IN THE COURT OF COMMON PLEAS OF LYCOMING COUNTY, PA

RICHARD H. CONFAIR,	:	
Plaintiff	:	
	:	
v.	:	NO. 00-00,464
	:	
MUNICIPAL AND SCHOOL INCOME	:	
TAX BOARD OF APPEALS,	:	
Defendant	:	

SAMUEL SIMON,	:	
Plaintiff	:	
	:	
v.	:	No. 00-00,509
	:	
MUNICIPAL AND SCHOOL INCOME	:	
TAX BOARD OF APPEALS,	:	
Defendant	:	

OPINION and ORDER

The question in this case is whether money received in return for a promise not to work is "earned." If so, the Williamsport Area School District and the City of Williamsport may tax payments made under covenants not to compete.

Prior to September 15 1998, the Municipal and School Income Tax Office, which collects taxes for the School District and City, did not tax money paid under such agreements. Now, however, the Tax Office has changed its mind and indeed is making up for lost time by attempting to tax payments made as far back as 1995.[1]

The taxpayers challenging this practice received money under covenants not to compete that were

[1] The taxpayers are appealing from an adverse decision made by the Municipal and School Income Tax Board of Appeals. As we have taken no additional evidence, our scope of review is limited to determining whether the Board committed an error of law, whether its findings of fact are supported by substantial evidence, and whether constitutional rights were violated. 2 Pa.C.S. § 754(b).

executed as a part of a sale of their businesses. They claim these funds were not "earned," and should be categorized instead as either a return of capital or as investment income, neither of which the City and School District have authority to tax. The court disagrees. Just because these taxpayers were not actively employed or engaged in some business activity does not mean they were not *earning* the money. Under a covenant not to compete, a player in the business world is paid to sit out the game for a while. Those benched players are "earning" their money just as surely as those on the field, and should be taxed like their teammates.

But although we find the School District and the City may tax income from covenants not to compete, we also find that the Tax Office has placed such income in the wrong category, and that they cannot tax non-compete payments under agreements executed prior to 12 March 1998.

DISCUSSION

I. Are the Payments "Earned"?

The Local Tax Enabling Act (LTEA), 53 P.S. §6801 et seq., permits second class cities and school districts to tax income that has been "earned." Under §6913, titled "Earned income taxes," the statute lists two kinds of income that fit into this general category: "Net Profits," and a specific type of income called, unfortunately, "Earned Income." It would have been nice if the legislature had refrained from using the term "earned income" twice, but at least the legislature distinguished the two by generally using capital letters when referring to the specific type of earned income called "Earned Income." See O'Reilly v. Fox Chapel Area Sch. Dist., 527 A.2d 581, 585 n.14 (Pa. 1987) ("total earned income" means the sum of "Earned income" plus "Net profits").

Although the term "earned income" without capital letters is never defined, it is clear from the statute that the legislature intended to permit taxation of income derived from providing some sort of service or conducting a business activity. See the definitions of "Earned income" and "Net profits." In granting this limited authority to tax, the legislature clearly meant to exclude income derived from investments or from the sale of capital assets. See Marchlen v. Township of Mt. Lebanon, 746 A.2d 566 (Pa. 2000); Pugliese v. Township of Upper St. Clair, 660 A.2d 155 (Pa. Commw. 1995); Scott v. Hempfield Area School District, 164 Pa.. Commw. 588, 643 A.2d 1140 (1991).

The taxpayers' primary argument is that money received under a non-compete agreement is not taxable under §6913 because it is not "earned." It is neither compensation for performing services nor income from the operation of a business, because the person receiving the money is not actively working. In fact, they argue, the performance under a non-compete agreement is the polar opposite of working because the covenant requires a person to conduct *no activity* in a certain business or profession.

In support of their argument, the taxpayers point to Rappaport v. Tax Review Board, 682 A.2d 862 (Pa. Commw. 1996) and Quaid v. Philadelphia Tax Review Board, 188 Pa. Super. 623, 149 A.2d 557 (1959). Both of these cases contain language which could be used to bolster the taxpayers' argument. For instance, they state the word "earned" means "to gain, get, obtain, or acquire as the reward of labor or performance of some service." This, however, merely begs the question of whether the service need entail active conduct.

