BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of

S. F. PELLAS

Appearances:

For Appellant: Brobeck, Phleger & Harrison Attorneys at Law

For Respondent: Burl D. Lack, Chief Counsel; Milton A. Huot, Mark Scholtz and Paul L. Ross, Associate Counsel

OPINION

This appeal is made pursuant to Section 18593 of the Revenue and Taxation Code from the action of the Franchise Tax Commissioner (now succeeded by the Franchise Tax Board) on the protest of S. F. Pellas to proposed assessments of additional personal income tax for the years 1939, 1940 and 1941 in the amounts of $359.38, $525.30 and $3,688.25, respectively, those assessments having been redetermined by the Commissioner in the amounts of $322.89, $477.92 and $2,200.25, respectively.

The proposed assessments resulted from the attributing by the Commissioner to Appellant of income from an irrevocable trust established by a trust agreement dated December 31, 1934, between Appellant, as Trustor, and Alice Mae Pellas, his wife, as Trustee, the pertinent passages of which are as follows:

> "Second: The Trustee shall accumulate the net income from the Trust Property until such time as both of the now living children of the Trustor shall have attained the age of twenty-one years, or if one of such children shall die prior thereto, then until such time as the survivor shall have attained the age of twenty-one years, after which the Trustee shall pay the net income from the Trust Property thereafter accruing

to the issue of the Trustor by right of representation, When both of the now living children of the Trustor shall have attained the age of thirty-one years, or if one of such children shall die prior thereto, then at such time as the survivor shall have attained the age of thirty-one years, or upon the death prior thereto of the last survivor of said now living children of the Trustor, the trust shall, terminate and the Trustee shall pay over, deliver and convey the Trust Property to the issue of the Trustor by right of representation, or, if none be then living, then to Alice Mae Pellas, the wife of the Trustor. The now living children of the Trustor are ROSITA JANE PELLAS, who was born September 30, 1927, and GLORIA VICTORIA PELLAS, who was born February 27, 1929.

"Third: Notwithstanding anything else herein contained, in the event the Trustee shall at any time determine that the proper maintenance, education, care, comfort or support of the beneficiaries of this trust, or any of them, or any illness or emergency affecting them or any of them, so requires, the Trustee may pay to or for the benefit of each one so requiring it such of the principal or accumulations of the Trust Property as she shall deem necessary or proper, in addition to any amounts then payable to such beneficiary out of the income from the Trust Property, and the judgment and determination of the Trustee as to the necessity and amount of such payment or payments shall be conclusive."

During the years 1939, 1940 and 1941 the beneficiaries of the trust were minors. Although all the income of the trust for those years was accumulated such income was taxed in its entirety to Appellant by the Commissioner on the basis of the decisions in Borroughs v. McColgan, 21 Cal. 2d 481, and Helvering v. Stuart, 317 U. S. 154.

The staturoty basis of the Stuart case, decided November 16, 1942, was Section 167 of the Internal Revenue Code, which provided that trust income is taxable to the trustor if it may be distributed to him either in his discretion or that of any person not having a substantial adverse interest. Because trustees without any interest adverse to the grantor had uncontroller discretion to use the income of the trust for the education, support and maintenance of the grantor's minor children, the possibility of the use of trust income. to relieve the grantor pro tanto of his parental obligation was held sufficient to make the entire income of such trust taxable to him, whether or not the grantor used it for that purpose; The Borroughs case, decided January 22, 1943, involved the application of Section 12(h) of the Personal Income Tax Act, the California counterpart of Section 167, to somewhat similar facts and tho decision was the same as in the Stuart case.

In 1943 Congress amended Section 167 to limit the taxing of trust income to the trustor under such circumstances to the income actually applied. or distributed for the support of the beneficiary, with a provision making the amendment retroactive to prior years on the filing of certain consents with the Commissioner of Internal Revenue, thereby consummating what has been termed a "retroactive repeal of the Stuart case." David Small, 3 T. C. 1142. The California law was similarly amended in 1945 by the addition of Section 18173.1 to the Revenue and Taxation Code, this amendment, however, not being retroactive. Stats. 1945, p. 1283.

