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VOLUME 15, NUMBER 9
APRIL 2007

THE M&A Tax Report

THE MONTHLY REVIEW OF
TAXES, TRENDS & TECHNIQUES



# Noncompete vs. Stock Payments: Evergreen Issue

**By Robert W. Wood • Wood & Porter • San Francisco**

In the tax world, some disputes are as old as the hills, and unlikely to change any time soon. Like the fundamental characterization between ordinary income and capital gain, the tax treatment of a covenant not to compete has always invited tax planning. There is no shortage of case law about this topic, but that hardly seems to prevent additional cases from coming along.

One recent entrant to this field is *R.W. Becker* [92 TCM 481, Dec. 56,697(M), TC Memo. 2006-264 (2006).] In this case, the question was whether the consideration paid by a family corporation to its COO after a dispute should be allocated to the purchase of the officer's stock, to a covenant not to compete, or both. Becker Holding Corporation was a family entity. Although its business was in sunny citrus fruit, a nasty dispute among family members over the management and control of the company resulted in William Becker's termination of employment.

After negotiations, the company and William entered into an agreement calling for the purchase of William's stock for nearly $23.9 million. The company agreed to pay William $5 million down, and executed a promissory note calling for five $5 million installments, including interest. There was also a non-compete provision in the deal, under which William agreed to refrain from competing in the citrus industry for three years, not to solicit the company's customers or business, *etc.*

There was no appraisal of the stock, nor was there any discussion at the time of sale about allocating some of the consideration to a covenant not to compete. Afterwards, though, when William's accountant flagged the issue, William and the company discussed a possible allocation of the purchase price to the covenant. Sadly, no agreement was reached.

This wasn't the end of the dispute, though, as witnessed by the fact that litigation erupted in 1992. William sued the company for nonpayment, and the company sued William for breaching the covenant. The federal

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district court found the covenant to be valid, and that it had not been breached, so the company appealed. The Eleventh Circuit upheld the district court's judgment in favor of William. In 1996 the company paid William more than $27 million in satisfaction of his judgment.

## Eye of the Beholder?

On their 1996 federal income tax return, William and his wife treated the $27 million payment as capital gain attributable to the sale of his stock. The IRS issued a deficiency notice, arguing that $5.3 million had to be treated at ordinary income attributable to the covenant not to compete. After all, the company (it turned out) had claimed an amortization deduction of $5.3 million attributable to the covenant. Due to this deduction as well as others, the company had a net operating loss in 1996, and attempted to carry it back to its prior three years. The IRS disallowed the company's amortization deduction, and determined deficiencies in the company's tax of approximately $1.9 million.

William and the company had very different views. William asserted that the total consideration paid was attributable to his stock, producing 100-percent long-term capital gain. That would mean that the company would have no amortization deduction, of course, since there was no asset to amortize.

In contrast, the company argued that it purchased more than merely corporate stock, but also bargained for a covenant not to compete. The company argued that at least $5.3 million of the consideration paid in 1996 had to be allocated to the covenant. From William's perspective, that would spell $5.3 million in ordinary income to him. Ouch.

One might think that such a dispute clearly involving three parties could be handled in a unified proceeding. No such luck, initially, although the magic of consolidation solved it eventually. The IRS asserted protective deficiencies against both William and the company, disagreeing with each parties' characterization. The cases were consolidated, and the IRS ultimately sided with William.

## Mutual Intent?

There is no unified test for analyzing covenant not to compete versus stock transactions. Under the "mutual intent" rule of *Better Beverages Inc.* [CA-5, 80-2 USTC ¶9516, 619 F2d 424 (1980)], the parties must mutually intend at the time of the sale that some portion of the lump sum consideration be allocated to a covenant not compete. Intent is clearly important, as is an agreement between the parties (which was sadly lacking on these facts). The Third Circuit went so far in *C.L. Danielson* [CA-3, 67-1 USTC ¶9423, 378 F2d 771 (1967)] to state that the allocation of consideration to a covenant may not be challenged for tax purposes, absent fraud, undue influence, or the like.

William and the IRS argued in Tax Court that this *Danielson* rule controlled, and that because the purchase agreement unambiguously allocated the entire consideration paid to William's stock, the transaction should be treated as 100-percent sale proceeds, with nothing allocable to the covenant. The company, on the other hand, argued that the purchase documents were ambiguous, and that the mutual intent test should control. The parties mutually intended to allocate a portion of the

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THE M&A TAX REPORT (ISSN 1085-3693) is published monthly by CCH, 4025 W. Peterson Ave., Chicago, Illinois 60646. Subscription inquiries should be directed to 4025 W. Peterson Ave., Chicago, IL 60646. Telephone: (800) 449-8114. Fax: (773) 866-3895. Email: cust_serv@cch.com.

consideration to a covenant not to compete, argued the company. Thus, the company argued that the court should make an independent determination of the economic value of the covenant.

The Tax Court had a relatively easy time agreeing with William, since the purchase documents reflected an unambiguous allocation of the entire $23.9 million to the stock. Although the Tax Court considered the mutual intent rule of *Better Beverages*, and the evidentiary rule of *Danielson*, the Tax Court simply found—as a matter of arithmetic—that no portion of the consideration could be allocated to the covenant not to compete.

## Recipe for Success

Many tax practitioners will recognize the fact pattern played out in the *Becker* case. Obviously, the covenant not to compete issue in a three party dispute such as this becomes very much a question of whose ox is being gored. Sometimes, it makes sense to expressly consider this issue. Perhaps it makes sense to do so more often than not.

William probably could have saved himself a headache (and money!) by having an express allocation of consideration to the covenant in the original purchase documents, perhaps allocating a very small amount to the covenant. Still, sometimes raising the specter of the issue can be a bad thing, if raising the issue causes the buyer (in this case, the company in a redemption transaction) to try to shift too much of the burden to amortization. In any case, it is often a recipe for disaster not to consider the issue at all.