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Taxation - Federal Income Tax - Consequences to Seller and Buyer of Covenant Not to Compete

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TAXATION—FEDERAL INCOME TAX—CONSEQUENCES TO SELLER AND BUYER OF COVENANT NOT TO COMPETE—The owners of the entire capital stock of a newspaper business received an offer of $1,000,000 for their stock and a covenant not to compete with buyers for ten years. After the offer was accepted and the contract of sale drawn up, buyer asked for a clause in the contract evaluating the covenant not to compete at $50 a share and the stock at $150 a share in order to help him taxwise. The clause was accepted with little discussion. The sellers reported the entire proceeds of the sale on their income tax returns as long term capital gain, but the Commissioner ruled that $50 per share of the proceeds constituted consideration for the covenant not to compete and was taxable as ordinary income. The Tax Court held that since the covenant was treated as a separate item in the negotiations, the amount received for it was ordinary income. *Clarence Clark Hamlin Trust,* 19 T.C. 718 (1953). The buyer treated $50 per share of the amount paid as a capital expenditure for the covenant and deducted an amount representing amortization of the cost. In this case the Commissioner argued that the agreement not to compete was no more than an incident to the transfer of the good will of the business and had no separable value. The Tax Court held that the covenant had a separable value and was a depreciable capital asset. *Gazette Telegraph Co.,* 19 T.C. 692 (1953).

When a contract for the sale of a business is accompanied by a covenant by the sellers not to compete[1] with the buyers for a specified period, questions arise as to the tax consequences of the transaction to both parties.[2] Where the covenant is made by a person other than the seller, e.g., a key employee or shareholder in a small corporation, the consideration he receives is ordinary income.[3] In these cases, the payment received by the covenantor is not an incident to a contract for sale of the covenantor's property, but compensation

[1] For a discussion of the legality of covenants not to compete from the restraint of trade point of view see Carpenter, "Validity of Contracts Not to Compete," 76 UNIV. PA. L. REV. 244 (1928).

[2] See Kamens and Ancier, "Tax Consequences of a Covenant Not to Compete," 27 TAXES 891 (1949).

[3] Cox v. Helvering, (D.C. Cir. 1934) 71 F. (2d) 987; Salvage v. Commissioner, (2d Cir. 1935) 76 F. (2d) 112, affd. Helvering v. Salvage, 297 U.S. 106, 56 S.Ct. 375 (1936); Beals' Estate v. Commissioner, (2d Cir. 1936) 82 F. (2d) 268.

for refraining from work which is as much income to him as is money paid to a person for the performance of services.[4] Research discloses no decided cases dealing with the treatment that should be accorded the consideration paid in the covenantee's return, but it would seem that it should be regarded as a deferred expense to be amortized over the life of the covenant if the expense meets the ordinary and necessary requirement. The questions are more difficult where the seller is the covenantor. The generally recognized rule is that where good will is sold in connection with the sale of a business, the seller is precluded from soliciting the former customers of the business sold, even though no covenant not to compete is included in the contract for sale of the business.[5] In many cases it is probable that forbearance from competition by the seller is the substance of the good will transferred, and the inclusion of a covenant not to compete in the contract is a superfluity or at most a mere incident to the transfer of good will. In such cases no attempt is made to split the consideration received by the seller into capital gain and ordinary income; the entire transaction is regarded as a capital transfer.[6] If, on the other hand, the covenant not to compete is bargained for by the buyer as a separate item in connection with the contract of sale, then the amount received for it is ordinary income to the seller.[7] A similar distinction must be made to determine the proper treatment by the buyer. Where the court concludes that the covenant is inseparable from the transfer of good will, the buyer may not amortize any of the consideration paid over the life of the covenant, since good will is not a depreciable asset.[8] If the covenant is separable, the buyer may amortize its cost. In

[4] "In this country, every man has the right to exercise any lawful avocation on the same terms with his neighbor. . . . If he sells his services for wages or salary, what he receives is income. If he refrains from exercising his skill and ability in a particular line for a definite period, what he receives in compensation is just as much a gain and is income." Cox v. Helvering, (D.C. Cir. 1934) 71 F. (2d) 987 at 988.

