Peterson Machine Tool, Inc. v. Commissioner, 79 T. C. 72 (1982)

When a stock purchase agreement includes covenants not to compete, a portion of the purchase price can be allocated to those covenants if they are intended as part of the contract and have independent economic significance.

Summary

In Peterson Machine Tool, Inc. v. Commissioner, the Tax Court ruled on the allocation of a $280,000 purchase price for the stock of Kansas Instruments, Inc. , between the stock itself and covenants not to compete signed by the sellers. The contract explicitly stated that the covenants were a 'material portion' of the purchase price. The court found that the covenants were intended to be part of the agreement and had real economic value, given the sellers' ability to compete. While the buyer allocated $100,000 to the covenants, the court determined $70,000 was a more appropriate allocation, allowing the buyer to amortize this amount over 5 years and treating it as ordinary income for the sellers.

Facts

Peterson Machine Tool, Inc. purchased all the stock of Kansas Instruments, Inc. from Carl U. Hansen, Robert W. Moses, and M. V. Welch for $280,000. The purchase agreement included covenants not to compete, which the sellers signed. The contract specified that the covenants were 'materially significant and essential to the closing' and 'a material portion of the purchase price. ' The sellers were aware of these terms and did not object. Peterson allocated $100,000 of the purchase price to the covenants, intending to amortize this amount over 5 years. The sellers did not allocate any portion of the price to the covenants and were unaware of the tax implications until later.

Procedural History

The Commissioner of Internal Revenue assessed deficiencies against both Peterson and the sellers based on inconsistent treatment of the covenant allocation. Peterson filed a petition in the U. S. Tax Court to challenge the disallowance of its amortization deductions, while the sellers contested the treatment of the covenant proceeds as ordinary income. The cases were consolidated for trial.

Issue(s)

1. Whether the parties intended to allocate a portion of the purchase price to the covenants not to compete?
2. Whether the covenants not to compete had independent economic significance?
3. What amount, if any, should be allocated to the covenants not to compete?

Holding

1. Yes, because the contract explicitly stated the covenants were a ‘material portion’ of the purchase price and the sellers were aware of this term.
2. Yes, because the sellers had the knowledge, resources, and ability to compete with Peterson, making the covenants economically significant.
3. $70,000, because while the covenants had real value, the $100,000 allocation by Peterson was too high based on the evidence presented.

Court’s Reasoning

The court applied general contract interpretation principles, focusing on the plain meaning of the contract terms. The phrase ‘material portion’ in the contract clearly indicated an intent to allocate some of the purchase price to the covenants. The court rejected the sellers’ argument that the ‘strong proof’ doctrine applied, as neither party was attempting to vary the contract terms but rather to construe them. The court found the covenants had independent economic significance because the sellers had the ability to compete effectively with Peterson. Hansen had turned Kansas Instruments around financially, Welch had the manufacturing capability, and Moses had intimate knowledge of the business. The court used its discretion under the Cohan rule to allocate $70,000 to the covenants, finding this amount reflected their economic reality within the overall purchase price.

Practical Implications

This decision clarifies that when a stock purchase agreement includes covenants not to compete, a portion of the purchase price can be allocated to those covenants if the contract language supports it and the covenants have real economic value. Attorneys drafting such agreements should carefully consider the language used to describe the covenants and their relationship to the purchase price. Buyers should assess the competitive threat posed by sellers when determining an appropriate allocation amount. The ruling also demonstrates the court’s willingness to adjust allocations it deems unreasonable, even when the parties agree on a specific figure. This case has been cited in subsequent decisions involving the allocation of purchase price to covenants not to compete, such as Schulz v. Commissioner and Leavell v. Commissioner.