48-SBE-039

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
JACOB PALEY)

Appearances:

For Appellant: Earl S. Wright, 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 Jacob Paley to a proposed assessment of additional personal income tax in the amount of $5,432.40 for the year 1938.

Aside from a minor adjustment to which the Appellant has not objected, the assessment arose out of the inclusion as Appellant's personal income of the income from property transferred irrevocably by Appellant by way of gift to a trust declared orally by him for the benefit of his daughter Jacqueline on August 1, 1929, and later, as to some of the property, reduced to writing on November 27, 1937. On the former date Jacqueline was approximately four years of age and on the latter, twelve, her date of birth being December 27, 1925. The trust corpus on August 1, 1929, consisted entirely of cash in the amount of $500,000, but under Appellant's trust administration up to December 1, 1937, the cash was transmuted by investments and loans into other types of proper' including corporate shares of stock with apparently considerable financial gain to the trust. Except for an entry upon Appellant's records of the fact of the gift and the establishment of a trust account in his daughter's name, there was no other evidence of the trust prior to the trust. instrument of November 27, 1937, which was drafted for the purpose of "memorializing in writing the terms conditions and limitations" of the original gift in trust, with respect, however, only to specified shares of trusteed stock listed therein.

In the trust instrument Appellant names himself the trustee, but reserves the right to resign at any- time and appoint a successor. He further reserves the right as trustor to remove any trustee thus appointed "with or without cause." He also provides for the appointment of a corporate trustee after his death in the event that he is then still acting as trustee.

Under other terms of the trust, any person acting as trustee is empowered to sell, exchange or lend ths principal or invest it in any property in which trust funds may by law be invested, "Upon such terms and conditions as said Trustee may deem to be for the best interest of said trust ..." If Appellant himself is the trustee, he may, as trustee, invest the corpus "in such investments as he in his sole discretion shall determine, whether the same is permissible far investment of trust funds or not, said Trustee to use reasonable precaution to protect all persons interested in this trust from loss by reason of such loans and/or investments."

The trustee powers mentioned in the preceding paragraph are of a kind customarily included in trust instruments, so also are other powers mentioned in the instrument under consideration, including some covering the borrowing of money, the leasing of property, the determination of principal, gross income and distributable income, the advancement of personal funds to the trust at prevailing rates of interest, the handling of trust securities as though the trustee is the owner thereof, and the holding of such securities in his own name. Customary, too, are provisions that the discretions conferred on a trustee are "absolute and uncontrol nnd that he "shall hove for the full duration of this trust, as to the trust estate, the income therefrom, and in the execution of this trust, the same and all the powers and discretions that an absolute owner of property has or may have." There is also language to the effect that in the exercise of his functions, the trustee shall hot be responsible for anything which does not constitute gross negligence.

It is additionally provided that if Appellant resigns as trustee and appoints a successor, the latter has no authority during Appellant's lifetime to iqvest, reinvest, loan or reloan the trust estate, or to sell, exchange or otherwise dispose of any property therein, "without first receiving written directions and instructions++ from Appellant. In that regard, "Trustor expressly reserves the right to himself and/or his nominees during his lifetime, the full right and authority to direct the Trustee in all matters concerning the investments, sales, exchanges or other disposition of this trust estate..." It is also provided, however, that Appellant, as trustor, has ho right to direct the substitute trustee to dispose of the trust income or principal except for the benefit of the trust estate and the beneficiary.

While Appellant acts as trustee, the net income of the trust is to be paid to him "as Trustee, for the use and benefit++ of his daughter. If a substitute trustee is appointed, the net income is to be paid to and received by Appellant "as Trustee for said beneficiary . . ." Moreover, where another acts as trustee, Appellant reserves the right to require him "by appropriate instructions, to hold or invest said net income or any part thereof, and in such event the same shall be added to the principal" of the trust and be dealt with as such, After Appellant's death, the entire net income is. to be paid to the beneficiary, with provision that if' the net income is lass than $12,000 a year, the trustee may invade the corpus to make up the difference. He also may pay

out such additional principal which in his discretion he decides is necessary for the beneficiary's "reasonable expenses incurred for education, medical expenses and other necessities of life... Upon the beneficiary's death the trust is to terminate and the entire corpus and any income accumulated thereon are to be distributed to the legal representative of her estate.

On December 1, 1937, Appellant resigned as trustee r-ad appointed The Farmers & Merchants National Bank of Los Angeles to act in his stead and thot organization then accepted the appointment.

