



BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
J. E. KOEBERLE)

Appearances:

For Appellant: George T. Altman, Attorney at Law.

For Respondent: W. M. Walsh, Assistant Franchise Tax
Commissioner; Harrison Harkins, Associate
Tax Counsel.

O P I N I O N

This appeal is made pursuant to Section 19 of the Personal Income Tax Act (Chapter 329, Statutes of 1935, as amended from the action of the Franchise Tax Commissioner in overruling the protest of J. E. Koeberle to a proposed assessment of additional tax in the amount of \$1,243.70 for the taxable year ended December 31, 1935.

In 1921 Appellant, a petroleum engineer, entered into a contract with the owners of certain land under which they agreed to pay him ten per cent of any royalties they might receive from an oil lease of their land which Appellant was instrumental in procuring for them with the General Petroleum Corporation. Royalties were paid to him pursuant to the agreement for several years. Subsequently, however, the landowners declared the lease cancelled due to an alleged default of the lessee, but the lessee was not in fact in default and continued to operate under the lease. The landowners thereupon refused to accept the royalties, which were deposited by the lessee in a bank to their account under Section 1500 of the Civil Code. Litigation involving the cancellation of the lease was terminated in 1932 by a compromise under which the landowners acknowledged full performance of the terms of the lease by the lessee and they were declared free to withdraw the money in the bank at any time they elected to do so. The landowners refused to pay Appellant the ten per cent of the royalties deposited in the bank to which he was entitled and *it was necessary for him to institute actions to recover the amount due him. The actions were finally terminated by decisions of the California District Court of Appeal in Appellant's favor on January 30, 1935 (4 Cal. App. (2d) 252; hearing by California Supreme Court denied March 28, 1935), and August 5, 1935 (8 Cal. App. (2d) 634. Following the decisions the Appellant received the amount of the royalties due him for services rendered prior to 1935.

The Commissioner regarded the amount so received by Appellant in 1935 as income for that year and levied his proposed

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assessment accordingly. His action was based on the position that the amount did not accrue until the termination of the litigation in Appellant's favor in 1935 and that it was, therefore, not **excludible** under Section 36 of the Act and Article 36-1 of the Regulations relating thereto. The Appellant contends on the other hand that the amount accrued prior to 1935 and was, accordingly, not **includible** under that Section and Article. In support of this contention he argues that Appellant's services **were** completed long prior to 1935, that Appellant was clearly entitled to the royalties upon the compromise in 1932 of the landowners' litigation involving the cancellation of the lease and that nothing occurred after that year except the filing of **his** suit to recover his portion of the royalties already received by the landowners, the suit being based on a written **agreement** and to which the defendants therein did not have a bona fide defense. As an alternative position Appellant argues that the income, assuming it did not accrue prior to 1935, was community income of which only one-half was attributable to him. He also contends that the income, again assuming it accrued in 1935, should be reduced by the amount of \$4,251.91, representing expert witness fees, court and printing costs and miscellaneous items in the total amount of \$2,751.91 paid by him in 1935 and attorneys' fees in the total amount of \$1,500 paid by him prior to 1935, all the fees and costs having been incurred in connection with his suit against the landowners. This contention is based on the ground that to the extent of said \$4,251.91, the amount received by him as a result of the litigation constituted not income but a recovery of costs. The question of the taxability of the income received by Appellant in 1935 was originally argued merely on the basis of the validity of that portion of Article 36-1 of the Commissioner's Regulations Relating to the Personal Income Tax Act providing that "income accrued prior to January 1, 1935, is not taxable and need not be reported, even though the income is received on or after that date and even though the taxpayer reports on the cash receipts and disbursements basis." The point discussed was whether the income accrued prior to 1935. Following the decision in Dillman v. McColgan, 63 A.C.A. 563 (hearing in California Supreme Court denied May 18, 1944) Appellant contended in a supplemental brief that the decision was not controlling here and that the taxpayer should prevail even if Article 36-1 of the Regulations had not been promulgated. We believe, however, that the case does control this matter and that it requires that the **position** of the Commissioner on the principal issue involved herein be sustained,

It was held in the Dillman case that a taxpayer reporting on a cash receipts and disbursements basis was entitled to deduct in 1935 as a loss sustained in that year the amount of a national bank stockholders' liability assessment paid in 1935 even though **the** liability may have accrued prior to that year. In reaching this conclusion the Court found that the portion of Article 36-1, providing that a taxpayer reporting on a cash basis could not deduct in 1935 an amount paid in that year if liability **therefor** was incurred prior to 1935 was not a proper interpretation of the Act. Section 16 of the Act was regarded as determinative, the Court quoting subsections (a), (d) and (e) thereof.