Although the taxpayers' argument appears sound on a superficial level, a close analysis proves it wrong. First of all, it requires an unreasonably narrow interpretation of the statute, in which "earning" depends on one's level of activity. If that were true, many listless employees who punch a daily time clock would have a cogent argument for escaping earned income taxes.

But on a deeper level, the taxpayers' argument must fail because the opposite of activity is *inactivity*. The performance of a covenant not to compete, however, is a sort of *non-activity*, and the two are very different. Inactivity is doing *nothing*, while non-activity is deliberately refraining from doing *something*. It is a *positive absence* of activity–an *affirmative restraint*. Each day throughout a certain time period, the payee is under a duty to refrain from working in that profession.

The difference between inactivity and non-activity can be further illuminated by considering the nature of unemployment. Under unemployment, a person is paid *because* he or she is not working. Under a covenant not to compete, however, a person is paid *for* not working.

Clearly, performance under a covenant not to compete is *deliberate and purposeful non-activity*. And while inactivity is generally weak and dissipating, non-activity can be extremely powerful and potent, as demonstrated by Gandhi, who brought the entire British Empire to its knees by seemingly doing nothing at all. But Gandhi was not doing nothing. He was deliberately refraining from cooperating with the British. His non-activity was, in a sense, extremely active. Similarly, consider the nature and effectiveness of boycotts, hunger strikes, sit-ins, and other types of passive resistence conducted for a political purpose.

In fact, in our competitive capitalist economy such purposeful non-activity can be just as powerful as activity. As the popularity of non-compete agreements demonstrates, many astute business persons are happy to pay their competitors to refrain from working. And our society considers such agreements so important that courts may even enforce them by issuing injunctions–a rare civil remedy–in addition to awarding money damages.

In a recent case similar to the one before us, the Pennsylvania Commonwealth Court reached the same conclusion. In Rauch v. Tax Review Board of Philadelphia, 708 A.2d 142, 145 (1998), the court held that money from a non-compete agreement was "earned" and therefore taxable under the Sterling Act's Net Profit Tax, 53 P.S. §§15971-15973. In doing so, the court looked to the federal case of Schaefer v. Commissioner, 105 T.C. 227, 233 (1995), which explained that under federal tax law, money from covenants not to compete is considered compensation for services because a negative covenant is "the equivalent of affirmative personal service." (quoting Ullman v. Commissioner, 29 T.C.129, 139 (1957)). The Schaefer court therefore held that money from a covenant not to compete could not be sheltered as "passive income" under federal tax law. The Rauch court did not feel that the language in cases such as Quaid, supra, and Rappaport, supra, which seems to indicate that the services rendered must be active, should be construed so narrowly. Although the Rauch court never stated precisely why, the most probable reason is because those two courts were faced with much easier questions that did not require an analysis of what level of activity is required for earned income. Quaid involved a purchase of good will, which requires no activity, and Rappaport involved income from real estate investment and management, which requires a great deal of activity. Therefore, neither court confronted nor anticipated the more subtle question involved in this case.

A. ***Is it a Return of Capital***?

The taxpayers argue that the money they received under their non-compete agreements should be viewed as a return of capital because the covenants were executed as part of a purchase of their businesses. We fail to see why the context in which the money was received makes any significant difference. Rather, we must examine the covenant itself to determine the nature of the money being exchanged.

In all covenants not to compete, one party promises to compensate another to refrain from working in a certain profession, within a limited geographical region, for a certain period of time. A person receiving such payment has sold no asset. Unlike good will, one cannot build up a quantity of non-work and sell it in one lump sum. Rather, the promise not to work has yet to be performed at the time the contract is made. Moreover, it cannot be performed all at once. One cannot deliver a year's worth of non-work in a neatly wrapped package. One can only perform on the contract by refraining from working every single day throughout the specified time period.

It is true that over time one can develop skill, business contacts, and a sound reputation in a given profession, all of which makes him or her a formidable business competitor and which makes their promise not to compete highly valuable. However, one's ability to succeed in a profession can hardly be considered a capital asset, any more than a college education or a law degree.

This analysis is supported by the Superior Court's decision in Rauch, supra, where the court held that income under a covenant not to compete was not comparable to income from the sale of good will.

