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AGREEMENT NOT TO COMPETE — TAX CONSEQUENCES

By

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In the law of contracts there are many aspects which may prove advantageous to one party to the agreement and disadvantageous to the other. The effect of the federal income tax on the parties to a contract is a major problem. In particular, one of these conflicting problems is the tax consequences of an agreement not to compete. Much of the conflict stems from the close relationship of such an agreement with good will.

The following is a fact pattern of two recent cases which involved the same contract.[1]

> The sellers owned the entire capital stock in a newspaper publishing business. Some of the sellers were actually connected with the newspaper business while others were investors in the business only. All the stockholders got together and sold all their stock to the purchasers. There was good will in the business. The purchasers well experienced taxwise in this type of sale were able to get the sellers to add a covenant not to compete in a separate clause of the contract and allocate a certain portion of the sales price to that covenant. The agreed sales price of the stock was allocated, to wit, $150.00 for each share of stock and $50.00 for the covenant not to compete.

The question presented was whether the allocation on the face of the contract should be upheld. If the allocation were upheld the $50 allocated to the covenant would be ordinary income to the seller. The buyer, on the other hand, would be allowed to amortize the amount paid for the covenant over the years the covenant not to compete was to run.

In the *Hamlin Trust* case[2] the Commissioner taxed the selling stockholders on the portion of the purchase price allocated to the covenant not to compete as ordinary income to them. Then the Commissioner took a contrary position in the *Gazette Telegraph Co.* case[3] contending that the purchasing stockholders paid the entire purchase price for the stock and nothing for the covenant and so were not entitled to amortize the amount claimed to have been paid for the covenant. Judge Tietjens who gave the opinion in both cases brings out the fact that the taking of inconsistent positions by the Commissioner is not an unusual situation since the Commissioner often does this in order to protect the revenues.[4]

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1 Clarence Clark Hamlin Trust, 19 T.C. —, No. 88 (1953), taxpayer was the seller of the covenant not to compete; Gazette Telegraph Co., 19 T.C. —, No. 86 (1953), taxpayer was the purchaser of said covenant.

2 See n. 1 supra.

3 See n. 1 supra.

4 Hamlin Trust, see n. 1 supra, first paragraph of opinion.

The holdings in both cases were consistent. In the *Hamlin Trust* case the sellers, whether connected with newspaper activities or not, were chargeable with ordinary income as to that portion allocated to the covenant not to compete. In the *Gazette Telegraph Co.* case the court did not agree with the Commissioner's contention that the covenant was nonseverable from the good will and held instead that it was subject to depreciation, allowing the purchasers to amortize that portion paid for the covenant.

These two cases bring out the basic tax conflict of the seller and the buyer of an agreement not to compete. The seller wishes to have a capital gain by showing either that (1) the covenant is part of the good will itself, or (2) he will try to show by extrinsic evidence that the covenant was either valueless or given a disproportionate value. This latter argument can be proven by showing that the parties never intended that the covenant was to have a value or that there was not an arm's length transaction.[5] The buyer, on the other hand, tries to show the severability of the covenant from the good will so that he may depreciate the cost to him for the period the covenant is to run.[6]

Good will is a capital asset.[7] The sellers' first argument in *Hamlin Trust* was based on the fact that the covenant not to compete was part of the good will. This was done in order to prove that all the money received for their stock was a capital gain and none was receivable for the covenant. This is another way of saying that the covenant was inseparable from the good will and thus capital gain resulted.[8] Distinguishing between good will and a covenant not to compete is a question of fact.[9]

In the *Toledo Newspaper* case[10] it was said that the agreement not to compete was necessary in order to prevent the sellers from destroying the value of the good will of the business transferred. Why then in *Hamlin Trust* was not the agreement inseparable from the good will and also a capital gain? The majority opinion distinguishes the *Toledo Newspaper* case in that here the sellers were not selling a going business together with the good will in which the covenant not to

[5] Part I infra which discusses these arguments deals only with cases in which the seller was the taxpayer involved.

[6] Part II infra which discusses the buyer's contentions deals only with cases in which the buyer was the taxpayer.

[7] Reg. 118, § 39.22(a)-10; Aaron Michaels, 12 T.C. 17 (1949). Contra: Williams v. McGowan, 152 F.2d 570 (C.C.A. 2d; 1945).

[8] Toledo Newspaper Co., 2 T.C. 794 (1943), in the sale of a going business together with good will, the court held that the agreement not to compete for 10 years had the function primarily of assuring to the purchaser the beneficial enjoyment of the good will he had acquired and thus was regarded as nonseverable, being in effect a contributing element to the asset transferred and hence gain was capital. Aaron Michaels, See n. 7 supra, held that the agreement not to compete was ancillary to the transfer of good will.

