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A Primer on Covenants Not to Compete

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Agreements not to compete feature in virtually every acquisition. Positioned between the tax treatment of compensation and of intangibles, there is a decided tension in negotiating them. Competing tax concerns existed long before Internal Revenue Code Sec. ("Code Sec.") 197 was enacted in 1993.

Prior to the enactment of Code Sec. 197, taxpayers could generally amortize intangible assets if they had ascertainable values and limited useful lives, the duration of which could be ascertained with reasonable accuracy. [*Newark Morning Ledger Co.*, SCt, 93-1 USTC ¶50,228, 507 US 546 (1993).] Covenants not to compete qualified since they usually had limited useful lives and values stated in the agreements. [*Warsaw Photographic Associates*, 84 TC 21, Dec. 41,882 (1985).]

When Code Sec. 197 arrived on the scene in 1993, it simplified the treatment of acquired intangible assets. Code Sec. 197 requires the taxpayer to capitalize the cost of certain intangible assets including goodwill and going-concern value. Code Sec. 197(a) permits the cost basis of a Code Sec. 197 intangible to be amortized over 15 years beginning with the month in which the asset was acquired. Covenants not to compete are included in the definition of Code Sec. 197 intangibles where the covenant is entered into in connection with the direct or indirect purchase and sale of an interest in a trade or business. [Reg. §1.197-2(b)(9).]

Notwithstanding Code Sec. 197, most developments have come in the case law. The case law is voluminous and nearly every case contains nuggets of information worth mining. Sometimes one learns what *not* to do.

In *Bemidji Distributing Co., Inc.*, 82 TCM 677, Dec. 54,502(M), TC Memo. 2001-260 (2001), *aff'd*, CA-8 (unpublished *per curiam* opinion), 2003-1 USTC ¶50,244, 59 FedAppx 168 (2003), the Tax Court

ALSO IN THIS ISSUE

considered a sale of assets by Bemidji (a beer distributor) to another beverage company for just over $2 million. The buyer, Bravo, required that the purchase agreement between it, Bemidji and Langdon (Bemidji's president and sole shareholder) allocate $1.2 million to two agreements with Langdon. The first was a $200,000 two-year consulting agreement. The second was a $1 million five-year covenant not to compete. Nothing was allocated to goodwill, going-concern value or the exclusive distribution rights with two major brewers.

In Tax Court, the issues were whether any of Bravo's payment to Langdon for the covenant was a disguised payment for intangibles, and whether any of Bemidji's payments of expenses were constructive dividends to Langdon paid to obtain the covenant. The purchase agreement allocated $817,461 to Bemidji's tangible operating assets and accounts receivable, $200,000 to the two-year consulting agreement with Langdon, and $1 million to Langdon's five-year covenant.

A notice of deficiency was issued in which the IRS asserted that Bemidji failed to report $1.2 million of income from Bravo. A notice of deficiency was also issued to Langdon personally. The Tax Court noted that the deficiency turned on the value of the covenant.

Significantly, if the allocation was left undisturbed, the covenant payment would escape tax at the corporate level. In addition to considering Code Sec. 1060's allocation rules, the Tax Court reviewed the case law dealing with tax allocations. In *Buffalo Tool & Die Manufacturing Co.*, 74 TC 441, Dec. 36,977 (1980), the court enunciated the following tests:

> The contractual allocation has "some independent basis in fact or some arguable relationship with business reality such that reasonable [persons], genuinely concerned with their economic future, might bargain for such agreement." If the answer to this question is yes, the agreement may be upheld.
>
> If the allocation by the buyer and the seller of a lump-sum purchase price is unrealistic, then neither the Commissioner nor the Tax Court is bound to accept it.

The Tax Court in *Bemidji* noted that the IRS had originally argued that neither the consulting agreement nor the covenant not to compete had any economic reality. By the trial, the IRS had conceded that the consulting agreement was worth $200,000 (the amount the taxpayer allocated to it), and that the covenant was worth $121,000 (considerably short of the amount claimed). The Tax Court set its task as determining the value of the covenant.

Valuation Factors

Many factors are considered in evaluating a covenant, including the seller's ability to compete; the seller's intent to compete; the seller's economic resources; the potential damage to the buyer posed by the seller's competition; the seller's business expertise in the industry; the seller's contacts and relationships with customers, suppliers and others in the business; the buyer's interest in eliminating competition; the duration

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and geographic scope of the covenant; and the seller's intention to remain in the same geographic area. [*See Lorvic Holdings, Inc.*, 76 TCM 220, Dec. 52,819(M), TC Memo. 1998-281 (1998), *aff'd,* 59 FedAppx 168, *supra*.]

The taxpayer in *Bemidji* relied upon these factors and did not offer an expert witness. The IRS, on the other hand, relied on an expert to establish value. The expert said the fair market value of the covenant was $121,000. After examining it, the court said it was based on assumptions "of dubious validity." For example, the expert assumed only a 45-percent likelihood that Langdon would actually compete in the first year, with decreasing percentages of likelihood in subsequent years.

To the court, if Langdon *began* to compete, it would be reasonable to *increase* the buyer's loss since he would continue competing. The IRS expert also tended to "[pile] discounts upon discounts." He assumed a potential 50-percent loss of business if Langdon competed, but cut this 50-percent loss in half saying that Langdon would need six months of start-up time. The court found this assumption would not apply if Langdon bought an existing distributorship or went to work for one.

