Code Section: Section 61 -- Gross Income Defined
Author: per curiam
Institutional Author: United States Court of Appeals for the Eleventh Circuit
Citations: John Jorgl, et ux. v. Commissioner; 88 AFTR2d Par. 2001-5079; No. 00-12462 (28 Jun 2001)
Tax Analysts Reference: 2001 TNT 142-6

Couple Must Recognize Income From Covenant Not to Compete

The Eleventh Circuit, in a per curiam opinion affirming the Tax Court, has held that a couple must recognize income from a covenant not to compete on the sale of their business, because the parties intended to allocate sales price to the noncompete agreement.

========== CASE NAME ==========

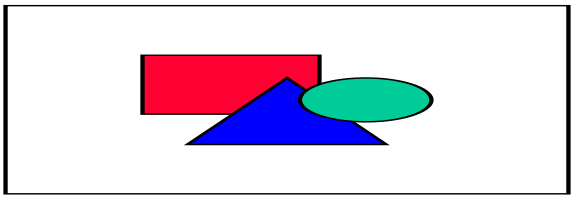
JOHN T. JORGL, SHARON ILLI,
Petitioners-Appellants
v.
COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee

========== SUMMARY ==========

The Eleventh Circuit, in a per curiam opinion affirming the Tax Court, has held that a couple must recognize income from a covenant not to compete on the sale of their business, because the parties intended to allocate sales price to the noncompete agreement.

John Jorgl was the sole shareholder of Little Rascals Child Care Centers Inc. In the early 1990s, John and his wife Sharon Illi created an irrevocable charitable remainder unitrust and transferred all of John's shares in Little Rascals to the trust. In 1993 the couple entered into negotiations to sell the child care business. The purchase agreement was executed between the buyer and the trustee of the Jorgls' trust as seller. The purchase agreement allocated $300,000 of the sale price to a noncompete covenant, which applied to the Jorgls. The Jorgls and buyer later entered into a separate noncompete covenant, and the Jorgls promised not to compete. The purchase price was deposited into the trust's account, and the Jorgls received no compensation for signing the separate document. The Jorgls didn't report any income from the sale, and the IRS determined deficiencies attributable to the portion of the sale price allocated to the noncompete covenant. The Jorgls petitioned the Tax Court

The Tax Court held that the Jorgls received income to the extent of the purchase price attributable to their covenant, concluding that the parties intended to allocate a portion of the purchase price to the covenant and that the allocation had economic reality. The court rejected the Jorgls argument that there should be no tax consequences because they did not participate in the purchase agreement and that their separate covenant had no value. The court noted that the Jorgls were involved in the negotiations with the buyer before the purchase agreement was executed and that the Jorgls provided the buyer with training under



the agreement. Thus, the court concluded that the Jorgls and buyer mutually intended to allocate a portion of the purchase price to the Jorgls' covenant. However, the Tax Court held that the Jorgls were not liable for an accuracy-related penalty, finding that they established reasonable cause and good faith because they relied on expert advice from their attorney and accountant. John T. Jorgl, et ux. v. Commissioner, T.C. Memo. 2000-10 (For a summary, see Tax Notes, Jan. 17, 2000, p. 360; for the full text, see Doc 2000-1554 (32 original pages) or 2000 TNT 8-3 /tnt3.nsf/4e85f1eacc55592785256825000078c81/31dc90300591936c85256864000bc905?OpenDocument /tnt3.nsf/4e85f1eacc55592785256825000078c81/31dc90300591936c85256864000bc905?OpenDocument.)
The Eleventh Circuit, noting that the record supported the Tax Court's decision that the Jorgls failed to meet their burden of proof on the lack of mutual intent and economic reality, affirmed the Tax Court. The appeals court noted that it is clear there was a mutual intent to allocate purchase price to the convenant and that the covenant was a critical and separately bargained-for component of the transaction.

========== FULL TEXT ==========

IN THE UNITED STATES COURT OF APPEALS
FOR THE ELEVENTH CIRCUIT

APPEAL FROM A DECISION OF THE UNITED STATES TAX COURT

U.S. Tax Court No. 11508-98

June 28, 2001) [sic]

Before Black, Roney and Hill, Circuit Judges.

PER CURIAM:
[1] In this case, taxpayers appeal the tax court's determination of a $79,869 income tax deficiency for tax year 1993. The issue is whether the tax court erred in finding taxable income to taxpayers for their giving a covenant not to compete in connection with the sale of stock of a business operated by taxpayers, which stock had been previously transferred by taxpayers into a charitable remainder unitrust. We affirm.
[2] In 1980, taxpayers, husband and wife, John T. Jorgl and Sharon Illi, opened Little Rascals Child Care Centers, Inc., a child care business in California. Jorgl was the sole shareholder, and maintained an office on the premises, managed the business operations, served as president and was a member of the board of directors. Illi became director of the school as well

as a corporate officer. Both were employees of the corporation and were compensated for their services.

