Kinney v. Commissioner, 58 T. C. 1038 (1972)

When selling a business, part of the purchase price must be allocated to a covenant not to compete if it has substantial economic value, even without an express allocation in the sales agreement.

Summary

In Kinney v. Commissioner, the Tax Court addressed the allocation of the purchase price of an insurance agency between the agency's expirations and a covenant not to compete. Harry Kinney sold his agency for $125,000, with no express allocation to the covenant. The court held that 33% of the purchase price was attributable to the covenant due to its substantial value, despite no allocation in the sales contract. The decision was based on the economic reality test from the Fifth Circuit's Balthrope case, which emphasized the covenant's independent significance in protecting the buyer's investment.

Facts

Harry A. Kinney operated an insurance agency in Houston, Texas, for over 20 years. In March 1962, he sold the agency to the Gem Insurance Agency partnership for approximately $125,000, plus $5,000 for furniture and fixtures. The sales agreement included a covenant not to compete within a 50-mile radius of Houston for five years, and a 10-year restriction on soliciting renewals or replacements from existing customers. No specific amount was allocated to the covenant due to disagreement between the parties. At the time of sale, the agency had 2,500 to 3,000 customers and 4,000 policies in force. Kinney was personally involved in 25-35% of new business and 10-15% of renewals. The purchaser considered the covenant essential, and the financing bank required it.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in Kinney's 1962 federal income tax, attributing the entire $125,000 to the covenant not to compete. Kinney petitioned the U. S. Tax Court, arguing that the entire amount was allocable to the expirations as a capital asset. The Tax Court, applying the Fifth Circuit's economic reality test, held that 33% of the $125,000 should be allocated to the covenant.

Issue(s)

1. Whether a portion of the purchase price of an insurance agency should be allocated to a covenant not to compete, despite no express allocation in the sales agreement.
2. If so, what portion of the $125,000 purchase price should be allocated to the covenant not to compete?

Holding

1. Yes, because the covenant not to compete had substantial economic value and was essential to protecting the purchaser's investment.
2. 33% of the $125,000 should be allocated to the covenant not to compete, because it had significant value in the context of the sale.

Court's Reasoning

The court applied the economic reality test from Balthrope v. Commissioner, which rejected the severability test and focused on whether the covenant had independent economic significance. The court found that the covenant was crucial to the purchaser, as evidenced by their testimony and the bank's requirement for it. Despite no express allocation, the court held that the absence of agreement on allocation did not indicate the covenant lacked value. The court considered Kinney's long history in the business, his personal involvement, and his potential to compete successfully if not restricted. The court allocated 33% of the purchase price to the covenant, balancing its value against the value of the expirations, based on the evidence and the Cohan rule of reasonable approximation.

Practical Implications

This decision underscores the importance of properly allocating purchase price in business sales, particularly when covenants not to compete are involved. It established that even without an express allocation, courts may allocate value to covenants based on their economic reality. Practitioners must carefully consider and document the value of covenants in sales agreements to avoid disputes and unexpected tax consequences. The ruling affects how similar cases are analyzed, emphasizing the need to assess the covenant's independent value. It also impacts business planning, as buyers may insist on covenants to protect their investments, and sellers must be aware of potential tax implications. Subsequent cases have applied this principle, refining the allocation process in business sales.