B. ***Is it Investment Income?***

Nor can money received under a non-compete contract be considered investment income, for the payments are directly dependent upon the conduct of the person receiving the money. This point was emphasized in Scott v. Hempfield Area School District, 164 Pa. Commw. 588, 643 A.2d 1140 (1991), where the Commonwealth Court found that the net profits of an S corporation, which were passed through to the sole shareholder, were investment income and therefore not taxable under the Earned Income section. The court reasoned:

> [Scott] receives a salary from Scott Electric for services rendered as President and Treasurer of the S corporation and is taxed thereupon. . . . Therefore, there is already attributed to the taxpayer an income earned as a result of his activity in the corporation and upon which he is taxed by the local government. The allocation of net profits to [Scott] as a shareholder does not then represent compensation for services rendered.

Id. at 1142. Instead, the money was characterized as "realized income," which is "investment income, not earned income." Id. at 1142-1143.

Similarly, in Pugliese, supra, 660 A.2d 155 (Pa. Commw. 1995), the issue involved funds received from a distribution of convertible debentures. The taxpayer had received an award from the company based on merit and performance. The taxpayer then chose to defer the award and use the money to purchase his company's convertible debentures. The court held that once the employee received a distribution on the debentures the amount of the deferred award was compensation, taxable as earned income. The interest and appreciation earned on the funds, however, was investment income. This makes sense because the appreciation occurred after the employee had received the award and invested the money. The increased value did not result from any services performed by the employee for the company, nor from the company's efforts to compensate the employee for services rendered, nor as an incentive for the employee to increase his productivity. Rather, the stock increased as a result of market forces, which were not in any way dependent on the employee's performance.

By contrast, in Marchlen, supra, the Pennsylvania Supreme Court recently held that stock options issued to an employee pursuant to a stock option plan constitute compensation, taxable under the LTEA. Unlike the situation in Pugliese, the employee realized the benefit of the option he was granted only when he purchased the stock. Therefore, the difference between the price he paid and the market price was compensation. Once the stock was purchased, however, any increase in value would be investment income. The court reasoned:

> Stock options are valuable inducements to attract and retain employees and to compensate them for their services. . . . The initial value received by Appellee from exercising his stock options, which is taxable compensation, is clearly distinguishable from any later increase in value generated by virtue of Appellee's investment decision to continue to hold the ALCOA stock, which would be taxable as passive investment income.

Id. at 570.

In the case of covenants not to compete, by contrast, all payments received are a direct result of the payee's performance, and are totally dependent on his or her conduct. If the payee violates the agreement and begins working in the forbidden field, within the geographical area specified in the contract, the payor can sue for money damages or injunctive relief.

The taxpayers also argue that under federal law the purchase of a covenant not to compete is treated the same as the purchase of good will–it may be amortized by the purchaser as a business expense. While that is true, the pertinent question is how the payment is treated to the *seller*, and under federal law such money is considered compensation for services. See Schaefer v. Commissioner, 105 T.C. 227 (1995). Moreover, the term "earned income" is not used in federal tax law or state tax law, and neither system limits the applicability of its tax to earned income. Therefore, neither system's treatment of money derived from covenants not to compete is controlling in this case. See Marchlen, supra, at 569 n.8; Pugliese, supra, at 156.

II. What Specific Type of "Earned" Income is it?

Having determined that payment from covenants not to compete is "earned" and therefore taxable under §6913, we must next determine in which of the two specific categories it belongs.

A. *"Earned Income"*

The Tax Office has placed it under "Earned Income," which is defined as

> Salaries, wages, commissions, bonuses, incentive payments, fees, tips and other compensation received by a person or his personal representative for services rendered, whether directly or through an agent, and whether in cash or in property . . . .

§6913(I).

Although this definition appears general enough to include payments under non-compete agreements, further reflection upon the statute reveals that Earned Income was meant to apply to compensation received as a result of *employment,* which is not the case under covenants not to compete.

We reach this conclusion by first examining §6913(III)(B) of the LTEA, which discusses the specific category "Earned Income." Under that section, Earned Income can be paid in two ways: (1) it can be collected at the source, or (2) if not collected at the source, the taxpayer must file a special form along with his or her quarterly or annual return, and pay it at that time.

