

BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA



In the Matter of' the Appeal of)
M. F. BERG

Appearances:

For Appellant: George T. Altman, 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 18593 of the Revenue and Taxation Code (formerly Section 19 of the Personal Income Tax Act) from the action of the Franchise Tax Commissioner on the protest of M. F. Berg to a proposed assessment of additional personal income tax in the amount of \$128.00 for the year 1939.

The assessment results from the inclusion by the Commissioner in the gross income of Appellant of the sum of \$3,200 received by Appellant as trustee under two trusts created by him on April 16, 1938, the beneficiary of each being on that date an adult daughter of Appellant, and the corpus of each consisting of 246 shares of the common stock of the California Mill Supply Corporation. Appellant was President of that organization and immediately prior to the creation of the trust owned 1,680 of its 3,000 outstanding shares. Other stockholders included the Flintkote Company and the El Rcy Products Company, each owning 600 shares. These companies, in neither of which Appellant had any interest, were the principal customers of California Mill Supply Corporation and elected four of the five members of its Board of Directors, Appellant being the fifth.

Except for necessary variations stemming from the difference in beneficiaries, the trust instruments are seemingly identical. Each names Appellant as sole trustee; each is made irrevocable and declares that the trustor is without power to modify any of its provisions; each vests the trustee with customary trustee powers of management and control, including the power "to vote any shares of stock in person or by proxy" and "to do any and all other acts in trustee's judgment necessary or desirable for the proper and advantageous management, investment, and distribution of the trust estate herein created." Each also empowers the trustee to allocate to corpus or income any trust money or other property received by him. As to any and all action taken by him within any discretion conferred, the decision of the trustee is made absolute and controlling and binding upon "all persons interested."

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Each trust provides that the net income available for distribution shall be paid to the beneficiary in quarterly or other convenient installments as follows: not less than 10% until she reaches 40; not less than 25% from ages 40 to 45; and not less than 50% from ages 45 to 50. When she reaches the age of 50, the beneficiary is to receive the corpus plus any accumulated income. If the beneficiary dies before she attains the age of 50, the trust corpus and any accumulated income is to be placed in her sister's trust, subject to all the terms and conditions thereof. There is no provision in either trust as to the disposition of the trust corpus and any accumulated income in the event that each beneficiary should die before she attains the age of 50.

There is also evidence that Appellant in 1941 transferred to his wife 540 of the 1200 shares of California Mill Supply Corporation which he owned personally after the creation of the trusts. In addition, the record shows that despite the fact that Appellant, personally and as trustee, and his wife owned a majority of the stock, various reorganization proposals which Appellant submitted to the Board of Directors were rejected by it from time to time during a period of several years immediately preceding the oral hearing in this case. Not only that, but it appears from the evidence that the directors turned down dividend recommendations made by Appellant, permitted no increase in his salary as President and in general controlled the policies of California Mill Supply Corporation. Furthermore, Appellant testified that California Mill Supply Corporation could not have remained in business without Flintkote Company and El Rey Products Company as customers.

The Commissioner maintains that he was justified in treating and taxing the trust income as Appellant's under Section 7(a) of the Personal Income Tax Act (the applicable provisions of which are now in Section 17101, Revenue and Taxation Code) on the ground that the creation of the trusts resulted in no substantial change in his economic position. He contends in this regard that the right given Appellant as trustee to vote the trustee stock of California Mill Supply Corporation, when coupled with his right to vote in his personal capacity the 1,200 shares not placed in trust, gave him voting control of all the company's outstanding stock, and that that was equivalent to his continued ownership of the trust corpus.

Appellant takes the position that regardless of his right to vote a majority of the stock the evidence shows that he neither had nor exercised any control over the Corporation, and that in any event his power to vote the trustee stock could only be exercised for the benefit of the trust, as would any other trustee power vested in him; consequently, it was improper for the Commissioner to conclude that Appellant continued to be the owner of the trust corpus for income tax purposes.

