77-SBE-130

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
DEAN D. AND BURDELLA M. DEVRIES)

Appearances:

For Appellants: Raymond Worster
Tax Consultant

For Respondent: Brian W. Toman
Counsel

O P I N I O N

This appeal is made pursuant to section 18594 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Dean D. and Burdella M. DeVries against a proposed assessment of additional personal income tax in the amount of $2,865.32 for the year 1972.

After a concession by the appellants, the issues remaining for decision are: (1) whether appellants are entitled to depreciate the cost of a covenant not to compete relating to their acquisition of the Carrollton, Missouri, Daily Democrat; and (2) whether appellants may deduct the "consulting and finder's fee" they paid to the broker who arranged their purchase of the Daily Democrat.

At all pertinent times, appellants were residents of Ukiah, California. For several years prior to 19.72, appellants actively sought to buy a, newspaper for their son to manage. Since they were unable to find what they wanted on their own, they decided to employ a Kansas'newspaper broker-consultant to help them locate a suitable investment. The broker found the Carrollton,, Missouri, Daily Democrat for them, and through his efforts the appellants purchase?! all of the stock of the newspaper'-s publishing corporation on March 23, 1972.

In paragraph 7 of the sales contract, the sellers agreed not to engage in the newspaper, radio,, television, or advertising business within 50 miles of Carrollton. The contract specifically provided that the consideration for this covenant was $48,750.00 (25 percent of the total purchase price of $195,000.00), but it did not stipulate any particular life for the covenant. Paragraph 3(c) of the contract stated that appellants would pay a broker's commission of $9,750.00 to their broker.

On their 1972 return, appellants claimed a depreciation deduction of $9,750.00 attributable. to the covenant not to compete. Appellants arrived at this figure by assigning a five-year life to the covenant and then deducting one-fifth of the $48,750.00 paid for the covenant. Appellants also deducted the $9,750.00 paid to the broker, describing this payment as a "consulting and finder's fee." Respondent disallowed both deductions. The depreciation deduction was denied principally on the ground that the covenant had no definite useful life, and the deduction for the broker's fee was denied because respondent determined that this payment should have been capitalized and treated as a part of the cost of the stock.

Under appropriate circumstances, Revenue and Taxation Code section 17208 authorizes a deduction for the depreciation of a covenant not to compete. One of the required circumstances is that the covenant must have a limited useful life. (See Cal. Admin. Code, tit. 18,

reg. 17208(c).) In this case the evidence is conflicting on whether the covenant was intended to have a specific life. The sale agreement did not specify any term of years, but appellant Dean DeVries testified at the hearing that he and the seller understood that the term was to be five years. This testimony is supported by a letter from the seller dated July 12, 1974, and also by a letter from the broker, dated May 23, 1974. However, when respondent's auditor later asked the seller whether a specific time period had been agreed to, he denied that this was the case. Although there is some uncertainty on this point, we have concluded that the weight of the evidence is in appellants' favor. We are inclined to discount the seller's later denial of an agreed five-year life for the covenant, since he had treated his entire gain on the sale as a capital gain for federal and state income tax purposes, and respondent's auditor informed him that any consideration received for a covenant not to compete for a limited time period should have been reported as ordinary income.

Having decided that the covenant is depreciable over five years, we turn now to the question of whether appellants properly computed their depreciation deduction for the year of acquisition. As we indicated previously, appellants deducted a full year's depreciation of $9,750.00 on their 1972 return. However, the sale agreement was dated March 23, 1972, and it provided that the sale was to close on or before April 28, 1972, and that the transfer of possession and control of the newspaper property was to take place on *May 1,* 1972. In the absence of any evidence to the contrary, we will assume that the sale did in fact close on or about April 28, 1972. The covenant became effective at that time, and it follows, therefore, that appellants are not entitled to take a full year's depreciation deduction for that asset. Respondent's regulations provide, in pertinent part:

> The period for depreciation of an asset shall begin when the asset is placed in service and shall end when the asset is retired from service. A proportionate part of one year's depreciation is allowable for that part of the first and last year during which the asset was in service. ... (Cal. Admin. Code, tit. 18, reg. 17208(j), subd. (2).)