[3] On June 26, 1991, taxpayer husband, as grantor, and Cupertino National Bank, as trustee, executed a "Charitable Remainder Unitrust Agreement." Taxpayers were designated as the income beneficiaries of the trust and Project Grant a Wish was named the charitable remainder beneficiary. For their lifetime, taxpayers were to receive annual distributions totaling the lesser of the trust income for the taxable year or nine percent of the fair market value of the trust assets. The trust was irrevocable and taxpayers were given no rights to or control over trust assets beyond receipt of the above-specified distributions. The next day, on June 27, 1991, the parties signed the stock certificate transferring all of taxpayers' shares in Little Rascals to Cupertino National Bank as trustee for the Jorgl unitrust. Taxpayers continued to serve as employees, officers, and directors of Little Rascals.

[4] On that date, also, the Little Rascal's board of directors resolved to proceed with having the corporation listed for sale with a business broker. The brokerage firm engaged for the sale prepared an extensive prospectus to market Little Rascals. The prospectus erroneously stated that the center "was established in 1980 by the current owner, an architect." One of the terms of sale recited in the document was "COVENANT 5 years 100 miles."

[5] Not until 1993 did Divyesh and Priti Shah purchase the stock of the business from the trustee for $650,000. Demanded by the purchasers as part of their purchase agreement, taxpayers signed a separate document entitled, "COVENANT NOT TO COMPETE." The closing statements indicated the value of the non-compete clause as $300,000, though at some point in the tax court proceedings, the IRS conceded in briefs of the sale, and taxpayers received no additional compensation for signing the separate document. Taxpayers reported no income as a result of the sale, and the IRS determined a deficiency for taxes attributable to the portion of the sale price allocated to a covenant not to compete.

[6] The tax court held that execution of a noncompete agreement resulted in taxable income to taxpayers to the extent of the purchase price attributable thereto. The court determined that a portion of the consideration paid can properly be allocated to the promise made by taxpayers; that taxpayers are the true earners of the income by agreeing not to compete; and that taxpayers anticipatorily assigned such income to the trust. The court held, however, that because taxpayers relied upon professional advisers and acted reasonably and in good faith regarding tax treatment of the sale, they were not liable for the $24,088 accuracy-related penalty for the substantial understatement of income tax. After an agreed recomputation, the tax court determined a deficiency of $79,869 for tax year 1993.

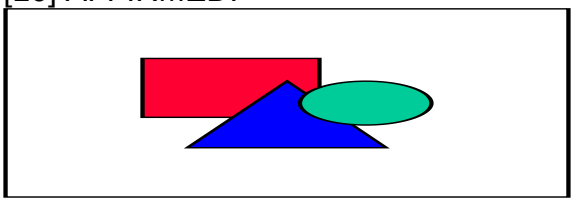
[7] To defeat the deficiency assessment, taxpayers must prove by a preponderance of the evidence that there was no mutual intent that an allocation of the purchase price be made to the covenant at issue and that the allocation does not "comport[] with economic reality." Peterson Mach. Tool, Inc. v. Commissioner, 79 T.C. 72, 84 (1982). An allocation will generally be given effect where 'the covenants had independent economic significance such that [the Court] might conclude that they were a separately bargained-for element of the agreement." Peterson Mach. Tool, 79 T.C. at 81.

[8] Contrary to taxpayers' assertions, the record adequately supports the tax court's decision that taxpayers have failed to meet their burden of proof regarding lack of mutual intent and economic reality. It is clear from the surrounding facts and circumstances as laid out in thorough detail in the tax court's opinion, that there was a mutual intent that an allocation of the purchase price be made to the covenant not to compete: taxpayers "intended that their

covenant be a part of the overall sale transaction, they understood from the contents of the documents that they were promising not to compete and that consideration was being allocated to a covenant not to compete, and they knew that in substance the buyers attributed importance to their agreement." See, e.g., Peterson Mach. Tool, Inc., v. Commissioner, 79 T.C. 72, 81-82 (1982). Likewise, the record supports the tax court's decision as to economic reality. As the tax court observed, the taxpayers' "covenant was in act a critical and separately bargained-for component of the transaction."

[9] Because this transaction obviously had an unexpected tax impact on the taxpayers, the panel explored during oral argument various ways the matter might otherwise have been structured, and all of the arguments made in brief and oral argument as to why the tax court should have reached a different result. The tax court, however, was not clearly erroneous in its findings of fact, the standard of review by this court, and properly applied the law to those facts.

[10] AFFIRMED.



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