BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
) No. 86A-0062-GO
COUNTRY CLUB CLEANERS)

For Appellant: Harold Kittleson
President

For Respondent: Kathleen M. Harris
Counsel

O P I N I O N

This appeal is made pursuant to section 25666[1/] of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Country Club Cleaners against a proposed ***assessment*** of additional franchise tax and penalties in the total amount of $5,653 for the income year ended September 30, 1981.

1/ Unless otherwise specified, all section references are to sections of the Revenue and Taxation Code as in effect for the income year in issue,

The primary issue for decision is whether income received for a covenant not'to compete may be reported under the installment method of accounting as provided under section 24667.

Appellant, an accrual basis taxpayer, sold its assets during the income- year ended September 30, 1981. Included in the amount received by appellant was $70,000 attributed to a covenant not to compete which resulted in a total gain realized of $65,647, (Resp. Br., Ex. A.1 Apparently, $19,777 of the sales price was received in cash in the year of sale with payment of the balance deferred to subsequent years,. **Appellant** filed a tax return for the year at issue on December 8, 1983, almost two years after its due date of December 15, 1981. In that return, appellant elected to use the installment method of reporting the consideration received for the covenant., thereby including the gain realized of $18,547 attributable to the $79,777 cash payment in the year of sale., but deferring the balance of the gain until received in subsequent years.

Upon audit, respondent disallowed appellant's use of the installment method of reporting gain. In a May 29, 1985, letter, respondent concluded that gain realized from a covenant not to compete "is not considered gain from the sale of property [since] a covenant not to compete is a contractual agreement." In addition, respondent concluded that since gain realized from the "sale" of such a covenant is characterized as ordinary income, "no sale or exchange" took place. Under either theory, respondent determined that the installment method of reporting gain could not be used for reporting gain from the "sale" of *the* covenant not to compete. Since appellant is an accrual basis taxpayer, respondent's determination required that all gain be recognized in the year of sale. In addition, respondent imposed a delinquent filing penalty of 25 percent, Denial of appellant's protest led to this appeal.

Section 24667 provides that a tax-payer who sells property for deferred payments and otherwise meets. the requirements of the section can elect to defer the reporting of gain until the years in- which the deferred payments are received. Included in the categories eligible for installment treatment is personal property other than inventory. (Rev, & Tax, Code,. § 24667, subd, (b); see **also** Cal. Admin. Code, tit. 78, reg. 24667-24673.5.) Within the installment sale provision the term "personal property" is **used in its broad sense, given its**

normal and natural meaning. (See generally 2. Mertens, Law of Federal Income Taxation, § 15.05, P.15 (1982 Rev.).) Regulation 24667-24673.5(a) subdivision (3) provides in relevant part the following limitations on the use of the installment method:

> (A) Income from the sale or other disposition of . .. casual dispositions of personal property may be reported on the installment method for income years beginning after December 31, 1954, only if, in the income year of the sale or other. disposition, (i) there are no payments or (ii) the payments (exclusive of evidences of indebtedness- of the purchaser) do not exceed 30 percent of the selling price.
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> (B) The income from a casual sale or other casual disposition of personal property may be reported on the installment method only if (i) the property is not of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the income year, and (ii) its sale price exceeds $1,000.

As indicated above, respondent first argues that the gain realized from the covenant is not gain resulting front the sale of property but gain from the sale of services and that sales of services are not eligible for installment reporting. (See, far example, Roberts v. Commissioner, 83,143 T.C.M. (P-H) (1983).) (Resp. Br. at 3.)[2/] For example, in Sorensen v. Commissioner, 22 T.C. 321 (1954), the taxpayer was given several options to purchase stock as compensation far his services. Rather than exercising the options, he sold them and reported his gain using the installment method. The tax court held that the installment sale provision did not apply to the sale because the statute's provisions "relate only to the reporting of income

2/ However, it is interesting to 'note that Treasury Regulation section 1.453-2(d)(6) provides that for sales of revolving credit plans which qualify far installment sale treatment "[t]he term 'sales' includes sales of services, such as a charge for watch repair, as well as sales of property, but does not include finance or service charges."

arising from the sale of property on the installment basis. Those provisions do not in' anywise purport to relate to the reporting of income arising by way of compensation for services." (Sorensen v. Commissioner, supra, 22 T.C. at 342.) Respondent argues that consideration received in return for the covenant is compensation received for refraining from labor and as such is similar to compensation far services to be performed. (Appeal of AlDean and Clara Washburn, Cal. St. Bd. of Equal.., June 29, 1982.) (Resp. Br. at 3.) However, contrary to respondent's allegation, we did not state in Washburn, supra, that amounts received for a covenant not to compete are "akin to compensation for services" in all respects. Instead, we merely stated there that payments received for such a covenant are taxable as ordinary income. As such, we were there concerned with the characterization of gain and the source of that gain, quescions which are not in issue in this appeal. Linking Washburn to the holding in Sorensen, respondent concludes that the consideration paid for the purchase of the covenant was gain from the sale of services and, therefore, not eligible for installment reporting. 3/

