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Allocations of Consideration for a Closely Held Business: *Muskat v. United States*

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When a closely held business is sold, the buyer often undertakes to make payments to the sellers (the business's owners) for (i) services expected to be provided by them after the closing and (ii) covenants not to compete and/or not to solicit employees or customers ("noncompetition covenants"). The allocation of consideration between these items, on the one hand, and amounts paid to purchase the assets of the business itself or any "personal" goodwill the owners may have (separate from the goodwill of the business), on the other, can have a significant impact on the tax liabilities of the sellers.

A payment for services or for granting a noncompetition covenant is ordinary income, while the sale of goodwill generally gives rise to long-term capital gain. Even where the goodwill is "personal" goodwill, cases such as *Martin Ice Cream Co. v. Commissioner*[1] open the door to recognizing a separate and distinct asset, gain on the sale of which may be treated as capital gain, rather than ordinary income.

The buyer will ordinarily prefer to characterize a payment as constituting compensation, since compensation is generally deductible when paid. By contrast, a payment for either a noncompetition covenant or goodwill acquired in connection with the purchase of a business will generally have to be amortized over 15 years.[2] However, the buyer may be indifferent as to whether consideration is allocated to personal goodwill or to a noncompetition covenant, so long as the allocation does not undercut the buyer's ability to enforce the covenant.

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One question that arises from time to time is whether a purchaser or seller of a business is bound for tax purposes by any contractual allocation of consideration, or whether a party may take a different tax return position that, if respected, would provide that party with a better tax result.[3]

The recent decision of the Court of Appeals for the First Circuit in *Muskat v. United States* held an executive and shareholder of a seller to be bound by a contractual allocation to a noncompetition covenant.[4] The decision confirms that a contractual allocation will generally be respected and enforced by the tax authorities and the courts absent strong proof that it is incorrect.

Facts

Irwin Muskat ("Muskat") was the CEO and owner of 37% of the stock of Jac Pac Foods, Ltd. ("JP"), a family-owned corporation engaged in meat processing and distribution.

In 1997, Muskat was contacted by the chairman of another corporation in the same industry about a possible acquisition of JP. After lengthy negotiations, an asset purchase agreement was executed by JP on March 31, 1998, providing for the sale of its business assets for a price of $34,000,000, of which more than $15,000,000 was allocated to goodwill. The sale of JP's assets closed later in 1998.

Muskat individually executed two agreements in connection with the acquisition. Under an employment agreement, he agreed to be employed by the buyer for a salary and bonus payments tied to sales targets. Under a separate noncompetition agreement, he agreed not to compete with any business conducted by JP or any other firm owned by the buyer for 13 years. An aggregate amount of approximately $4,000,000 was to be paid in installments under the noncompetition agreement, which further provided that the buyer's obligation to make payments would survive Muskat's death or disability. No allocation was made in the documents to any personal goodwill of Muskat, notwithstanding that he had played a dominant role in the growth of the business for a decade preceding the sale.

Muskat worked for the buyer for approximately six years after the sale, and the payments required by the noncompetition agreement were made.

On Muskat's original Federal income tax return for 1998, the first payment made under the noncompetition agreement, in the amount of $1,000,000, was reported as ordinary income.

Subsequently, however, Muskat filed an amended tax return, claiming that the $1,000,000 payment constituted proceeds from the sale of Muskat's personal goodwill and should therefore be characterized as the proceeds from the sale of property, giving rise to long-term capital gain. On this basis, Muskat asserted that he had made an overpayment of income taxes for 1998 in the aggregate amount of $203,434. The IRS denied Muskat's claim

for a refund, and he brought suit in U.S. District Court.

Discussion

Both the District Court and the Court of Appeals ultimately found that the noncompetition agreement provided that the amounts to be paid to Muskat were in consideration for the various promises made by him in that agreement: to protect the goodwill of JP; not to participate in competing businesses; not to solicit employees to leave the employ of the buyer; and not to divert business opportunities from the buyer.

Because of the parties' unambiguous allocation of consideration in the transaction documents and because Muskat himself was a signatory to, and deeply involved in the negotiation of, those documents, the courts also concluded that the "strong proof" rule applied,[5] under which Muskat would have to meet a heightened burden of proof to sustain a different allocation.

