The Tax Impact of Covenants Not to Compete Under Current Judicial Concepts

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THE TAX IMPACT OF COVENANTS NOT TO COMPETE UNDER CURRENT JUDICIAL CONCEPTS

ROBERT GROSS*

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I. INTRODUCTION

The sale of proprietorship, partnership interest, or stock in a closely held corporation, when accompanied by a covenant not to compete by the vendor, has resulted in a constant source of tax litigation concerning the proper treatment to be accorded the covenant by both the vendor and vendee. Various criteria involving both procedural and substantive factors have been given differing degrees of weight in deciding the basically factual issue of whether the covenant has an ascertainable value independent from the good will transferred with the business.

Consideration of the tests developed by the courts and evaluation of the merits of these tests is intended to provide a more comprehensive view of the case law as it exists today.

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1. The courts have attempted to distinguish between a sale of the proprietorship or partnership wherein the vendor is said to have a direct proprietary right in the good will as opposed to the sale of stock by a shareholder who purportedly has no good will to transfer since it is an asset of the corporation. E.g., Beal's Estate v. Commissioner, 82 F.2d 268 (2d Cir. 1936); Salvage v. Commissioner, 76 F.2d 112 (2d Cir. 1935), aff'd, 297 U.S. 106 (1936); Balthrope v. Commissioner, 356 F.2d 28 (5th Cir. 1966). The validity of this distinction is discussed under the Shareholders as Covenantors section of this paper.

2. Annabelle Candy Co. v. Commissioner, 314 F.2d 1 (9th Cir. 1962) (whether the parties intended to allocate a part of the purchase price to the covenant); Schulz v. Commissioner, 294 F.2d 52 (9th Cir. 1961) (the covenant had no basis in economic reality). Further attention is later given to the implications of the issue being primarily factual (in that the basic evidentiary facts were in dispute at trial level).

3. One of the best known definitions of good will is that of Justice Story: This good will 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 cus-
II. Tax Consequences to Vendor and Vendee

In covenanting not to compete with the vendee pursuant to the sale of the vendor's property, including good will, the vendor in effect surrenders his right to earn income by promising not to engage in a similar business within certain territorial limits. Any consideration received for this promise as a distinct and separable amount from the sale of the other assets is characteristically as much ordinary income as compensation for the affirmative act of rendition of personal services.

It is evident, therefore, that the vendor's tax liability is greatly increased by being forced to report the consideration received for the covenant as ordinary income. However, if the total consideration in excess of tangible and specific intangible assets is deemed to be received for good will, with the covenant not to compete merely assuring the vendee the beneficial enjoyment of the good will which he has acquired, the gain therefrom is accorded favorable capital gain treatment. If the

tomers, on account of its local position, or common celebrity, or reputation for skill or affluence, or punctuality, or from other accidental circumstances or necessities or even from ancient partialities, or prejudices.

4. As shown by the definition in note 3 supra, good will includes favorable customer attitudes, customer lists, and location. Thus, in Estate of Masquelette v. Commissioner, 239 F.2d 322 (5th Cir. 1956), it was not necessary for the contract of sale to include the words "good will" since in fact the transfer enabled the purchaser to "step into the shoes of the seller." See also Barran v. Commissioner, 334 F.2d 58 (5th Cir. 1964).

5. The enforceability under the common law of a noncompetition agreement depends among other things upon the fact that the territory which it embraces shall be no greater than is reasonably necessary to secure the protection of the business or good will. See 9 A.L.R. 1468 (1920) for the general rule. Also in Welcome Wagon Int'l, Inc. v. Fender, 255 N.C. 244, 247, 120 S.E.2d 739, 742 (1961) the court stated:

Where the territory embraced in restrictive covenants is unreasonable, but is expressed in divisible terms, i.e., in terms of local geographical or governmental units, the majority of the courts enforce the covenant in as many of the units as are reasonable and disregard the remainder.

6. The early cases set the precedent which has since been followed. E.g., Cox v. Helvering, 71 F.2d 987 (D.C. Cir. 1934); Christensen Mach. Co., 18 B.T.A. 256 (1929); Black River Sand Corp., 18 B.T.A 490 (1929); Hamlin's Trust v. Commissioner, 209 F.2d 761 (10th Cir. 1954); 3B MERTENS, FEDERAL INCOME TAXATION § 22.33 (rev. ed. 1966). Since there must be an exchange of "property" for capital gain treatment to be allowable, it has been contended that the covenant given by the seller as an integral part of the sale is in effect a conveyance of property. When faced with this contention the Second Circuit reasoned that even if the privilege of the vendor to engage in business is a right of property to him, such property was not conveyed to the vendee. The vendee could not acquire the vendor's privilege, all it received was his promise not to exercise his privilege. Payment received for such a promise was therefore held to be ordinary income and not proceeds received from sale of a capital asset. Beal's Estate v. Commissioner, supra note 1, citing Salvage v. Commissioner, supra note 1.

7. For the maximum tax rate for individuals for taxable years beginning after December 31, 1964, see INT. REV. CODE of 1954, § 1. The maximum effective capital gain rate is 25%. INT. REV. CODE of 1954, § 1201.

