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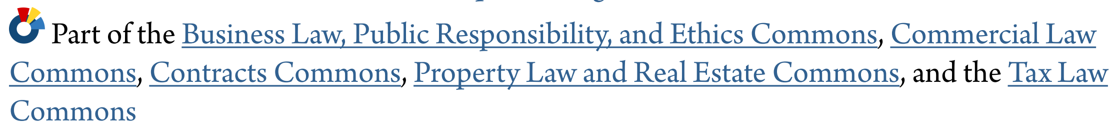

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TAXATION OF COVENANTS NOT TO COMPETE IN THE SALE OF A BUSINESS

JAMES F. QUEENAN, JR.*

I. INTRODUCTION

When a business is sold and the seller has been active in its management, the buyer usually insists that the seller give a covenant not to compete for a specified period. There are sound business reasons for the buyer to protect himself from such competition. In addition, not far from his (or his lawyer's) mind is the pleasant thought that such a covenant might provide an opportunity to recoup at least a portion of the purchase price by means of a tax deduction. In order to realize this expected tax benefit, he will seek to have the contract allocate a specific portion of the purchase price to the covenant with the intention of amortizing this amount over its term. The seller, although willing to grant the covenant, may well object to any sum being allocated to it on the ground that this will bring ordinary income to him as opposed to the capital gain treatment which could otherwise be obtained. Often the parties take it for granted that there is a well settled rule of law that a covenant not to compete brings a tax deduction through amortization to the buyer and ordinary income to the seller. It is the purpose of this article to determine in the first instance the extent to which the case law supports this view of the covenant's tax consequences and, secondly, to attempt an analysis of the question. Before dealing with these tax questions, however, it may be helpful at this point to review the common law incidents of covenants not to compete.

Seller's Right to Compete

In the absence of a restrictive covenant, the seller may thereafter engage in a competing business and solicit his former customers by indirect means such as public advertising.[1] Nor is he prohibited from disclosing his prior relationship with the business provided this is not done in such a manner as to convey the impression that his new business is but a continuation of the old.[2] He may not, however, resort to private solicitation of his former customers for this is regarded as rendering the entire sale a fraud upon the purchaser.[3] The buyer may

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1 38 C.J.S. Goodwill § 12 (1943); 24 Am. Jur. Goodwill § 18 (1939). See Annotation, 82 A.L.R. 1030 (1933).

2 White v. Trowbridge, 216 Pa. 11, 64 Atl. 862 (1906); Getter v. Levine, 315 Mich. 353, 24 N.W.2d 149 (1946).

3 Bergum v. Weber, 136 Cal. App. 2d 389, 288 P.2d 623 (1955); LaGrange v. Datsis, 142 Me. 48, 46 A.2d 408 (1946); Colton v. Duvall, 254 Mich. 346, 237 N.W. 48 (1931);

enjoin him from dealing with customers obtained by such activity even though they may well have eventually traded with him on their own initiative.[4] A few courts have found a distinction between the sale of a professional practice and the sale of a commercial business, holding that in the former the goodwill sold is too closely linked to the personal qualities of the seller to permit his subsequent competition.[5] Also, in Massachusetts, as opposed to the prevailing opinion elsewhere, the expressed or implied transfer of goodwill imposes upon the seller an obligation to refrain from any competition, whether through private or public solicitation, which is in derogation of the transfer.[6]

This considerable freedom of action which is permitted the seller by most courts is apparently the result of a belief that the right to compete is too basic to be proscribed by implication. Since the courts would have no particular difficulty in establishing a restriction upon the seller appropriately limited in time and area,[7] the merit of the rule permitting competition in the absence of a covenant is questionable. The seller's subsequent competition could be disastrous to the business because he can often retain a substantial number of his customers by simply going into business again without the necessity of resorting to private solicitation. A covenant not to compete does, therefore, give the buyer significant protection.

When given in connection with the sale of a business and not unduly extended in time and area, the covenant is valid as a reasonable means of protecting the business.[8] If its term or the geographical area encompassed is such that the buyer has more protection than is necessary for this purpose, the covenant may be rewritten by the court in order to avoid an unreasonable restraint upon competition.[9] A covenant granted in connection with the sale of a business or ancillary to some other valid transaction is to be contrasted with the so-called "naked" covenant between competitors which is totally void as an unreasonable restraint upon competition.[10]

Gibbons v. Hansch, 185 Minn. 290, 240 N.W. 901 (1932). See Annotation, 82 A.L.R. 1030.

[4] Synder Pasteurized Milk Co. v. Burton, 80 N.J. Eq. 185, 83 Atl. 907 (1912).

[5] See, e.g., Brown v. Benzinger, 118 Md. 29, 84 Atl. 79 (1912); Yeakley v. Gaston, 50 Tex. Civ. App. 405, 111 S.W. 768 (1908).

[6] Lynn Tucker Sales, Inc. v. LeBlanc, 323 Mass. 721, 84 N.E.2d 127 (1948); Auslyn, Inc. v. Rousseau, 321 Mass. 735, 75 N.E.2d 641 (1947); Old Corner Book Store v. Upham, 194 Mass. 101, 80 N.E. 228 (1907). Compare Martin v. Jablonski, 253 Mass. 451, 149 N.E. 156 (1925).

[7] See the Massachusetts cases cited supra note 6.

[8] 5 Williston, Contracts § 1641 (rev. ed. 1937).

[9] Restatement, Contracts, § 518 (1932), would permit the covenant to be rewritten only if the valid and invalid aspects are grammatically divisible. The present tendency seems to be away from this emphasis upon form. See 5 Williston, Contracts § 1660 (rev. ed. 1937).

