BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeals of)
)
ROBERT D. AND LORNA WATSON)

Appearances:

For Appellants: Thomas A. Crear
Attorney at Law

For Respondent: Michael E. **Brownell**
Counsel

O P I N I O N

These appeals are made pursuant to section 18593 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protests of Robert D. and Lorna Watson against proposed assessments of additional personal income tax in the amounts of **$6,112.95** and **$2,053.48** for the year 1978. Robert Watson and Lorna Watson are husband and wife. Lorna Watson is a party to this appeal only because the couple filed a joint income tax return. Consequently, Robert Watson will hereafter be referred to as appellant.

The question presented for decision is whether appellant is entitled to deduct a loss incurred by his purchase of a franchise.

Appellant is a real estate broker by profession. In 1978 he purchased a territorial license from Medi-Health Financial Corporation, a newly formed Nevada corporation. The territorial license entitled appellant to use the trademark and sell the product of Medi-Health Systems, Inc., a California corporation, within a specified geographical area of Honolulu, Hawaii. The Medi-Health product is described in general terms as a combination of equipment, instructional material, and on-site training for smoking and weight control. The term of the license was for 20 years. Medi-Health Financial Corporation retained the right to disapprove an assignment of the license, the right to require that appellant sell or advertise the Medi-Health product, and the right to prescribe standards of quality.

The purchase price of the territorial license was $350,000. Under the terms of the license agreement, the purchase price was payable in installments of $70,000 in 1978, $70,000 in 1979, $61,250 in 1980, and $8,750 per year for the remaining 17 years of the license. The terms of the purchase required appellant to pay $17,500 in cash in 1978, the year of sale. The remainder of the first year payment was payable with a nonrecourse note for $52,500. The agreement provided that appellant could, at his option, pay each of the remaining yearly installments with nonrecourse notes or a combination of cash and nonrecourse notes or,cash and recourse notes. The nonrecourse notes 'were to bear interest at seven percent while any recourse notes would bear a six percent rate. Payments on the notes, characterized as prepayments in the agreement, were to be made in amounts equal to five percent of the debtor's cost of all products acquired, two percent of gross receipts from the operation of a Medi-Health Center, and 35 percent of the royalties received from any sub-territorial licensees. If such prepayments were not sufficient to liquidate the total indebtedness, the notes were due and payable at the conclusion of the 20 year term. The nonrecourse notes were secured only by appellant's interest in the Medi-Health trademark and license, any receivables pertaining to merchandising the Medi-Health products, and any inventory of Medi-Health products.

When the business venture was proposed, appellant was told that a Medi-Health center was already

operating in Phoenix, Arizona. He visited the Phoenix operation, but was not permitted to examine the books to see if the venture was profitable. From a list of potential business territories, appellant selected the Honolulu area. Appellant undertook no market surveys in Honolulu and went to Hawaii in December 1978, only after the contract was signed. On that trip, appellant met with a real estate acquaintance and discussed the possibility of sublicensing the franchise. Appellant was advised that before he could sell. sublicensing arrangements in Hawaii, he would have to register Medi-Health as a franchise with the Department of Regulatory Agencies. Appellant made two attempts through local counsel to contact an attorney in Honolulu. When he did not receive a response to his inquiries, appellant made no further effort to register his franchise or engage in business activity in Hawaii. Appellant has received no Medi-Health products in connection with his license agreement, ostensibly because he has not yet found an attorney to accomplish the necessary franchise registration.

On his 1978 tax return, appellant claimed a business loss of $71,168. Appellant deducted $1,168 in travel and entertainment expenses and $70,000 for the purchase of the Medi-Health franchise. The $70,000 deduction for the Medi-Health franchise consisted of a $17,500 cash payment and a $52,500 nonrecourse note. Appellant contends that because he selected the accrual basis of accounting for his Medi-Health business, deduction of the nonrecourse note was proper.[1/] Respondent contends that appellant is not entitled to the loss because (1) the nonrecourse indebtedness was a contingent liability and, therefore, had not accrued under the "all events" test, and (2) in any event, the deductibility of the loss is limited to the extent provided under Revenue and Taxation Code section 17233 because purchase of the franchise was not an activity engaged in for profit.