8. The generally accepted test for covenants is whether "the covenant is so closely related to a sale of good will that it fails to have any independent significance apart from merely assuring the effective transfer of that good will." Ullman v. Commissioner, 264 F.2d 305, 307 (2d Cir. 1959); see also Aaron Michaels, 12 T.C. 17 (1949).

9. See note 7 supra.
covenant is deemed to be merely ancillary to the enjoyment of the acquired good will, no deduction in the form of depreciation or amortization is available to the vendee.\textsuperscript{10}

However, if the covenant has separate value (thus requiring the vendor to report the proceeds received for it as ordinary income) and it has a specified life,\textsuperscript{11} the vendee will be entitled to amortize its cost over the period during which the vendor has promised to refrain from competition.\textsuperscript{12}

The amortization allowance is by no means guaranteed as a necessary corollary to ordinary income treatment to the vendor. Amortization has not been allowed where the benefits of elimination of competition were permanent or of indefinite\textsuperscript{13} duration. The early cases which denied amortization on this basis guided covenantees in later transactions so that restraints from competition for a specified term of years were provided for contractually.\textsuperscript{14}

It is most probable, however, that the income-producing or economic benefits to be derived by the covenantee who has acquired the good will of the covenantor-vendor will continue long past the period fixed by the sales agreement.\textsuperscript{15} Although the covenant not to compete could then be said to be of use in the production of income for an indefinite period and consequently not subject to depreciation,\textsuperscript{16} this rationale has never been advanced by the Commissioner.

Due to the above-described conflicting tax consequences it is obvious that the interests of the vendor and vendee are antithetical in negotiating the amount which is to be paid for the covenant not to compete.\textsuperscript{17} Assum-

\textsuperscript{10} Treas. Reg. § 1.167(a)-3 (1956).

\textsuperscript{11} As to the allowance of amortization, the necessity for a limited period is a requirement imposed by Treas. Reg. § 1.167(a)-3 (1956) and is well supported by prior decisions. \textit{E.g.}, Christensen Mach. Co. v. United States, 73 Ct. Cl. 149, 50 F.2d 282 (1931); Toledo Newspaper Co., 2 T.C. 794 (1943); News Leader Co., 18 B.T.A. 1212 (1930).

\textsuperscript{12} The courts have been uniform in allowing the cost of a covenant not to compete to be amortized over the promised period of restraint from competition as stipulated in the contract of sale. See note 11 \textit{supra}.

\textsuperscript{14} In Clark Thread Co., 28 B.T.A. 1128 (1933), a competitor was paid $500,000 to discontinue the sale of thread under a competitive trade name. The contract did not specify a definite period of restraint. Due to the indefinite life, amortization of the $500,000 was disallowed. See also Press Publishing Co., 17 B.T.A. 452, 56 F.2d 125 (3d Cir. 1932), aff'd \textit{sub. nom.}

\textsuperscript{15} As a result, there has been no litigation on this point in recent years.

\textsuperscript{16} See 8 \textit{Tax. L. Rev.} 236 (1952-1953). The vendee-covenantee can develop customer attachments that are not impaired when the covenantor returns to competition. These attachments may last, therefore, as long as the business. See generally \textsc{Chamberlain}, \textsc{The Theory of Monopolistic Competition} (8th ed. 1962).

\textsuperscript{17} The vendor, being motivated by a desire for more capital gain and less ordinary
ing the tax sophistication of both parties, the tax consequences should be theoretically reflected in the final purchase price of the business.

It would seem that the contrasting results to the parties’ tax liabilities would serve to mitigate the Treasury’s hazard of loss of revenue. This could be a substantially valid hypothesis if the parties treated the good will and/or covenant transferred pursuant to the sale in a consistent manner for tax purposes.

This is frequently not the case, however, since many vendors, after agreeing to a contractual allocation of a specific amount of the sales price to the covenant, will thereafter report the entire amount as capital gain. Since the vendee has most certainly relied upon the contractual allocation and claimed depreciation deductions for the acquired covenant, the government may often challenge the vendor’s position just so the court can resolve the inconsistency.

Since loss of revenue to the Treasury is apparently due to this inconsistency, litigation on this issue has been, and will continue to be, necessarily resorted to by the Commissioner.

18. Occasionally the courts have relied upon the covenantor’s awareness of the tax consequences as indicative of whether there was arm’s length bargaining for the covenant. See Schulz v. Commissioner, supra note 2 (lack of vendor’s knowledge of tax consequences a factor in finding the covenant to be a sham); Yandell v. United States, 315 F.2d 141 (9th Cir. 1963) (the covenant was found not to be a sham, one factor being the vendor’s representation by counsel when the agreements were prepared); Balthrope v. Commissioner, supra note 1 (vendor’s accountant being present during negotiations negated vendor’s alleged ignorance of unfavorable tax consequences attributable to the covenant).

19. This practical consideration is mentioned in 3B MERTENS, FEDERAL INCOME TAXATION § 22.33, at 149 (rev. ed. 1966). Disregarding tax rate differentials between vendor and vendee, ordinary income treatment to the vendor and amortization deductions allowed to the vendee would result in the maximum equalization of tax revenue. Capital gain treatment to the vendor, however, results in an immediate increase in tax revenue, whereas the consequent nonamortizable good will, which must be carried by the vendee, may never serve to reduce the vendor’s tax liability.

