31 T.C. 278 (1958)

When a business is purchased, the purchase price must be allocated between the goodwill and the covenant not to compete, to determine the amount eligible for amortization for tax purposes.

Summary

United Finance & Thrift Corporation (petitioner) purchased two small loan companies, allocating portions of the purchase price to covenants not to compete. The IRS disallowed amortization of these amounts, claiming they represented goodwill, which is not amortizable. The Tax Court held that a portion of the allocated amounts were indeed for the covenants and were amortizable, while a portion was for goodwill and thus non-amortizable. The court used the *Cohan* rule to make a reasonable allocation, emphasizing the importance of demonstrating the true nature of the transaction and the intent of the parties.

Facts

United Finance & Thrift Corporation, a subsidiary of State Loan and Finance Company, acquired two small loan companies in Tulsa, Oklahoma. In the purchase agreements, specific amounts were allocated to covenants not to compete. Petitioner sought to amortize these costs over the duration of the covenants, claiming the payments were for a limited-life intangible asset. The IRS challenged these deductions, arguing that the payments were primarily for goodwill, a non-amortizable asset. Petitioner also sold the remaining assets of one acquisition to a subsidiary.

Procedural History

The Commissioner of Internal Revenue determined deficiencies against the petitioner for disallowed deductions claimed for amortization of the covenants not to compete. The Tax Court consolidated the cases and reviewed the issue.

Issue(s)

1. Whether the amounts allocated to the covenants not to compete could be amortized over the life of the covenants.

2. To what extent, if any, was the purchaser entitled to amortize the cost of the purported non-competition covenants.

3. If the allocations were proper, what amounts were to be allocated to goodwill and the covenants not to compete?

Holding

1. Yes, a portion of the amounts allocated to the covenants not to compete was amortizable.

2. The purchaser was entitled to amortize only the portion of the cost of the covenants not to compete that the court determined, based on the facts, to have been attributable to the covenants.

3. The court allocated portions of the purchase price to goodwill and to the covenants not to compete.

Court's Reasoning

The court considered whether the covenants not to compete were severable from the goodwill. The court held that "if, in an agreement [...] a covenant not to compete can be segregated as opposed to other items transferred in the overall transaction, and we can be assured that the parties in good faith and realistically have treated the covenant in a separate and distinct manner with respect to value and cost so that a severable consideration for it can be shown, the purchaser is entitled to amortize the price for the covenant paid ratably over the life of the covenant." The court found that the contracts did allocate separate consideration to the covenants. However, the court also determined that part of the consideration paid was attributable to goodwill. The court stated, "We do not think that the old record cards had other than nominal value. The significant factor in connection with goodwill is the petitioners' own testimony to the effect that the paper they bought would be turned over on the average 2 1/2 times and would remain on the books of the purchaser for an average period of 30 months." The court also found the covenants were severable and substantial in value, as they removed competition. Since neither party offered specific allocations for the value of goodwill and the covenant, the court used the *Cohan* rule, which allowed the court to make a reasonable allocation based on all the facts, to determine the portion of the payment attributable to each. The court emphasized that the taxpayer bears the burden of proving the allocation.

Practical Implications

This case underscores the importance of clearly delineating and valuing covenants not to compete in business purchase agreements for tax purposes. It demonstrates that although allocations in contracts are considered, the IRS and the courts will examine the substance of the transaction to determine the true allocation. Taxpayers must be prepared to show the economic reality and the good faith intent of the parties in making the allocation. Failure to do so may lead the court to make its own allocation based on the available evidence, potentially leading to a less favorable tax outcome. This case highlights the need for careful planning and documentation in business acquisitions, including the consideration and valuation of intangible assets.