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The first of these subsections provides, so far as material herein, that net income shall be computed in accordance with the method of accounting regularly employed in keeping the books of the taxpayer; the second that all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless pursuant to subsection (a) any such amounts are to be properly accounted for as of a different period and the third that deductions and credits shall be taken for the taxable year in which paid or accrued or paid or incurred depending upon the method of accounting employed in computing net income. Just as subsections (a) and (e) were there held to require the conclusion that a taxpayer on a cash basis could deduct an amount paid in 1935 even though the liability accrued prior to that year, so in our opinion, do subsections (a) and (d) require the conclusion that an item of gross income received in 1935 is **includible** in gross income for that year even though it may have accrued in a prior year. Only if the amount received by Appellant in 1935 as **compensation** for his services in prior years is included in his gross income for 1935 will his net income for that year have been computed in accordance with the method of accounting regularly employed in the keeping of his books, as required by subsection (a) and will there have been compliance with the specific mandate of subsection (d).

We are unable to accept Appellant's contentions that Sections 16 and 36 need not be harmonized, it being argued that the purpose of the former is to determine merely in which year an item should be included in gross income and the purpose of the latter to draw a line between items which should be included in some year and items which should never be included at all. It appears to us, quite to the contrary, that Sections 16 and 36, which after all are merely parts of a single Act, must be considered together and that as so considered Section 36 in providing that the Act "shall apply to the net income of persons taxable hereunder received or accrued on and after January 1, 1935" merely fixed the starting date of the tax at January 1, 1935, for a taxpayer reporting on the cash basis as well as for one reporting on the accrual basis. The items of income to be included in gross income or the amounts to be deducted from gross income in 1935 or any other particular year are in our opinion controlled by Section 16. That such was the view of the Court in the Dillman case is, we believe, **clearly** established by the following excerpt from its opinion:

"We find nothing in the applicable portions of the statute before us that calls for the construction placed upon it by art. 36-1. Section 16, supra, states definitely that net income shall be computed upon the basis of the taxpayer's annual accounting period in accordance with the method of accounting regularly employed by him in keeping his books; that the amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, and that the

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deductions and credits provided for shall be taken for the year in which "paid or accrued," or paid or incurred, dependent upon the method of accounting upon the basis of which net income is computed. This is admitted by the rule itself which recites that 'ordinarily' a taxpayer reporting on the cash receipts and disbursements basis must report all income received during his taxable year even though accrued in a prior year, and may deduct all amounts paid during such year, even though incurred in a prior year. Our attention is not directed to any language in the statute that authorized the commissioner to make the exception set forth in art. 36-1, that income accrued prior to January 1, 1935, was not taxable and need not be reported though received after that date and even though the taxpayer reported on the cash receipts and disbursements basis, and that such taxpayer could not deduct amounts paid after January 1, 1935, for obligations previously incurred. As a rule of convenience this provision⁹ may have had its advantages in the administration of the act; but it is plain that in promulgating it the commissioner was not construing any language of the statute, for it makes no distinction between the years prior to and those subsequent to its enactment, but was supplementing it. And if the commissioner could modify the provisions of the act as to income accrued or liability incurred prior to 1935, he could as well be said to have been given authority to so provide for subsequent years, and thus to nullify the provision of the act that a taxpayer who keeps his books on a cash basis must report as income for a given year all cash income received during said year, and credit himself with disbursements for the year when disbursed." (Underscoring added)
63 A.C.A. 567.

Helvering v. Estate of Enright, 312 U.S. 636, is cited by Appellant as a case dealing with a problem identical in all respects with that involved herein. While it may be true that if Appellant's construction of Section 36 be adopted, the two matters are somewhat similar, the problems presented therein are in our opinion far from identical. The Enright case involved the following statutory provision:

"In the case of the death of a taxpayer there shall be included in computing net income for the taxable period in which falls the date of his death, amounts accrued up to the date of his death if not otherwise properly includible in respect of such period or a prior period."

This language and the Congressional Committee Reports left no doubt as to the underlying purpose of Congress in enacting the provision, viz., to put a cash receipts taxpayer on an

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accrual basis for the taxable period in which his death occurred. The question at issue was the precise meaning to be given the term "accrued" as used in the provision. Here, however, the construction of Section 36 urged by Appellant has not been set forth by the Legislature with any such degree of clarity and in the light of the Dillman case that construction does not appear to us to be correct. The phrase "net income of persons taxable hereunder received or accrued on and after January 1, 1935," must, we believe, under the principle of that case be construed as meaning, in the case of persons reporting on the cash basis, net income computed on the basis of items of income received and disbursements made on and after January 1, 1935, and, in the case of persons reporting on the accrual basis, net income computed on the basis of accruals of items of income and deductible amounts on and after January 1, 1935.

