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Hardware Plus Victory Is Good News

by Robert W. Wood • San Francisco

The difference between goodwill, which yields no tax benefit, and a covenant not to compete, which is generally amortizable, has long been apparent. Even before Section 197 was added by the

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Revenue Reconciliation Act of 1993, a covenant not to compete could be amortized, generally over the covenant's term. Section 197 substantially hurt the attractiveness of covenants not to compete, because now they must be amortized over the 15-year period prescribed by that section. While goodwill is now less of a pariah because it can now be amortized over 15 years, covenants not to compete in many cases are now amortizable over a (longer) 15-year period. (See Bloom, "Covenants Not to Compete After Section 197," 2 *M&A Tax Rep't* 4 (November 1993), p. 1.)

A covenant, like all other Section 197 intangibles, will be an amortizable Section 197 intangible, and thus, subject to 15-year amortization, if it was acquired by the taxpayer after 8/10/93. As a practical matter, the requirement of Section 197(c)(1)(B) that the Section 197 intangible be held in connection with the conduct of a trade or business or an activity described in Section 212 will be met by any covenant that satisfies the definition in Section 197(d)(1)(E) ("entered into in connection with an acquisition (directly or indirectly) of an interest in a trade or business or substantial portion thereof").

The *Hardware Plus* Covenant

In *Hardware Plus Inc.*, TC Memo 1994-250, the taxpayer, organized in 1987, was an incorporated representative of a number of hardware manufacturers. To expand its business, Hardware Plus signed an agreement in 1988 with another incorporated representative, Lee Smith Sales, for the transfer of rights to represent five manufacturers. The agreement thus occurred long before the 15-year mandate of Section 197.

The selling company agreed not to compete with Hardware Plus regarding the five manufacturers for a period of five years. Lee Smith Sales did not transfer any tangible assets in connection with this sale, other than its "right" to represent the five manufacturers and a commitment not to compete.

Payments for the covenant were $20,000 in the first year and a $5,000 final payment in year five, plus commissions during the interim. During the first two years of this arrangement, the commissions paid to Lee Smith Sales amounted to $41,337. Lee Smith Sales continued to represent other manufacturers.

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Amortization Contested

Hardware Plus amortized the initial $20,000 payment and the $41,337 in commissions paid over five years. The IRS disallowed the deductions, arguing that one could not distinguish between the portions of the $20,000 attributable to goodwill and the covenant not to compete. As to the disallowed $41,337 in commissions paid, the Service viewed these commissions as not amortizable, because they were paid for the transfer of contracts and goodwill.

The Service also argued that Hardware Plus was effectively buying long-term relationships with the manufacturers, and a customer-based intangible with an indefinite useful life. Finally, the Service argued that Hardware Plus had effectively bought a self-regenerating asset.

Taxpayer Wins

However, the Tax Court ruled for the taxpayer, determining that the deductions claimed by Hardware Plus were proper because the entire down payment, the final payment, and the commissions payable over five years were all in consideration for a covenant not to compete. Disagreeing with the IRS' interpretation of the contract as representing the sale of goodwill, the court pointed out that the agreement expressly provided that the seller was selling a covenant not to compete regarding five manufacturers. The agreement tied the successive payments to the seller's fulfillment of the terms of the covenant, giving the seller every incentive to satisfy the covenant's terms.

As to the IRS' argument that Hardware Plus had really bought a long-term relationship with the five manufacturers and a customer-based intangible with an indefinite useful life, the court pointed to the lack of transferability of the relationships. The agreements between Lee Smith Sales and the five manufacturers were not transferable. Consequently, the only benefit to Hardware Plus in entering into an agreement with Lee Smith Sales was to achieve the latter's agreement that it would refrain from competing with the five manufacturers.

The Tax Court also rejected the Service's argument that the relationship with the manufacturers was a self-regenerating asset, noting that Hardware Plus' representation of the manufacturers could end at any time, and might not be replaced by another relationship.

Planning Tips

How might the situation with Hardware Plus have been handled under 15-year amortization? One of the traditional avenues for achieving covenant-like benefits is to enter into a consulting agreement with the former business owners. Indeed, the Conference Report to Section 197 states that arrangements that require former business owners to continue to perform services for the acquired business have substantially the same effect as a covenant not to compete to the extent that the amount paid to the former owner under the arrangement exceeds the amount that represents reasonable compensation for the services actually rendered.

The key here, of course, is to determine what amount would constitute reasonable compensation for the services rendered. The Conference Report states that excess amounts (over and above the ceiling for any reasonable compensation) may be treated as additional payment for the stock, and will be added to basis rather than amortized under Section 197. This makes the stakes in determining what is "reasonable compensation" fairly high.

On the other hand, just as the Service has never fared very well in litigating the reasonableness of compensation (*i.e.*, in arguing that compensation is too high and therefore is not deductible under Section 162), it seems likely that the Service will not fare too well in litigating whether payments were too high and must represent disguised payment for the stock. In most circumstances, it is other evidence of the stock's value, rather than the particulars of the compensation arrangement and the specific qualifications of the former business owner, that will be most important.

Where the parties get too aggressive and attempt to allocate a huge number to the consulting fees of the former business owner, there will be a risk that the deducted consulting fees will be recharacterized. However, in many cases it will not be possible to judge at the time the contract is signed whether the payments to be made for the services to be rendered by the former business owner are truly

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reasonable. Often, someone's willingness to remain *available* to consult can be as important as a commitment to show up on a daily basis.

All this does little to affect the situation in *Hardware Plus*. After all, in that case no business was sold and the president and owner of the selling corporation did not go out of business or agree to work for or consult with the buyer. ■