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Tax Treatment of Covenants Not to Compete

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TAX TREATMENT OF COVENANTS NOT TO COMPETE

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I. INTRODUCTION

The tax treatment of covenants not to compete sold in conjunction with goodwill is an area of tax law fraught with uncertainty and confusion. This article will attempt to critically examine current judicial approaches and to explore and analyze the critical issue involved—the nature and function of a covenant not to compete and its relationship to goodwill. Upon completion of this analysis, an alternative method of tax treatment will be suggested.

When a covenant to refrain from competition is given in association with the sale of a business, either in sole proprietorship, partnership, or corporate form, the excess of the purchase price over the value of the tangible assets must be attributed either to the covenant or to some other intangible asset, usually goodwill. This attribution is of paramount concern to the tax status of vendor and vendee because the amount allocated to the covenant produces ordinary income for the covenantor-vendor and an amortization deduction for the covenantee-vendee, and the amount allocated to goodwill secures capital-gain treatment for the seller but no deduction for the buyer.

At present, the courts have dealt with agreements not to compete associated with the sale of a business in three ways: (1) by applying the

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'severability' theory, (2) by applying the test employed in *Wilson Athletic Goods Mfg. Co. v. Commissioner*,[1] and (3) by applying the test employed in *Carl Danielson v. Commissioner*.[2] For tax purposes there are three classes of covenants: 1) the "naked covenant," an agreement not to compete unaccompanied by the sale of a going business; 2) the "third party covenant," an agreement not to compete accompanied by a transfer of a going business, where the covenantor is not the one whose business is being transferred; and 3) a "seller's covenant," an agreement given by the operator of a going business in conjunction with the sale of assets and goodwill.

II. The Severability Theory

The severability theory (sometimes referred to as the "strong proof rule") which originated in *Toledo Newspaper Co.*,[3] is by far the most prevalent approach to be found in the current opinions of the courts. Its content and rationale are exemplified by the language of the court in *David H. Ullman*.[4] The second circuit, in affirming the Tax Court, stated that

> It is well established that the amount a purchaser pays to a seller for a covenant not to compete in connection with the sale of a business is ordinary income to the covenantor and an amortizable item for the covenantee unless the covenant is so closely related to a sale of goodwill that it fails to have any independent significance apart from merely assuring the effective transfer of the goodwill . . . .[5]
>
> The burden of proof in the Tax Court is on the taxpayer, and when the parties to a transaction . . . have specifically set out the covenants in the contract and have there given them an assigned value, strong proof must be adduced by them in order to overcome that declaration. The tax avoidance desires of the buyer and seller in such a situation are ordinarily antithetical, forcing them, in most cases, to agree upon a treatment which reflects the parties' true intent with reference to the covenants, and the true value of them in money.[6]

In *Ullman*, petitioners (sellers of the covenant) sold their stock in a laundry and linen supply business to a corporation and promised, for a fixed sum bargained for by the parties, not to compete. The court, applying the severability test, held that since the covenants were bargained for separately, and the taxpayers failed to prove that the cov-

1. 23 P-H Tax Ct. Mem. 845 (1954), *rev'd and rem'd*, 222 F.2d 355 (7th Cir. 1955).
2. 44 T.C. 549 (1965), *vacated and rem'd*, 378 F.2d 771 (3d Cir. 1967), *cert. denied*, 389 U.S. 858 (1967) (hereinafter cited as *Danielson*).
3. 2 T.C. 794 (1943).
4. 29 T.C. 129 (1957), *aff'd*, 264 F.2d 305 (2d Cir. 1959).
5. 264 F.2d at 308.
6. *Id.*

enants had no independent significance apart from the goodwill, the covenants were severable from the goodwill transferred and the consideration received for the covenants was taxable as ordinary income rather than as capital gain.[7] In *Aaron Michaels*[8] the parties failed to allocate a value to a covenant not to compete or to goodwill. The Tax Court held that where the covenant has not been dealt with as a separate item (as here) and

> accompanies the transfer of good will 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 purchaser the beneficial enjoyment of the good will which he has acquired, the covenant is regarded as nonseverable and as being in effect a contributing element to the assets transferred.[9]

Obviously, in the case of the execution of a naked covenant unaccompanied by the transfer of goodwill or any other asset, the covenant is a separate item and a fortiori "severable." It thus produces ordinary income to the seller and an amortization deduction to the buyer.[10] A generally recognized principle that evolved from early common law, however, holds that any covenant which suppresses competition by the covenantor, and which is not ancillary to a lawful contract and necessary to the protection of the covenantee, is void and unenforceable because it tends to create a monopoly or to unreasonably restrain trade, contrary to public policy.[11] To permit an amortization deduction of the payment for an illegal covenant to the buyer presupposes that his payments for the covenant are an ordinary and necessary business expense,[12] yet many decisions have held that where an otherwise deductible payment is not itself illegal under state law but is contrary to public policy, its deduction is disallowed.[13] Payments to secure an illegal covenant seem a fortiori contrary to public policy and therefore not deductible; however, this issue has apparently never been raised in tax cases.[14]

In the case of "sellers" and "third party" covenants, the courts, in applying the "severability" test, look primarily at whether the parties bargain over the covenant and allocate a part of the sale proceeds to it[15]

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7. *Id.* The court said that "[p]etitioners [taxpayers] were not in any real sense connected with that good will since they had little, if any, contact with customers."

8. 12 T.C. 17 (1949).

9. *Id.* at 19.

10. News Leader Co. v. Commissioner, 18 B.T.A. 1212 (1930), *acquiesced in*, IX-2 CUM. BULL. 44 (1930). *See* Taylor, *Covenants Not to Compete Consulting Arrangements, Adjustments to Purchase Price*, N.Y.U. 12TH INST. ON FED. TAX. 1047 (1954).

11. 36 AM. JUR. *Monopolies* § 50 (1941); United States v. Addyston Pipe & Steel Co., 85 F. 271 (1899).

12. INT. REV. CODE OF 1954, § 162(a).

13. S. SURREY & W. WARREN, FEDERAL INCOME TAXATION 246 (1961). *See* Harden Mort. Loan Co. v. Commissioner, 137 F.2d 282 (10th Cir. 1943).

14. *See* Taylor, note 10 *supra* at 1048.

15. *See, e.g.*, Aaron Michaels, 12 T.C. 17 (1949).

to determine if the covenant is severable from goodwill. A judicial gloss, however, has been added to the well-settled rule. The courts will defer only to a good faith allocation made by the parties, and in at least one case a court has ignored an allocation based purely on tax reasons.[16] If the allocation of value to the covenant is the product of arm's-length bargaining between the parties, the courts will generally not challenge it. The courts will, however, disregard an allocation that is so unrealistic as to constitute a sham, as for example where the agreement not to compete is devoid of economic value.[17]

A. *Critique of the "Severability" Theory*

The "severability" test has been severely criticized as illogical, evidentially narrow, and inconsistent in its application by the courts. The *ratio decidendi* in the cases applying the test is that since the buyer's and seller's tax motives are antithetical,[18] it is reasonable to assume that the parties would allocate a value to the covenant not to compete that is in accord with economic reality.

This approach obtains in other areas of the tax law, *e.g.*, the tax treatment of payments for goodwill by a partnership to a retiring or deceased partner's estate. Under Section 736(b) of the Code,[19] payments made by a partnership in liquidation of the interest of a retiring or deceased partner are considered incurred to purchase the former partner's interest in the assets; or under Section 736(a),[20] the payments are treated either as the former partner's distributive share of the partnership in-

16. *See* Harold J. Burke, 18 T.C. 77 (1952), where the parties made no allocation except as an apparent tax consequence afterthought. In *George H. Payne*, 22 T.C. 526 (1954), no separate consideration for the covenant was discussed in the negotiations or delineated in the orginal sales contract. The Tax Court held that the covenant was ancillary, and it disallowed amortization even though a value was ascribed to it in an amended contract on the ground that such modification was an afterthought for the tax convenience of the purchasers. *Accord*, Harry Shwartz, 29 P-H Tax Ct. Mem. 1419 (1960); Dauksch v. Busey, 125 F. Supp. 130 (D.C. Ohio 1954).

