BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of )
) No. 83A-1320-SW
OCTOGON DEVELOPMENT COMPANY )

Appearances:

For Appellant: Arthur W. Landing, Enrolled Agent
Howard Essex

For Respondent: Lorrie K. Inagaki
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 Octogon Development Company against proposed assessments of additional franchise tax in the amounts of $2,089 and $287 for the income years ended September 30, 1980, and September 30, 1981, respectively..

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

Appeal of Octogon Development Company

The sole issue presented in this appeal is whether appellant has shown its entitlement to a loss deduction claimed for a customer list which was destroyed in a fire.

Appellant is a company which on October 1, 1979, purchased a travel-agency in Compton, California. In the sales agreement for the agency, the $70,000 purchase price was stated as including $5,000 for furniture and equipment, $5,000 for goodwill, and $60,000 for a customer list. The $60,000 figure was arrived at by averaging the yearly totals of sales for a three-year period and then multiplying by a factor of .10, the normal sales commission in the industry. The seller agreed to a five-year noncompetition clause and allowed appellant to maintain the same location of the business. Appellant was also permitted to use the name of the seller for six months. The customer list was not insured and had not, in the sales agreement, been given a useful life.

Shortly after appellant purchased the business, a key managerial employee left the company and opened a competing travel agency within several miles of appellant's location. When a fire in August of 1980 destroyed appellant's agency, including all its records and its customer list, this previous employee contacted some of appellant's customers and informed them that appellant was out of business. Because appellant's office was destroyed and because it had trouble getting the telephone company to refer calls to a new telephone number, many of appellant's accounts were lost to its competitors, including the former employee mentioned above.

For the income year ended September 30, 1980, appellant amortized $30,000 of the customer list's cost. Appellant concluded that the combination of the loss of records, the inability to service clients, and the lack of proper phone services, all of which were the direct result of the fire, effectively reduced the value of the purchased customer list. Only half of the cost of the customer list was amortized because appellant determined that the list had some remaining value after the fire due to walk-in trade which was duplicated on the destroyed list.

The following year, appellant amortized an additional $3,000 of the value of the customer list because, in reappraising the effects of the loss, it found that its business was interrupted four months longer than originally anticipated. Appellant had estimated that it'would take three months to rebuild the store when in reality it took almost seven months. We note that appellant now concedes that it incorrectly claimed the additional loss in 1981. The entire loss should have been claimed in 1980.

Respondent disallowed the amortization and concluded that appellant's losses are capital losses which cannot be deducted prior to the discontinuance of the business. Although appellant originally indicated on its tax returns that it was amortizing the cost of the customer list, it now appears that both parties agree that the issue in this appeal is whether appellant is entitled to a loss deduction for a customer list which was destroyed in a fire.

Section 24347, subdivision (a), provides that a deduction shall be allowed for any loss sustained during the income year which is not compensated for by insurance or otherwise. This section is similar to section 165(a) of the Internal Revenue Code, and, therefore, federal case law is highly persuasive as ta the interpretation of the California statute. (Rihn v. Franchise Tax Board, 131 Cal.App.2d 356 [280-d 893] (1955).) It is well established, moreover, that deductions are a matter of legislative grace, and the burden is on the taxpayer to show by competent evidence that it is entitled to the deduction claimed. (New Colonial Ice co. v. Helvering, 292 U.S. 435 [78 L.Ed. 1348] (1934).) Appellant, therefore, must establish (1) that it actually sustained a deductible loss; (2) that the loss was sustained during its income year ended September-30, 1980, as evidenced by a closed and completed transaction and as fixed by identifiable events; (3) that the loss was uncompensated; and (4) the amount of the loss. (United States v. White Dental Mfg Co., 274. U.S. 398 [71 L.Ed. 1120] (1927); Cal. Admin. Code, tit. 18, reg. 24347-1, subds. (b) and (d).)

The evidence clearly indicates that appellant sustained some type of loss which was not compensated for 'by insurance or otherwise. This loss, however, must be correctly classified so that appellant can receive the appropriate relief for its loss. Respondent's position is that the loss is by nature a capital loss while appellant contends that the loss is not a capital loss but but rather a casualty loss which is fully deductible in the year of the fire.

