Miller v. Commissioner, 56 T. C. 636 (1971)

Payments for goodwill are taxable as capital gains until a breach of a noncompete covenant divests the buyer of that goodwill.

Summary

Charles Miller sold his city directory business to his controlled corporation, Southern Directory Co. , in 1959, receiving payments over time. The Tax Court held that these payments were capital gains until August 1965, when Miller's subsequent agreement with Mullin-Kille Co. breached his covenant not to compete with Southern, divesting Southern of its goodwill. Consequently, post-August 1965 payments to Miller were taxable as ordinary income. Southern's sale of its assets to Mullin-Kille did not result in a deductible loss due to the lack of goodwill value remaining.

Facts

Charles Miller operated a city directory business, selling portions to R. L. Polk & Co. in 1953 and the remainder to Southern Directory Co. , Inc. , a corporation he controlled, in 1959. The 1959 sale included goodwill and a 10-year noncompete covenant. Miller received payments over time, accelerating them before 1966. In 1965, after receiving a contempt summons related to antitrust violations, Southern sold its assets to Mullin-Kille Co. for $3,000, and Miller entered a consulting and noncompete agreement with Mullin-Kille.

Procedural History

The Commissioner determined deficiencies in Miller's income tax for 1964-1966, treating payments as ordinary income instead of capital gains. Southern claimed a $110,000 loss from its 1965 sale to Mullin-Kille. The Tax Court addressed these issues in its 1971 decision.

Issue(s)

1. Whether amounts received by Charles Miller from 1959-1966 sales were taxable as ordinary income or capital gain.
2. Whether Southern Directory Co. , Inc. , experienced a section 1231 loss in 1965 from its sale to Mullin-Kille.

Holding

1. Yes, because the payments were for goodwill until August 1965, when Miller's breach of the noncompete covenant divested Southern of that goodwill, making post-August 1965 payments ordinary income.
2. No, because the sale to Mullin-Kille did not include goodwill, and the assets sold were not worth more than $3,000, so no loss was sustained.

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Court’s Reasoning

The court found that the 1959 sale included goodwill, which was a capital asset, and the noncompete covenant was an adjunct to that goodwill. The court applied the rule that goodwill is a capital asset and payments for its sale are capital gains. However, Miller’s 1965 agreement with Mullin-Kille breached the noncompete covenant with Southern, ending Southern’s ability to benefit from the goodwill. The court reasoned that any payments received by Miller after this breach were no longer for goodwill but for services or dividends, taxable as ordinary income. Regarding Southern’s claimed loss, the court held that without goodwill, the assets sold to Mullin-Kille were worth only $3,000, and no loss was realized. The court considered policy implications, noting that allowing a loss deduction would permit tax avoidance through the manipulation of goodwill sales and noncompete agreements.

Practical Implications

This case informs how goodwill sales and noncompete covenants are analyzed for tax purposes. It emphasizes that payments for goodwill are capital gains until a material breach of a noncompete covenant, which can divest the buyer of the goodwill’s value. Legal practitioners should carefully draft noncompete agreements to ensure they support the goodwill’s value. Businesses must consider the tax implications of structuring transactions involving goodwill and covenants not to compete. Subsequent cases have cited Miller v. Commissioner when addressing similar tax issues, reinforcing its precedent on the tax treatment of goodwill and the impact of breaching noncompete agreements.

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