[10] United States v. Addyston Pipe & Steel Co., 85 Fed. 271 (6th Cir. 1898), aff'd sub nom., 175 U.S. 211 (1899). See 5 Williston, Contracts § 1636 (rev. ed. 1937). Standard

II. TAX CONSEQUENCES: TREATMENT BY THE COURTS

A. *The Problem*

A business usually has a value which exceeds the total value of its tangible property. Part of this excess value may be attributed to a depreciable intangible such as a patent, but the remainder is called "goodwill." As shall be more fully discussed later,[11] the tax consequences to both buyer and seller from the sale of goodwill are clear: The buyer is not allowed a deduction for depreciation and because of goodwill's non-depreciable nature, the seller is entitled to capital gain treatment. Lawyers representing buyers are thus constantly attempting to minimize the amount that is attributed to the residual excess value. The only method which has met with any degree of success, other than inflating the value of depreciable property where there is a sale of assets rather than stock, consists of allocating a portion of the price to a covenant not to compete.

Perhaps no other subject in our tax law can surpass the covenant in ambivalence of treatment by the courts. The difficulty is caused by its relationship with goodwill. Goodwill is generally regarded as a species of intangible business property which is an improper subject of depreciation or amortization due to its indeterminate life. A covenant not to compete, on the other hand, is a personal obligation of the covenantor requiring him to refrain from competition for only a specified period. Should it be treated differently from goodwill or are they nonseverable?

B. *Theory of Nonseverability*

The theory of nonseverability has as its origin the decision in *Toledo Newspaper Co.*[12] The petitioner had entered into an agreement with the Toledo Blade Company, which published a rival paper, whereby it sold to the latter the exclusive right to use the name of its newspaper, the Toledo News-Bee, together with all circulation, route, subscription, dealer and carrier lists, syndicated features and wire service rights. No tangible assets, such as machinery and equipment, were included in the sale. The contract set the price for the transfer at $100,000. In addition, the petitioner covenanted not to compete in the City of Toledo for a period of ten years in consideration of the payment of $780,000. The buyer expressly agreed in the

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Lumber & Hardware Co. v. Commissioner, 17 CCH Tax Ct. Mem. 796 (1958), is apparently the only tax case in which the question of voidness, illegality or even public policy has been raised. The court noted that the Commissioner cited "no authority for his contention that the deduction would not be allowable if the agreement could not be enforced." Moreover, it stated that the tax deduction for amortization does not depend upon state laws.

[11] See Section III. A., infra.

[12] 2 T.C. 794 (1943).

written contract to share with the seller fifty per cent of the expected tax savings resulting from amortization of the covenant. The Tax Court ruled that the $780,000 should be treated by the seller as part of the purchase price rather than ordinary income, reasoning that the covenant's purpose was to protect the value of the goodwill transferred and thus it should not be segregated from the transfer of assets.

The tax consequences to the buyer of the Toledo News-Bee were litigated several years later in *Toledo Blade Co.*[13] The court reaffirmed its position that the covenant was not divisible from the remainder of the transaction and denied to the buyer the right to amortize the price of the covenant. Judge Murdock, dissenting, pointed out that several previous decisions of the court[14] supported seperate tax treatment for the covenant. He admitted that perhaps other provisions of the contract (presumably the agreement to share the expected tax savings) might lead to the conclusion that the cost of the covenant was less that $780,000, but was dissatisfied with the decision in that he believed it was incumbent upon the court to determine a proper allocation. As one writer[15] has pointed out, the Tax Court in the Toledo newspaper decision may well have been influenced by factors other than the theory of nonseverability. After having transferred the name of its newspaper, together with circulation and subscription lists, syndicated features and wire service rights, it would seem that the seller would not be in a position to compete even if it was free to do so. This plus the agreement to share expected tax savings indicate that the allocation of so large a portion of the total consideration to the covenant was highly unrealistic. However, the court did not base its decision on this ground.

An attempt at reconciling the Toledo News-Bee cases with prior decisions was made in *Aaron Michaels*[16] where the court formulated the following statement of the theory of nonseverability which has been adopted in many other cases:

> If such an agreement can be segregated, not so much for the purposes of valuation as in order to be assured that a separate item has actually been dealt with, the agreement is ordinary income and not the sale of a capital asset. . . . But where it accompanies the transfer of goodwill in the sale of a going business and it is apparent that the covenant not to compete has the function primarily of assuring to the pur-

[13] 11 T.C. 1079 (1948), aff'd per curiam, 180 F.2d 357 (6th Cir.), cert. den., 340 U.S. 811 (1950).

[14] News Leader Co., 18 B.T.A. 1212 (1930); Christensen Mach. Co., 18 B.T.A. 256 (1929); William Ziegler, Jr., 1 B.T.A. 186 (1924).

[15] Barrett, Covenants Not To Compete: Their Effects Upon the Covenantor and Covenantee, 18 N.Y.U. Inst. on Fed. Tax. 861 (1960).

[16] 12 T.C. 17 (1949).

chaser the beneficial enjoyment of the goodwill which he has acquired, the covenant is regarded as nonseverable and as being in effect a contributing element of the assets transferred.[17]

Joseph Faulkner[18] illustrates the theory's application to a transaction involving a typical use of the covenant not to compete. The petitioner's business was renting clothing such as aprons and dental gowns. At the time of the sale he enjoyed an acquaintance of many years standing with his customers. The price assigned to the assets of the business was $13,867.80 with $3,000 allocated to goodwill and an additional $10,000 paid for the seller's covenant not to compete. In view of the fact that the volume of the business seemed to be based chiefly on the personal relationship between the individual proprietor and his customers, the proportionate allocation between goodwill and the covenant appears to have been reasonable. Finding that the primary function of the covenant was clearly to protect goodwill, the court ruled that it was nonseverable from goodwill so that the consideration paid for it was a portion of the sale proceeds to be taxed to the seller at capital gain rates rather than as ordinary income.

