T.C. Memo. 1963-239

When a covenant not to compete is integral to the sale of a business and assures the buyer's beneficial enjoyment of acquired goodwill, its value is nonseverable and cannot be depreciated.

Summary

Barr purchased a dry cleaning business, including intangible assets, for $15,000, with a covenant not to compete from the seller. Barr sought to depreciate this $15,000 over the 5-year term of the covenant. The Commissioner denied the deduction. The Tax Court ruled against Barr, holding that the covenant was nonseverable from the acquisition of goodwill and, therefore, not depreciable. The court emphasized that the covenant was intended to protect Barr's enjoyment of the acquired business and its goodwill.

Facts

Barr acquired a dry cleaning business, Killey Cleaners, which had a reputation for quality work. The purchase price included $15,000 for intangible assets, accompanied by a 5-year covenant not to compete from the seller. Barr continued to operate the business under the same trade name. At the time of the sale, the seller was retiring due to health reasons and placed little independent value on the covenant.

Procedural History

Barr deducted the cost of the covenant not to compete as depreciation expense on his tax return. The Commissioner disallowed the deduction. Barr petitioned the Tax Court for review.

Issue(s)

Whether the $15,000 paid for intangible assets, including a covenant not to compete, is depreciable over the 5-year period of the covenant.

Holding

No, because the covenant not to compete was integral to the transfer of goodwill and served to protect the petitioner's beneficial enjoyment of the acquired business; therefore, it is nonseverable and not depreciable.

Court's Reasoning

The court reasoned that the covenant was intended to assure Barr's beneficial enjoyment of the goodwill he acquired with the business. The court found that the business possessed goodwill, as evidenced by Barr's investigation of the company's

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reputation prior to purchase. The court distinguished cases where depreciation was allowed for a covenant not to compete, noting that in this case, the covenant was intertwined with the transfer of a capital asset and its associated goodwill. Because the seller was already planning to retire, the court inferred that the primary purpose of the payment was to secure the acquired goodwill, not to compensate the seller for abstaining from competition. The court stated, “While it is true that any value attributable to customers’ lists and formulae was negligible, we feel that the business did have good will connected with it.”

Practical Implications

This case reinforces the principle that covenants not to compete are not always depreciable. The key is whether the covenant is truly bargained for independently or is merely ancillary to the transfer of goodwill. Attorneys must carefully analyze the substance of the transaction, focusing on the parties’ intent and the economic realities. If a covenant primarily protects the buyer’s investment in goodwill, its value cannot be depreciated. This decision influences how acquisitions of businesses are structured and how purchase price allocations are negotiated, especially when allocating value to covenants not to compete. Subsequent cases will consider if the covenant is separately bargained for, or merely part of the purchase to protect the existing goodwill. If the seller has no intention to compete, this further proves that the covenant is not distinct from the purchase of goodwill.

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