T.C. Memo. 1963-279

When a covenant not to compete is integral to the transfer of goodwill in the sale of a business, and primarily ensures the purchaser's enjoyment of that goodwill, the covenant is considered nonseverable and therefore not depreciable.

Summary

The petitioner, Barr, sought to depreciate $15,000 of the purchase price of a dry-cleaning business, arguing it represented the value of a 5-year covenant not to compete. The Tax Court denied the deduction, finding the covenant was nonseverable from the goodwill acquired with the business. The court reasoned that the covenant's main purpose was to protect Barr's beneficial enjoyment of the acquired goodwill, and therefore the cost associated with the covenant could not be depreciated separately.

Facts

Barr purchased a dry-cleaning business, Killey Cleaners, including tangible and intangible assets. The purchase agreement included a 5-year covenant not to compete from the seller, Killey. Barr allocated $15,000 of the purchase price to intangible assets, which he argued was attributable to the covenant not to compete. Barr continued to operate the business under the Killey Cleaners name. Killey had been advised to retire due to health reasons and initially placed little value on the covenant. Killey later re-entered the dry cleaning business, and Barr was then protected by the covenant.

Procedural History

Barr claimed a depreciation deduction for the allocated value of the covenant not to compete on his tax return. The Commissioner disallowed the deduction. Barr petitioned the Tax Court for review of the Commissioner's determination.

Issue(s)

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

Holding

No, because the covenant not to compete was essentially to assure the purchaser the beneficial enjoyment of the goodwill he has acquired; therefore, the covenant is nonseverable and may not be depreciated.

Court's Reasoning

The court relied on the principle established in *Aaron Michaels, 12 T.C. 17 (1949)*, that a covenant not to compete is nonseverable and non-depreciable when it accompanies the transfer of goodwill and its primary purpose is to ensure the purchaser's beneficial enjoyment of the acquired goodwill. The court determined that Killey Cleaners had goodwill, evidenced by Barr's investigation revealing customer loyalty. Although Barr cited expense as the reason for retaining the Killey Cleaners name, he still operated under it, further suggesting goodwill existed. The court noted Killey's initial willingness to provide the covenant due to health reasons impacting its value to him at the time of the sale. The court concluded any value assigned to the covenant was inseparable from the overall transaction involving the acquisition of a capital asset and the related protection of its beneficial enjoyment. The court distinguished cases cited by the petitioner where depreciation was allowed for covenants not to compete, referring to prior distinctions made in cases like *Rodney B. Horton, 13 T.C. 143 (1949)*.

Practical Implications

This case reinforces the importance of carefully analyzing the true nature of a covenant not to compete in business acquisitions. It clarifies that merely assigning a value to a covenant does not automatically make it depreciable. The key factor is whether the covenant is truly separate from the goodwill being transferred. Attorneys structuring business acquisitions must consider the relationship between the covenant and the goodwill to determine whether the covenant's primary purpose is to protect the goodwill or serves an independent function. If the former, the allocation of value to the covenant may be challenged by the IRS, and no depreciation will be allowed. This case highlights the difficulty in depreciating covenants not to compete when they are intertwined with the transfer of goodwill, impacting tax planning and negotiation strategies in M&A transactions. Later cases would further refine the tests for severability, considering factors like the economic realities of the situation and the intent of the parties.

