University of Miami Law Review

Volume 13 | Number 2 | Article 6

12-1-1958

Tax Aspects of Covenants Not to Compete

A. Jay Cristol

TAX ASPECTS OF COVENANTS NOT TO COMPETE

INTRODUCTION

In a transaction involving the sale of a going business the contract of sale provides the primary means of fixing future tax consequences for the vendor and the purchaser. The tax laws have always permitted tax planning by business men in order that they might take advantage of the most favorable rate of taxation.[1] When transactions pass the planning stage, tax liabilities are established and the parties are bound by the substance of their acts. Because of the great difference between ordinary income tax rates and long term capital gain tax rates[2] frequent disputes arise at the close of tax periods following such sales with both vendor and purchaser claiming the more favorable treatment on the proceeds or property of the sale. In the absence of bad faith the usual cause of such problems is a failure of one or both parties to the sale to consider how his tax planning will affect the other party. A typical problem of this nature is *the covenant not to compete.*

This comment is an attempt to present the combined tax picture for the vendor and the purchaser. It appears to this writer that many of the disputes discussed herein resulted from the publication of articles dealing exclusively with one position.

When a business is sold and, coincident to the sale, the vendor promises the purchaser that he will not compete with him, many questions arise as to how the consideration and the covenant may be treated for tax purposes. The vendor wishes a capital gain on the sale of his business. The purchaser desires to allocate as much as possible of the purchase price to depreciable assets which he can amortize, or to business expense which he can deduct rather than to assets which are not depreciable or deductible. Usually each party computes his taxes on the basis of the most favorable possible tax liability. Subsequently the matter comes to the attention of the treasury department and all too frequently a different interpretation is placed on the transaction.

ADMINISTRATIVE INTERPRETATION

The Bureau of Internal Revenue has established its rules for determination of the tax treatment to be accorded to covenants and proceeds therefrom. Generally the Bureau warns the vendor "payments you receive

1. Superior Oil Co. v. Mississippi, 280 U.S. 390 (1930); United States v. Isham, 84 U.S. (17 Wall.) 496 (1864); Jones v. Helvering, 71 F.2d 214 (D.C. Cir. 1934); George H. Payne, 22 T.C. 526 (1954).
2. *Capital gains* are taxed up to a maximum rate of 25%. The *ordinary income* maximum rate is 91%. INT. REV. CODE of 1954.

from a covenant not to compete for a fixed number of years, which is not in effect a sale of good will are ordinary income."[3] The only exception to the general rule provides that when

> a covenant not to compete accompanies the transfer of good will in the sale of a going concern and it has the function primarily of assuring to the purchaser the beneficial enjoyment of the goodwill he acquires, the covenant is nonseverable from goodwill and is a capital asset.[4]

In either case the burden of proof is placed upon the vendor to establish whether the transaction involves a covenant which is not a capital asset or a covenant which is nonseverable from good will and which is a capital asset.[5]

The purchaser is advised generally that intangible assets may be subject to depreciation upon certain conditions, but goodwill is never subject to depreciation.[6] The bureau specifically defines a covenant not to compete as an agreement whereby the vendor states that he will not compete with the purchaser, "either for a limited time or within an agreed area or a combination of both." Amortization over the life of the covenant in the case of a lump sum payment or deduction as an expense in the case of periodic payments is allowed, providing the covenant is for a definite number of years and represents an "excess purchase price over the market value."[7] As with the vendor the burden of proof is upon the purchaser to establish that the covenant is not, in effect, the purchase of goodwill.[8] The position of the bureau may be summarized as follows:

1) In a transaction including a covenant not to compete not accompanied by the sale of tangible assets,

---

3. U.S. Dep't of Treasury, Your Federal Income Tax 70, (Internal Revenue Service Pub. No. 17 (1959).
4. U.S. Dep't of Treasury, Tax Guide for Small Business 118 (Internal Revenue Service Pub. No. 334 1959).
5. *Ibid.*
6. 26 C.F.R. § 1.67 (a)-3 (Revised 1956).