[5] This rule was laid down in England in Trego v. Hunt, [1896] A. C. 7, and is generally followed in the United States. See, e.g., Von Bremen v. MacMonnies, 200 N.Y. 41, 93 N.E. 186 (1910). Connecticut apparently refuses to give any protection to the buyer in the absence of an express covenant. Cottrell v. Babcock Printing Press Mfg. Co., 54 Conn. 122, 6 A. 791 (1886). In Massachusetts, "it is a question of fact whether having regard to the character of the business sold and that set up, the new business does or does not derogate from the grant made by that sale." Old Corner Book Store v. Upham, 194 Mass. 101 at 105, 80 N.E. 228 (1907).

[6] In Toledo Newspaper Co., 2 T.C. 794 (1943), this result was reached even though the contract stated a separate consideration for the covenant not to compete. A similar result was reached in Aaron Michaels, 12 T.C. 17 (1949), where the sole proprietor of a laundry sold his business and agreed not to compete for five years.

[7] In Rodney B. Horton, 13 T.C. 143 (1949), taxpayer sold his accounting business listing good will as a specific item and including in the contract a covenant not to compete for six years. There was no allocation of the consideration in the contract. The court held that part of the consideration was allocable to the sale of good will and part to ordinary income as payment for the covenant not to compete.

[8] "No deduction for depreciation, including obsolescence, is allowable in respect of good will." Treas. Reg. 118, §39.23(l)-3. The regulation is based on the decision in Clarke v. Haberle Crystal Springs Brewing Co., 280 U.S. 384, 50 S.Ct. 155 (1929). When the buyer of the newspaper involved in Toledo Newspaper Co., note 6 supra, tried to amortize the cost allocated in the covenant, the Tax Court was consistent with its former holding

Christensen Machine Co. v. United States,[9] a corporation bought out the stock of an inventor who was one of the two principal stockholders and secured a covenant from him not to compete for five years. No allocation of the $60,000 consideration was made by the parties. The corporation in its tax return allocated $30,000 to the covenant and deducted one-fifth of this amount during the first year. This treatment of the transaction was approved by the court since the $30,000 was viewed as purchase of a "valuable asset."[10] In the principal case, the form which the sale of the business took may be important, since in theory, at least, it would seem that corporate good will is attached to the corporation itself and not the individual ownership interests. Therefore, when the owners sell their stock there is no transfer of good will to which the covenant not to compete can be said to be a mere incident. This is somewhat unrealistic, of course, and the factor which the court stresses is that the parties themselves allocated a portion of the consideration to the covenant which showed they had dealt with it as a separate item from good will.[11] Although the principles of law governing cases of this type are reasonably clear, the cases illustrate the difficulties of trying to determine whether or not the covenant was treated as a separate item by the parties in their negotiations. Since the court in the principal case gives much weight to the recitals in the contract as to the allocation of the consideration, the decision indicates the importance to both buyer and seller of being aware of the possible tax consequences of such recitals. If both are familiar with the problem, it is more likely that the bargaining process will set a price on the covenant which reflects its true value to both parties, and will serve as a fair basis for tax treatment.

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and refused the deduction. Toledo Blade Co.,11 T.C. 1079 (1948), affd. (6th Cir. 1950) 180 F. (2d) 357. In R. Bryson Jones, 17 B.T.A. 1213 (1929), a similar result was reached in a case involving the sale of an insurance business coupled with a covenant not to compete for 10 years. The court felt that the good will was the principal asset transferred in the sale.

[9] (Ct. Cl. 1931) 50 F. (2d) 282.

[10] Similar decisions are Black River Sand Corp., 18 B.T.A. 490 (1929), and B. T. Babbitt, Inc., 32 B.T.A. 693 (1935).

[11] "After taking into account all of the relevant facts of the transaction and considering the whole record, we have concluded that the written contract accurately reflected the agreement of the parties and that the agreement was reached at arm's length. In the circumstances it is not incumbent on the Court to disturb the allocation of purchase price made by the parties themselves." 19 T.C. 718 at 724. The dissent points out that the evaluation clause was inserted at the last moment with little discussion "to help the buyers taxwise," and that the sellers were unaware of the consequences to themselves of what they were doing.