C. *Covenant Accorded Separate Treatment*

A concise statement of the view allowing amortization by the buyer is found in *Commissioner v. Gazette Tel. Co.*:[19]

> . . . in a transaction in which property is sold and the seller covenants to not engage in business in competition with the purchaser for a specified period of time, if the parties in good faith and realistically treat the covenant in a separate and severable manner in respect to value and cost the purchaser may amortize the price paid for the covenant and claim annual deductions pro rata during the life of the covenant.[20]

Courts which have permitted the buyer to amortize take the position that the right to be free from the seller's competition is a separate asset. Because of its limited life, the reasoning goes, amortization should be allowed on the same principle permitting a deduction for the exhaustion, wear and tear of other property used in a trade or business.[21] In an early Board of Tax Appeals decision[22] which falls within this category, the Commissioner argued that the buyer might so strengthen his position by the end of the covenant's term as to be

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[17] Id. at 19.
[18] 15 CCH Tax Ct. Mem. 175 (1956).
[19] 209 F.2d 926 (10th Cir. 1954).
[20] Id. at 928.
[21] See, e.g., Commissioner v. Gazette Tel. Co., supra note 20.
[22] Christensen Mach. Co., supra note 14.

unaffected by the seller's competition for one or more years thereafter. The Board conceded this as a possibility, but nevertheless believed the covenant to have essentially a limited life and concluded that amortization based upon the stated term was reasonable.

Under this theory the covenant is regarded as being capable of coexisting with that potpourri of expectancies and advantages called goodwill without either losing its essentially independent nature.[23] The Tax Court decision in *United Fin. & Thrift Corp. of Tulsa*[24] is perhaps the clearest illustration. The petitioners, subsidiaries of a parent finance company, each purchased the assets of a branch office operated by a competitor. Both of these newly acquired branch offices were located in Tulsa, Oklahoma. A covenant not to compete within fifteen miles of Tulsa for a specified period of time was obtained from the sellers in both transactions. The entire excess of the purchase price over the book value of the accounts and notes assigned was allocated to the covenant. In one purchase, $181,803 was paid for the accounts and notes and $23,397 for the covenant; in the other, $26,125.54 was paid for the accounts and notes and $4,750 for the covenant. The Commissioner, armed with the Toledo newspaper cases and the line of cases[25] following them, refused to allow amortization of the covenant. At the trial, evidence was introduced indicating that the typical customer in the field renews or refinances his outstanding loan approximately 2.6 times and on the average remains on the books of the loan company as a borrower for 27 to 30 months. The court found that the likelihood of obtaining this repeat business represented a valuable intangible asset, the acquisition of which was not reflected by assigning to the covenant the entire excess of the purchase price over book value. It concluded, nevertheless, that some portion of the excess should be allocated to the covenant for two reasons: (1) it removed the sellers from the field of competition for future customers and (2) although the sellers would be prohibited from soliciting the customers whose obligations were assigned even in the absence of the covenant, nevertheless the covenant gave the buyers much greater assurance that during the periods specified the sellers could not in any other way attract their former customers. The court allocated to the covenant not to compete $11,579.80 out of the total of $23,397

[23] See, e.g., J. W. Rogers v. Commissioner, 290 F.2d 501 (9th Cir. 1961); Williamson & Waite, Inc. v. United States, 62-1 U.S. Tax Cas. ¶ 9163 (S.D. Ind. 1961); Daukch v. Busey, 125 F. Supp. 130 (S.D. Ohio 1954); Max Levine, 21 CCH Tax Ct. Mem. 363 (1962); United Fin. & Thrift Corp. of Tulsa, 31 T.C. 278 (1958), aff'd, 282 F.2d 919 (4th Cir. 1960), cert. den., 366 U.S. 902 (1961).

[24] Supra note 23.

[25] Aaron Michaels, supra note 16; Lee Ruwitch, 22 T.C. 1053 (1954); Lloyd H. Walker, 13 CCH Tax Ct. Mem. 558 (1954); Harold J. Burke, 18 T.C. 77 (1954); D & H Begal Bakery, Inc., 14 CCH Tax Ct. Mem. 334 (1955); Joseph Faulkner, supra note 18; S. Alper, 15 CCH Tax Ct. Mem. 1414 (1956); Masquelette's Estate v. Commissioner, 239 F.2d 322 (5th Cir. 1957).

in the first transaction and $3,051.84 out of the total of $4,750 in the second, and permitted amortization during their respective terms.

There is a sidelight to this decision which may interest students of *stare decisis*. In finding the existence of a potential for retaining customers, the court employed the phrase "valuable intangible asset" rather than that catch-all and garden-variety term "goodwill." This was apparently due to the fact that the theory holding the covenant and goodwill to be nonseverable has been particularly prevalent in Tax Court decisions. The Great Bard's verse on the rose would seem to have application here. Another technique, resorted to in one decision[26] of the Tax Court, consists of rendering lip service to the theory of nonseverability and then, under the guise of fact finding, holding the covenant to be severable.