17. *See* Barnet, *Covenants Not to Compete: Their Effects Upon the Covenantor and Covenantee*, N.Y.U. 18TH INST. ON FED. TAX. 861, 865-68 (1960); Maddrea, *Both Buyer and Seller Face Traps in Covenants Not to Compete*, 6 J. OF TAX. 86, 87 (1957). For example, in Lee Ruwitch, 22 T.C. 1053 (1954), petitioner-lessor sold the lease and building in a shopping center located in Los Angeles and agreed not to compete for $22,000. Both parties knew that the seller was planning to leave for Florida and had only this one experience in building houses. The court stressing these facts held that the consideration paid was for the lease, not the covenant, and was taxable as capital gains. In Andrew A. Monaghan, 40 T.C. 680 (1963), the court, in determining whether the covenant had a separate value, pointed not only to the fact that the final contract of sale did not contain the allocation of value to covenant, but also to the fact that the covenantor-seller was ill, tired, and had no intention of competing. *Accord*, Radio Medford, Inc. v. United States, 150 F. Supp. 641 (D.C. Ore. 1957).

18. If the covenant is deemed severable from goodwill, the consideration paid for it produces ordinary income for the covenantor and may be amortized over its useful life by the buyer-covenantee; if the covenant is not severable from goodwill, the consideration paid for it produces capital gain and it is not amortizable by the buyer.

19. INT. REV. CODE OF 1954, § 736(b).

20. INT. REV. CODE OF 1954, § 736(a).

come[21] or as a "guaranteed payment."[22] If 736(b) applies, the payments may result in capital gain or loss to the retiring partner,[23] and are not deductible by the partnership composed of the remaining partners.[24] If 736(a)(1) applies, the payments will continue to have the same income character in the hands of the former partner as the partnership income out of which such payments are made[25] and are not includible in the remaining partners' distributive share of partnership income.[26] If 736(a)(2) applies, the payments treated as "guaranteed" will be ordinary income to the former partner[27] and result in a deduction to the partnership.[28] Payments for the former partner's goodwill will be treated as a 736(b) payment if the partnership agreement so provides; otherwise, the payments for goodwill will be treated as part of the distributive share of income or as a guaranteed payment.[29] Any "reasonable" allocation or nonallocation to goodwill in an arms-length transaction by the parties will be regarded as correct and not disturbed,[30] apparently because of the conflicting tax motives of the withdrawing and remaining partners.[31]

This reliance on the allocations of taxpayers with conflicting tax interests in order to measure the economic value of a covenant not to compete or the goodwill of a former partner seems unsound. It unrealistically assumes equal tax knowledge and bargaining power between the parties. In the case of covenants not to compete, the courts applying the severability rule also rely on such allocations to resolve the more crucial issue of whether the sale of a covenant not to compete in conjunction with goodwill should be treated as a capital or ordinary income transaction. In resolving this issue, the fundamental inquiry, in this writer's view, should be directed at the nature and function of a covenant not to compete and its relationship to goodwill.[32] Consequently, a formalistic test that merely looks at how the parties treat a covenant not to compete in their contract of sale is not responsive.[33] The fact that parties bargain over a covenant does not relate to the function or economic nature of the covenant, which is to protect goodwill. Perhaps

21. INT. REV. CODE OF 1954, § 736(a)(1).
22. INT. REV. CODE OF 1954, § 736(a)(2).
23. INT. REV. CODE OF 1954, §§ 731(a), 732(a).
24. Treas. Reg. § 1.736-1(a)(2) (1956).
25. INT. REV. CODE OF 1954, § 702.
26. Treas. Reg. § 1.736-1(a)(4) (1956).
27. INT. REV. CODE OF 1954, § 707(c).
28. Treas. Reg. § 1.736-1(a)(4) (1956).
29. INT. REV. CODE OF 1954, § 736(b)(2)(B).
30. Treas. Reg. § 1.736-1(b)(3) (1956).
31. V. Zay Smith, 37 T.C. 1033 (1962), *aff'd*, 313 F.2d 16 (10th Cir. 1963); *contra*, Joseph V. Meister, 29 P-H Tax Ct. Mem. 576 (1960), *aff'd*, 302 F.2d 54 (2d Cir. 1962).
32. *See* discussion at pp. 16-23 *infra*.
33. It is quite conceivable, for example, that a seller of a highly personalized business (so that there is a strong goodwill element) has no intention of competing (so that the income element is weak), yet he bargains over and agrees to a separate consideration for the covenant.

the formulators of the severability theory did examine the nature or function of a covenant not to compete and concluded that the consideration paid for such a covenant is theoretically ordinary income, but that it cannot be segregated as a practical matter from the proceeds received for the remainder of the business when the parties fail to make an allocation between the covenant and goodwill. Even if this was the rationale for the theory, it was never expressed in any of the cases except possibly *Rainier Brewing Co.*[34]

Under contract law a covenant is enforceable only if executed for the purpose of protecting the goodwill that is transferred.[35] Under the severability test, however, the two-fold result is that only covenants, which may be unenforceable as contrary to the spirit of free trade are accorded separate tax treatment, and those persons who induce or demand such "tainted" promises reap both the nontax benefit of restraint of trade and the tax benefit of an amortization deduction.[36]

In addition, the fact that often the courts have not disturbed the somewhat unrealistic allocations by parties has enabled those parties receiving a modicum of tax advice to manipulate an allocation which is to their net tax advantage, and which may bear no relationship to the economic reality of the situation.[37] For example, a seller-covenantor in a low-income bracket could arrange with a purchaser-covenantee who anticipates high business income to apportion a high figure to the covenant. The tax savings to the buyer in the form of a high amortization deduction could offset the tax loss to the seller, especially if the seller were to avoid bunching his income by having the payments for the covenant received in installments.[38] An adjustment of the purchase price could then be made by the purchaser so that the seller could share the tax benefits. To avoid treatment of the transaction as a sham,[39] the parties could make an allocation when negotiations begin and have the periodic payments conditoned upon compliance with the covenants.[40]

The strongest objection to the "severability" approach has been the uncertainty in the law created by the courts' confused and inconsistent application of the test.[41] Most courts applying the severability test have

34. 7 T.C. 162, 180 (1946), *aff'd*, 165 F.2d 217 (9th Cir. 1948).

35. A. CORBIN, *Contracts* § 1387 (1960); 38 C.J.S. *Goodwill* § 13 (1943).

36. *See* discussion at p. 3 *supra.*

37. *See* United Finance & Thrift Corp. of Tulsa, 31 T.C. 278 (1958), *aff'd*, 282 F.2d 919 (4th Cir. 1960); Clarence Clark Hamlin Trust, 19 T.C. 718 (1953), *aff'd*, 209 F.2d 761 (10th Cir. 1954); Gazette Tel. Co., 19 T.C. 692 (1953), *aff'd*, 209 F.2d 926 (10th Cir. 1954). But if the allocation is so unrealistic as to constitute a sham, the courts will challenge it. *See* p. 4 *supra.*

38. When a seller is paid a lump sum for the covenant, he is taxed on the entire amount in the year of receipt whether on the cash or accrual method, under the claim of right doctrine.

39. *See* Harold Burke, 18 T.C. 77 (1952); *see* note 16 *supra.*

40. This method was effective in Carboloy Co., 2 T.C. 1267 (1943).

41. *See* Taylor, note 10 *supra* at 1062; Queenan, *Taxation of Covenants Not to Compete in the Sale of a Business*, 4 B.C. IND. & COMM. L. REV. 267, 280, 284 (1963).

respected the parties' allocation or lack of allocation of value to a covenant if made in good faith and in arm's-length negotiations, and absent strong proof to vitiate such allocation. There have, however, been cases where the parties, in good faith, realistically treated the covenant in a separate and severable manner, yet their allocation was denied. In *Sidney Alper*,[42] the sellers of a luncheonette executed a covenant not to compete, which the contract recited to be in consideration of $42,235. The evidence, accepted by the court, conclusively pointed to the fact that the buyer would not have bought the business without the covenant. Nevertheless, the court applied the severability test and concluded that the covenant was incident to the goodwill.[43] Similarly, *Toledo Newspaper Co.*[44] held that despite a specified consideration for the covenant, the taxpayer corporation accrued only capital gain because the covenant was "unnecessary in order to prevent the seller from destroying the value of the goodwill . . . transferred."[45] The case of *Toledo Blade Co.*,[46] following *Toledo Newspaper Co.*, held that the buyer incorrectly amortized the covenant, which was indivisible from the goodwill.

