BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
WALTER MORTENSEN INSURANCE, INC.)

For Appellant: George Manolakas
Attorney at Law

For Respondent: Gary M. Jerrit
Counsel

O P I N I O N

This appeal is made pursuant to section 25666 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Walter Mortensen Insurance, Inc., against proposed assessments of additional franchise tax in the amounts of $4,487, $2,915, $3,046, and $2,973 for the income years 1978, 1979, 1980, and 1981, respectively.

The issues for determination in this appeal are whether appellant has established that the insurance expiration lists it purchased from other local insurance agencies had: (i) an ascertainable value separate and distinct from the goodwill purchased from these agencies, and (ii) a limited life.

Appellant is an insurance broker operating in Kern County. In 1976, 1977, and 1978, appellant purchased three local insurance agencies, the Trammel Agency in 1976, the Curran-Pitts Agency in 1977, and the I. E. Moore Agency in 1978. The purchase agreements for each agency were similar. Each agreement included a purchase price allocated between the assets of the business and a covenant not to compete.* Although none of the purchases included the acquisition of any real or tangible personal property, the purchase price did include expiration insurance lists owned by the sellers along with the goodwill existing in their businesses. There was no attempt, however, to allocate the purchase price of the businesses between goodwill and the insurance expiration lists.

On its returns appellant allocated all of the purchase price not allocated to the covenant not to compete to the insurance expiration lists. The cost thus allocated was amortized over periods varying from five to eight years. Respondent denied the claimed amortization deductions which gave rise to this timely appeal.

Respondent's position is that the insurance expiration lists did not have an ascertainable value separate and distinct from the goodwill purchased from each business and no limited life; therefore, their value could not be amortized.

Appellant contends that, despite the fact standard form purchase agreements reciting the transfer of various assets such as goodwill were used in each transaction,.it did not purchase any assets from the three businesses other than the insurance renewal lists possessed by each business. Appellant offers as evidence of this the fact that it did not occupy the buildings or

* Respondent has not raised any issues relative to the value of the covenants not to compete.

locations of any of the purchased agencies, did not acquire any of the physical office assets, and made limited use of the business names of the businesses. Finally, appellant states that the employment agreements and covenants not to compete were entered into for the sole purpose of protecting its right to the full use and enjoyment of the renewal lists which were the sole object of its purchase of each of the businesses.

California Revenue and Taxation Code section 24349 provides that a depreciation deduction may be taken for the exhaustion, wear and tear, or obsolescence of property used in a trade or business. Section 24349 is substantially similar to section 167 of the Internal Revenue Code; therefore, federal interpretations of this section are persuasive as to its proper interpretation. (Meanley v. McColgan, 49 Cal.App.2d 203 [121 P.2d 45] (1942); Holmes v. McColgan, 17 Cal.2d 426 [110 P.2d 428] (1941).) Treasury regulation § 1.167(a)-3 allows amortization of intangible assets with a limited life.

An insurance expiration list is a compilation of policies. Normally, it shows the name of the insured, address, type of insurance, premium carrier, property covered, and expiration date. The value of such a list is its function as a customer list, informing the purchaser when and from whom to solicit renewals. Such lists generally have been considered to represent the customer structure of a business, with a value lasting until an indeterminate time in the future. (See Appeal of Raymond and Rosemarie J. Pryke, Cal. St. Bd. of Equal., Sept. 15, 1983.) In the past, customer lists were consistently viewed by the courts as being in the nature of goodwill or otherwise to have indeterminable lives and were not, therefore, subject to depreciation. (Ralph W. Fullerton Co. v. United States, 550 F.2d 548 (9th Cir. 1977); Marsh & McLennan, Inc. v. Commissioner, 420 F.2d 667 (3d Cir. 1969).) This view was reflected in Revenue Rulings 65-175 and 65-180. (See 1965-2 Cum. Bull. 41 & 279.) In recent years, however, this view has been modified. Essentially, the courts now recognize that if an asset of this sort, or a portion thereof, does not possess the characteristics of goodwill, is susceptible of valuation, and is of use to the taxpayer in its trade or business for only a limited period of time, a depreciation deduction will be allowed. (Houston Chronicle Publishing Co. v. United States, 481 F.2d 1240 (5th Cir. 1973); Skilken v. Commissioner, 420 F.2d 266 (6th Cir. 1969); Manhattan Co. of Virginia, Inc., 50 T.C. 78 (1968).) In each of these cases, the courts recognized that under certain conditions, a purchased asset such as a subscription list may be amortizable, especially when the purchase is from a business which thereafter ceases to exist.

In 1974, the Internal Revenue Service issued Revenue Ruling 74-456,. incorporating this latter concept and modifying its previous rulings, to-the extent that they had indicated such lists were, as a matter of law, indistinguishable from goodwill. Revenue Ruling '74-456 provides, in part, as follows:

> The depreciability of assets of this nature is a factual question, the determination of which rests on whether the taxpayer establishes that the assets (1) have an ascertainable value separate and distinct from goodwill, and (2) have a limited useful life, the duration of which can be ascertained with reasonable certainty.

(1974-2 Cum. Bull. 65, 66.)

