BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the appeal of)
)
G.D.ROBERTSON CO., INC.)

Appearances:

For Appellant : Charles J. Higson, Attorney at Law

For Respondent: Burl D. Lack, Chief Counsel; Mark Scholtz, Associate Tax Counsel

OPINION

This appeal is made pursuant to Section 25 of the Bank and Corporation Franchise Tax Act (Chapter 13, Statutes of 1929, as amended) from the action of the Franchise Tax Commissioner (now succeeded by the Franchise Tax Board) on the protests of G. D. Robertson Co., Inc. , to proposed assessments of additional tax in the amounts of $49.57 and $169.92 for the income years 1943 and 1945, respectively.

In 1925 an employee of Appellant embezzled property belonging to appellant worth some '$144,000. While recovery might have been had from the surety on a faithful performance bond previously furnished by the employee, Appellant did not so seek recovery, but rather had the employee assign his assets over to it and credited the sums realized therefrom to an account receivable in the amount of $144,000 which it set up on its books as due from him. Included in the assigned property were three insurance policies naming the employee as the insured and providing both life insurance and disability insurance coverage. Following the assignment Appellant paid the premiums falling due on the policies, doing likewise with respect to two other policies of the same nature as those assigned as to coverage but which had been purchased directly by Appellant from the insurer. In 1938 the employee became totally incapacitated and thereafter disability payments were made under each of the five policies to Appellant. The payments received under the assigned policies prior to Appellant's income years 1943 and 1945 exceeded the aggregate amount of the premiums paid out by Appellant on such policies before those years. AS of January 1, 1943, however, the premiums paid out by Appellant on the purchased policies exceeded the payments received under those policies by $1,226.25. In each of the income years 1943 and 1945, Appellant received disability payments in the amount of $1,450 on the assigned policies and in the sum of $1,800 on the purchased policies, and out of the aggregate turned over to the employee $1,457 in 1943 and $1,672.55 in 1945. The amounts received by Appellant were not reported as income to it for the years mentioned, but the Commissioner believed that they should have been and based the proposed assessments under consideration in part thereon.

Other property assigned by the employee to Appellant included some realty consisting of land and a dwelling thereon, the Appellant and the Commissioner agreeing that the latter on the date of assignment in 1926 had a basis of $1,898.95. The dwelling was apparently approximately 10 to 15 years old when acquired by the Appellant and was carried on Appellant's books from 1926 to 1945 at a figure of $2,000, no deductions having been taken for depreciation during that time. Appellant sold the property in 1945, and in reporting a resulting gain as income for that year, treated the dwelling &s having a life expectancy in 1926 of 33 years and a consequent adjusted basis in 1945 of $805.59. The Commissioner, however, considered that the dwelling had a life expectancy of 33 years when new and a remaining life of only 18 years in 1926, and that, therefore, it had been fully depreciated prior to 1945, so that in that year its adjusted basis was zero. This determination also accounts in part for the proposed assessment for the income year 1945. At the hearing of this matter Appellant's Vice-President testified concerning the nature of the building and that it had a life expectancy when built of about 50 years. His testimony was not controverted by the Commissioner.

With respect to the treatment of the disability payments as income to Appellant, the latter contends that they are within the scope of the following provisions of Section 6(b) of the Bank and Corporation Franchise Tax Act:

> "(b) The term 'gross income' does not include the following items which shall be exempt from taxation under this act:
>
> (1) Amounts received under life insurance policies and contracts paid by reason of the death of the insured but if such amounts are held by the insurer under an agreement to pay interest thereon, the interest payments shall be included in gross income.
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> (2) Amounts received (other than amounts paid by reason of the death of the insured) under life insurance, endowment or annuity contracts, either during the term or at maturity or upon surrender of the contract, equal to the total amount of premiums paid thereon. In the case of a transfer for a valuable consideration by assignment or otherwise, of a life insurance, endowment or annuity contract or any interest therein, only the actual value of such consideration and the amount of the premiums and other sums subsequently paid by the transferee shall be excluded from gross income under paragraph (b)(1) of this section . . ."

Appellant urges that the payments received on the purchased policies are nontaxable under the first sentence of Section 6(b)(2) until all the premiums which it has paid out on such policies have

been recovered by it; and that as to the payments received under the assigned policies, in view of the second sentence of 6(b)(2) no portion thereof is taxable until all the $144,000 embezzled by the employee is recovered by Appellant, $25,000 thereof being still unpaid and chargeable to him on its books at the end of 1945. It argues, in the alternative, that if the payments received under any of the policies are subject to tax, it should be allowed offsetting deductions in the amounts turned over to the employee, the theory here being that such amounts constituted payments in consideration of past services performed by him and, therefore, were in the category of ordinary and necessary business expenses.

