13 T.C. 143 (1949)

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When a business is sold with a covenant not to compete, the portion of the purchase price attributable to good will is taxed as capital gain, while the portion attributable to the covenant not to compete is taxed as ordinary income, provided these elements are severable.

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Summary

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Rodney B. Horton sold his accounting practice, including client files, work papers, and good will, to Masquelette & Co. The sale included a six-year covenant not to compete. The Tax Court addressed whether payments received under the sale agreement should be treated as capital gains from the sale of good will or ordinary income. The court held that the payments were partially attributable to good will (capital gain) and partially to the covenant not to compete (ordinary income), allocating 50% to each. This determination hinged on the severability of the covenant from the good will in the sales agreement.

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Facts

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Rodney B. Horton, a certified public accountant, operated an accounting practice in Albuquerque, New Mexico, under the name Horton & Bixler. On October 1, 1941, Horton sold his business to F. G. Masquelette & Co. The sale included: the good will of the firm, furniture, fixtures, office supplies, uncompleted audit contracts, and client files. As part of the agreement, Horton agreed not to compete in public accounting in New Mexico for six years. The consideration included a cash payment, monthly payments for three months, and a percentage of fees collected by Masquelette from its Albuquerque office for five years.

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Procedural History

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The Commissioner of Internal Revenue determined deficiencies against Rodney and Eileen Horton for the years 1942 and 1943, arguing that payments received from the sale constituted ordinary income, not capital gains as reported by the Hortons. The Tax Court reviewed the Commissioner's determination.

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Issue(s)

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Whether payments received by the petitioners in 1942 and 1943, pursuant to a sale agreement including a covenant not to compete, constitute ordinary income or capital gain from the sale of good will.

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Holding

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No, in part, and yes, in part. The payments were partially for the sale of good will (capital gain) and partially for the covenant not to compete (ordinary income), because the agreement and circumstances allowed for a severable allocation between the two.

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Court's Reasoning

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The Tax Court relied on the principle that payments for a covenant not to compete are ordinary income if the covenant is severable from the sale of good will. The court distinguished cases where the covenant primarily assures the purchaser's enjoyment of the good will, in which case the covenant is considered non-severable and part of the capital asset. The court found that the contract clearly indicated the sale of good will, stating: "Horton agrees to sell, and Masquelette agrees to buy…the good will of said firm of Horton and Bixler…" However, the court also noted the importance of Horton's agreement not to compete, leading to the 50/50 allocation. The court cited regulatory language defining good will as "the probability that the old customers will resort to the old place."

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