Silberman v. Commissioner, 12 T.C.M. (CCH) 1254 (1953)

When a business is sold, the allocation of the purchase price between a covenant not to compete and goodwill is determined by the intent of the parties, supported by the economic realities of the transaction, and the allocation made in the agreement is not determinative but is evidence of intent.

Summary

The Tax Court addressed whether a portion of a business sale's purchase price should be allocated to a covenant not to compete or to goodwill. The court found that $14,375 of the total price paid by Silberman to Rothman was for Rothman's agreement not to compete. This determination was based on the parties' intent, the business's nature, and the economic realities, including the lack of substantial goodwill value. The court emphasized that the allocation in the agreement, and the accounting entries, were not decisive, but provided evidence of the parties' intentions.

Facts

Joseph Silberman purchased Harry Rothman's interest in Tissue Products Company. The parties entered into an agreement, and a "Good Will" account was opened on the books for $14,375, which matched the claimed amount for a non-compete covenant. The business, which packed and converted private imprint tissues, did not have significant goodwill because its main selling point was printing the customer's name, with sales dependent on personal contacts. Rothman agreed not to compete with Silberman and his assigns for three years.

Procedural History

The case appeared before the Tax Court to determine the proper allocation of the purchase price for tax purposes, specifically addressing whether the amount paid for the covenant not to compete could be amortized. The court considered the facts and arguments presented by both the taxpayers and the Commissioner of Internal Revenue.

Issue(s)

1. Whether the purchase price paid by Silberman included a payment for Rothman's covenant not to compete.

2. If so, what amount of the purchase price should be allocated to the covenant not to compete.

3. Whether the amount allocated to the covenant not to compete could be amortized for tax purposes.

Holding

1. Yes, because the court found the $14,375 was, in fact, paid solely for the agreement not to compete, supported by the testimony and circumstances.

2. $14,375 of the purchase price was allocated to the covenant not to compete because the business had no goodwill value, and the covenant was essential to protect Silberman's business.

3. Yes, the court found that the amount of consideration allocated to the covenant not to compete could be amortized ratably over the term of the covenant because there was a severable consideration.

Court's Reasoning

The court analyzed the economic realities to determine the true nature of the transaction. They found the business lacked goodwill due to its dependence on personal services and customer relationships, not a brand name. The court emphasized the significance of the non-compete covenant in protecting Silberman's business from Rothman's potential actions, especially during tissue shortages. The court also found that the accounting treatment did not accurately reflect the true nature of the transaction. The court stated, "We find no goodwill value attributable to Rothman's interest." The court held that "the naming or misnaming of the account is not determinative to the contrary." The fact that the agreement required Rothman to return part of the price if he competed before a certain date further corroborated the intention.

Practical Implications

This case highlights the importance of properly documenting and structuring agreements for business sales. It emphasizes that the allocation of the purchase price should be based on the economic realities of the transaction. This decision informs how tax professionals should advise clients on allocating purchase prices in business sales, focusing on the intent of the parties as reflected in the agreement and the underlying circumstances. The lack of goodwill and the importance of the non-compete agreement were crucial. It means practitioners must carefully examine the nature of the business, the parties' intentions, and any potential for competition to properly structure and allocate the transaction.