Lazisky v. Commissioner, 72 T. C. 495 (1979)

A contract's allocation of purchase price between goodwill and a covenant not to compete will be enforced unless strong proof shows the parties intended a different allocation.

Summary

In Lazisky v. Commissioner, the Tax Court upheld the allocation of a business's purchase price as stated in the sales agreement, with none allocated to the covenant not to compete. The Laziskys sold their restaurant, The Surf, to Sabanty for $427,000, with $67,000 allocated to goodwill and none to the covenant. The court applied the First Circuit's 'strong proof' rule, finding no evidence that the parties intended any allocation other than what was in the contract. Additionally, the court denied Magnolia Surf, Inc. 's claim for an investment tax credit, as the assets were acquired pursuant to a contract made before the applicable date.

Facts

Albert and Elizabeth Lazisky owned The Surf restaurant through their corporation, Old Surf, and the real estate personally. They sold The Surf to Christopher Sabanty, who formed New Surf to operate it. The purchase price was $427,000, allocated as follows: $175,000 to real estate, $170,000 to furniture, fixtures, and equipment, $15,000 to inventory, and $67,000 to the name, business, and goodwill. The agreement included a covenant not to compete but allocated no value to it. New Surf later attempted to allocate $65,000 of the goodwill payment to the covenant for tax purposes, which the IRS contested.

Procedural History

The IRS issued notices of deficiency to the Laziskys and New Surf. The Laziskys contested the deficiency related to the covenant not to compete, while New Surf contested the denial of an investment tax credit. The Tax Court consolidated the cases and ruled in favor of the IRS on both issues.

Issue(s)

1. Whether the $67,000 allocated to goodwill in the purchase agreement included any payment for the covenant not to compete.
2. Whether New Surf was entitled to an investment tax credit for the purchase of furniture, fixtures, and equipment.

Holding

1. No, because the agreement's allocation of the purchase price to goodwill and not to the covenant was the parties' clear intent, and no strong proof showed otherwise.
2. No, because the assets were acquired pursuant to a contract made before the

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applicable date, and no ‘order’ was placed after March 31, 1971.

Court’s Reasoning

The court applied the First Circuit’s ‘strong proof’ rule, which focuses on the parties’ intent as expressed in the contract. The court found that the agreement allocated the entire $67,000 to goodwill and none to the covenant, with no evidence of a different intent. The court rejected New Surf’s argument to interpret ‘business’ as including the covenant, as it was listed alongside ‘name’ and ‘goodwill,’ indicating going-concern value. The court also noted the absence of discussions about allocating any price to the covenant and the post-purchase attempt to amend the contract. For the investment credit, the court held that an ‘order’ must be placed after March 31, 1971, and before August 16, 1971, which did not occur as the contract was signed on February 24, 1971.

Practical Implications

This decision emphasizes the importance of clearly documenting the allocation of purchase price in business sale agreements, particularly between goodwill and covenants not to compete. Parties should explicitly state their intentions to avoid disputes and potential tax reallocations. The ruling also clarifies the requirements for claiming an investment tax credit, requiring a post-March 31, 1971 ‘order’ for assets acquired during the specified period. Practitioners should ensure compliance with these timing rules when advising clients on tax credits. Subsequent cases, such as Lucas v. Commissioner and Rich Hill Insurance Agency, Inc. v. Commissioner, have followed this precedent, reinforcing the need for clear contractual allocations in business sales.

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