As an alternative ground Appellant takes the position that the income in question, if taxable at all in 1935, is community property of which only one-half is taxable to him. He states that the Commissioner is acting inconsistently in contending that although the income did not accrue until the final termination of the litigation in 1935, Appellant's right or claim thereto arose prior to July 29, 1927, the effective date of Section 161a of the California Civil Code giving the wife a vested one-half interest in community property. In support of his position Appellant cites only Edwin C. F. Knowles, 40 B.T.A. 861. That case is not believed to be authority for his position, however, for the taxpayer therein was held to have had no enforceable right prior to July 29, 1927, to the stocks determined to be community property. It is clearly recognized in that case that the "time when property is deemed by law to be acquired, as between husband and wife, is as of the time of the acquisition of the initial right" and that "in a broad sense, contractual obligations are property, and such property, as between husband and wife, is acquired as of the date when the obligation becomes binding." 40 B.T.A. 866, 867. The Commissioner's position that the income is taxable in its entirety to Appellant is upheld by Sara R. Preston, 35 B.T.A. 312. In that matter, as here, the contract under which the husband performed personal services was entered into prior to July 29, 1927, the services were completed prior thereto and compensation therefor was received after that date. There, too, as here the husband was compelled to sue to recover a portion of the fee to which he was entitled and subsequently received payment pursuant to a judgment entered after July 29, 1927. The amount received by the husband was held to be his separate property upon the ground that determination of the character of the property is to be made not at the time of the vesting of the property in the husband or the receipt of the income therefrom, but at the time of the inception of the rights whereby the income is earned.

As a second alternative ground Appellant contends that to the extent of \$4,251.91, the amount received by him in 1935 following the termination of the litigation was not income, but a recovery of costs. The \$4,251.91 represents expert witness fees and court, printing and miscellaneous costs totalling

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\$2,751.91 paid by him in 1935 and advances on attorneys' fees totalling \$1,500 paid prior to 1935, all the costs and fees relating to the litigation as a result of which he received the income in question in 1935. The Commissioner denies that such litigation expenses may be considered as capital items or that any portion of the amount received by Appellant constituted a return of capital and contends that the items are merely expenses, the deductibility of which is governed by the rules relating to the deductibility of expense items. Under such rules, he contends, the attorneys' fees paid prior to 1935 are not deductible in 1935 under Section 8(a) of the Personal Income Tax Act inasmuch as they were not "paid or incurred during the taxable year" and the witness fees and other costs paid in 1935 are not deductible in that year by virtue of Article 36-1 of the Regulations relating to that Act as the obligation to pay them was incurred prior to 1935. Neither the Appellant nor the Commissioner has cited any authorities in support of his respective position. The contention of the Commissioner that the items making up the \$4,251.91 are properly to be regarded as ordinary expenses rather than capital items appears to us to be correct. Commissioner of Internal Revenue v. Feyer, 77 (2d) 824. In fact, Appellant himself so regarded the attorneys' fees of \$1,500 paid in years prior to 1935 for he deducted the amounts of such fees in his federal income tax returns (filed on a cash basis) for the years prior to 1935 in which the amounts were paid. As respects the fees and costs totalling \$2,751.91 paid in 1935, Appellant is entitled to a deduction in that amount under Dillman v. McColgan, 63 A.C.A. 563.

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 that the action of Chas. J. McColgan, Franchise Tax Commissioner, in overruling the protest of J. E. Koeberle to a proposed assessment of additional tax in the amount of \$1,243.70 for the taxable year ended December 31, 1935, pursuant to Chapter 329, Statutes of 1935, as amended, be and the same is hereby modified as follows: said Commissioner is hereby directed to allow the deduction from the gross income of said J. E. Koeberle for the taxable year 1935 of the amount of \$2,751.91 as an expense under Section 8(a) of said Act; in all other respects the said action of the said Commissioner is hereby sustained.

Done at Los Angeles, California, this 14th day of November, 1944, by the State Board of Equalization.

Wm. G. Bonelli, Member
J. H. Quinn, Member
Geo. R. Reilly, Member

ATTEST: F. S. Wahrhaftig, Acting Secretary