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Sentence Diagramming for Code Sec. 197 Intangibles

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When former U.S. Supreme Court Associate Justice David H. Souter retired in 2009, most assumed he would return to his family farm in Weare, New Hampshire, thereafter passing his time climbing mountains and reading books. Retired Justice Souter himself had complained that his term in Washington, D.C. required him to undergo a "sort of annual intellectual lobotomy." Presumably, ensconced in the bucolic New Hampshire wilderness, the former Justice could dedicate himself to more serious study.

However, it appears that the former Justice has decided to spend at least a portion of his retirement in another erudite pursuit: sentence diagramming. The retired Justice, sitting by designation, recently joined two other First Circuit judges in rendering an opinion regarding the appropriate method to amortize covenants not to compete. The dispositive issue in *Recovery Group, Inc.*, 2011 U.S. App. LEXIS 15364 (1st Cir. 2011), boils down to a simple question: what is the antecedent of the word "thereof" in Internal Revenue Code Section ("Code Sec.") 197(d)(1)(E)? No, gentle readers, I am not joking.

Depreciation Treatment of Intangibles

In general, assets that have a useful life substantially beyond one tax year must be capitalized and their costs recovered over their useful lives. [*See* Code Sec. 167.] Tangible assets are normally assigned class lives that dictate the length of the cost recovery. [*See* Rev. Proc. 87-56, 1987-2 CB 674.] Intangible assets may also be amortized over the term of their useful lives. [*See* Reg. §1.167(a)-3(a).]

However, Congress has deemed that the cost recovery of a certain class of intangible assets must be ratably recovered over a 15-year period. These "Code Sec. 197 intangibles" include the following:

1. Goodwill and going-concern value
2. Certain specified types of intangible property that generally relate

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to workforce, information base, know-how, customers, suppliers or other similar items
3. Any license, permit or other right granted by a governmental unit or an agency or instrumentality thereof
4. Any covenant not to compete (or other arrangement to the extent that the arrangement has substantially the same effect as a covenant not to compete) entered into in connection with the direct or indirect acquisition of an interest in a trade or business (or a substantial portion thereof)
5. Any franchise, trademark or trade name

Importantly, Code Sec. 197 intangibles only include intangibles that have been acquired in connection with the conduct of a trade or business or an activity engaged in for the production of income. [Code Sec. 197(c)(1).] If the intangible assets are *not* acquired as part of a business acquisition, they may not be subject to the 15-year amortization rule. Similarly, intangibles that are self-created are not subject to the 15-year rule. [Code Sec. 197(c)(2).] Apart from these two general exclusions from the rule, no other depreciation or amortization deduction is allowed for Code Sec. 197 intangibles.

Covenants Not to Compete—Another Possibility

Code Sec. 197 intangibles include covenants not to compete entered into in connection with an acquisition (directly or indirectly) of an interest in a trade or business or substantial portion thereof. [Code Sec. 197(d)(1)(E).] Particularly in M&A deals, the acquiring entity must exercise special care in the treatment of the covenants it enters or obtains as part of the transaction. Such covenants must generally be amortized over the 15-year period set by Congress. There appears to be little alternative.

The eponymous S corporation in *Recovery Group*, however, had a different idea. A founder and 23-percent minority shareholder of the corporation decided to leave Recovery Group. The corporation agreed to redeem all the founder's shares. In addition, Recovery Group entered into an agreement with the departing shareholder prohibiting him from competing with Recovery Group for a period of one year.

The one-year term of the noncompete agreement straddled two years. Therefore, Recovery Group elected to amortize the cost of the noncompete agreement over two tax years. The IRS balked and disallowed the amortization deduction, because the IRS viewed the cost of the noncompete agreement as a Code Sec. 197 intangible that had to be amortized over 15 years.

There's No "There There"

What was Recovery Group's argument? Recovery Group carefully parsed Code Sec. 197(d)(1)(E)'s phrase "entered into in connection with an acquisition … of an interest in a trade or business or substantial portion thereof." According to Recovery Group, "an interest in a trade or business" refers to "the *entire* interest in a trade or business." Plus, the phrase "an interest in a trade or business" is the antecedent of the word "thereof."

In effect, Recovery Group maintained that Code Sec. 197(d)(1)(E) only sweeps into its

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rules a covenant not to compete entered into in connection with an acquisition of either of the following:

1. The *entire* interest (either assets or stock) in a trade or business
2. A substantial portion *of an interest* (either assets or stock) of a trade or business

Here, Recovery Group had only redeemed 23 percent of its shares from the departing shareholder. As a result, it had not acquired the "entire interest" or even a "substantial portion of an interest" in a trade or business. That meant the cost of the covenant entered into in conjunction with the stock redemption should not be caught in the Code Sec. 197 intangibles net.

