76-SBE-077

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
GEORGE J. AND)
CATHERINE PRAT)

For Appellants: George J. Prat, in pro. per.

For Respondent: James W. Hamilton
Chief Counsel

Paul J. Petrozzi
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 George J. and Catherine Prat against proposed assessments of additional personal income tax and penalties in the total amounts of $330.66, $80.25, and $459.38 for the years 1969, 1970, and 1971, respectively. Subsequent to the filing of this appeal, respondent withdrew the penalties imposed for each of the years on appeal. Consequently, the amounts in issue for the years 1969, 1970, and 1971 are reduced to $264.53, $64.20, and $367.51, respectively.

This appeal involves the propriety of several adjustments to taxable income made by respondent with respect to the joint California personal income tax returns of appellants for the years 1969, 1970, and 1971. Specifically, the questions presented for resolution are: (1) whether respondent properly disallowed certain deductions claimed by appellants for expenses incurred in maintaining an apartment house during the years under appeal, (2) whether respondent properly included in appellants' 1971 gross income certain money and property received by George J. Prat (hereafter appellant) in settlement of his claim against the estate of Mr. Henry Sharp, and (3) whether respondent properly included in appellants' 1969 gross income the value of certain property transferred _inter vivos_ from Mr. Sharp to appellant.

During and prior to the years on appeal, appellants, husband and wife, owned a three unit apartment house. On their returns for the years 1969, 1970, and 1971, appellants claimed certain deductions for expenses allegedly incurred in maintaining the apartment house. The claim to these deductions was apparently founded on section 17252 of the Revenue and Taxation Code which allows as a deduction ordinary and necessary expenses incurred "for the management, conservation, and maintenance of property held for the production of income." Respondent disallowed the claimed deductions on the basis of its determinationthat appellants did not intend to rent the apartment units and, therefore, that the expenses in question were not incurred for the maintenance of property held for the production of income.

During the course of these proceedings, appellants conceded their liability for that portion of the deficiency assessments for the years 1969, 1970, and 1971 which resulted from respondent's disallowance of the section 17252 deductions.1/ Therefore, the only issues remaining for resolution involve the receipt by appellant of certain property and money from Mr. Sharp and his estate.

For several years prior to 1970, appellants maintained a close personal relationship with Mr. Henry Sharp. In November 1969, Mr. Sharp apparently transferred to appellant more than 600 shares of stock valued at $5,987.30.

Mr. Sharp died in 1970. During the administration of Mr. Sharp's estate, appellant filed an application with the probate court to admit a document alleged to be the last will and testament of Mr. Sharp. The alleged will apparently named appellants as legatees to a substantial portion of Mr. Sharp's estate. However, the probate court rejected appellant's application and determined that Mr. Sharp died intestate. Appellant then filed a legal action against the estate on a claim for compensation for services rendered to Mr. Sharp during his lifetime. Following institution of the lawsuit, the various parties reached a settlement agreement wherein appellant relinquished all claims against the estate.

The settlement agreement, as approved by the court on August 6, 1.97 1, also contained the following provisions: (1) a $3, 100.00 cash payment by the estate to appellant, (2) cancellation of a debt in the amount of $2,500.00 owed by appellants to the

1/ In August 1975, a check in the amount of $189.00 was forwarded ro the Franchise Tax Board in payment of the portion of appellants' tax liability which resulted from the disallowance of the section 17252 deductions. Accordingly, the assessments on appeal must be reduced to reflect the $189.00 payment regardless of our decision with respect to the remaining issues on appeal.

estate[2], and (3) payment by the estate of California inheritance tax in the amount of $563.78, due by reason of Mr. Sharp's 1969 inter vivos transfer of stock to appellants. The record on appeal indicates that for purposes of the California inheritance tax the total value of the above items, $6,163.78, was treated as a debt owed by the estate to appellant for services rendered to Mr. Sharp. The record also indicates that the inheritance tax appraiser treated the 1969 inter vivos transfer of stock to appellant as a transfer for less than adequate consideration and, therefore, subject to inheritance tax under sections 13641 through 13648 of the Revenue and Taxation Code.

Respondent contends that the money and benefits which appellant realized in 1971 by virtue of the settlement agreement represented compensation for services and, consequently, that their value is includible in appellants' gross income for the year 197 1. Appellants, on the other hand, contend that any money and benefits which appellant received from Mr. Sharp's estate represented property acquired by gift or bequest and, as such, arc exempt from inclusion in their gross income.

In determining whether the distributions to appellant under the settlement agreement constituted taxable compensation for services or a nontaxable gift or bequest, we note at the outset that the tax treatment of proceeds from the settlement of an action brought against a decedent's estate must reflect the nature of the claim upon which the settlement is based. (See Bath v. United States, 480 F.2d 289, 292: Braddock v. United Staten34 F.2d 631.

