29 T.C. 129 (1957)

When a covenant not to compete is separately bargained for and has an allocated value, the consideration received for the covenant is taxable as ordinary income, distinct from the sale of stock, which may be taxed at capital gains rates.

Summary

The Ullman brothers, along with Herman Kaiser, sold the stock of their linen supply businesses to Consolidated Laundries Corporation. As part of the agreement, the Ullmans and Kaiser individually signed covenants not to compete. These covenants were explicitly assigned a monetary value of $350,000, allocated among the sellers. The IRS determined that the money received for the covenants should be taxed as ordinary income, not capital gains from the sale of stock. The Tax Court agreed, holding that because the covenants were bargained for separately and had a distinct value, the payments were essentially compensation for a service and were thus taxable as ordinary income.

Facts

The Ullman brothers owned all the stock in several linen supply companies. They decided to sell the businesses and negotiated with Consolidated. During the sale, the parties agreed to a price based on weekly collections. Consolidated insisted on covenants not to compete from the sellers, which were negotiated separately. The final agreement allocated $350,000 to these covenants, with specific amounts assigned to each seller. The sale of the stock and the covenants not to compete were documented in separate agreements. The Ullmans and Kaiser reported the entire proceeds as capital gains, allocating nothing to the covenants.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in the income tax of the Ullmans and Kaiser, reclassifying the payments for the covenants not to compete as ordinary income. The taxpayers challenged this determination in the U.S. Tax Court.

Issue(s)

1. Whether the amounts received by the Ullmans and Kaiser for their individual covenants not to compete constituted ordinary income or capital gain.

Holding

1. Yes, because the court found the covenants to be severable and separately bargained for with a specific monetary value, the amounts received were ordinary income.

Court’s Reasoning

The court distinguished between the sale of a business, where goodwill belongs to the owner, and the sale of corporate stock, where the goodwill belongs to the corporation. The Ullmans, as stockholders, did not directly own the goodwill of the linen supply companies. The court emphasized that the covenants were separate agreements and were specifically bargained for. Consolidated wanted to prevent the Ullmans from competing, and allocated a distinct value to the covenants during negotiations, which was reflected in the written agreements. The court cited the principle that a covenant not to compete is treated as ordinary income because it is a payment for personal services. The court highlighted that the buyers and sellers were aware of the tax implications of allocating value to the covenant.

Practical Implications

This case underscores the importance of properly structuring and documenting business transactions to reflect the economic substance of the deal. Attorneys should advise clients to:

- Clearly allocate consideration between the sale of stock (potentially capital gains) and covenants not to compete (ordinary income).
- Ensure covenants are bargained for separately, to establish that they were a distinct part of the agreement.
- Have these allocations reflected in the written agreements.
- Understand that a separately bargained and valued covenant not to compete will likely be taxed as ordinary income.

Later courts often rely on the specifics of bargaining when determining tax treatment. If the covenant is inextricably linked to the sale of goodwill, it might be treated differently, but in this case, the court viewed the covenant as a distinct agreement, independent of the stock sale, which dictated the tax treatment.

