

BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeals of)
JENNIE CROCKER HENDERSON)

Appearances:

For Appellant: Edward L. Mulliner,
Attorney at Law

For Respondent: Tom Muraki,
Associate Tax Counsel

O P I N I O N

These appeals are made pursuant to section 18594 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protests of Jennie Crocker Henderson against proposed assessments of additional personal income tax in the amounts of \$4,066.73, \$4,887.85, \$5,207.83 and \$7,009.99 for the years 1959, 1960, 1961 and 1962, respectively.

The sole issue raised by these appeals concerns whether the periodic payments received by appellant from St. Francis Investment Company were includible in full in appellant's gross income, or were taxable as annuity payments under the provisions of section 17101 of the Revenue and Taxation Code.

Appellant's brother, Templeton Crocker, died on December 12, 1948. By his will he set up a testamentary trust of the residue of his estate after payment of specific bequests and taxes. The trust property consisted principally of real estate and stock which had a net value, as of the date of his death, of \$2,649,752.92. Appellant was named life beneficiary of the income from that trust, and at her death the trust property was to be distributed to her issue.

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On November 2, 1955, appellant and the St. Francis Investment Company (hereafter referred to as "St. Francis") entered into an agreement whereby appellant transferred all her right, title and interest in the trust to St. Francis, in consideration for that company's agreement to make regular "annuity" payments to her in the amount of \$28,500 each quarter-year, or a total of \$114,000 per annum, for the remainder of her life. Since its incorporation under California law in 1930 St. Francis had been engaged principally in the business of owning and renting commercial real properties. It also invested in stocks of various corporations, Twenty percent of its capital stock was held by appellant and the rest was held by her three adult children and trustees for her grandchildren. Her stock was redeemed in December 1961.

After November 2, 1955, the trustee distributed the net income of the trust to St. Francis, as the purchaser of appellant's life interest. The following amounts of trust income were distributed to St. Francis during the years on appeal:

<u>Year</u>	<u>Amount</u>
1959	\$ 167,425.25
1960	199,862.35
1961	256,316.24
1962	240,793.02

In each of these years, appellant received payments totalling \$114,000 from St. Francis, pursuant to the terms of the agreement.

In her federal and state income tax returns for 1956 and subsequent years, appellant treated the transaction of November 2, 1955, as the purchase of an annuity. Under the provisions of section 17101 of the Revenue and Taxation Code, amounts received as an annuity under an annuity contract are excludible from gross income, except to the extent of 3 percent of the consideration paid for the annuity, until the aggregate amount excluded exceeds the amount paid for the annuity.

The value of appellant's life interest in the trust as of November 2, 1955, when she was 69 years of age, and therefore also the cost to her of the "annuity!" was \$1,316,748.46. In each of the years in question appellant included 3 percent of that amount, or \$39,502.45, in her gross income. She excluded \$74,497.55 per annum, the difference between the \$114,000 she received annually from St. Francis and \$39,502.45, as a recovery of the cost of the annuity.

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Respondent determined that the \$114,000 received by appellant from St. Francis in each of the years on appeal was includible in its entirety in appellant's gross income, since it amounted to nothing more than a substitution for the income which appellant would have received had she retained her interest as life beneficiary under the trust created by the will of her brother. Respondent thereupon issued its proposed additional assessments based upon inclusion in appellant's gross income of an additional \$74,497.55 in each year. Respondent's denial of appellant's protests against those assessments gave rise to these appeals.

Appellant's position is based upon federal case law to the effect that the transfer of a life interest in trust property gives rise to capital gain rather than ordinary income. (Bell's Estate v. Commissioner, 137 F.2d 454; Allen v. First Nat. Bank & Trust Co., 157 F.2d 592; McAllister v. Commissioner, 157 F.2d 235.) The courts in those cases relied in part on the conclusion of the United States Supreme Court in Blair v. Commissioner, 300 U.S. 5 [81 L. Ed. 4651, that a life income interest in a trust constitutes an equitable interest in the trust corpus which is transferable like any other property interest, in the absence of a valid restraint on alienation. An assignment of such an interest in its entirety was held to be a transfer of a capital asset, an interest in the trust assets themselves, and not merely an assignment of the right to Income. (Bell's Estate v. Commissioner, supra.)