> *Intangibles.* If an intangible asset is known from experience or other factors to be of use in the business or in the production of income for only a limited period ,the length of which can be estimated with reasonable accuracy, such an intangible asset may be the subject of a depreciation allowance. Examples are patents and copyrights. An intangible asset, the useful life of which is not limited, is not subject to the allowance for depreciation . . . . No deduction for depreciation is allowable for good will . . . .

7. U.S. Dep't of Treasury, Tax Guide for Small Business 7 (Internal Revenue Service Pub. No. 334 1959).

> In some cases the excess of the purchase price over the market value of the assets of the business purchased is paid to eliminate future competition from the seller under a *covenant not to compete.* In other cases the excess purchase price is for both a covenant not to compete and goodwill. In these cases you should determine whether the price paid for a covenant not to compete represents a business expense or the purchase of an asset. If you determine that it is for the purchase of an asset, you should also determine whether the asset is amortizable and whether the amount paid for the covenant can be separated from the total amount paid.

8. *Ibid.*

(a) The vendor receives ordinary income and
(b) The purchaser buys an asset subject to deduction or amortization.

2) In a transaction including a covenant not to compete accompanied by the sale of tangible assets where no specific allocation of a part of the consideration to the covenant is inclined,
(a) The vendor receives a capital gain and
(b) The purchaser buys an asset not subject to deduction or amortization.

3) In a transaction including a covenant not to compete accompanied by the sale of tangible assets where a specific allocation or a part of the consideration to the covenant is included and the covenant is for a definite period of time,
(a) The vendor receives ordinary income and
(b) The purchaser buys an asset subject to deduction or amortization.

JUDICIAL INTERPRETATION

Though the possible combination of situations seems quite simple, there are several complications. The transaction seldom comes to the attention of the bureau until considerable time has elapsed. The two taxpayers are never parties in the same action. This raises the interesting questions of what effect a decision in *Vendor v. Commissioner* has upon *Purchaser v. Commissioner* and vice versa. Would it be possible for both taxpayers to win in their respective actions and each receive the more favorable tax consequences? If the government wins both cases could it apply the less favorable tax consequences to *both* taxpayers? Finally, what right has the bureau or the courts to examine the allocations of the taxpayers and readjust them according to substance and actuality rather than the form or recited allocation of consideration?

The vendor's claim of a capital gain in the sale of a covenant not accompanied by a sale of tangible assets has never been allowed. In an early opinion of the second circuit, the court said, "Compensation paid for refraining from labor would seem to be taxable income no less than compensation for services performed . . . . It is neither a capital payment nor a gift."[9] Thus, where an employee was "paid out" to terminate a contract with a covenant included,[10] and where a wife gave a covenant as part of a divorce settlement,[11] the consideration was held ordinary income.

---

9. Salvage v. Commissioner, Helvering v. Salvage, 76 F.2d 112 (2d Cir. 1935), *aff'd* on other grounds 297 U.S. 106 (1936).
10. Tate v. Knox, 131 F. Supp. 514 (D. Minn. 1955).
11. Estate of Mildred K. Hyde, 42 B.T.A. 738 (1940) (the wife had actively participated in the management of her husband's business and was a capable executive).