The IRS, however, saw the text of Code Sec. 197(d)(1)(E) in an entirely different light. According to the IRS, an "interest in a trade or business" refers to a portion—all or a part—of an ownership interest (*i.e.,* stock interest) in a trade or business, and the phrase "trade or business" is the antecedent of the word "thereof." Thus, a Code Sec. 197 intangible includes any covenant not to compete entered into in connection with an acquisition of either of the following:

1. Any stock interest in a trade or business
2. A substantial portion of *an actual trade or business*

Under the IRS's reading of Code Sec. 197(d)(1)(E), the question of whether an acquisition is "substantial" could arise only where the acquisition is of an actual trade or business (*i.e.*, of assets constituting a trade or business). It would not (as Recovery Group advocated) include the acquisition is of "an interest" (*i.e.*, a stock or partnership ownership interest) in a trade or business.

In other words, under the IRS's reading, a covenant not to compete executed in connection with a stock acquisition of *any size*—substantial or not—should be considered a Code Sec. 197 intangible. However, a covenant not to compete entered into in connection with the acquisition of trade or business assets would only be considered a Code Sec. 197 intangible if all or *a substantial portion* of such assets were acquired.

Since Recovery Group had obtained a 23-percent *stock interest* from the departing shareholder by virtue of the redemption, the IRS asserted that the related covenant not to compete was properly a Code Sec. 197 intangible and Recovery Group had to amortize it over 15 years.

Judicial Deference

Retired Associate Justice Souter and his peers were thus left with two issues to resolve: a textual analysis problem and a sentence diagramming dilemma. To wit, for purposes of Code Sec. 197(d)(1)(E), does an "interest" in a trade or business mean the "*entire* interest" or just an "interest"? Based on this interpretation, must the taxpayer acquire a "substantial portion" of an "*interest* in a trade or business" or must he acquire a substantial portion of "a trade or business"?

The legislative history is framed by the desire to reduce confusion about the tax treatment of intangible assets.

The First Circuit methodically worked its way through these two issues. However, even from the beginning, it seemed clear that Recovery Group's interpretation was unlikely to carry the day. The First Circuit pointed out that Recovery Group's reading of the statute seems redundant, failing to give effect to the entire statute. The court properly opined that if Code Sec. 197(d)(1)(E) should be read to include "the entire interest in a trade or business" or "a substantial portion of an interest in a trade or business," then the first category may be considered redundant.

In essence, under Recovery Group's statutory interpretation, any acquisition of the "entire interest" would also satisfy the "substantial portion of interest" category. Presumably, had Congress wanted an acquisition of a substantial portion of an interest in a trade or business to satisfy the Code Sec. 197(d)(1)(E) requirement, it would have only set this standard as the benchmark. Whether the "entire interest" in the trade or business was acquired would not matter.

Despite the asserted redundancy of Recovery Group's textual interpretation, the First Circuit conceded that the relevant statutory language is ambiguous. Given the ambiguity, the court was forced to review the legislative history in search of the appropriate definition of the word "interest" and the antecedent of "thereof."

Fixing the Unfixable?

The First Circuit reviewed the circumstances that gave rise to the enactment of Code Sec. 197(d)(1)(E). Prior to the creation of the Code Sec. 197 intangibles category, taxpayers and the IRS expended significant time and resources arguing about identifying amortizable intangible assets and defining their useful lives. Provided taxpayers could show that an intangible had a limited useful life that could be determined with reasonable accuracy, they were allowed an amortization deduction.

The court pointed out that in 1993, the IRS estimated that a whopping $14.4 billion in proposed adjustments relating to intangible amortization cases were at various levels of the audit and litigation process. Thus, Congress created the category of Code Sec. 197 intangibles at least in part to simplify the law regarding their amortization. [H.R. REP. NO. 103-111, at 760 (1993).] The legislative history is framed by the desire to reduce confusion about the tax treatment of intangible assets.

Legislative Leanings

In the context of both stock and asset acquisitions, the First Circuit pointed out that Code Sec. 197(d)(1)(E) was necessary if Congress' intent was to simply. Congress essentially had to create a bright line rule for all intangibles that might have an identifiable useful life and therefore be subject to litigation.

Had Congress not implemented Code Sec. 197(d)(1)(E), a buyer of assets would have had a significant incentive to allocate the price of other Code Sec. 197 intangibles (such as goodwill and going concern value) to covenants not to compete. In effect, buyers could game the Code Sec. 197 intangibles net by allocating the purchase price to the covenants. This would allow such buyers to amortize costs over the presumably shorter useful life of the covenants, rather than the 15-year requirement for other intangibles.

Similarly, in the context of stock acquisitions, the First Circuit acknowledged that absent Code Sec. 197(d)(1)(E), a buyer of stock would have had an incentive to allocate to the cost of the covenant what was in fact stock purchase price. Amounts allocated to the stock's purchase price are, of course, not deductible. In contrast, costs allocated to a covenant would presumably be amortized over its useful life.

After a detailed analysis, the court concluded that in the context of asset acquisitions, Congress intended Code Sec. 197(d)(1)(E) to apply only where the covenant not to compete was entered into in connection with the acquisition of *at least a substantial portion* of assets constituting a trade or business. This reading of the Congressional intent regarding asset acquisitions did not favor either Recovery Group or the IRS.