The corollary to allowing the buyer to deduct the price of the covenant through amortization is charging the seller with the receipt of ordinary income.[27] The consideration paid for the covenant is treated as income from forebearing, rather than performing, personal services.[28] The courts which so hold reject the contention that the covenant is given by the seller as an integral part of the sale so that it should be treated as essentially capital in nature. In their view this would amount to holding that the seller has conveyed his individual privilege to refrain from engaging in business which, of course, is an impossibility. They regard the covenant as merely a promise which is no more of a conveyance than any other promise between contracting parties.[29]

III. RELATIONSHIP BETWEEN COVENANT AND GOODWILL

A. *Goodwill*

For many years there has been a regulation[30] in effect containing the broad proposition that goodwill is not depreciable and this rule is well established in our tax law. Its basis stems from the decision in *Clarke v. Haberle Crystal Springs Brewing Co.*[31] and its companion case, *Renziehausen v. Lucas*.[32] The taxpayers had attempted to amortize and deduct the value of goodwill over the period remaining before the effective date of the eighteenth amendment establishing prohibi-

[26] Rodney B. Horton, 13 T.C. 143 (1949).

[27] Hamlin's Trust v. Commissioner, 209 F.2d 761 (10th Cir. 1954); Beal's Estate v. Commissioner, 82 F.2d 268 (2d Cir. 1936); Salvage v. Commissioner, 76 F.2d 112 (2d Cir. 1935), aff'd on other grounds, 297 U.S. 106 (1936); Cox v. Helvering, 71 F.2d 987 (D.C. Cir. 1934); Richard Ullman, 29 T.C. 129 (1957), aff'd, 264 F.2d 305 (2d Cir. 1959).

[28] See, e.g., Cox v. Helvering, supra note 27.

[29] Beal's Estate v. Commissioner, supra note 27.

[30] Treas. Reg. § 1.167(a)-3 (1960).

[31] 280 U.S. 384 (1930).

[32] Id. at 387.

tion. The Supreme Court denied the deduction, but based its decision upon a policy judgment that a tax benefit should not accrue to a business by reason of it becoming illegal. As has been pointed out by Judge Learned Hand,[33] this reasoning has rather limited application. Nonetheless, these two cases are generally regarded as authority for denying depreciation or amortization of goodwill.[34] The present vitality of the rule, however, is due to the difficulty which is inherent in ascertaining the life of goodwill.[35] The effect upon the seller of the unavailability of a depreciation allowance is that goodwill is then by definition a capital asset and he is entitled to report its sale accordingly.[36]

As has been seen, lawyers representing the buyer of a business have on many an occasion convinced a court that a covenant not to compete is something distinct from goodwill so that the price paid for it should not bring about the same tax consequences. Semantics has certainly aided the buyer on this question. Undeniably the covenant and goodwill are not identical, but the real question is: What is its relationship with goodwill? The concept embodied by the word "goodwill" is such a broad one that problems can be created when we depend upon a single word to express it. Perhaps the best known definition is that of Justice Story:

> Goodwill may be properly enough described to be the advantage or benefit which is acquired by an establishment beyond the mere value of the capital stock, funds, or property employed therein, in consequence of the general public patronage and encouragement which it receives from constant or habitual customers on account of its local position, or common celebrity, or reputation for skill, or influence, or punctuality, or from other accidental circumstances or necessities, or even from ancient partialities or prejudices.[37]

Although the word is commonly used in reference to the advantageous relationship that a business enjoys with its customers, and shall be so used here, it does include advantageous relationships with suppliers, financiers, employees and many others having a relationship with it.[38] The extent of the mileage realized from it, even when describing only advantageous customer relations, becomes apparent when

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[33] Williams v. McGowan, 152 F.2d 570 (2d Cir. 1945).

[34] McDonald, Goodwill and the Federal Income Tax, 45 Va. L. Rev. 645 (1959).

[35] Dodge Bros. v. United States, 118 F.2d 95 (4th Cir. 1941); X-Pando Corp., 7 T.C. 48 (1946).

[36] Int. Rev. Code of 1954, § 1221.

[37] Storey, Partnerships § 99 (7th ed. 1881).

[38] Commons, Industrial Goodwill, 18-26 (1919); Grace Bros., Inc. v. Commissioner, 173 F.2d 170 (9th Cir. 1949).

we consider that the intended benefit may be due to a trademark in one business, with location being of no importance, whereas in another, location may be the principal factor. No attempt will be made here to present a comprehensive discussion of the concept in the abstract. Since our purpose concerns itself with the role of the covenant in the transfer of goodwill, the approach shall be orientated upon the intent of the parties and the economic facts which precipitate their bargain. The comment of Judge Cardozo is particularly appropriate in this connection: "Men will pay for any privilege that gives a reasonable expectancy of a preference in the race of competition."[39]

B. *Function of the Covenant*

The transfer of those advantageous relations and expectancies which depend upon factors having no direct connection with an individual active in the business poses no problem for the buyer. Factors such as a location, customer list, and trademark or trade name, which may be called non-personal elements of goodwill, are specific items of property whose ownership and enjoyment can be passed to the buyer by traditional methods. But often there is an individual, whether he be a stockholder, proprietor or partner, who must be taken into account because a significant aspect of the favorable customer attitude seems to be centered upon him personally. Depending to a great extent upon the nature of the business, this personal predilection on the part of customers or clients may vary from a pleasant business acquaintanceship to a deep admiration and respect for the individual's ability arising out of a close working relationship. It may also be based upon such non-business factors as personal friendship or the individual's general prominence in the area as a result of civic activity. The personal element of goodwill often cannot be isolated from other elements. Thus, one customer may be doing business with the enterprise not only because he is favorably disposed toward the person with whom he has direct dealings but also because he has a high regard for the general quality of the company's services or products. The continued patronage of another may be as much a matter of habit as it is his favorable disposition toward an individual.