The purpose of Sections 12(h) and 167 is to prevent tax avoidance and they are to be interpreted in the light of that purpose. Hopkins v. Commissioner, 144 Fed. 2d 683. That the rule of the Stuart case has its limitations is demonstrated by the decisions in Commissioner of Internal Revenue v. Katz, 139 Fed. 2d 107; Robert P. Scherer, 3 T. C. 776; Alex McCutchin, 4 T. C. 1242; J. M. Leonard, 4 T. C. 1271; Jane C. Hemphill, 8 T. C. 257; Thomas W. Cullen, T. C. M. Dec., Docket 794, entered July 15, 1944; and E. A. Obering, T. C. M. Dec.; Dockets 13526. 13527, entered February 26, 1948, involving situations not reached by the retroactive operation of the 1943 amendment to Section 167. Thus, in Jane C. Hemphill tho Tax Court construed a provision permitting use of trust income for the needs of the beneficiary in case of accident, sickness, or other unforeseen emergency as exercisable only if the parent is unable to fulfill his parental obligation to his children. During the taxable period no such accident, sickness or emergency occurred and no expenditures were made. Section 167, therefore, was held inapplicable.

In Robert P. Schercr, supra, the Tax Court distinguished, from the Stuart case trust instruments under which the trustee was empowered to use the income of the trust for the support, maintenance and education of the minor beneficiaries only when Scherer, the grantor, was unable to provide properly for them, it being shown that at all times he was able to provide amply for his children and that none of the income of the trust was used for such purpose.

In E. A. Obering, supra, the trust was set up for the express purpose of creating a fund to provide each of the grantor's children with a college education. The trust agreement, however, contained the following language:

> "FOURTH: If it shall appear to the satisfaction of the trustee that any benefici-, ary hereunder shall-be in need of support, care or maintenance, at any time during the trust, and without regard to the cause thereof, the trustee may, in his discretion, pay to or apply for the benefit of such beneficiary, during the period such beneficiary is in need of support, care or maintenance, such amounts out of such beneficiary's share of the income, or if the same be. insufficient, out of such beneficiary's share of the principal, as the trustee shall deem appropriate for the care, support and maintenance of such beneficiary."

In construing the trust agreement the Tax Court determined that the case before it was fully as strong for the'petitioners as was the Scherer case. The trust was primarily for the benefit ofhildren while they were in college and the income was to be used at other times only where it appeared "to the satisfaction of the trustee" that a beneficiary was in need of support, care or maintenance. The evidence showed that the children were not in college and that their parents were able to support them.

In the trust agreememt with which we are. concerned the primary purpose was to accumulate an estate for the benefit of the settlor's children after they reached their majority. It thus clearly appears, as in the Obering case, that the provision permitting the use of income from the trust for the support, maintenance and education of the beneficiaries while in their minority was intended as a protective clause, to be *exercised* only in the event the grantor became unable to furnish such support. The parents, during the years 1939, 1940 and 1941 were able to support and educate their children and none of the trust income was used or distributed for such purposes. We conclude, therefore, that the trust income for those years was not attributable to the grantor.

The Commissioner contends that the Obering case is not decisive of this appeal because of the decision in Curtis A. Herberts, 10 T. C. 1053. The trust instrument considered in the Herberts case, however, provided that such portion of the trust income as in the discretion of the trustee is reasonably necessary for the care, maintenance, support and education of the beneficiary was to be distributed quarterly, or at other intervals, for his use and benefit during his minority. Thus, in contrast to the instant trust, it appears that the Herberts trust was created primarily for the support and maintenance of the beneficiary during minority, the provision for accumulation being subordinate to that purpose.

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 18595 of the Revenue and Taxation Code, that the action of the Franchise Tax Commissioner (now succeeded by the Franchise Tax Board), on the protest of S. F. Pellas to proposed assessments of additional personal income tax for the years 1939, 1940 and 1941 in the amounts of \$359.38, \$525.30 and \$3,688.25, respectively, those assessments having been redetermined by the Commissioner in the amounts of \$322.89, \$477.92 and \$2,200.25, respectively, be and the same is hereby reversed.

Done at Sacramento, California, this 22d day of July, 1952, by the State Board of Equalization.

J. L. Seawell, Chairman

J. H. Quinn, Member

Geo. R. Reilly, Member

________________, Member

Thomas H. Muchel, Member

ATTEST: Dixwell L. Pierce, Secretary