20. See, e.g., Federal Oil Co., P-H Tax Ct. Mem. 1966-195, Docket No. 5466-64, Aug. 31, 1966; Balthrope v. Commissioner, supra note 1; Montesi v. Commissioner, 340 F.2d 97 (6th Cir. 1965); Barran v. Commissioner, supra note 4; Louis A. Kitzner, 23 CCH Tax. Ct. Mem. 466 (1964), aff’d, 66-1 U.S. Tax Cas. 9341. The above cases all involved contractual allocations of specified amounts paid for the agreement not to compete. The vendors in each case claimed capital gain treatment for the amounts so allocated, which was determined to be ordinary income by the courts.

21. The Commissioner has often made inconsistent determinations and the cases of the vendor and vendee are thereafter consolidated for trial in order to afford the Tax Court the opportunity to consider the varying versions of the transaction after one hearing. Thus a consistent result may be reached with respect to all parties. Ray H. Schulz, 34 T.C. 235 (1960), 294 F.2d 52 (9th Cir. 1961), aff’d sub nom; Howard Construction Co., 43 T.C. 343 (1964); Benjamin Levenson, 45 T.C. 380 (1966).

22. An interesting case involving an action for breach of contract arose due to inconsistent treatment between the parties to a contract for the sale of stock in four finance companies. The court found the plaintiff-vendor justified in concluding that both parties intended that the sales price of the stock, $2,500,000, was to be paid for the stock alone
The procedural problems of litigating a case before the Tax Court or federal courts are not the main concern of this paper, but some discussion will provide a better understanding of the decisions considered later.

A. Tax Court

The Tax Court Rules state that the burden of proof is on the petitioner (taxpayer). The rule is well settled, however, that when the proof shows that the Commissioner's determination was wrong, the taxpayer need not show the exact amount of the tax that might lawfully be assessed against him.

Although the Tax Court will not make findings of fact upon conjecture, nevertheless, its problem is sometimes making the "closest approximation" it can. This approach has evolved from the well-known "Cohan rule" which has been applied by the Tax Court to arrive at a fair approximation in determining amounts of deductions allowable to taxpayers when the evidence falls short of proving exact allowances. This "rule," which had its origin in deduction cases, has been extended to good will versus covenant controversies.

The application of the "Cohan rule" to covenant cases is perhaps and for nothing else since there was no contractual allocation to the covenant not to compete. The Internal Revenue Service disallowed capital gain treatment to the vendor because:

[t]he purchasers of certain of these capital stocks treated a portion of the purchase price as a payment for covenants not to compete . . . thus creating an inconsistency in the position taken regarding the sale between the purchaser and the seller. Stern & Co. v. State Loan & Fin. Corp., 238 F. Supp. 901, 915 (D. Del. 1965).

The court concluded that the vendee breached an agreement that the vendor was to receive the entire purchase price solely for this stock, and thereby held the vendee liable for attorneys' fees incurred by the vendor in successfully contesting the deficiency asserted against it due to the vendee's allocation. The court stated:

Defendant should have known that its contention that a part of the money paid to plaintiff represented the cost of the covenant not to compete, was irreconcilable with plaintiff's treatment of the entire consideration as the sales price of the stock; and that the allowance of the tax benefits which defendants sought would, in all likelihood, result in the disallowance of the capital gains benefits to plaintiff.

Id. at 915.

26. In Cohan v. Commissioner, 39 F.2d 540 (2d Cir. 1930), it was held that in the absence of detached accounts of travel and entertainment expenses, the Board of Tax Appeals must make as close an approximation as it can, bearing heavily, if it chooses, upon the taxpayer whose inexactitude is of his own making.
27. E.g., John T. Fletcher, P-H Tax. Ct. Mem. 1965-273 (a deduction case in which the court allocated 45% to the covenant, 45% to insurance expirations, and 10% to good will); Melvon C. Miller, P-H Tax Ct. Mem. 1964-305 (court allocated 50% to the covenant and 50% to good will); Levine v. Commissioner, 324 F.2d 298 (3d Cir. 1963) (another 50/50 allocation).
the greatest advantage a taxpayer, contesting such an issue, can gain by choosing the Tax Court as the forum rather than the federal district courts. In *M. Levine* the taxpayer sold a fuel oil business for $85,000 dollars. In negotiations leading up to the sale no separate consideration was stated for good will or for a covenant not to compete for 7 years, but the sales agreement recited the buyer’s allocation of $35,000 dollars of the $85,000 dollar sale to “restrictive covenants.” The Commissioner asserted a deficiency against the seller by considering the entire $35,000 dollars to represent ordinary income received in consideration of the covenant rather than for good will as contended by the seller. The Tax Court found both the good will and the covenant to have value. The Third Circuit, in affirming the Tax Court’s allocation of 50 per cent of the $35,000 dollars to each element, concluded that to allow nothing for the good will or for the covenant or both would have been inconsistent with the evidence. At the same time one hundred per cent accuracy in fixing the respective amounts was impossible.

The Tax Court’s willingness to find some mid-ground which is fair to both the taxpayer and the Commissioner in this difficult area of evaluation is to be contrasted with the approach to the burden of proof problem in the federal district courts.