Under §6913(IV), entitled "Collection at Source," the LTEA requires every "employer" who "employs one or more persons . . . for a salary, wage, commission or other compensation," to withhold the tax on earned income and file various forms reporting that withholding. "Employer" is defined as "A person, partnership, association, corporation, institution, governmental body or unit or agency, or any other entity employing one or more persons for a salary, wage, commission or other compensation."

Similarly, the section entitled "Earned Income Not Subject to Withholding" requires every taxpayer "who is employed for a salary, wage, commission, or other compensation and who received any earned income" that has not been collected at the source to report the income and pay it on their quarterly or annual tax return.

These sections clearly indicate that the statute envisions Earned Income as compensation arising within an employer/employee relationship. In fact, the Tax Office's own regulations list examples of Earned Income under the heading "Taxable Compensation of Employees." And indeed, the list of taxable items includes mainly compensation arising directly out of an employment relationship.[2] Recently added to this list is "Covenants Not to Compete," which sticks out like a sore thumb.

Moreover, the case law involving decisions on Earned Income involve compensation arising out of

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[2] Examples include: cash for opting out of a benefit plan, flexible spending accounts, group legal assistance, vacation buyouts, commissions, court awards representing back wages, deferred compensation plan contributions, dependent care assistance, employee discounts, employer contribution to a cafeteria plan, gifts from employer, golden parachute payments, holiday pay, incentive payments, meals and lodging for employee convenience, employer contributions on non-qualified stock bonus incentive plans, payment incentives for early retirement, payment in lieu of employee health insurance benefits, proceeds from profit sharing plans, reimbursed moving expenses, reimbursement and allowances of business expenses, relocation expenses, salaries, termination and severance pay, sick page if wage continues, taxes paid by employer on behalf of employee, tips, tuition forgiveness reduction, vacation pay, and wages.

an employee-employer relationship: Marchlen, supra; Newberry v. Tp.of Upper St.Clair, 710 A.2d 96 (Pa. Commw. 1998); Pugliese, supra; Scott, supra.

The Tax Office's mistake is the result of some unfortunate ambiguity in the LTEA as well as the Rauch case, which both muddle the distinction between "earned" income in general, which includes the specific category "Earned Income."[3] Rauch concludes that money from a non-compete clause should be treated as "earned income." Rauch at 145. However, the Rauch court was not even addressing the "Earned Income" category; it was addressing the "Net Profits" category, and the term "Net Profits" happened to contain the term "earned" in its definition.[4] The Rauch court obviously used the word "earned" in the general sense, and the Tax Office latched onto that word and applied it in the specific sense.

In the case before the court, the persons receiving the payments have no employment relationship with the person or entity paying the money. Therefore, we find that the Tax Office has mischaracterized income from such covenants not to compete.

We acknowledge, however, that in some cases covenants not to compete arise within an employment relationship, such as when an employee signs a covenant not to compete with the employer if and when he or she is no longer employed. In those cases, the consideration for the agreement is usually provided at the time the agreement is executed, and often consists of the employment itself. To the extent that explicit compensation is provided to the employee during his or her employment, such compensation would be taxable under the Earned Income section.

B. *Net Profits*

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[3] See our previous discussion under Section I.

[4] "The Net Profits Tax applies to 'net profits earned in business, professions, or the activities . . . ."

As discussed above, the other type of income taxable as "earned" income under the LTEA is Net Profits, which is defined as:

> The net income from the operation of a business, profession, or other activity, except corporations, after provision for all costs and expenses incurred in the conduct thereof . . . .

This language envisions a business activity carried on outside an employment relationship, as is clear from §6913(II)(A)(1), which states that taxpayers making net profits must file annual or quarterly returns to report and pay the income. Unlike with Earned Income, the statute does not envision the possibility that taxes from Net Profits will be collected at the source. Moreover, the cases discussing the application of Net Profits involve taxpayers who are not employees. Rauch, supra; Rappaport, supra; Aronson v. City of Pittsburgh, 485 A.2d 890 (Pa. Commw. 1985); Quaid, supra.

The taxpayers again argue that income from a covenant not to compete cannot fall into the Net Profits category because Net Profits requires active conduct. As discussed above, we believe that §6913 grants municipalities the power to tax "earned" income, which does not require affirmative, active conduct. Similarly, we do not find the definition of Net Profits to be so limited.