It also appears from the record that the trust was created by Appellant far the purpose of giving his daughter economic security during her lifetime and especially after his death; that he has maintained separate books and bank accounts for the trust income received by him for his daughter's benefit; and thnt a Federal gift tax return evidencing the transfer in trust was filed by Appellant and a Federal gift tax paid by him thereon. Tha record also indicates that, except for some expenditures which apparently were improperly made with trust income after 1940, no part of such income has ever been used by Appellant for his daughter's support, and that Appellant is a man Of substantial means who has always been able to support his daughter with his own funds.

The Commissioner's proposed assessment and the memoranda filed herein in support of his position indicate quite clearly that his primary reason for making the assessment was the thought that the trust income might have been used by Appellant under the terms of the trust in the discharge of his parental obligation to support his daughter, and that, consequently, whether or not the income was so used, it is taxable to Appellant by virtue of the decisions in Helvering v. Stuart, 317 U.S. 154, and Borroughs v. McColgan, 21 Cal. 2d 481.

In Helvering v. Stuart the United States Supreme Court held as to a trust created for the benefit of the trustor's minor children, which provided specifically that the trustees should "pay over to (the beneficiary) so much of the net income from the Trust Fund, or shall apply so much of said income for his education, support and maintenance, as to them shall seem advisable . . . , the unexpended portion, if any, of such income to be added to the principal of the Trust Fund," that the income therefrom was taxable to the trustor even though not paid over for the purposes specified. The California Supreme Court held similarly in Borroughs v. McColgan with respect to the income from two trusts established for the benefit of the trustor's minor children, which also expressly provided that the trustee in his discretion could either accumulate the trust income or use it for the "education, support, maintenance and amusement" of the beneficiaries. The statutory basis for the decision in the Stuart case was a provision in Section 167 of the Federal Internal Revenue Code taxing trust income to the trustor if such income "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 statutory ground in the Borroughs case was identical language in Section 12(h) of tho

Personal Income Tax Act, now in Section 18172 of the Revenue and Taxation Code. It may be noted that in 1943, the year following the decision in the Stuart case, Congress amended Section 167 of the Internal Revenue Code to provide that income which may be applied or distributed for the support or maintenance of a beneficiary whom the trustor is legally obligated to support is not taxable to the grantor except to the extent that the income is so applied or distributed, The amendment was made effective with respect to taxable years commencing after December 31, 1942, with a provision making it retroactive to prior years on the filing of certain consents with the Commissioner of Internal Revenue. The California law was similarly amended in 1945, which was two years after the decision in the Borroughs case, by the addition of Section 18173.1 to the Revenue and Taxation Code; but, unlike the Federal, the amendment is not retroactive and applies only to taxable years commencing after December 31, 1944 (Stats. 1945, Chap. 645, Sec. 123). Since the taxable year here involved is 1938, we are not concerned with the amendment, but must look rather to the principles of the Stuart and Borroughs cases.

In determining the propriety of the Commissioner's view of the matter, it becomes necessary at the outset to ascertain whether Appellant could legally use the trust income in meeting his legal obligation to support his minor daughter, for unless he could do so, it seems to us that the Stuart and Borroughs cases are inapplicable.

We note, in the first place, that the trust instruments construed in those cases expressly authorized the use of trust income for the support, maintenance and education of the beneficiary during the period of his minority. In other words, each trustee there involved was given specific authority to make payments for support purposes. And so also was the trustee in every other case examined by us in which the Stuart-Borroughs rule was applied, Here, on the other hand, we have a situation in which the trustor, when also acting as trustee, is simply to receive the trust income in his latter capacity "for the use and benefit" of his daughter, or when not also acting as trustee, is merely to receive it "as Trustee for said beneficiary", nothing being said in addition relative to the expenditure of the funds for support or any other purpose. The Commissioner argues, however, that the language just quoted is so broad in its connotation as to embrace and authorize expenditures in satisfaction of Appellant's obligation to support his daughter, and that, therefore, we have here a factual picture comparable to those dealt with in the Stuart and Borroughs cases. But he fails to submit any clear legal authority in favor of such a construction. As a matter of fact, the only authority of which we are ware is, in our opinion, directly to the contrary.

In Shanley v. Bowers, 81 Fed. 2d 13, there was before the court a trust instrument which in part merely provided for the payment of $25,000 a year to the trustor's dependent wife. In answer to an argument that this provision was in discharge of the trustor's marital duty of support, "and so within the principle of Douglas v. Willcutts, 296 U.S. 1," a case generally considered the

progenitor of the Stuart-Borroughs rule, the Court stated:

> ". . . But the trust instrument says nothing about discharging such marital duty, nor is there any outside evidence of the settlor's intention to do so, Certainly a man mast be able to make his wife a gift, if he wishes, without affecting his maritalduty. No authority has been cited for the theory that every gift by a husband to his wife must be presumed to be in discharge of it, Nothing short of this will suffice to sustain the contention in the case at bar." 81 Fed.2d, at 15.