Sometimes the courts have disregarded a good faith, arm's-length allocation by the parties and have substituted one of its own. In *Max Levine*,[47] a taxpayer sold his fuel oil business and, at the behest of the buyer and with the approval of his tax accountant, agreed to an allocation of $35,000 in the sales agreement to a covenant acknowledged to be very valuable by the Tax Court. The Third Circuit, espousing the severability test, affirmed the Tax Court's reallocation of 50 percent ($17,500) to goodwill and 50 percent to the covenant.[48]

Under the "severability" theory, if buyer and seller fail to allocate part of the consideration paid to a covenant not to compete, the covenant is deemed inseverable from the goodwill absent strong proof to the contrary. Nevertheless, frequently under these circumstances courts have held the covenant to be severable. In both *Rodney B. Horton*[49] and *Melvon C. Miller*,[50] the courts, after acknowledging the presence of goodwill

42. 25 P-H Tax Ct. Mem. 1156, 1157 (1956).

43. There was no mention of the seller-shareholder lacking a direct proprietary interest in the transferred assets. This may have influenced the court; *see* discussion at p. 000, *infra*.

44. 2 T.C. 794 (1943).

45. *Id.* at 802. The Court was influenced by the fact that the seller possessed a direct proprietary interest. *See* the discussion at p. 8 *infra*. The Court also viewed as a whole the consideration paid for both tangible and intangible assets. Williams v. McGowan, 152 F.2d 570 (2d Cir. 1945), was not yet the law.

46. 180 F.2d 357 (6th Cir. 1950), *cert. denied*, 340 U.S. 811 (1950).

47. 324 F.2d 298 (3d Cir. 1963), *aff'g*, 31 P-H Tax Ct. Mem. 410 (1962).

48. *Id. See* Fox & Hounds, Inc., 31 P-H Tax Ct. Mem. 1344 (1962), where the court disregarded the parties' allocation of consideration to a bargained-for covenant and attributed the consideration to goodwill, though goodwill did not appear as an asset in any of the balance sheets, records, or even as an item in the sales contract; and Joseph Faulkner, 25 P-H Tax. Ct. Mem. 154 (1956), where the Tax Court found a separately bargained-for covenant to be inseverable from goodwill.

49. 13 T.C. 143 (1949), *Commissioner's appeal dismissed*, 180 F.2d 354 (10th Cir. 1950).

50. 33 P-H Tax Ct. Mem. 2079 (1964).

among the assets transferred, arbitrarily assigned equal amounts of consideration to both the covenant and goodwill,[51] even though the parties failed to make an allocation. Pursuant to a contract, the taxpayer-purchaser in *Williamson & Waite, Inc. v. United States*[52] acquired the name-goodwill, customer list, rights to renewal premiums, and office equipment of an insurance agency, along with a covenant not to compete, for a total unallocated consideration of $25,000. The district court held that the covenant was worth $18,750 and could be amortized by the buyer. In *Wilson Athletic Goods Mfg. Co.*,[53] the Seventh Circuit reversed the Tax Court and held that the purchaser could amortize a covenant even though it was not given a specific value in the purchase agreement. The court cited *Clarence Clark Hamlin Trust*[54] (which rigidly followed the severability theory), but stated that "it is immaterial whether the contract did or did not define a specified amount as the value of the covenant."[55]

For an allocation of the parties to be respected by the courts it should bear some semblance of reality, yet some courts applying the "severability" rule have accepted highly unrealistic apportionments. In *Clarence Clark Hamlin Trust*,[56] the Gazette Telephone Company published a newspaper in which the taxpayer owned stock. A prospective purchaser stated in a letter to taxpayers that he wanted part of the purchase price of the stock to be in the form of a covenant not to compete so that the new corporation could get an amortization deduction. The taxpayers accepted the purchaser's allocation of $150 per share for the stock and $50 per share for the covenant with very little discussion, on the premise that the allocation would make no difference to them. The court rejected the argument that the entire sum was in reality paid for the stock, and held that the covenant produced ordinary income, stating that even if there was little discussion on the allocation it was enough for tax purposes that the parties understood the contract and entered into it.[57] In *Gazette Tel. Co.*[58] the buyer was permitted to amortize the covenant.

Another area of confusion associated with the severability test is the inconsistent judicial treatment of "third party covenants." Some courts hold that if the covenantor has no direct proprietary interest in

51. Justice Black in *Horton* may have been influenced by the fact that a contract provision reduced percentage payments 50 percent in the event that the seller-convenantor were to die or cease to be a resident of the State; however, no mention of this provision is made in the opinion.

52. 62-1 U.S. Tax Cas. ¶ 9163 (D.C. Ind. 1961).

53. 222 F.2d 355 (7th Cir. 1955), *rev'g & rem'g*, 23 P-H Tax Ct. Mem. 845 (1954).

54. 19 T.C. 718 (1953), *aff'd* 209 F.2d 761 (10th Cir. 1954).

55. 222 F.2d 355, 357 (7th Cir. 1955). *See also* Christensen Machine Co. v. United States, 50 F.2d 282 (Ct. Cl. 1931).

56. 19 T.C. 718 (1953), *aff'd*, 209 F.2d 761 (10th Cir. 1954). *See also* the companion case of Gazette Tel. Co., 19 T.C. 692 (1953), *aff'd*, 209 F.2d 926 (10th Cir. 1954).

57. 19 T.C. at 725. The court seemed to ignore the petitioners' evidence bearing on the value of the covenant, which petitioners contended was zero because none of them intended to engage further in the newspaper business and there was doubt about the legal capacity of the Hamlin Trust and El Pomar Investment Co. to do so.

58. 19 T.C. 692 (1953), *aff'd*, 209 F.2d 761 (10th Cir. 1945).

the goodwill being sold (as when a shareholder, officer, or employee executes a covenant in conjunction with the sale of corporate goodwill), then the covenant is incapable of co-existing with goodwill and maintains its independent nature; thus its sale always produces ordinary income for the covenantor.[59] Other courts regard this distinction as unsound.[60] The latter view seems more logical; whether a covenantor sells stock (shareholder) or assets (proprietor), his promise is primarily of value in protecting the goodwill sold. The differences arising from the status of the covenantor are differences not in the purpose or function of the covenant but in the particular circumstance in which its value is ascertained.[61]

A final inconsistency in the judicial application of the "severability" theory is the treatment accorded a transaction involving a covenant when there exists a disparity in the tax knowledge of the parties. In *Clarence Clark Hamlin Trust*[62] the purchaser prevailed upon the seller to assign a high value to a covenant to help them taxwise. The sellers agreed because they thought the allocation was of no consequence, and the court upheld the allocation. However, in *John W. Shleppey*,[63] a purchaser induced a tax-ignorant seller to consent to a high apportionment of value to a covenant and the Tax Court ignored it.

B. *Substance Versus Form*

One may ponder why the severability theory has been so shrouded with confusion and why courts have taken such divergent paths in applying it. The explanation may be the problem of substance versus form, a problem certainly not new to the tax law. It has cropped up in virtually every area of tax law: *e.g.*, sales to establish losses; transactions between controlling shareholders and corporations; corporate reorganizations and the "business purpose" test; the distinguishing of rents and royalties from sales; the recognition or non-recognition of the corporate entity; and transactions producing constructive income.[64] Numerous Supreme Court decisions have enunciated the principle that substance will prevail over form.

> Questions of taxation must be determined by viewing what was actually done, rather than the declared purpose of the participants; and when applying the provisions of the Sixteenth Amendment and income tax laws enacted thereunder, we must regard matters of substance and not mere form.[65]

59. *See* David H. Ullman, 29 T.C. 129 (1957), *aff'd*, 264 F.2d 305 (2d Cir. 1959); Pickering & Co., 33 P-H Tax Ct. Mem. 515 (1964) (appeal dismissed).

60. *See* Sidney Alper, 25 P-H Tax Ct. Mem. 1156 (1956); George Payne, 22 T.C. 526 (1954).

61. Note, *Tax Treatment of Covenants Not to Compete: A Problem of Purchase Price Allocation*, 67 YALE L.J. 1260, 1265 (1958).

62. 19 T.C. 718 (1953), *aff'd*, 209 F.2d 761 (10th Cir. 1954).

63. 32 P-H Tax Ct. Mem. 897 (1963).

64. *See* cases collected in 5 AM. FED. TAX. SERV. ¶¶ 41,000-20 (1967).