We believe that Appellant's view of the matter should be sustained. Although he does not say so directly, the Commissioner apparently relies upon the decision in Helvering v. Clifford, 309 U.S. 331, in which the United States Supreme Court stated in effect that a trustor-trustee of a family trust who retains

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economic control over the corpus of a kind usually associated with ownership will be taxed on the income of the trust under Section 22(n) of the Federal Internal Revenue Code on the theory that he has remained in substance the owner of the property notwithstanding the legal niceties of the trust arrangement. The Section mentioned which contains substantially the same language as Section 'i'(a) Of the Personal Income Tax Act, the latter, as a matter of fact, having been modeled after it, provides that "gross income" includes all "gains, profits,, and income derived ... from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever." Continued ownership in the trustor was found by the Court in the Clifford case in the short duration of the trust (five years), in the fact that the corpus would revert to the trustor on termination of the trust, inasmuch as the wife was the beneficiary, and in the vesting of broad powers of management and control over the corpus in the trustor in his capacity as trustee. The Court carefully pointed out, however, "that no one fact is normally decisive but that all considerations and circumstances of the kind we have mentioned are relevant to the question of ownership and are appropriate foundations for findings on that issue." 309 U.S. at 336. Furthermore, after noting that the issue as to the taxation of trust income to the trustor under Section 22(a) of the Internal Revenue Code is whether the trustor "may still be treated as the owner of the corpus," the Court stated: "In absence of more precise standards or guides supplied by statute or appropriate regulations, the answer to that question must depend on an analysis of the terms of the trust and all the circumstances attendant on its creation and operation." 309 U.S. at 334.

Aside from the single fact that by reason of the right given him by the trust instruments to vote the trustee stock in his capacity as trustee Appellant was thereby enabled to retain technical voting control of the outstanding stock of California Mill Supply Corporation, we find nothing in either the language of the instruments or in the circumstances relating to the creation of the trusts and their operation indicative of control tantamount to continued ownership of the corpus in Appellant. On the contrary, shelving for the moment the element of voting control, we find the evidence pointing exactly the other way. In the first place! each trust instrument provides explicitly that any powers vested in the Appellant as trustee thereunder shall be exercised "to carry out the purposes of this trust." While Appellant is given considerable latitude in such exercise, he is, of course? prohibited by law from taking personal advantage of the situation. Civil Code, Section 2228, et seq.; Overell v. Overell, 78 Cal. hpp. 251. In addition, the mere specification, as here, of broad trustee powers of management of a conventional nature in order to enable a trustee to function for the best interests of his trust is alone insufficient to support a finding of retained control for the trustor's individual benefit. Jones v. Norris, 122 Fed. 2d 6; Armstrong v. Commissioner, 143 Fed. 2d 700; Commissioner v. Branch, 114 Fed. 2d 985;

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United States v. Morss, 159 Fed. 2d 142.. Nor does it appear from the evidence-that the trusts or income therefrom were ever used by Appellant for other than trust purposes*

As for the matter of voting control, in considering the problem with reference to Section 22(a) of the Federal Internal Revenue Code, the Circuit Court of Appeals said in Kohnstamm v. Pedrick, 153 Fed. 2d 506, 509:

"One or two courts have considered it a relevant circumstance that the settlor - either as trustee, or having power over the trustee - was a high official in a company, a controlling number of whose shares were in the fund; but they have merely counted it as one of many factors which taken together left the 'ownership' in the settlor, and we have no way of knowing how much it weighed in their conclusion. Miller v. Commissioner, 6 Cir., 147 F. 2d 189, 193; Edison v. Commissioner, 8 Cir., 148 F. 2d 810."

It was held in the Kohnstamm case that the income for the years 1939, 1940 and 1941 from the trust there involved (in which a bank was the trustee, the corpus consisting of stock in a corporation of which the trustor was president and later vice-president, the trustor holding 23.3% of the outstanding voting shares, individually and as settlor, and having joint control of another 27.5%) was not taxable to the trustor. The trustor retained power to sell any part of the trust corpus and substitute other property therefor, possible power to terminate the trust and thus accelerate distribution to the beneficiary, and power to vote all shares of stock.

