Covenant not to compete: An analysis of its tax consequences

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THE COVENANT NOT TO COMPETE:
AN ANALYSIS OF ITS TAX CONSEQUENCES

By

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B. S. Bradley University, 1957

Presented in partial fulfillment of
the requirements for the degree of
Master of Science
UNIVERSITY OF MONTANA
1967

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JUL 6 1967

Date
ACKNOWLEDGMENTS

One of the first barriers to the student who embarks upon the thesis adventure is the selection of a suitable topic. In this particular study, four topics were considered and discarded before a feasible one was chosen. It was necessary to have the committee examine two complete thesis drafts before the third, and final, form could be acceptable. For their kind patience and understanding through an inordinate degree of tacking, especially grateful regards are tendered to the chairman and members of his committee.

A most sincere expression of thanks is offered to Mr. Sebastian Smith of the Missoula office of the Internal Revenue Service. His willingness to acquaint an unknown graduate student with much of the nomenclature in the subject area, even while in the midst of a substantial work load, was noteworthy.

In the specific realm of the thesis, Mr. George S. Hanson, general counsel of the National Association of Insurance Agents, was quite helpful. Within a week after receiving a letter of inquiry about relevant articles in the American Agency Bulletin, Mr. Hanson remitted reprints of thirteen highly germane items which spanned the preced-
ing five years. For persons who might be interested in this bundle of material, a letter to Mr. Hanson at his offices located 96 Fulton Street, New York, New York 10033, will suffice.

To this writer's family must go a deep tribute for the disruptions of nearly a year—having to keep the television set volume low, putting up with occasional outbursts from a struggling researcher, giving up nights out and weekends of family fun so that "Dad" could work on his thesis. The understanding attitude of his family through this struggle will be long remembered by the writer.

Finally, to a true educator who believed in him and encouraged him to the end, Professor Fred A. Henningsen, the committee chairman, must go deep-felt gratitude. Professor Henningsen's example shall serve as a guideline for the writer in his own on-going experiences as an educator. If at any time the writer might feel inclined to be abusive of the power given him over students, he shall look back to the kind respect afforded him by his thesis chairman and try to follow that pattern of dignity toward fellow man with the understanding mien of one of genuine knowledge.
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CHAPTER I

INTRODUCTION AND STATEMENT OF THESIS

Definitions and Restrictions

To establish the boundaries for this study, the two major phrases in its title should be examined first. A covenant not to compete, in the framework herein used, has been defined by the Internal Revenue Service to be simply, "an agreement whereby the seller of a business states that he will not compete with the buyer for a limited time or within an agreed area or a combination of both."¹ Commerce Clearing House describes the covenant not to compete with brevity, "Agreements not to compete—Where the vendor of a business covenants to refrain for a specified period from competing with the vendee . . . ."²

Although the preceding two definitions could serve to identify a covenant, a more elaborate classification is neces-


²665 CCH 1965 STAND. FED. TAX. REP. Par. 4717.0971.

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Essentially, the covenant not to compete is an agreement to be included within, or to accompany, the contract for the sale of a business in which the seller agrees to refrain from certain or all of the activities of that business for a specified period of time and/or within a designated geographical area. Whether it is a part of the general sales agreement or a separate item, the covenant constitutes a contractual obligation of the seller. Its specific elements are: (1) it is given by the seller of a business to the buyer for the buyer's protection; (2) it is an agreement by which the seller is restrained from competing, partially or wholly, with the buyer; and (3) it may state a time period, a geographical area, or both, within which the defined competition is prohibited.

The matter of Ernest E. Suggs and Marjorie S. Suggs v. Commissioner of Internal Revenue furnishes an example of a covenant not to compete which accompanied the sale of an insurance agency:

The seller further agrees that they will not for a period of five years from the date of this contract, directly or indirectly, engage in business as a general insurance agent within a radius of 100 miles of Phoenix, Arizona, nor aid, nor assist anyone else in said business in said territory, except that it is agreed that Seller may retain their insurance agent's licenses, and that as to insurance sold to any new accounts, such business shall be placed only through the office of the Buyer, the Seller to be compensated on the basis of fifty per cent (50%) of the commission payable on the entire premium, whether paid in advance

\[3 \text{E. E. Suggs, 24 CCH Tax Ct. Mem. 1194 (1965).}\]
or paid in monthly, quarterly, semi-annual, or annual installments.

This study's "Analysis Of Its (the covenant's) Tax Consequences" will be a restricted one. Only federal income taxes and consequences resulting therefrom will be considered, although some parallels might be drawn for state income taxes since these often seem to follow federal rulings. Further, the analysis is focused on a consideration of the relative certainty of the covenant's tax consequences. Specifically, it is concerned with the designation of all or part of the sale proceeds, from the viewpoint of both buyer and seller, and how sure the parties can be of a given designation. The object here is to observe what impact the covenant has upon the tax consequences, and how certain that impact is in effecting one designation or another.

Finally, it should be noted that only sales of going businesses will be examined. Basically, a going business is one which is pursuing its normal course of commerce, is operating as is customary to its kind of enterprise, and is not in the process of bankruptcy or dissolution.4

Nature of the Covenant

A covenant not to compete is, in itself, a contract or a promise in writing under seal. The unqualified word, "cove-

4For a recent decision in the sale of an inoperative business, interested persons are referred to the matter of Savings Assurance Agency, Inc. v. C.I.R., CCH Tax Ct. Mem.
nant," is sometimes used as a substitute for the word "contract."
Therefore, if one were to look for information about
the covenant not to compete (also called a negative covenant,
agreement not to compete, restrictive agreement, or restric-
tive covenant) in commercial law publications, he would find
it usually in the section dealing with contracts. Interest-
ingly enough, the covenant is found most often in a subsection
entitled "Illegal Contracts." Contracts, or segments thereof,
which provide for the restraint of trade or the limitation of
competition are ordinarily deemed inimical to the public in-
terest and, therefore, illegal and unenforceable. Although
the covenant not to compete has as its basic purpose the re-
straint of competition, it is one of the exceptions to the
rule of illegal contracts and is valid when it is reserved
to the sale of a going business. A number of other qualifi-
cations are necessary to establish the covenant's legality
and enforceability, but these will be illustrated in detail
in Chapter II.

The Uniform Commercial Code, adopted or pending adop-
tion in nearly every jurisdiction in the United States at
this writing, deals with agreements not to compete in its
Section 2-302. The Code applies the rule of "unconscionabil-
ity" to contracts for sale (closely allied to "illegality" and
"inimical to the public interest"), and also deems the covenant
to be in the nature of an exception under unconscionable con-
tracts.
Necessity of the Covenant

The purchaser of a functioning enterprise obtains not only the physical assets of the firm, but also what is often the most valuable asset, its goodwill. The latter has been variously defined, but, for the purposes of this study, it might best be deemed the potential of a business to realize earnings above a normal return from the investment in its tangible assets. This intangible, goodwill, is the essence of the purchase of a going business.