In the sale of a corporation there is a sale of tangible assets. Frequently a covenant is given by shareholders and officers. The courts treat such a covenant with shareholders[12] and corporate officers[13] as ordinary income on the theory that the sale of the covenant does not convey property and is therefore not a capital transaction. The theory is harder to justify in the *Gazette Telegraph Co.*[14] and *Clarence Clark Hamlin Trust*[15] cases involving the sale of a newspaper corporation. The vendor stockholders and the purchasers had agreed upon a sale price of two hundred dollars per share of stock. Prior to the closing, the purchaser, with full knowledge of the tax consequences involved, advised the vendors that the "contract was satisfactory" and asked whether the vendors would add an allocation clause of fifty dollars per share for a covenant not to compete, "to help the buyers tax-wise." The vendors agreed to the allocation. They were totally without knowledge of the unfavorable tax consequences which would follow such allocation. The vendors claimed a capital gain and the purchaser attempted to depreciate the cost of the covenant. The Commissioner of Internal Revenue found himself in the rather confusing position of contending in the tax court that the fifty dollars per share allocated in the contract of sale was a separate covenant, hence ordinary income in *Clarence Clark Hamlin Trust*,[16] while at the same time contending that the fifty dollars per share was *not* a separate covenant, hence non-depreciable in *Gazette Telegraph Co.*[17] The court, in both cases, treated the transaction as it was described in the contract of sale in spite of a vigorous dissent in *Clarence Clark Hamlin Trust*,[18] pointing out that the covenant was not bargained for and had no actual value.

In a more recent case involving a closely held family corporation,[19] the vendors and purchasers were both aware of the possible tax consequences of a covenant and gave it "deliberate and careful consideration." The allocation to the covenant was arrived at after bargaining and set at three hundred fifty thousand dollars. Other negotiations produced a formula[20] for evaluating the tangible assets transferred so that the actual "excess purchase price over the market value"[21] could have been determined by the court. The transaction was treated on the basis of the contract

---

12. Cox v. Helvering, 71 F.2d 987 (D.C. Cir. 1934).
13. Beal's Estate v. Commissioner, 82 F.2d 268 (2d Cir. 1936).
14. 19 T.C. 692 (1953), *aff'd* Commissioner v. Gazette Tel. Co., 209 F.2d 926 (10th Cir. 1954).
15. 19 T.C. 718 (1953), *aff'd sub. nom.* Hamlin's Trust v. Commissioner, 209 F.2d 761 (10th Cir. 1954).
16. *Ibid.*
17. Note 14 *supra.*
18. Note 15 *supra.*
19. Richard Ullman, 29 T.C. No. 18 (Oct. 28, 1957).
20. The valuation arrived at was $40.00 for each $1.00 of average weekly sales. The round figure was about $1,000,000.00 prior to adjustment. This involved an additional subsidiary corporation. It is clear that the tangible assets involved were valued at only about half the gross sale price.
21. As defined by the bureau in its instructions on covenants. See note 7 *supra.*

of sale without adjustment of the allocation of the consideration to the covenant.[22] The court felt that a heavy burden was upon the vendor to overcome the terms of the written contract. It concluded "it is not incumbent on the court to disturb the allocation of purchase price made by the parties themselves."[23]

The allowance of a vendor's claim[24] of a capital gain in the sale of a covenant accompanied by the sale of tangible assets and the denial of a purchaser's claim[25] of deduction or amortization of the intangible thus purchased is quite common where the covenant not to compete has the primary function of assuring the purchaser the beneficial enjoyment of good will which he has acquired. The covenant is regarded as non-severable and as being in effect a contributing element to the assets transferred.[26]

In *Aaron Michaels*,[27] coincident to the sale of a laundry, the vendor gave a covenant not to compete in a similar business for five years. The court found that because of the nature of the laundry business in that area the value of the covenant was greatly diminished. It was therefore "treated as a capital asset ancillary to the transfer of good will and customers . . . the entire proceeds of the sale . . . taxable as a capital gain."[28] *George H. Payne*[29] involved the sale of a newspaper. After agreement upon the sale price and execution of a contract, the purchaser[30] asked the vendor to allocate one hundred thousand dollars to a covenant not to compete which was already in the contract without valuation "to ameliorate tax consequences for him." The court found the covenant "not bargained for" and "mere window dressing inserted only to benefit the purchaser tax-wise." The sale of an accounting firm with a restrictive

---

22. It is interesting to note that two of the three Ullman brothers involved were giving up business on doctors advice and a third, 60 years of age, had worked inside the plant and was seldom in contact with customers of the corporation. These facts make it difficult to understand how their covenant could be worth over half of the entire sales price. Herman Kaiser, the fourth stockholder, was a manager primarily engaged in supervising internal affairs.

