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No Amortization for Covenant Not to Compete: Yes on Client List

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The dichotomy between a group of intangibles, including a covenant not to compete on the one hand, and other intangibles (such as the client list) on the other, has never been subject to precise definition. How one determines the value of someone's agreement not to compete, or

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someone's client list, is a sizable part of the fundamental problem. That there can be distinct differences in tax result depending upon the numbers that one plugs into this equation is clear.

Take the recent case of *Philip M. Welch, et ux. v. Commissioner*, T.C. Memo 1997-120 (1997). Philip Welch agreed to purchase an accounting practice from an aging accountant, Mr. Rahill, in 1987. The purchase price was set at 25% of the gross revenue earned from 206 clients listed on a schedule attached to the agreement for a period of 48 months.

Under the agreement, Rahill was prevented from competing, including soliciting business from any of those clients for a four-year period. As it happened, Rahill assigned his right to receive the payments to a trust, and died in the same year as the sale (1987). Welch kept track of his newly-acquired accounting business on a Schedule C.

Accordingly, on his 1989 and 1990 Schedule C, he deducted $40,000 and $41,000 respectively for the covenant not to compete. The IRS disallowed the deductions, on the theory that the value of the covenant was inseparable from the total purchase price he paid for the accounting practice. Mr. Welch, on the other hand, claimed that the deductions were expressly allowed under Section 167(a)(1) because they represented the amortized costs of either the seller's covenant not to compete or the cost of the seller's client list.

Faced with these competing claims, the Tax Court supported the IRS, finding that the covenant not to compete lacked economic reality. Both Rahill's age at the time (65) and his health problems (he did end up dying the same year as the sale) combined with other factors, caused the court to conclude that the covenant not to compete had no independent basis in fact or arguable relationship with business reality (a pretty harsh conclusion). The court found that reasonable persons genuinely concerned with their economic futures would not be likely to bargain for this covenant not to compete.

All's Well That Ends Well

Nonetheless, the Tax Court allowed Mr. Welch to amortize a portion of the payments on his alternative theory: that the payments represented the cost of Mr. Rahill's client list. The court concluded that a portion of the payments also represented an element of going concern value. After all, Mr. Welch not only acquired Rahill's clients, but also his office equipment, office and employees. The court made its own allocation of payments to the client list, giving the client list a useful life of seven years. ■