Schneider v. Commissioner, 56 T. C. 207 (1971)

A covenant not to compete is not depreciable unless it is severable from the goodwill of a business and the parties intended to allocate part of the purchase price to it.

Summary

In Schneider v. Commissioner, the Tax Court ruled that a covenant not to compete included in the sale of an insurance agency was not depreciable. The court found that the covenant was not severable from the agency's goodwill and that there was no evidence that the buyer and seller intended to allocate part of the purchase price to the covenant. The decision hinged on the application of the severability and economic reality tests, emphasizing the need for clear evidence of intent and separate bargaining for the covenant. This case underscores the importance of documenting and negotiating covenants not to compete distinctly from other business assets to ensure their tax treatment as depreciable assets.

Facts

James Schneider purchased the Rich Hill Insurance Agency from George Flexsenhar in 1964. The purchase price was not paid in cash but through Schneider's assumption of the agency's liabilities. The sale agreement included a covenant not to compete for five years within a 100-mile radius of Rich Hill, Missouri. Schneider later incorporated the agency, and in 1967, the corporation claimed a depreciation deduction for the covenant not to compete, attributing $35,547. 19 of the purchase price to it. The IRS challenged this deduction, leading to the Tax Court case.

Procedural History

The IRS determined a tax deficiency for the year 1967 based on the disallowance of the depreciation deduction for the covenant not to compete. Schneider contested this determination, leading to the case being heard by the Tax Court. The court's decision focused on whether the covenant was severable from the goodwill and whether the parties intended to allocate part of the purchase price to it.

Issue(s)

1. Whether the covenant not to compete was severable from the goodwill of the Rich Hill Insurance Agency?
2. Whether the parties intended to allocate part of the purchase price to the covenant not to compete?

Holding

1. No, because the covenant was not separately bargained for or treated distinctly from the goodwill.
2. No, because there was no evidence that the parties intended to allocate any part

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of the purchase price to the covenant not to compete.

Court’s Reasoning

The court applied the severability and economic reality tests. Under the severability theory, the covenant not to compete was not treated as a separate element from the agency’s goodwill, as there was no separate evaluation or bargaining for it. The court noted that for a covenant to be severable, it must be distinctly bargained for and treated separately, which was not the case here. The economic reality test focused on the parties’ intent at the time of the agreement. The court found no evidence of such intent, noting that the sale agreement did not allocate any part of the purchase price to the covenant, and the seller reported the gain as capital gain without any allocation to the covenant. Additionally, the court considered Flexsenhar’s plans to leave the area and Schneider’s behavior in other agency acquisitions where covenants were clearly allocated. The delay in claiming depreciation until 1967 further suggested that the intent to allocate was an afterthought. The court concluded that the taxpayer failed to prove the necessary intent and severability for the covenant to be depreciable.

Practical Implications

This decision emphasizes the importance of clearly documenting and negotiating covenants not to compete separately from the sale of a business to ensure their depreciability. Legal practitioners should advise clients to allocate specific portions of the purchase price to such covenants during negotiations and to reflect this in the sale agreement. The case also highlights the need for contemporaneous evidence of intent at the time of the agreement, rather than retroactively claiming depreciation. For businesses, this ruling may affect how they structure the sale of assets and the tax treatment of covenants not to compete. Subsequent cases have continued to apply the principles from Schneider, reinforcing the need for clear intent and severability in allocating purchase prices to covenants not to compete.

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