Hamlin's Trust v. Commissioner, 209 F.2d 761 (10th Cir. 1954)

When a covenant not to compete is bargained for as a separate item in a sale of stock, the portion of the purchase price allocated to the covenant is treated as ordinary income to the seller, regardless of the covenant's actual value.

Summary

Hamlin's Trust sold its stock in Gazette-Telegraph Company, allocating a portion of the purchase price to a covenant not to compete. The IRS sought to tax this allocation as ordinary income to the selling stockholders. The Trust argued that the entire amount was for the stock. The Tax Court held that because the covenant was a separately bargained-for item in an arm's-length transaction, the allocation should be respected. The court emphasized that the purchasers were aware of the tax implications and treated the covenant as a separate item in their negotiations, making it taxable as ordinary income to the sellers.

Facts

Hamlin's Trust, along with other stockholders, sold their stock in Gazette-Telegraph to the Hoileses. The sale agreement specifically allocated $150 per share to the stock and $50 per share to a covenant not to compete. The selling stockholders later claimed that the entire purchase price was solely for the stock. The Hamlin Trust argued they didn't intend to engage in the newspaper business, and the trust's legal capacity to compete was doubtful.

Procedural History

The Commissioner of Internal Revenue assessed a deficiency against Hamlin's Trust, arguing that the amount allocated to the covenant not to compete should be taxed as ordinary income. The Tax Court upheld the Commissioner's assessment. Hamlin's Trust appealed to the Tenth Circuit Court of Appeals, which affirmed the Tax Court's decision.

Issue(s)

Whether the portion of the purchase price allocated to a covenant not to compete in a stock sale agreement should be treated as ordinary income to the seller, even if the seller argues the covenant had no actual value.

Holding

Yes, because the covenant was a separately bargained-for item in an arm's-length transaction, and the purchasers specifically allocated a portion of the purchase price to it.

Court's Reasoning

© 2025 SCOTUSreports.com. All rights reserved.

The court reasoned that the written contract accurately reflected the agreement of the parties, which was reached at arm's length. The court distinguished this case from situations where a covenant not to compete accompanies the transfer of goodwill in the sale of a going concern, where the covenant might be considered non-severable. Here, the court found that the parties treated the covenant as a separate item of their negotiations. The court emphasized that while the petitioners may not have fully appreciated the tax consequences, the purchasers were aware and had put the petitioners on notice that tax problems were involved. The court stated, "[T]he question is not whether the covenant had a certain value, but, rather, whether the purchasers paid the amount claimed for the covenant as a separate item in the deal and so treated it in their negotiations." The court also noted the inconsistent position taken by the IRS in a related case (Gazette Telegraph Co.), but still sided with the IRS in this case, emphasizing the importance of upholding the parties' written agreement.

Practical Implications

This case highlights the importance of carefully considering the tax implications of allocating portions of a purchase price to a covenant not to compete. It underscores that even if the seller believes the covenant has little or no value, the allocation will likely be respected by the IRS if it was separately bargained for and agreed upon by the parties, particularly where the buyer is aware of the tax benefits. This ruling influences how similar transactions are structured, encouraging clear documentation of the parties' intent regarding covenants not to compete. Later cases have applied this ruling by focusing on the intent of the parties and the economic substance of the transaction to determine whether the allocation to the covenant not to compete is bona fide or a mere tax avoidance scheme. Attorneys should advise clients to carefully negotiate and document such allocations to avoid unintended tax consequences. The case serves as a reminder of the potential conflict of interest when the IRS takes inconsistent positions regarding the same transaction with different parties.

© 2025 SCOTUSreports.com. All rights reserved.