In these circumstances it becomes obvious to the buyer that he must do something more than merely obtain the non-personal elements which contribute to the goodwill. What he does, of course, is to exact a covenant not to compete from the individual in question. Otherwise, assuming an ability to compete, a substantial number of customers may well be diverted to the seller if he were to go into business again. It is, therefore, a combination of two methods which transfers the goodwill of the business: (1) the buyer is furnished with the symbols

[39] In re Brown, 242 N.Y. 1, 6, 150 N.E. 581, 582 (1926).

which have evoked a favorable response on the part of customers and (2) the seller is eliminated as an alternative attraction.[40]

The term of the covenant is set in accordance with the buyer's estimate of the length of time necessary to be free from the seller's competition before the business will have a sufficiently solid relationship with its customers as to be unaffected thereafter by the seller re-entering the field. Any term which is reasonably designed to attain this end is valid.[41] Although the period of the covenants in reported cases is usually substantially less than ten years, a longer term will be approved where the court believes this length of time is necessary to secure the goodwill of the purchased business.[42] The seller is hardly in a position to object to a covenant with any term which bears a logical relation to the transfer of the goodwill he desires to sell. Objection on the part of the seller is seldom a problem in any event. He is usually selling because he intends, at least at the time, to go out of the business entirely or leave the area.

The buyer intends to obtain as nearly the equivalent goodwill as was enjoyed by the seller. It may be necessary for him thereafter to devote a good deal of time and effort and incur substantial expenses in order to maintain the goodwill. This does not destroy the fact that he is the recipient of a concrete business advantage. Even with such activity, he cannot expect to secure the patronage of all the customers. But neither would the seller be so sanguine as to think that he could have retained them all. The parties are dealing with an expectancy and nothing more. If it is apparent that some customers will not do business with the successor, then an adjustment in the price might be made.

It is unrealistic to think of the seller as hovering in the background ready to commence ruinous competition upon expiration of the covenant's term. At that point he will have been out of the field too long and the advantage which he previously possessed will be firmly anchored with his former business.[43] Every transaction involving a covenant not to compete illustrates this principle of human obsolescence.

It is true that in addition to securing the goodwill of the business the covenant also eliminates the seller's competition with respect to future customers. This aspect of the covenant is much like a naked covenant between competitors, particularly where the purchase represents an expansion of the buyer's present business, and it can be logically separated from the transfer of goodwill. If this function of

[40] See Malcolm J. Watson, 35 T.C. 203 (1960); Note, An Inquiry into the Nature of Goodwill, 53 Colum. L. Rev. 660 (1953).

[41] Williston, supra note 8.

[42] See, e.g., Bonneau v. Meaney, 1961 Mass. Adv. Sh. 1465, 178 N.E.2d 577 (1961)

[43] See Chamberlain, Theory of Monopolistic Competition 69 (3d ed. 1938).

the covenant is of importance to the buyer so that a portion of the purchase price may be treated as having been paid for it, then, to the extent of this value, the covenant should be subject to amortization and should bring ordinary income to the seller. Moreover, it is possible to imagine a transaction in which the pure elimination of competition is an important element in the total price paid. This would be so if the seller's competition had been hurting the buyer in his present business so that he felt it necessary to make the purchase as a matter of self-preservation. But this is not the typical transaction. Certainly in most instances the buyer wants the covenant only as an aid in obtaining the goodwill presently enjoyed by the seller. The entire price reflects this intention leaving no value to be affixed elsewhere. The decision in *United Fin. & Thrift Corp. of Tulsa,*[44] which allowed amortization, was based in part upon the covenant's function of removing the sellers from the field of competition for potential customers. Since the court's findings of fact do not indicate that elimination of formidable competition was a motive of the buyer in making the purchase, the court's reliance upon this function of the covenant appears to be erroneous.

The covenant does, therefore, operate as a means of transferring goodwill. Granted, the covenant of itself is not a conveyance. But goodwill is a unique concept. Although it has some of the attributes of property, such as being a proper subject of legal protection, it cannot be adequately treated in property terms. Its transfer in particular should be analyzed by concentrating upon the factual reality of what the parties intended and did rather than upon legal theory. Amortization of the covenant should not be allowed because, although it has a limited life, the expiration of its term brings about no event which affects the business. The only event which did affect the business transpired when the covenant was granted and an expectancy with an indeterminate life passed to the buyer. The covenant is somewhat similar to a license for the operation of a television station or liquor store. Because such licenses are readily renewable by the holder, the initial cost of obtaining them, as opposed to the nominal periodic fees charged by the issuer, is deemed to be paid for an asset with an indefinite life which is not the subject of a depreciation allowance.[45]

C. *Supplementary Means of Transferring "Personal" Goodwill*

The personal element of goodwill may be of such significance that the extraction of a covenant not to compete from the seller coupled with the transfer of any pertinent non-personal factors would not give the buyer anywhere near the goodwill enjoyed by the seller. This is

[44] Supra note 23.

[45] KWTX Broadcasting Co., 31 T.C. 952 (1959), aff'd, 272 F.2d 406 (5th Cir. 1959); Nachman v. Commissioner, 191 F.2d 934 (5th Cir. 1951).

likely to be the case where the business has been founded and operated by one man and deals in personal services. Here, all or substantially all of the goodwill arises from the individual seller. He, in reality, is the goodwill. How can goodwill of this nature be transferred in any permanent sense to the buyer?