**B. Federal District Courts**

Similar to the rule as to presentation of evidence before the Tax Court, in the district courts the findings of the Commissioner as to value and other facts are presumptively correct and the burden of overcoming them rests upon the taxpayer suing to recover alleged excessive tax payments. However, there is a somewhat greater burden of proof upon the taxpayer in a refund suit than in a Tax Court proceeding.

Since the action for refund of taxes is in the nature of a common law action for money had and received and is governed by equitable principles, the burden of proof is on the taxpayer to prove not only that the Commissioner’s determination was wrong, or that the claim for refund is reasonable, but to produce evidence from which another and proper determination could be made.

28. See note 35 infra.
30. 324 F.2d 298 (3d Cir. 1963).
31. Prior to bringing suit in a federal district court or Court of Claims, a claim for refund must first be filed. *Int. Rev. Code of 1954*, § 7422. Thereafter a suit may not be brought before the expiration of 6 months from the date of filing the claim unless the Secretary or his delegate (District Director) renders a decision within that time. *Int. Rev. Code of 1954*, § 6532(a)(1).
35. United States v. Pfister, 205 F.2d 538 (8th Cir. 1953). The Supreme Court has stated by way of dictum that in an action to recover taxes paid:
The pitfalls awaiting a taxpayer engaged in a contest over the proper tax treatment of a covenant in a district court are aptly illustrated by the Fifth Circuit decision in David v. Phinney.36

In that case the taxpayer sold a fifty per cent interest in a corporation along with a covenant not to compete for a 500,000 dollar lump sum. The other fifty per cent stockholder, a corporation, sold its stock for 333,000 dollars. The Commissioner determined that 166,000 dollars of the amount received by the taxpayer should be accorded ordinary income treatment. The only evidence concerning the amount paid for the covenant was the taxpayer's testimony that he was paid nothing for it.

The district court upheld the Commissioner's determination of 166,000 dollars attributable to ordinary income as being presumptively correct. The Fifth Circuit grounded its affirmance on the taxpayer's failure to offer any credible evidence from which any other determination of his federal income tax liability could be made.

In effect, the taxpayer lost because he could not prove exactly how much was attributable to the covenant. Obviously, this is virtually impossible since the parties themselves did not arrive at a precise allocation. Thus this case demonstrates that what is euphemistically called a "presumption" of correctness develops into an "absolute" to sustain the Commissioner's implied finding in a deficiency determination.38

Due to the inherent difficulties in meeting the burden of proof in covenant cases in the federal district court, it is not surprising that the great majority of such cases have been tried by taxpayers in the Tax Court where a more liberal standard is applied in allocating between covenants and good will.40

C. Appellate Courts

If the losing party wishes to appeal the decision of either the Tax Court or a federal district court, it would be well to consider the obstacles to obtaining a reversal.

Obviously the burden was on the plaintiff in order to establish a basis for judgment in his favor, specifically to show not merely that the assessment was erroneous but also the amount to which he was entitled. Helvering v. Taylor, 293 U.S. 507, 514 (1935).

36. Supra note 32.
38. See note 36 supra.
39. A dissenting opinion felt it would be proper to find out what a fair value to the covenant would be. The mere fact that the taxpayer received $500,000, or $166,000 more than the other selling stockholder, was not felt to be conclusive evidence that the entire $166,000 was received for the covenant. The dissent stated:

How two sellers, each with different interests to serve, arrive at a price is a precarious basis for determining intrinsic attribution. Maybe one just wants more money. Maybe one thinks that the buyer will pay more.

350 F.2d at 378.
40. See note 27 supra.
In general, the function of the appellate court is to review such decisions in the same manner and to the same extent as decisions of the district courts in civil actions tried without a jury. Review of the trial court's decision is governed by the rule that findings of fact shall not be set aside unless clearly erroneous and due regard shall be given to the trial court's ability to determine the credibility of the witnesses.

Questions of motive, intent, and the like, if at all doubtful, are ordinarily issues of fact, and where inconsistent inferences may reasonably be drawn from evidence in regard thereto, it is for the trial court to determine what inference shall be drawn. The factual issue has been phrased in covenant versus good will cases as whether: (1) the agreement not to compete was actually dealt with as a separate item; (2) the parties bargained for the agreement not to compete in good faith; (3) the covenants were realistically bargained for; (4) the payments, which were allocated to the covenant, were in fact payments for something else; and (5) the covenant has such a relationship with business reality that reasonable men, genuinely concerned with their own economic future, might bargain for the agreement.

Since the heart of the issue is determining the real intent of the parties and therefore searching for the substance of the transaction rather than the form, the "clearly erroneous" rule severely confines the appellate courts in their review. Although the cases appealed on this issue have been plentiful, only an incorrigible optimist would believe a reversal of the trial court could be achieved in light of the above rule.

The only realistic possibility of obtaining a reversal, then, would seem to be through the trial court committing an error of law where the facts are undisputed.
In exceptional situations, both the Fifth and Seventh Circuits have reversed the Tax Court for having made erroneous decisions of law. Both cases involved undisputed oral testimony and erroneous assumptions of law which when coupled with the appellate courts' own interpretations of the written contracts resulted in reversals.

Since this type of error at the trial court level has been uncommon in the covenant area it seems safe to say that when the battle has been lost at that level, so too has the war.