2/ The indebtedness in question was represented by a promissory note, payable to Henry Sharp, which had been executed by appellants in 1956. Appellants now contend that they repaid the $2,500.00 debt prior to Mr. Sharp's death. However, appellants have presented no evidence of the alleged repayment, nor have they offered an explanation regarding the estate's cancellation of the debt as a term of the settlement agreement. Therefore, we must conclude that the debt was due and payable until cancelled by the estate and, upon cancellation of the debt, that appellants thereby received a benefit in the amount of $2,500.00.

See also Lyeth v. Hoey, 305 U. S. 188 [83 L. Ed. 119]; Cotnam v. Commissioner, 263 F. 2d 119, 122.) Thus, if the money and benefits which appellant received pursuant to the settlement agreement represented payment in compromise of his claim as legatee to a portion of the estate, then the proceeds may be characterized as property acquired by bequest and, under section 17136 of the Revenue and Taxation Code, exempt from inclusion as gross income. (See Lyeth v. Hoey, supra.) However, if the money and benefits were received by appellant in compromise of his claim for compensation for services rendered to Mr. Sharp during his lifetime, then the proceeds must be characterized as taxable income, (Braddock v. United States, supra; Cohen v. United States, 241 F. Supp. 740.)

Appellants maintain that the lawsuit was filed against the estate solely for the purpose of enforcing the provisions of the alleged will which appellant had unsuccessfully attempted to admit to probate. Thus, appellants argue, the settlement agreement was based upon a compromise of appellant's claim as a legatee to a portion of the estate. However, appellants' position is contradicted by the weight of the evidence contained in the record on appeal. For example, the court order which approved settlement of the lawsuit clearly described the action as a creditor's claim for compensation for services which had been rendered to the decedent during his lifetime. Furthermore, for purposes of the California inheritance tax, the settlement proceeds were treated as a debt of the decedent which was deductible in computing the fair market value of the estate. (Rev. & Tax. Code, § 13983.) Therefore, on the basis of the evidence presented, we must conclude that the settlement distribution represented compensation to appellant for services which he rendered to Mr. Sharp during his lifetime. Accordingly, we must sustain respondent's determination that the settlement proceeds were includible in appellants' gross income for the year 1971.

The remaining issue on appeal involves Mr. Sharp's 1969 inter vivos transfer of stock to appellants. Respondent contends that this payment also represented compensation to appellant for services rendered to Mr. Sharp and, as such, it is includible in appellants' gross income for the year 1969. Appellants contend that the stock represented property acquired by gift and that its value is, therefore, not includible in their gross income. As a preface to our analysis of this issue, we must emphasize that respondent's determination of a tax deficiency is presumed to be correct; the burden is upon the taxpayer to prove that it is erroneous. (Appeal of Victor and Evelyn Santino, Cal. St. Bd. of Equal., Aug. 19, 1975; Appeal of Robert C. Sherwood, Deceased, and Irene Sherwood, Cal. St. Bd. of Equal. , Nov. 30, 1965.)

The determination of whether, for tax purposes, a transfer of property or money represents compensation for services or a gift depends upon the particular facts of each case. (Commissioner v. Duberstein, 363 U. S. 278 [4 L. Ed. 2d 1218]; Appeals of Mary Frances Sayer, Cal. St. Bd. of Equal. , Oct. 27, 1971.) In the instant case, appellants have not presented any evidence in support of their contention that the stock transfer was a gift. The record does indicate that an inheritance tax appraiser determined that the inter vivos transfer was made for less than adequate consideration and, therefore, that the value of the stock was includible in Mr. Sharp's estate. However, the appraiser's determination was apparently not challenged by any of the parties to the probate proceeding. Under the circumstances, we attach little significance to the appraiser's determination regarding the nature of the transaction in question. 3/ Therefore, we must conclude that appellants have not sustained their burden of establishing error in respondent's determination that the transfer represented compensation for services. Accordingly, we conclude that the value of the transferred stock was includible in appellants' gross income for the year 1969.

3/ It should also be noted that, in the determination of any issue of law or fact, this board is not bound by the determination of any other officer or administrative agency of the state. (Rev. & Tax. Code, § 19451.)

Appeal of George J. and Catherine Prat

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 Board on the protest of George J. and Catherine Prat against proposed assessments of additional personal income tax and penalties in the total amounts of $330.66, $80.25, and $459.38 for the years 1969, 1970, and 1971, respectively, be and the same is hereby modified in the following respects: (1) the penalties imposed for the years 1969, 1970, and 1971 are cancelled; and (2) the proposed assessments are reduced by $189.00 to reflect appellants' payment in that amount. In all other respects the action of the Franchise Tax Board is sustained,

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

William G. Bennett, Chairman

George R. Reilly, Member

Richard Nevins, Member

________________, Member

________________ Member

ATTEST: W. W. Dunlop, Executive Secretary