Should the seller of a business retake, or attempt to retake, the physical assets of the business he had sold, he would be subject to prosecution for burglary, robbery, or larceny—the exact crime dependent upon the method employed. However, the possibly most valuable asset, the goodwill, is his for the retaking in the absence of a contractual agreement prohibiting such action. If any goodwill does in fact exist, it is the seller who built it through his business acumen, his customer dealings, and his intimate knowledge of the enterprise. It is not unreasonable to believe that he could easily decimate his old business by starting a new one in competition. Substantial in any case, depletion of a personal service business by seller competition could be ruinous to the buyer—re-capture estimates run as high as ninety-five per cent of the business sold in the case of insurance agencies, according to
one authority.\(^5\)

From a practical viewpoint, physical assets—all other things equal—could be resold without great loss in the event of dissipation of the business from seller raids. Regardless of the volume of business being transacted in the enterprise (short of accelerated wear and tear which would be inversely related to loss of business), a typewriter remains much the same item as does a desk, chair, filing cabinet, and so on.

However, goodwill establishment is a function of time; its existence and solidity vary directly with the passage of time. For the buyer, goodwill may not have a form and amount capable of early resale. He must have time to build his own goodwill in the business, and he must be free from untoward competition in order to do so satisfactorily. Therefore, this intangible, goodwill, is an item which could be most severely damaged by seller raids and open animosity. Thus, the covenant not to compete is a necessity in agreements for the purchase and sale of going businesses. Subject to its stated limits of time and area, a covenant legally removes the uncertainty of seller competition with the buyer and gives the buyer sufficient opportunity to establish his own goodwill. In addition, by his execution of the covenant, the seller

provides tangible evidence of his good faith and intention to refrain from such abnormal competition.

By its inherent powers, the covenant not to compete may well enable a proper, arm's length sale of goodwill. The buyer, therefore, is willing to pay a price, and the seller can receive a sum, both of which exceed the value of the business' tangible assets.

Statement of Thesis

Up to this point, there would seem to be no legitimate criticism of the covenant, no valid reason to omit this item from a properly-drafted contract of sale. However, accompanying the introduction of the covenant not to compete there appears to be a heightened degree of uncertainty in the federal income tax designation(s) of the sale proceeds. The problem can be stated as follows: Does the covenant not to compete achieve greater certainty of eliminating future competition from the seller at the cost of diminishing certainty in the federal income tax designation(s) of the purchase monies?

This problem has two broad categories, the first of which is: just how certain is the protection afforded buyer from a covenant not to compete? When are the terms of a covenant not to compete too restrictive of trade and competition to be valid? If the time and area are too great, will the covenant be declared wholly unenforceable, or will the
court amend its terms to be enforceable? What reliefs can the buyer seek if seller violates his agreements? Essentially, therefore, the first part of the problem is to determine if a covenant not to compete actually does accomplish what it purports to do—to eliminate future competition from the seller for a specified period of time and within a designated geographical area.

The second portion of the problem is similarly complex. It requires that one determine how uncertain the tax designation(s) of the purchase monies would be in the absence of a covenant, and then to ascertain what difference (if any) is traceable to the inclusion of the covenant. Is this truly a matter of uncertainty, or is it simply hard to understand—a matter for expertise? In making a tax designation and an allocation of proceeds to the agreement not to compete, what criteria are applied?

Approach for Resolution of Thesis

Of course, the problem and its implicit questions are of a legal nature. Therefore, to implement the process of resolution, information must be sought in legal, or law-oriented, publications. Business law texts and germane government publications, as well as periodicals, can serve well as routing indicators in the matter. However, to make any truly conclusive kind of analysis, one must look to the ultimate
designators of contract validity and tax status of proceeds and payments--the courts of record.

This study shall utilize the pertinent publications to obtain general background material and citations of cases relevant to the problem. It shall provide its summary and conclusions through a careful probe of the recorded cases, the evidences of ultimate designations.
CHAPTER II

VALIDITY AND ENFORCEABILITY OF COVENANT

History and Rules of Validity

Agreements not to compete were held to be void in such early cases as Cyrus Alger v. George C. Thacher\(^1\) dated March, 1837. Covenants which impaired competition were invalidated by the courts on the grounds that they: (1) exposed the public to monopoly; (2) deprived the public of the services of the covenantor; (3) reduced desirable competition; and (4) impaired the covenantor's means to earn a livelihood. Basically, the covenant was viewed as a measure to restrain trade and, therefore, inimical to the best interests of the public.

As time passed, some courts began to regard this negative covenant to be valid if it accompanied the sale of a going business and was limited in length of time and geographical area. In 1918, the case of J. R. Shute v. J. T. Shute\(^2\) resulted in the covenant being voided, but the court noted that it would have been enforced had the period of time been

\(^1\)Alger v. Thacher, 19 Pick (Mass.) 51 (1837).

Gradually, the concept of "reasonableness" in the restraints was introduced, and the terms of a covenant would be upheld so long as they were reasonable and not contrary to public policy. Becker College of Business Administration and Secretarial Science v. Summer H. Gross in 1933 set forth this approach and advised that "... what is reasonable depends upon the facts of each case."

A 1953 matter, Maola Ice Cream Company of North Carolina, Inc. v. Maola Milk and Ice Cream Company, contains two concepts which are germane to covenants to the present date. In the first of these concepts can be found the essence of rulings on the reasonableness of covenants not to compete:

An agreement in partial restraint of trade contained in a contract for the sale of a business is reasonable if the restraint is such as to afford a fair protection to the interests of the party to whose favor it is given and not so large as to interfere with the interests of the public. However, contracts in partial restraint of trade are contrary to public policy and void if nothing shows them to be reasonable.

The court's findings further noted that a reasonable geographic area for restriction would be limited to a well-defined territory which had been served by the seller prior to the sale. Reasonableness in time was indicated as that sufficient

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for a competent businessman to establish his legitimate interests in the enterprise which he had purchased, a length of time which would vary from one type of business to another, but would not normally exceed three to five years.

In its second conceptual area, this same case reiterates Chapter I's observation regarding the buyer's relative lack of protection for goodwill in the absence of a covenant not to compete:

Generally, in the absence of an agreement as to the right to compete, vendor of premises and its goodwill is not precluded from engaging in a similar business in the vicinity, provided he does not interfere with purchaser's enjoyment of the premises sold and provided he does not engage in unfair competition.

In 1955, the matter of J. L. Donahue v. Permacel Tape Corporation\(^5\) prescribed who was to decide the question of reasonableness and elaborated on the criteria with a quote from *Williston on Contracts* (Section 1636, page 4580):

It is everywhere agreed that in order to be valid a promise imposing a restraint in trade or occupation must be reasonable. The question of reasonableness is for the court, not the jury; and in considering what is reasonable, regard for the question must be paid to (a) whether the promise is wider than is necessary for the protection of the covenantee in some legitimate interest, (b) the effect of the promise upon the covenantor, and (c) the effect upon the public . . . .

Further, this case also serves to illustrate in the court's own words what can be the fate of covenants not to compete which are not reasonable in time and/or area:

We cannot rewrite the contract made by the parties and add to it matters which it does not contain and then use the contract as rewritten as a basis for litigation, however justifiable equitable interference under the circumstances might seem to be. We conclude, therefore, the covenant of contract upon which this action is predicated is unenforceable in its entirety.

Thus, if the covenant's terms are not reasonable in the opinion of the court, the entire covenant may be declared void. Such an approach follows the general reluctance of the courts to modify and construe contracts. As a rule, cases which were examined followed the practice of voiding the entire covenant when its restrictions were too broad, leaving the buyer without protection. In several cases, by the time that the buyer could bring his case to court, the time limit in the covenant had already expired—for all practical purposes, the subsequent invalidation by the court was superfluous, except to prevent collection for damages, for purposes of injunction.