65. Weiss v. Stearn, 265 U.S. 242 (1924); *see* Gregory v. Helvering, 293 U.S. 465 (1935).

Furthermore, the Court specifically related the principle to the issue of capital gain versus ordinary income discussed in *Corn Products Refining Co.*[66]

A formalistic approach to problems, however, often contributes simplicity, consistency, and objectivity to the judicial decision-making process, especially in relation to substance versus form. Under the severability doctrine, substance is a complex of many factors (allocation of parties, status of covenantor, covenantor's ability and desire to compete, mode of payments, tax knowledge of parties, etc.). Consequently, some judges who are oriented to "substance" have held that treating the allocation of the parties as the primary factor is evidentially narrow;[67] that the proprietary status of the covenantor is irrelevant;[68] that the assignment of value to the covenant must be realistic;[69] that the tax knowledge of the parties is relevant;[70] and that the capacity and intent of the covenantor is relevant.[71] Other judges, who are oriented to "form," have held that the way in which the covenant is treated in the sales agreement is of paramount importance;[72] that the tax knowledge of the parties is irrelevant;[73] and that the proprietary status of the covenantor is relevant.[74] As an outgrowth of this tension between "substance" and "form," two courts diametrically opposed in views, the Seventh Circuit in *Wilson Athletic Goods Mfg. Co.*[75] (substance) and the Third Circuit in *Carl Danielson*[76] (form) have formulated a new test to determine the tax consequences of selling a covenant not to compete in association with goodwill, under the guise of applying the "severability" theory.

1. WILSON TEST (SUBSTANCE OVER FORM)

In *Wilson*, the taxpayer had for many years been engaged in purchasing athletic shoes from various companies and selling them under the "Wilson" label. Taxpayer company then purchased a shoe manufacturing concern to eliminate its reliance on outside suppliers, and insisted on having a covenant included in the purchase agreement. The Wilson Company had its own means and methods of distribution, its own customer lists, and its own brand names, so that it was not as interested in purchasing goodwill as it was in obtaining a noncompetition agreement;

66. 350 U.S. 46 (1955).

67. *See* Barnet, note 17 *supra* at 873.

68. *See e.g.*, George Payne, 22 T.C. 526 (1954).

69. *See e.g.*, Joseph Meister, 29 P-H Tax Ct. Mem. 576 (1960), *aff'd*, 302 F.2d 54 (2d Cir. 1962).

70. *See e.g.*, John W. Shleppey, 32 P-H Tax Ct. Mem. 897 (1963).

71. *See e.g.*, Lee Ruwitch, 22 T.C. 1053 (1954).

72. *See e.g.*, Pickering & Co., 33 P-H Tax Ct. Mem. 515 (1964) (appeal dismissed).

73. *See e.g.*, Clarence Clark Hamlin Trust, 19 T.C. 718 (1953), *aff'd*, 209 F.2d 761 (10th Cir. 1954).

74. *See e.g.*, David H. Ullman, 29 T.C. 129 (1957), *aff'd*, 264 F.2d 305 (2d Cir. 1959).

75. 222 F.2d 355 (7th Cir. 1955), *rev'g & rem'g*, 23 P-H Tax Ct. Mem. 845 (1954).

76. 378 F.2d 771 (3d Cir. 1967), *rev'g & rem'g* 44 Tax Ct. 549 (1965), *cert. denied*, 389 U.S. 858 (1967).

however, the parties failed to allocate a value to the covenant in the contract. The Tax Court, applying the "severability" rule, held the covenant to be severable from goodwill. The Seventh Circuit reversed and remanded:

> But in tax matters we are not bound by the strict terms of the agreement; we must examine the circumstances to determine the actualities and may sustain or disregard the effect of a written provision or of an omission of a provision, if to do so best serves the purpose of the tax statute . . . . The incidence of taxation depends upon the substance of the transaction . . . . Consequently, it is immaterial whether the contract did or did not define a specified amount as the value of the covenant.[77]

The *Wilson* approach has been followed by the Ninth Circuit in *Annabelle Candy Co.*,[78] and by the Tax Court in occasional memorandum decisions.[79]

The severability test has often been criticized for giving too much weight to a single evidentiary factor—the presence or absence of an allocation of value to a covenant. The *Wilson* approach certainly is as refined and broad, in an evidentiary sense, as the "severability" approach is crude and narrow, and even if one concludes that a covenant should always be treated as capital in nature or always as "ordinary income" in nature there will always be that hard case not amenable to the general rule. This would be the situation in which the case-by-case *Wilson* approach would be most responsive.

It would appear that a logical extension of the "substance over form" view would be for a court not only to accept or reject an allocation of the parties, looking to the substance of the transaction (as was done in *Wilson*), but also to reallocate where all the facts and circumstances indicate that both the covenant and goodwill have value.[80] One might argue that such reallocation involves the courts in complicated questions of valuation which they can only resolve by making arbitrary allocations between covenants not to compete and goodwill.[81] Yet the supporters of the

77. 222 F.2d 355, 357 (7th Cir. 1955), *rev'g & rem'g*, 23 P-H Tax Ct. Mem. 845 (1954). It is interesting to note that the court cites *Hamlin*, which rigidly followed the severability rule.

78. 314 F.2d 1 (9th Cir. 1962), *aff'g*, 30 P-H Tax Ct. Mem. 953 (1961).

79. John T. Fletcher, 34 P-H Tax Ct. Mem. 1633 (1965). *See also* George H. Wilcox, 37 P-H Tax Ct. Mem. 771 (1968); Harry Shwartz, 29 P-H Tax Ct. Mem. 1419 (1960).

80. The "*Cohan* rule" [Cohan v. Commissioner, 39 F.2d 540 (2d Cir. 1930)] has been used by the Commissioner to arrive at a fair approximation of allowable deductions absent sufficient evidence to support exact allowances. The rule has been applied by the Tax Court to reallocate between covenants not to compete and goodwill; *e.g.*, Max Levine, 31 P-H Tax Ct. Mem. 410 (1962), *aff'd*, 324 F.2d 298 (3d Cir. 1963) (50-50 allocation); James M. Herndon, 31 P-H Tax Ct. Mem. 1115 (1962).

81. In Max Levine, 31 P-H Tax Ct. Mem. 410 (1962), *aff'd*, 324 F.2d 298 (3d Cir. 1963), and Melvon C. Miller, 33 P-H Tax Ct. Mem. 2079 (1964), the Tax Court conveniently allocated one-half to the covenant and one-half to goodwill.

Cohan-Wilson approach[82] would argue, as did Judge Murdock in *Toledo Blade Co.*, that "[t]he one sure way to do injustice in such cases is to allow nothing whatever upon the excuse that we cannot tell how much to allow."[83] Furthermore, the proponents of the *Cohan-Wilson* approach might point to the *Williams v. McGowan* rule requiring the sale of a going concern to be comminuted into its fragments, with the fragments to be separately matched against the definition in sections 1117, 1221 and 1231.[84] The argument would be that since *Williams v. McGowan* the Commissioner and the courts have become involved in the valuation of capital, both ordinary and section 1231 assets, especially where the buyer and seller have failed to set forth an allocation in their agreement. However, those opposing the *Wilson* view would contend that a situation involving a covenant is not one where the directive of the *Williams v. McGowan* case applies, because the more important question involved is not the price or market value of the covenant but whether the covenant should be treated as a capital or ordinary asset.[85] To determine what portion of the selling price is to be allocated to a particular asset one may look at objective and easily ascertainable criteria of value[86] such as market value, book value, cost, and at how the parties treated the particular item in their sales agreement. To determine tax consequences of the sale of a covenant with good will, however, one applying the *Wilson* test would also be compelled to examine more amorphous factors, such as the nature and function of the particular covenant and the circumstances of its creation.

The strongest objection to the *Wilson* approach would appear to be that the Commissioner and courts would, in each case, be required to examine a profusion of intangible factors to reach an allocation decision, and as a consequence, increased revenues may be outweighed by increased investigatory expenses; the conquest of substance over form may be outweighed by needless uncertainty and a disruption of honest tax planning.

2. CARL DANIELSON TEST (FORM OVER SUBSTANCE)

At the other end of the "substance versus form" spectrum is *Carl Danielson*,[87] where taxpayers who were shareholders in a small loan business agreed to sell their stock to Thrift Investment Corporation (herein-

82. *See e.g.*, Grogan, *Planning for the "Excess" Cost of a Purchased Business; Allocation Problems*, 19 J. OF TAX. 332, 334 (1963).