After skewering the IRS's expert, the Tax Court rejected the IRS's $121,000 valuation as "unrealistically low and built upon faulty assumptions." The taxpayer (with no expert), asserted that the covenant was worth $2,247,992. This "exceeds the entire purchase price of the business," said the court. The court ultimately concluded that the covenant had a fair market value of $334,000. The remaining $666,000 (out of the $1 million in question) represented other intangibles.

The *Bemidji* case contains useful reminders about the importance of documentation. The taxpayer was arguing for an allocation in excess of the purchase price for the entire business, without using an expert. It was simply good fortune that the Tax Court found the Commissioner's expert to be wanting.

Disguised Stock Payments?

Facts suggesting disguised consideration also arise frequently. The dual prongs of a noncompete agreement and an employment agreement may muddy the waters. For example, in *C.B. Thompson*, 73 TCM 3169, Dec. 52,113(M), TC Memo. 1997-287 (1997), the sole issue was how much the taxpayers could deduct for covenants not to compete entered into as part of an acquisition.

In reviewing whether the amount was a disguised payment for stock, the court focused on whether the employment contracts significantly negated the value of a covenant not to compete. The target, State Supply, was engaged distributing beauty supply products through sub-distributors. Group One sought to acquire State Supply and used a multiple of three and a half to four times earnings to set a price to offer for the shares of the target.

After learning that State Supply had pretax earnings of approximately $1.5 million, Group One offered to purchase the stock for $6 million. There were no provisions for covenants not to compete. When Group One discovered two key people, Beaurline and Holliday, who had both been in the business for decades and with key relationships, Group One concluded it had to have noncompete agreements from both.

Moreover, as a condition of the acquisition loan, the bank required Beaurline and Holliday to execute noncompete agreements with the target. They also signed one-year employment agreements. The amount due under the two covenants totaled $2.5 million.

Following the merger, State Supply elected S status. It claimed amortization deductions for the Beauline and Holliday covenants. The IRS disallowed them.

The Tax Court was bothered that the noncompete and employment agreements were entered into at the same time and referred to each other. They were part and parcel of the stock-sale transaction, said the court.

When the court analyzed whether the noncompete agreements had economic reality, the facts established a strong need for them. That suggested a correspondingly high relative value. Thus, the court sustained the taxpayers' claimed value for the covenants not to compete.

Acquiring companies may sometimes be reluctant to enter into employment agreements and covenants not to compete notwithstanding their business necessity. They may worry that an employment contract could significantly impact the cost recovery from the noncompete. Yet even where employment and noncompete agreements are entered into simultaneously and refer to one another, the covenant's value may not be greatly impacted. Properly structured covenants not to compete can still be respected.

C.H. Robinson, Inc., et al., 76 TCM 969, Dec. 52,980(M), TC Memo. 1998-430 (1998), underscores the importance of distinguishing between employment and noncompete agreements. The president, namesake and sole shareholder of Meyer Customs Brokers, was a well-known customs broker. C.H. Robinson began negotiations to acquire the business.

C.H. Robinson made a cash payment of $300,000 to Meyer Customs Brokers, plus paid $1.3 million to Meyer individually under a three-year covenant not to compete. Meyer received an additional $292,000 each year under the covenant.

On top of the covenant not to compete, Meyer signed a three-year employment agreement. It called for contingent bonuses depending on whether the buyer reached its net profit goals. Meyer received annual bonus payments of $250,000.

The buyer deducted them (as well as the amounts paid under the covenant). The IRS disallowed the deductions asserting that they were nondeductible capital expenditures. The Tax Court concluded that the payments for the covenant represented nondeductible capital expenditures because the covenant did not reflect economic reality.

The $1.3 million paid to Meyer at closing (in addition to the $300,000) was effectively a payment for the company's assets. The two cash payments, $1.3 million plus $300,000, closely resembled the original terms by which C.H. Robinson was to pay $1.5 million for the target's assets. The Tax Court went on to hold that the additional payments under the covenant were deductible business expenses as they did reflect economic reality.

Meyer had sufficient capital and the ability to start a new customs brokerage business. The real ability to compete is often a factor making the courts willing to allocate significant dollars to a covenant not to compete. Finally, the Tax Court concluded that the annual bonuses were properly deductible as reasonable compensation. The company's earnings depended primarily on Meyer's efforts. Meyer maintained all of the former clients and managed the expansion of the company post-acquisition.

Economic Reality Key

The amount a taxpayer pays or allocates to a covenant is not controlling for tax purposes. The Tax Court has strictly scrutinized an allocation if the parties do not have adverse tax interests. Economic reality has been defined as some independent basis in fact or some arguable relationship with business reality so that reasonable persons might bargain for such an agreement.

Courts apply numerous factors in evaluating a covenant including the following:

- The grantor having the business expertise to compete
- The grantor's intent to compete
- The grantor's economic resources
- The potential damage to the buyer posed by the grantor's competition
- The grantor's contacts and relationships with customers, suppliers and other business contacts
- The duration and geographic scope of the covenant not to compete
- The enforceability of the covenant not to compete under state law
- The age and health of the grantor
- Whether payments for the covenant not to compete are *pro rata* to the grantor's stock ownership in the company being sold
- Whether the payments under the covenant not to compete cease upon breach of the covenant or upon the death of the grantor
- The existence of active negotiations over the terms and value of the covenant not to compete

If an examination of these factors indicates economic reality in the covenant not to compete and the consideration given for it, then the courts have been likely to find likewise.

Conclusion

Be realistic and reasonable in allocating between a covenant not to compete, salary and bonus. More importantly, be reasonable and realistic in allocating payments between a covenant not to compete and the purchase price for assets. If there is a dispute, use an expert, and have good documentation of how values were reached.