

Appeal of Fred and Helen Gottschalk

Appellants were employed by J. & T. Food Corporation during the year in issue; they were not covered by a qualified pension plan through their employer. On their 1978 joint California personal income tax return, appellants reported income of \$28,556 consisting of, inter alia, \$7,500 in wages and \$20,000 from a covenant not to compete. The \$20,000 was apparently received from appellants' employer in compensation for refraining from engaging in a self-employment venture in which appellants had engaged prior to their employment.

Upon audit, respondent discovered that appellants had computed their individual retirement arrangement ("IRA") contribution deduction on the basis of their wages and the income received from the covenant not to compete. Respondent determined that the income received by appellants for refraining from their self-employment venture did not constitute ("net earnings from self-employment" from a trade or business for purposes of computing their allowable IRA contribution deduction. On the basis of this conclusion, respondent reduced the \$3,000 IRA contribution deduction claimed by appellants to \$1,125 (15 percent of their wage income). The subject notice of proposed assessment was subsequently issued, thereby resulting in this appeal.

As further explained below, the question presented by this appeal is one of law, i.e., whether under the circumstances of this appeal, the income received by appellants for the covenant not to compete constituted "net earnings from self-employment," as that term is defined in section 1402(a) of the Internal Revenue Code of 1954.

Revenue and Taxation Code section 17240 provides, in pertinent part, as follows:

(a) In the case of an individual, there is allowed as a deduction amounts paid in cash for the taxable year by or on behalf of such individual for his benefit--

(1) To an individual retirement account described in Section 17530(a).

(2) For an individual retirement annuity described in Section 17530(b), or

(3) For a retirement bond described in Section 17530.1

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(b)(1) The amount allowable as a deduction under subdivision (a) to an individual for any taxable year may not exceed an amount equal to 15 percent of the compensation includable in his gross income for such taxable year, or one thousand five hundred dollars (\$1,500), whichever is less.

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(c)(1) For purposes of this section, the term "compensation" includes earned income as defined in Section 17502.2(b). (Emphasis added.)

Subdivision (b) of Revenue and Taxation Code section 17502.2 provides, in pertinent part, as follows:

(b)(1) The term "earned income" means the net earnings from self-employment (as defined in Section 1402(a) of the Internal Revenue Code of 1954)

Section 1402(a) of the Internal Revenue Code of 1954 defines the term "net earnings from self-employment," in relevant **part, as follows:**

The term "net earnings from self-employment" means the gross income derived by an individual from any trade or business carried on by such individual

Payments received in compensation for a covenant not to compete constitute ordinary income "no less than [payments made in] compensation for services to be performed." (Salvage v. Commissioner, 76 F.2d 112, 113 (2nd Cir. 1935); see also, Cox v. Helvering, 71 F.2d 987 (D.D.C. 1934); Charles W. Balthrope, ¶ 64,031 P-H Memo. T.C. (1964).) The question of whether payments and benefits received by an individual for refraining from engaging in his trade or business are to be considered gross income from such trade or business, and thereby be includable in his "net earnings from self-employment," has also been addressed. (Rev. Rul. 60-32, 1960-1 Cum. Bull. 23; see also, G. A. Stafford & Co., Inc. v. Pedrick, 171 F.2d 42 (2nd Cir. 1948); Baboquivari Cattle Co., 47 B.T.A. 129, affd., 135 F.2d 114 (9th Cir. 1943); Treas. Reg. § 1.61-4 (a)(4).) The cited authority stands for the proposition that payments and benefits received in compensation for refraining from one's trade or business constitute gross income therefrom. Accordingly, the

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income received by appellants for the covenant not to compete constituted "net earnings from self-employment" within the -meaning of Internal Revenue Code section 1402(a) and, under the circumstances of this appeal, may be used by appellants to compute their allowable IRA contribution deduction.

For the reasons set forth above, respondent's action in this matter will be reversed.

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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 18595 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Fred and Helen Gottschalk against a proposed assessment of additional personal income tax in the amount of \$158.04 for the income year 1978, be and the same is hereby reversed.

Done at Sacramento, California, this 26th day of July, 1982, by the State Board of Equalization, with Board Members Mr. Bennett, Mr. Dronenburg and Mr. Nevins present.

William M. Bennett, Chairman

Ernest J. Dronenburg, Jr., Member

Richard Nevins, Member

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