In support of its contention that the payments received by appellant from St. Francis constituted ordinary income, respondent relies primarily on the case of Commissioner v. P. G. Lake, Inc., 356 U.S. 260 [2 L. Ed. 2d 743). There the owners of mineral interests transferred oil payment rights and sulphur payment rights in fixed dollar amounts plus interest, in consideration for cash and the cancellation of debts. As had been anticipated, the assigned rights paid out in two to three years. The assignors reported the assignments as sales of capital assets which resulted in capital gains. The commissioner contended, and the Supreme Court of the United States agreed, that the consideration for the rights was taxable as ordinary income. Although the Court conceded that the payment rights constituted interests in land, it held that there had been no conversion of capital investments, but rather that the substance of what was assigned by the owner of the mineral interests was the right to receive future ordinary income. Respondent argues that this Lake doctrine should govern our decision in the instant case.

In reaching its decision in Commissioner v. P. G. Lake, Inc., supra, the Supreme Court emphasized that the

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payment rights which were assigned constituted only carved-out portions of the assignors' mineral interests, the assignors retaining the balance of their interests. It was also noted that the "pay-out" of those assigned rights could be ascertained with reasonable accuracy. The Court quoted a ruling by the Commissioner of Internal Revenue, distinguishing the case in which the assigned right constitutes the assignor's entire interest in the property, or a fraction of that interest extending over the entire life of the property. It also observed that the consideration received by the assignor for the assignment was equivalent in amount to the income which would accrue from oil payments during the term of the assignment,

In the case before us appellant transferred all her right, title and interest in the trust to St. Francis. There was no "carving-out" of an interest less than her entire interest. She retained no reversionary interest in the trust which would be enjoyed and possessed by her in the future, upon expiration of an assigned right. In addition, the annual payments which she was to receive from St. Francis for the remainder of her life appear to bear little relationship in amount to the income actually received and distributed by the trust. She did not contract for a percentage of trust income, but instead settled for a flat sum which was to be paid to her each year by St. Francis, regardless of the amounts it received in the future from the trust. In view of these distinguishing facts, we do not consider the bake decision controlling in this case.

In Gladys Cheesman Evans, 30 T.C. 798, a decision rendered several months after the Lake decision, the Tax Court considered a case much like the one before us. In the Evans case the taxpayer-, a life income beneficiary of a trust, conveyed her entire interest in the trust to her husband, in exchange for his agreement to pay her a lifetime annuity. The taxpayer treated the payments received from her husband pursuant to their agreement as recovery of her cost basis in her interest in the trust. The commissioner contended that those payments constituted ordinary income. The Tax Court scrutinized the transaction carefully, and determined that by her agreement with her husband the taxpayer had made a valid transfer of her beneficial interest in the trust and had correctly reported the annuity payments which she received as a recovery of the basis of her life income interest in the trust. The Commissioner of Internal Revenue formally acquiesced in that decision. (1958-2 Cum. Bull. 5.)

In reliance on the federal decisions which have dealt with this precise issue, we conclude that appellant's

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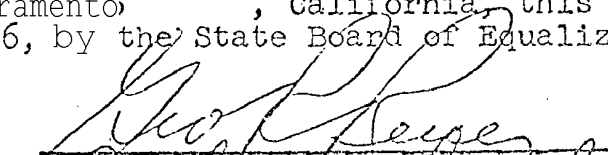
transaction with St. Francis constituted the sale of a capital asset in consideration for an annuity, rather than a mere transfer of a right to future income,. Appellant therefore properly reported the payments received from St. Francis in accordance with the provisions of section 17101 of the Revenue and Taxation Code,

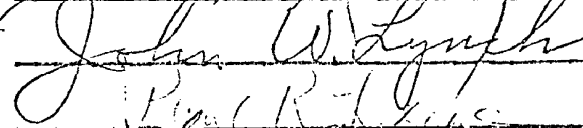
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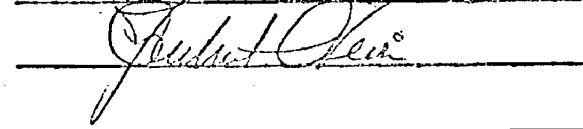
Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

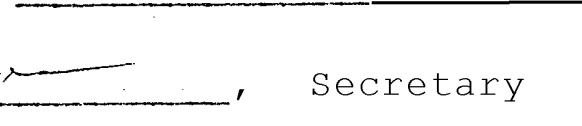
IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 18595 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protests of Jennie Crocker Henderson against proposed assessment of additional personal income tax in the amounts of \$4,066.55, \$4,887.85, \$5,207.83 and \$7,009.99 for the years 1959, 1960, 1961 and 1962, respectively, be and the same is hereby reversed,

Done at Sacramento, California, this 6th day of October, 1966, by the State Board of Equalization.



Chairman


Member


Member


Member

Member

Attest:  Secretary