BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
) No. 84R-1307-GO
VILLA MARIA MANAGEMENT)
CORPORATION)

For Appellant: Rusty Rinehart
Attorney at Law

For Respondent: Lorrie K. Inagaki
Counsel

O P I N I O N

This appeal is made pursuant to section 26075, subdivision (a),[1/] of the Revenue and Taxation Code from the action of the Franchise Tax Board in denying the claim of Villa Maria Management Corporation for refund of franchise tax in the amount of $4,425 for the income year ended February 28, 1983.

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

The questions presented are: (1) whether appellant is entitled to an interest expense deduction for amounts paid in connection with notes involving a sales agreement executed between stockholders of appellant; and (2) whether appellant is entitled to a deduction for amounts allocated to a covenant not to compete in connection with a sales agreement executed between stockholders of appellant.

The principal business activity of appellant, a California corporation, is the ownership and operation of a convalescent hospital in Fremont, California. During the period at issue, Verne R. Lee (Lee) was both president of appellant and its sole shareholder. In order to resolve a dispute with appellant's former owners, Jimmy Mitchell and O. Merle Custer, concerning the ownership of appellant's stock, Lee entered into an agreement in 1982 settling such ownership questions. The agreement provided that the former owners were to sell to Lee, denoted as buyer, "all their right, title, and interest in [appellant] and any stock thereof." (Ex. A at 3.) The terms of the agreement provided that $23,295 was initially to be paid to Mitchell and $5,000 to Custer and that the balance was to be paid on an installment basis, $158,783.50 to Mitchell and $48,000 to Custer, with interest at the rate of 12 percent per annum. In addition, the agreement provided that Mitchell agreed not to compete "with any business owned in whole or in part by Buyers [i.e., Lee] engaged in the operation of skilled nursing facilities. ..." (Ex. A at 7.) The agreement allocated $152,100 of the purchase price paid to Mitchell to his covenant not to compete.

Appellant filed a timely tax return for the period at issue but, thereafter, concluded that it had inadvertently overlooked interest expenses paid to Mitchell and Custer and amortization of Mitchell's covenant not to compete. Therefore, appellant filed an amended return deducting $48,058 for interest expense and $10,140 for the covenant.

On audit, respondent concluded that the agreement was made between stockholders and that the payment of the interest was Lee's obligation and not that of his corporation, appellant herein. Moreover, respondent concluded that the owner of the covenant was Lee and not appellant and that any payments made by appellant on this obligation were not deductible by it. In addition, respondent now argues that even if the covenant was found to be appellant's, appellant has not shown that it had

made a capital investment in such covenant or what portion of such covenant was used in its trade or business.

Appellant answers that the agreement was, in fact, executed by and on behalf of the corporation so that the notes at issue were its own obligations. However, appellant has not addressed respondent's arguments concerning the covenant not to compete.

Section 24344 allows a deduction for "all interest paid or accrued during the income year on indebtedness of the taxpayer." It also is well settled that the deduction for interest on indebtedness means for interest on an obligation of the taxpayer claiming it. Payments made on obligations of others do not meet the statutory requirement. (Post v. Commissioner, ¶ 79,419 T.C.M. (P-H) *(1979.)* **There appears** to be no dispute that appellant paid the interest on the notes referred to above. However, as indicated above, before appellant is entitled to claim an interest deduction for these payments, it must demonstrate that it was liable on the obligations.

Although appellant has argued that it was an obligor of the subject notes in that the agreement was executed by and *on* its behalf, no documentary evidence has been introduced which would support a finding that it was directly liable on such notes. In the agreement presented and the supporting documents, Lee and his wife, not appellant, are designated as payors and obligors of the obligation. While appellant is designated as guarantor on the promissory note made in behalf of Mitchell, it is well settled that a guarantor is not primarily liable on the obligation and, consequently, its payment of interest is not deductible by it. (Golder v. Commissioner, 604 **F.2d** 34 (9th Cir. 1979.) In this light, we must uphold respondent's determination denying appellant's deduction of the interest.

With respect to the second issue presented, amounts paid for an agreement not to compete in a trade or business where the taxpayer can prove the existence of such an agreement are capital expenditures and subject to allowance for depreciation ratably spread over the period mentioned in the agreement. (4 Mertens, Law of Federal Income Taxation § 23A.93 (1985 Rev.).) As indicated *above, respondent* contests appellant's right to amortize the covenant not to compete contending that any agreement existed between Mitchell and Lee and. not with appellant. Moreover, respondent argues that even if the covenant was

found to be appellant's, appellant has not established the economic reality of such agreement. As indicated above, appellant has not responded to this issue. It is, of course, well settled that a covenant not to compete cannot be amortized if it has no economic substance or discernable value. (See, e.g., Nye v. Commissioner, 50 T.C. 203 (1968).) Based upon the record before us, we find respondent's second argument to be decisive and we find that appellant has not met its burden of proving that the covenant has a discernable value. Accordingly, deduction of the covenantmust be disallowed.

For the reasons cited above, respondent's action must be sustained.

Appeal of Villa Maria Management Corporation

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 26077 of the Revenue and Taxation Code, that the action of the Franchise Tax Board in denying the claim of Villa Maria Management Corporation for refund of franchise tax in the amount of $4,425 for the income year ended February 28, 1983, be and the same is hereby sustained.

Done at Sacramento, California, this 10th day Of June , 1986, by the State Board of Equalization, with Board Members Mr. Nevins, Mr. Collis, Mr. Bennett, Mr. Dronenburg and Mr. Harvey present.

Richard Nevins , Chairman

Conway H. Collis , Member

William M. Bennett , Member

Ernest J. Dronenburg, Jr. , Member

Walter Harvey* , Member

*For Kenneth Cory, per Government Code section 7.9