Wager v. Commissioner, 50 T. C. 426 (1968)

Payments for a covenant not to compete and availability for consulting services are taxable as ordinary income, not capital gains, under the strong-proof rule unless strong evidence shows otherwise.

Summary

In Wager v. Commissioner, the Tax Court ruled that payments received by Henry P. Wager for a covenant not to compete and availability for consulting services must be treated as ordinary income rather than capital gains. Wager sold his patent and stock to United Fruit Co. , and entered into an employment agreement. The court applied the strong-proof rule from Ullman v. Commissioner, finding that Wager did not provide sufficient evidence to contradict the terms of the agreements, which clearly allocated the payments to ordinary income categories. This decision reinforces the principle that the tax treatment of such agreements is determined by their substance unless strong evidence suggests otherwise.

Facts

Henry P. Wager, a physician, owned a patent for a food freeze-drying process and shares in Liana, Inc. , which utilized this process. In 1960, Wager sold the patent to United Fruit Co. for $200,000 plus royalties and his stock for $195,000. Concurrently, he entered into an employment agreement with United, stipulating a $15,000 annual retainer for advisory services and a covenant not to compete for one year post-employment. Wager reported the $15,000 received in 1962 as long-term capital gain, while United treated it as salary expense. The IRS challenged this classification, asserting it should be ordinary income.

Procedural History

The IRS determined a deficiency in Wager's 1962 income tax and Wager petitioned the Tax Court. The court reviewed the agreements and the tax treatment of the payments under the strong-proof rule, ultimately deciding in favor of the IRS.

Issue(s)

1. Whether payments received by Wager for a covenant not to compete and availability for consulting services should be classified as ordinary income or capital gain.

Holding

1. Yes, because Wager failed to provide strong proof to contradict the terms of the agreements, which clearly allocated the payments to ordinary income.

Court's Reasoning

The court applied the strong-proof rule from Ullman v. Commissioner, requiring strong evidence to overcome the apparent tax consequences of an agreement. Wager did not meet this burden, as he provided no evidence of mistake, undue influence, fraud, or duress, nor did he show that the payments were not for the covenant not to compete and consulting services. The court noted that the agreements' terms were clear and reflected an arm's-length transaction. The court emphasized that payments for covenants not to compete and consulting services are typically ordinary income, citing cases like Arthur C. Ruge. The fact that Wager was only called upon for a few days of service did not negate the economic reality of the agreement, as United bargained for Wager's availability.

Practical Implications

This decision underscores the importance of carefully structuring and documenting agreements involving covenants not to compete and consulting services to ensure the desired tax treatment. Practitioners must be aware that the strong-proof rule places a high burden on taxpayers to prove that payments should be treated differently than stated in the agreements. This case may influence how similar agreements are drafted and negotiated, with parties potentially seeking to allocate payments more clearly between capital and ordinary income components. Businesses and individuals engaging in such agreements should consult with tax professionals to ensure compliance with tax laws and optimize their tax positions. Subsequent cases have continued to apply the strong-proof rule, reinforcing its significance in tax law.

