



BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
EARL R. AND ALLEENE R. BARNETT)

Appearances:

For Appellants: Anthony T. Karachale
Attorney at Law

For Respondent: Brian W. **Toman**
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 protest of Earl R. and Alleene R. Barnett against a proposed assessment of additional personal income tax in the amount of \$8,025.12 for the year 1973.

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The issue presented is whether the income realized by appellants from a stock option accrued before or after they became residents of California. "Appellant" herein refers to Earl R. Barnett.

Appellants became residents of Canada in 1949. In 1950 appellant became a vice president and director of Canadian Superior Oil, Ltd. (Canadian), positions he continued to occupy until his retirement on January 31, 1973.

On August 1a, 1969, appellant entered into a stock option agreement with Canadian whereby he acquired the right to purchase a maximum of 6,000 shares of Canadian's common stock over a five year period (1,200 shares per year) at a fixed price of \$31.20 per share. An express purpose of the agreement was to induce appellant to remain in the employ of the company. His option rights were nontransferable during his lifetime and were forfeitable in the event of termination of his employment either for cause or without the corporation's written, approval.

On January 31, 1973, while still a resident of Canada, appellant retired from Canadian with the company's consent. At that point he had a right to purchase 4,800 shares of Canadian's stock, as long as the option was exercised within three months from the date of his retirement. If he died during the three-month period, his option rights were exercisable within one year of his death by his estate's personal representative or a transferee by will or inheritance. The fair market value of the stock on January 31, 1973, was \$55.50 per share.

Appellants moved to California on February 13, 1973. On April 5, 1973, appellant exercised his option rights to 4,800 shares of Canadian stock at \$31.20 per share, for a total price of \$149,760. On that date the stock was listed on the American Stock Exchange at \$52.20 per share or \$250,560 for 4,800 shares. Appellant sold all 4,800 shares on August 15, 1973, for a total price of \$272,016, or \$56.67 per share.

On their 1973 California personal income tax return, appellants did not report any income from the above transactions. Upon auditing appellant's return, respondent determined that income accrued to the appellants from the stock option after they became California residents. A proposed assessment was issued based

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solely on the income realized by appellant's exercise of the stock option. Appellants protested and after denial of their protest, filed this timely appeal.

The California personal income tax is imposed on the entire taxable income of every resident of this state, regardless of the source **of the** income, and upon the income of nonresidents which is derived from sources within California. (Rev. & Tax. Code, § 17041.) Where a change in residence occurs, section 17596 of the Revenue and Taxation Code provides:

When the status of a taxpayer changes from resident to nonresident, or from nonresident to resident, there shall be included in determining income from sources within or without this State, as the case may be, income and deductions accrued prior to the change of status even though not otherwise includible in respect of the period prior to such change, but the taxation or deduction of items accrued prior to the change of status shall not be affected by the change.

The taxability of income when residence is changed is determined by when the income accrues, regardless of whether the **taxpayer uses** the cash basis or accrual accounting method. (Cal. Admin. Code, tit. 18, reg. 17596.)

In the instant case, if income realized from the stock option accrued while appellants were residents of Canada, it would not be taxable in California because nonresidents are taxed only on income from **sources within California**. If the income accrued after appellants became California residents, it would be taxable in California, since tax is imposed on the entire taxable income of residents, regardless of the source of the income.

Respondent's regulations, as well as the federal income tax regulations and case law, provide that under the accrual method of accounting, income is includible in gross income when all events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy. (Cal. Admin. Code, tit. 18, reg. 17571(a), subd. (1); Treas. Reg. **§ 1.446-1(c)(1)(ii)**, Spring City Foundry Co. v. Commissioner, 292 U.S. 182, 184-185 [78 L.Ed. 1200] (1934), reh'g. den., 292 U.S. 613 [78 L.Ed.

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1472] (1934).) If there are substantial contingencies as -to the taxpayer's right to receive, or uncertainty as to the amount to be received, an item of income does not accrue until the **contingency** or events have occurred and fixed the fact and amount of the sum involved. (Midwest Motor Express, Inc., 27 T.C. 167, 180 (1956), affd., 251 F.2d 405 (1958); San Francisco Stevedoring Co., 8 T.C. 222, 225 (1947);) Both this board and respondent have applied these criteria in determining whether or not income had "accrued," within the meaning of section 17596, prior to a change of residence. (See, e.g., Appeal of James H. and Heloise A. Frame, Cal. St. Bd. of Equal., Nov. 14, 1979; Appeal of Christian M. and Lucille V. McCririe, Cal. St. Bd. of Equal., Dec. 6, 1977; Appeal of Jerald L. and Joan Katleman, Cal. St. Bd. of Equal., Dec. 15, 1976; Appeal of Kenneth Ellington and Estate of Harriet Ellington, Deceased, Cal. St. Bd. of Equal., Oct. 17, 1973; Appeal of Lee J. and Charlotte Wojack, Cal. St. Bd. of Equal., March 22, 1971; Appeal of Edward B. and Marion R. Flaherty, Cal. St. Bd. of Equal., Jan. 6, 1969; and FTB LR 340, Oct. 5, 1970.)

