BEFORE THE STATF BOARD OF EQUALIZATION

OF- THF STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
HALCYON SFRVICES, INC.)

For Appellant: Warren F. Westermeier,
President

For Respondent: Bruce W. Walker
Chief Counsel

Brian W. Toman
Counsel

O P I N I O N

This appeal is made pursuant to section 25667 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Halcyon Services, Inc., against a proposed assessment of additional corporate franchise tax in the amount of $1,119.00 for the income year ended May 31, 1976.

The issue presented is whether the consideration paid for a covenant not to compete upon the sale of a major portion of appellant's business constituted recognizable income.

Appellant was incorporated in California and began doing business in this state during the year 1970. On December 5, 1975, appellant and Warren F. Westermeier, its president, agreed to sell to Doctors Service Bureau, Inc., all the assets of a business conducted by appellant in San Diego known as Mediscribe, a division of appellant. This business constituted the major portion of appellant's activities., Westermeier was named as a principal in the agreement in order to guaranty performance.

In addition to selling all the assets, including the physical assets, the tradename "MEDISCRIBE" (and all of the goodwill and going concern value of the tradename), the existing contracts, customer accounts, orders, customer lists, inventories, work in process, and finished products, appellant also covenanted not to compete with the purchaser. The total consideration was allocated. The agreed consideration for the promise not to compete was $18,000.

The covenant was described in the contract as a material part of the consideration for the transaction. In that part of the contract relating to the covenant, the sellers agreed not to use any name similar to "Mediscribe" or "World Wide Dictation Service"; agreed for a period of five years after closing not to engage in any similar or competitive business in San Diego, Orange, or Los Angeles Counties; and agreed for the same period not to solicit any customers or employees of "Mediscribe", present or past. The contract also provided that it was contemplated the buyer would employ Westermeier as a consultant for thirty days but thereafter Westermeier was not to engage in any similar or competitive business.

As the Mediscribe division constituted appellant's principal business, it was previously decided that appellant would be liquidated. A liquidation was effected in accordance with the requirements of sections 24512 and 24513 of the Revenue and Taxation Code. Appellant concluded that it need not recognize any gain from the sale because of compliance with those statutory provisions.

Upon audit, respondent found that appellant had complied with those provisions and that no gain need be recognized, with one exception. It concluded that

the $18,000 paid for the promise not to compete should be recognized as taxable income. Consequently, respondent issued the proposed assessment, and appellant has filed this timely appeal.

Sections 24512 and 24513 of the Revenue and Taxation Code provide that if a corporation adopts a plan of complete liquidation and, within the 12-month period beginning on the date of the adoption of such plan, all of its assets are distributed in complete liquidation (less assets retained to meet claims), no gain or loss shall be recognized from the sale or exchange by it of property within such 12-month period. Respondent concluded, however, that the $18,000 was not received in exchange for property.

Appellant alleges that the covenant was property, specifically, an intangible asset, and thus the gain on the transaction was entirely nonrecognizable. It is contended that the federal decisions relied upon by respondent are inapplicable because the federal and state laws are not comparable: specifically, reliance is placed upon the distinction in the federal law, unlike the California law relating to corporate taxation, between ordinary income and capital gain.

It is also urged that because the corporation was in the process of liquidation, it would not be in existence to perform or not perform a noncompete covenant; thus, it is also asserted that the $18,000 consideration was not realistically paid for a promise by appellant not to compete.

The above sections were patterned after section 337 of the Internal Revenue Code of 1954. The regulations pertaining to the above sections are substantially similar to the federal regulations relating to section 337. Consequently, we do not agree with appellant that we should not look to federal authority. Where the federal and state tax statutes and regulations are substantially similar, the federal interpretations are highly persuasive, (Rihn v. Franchise Tax Board, 131 Cal. App. 2d 356 [280 P.2d 893] (1955); see also Meanley v. McColgan, 49 Cal. App. 2d 203 [121 P.2d 45] (1942).) Consequently, this case should be examined in the light of federal authority.

Federal decisions establish that an amount received by the seller of a going business as consideration for a promise not to compete, separately bargained for

and severable from goodwill (which, unlike the promise, is property), is not gain realized from the sale of property. Consequently, it is not subject to the non-recognition provisions. (Harvey Radio Laboratories, Inc., P-H Memo. T.C. 1172,085 (1972), affd., 470 F.2d 118 (1st Cir. 1972); Rev. Rul. 74-29, 1974-1 Cum. Bull. 80; cf. Valley Broadcasting Co., et al., P-H Memo. T.C. ¶ 74,247 (1974).)

Strong proof by the taxpayer is required to contradict the express terms of the sales agreement. (Harvey Laboratories, Inc., supra.) Knowledge of the buyer that the seller plans to liquidate is, without other evidence,. insufficient proof that the amount received was not realistically intended as consideration for a promise not to compete. As explained in Harvey, the covenant may well be bargained for by the buyer as protection in the event that liquidation does not occur.

It is true that, unlike the California bank and corporation tax, the federal corporate tax structure has two classifications of corporate income, ordinary income and capital gain. However, we are not concerned with the characterization of income by the state or federal law; we are concerned with which items are allowed to be transferred tax-free at the corporate level. Consequently, the federal holdings are clearly applicable.

Accordingly, respondent's action in this matter should be sustained.

Appeal of Halcyon Services, 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 Halcyon Services, Inc., against a proposed assessment of additional corporate franchise tax in the amount of $1,119.00 for the income year ended May 31, 1976, be and the same is hereby sustained.

Done at Sacramento, California, this 26th day of July, 1978, by the State Board of Equalization.

_____, Chairman

_____, Member

_____, Member

_____, Member

_____, Member