Respondent concedes that in rare cases a taxpayer may be entitled to a depreciation deduction when it can be established as a factual matter that the insurance expiration lists had a value separate from goodwill and a reasonably ascertainable limited life. (Rev. Rul. 74-456, supra; Richard S. Miller & Sons, Inc. v. U.S., 537 F.2d 446 (Ct. Cl. 1976).) However, respondent points out that no deduction is allowable merely because the taxpayer, in its unsupported view, has estimated a basis. (Rev. Rul. 74-456, supra.) It submits that in the instant case it is impossible to distinguish the value of the goodwill from any value associated with the insurance expiration lists because of the following factors: (1) the businesses purchased were ongoing concerns which had been established for lengthy periods in the community; (2) the contract called for the transfer of goodwill; (3) appellant attempted to retain the goodwill of the purchased businesses by bargaining to retain the name of the former agencies in the letterhead; (4) a continuity of the operations of the purchased insurance agencies was insured by employing the former owners/operators for a year: and finally (5) no attempt was made to allocate the purchase price between the value of goodwill and the value of the insurance expiration lists. For the reasons stated below, we disagree with respondent's contentions in this regard.

Although, as respondent points out, the businesses purchased were ongoing concerns which had been established for lengthy periods in the community, all ceased to exist after they were purchased by appellant. This factor has been given great weight by the courts in determining that the parties were not simply bargaining for the purchase of goodwill. (See Appeal of Raymond and Rosemarie J. Pryke, supra.) The fact that each contract called for the transfer of goodwill, and no attempt was made to allocate the purchase price between goodwill and the insurance expiration lists, is not fatal to appellant's case. Respondent would bind appellant to the precise terms of the standard form language contained in each purchase agreement and would ignore the fact that in each case appellant did not continue the business of the purchased agency, thus lessening the value of the goodwill. When dealing with problems of this sort, the courts are not always bound by the precise terms of a written agreement. (John T. Fletcher, ¶ 65,273 P-H Memo. T.C. (1965).) Respondent does correctly point out that appellant d-id attempt to retain the goodwill of the purchased businesses by bargaining to retain the name of the former agencies in the letterhead and insured a continuity of the operations by employing the former owners/operators for a year. We recognize, however, that goodwill may have been only one element among several of the elements bargained for in the sale, along with the transfer of a going business and the expiration lists. As such, we conclude that appellant has met its burden with regard to establishing that, as a factual matter, the insurance lists in question have an ascertainable value separate and distinct from goodwill.

Having concluded that the insurance expiration lists have an ascertainable value separate and distinct from goodwill, we are left with the necessity of determining what portion of the total purchase price is allocable to the lists and what portion to goodwill. (See John T. Fletcher, supra; Cohan v. Commissioner, 39 F.2d 540, 543-544 (2d Cir. 1930).) After considering all the facts contained in this record relevant to such allocation, and applying our own best judgment, we conclude that 50 percent of the total purchase price of each purchase should be allocated to the insurance expiration lists and that 50 percent should be allocated to goodwill. This determination is consistent with our finding that goodwill, as well as the expiration lists, was an element in each of the sales, and appellant has not offered sufficient evidence to establish that the value of the goodwill was of a lesser amount or that the value of the lists was of a greater amount.

We turn next to the question of whether the lists did in fact have a limited useful life, the duration of which can be ascertained with reasonable certainty. (See Rev. Rul. 74-456, supra.) Appellant submitted to respondent a computerized record which establishes that 51-55 percent of the accounts contained in the purchased lists have been lost over' a period of 3 years and 8 months to 5 years. (Resp. Ex. D.) Appellant argues that the renewal lists had a limited life. because of the fact that clients move out of the area, die, and change insurance companies. Based on previous experience, appellant estimates that such lists generate additional business for a period of five to eight years. According to appellant's records, the premiums on policies represented by these renewal lists are nearly exhausted in a five- to eight-year period.

In respondent's view, appellant's high retention rate of accounts on the original insurance expiration lists and its potential for acquisition of referral business is compelling evidence that the lists were assets with indeterminable life and, therefore, not subject to amortization. 'However, respondent's only offer of proof that the insurance expiration lists had an indeterminable life, and thus were not subject to depreciation, is the fact that after a lapse of four to five and one-half years from the date of purchase, between 44 percent and 49 percent of the original accounts were retained by appellant and that the lists would also lead to referrals to other customers. We believe that the retention-rate figure is consistent with appellant's claim that the lists have a useful life of between five and eight years. Accordingly, we conclude that appellant has adequately shown that the five- to eight-year useful lives claimed for the insurance expiration lists were reasonable and accurate.

For the reasons stated above, respondent's action in this matter must be modified.

Appeal of Walter Mortensen Insurance, Inc.

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 Walter Mortensen Insurance, Inc., against proposed assessments of additional franchise tax in the amounts of $4,487, $2,915, $3,046, and $2,973 for the income years 1978, 1979, 1980, and 1981, respectively, be and the same is hereby modified in accordance with our opinion. In all other respects, the action of the Franchise Tax Board is sustained.

Done at Sacramento, California, this 27th day of June, 1984, by the State Board of Equalization, with Board Members Mr. Nevins, Mr. Dronenburg, Mr. Collis and Mr. Bennett present.

Richard Nevins, Chairman

Ernest J. Dronenburg, Jr., Member

Conway H. Collis, Member

William M. Bennett, Member

_______________, Member