BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
JOHN Z. AND DIANE W. MRAZ)

For Appellants: Stanley E. Jennings
Attorney at Law

For Respondent: Crawford H. Thomas
Chief Counsel

Marvin J. Halpern
Counsel

OPINION

This appeal is made pursuant to section 18594 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of John Z. and Diane W. Mraz against proposed assessments of additional personal income tax in the amounts of

$232. 46, $194. 49, and $171.40 for the years 1965, 1966, and 1967, respectively . Mr. Mraz is involved only because he filed a joint return. Consequently, Mrs. Mraz will be referred to as appellant.

Prior to his death in 1934, appellant's grandfather created four trusts under which appellant acquired future interests as a remainderman. Upon the death of her father in 1965, appellant acquired a present interest in each of the trusts and first began receiving distributions of trust income. Such distributions continued during all of the appeal years,

When appellant and her husband filed their joint California personal income tax returns for the years 1965-1967, they computed their tax liability by means of the income averaging method set forth in sections 18241-18244 of the Revenue and Taxation Code. Respondent determined, however, that they were not entitled to average their income because they did not have averageable income in excess of $3,000 in each year, as required by section 18241. In making this determination, respondent concluded that appellant's trust income had to be excluded from the computation of averageable income. Whether that conclusion was correct is the question we must resolve.

Under section 1.8241 "averageable income" is subject to a reduced rate of tax if an eligible individual has more than $3,000 of such income for a particular taxable year (which is termed the "computation year"). During the years in question, subdivision (a)(I) of section 18242 defined "averageable income" as the amount by which "adjusted taxable income" exceeds 133 1/3 percent of average base period income (which is one-fourth of the sum of the taxpayer's incomes for the four years immediately preceding the computation year). The term "adjusted taxable income" was defined as the taxable income for the computation year, decreased by, among other things:

> The amount of net income attributable to an interest in property where such interest was received by the taxpayer as a gift, bequest, devise, or inheritance during the computation year or any base period year.. .. (Former Rev. & Tax. Code, § 18242, subd. (b)(2)(A).)

Resolution of this appeal depends upon whether respondent correctly classified appellant's trust income as income attributable to "an interest in property" received gratuitously "during the computation year or any base period year." For the reasons expressed below, we believe respondent was correct.

Former section 18242 and its companion sections were adopted by California in 1964, shortly after Congress added substantially identical provisions to the Internal Revenue Code, (Int. Rev. Code of 1954, §§1301- 1305.)1/ It is settled law in California that when state statutes are patterned after federal legislation on the same subject, the interpretation and effect given the federal provisions by the federal courts and administrative bodies are relevant in determining the proper construction of the California statutes. (Andrews v. Franchise Tax Board, 275 Cal. App. 2d 653, 658 [80 Cal. Rptr. 403]; Rihn v. Franchise Tax Board, 131 Cal. App. 2d 356, 360 [280 P. 2d 893].) Since the federal courts apparently have never been called upon to interpret Internal Revenue Code section 1302(b)(2)(A), which is the virtually identical federal counterpart of section 18242, subdivision (h)(2)(A), respondent based its action in this case on the federal regulation that construed the pertinent language. That regulation, which was adopted in 1966 but made applicable to years beginning after December 31, 1963, provided in relevant part as follows:

> (2) Date of receipt. -- (i) For purposes of section 1302(b)(2) and this paragraph, an interest in property is received at the time an individual has a present right to such property or the income from such property. ...
>
> (ii) An individual may receive, at various times, different interests in a single property. ... (Treas. Reg. 4 I. 1302-2(c)(2), T.D. 6885, 1966-2 Cum. Bull. 307, 311-312.)

1/ Subsequent to the years on appeab the statutory language in question was deleted from both the federal and California tax laws.

Following this construction of the statutory language, respondent determined that appellant's trust income was attributable to "an interest in property" received "during the computation year or any base period year," since appellant first acquired a present right to that income in 1965, the year her father died.

Although respondent's reliance on the federal regulation in this matter would appear to be well supported by the case law cited above, appellant contends that the regulation is not controlling. First, she argues that the regulation may not be assumed to represent the intent of the California Legislature in adopting former section 18242, since the regulation was not promulgated until two years after the state statute was enacted. Second, she alleges that the regulation is invalid because it differentiates between present and future interests in property, a distinction that she believes is not supported by either the language of the federal statute or its legislative history.

There is no question that the federal regulation involved here does not have the persuasive force that would attach, for example, to a federal judicial decision of similar import rendered prior to California's adoption of former section 18242. (Andrews v. Franchise Tax Board, supra; see Meanley v. McColgan, 49 Cal. App. 2d 313 [121 P. 2d 772].) But it is also clear that the regulation is a relevant factor to be considered in determining the proper interpretation of the state statute, even though the regulation postdated enactment of former section 18242. (Andrews v. Franchise Tax Board, supra.) Thus, the timing of the regulation affects the weight it receives for state tax purposes, but does not eliminate it from consideration in determining the intent of the Legislature.