Some state courts did modify the terms of the covenant not to compete to be reasonable. Here the assumption was that the parties must have envisioned some restraints when they entered into the original agreement for sale. Thus, to avoid restraint entirely would amount effectively to a material amendment of the terms. The matter of Georgette N. Thomas v.
Toufiq Paker is an example of such a modification. Originally, the agreement in this case called for the defendant to refrain from engaging directly or indirectly in the baker business for a period of seven years within a radius of seven miles from the business which he had sold to the plaintiff. These limitations were held to be unreasonable, but the judge amended them to four years and four miles rather than to void the covenant entirely. He identified the covenant as a negative covenant since it was an agreement not to do something.

Are there any rules of thumb regarding time and area restrictions which can be relied upon by contracting parties, particularly buyers, to be reasonable? One text indicates that three years tends to be the maximum safe limit on time which a covenant may embody. This conclusion coincides well with this study as in no case examined was a three year time limit considered unreasonable.

The trade area within which a firm's transactions have been conducted previously is readily establishable for businesses with a fixed, localized clientele. This would constitute a defensible geographic restriction. Where the firm has catered to a transient customer group, the question of area be-

comes somewhat nebulous. No concrete rule of thumb appears to be available regarding territorial restrictions where the trade area is not readily definable, but in the cases examined wherein these kinds of restrictions were invalidated, the excesses were somewhat overt. Where the business had been of a localized nature, the area restriction was extended to a major portion of the state of domicile, or to the entire state; intrastate businesses attempted to restrict the United States from competition. In both time and area constraints, a very conservative approach would be advisable if the buyer desires a high degree of certainty in the legal enforceability of what is prescribed.

Covenant Enforceability

A covenant not to compete constitutes a contractual obligation of the seller. The point of consideration given for it by the buyer will be developed in Chapter III, but essentially any part of the purchase price may be allocated to the covenant, it may be separately measured and drawn, or its consideration may be deemed indivisible from the entire sale proceeds. Violations of a valid covenant's terms constitute a breach of contract.

As an initial enforcement of the contract, a competing seller may be enjoined from such action in violation of his legal promise. The matter of *Thomas v. Fowler*, supra, note 6,
this chapter, noted that "... the covenant may be enforced by injunction if the interests to be protected are consonant with public policy and if the restraint is limited reasonably in time and space."

Where damages are positive and provable by buyer, an appropriate award may accrue to the injured party as in *Whiting Milk Companies v. William J. O'Connell*\(^8\) where it was noted, "Contracts in restraint of trade ... may be ... enforced in equity ... Damages may be awarded for interference within a reasonable time and space if vendee is injured."

What constitutes damages, as far as the sum is concerned, is more readily ascertainable where the covenant is valued in the contract as a separate item, or is handled wholly as a separate contract. In some cases the rule is that installment payments for a covenant cease from the point of violation as in *Emmette L. Barran and Martha Barran, et al v. Commissioner of Internal Revenue*\(^9\) Seller is obliged to return the subsequent payments received, and is entitled to no further payment. Other cases, such as *Fred Montesi and Carmela Montesi v. Commissioner of Internal Revenue*\(^10\) provide for fixed damages as agreed to in the contract of sale. The court must determine

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\(^8\) *Whiting Milk Cos. v. O’Connell*, 277 Mass. 570 (1931).


damages in many cases on the basis of proof offered by the buyer, as in Metropolitan Ice Company v. James J. Ducas.\textsuperscript{11}

Regardless of the many avenues for enforcement of a covenant, legal remedies may be inadequate to the long-range harm done by violations. The buyer often purchases a going business, paying for goodwill in addition to tangible assets, in the contemplation of securing his economic future. Only time, without undue competition and with his good performance, may seem necessary to solidify this plan. With seller competition, the buyer may find himself in a situation worse than if he had bought only the physical appurtenances of a firm since he paid for more. Customer relationships may be so impaired by seller raids and open animosity that the better clients seek a third firm with which to deal rather than become involved in an unsavory situation. Many nationally-prominent firms thrive in spite of proxy battles, suits for patent infringements, and other competitive joustings so long as the artwork on the product label remains the same. Local enterprises, however, with buyer and seller sharing many of the same friends and acquaintances are especially susceptible to competition backlash. Whether such rivalry is in violation of a protective covenant or not, its disruption could be extremely perilous to the firm, mentally and fiscally ruinous.

\footnote{Metropolitan Ice Co. v. Ducas, 196 N.E. 857 (1935).}
to a new entrepreneur trying to build his own goodwill.

Is a Covenant Necessary in an Otherwise Desirable Purchase?

In view of the mitigating considerations regarding the enforcement of a covenant not to compete, this question must arise. If the covenant is included due to a lack of trust between the parties, the whole matter should be reviewed. In the absence of such evidence, and where there is a clear and obvious meeting of the minds, some persons might deem a written agreement not to compete to be superfluous.

There are a number of sound reasons in support of the inclusion of a covenant. The first, and perhaps most basic, cause is that the Uniform Commercial Code (Section 2-201), as the old English Statute of Frauds, requires contracts for sales of $500 or more to be in writing to be enforceable. If the parties are dealing with a matter of competition for which a value of this amount or more can be ascribed, they must at least mention it in written form.

Other considerations coincide with the reasons for reducing nearly any important agreement to written, legal form. One needs always to consider that the party with whom he dealt and enjoyed freedom from doubts may die. His heirs, whose name alone may be sufficient for strong competition, may be less scrupulous and may have no intention to be bound by the terms of the decedent’s unrecorded promises.

Inclusion of a covenant not to compete in the contrac-
tual agreements may force the contracting parties to a more thorough understanding, a better meeting of the minds about future competition. If the seller is sincere about refraining from competition, he should be willing to sign a legal instrument which defines and details such abstinence. His willingness to do so, or lack thereof, is significant. Further, consideration of the matter in detail may avoid unwarranted litigation after the signing, including some unforeseen tax consequences which will be detailed in the next two chapters. So that the parties may know, before and after, that to which they have agreed, and so that others may also be properly informed, the matter must be discussed and reduced to written form.

The manner of payment places a heavier burden on one or the other of the parties to be very clear about the covenant's terms. In a cash transaction, buyer must give up the entire consideration in advance of seller's demonstration that he will honor his agreement not to compete. The more thoroughly the parties discuss the transaction, the more will buyer have the opportunity to gauge seller's intentions on each point and on the whole matter. Further, seller is similarly given a chance to observe the buyer's behavior in this and other areas, and thereby to know better with what kind of man he is dealing.

A sale which embodies deferred payments may require even more care in assuring mutual understanding because of
the futurity factor. The buyer may be inclined to cease making payments if he believes that seller is acting in violation of the agreement as he (buyer) understands it. On the other hand, buyer may find seller more quickly on the verge of competing should the seller become anxious about the manner in which the new owner is operating and thereby affecting his (buyer's) ability to complete the payment schedule. This time element creates strong anxieties for both parties, and a thorough pre-sale understanding is a helpful preventive for such tensions. Again, a detailed covenant with prescribed penalties forces more questions to be resolved before the sale.

Summary and Conclusions About Protection

On first probe, a covenant not to compete may appear to be little more than a legal latch on the door. There is the difficulty of constructing a valid agreement, and then, should violations occur, of enforcing it—with possibly little hope of full compensation in a long-range practical sense. However, reasonableness of the covenant's terms can be established within conservative limits, and, if buyer bargains in terms of minimum time and provable trade area, he can be reasonably certain of his legal protection.