Neither does the Commonwealth Court. In Rauch, supra, the court held that income from non-compete agreements could be taxed as Net Profits, and affirmed the explanation of the Philadelphia Tax Review Board which found that:

> the promise not to compete and the subsequent 'undertaking' of that effort pursuant to a business arrangement is sufficient to bring this within the purview of the Net Profits Tax. The fact that this is a negative covenant or rather, a promise not to do something, does not remove it from the realm of a business activity which is undertaken as part and parcel of a contract for a fee. The act of not competing is the consideration contributed to this contract by the Appellant. It is consideration that has a business [purpose], not a personal purpose.

Rauch, supra, at 143. The Commonwealth Court firmly rejected the taxpayers' arguments that some level of activity is required before a person can be treated as a taxpayer under the Net Profits Tax and that sums received for refraining from activity are not "earned" as the term is used in the ordinance. Id. at 144.

The taxpayers in the case before this court argue that Rauch is not on point for several reasons. First, they state that Rauch involved the interpretation of the Philadelphia Net Profits Tax, an ordinance enacted pursuant to the Sterling Act, 53 P.S. §15971-15973, rather than the LTEA. They go on to argue that the Sterling Act grants greater taxation powers than the LTEA–specifically, that under the Sterling Act first class cities can tax investment income.

While those facts are undeniable, we do not believe they are relevant because the language the Rauch court was interpreting is almost exactly the same as the language contained in the definitions of Net Profits under the LTEA §6913.[5] Moreover, the Rauch court never even mentioned the fact that Philadelphia had the power to tax investment income. In fact, the Rauch court specifically rejected the taxpayers' efforts to characterize payment under a non-compete agreement as investment income.

The taxpayers also argue that Rauch should not apply because the facts behind the covenant not to compete are different from the circumstances under which their own covenants were executed. In Rauch, the taxpayer withdrew from an architectural firm and received payments for his interest in the corporation, his interest in a partnership that held real property, and his agreement not to compete as architect for a stated period of time. We fail to see why the covenant not to compete in Rauch should be treated any differently than the ones executed by the taxpayers in the case before us, whose agreements were executed as part of a sale of their businesses. In fact, the essence of all such agreements is the same: one person is being compensated to refrain from working in a particular business or profession. Therefore, all such agreements should be treated the same for tax purposes, regardless of the manner in

[5] The Philadelphia Net Profits Tax taxes "net profits earned in business, professions or the activities . . . ." "Net Profits" are defined as the "net gain from the operation of a business, profession or enterprise . . . ." A "business" is defined as an "enterprise, activity, profession or undertaking of any nature conducted for profit or ordinarily conducted for profit." Rauch at 143.

which they arose.[6]

The taxpayers' argument really boils down to the contention that their agreements were considered by both buyer and seller as a part of the purchase price of an ongoing business. But the purchase of the business is quite separate and distinct from the owner's promise not to compete. Businesses are sold every day without the execution of such covenants. The two cannot and should not be merged. These taxpayers chose to characterize the payments as covenants not to compete, and they had a perfect right to do so. However, once one executes a covenant not to compete, one must be prepared to pay the tax consequences.

III. Retroactive Application

Having found that the Tax Office may tax payments from a covenant not to compete, we must now decide whether it can tax payments that have been made prior to 12 March 2000, the date Rauch was issued.[7] The Tax Office argues it may, because Rauch is binding and because it is not a new pronouncement of law, but instead is only an interpretation of existing law.

To begin with, we find that Rauch is indeed binding. We must reach this conclusion despite the fact that the case addresses the Philadelphia Net Profits Tax, under the Sterling Act, and not the local ordinance, under the LTEA, because the language defining "Net Profits" is virtually the same. Furthermore, as discussed above, although the Sterling Act grants first class cities greater taxing power than the LTEA grants to second and third class cities, there is no indication that distinction had any bearing

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[6] With the exception, of course, of agreements that are executed within an employment relationship, where the consideration is paid to current employees. As discussed above, any explicit compensation received under this circumstance would fall into the "Earned Income" category.

[7] We need not address the Tax Office's improper handing of the proposed regulation including income from covenants not to compete because we have found that such income cannot be taxed under the Earned Income section.

whatsoever on the Commonwealth Court's decision.

