2000-SBE-003

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeals of	)	
	)	
Paul B. and Mary A. Milhous	)	No. 99A-0186
	)	Case No. 89002466650
	)	
Robert E. and Gail P. Milhous	)	No. 99A-0187
		Case No. 89002466660

Representing the Parties:

For Appellant: Roy E. Crawford, LLP

For Respondent: Richard Gould, Tax Counsel

Counsel for Board of Equalization: Selvi Stanislaus, Tax Counsel III

OPINION

This appeal is made pursuant to section 19045[1] of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protests of Paul B. and Mary A. Milhous and Robert E. and Gail P. Milhous against proposed assessments of additional personal income tax in the amounts of $227,246 and $670,825, respectively, for the year 1993.[2]

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[1] Unless otherwise specified all section references are to sections of the Revenue and Taxation Code as in effect for the year in issue.

[2] Appellants appeals have been consolidated, because the facts and issues arising in both assessments are identical .

The issue presented on appeal is whether California may tax appellants' income from a covenant-not-to-compete (hereafter also known as covenant income) executed in connection with the sale of a business.[3]

Appellants are, and during all material times herein were, residents of the State of Florida, having left California in 1988. In 1973, appellant-Robert and his brother, appellant-Paul, formed Treasure Chest Advertising Company, Inc. (Treasure Chest), a California corporation. Treasure Chest's business primarily involved the printing of advertising circulars, flyers and inserts for newspapers. Over the years, Treasure Chest's business expanded to markets throughout the United States, Canada and Mexico. In fact, during the appeal year, Treasure Chest was the largest printer of advertising circulars, Sunday comics and TV listing guides and was the fourth largest commercial printer, in the United States.

Prior to incorporation, Treasure Chest was a California partnership. After incorporation, the corporate headquarters were located in Glendora, California. In 1987, Treasure Chest reorganized as a Delaware corporation; however, the corporate headquarters remained in California. From its inception, appellants were actively involved in the operations of Treasure Chest. Appellant-Robert assumed overall management responsibilities of the corporation, while appellant-Paul specialized in acquiring real estates and constructing printing plants. Treasure Chest operated 16 plants located throughout the United States to satisfy its substantial printing needs; three were located in California.

In 1993, Treasure Chest sold its assets to TCA Holdings Corporation for $120,000,000. Related to this sale, appellants, as shareholders and officers of Treasure Chest, executed a five-year covenant-not-to-compete agreement with the buyer, which prohibited them from competing with the buyer in the United States, Canada and Mexico, i.e., the same locations where Treasure Chest had conducted business. The consideration paid to appellants for said covenant was $30,000,000. Appellants did not report the covenant income on their California returns. Upon review, respondent determined that the income received in exchange for appellants' promise not to compete should be sourced to the states in which appellants agreed not to compete, and that California was one of those states. As such, some portion of the consideration appellants paid for the covenant-not-to-compete is California-source income, subject to tax by this state.

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[3] A second issue was raised on appeal: whether appellants are entitled to net operating loss deductions in computing their California adjusted gross income. Appellants have now conceded this issue. Because this issue is completely resolved, we will not address it in this decision.

In this appeal, the parties raise and brief three sub issues, which are:

1) What is the character of appellants' covenant-not-to-compete? (Respondent argues that it is intangible personal property having a business situs in this state [Cal. Code Regs., tit. 18, § 17951-2].) Appellants argue that it is more akin to payment for nonperformance of services.

2) Does any part of appellants' covenant income have a California-source?

3) If so, what is the proper method to ascertain the California portion of the covenant income?

