



BEFORE THE STATE BOARD OF EQUALIZATION  
OF THE STATE OF CALIFORNIA

In the Matter of the Appeals of )  
W. L. APPLEFORD and ANN APPLEFORD )

Appearances:

For Appellants: W. L. Appleford, Attorney at Law

For Respondent: John S. Warren, Associate Tax  
Counsel

O P I N I O N

This appeal is made pursuant to Section 18593 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protests of W. L. Appleford and Ann Appleford to proposed assessments of additional personal income tax in the amounts of \$2,554.36 against W. L. Appleford and \$2,562.97 against Ann Appleford for the year 1951.

Some years previous to 1947 the State of California gave W. L. Appleford an oil and gas lease on certain tide and submerged lands lying off the California coast. Appleford then entered into an operating agreement with Signal Oil and Gas Company for the development of the lease whereby Signal paid Appleford monthly royalties based on the amount of oil and gas produced.

This arrangement continued until June 23, 1947, when the United States Supreme Court decided

**"that California is not the owner of the three-mile marginal belt along its coast, and that the Federal Government rather than the state has paramount rights in and power over that belt, an incident to which is full dominion over the resources of the soil under that water area, including oil." (332 U.S. 19, 38, 39.)**

Because this decision made uncertain the rights of parties holding leases from California, Signal immediately stopped paying and impounded Appleford's royalties, although monthly statements were issued to Appleford with respect to the sums earned.

On July 26, 1947, the State of California and the United States entered into a stipulation, the purpose of which was

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to allow the production of oil and gas to continue on the lands affected by the Supreme Court decision. The stipulation recited that the "precise location of the 'three-mile marginal belt'" was unknown and that further proceedings might be necessary to determine whether any given piece of land was property of the United States or property of California. It provided that operations under rights given by California could be continued subject to liability to the United States for the value of the oil produced after deducting all reasonable costs of production including royalties paid to California. Royalties paid to California were to be impounded and held by the State until some further arrangement was made,

The stipulation did not make clear whether an operator could, without **becoming** liable to the United States, pay overriding royalties to such persons as Appleford. Signal could not be sure that overriding royalties were part of the "reasonable costs" of production which the government allowed Signal to deduct. Consequently, Signal chose to continue to send monthly statements, to Appleford without making payment throughout the years 1947, 1948, 1949 and 1950.

On September 24, 1951, the stipulation was amended to provide that the overriding royalties could be included as part of the costs for which the operators would not have to account to the United States. Signal at that time paid Appleford the amount of the royalties earned between 1947 and 1951, a total of \$127,342.06.

In 1953 Congress granted to the coastal states the interest of the Federal Government in the three-mile marginal belt along their coasts.

Appellants used the cash basis of reporting income and filed separate returns for each of the years in question, each reporting one-half of the royalties as indicated by the monthly statements. They maintain that the income should be taxed as they have reported it in 1947, 1948, 1949 and 1950. The Respondent maintains that the entire sum, \$127,342.06, should be taxed in 1951, the year in which it was received by Appellants. Respondent states that Appellants will be credited with the amounts by which they overpaid their tax in the years 1947 through 1950.

Appellants do not dispute that a cash basis taxpayer ordinarily is taxed on his income in the year in which it is received. (Section 17571 of the Revenue and Taxation Code, formerly Section 17562.) Appellants, however, invoke the doctrine of constructive receipt in support of their contention that the income should be taxed in the years 1947

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through 1950. This doctrine is set out in Title 18, California Administrative Code, Regulation 17562(b):

"Income which is credited to the account of or set apart for a taxpayer and which may be drawn upon by him at any time is subject to tax for the year during which so credited or set apart, although not then actually reduced to possession. To constitute receipt in such a case the income must be credited or set apart to the taxpayer without any substantial limitation or restriction as to the time or manner of payment or condition upon which payment is to be made, and must be made available to him so that it may be drawn at any time, and its receipt brought within his own control and disposition,..."