In Killer v. Commissioner, 147 Fed. 2d 189, one of the cases cited by the court in Kohnstamm v. Pedrick as authority on the point of voting control, the trustor created trusts whose properties consisted of a total of 9,300 shares of stock in a corporation which had 335,000 shares outstanding in the hands of 805 stockholders, the trustor also owning 9,100 shares individually and acting as attorney and secretary of the organization. Considering these facts along with provisions in the trust instruments, including some giving the trustor, as trustee, the right to vote the trusteed shares, the right to determine whether trust property should be treated as principal or income, and the right to deal in general with the trust property as though he were the "absolute owner thereof," the Court sustained a decision of the Tax Court taxing the trust income for the years 1937 to 1940, inclusive, to the trustor. Other elements present were the ages of the beneficiaries (21, 17 and 15 at the time of the creation of the trusts) and the possibility that the trustee in his discretion could prolong the life of the trusts until his grandchildren reached the age of 30.

In Edison v. Commissioner, 148 Fed. 2d 810, cert. den. 326 U.S. 721, also cited as 'supporting authority in Kohnstamm v. Pedrick, the trustor created two trusts, one for his minor

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daughter and the other for his adult son, in each of which he named himself the trustee. The trust properties consisted of an original aggregate of 5,000 shares of common stock in a corporation of whose 385,490 common shares outstanding the trustor at the date of the creation of the trusts owned 40,576, that making him one of the principal single stockholders. Hewasalso the president and a director of the corporation. By the terms of the trusts, tha trustor, as trustee, not only was vested with the right to vote the trusteeed shares, but was also given even wider powers of management and control than was the trustee in the Killer case. The powers included the right to invest trust property%! the trustor "were the absolute owner" of trust property in "his private individual capacity," the right to hold, manage and dispose of the trust property "according to 'his sole judgment and discretion," the right to retain trust property "without accountability for loss," the right to determine whether trust property shall be capital or income and to apportion losses between capital and income "in such manner and division as to him may seem just and equitable." In holding that the trust income for the years 1938 to 1941, inclusive, was taxable to the trustor, the Court stated that the powers mentioned, along with others giving him control over the disposition of the income; indicated that the trustor "intended to avoid subjecting himself to the restraints of a conventional fiduciary - holding of property in his handling of the trust estates, and has designed to leave himself in the position to apply his personal skill and earning capacity as an income and accumulation factor, in conjunction with the property, the same as before the trusts were created ..."

'The Miller and Edison decisions thus do seem to support the statement in the Kohnstamm case that where a trustor retains voting control of trusteeed stock issued by a company of which he is a high-ranking official, that is a relevant factor to be considered, together with any others that may be present, in determining whether the trustor has retained economic dominion and control for his own personal benefit. They also support a conclusion that mere voting control alone will not justify the taxing of trust income to the trustor individually. To buttress any such action, the taxing authorities must be able to point additionally to other manifestations of intent on the part of the trustor to maintain economic command.

Other cases similar either on their facts and holdings or in effect to the Miller and Edison cases with regard to the element of voting control include Funsten v. Commissioner, 148 Fed. 2d 805; McCutchin v. Commissioner, 159 Fed. 2d 472; Chertoff v. Commissioner, 160 Fed. 2d 691; Shapiro v. Commissioner, 165 Fed. 2d 811; Frank G. Hoover, 42 B.T.A. 786; Frederick Rentschler, 1 T.C. 814; and M. Friedman, 7 T.C. 54. Each upheld the taxing of trust income to the trustor involved.

We have also examined numerous other cases wherein the matter of voting control was clearly considered relevant, but nevertheless uncontrolling and alone insufficient to warrant the taxation of trust income to the trustor. These include Cushman v. Commissioner, 153 Fed. 2d 510; United States v. Morss, 159

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Fed. 2d 142; Alice O. and Lester A. Smith 4 T.C. 573; Ward Wheelock, 7 T.C. 98; David L. Loew, 7 T.C. 363; and Lewis W. Welch, 8 T.C. 1139. Another is Donald S. Black, 5 T.C. 759, in which the United States Tax Court refused to hold the trustor taxable where, aside from the maintenance of voting control by the trustor and his family, there was nothing else in the evidence to indicate the retention of an economic string. The Court specifically distinguished the case from Miller v. Commissioner and Funsten v. Commissioner, supra, on the ground that there was no language in the trust instrument considered by it specifically giving the trustee "full and plenary powers of investment such as he would possess if he were the absolute owner of the 'trust property in his private individual capacity.'" That is equally true of the terminology, in the trust instruments in the case at hand. Indeed, they are completely silent as to authority in Appellant to act as "absolute owner" for any purpose whatsoever.