The question then becomes whether Rauch should be applied retroactively. This issue involves two possible situations: (1) the taxing of payments received before Rauch was issued, and (2) the taxing of payments received after Rauch was issued, pursuant to agreements signed before Rauch.

A. **Should *Rauch* be Applied Retroactively?**

Neither the Federal Constitution nor the Pennsylvania Constitution requires or forbids retroactive application of court decisions announcing a new rule. Retroactive application is a matter of judicial discretion which must be determined on a case by case basis. August v. Stasak, 492 Pa. 550, 554, 424 A.2d 1328, 1330 (1981). In considering whether to give a case retroactive effect, the court must consider three factors.

First, a decision to be applied nonretroactively must establish a new principle of law, either by overruling clear past precedent on which litigants may have relied or by deciding an issue of first impression whose resolution was not clearly foreshadowed. Chevron Oil Company v. Huson, 404 U.S. 97, 92 S.Ct. 349, 30 L.Ed.2d 296 (1971). Rauch meets this criterion because the issue whether income from non-compete agreements was taxable as earned income had not previously been decided by a Pennsylvania appellate court. Moreover, as the length and depth of this opinion demonstrates, the answer was certainly not clear from reading the LTEA.

Second, the court must weigh the merits and demerits of each case by considering the prior history of the rule in question, its purpose and effect, and whether retrospective operation will further or retard its operation. Chevron, supra. As an issue of first impression, the rule in Rauch had no prior history. The point of the new pronouncement in Rauch is to permit cities and school districts to tax income from covenants not to compete. There is no reason why prohibiting the taxation of income received in the past or income from agreements signed in the past will hinder or undermine the future operation of the rule.

Third, the court must consider any inequity imposed by retroactive application. Chevron, supra. For where retroactive application could produce substantial inequitable results, courts may avoid injustice or hardship by refusing to apply a decision retroactively. Id. In weighing the equities in this case, it is apparent that retroactive application of the new rule would cause many taxpayers substantial injustice and financial hardship.

Non-compete covenants arising out of a sale of a business are often just one part of an overall agreement on the purchase, which includes separate values for aspects such as the business itself, the good will associated with the business, and the seller's promise not to compete. Each of these things carries its own unique tax advantages and disadvantages for both parties, and can thus be used as bargaining chips. For instance, since the Tax Office formerly did not tax money derived from non-compete agreements and the payment is deductible to the buyer under federal, state, and city laws, sellers could offer to lower the price of the business while increasing the price of the covenant. No doubt countless business deals have been made by "loading" such agreements. There is nothing illegal or unethical about this, so long as the amount attributed to each aspect is reasonable.

Now, however, the Tax Office wishes to change the rules of the game by making the non-compete income taxable to the seller. Thus sellers who have lowered the price of other aspects of their business in return for a higher price for their covenant will suddenly find themselves far worse off than they had bargained for. This is highly unfair to people who relied on the past practice of the Tax Office when negotiating such sales. It could also cause some sellers financial hardship, because they have not budgeted for the bill the Tax Office intends on sending them. This discussion applies both to payments that have been received prior to Rauch and also to payments from agreements executed prior to Rauch. Therefore, we find that the Tax Office cannot tax any payment made under an agreement executed prior to 12 March

1998, the date Rauch was issued.

B. Is it a Retroactive Tax?

Although the tax at issue is not explicitly imposed by legislation, we note that the manner in which the Tax Office wishes to collect it makes the tax *effectively* retroactive in practice, and under the appropriate analysis we reach the same conclusion as above.

Our reasoning is as follows: the Due Process clauses of the federal and state Constitution prohibit legislatures from imposing taxes retroactively beyond the year of the general legislative session preceding the enactment. Welch v. Henry, 305 U.S. 134, 59 S.Ct. 121, 83 L.Ed. 87 (1983); Philadelphia Life Ins. Co. v. Com, 309 A.2d 811 (Pa. 1973); Commonwealth v. Budd, 379 Pa. 159, 108 A.2d 563 (1954). Therefore, the Tax Office is unable to tax payments made prior to 12 March 1997, one year before Rauch.

