BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
KRAMER INK CO., INC.)

Appearances:

For Appellant: Aloke Bosu.
Certified Public Accountant

For Respondent: Carl G. Knopke
Counsel'

OPINION

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 Kramer Ink Co., Inc., against proposed assessments of additional franchise tax in the-amounts of $773, $507, $2,475 and $1,499 for the income years ended October 31, 1975, 1976, 1977, and 1978, respectively.

The issues for decision are whether the cost of a covenant not to compete should be amortized ratably over the term of such covenant and whether certain expenditures associated with the operation of a boat should be deductible as ordinary and necessary business expenses. A third issue relating to the deductibility of certain traveling expenses as ordinary and necessary business expenses has now been conceded by respondent.

Appellant, a closely held California corporation, manufactures inks used in printing. One hundred percent of its stock is owned by the DeKramer family which consists of the mother, father and son. Effective October 31, 1977, the last day of its taxable year, appellant acquired Imperial Ink. As part of this acquisition, the purchase agreement provided that Imperial's owner would not compete with appellant for a period of fiive years commencing on October 31, 1977. The agreement assigned a value of $67,365 to this covenant, payable' in the following manner:

(1) $15,000 on October 31, 1977
(2) $7,500 on January 31, 1978
(3) $7,500 on April 30, 1978
(4) $37,365 in 60 monthly installments of $622.75 each commencing November 30, 19'77.

On its tax 'return for the income year ended October 31, 197-7, appellant deducted the $15,000 payment made on October 31, 1977. On its tax return for the income year ended October 31, 1978, appellant deducted the two balloon payments of $7,500 each and the twelve monthly payments of $622.75 each for a total deduction of $22,473. Upon audit, respondent concluded that appellant's method of deducting the payments made for the covenant was improper. Respondent determined that the amount paid for the covenant should be amortized ratably over the life of such covenant, which amounted to $13,473 per year. Accordingly, respondent disallowed appellant's claimed deduction of the $15,000 initial payment made on October 31, 1977, the last day of its income year, and reduced the allowable deduction for the income year ended October 31, 1978, from $22,473 to $13,473. Appellant contends that its method of deducting the payments was proper in that the value of the covenant was greater in the earlier years than in the later years. In the alternative, appellant argues that these payments should be considered deductible as ordinary and necessary business expenses when paid. (Rev. & Tax. Code, § 24343.)

During the 1975, 1976, and 1977 income years, appellant owned a boat. Appellant deducted the expenses associated with this boat contending that it used the boat to promote its business by taking employees and clients on fishing trips. Respondent disallowed part Of the expenditures for the fishing trips and all of the expenditures associated with promotion. The record indicates that respondent disallowed part of the expenditures for fishing trips by dividing the number of days of business use by the total number of days used based on information obtained from the boat's guest register. After the hearing, apellant presented a letter signed by a person purporting to be president of a marine hardware company, stating that the boat's engine had to be run "weekly if not more" in order to be properly maintained and a list of individuals associated with promotional activities.

Covenant not to Compete

It is well settled that "the cost of eliminating competition is a capital asset." (B. T. Babbitt, Inc., 32 B.T.A. 693, 696 (1935).) It is also well established that if an agreement not to compete can be segregated and be shown to be a realistic and bona fide item in the purchase of a business so that severable consideration for it can be demonstrated, the purchaser is entitled to amortize the consideration paid for the covenant over its term. (Frances Silberman, 22 T.C. 1240 (1954); Commissioner v. Gazette Tel. Co., 209 F.2d 926 (10th Cir. 1954).)

The record indicates that the subject covenant not to compete has been properly established as being a separate and severable item in the purchase agreement entitled to a deduction for depreciation under section 24349 of the Revenue and Taxation Code. The question for decision here is the proper'rate of that depreciation.

As indicated above, the covenant was for a period of five years. In the ordinary situation, the cost of the covenant would be amortizable over the term of that contract, i.e., five years. (See Frances Silberman, supra.) However, appellant argues that the value of the covenant was greatest in the earlier years when the greatest harm from competition would have resulted, and its payment of and deduction for that covenant mirrored that. fact. This argument has been previously rejected by the United States Tax Court. (Andrew Newman, Inc., ¶ 57,224 P-H Memo. T.C. (1957).) As the tax court there stated, "[t]he petitioner bargained for a 10-year covenant. That is what he got and in the absence of any evidence to the

contrary the covenant presumably had a depreciable life over its entire term." As appellant has presented no evidence or case law to the contrary, we see no reason to hold otherwise here. Moreover, as the useful life of the subject covenant is greater than one year, to the extent that a deduction is allowable, it must be obtained under section 24349 (depreciation) and not section 24343 (ordinary and necessary expenses). (See, e.g., Falstaff Beer, Inc. v. Commissioner 322 F.2d 744 '(5th Cir. 1963).) Thus, we hold that appellant's alternative argument that it should be able to deduct the payments for the covenant as ordinary and necessary expenditures is also without merit. Accordingly, respondent's determination that cost of the covenant must be amortized ratably over its term must be sustained.

Boat Expenditures

Section 24343 of the Revenue and Taxation Code allows as dedudtions all ordinary and necessary business expenses. Appellant contends that its expenditures associated with the boat which it owned qualifie-d as such ordinary and necessary business expenses. Deductions are a matter of legislative grace, and the burden of proof is upon the taxpayer to show that expenses are within the terms of the statute. (New Colonial Ice Co. v. Helvering, 292 U.S. 435 [78 L.Ed. 13481 (1934).) In the case of entertainment expenses, this burden of proof may be satisfied by records which establish the business nature of the expenditures: the date, place and amount of the expenditures; the recipient of the funds expended; and the nature of the product or service received. (Appeal of Oilwell Materials & Hardware Co., Inc., Cal. St. Bd. of Equal., Nov. 6, 1970; Appeal of National Envelope Corp., Cal. St. Bd. of Equal., Nov. 7, 1961.)

As indicated above appellanthas now introduced a letter that purports to indicate that the boat had to be operated at least weekly in order to properly maintain its engine. Appellant argues that this would indicate that the days which the auditor determined that the boat was used for pleasure were primarily used for maintenance purposes. We find this letter to be unconvincing. Not only has the credibility of the signatory not been established, but also the reason for the extra trips, as opposed to the mere running of the engine, has not been satisfactorily explained. Inaddition, the list of individuals involved in promotional activities lacks the specificity which would allow a deduction. (Appeal of Oilwell Materials & Hardware Co. 'Inc., supra.) Therefore., we must sustain respondent's determination on this issue,

Appeal of Kramer Ink Co., 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 Kramer Ink Co., Inc., against proposed assessments of additional franchise tax in the amounts of $773, $507, $2,475 and $1,499 for the income years ended October 31, 1975, 1976, 1977, and 1978, respectively, be and the same is hereby modified in accordance with respondent's concession. In all other respects, the action of the Franchise Tax Board is sustained.

Done at Sacramento, California, this 26th day of October , 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