We will deal first with the issue of whether the note had accrued in 1978 under the all events test.

1/ There is no question that deduction of the $52,500 Gould be improper under subsequent changes in the "at risk" provisions of Revenue and Taxation Code section 17599. However, these changes are applicable only to taxable years beginning after December 31, 1978.

Deduction of the $70,000 franchise payment is based on section 18218.5 of the Revenue and Taxation Code.2/ Under section 18218.5, when a transferor of a franchise retains significant rights pertaining to the franchise, such as those rights retained by Medi-Health Financial Corporation, the transaction is not treated as a sale or exchange of a capital asset. Instead, the deductibility of payments made for the franchise is governed by section 18218.5, subdivision (d).

2/ Section 18218.5 reads as follows:

> (a) A transfer of a franchise, trademark, or trade name shall not be treated as a sale or exchange of a capital asset if the transferor retains any significant power, right, or continuing interest with respect to the subject matter of the franchise, trademark, or trade name.
>
> (b-) For purposes of this section--
>
> (1) The term "franchise" includes an agreement which gives one of the parties to the agreement the right to distribute, sell, or provide goods, services, or facilities, within a specified area.
>
> (2) The term "significant power, right, or continuing interest" includes but is not limited to, the following rights with respect to the interest transferred:
>
> (A) A right to disapprove any assignment of such interest, or any part thereof.
>
> (B) A right to terminate at will.
>
> (C) A right to prescribe the standards of quality of products used or sold, or of services furnished, and of the equipment and facilities used to promote such products or services.
>
> (D) A right to require that the transferee sell or advertise only products or services of the transferor.

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Section **18218.5**, subdivision (d)(1) provides that amounts paid or incurred during the taxable year on account of a transfer of a franchise which are contingent on the productivity, use, or disposition of the franchise transferred, shall be allowed as a deduction under subdivision (a) of section **17202** (relating to trade or business expenses).

2/ (Continued)

(E) A right to require that the transferee purchase substantially all of his supplies and equipment from the transferor.

(F) A right to payments contingent on the productivity, use, or disposition of the subject matter of the interest transferred, if such payments constitute a substantial element under the transfer agreement.

(3) The term "transfer" includes the renewal of a franchise, trademark, or trade name.

(c) Amounts received or accrued on account of a transfer, sale, or other disposition of a franchise, trademark, or trade name which are contingent on the productivity, use, or disposition of the franchise, trademark, or trade name transferred shall be treated as amounts received or accrued from the sale or other disposition of property which is not a capital asset.

(d)(1) Amounts paid or incurred during the taxable year on account of a transfer, sale, or other disposition of a franchise, trademark, or trade name which are contingent on the productivity, use, or disposition of the franchise, trademark, or trade name transferred shall be allowed as a deduction under subdivision (a) of Section 17202 (relating to trade or business expenses).

(2) If a transfer of a franchise, trademark, or trade name is not (by reason of the application of subdivision (a)) treated as a

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Section 18218.5, subdivision (d)(2) provides that if the transfer of a franchise is not treated as a sale or exchange of a capital asset, any payment not described in subdivision (d)(1) which is made in discharge of a principal sum agreed upon in the transfer agreement shall be allowed as a deduction as follows:

2/ (Continued)

sale or exchange of a capital asset, any payment not described in paragraph (1) which is made in discharge of a principal sum agreed upon in the transfer.agreement shall be allowed as a deduction--

(A) In the case of a single payment made in discharge of such principal sum, ratably over the taxable years in the period beginning with the taxable year in which the payment is made and ending with the'ninth succeeding taxable year or ending with the last taxable year beginning in the period of the transfer agreement, whichever period is shorter;

(B) In the case of a payment which is one of a series of approximately equal payments made in discharge of such principal sum, which are payable over--

(i) The period of'the transfer agreement, or

(ii) A period of more than 10 taxable years, whether ending before or after the end of the period of the transfer agreement,

in the taxable year in which the payment is made; and

(C) In the case of any other payment, in the taxable year or years specified in regulations prescribed by the Franchise Tax Board, consistently with the preceding provisions of this paragraph.

