T.C. Memo. 1962-246

When parties to a transaction explicitly agree in writing to allocate a portion of the purchase price to a non-compete agreement, the party seeking to recharacterize that allocation for tax purposes must present 'strong proof' that the stated allocation lacks economic reality or was not the parties' actual intent.

Summary

Robert J. Schulz sold his snack food distributing business and executed a separate agreement not to compete with the purchaser, Laura Scudder's, for which $50,000 was explicitly allocated as consideration. Schulz argued that this $50,000 was actually payment for goodwill and should be taxed as capital gains, not ordinary income. The Tax Court held that Schulz failed to provide 'strong proof' to overcome the contractual allocation. The court reasoned that the non-compete agreement had economic substance due to Schulz's experience and market knowledge, and the parties knowingly entered into the agreement, regardless of Schulz's alleged ignorance of the tax consequences.

Facts

Robert J. Schulz sold his snack food distributing business to Laura Scudder's. In initial discussions, Schulz offered to sell for $75,000 plus inventory, equipment, and receivables. Laura Scudder's requested that $25,000 of the $75,000 be allocated to equipment and $50,000 to a separate non-compete agreement. Schulz agreed to this allocation and signed the non-compete agreement, which explicitly stated $50,000 as consideration. Schulz later claimed he was unaware of the tax implications and that the $50,000 was actually for goodwill, taxable as capital gains, not ordinary income from the non-compete agreement.

Procedural History

The Commissioner of Internal Revenue determined that the $50,000 was ordinary income from the non-compete agreement. Schulz petitioned the Tax Court to redetermine the deficiency, arguing the $50,000 was for goodwill and should be taxed as capital gains.

Issue(s)

1. Whether the $50,000 allocated in a separate agreement to a covenant not to compete should be treated as ordinary income, as determined by the Commissioner.

2. Whether the petitioner presented 'strong proof' to overcome the contractual allocation and demonstrate that the $50,000 was actually consideration for goodwill, taxable as capital gains.

Holding

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1. Yes. The $50,000 allocated to the non-compete agreement is treated as ordinary income because the contractual allocation is presumptively correct.

2. No. Schulz failed to present 'strong proof' to overcome the contractual allocation because the non-compete agreement had economic reality and reflected the parties' understanding, regardless of tax consequences.

Court's Reasoning

The court applied the 'strong proof' rule, which requires a taxpayer to present strong evidence to contradict the express terms of a contract, especially when challenging tax consequences. The court cited numerous precedents, including *Ullman v. Commissioner*, emphasizing that when parties explicitly agree to a non-compete and state the consideration, strong proof is needed to overturn that declaration. Quoting *Schulz v. Commissioner*, the court stated that "the covenant must have some independent basis in fact or some arguable relationship with business reality such that reasonable men, genuinely concerned with their economic future, might bargain for such an agreement."

The court found that the non-compete agreement had economic reality because of Schulz's extensive experience, customer relationships, and contributions to his business's growth. Laura Scudder's legitimately had a business reason to seek protection from Schulz's potential competition. The court noted, "considering his many years of experience, the fact that he was known to the various store owners and purchasing agents, the fact that he was highly regarded by his competitors, and the fact that his personal efforts had contributed to the substantial growth of his business, we cannot conclude that it would have been unreasonable for Laura Scudder's, out of concern for its economic future, to have required an agreement not to compete."

The court dismissed Schulz's claim of ignorance regarding tax consequences, citing *Hamlin's Trust v. Commissioner*: "But the effectiveness taxwise of an agreement is not measured by the amount of preliminary discussion had respecting it. It is enough if parties understand the contract and understandingly enter into it…where parties enter into an agreement with a clear understanding of its substance and content, they cannot be heard to say later that they overlooked possible tax consequences." The court concluded Schulz understood and was bound by the agreement he signed.

Practical Implications

Schulz v. Commissioner reinforces the 'strong proof' rule in tax law, highlighting the difficulty of retroactively altering contractual allocations for tax advantages. It emphasizes that when a contract clearly allocates consideration to a non-compete agreement, taxpayers face a high burden to recharacterize that income as capital gains. This case serves as a cautionary tale for parties entering into business sale agreements: clearly understand and consider the tax consequences of all contractual

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terms, especially allocations. It underscores that courts will generally uphold the express terms of agreements unless there is compelling evidence of mistake, fraud, or lack of economic substance, and ‘buyer-initiated’ allocation requests are not inherently suspect. Later cases continue to apply the ‘strong proof’ rule, making it a significant precedent in tax litigation involving non-compete agreements and contractual allocations.

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