The Court of Appeals in *Muskat* described the "strong proof" rule as requiring that "a taxpayer's evidence must have persuasive power closely resembling the 'clear and convincing' evidence required to reform a written contract on the ground of mutual mistake," in order to be able to ignore a contractual allocation of consideration in determining the tax consequences of a transaction. (The IRS, which is not a party to taxpayers' contracts, is of course not bound by the "strong proof" rule when it seeks to recharacterize payments.)

The Court of Appeals agreed with the District Court that the evidence offered by Muskat, to the effect that the parties intended the payments under the noncompetition agreement to constitute consideration for acquisition of his personal goodwill. was insufficient to meet the "strong proof" standard.

In particular, there had been extensive negotiations in which Muskat sought to assure the adequacy of the compensation he would receive in the transaction, apart from what would be paid for his shares of stock, and the undertaking to make substantial payments under the noncompetition agreement apparently emerged as a solution to address his concerns. There was no reference in those negotiations, however, to Muskat's having any personal goodwill with respect to the business apart from the goodwill owned by JP.

Moreover, the president of the buyer testified that he could not imagine that there was any goodwill material to the transaction other than that of JP, and the Court of Appeals observed that the allocation in the asset purchase agreement of a large portion of the overall consideration to the purchase of JP's goodwill made it less likely that Muskat had substantial separate goodwill.

Muskat argued that his age – he turned 61 in the year of sale – and personal lack of interest in competing with the buyer, as well as the difficulties in starting a competing business in the industry, made a noncompetition agreement unnecessary as a business matter, so that the agreement must have been used as a vehicle for payment for something else, that is, for Muskat's personal goodwill. The District Court and Court of Appeals were not persuaded by these factors, noting that the buyer routinely obtained noncompetition agreements in its acquisitions, thought highly of Muskat's business acumen, and believed that a noncompetition agreement was needed to protect the buyer's investment in the business.

Muskat further argued that the requirement in the noncompetition agreement that all payments be made even if Muskat died or became disabled during the term indicated that the payments were being made for something other than the noncompetition covenant. The courts did not address the argument directly, but concluded that the weight of evidence favored giving effect to the treatment of the payments in accordance with the characterization in the noncompetition agreement, that is, as payments for a covenant not to compete.

Observations

It is difficult to determine whether Muskat would have ultimately prevailed in his argument for capital gain treatment if the transaction documents had allocated part of the $4,000,000 that was paid under the noncompetition agreement to personal goodwill and the IRS had then challenged that on audit. As a practical matter, many such allocations are not closely scrutinized by the IRS, especially where all parties to a transaction reports the payments in a manner consistent with the stated allocation.

In any event, it seems apparent that Muskat would have been in a much stronger position to sustain his claim of capital gains treatment with respect to at least a portion of the $4,000,000 amount had an allocation of some portion to personal goodwill been reflected in the documents, even given the skepticism sometimes expressed by the tax authorities as to whether personal goodwill exists absent unusual circumstances. A taxpayer may be able to defeat the IRS with the help of the taxpayer's own documents, but, when the IRS can arm itself with an allocation in the transaction documents, it often proves to be an unbeatable foe!

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[1] 110 T.C. 189 (1998).

[2] IRC § 197.

[3] Under certain circumstances, the Code may require that, if the buyer and seller of assets constituting a trade or business agree as to the allocation of consideration, they report the transaction in a manner consistent with the agreement. IRC § 1060(a).

This requirement does not appear to be applicable, however, to an individual shareholder and executive who is neither the buyer nor the seller of assets constituting a trade or business, and was not discussed in the case described below.

[4] 103 AFTR 2d 2009-_____, Dkt. no. 08-1513 (1st Cir., Jan. 29, 2009), aff'g 101 AFTR 2d 1008-1606 (D.N.H. 2008).

[5] See *Harvey Radio Laboratories, Inc. v. Commissioner*, 31 AFTR 2d 73-396 (1st Cir. 1972). As indicated in *Muskat*, other Courts of Appeals have also adopted the "strong proof" rule.

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