Dodson v. Commissioner, 52 T. C. 544 (1969)

Amounts allocated to covenants not to compete in asset sales are taxable as ordinary income if they have economic reality and independent significance.

Summary

Radford Finance Co. sold all its assets, including a covenant not to compete, to two Piedmont corporations for $187,200, with $37,000 allocated to the covenant. The IRS determined that this amount was taxable as ordinary income, not qualifying for nonrecognition under section 337 of the Internal Revenue Code. The Tax Court upheld this determination, finding the covenant had economic reality and was bargained for at arm's length. The court also ruled that any loss on the sale of notes receivable could not offset the company's reserve for bad debts.

Facts

Radford Finance Co. , a Virginia corporation, sold its entire business to Piedmont Finance Corp. and Piedmont Finance of Staunton, Inc. on February 29, 1964, for $187,200. The sale included notes receivable, furniture, fixtures, and a covenant not to compete for five years, with $37,000 allocated to the covenant. Radford's shareholders and directors authorized the sale, but the executed agreements named the Piedmont corporations as buyers, not Interstate Finance Corp. as initially resolved. Radford liquidated under section 337 of the Code, but the IRS determined the covenant amount was taxable income.

Procedural History

The IRS issued a statutory notice of deficiency, asserting that the $37,000 for the covenant not to compete was ordinary income and that Radford's reserve for bad debts was fully includable in income. Radford and its shareholders petitioned the U. S. Tax Court for a redetermination of these deficiencies. The Tax Court affirmed the IRS's determinations.

Issue(s)

1. Whether the $37,000 allocated to the covenant not to compete represented payment for the covenant and was thus taxable as ordinary income.
2. Whether the difference between the book value of Radford's notes receivable and their sales price could offset the company's reserve for bad debts.

Holding

1. Yes, because the covenant not to compete had economic reality and independent significance, and the parties intended to allocate $37,000 to it at the time of the agreement.
2. No, because a loss on the sale of notes receivable cannot be considered a bad

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debt loss offsetting a reserve for bad debts account, and petitioners failed to establish their basis in the notes receivable.

Court's Reasoning

The court applied the "economic reality test" adopted by the Fourth Circuit, finding that the covenant not to compete was bargained for at arm's length and had independent significance to protect the buyer's investment. The court rejected Radford's argument that the corporate resolution constituted the final contract, holding that the subsequent agreements with the Piedmont corporations embodied the definitive terms of the sale. The court also found that the president and secretary had authority to execute the agreements, and any lack of authority was cured by the acceptance of benefits by Radford's shareholders. The court determined there was no fraud under Virginia law, as the means to ascertain tax consequences were equally available to both parties. Regarding the bad debt reserve, the court ruled that a loss on the sale of notes receivable cannot offset a reserve for bad debts and that petitioners failed to prove their basis in the notes.

Practical Implications

This decision clarifies that allocations to covenants not to compete in asset sales will be respected and taxed as ordinary income if they have economic reality and are bargained for at arm's length. Practitioners must carefully document the business rationale for such covenants and ensure they are not merely tax-motivated. The decision also reinforces that losses on asset sales cannot offset reserves for bad debts, emphasizing the importance of accurate record-keeping and valuation in asset sales. Later cases, such as *General Insurance Agency, Inc. v. Commissioner* and *Schmitz v. Commissioner*, have continued to apply the economic reality test in similar contexts.

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