***Burke v. Commissioner*, 18 T.C. 77 (1952)**

A covenant not to compete, when it is executed in connection with the sale of a business and is considered nonseverable from goodwill, is not a depreciable asset for tax purposes.

Summary

Harold and Dorothy Burke purchased a dry cleaning business, allocating $10,000 to tangible assets and $15,000 to intangible assets, which they argued was solely for a 5-year covenant not to compete. The Burkes sought to depreciate the $15,000 over the covenant's term. The Tax Court disallowed the depreciation deduction, holding that the covenant was nonseverable from the acquired goodwill of the business. The court reasoned that the covenant's primary purpose was to protect the goodwill purchased, making it a capital asset inseparable from the overall acquisition of the business's intangible value, and therefore, not depreciable.

Facts

Petitioners, Harold and Dorothy Burke, purchased a dry cleaning business named Killey Cleaners & Furriers for $25,000. The sale agreement included tangible assets, customer lists, trade name, goodwill, and a 5-year covenant not to compete in a specified geographic area. Initially, the contract did not allocate the purchase price between tangible and intangible assets. Later, an amendment allocated $10,000 to tangible assets and $15,000 to intangible assets, which the petitioners claimed was solely for the covenant not to compete. The petitioners sought to depreciate the $15,000 over the five-year term of the covenant. The seller, Mr. Killey, was in poor health and had been advised to retire, suggesting the covenant was not a significant factor for him at the time of sale.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in the Burkes' income tax for 1946, disallowing their claimed depreciation deduction for the covenant not to compete. The Burkes petitioned the Tax Court to contest this deficiency.

Issue(s)

1. Whether the $15,000 allocated to intangible assets, specifically attributed to a covenant not to compete, in the purchase of a dry cleaning business, is depreciable over the 5-year term of the covenant.

Holding

1. No, because the covenant not to compete was nonseverable from the goodwill of the business acquired, and therefore represents a capital asset inseparable

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from goodwill, which is not depreciable.

Court's Reasoning

The Tax Court relied on established precedent that holds when a covenant not to compete is part of the sale of a going concern and is intended to protect the goodwill acquired by the purchaser, it is considered nonseverable from that goodwill and is not depreciable. The court emphasized that the Burkes acquired a going business with value beyond its tangible assets, including goodwill, as evidenced by customer preference for Killey Cleaners. The court noted, "where a covenant not to compete accompanies the transfer of good will in the sale of a going concern, and such covenant is essentially to assure the purchaser the beneficial enjoyment of the good will he has acquired, the covenant is nonseverable and may not be depreciated." Even though the contract allocated $15,000 to intangible assets, which the petitioners argued was for the covenant, the court found that the covenant's purpose was to protect the purchased goodwill. The court distinguished cases where covenants not to compete were found to be separately bargained for and depreciable, concluding that in this instance, the covenant was inextricably linked to the transfer of goodwill, making the entire $15,000 a non-depreciable capital expenditure.

Practical Implications

The *Burke* case clarifies that in business acquisitions, the tax treatment of covenants not to compete hinges on their relationship to goodwill. If a covenant is deemed integral to protecting the acquired goodwill, it is treated as a non-depreciable capital asset. This ruling is crucial for tax planning in business sales and acquisitions. It highlights the importance of properly characterizing and allocating value to different assets in purchase agreements. Legal professionals must carefully analyze the substance of such agreements to determine if a covenant truly stands alone or is merely ancillary to the transfer of goodwill. Subsequent cases have continued to apply this principle, often requiring a factual analysis to determine the severability of a covenant from goodwill in the context of business acquisitions for tax depreciation purposes.

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