Volume 67 | Issue 3 Article 5

April 1965

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

William Walter Smith
West Virginia University College of Law

West Virginia Law Review

Published by the College of Law of West Virginia University. Official publication of The West Virginia Bar Association

STUDENT NOTE

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 capitol asset which is good will, resulting in capital gains treatment.[1] 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.[2] 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).

If this be the case, the 25,000 dollars received by *A* for the covenant will be treated as ordinary income[3] which will be taxed at a higher rate than capital gains, and *B* will now have the tax advantage of amortizing the 25,000 dollars over the life of the covenant as a business expense.[4]

Such a transaction is common. The parties should be afforded guidelines to follow in assessing the tax consequences of their venture. Much litigation has grown out of this area, but the cases decided to date have failed to present a reliable guide for the vendor and vendee in determining whether they have actually sold good will or entered into a covenant not to compete so far as tax aspects are concerned. Generally speaking, the courts will place a value on the covenant not to compete if there is a rational basis for saying the covenant had some value. The following discussion is intended to point out factors the courts have considered in deciding whether the covenant should be recognized as having a value.

Good will is the benefit acquired in the purchase of a business beyond physical assets, resulting from the patronage of habitual customers and its local position, reputation, influence, or punctuality.[5] It is the product of the confidence[6] customers have in a business, a preference over others in the race with competition.[7] Before good will may be considered a property interest and subject to capital gains treatment, it must be capable of being transferred, and thus, must depend upon more than the purely personal qualifications of the owner.[8] Hence, a lawyer who has built up a good reputation with his clients by rendering personal services with skill cannot transfer this personal qualification as good will.[9]

---

[3] See, *e.g.*, Hamlin's Trust v. Commissioner, 209 F.2d 761 (10th Cir. 1954).
[4] Commissioner v. Gazette Tel. Co., 209 F.2d 926 (10th Cir. 1954).
[5] Estate of Masquelette v. Commissioner, *supra* note 1; see Horton v. Commissioner, 13 T.C. 143, 148 (1949), for a definition of good will; see Cruttwell v. Lye, 17 Ves. Jun. 335, 346, 34 Eng. Rep. 129, 134 (Ch. 1810), where Lord Eldon gave the first reported definition of good will when he said, "The good-will which has been the subject of sale, is nothing more than the probability, that the old customers will resort to the old place."
[6] Kenney v. Commissioner, 37 T.C. 1161 (1962); see Watson v. Commissioner, 35 T.C. 203, 213 (1960), where the court held that good will was "an opportunity to succeed to the advantageous position of a predecessor."
[7] In re Brown, 242 N.Y. 1, 150 N.E. 581 (1926).
[8] Brooks v. Commissioner, 36 T.C. 1128 (1961); *accord*, Watson v. Commissioner, *supra* note 6.
[9] E. C. O'Rear, 28 B.T.A. 698 (1953); *accord*, Watson v. Commissioner, *supra*, note 6.

Moreover, it has been held that good will has an existence only in connection with a going business and cannot be separated from the specific business.[10]

A covenant not to compete on the other hand is only a promise whereby the vendor guarantees the vendee that he will not compete with the latter in that business for a specified period of time and within a designated area.[11] The court must find that the covenant has a distinct value before it will be deemed a covenant not to compete rather than good will for tax purposes. To find a distinct value, the covenant must not be "so closely related to the sale of good will that it fails to have any independent significance apart from merely assuring the effective transfer of that good will."[12] In other words, it must be "severable".

In determining whether the covenant has a distinct value and is thus severable from good will, the fact that the parties have specified a certain value for the covenant in the contract has been deemed controlling. This point was demonstrated in *Yandell v. United States,*[13] where a sum of 15,000 dollars was specified for the vendor's covenant not to compete, and the vendor argued that this amount was in reality only good will. The court held that the covenant represented ordinary income mainly because of its specified character. The court further held that the vendor's testimony that the covenant had no value was of little weight and that the parties were aware of the tax consequences when the agreement was signed. Another case held that the failure to specify in the contract that the covenant was to have a value was substantial evidence that this was the intent of the parties, but was not conclusive.[14] In *Payne v. Commissioner,*[15] it was again held that the parties were bound, with regard to tax effect, by the provisions of the contract. There the court stated that when a lump sum was provided for in the purchase agreement and no amount allocated

[10] Grace Brothers, Inc. v. Commissioner, 173 F.2d 170 (9th Cir. 1949).