83. 11 T.C. 1079, 1087 (1948) (dissenting opinion), quoting Commissioner v. Maresi, 156 F.2d 929, 931 (2d Cir. 1946) (opinion of Handin, J.).

84. 152 F.2d 570, 572 (2d Cir. 1945).

85. Note, *Considerations in Applying the Rule of Williams v. McGowan*, 13 TAX. L. REV. 369, 381 (1958).

86. *See* Rev. Rul. 55-79, 1955-1 CUM. BULL. 370

87. 44 T.C. 549 (1965), *rev'd & rem'd*, 378 F.2d 771 (3d Cir. 1967), *cert. denied*, 389 U.S. 858 (1967).

after called Thrift) for $374 per share and each shareholder agreed to execute a covenant not to compete. The covenants were of little economic value because the business was being run by a manager and none of the taxpayers were acquainted with the small loan company business. Before the closing, Thrift officials had unilaterally decided to allocate roughly $152 of the purchase price per share to the covenant and the remaining $222 to the stock. At the closing, they presented the covenants and sales agreement, including the allocation, to the taxpayers for signature. When the taxpayers questioned the unexpected and large amounts allocated to the covenants, the Thrift officials explained that the allocations were to Thrift's tax benefit but did not explain to the shareholders that these amounts would be taxable to them as ordinary income. The taxpayers, after a brief discussion, signed the documents on advice of counsel. The Tax Court, applying the "severability" rule, held that the covenants were not realistically bargained for by the parties, and that the taxpayers had presented strong proof to overcome the contract allocation.[88] Consequently, the taxpayers were allowed to report the entire gain from the sale of their shares as capital gain. In a closely divided opinion, the Third Circuit vacated and remanded, holding that even if the sellers could prove (and the Tax Court so found) that the allocation had no economic reality or independent basis in fact, this proof would, in the absence of fraud, duress, mistake, or undue influence, be irrelevant. The court stated "[W]e adopt the following rule of law: a party can challenge the tax consequences of his agreement as construed by the Commissioner only by adducing proof which in an action between the parties to the agreement would be admissible to alter that construction or to show its unenforceability because of mistake, undue influence, fraud, duress, etc."[89] The *ratio decidendi* of the decision is that, without such a rule, the parties to contracts allocating a specific value for the covenant would be able unilaterally to reform the agreement to their benefit. Tax results in such cases would no longer be predictable, and the Commissioner would be hindered in collecting taxes because he would be required to meet the parties' separate interpretations of their agreement.

The *Danielson* result, as dissenting Judge Staley points out, clearly disregards repeated declarations by the Supreme Court that substance should prevail over form.[90] In addition, *Danielson* ignores what should be the fundamental inquiry in evolving any test in this area—that is, the nature and function of a covenant not to compete and its relationship to good will.[91] Merely determining the value of a covenant not to compete

88. 44 T.C. at 556. *Cf.* David H. Ullman, 29 T.C. 129 (1957), *aff'd*, 264 F.2d 305 (2d Cir. 1959).

89. 378 F.2d at 775. A rule very similar to this was set forth in John Rogers v. U.S., 4 Am. Fed. Tax R.2d 5770 (D.C. Nev. 1959), *aff'd*, 290 F.2d 501 (9th Cir. 1961), where the severability test was applied very rigidly.

90. 378 F.2d at 779-80.

91. *See* discussion at p. 16 *et seq. infra.*

does not decide whether it should be treated, when sold, as a capital or an ordinary income transaction.

Even if it is decided that a bargained-for covenant with a fixed consideration ascribed to it in a contract produces ordinary income to the seller and an amortization deduction for the buyer (as is generally presumed in the severability test), the *Danielson* approach is not too helpful in determining the actual economic or business value of the covenant. This is for the reason that it invites, to an even greater extent than the "severability" test, tax manipulation by the parties.[92]

The language in the *Danielson* opinion suggests that an allocation of value in a contract between a covenant and good will should, as a matter of tax law, be no less binding on the parties than is, as a matter of contract law, the setting of the purchase price. In a contract of sale, courts respect and enforce the value (selling price) of that which is sold, as determined by the parties in their agreement. This may be due to the fact that when two parties bargain over sales price their conflicting interests will assure a figure that is reasonably fair to both; however, even if the agreed upon price is outlandish, the courts will generally enforce the terms of the contract absent fraud or mistake because of the reliance upon these terms by the promisee.[93] However, the contract situation is not wholly analogous to the situation involving a covenantor and covenantee who allocate a value to the covenant in a sales agreement. It is true that if the parties allocate a value to the covenant, the covenantee relies upon such allocation for an amortization deduction; and similarly, if the parties fail to allocate, the covenantor relies upon the absence of an allocation for capital gain treatment. Indeed, at least one court has indicated that if one party subsequently denies the allocation or nonallocation for tax reasons and thus deprives the other party of his anticipated favorable tax treatment, this may be treated as a breach of contract.[94]

The situation involving covenantor and covenantee making an allocation, however, is unlike the contract situation in that a third party is involved—the Commissioner, who represents the public interest in tax revenues. In a contract, the interests of the buyer and seller are antithetical (buyer wants a low purchase price and seller wants a high one); but a covenantor and covenantee, with some tax advice, can resolve their tax conflict[95] and thus adversely affect the interest of the public in maximizing its revenues. The majority in *Danielson* should, it seems, be more concerned about this danger to public resources than the alleged danger to revenues resulting from the parties espousing inconsistent interpretations on the meaning of their contract. The argument of the majority, that to permit one party to refute the allocation "would be in effect to

92. *See* discussion at p. 5 *supra*.
93. *See* 1 CORBIN, CONTRACTS §§ 126, 127 (1963).
94. Stern & Co. v. State Loan & Fin. Corp., 205 F. Supp. 702, 705-06 (D.C. Del. 1962).
95. *See* discussion at p. 5 *supra*.

grant . . . a unilateral reformation of the contract with a resulting unjust enrichment,"[96] is not consonant with case-law principles on the doctrine of unjust enrichment.[97] It is true that permitting the objecting party to obtain a tax benefit by challenging the agreed upon allocation may be detrimental to the other party whose tax position is more vulnerable to an attack by the Commissioner. However, the alleged unjust enrichment of the objecting party and concomitant damage to the other contracting party is due not to the action of the objecting party but to the action of the Commissioner, who is a third party and thus a stranger to the contract.

Even in a strict evidentiary sense, the *Danielson* rule seems unsound and against the weight of precedent. The rule, substantially equivalent to the parol evidence rule, prohibits the admission of parol and other extrinsic evidence to vary or contradict the terms of the written contract. "The purpose of the parol evidence rule is to carry out the presumed intention of the parties who have put their contract in written form, thus to achieve certainty and finality as to their rights and duties and to exclude fraudulent and perjured claims."[98] The Tax Court, refusing to follow *Danielson* in a recent decision, points out that one of the historic reasons for the rule—protection for the party to the agreement who changes his position in reliance upon its terms—is never present in a contest between the taxing authority and one of the parties to the questioned agreement.[99] Moreover, under the rule, the dissent in the *Danielson* case points out that it would be possible, in view of the difficult burden of showing fraud, for "knowledgeable buyers [to] engage in questionable and sharp deals to secure the advantages of such covenants, and the majority's rule will shield their agreements."[100] This in fact did happen in *Danielson*, but a reading of the cases has not shown that parties, without such a rule, have been able unilaterally to reform their agreements by attacking them in order to avoid unfavorable tax consequences.[101] The strange result is that the *Danielson* rule encourages deception, if not outright fraud, which is the very evil it was designed to prevent.

Furthermore, notwithstanding a denial in the majority opinion, the *Danielson* rule is clearly against the weight of precedent. The general rule is that since substance rather than form is controlling in tax law, the

96. 378 F.2d at 775.

97. *See* RESTATEMENT OF RESTITUTION § 1 (1937).

98. L. SIMPSON, CONTRACTS § 98 (2d ed. 1965). For comprehensive treatment of the parol evidence rule, *see* 3 CORBIN, CONTRACTS §§ 573-96 (rev. ed. 1960).

