2 T.C. 794 (1943)

When a business is sold, and the sales agreement includes a covenant not to compete, the entire consideration should be treated as a single transaction for tax purposes, and the value of the covenant not to compete is not considered separate income.

Summary

Toledo Newspaper Co. sold its newspaper business, including intangible assets and a covenant not to compete, to Toledo Blade Co. The Commissioner argued that the portion of the sale price allocated to the non-compete agreement was ordinary income, not capital gains. The Tax Court held that the entire transaction should be treated as a single sale of a business, and the gain should be calculated by subtracting the March 1, 1913, value of the intangibles from the total consideration received. The court determined the March 1, 1913, value of the company's intangibles based on its financial history.

Facts

Toledo Newspaper Co. published "The Toledo News-Bee" from 1903 to August 2, 1938. On August 1, 1938, Toledo entered into a contract with Toledo Blade Co. to discontinue publication of The Toledo News-Bee for ten years, and not allow its equipment to be used for any other publication in Toledo during that time. The contract also included the sale of the name, circulation lists, and related assets of the newspaper. The Toledo Blade Co. agreed to pay $780,000 for Toledo's agreement not to compete and $100,000 for the newspaper's name and circulation lists.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in Toledo Newspaper Co.'s income and excess profits taxes for 1938, arguing that the income from the non-compete agreement was taxable as ordinary income. Toledo Newspaper Co. appealed to the Tax Court.

Issue(s)

Whether the consideration received for a covenant not to compete, included in the sale of a newspaper business, should be treated as ordinary income or as part of the total consideration for the sale of the business?

Holding

No, because when the covenant not to compete is integral to the sale of a business, the entire consideration received should be treated as a single transaction when calculating gain.

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Court’s Reasoning

The Tax Court reasoned that the covenant not to compete was an integral part of the sale of the newspaper business. The court distinguished cases where payments for promises not to compete were made to individuals (officers or stockholders) rather than the selling corporation itself. In those cases, the individual sold no capital asset but simply received money for agreeing not to compete. The court noted, “In the purchase of a newspaper business, as a going concern, it is customary that the purchaser require of the seller… a covenant to refrain for a reasonable period from reentering into the business… This is necessary in order to prevent the seller from destroying the value of the good will of the business transferred.” Because the non-compete agreement was intended to protect the goodwill transferred to the buyer, it was inseparable from the sale itself. The court used a formula to determine the March 1, 1913 value, and subtracted that from the total consideration to determine taxable gain.

Practical Implications

This case clarifies that when a covenant not to compete is an integral part of the sale of a business, the payment for that covenant is not treated as separate ordinary income. This benefits sellers by allowing them to offset the payment against the basis of the assets sold. Attorneys structuring business sales need to carefully consider whether a non-compete clause is truly integral to protecting the transferred goodwill, or whether it could be construed as a separate agreement. Later cases may distinguish this ruling if the non-compete agreement is not clearly tied to protecting the value of the business being sold. This decision emphasizes the importance of properly valuing intangible assets and goodwill when structuring business sales.

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