Although the buyer may appear to be the favored party in considerations about the covenant, it should be kept in mind that this agreement well may be the implement which en-
ables seller to market his goodwill. In any given case where seller competition could be detrimental, the sale proceeds would probably be less without the inclusion of a protective covenant.

In summation, therefore, the initial portion of the problem statement is activated. A properly conceived and drafted covenant not to compete does achieve greater certainty of eliminating future competition by the seller, and it accomplishes this in two respects. First, within the limitations of reasonableness in its restrictions, the covenant provides an enforceable legal barrier against seller competition. Secondly, and in the practical sense more importantly, a covenant wrought from arm's length bargaining actualizes its protection by: (1) requiring the parties to entertain considerations about future competition more thoroughly while they are at the bargaining table; (2) helping to make the parties more aware of the restrictions on competition and the consequences for violations; (3) causing each party to reveal himself more fully to the other in his concepts and intentions regarding future competition; and (4) bringing the parties into a more complete understanding and meeting of the minds than would have occurred otherwise. Without a covenant, it is extremely doubtful that any of these conditions would exist to the extent that its existence effectively insures.
CHAPTER III

TAX CONSEQUENCES OVERVIEW

INCOME TAX TREATMENT

Without Covenant

When a going business is sold, the assets included must be classified in three different categories in order to determine the proper designation of the gain or loss on each particular asset: (1) capital assets; (2) real property and depreciable property used in the trade or business and held for more than six months; and (3) all other property. Although a detailed explanation of the accounting methods employed in the taxation of each of these categories is beyond the scope or needs of this study, some elaboration about them is necessary. Initially, the basis of gain and its proper designation for each will be outlined, assuming a sale effected without a covenant not to compete. Following this, the same kinds of information will be presented relevant to the covenant.

Taking the assets in reverse order to the categories indicated in the preceding paragraph, the items properly includible in the "all other" group would be such as stock-
in-trade, inventory, or property used in the business and held for six months or less. Cost is the basis for calculating gain on items in this category, less accumulated depreciation (if any), and the gain which results from the sale would be considered as an ordinary gain.

The assets in category two, real property and depreciable property used in the trade or business and held for more than six months, come under Section 1231 of the Internal Revenue Code of 1954. Again, cost is the usual basis for such property, although other bases may be applicable, with an adjustment made for depreciation. If the adjusted basis is a result of straight-line depreciation, amortization, or depletion taken, then gain to the extent of such adjustment will be considered ordinary and placed in category three. That which exceeds recovery of previously-deducted amounts will be placed in category one as a capital gain. Essentially, items in category two are such as buildings, machinery, furniture, fixtures, land, lease-holds, patents, and copyrights—all of which have been held for more than the six months' period.

Other than that portion of items included in category two

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which is properly allocated to category one, capital assets, the major component of capital assets in the sale of a going business is goodwill. As indicated in Section 1221 of the Code, goodwill is an intangible capital asset of a business which is not subject to depreciation or amortization. If it is included in a resale, its basis will ordinarily be its previous cost. In the absence of this, however, there is no one method which is exclusively correct in establishing its alternative basis, the fair market value.

Without being so presumptuous as to suggest a sole, proper approach to calculating the fair market value of goodwill, but with the latent knowledge of having examined many tax court cases, this study will suggest one method apparently acceptable to the Internal Revenue Service. A normal return from the investment in tangible assets for the particular kind of enterprise is obtained through examining germane key ratios procurable from Dun and Bradstreet. The current three to five years' return from the business in question is then compared to the normal return. If a positive difference results in favor of the subject business, this is capitalized at the prevailing rate of interest. Following this approach, the ability of the firm to realize earnings above a normal return from the investment in its tangible assets will have been demonstrated in a manner previously accepted by the Internal

\(^2\)Ibid., p. 372.
Revenue Service.

Once the proper basis has been determined for each of the assets, the selling price must be allocated among all of them on the ratio that each bears to the total of the bases. It is in this manner that gain (or loss) is properly determined for each component. Essentially, therefore, the proper allocation and designation of a sale without a covenant is a function of proper bases, previous deductions taken, time held, and sale price. In the aggregate, that which is recovery of investment and ordinary gain to the seller establishes buyer's base for resale and, in the appropriate areas, depreciation (or amortization or depletion). In the case of long term capital gain to the seller, one-half is excludible from taxable income and the balance is taxed at a rate not to exceed twenty-five per cent on the total gain, basically. No future deductions may be taken through depreciation, amortization, or depletion on this portion by the buyer; it simply creates his base for possible resale.

Although the preceding has been a considerable understatement of the intricacies involved in such affairs, the fact remains that there are definite, established, approved methods for accomplishing the end objective—allocation and designation for federal income tax purposes. The procedures are hard to understand—matters for expertise—but there are knowable approaches, and the degree of risk in erring is low.
when the proper technicians handle the matter.

Treatment of Covenant

No organization such as Dun and Bradstreet exists to aid in the proper valuation of a covenant not to compete, and its designation is not definable in terms of cost, depreciation, and time. The Internal Revenue Service, in its booklet entitled *Tax Guide For Small Business*, furnishes criteria for the covenant's proper designation (none for valuation) as follows:³

Where a portion of the purchase price is for a covenant not to compete, and the covenant is for a fixed number of years, the amount paid for the covenant is deductible as a business expense proportionately over the life of the covenant. If no portion of the purchase price represents an amount paid for a covenant not to compete, but the contract of purchase requires you (purchaser) to make periodic payments in return for such a covenant, you may deduct such payments as a business expense. To do this you must be able to establish that the amount you paid was for a covenant not to compete and was not, in effect, the purchase of goodwill.

If a covenant not to compete accompanies the transfer of goodwill and it has the function of assuring you (purchaser) the beneficial enjoyment of the goodwill you acquire, the covenant becomes nonseverable and its cost is considered a capital asset which, like goodwill, is not subject to depreciation or amortization.

As the preceding advices imply, there is a divergence of effects on the contracting parties' tax designations. A

³U.S., Treasury Department, loc. cit.
good illustration of this may be found in Benjamin Levinson and Florence Levinson, et al v. Commissioner of Internal Revenue in 1966. In this case, the court noted that the Commissioner had assumed a neutral stand "... recognizing that if we find that the payments were for a covenant not to compete, they are deductible by the buyers and taxable as ordinary income to the sellers, or, if we find that the payments were for goodwill, they are not deductible by the buyers but are taxable as capital gain to the seller."

The following hypothetical example illustrates the difference in tax impact or burden in a very simplified situation. The assumptions are that these are individual (non-corporate) taxpayers who are married and filing joint returns, that each has net taxable income exclusive of the covenant amounting to $12,000, and that A has sold a going business to B in a transaction which calls for B to pay A $3,000 per year for A's covenant not to compete. This covenant was valued by the parties with the mutual understanding and belief that it would be designated in its payments as ordinary income to A and, therefore, be deductible by the buyer, B. With their net taxable incomes exclusive of the covenant payment, each principal would have a marginal tax rate of 25% on the next $4,000 of taxable income which he receives. If the tax situation were to stand as contem-

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plated by the parties, therefore, B's situation would be unchanged as all of the $3,000 required to make the annual payment would be deductible from net income before taxes. For A, 25% of the $3,000, or $750, would accrue to taxes, and he would realize $2,250 net each year—all other things being equal. Should this designation be declared improper, however, say the covenant is deemed to be given for the beneficial enjoyment of the goodwill that B purchased (and thereby inseparable from goodwill), the tax picture changes considerably. In order to have $3,000 net income after taxes with which to make the payment, B would have to earn $4,000 before taxes, net. Of the $3,000 payment received by A, one-half, or $1,500 would be excludible as a long term capital gain. The tax on the remaining $1,500 at 25% would be $375, thus leaving A with a net payment of $2,625, an increase of $375 from the previous situation. However, the federal government is the real gainer in such cases as it now receives a total of $1,375, where its previous income was the $750 tax paid by A.