23. Richard Ullman, 29 T.C. No. 18 (Oct. 28, 1957) *citing* Clarence Clark Hamlin Trust, note 15 *supra*.

24. Estate of F. G. Masquelette v. Commissioner, 239 F.2d 322 (5th Cir. 1956); George H. Payne, 22 T.C. 526 (1954); Richard S. Wyler, 14 T.C. 1251 (1950); Aaron Michaels, 12 T.C. 17 (1949); Toledo Newspaper Co., 2 T.C. 794 (1943).

25. Toledo Blade Co., 11 T.C. 1079 (1948), *aff'd* 180 F.2d 357 (6th Cir. 1950), *cert. Den.* 340 U.S. 811 (1950); Radio Medford, Inc. v. U.S., 150 F. Supp. 641 (D. Or. 1957); Dauksch v. Busey, 125 F. Supp. 130 (D. Ohio 1954); D. & H. Bagel Bakery, Inc. 14 CCH Tax Ct. Mem. 334 (1955), P-H 1955 T.C. Mem. Dec. § 55,100; Jacques L. Ach, 13 CCH Tax Ct. Mem. 1225 (1954), P-H 1954 T.C. Mem. Dec. § 54,348; Harold J. Burke, 18 T.C. 77 (1952); Frank L. Newburger, Jr., 13 T.C. 232 (1949).

26. See notes 24 and 25 *supra*.

27. 12 T.C. 17 (1949).

28. *Ibid.*

29. 22 T.C. 522 (1954).

30. The purchaser was none other than R. C. Hoiles, the purchaser who asked the vendors of a newspaper in Clarence Clark Hamlin Trust, (note 15 *supra*) to "help the buyers tax-wise" and thereby purchased a depreciable asset while the purchasers paid a $32,294.63 deficiency on their 1946 taxes.

covenant not to compete was held a capital gain.[31] Also, fifty thousand dollars received for the sale of good will and a covenant not to compete of an accounting firm which sold tangible assets of less than four thousand dollars was held non-severable and a capital gain.[32] Where a newspaper sold only its "intangible" assets to a rival paper, including a covenant to cease publication and not compete for ten years, the entire consideration was held a capital gain.[33] Following the transaction, the purchaser carried the cost of the covenant on its books as a depreciable asset and amortized its cost[34] over four years. The commissioner disallowed the amortization and insisted the asset was non-depreciable. In spite of the contractual allocation and the fact that the covenant was bargained for, the court[35] refused to sever the covenant or give it any valuation. In an excellent dissenting opinion,[36] Justice Murdock pointed out that the government offered no evidence to show the cost of the covenant was less than the stated valuation while evidence of the petitioner showed he paid a substantial portion of the consideration for the covenant. Justice Murdock stated, "it is incumbent upon this court to determine what portion of the total consideration may be properly regarded as the cost of the agreement not to compete for the purposes of allowing deductions . . . ." He concluded "the one sure way to do injustice in such cases is to allow nothing whatever upon the excuse that we cannot tell how much to allow."[37] It is possible that the decision of the court was based upon earlier holdings that the cost of eliminating competition is a non-deductible capital expenditure; however, these cases *did not involve covenants not to compete*.[38]

Similarly, covenants not to compete have been found non-depreciable or non-deductable where parties to a dissolved partnership made reciprocal

31. Estate of F. G. Masquelette v. Commissioner, 239 F.2d 322 (5th Cir. 1956). The tangible assets were valued at $26,689.24 and adjustments, the covenant at $24,000.00.