As to payments made after that time, we must first decide whether they should be considered retroactive in practice and effect. While we acknowledge the strong public policies that lead to the presumption that every tax statute is valid, we find there is a serious countervailing prejudice which overrides these policy considerations: at the time the non-compete agreements were signed, the taxpayers could not reasonably have foreseen that a tax would be imposed, and would have been likely to alter their conduct to avoid the tax had they foreseen it. See Welch, supra; Budd, supra.

It is true that courts generally decline to invalidate income taxes on these grounds because it is thought that the taxpayers would have elected to receive the income even if they had known of the subsequent tax, and that the taxpayer did not rely on the non-taxability of the income. The tax in this case, however, is no ordinary income tax. It is the result of a negotiated agreement which very likely would have been changed if the tax consequences had been known at the time of execution.

The case before this court is quite different from that in Philadelphia Life, supra. In that case, the Pennsylvania Supreme Court considered the question of whether the Gross Premiums Tax Act of 1961 was unconstitutionally retroactive as applied to policies written prior to January 1, 1961. That Act taxes 2% of the gross premiums received from insurance policies. The Act was challenged by Philadelphia Life Insurance Company, which argued that it was unconstitutional as applied to its non-participating policies written prior to the effective date of the tax. Because such policies are written on a fixed premium basis, without subsequent dividends, the increased costs to the insurer cannot be passed on to the policy holder. The Insurance company argued that the tax was retroactive because in practice it reached contracts written many years prior to 1961.

The Supreme Court refused to declare the tax retroactive because: (1) it refused to believe that the insurance companies would not have written the contracts if they had been aware of the tax, (2) the imposition of a new tax or an increase in the rate of an old one is one of the usual hazards of business enterprise, and (3) the insurance company was clearly able to absorb the tax without significant detriment.

In the case before us, however, we are convinced that many taxpayers relied heavily on the Tax Office's former policy of non-taxation when they negotiated their agreements, and that had they anticipated the Rauch case, these agreements would be different. Moreover, payment under these types of agreements usually is made to individuals, not corporate entities. Therefore, they are more likely to suffer a significant and personal financial detriment from the surprise tax. We thus reach the same conclusion: The Tax Office may not tax payments received under agreements not to compete executed prior to 12 March 1998.

C. A Plea for Fair Play

Although there is no legal basis for us to compel the Tax Office to adopt a regulation listing income from covenants not to compete arising from the sale of a business as Net Profits, we sincerely hope the Tax Office will do so and that it will decline from taxing any payments from agreements executed prior to the date the regulation is adopted. That will give all Lycoming County taxpayers fair notice of the new tax, and permit them to arrange non-compete agreements differently if they so choose. After all, the Rauch case can hardly be considered a bright beacon of warning. In addition to addressing a Philadelphia tax, the opinion is somewhat confusing.[8]

No one likes to pay taxes–especially Americans. However, U.S. taxpayers are generally pretty cheerful about rendering to Caesar what is Caesar's, so long as Caesar plays fair. When the government attempts to change the rules of the game after significant plays have already been made, however, citizens justifiably become incensed. Taxpayers have a right to rely on the past practices of the Tax Office, and should be clearly warned in advance before those practices change so they can engage in the venerable American tradition of tax avoidance.[9]

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[8] Consider, for instance, the court's conclusion, in which the court ties itself up into "nots" by using a triple negative: "[T]he authority cited by Rauch has *not* convinced this court that the sums he received pursuant to the covenant not to compete should be considered *not* to have been earned in the course of business activity and, therefore, *not* subject to the NPT. Rauch, supra at 145 (emphasis added).

[9] Tax *avoidance* is, of course, in stark contrast to tax *evasion*, which is illegal.

O R D E R

AND NOW, this 12th day of September, 2000, for the reasons stated in the foregoing opinion, we hold that the Municipal and School Income Tax Board of Appeals committed an error of law and we hereby reverse its decisions and orders issued in the above-captioned matters.

We specifically find that compensation from covenants not to compete which are executed as part of a sale of a business rather than an employment relationship is taxable as Net Profits, but not as Earned Income. We further find that the Williamsport Municipal and School Income Tax Office has no authority to tax payments received from such covenants executed prior to 12 March 1998.

BY THE COURT,

Clinton W. Smith, P.J.

cc: Dana Stuchell Jacques, Esq.
Hon. Clinton W. Smith
Fred Holland, Esq.
Carl Barlett, Esq.
Elliott Weiss, Esq.
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