The difference in the parties' marginal tax rates can make the disparity wider or narrower, depending upon the change in designation. In the case of corporations, higher taxes can result in the capital asset designation of the covenants proceeds since corporations do not enjoy the one-half exclusion on long term capital gains.

Regardless of the arithmetic involved in a changed designation, and how much additional taxes the government may
gain, the fact remains that the parties envisioned a different structure in their bargaining, and the change results in a distortion of the agreement. Had seller known that he would enjoy capital gains tax treatment on the proceeds, instead of ordinary income, he would likely have been willing to accept a lower sum. On the other hand, had the buyer known that his payments would have to come from after-taxes dollars, he well may have been unwilling to pay as much.

How much of a disconcerting effect this changeling situation may have depends upon the certainty which the parties have in effecting one designation or another. This, of course, is a function of being able to follow the criteria laid down by the designating entity. The criteria will be closely examined for reliability and precision in Chapter IV, but it is necessary to trace the steps in the processes of allocation and designation first to enable one to identify the allocators and designators in order of authority.

Initially, the parties to the contract of purchase and sale discuss the value of each component in their negotiations. Presumably, each is concurrently mentally designating each item in terms of his own tax structure in order to determine how many net dollars will be required to pay for the firm (buyer's contemplations as to the deductibility of his payments, wholly or partially), and how much of the proceeds will be realized after taxes (seller's approach).
Next, if a contract is effected, the allocations may be inserted into the instrument, in fact or implicitly. In some few cases examined, the income tax designation may also be specifically mentioned, as it was contemplated by the parties to the agreement, as in Benjamin Levinson, et al., supra, note 4, this chapter.

Following the execution of the contract, each party must make both an allocation and a designation of the proceeds in his income tax return. The Internal Revenue Service then screens the return, and, if it agrees with taxpayer's conclusions, the matter essentially ends at that point. However, if a discrepancy is noted, the taxpayer will be notified to that effect with a statement of the amount of deficiency (this study is not concerned with overpayments). The taxpayer then must pay the deficient sum. If he refuses to pay, the Commissioner of Internal Revenue will instigate criminal action against him. On the other hand, if he pays and wishes to dispute the matter, a hearing with the Commissioner is requested. If the taxpayer is still dissatisfied after such a hearing, he then may instigate legal action against the Commissioner. Thus, in the case of Commissioner against the taxpayer, or taxpayer against Commissioner, the ultimate allocator and designator is the tax court. It is the tax court's criteria for allocation and designation which must be followed to avoid uncertainty in the tax treatment. The question is: Can these criteria be followed?
CHAPTER IV

COVENANT TAX DESIGNATION AND ALLOCATION

ELEMENTS OF UNCERTAINTY

Contradictions in the Courts

In determining the validity and enforceability of the covenant from the protection standpoint, the courts rely upon the criterion of reasonableness consonant with the public interest. As indicated in Chapter II, concepts of time and geographic area in support of reasonableness can be definitely expressed in conservative terms. It was concluded that a high degree of protective certainty could be assured by adhering to the previously court-approved restraints of three years in time and the provable trade area. Are there any such readily discernible concepts which support the designative and allocative criteria of the tax courts?

First, one needs to look at the general criteria used by these courts in designating the covenant not to compete. In its 1965 Standard Federal Tax Reports, Commerce Clearing House sets forth two broad criteria which are essentially the

1 665 CCH STAND. FED. TAX REP., Par. 4717.0977.

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same as the guidelines indicated by the courts in that portion of each case where the opinion is introduced:

1) Where an agreement not to compete accompanies the transfer of goodwill 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 goodwill he has acquired, the agreement is regarded as nonseverable and as being in effect a contributing element to the assets transferred, and hence gain therefrom is treated entirely as a capital gain.

2) Where the covenant not to compete is dealt with as a separate item in the sale of a business, payment received for the covenant is ordinary income.

To illustrate the application of these criteria in the courts, Commerce Clearing House cites fourteen exemplary cases for the first category, and seventeen such cases for the second. Most of these matters are of recent (current ten years) adjudication, but some older cases are cited to show development over time. In an attempt to determine if any basic concepts from these cases had been used with a high degree of consistency, or certainty, in supporting either of the designative criteria, all of them were analyzed in detail. Thirteen additional cases, all recent and pertaining to the same matter, were also examined.

The criteria for designating the tax status of the covenant are generally well-known and established in the tax courts, but in the form indicated by Commerce Clearing House. One other highly pervasive guideline should be added: "All of the facts and circumstances of each case must be considered."
Using these forms of criteria, the tax courts have the considerable task of determining when and under what conditions a covenant is given "primarily" to assure the purchaser of the "beneficial enjoyment of the goodwill he has acquired," and what constitutes dealing with the covenant as a "separate item in the sale of a business."

From the forty-four legal battles analyzed, ten basic concepts have been selected for illustration. These concepts are of a type which might reasonably be expected to transcend the boundaries of any case or set of cases, as will be apparent. The matter of certainty in the tax designation of the covenant not to compete will also become obvious as these cases are . . . .

One of the concepts advanced throughout the cases is that an allocation of a portion of the purchase price to the covenant not to compete constitutes evidence that the parties dealt with the covenant as a separate item. Consequently, in Ernest E. Suggs, supra, note 3, Chapter I, when $50,250 of the total of $72,000 paid for the Suggs' insurance business was allocated in the contract to the covenant, it was designated by the court as ordinary income. The court stated, "The value agreed upon as evidenced by the executed contract is all we have to measure . . . ." However, in Joseph Faulkner and Marjorie Faulkner v. Commissioner of Internal Revenue, 2

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with $10,000 of the total price of $29,250 ascribed in the contract for the restrictive covenant, the court said that "... allocations within a contract do not make the proceeds ordinary income," and designated the entire sum as from the sale of a capital asset.

Conversely, where no allocation is made to the covenant in the contract, the admission has been in support of the nonseverability of the covenant and treatment of the proceeds as a capital asset. Therefore, in Edward A. Kenney and Estate of Helen V. Kenney, Deceased, etal v. Commissioner of Internal Revenue, the court noted that "neither party placed any independent value on the covenant not to compete, and we can ascribe none to it." In another case wherein there was no allocation to the covenant, however, Williamson & Waite, Inc. v. United States of America, it was observed by the court that while the contract did not specify any portion of the total consideration of $25,000 as applicable to the covenant, such was the "dominant and controlling asset" that $18,750 was allocated to it and designated as ordinary income.

Another concept often advanced to negate any value of a covenant not to compete is the inability of the covenantor

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to compete. This was considered relevant and admissible in *George J. Aitken and Elizabeth M. Aitken v. Commissioner of Internal Revenue,* where the court found that the covenant had no worth, stating, "Because of his ill health at the time of entry into this contract, petitioner would not have been physically able to compete with (buyer)." A little over three years later, the court was unimpressed with this concept and, in *Charles W. Balthrope and Mary W. Balthrope v. Commissioner of Internal Revenue,* it stated that, "In this case, the ill health of seller only established an urgency to the sale." The allocation to the covenant was upheld as ordinary income.