(e) This section shall not apply to the transfer of a franchise to engage in professional football, basketball, baseball, or other professional sport.

(1) Where a single lump sum payment is made in discharge of the principal sum, the payment is deductible ratably over ten years or the period of the contract, whichever is shorter.

(2) Where equal payments are made in discharge of the principal sum over the term of the contract or over a period in excess of ten years, the payments are deductible when made.

(3) Where the payments in discharge of the principal sum are unequal, their deductibility is governed by regulation.

In Revenue Ruling 81-262, 1981-2 Cum. Bull. 164, the Internal Revenue Service was presented with a situation very similar to the present case. In 1978, the taxpayer purchased a ten-year franchise to sell a machine which performed blood type analysis and printed a blood type identification card. Under the terms of the franchise agreement, the taxpayer was to pay the transferor 50 percent of the net profits from the sale of the machines and 50 percent of the fee for each identification card produced. In addition, the taxpayer was to pay a minimum franchise fee of 50,000x dollars each year during the term of the franchise. The transferor's rights were secured only by a security interest in the taxpayer's 50 percent share of the net profits and by the franchise. The agreement provided that the entire first year's franchise fee could be paid with a 50,000x dollar nonrecourse note payable'in ten years. No machines were sold the first year. The taxpayer paid the yearly franchise fee with a 50,000x dollar nonrecourse note which he signed and delivered in 1978. On his 1978 tax return, he claimed a 50,000x dollar deduction under section 1253 of the Internal Revenue Code, the federal counterpart to section 18218.5 of the Revenue and Taxation Code. The taxpayer could not show that the market value of his rights in the franchise and the net profits were equal to 50,000x dollars.

The Service first analyzed the transaction to determine whether Internal Revenue Code section 1253 (d)(1) or 1253(d)(2) was applicable. The wording in each section is almost identical to the wording of Revenue and Taxation Code section 18218.5, subdivisions (d)(1) and (d)(2), respectively. The Service looked behind the form of the transaction and found that the obligation to pay the note was contingent. Even though the note was for a fixed amount, the Service reasoned that because the note

was not secured by property having a fair market value equal to the amount of the note, there was no economic incentive for the taxpayer to pay the note. The note would be paid from income produced by the franchise or not at all. Therefore, the obligation to make payments was contingent on the productivity, use, or disposition of the franchise within the meaning of section 1253 (d)(1). The Service then concluded that the taxpayer was not entitled to a deduction under section 1253(d)(1) because, due to the speculative and contingent nature of the nonrecourse note, all the events had not occurred that determined the fact of liability,

We agree with the foregoing analysis. The federal courts have held that a nonrecourse note which is not secured by property of at least equivalent value is a contingent obligation. In Gibson Products Co. v. United States, 460 F.Supp. 1109 (N.D. Tex. 1978), affd., 637 F.2d 1041 (5th Cir. 1981), a partnership purchased five oil and gas leases. The seller was to drill an exploratory well on each of the properties under a separate drilling contract. Forty percent of the purchase price for the two contracts was paid in cash and the remaining sixty percent was paid with a nonrecourse note. The note was secured by the leases, by operating equipment on the leases, and by eighty percent of any future oil and gas production. The partnership deducted the nonrecourse liability as an intangible drilling expense in the year it executed the contracts.

The district court examined the purchase agreement, the promissory note and the security agreement, and found that the sole recourse for nonpayment of the liability was against the collateral, principally the future production of oil and gas. Based upon that fact, the court determined that although the purchase price was not expressly made conditional upon production, payment of the liability was in substance contingent uponfuture oil and gas production from the wells. The court concluded that the liability had not accrued under the all events test and, therefore, its deduction was improper. The Fifth Circuit affirmed.