32. Richard S. Wyler, 14 T.C. 1251 (1950). *But see* Rodney B. Horton, 13 T.C. 143 (1949).

33. Toledo Newspaper Co., 2 T.C. 794 (1943). The contract of sale allocated $100,000.00 for such intangibles as "circulation, route, subscription, dealer, and carrier lists," and copies of all records relating to sales and distribution. The fair market value of these intangibles including good will on the contract date was $437,590.60. An additional $780,000.00 was allocated to the covenant not to compete. Though the term "intangibles" is used by the parties and the court, it should be noted that certain physical property or tangible assets were exchanged. The wording is probably used because the physical assets transferred have little value in themselves and the major physical plant or the newspaper was not part of the transaction. Thus in spite of the technology, this case is not contradictory to the introduction or this section as stated at note 9 *supra*.

34. $780,000.00 as per contract. *Ibid.*

35. Toledo Blade Co., 11 T.C. 1079 (1948), *aff'd* 180 F.2d 357 (6th Cir. 1950), *cert. den.* 340 U.S. 811 (1950).

36. *Id.* at 1086.

37. Quoting Judge Learned Hand in Commissioner v. Maresi, 156 F.2d 929 (2nd Cir. 1946).

38. Public Opinion Publishing Co. v. Jensen, 76 F.2d 494 (8th Cir. 1935); Newspaper Printing Co. v. Commissioner, 56 F.2d 125 (3d Cir. 1932).

covenants,[39] where allocation was made only to "intangible assets" including good will,[40] or no allocation of consideration was made.[41] The purchaser of a competing insurance business was not permitted to depreciate a covenant given by a seventy three year old vendor.[42] Recently the purchaser of a radio station under a contract which did not allocate any amount to a covenant not to compete attempted to show the value of the covenant and depreciate it. The court upheld the terms of the contract,[43] finding the covenant not a separate item. The opinion indicated, however, that the court did not consider that it was bound by the terms of the contract.[44]

There are very few cases allowing deduction or depreciation by the purchaser. The purchase of a partner's interest in an insurance business where a covenant was allocated separate valuation was found severable and depreciable.[45] In *Wilson Athletic Goods Mfg. Co. Inc., v. Commissioner*,[46] the purchaser paid five hundred and seventy thousand dollars for the tangible and intangible assets[47] of a going concern *without specific allocation of consideration* to a covenant not to compete for ten years. The court of appeals reversed the tax court and allowed depreciation upon the basis that the evidence[48] established the value of the covenant and the contract was not binding upon the court.[49]

In some cases the courts have examined the allocations of the parties and adjusted the amounts according to the substance and actuality of the transaction:

> Tax consequences from the sale of property depend upon the substance and actuality of the transaction rather than the form or recited consideration in the contract . . . . To permit the true

39. Frank L. Newburger, Jr., 13 T.C. 232 (1949).
40. Harold J. Burke, 18 T.C. 77 (1952).
41. D. & H. Bagel Bakery, Inc., 14 CCH Tax Ct. Mem. 334 (1955), P-H 1955 T.C. Mem. Dec. § 55,100; Jacques L. Ach, 13 CCH Tax Ct. Mem. 1225 (1954), P-H 1954 T.C. Mem. Dec. § 54,348.
42. Dauksch v. Busey, 125 F. Supp. 130 (D. Ohio 1954).
43. Radio Medford, Inc. v. United States, 150 F. Supp. 641 (D. Or. 1957).
44. Id. at 643. "we are not bound by the strict terms of the agreement but 'we must examine the actualities and may sustain or disregard the effect of a written provision or of an omission of a provision, if to do so best serves the purposes of the tax statute.'"
45. Dauksch v. Busey, 125 F. Supp. 130 (Ohio 1954).
46. 222 F.2d 355 (7th Cir. 1955).
47. The total purchase price of $570,000.00 included $270,000.00 for current assets, $157,307.70 for machinery, equipment, molds, lasts, patterns and dies and $142,692.30 for intangibles. At the time of the transaction the purchaser allocated the consideration for intangibles upon its books as follows: "covenant not to compete $132,692.30; good will $10,000.00."
48. The Wilson Co., was able to show that it had no interest in purchasing goodwill, it did not use the name of the company purchased, it did not wish to acquire the vendors customers as it already had more than it could supply and that it desired only the tangible assets and the covenant not to compete.
49. See note 46 *supra* at 357. "Therefore, it was the duty of the tax court and it is our duty here to ascertain the true intent, insofar as tax consequences are concerned. Consequently, it is immaterial whether the contract did or did not define a specified amount as the value of the covenant."

> nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policy of Congress.[50]

Thus, in the purchase of a bookbinding machine company for sixty thousand dollars, the court allocated half the consideration to a covenant not to compete and allowed depreciation on the covenant.[51] The sale of a sand company[52] provided payments to the vendors for performing work and refraining from competition. The court again allocated half the consideration to the covenant and allowed the purchaser to exhaust it by deduction.[53] A contract providing for contingent payments for services and a covenant not to compete by the vendor of an accounting firm was adjusted by the court in *Rodney B. Horton*.[54] Terms of the contract provided a fifty percent reduction of payments in the event Mr. Horton died or left the state.

Conclusion

It is noted that there are very few instances in which both parties to a transaction involving a covenant not to compete go to court. In the majority of instances where only one party to the transaction litigates the treatment of a covenant or proceeds therefrom, it is conceivable that the other party may receive similar treatment of his portion of the transaction, that is, either the more favorable or less favorable tax treatment resulting in favorable or unfavorable treatment for *both* taxpayers. The effect of a decision between the government and one party in the paired cases[55] seems to influence the courts to decide the subsequent case contra without attention to merit or fact. It also appears that the trend today is towards examination of substance and reality of transactions, rather than strict reliance upon form and recitation of consideration.

The judicial approach to the problem can be summarized as follows:

1) Strict enforcement of the allocations of the contract between the parties,
2) Allocation of the consideration according to the substance of the transaction.

---

50. Commissioner v. Court Holding Co., 324 U.S. 331 (1945); Higgins v. Smith, 308 U.S. 473 (1940); Gregory v .Helvering, 293 U.S. 465 (1935); Jones v. Grinnell, 179 F.2d 873 (10th Cir. 1950); George H. Payne, 22 T.C. 526 (1954).

51. Christensen Machine Co. v. Commissioner, 18 B.T.A. 526 (1929), *aff'd* 73 Ct. Cl. 149, 50 F.2d 282 (1931).

52. Black River Sand Corp., 18 B.T.A. 490 (1929).

53. *Ibid*, the opinion noted that the vendor treated the entire consideration as ordinary income and did not seek a capital gain.

54. 13 T.C. 143 (1949); *Appeal dismissed* 180 F.2d 354 (10th Cir. 1950).

55. Hamlin's Trust v. Commissioner, 19 T.C. 718 (1953), *aff'd sub. nom.* 209 F.2d 761 (10th cir. 1954); Commissioner v. Gazette Tel. Co., 19 T.C. 692 (1953), *aff'd*, 209 F.2d 926 (10th cir. 1954); Toledo Blade Co., 11 T.C. 1079 (1948), *aff'd*, 180 F.2d 357 (6th cir. 1950), *cert. denied*, 340 U.S. 811 (1950); Toledo Newspaper Co., 2 T.C. 794 (1943).

The problem remaining seems to be when should the courts enforce a contract and when should they make adjustments? The decisions do not provide a consistent answer.

It is suggested that in a transaction where the parties are both fully aware of the tax consequences of allocation, *any* contract between them should be enforced. Thus from the bargain arrived at, each can rely upon computations of *net cash* after taxes and fixed *allowable* depreciable assets or deductions. Also the bureau is immediately aware of which party is entitled to the favorable and which party unfavorable tax consequences for each element of the consideration. The courts should make adjustment of the allocations only when one or more parties to the contract can affirmatively show total lack of consideration of tax consequences in the making of such contract, and that such party or parties would be subjected to tax consequences which would substantially alter the intended result of the original contract.

A. Jay Cristol