IV. Substantive Tests Considered

A. Contractual Allocation to Covenant

Generally, the courts are not bound by the form in which parties to an agreement clothe their transaction but are charged with the duty of determining the realities of the transaction after having considered all the pertinent facts. However, the cases which have contributed to the jurisprudence in this area seem to hold that where the parties bargain at arm's length over the terminology to be used in expressing an agreement not to compete and conclude with a separately stated consideration for the forbearance from competition, this amounts to an implied bargain between them that the seller, covenantor, will assume the unfavorable tax consequences flowing from the receipt of the consideration and the purchaser will obtain the corresponding benefits.

Accordingly, when faced with sales agreements wherein specific values have been assigned to the covenant not to compete, the great but for the trial court to apply the process of reasoning to achieve a correct interpretation of the legal significance of the evidentiary facts, such conclusion as the trial court reaches as an "ultimate fact" is subject to review, not as a review of a finding of fact, but free from the restraint of the "clearly erroneous" rule. See, e.g., Goldberg v. Commissioner, 223 F.2d 709 (5th Cir. 1955); Fahs v. Taylor, 239 F.2d 224 (5th Cir. 1956); Estate of Masquelette v. Commissioner, 239 F.2d 322 (5th Cir. 1956).

55. In Masquelette, the Tax Court stressed the omission of the words "good will" from the contract of sale in allocating the entire consideration over and above that received for tangible assets to a covenant not to compete. As a matter of law, the words "good will" were not considered necessary by the Fifth Circuit if in fact the transfer enabled the purchaser to "step into the shoes of the seller." See note 53 supra at 325.

In the Wilson case the Seventh Circuit disagreed with the Tax Court's thinking that absent an express segregation of the purchase price to an amount specified for a covenant, no value could be attributed to the covenant for amortization purposes by the buyer. In view of the silence of the contract in this respect, it then became necessary to determine from the other evidence whether the covenant had value, and if so the amount. See note 54 supra.

56. See note 49 supra.
57. See Yandell v. United States, 208 F. Supp. 306 (Ore. 1963), aff'd per curiam, 315 F.2d 141 (9th Cir. 1963); Barran v. Commissioner, 334 F.2d 58 (5th Cir. 1964); Rogers v. United States, 290 F.2d 501 (9th Cir. 1961).
majority of courts have, upon various rationales, held the seller to the bargain which he made and determined ordinary income treatment for the specified amount.\(^\text{58}\)

The generally accepted test for covenants is whether "the covenant is so closely related to a sale of good will that it fails to have any independent significance apart from merely assuring the effective transfer of that good will."\(^\text{59}\) The crux of the problem is the inherent difficulty, if not impossibility, in determining whether the covenant had a value independent of the good will. Were it not for the good will transferred it might be stated that the covenant itself was valueless, since it was the sale of the business, with its good will, which generated the need for the covenant in the first place. Indeed, at the common law, any covenant not to compete must to some degree protect the reputation and customer loyalty transferred with the good will of the business or it would be held to be unenforceable.\(^\text{60}\)

Equally true, however, is the fact that should the vendor engage in a competing business shortly after the sale, the value of the good will purchased pursuant to the transfer of the business would be soon destroyed.\(^\text{61}\)

Because of this interrelation between the good will and the covenant not to compete, the courts have placed great weight upon the contractual terms agreed to by the parties themselves. The fact that tax considerations admittedly played a part in determining the amount of the purchase price allocated to a covenant not to compete has not contaminated the transaction as long as the covenant was separately bargained for and could not be considered a sham.\(^\text{62}\)

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58. For ordinary income treatment where the property sold was either partnership interest or a proprietorship: Louis A. Klitzner, 23 CCH Tax Ct. Mem. 466 (1964), aff'd, 66-1 U.S. Tax Cas. 9341; Barran v. Commissioner, supra note 57; Yandell v. United States, supra note 57.

For similar treatment where the property sold was either corporate assets or stock and the covenantor was the selling stockholder or principal officer in the corporation: Beals' Estate v. Commissioner, 82 F.2d 268 (2d Cir. 1936); Hamlin's Trust v. Commissioner, supra note 49; Howard G. Mathews, 20 CCH Tax Ct. Mem. 1565 (1961), aff'd per curiam, 311 F.2d 795 (3d Cir. 1963); Montesi v. Commissioner, supra note 50; Balthrop v. Commissioner, 356 F.2d 28 (5th Cir. 1966); Fuhering & Co., 23 CCH Tax Ct. Mem. 466 (1964); B. Lehtman, 23 CCH Tax Ct. Mem. 1745 (1964); Helvering v. Salvage, 297 U.S. 106 (1936).


61. Prevailing authority at the common law will not permit a vendor to destroy the value of good will by directly canvassing the old customers, endeavoring to dissuade them from dealing with the purchaser of the good will, and soliciting them to trade with the vendor. However, absent a restrictive contract, the vendor of good will, by engaging in a rival business, may deal with the old customers who, attracted by their knowledge, gained by advertising or otherwise, that he is in business, choose to trade with him. See, e.g., Ranft v. Reimers, 200 Ill. 386, 65 N.E. 720 (1902); Brown v. Benzinger, 118 Md. 29, 84 A. 79 (1912); Foss v. Roby, 195 Mass. 292, 81 N.E. 199 (1907); Fine v. Lawless, 139 Tenn. 160, 201 S.W. 160 (1918).

