19 T.C. 718 (1953)

When a contract for the sale of stock includes a separate, bargained-for covenant not to compete, the portion of the purchase price allocated to the covenant is taxed as ordinary income to the seller, even if the seller subjectively believes the covenant has little value.

Summary

The Hamlin Trust case addressed whether proceeds from a covenant not to compete, included in a stock sale agreement, should be taxed as ordinary income or capital gains. The owners of a newspaper publishing company sold their stock and agreed not to engage in the newspaper business for ten years. The contract allocated a portion of the purchase price to the covenant. The Tax Court held that the amount allocated to the covenant was ordinary income because it was a separately bargained-for element of the transaction, despite arguments that the covenant had little value to the sellers.

Facts

The Clarence Clark Hamlin Trust and T.E. Nowels (along with other shareholders) sold all the stock of Gazette & Telegraph Company to R.C. Hoiles and his sons. The negotiations began with Hoiles offering $750,000, which was rejected. Hoiles later offered $1,000,000 for the stock and a covenant not to compete for ten years. The final contract allocated $150 per share to the stock and $50 per share to the covenant not to compete. Hoiles explicitly stated the allocation was for tax purposes. Some stockholders were active in the newspaper business, while others were passive investors. Hoiles was concerned about competition from all stockholders.

Procedural History

The taxpayers reported the entire gain from the stock sale as long-term capital gain. The Commissioner of Internal Revenue determined that the portion of the proceeds allocated to the covenant not to compete should be taxed as ordinary income. The Tax Court consolidated the cases and ruled in favor of the Commissioner.

Issue(s)

Whether the portion of the purchase price allocated to a covenant not to compete in a stock sale agreement constitutes ordinary income to the selling stockholders, or should it be considered part of the capital gain from the sale of the stock?

Holding

No, because the covenant was a separate, bargained-for item in the transaction, and the parties explicitly allocated a portion of the purchase price to it.

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Court’s Reasoning

The Tax Court emphasized that it was not bound by the parol evidence rule and could consider all relevant facts. However, the court found that the written contract accurately reflected the agreement reached at arm’s length. The court distinguished this case from situations where a covenant not to compete is merely incidental to the sale of a going business and its goodwill. Here, the stockholders were selling stock, not a business. The court acknowledged the sellers might not have fully appreciated the tax consequences but the buyers were aware and had put the sellers on notice. The court stated: “It is well settled that if, in an agreement of the kind which we have here, the covenant not to compete can be segregated in order to be assured that a separate item has actually been dealt with, then so much as is paid for the covenant not to compete is ordinary income and not income from the sale of a capital asset.” The court concluded that the purchasers paid the amount claimed for the covenant as a separate item, regardless of the sellers’ subjective valuation of the covenant.

Practical Implications

The Hamlin Trust case highlights the importance of clearly delineating and valuing covenants not to compete in sale agreements. It establishes that if a covenant is explicitly bargained for and a specific amount is allocated to it, that amount will likely be treated as ordinary income to the seller, regardless of their personal assessment of its value. This case informs how tax attorneys advise clients during negotiations. Attorneys must make clients aware of the tax implications of such allocations. Later cases have relied on Hamlin Trust to determine the tax treatment of covenants not to compete, emphasizing the need for clear contractual language and evidence of arm’s-length bargaining.

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