The first two issues may be disposed of quickly. The character of a covenant-not-to-compete was analyzed in the Appeal of James B. and Linda Pesiri (89-SBE-027), decided by this Board on September 26, 1989. In that case, the taxpayers sold their California business, which was operated in a corporate form and, as part of that transaction, entered into a personal covenant-not-to-compete. The Pesiri taxpayers argued that the covenant was an intangible and not taxable by California since it did not acquire a situs here. Citing to the seminal covenant income case, The Korfund Company, Inc. v. Commissioner (1943) 1 T.C. 1180, this Board held that the right to compete is a property right with its situs in the location where such competition would have occurred absent the covenant. (Appeal of Aldean and Clara Washburn, Cal. St. Bd. of Equal., June 29, 1982.) In these cases, this Board effectively rejected the *mobilia sequuntur personam* maxim (income from intangible personal property is sourced to the taxpayer's state of residency) with respect to covenants-not-to-compete, in favor of the business situs exception. (Holly Sugar Corporation v. Franchise Tax Commissioner (1941) 18 Cal.2d 218, 223 ["Business situs arises from the act of the owner of the intangibles in employing the wealth represented thereby, as an integral portion of the business activity of the particular place, so that it becomes identified with the economic structure of that place, and loses its identity with the domicile of the owner."].)

Second, and along these same lines, we consider whether appellants' covenant income has a California-source. Under Revenue and Taxation Code section 17041, subdivision (b), California has the right to tax the income of nonresidents which is derived from sources in this state. Prior Board opinions addressing this issue have always upheld the federal rule, which is that covenant income is sourced to the "Place of Abstinence." Specifically, in Pesiri, supra, and in Washburn, supra, the Board determined that the source of income from a covenant-not-to-compete is the place where the promissor promised not to act. In this case, one of the places where appellants promised not to compete was California.

A more difficult problem arises regarding the methodology used to determine what portion of the covenant income should be assigned to California. Neither the Revenue and Taxation Code, nor the supporting regulations,[4] nor existing case authorities, provide clear guidance for taxpayers or this Board in resolving this issue. Respondent contends that it has reviewed numerous assignment formulas and believes the use of the three-factor formula (described below) is preferable because it fairly addresses the reality that businesses compete for the means of conducting business (e.g., labor, capital, materials, access to vendors and desirable property sites), as well as customers. Appellants reject respondent's formula and offer a duty day formula (the number of days appellants were physically present in California) and/or a facts and circumstances test (each covenant promise is considered separately). Due to the lack of formal guidance, we asked for supplemental briefing on the question of whether an alternative method of assigning covenant income; i.e. using a single sales factor approach, would be preferable. After reviewing the briefs and conducting extensive research on this issue, we are now comfortable in holding that the use of the three-factor formula in assigning income from a covenant-not-to-compete executed in connection with the sale of business is appropriate.

Within the corporate realm, the formula used to assign business income attributable to a state (the "three-factor formula") is determined by multiplying the income by a fraction, the numerator of which is the property factor plus the payroll factor plus the (double weighted) sales factor, and the denominator of which is three. (Rev. & Tax. Code, § 25128.)[5] The numerators of the respective factors are comprised of the taxpayer's property, payroll, and sales in California; the denominators consist of the taxpayer's property, payroll, and sales everywhere. (Rev. & Tax. Code, §§ 25129, 25132, and 25134.)

If the Uniform Division of Income for Tax Purposes Act (hereafter UDITPA) apportionment formula outlined above results in distortion, and thereby fails to fairly reflect the extent of the taxpayer's business in this state, an alternative method may be utilized. (See Rev. & Tax. Code, § 25137.) But section 25137 cannot be invoked unless the party seeking to use it

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[4] As of the date of this opinion, respondent has not published some definitive guidance (in the form of regulations, or otherwise) on the issue presented. However, respondent informed us that it is currently in the process of a regulation project which sets out the three-factor formula as the sourcing rule to be applied to covenants-not-to-compete.

[5] The Legislature amended Revenue and Taxation Code section 25128, subdivision (a), to allow for a double-weighted sales factor and a denominator of four for all income years beginning on or after January 1, 1993. (Ch. 946, Laws 1993, § 1, p. 4971.)

proves that application of the general provisions of UDITPA would lead to an unfair representation of the extent of the taxpayer's activities in this state. (See Appeal of Dart Container Corp. of California, 92-SBE-021, July 30, 1992; Appeal of Merrill, Lynch, Pierce, Fenner & Smith, Inc., 89-SBE-017, June 2, 1989.) While the three-factor formula is generally used in the corporate income tax setting, this Board has allowed respondent to assign nonresident taxpayers' personal income pursuant to this formula. (See Appeal of Chester A. and Mary E. Johnson, Cal. St. Bd. of Equal., July 29, 1981.)

