BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
ESTATE OF DAVID H. MARCH, DECEASED, AND)
DOROTHY MARCH HENLEY, EXECUTRIX OF THE)
ESTATE OF DAVID H. MARCH, DECEASED)

Appearances:

For Appellant: Stanley M. Arndt, Attorney at Law

For Respondent: W. M. Walsh, Assistant Franchise Tax Commissioner; James J. Arditto, Franchise Tax Counsel

OPINION

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 protests of the Estate of David H. March, Deceased, and Dorothy March Henley, Executrix of the Estate of David H. March, Deceased, to proposed assessments of additional personal income tax in the amounts of $45.37 and $9.59 for the year 1938 and $158.22, $108.16 and $11.48 for the years 1939, 1940 and 1941, respectively.

David H. March died in 1938 and throughout the years involved herein his Estate was in the course of administration. The following issues are presented herein as respects the determination by the Commissioner of the tax liability of the Estate.

(1) In determining gain or loss realized upon the sale in 1939 of certain securities which were the community property of the decedent and his wife, the proceeds of the sale being used to pay expenses of administration, the Commissioner assigned to a one-half interest in the securities a basis of cost and to the other half a basis equivalent to its fair market value at the date of the decedent's death. Appellant contends that the entire interest in the stock was entitled to a basis of fair market value at the date of decedent's death.

(2) The Commissioner disallowed the deduction from gross income of certain accountant's expenses incurred by the Estate in connection with the administration of its securities and real property and the reporting of its income. Appellant contends that these expenses are deductible as business expenses.

As to the first issue, Section 9.3 of the Personal Income Tax Act provides, in part, as follows:

> "The basis of property shall be the cost of such property, except ...(5) If the property was acquired by bequest; devise or inheritance, or by the decedent's estate from the decedent, the basis shall be the fair market value of such property at the time of such acquisition."

The propriety of the Commissioner's action depends upon whether under the laws of California, the stock in question was "acquired" in whole or in part in the manner described in this provision. Although the wife has a present, existing and equal interest in community property during tile continuance of the marriage (Civil Code Section 161a), the management and control of such property is in the husband (Civil Code Sections 172 and 172a), subject to certain restrictions designed for the protection of the wife. The husband has the same "absolute power of disposition, other than testamentary, as he has of his separate estate" (Civil Code Section 172) as to non-restricted personal property and in spite of Civil Code 172a hrs sufficient power to dispose of community real property without the wife's consent or joint execution of a deed as to require her to return the consideration to an innocent purchaser in order to set the sale aside (Mark v. Title Guarantee & Trust Co., 122 Cal. App. 301); the sale is merely voidable by the wife. Maxwell v. Carlon 30 Cal. App. 2d 356.

With the one exception of the wife's earnings, the community property is liable for all debts of the husband, however and whenever contracted. This rule is derived from the husband's control over community property under Civil Code Sections 172 and 172a and is unaffected by the enactment of Civil Code Section 161a defining the wife's interest. Grolemund v. Cafferata, 17 Cal. 2d 679, cert. denied 314 U.S. 612. During the marriage the wife may file a separate income tax return on one-half of the community income (United States v. Malcolm, 282 U.S. 792) from property acquired after the enactment of Civil Code Section 161a. The Malcolm case is in no way affected by the holding in the Grolemund case. Commissioner of Internal Revenue v. Cavanaugh 125 Fed. 2d 366.

On the death of either husband or wife the community as such is dissolved end under Probate Code Section 201 "one-half of the community property belongs to the surviving spouse; the other half is subject to the testamentary disposition of the decedent ..." Section 202 of thnt Code provides, in part, that

> "Communitv property passing from the control of the husband, either by reason of his death or by virtue of testamentary disposition by the wife, is subject to his debts and to administration and disposal under the provisions of Division III of this Code..."

The situation of the community property after the death of the husband is comparable to that which existed during the husband's lifetime. Section 201 of the Probate Code recognizes the wife's one-half interest at death as does Civil Code Section 161a during the existence of the community. Section 202 makes the entire community liable for the husband's debts, as it was during the existence of the community, and during the administration of the estate the income of the community property is reportable one-half by the estate and one-half by the surviving widow (Bishop v. Commissioner of Internal Revenue 152 Fed. 2d 389), as it was during the existence of the marriage under the Malcolm decision. Thus, one-half of the stock in question belonged to the widow of David March, not by virtue of a bequest, devise or inheritance from, her husband, but by virtue of her interest in the community prior to his decease.

Appellant contends, however, that only thot portion of the wife's share in the community property which remains after the payment of the debts of the decedent, the family allowance and the charges and expenses of administration "belongs" to the wife, and, therefore, we assume, that share of stock held as community property which are sold to defray expenses of administration should be treated as property of the estate and not of the surviving spouse? and under Section 9.3(5) should have the same basis for determining gain or loss as property ccquired by the estate from the dacodent. Estate of Coffee, 19 Cal. 2d 248, is urged upon us as compelling this conclusion.

The Supreme Court, in the Coffee case, concluded that as a result of Probate Code Section 202 only that portion of the community property of the wife which remained after appropriate charges had been made, was excludible from the measure of the California Inheritance Tax. As the Appellant has pointed out, the Court said

> "It is clear, therefore, that the portion of the community property which belongs to the wife is the one-half which remains after the payment of the husband's debts and expenses of administration ..."

