Revenue Rulings

Rev. Rul. 77-403, 1977-2 CB 302, IRC Sec(s). 1012

Full Text:

Advice has been requested concerning the Federal income tax treatment of a payment for a covenant not to compete under the circumstances described below.

P, whose primary business was managing rental property, purchased a newly-constructed rental building from *S,* a real estate developer, for 12*x* dollars. *P* made a cash payment to *S* of 2*x* dollars and assumed an existing 10*x* dollar mortgage on the property. *P* made an additional cash payment to *S* of 3*x* dollars for a covenant not to compete under which *S* is obligated for a specified time not to participate directly or indirectly in the construction, purchase or management of competing property within a specified distance from the building. *S* had constructed and sold many buildings but did not have personnel capable of managing rental property, had never managed rental property, and, irrespective of the existence of the covenant, did not intend to construct, purchase or manage rental property. At the time that the covenant was executed, the area specified therein contained no buildings suitable for competing with the property purchased by *P.* Additionally, construction of such a building within the specified time was unlikely.

Section 1012 of the Internal Revenue Code of 1954 provides, in part, that the basis of property is the cost of the property.

Whether a payment for a covenant not to compete made in connection with the purchase of real property is part of the cost of the property or is the cost of a separate asset depends on whether the covenant has any demonstrable value. In determining whether the covenant has any demonstrable value, the facts and circumstances in the particular case must be considered. The relevant factors include: (1) whether in the absence of the covenant the covenantor would desire to compete with the covenantee; (2) the ability of the covenantor to compete effectively with the covenantee in the activity in question; and (3) the feasibility, in view of the activity and market in question, of effective competition by the covenantor within the time and area specified in the covenant. *See Schulz v. Commissioner,* 294 F.2d 52 (9th Cir. 1961).

Although *S* and *P* characterized the 3*x* dollar payment as consideration for a covenant not to compete, under the circumstances *S*'s obligation not to construct, purchase or manage a competing property has no demonstrable value. Therefore, the 3*x* dollar payment is part of the cost of the real property rather than the cost of a separate asset. If the covenant not to compete did have a demonstrable value, the amount characterized as a payment for that covenant would be regarded as the cost of an asset separate from the real property only to the extent it did not exceed the demonstrable value of the covenant.

Accordingly, the 3*x* dollar payment must be added to *P*'s basis in the real property pursuant to section 1012 of the Code, and it may not be amortized over the duration of the covenant.