[11] 67 YALE L.J. 1261 (1958).

[12] Ullman v. Commissioner, 264 F.2d 305, 307 (2d Cir. 1959); *contra,* Schultz v .Commissioner, 294 F.2d 52 (9th Cir. 1961); see generally Michaels v. Commissioner, 12 T.C. 17 (1949), where the court distinguished between a covenant with a separate value and a covenant dealt with separately by the parties.

[13] 208 F. Supp. 306 (D. Ore. 1962).

[14] Annabelle Candy Co. v. Commissioner, 294 F.2d 52 (9th Cir. 1961); the court also states that when there was no allocation to the covenant, the burden was on the vendee to show that the parties intended a value to be placed on the covenant.

[15] 22 T.C. 526 (1954).

to the covenant, the covenant had no value. This was held to be true even where the parties entered into a subsequent contract and in fact did specify a certain value for the covenant. Thus, it will be of no tax benefit for the parties to enter into a subsequent contract as far as the court's determination of the value of the covenant is concerned.

Though the courts generally determine that the covenant had a value if the parties designated a value in the contract, one case has held the covenant to have a value without a specific designation in the contract.[16] In this case there was one lump sum designated in the purchase agreement, and the covenant was not given a specified value. The purchaser allocated on his books a portion of the purchase price to the expense of the covenant and began amortizing this amount over the life of the covenant. The court held that the purchaser could amortize that portion because he had proved that he did not buy good will from the seller but only the covenant not to compete. The purchaser was able to show that he had his own customer lists and brand names and did not need the good will which was connected with the business of the vendor. Significantly, the court further stated that it was not bound to the strict terms of the purchase agreement in determining the value of the covenant, but could look at the circumstances to determine the actual value.

The court may place its own value on the good will and the covenant not to compete when there is no designated allocation to either in the purchase agreement. This was done in *Levine v. Commissioner*,[17] where the vendor sold his fuel oil business for 85,000 dollars and gave a covenant not to compete. The vendor on his books allocated 50,000 dollars to the sale of his physical assets and 35,000 dollars to the sale of good will, and no value was given to the covenant not to compete. On the other hand, the vendee allocated 35,000 dollars to the covenant not to compete and wanted to amortize this amount over the life of the covenant. The vendee introduced evidence showing that the covenant had some value, and the vendor was unable to prove that the covenant was without value. In reaching what appears to be a fair and rational decision, the court allocated 17,500 dollars to good will and 17,500 dollars to the covenant not to compete. The vendor thus received capital gain treatment on 17,500 dollars and ordinary income on 17,500

[16] Wilson Athletic Goods Mfg. Co. v. Commissioner, 222 F.2d 355 (7th Cir. 1955).
[17] 324 F.2d 298 (3d Cir. 1963).

dollars, and the vendee was permitted to amortize 17,500 dollars over the life of the covenant even if he had to capitalize 17,500 dollars. It is important to note that the covenant was given a value because the vendee subsequently was able to show that the covenant had some value. Once again this seems to show that the court will look beyond the terms of the contract if a more just result can be reached.

The fact that the vendor was in a personal relationship with the customers may in itself be enough for the court to hold that the covenant is not severable from the good will and does not have a value for tax purposes. Behind this reasoning lies the idea that if the vendor was in a personal relationship with his customers, the covenant is essential to the transfer of good will. Therefore, it must be shown that the covenant was not needed to assure the effective transfer of the good will if the covenant is to have a value. The above reasoning was used in *Barran v. Commissioner,*[18] where the court held the covenant to be severable and the amount paid therefore was ordinary income to the vendor. In the *Barran* case the vendor sold a dairy business and it was not the vendor but rather the deliverymen who were in personal contact with the customers.

Because the courts seem to give the covenant a value only when there is some rational basis for doing so, the courts are apt to look into the character of the covenant before a determination of value is made. The court will employ this approach to prevent the parties from creating an obvious "fake" situation. Such a situation would exist where the vendor made a covenant not to compete which was given a value in the contract and in reality the vendor was not capable of competing with the vendee. Such a situation existed in the case of Commissioner v. Killian.[19] Here a vendor sold his interest in an insurance partnership and there was included in the purchase agreement a covenant not to compete. The court held the covenant was of no value because the vendor was in ill health and could not compete with the vendee even without the covenant. The

[18] 334 F.2d 58 (5th Cir. 1964); *accord,* Brooks v. Commissioner, *supra* note 8; see Ullman v. Commissioner, *supra* note 12, where the court held the covenant to be ordinary income and the vendor was not in a personal relationship with the customers.