99. J. Leonard Schmitz, 51 T.C. 214 (1968). In this case, unlike *Danielson*, the proceeding was consolidated so that both the buying and selling parties were before the court, and the Commissioner, in the position of a "stockholder," merely asked that the interpretation of the agreement be consistent as to each of the parties. However, the court indicated it was not influenced by this fact in its holding that the *Danielson* rule did not apply. *Id.* at 221, 222. It is interesting to note that thus far none of the other circuit courts have ruled on the *Danielson* degree of proof rule.

100. 378 F.2d at 782.

101. *See, e.g.*, Clarence Clark Hamlin Trust, 19 T.C. 718 (1953), *aff'd*, 209 F.2d 761 (10th Cir. 1954).

standard rules of evidence are restricted in application. The parol evidence rule does not apply to transactions involving a third party,[102] and where the Commissioner was neither a party nor privy to a written instrument a taxpayer may introduce evidence at variance with its terms in order to show the real nature of the transaction.[103]

Proponents of the *Danielson* rule[104] suggest that the rule will ease the administrative burden of the Commissioner in collecting taxes. The new rule would eliminate the vagueness of the current standard and thus discourage taxpayers from risking court action. It would also obviate the need of the Commissioner to litigate one party's claim without certainty that the result will be applied consistently to the other party, since the statute of limitations may have run or the litigation may have arisen in a different forum which can reach a different result on the same facts.[105] Moreover, the *Danielson* result would foster an increased predictability of the tax consequences associated with the sale of a covenant not to compete. However, both the advantages of eliminating difficulties for the Commissioner in the collection of taxes and that of creating tax certainty can be achieved by the adoption of a different hard-and-fast rule—to always treat the proceeds from the sale of covenants as part of the proceeds from the sale of goodwill—which, as we shall see, is the rule most responsive to the nature and function of a covenant and its relationship to goodwill.[106]

III. Nature and Function of Covenant Not to Compete and Goodwill

Having examined and criticized the present state of the law, focus shall be on alternatives. The threshold question in deciding how the sale of a covenant not to compete should be treated should be whether the

102. *See* cases collected in 5 Am. Fed. Tax. Serv. ¶ 39,235 (1968).

103. *See* Clarence Clark Hamlin Trust, 19 T.C. 718, 724 (1953), in which the Tenth Circuit affirmed this principle without discussion. Occasionally, in tax cases *not involving covenants*, the Commissioner has been successful in preventing a taxpayer from using parol evidence to contradict the terms of his own agreement in order to obtain a tax advantage. *See, e.g.*, Sullivan v. United States, 363 F.2d 724 (8th Cir. 1966). However, the courts have generally proscribed invocation of the parol evidence rule by the Commissioner on the ground (expressed in *Clarence Clark Hamlin Trust*) that the parol evidence rule cannot be utilized by a third party (the Commissioner representing the United States, which is a stranger to the contract). *See, e.g.*, Haverty Realty & Investment Co., 3 T.C. 161, 167 n.2 (1944) (citing additional cases).

It is interesting to note that in Thomas Yandell v. United States, 208 F. Supp. 306 (D.C. Ore. 1962), *aff'd*, 315 F.2d 141 (9th Cir. 1963), the lower court, which was so formalistic in its approach as to resemble *Danielson*, stated in dictum, "the above statutes and rules [parol evidence and best evidence rules] of evidence would not prevent the plaintiff, (taxpayer in refund suit) where a third party is involved, such as here, [the Commissioner], from introducing evidence as to the true nature of the agreement." *Id.* at 308.

104. *See, e.g.*, Comment, *The Danielson Rule on the Tax Consequences of a Covenant Not to Compete*, 116 U. Pa. L. Rev. 517, 524 (1968).

105. Brief for Appellant, Commissioner, at 12, Commissioner v. Danielson, 378 F.2d 771 (3d Cir. 1967).

106. *See* discussion at pp. 20-22 *infra*.

sale of such a covenant in conjunction with goodwill ought to be viewed as a capital or an ordinary income transaction. A capital gain or loss is a gain or loss from the sale or exchange of a capital asset. All other gains or losses are taxed at ordinary income rates. In deciding whether a disposition of property constitutes a capital gain or ordinary income transaction, the Supreme Court and the lower courts have not rigidly relied upon the statutory definitions of Sections 1221 and 1232, nor have they blindly relied upon the treatment accorded to a transaction by the parties involved (contrary to what has resulted under the severability theory). Rather, they have laid bare the economic substance and reality of a particular transaction and probed the nature and function of the assets involved.[107] Therefore, before concluding with an alternative to the "severability," *Wilson* and *Danielson* approaches,[108] it will first be necessary to explore briefly the nature of goodwill and its relationship with covenants not to compete, and the nature and function of such covenants.

A. *Goodwill*

An early English decision defined goodwill as nothing more than the probability that the old customers would resort to the old place of business.[109] This definition has been expanded to include any transferable competitive advantage which attaches to a business. Goodwill has been categorized as consumer goodwill, industrial goodwill (harmonious labor relations), and financial goodwill (ability to obtain capital), and has been segmented into customer attitudes, general reputation, customers lists, prospective patronage, and symbols invoking customer response.[110] Goodwill has long been recognized for tax purposes as an intangible, nondepreciable (since it has an unascertainable useful life), capital asset.[111] The usual method for valuing goodwill for tax purposes is to capitalize the earnings of the business that are attributable to goodwill. This is done by (1) determining the average annual net earnings of the business, (2) determining the value of the tangible assets, (3) deducting from the total net earnings the earnings attributable to the tangible property, and (4) capitalizing the balance.[112]

Goodwill is property, recognized as such and protected by the law. Where the seller of a business and its goodwill improperly interferes with the transferred goodwill, the purchaser may have an action for damages. A suit also lies to enjoin further interference by the seller, the damage to

107. Corn Products Refining Co., 350 U.S. 46 (1955); Court Holding Co., 324 U.S. 331 (1945).

108. *See* discussion at pp. 10-13 *supra*.

109. Lord Eldon in Cruttwell v. Lye, 34 Eng. Rep. 129, 134 (Ch. 1810).

110. *See* Note, *An Inquiry Into the Nature of Goodwill*, 53 COL. L. REV. 660, 664-65 (1953).

111. *Id.* at 712.

112. J. MERTENS, LAW OF FEDERAL INCOME TAXATION § 59.37 (1958); Rev. Rul. 59-60, 1959-1 CUM. BULL. 237, 241.

the purchaser in such cases being usually regarded as irreparable and the legal remedy as inadequate because the damages are difficult to prove and because the injury is a constantly recurring one.[113] The fact that damages are not easily ascertainable does not bar the buyer from bringing suit, nor is it necessary that he first prove special pecuniary damages or show an actual loss of customers who might in any event have discontinued their patronage.[114]

A general rule of law is that where the seller of a business agrees not to engage in the same business in the same place, the obvious intent of the seller is to transfer the goodwill of the business.[115] The courts have also held that, where a contract for the sale of a complete business does not include a covenant and even omits to mention goodwill, there is a presumption that the intention of the parties was to sell the goodwill with the other assets because goodwill cannot exist except in connection with the business.[116] It would seem to follow, in view of the aforementioned expanding definition of goodwill, that even in the absence of an express covenant not to compete, there is an implied promise not to compete (for new as well as old customers) when someone sells his business. However, the rule of law followed in most jurisdictions is that, absent an express covenant, the sale of a business together with the goodwill thereof does not import an agreement by the vendor not to engage in a competing business in the same vicinity as long as there is nothing to injure the good disposition of the public toward the old place of business, or to impair any of the advantages which the purchaser had properly acquired by the purchase of the goodwill of the old customer.[117] Yet a minority of jurisdictions (following the "Massachusetts view") hold that one who sells the goodwill of his business thereby precludes himself from competing with the old business, even for new customers.[118]

The majority view seems self-contradictory. In most instances it is impossible for a vendor not to injure the goodwill sold if he competes with the old business. In a narrow sense, goodwill does not include the ability to attract future customers, so perhaps the majority rule is sound in permitting the vendor to compete for new customers. The policy behind the majority rule, as one commentator suggests,[119] is apparently that the courts regard the right to compete to be too basic to be proscribed by

113. 38 C.J.S. *Goodwill* § 16 (1943).

114. *Id.*

115. 24 AM. JUR. *Goodwill* § 13 (1939). *See, e.g.*, Mahlstedt v. Fugit, 79 Cal. App. 2d 562, 180 P.2d 777 (1947); Yost v. Patrick, 245 Ala. 275, 17 So.2d 240 (1944).