It will be noted that the Court in the Kohnstamm case, supra, at pages 509-510, mentions Lewis A. Cushman, Jr., 4 T.C. 512, as the "nearest approach to any decision in which voting control appears to have played an important part ... where the Tax Court held that absolute power of management and investment, coupled with the power to vote the shares of a company in which the settlor was chairman of the board, subjected him to tax." After observing that the settlor had control of about 40% of the voting strength, the court went on to comment: "It is of course true that the ownership of enough shares to control a company adds to their value, and is often an important incident of ownership ...". All this we construe as equivalent to saying that the factor of voting control is not conclusively decisive of the issue as to whether a case comes within the ambit of the Clifford Doctrine, but is nevertheless something which should be weighed in conjunction with other relevant and material evidence. It will be further noted that, without in any way mitigating the effect and weight to be given the element of voting control, the Circuit Court of Appeals in 153 Fed. 2d 511 reversed the Tax Court in the Cushman case in holding that it did not consider the evidence in its entirety as indicative of the retention of the "facts of ownership."

The Commissioner mentions John Stuart, 2 T.C. 1103, which was before the Tax Court after remand by the United States Supreme Court in Helvering v. Stuart, 317 U. S. 154, the case involving some trusts the corpus of each of which consisted of stock in a company of which the trustor was president, the trustor and his immediate family, however, owning only 5.4% of the shares outstanding. After referring to a statement in the Supreme Court's opinion as to the control of the stock, determining the manner of the creation of the trusts, and assuming therefrom that the Supreme Court had in mind the possibility that the stock in the trusts might be essential to the maintenance of voting control in the company, the Tax Court stated (pages 1111-1112: "If this were the situation, it would be apparent that petitioners would realize an economic gain from such a control of the trust corpus." The Commissioner apparently seizes upon this language to support his thought that the retention of voting control through trustee

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stock renders the trust income taxable to the trustor. In so doing, however, he apparently has read something into the language for at the very most it seems to us that it says no more on the subject of voting control than that evidence of the same is relevant and requires consideration. Furthermore, in view of the fact that there was no voting control in the trustor in the Stuart case, it appears that anything which the Court therein stated on the matter was merely dictum.

In light of the foregoing, we are of the opinion that the Commissioner erroneously concluded that the single circumstances of retained voting control in Appellant called for an application of the rule of the Clifford case.

Aside from the trust instruments, we have other evidence in the record pointing directly to the conclusion that the Appellant did not retain any economic dominion and control over the trust corpus for his own personal ends. We refer to the evidence that both before and after the creation of the trusts actual control of the California Mill Supply Corporation was exercised by Flintkote Company and El Rey Products Company through their four representatives on the Board of Directors, and to the evidence that Appellant's technical voting control was never of any advantage to him as an individual. This is all quite significant in view of the statement in the Clifford case (309 U.S. at 334) that the circumstances of operation under a trust are to be considered along with the terms of the trust and the circumstances relative to its creation. See also Alice Ogden and Lester A. Smith, 4 T.C. 573; Donald S. Black, 5 T.C. 759767.

O R D E R

Pursuant to the views of the Board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to Section 18595 of the Revenue and Taxation Code, that the action of Chas. J. McColgan, Franchise Tax Commissioner, on the protest of M. F. Berg to a proposed assessment of additional personal income tax in the amount of \$128.00 for the year 1939, be and the same is hereby reversed.

Done at Sacramento, California, this 16th day of Decenzber, 1948, by the State Board of Equalization,

Wm. G. Bonclli, Chairman
J. H. Quinn, Member
J. L. Seawell, Member
Geo. R. Reilly, Member
Thomas H. Kuchel, Member

ATTEST: Dixwell L. Pierce, Secretary