The point at which the covenant enters the negotiations, relative to the time when the purchase price is set, is a concept often noted. In *James G. Thompson v. Commissioner of Internal Revenue,* the total purchase price was agreed upon before the parties discussed the covenant not to compete. Disallowing any allocation to the covenant, the court declared, "Coming as it did after the price had been fixed, it (the covenant's allocation) can hardly be taken as being part of the bargained-for consideration." Such conceptual logic was unimportant to the court in the matter of

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Anthony Rock v. Commissioner of Internal Revenue. Rock arrived at an agreed price of $108,000 for his minority stock interest in a dairy. Then, on the day of the contract's execution, two agreements were presented—one for $63,000 for stock and another of $45,000 for a separate covenant. The allocation to the covenant was upheld.

In Bertha Schwartz and Harry Schwartz v. Commissioner of Internal Revenue, an allocation of $110,000 of the total price of $725,000 paid petitioners for their markets—specified in the contract as for the covenant not to compete—was disallowed for being "unrealistic." However, petitioner's plea in Benjamin Levinson, supra, note 4, Chapter III, that $142,000 of the $147,000 purchase price received by him was unrealistically allocated to the covenant was rejected. The court noted that it realized that a more realistic allocation might have been made and that the allocation included in the subject contract was made at the insistence of purchasers acutely aware of the tax consequences, but it rejected unrealism as in impinging concept.

Whether the installment payments for a covenant not to compete cease upon actual competition has been a concept for testing the agreement's authenticity. In Emmette L. Bar-

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ran, supra, note 9, Chapter II, the covenant's allocation gained in credibility as a separate item because its payments were to stop if sellers competed. However, the contractual agreement that payments for the covenant were to continue, even after seller's death, in Benjamin Levinson, supra, note 4, Chapter III, did not even gain admission as a concept in devaluing the covenant. Dismissing it from consideration, the court observed that "... the payments to other persons of any remaining installments in the event of (petitioner's) death prior to (completion of the contract) we think, are immaterial."

The courts appear to alternate in admitting the concept of whether the parties had knowledge of the tax consequences of the agreement into which they entered. Thus, in E. E. Suggs, supra, note 3, Chapter I, the court stated that "It may well be that the sellers did not know ... the tax consequences of the allocations in (paragraph containing the covenant), but that is immaterial as long as the contract was otherwise fully understood by the parties." Greater sympathy was offered by the court, although the allocation was not changed, in John W. Rogers and Creta B. Rogers v. United States of America when it was allowed that "Had there been any equivocation or any confusion as to what was done (allocation to the covenant designated as ordinary income to sellers), then

taxpayers would have had a far different case."

In William D. Allison and Sara L. Allison v. Commissioner of Internal Revenue\(^{11}\) the concept that purchaser would not have bought without a protective covenant was admitted as consideration in support of the covenant's being primarily to assure purchaser the benefit of the goodwill which he had bought, hence nonseverable from goodwill. The same concept in Benjamin Levinson, supra, note 4, Chapter III, and E. E. Suggs, supra, note 3, Chapter I, was admitted as contributing to the opposite contention—that the covenant had been dealt with as a separate item.

When the agreement for sale and the covenant not to compete are contained in a single contract, the court might deem this as contributing evidence that the covenant is no more than protection of goodwill and, therefore, a capital asset. Such was the conclusion in Joseph Faulkner, supra, note 2, this chapter. On the other hand, this type of contract may be acceptable in a matter similar to Ben Lichtman and Ruth Lichtman, et al v. Commissioner of Internal Revenue\(^{12}\) where $35,000 of a $40,000 purchase price was held to be for the covenant, severable from goodwill.

Finally, in the matter of Sidney Alper and Sydelle

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Alper v. Commissioner of Internal Revenue\textsuperscript{13} the covenant's separated allocation of $42,335 of the total proceeds of $35,000 was adjudged nonseverable from the goodwill purchased because the court saw it not as personal in nature, but simply as a means for the buyers to decrease possible future competition and thereby protect goodwill. This concept was applied oppositely in Emmette L. Barran, supra, note 9, Chapter I, where one of the reasons advanced for designating the covenant as a severable item was that the buyers might have been willing to effect such an agreement with anyone, without buying his business and goodwill, as a means of decreasing possible future competition. In one case decreasing competition contributed to evidence that the covenant was nonseverable from goodwill, yet in another case the same concept was accepted in support of the opposite proposition.

The point of these examples, and there are many more, is that finding concepts which are certain to support one desired designation is difficult to say the least when one is dealing with the designative criteria of the covenant not to compete. In all of these examples, the same concept accrued to either designation. Thus, a taxpayer may not take a concept, or a bundle of them, from cases already decided and thereby assure himself of a similar outcome— even though his

\textsuperscript{13} S. Alper, 15 CCH Tax Ct. Mem. 1415 (1956).
concepts may seem to parallel those in other cases. The sum of the concepts is not a guarantee of a desired designation because each case's total context—its collective facts and circumstances—will bear upon the alignment of each concept, and each case will differ from its predecessors and successors.

Although the allocation and designation may change, the covenant's protective features are not altered by such changes in its taxation. Once validated, or not invalidated, the protection remains even though the consideration paid for it may be drastically altered in after-taxes dollars.

For all of the other components to the sale, some kind of reliable approach is available to secure a high degree of certainty in the tax treatment. No precise means of valuing or designating the covenant exists at this time, however, as the preceding cases indicate. Perhaps it was after a study of such cases that the National Association of Insurance Agents' general legal counsel, George S. Hanson, was prompted to write, "The tax consequences of the purchase and sale of an insurance agency cannot be stated in a categorical way"—almost every sale of an insurance agency contains an agreement with a covenant not to compete.\textsuperscript{14}

Aside from the designative and allocative uncertainties which result even with expert legal handling of a cove-

nant, other elements of uncertainty are inevitable.

Miscellaneous Covenant Tax Pitfalls

The entrapments which contribute to tax uncertainties in this area can be divided into two broad types: (1) technicalities of the law, and (2) taxpayer-initiated difficulties. In the former category, a cure could be legal expertise, but even with a highly-skilled tax attorney, oversights can occur. The second division will not diminish until the basic human personality is altered—as the cases used to illustrate it will show. Both of these areas represent elements of uncertainty which are bound to re-occur, and the inclusion of a covenant not to compete in the agreement for sale is the catalyst.