[9] The following cases held that good will was sold: Rainier Brewing Co., 7 T.C. 162 (1946), aff'd 165 F.2d 217 (C.C.A. 9th 1948), rehearing denied 166 F.2d 324 (C.C.A. 9th 1948); Richard S. Wyler, 14 T.C. 1251 (1950); Lester T. Cox v. U.S., 99 F. Supp. 518 (D.C. Ariz. 1951); Ethyl M. Cox, 17 T.C. 1287 (1952); Rodney B. Horton, 13 T.C. 143 (1949) where under the facts a 50/50 allocation was made.

[10] See n. 8 supra.

compete might have been regarded as nonseverable, but were only selling their stock in the newspaper.[11] As the cases indicate, this distinction is a valid one to make.[12] It is also stated in the regulations[13] that good will must be accompanied by a transfer of the assets, i.e., a transfer of the business or a part of the business to which good will attaches.[14] The sellers have no good will to transfer unless the corporate veil is pierced. The sellers are merely selling their stock while in the *Toledo Newspaper* case they are selling a going business to which good will attaches.

In *Cox v. Helvering,*[15] however, there was a sale of a going business but the covenant was held to be ordinary income. This case was distinguished by the *Toledo Newspaper* case[16] in the following manner: Good will will not attach if (a) the promise not to compete was unrelated to any sale made by the promisor and (b) the promise not to compete does not operate as a restraint upon any property of the promisor and is not, therefore, an inherent part of anything sold by the promisor.

Another reason why the agreement not to compete may be inseparable from good will is by the application of an equitable principle which is the local law of some jurisdictions and which would greatly cut down the value of the covenant.[17] This rule of equity is that the sale of good will in a business carries with it an implied covenant by the seller that he will not solicit his old customers nor do any act which would interfere with buyer's use and enjoyment of what he has purchased. The application of this rule would give little significance to the covenant not to compete and the covenant would appear to merge with the good will since the covenant is already implied with the sale of the business.

If the agreement is a separate item, i.e., consideration is paid primarily for the agreement not to compete, ordinary income results.[18] The seller tried to disprove by extrinsic facts, in *Hamlin,* that the consideration was paid primarily for the agreement by showing that all the money received was for the stock and none was for the agreement not to compete. The seller also argued that he was unaware of the tax consequences to him and thus it was not an arm's length deal. In answer to the latter argument the court said that it made no difference that the seller did

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11 See n. 4 supra, sixth paragraph of opinion.
12 George Prince, ¶ 42,238 P-H Memo B.T.A., where the amount received to refrain from competition was ordinary income and not allocable to good will since neither the business nor the assets of the ferry company were sold. Similarly: Cox v. Helvering, 71 F.2d 987, (C.C.A. D.C. 1931) the amount paid to the shareholder for his agreement not to compete was ordinary income since the sale of business was made by the corporation and not the promisor.
13 Reg. 118, § 39.22(a)-10.
14 Stratton Grocery Co., 8 B.T.A. 317 (1927), sale of the assets includes good will; but see Akers, 6 T.C. 693 (1946) where there is no good will in the assets if embodied in a franchise which was not subject to transfer or other disposition.
15 See n. 12 supra; note that the promisor of the covenant was not the seller of the going business.
16 See n. 8 supra, at p. 805-806.
17 Rainier Brewing Co., see n. 9 supra.
18 Cox v. Helvering, see n. 12 supra: Salvage v. Commissioner, 76 F.2d 112 (C.C.A.2d 1935), aff'd, sub. nom. Helvering v. Salvage, 297 U.S. 106 (1936); John D. Beals' Estate, 82 F.2d 268 (C.C.A.2d 1936), aff'd 31 B.T.A. 966 (1934); Estate of Mildred K. Hyde, 42 B.T.A. 738 (1940).

not fully appreciate the significance taxwise of what he was doing, since the buyer was fully aware of what the consequences to him might be and thus put the seller on notice that tax problems were involved. As to the seller's argument that no value could be placed on the covenant the court in their opinion puts great weight on the fact that the written contract treated the covenant as a separate item. The court said simply that if the allocation given to the covenant were not upheld the clause so allocating would be rendered meaningless.

A strong dissent appears in the *Hamlin Trust* case. Judge Johnson, the trier of the facts, wrote the opinion for the dissent. The facts as the dissent relates are: The parties never intended that the covenant was to have any significance. All during the negotiations the only price discussed was the overall price and the only time a separate value appeared was in the addition of the clause in the contract making the allocation. The evidence showed that the real market value of the stock was over the allocated price of $150.00. The agreement not to compete was out of proportion to any value possessed by the noncompetitive agreement of the sellers. Those stockholders who never had anything to do with the business certainly could not place any value on their agreement. Only Nowels, the president of the corporation and editor of the newspaper, had the necessary experience which might cause him to compete but the buyers had employed Nowels by written contract to work for them even before the consummation of the sale.