116. 24 AM. JUR. *Goodwill* § 13 (1939). *See, e.g.*, Langberg v. Wagner, 101 N.J. Eq. 383, 139 A. 518 (1927).

117. 24 AM. JUR. *Goodwill* § 18 (1939); 38 C.J.S. *Goodwill* § 12 (1943). *See, e.g.*, Knoedler v. Glaenzer, 55 F. 895 (2d Cir. 1893).

118. 24 AM. JUR. *Goodwill* § 18 (1939); 43 C.J.S. *Injunctions* § 84 (1945). *See, e.g.*, Martino v. Pontone, 270 Mass. 158, 170 N.E. 67 (1930).

119. Queenan, *Taxation of Covenants Not to Compete in the Sale of a Business*, 4 B.C. IND. & COM. L. REV. 267, 268 (1963).

implication. Nevertheless, they have no difficulty in enforcing restrictive covenants which limit competition for as many as ten years. The majority rule seems to ignore the fact that a seller's subsequent competition could be disastrous to the old business. By simply going into business again, the seller often could retain many of his old customers without even actively competing with the old business.

In summary, the general rule of law seems to be that a person who sells a business impliedly covenants not to compete, at least for his old customers, with the new owner of the business.

B. *Covenant Not to Compete*

Express covenants not to compete are enforceable only if adopted for the purpose of protecting transferred goodwill.[120] They are not deemed to be illegal restraints on trade when reasonably limited in time and in geography, and are enforced by an action for damages or an injunction.[121] There seem to be three plausible ways to characterize a covenant not to compete: (1) the covenant is in substance a part of goodwill; (2) the execution of a covenant not to compete is merely incidental to, and should be subsumed under, the transfer of goodwill; and (3) the covenant is a promise of certain conduct (forbearance) supported by consideration which, to the promisor, is nothing more than a lump sum substitute for future ordinary income.

C. *A Covenant Not to Compete is in Substance Part of Goodwill*

As previously noted, the concept of goodwill is an ever expanding one. Anything that contributes to net earnings in excess of a fair return on the net tangible assets is properly characterized as goodwill.[122] If goodwill can include as one of its components symbols invoking customer response, then a fortiori it can also include the prospect of non-competition from the former owner. This competitive advantage bears most directly on the original definition of goodwill—the probability that old customers will resort to the old place of business.

Opponents of this view would argue that goodwill has been historically treated as "property" and that only property can constitute a capital asset as defined in Section 1221. They would contend that a covenantor is receiving compensation for forbearing from competition and that this payment should be classified as is any other payment for personal service, *i.e.*, ordinary income. However, the mere fact that goodwill has been built up by personal service is no bar to its classification as a capital asset.[123] This is true even when the advantage is sustained largely

120. 6 A. CORBIN, *Contracts* § 1387 (1960); 38 C.J.S. *Goodwill* § 13 (1943).
121. 17 C.J.S. *Contracts* §§ 241, 242 (1963).
122. *See* p. 000 *supra.*
123. *Cf.* Bisbee-Baldwin Corp. v. Tomlinson, 320 F.2d 929 (5th Cir. 1963); Commis-

by personal elements.[124] It must be added, however, that goodwill and a covenant not to compete have traditionally been treated as separate entities, and in none of the cases previously discussed, have the parties to the transaction regarded the two as equivalent.

D. *The Covenant as an Incident to the Transfer of Goodwill*

That the execution of a covenant not to compete is merely incidental to, and should be subsumed under, the transfer of goodwill seems to be the most plausible of the three possibilities. If when a person sells a business he impliedly covenants not to compete for his former customers, then his express covenant not to compete seems to have little independent significance apart from assuring, as an extra measure, the effective transfer of the goodwill. It would appear that in tax law, just as in the law of contracts, little if any significance should attach to a promise to do that which one is already legally bound to do. Under this view the proceeds from the sale of a covenant should be treated as inseverable from or part of the proceeds received for the goodwill.

It is possible to imagine a transaction in which the pure elimination of competition for future customers is an important element in the total price paid for the covenant, but this is not the typical transaction. In most instances the buyer wants the covenant only as an aid in obtaining the goodwill of the seller.[125] One suspects that if the average businessman were asked to express his opinion as to the purpose of a covenant not to compete, he would probably say the purpose is not to get something new (elimination of competition for future customers) but merely to protect that which the purchaser already obtained from the seller—the seller's goodwill with existing customers. A careful reading of the cases previously discussed buttresses this belief: the language used in the covenant clauses, as set forth in the sales agreements, reveals that none of the covenants were more than incidentally concerned with the elimination of competition for future customers.[126]

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sioner v. Maurice L. Killian, 30 P-H Tax Ct. Mem. 420 (1961), *aff'd*, 314 F.2d 852 (5th Cir. 1963).

124. Richard S. Wyler, 14 T.C. 1251 (1950).

125. Commentators supporting this view include Queenan, note 119 *supra* at 277, and the author of Note, *Tax Aspects of Goodwill and Covenants Not to Compete in the Transfer of Partnership Interests*, 16 U. OF FLA. L. REV. 449-51 (1963). MERTENS, note 112, *supra* § 22.33 at 219 writes that

> [i]t is difficult to understand as a matter of economic reality how, in this kind of a case, [covenant sold with goodwill] such a covenant can be anything except "nonseverable" or "ancillary" regardless of whether or not the parties segregate or deal with it as a separate item, since in either event the function of the covenant is to protect the assets transferred and enters into the goodwill intangible.

126. A reading of the cases reveals a marked similarity in the language and substance of those covenant clauses which detail the kinds of competition proscribed by the agreement. Typical of such clauses is the one involved in Benjamin Levinson, 45 T.C. 380 (1966), wherein the seller agreed, for a period of twelve years, not to

> (a) [s]olicit or accept any business from any [previous client] . . . . (b) [r]equest or advise any clients . . . to withdraw, curtail, or cancel his business . . . ,

The execution of a covenant not to compete simultaneously with the transfer of goodwill seems analogous to a transferor's performance of "incidental services" in connection with the sale of property or in connection with the simultaneous tax-free transfer of property for stock in a section 351 exchange.[127] According to Rev. Rul. 64-56,[128] "[w]here the transferor agrees to perform services in connection with a transfer of property, tax-free treatment will be accorded if the services were merely ancillary and subsidiary to the property transfer . . . . Ancillary and subsidiary services could be performed for example, in promoting the transaction by demonstrating and explaining the use of the property, or by assisting in the effective 'starting-up' of the property transferred, or by performing under a guarantee relating to such effective starting-up . . . ."[129] However, training the transferee's employees in specialized skills, continuing technical assistance after the starting-up phase, or assistance in the construction of a building to house property transferred will be regarded as furnishing services that are separate from and in addition to the property transferred. For example, if a dealer in complex IBM computers were to sell his business or transfer it to a "controlled" corporation in exchange for section 351 stock, he might offer to explain both the intricacies of the computer to new employees and to render continued technical assistance in conjunction with the transfer of the physical assets. He might also offer to forego competition with the new owner and, in addition, offer to stay on for six months to acquaint the owner with his former customers, in conjunction with the transfer of his goodwill. Under the Revenue Ruling his indoctrination of new employees would be ancillary to the transfer of the computers, but his rendition of continued technical advice would be a service, separate from the transfer of property, thus disqualifying the exchange from tax-free treatment. If he sold the business the indoctrination would be treated as ancillary to the transfer of the computers, but a part of the sales proceeds would probably be attributed to his consulting efforts and taxed as ordinary income. It is reasonable to assume that advising new employees is necessary in order to assure the transferee's beneficial enjoyment of the transferred tangible assets, and that his continued technical assistance would add something new to the bargain. Similarly, if the owner were to stay on for six months he would be giving the buyer or transferee corporation more than was bargained for, but if he were to promise not to compete he would be protecting the transferee's enjoyment of the transferred intangible asset—

(c) [i]nduce or influence any employee, salesman, distributor, or broker of the company to terminate his relationship; (d) [e]ngage in [competing] business . . . in the State of Washington, either as an employee, proprietor, partner or stockholder. *Id.* at 386.

127. Under INT. REV. CODE OF 1954, § 351, a transfer of property unaccompanied by service and solely for stock in a corporation controlled by the transferor is a tax-free exchange.