Moreover, it seems to us that the subject covenant does not in any way represent "compensation for services" as in Sorensen, but rather the future profit to be realized from the rendition of services, which services were to be rendered by someone else after the sale. (See Realty Loan Corp. v. Commissioner, 54 T.C. 1083 (1970), affd., 478 F.2d 1049 (9th Cir. 1973).) The facts in Realty Loan Corp. are instructive in this appeal. In that case, the taxpayer sold its mortgage-. servicing business for a sales price of $86,500 which was allocated on the basis of $10,000 for goodwill and $76,500 for its right to future income from servicing

3/ A line of cases has held that for sections 24512 and. 24513 liquidation purposes, compensation received for a promise not to compete is taxable as ordinary income and does not constitute sale of property either real or personal. (Appeal of Halcyon Services, Inc., Cal, St. Bd. of Equal., July 26, 1978; see also, Beals' Estate v. -Commissioner, 82 F.2d 268 (2d Cir. 19361; Rev. Rul. 74-108, 1974-1 C.B. 248.) However, that line of reasoning deals with the characterization of the gain rather than the timing of the recognition of that gain..

fees. Income from servicing the loans would clearly be income from services when earned. The court concluded that both the qoodwill and the right to future income were property and the right to future income was not compensation for services. Accordingly, the taxpayer was entitled to report the entire gain from the sale of its business on the installment basis. Similarly, in the instant appeal, as indicated above, the cunsidoration received for the subject covenant did not represent compensation for services- but future profit to b-e realized from the rendition of services by someone else..

In addition, respondent argues that since the gain realized from the disposition of the covenant is ordinary income, no sale or other disposition took place therefore precluding installment method treatment, However, since dealers in real property may qualify for installment method treatment, qualificatiaa does not deoend on the characterization of net gain (i.e. ordinary versus capital gain). Moreover, appellant clearly sold or disposed of any interest it had in its assets. Accordingly, respondent's second argument is also without merit. Therefore, we must hold that appellant is entitled to utilize the installment method of accounting with respect to consideration received for the covenant not to compete.

As noted above, appellant's return far the year at issue was due on December 15, 1981, but not filed until December 8, 1983. No extension of time in which to file the return was obtained. Respondent imposed a penalty for failure to file a timely return. The penalty is applicable "unless it is shown that the failure [to file] *is* due to reasonable cause and not due to willful neglect." (Rev. & Tax, Code, § 25931). Appellant has not presented any argument in opposition to the imposition of the penalty. Since the burden of proof is upon the taxpayer (Appeal of Citicorp Leasing, Inc., Cal. St. Bd. of Equal., Jan. 6, 1976), we must assume the penalty applies based on the tax as hereby determined,

For the foregoing reasons, respondent's action must be modified,

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 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Country Club Cleaners against a proposed assessment of additional franchise tax and penalties in the total amount of $5,553 for the income year ended September 30, 1981, be and the same is hereby modified in accordance with this opinion. In all other respects the action of the Franchise Tax Board is sustained.

Done at Sacramento, California, this 19th day of November, 1986, by the State Board of Equalization, with Board Members Mr. Nevins, Mr. Collis, Mr. Bennett, Mr. Dronenburg, and Mr. Harvey present.

Richard Nevins, Chairman

Conway H. Collis, Member

William M. Bennett, Member

Ernest J. Dronenburg, Jr., Member.

Walter Harvey*, Member

*For Kenneth Cory, per Government Code section 7.9

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ORDER DENYING PETITION FOR REHEARING

Upon consideration of the petition filed December 22, 1986, by the Franchise Tax Board for rehearing of the appeal of Country Club Cleaners, we are of the opinion that none of the grounds set forth in the petition constitute cause for the granting thereof and, accordingly, it is hereby ordered that the petition be and the same is hereby denied and that the petition be and the same is hereby denied and that our order of November 19, 1986, be and the same is hereby affirmed. It is further ordered that our opinion of November 19, 1986, be withdrawn from publication and that it is not to be relied upon as precedent for any purpose.

Done at Sacramento, California, this 1st day of June, 1988, by the State Board of Equalization, with Board Members Mr. Dronenburg, Mr. Bennett, Mr. Collis, and Mr. Davies present.

Ernest J. Dronenburg, Jr., Chairman

William M. Bennett, Member

Conway H. Collis, Member

John Davies*, Member

_____, Member

*For Gray Davis, per Government Code section 7.9