In Rogers v. United States63 the vendors of a small loan business at first agreed to a total stated purchase price with nothing allocated to a covenant not to compete. However, the final sale contract provided a specific segregation of 60,000 dollars to the covenant. The Ninth Circuit, in first finding no confusion between the parties as to what was done, stated:

The taxpayers probably have been maneuvered by their purchaser into a big tax advantage. But, when in their second option, they agreed in writing after negotiation to the assignment of some $60,900 as consideration for a covenant not to compete, the trial court could refuse to go behind the agreement and uphold the commissioner in treating the sum as ordinary income.64

The Ninth Circuit's attributing primary importance to the parties' separately stated contractual allocation is consistent with recent decisions in other courts of appeal.65 These courts have required strong proof to be adduced by the vendor to overcome the contractual allocation.

At least one writer,66 and also the Commissioner (apparently wearying from litigation on this issue) has advocated the adoption of a "new rule." The proposed rule would prevent either contracting party or the Commissioner from subsequently attacking the stated consideration in such agreements unless fraud, duress, or undue influence existed at the time they were signed. The Tax Court summarily rejected this "rule" in view of its judicial responsibility of examining the substance of a transaction.67 It can thus be seen that the proof required to set aside the contract may encompass many more factors than fraud and duress between the parties.

1. THE STRONG PROOF REQUIREMENT

Various factors have been considered by the courts in determining whether the vendor has met the strong burden of proof required to overcome a specific value assigned to a covenant not to compete in the written contract of sale. While no single factor is sufficient to overcome the contractual allocation of the parties, the weight of several of these factors when considered together has been accepted as proving that the

63. Supra note 57.
64. Rogers v. United States, supra note 57, at 501. In choosing to leave the vendors with their written bargain, the Ninth Circuit conveniently followed the doctrine that while third parties may question the resolutions of parties to a contract, in the absence of fraud it is not ordinarily open to the bargainers to do so. Gray v. Powell, 314 U.S. 402 (1941); Higgins v. Smith, 308 U.S. 473 (1940).
65. E.g., Balthrope v. Commissioner, supra note 58; Ullman v. Commissioner, 264 F.2d 305 (2d Cir. 1959); United Fin. & Thrift Corp. v. Commissioner, 282 F.2d 919 (4th Cir. 1960); Montesi v. Commissioner, supra note 50; Hamlin's Trust v. Commissioner, supra note 49.
covenant did not reflect the substance of the agreement entered into by the parties.

The standard used generally to make this factual determination is whether "the covenant must have some independent basis in fact or some arguable relationship with business reality such that reasonable men, genuinely concerned with their economic future, might bargain for such an agreement." Thus, before the contractual provisions will be set aside, the aggrieved vendor must prove that the covenant was nothing more than a sham inserted in the contract for the tax advantage of the buyer.

(a) Real Bargaining for the Covenant

One critical element which must be shown by the vendor is the lack of any realistic bargaining for the covenant by the parties. Where it has been determined that the parties were represented by counsel and held negotiations during which the covenant not to compete was mentioned as a material factor, the contractual allocations have been upheld.

However, where the covenant was not even considered until late in the negotiations when the vendee's attorney advised them of its tax advantages, the Ninth Circuit in *Schulz v. Commissioner* found the covenant allocation was nothing but a sham.

Similarly, where the vendee unilaterally decided to allocate 152 dollars per share to a covenant just prior to closing, after having agreed to a total consideration of 374 dollars for each share of stock in a small loan corporation, the Tax Court found no real bargaining for the covenant. Along with other evidence, this factor was sufficient to constitute the strong proof required to overcome the terms of the contract.

(b) Terms of the Covenant

Occasionally, the courts have been concerned with the actual terms of the noncompetition provision in the contract.

The vendor in a recent case attempted to show that the covenant lacked economic reality by contending that the agreement was void and unenforceable due to the unreasonable territorial restriction in the covenant. The Tax Court rejected this argument since the question of the covenant's enforceability in equity or the validity of the provision for liquidated damages for its violation by the vendor had not actually arisen.

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71. *Supra* note 48.
72. See note 67 supra.
Further, the Tax Court knew of no authority for the vendor's conclusion that an amount paid in good faith for a covenant not to compete should be considered as paid for good will nunc pro tunc even if the covenant were probably void under the law of the state in which the agreement was entered into.\textsuperscript{73}

It thus appears that state law considerations have a minimal impact on the tax effect of the covenant unless evidence can prove on a subjective basis that the vendee had knowledge of the probabilities of the covenant's unenforceability and therefore would not realistically have expected to benefit from its restrictive provisions.\textsuperscript{74}

Under the terms of the covenant in \textit{C. L. Danielson}\textsuperscript{75} the selling stockholders were precluded from competing in the small loan business as individuals; however, there was nothing to preclude the sellers from merely incorporating a new entity, electing themselves as directors, and hiring office personnel to conduct the business.\textsuperscript{76} The value of the covenant was shown to be highly questionable due to this gaping loophole in its restrictiveness.