As indicated previously, appellant has also alleged that the regulation's interpretation of the statutory language is invalid because it distinguishes between present and future interests in property. While it is clearly the exclusive province of the federal courts to rule on the propriety of a federal regulation, they have not had occasion to make such a ruling, and we therefore believe that we legitimately may consider this issue in assessing the amount of weight the regulation should be accorded. In order to determine whether there is any reason to doubt the regulation's validity, an examination of the background leading to enactment of the 1964 federal averaging provisions is necessary.

The legislative history of those provisions indicates that Congress sought to create an averaging scheme of more general application than was provided for by then existing law, and that it was primarily concerned with ameliorating the effects of the progressive tax rate structure on taxpayers engaged in occupations peculiarly susceptible to wide variations in yearly income. The report of the House Ways and Means Committee says, in part:

> A general averaging provision is needed to accord those whose incomes which [sic] fluctuate widely from year to year the same treatment accorded those with relatively stable incomes. Because the individual income tax rates are progressive, over a period of years those whose incomes vary widely from year to year pay substantially more in income taxes than others with a comparable amount of total income but spread evenly over the years involved.. .. The absence of any general averaging device has worked particular hardships on professions or types of work where incomes tend to fluctuate. This is true, for example, in the case of authors, professional artists, actors, and athletes as well as farmers, fishermen, attorneys, architects, and others.
>
> The present averaging provisions have proved unsatisfactory, first, because they are limited to a relatively small proportion of the situations where averaging is needed. Thus, while they presumably cover inventors and writers, they do not provide for actors, athletes, and in most cases do not provide for attorneys, architects, and others.. .. (H. R. Rep. No, 749, 88th Cong., 2d Sess. (1963) [Vol. 1, 1964 U. S. Code Cong. & Ad. News, pp. 1418-1419].)

In a later passage, the House Committee report explained why income from gifts was being excluded from the benefits of the proposed change in the law:

> Averageable income.. .excludes income from gifts, devises, or inheritances where the gifts, etc., have been received either in the computation year or in any of the four prior base period years, because such income does not arise from any additional efforts on the part of the taxpayer but merely represents a transfer to the taxpayer of income previously received by someone else. In addition, in the case of the transfer by gift of income producing properties between related parties, there would be some opportunity for manipulation if such income were not excluded from that which can be averaged. ... (Emphasis added.) (Id., [Vol. 1, 1964 U. S. Code Cong. & Ad. News, p. 1421].)

On the basis of the passage quoted immediately above, appellant argues that Congress was not concerned with present and future interests as such, but rather with the possibility that there would be some opportunity for manipulation in cases of gratuitous transfers of income producing properties. Appellant believes that such manipulation is more likely to occur when present, rather than future, interests are transferred, and she emphasizes that there was no possibility in this case for any deliberate tax planning regarding her trust income. While it may be conceded that the feared manipulation could not and did not take place here, we do not believe that appellant is thereby entitled to prevail. The portion of the House report underscored above reveals that Congress had a second reason for discriminating against income from gifts: "because such income does not arise from any additional efforts on the part of the taxpayer but merely represents a transfer to the taxpayer of income previously received by someone else. " This language describes appellant's trust income with exquisite accuracy, leaving little doubt that Congress intended to exclude it from averageable income.

The regulation's differentiation between present and other interests in property appears to be a reasonable and well calculated effort to accomplish the desired exclusion of income from gifts. When one recalls that income averaging is a method of computing the tax on a taxpayer's currently taxable income, the sense of focusing on the receipt of a present right to property or to the income from such

property becomes clear, because currently taxable income arises only from the actual receipt of income or from the present right to receive an item of income. Thus, in order to effectuate the intent of Congress to deny averaging to income from gifts, it is necessary to exclude such income from the computation if the taxpayer first begins to receive it, or first acquires a present right to receive it, during the computation year or a base period year.?/ Moreover, the receipt during one of those years of a present right to such income would seem to be the only case calling for exclusion. For example, if a taxpayer receives only a future interest in property during that five-year period, it would make no sense to read the statute as requiring the exclusion of income from such an interest, since there is no "income" to exclude unless and until the future interest has ripened into a present interest. That reading of the statute would appear to follow, however, if we accepted appellant's position that the regulation's distinction between present and future interests in this context is not permissible,

2/ It is important to note that the basic purpose of Congress will rarely be thwarted by the regulation's failure to exclude such income when the taxpayer first receives a present right to it prior to the base period, because in such cases the income of each base period year will include the income from the gift. Thus, unless the income from the gift suddenly increases quite dramatically in the computation year, the taxpayer will not have sufficient averageable income to use income averaging unless his income from other sources (such as wages and salaries) increases substantially. If his other income does so increase, then the taxpayer should be permitted to use income averaging because that is the very situation for which Congress intended to provide this device.

Based on our analysis of the statutory language and its legislative history, therefore, we conclude that the federal regulation presents not only a reasonable interpretation of that language but the only sensible one as well. For that reason we believe that it should be followed in construing former section 18242, subdivision (b)(2)(A). Accordingly, respondent's action in this matter will be sustained.

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 18595 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of John Z. and Diane W. Mraz against proposed assessments of additional personal income tax in the amounts of $232.46, $194.49, and $171.40 for the years 1965, 1966 and 1967, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 26th day of July 1976, by the State Board of Equalization.

_____, Chairman

_____, Member

_____, Member

_____, Member

_____, Member

ATTEST: _____, Executive Secretary