We cannot agree that Appellants were in constructive receipt of the income withheld by Signal in the years 1947 through 1950. Appellants received monthly statements, but they could not draw upon any account with Signal. Signal, of its own volition, stopped making the payments and manifested an intent not to turn the royalties over to anyone until there was legal sanction for payment. **Signal's** action in withholding the royalties thus imposed a substantial limitation on Appellants' free control of the income (Farrell v. Commissioner, 134 Fed. 2d 193, cert. den., 320 U.S. 745).

In Farrell v. Commissioner, the oil company refused to make oil royalty payments to the taxpayer after 1934 solely because it was "apprehensive lest it incur liability by paying out contested funds." The oil company withheld earned payments until 1936, and then paid the taxpayer the aggregate of the sums due him. It was held that the income was taxable in 1936, the year in which it was received. The Farrell case thus makes it clear that a cash basis taxpayer does not constructively receive income where the party owing him the income will not make payment because there is a change of liability to a third party if payment is made. Signal refused to make payment to Appellants because it feared liability to the Federal government if it did so, and the present case falls within the rule of the Farrell case,

Appellants rely on Ross v. Commissioner, 169 Fed. 2d 483; Weil v. Commissioner 173 Fed. 2d 805; McEuen v. Commissioner, 196 Fed. 2d 127; U. S. v. Pfister, 205 Fed. 2d 538; McDuffie v. U. S., 19 Fed. Supp. 239; Lichtenberger-Ferguson Co. v. Welch, 54 Fed. 2d 570; Clark v. Woodward Construction Co., 179 Fed. 2d 176; Universal Oil Products Co. v. Campbell, Fed. 2d 451; Park Hosiery Mills v. Commissioner, 183 Fed. 2d 583; Keasbey & Mattison Co. v. U. S., 141 Fed. 2d 163; Welp

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v. U. S., 103 Fed. Supp. 551; and Aluminum Castings Co. v. Routzahn, 282 U.S. 93. We have examined these cases and find them factually dissimilar from the present case. Many of them involve the question of when income is accruable, Since the Appellants reported their income on the cash basis, the question of whether the royalties were accruable in the years in which they were earned does not arise.

Appellants also argue that Signal was their agent and that the doctrine of constructive receipt holds that receipts of income by an agent is receipt by the principal. Whether or not this is a correct statement of the law, there is no showing that the relationship between Appellants and Signal was that of principal and agent. The absence of such relationship is indicated by the fact that Signal acted on its own authority to stop making payments to Appellants. In both Farrell v. Commissioner, supra, and Spalding v. U. S., 97 Fed. 2d 697, the court expressly rejected the contention that the operator under an oil and gas lease was the agent of the taxpayer who sold oil and gas rights to the operator,

It is further contended that the State is estopped to deny its title to the land in question against its lessees, the Appellants. We are concerned, however, with the receipt of income, not the status of title to lands. As discussed above, Appellants had neither actual nor constructive receipt of the income in question until the release of the royalties by Signal in 1951. Signal's refusal to pay the royalties as they accrued was motivated by a decision of the Supreme Court of the United States, not by any action of the State. Upon these facts we perceive no bar to the imposition of the tax as proposed by the Franchise Tax Board,

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 protests of W. L. Appleford and Ann Appleford to proposed assessments of

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additional personal income tax in the amounts of \$2,554.36 against W. L. Appleford and \$2,562.97 against Ann Appleford for the year 1951 be and the same is hereby sustained.

Done at Sacramento, California, this 15th day of September, 1958, by the State Board of Equalization.

Geo. R. Reilly, Chairman

Paul R. Leake, Member

Robert E. McDavid, Member

J. H. Quinn, Member

Robert C. Kirkwood, Member

ATTEST: Ronald B. Welch, Acting Secretary

*of Thomas*

TO: All Auditors - Northern Region

DATE: October 21, 1958

SUBJECT: Petition for Rehearing  
Appleford Oil and Gas Royalties

A petition for a rehearing has been filed in connection with the Board's opinion in the case of W. L. Appleford and Ann Appleford. The opinion is dated September 15, 1958. Issue is taxability of lump ~~sum~~ payments of accumulated oil and gas royalties by cash basis taxpayer.

*George A. Ragan*  
George A. Ragan  
Regional Director

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