To the same effect is Suhr v. Commissioner, 126 Fed. 2d 283.

We believe that the Court's reasoning in the Shanley case is of equal application here, particularly since the rule of the Stuart and Borroughs cases has, to our knowledge, never been applied except where the trustor had clearly indicated his intent that the trust income be used by the trustee in fulfillment of the trustor's legal duty to support. Without some specific authority of that kind, it seems to us that the trustee, irrespectiveof whether he is also the trustor, wouldclearly be guilty of a violation of his trust in using the trust income in satisfaction of the trustor's personal obligation, or, for that matter, for my other purpose inconsistent with the trustor's declared intent to make a gift by way of trust for the sole advantage of the beneficiary. Civil Code, Section 2229. Furthermore, in the absence of any evidence to the contrary, it cannot be assumed that a trustee will act otherwise than for the best interests of the trust and beneficiary. Hall v. Commissioner, 150 Fed. 2d 334; Nossaman's "Trust Administration and Taxation," Vol. 2, Sec. 666, pp. 149-150. There is no such contrary evidence here as to the year 1938. While there is some evidence that trust income was used after 1940 to meet Appellant 's parental obligations, we believe that any consideration respecting the circumstances of that use and the effect thereof should be deferred until such time as a question may arise as to the taxability of trust income during the year or years involved.

For the foregoing reasons, we are unable to agree with the Commissioner that the rule of the Stuart and Borroughs cases requires the taxation to Appellant of the 1938 trust income here involved.

As an alternative ground, the Commissioner argues that under the so-called Clifford Rule (based on the decision in Helvering v. Clifford, 309 U.S. 331) the trust income can be taxed to Appellant on the theory that he never ceased to be the owner of the trust corpus in view of the broad powers of control vested in Appellant by the trust instrument in both his capacity as trustee, when acting as such, and his role of trustor.

The United States Supreme Court held in the Clifford case that the technicalities of the law of trusts will be ignored to the extent of treating a truotor-trustee of a family trust as the owner of the corpus in his individual capacity for the purposes 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), whichis substantially the same as Section 7(a) of the California Personal Income Tax Act (now Section 17101 of the California 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 effect any substantial change in his economic position," 309 U.S. at 335.

The Court want 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 the question of ownership and are appropriate foundations for findings on that issue.'? 309 U.S. at 336. In addition , af tar noting that the issue as to the taxation of the 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 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 Cf the trust and all the circumstances attendant on its creation and operation.'? 309 U.S. at 334.

We are unable to agree with the Commissioner, however, that the terms and attendant circumstances of the trust under consideration bring it within the Clifford Rule. Generally speaking, the trustee powers of management and control vested by the trust instrument in Appellant while acting as trustee are of 3 kind which are customarily given a trustee in order to enable him to function to the advantage and for the best interests of the trust, As such, they alone will not 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; 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, pp. 149-150:

> "It seems clear, however, that the fact 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."

And as said in Helvering v. Stuart:

"On the other hand broad powers of management in trustees, even though without adverse interest, point to complete divestment of control, as does/the impossibility of reversion to the grantors." 317 U.S. at 169.

As for the several powers which Appellant has reserved for exercise in his capacity as trustor, we find nothing in anything there contained which might be construed as a retention of control for his personal economic advantage. The mere right to remove and appoint trustees is not so indicative; nor is the lone power to direct and instruct the trustee as to investments or the accumulation of trust income. David Loew, 7 T.C. 363; Central National Bank of Cleveland v. Commissioner, 141 Fed, 2d 352.

There is some possibility here/that the trust corpusand any accumulated income thereon may revert to Appellant if his daughter should predecease him. It seems to us, however, that this contingency is so remote as to be almost negligible, and therefore of no significance in any consideration of the question of retained control. United States v. Morss, supra; Suhr v. Commissioner, supra.

ORDER

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 Jacob Paley to a proposed assessment of additional personal income tax in the amount of $5,432.40 for the calendar year 1938, be and the same is hereby modified; the action of the Commissionor in including in the gross income of said Jacob Paley certain trust income in the amount of $38,638 is hereby reversed; in all other respects the action of the Commissioner is hereby sustained.

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

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

ATTEST: Dixwell L. Pierce, Secretary