In computing its business income apportioned to California, Treasure Chest reported an apportionment percentage of 25.053 percent. Respondent determined that the income from the covenant-not-to-compete should be reported to California in the same percentage that Treasure Chest apportioned business income to California. We agree. If 25.03 percent of Treasure Chest's business was done in California, then we believe it follows that 25.03 percent of the value of the covenant-not-to-compete should be assigned to the portion of the covenant which restricts appellants from competing in California with the buyer of Treasure Chest's business and assets.

We reached this conclusion after consideration of over seven different formulas submitted by the parties and narrowing the field down to two; a single sales factor approach versus the three-factor approach. Of the two, we believe that the three-factor formula is preferable for the same reasons that a single sales factor formula is not. Generally, a single sales factor approach assigns income to places where a business delivers goods. It does not assign income to where the business manufactures goods, owns property, employs personnel, or for that matter where the business conducts any other related activity. The problem with this approach is that it may conflict with the terms of a taxpayers' covenant, which fixes the geographic scope to all places where the business conducted activities, not just to the locations where it made sales. For example, if a corporation manufactures goods in Arizona and sells them exclusively in California, using the single sales factor formula will result in all income being assigned to California, even though much of the business activity occurred in Arizona. This result would conflict with the terms of a covenant which prohibited competition in both states. Additionally, a single sales factor approach does not accurately reflect the types of activities the covenant prohibits. This is especially true in the instant case because the buyer, TCA Holdings Corporation, desired protection from both appellant-Robert's business expertise and appellant-Paul's real estate acquisition and plant construction expertise. While appellant-Robert's activities will arguably be reflected in a single sales factor approach, appellant-Paul's activities will not.

By contrast, the three-factor formula assigns income to all places where business is conducted in amounts that reflect the various types of business activities. This approach reflects the terms of a typical covenant, such as the one here, which prohibits competition where all phases of business were carried on and in terms of the types of business activities conducted by the corporation. It also honors the geographic limit imposed on covenants and assigns income to where the buyer seeks protection and where harm from unwarranted competition would be concentrated. Because the three-factor formula rightfully sources covenant income to the places where the promisor forfeited the right to act in amounts that reflect the degree of corporate activity within the prohibited area, we believe that this formula is superior.[6]

For the above stated reasons, we hold that the use of the three-factor formula as found in the Revenue and Taxation Code section 25128, in assigning income from the covenant-not-to-compete executed in connection with the sale appellants' former corporation was appropriate. We direct respondent to assess the tax liability based on our holding in this case. The factors to be used when computing appellant's covenant income should be limited to the corporate factors of the business sold for the income year preceding the sale of the business.

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[6] We recognize that like all formulas this, too, may not be appropriate for all situations. For example, if a corporation conducts business in Arizona, California and Nevada but the covenant only prohibits competition in Arizona and California, then it would be inequitable to use the three-factor formula. Therefore, we believe that if the assignment of income by the three-factor formula does not fairly reflect both the nature of the prohibited activities and the locations of the business sold, or the use of the factors for the year of the business in which the sale occurs does not accurately represent the location of recent historical business activities of the business sold, such that there is a gross distortion of income assigned to California, either party may move for a more fair and equitable result. (Rev. & Tax. Code, § 25137.) Neither party has demonstrated that the use of the three-factor formula would produce a gross distortion of income to be assigned to California in the present case.

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 19047 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protests of Paul B. and Mary A. Milhous and Robert E. and Gail P. Milhous against proposed assessments of additional personal income tax in the amounts of $227,246 and $670,825, respectively, for the year 1993 be and the same is hereby sustained.

Done at Sacramento, California, this 2nd day of November, 2000, by the State Board of Equalization, with Board Members Mr. Andal, Mr. Parrish, Mr. Klehs, Mr. Chiang, and Ms. Mandel* present.

Dean Andal, Chairman

Claude Parrish, Member

Johan Klehs, Member

John Chiang, Member

Marcy Jo Mandel*, Member

*For Kathleen Connell per Government Code section 7.9.

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