In spite of the above facts the majority of the court stresses form over the substance and gives the utmost consideration to the allocation fixed by the parties. There has been a recent memorandum decision, however, which supports the dissent.[19] The majority court quoting from the *Rodney B. Horton* case[20] indicates that even in the sale of a going business if the covenant can be segregated there will be ordinary income to the seller. Again this would be a factual question.[21]

II

As is brought out in *Gazette Telegraph Co.*[22] the buyer has the problem of proving that a deduction for the covenant not to compete is not precluded under the depreciation regulation.[23] Good will has an indeterminate life, therefore it is not subject to depreciation.[24] A collateral promise not to compete for a stated number of years does not measure the life of good will if in fact the price was for good will.[25] An agreement not to compete will have an indeterminate life if it is so tied up with good will as to become an integral part of it, despite the provisions

19 Giulio Particelli, 11 T.C.M. 150 (1952), appeal pending before 9th Circuit; allocation of price made on the face of the contract was found to be greatly disproportionate in view of the evidence, whereupon a reallocation was made by the court; the form of the contract was not controlling.

20 13 T.C. 143 (1949).

21 See n. 9 supra.

22 19 T.C. —, No. 86 (1953).

23 Reg. 118, § 39.23(1)-3.

24 Ibid.

25 Valdosta Drug Co., ¶ 34,131 P-H B.T.A. Memo.

in the contract to the contrary, and will not be subject to depreciation.[26] The contract involved in the *Toledo Blade* case[27] was the same as in *Toledo Newspaper Co.*[28] The purchasers in *Toledo Blade* were not allowed depreciation deduction for the cost of the covenant. A specific amount was put on the covenant and on the other intangibles such as the trade name, circulation route, subscription lists and others. The covenant accompanied the transfer of good will in the sale of a going concern. It was held that the covenant was essentially to assure the purchasers the beneficial enjoyment of the good will. In a sense the covenant not to compete was really good will under a different name. Therefore, the sale of good will and the covenant were indivisible.[29] The implied covenant not to compete theory is also applicable here to cut down the value of the covenant.[30]

At first glance the case of *B. T. Babbitt, Inc.*[31] appears as contrary to the rule set down by *Toledo Blade.* The court in *Babbitt* allocated a lump sum payment in the sale of a going business where the value of the covenant not to compete was capable of being proved. The explanation of this divergence is that the court found that Babbitt's object in entering into the contracts was primarily to eliminate competition, i.e., good will was not an important part of the business acquired.

The distinction, therefore, boils down to whether the forbearance from competition is good will itself, depreciation not being allowed, and conversely depreciation will be allowed if the restraint on competition is in fact something other than the good will of the business.

The buyer in *Gazette Telegraph* did not have the problem presented in the *Toledo Blade* case since there was no sale of a going business to which good will could attach. The buyer does have the problem of showing that the agreement not to compete meets certain qualifications. Consideration paid for an agreement not to compete is itself a capital outlay.[32] If the terms of the agreement are indefinite there can be no deduction.[33] There is no depreciation deduction if there is a failure to prove the value of the agreement in the contract price,[34] nor is there

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26 Toledo Blade, 11 T.C. 1079 (1948), aff'd without opinion in 180 F.2d 357 (C.C.A. 6th), cert. denied 340 U.S. 811.
27 Ibid.
28 See n. 8 supra.
29 Similarly: Harold Burke, 18 T.C. 17 (1952); R. Bryson Jones, 17 B.T.A. 1213 (1929).
30 See text on p. 4 supra, first paragraph.
31 32 B.T.A. 693 (1935).
32 All the cases in Part II are authority for the statement. In particular, see L. M. Brown, 1 T.C.M. 509 (1943).
33 Market Supply Co., 3 B.T.A. 841 (1926); Press Publishing Co., 17 B.T.A. 152 (1929); Clark Thread Co., 23 B.T.A. 1128 (1933), aff'd 100 F.2d 257 (C.C.A. 3rd 1938); Salinas Valley Ice Co., Ltd., 1 T.C.M. 84 (1942); L. M. Brown, see n. 32 supra.
34 Boonville National Bank, 2 B.T.A. 352 (1925), (the court erred in holding that the difference between book value of the stock and the price paid represented good will. The right result was reached, however, in that the value of the covenant could not be proven and all gain was capital.); General Equipment Co., 2 B.T.A. 804 (1925); J. I. Case Co., 32 F. Supp. 754 (Ct. Cls. 1940).

a deduction if the money is shown to be paid primarily as a down payment on the purchase price and not allocated to the agreement not to compete.[35]

The cases are clear that if there is no sale of the business, good will not attaching, and the consideration paid is primarily for the agreement, depreciation over the period of the agreement not to compete is allowable.[36] In allowing the buyer to depreciate the agreement the court in *Gazette Telegraph* does not cite any of the cases cited in footnote 36 in support of their conclusion. But the court does make certain statements[37] which follow the rationale of those cases.