128. 1964-1 CUM. BULL. 133.

129. *Id.* at 134.

goodwill—and his promise would merely be a contributory element of the transfer.[130]

This view on the nature and function of a covenant was hinted at in an opinion by the Ninth Circuit in *Ray H. Schulz*.[131] The court, affirming the Tax Court's decision that payments for a covenant were really for goodwill, did not flatly state that goodwill and a concomitant covenant not to compete should never be afforded separate tax treatment; the court did, however, express the view that

> If there is a covenant which has a basis in economic reality, it *must* contribute to goodwill. . . .
>
> If there is reason to believe that the business has prospered because of the character or the reputation of the proprietor or partner—the friendly bartender or the trusted stockbroker are examples—this would tend to show that a genuine business reason prompted the covenant. Such reputation or character would also form a part of the goodwill. However, the question is one of fact and not one of classification as "severable" or "non-severable."[132]

E. *The Covenant Not to Compete as A Lump-Sum Substitute for Future Ordinary Income*

Many commentators have argued along traditional lines that a covenant not to compete cannot produce capital gain because it is not "property" and thus not a capital asset within the definition of section 1221, and because its disposition by the covenantor is not a "sale or exchange."[133] These definitional complexities are beyond the scope of this paper; briefly, however, it may be argued that a covenant not to compete represents to the covenantor a promise not to work for another or for oneself and is no more a conveyance of "property" than is a promise to enter the promisee's employ. According to this view, a covenant not to compete is the renunciation of the seller's right to compete, which is akin to a "naked contract" right to earn future ordinary income, and which lacks the attributes of either an "equitable" interest or an estate in specific property, either real or personal.[134] It may also be argued that the execution of a covenant is not a sale or exchange but the extinguishment of his right to compete.[135] Unlike a true extinguishment, however, some-

130. *See* Heil Co., 38 T.C. 989 (1962), where the court found a sale of "know-how" to be incident to a transfer of patents and thus entitled to capital-gain treatment.

131. 294 F.2d 52 (9th Cir. 1961), *aff'g*, 34 T.C. 235 (1960).

132. 294 F.2d at 56 (emphasis by the court).

133. *See* Taylor, note 10 *supra* at 1049; 67 YALE L.J., note 61 *supra* at 1266.

134. *See* Jose V. Ferrer, 35 T.C. 617 (1961), *rev'd*, 304 F.2d 125 (2d Cir. 1962). It is interesting to note that the covenant, in the hand of the *covenantee*, does possess one significant attribute of property under the *Ferrer* test—the covenantee may resort to injunctive relief to protect his rights under the covenant.

135. *See* Galvin Hudson, 20 T.C. 734, 736 (1953), where the settlement of a judgment purchased from another party was held to be an extinguishment of a right rather than a sale or exchange.

thing does "survive" the transfer to the hands of the transferee-covenantee, because it is generally held that the covenant is assignable to a future vendee.[136]

The main objection to this approach is that it ignores the nature and function of a covenant not to compete and its interrelationship with goodwill. In deciding whether a transaction produces capital or ordinary income, the courts have not rigidly relied upon statutory definitions but rather have probed the economic substance of the transaction and the nature and function of the assets involved. For example, in *Corn Products Refining Co.*[137] the Supreme Court held that trading in commodity futures, normally a capital gain or loss transaction, produced ordinary gains and losses when undertaken by a manufacturer of corn products for the purpose of protecting his ordinary-income manufacturing operations. As previously contended, the preponderant purpose of a covenant not to compete is to protect and assure the beneficial enjoyment of a transferred capital asset—goodwill. Another example of judicial probing is in the "tie-in purchase" area. In a trend-setting Tax Court case,[138] a liquor dealer, finding it difficult to obtain liquor under World War II restrictions, bought stock in a distilling company and shortly thereafter sold at a loss. The court held that the payments made for the stock less the amount realized from its sale was in fact a part of the cost of the liquor inventory acquired by the taxpayer. If the purchase of stock to obtain inventory colors its capital-gain status, then perhaps the sale of a covenant to effectuate the transfer of goodwill colors the covenant's status.

The proponents of the ordinary-income approach to covenants not to compete would reply by citing the much quoted maxim set forth in the *Corn Products* opinion: "Since this section [1221] is an exception from the normal tax requirements of the Internal Revenue Code, the definition of a capital asset must be narrowly applied and its exclusions interpreted broadly. This is necessary to effectuate the basic congressional purpose."[139] However, the congressional purpose in enacting the capital gain and loss provisions,[140] applies to a large extent to covenants not to compete.

Capital gain provisions were first introduced into revenue legislation in 1921, and though the legislative approach has been somewhat unclear and inconsistent, early legislative history indicates two reasons for the preferential treatment accorded capital gains: (1) passage of such a provision will maximize mobility in investment capital and stimulate profit-taking transactions which will increase revenues; (2) it is inequi-

136. 38 C.J.S. *Good Will* § 13 (1943).

137. 350 U.S. 46 (1955).

138. Western Wine & Liquor Co., 18 T.C. 1090 (1952), *acquiesced in*, Rev. Rul. 58-40, 158-1 CUM. BULL. 275; 22 MERTENS 100 § 22.16.

139. 350 U.S. at 52.

140. *See* discussion at p. 17 *supra*.

table to tax in full, in one year under progressive rates, appreciations in value which have occurred over a period of years.[141] A strong argument for taxing covenantors at capital gain rates is that this would encourage more sellers to execute covenants, which would in turn maximize efficient mobility in investment capital by protecting transfers of goodwill, a vital component of capital. Furthermore, the value of a covenant, like goodwill, appreciates over a period of years as the seller builds up his competitive position.

As previously noted,[142] the law seems to recognize a seller's right to compete for future customers even after he has transferred goodwill, and it is possible to imagine a situation where the only or major purpose of a covenant is to eliminate competition for future customers rather than to protect goodwill. However, if the courts were to recognize such a covenant and treat it as producing ordinary income to the seller and an amortization deduction to the buyer, they would be sanctioning and encouraging covenants that are illegal and contrary to the spirit of antitrust.[143]

IV. Conclusion

In this writer's opinion, the soundest tax approach to covenants not to compete, when they are sold with goodwill, would be to always treat the proceeds from the sale of such covenants as part of the proceeds from the sale of goodwill. This treatment follows from the conclusion that the execution of a covenant not to compete is best characterized as being merely incidental to, and subsumptive under the transfer of goodwill.[144] The covenant would thus always produce capital gain for the seller and no amortization deduction for the buyer.[145] There may be a covenant the primary function of which is to eliminate competition for future customers rather than to protect the goodwill of existing customers. In such event, the legitimacy of the latter purpose might remove the

141. *See* Seidman, *Legislative History of Federal Income Tax Laws (1938-1861)* 813-15 (1938); S. Rep. No. 275, 67th Cong., 1st Sess., 12 (1921).

142. *See* p. 18 *supra.*

143. *See* discussion, p. 3 *supra.*

144. *See* discussion, p. 19 *supra.*

145. Much has been said concerning the tax treatment of the seller (capital gain or ordinary income), so it seems appropriate, in this final comment, to mention the situation of the buyer. Some would say that the proposed rule would be unfair to the buyer by depriving him of an amortization deduction. It seems, however, that amortization of a 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 TV station or liquor store. Because such licenses are readily renewable by the holder, the initial cost of obtaining them, as opposed to the normal 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. *See Queenan*, note 119 *supra* at p. 277. Furthermore, the loss to the buyer of the amortization deduction could be compensated for by an adjustment in the purchase price of the goodwill.

covenant's taint of illegality and render it enforceable, and the proposed rule would not fit such a covenant because of its hybrid nature; however, a reading of the cases suggests that such covenants are very atypical. On the one hand the proposed rule, unlike the "severability" and *Danielson* tests, would recognize substance rather than form, and would conform to economic reality. Unlike the *Wilson* and "severability" approaches, on the other hand, it would eliminate subjectivity from the judicial decision-making process and would provide tax certainty where confusion now prevails. The proposed rule respects the spirit of antitrust in assuming that the purpose of a covenant is to protect goodwill rather than to restrain trade, and it attempts to eliminate tax avoidance by disregarding the parties' treatment of the transaction. Finally, the rule would ease the administrative burden of the Commissioner in collecting taxes, by obviating his need to litigate one party's claim without any certainty that the result will be applied consistently to the other party.