What Transferor Is Not a Transferor? A Shareholder

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Irwin and Margery Muskat may breathe a temporary sigh of relief as a District Court in New Hampshire denied the United States motion for summary judgment in *Muskat v. United States,* Civil No. 06-cv-30-jd, 2007 U.S. Dist. LEXIS 53956, at *1 (D. N.H. Jul. 25, 2007). The sole issue for the District Court was whether Irwin, as President, Chief Executive Officer (CEO), and 37-percent shareholder qualified as a transferor within the meaning of Internal Revenue Code Section ("Code Sec.") 1060. As a transferor, Irwin would be subject to the express allocation of income terms contained in the Asset Purchase Agreement (APA). As such, the motion would have precluded the Muskats from reclassifying the payment Irwin received from the sale of his business from ordinary income to capital gain treatment.

Jac Pac Foods, Ltd.("Jac Pac"), a meat processing, marketing, and distributing business in Manchester, New Hampshire was started in 1933 by Irwin's grandfather. As of 1998, Irwin was acting as President and CEO of Jac Pac. In March of 1998, Manchester Acquisition Corporation ("MAC"), a subsidiary of Corporate Brand Foods America, Inc., agreed to purchase the assets of Jac Pac.

The two parties executed the APA that was signed by Irwin "on behalf of Jac Pac." The APA provided for payment to Irwin in the amount of $3,995,599 in exchange for his signature on a non-competition agreement, and $15,908,511 characterized as a payment for goodwill calling for payments in installments, the first payment of $1 million under the noncompetition agreement was due on signing.

When the initial $1 million payment was made in 1998, the Muskats included the amount as ordinary income on their federal income tax return. Later, in 2002, the couple amended their return, characterizing this initial $1 million as a long-term capital gain. The Muskats contended that the $1 million was paid to Irwin in exchange for his goodwill, not for the noncompetition agreement as indicated in the APA.

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Code Sec. 1060 states that when, in a written agreement signed in connection with an applicable asset acquisition, the transferor and transferee provide for the allocation of any consideration, that allocation will be binding

on the parties, unless deemed inappropriate by the Secretary. The District Court held that the sale of Jac Pac to Mac was, in fact, an applicable asset acquisition within the meaning of Code Sec. 1060. The sole issue on summary judgment was whether Irwin was considered a transferor of assets.

If Irwin was a transferor of assets, and assuming the Secretary did not challenge the appropriateness of the allocation, Irwin would be bound by the express allocations of income made in the APA. Consequently, if Irwin was deemed a transferor, the $1 million payment, according to the APA, would constitute ordinary income on his federal income tax return.

Predictably, the government argued that Code section 1060 applied to Irwin because Irwin was a party to the APA and his noncompetition agreement was part of the transaction of selling Jac Pac. In contrast, the Muskats argued that they were not transferors within the meaning of Code Sec. 1060. Instead, Jac Pac was the transferor. Accordingly, the Muskats did not believe they were bound by the allocation of income in the APA. On the contrary, they argued that they should be able to classify the payments as goodwill subject to taxation as a long-term capital gain.

The District Court held Code Sec. 1060 to be inapplicable to the Muskats, as they were not transferors nor transferees as defined in that Code provision. For that reason, the motion for summary judgment was denied. As the District Court did not make any findings on whether the Muskats could reclassify the income as a long-term capital gain, it remains to be seen how the $1 million will be treated for income tax purposes.