One of the legal pitfalls which sellers might encounter is best exemplified by the case of *Anthony Rock*, *supra*, note 8, this chapter. In this matter, Rock sold his stock interest in a dairy and designated part of the proceeds for the stock and part for a covenant not to compete—in the contract. When he filed his tax return, Rock treated the entire sum as proceeds from the sale of a capital asset and the Internal Revenue Service disagreed. In the ensuing legal battle, Rock based part of his argument on the contention that the covenant had been given to insure the purchaser the beneficial enjoyment of the goodwill transferred and was, therefore, nonseverable from that goodwill. The argument lost all weight, however, when
the court noted that stock had been sold—evidence of ownership of a business, not the business itself. Since stockholders have no direct proprietary interest in goodwill, the covenant had to be severable. Therefore, if stock is being sold, taxpayers may not rely on the contention that an accompanying covenant is to insure the purchaser the beneficial enjoyment of goodwill being transferred since no goodwill is being transferred. This same factor applied to Charles W. Balthrop, supra, note 6, this chapter, and to Pickering and Company, Inc. v. Commissioner of Internal Revenue.\textsuperscript{15}

In Nelson Weaver Realty Company and Nelson Weaver Mortgage Company, Inc. v. Commissioner of Internal Revenue,\textsuperscript{16} Nelson Weaver Mortgage Company, Inc., sold its mortgage servicing contract with the New York Life Insurance Company to a third party. Nelson Weaver Realty Company, which had written policies of dwelling insurance on the mortgaged properties, thought that it was also selling those policies' expirations to that same third party. Realty Company accompanied the sale with an agreement not to solicit nor write the renewal policies on any of the dwellings whose mortgages were being transferred for servicing. Because the mortgage records contained all of the information necessary to renew the insurance policies, in many cases containing the original


policies, Realty Company saw no reason to furnish any of its insurance agency records to the purchaser. This was one of their downfalls in the case because the court held that the absence of tangible records of insurance being transferred made it evident that expirations had not been sold. Thus, no capital assets in the nature of goodwill—from an insurance standpoint, the expiration records—were involved, and the covenant not to compete was the real benefit which the court saw being transferred as a separate item. This changed the tax designation of $3,000 of the proceeds to Nelson Weaver Realty Company from capital gain to ordinary income.

The second major category of miscellaneous pitfalls is taxpayer-initiated difficulties. Taxpayers often appear to be their own worst enemies in cases involving the covenant not to compete. Perhaps persons with the business acumen and personality complex capable of building a going concern which is salable have the fallibilities of specialization and extreme independence. Regardless of whether the problems are personality-derived, however, the following three cases will serve to illustrate this further area of uncertainty in the instance of the covenant not to compete.

In the matter of Thomas R. Yandell and Dorothy S., Yandell v. United States of America, Mr. Yandell sold his

partnership interest in an accounting firm through a contract which stated that the total consideration was being paid to him for his covenant not to compete. As Mr. Yandell was an accountant, he felt no need to engage a tax attorney to assist him. He was certain by all rules of the ledger that he was selling fundamental goodwill no matter what the contract called it. The court was not as cognizant of good accounting practices as Yandell, however, and it held that his testimony in direct conflict with the provisions of a written instrument freely signed by him was of little weight. Therefore, his entire proceeds were designated as ordinary income, despite Yandell's firm conviction that the whole matter was simply an error in terminology.

Mr. Ernest Suggs, in the case of E. E. Suggs, supra, note 3, Chapter I, engaged and consulted with an attorney, but his lawyer was not a tax specialist. When Suggs took the contract for the sale of his insurance agency, in its final pre-signing form with $50,250 of the total price of $72,000 allocated to a covenant not to compete, to his counsel the latter advised some minor changes, but completely overlooked the covenant's significance. This moved the court to note that, "It may well be that the sellers either did not know or entirely overlooked the tax consequences of the allocations in Paragraph 11 (the covenant), but that is immaterial as long as the contract was otherwise fully understood by the parties."
The court then designated the $50,250 that the Suggs had contemplated as capital gain to be ordinary income.

Perhaps the party for whom one is least inclined to feel sympathy in these matters is he who engages competent tax counsel, lawyer and accountant, and then disregards their advices. In the case of Benjamin Lichtman, supra, note 12, this chapter, the court also held little pity for petitioner when it designated $35,000 of the $40,000 proceeds from the sale of his laundry as ordinary income instead of capital gain. It was noted that the covenant's allocation of $35,000 had been separately bargained for, valued, and agreed to by parties advised by competent tax counsel. Lichtman apparently was certain that the covenant would be nonseverable from goodwill and did not heed expert advices that it possibly could be severed.

No One Factor a Sole Determinant

It should be stressed that many other factors entered into the decision in all of these cases. Although some concepts indicated may have had an apparently strong bearing on the outcome, in no case examined was any single item indexed as the entire basis of the promulgation. It is this matter of having to consider the total context of each case in order to accept, reject, weight, and align its concepts that makes each matter unique. Because of this singular nature, the changeling aspects of the covenant not
to compete's tax designative criteria make it an item of high risk—uncertainty—from a tax standpoint.

Further, where the other components are definable in mathematical terms, the covenant not to compete is a purely rhetorical item. It is defined in words, not accounting procedures, and it can be attacked rhetorically. Once given a legitimate birth, however, it can then be dealt with in accounting terms.

Of course, there is a way to avoid the tax uncertainties introduced by the covenant not to compete—do not include one. Excluding the covenant, however, also excludes its protective qualities and its ability to assist in the marketing of goodwill.
CHAPTER V

SUMMARY AND CONCLUSIONS

Protection Certainty Greater Due To Covenant

A covenant not to compete constitutes a contractual obligation of the seller. If reasonable in its terms, the covenant is legally valid and its protective qualities for the buyer are achieved with a high degree of certainty. If unreasonable, however, the protection will be no less than that afforded in the absence of such an agreement. Further, a valid covenant is enforceable at law, and violations of its restrictions entitle the injured party to seek relief and/or damages through the courts.

One possible detraction of some import is obvious to those who delve into this matter to any extent, and it should be asserted at this point. Since there is no way to be absolutely certain of the protective features of a covenant, a measure of this consideration should be injected into every such bargaining series. A buyer could find himself in far worse circumstances if he believed a covenant was effective, bargained in price terms commensurately, and executed a con-
tract with a subsequently-deemed unenforceable covenant, than if he had dealt originally without a covenant. In such a situation, the purchase price would be higher due to belief in the covenant's validity than it would have been in the absence of any contemplation of a covenant. Thus, at least a portion of the price paid would have gone for a non-existent asset—an unenforceable covenant. When no covenant is included in a sale of a going business, the buyer can assume a defensive price posture. In these cases, it is better not to have bargained at all than to have bargained and lost.

As Chapter II indicated, however, the protective certainty afforded by a covenant with parameters of minimum reasonable time and provable geographic area is greater than would exist in the case of no covenant. A high certainty of protection in such matters is a direct function of proper legal advice sought and followed. Further, price considerations should be in terms of minimums of time and space as the maximums, i.e. — outer feasible limits of three years for the time restriction and a definable, provable radius of past business transactions as the trade area constraint. In this manner, a conservative approach will reduce the chance of loss resulting from an invalidated covenant. With these qualifications, the first portion of the thesis' problem statement was activated affirmatively. To restate it, the certainty of protection is greater with a covenant not to compete.
Tax Designation Certainty Diminished

As Chapters III and IV indicated, the introduction of a covenant is accompanied by elements of uncertainty in designating the sale proceeds for federal income tax purposes. A proper handling of the assets is a matter for considerable expertise without the complications of a third variable, the covenant not to compete. Not only is the valuation of a covenant a matter unique to each case, it is an item whose allocation and designation in the contract may have little or no bearing on the tax courts' findings. No appraisal experts or prior accounting functions are available in the uncharted grounds of the covenant.

