Lemery v. Commissioner, 45 T. C. 74 (1965)

A covenant not to compete is not amortizable if it lacks substance and an arguable relationship to business reality.

Summary

In Lemery v. Commissioner, the Tax Court ruled that a covenant not to compete included in a stock purchase agreement was not amortizable. The petitioners, shareholders of Palms Motel, Inc. , sought to deduct their share of the corporation's net operating loss, which included amortization of a covenant not to compete. The court found that the covenant lacked independent value and was not bargained for in good faith, as the seller's financial interest in the business's success made competition unlikely. This case underscores the importance of demonstrating the substantive value and business necessity of covenants not to compete for tax deduction purposes.

Facts

Raymond and Douglas Lemery purchased all the stock of three Oregon corporations, including Palms Motel, Inc. , from Thomas Mugleston for $1,131,000. The agreement included a covenant not to compete, assigning $200,000 of the purchase price to this covenant. The covenant prohibited Mugleston from competing with the businesses within 10 miles of Portland for five years. The remaining purchase price was contingent on the corporations' net profits. The Lemerys assigned the covenant to Palms Motel, Inc. , and sought to amortize it as part of the corporation's net operating loss deduction.

Procedural History

The Commissioner of Internal Revenue disallowed the amortization deduction, increasing the taxable income of the Lemerys. The Lemerys petitioned the Tax Court, which held a trial and subsequently issued its decision.

Issue(s)

1. Whether the covenant not to compete was amortizable under the Internal Revenue Code.

Holding

1. No, because the covenant not to compete lacked substance and an arguable relationship to business reality, and was not separately bargained for.

Court's Reasoning

The Tax Court analyzed the covenant not to compete under the Internal Revenue

Code and relevant case law. The court applied the principle that for a covenant to be amortizable, it must have been bargained for at arm’s length and possess some independent basis in fact or arguable relationship with business reality. The court found that the covenant lacked substance because Mugleston’s financial interest in the companies’ success made competition unlikely. The court noted that the allocation of $200,000 to the covenant was not based on genuine negotiation, as evidenced by the lack of corroborating testimony and the contingent nature of the remaining purchase price. The court cited Schulz v. Commissioner and other cases to support its conclusion that the covenant was not amortizable. The court emphasized 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. “

Practical Implications

Lemery v. Commissioner sets a precedent that covenants not to compete must demonstrate substantive value and a genuine business necessity to be amortizable. This decision impacts how businesses structure and negotiate covenants in acquisition agreements, emphasizing the need for clear evidence of independent value and arm’s-length bargaining. Practitioners must ensure that covenants are not merely formalities but reflect real economic considerations. The ruling also affects tax planning strategies, as businesses must carefully assess the deductibility of such covenants. Subsequent cases like Balthrope v. Commissioner have continued to apply this principle, reinforcing the need for substantive covenants in business transactions.

