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TAXATION-FEDERAL INCOME TAX-SALE OF GOODWILL TREATED AS SALE OF A CAPITAL ASSET

David F. Ulmer S.Ed.
University of Michigan Law School

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TAXATION—FEDERAL INCOME TAX—SALE OF GOODWILL TREATED AS SALE OF A CAPITAL ASSET—Plaintiffs were partners in a wholesale produce business which was well established and had a large goodwill value in the area. Plaintiffs sold the whole business, including goodwill, to another produce dealer, with a specific portion of the sale price being allocated to the sale of the goodwill. Included in the sale contract was an agreement by the sellers not to compete with the purchaser for a certain number of years, but it was understood by the parties that none of the sale price was given in consideration of this agreement. Plaintiffs returned the amount received from the sale of goodwill as gain from the sale of a capital asset. The Commissioner of Internal Revenue assessed a deficiency on the theory that this amount should be considered ordinary income. On a petition to the United States District Court, it was *held* that the sale of goodwill constitutes the sale of a capital asset. *Cox v. United States*, (D.C. Ariz. 1951) 99 F. Supp. 518.

Although there is no one definition of goodwill which has been accepted as applying to all cases, it is generally thought of as, "the value attaching to a concern by virtue of which it can earn more than a reasonable return on its tangible assets."¹ The courts have decided that this value is an intangible asset,

¹ Rolnik, "The Probable Life of Goodwill as a Basis for Depreciation," 9 TAXES 248 (1931). For other definitions see *Pfleggar Hardware Specialty Co. v. Blair*, (2d Cir. 1929) 30 F. (2d) 614 at 616; *Strong Publishing Co. v. Commissioner*, (7th Cir. 1932) 56 F. (2d) 550 at 552; Foreman, "Conflicting Theories of Goodwill," 22 COL. L. REV. 638 (1922); Wright, "The Nature and Basis of Goodwill," 24 ILL. L. REV. 20 (1929).

and hence property within the meaning of that term as used in the Internal Revenue Code.² In the ordinary case there can be no allowance for depreciation or obsolescence of goodwill because its useful life cannot be measured.³ However, when Prohibition became imminent, many distilleries and breweries attempted to take obsolescence allowances, since they could show that in a definite time their goodwill would be virtually worthless. Originally the Board of Tax Appeals was willing to allow such a deduction if the taxpayer could prove the value of its goodwill.⁴ When this question reached the higher federal courts, one circuit held that goodwill was not the type of asset for which an obsolescence allowance could be had.⁵ Another circuit reached the opposite conclusion,⁶ but when this case came before the Supreme Court the issue of whether an obsolescence allowance could ever be given for goodwill was not settled, but rather it held that a business which had been declared noxious under the Constitution could not in effect be compensated for loss of value of its goodwill by giving it a tax deduction.⁷ Having decided that goodwill is property and not subject to depreciation, the courts hold that it is a capital asset, the sale of which gives rise to capital gain rather than ordinary income.⁸ In accord with this holding it has been decided that expenses to gain goodwill are capital expenses not deductible as business expenses,⁹ and that a recovery for damage to goodwill is a return of capital and not taxable unless it results in gain.¹⁰ The

² *Red Wing Malting Co. v. Wilcuts*, (8th Cir. 1926) 15 F. (2d) 626; *Metropolitan Bank v. St. Louis Dispatch Co.*, 149 U.S. 436, 13 S.Ct. 944 (1893); *Coca-Cola Bottling Co. v. Coca-Cola Co.*, (D.C. Del. 1920) 269 F. 796.

³ 4 MERTENS, *THE LAW OF FEDERAL INCOME TAXATION* §23.10 (1942); Rohnik, in "The Probable Life of Goodwill as a Basis for Depreciation," 9 *TAXES* 248 (1931), contends that goodwill should be depreciable in all cases. He says that although a concern may have goodwill in one year and the same amount or more in a later year, this is not the same goodwill. This view gains some support from a dictum in *Metropolitan Bank v. St. Louis Dispatch Co.*, supra note 2 at 446.

⁴ *Rock Springs Distilling Co.*, 2 B.T.A. 207 (1925); *Victor J. McQuade*, 4 B.T.A. 837 (1926).