It is well settled, and the parties do 'not dispute, that any gain realized in connection with the **stock** option is considered compensation and, as such, would be taxable as ordinary income. (Commissioner v. LoBue, 351 U.S. 243 [100 L.Ed. 1142] (1956).) Appellant argues that the stock option was compensation for services rendered while he was a resident of Canada and, since his rights under that option became nonforfeitable while he was a Canadian resident, the compensation accrued prior to his change of residence and was therefore not subject to taxation in California. The amount of compensation, it is contended, was the difference between the option price and the fair market value of the stock on the date of appellant's retirement.

Respondent takes the position that until the stock option was exercised, substantial contingencies existed as to both the right to receive income from the option and the amount of such income. Therefore, respondent contends, the income did not accrue until appellant's exercise of the option, at which time he was a resident of California, making the stock option' income taxable in California. The amount of income, according to respondent, was the difference between the option price and the fair market value of the stock on the date the option was exercised. For the reasons stated below, we agree with respondent.

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In the case of John Graf Co., 39 B.T.A. 379 (1939), an accrual basis taxpayer had a contract right to receive a **fixed amount** of income in the form of discounts, payable to it upon the purchase of certain beer. The Board of Tax Appeals held that even though the obligor was under liability to pay the discounts, the taxpayer's option whether or not to order **the** beer was a sufficient contingency to prevent accrual of the income from the discounts. The United States Tax Court followed the reasoning of John Graf Co., supra, in Estate of John J. Hessian, ¶ 43,203 P-H Memo. T.C. (1943), where the taxpayer entered into an employment contract with a company whereby he was to receive 10,000 shares of common stock as an inducement to work for the company. He also agreed to purchase certain other shares of the company. None of the stock was to be issued to the taxpayer until he delivered a promissory note for the stock he was to purchase. The Tax Court held that, although the taxpayer had an enforceable contract right to have the stock delivered to him, until he had performed the condition of delivery of the note, "there existed no such fixed and definite right as would require accrual." (Estate of John J. Hessian, supra, at 43-636.)

Here, although appellant's right to purchase shares pursuant to the stock option agreement was "**non-forfeitable**" as of his retirement date, there was still a substantial contingency to be met before his right to receive income became fixed. Unless appellant (or, if he died, his representative) exercised the option and paid for the stock within the requisite period of time, he would receive nothing under the plan. At the time of his retirement, appellant had only a right to exercise the option, not a right to receive any income from the option.

Until the option was exercised, there was also substantial uncertainty as to the amount of income to be received. At his retirement, appellant had a fixed right to exercise his option for a maximum of 4,800 shares. However, he could have exercised the option as to any number of shares up to that limit. The amount of income would have been quite different had he chosen to purchase only one hundred or even one thousand shares. Market price fluctuations over the three-month period following appellant's retirement also made the income amount uncertain. Until these two factors were fixed by the exercise of the option, it was impossible to determine with reasonable accuracy the amount of income appellant would receive.

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Appellant cites several of respondent's legal rulings as authority for the proposition that the word "accrued," as used in this context, should be broadly **interpreted and** generally equated with the time income is earned. (FTB LR 248, Oct. 30, 1959; FTB LR 48, LR 132, and LR 194, all issued Dec. 5, 1958.) These rulings were issued by respondent in 1958 and 1959. Since that time, as previously **noted**, this board has decided a long line of cases in which we have defined "accrued" for purposes of section 17596. Respondent has followed the criteria set forth in those appeal decisions in its subsequent administration of the law. None of appellant's arguments persuade us that our interpretation of the word "accrued," as it is used in section 17596, should be changed.

Appellant also contends that the Appeal of Charles W. and Mary D. Perelle, decided by this board on December 17, 1958, should control here. That case is distinguishable from the situation before us now since the income involved there was from a California source and therefore taxable in California whether or not the taxpayer was a resident.

We are convinced that under the applicable rules of law, the income which appellant realized from the stock option accrued after he had become a California resident. Therefore, it was subject to tax under the California **Personal Income Tax Law**. Respondent's action is sustained.