[19] 314 F.2d 298 (5th Cir. 1963); see generally Hamlin's Trust v. Commissioner, *supra* note 3, at 764, where the court stated, "The government may look at the realities of a transaction and determine its tax consequences despite the form or fiction with which it is clothed."

fact that the covenant not to compete is to last for a limited period of time has been held sufficient to find that the covenant was without value. This point was emphasized in *Schultz v. Commissioner*,[20] where the covenant was to last for only one year. Moreover, it has been held that the character of a covenant was bad when the vendor could not compete with the vendee because of a trade agreement with the industry. This was held to be true in *Michaels v. Commissioner*,[21] where the vendor of a laundry business was not allowed by agreement to pirate away the customers of the vendee.

If the courts permit a party to show by evidence that the covenant has a value, some mention should be made of the type of evidence that the court will accept as persuasive that the covenant has a value. The fact that the vendee can prove that he would not have purchased the business in the absence of the covenant is an example of the evidence which has been held to be persuasive.[22] However, this type of evidence also has been held to not be persuasive where the court followed the strict opinion that the covenant can not have a value unless its value is designated in the contract.[23]

One court based its decision on the fact that the vendors were the stockholders of a corporation.[24] Here the parties did allocate a portion of the contract price to the covenant. The court held the value of the covenant represented ordinary income to the vendors-stockholders because stockholders of a corporation did not have a direct proprietary interest in the corporate good will. The court concluded that the sale of shareholders' covenant not to compete can only be compensation for personal services, which is taxable as ordinary income. It should be added that the court also based its determination on the fact that the parties allocated a portion of the contract price to the covenant.

From the aforementioned court decisions, it can be seen that there are several tests that the courts will apply in determining if the covenant has a value, depending upon the particular factual situations that exist in each case. Because there is no one standard that the parties can look to in preparing the contract, many times

---

[20] Schultz v. Commissioner, *supra* note 12.
[21] Michaels v. Commissioner, *supra* note 12.
[22] Wilson Athletic Goods Mfg. Co. v. Commissioner, *supra* note 16.
[23] Annabelle Candy Co. v. Commissioner, *supra* note 14.
[24] Ullman v. Commissioner, *supra* note 12.

a party has been confronted with tax consequences which were unexpected. This undesirable situation has prompted one author[25] to suggest that whenever there is a stated value placed on the covenant not to compete this amount should be attributed to ordinary income. He based his opinion on the fact that a covenant is not property and is thus not a capital asset. Also, it was suggested that this view would not greatly reduce tax revenue because the vendor would have to include the amount placed on the covenant as ordinary income and this would counterbalance the tax advantage of amortization allowed to the vendee. In addition, it was suggested that the vendor could specify that he would receive his payments for the covenant over the life of the covenant instead of in one lump sum, and there would not be any one large amount of ordinary income received in any one year. Another author[26] has stated an opinion that adopts an approach different from the preceding one. He suggests that the covenant not to compete should always be treated as a capital asset because in reality the covenant is a protection of the good will that the purchaser has bargained for. Furthermore, it is pointed out, whenever there is a covenant not to compete inserted in the purchase agreement, it is the intent of both the vendor and the vendee that the sole purpose for the covenant is to protect the acquired good will of the vendee.

Regardless of which of these opinions is the sounder approach in resolving the problems suggested in this note, it is obvious that the existing situation is in need of remedy. The reasoning the courts use in determining if there is a rational basis for finding the covenant to have a value has been shown to vary with the facts of each case. The cases seem to indicate that the practitioner who arranges the sale of a business which includes a covenant not to compete should specify in the contract that the covenant has a designated value. Once this allocation has been made, the vendee can then hope that the court finds there to be a rational basis for saying the covenant had a value.

William Walter Smith

---

[25] 67 YALE L.J. 1266 (1958).
[26] *Note,* 53 COLUM. L. REV. 660 (1953).