The Commissioner's answer is that it cannot. Revenue Ruling 60-301[46] states:

> . . . if a business is dependent solely upon the personal characteristics and competence of the owner, no element of goodwill exists with respect thereto and no portion of the sales price of the business may be treated as proceeds from the sale of goodwill, irrespective of whether or not such sale comprehends a valid assignment of the right to the exclusive use of the firm name.

The Commissioner regards the sale of this type of business as an assignment of future earnings and taxes the proceeds (except those from any tangible property), including whatever may be allocated to the covenant, as ordinary income.

This position has been rejected by the courts[47] and the decision in *Richard S. Wyler*[48] demonstrates the fallacy of its reasoning. The petitioner was an accountant who had been in practice under the name of Richard S. Wyler & Company for twenty-four years prior to the sale. He had no partners and employed five accountants. Most of his clients had been with him a number of years and he enjoyed an excellent reputation, particularly in the lumber industry. He decided to "take life easier" and, at the age of sixty, entered into negotiations for the sale of his practice to Peat, Marwick, Mitchell & Co., a firm of accountants with offices throughout the country.

The buyer was clearly confronted with the problem of securing goodwill of a highly personalized nature. Obtaining Wyler's working papers and placing a partner in charge of the staff would certainly not be sufficient. It was, after all, Wyler who was the symbol which had invoked a favorable response from clients. The method selected was one which had been used by the buyer in previous purchases. Wyler became one of its partners for a term of slightly less than three and one-half years. He also agreed not to compete within three states for a period of three years thereafter. No separate price was allocated to the covenant. Wyler was to handle the business of his former clients

[46] 1960-2 Cum. Bull. 16.

[47] Masquellette's Estate v. Commissioner, supra note 25; Rees v. United States, 187 F. Supp. 924 (D.C. Ore. 1960), aff'd, 295 F.2d 817 (9th Cir. 1961); Estate of L. Melnik, 20 CCH Tax Ct. Mem. 74 (1961); Merle P. Brooks, 36 T.C. 1128 (1961); Malcolm J. Watson, 35 T.C. 203 (1960); Richard S. Wyler, 14 T.C. 1251 (1950); Rodney B. Horton, 13 T.C. 143 (1949).

[48] Supra note 47.

with the proviso that all his appointments, business and correspondence were to be in the name of the partnership which was to bill for and collect the fees. The contract required him to use his best efforts to hold his clients as clients of the buyer. At the time the contract was executed, Wyler received $50,000 which was expressly designated as being paid for goodwill. His compensation during his short term as partner was a combination of straight salary and profit sharing with a specified adjustment downward in the last year if the total gross income from his former clients was less than anticipated. Shortly after the contract was signed, Peat, Marwick, Mitchell & Company, with Wyler as a new partner, took over Wyler's working papers, files and all of his staff and continued in the same suite of offices until more space was available where it maintained its local office. For several years, the name of Richard S. Wyler & Co. was displayed on the office door and listed in the telephone book under the buyer's number.

The entire transaction was obviously a well thought out plan designated to dilute the goodwill previously centered upon Wyler alone. The buyer could have simply required Wyler to inform his clients of the sale, have him recommend that they allow the buyer to act as their accountant, and obtain a covenant not to compete for a term commencing at the time of the sale. The partners handling negotiations for Peat, Marwick, Mitchell & Co. may well have rejected this technique as forming too transitory a nexus between their firm and Wyler. The practice of Wyler was such that a gradual transition process was appropriate with Wyler in the interim doing everything possible to establish a favorable relationship between the buyer and his clients. Partners and employees of the buyer could then play an increasing role in dealing with his clients by at first sitting in on conferences, then gradually establishing a direct working relationship in conjunction with Wyler, and finally completely taking over the accounts. Assuming no particular problems with respect to relative abilities and personalities, the process is not a difficult one. Binding Wyler to this arrangement, coupled with eliminating him as a competitor for a period thereafter, assured the transfer of goodwill at the time the contract was executed. Records of the buyer established the transfer as a reality by the time the case was tried. The court had no difficulty in rejecting the Commissioner's argument and holding that goodwill had, in fact, been transferred.

IV. CRITIQUE OF NONSEVERABILITY THEORY

The theory of nonseverability, as stated by the courts, is in substance this: The covenant has a separate tax consequence if the parties treat it separately, but if its function is to assure to the buyer the enjoyment of goodwill, then the covenant is nonseverable from

goodwill. The theory does recognize the covenant as related to the transfer of goodwill. But this manner of expressing the relationship as an exception or alternative to a general rule of severability is most misleading. As has been seen, the exception all but swallows the rule. This has led to some rather strange results.

A. *Existence of Goodwill*

Several decisions[49] have accorded separate tax treatment to a covenant not to compete on the strength of questionable findings that the business transferred did not have goodwill. If such a finding is made, the "exception" to the theory of nonseverability then poses no problem.