The terms of the covenant in \textit{Schulz v. Commissioner}\textsuperscript{77} also influenced the court in disregarding the contract. The covenant was actually valueless because it restrained the vendor from competition for the minimal period of one year and extended over a one mile area only.

The careful tax-planning vendee should have little difficulty in providing for both a reasonable length of time and area to be covered by the covenant to give it at least the indicia of genuineness. The vendees in \textit{Schulz} were most likely a bit overzealous in attempting to deduct the consideration stated for the covenant all in one year rather than settle for amortization over a lengthier but more reasonable period.\textsuperscript{78}

(c) Ignorance of the Law—An Excuse?

Occasionally, the vendor-covenantor's appreciation of the tax consequences has been given probative weight in determining whether there was arm's length bargaining.\textsuperscript{79} This test, however, is of secondary importance in the ultimate determination of whether the "strong proofs" will defeat the contractual terms.\textsuperscript{80} The Tax Court has considered the
tax awareness of the vendor as an "iffy" question at best and one which would not control the issue. Nevertheless, when the unwary vendor has been rescued from his bad bargain, evidence as to his ignorance of the tax impact has been accepted by the courts to bolster the final decision to disregard the covenant.

Conversely, where the vendor was shown to have been represented by tax-conscious counsel during negotiations, this fact has usually spelled instant death to his argument that the covenant was a sham. The Fifth Circuit has even precluded a vendor from pleading tax ignorance where he was not naive about tax matters generally. In Balthrop v. Commissioner the court noted the vendor's desire to take advantage of the installment method of reporting the gain from the sale as indicative of his lack of naivete as to taxes. Furthermore the vendor had his accountant review the agreement prior to closing the sale. The court refused to judicially notice the vendor's lack of awareness as to ordinary income treatment aspects of the covenant although his tax advice was not really competent on this particular point. Thus, the presence of either an attorney or accountant during final negotiations appears to charge the vendor with implied tax sophistication and result in an ultimate finding that the bargaining was at arm's length.

Taking into consideration that the contractual allocation of a specified amount to the covenant is usually done for tax purposes and the importance placed on that allocation by the courts, it is evident why the "tax awareness" test has been used frequently. Nevertheless, the more emphasis which is placed on what is often an arbitrarily negotiated allocation, the more important this "tax awareness" test becomes. The relevancy of this factor to the question of a covenant's economic reality exemplifies the extent to which the judiciary has accepted tax considerations as a necessary element of value in today's society.

(d) Actual Ability of Vendor To Compete

The business acumen of the vendor has been considered in conjunction with other tests in determining objectively whether a covenant was truly necessary. A lack of engineering background and sales contracts by the vendor (a retiring partner) in Schulz v. Commissioner the vendor (a retiring partner) in Schulz v. Commissioner knowledge of the tax consequences might be able to dominate the entire negotiations so that it could not be said that the vendor understood any of his agreements," including the covenant. Supra note 58, at 34 (1966). 81. Gazette Tel. Co., 19 T.C. 692, 704 (1953), aff'd, 209 F.2d 926 (10th Cir. 1954); Anthony Rock, 21 CCH Tax Ct. Mem. 46 (1962).
82. Schulz v. Commissioner, supra note 48.
84. Supra note 58.
85. Id. at 34.
86. Supra note 48.
helped convince the Court that a specific payment for a covenant was known to be unnecessary by the vendees, the continuing partners.

Similarly, after finding other indications of a sham arrangement, the Tax Court in *C. L. Danielson* drove the final nail into the covenant's coffin by noting that the selling stockholders of a corporation engaged in the small loan business were three housewives, a successful surgeon, and a retired businessman, none of whom could or would be likely to compete with the buyer.

The age and health of the vendor have been additional indications that the vendee knew a covenant was not necessary for the protection of the acquired good will.

B. *No Contractual Allocation to Covenant*

The absence in the sale agreement of an amount specifically assigned to the covenant has generally resulted in the ultimate finding that the vendor was entitled to capital gain treatment or the vendee was precluded from amortization deductions. The rationale for this conclusion is that since the parties did not negotiate specifically for the covenant, they did not intend to allocate any part of the purchase price to it. The ultimate fact is then determined that the vendor did not receive anything for the covenant as a separate item or, couched in other terms, the covenant was not severable from the good will. Since separate values are almost impossible to formulate, this approach is workable.
with the only vital evidence being the existence of some good will being transferred.

In instances where there was a contractual allocation of a lump sum to both good will and the covenant together, other assets being paid for separately, the courts, finding some evidence of value in both, allocated the amount on an estimated basis.\(^9\)

It is noted that the enforceability of the covenant is not diminished at common law merely because a specific amount is not paid for it. It has long been held that the price paid for the good will of a business is a sufficient consideration to support the vendor's covenant not to compete.\(^9\)

Thus, it could well be contended that any negotiation relating to the amount of the consideration to be assigned to the covenant apart from the good will is unnecessary other than to satisfy the tax motives of the vendee who is acquiring the good will and its protection in a single transaction. As mentioned previously, the validity of the covenant itself depends upon its protection of good will.\(^9\)

This view, if adopted by the judiciary, may better accomplish its stated obligation of looking past the formalities of a transaction to the economic realities.

