportion to their respective transfers to it under the agreements of May, 1932, and for the cancellation of the promissory notes executed by the stockholders. The concluding paragraph of the 1938 agreement reads:

> "It is the intention and purpose of this agreement that all of the parties hereto do and perform *every* act necessary to place each of the parties as nearly as possible in the same position as though said agreement of May 20, 1932, had never been entered into,"

No dividends were ever distributed by the Corporation on the basis of stockholdings, or otherwise, and so far as we are informed no other action was ever taken by the Corporation which

involved recognition of the stockholdings of the Appellant and her son as indicative Of their respective real interests therein. In the lightof these circumstances we cannot say that action of the Commissioner in regarding as Appellant's income such portion of the income of the Corporation as assets contributed by her to it bore to the total assets contributed to it by her and her son was unreasonable or improper.

On one point, however, we do not believe that the Commissioner's action was correct. Before assigning to Appellant her share of the income of the Corporation, he adjusted that income by eliminating from gross income the $6,000 in rents received by the Corporation from Appellant for one of the real properties conveyed by her to the Corporation and by eliminating from deductions the $8,772.79 for repairs, depreciation and insurance on those properties. At the same time, however, the Commissioner included the value of the pro'perties in determining the portion of the Corporation's assets contributed by Appellant. Apart from his citation of Section 24 of the Act, the Commissioner was offered no explanation or justification for this adjustment of the Corporation's income and his action in this respect was not in our opinion authorized by law.

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 Grace R. Glaser to a proposed assessment of additional tax in the amount of $357.96 for the year ended December 31, 1936, pursuant to Chapter 329, Statutes of 1935, as amended, be and the same is hereby modified as follows: Said Commissioner is hereby directed to include the $6,000 in rents paid by said Grace R. Glaser to the Iroquois Investment Corporation in the gross income of that Corporation and to allow the deduction from such gross income of $8,772.79 for repairs, depreciation and insurance on the real properties conveyed by her to said Corporation in computing the net income of said Corporation for the purpose of allocating to said Grace R. Glaser her proper share of the net income of said Iroquois Investment Corporation under Section 34 of said Act; .in all other respects the action of the Commissioner is hereby sustained.

Done at Sacramento, California, this 11th day of May, 1944, by the State Board of Equalization.

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

ATTEST: Dixwell L. Pierce, Secretary