Schaefer v. Commissioner, T. C. Memo. 1996-483

Income from a covenant not to compete is not considered passive income under section 469 of the Internal Revenue Code.

Summary

In Schaefer v. Commissioner, the Tax Court upheld the validity of a temporary regulation under section 469, ruling that income from a covenant not to compete does not constitute passive income. William Schaefer, who sold his Toyota dealership and received payments from a covenant not to compete, argued that these payments should be treated as passive income to offset his passive activity losses. The court, however, found that such income is more akin to earned or portfolio income, which Congress intended to exclude from being sheltered by passive losses, and thus upheld the regulation.

Facts

William H. Schaefer, Jr. , the petitioner, was the sole shareholder of Toyota City, which he sold on November 7, 1984. The sale agreement included a covenant not to compete within a 5-mile radius of the buyer's business for 3 years. Schaefer received monthly payments under this covenant, starting 6 months after the sale and continuing for 13 years. He reported these payments as passive income on his 1988, 1989, and 1990 tax returns, claiming they should be offset by his passive activity losses. The Commissioner of Internal Revenue disagreed, asserting that income from a covenant not to compete is not passive income under the applicable regulation.

Procedural History

The Commissioner determined deficiencies in Schaefer's income taxes for the years 1988, 1989, and 1990. After Schaefer's concessions, the sole issue remaining was the characterization of the covenant not to compete income. The case was brought before the United States Tax Court, where Schaefer challenged the validity of the temporary regulation under section 469 that classified such income as non-passive.

Issue(s)

1. Whether income received pursuant to a covenant not to compete is passive income for purposes of section 469 of the Internal Revenue Code?

Holding

1. No, because the court found that the temporary regulation excluding income from a covenant not to compete from passive income was valid and consistent with the legislative intent behind section 469.

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Court’s Reasoning

The court upheld the validity of the temporary regulation under section 1. 469-2T(c)(7)(iv), which excludes income from a covenant not to compete from passive income. The court reasoned that temporary regulations are entitled to the same deference as final regulations and must be upheld if they reasonably implement the congressional mandate. The court found that the regulation was consistent with the purpose of section 469, which was to prevent taxpayers from using passive losses to shelter income that does not bear similar risks, such as portfolio or earned income. The court cited historical cases equating covenant not to compete income with earned income, emphasizing that such income is positive and does not bear deductible expenses, aligning it more closely with non-passive income sources. Schaefer’s arguments that the income was different from earned or portfolio income were rejected, as the court found that the regulation’s classification was reasonable and within the Secretary’s authority granted by Congress.

Practical Implications

This decision impacts how income from covenants not to compete is treated for tax purposes. Taxpayers cannot use such income to offset passive activity losses under section 469. Legal practitioners must advise clients accordingly when structuring sales agreements involving non-compete clauses, ensuring that the tax implications of such income are clearly understood. The ruling reinforces the IRS’s ability to issue regulations that clarify and interpret tax laws, even on a temporary basis. Future cases involving similar issues will likely follow this precedent, and taxpayers may need to adjust their tax planning strategies to account for this classification of income.

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