Betty W. Crissey[50] involved the sale of an insurance agency by its two partners. The buyers insisted at the outset that the contract include a covenant not to compete in order to protect renewals on existing policies. A price of $60,000 was agreed upon, and on the advice of an accountant, the final contract contained an allocation to the covenants. A total of $55,000 was allocated to the sellers' six-year covenants and $5,000 to furniture, fixtures and supplies. The buyers claimed an annual deduction of $9,165, or one-sixth of the covenant's price. Renewals had been running rather poorly prior to the sale and the agency was operated at a loss for the first few years thereafter. Because of this history, the Tax Court ruled that goodwill was not transferred and allowed amortization of the covenant. This reasoning is opposed to the traditional concept of goodwill which does not require any minimum degree of profit.[51] There is nothing inconsistent with a business having advantageous relations and yet operating at a loss because of any number of unrelated factors such as inefficient management. The degree of profit is of importance in the accountant's definition of goodwill[52] which is properly governed by conservative principles tending to understate values. It should play no role in a tax law that can only be effective when based upon existing facts and the parties' intent. Since the buyers in the *Crissey* case were primarily interested in obtaining renewals, undoubtedly the sale included so-called "expirations." These are records as to policies previously sold, including the name of the insured, type of insurance, expiration date and so forth. This information enables the buyer to contact an insured before the present policy expires and places him in a position to readily obtain a renewal. It is an intangible asset in the nature of

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[49] See, e.g., Wilson Athletic Goods Mfg. Co. v. Commissioner, 222 F.2d 355 (7th Cir. 1955); Betty W. Crissey, 20 CCH Tax Ct. Mem. 947 (1961); Frances Silberman, 22 T.C. 1240 (1954).

[50] Supra note 49.

[51] See Note, supra note 40.

[52] Id. at 681.

goodwill.[53] The actual facts of the case, therefore, present the typical situation of a buyer obtaining an expectancy of a preference through the transfer of specific assets in conjunction with the seller's covenant not to compete.

In *Wilson Athletic Goods Mfg. Co. v. Commissioner*,[54] the plaintiff had been purchasing athletic shoes from another manufacturer and selling them under its own label. It bought out the other manufacturer and received a ten-year covenant not to compete from the selling company rather than any individual in it. Although the contract contained no allocation, the buyer recorded $142,692.30 as the cost of the covenant and $10,000 as the cost of goodwill. In view of the previous dealings between the parties, the court accepted the buyer's testimony that it was not interested in the customers of the seller. It found that little or no value should be placed upon goodwill in the transaction and allowed amortization of the price that the buyer had assigned to the covenant. This decision seems to be another instance of a court applying an incorrect concept of goodwill. It restricted the concept to advantageous customer relations whereas in all probability some form of industrial goodwill (perhaps advantageous employee relations) had been included in the sale.

B. *Covenants of Stockholders and Employees*

Courts which have adopted the theory of nonseverability find a distinction between a stockholder's covenant not to compete and a covenant granted by a proprietor or partner. Where the business is in corporate form, the corporation is regarded as the owner of the goodwill, not its stockholders.[55] The covenant of the stockholders in a stock sale is thus considered severable from the goodwill.[56] The result is the same where the sale is cast in the form of an asset deal with the stockholders receiving the proceeds in liquidation.[57] This reasoning exalts form over substance. In these transactions the stockholder's interest in the business, including the goodwill, is being sold and he receives the proceeds. His covenant aids in the transfer of that goodwill in precisely the same manner as does the covenant of a proprietor or partner. There is no essential difference between the two situations.[58]

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[53] George J. Aitken, 35 T.C. 227 (1960).

[54] Supra note 49.

[55] See Hamlin v. Commissioner, 209 F.2d 761 (10th Cir. 1954), where the court held that the covenant was not ancillary to the sale because the sellers sold stock and not a going business.

[56] Anthony Rock, 21 CCH Tax Ct. Mem. 46 (1962); Howard G. Mathews, 20 CCH Tax Ct. Mem. 1565 (1961); Richard Ullman, 29 T.C. 129 (1957), aff'd on other grounds, 264 F.2d 305 (2d Cir. 1959).

[57] See Beal's Estate v. Commissioner, 82 F.2d 268 (2d Cir. 1936); Cox v. Helvering, 71 F.2d 987 (D.C. Cir. 1934).

[58] In Tobin v. Cody, 1962 Mass. Adv. Sh. 339, 180 N.E.2d 652 (1962), the Massachusetts court rejected the distinction and extended its rule prohibiting competition by the seller to a sale of stock.

A more difficult problem is presented when the sale is accompanied by a covenant not to compete on the part of an employee who owns no interest in the business. Since the employee purports to be selling nothing, at first blush his covenant would appear to be severable from the goodwill transferred and thus bring him ordinary income. The function of the covenant, however, is the same: the transfer of goodwill. The tax consequences to the buyer are clear because he is the recipient of the goodwill. But what of the employee? Should he be considered a co-vendor with the owner or would it be more appropriate to treat him as receiving compensation for forbearing from the performance of services? Here again, the essential capital nature of the transaction should prevail. The price paid to the employee should be treated as proceeds from the sale of a capital asset with a zero basis. If the owner of the business, or the corporation, receives the covenant's consideration and passes it on to the employee, the result should be the same even though this resembles severance pay. An analysis of the question based upon a view of goodwill as just another item of property owned by the business would, of course, lead to a different conclusion.

V. COVENANTS WITHOUT VALUE

Covenants not to compete have frequently been inserted into a sales contract for tax reasons only. The buyer, either through his own strong bargaining position or the seller's ignorance of the possible tax consequences, may be successful in assigning a specific consideration to the covenant where a much lower price or no allocation at all would more nearly express the realities of the situation. The courts have been quick to recognize these sham transactions.

