22 T.C. 1053 (1954)

When a sale agreement includes both the sale of capital assets and a covenant not to compete, the portion of the sale price allocated to the covenant not to compete is taxed as ordinary income only if the parties treated the covenant as a separate item in their negotiations and actually paid a separate consideration for it.

Summary

Lee Ruwitch sold his interest in a shopping center, including the master lease, subleases, and buildings, along with a covenant not to compete. The agreement specified a lump-sum payment but didn’t allocate specific amounts to each component. The Commissioner of Internal Revenue argued the payment was for the covenant and taxed it as ordinary income. The Tax Court held that the entire amount received was for the sale of capital assets, taxable as capital gain, because the parties did not treat the covenant as a separate item in their negotiations nor did they allocate a specific payment to it.

Facts

Ruwitch leased land near a veterans’ housing project to build a shopping center. He constructed 11 stores and subleased them. After operating the center for about 1.5 years, he decided to move to Florida for permanent employment and sold his interests. The purchase and sale agreement included the master lease, subleases, buildings, and a covenant not to compete within a 3-mile radius. The total purchase price was $55,000: $33,000 for the buildings and improvements and $22,000 for the assignment of the master lease, subleases, and the covenant not to compete. The parties did not specifically discuss a separate amount for the covenant during negotiations.

Procedural History

The Commissioner of Internal Revenue determined a tax deficiency, arguing that the $22,000 received for the master lease, subleases, and covenant not to compete should be taxed as ordinary income. Ruwitch petitioned the United States Tax Court, claiming the $22,000 should be taxed as capital gain. The Tax Court sided with Ruwitch, deciding the entire amount was capital gain.

Issue(s)

1. Whether the $22,000 received by Ruwitch for the assignment of his interest in the master lease, subleases, and the covenant not to compete is taxable as ordinary income.

2. Whether the restrictive covenant was a separate item of consideration in the sale.

Holding

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1. No, the $22,000 is not taxable as ordinary income because it was a capital gain.

2. No, the restrictive covenant was not a separately bargained-for item.

Court's Reasoning

The Court found the substance of the transaction and the intent of the parties determined the tax consequences. The court relied on prior cases which established that the allocation of a sale price to a covenant not to compete hinges on the parties' treatment of the covenant during negotiations. The court found that the parties did not negotiate the covenant as a separate item nor did they allocate any portion of the consideration to it. Ruwitch testified that no mention of a covenant was made during oral negotiations and that his intention to relocate made the covenant's value negligible to him. The court emphasized that the restrictive covenant was simply included as part of the overall sale. The Court referenced cases like *Clarence Clark Hamlin Trust*, which addressed similar issues related to allocating proceeds between capital assets and restrictive covenants. The Court reasoned that the substance of the agreement and the intent of the parties indicated the covenant was not a separately bargained-for item.

Practical Implications

This case underscores the importance of explicitly allocating the purchase price in agreements involving both the sale of assets and covenants not to compete. Taxpayers and their legal counsel should ensure any intention to treat the covenant as a separate item is clearly documented during negotiations and reflected in the contract. A failure to do so, especially when there's no separate allocation, may result in the entire proceeds being treated as capital gain, as was the case here. This case provides a clear guide for structuring transactions to achieve a desired tax outcome. Legal practitioners should advise clients about the tax implications of the allocation of the sale price to a covenant not to compete.

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