89-SBE-027

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
) No. 88R-0925-LB
JAMES B. AND LINDA PESIRI)

Appearances:

For Appellants: Hans van Yperen
Certified Public Accountant

For Respondent: John A. Stilwell, Jr.
Counsel

OPINION

This appeal is made pursuant to section 19057, subdivision (a),[1/] of the Revenue and Taxation Code from the action of the Franchise Tax Board in denying the claim of James B. and Linda Pesiri for refund of personal income tax in the amounts of $3,990, $3,700 and $122 for the years 1980, 1981, and 1982, respectively.

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

The sole question for determination is whether appellants' income from the sale of a covenant not to compete was from a California source.

In 1978, Mr. Pesiri, hereinafter appellant, was the owner of J. C. Sales and Manufacturing, a California corporation engaged in designing and manufacturing parts and interiors for recreation vehicles. The corporation operated manufacturing facilities solely in the Los Angeles area although it sold only 25 percent of its finished products in California and 75 percent in other states. In 1978 appellant sold his business. Included in the sale was a covenant not to compete. In exchange for the covenant appellant was to receive $5,000 per month from January 1, 1980, through December 31, 1985. After the sale appellants became Oregon residents who are taxable only on their California source income.

The Franchise Tax Board (FTB) concluded that appellants received $60,000 annually that was taxable as California source income and issued the appropriate assessments. Thereafter, the assessments were paid and appellants filed claims for refund which were denied.

Appellants contend that at least some of the income was not California source income since 75 percent of the sales of the company came from sources outside California. Therefore, no more than 25 percent of the income could be taxable to them since they were Oregon residents. Apparently, appellants also argue that the income from the sale of the covenant was an intangible and not taxable by California at all since the covenant did not acquire a taxable situs in California.

The FTB points out that in order to be valid under California law, a covenant not to compete must be limited in scope (i.e., within a specified county or counties). (See Cal. Bus. & Prof. Code, §§16600-02.) Since the covenant in question was not limited in scope, in order for it to be enforceable, an appropriate geographical limitation must be presumed (i.e., the covenant must be limited to Los Angeles county). Therefore, the FTB concludes that the source of the proceeds from the sale of the covenant not to compete is California and that all of the income is taxable here.

We first dispose of appellants' argument that the covenant was an intangible and not taxable by California since it did not acquire a situs here. We reject this argument on the authority of The Korfund Company, Inc. v. Commissioner, 1 T. C. 1180 (1943) which determined that the right to compete is a property right with its situs in the location where such competition would have occurred absent the convenant.

Next, we consider the source of appellants' income from the sale of the covenant. A nonresident taxpayer must include in gross income "only the gross income from sources within this State." (Rev. & Tax. Code, § 17951.) The source of income from the sale of a covenant not to compete is where the taxpayer agrees to refrain from doing specific acts, where he forfeited his right to act. (See, e.g., The Korfund Company, Inc. v. Commissioner, supra.) The right of a shareholder to make a contract in restraint of business is limited by the provision of section 16601 of the Business and Professions Code, which provides in relevant part that a shareholder who sells all of his shares in his corporation "may agree with the buyer to refrain from carrying on a similar business within a specified county or counties, city or cities, or a part thereof, in which the business so sold, or that of, said corporation ... has been carried on ..."

If a contract contains a covenant not to compete, but does not contain a geographic area limiting such covenant, the covenant will be interpreted by the courts in such a manner as to preserve the covenant's validity. (See, e.g., Swenson v. File, 3 Cal.3d 389, 395 [90 Cal.Rptr. 580; 475 P.2d 852] (1970).) In this appeal, as the FTB points out, the covenant under consideration did not contain any provision limiting the geographic area to which it applied. The FTB agrees, under the circumstances, that a geographic limit must be assigned to the covenant.

However, the FTB contends that the largest geographical area permissible under section 16601 of the Business and Professions Code is Los Angeles County, the location of the corporation's sole manufacturing facility. Therefore, the FTB concludes that the source of all the proceeds from the sale of the covenant not to compete is California, the state in which appellant abstained from performance. Thus, the FTB concludes all the income is taxable by California. We disagree; the FTB views the area in which the corporation carried on its business too narrowly. (See Kaplan v. Nalpak Corp., 158 Cal.App.2d 197, 203 [322 P.2d 226] (1958).)

In Kaplan the court rejected a contention similar to the FTB's that a business is only carried on where the covenator's plant, warehouse, store or other physical structures were located, and concluded that selling products also involved carrying on a business in the counties where such sales were made. (Kaplan v. Nalpak Corp., supra, 158 Cal.App.2d at 203; accord Monogram Industries Inc. v. Sar Industries Inc., (64 Cal.App.3d 692, 702 [134 Cal.Rptr. 714] (1976) holding that within the terms of the statute the area where a business is "carried on" is not limited to the location of its physical plant, nor the areas where it makes sales; but includes the entire area, in which the parties conducted all phases of their business including production, promotional and marketing activities.)

Thus, we agree with the FTB that it is appropriate to recast the covenant within the terms of section 16601 of the Business 'and Professions Code in order to maintain its validity. However, the included area would be all the counties in California in which appellant made sales as well as Los Angeles County, the location of its plant. Never theless, this reconstituted area would still encompass only 25 percent of the area where the corporation's business was carried on since 75 percent of the sales were in other states. (See Kaplan v. Nalpak Corp., supra; Monogram Industries, Inc. v. Sar Industries Inc., supra.) Therefore, in accordance with the authority discussed above only 25 percent of the income received by appellants in exchange for the convenant not to compete would be from a California source and, thus, taxable by this state.[2] Accordingly, the action of the FTB must be modified.

2/ We do not hold that sales are the sole basis for an apportionment. However, based on this record, it is the only available basis.

Appeal of James B. and Linda Pesiri

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 19060 of the Revenue and Taxation Code, that the action of the Franchise Tax Board in denying the claim of James B. and Linda Pesiri for refund of personal income tax in the amounts of $3,990, $3,700, and $122 for the years and 1980, 1981, and 1982, respectively, be and the same is hereby modified.

Done at Sacramento, California, this 26th day of September1989, by the State Board of Equalization, with Board Members Mr. Carpenter, Mr. Bennett, Mr. Dronenburg, and Mr. Davies present.

Paul Carpenter, Chairman

William M. Bennett, Member

Ernest J. Dronenburg, Jr., Member

John Davies*, Member

________________, Member

*For Gray Davis, per Government Code section 7.9