In Brountas v. Commissioner, 692 F.2d 152 (1st Cir. 1982), the facts were nearly identical to the facts in Gibson, supra. A limited partnership purchased oil and gas leases and a drilling contract. Forty percent of the purchase price was paid in cash and the remaining sixty percent was paid with nonrecourse notes. The notes were secured by a percentage of oil and gas production,

by a percentage of the leaseholds, and by some of the equipment used. The partnership deducted its total intangible drilling and development costs, which consisted of $300,000 cash and $450,000 in nonrecourse notes, The court ruled that the partnership could not accrue the noncash portion of the cost for tax purposes. The court determined that because the investors were not personally liable on the notes, the operators could only look to the property securing the notes for payment and that property would be essentially worthless if the wells were dry; thus, as a practical matter, the notes would be paid out of production or not paid at all. Based on these facts, the court found that payment of the notes was contingent and all the events necessary to determine liability had not yet occurred. Therefore, accrual of the liability as an expense was not yet proper.

We believe that the nonrecourse liability in the present case can be characterized as similarly contingent upon the production of income from the franchise. Although appellant executed a note in a fixed amount, the note was not secured by property having a fair market value equal to the amount of the note. An examination of the record discloses nothing which would support a $350,000 value for the Medi-Health franchise or a value of $52,500, the face amount of the note. Appellant did not have an independent appraisal made of the franchise, nor did he inquire into the earning history of any previously sold franchises. He made no inquiry into the financial condition of either Medi-Health Systems, Inc., or Medi-Health Financial Corporation. We note, in addition, that Medi-Health Financial Corporation is described in the security agreement as being a newly formed Nevada corporation with no prior business activity. Further, the security agreement states that the corporation is relying entirely upon loans to carry on its business activities until revenues are derived from sales of its franchise. Absent a sufficient cash flow from the franchise, appellant had no economic incentive to pay off the note. Thus, the note was a contingent liability and appellant's obligation to make actual payments was contingent on the productivity, use or disposition of the franchise within the meaning of Revenue and Taxation Code section 18218.5, subdivision (d)(1).

Section 18218.5, subdivision (d)(1),provides that contingent payments shall be allowed as a deduction under subdivision (a) of section 17202 relating to trade or business expenses. The test for determining whether a liability may be accrued in a particular year is the all

events test. 'This test provides that an item may be deducted in the year in which all events necessaryto determine both the fact and the amount of liability have occurred. (United States v. Anderson, 269 U.S. 422 [70 L.Ed. 347]. (1926).) The existence of a contingency in the taxable year with respect to a liability or its enforcement prevents accrual. (Trinity Construction Co. V. United States, 424 F.2d 302 (5th Cir. 1970).) The same facts which make the nonrecourse note contingent for the purposes, of section 18218.5, subdivision, (d)(1), make it too contingent to accrue as a liability incurred for the transfer of a franchise. That is, because the note would effectively be paid from proceeds from the franchise or not at all, all of the events necessary to determine the fact and amount of liability had not yet occurred. Accordingly, the accrual of the liability as an expense was improper. (Brountas v. Commissioner, supra; Gibson Products Co. v. United States, supra; Rev. Rul. 81-262, supra.) Therefore, the $52,500 nonrecourse note cannot be considered an amount paid or incurred on account of a sale of a franchise.

The next issue presented is whether appellant is entitled to deduct the $17,500 cash payment for the a franchise and $1,168 in travel and entertainment expenses. Respondent contends that these deductions should be allowed only to the extent provided in Revenue and Taxation Code section 17233.

Section 17233, subdivision (a), provides that if an individual does not engage in an activity for profit, the deductions arising out of such activity shall not be allowed except as provided in that section,, An activity not engaged in for profit is defined in section 17233, subdivision (c), as any activity other than one with respect to which deductions are allowable for the taxable year under section 17202 (trade or business expenses) or under subdivision (a) or (b) of section 17252 (expenses for production of income).[3/] If the

3/ Section 17233, subdivisions (a) through (c), read as follows:

> (a) In the case of an activity engaged in by an individual, if such activity is not engaged in for profit, no deduction attributable to such activity shall be allowed under this part except as provided in this section.