C. Shareholders as Covenantors

A distinction is commonly made between sellers of proprietorships or partnership interests and employee-stockholders who either sell their stock or have their closely held corporation sell its assets and covenant not to compete as part of the sale. The Tax Court has stated that the proprietor or partner who sells his business has a direct interest in the good will and his covenant may well be a contributing factor in the sale of the entire business.\(^9\) On the other hand, even though the corporation is only a legal garment worn by the stockholders to conduct business, the covenantor-stockholders are stated to have no direct proprietary rights in the good will owned by the corporation. Accordingly, covenants given by them as individuals have been taxed as ordinary income, being personal promises and thus severable from the good will.\(^9\)

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94. See notes 26 and 27 supra.
95. See 17 Am. Jur. 2d Contracts § 101, at 445 (1964) and cases cited therein.
96. The Barran case, while holding the parties to their contractual allocations also pointed out the fact that the total price paid was substantially in excess of the assets transferred. This supported the payment for the covenant as not in fact paid for the other assets. Barran v. Commissioner, 334 F.2d 58 (5th Cir. 1964). However, the Fifth Circuit later relied strongly on its Barran approach as to importance of the contract itself and held the vendor to the contractual allocation notwithstanding the fact that the total purchase price, including the contractual value of the covenant, was the minimum estimated value of the assets. Balthrope v. Commissioner, 356 F.2d 28 (5th Cir. 1966).
Recent decisions have attempted to make a less formalistic distinction between the two classes of covenantors by requiring analysis of the stockholder’s actual relationship to the good will transferred by his corporation rather than merely postulating that a stockholder has no good will to sell with his covenant.99

If the shareholders had personal contacts with the customers it would necessitate their covenant in order to guarantee to the vendee of the corporate stock the enjoyment of the good will. However, where there is no personal relationship between the selling shareholders and the customers, and such shareholders have the ability to enter into competition with the vendee, the covenant alone would have independent value. This test is no different from that applied in proprietorship cases. While the barrier appears to have been weakened to a great extent, this distinction has been used recently by the Fifth Circuit as a supporting factor in finding an allocation to the covenant to be valid.100

When coupled with a shareholder as seller a contractual allocation has and should continue to result in ordinary income treatment for the consideration paid for the covenant, barring a sham situation.101

V. SUMMARY AND RECOMMENDATIONS

Since a finding of fraud, duress, or a sham situation is necessary to overturn a contractually assigned value to a covenant, the importance of proper representation by counsel at the negotiating table when a business is sold is evident. The substance-seeking function of the judiciary has been relegated to the extreme situations where the covenant’s lack of authenticity leaves little to the imagination.

Within this framework the parties are left to play the game within very broad rules, with little further attention being paid to such important factors as whether the actual value of the assets may equal or exceed the total consideration received including the covenant. Having made his bed, the tax-informed vendor must now sleep in it.

It seems evident that the allocations to covenants in the majority of cases are made with tax purposes as the primary motive. Although it is more practical to hold the parties to their bargain, the following considerations are advanced in support of the proposition that the “strong proofs” now needed to overcome a contractual allocation should instead be placed upon the vendee to prove that the total purchase price paid

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99. Ullman v. Commissioner, 264 F.2d 305 (2d Cir. 1959); Barran v. Commissioner, supra note 96.
100. Balthrope v. Commissioner, supra note 96.
101. Shareholders have been allowed capital gain treatment where no allocation to the covenant was made contractually without mention by the courts that shareholders lacked direct proprietary interest in good will sold. George H. Payne, 22 T.C. 526 (1954); J. G. Thompson, 23 CCH Tax Ct. Mem. 1193 (1964).
for both assets and the covenant not to compete exceeded the actual value of the assets (including good will):

(1) The validity of the covenant at common law is dependent upon its primary purpose of protecting the good will and the provision for the covenant at time of sale is the intent to protect that good will.\textsuperscript{102}

(2) The consideration paid for the good will has been held to support the promise of the vendor to refrain from competition, thus requiring no additional amount to be specified for the covenant.

(3) The economic benefits to the covenantee from customer attachments may last as long as the business even though the covenantor may return to compete after a specified number of years. If the benefits were then considered to run for an indefinite time, no amortization would be allowable in any event.

Since the judiciary is lending so much weight to the form of the transaction, this writer would suggest a legislative remedy aimed at foreclosing inconsistent treatment of covenants and at the same time estopping the vendor from asserting that he was innocently misled by a more knowledgeable vendee when the contract was executed.

Congress could authorize use of a statement of intent, the form of which would be devised by the Commissioner, whereby both the vendor and vendee could stipulate that (1) the covenant’s contractual value exceeds the value of other assets sold; (2) it was negotiated without duress and with full knowledge of the tax consequences to each party; (3) the period of noncompetition is both reasonable and necessary under the circumstances; and (4) both parties will treat the covenant consistently or be subject to the proper penalties.

A copy of this “statement of intent” would then be filed by both parties with their respective tax returns for the year of sale.\textsuperscript{103}

This procedure would enable the contracting parties to be positive of tax consequences. The Commissioner could also expect a more uniform treatment by the courts in this area.

\textsuperscript{102} In 53 Colum. L. Rev. 660 (1953) the author felt that the covenant 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.

\textsuperscript{103} Both parties should sign each copy.