BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
HARRY COHN)

Appearances:

For Appellant: Spencer R. Thorpe, Attorney at Law

For Respondent: W. M. Walsh, Assistant Franchise Tax Commissioner; James J. Arditto, Franchise Tax Counsel; Milton A. Huot, Assistant 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 protests of Harry Cohn to proposed assessments of additional personal income tax in the amounts of $3,817.41 and $686.92 for the years 1937 and 1938, respectively.

The assessments resulted from the inclusion as Appellant's personal income of the income from two trusts created by him on April 3, 1937, one for the benefit of his niece Leonore Cohn and the other for the benefit of his niece Judith Cohn, each of whom was then a minor, The corpus of each trust consisted of a voting trust certificate representing 2,500 shares of common voting stock of Columbia Pictures Corporation. At the date of the creation of the trusts, Appellant was President and a Director of the Corporation and owned 70,500, about 22 per cent, of its outstanding 320,000 common voting shares. His brother Jack Cohn, Vice-Presider: and also a Director, owned 28,000 of such shares, and they, togethe with A. H. Giannini, President and Director of a bank to which the Corparatioq was indebted, were trustees of a voting trust in which 96 per cent of the total outstanding voting shares were deposited, including, apparently, all shnres herein mentioned. The voting trust certificates placed in the trusts established by Appellant were issued by this voting trust. The Appellant also ownad'stock purchase warrants issued by Columbia Pictures Corporation which entitled him to subscribe to 24,586 of its common shares at $16.7623 per share, the option thus given expiring on June 30, 1937. The shares were selling on the market immediately prior to April 3, 1937 at $37 per share.

It appears that Appellant had actually been supporting his two nieces for some time, even claiming them as dependents for income tax purposss although not legally liable for their support, and that ha estnblished the trusts by reason of a desire to provide for them with the potential profit residing in the stock purchase warrants, not wishing to exercise the warrants himself and thus add to his own Columbia stock holdings? So prompted, he conceived a plan under which, in addition to the trusts, a corporation to be known as the JHL Company was to be formed. The entire stock of this organization was then to be purchased by the trusts and the corporation, in turn, was to purchase Appellant's warrants and exercise them. The plan was carried out, the trusts purchasing all the JHL stock for $125,000, JHL purchasing the warrants from Appellant for $202,663, payable in 10 equal annual installments, and JHL then converting the warrants into Columbia common, the latter being made subject to the voting trust. The shares received by JHL, selling at the time on the market at $33 per share, had a value of $811,338.00.

Except for variations occasioned by the difference in beneficiaries, the provisions of the trusts were identical. Each named Appellant as sole trustee and as such he was vested with general power "to manage and control all of the Trust Estate upon such terms and conditions as in his judgment may seem best and proper." He was specifically empowered to transfer, lease, mortgage and otherwise dispose of the trust property, to borrow money upon such terms "as he, in his sole discretion shall determine," to sell any property "without being liable for any loss thereby incurred,'? and to invest trust funds in such securities as he "in his sole discretion shall deem for the best interests of the Trust Estate," and whether or not such securities are legal investments for trust funds. He was authorized to hold securities in his own name either as trustee or individually, to apportion dividends between income and principal "as to him may seem just and fair," and to exercise all rights accruing to the trust by reason of its ownership of securities "to the same extent and as fully as any individual could with respect to properties owned individually by him." When exercising any voting power, he could vote for himself or any other person as he saw fit, and could accept offices or positions to which he might have become eligible by reason of the holding by.the estate of any securities. He was permitted to sell the original trust assets and use the proceeds to purchase the stock of the JHL Company; and, as trustor or trustee, might sell the latter any stock, or voting trust certificates representing the stock, of Columbia Pictures Corporation, or any warrants to acquire such stock or certificates, at such price nnd upon such terms and conditions as he in his sole discretion might determine, It was provided that "any such sale shall be vali and shall not be subject to disaffirmance by reason of any of the fiduciary relationships. .." In addition, Appellant could enter into any other trcnsnction with the trust or JHL Company affecting the trust, such transaction to be valid and impregnable to attack if ratified and approved by Judith Cohn and Leonore Cohn, or the survivor, Indeed, any act of Appellant as trustee was valid against all persons, including the beneficiaries, if authorized, ratified or approved by Judith and Leonore, or the survivor. He was furthermore not liable for any error of judgment in administering the trust, but was liable for his own wilful neglect or default or for acts in bad faith.

