Freedom Newspapers, Inc. v. Commissioner, 1953 Tax Ct. Memo LEXIS 254 (1953)

A covenant not to compete is a capital expenditure that can be amortized over its lifespan if it's treated as a separate item in a transaction and a specific price is allocated to it.

Summary

Freedom Newspapers, Inc. contested deficiencies in income tax and surtax, arguing they were entitled to deduct amortization expenses related to a covenant not to compete. The Tax Court ruled in favor of Freedom Newspapers, finding that the covenant was bargained for at arm's length, had a specific consideration assigned to it, and a definite lifespan, making it subject to depreciation. The court also sided with the taxpayer on a Section 102 issue, finding that accumulated earnings were not beyond the reasonable needs of the business.

Facts

Freedom Newspapers acquired the Gazette and Telegraph Company and, as part of the acquisition, obtained a covenant from the sellers not to compete for ten years. The agreement explicitly allocated $250,000 of the purchase price to the covenant. Freedom Newspapers then sought to amortize this amount over the ten-year period. The IRS disallowed the deduction, arguing the covenant was inseparable from goodwill. The company was prohibited from paying dividends due to a term loan agreement with the Bank of America.

Procedural History

Freedom Newspapers, Inc. challenged the IRS's determination of deficiencies in income tax and surtax in Tax Court. The Tax Court reviewed the case, considering evidence and arguments presented by both sides.

Issue(s)

1. Whether Freedom Newspapers could deduct amortization expenses for the cost of the covenant not to compete.

2. Whether Freedom Newspapers was subject to surtax for improperly accumulating surplus earnings under Section 102 of the Internal Revenue Code.

Holding

1. Yes, because the covenant not to compete was treated as a separate item in the transaction, with a specific price allocated to it, making it amortizable.

2. No, because the accumulated earnings were not beyond the reasonable needs of

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the business, considering the company’s obligations and expansion plans.

Court’s Reasoning

The court reasoned that the agreement not to compete was actually dealt with as a separate item and a specific amount was paid for it. The court found the parties to the contract of sale were strangers dealing at arm’s length, that the sellers were adequately put on notice that a covenant not to compete was a "sine qua non" of the sale, and that the buyers were treating the covenant as a separate item. The court distinguished this case from others where the covenant was not severable from goodwill. Regarding the Section 102 issue, the court stated, "The fact that the earnings or profits of a corporation are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid surtax upon shareholders unless the corporation by the clear preponderance of the evidence shall prove to the contrary." The court found that Freedom Newspapers had shown by a clear preponderance of the evidence that its earnings or profits had not been allowed to accumulate beyond the reasonable needs of the business.

Practical Implications

This case clarifies that covenants not to compete can be amortized if they are specifically bargained for and assigned a value in an acquisition. It emphasizes the importance of clear contractual language and allocation of purchase price. Attorneys should advise clients to explicitly address covenants not to compete in transaction documents. It also provides guidance on Section 102, indicating that companies can accumulate earnings to meet obligations and plan for expansion without automatically triggering surtax liability, especially if there are restrictions on paying dividends such as a term loan agreement.

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