Recovering from *Recovery Group*

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

In our current era of reality TV, we have shows about intervention, but none, it seems, devoted explicitly to recovery. Anyone who thirsts for what may be the one neglected area of reality TV might be partially sated by reading *Recovery Group, Inc.*, 99 TCM 1324, Dec. 58,184(M), TC Memo 2010-76. This recent Tax Court memo decision deals with an issue that comes up in plenty of small transactions: a covenant not to compete.

Crisis Management?

Recovery Group, Inc. was an S corporation engaged in the turnaround and crisis management business. Recovery Group provided consulting and management services to insolvent companies. It also offered services as a bankruptcy trustee, as an examiner in bankruptcy cases, and as a receiver in federal and state courts. All of the stock of Recovery Group was held by a handful of shareholders, but the holdings of one 23-percent shareholder (James Edgerly) was redeemed.

When Recovery Group paid Edgerly for his 23-percent stock interest, it also paid him $400,000 (an amount comparable to his annual earnings) in exchange for a one-year covenant not to compete. With a knee-jerk reaction that many readers of the M&A TAX REPORT will recognize, what did Recovery Group do next? It deducted the payment.

On audit, the IRS disallowed the deduction, which increased the taxable income flowing through the S corporation to its shareholders. Recovery Group argued that the phrase "interest in a trade or business" in Internal Revenue Code Section ("Code Sec.") 197(d)(1)(E) refers to a 100-percent ownership interest. That, it claimed, made the payment deductible.

According to Recovery Group's strained statutory interpretation, a covenant not to compete would have to be amortized and deducted over 15 years (as Code Sec. 197 would seem to require) *only* if it was obtained *either* in an acquisition of a 100-percent interest in a trade or business, or in an acquisition of a substantial portion of an interest in a trade or business. Essentially, Recovery Group contended that it only acquired a 23-percent interest, and it did so *via* redemption, not *via* an acquisition of a "substantial" interest. Recovery Group claimed that this meant the covenant not to compete and the payment of $400,000 to Edgerly was outside the reach of Code Sec. 197.

New Frontier?

Yet Recovery Group relied upon *Frontier Chevrolet*, 116 TC 289, 294–95, Dec. 54,336 (2001), *aff'd*, CA-9, 2003-1 USTC ¶50,490, 329 F3d 1131 (2003).

In *Frontier Chevrolet*, the Tax Court and the Ninth Circuit held the taxpayer's redemption of 75 percent of its own stock was an indirect acquisition of a trade or business. Significantly, though, neither the Tax Court nor the Ninth Circuit had ruled on whether a redemption *smaller* than 75 percent might result in the acquisition of an interest in a trade or business under Code Sec. 197(d)(1)(E). That was the question Recovery Group's facts presented.

Bumpy Recovery

Predictably, the IRS contended that this strained wording for which Recovery Group was lobbying made no sense. According the IRS, a covenant not to compete must be amortized over 15 years if it was obtained *either* in an acquisition of any interest in a trade or business, or in an acquisition of a substantial portion of a trade or business. The first prong of this two-pronged rule applies to just about everything, certainly to the 23-percent interest Recovery Group acquired *via* Edgerly's stock.

Was Edgerly's 23-percent stock interest a "substantial" interest? That simply was immaterial, said the IRS. After all, the 23 percent was clearly an interest in a trade or business.

Tax Court Holding

The Tax Court rejected Recovery Group's argument that "an interest" means only the *entire* interest. After all, said the Tax Court, under that view, a redemption could *never* trigger Code Sec. 197(d)(1)(E). Clearly, a corporation could not entirely deprive itself of shareholders by redeeming all of its stock!

Instead of overturning its prior holding in *Frontier Chevrolet*, however, the Tax Court held that "an interest in a trade or business" in Code Sec. 197(d)(1)(E) includes the 23-percent minority interest acquired by Recovery Group. Such a holding, noted the court, accomplished what Congress clearly had in mind in enacting Code Sec. 197(d)(1)(E). That was to impose 15-year amortization period *either* when a stock acquisition includes a covenant not to complete, *or* when a substantial asset acquisition includes a covenant not to compete.

Partial Recovery

One bit of good news for Recovery Group, however, came with respect to penalties. The Tax Court noted that Recovery Group had reasonably relied on competent, fully informed professionals to prepare its tax returns. As a result, the Tax Court concluded that the reasonable cause and good faith exception of Code Sec. 6664(c) was satisfied. Recovery Group was not liable for the Code Sec. 6662 accuracy-related penalty on the underpayments that resulted from the disallowance of the excess deductions it had claimed by improperly amortizing the covenant not to compete over its 12-month term.

Covenants not to compete come up frequently, especially in closely held businesses. Watch out for them.

ARTICLE SUBMISSION POLICY

THE M&A TAX REPORT welcomes the submission of unsolicited articles. Submissions should be 2,000 words or less and use textual citations, rather than footnotes. All submissions should be made via email attachment in either Microsoft Word or WordPerfect format to Robert W. Wood, Editor-in-Chief, at *wood@woodporter.com.* THE M&A TAX REPORT reserves the right to accept, reject, or edit any submitted materials.

CCH
a Wolters Kluwer business

4025 W. Peterson Ave.
Chicago, IL 60646

PRESORTED
FIRST-CLASS MAIL
U.S. POSTAGE
PAID
CCH