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activity is not engaged in for profit, then section 17233, subdivision (b), separates the claimed deductions into two groups. Section 17233, subdivision (b)(1), allows only those deductions which are not dependent upon a profit motive, e.g., interest and taxes. Section 17233, subdivision (b)(2), allows the balance of the deductions which would otherwise be permitted only if the activity was engaged in for profit, but only to the extent that the gross income derived from the activity exceeds the deductions allowed under paragraph (1). Thus, to determine whether the limitations of section 17233 apply, we must determine whether appellant engaged in an activity for profit with respect to his purchase of the Medi-Health franchise.

The federal counterpart to section 17233 is section 183 of the Internal Revenue Code. Treasury regulation § 1.183-2(b) lists nine factors to be considered when determining whether a profit motive exists. They are: (1) the manner in which the taxpayer carries on the activity;' (2) the expertise of the taxpayer or his

3/ (Continued)

(b) In the case of an activity not engaged in for profit to which subdivision (a) applies, there shall be allowed--

(1) The deductions which would be allowable under this part for the taxable year without regard to whether or not such activity is engaged in for profit, and

(2) A deduction equal to the amount of the deductions which would be allowable under this part for the taxable year only if such activity were engaged in for profit, but only to the extent that the gross income derived from such activity for the taxable year exceeds the deductions allowable by reason of paragraph (1).

(c) For purposes of this section, the term "activity not engaged in for profit" means any activity other than one with respect to which deductions are allowable for the taxable year under Section 17202 or under subdivision (a) or (b) of Section 17252.

advisers; (3) the time and effort expended by the taxpayer in carrying on the activity; (4) the expectation that assets used in the activity may appreciate in value; (5) the success of the taxpayer in carrying on other similar or dissimilar activities; (6) the taxpayer's history of income or losses with respect to the activity; (7) the amount of occasional profits, if any, which are earned; (8) the financial status of the taxpayer; and (9) whether elements of personal pleasure or recreation are involved.

The facts show that appellant has expended little effort in establishing, developing, or promoting his Medi-Health franchise. He has made one trip to Honolulu in connection with the venture, and during that trip he conversed only briefly with a previous business acquaintance about promoting the franchise. He has conducted no market surveys or site studies and has not registered his franchise with the State of Hawaii. These facts show the nonbusinesslike manner in which appellant has treated a franchise he claims to be worth $350,000.

Appellant purchased a franchise to establish centers related to smoking and weight control. However, appellant has no medical training or background. He is a real estate broker by profession. He has not contacted anyone with medical or paramedical training to assist or advise him in the technical aspects of his franchise.

Appellant has not demonstrated that, he has devoted any significant time and effort to carrying on his purported business activity, nor has he employed anyone to do so in his behalf.

Appellant has demonstrated no history of earnings with respect to this or similar business activities. His 1979 and 1980 tax returns show no such income, and there is no Schedule C for the Medi-Health franchise on appellant's 1980 tax return.

Finally, we note that for the year 1978, appellant reported $170,342 in income from other sources. Thus, the losses from his purchase of the Medi-Health franchise generate substantial tax benefits. As a result of the nonrecourse financing, appellant would have advanced $17,500 in cash, received $40,000 in combined federal and state tax savings, and could have walked away from the project without suffering any economic loss as a result. We believe that the record shows that this is exactly what appellant attempted to do. We conclude that appellant was not engaged in the ownership of the Medi-Health franchise for profit.

In conclusion, we find that the nonrecourse note was a contingent liability and that its accrual was improper. We also find that appellant was engaged in an activity not for profit within the meaning of section 17233 and, therefore, apellant's deductions attributable to such activity are subject to the limits of that section.

O R D E R

Pursuant to the views expressed in the opinion of the board on file in these proceedings, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 1859.5 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protests of Robert D. and Lorna Watson against proposed assessments of additional personal income tax in the amounts of $6,112.95 and $2,053.48 for the year 1978, be and the same is hereby sustained.

Done at Sacramento, California, this 15th day of September, 1983, by the State Board of Equalization, with Board Members Mr. Bennett, Mr. Collis, Mr. Dronenburg, Mr. Nevins and Mr. Harvey present.

William M. Bennett, Chairman

Conway H. Collis, Member

Ernest J. Dronenburg, Jr., Member

Richard Nevins, Member

Walter Harvey*, Member

*For Kenneth Cory, per Government Code section 7.9