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The net income of each trust was payable to the beneficiary for life and if she died without issue to her sister for her lifetime. The income was to be accumulated, however, for the beneficiary until she reached the age of twenty-five or married, with provision for payment or application by the trustee, in his sole discretion, for the use or benefit of the beneficiary of "any portion of such income reasonably necessary or desirable for her support, care, maintenance, or education." Each trust terminated upon the beneficiary's death if she left any issue; if she did not and was survived by her sister, then upon the death of her sister. Thereupon, the corpus was to be distributed to the beneficiary's issue; or if none, to any issue of the sister; and if none of the latter, to the heirs-at-law of the survivor. Each trust also provided that it might be revoked, changed, or amended by written instrument signed by Appellant and the beneficiary and filed with the trustee.

There are two major questions presented here for consideration: (1) whether by reason of the fact that the trust income might be used by Appellant as trustee for the support of his nieces, whose support he had assumed but for which he was not legally liable, Appellant is taxable on such income under the holding in Helvering v. Stuart, 317 U.S. 154, and, we assume, a similar decision of our Supreme Court in Borroughs v. McColgan, 21 Cal. 2d 481; and (2) whether he is taxable thereon on the basis of the principle laid down in Helvering v. Clifford, 309 U.S. 331.

It was held in the Stuart case that if the income of a trust created for the trustor's minor children can in his discretion as trustee be used for the support of the children, whether actually so used or withheld and accumulated, such income is taxable to the trustor under Section 167 of the Federal Internal Revenue Code, which provides for taxing trust income to the trustor if it "may, in the discretion of the grantor or of any person not having a substantial adverse interest in the disposition of the income, be distributed to the grantor." The decision in the Borroughs case was similar, the Court there considering comparable language in Section 12(h) of the California Personal Income Tax Act.

The Commissioner contends, in effect, that the rule of these cases is applicable here since Appellant had assumed the obligation of and actually had been supporting his nieces, and because the trusts give him the right to use trust income in implementation of such obligation. He does not claim, however that there was any legal obligation on Appellant's part to provide such support, nor is there any evidence in the record that that was the case.

In view of the lack of such a legal obligation, it seems to us that the matter at hand cannot come within the scope of that rule, which, as we understand it, presupposes or is conditioned upon the existence of a parental or marital obligation to support enforceable by law and which may legally be satisfied with trust income.

Coming now to the question relative to the Clifford case, we find that the United States Supreme Court held therein that tho technicalities of the law of trusts will be ignored to the extent of treating a trustor-trustee of a family trust as in substance the owner of the corpus in his individual capacity for the purpose of Section 22(a) of the Federal Internal Revenue Code ,if it appears that despite the creation of the trust he has not in fact relinquished his economic dominion and control over the trust principal. Section 22(a), which is substantially the same as Section 7(a) of the Personal Income Tax Act (now Section 17101 of the Revenue and Taxation Code), provides that "gross income" includes "gains, profits and income. . . growing out of the ownership or use of or interest in. . . property. . . ." It was found in the Clifford case that the trustor-trustee there involved remained in substance the owner of the corpus because (1) the trust, being for five years, was of short duration; (2) the corpus would revert to the trustor on the termination of the trust; (3) the trustor's dependent wife was the beneficiary; and (4) broad powers of management and control were vested in the trustor in his capacity as trustee. The Court stated

> ". . ..We have at best a temporary reallocation of income within an intimate family group. Since the income remains in the family and since the husband retains control over the'investment he has rather complete assurance that the trust will not affect any substantial change in his economic position.)' 309 U.S. at 334,

The Court went on to say that "no one fact is normally decisive but that all considerations and circumstances of the kind we have mentioned are relevant to tile question of ownership and are appropriate foundations for findings on that issue." 309 U.S. at 336. In addition, after noting that the issue as to the taxation of the trust income to the truetor under Section 22(n) of the Internal Revenue Code is whether the trustor "may still be treated as the owner of the corpus," the Court further said

> ". . ..In absence of more precise standards supplied by Statute or appropriate regulations, answer to that question must depend on an analysis of the terms of the trust and all the circumstances attendant on its creation end operation." 309 U.S. at 334.

