12 T.C. 204 (1949)

When a business is sold for a lump sum and the seller claims capital gains treatment for the entire gain, the burden is on the seller to prove what portion of the purchase price should be allocated to goodwill or other capital assets; failure to do so will result in the entire gain being treated as ordinary income.

Summary

Violet Newton and her husband sold their business, Puget Sound Novelty Co., for a lump sum. The assets included inventory, accounts receivable, credit deposits, goodwill, and the right to use the firm name. The Newtons treated the entire gain as a capital gain, but the Commissioner of Internal Revenue determined that 95.51224% was ordinary gain and only 4.48776% was capital gain. The Tax Court upheld the Commissioner's determination, finding that the Newtons failed to provide sufficient evidence to establish a specific selling price attributable to goodwill or other intangible assets. Because the bulk of the assets consisted of inventory and equipment, and the taxpayers failed to adequately value any goodwill, the court sided with the IRS.

Facts

The Newtons, a marital community in Washington state, owned the Puget Sound Novelty Co., a wholesale distributor of pinball machines and amusement devices. They sold the business on December 24, 1943, for $22,150. The sale included all assets: furniture, fixtures, equipment, inventory ($14,033.05), a deposit on equipment ($2,950), a reserve with American Discount Co. ($2,670), accounts receivable, goodwill, and the right to use the business name. The inventory was listed at cost. The sale agreement did not allocate a specific price to each asset.

Procedural History

The Newtons reported the entire gain from the sale as capital gain on their 1943 tax return. The Commissioner of Internal Revenue determined a deficiency, allocating 95.51224% of the gain to ordinary income from the sale of inventory and 4.48776% to capital gain. The Newtons petitioned the Tax Court, contesting the Commissioner's allocation.

Issue(s)

Whether the gain realized from the sale of the Puget Sound Novelty Co. constituted a capital gain in its entirety, as claimed by the Newtons, or whether the Commissioner's allocation of 95.51224% ordinary income and 4.48776% capital gain was correct.

Holding

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No, because the Newtons failed to present sufficient evidence to establish a definite part of the gain resulted from the sale of goodwill and other intangibles.

Court’s Reasoning

The court stated that the Commissioner’s determination is presumed correct, and the burden is on the taxpayer to prove it wrong. The court noted that while the sale included tangible assets (furniture, fixtures, equipment, inventory, deposits, reserves) and intangible assets (goodwill, right to use the name), the Newtons failed to provide evidence supporting a specific allocation of the purchase price to goodwill. The court found the location of the business, while potentially valuable, was not owned by the Newtons but leased on a short-term basis, and the purchasers had to negotiate a new lease. Any “franchise” to represent manufacturers was based on oral agreements terminable at will. The court emphasized the absence of a goodwill item on the company’s books. The court concluded that the tangible assets, especially the inventory, represented the primary value of the business. As the court stated, “We conclude, therefore, that insufficient evidence has been introduced to establish that any definite part of the gain resulted from the sale of good will and other intangibles, and the respondent’s determination is sustained.”

Practical Implications

This case reinforces the importance of properly documenting and valuing intangible assets, such as goodwill, when selling a business. Taxpayers seeking capital gains treatment for the sale of such assets must provide concrete evidence supporting the allocation of the purchase price. This can include expert appraisals, detailed financial records, and evidence of the factors contributing to the value of the intangible assets. The case highlights that simply claiming a portion of the sale price is attributable to goodwill is insufficient; taxpayers must substantiate their claims with verifiable data. This case informs tax planning for business sales, underscoring the need for detailed agreements that explicitly allocate the purchase price among various assets to avoid disputes with the IRS. Later cases cite *Newton* for the principle that the taxpayer bears the burden of proving the value of goodwill when seeking capital gains treatment. Also, cases regarding the sale of a business must specify what assets constitute the capital assets being sold and their value.

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