BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeals of)
)
CHARLES H. STRUB and VERA W. STRUB)

Appearances:

For Appellants: Robert E. King, Certified Public Accountant.

For Respondent: James J. Arditto, Franchise Tax Counsel.

O P I N I O N

These appeals are made pursuant to Section 19 of the Personal Income Tax Act (Chap. 329, Stats. of 1935, as amended) from the action of the Franchise Tax Commissioner in overruling the protest of Charles H. Strub to a proposed assessment of additional tax of $2,472.89 for the taxable year ended December 31, 1935, and in overruling the protest of Vera W. Strub to a proposed assessment of additional tax of $2,400.78 for the same taxable year.

These appeals relate solely to a bonus of $99,320.14 which was received in 1935 by Dr. Charles H. Strub from Los Angeles Turf Club, Inc. It is the position of the Commissioner that this bonus did not accrue until 1935 and that one-half thereof constituted income of Dr. Strub for the year 1935 and that the other half constituted income of his wife Vera W. Strub for the year 1935. It is the position of the Appellants that the bonus was earned because of services rendered during the entire year 1934 and the first six months of 1935: that only one-third of the bonus constituted income for the year 1935, that the remainder accrued prior to January 1, 1935, and was therefore exempt from tax under the Personal Income Tax Act.

Dr. Strub entered into an agreement (dated February 28, 1934) with the Los Angeles Turf Club, Inc. entitled "Contract of Employment" pursuant to which Dr. Strub was employed as executive manager for the term of five years and three months commencing on the first day of January, 1934, and ending on the thirty-first day of March, 1939. Under this agreement, in addition to a monthly salary, Dr. Strub was to receive ten per cent of the net profits to be computed and paid in the manner in the agreement specified. It was specified that the net profits should be computed at the close of each year commencing on the first day of April and ending on the thirty-first day of March, the computation together with an audit to be made by a certified public accountant, with payment of the bonus being made thirty days after the completion of each audit.

It was also specified that in the event of the death of Dr. Strut an accounting of the amount of the bonus due up to the date of death should be made in the same manner as if the date of death were the

termination of the yearly period. On June 14, 1935, a supplementary agreement was made, it being recited therein that some uncertainty had arisen between the parties as to the meaning of the original agreement. This supplementary agreement provided that the first bonus should be computed for the period from January 1, 1934, to June 30, 1935, and that in the event of the death of Dr. Strub the bonus should be a pro rata share of the amount which would have become due in the event that the employment had continued through the close of the period for the computation of the bonus. It will be noted that this supplementary agreement made substantial changes in the original agreement and that it was not entered into until long after the close of the year 1934.

In Kaufman Department Stores, Inc. v. Commissioner, 34 Fed. (2d) 257, it was held that bonus at the rate of two per cent of net profits during the five-year period was not earned prior to the expiration of the period. In the opinion it was said, "It did not have to be set aside, withdrawn from use or paid until the five-year period was over. It was measured by 'final net profit.' Its amount could not be determined before the expiration of the contract and a liability for it under the contract did not accrue before that time." Likewise in the present appeal the amount of the bonus did not have to be paid until the year 1935 and its amount could not be determined before the end of the period for which the bonus was payable and, in our opinion, the liability for the bonus and the right to receive the bonus did not accrue until 1935.

Dr. Strub did not die. Even had he died, say on December 31, 1934, the amount, if any, due him under the provisions of the original contract would have been based on the net earnings of the corporation up to the time of death. It has not been shown that there were any net earnings for operations during the period 1934. The earnings of the corporation came from the operation of the Santa Anita Race Track, The first racing season at that track began on December 25, 1934, and ended March 9, 1935. Prior to December 25, 1934, the corporation had been at heavy expense in preparation for the opening of the racing season and so far as can be told from the evidence adduced the profits for the first six days of the racing season were not in excess of the expenses for the year 1934. As of December 31, 1934, there was no unconditional liability on the part of the corporation to pay any bonus. Whether any bonus would become due for the first period of the contract depended as of that time on future events, namely, whether there would be a profit or loss from the operation of the track during the balance of the first period, In determining whether any bonus had been earned and accrued prior to January 1, 1935, we must of necessity look to the original agreement as the supplementary agreement was not at that time in existence.

In United States v. Wood, 79 Fed. (2d) 286 it was contended by the Commissioner of Internal Revenue that a partner's pro rata share of 48/365ths of the income of the partnership for the taxable year was income to that partner for the first forty-eight days of the year That partner died after forty-eight days of the taxable year had elapsed. There was no evidence that profit had been earned during those forty-eight days. The court pointed out that because of the

nature of the partnership business, the profits could not be determined until the end of the year and also that until the end of the year no partner had the right to demand any part of the profits, It was held that no part of the profits was taxable to the deceased partner for the forty-eight day period. It is our opinion that no part of the bonus can be properly considered as income to the Appellants for the year 1934 and that, on the contrary, the whole thereof must be considered as income for the year 1935. We expressed a similar opinion in the Appeal of Oppenheimer (July 7, 1942).

Both the Appellants and the Commissioner have relied on Article 36-1 of the Regulations of the Franchise Tax Commissioner under the California Personal Income Tax Act which provides, in part, "However, income accrued prior to January 1, 1935, is not taxable and need not be reported.... Thus, salaries and other compensation for personal services earned in 1934 or prior years, for example, are not taxable even though received in 1935 or subsequently." The meaning of the words "accrued" and "accrual" has been the subject of many opinions of which we shall mention a few that may be deemed fairly illustrative. H. Liebes & Co. v. Commissioner, 90 Fed. (2d) 932, 936, discusses the meaning of the term "accrual" at some length with several citations of authorities. In Lucas v. North Texas Lumber Co., 281 U. S. 11 it was held that income from the sale of land accrued at the time that the papers were prepared", the contract providing for payment "as soon as the papers were prepared" rather than during the previous year when an option to purchase was exercised by the giving of notice of intention to purchase. The court said, "Consequently, unconditional liability for the purchase price was not created in that year," meaning the year when the purchaser notified taxpayer that it would exercise the option. In Patrick McGuirl Inc. v. Commissioner of Internal Revenue, 74 Fed. (2d) 729, it was held that the profit realized by Petitioner upon the taking of his property did not accrue until 1929 which was the year in which the final decree of the State Supreme Court fixed the amount to be awarded. The property had been taken by the State of New York in 1926. The court said:

> "But here, though the petitioner was entitled to just compensation for property condemned under eminent domain, the amount of the award was to be determined in judicial proceedings involving values placed upon the real estate by expert testimony. .. Thus the amount of the award depended upon the course of future events. Unless all the events which fixed the amount and determined the liability of the city to this taxpayer occurred within the year, it may not be said that this was taxable in the year the right to an award accrued."

Appellants have not cited any cases in support of their views.

O R D E R

Pursuant to the views expressed in the opinion of the Board on

file in these proceedings and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED, AND DECREED that the action of Chas. J. McColgan, Franchise Tax Commissioner, in overruling the protests of Charles H. Strub and Vera W. Strub to his proposed assessments of additional taxes under the Personal Income Tax Act for the taxable year ended December 31, 1935, against Charles H. Strub in the amount of $2,472.89 and against Vera W. Strub in the amount of $2,400.78 be, and it is hereby affirmed.

Done at Sacramento, California, this 3rd day of February, 1944, by the State Board of Equalization.

R. E. Collins, Chairman
Wm. G. Bonelli, Member
Geo, R. Reilly, Member
Harry B. Riley, Member
J. H. Quinn, Member

ATTEST: Dixwell L. Pierce, Secretary