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STATE OF HAWAII
P.O. BOX 259
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TAX INFORMATION RELEASE NO. 95-1

RE: Application of the General Excise Tax on the Gross Receipts from a Covenant Not to Compete

A covenant not to compete is an agreement in which the grantor of the covenant promises to refrain from competing with the purchaser of the covenant for a prescribed period of time. The covenant may also restrict the grantor from engaging in a business competing with the purchaser within a designated geographical area. These covenants are commonly found in contracts to sell a business. The purchaser compensates the grantor for the performance of the promise.

In In Re Ronald G. Keehn, No. 3045 (Haw. Tax App. Ct., January 10, 1994), the court held that income received by a taxpayer under a covenant "is gross income subject to the general excise tax imposed by Chapter 237, Hawaii Revised Statutes ('HRS') because the income, being payment for performance of a promise, compensation for lost earnings, income from an independent undertaking, and compensation for personal services is both derived from trade, business, commerce, or sales, and is compensation for personal services under HRS §237-3." Based on this, the Department's position is that although the seller of the covenant is being paid to refrain from acting, instead of being paid to act, the seller is still considered to be engaging in business.

The gross receipts from a covenant not to compete are subject to the general excise tax at the rate of four per cent. The grantor is responsible for reporting any consideration received for the covenant as "other income" on line 16 of Forms G-45 and G-49.

A handwritten signature in black ink, appearing to read "Ray K. Kamikawa".

RAY K. KAMIKAWA
Director of Taxation

HRS Section Explained: HRS §237-3