We are of the opinion that the instant situation is not within the purview of the Clifford Rule. In arguing for the taxability-of the trust income to Appellant, the Commissioner mentions the broad trustee powers of management nnd control which Appellant may exercise. For the most psrt, however, they appear to be of a kind ordinarily granted a trustee so that he may function to the advantage and for the best interests of the trust, and as such they alone will not support a finding of retained control for the trustor's individual benefit of a character sufficient to call for an application of tho Clifford Rule, Jones v. Norris, 122 Fed. 2d 6; Armstrong v. Commissioner, 143 Fed. 2d 700; Hall v. Commissioner, 150 Fed. 2d 304; United States v. Morss 159 Fed. 2d 142. As stated by Nossaman in his work entitled "Trust Administration and Taxation," Vol. 2, Sec. 666, pages 149-150

> "It seems clear, however, that the fact that the grantor is also trustee or may remove and appoint trustees or retains broad power of management does not, independently of other circumstances, render him liable for the tax on the income. Such reservations are consistent with bona fide trust arrangements."

The Commissioner also claims that the powers vested in Appellant to vote any stock owned by the trusts and to accept offices in the issuing corporations, coupled with his presidency of Columbia Pictures Corporation and his ownership of stocktherein, which he can vote through the voting trust along with the stock covered by the voting certificates constituting the trust corpus of the JHL Company, manifest a retention of the type of control contemplated by the Clifford case. In this also we do not concur. For one thing, even if we grant that Appellant could exercise voting control through the voting trust, as to which we are dubious in view of the fact that there are two other voting trustees with equal voice, such control, while a relevant circumstance and something definitely to be taken into consideration, is by no means decisive but is merely to be weighed in conjunction with all other factors bearing on the issue, Kohnstamm v. Pedrick, 153 Fed. 2d 507; Cushman v. Commissioner, 153 Fed. 2d 510; United States v. Morss 159 Fed. 2d 142; Funsten v. Commissioner, 143 Fed. 2d 805; Miller v. Commissioner, 147 Fed. 2d 189; Edison v. Commissioner, 148 Fed. 2d 810, cert. den. 326 U.S. 721; Chertoff v. Commissioner, 160 Fed. 2d 691; Shapero v. Commissioner, 165 Fed. 811. Moreover, as stated in Cushman v. Commissioner, supra, at page 514, "the power to vote the stock held in trust may not be exercised by the trustee for his own purposes."

In the Miller, Edison and Funsten cases, supra, the Clifford Rule was applied in each to subject the trustor to tax on the trust income on the basis of a combination of circumstances which included voting or business control, trustee powers of a broad and- unconventional character, and a power so to control the disposition of the income, either by an express provision for its withholding or accumulation or specific authority to shift it to another than the primary beneficiary, that the latter might never enjoy it during his lifetime. A similar, or nearly similar, combination will be found in almost all the cases in which voting or business control, along with other factors, has apparently been of some importance in leading to the conclusion that the trust income involved was taxable to the trustor under the Clifford Doctrine.

Here, there is nothing in either of the trust instruments involved, aside from possible voting control, which can even conceivably present a situation analagous to that considered in the Miller, Edison and Funsten cases. As we have stated, the trustee powers are of a conventional nature. Furthermore, the mere power in Appellant to withhold trust income until a beneficiary marries or reaches the age of twenty-five will not in all probability result in keeping the income from the beneficiary.

The power is so limited that the beneficiary may reasonably expect to receive and enjoy the income within her lifetime. It may be noted additionally that there is no evidence indicating that Appellant ever used his voting control or trustee powers for his own personal ends.

The Commissioner also argues that the corpus of each trust might revest in Appellant with the consent of the beneficiary, who, according to the Commissioner, is without a substantial adverse interest, and that, therefore, the income is taxable to Appellant under Section 12(g) of the Personal Income Tax Act (now Section 18171 of the Revenue and Taxation Code), which provides that if title to the trust corpus may revest in the grant or without the consent of any person having a substantial adverse interest in any part of the corpus or trust income, and the revesting is not contingent upon the death of the beneficiary, the income is taxable to the trustor. We believe, however, that the Commissioner's premise that the beneficiary has not a substantial adverse interest is very obviously erroneous in view of the fact that a revocation would clearly deprive her of valuable property rights in the trust income and corpus. Commissioner v. Katz, 139 Fed. 2d 107, 110.

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 protests of Harry Cohn to proposed assessments of additional personal income tax in the amounts of $3,817.41 and $686.92 for the years 1937 and 1938, respectively, be and the same is hereby reversed.

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