Recall that Recovery Group had argued Code Sec. 197(d)(1)(E)'s language "an interest in a trade or business or substantial portion thereof" should be read to require the acquisition of a substantial interest in *either* assets *or* stock. At least with respect to asset acquisitions, the IRS's position was the same: Code Sec. 197(d)(1)(E) should be read to that a substantial portion of *assets only* had to be acquired.

The Crux

The court then turned to the key issue: whether Congress intended Code Sec. 197(d)(1)(E) to apply to *any* stock acquisition or only those stock acquisitions considered *substantial*. The First Circuit conceded that had Congress not imposed a bright line for covenants not to compete, there would have been incentives for acquirers in *both* asset acquisitions *and* stock acquisitions to over-allocate a portion of the purchase price to the covenants.

However, the court made an important distinction. In a stock acquisition, a taxpayer who enters into and pays for a covenant not to compete in connection with the acquisition of either a substantial *or a nonsubstantial* portion of corporate stock generally has the same opportunity to overstate the cost of the covenant and understate the value of the stock. In contrast, in the case of an asset acquisition that does not constitute a substantial portion of a trade or business, goodwill or going concern (other Code Sec. 197 intangibles) are presumably not being transferred.

Consequently, the risk of price allocation to covenants not to compete rather than goodwill and going concern is less likely. Based on this distinction of the relative risks in asset and stock acquisitions, the First Circuit stated:

> Congress' concerns and purposes behind the enactment of I.R.C. § 197(d)(1)(E) strongly suggest that Congress intended that the section be made applicable to covenants entered into in connection with the acquisition of *any shares of corporate stock*, regardless of whether they constitute a substantial portion of the corporation's total stock. [*Recovery Group, Inc., supra*, at 25.]

Court's Conclusion

After concluding that Congress elected to bifurcate the treatment of covenants not to compete between asset acquisitions and stock acquisitions, the First Circuit sided with the IRS. The court read Code Sec. 197(d)(1)(E) to include any covenant not to compete entered into in connection with the acquisition of *any shares*—substantial or not—in a corporation engaged in a trade or business. According to the court, this reading comported with Congress' goal of simplifying the law regarding the amortization of intangibles and reducing the voluminous amount of litigation that plagued this area.

What Were They Thinking?

This reading seems perfectly sensible if Congress' goal was to simplify the amortization rules for difficult to quantify Code Sec. 197 intangibles. Incentives to overallocate purchase price to covenants in stock acquisitions appear to exist no matter how much or how little stock is sold. Thus, the First Circuit's decision that Congress applied a different quantitative standard to asset acquisitions and stock acquisitions appears sound.

However, there is one important piece of legislative history the First Circuit mentions but does not appear to properly address. Recovery Group's primary argument was that Code Sec. 197(d)(1)(E) should be read to require a *substantial portion of an interest* (*i.e.,* stock) in a trade or business be acquired before the acquisition causes the accompanying covenant to be subject the Code Sec. 197 intangibles rules. The House Report indicates that for purposes of Code Sec. 197(d)(1)(E):

> … an interest in a trade or business includes not only the assets of a trade or business, but also stock in a corporation that is engaged in a trade or business or an interest in a partnership that is engaged in a trade or business. [H.R. Rep. No. 103-111, *supra*, at 764.]

This legislative history appears to fundamentally contradict the IRS's argument. Presumably when Congress wrote "entered into in connection with an acquisition … of an interest in a trade or business or substantial portion thereof," it intended the phrase "interest in a trade or business" to include both the assets and the stock of such a business. Thus, a "substantial portion thereof" appears to include a substantial portion of stock (as well as assets) in a corporation. This is Recovery Group's very argument.

The First Circuit does acknowledge this portion of the legislative history in a footnote. Yet, it states that a *comprehensive* analysis of the Congressional concerns and purposes manifested in the legislative history of Code Sec. 197 makes clear that Recovery Group's reading of the statute is incorrect. Recovery Group's reading of the statute may indeed be wrong. The intransient allocation issues and desire to minimize costly litigation which led to the creation of Code Sec. 197(d)(1)(E) bear this out.

However, Recovery Group may have been right when it said the antecedent of "thereof" is "an interest in a trade or business." The above-quoted legislative history of Code Sec. 197(d)(1)(E) could certainly be read in such a manner and a grammar maven like Associate Justice Souter may well have decided this case differently based solely on the text of the statute and the accompanying legislative history.

Finé

In her lecture *Poetry and Grammar,* Gertrude Stein stated: "I really do not know that anything has ever been more exciting than diagramming sentences." Yet for most others of us, perhaps including judges tasked with the difficult job of statutory interpretation, this may not be true. Nevertheless, when dealing with the subtle intersection of Congressional intent and possibly competing legislative history, statutory sentence diagramming can become a particularly complicated. Of this (sentence diagramming), there can be no doubt.