But the subjection of all the community property to the debts of the husband does not work a modification of the rule Of succession declared in Section 201. This the Court expressly recognized when it said

> "Section 201, like its predecessor, is a statute of succession. Section 202 is a legislative declaration that 'the community property' is chargeable with the husband's debts and is subject to the general provisions concerning the administration of the property of a decedent."
> 19 Cal. 2d 245 at 251.

Although the community property of the wife was subject to certain charges, the Estate did not, accordingly, succeed to it as succession is determined by Section 201.

Estate of Atwell, 85 A.C.A. 565 in following the Coffee case does not militate against this result despite certain language appearing therein, The Atwell and Coffee cases involve applications of the California inheritance tax laws. The District Court of Appeal stated in the Atwell case:

> "The inheritance tax is on the 'net succession'; that is, it is levied on what the beneficiary receives after lawful burdens and deductions during the course of administration."
>
> "One-half of the entire community belongs ad goes to the widow upon condition, the condition being that the property lawfully diverted during the course of administration, i.e., necessary for the payment of debts, expenses of administration, the Federal Estate Tax, etc., shall be used for such purposes and shall not go to the widow. The property so lawfully diverted therefore never passes to the widow."

It is difficult, if not impossible, to reconcile this language with the theory of the income tax cases under which one-half of' the income from community property is reportable by each spouse during the existence of the community and one-half is reportable by the estate and one-half by the surviving spouse after the death of the husband. In fact, it may readily be demonstrated that the language cannot be given its full import for purposes of income taxation. suppose, for example, that the husband died during 1938 leaving an estate consisting in part of community property in the form of securities as to which certain interest and dividend payments were made during the portion of the year following his death and that it was not necessary to dispose of nny of' the securities during 1938 to meet any charges against the estate. Clearly, one-half of the income from the securities realized after the date of the husband's death in 1938 would be reportable by the estate and the remaining one-half by the surviving widow. If the estate remained in the course of administration during 1939 and no portion of the securities was sold or distributed, the same rule would apply as respects the reporting of the income from the securities for that yenr. If the above-quoted language of the Coffee and Atwell decisions was recognized as controlling for income tax purposes, however, upon the sale in 1940 of the securities to meet expenses of administration it would appear that the surviving widow hzd not at any time after the death of her husband been the owner of a half interest in the securities and should not have been required to report one-half of the income therefrom on her return.

Since this is not the case, however? and unfortunately so as it would obviously be impractical to apply the annually computed income tax on this basis, it necessarily follows that the

language of those decisions is not determinative of the question of income tax liability. From an income tax standpoint it appears that it cannot be said that the interest of the surviving widow in the community property never passed to her, but the question is rather at what time she is divested of her interest.

The Commissioner cites Estate of Waters, 3 T.C. 407, in support of his position that the basis to be applied in determinin the gain or loss from the sale of the stock by the Estate is one-half the cost of the stock plus one-half of its fair market value at the time of the decedent's death. The United States Tax Court did, undoubtedly, so hold in that matter in applying Section 103(a)(5) of the Internal Revenue Code which is similar to Section 9.3 of the California Act. It should be observed, however, that the taxpayer in that matter did not object to the taxation to it of the entire gain from the sale of the stock and that the decision of the Tax Court is inconsistent with Bishop v. Commissioner of Internal Revenue, 152 Fed. 2d 389, holding that one half the gain or loss from the sale of community property by the estate of the husband is reportable by the surviving widow. Under this decision and the authorities relating to the interest of the wife in community property, it must be held that the widow's share of the gain from the sale of the stock in the instant case is reportable by her and that only the remaining one-half of that gain is reportable by the Estate. The basis to be applied in computing the gain to the Estate, in accordance with Seotion 9.3 of the California Act, is one-half the fair market value of the stock as of the date of the death of the husband.

As to the second question, we agree with the Commissioner that the issue is controlled by the decision in the case of Meanley . McColgan, 49 Cal. App. 2d 203. Prior to the 1943 amendment of Section 8(a) of the Act only ordinary and necessary expenses paid or incurred during the taxable year "in carrying on any trnde or business" were deductible from gross income of the taxpayer. In the Meanley case the Court held that attorney's fees incurred by the executor of a large estate in the management of real property held for income purposes were deductible as expenses incurred in carrying on the trade or business of the estate, but that such fees incurred in the management of investment securities were not so deductible. It follows, accordingly, that the cction of the Commissioner in limiting the deduction for accounting fees to the portion attributable to real property and excluding the fees attributable to securities must be upheld.

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 13595 of the Revenue and Taxation Code, that the cction of Chas. J. McColgan, Franchise Tax Commissioner, on the protests of the Estate of David H. March, Deceased, and Dorothy March

Henley, Executrix of the' Estate of David H. March, Deceased, to proposed assessments of additional personal income tax in the amounts of $45.37 and $9.59 for the year 1938 and $158.22, $108.16 and $11.48 for the years 1939, 1940 and 1941, respectively, be and the same is hereby modified; the Commissioner is hereby directed to determine the income of the Estate from the sale of the securities in question as one-half of the selling price thereof less one-half' of the value thereof as of the date of the death of the decedent; in all other respects the action of the Commissioner is hereby sustained.

Done at Sacramento, California, this 15th day of December, 1948, by the State Board of Equalization.

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

ATTEST: Dixwell L. Pierce, Secretary