In *Ray H. Schulz*,[59] the parties to the agreement, who were partners, assigned $18,000 to the seller's covenant not to compete. It was brought out in evidence that the seller was leaving the business in order to enter a noncompetitive field. Furthermore, he did not have the engineering background or sales contacts to compete and could not have possibly obtained the necessary equipment before the expiration of the covenant's term. The court had no difficulty in concluding that the only significance of the covenant was as an attempted tax deduction. In reply to the contention that the covenant was important to the business as a protection of its pool of labor and customer accounts, the court stated that even if this were so, the covenant would nevertheless be nonseverable from these elements of goodwill. *Radio Medford, Inc. v. United States*[60] involved the purchase of a radio station from a widow who was of retirement age and not likely to go into

[59] 34 T.C. 235 (1960), aff'd, 294 F.2d 52 (9th Cir. 1961).
[60] 150 F. Supp. 641 (D.C. Ore. 1957).

business again. The purchaser unsuccessfully sought to have a sum assigned to the covenant in the written contract. He later attempted to amortize an amount which he alleged was paid for the covenant, but the court held that no value should be affixed to it.

The negotiations which formed the background in *Harry Swartz*[61] present an interesting example of the manner in which the supposed tax benefits of the covenant can be a factor in the total price paid. The petitioners entered into negotiations for the sale of the assets of their three closely held corporations to Food Fair Stores, Inc., the operator of an expanding chain of supermarkets. They eventually asked $750,000 for the assets exclusive of inventory and the buyer remained firm at an offer of $600,000. The representatives of Food Fair later stated they were willing to pay $700,000 but would have to insert a covenant not to compete in order to give them a tax benefit. This was the first time a restrictive covenant had been mentioned by any of the parties. The petitioners replied they did not intend to compete and had no objection to the covenant, but insisted that the price be raised to $750,000. Negotiations resumed and they split the difference at $725,000 with $110,000 being allocated to the covenant. The court ruled that the covenant did not bring ordinary income to the petitioners because (1) having been inserted at the final stage of negotiations for tax reasons only, it was not bargained for and (2) the petitioners had no intention of competing and, in fact, could not have competed with the new owners.

It will be recalled that the courts which are disposed toward viewing the covenant as something separate from goodwill require that the parties, in the language of the *Gazette Tel. Co.* case,[62] "in good faith and realistically treat the covenant in a separate and severable manner." The problem of the covenant's relationship with goodwill aside, there should be no difficulty with the requisite of good faith and realistic treatment. If the seller is able to compete, taking into account such factors as his health, age and general capabilities, the insertion of the covenant in the contract certainly would be realistic and done in good faith. This would be so even though he has no present intention of competing. The buyer wants an enforceable right in this regard and is willing to pay for it.

The meaning of the phrase "separate and severable manner" is not as clear. Although courts have been willing to make an allocation of their own when convinced that the covenant was a meaningful element in the transaction,[63] this language may be interpreted to

[61] 19 CCH Tax Ct. Mem. 1276 (1960).

[62] Supra note 20.

[63] See, e.g., Wilson Athletic Goods Mfg. Co. v. Commissioner, supra note 49; Williamson & Waite, Inc., supra note 23; B. T. Babbitt, 32 B.T.A. 693 (1935); Rodney B. Horton, supra note 26.

require that the parties allocate a price to the covenant in the written contract. Certaintly without doing this the buyer is rather hard put to prove that he paid anything for the covenant itself.[64] If the contract does make an allocation, is it also necessary for the parties to put a price tag on the covenant throughout their negotiations? The *Gazette Tel. Co.* line of cases has never required this and it would be most unrealistic to do so. Buyer and seller quite naturally view the business as an entity. Counsel representing the buyer and thus hopeful of a tax benefit should, however, advise his client to mention the covenant at the outset of the negotiations and see that a record is made of this in contemporaneous notes and communications. The amount which the contract allocates to the covenant is presumptively correct and strong proof would have to be introduced to overcome this evidence of its price.[65] Counsel representing the seller should, of course, resist any allocation. It would also be helpful to the seller if the contract contained a separate provision dealing with both goodwill and the covenant, with a statement that the covenant is intended only as an aid in the transfer of goodwill.[66]

VI. CONCLUSION

The present uncertainty in the taxation of covenants not to compete adds a complication to a transaction which often is already sufficiently complex. A good deal of the confusion is no doubt caused by the continued use of the term "goodwill" without recognition of the tremendously broad concept that it denotes. Certainly the covenant's role as merely an aid in the transfer of goodwill needs to be more fully recognized so that the only question remaining concerns itself with the tax consequences of the purchase and sale of goodwill. The case for depreciating goodwill has been argued elsewhere.[67] The subject should be explored without false premises concerning covenants not to compete.

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[64] See, e.g., Fox & Hounds, Inc., 21 CCH Tax Ct. Mem. 1216 (1962); Radio Medford, Inc. v. United States, supra note 59.

[65] Commissioner v. Ullman, 264 F.2d 305 (2d Cir. 1959). See also Roy H. Schulz, supra note 59.

[66] In George H. Payne, 22 T.C. 526 (1954), the fact that the transfer of goodwill and the covenant were treated in one sentence was of aid to the seller.

[67] McDonald, Goodwill and the Federal Income Tax, 45 Va. L. Rev. 645 (1959). Mr. McDonald believes it should make no difference that goodwill is purchased rather than gradually developed and contends that goodwill does have a limited life, albeit one not susceptible of exact computation. He advocates separating capitalized goodwill into component parts and amortizing the values assigned to the various elements. For example, if a trained labor force contributes toward the goodwill of a business, then its value would be deducted through amortization over the period that the seller would have required to hire and train an equivalent force. Perhaps the answer lies in legislation allowing amortization over an arbitrary period as is permissible for research and experimental expenditures and trademark and trade name expenditures. See Int. Rev. Code of 1954, §§ 174(b) & 177.