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A Comparison of the Tax Consequences of a Sale of Good Will with a Covenant Not To Compete

A, the owner of a business with tangible and identifiable intangible assets valued at $75,000 dollars, sells his business to B for $100,000 dollars and A promises in the sales agreement that he will not compete with B in this business for a specified time and within a specified area. This transaction may give rise to serious tax consequences which affect both A and B concerning the amount of the contract price which exceeds the value of A's tangible and identifiable intangible assets. A will argue that the $25,000 dollars was the proceeds from the sale of a capital asset which is good will, resulting in capital gains treatment. Should A prevail in this contention, B in turn must capitalize this amount, a distinct disadvantage to B, because he will not be allowed to amortize the amount as a deduction for income tax purposes. On the other hand, B will argue that the amount was paid for a covenant not to compete.

1 See, e.g., Estate of Masquelette v. Commissioner, 239 F.2d 322 (5th Cir. 1956).
2 Farmers Feed Co. v. Commissioner, 17 B.T.A. 507 (1929).