It is our view, however, that these contentions of the Appellant are unsound. Section 6(b)(1) and (2) do not provide, in our opinion, any exclusion or exemption for amounts received pursuant to the disability coverage provisions of an insurance policy. Since disability insurance as such is not specifically mentioned in the Section, it appears that it cannot be considered as being subject to the provisions thereof unless it can be said to be embraced 'by the term 'life insurance." That, however, does not seem to 'be the case. Our insurance Code draws a clear line between the two kinds of insurance, listing each as a separate class of insurance in Section 100. The Code defines "life insurance" in Section 101 as including "insurance upon the lives of persons or appertaining thereto, and the granting, purchasing or disposing of annuities" and "disability insurance" in Section 106 as including "insurance pertaining to injury, disablement or death resulting to the insured from accidents, and appertaining to disablements relating to the insured from sickness" and in Section 10110, et seq., sets forth various provisions particularly applicable to each type. In addition, it is to be observed that despite the inclusion in Sections 22(b)(1) and (2) of the Internal Reveriue (2) of the Bank and Corporation Franchise Tax Act, Section 22(b)(5 of that Code expressly provides for the exclusion of amounts received as disability insurance. Indeed, we find in our own Personal Income Tax Law, in Section 17127 of' the Revenue and Taxation Code, a similar express exclusion of disability insurance payments notwithstanding other provisions in Sections 17122 and 17124 which are the counterparts of those in Sections. 6(b)(1) and (2).

Although we believe that Sections 6(b)(1) and (2) do not provide for exclusion of disability insurance payments, we nevertheless think that thesa payments are excludibla as a return of capital to the extent that premiums to an equivalent amount have been paid for the disability insurance, it being the intent of the Bank and Corporation Franchise Tax Act to include only income in the measure of the tax thereby imposed. See Section 4; Fullerton Oil Co. v. Johnson, 2 Cal. 2d 162. With respect to the purchased policies, however, Appellant has not submitted any proof that it has not recovered the portion of the premiums paid relating to the disability coverage. It has merely stated that it has not recovered all the premiums paid on the policies, the unrecovered amount being $1,226.25 as of January 1, 1943, but this could

relate in whole or in part to the prtion of the premiums paid for life insurance coverage. The burded was clearly on Appellant to show how much was paid for the disability coverage in order to justify a-n exclusion from taxation of any portion of the disability payments (see Corporation of America v. Johnson, 7 Cal. 2d 295; People v. Richardson;" 37 Cal. App 2d275), the maximum of such an exclusion being limited to the amount thus shown, The premiums paid for the life insurance coverage were not also excludible since no part of the payments received was for life insurance.

As for the assigned policies, there is no issue as to the excludibility of premiums paid. The issue is rather one as to whether any payments received can be treated as taxable income until the entire $144,000 embezzled by the employee is recovered by Appellant. We agree with the Commissioner that the payments should be considered as a return on Appellant's own investment in the policies, rather than in extinguishment of any indebtedness from the employee? and, consequently, taxable to the extent that they exceed Appellant's capital investment in the policies as income to it since Appellant became the owner of the policies at the time and by virtue of the assignments. (See Peoples Finance and Thrift Company (June 13, 1949) Docket No. 15919, 12 T.C. No. 136.

Any loss sustained by Appellant by reason of the embezzlement could have been deducted as a loss under Section 8(d) of the Bank and Corporation Franchise Tax Act, that Section providing for a deduction of losses "sustained during the income year and not compensated for by insurance or otherwise ...," and not, as Appellant apparentiy supposes, as a bad debt under Section 8(e). See C. T. Haskell, T. C. Memo. Op. Dkt. No. 112627-8, Feb. 28, 1944; Merten's "Law of Federal Income Taxation,*' Vol. 5, Secs. 28.59 30.05.

Appellant has not met the burden resting upon it (Botany Worsted Mills v. United States, 278 U. S. 282; Wagegro Corporation, 38 B.T.A. 1225; Miller Mfg. Co, v. Commissioner, 149 Fed. 2d 421) of establishing that the amounts of the disability payments which it turned over to the employee in 1943 and 1945 were deductible under Section 8(a) of the Act as a reasonable allowance for compensation for personal services actually rendered by him. In fact, the evidence indicates that the paymenets to the employee constituted gifts to enable him to meet living expenses rather than payments of compensation.

The Commissioner's proposed assessments were also based in part on the inclusion in the Appellant's gross income of dividends of $34.70 in 1943 and $68.20 in 1945 on the aforementioned insurance policies. Since no evidence or argument has been presented by the Appellant with respect to the matter, this action of the Commissioner must be sustained.

There remains for uonsideration only the correctness of the Commissioner's view that the dwelling sold by Appellant in 1945 had an adjusted basis of zero at that time, rather than, as con-

tended by the Appellant, an adjusted basis of $805.59. While the Commissioner's determination of the point was presumptively correct (Todd v. McColgan, 89 A.C.A. 562), we believe that such presumption was overcome and Appellant's position sustained by the uncontroverted evidence offered by the Appellant's Vice-President.

ORDER

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 25 of the Bank and Corporation Franchise Tax Act, that the action of the Franchise Tax Commissioner (now succeeded by the Franchise Tax Board) on the protests of G. D. Robertson Co., Inc., to proposed assessments of additional tax in the amounts of $49.57 and $169.92 for the income years 1943 and 1945, respectively, be and the same is hereby modified as follows: said action is hereby reversed in so far as the Commissioner has reduced the adjusted basis of the dwelling sold by Appellant in 1945 from $805.59 to zero; in all other respects said action is hereby sustained,

Done at Sacramento, California, this 5th day of January, 1950, by the State Board of Equalization.

George R. Reilly, Chairman
J. H. Quinn, Member
J. L. Seawell, Member
Wm. G. Boneili, Member

ATTEST: Dixwell L. Pierce, Secretary