Major v. Commissioner, 76 T. C. 239 (1981)

The court will not reallocate the purchase price in a stock sale to a covenant not to compete absent strong proof that the parties intended such an allocation at the time of contracting.

Summary

Hugh and Charlotte Major sold all their stock in Thunderbird Motor Freight Lines, Inc. to Specialized Transportation, Inc. for $800,000, with the contract including a covenant not to compete but no allocation of the purchase price to it. The Commissioner assessed deficiencies against both parties, arguing for a reallocation. The Tax Court held that the Majors could report the entire gain as capital gain, while Specialized could not deduct any amount for the covenant not to compete, as there was no strong proof that the parties intended an allocation at the time of contracting.

Facts

In 1972, the Majors sold their stock in Thunderbird, a trucking company, to Specialized for $800,000. The sale agreement included a covenant not to compete but allocated the entire purchase price to the stock. Specialized's representative testified that he would not have paid $800,000 without the covenant, but no allocation was discussed or made to it. The Majors had no intention of competing and agreed to the covenant without additional consideration. After the sale, Specialized attempted to allocate $400,000 to the covenant for tax purposes, which the Majors rejected.

Procedural History

The Commissioner assessed deficiencies against the Majors and Specialized, taking inconsistent positions. The Majors contested the reallocation of $400,000 to the covenant as ordinary income, while Specialized sought to deduct amortization of the same amount. The cases were consolidated and heard by the U. S. Tax Court, which ruled in favor of the Majors and against Specialized.

Issue(s)

1. Whether any portion of the $800,000 sale price of Thunderbird's stock must be allocated to the covenant not to compete for tax purposes?

Holding

1. No, because the Majors and Specialized did not intend to allocate any part of the purchase price to the covenant not to compete at the time of contracting, and Specialized failed to provide strong proof of such intent or that the covenant had substantial economic value.

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Court’s Reasoning

The court applied the “strong proof” standard, requiring clear evidence that the parties intended an allocation to the covenant at the time of contracting. The court found no such intent, as evidenced by the contract’s allocation of the entire purchase price to the stock and the lack of discussion or negotiation regarding an allocation to the covenant. The court also considered the economic reality test but found that Specialized failed to prove the covenant had substantial value, given the Majors’ lack of intent to compete and their health issues. The court rejected Specialized’s post-sale attempts to allocate a portion of the purchase price to the covenant, as these were not reflective of the parties’ intent at the time of contracting.

Practical Implications

This decision emphasizes the importance of clearly expressing allocation intentions in purchase agreements, particularly when covenants not to compete are involved. Parties should negotiate and document any intended allocation at the time of contracting to avoid disputes and potential tax reallocations. The ruling also highlights the difficulty of reallocating purchase prices after the fact without strong evidence of the parties’ original intent. For tax practitioners, this case serves as a reminder to advise clients on the tax implications of covenants not to compete and to ensure that any desired allocations are clearly stated in the contract. Subsequent cases have continued to apply the strong proof standard, reinforcing the need for clear contractual language regarding allocations.

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