⁵ *Red Wing Malting Co. v. Wilcuts*, supra note 2.

⁶ *Haberle Crystal Springs Brewing Co. v. Clark*, (2d Cir. 1929) 30 F. (2d) 219. The Court of Appeals for the Second Circuit has recently cited this decision with approval on this point indicating they still consider goodwill depreciable in a proper case, *Williams v. McGowan*, (2d Cir. 1945) 152 F. (2d) 570 at 572. Some text writers say that when the useful life of goodwill can be measured, a deduction for obsolescence should be allowed, HOLMES, *FEDERAL INCOME TAX*, 6th ed., 1075 (1925); KLEIN, *FEDERAL INCOME TAXATION* 657 (1929); see also notes in 43 *HARV. L. REV.* 835 (1930); 38 *YALE L.J.* 829 (1929); 30 *COL. L. REV.* 577 (1930); 6 *ST. JOHNS L. REV.* 166 (1931).

⁷ *Clark v. Haberle Crystal Springs Brewing Co.*, 280 U.S. 384, 50 S.Ct. 155 (1930). Since this decision the Tax Court has held that goodwill is not depreciable, *X-Pando Corp.*, 7 T.C. 48 (1946). The Regulations provide that no depreciation or obsolescence allowance will be given for goodwill. *Treas. Reg.* 111, §29.23(1)-4.

⁸ *Arron Michaels*, 12 T.C. 17 (1949); *Ellen J. Franklin*, 1947 P-H T.C. Memo. Dec. ¶147,273; *Ensley Bank & Trust Co. v. United States*, (5th Cir. 1946) 154 F. (2d) 968.

⁹ *Seattle Brewing & Malting Co.*, 6 T.C. 856 (1946), *affd.* 165 F. (2d) 216 (1948); *Arthur P. Williams*, 24 B.T.A. 1070 (1931).

¹⁰ *Farmers' & Merchants' Bank of Catlettsburg, Ky. v. Commissioner*, (6th Cir. 1932) 59 F. (2d) 912. *Durkee v. Commissioner*, (6th Cir. 1947) 162 F. (2d) 184.

principal problems arising today where a claim is made that a sale of goodwill has given rise to capital gain are that the seller had no good will to sell,¹¹ or, if he did he has not sold it,¹² or that more of the purchase price is being allocated to the goodwill than its value warrants,¹³ or that the amount allegedly paid for goodwill was actually paid for an agreement not to compete. In connection with this latter point, it is usually held that if the agreement not to compete is given in connection with the sale of the whole business including goodwill, it is merely to protect the enjoyment of the goodwill and is a part thereof, so whole transaction results in capital gain.¹⁴ However, if it appears that the agreement not to compete was the principal consideration or that the other factors of goodwill were not sold, then this will be taxed as ordinary income.¹⁵ On the sale of a one man business, the former position of the Board of Tax Appeals was that the goodwill is attached to the personal reputation of the individual and cannot be transferred,¹⁶ but recently the Tax Court has held that an accountant selling his business at a price substantially in excess of physical asset value effected a sale of goodwill and a major part of the profit was taxed as capital gain.¹⁷

David F. Ulmer, S.Ed.

¹¹ Fox River Paper Corp. v. United States, (D.C. Wis. 1946) 65 F. Supp. 605.

¹² Grace Bros., Inc., 10 T.C. 158 (1948), affd. 173 F. (2d) 170 (1949). Cf. Shilling Grain Co., 8 B.T.A. 1048 (1927).

¹³ Estate of John C. Burns, 1947 P-H T.C. Memo. Dec. ¶47,242.

¹⁴ Toledo Newspaper Co., 2 T.C. 794 (1943); The Toledo Blade Co., 11 T.C. 1079 (1948).

¹⁵ Mildred K. Hyde Estate, 42 B.T.A. 738 (1940).

¹⁶ E. C. O'Rear, 28 B.T.A. 698 (1933), affd. 80 F. (2d) 473 (1935).

¹⁷ Rodney B. Horton, 13 T.C. 143 (1949); Richard S. Wyler, 14 T.C. 1251 (1950).