The court in *Gazette Telegraph* strongly states:[38]

> "The nub of the question is whether the agreement not to compete was actually dealt with as a separate item in the transaction, and, if so, how much was paid for it." Citing: *Aaron Michaels*[39] and *Rodney B. Horton*[40].

The above statement of the court shows its approval to a depreciation deduction where consideration for the agreement is stated separately even though the agreement is made in connection with the sale of a going business.[41] The *Toledo* cases would indicate a contrary result if the covenant was an integral part of the good will, i.e., the acquisition of the good will being the main objective.

Once it is determined that the seller has ordinary income it would seem to follow that the purchaser should be able to deduct his expense under I.R.C. Sec. 23(a)(1)(A), as an ordinary and necessary business expense. The courts, however, treat the proceeds of a covenant not to compete as a valuable asset of a capital nature and not as an ordinary deduction.[42] The only time the courts discuss both the ordinary and necessary business deduction and the depreciation deduction as a possibility is when the contract expressly provides for specific payments to be made over a period of time. In such a situation, once the deduction is determined the

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35 A. Levy & J. Zentner Co., 31 B.T.A. 386 (1934); Frank L. Neuburger, 13 T.C. 232 (1949); Similarly: City Ice Delivery Co. v. U.S., 82 F. Supp. 490 (D.C. N.C. 1948), aff'd 176 F.2d 347 (C.C.A. 4th 1949).

36 Farmers' Feed Co. of N.Y., 17 B.T.A. 507 (1929); Christensen Machine Co., 18 B.T.A. 256 (1929); Black River Sand Corp., 18 B.T.A. 490 (1929); News Leader Co., 18 B.T.A. 1212 (1930); Eitingon-Schild Co., 21 B.T.A. 1163 (1931); Eagle Pass & Piedras Negras Bridge Co., 23 B.T.A. 1338 (1931); J. S. L. Restaurants, Inc., 10 T.C.M. 180 (1951).

37 See n. 22 supra, fourth paragraph of opinion.

38 See n. 22 supra, second paragraph of opinion.

39 See n. 7 supra. Michaels followed the Toledo cases but the opinion brought out the fact that if the agreement could be segregated, indicating a separate item, then the agreement is ordinary income.

40 See n. 20 supra. The Horton case by its facts indicated a segregation, i.e., the court probably put weight on the clause which stated that if Horton ceased to reside in New Mexico or died, the percentage should be reduced by 50% in holding that 50% of the 6 year agreement was ordinary income.

41 Similarly: Carboloy Co., Inc., 2 T.C.M. 413 (1943).

42 Appeal of the Record Abstract Co., 2 B.T.A. 638 (1925); News Leader Co., see n. 36 supra; Eagle Pass & Piedras Negras Bridge Co., see n. 36 supra; Newspaper Printing Co., 17 B.T.A. 452 (1929), aff'd 56 F.2d 125 (C.C.A.3d 1932); Clark Thread Co., see n. 33 supra; J. I. Case Co., see n. 34 supra; Salinas Valley Ice Co., LTD., see n. 33 supra; L. M. Brown, see n. 32 supra.

court will allow it either under I.R.C. Sec. 23(a)(1)(A) or Sec. 23(1) since the result will be the same.[43]

Conclusion

It is to the seller's advantage to allocate as much as possible to good will, a capital asset. This can be done if he sells a going business or assets to which good will can attach. If the asset to which the good will attaches has been held for more than six months, the gain attributable to it by virtue of a sale will be a long term capital gain.

The purchaser in order to get a tax saving in the way of a depreciation deduction should place a separate value on the covenant and have the covenant run for a definite period of time. Recent tax court decisions seem to indicate that utmost consideration will be given to the allocation fixed by the parties to the contract. If the covenant is tied up with the sale of a going business there is a risk to the buyer that the covenant will be considered nonseverable from the good will and nondepreciable.

Finally, if stock is sold along with the covenant an allocation will be made unless there is strong evidence that the covenant is valueless or has a value highly out of proportion to any value assigned to the covenant.[44] If the value is highly disproportionate the court will allocate what they consider to be a proper amount.

Obviously, an allocation cannot be made to please both the buyer and the seller; but armed with this knowledge, either party can bargain for better terms elsewhere in the contract of sale. If no specific valuation is made, the Commissioner is apt to make his own allocation depending upon which of the parties is before him.

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43 Eitingon-Schild Co., see n. 36 supra; Carboloy Co., Inc., see n. 41 supra.
44 Boonville National Bank, 2 B.T.A. 354.