The cases in Chapter IV illustrated that the designation of the sale proceeds can be changed, wholly or partially, from capital gain to ordinary income whether any part of the sale price was allocated to the covenant or not. Similarly, with no established precedents to follow, any contractual allocation or designation may be wholly embraced or rejected by the courts. Of course, cases can be found (to a lesser extent) in which any of the assets' allocations and designations were changed. The point to be made for the covenant, however, is that it enhances the uncertainties of the situation by constituting a more volatile variable which adds to the number of uncertainty combinations. It is, in a sense, exponential where the others are arithmetic. In any
case, the degree of risk or uncertainty in the sale proceeds' tax designation is greater with a covenant than without it.

To illustrate this point, the cases chosen for Chapter IV were of an exemplary nature in the area concerned. They contained concepts of a basic nature, and it was demonstrated that the same concept could aid in the establishment of either tax designation. Even in cases where expert counsel had been employed, the matter was of such a controversial nature that legal gamesmanship became necessary to resolve many cases. Because of the fundamental character of these conflicts, and because of the continuing vague designative criteria, it can readily be expected that any number of future tax court battles will have the same underlying structure, conceptually.

Conclusions

On the basis of the evidence revealed and analyzed by this study, the problem must be stated in the affirmative: Yes, the covenant not compete does achieve greater certainty of eliminating future competition from the seller at the cost of diminishing certainty in the federal income tax designation(s) of the purchase monies. Other conclusions in the nature of observations, advices, and comments are coincident with the purposes of the study, however, and will forthwith be offered.

It is not within the province of this thesis, legally
nor logically, to offer firm advice about the drafting of contracts. What will be given, in the interest of disseminating information and thoughts, are suggestions of some approaches which the cases examined seem to indicate as favorable. In order to instill these implications with the property of emanating from a valid sampling, the sole frame of reference will be the thirty-one exemplary cases from Commerce Clearing House.

Among the cases indicated, certain concepts were conspicuous by their prevalence, or absence, from either designation. Fourteen of the thirty-one cases were listed under a heading which categorized their designation outcome as capital asset, nonseverable from goodwill. The remaining seventeen cases comprised the separable, ordinary income designation outcome. Although it must be noted again that no single concept was found which constituted the court's sole determinant in promulgating a decision, some concepts appear to be amenable to forming a base upon which to build for a particular designation.

In nine of the fourteen cases which culminated in the capital asset designation of the covenant, no part of the purchase price was allocated to the covenant in the contract of sale. Further, in none of these cases was the covenant contained in a separate instrument. Conversely, all seventeen ordinary income cases had some part of the
proceeds specifically allocated to the covenant, and nine of these cases dealt with the covenant in a separate contract with a separate price designation. What is strongly evident here is that the courts have accepted the concept of separation, as evidenced by the draftsmanship of the contracts, in support of the designative criterion for ordinary income, "dealt with as a separate item." Alternatively, the absence of such separation appears to accrue to the "nonseverable from goodwill" standard.

Transfers of personal service businesses seem to be especially susceptible to uncertainty and ensuing litigation over the covenant's designation. Of the thirty-one cases in Commerce Clearing House, the highest incidence of suit—five of the thirty-one cases—involves fire and casualty insurance agency sales. Second place on this dubious list is accorded to accounting firms with four of the cases cited.

Drafting a covenant not to compete, both from the protective and tax designative viewpoints, is a matter of some degree of uncertainty and for technical expertise. Professional tax counsels—tax attorneys and accountants—are aware of this. Persons who engage in study and research in the particular realm of the covenant become cognizant of its powers and tax consequences. But professional businessmen, who are the immediately interested parties to many contracts containing the restrictive covenants and whose dollars are at stake, all too often do not realize fully the cove—
nant’s implications. If their dollars and cents deliberations are to culminate in a meaningful, after-taxes meeting of the minds, the advices of experts in the tax field are needed from the beginning of negotiations. As previously mentioned, the purchase price is the essence of a contract of sale, but the significant sum is that to be realized by both parties after taxes. Logically, any distortion of that bargained-for sum must result in an alteration of the original meeting of the minds.

As an example of the degree of careful draftsman-ship requisite to the designation of an allocation to the covenant not to compete as ordinary income, some of the courts’ judgment criteria in addition to those previously indicated are: (1) the covenant must be bargained for as a separate item in the total affair, not merely entered into a separate contract; (2) the value assigned to the covenant must have some independent basis in fact and not be just a tax device; (3) the price allocated to the other assets must be realistic; (4) the contract must accurately reflect the parties’ agreement reached at arm’s length with respect to the covenant; (5) the covenantor must have the capacity to compete.

The parties should consider and agree to the covenant not to compete’s allocation and designation so that they are clear about their desires. This process requires knowledgeable assistance. Then the parties’ desires must be entered
into a contract in such a form that the probability will be high for any subsequent tax authority or court to find only that which the parties intended. Again, the drafting excellence of artisans is required. In summation, the admonition given to member-agents by the National Association of Insurance Agents' chief legal counsel, George Hanson, is highly appropriate:

Some concepts of great value have been emerging from recent tax decisions. The most fundamental concept is that, whether the agent is buying or selling, professional legal and tax advice is essential before the contract is entered into. Careful draftsmanship of the purchase and sale contract is essential. After the contract is signed, it is too late to change the tax consequences.

A proper contract entered into by parties with adequate information on which to make their judgments is one which will reduce the necessity for the courts to construe. It is submitted that this will also elevate the probability that the parties' wishes will succeed, based as they are on expertise.

Final Observations

Many of the cases examined culminated in economic heartbreak for one of the parties involved. Although this

adversity was severe in many cases, coincident with it was evidence that it was often a function of people trying to arrive at proper judgments armed with inadequate or improper information. In some few cases, however, where the advised careful draftsmanship and expert counsel was present, the courts still found contrary to the contractually-stated allocative and designative terms. While this study could offer little hope to those who dealt from positions of ignorance, it was going to propose a remedy for the well-conceived cases' adverse outcomes which would establish near-ultimate certainty for those prudent enough to seek and follow proper ascriptions.

As a final observation, therefore, this study was going to recommend that the courts and the Internal Revenue Service concur on a rule which would force all parties to follow the allocations and designations agreed to in the contract for sale, excepting only otherwise illegal contracts. Thus, those who would make themselves aware of this rule could deal with great certainty about the tax treatment of their sale proceeds. Before the study was concluded, however, it was discovered that the Internal Revenue Service had already made such a recommendation to the courts in a 1965 case, Carl L. Danielson and Pauline L. Danielson, et al. v. Commissioner of Internal Revenue, where the court noted that:

Respondent vigorously urges us to adopt a new "rule"
of law concerning the treatment of such written covenants. The proposed "rule" would prevent either contracting party thereto or the respondent from subsequently attacking the stated consideration in such agreements unless fraud, duress, or undue influence existed at the time they were signed...

We are unwilling to abdicate our judicial responsibilities of examining the substance of a transaction. We are not bound by its form. We are under no obligation to restrict ourselves to the written documents evidencing covenants not to compete, which, of course, would prevent us from arriving at a decision based on all the pertinent facts.

With this pronouncement, the court effectively emasculated what was to have been this study's recommendation for the resolution of the problem. Perhaps the best advice to be offered is to restrict oneself to dealings with men of good will and sound knowledge. Further, one should beware of petty men in all dealings for no contract can be written or adjudicated to afford protection from such as they.

After reading the works of Malthus, Thomas Carlyle was led to call economics the "dismal science." Based upon the final outcomes of its research, this study would propose that the attempt to inquire scientifically into the federal income tax treatment of the covenant not to compete be deemed the contemporary "dismal science."

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