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TAX BENEFITS OF COVENANTS NOT TO COMPETE

by Robert Willens • Lehman Brothers, New York, and Robert W. Wood • San Francisco

The term "goodwill" in acquisitions used to be a dreaded word. True, with the eventual enactment of Section 197, there was less concern, since Section 197 expressly allows acquirers of intangible assets (including goodwill) to amortize those assets. The problem is that the amortization is allowed over a 15-year period. Thus, the opportunities to secure meaningful deductions are actually few and far between.

Moreover, Section 197 applies only to intangibles that are acquired in a transaction structured as a taxable purchase of

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assets or as a taxable purchase of stock that is coupled with a Section 338 election. Section 338 elections, in turn, are quite rare because the "deemed asset sale" associated with a Section 338 election is a fully taxable event.

As a result, the tax triggered by the 338 election almost always outweighs the tax benefits one can expect from being able to amortize the intangible assets deemed to have been purchased. Accordingly, when pricing stock acquisitions, most buyers will use a model that assumes that the target's assets will continue to be amortized and depreciated at their historic (and invariably low) bases.

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Tax Benefits of Covenants Not to Compete

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Paying for Covenants

Despite the seemingly incongruous tax rules, tax benefits from a stock acquisition can be salvaged if the transaction is converted from a straight stock acquisition into an acquisition of stock coupled with the acquisition of a covenant not to compete. The seller sells two items, stock plus a covenant. The amount paid for a covenant is covered by Section 197, so it can be amortized over 15 years, where there is a related purchase of a business through the purchase of assets or stock. A covenant not to compete is therefore unique: It is the only type of Section 197 intangible that can arise in a transaction that is not structured (actually or via a Section 338 election) as a taxable purchase of assets.

Stock buyers have an incentive to allocate as much of the purchase price as possible to a covenant. In theory, a corporate seller of stock will be indifferent to an allocation of purchase price to a covenant. Although the allocation would "convert" capital gains (from the stock sale portion of the transaction) into ordinary income (to the extent of the amount allocated to the covenant), the corporate seller will not see its tax bill increase.

One good question is just how far this kind of bifurcation can go. Can't the consideration allocated to a covenant not to compete be huge? In recognition of this fact, the Committee Reports accompanying the enactment of Section 197 admonish taxpayers that where amounts allocated to such a covenant are unreasonable, the excess will be reallocated to the stock purchase component of the transaction. The $64,000 question is when is such an allocation unreasonable?

Lorvic Holdings

The recent case of *Lorvic Holdings v. Commissioner,* T.C. Memo. 1998-281 (1998), gives some guidance on this limit. There, the buyer paid for a covenant, and the issue was whether the amount paid was "properly allocable" to the covenant. Did the allocation have economic reality?

The Tax Court said that an allocation will have economic reality in cases where the parties to the covenant have adverse tax interests. Adverse tax interests, the court felt, deter allocations that lack the requisite economic reality. Where the parties do not possess adverse tax interests (as is typical in many corporate transactions), it is simply a question of fact whether an allocation features economic reality.

The court in *Lorvic Holdings* then advanced a two-part test for assessing whether economic reality exists to support an allocation. There is economic reality to an allocation only where the seller of the covenant has: (1) the economic and industrial potential to compete; and (2) the intent to compete with the buyer. In *Lorvic Holdings,* the court felt that a 25% discount from the agreed-upon allocation was warranted because the record did not indicate that the seller had the requisite intent to compete. The court observed that the seller, notwithstanding its industrial might, would have been at a severe disadvantage because it lacked crucial relationships with the business' suppliers and distributors with respect to the business sold.

Thus, the agreed-upon allocation of purchase price to the covenant lacked economic reality (to the extent of the discount imposed by the court), because it could not be shown that the buyer of the business would lose earnings, comparable to the amount purportedly paid for the covenant, if the seller was to compete with the buyer. In an era where buyers and sellers are rarely tax adverse with respect to allocations of purchase price to a covenant not to compete, the lesson of *Lorvic Holdings* is that such an allocation must run the gauntlet of the economic reality test. Economic reality will only be present in cases where reasonable people, truly concerned with their economic well being (due to the seller's ability and intent to compete), would demand an allocation of purchase price to such a covenant.

Easy Rider?

Sound easy? Hardly. It may not be too difficult to show this kind of economic reality in some cases, depending on how good a record exists in a case. But all of this is hard from a planning perspective. Will tax advisors be asked to opine on the degree to which economic reality exists? On the adversity of interests in a negotiation? On the plain eye-balling of allocation figures?

In an area where advance rulings from the IRS are sure not to be requested, someone has to make these determinations.