Under this rule, appellants are entitled at most to depreciate the covenant over the last eight months of 1972. (Taylor S. Hardin, II 73,193 P-H Memo. T.C. (1973), affd.,

507 F.2d 903 (4th Cir. 1974); William R. Collins, 18 T.C. 99 (1952), affd., 203 F.2d 565 (6th Cir. 1953). Therefore, their allowable deduction is $6,500.00 (8/12 x $9,750.00). Respondent's assessment will be modified accordingly.

With respect to the purpose and nature of the $9,750.00 paid to the broker, we find again that the evidence is conflicting. Relying on cases holding that broker's commissions and legal and appraisal fees incurred in connection with the acquisition of stock are nondeductible capital expenditures that must be added, to the basis of the stock, (Woodward v. Commissioner, 397 U.S. 572 [25 L. Ed. 2d 577] (1970); Helvering v. Winmill, 305 U.S. 79 [83 L. Ed. 52] (1938)), respondent contends that this payment was a nondeductible-commission- paid for the broker's services in arranging for appellants' acquisition of the Daily Democrat's outstanding stock. The evidence tending to support respondent's position is as follows: first, the sale agreement described the payment specifically as a "broker's commission"; second, Mr. DeVries himself stated that the broker was employed to find a newspaper after appellants had been unsuccessful in locating one themselves: and third, the payment amounted to exactly five percent of the agreed $195,000.00 purchase price for the Daily Democrat, a percentage very likely to constitute a standard commission.

The appellants argue, however, that this fee was not a commission but rather was compensation for consulting services the broker had agreed to render for five years following the sale. In support of their version of the payment, appellants have submitted two different copies of a letter from the broker detailing the terms of the consulting agreement. Both copies are dated March 23, 1972, the date of the stock purchase agreement, and both contain spaces for Mr. DeVries to sign and date his agreement to the terms outlined by the broker. The copy appellants submitted with their opening brief indicates that Mr. DeVries signed it on August 20, 1974. The copy appellants submitted after the hearing, however, indicates that it was signed on March 28, 1972, and appellants allege' that this copy is the original letter. It is readily apparent, however, that this copy is a photocopy rather than an original typed letter, and it is clear (because of differences in the broker's signature) that this alleged "original" was not used to make the copy submitted with appellants' opening brief.

Faced with these inconsistencies, we are inclined to agree with respondent that this letter was drafted sometime in 1974, after respondent had begun its audit of appellants' return. During the later stages of the audit, appellants' representative told the auditor that the consulting agreement had never been reduced to writing, and in his reply brief on appeal Mr. DeVries described the letter dated March 23, 1972, as a confirmation of his oral agreement with the broker and admitted that he signed the letter on August 20, 1974, because he had been advised to do so by his attorney. Moreover, in another letter from the broker that was notarized as having been signed on May 23, 1974, the broker did not mention any written consulting contract even though this letter was clearly written to persuade respondent that a consulting agreement had been entered into at the time of the stock purchase. We conclude, therefore, that the letter dated March 23, 1972, was in fact written sometime after May 23, 1974, in a belated attempt to justify the deduction in question. Under the circumstances, that letter is insufficient to establish that the payment to the broker was anything other than a commission, as stated in the stock purchase agreement. Accordingly, on this issue respondent's determination will be sustained.

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 Dean D. and Burdella M. **DeVries** against a proposed assessment of additional personal income tax in the amount of **$2,865.32** for the year 1972, be and the same is hereby modified to allow a depreciation deduction of **$6,500.00.** In all other respects, respondent's action is **sustained.**

Done at Sacramento, California, this 18th **day** of Odtober , 1977, by the State Board of Equalization.

, Chairman

, **Member**

, **Member**

, **Member**

, Member