Section 18161 and Internal Revenue Code section 1221 define capital assets'as all assets, except those specifically listed in the statutes, such as property used by a taxpayer in his trade or business which is depreciable or is real property. The purpose of creating this class of assets was to distinguish profits and losses arising from Ehe everyday operation of a business from the realization of appreciation in the value of assets. which has accrued over a substantial period of time. Inventory items or property held for sale to customers were therefore distinguished from the profits made by investors who engaged in relatively few transactions. While the sale of the former resulted in the recognition of ordinary income, the capital assets were given favorable treatment if they were held over a year. If the customer list is found to be a capital asset, the loss must be recognized when the business is sold.2/ If the list is found to be a noncapital asset, the loss may be taken in the year of the fire. Given the nature of the customer list, we must conclude that respondent correctly classified the list as a. capital_ asset.

There are several reasons for reaching this conclusion. First, the value of the customer list cannot be ascertained accurately until the business is sold, which is indicative of a capital asset. When the list was purchased, it was purchased as a mass asset with no value given to any particular customer. (See' Sirovatka v. Commissioner, ¶ 83,634, T.C.M. (P-H) (1983).) Without an established formula whereby the loss of any customer could be valued, the loss of an-individual account would merely diminish the value of the entire customer list by some undeterminable amount. (See Tomlinson v. Commissioner, 507 F.2d 723 (9th Cir. 1974); Sunset Fuel Co. v. United States, 519 F.2d 781 (9th Cir. 1975).) In this case, appellant determined that at least 30 percent of its former customers had returned to the agency. Given a yearly average of gross sales at $600,000, minus the $325,000 in annual sales generated by the six major customers which appellant admittedly retained, appellant lost only two-thirds of $275,000 or $183,333 in gross sales, while retaining $416,667 in sales. In addition,' appellant concedes that one-half of

2/ The destruction of the list by fire does not constitute a sale or exchange if the'property is a capital asset. (Bittker, 2 Federal Taxation of Income, Estates and Gifts, ¶ 52.1.3 (1981).)

its losses resulted because a competitor used appellant's misfortune as an excuse to lure away some of its clients. While regrettable, this is not the type of loss covered by the casualty loss statute. One-half of 'any loss attributable to lost customers would therefore have to be eliminated. Given the above ambiguities, even if the loss were not a capital loss, the value of the loss would be minimal if even ascertainable.

Secondly, appellant has not shown that the goodwill value of the list has been segregated out. As the court stated in Sunset Fuel Co., 519 F.2d at 783,

> "When an account is lost, a ratable portion of the mass' goodwill, beyond the expected flow of income from a particular account, is not necessarily lost with it, as the lost customer may refer other customers to the business, and may later resume his orders."

In sum, the indivisible-asset rule prevents a loss deduction if the goodwill or ongoing concern value' cannot be segregated out and a value cannot be allocated to the particular accounts lost. (See Appeal of George O. and Alice E. Gullickson, Cal. St. Bd. of Equal., June 29, 1982.) As there is clearly a substantial amount of goodwill involved in the customer list, as evidenced by the fact that 30 percent of the customers returned, unless this value can be segregated out, the amount of the loss cannot be determined and the list should be classified as an indivisible capital asset. (See Ralph W. Fullerton Co. v. United States, 550 F.2d 548 (9th Cir. 1977).)

Finally, it must be noted that the loss of the customer list was not the type of loss generally associated with the casualty loss provisions. Rather, the list was at least partially intangible in that it had a continuing value which did not cease when the actual list was burned. Customers continued to return or refer others to appellant. Admittedly, the loss lowered appellant's income; however, it also lowered appellant's franchise tax liability. And when the business is eventually sold, there will be a completed and closed transaction which will establish when the loss is actually sustained. (Citizens Bank of Weston v. Commissioner. 28 T.C. 717, 721 (1957).)

In sum, while we appreciate appellant's efforts to set a'realistic value on the loss, we cannot disregard the well-established legal principles discussed above. As the amount of the loss cannot be segregated from the goodwill and the going concern value, we cannot conclude that the loss is deductible as a casualty loss. The action of respondent must, therefore, be sustained.

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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 DECHEED, pursuant to section 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Octogon Development Company'against proposed assessments of additional franchise tax in the amounts of $2,089 and $287 for the income years ended September 30, 1980, and September 30, 1981, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 6th day of October , 1987, by the State Board of Equalization, with Board Members Mr. Collis, Mr. Dronenburg, Mr. Carpenter and Ms. Baker present.

Conway H. Collis, Chairman

Ernest J. Dronenburg, Jr., Member

Paul Carpenter, Member

Anne Baker*, Member

________________, Member

*For Gray Davis, per Government Code section 7.9