Revision Date: February 19, 1996

COORDINATED ISSUE
ALL INDUSTRIES
COVENANTS NOT TO COMPETE

ISSUE:

When can a covenant not to compete, entered into in conjunction with the acquisition of a business or a stock purchase, be amortized?

BACKGROUND:

During the negotiations for the purchase of a business or the buy-out of a shareholder's stock holdings, the buyer will sometimes insist that the seller enter into an agreement not to operate a competing business within a specified territory for a specified length of time. Such an agreement is called a "covenant not to compete." If the terms of the covenant not to compete are reasonable, and if the seller is truly being compensated for giving up his/her right to forego opportunities that would place him/her in competition with the purchaser, then the payment allocable to the covenant constitutes ordinary income to the seller, and the buyer is entitled to amortize the cost of the covenant over the life of the agreement.

Prior to 1987, the buyer and seller had competing and conflicting tax interests in the allocation of the purchase price of the business to a covenant not to compete. Due to the differential in tax rates between capital gains and ordinary income, a tension existed between the buyer and the seller in negotiating the allocation of the purchase price between the business and the covenant not to compete. The seller benefitted with respect to his/her taxes by allocating as little as possible to the covenant not to compete, and allocating as much as possible to the purchase price received for the business, including its goodwill. Similarly, consideration received in payment for stock was preferable to a seller because such payments represented capital gain to the seller to the extent that the purchase price exceeded the seller's basis in the stock. The buyer, on the other hand, preferred to allocate as much of the purchase price as possible to the covenant not to compete because that amount was amortizable, Ullman v. Commissioner, 264 F.2d 305 (2d Cir. 1959), allowing the buyer a deduction against ordinary income, Sonnleitner v. Commissioner, 598 F.2d 464, 466 (5th Cir. 1979). The portion of the purchase price paid for the business, including the transferred goodwill and going concern value, represented a nondepreciable capital investment by the buyer.

The Tax Reform Act of 1986 generally eliminated the preferential tax rate for capital gains. Thus, for transactions occurring after 1986 and before ordinary income tax rates were increased in 1990, the tax interests of the buyer and the seller with respect to a covenant not to compete are not adverse. With the elimination of the preferential rate, the seller of a business no longer suffered any significant tax disadvantage if more of the purchase price was allocated to the covenant not to compete. Consequently, the seller was more inclined to agree to include a covenant not to compete provision in the buy-sell agreement, and willing to allocate a greater portion of the purchase price to the covenant. The buyer benefitted because he/she could amortize a greater portion of the total purchase price of the acquired business.

The Omnibus Budget Reconciliation Act of 1990 and the Omnibus Budget Reconciliation Act of 1993 increased the highest marginal tax rate for individuals by 3 percent and 11.6 percent, respectively, over the capital gain rate. Small rate differences, such as these, do not provide a compelling tax disincentive to buyers and sellers that would ensure that covenants not to compete reflect economic reality. In tax years in which there is rough parity between marginal ordinary income and capital gains tax rates, there are opportunities for the buyer and seller to plan their transaction to maximize the tax benefits. The Service has been faced with a number of problems as a result. First, where a buy-sell agreement contains a covenant not to compete, the covenant may not comport with reality; the buyer, in reality, may have no concern that the seller will compete against the acquired business and draw customers away from it. In the case of a stock purchase, the amount allocated to the covenant may actually be an additional payment for the stock.

Second, an excessive value may have been assigned to the covenant, resulting in overstated amortization deductions by the buyer. Without the tension of adverse tax interests between the parties, the seller has no tax incentive to minimize the amount allocated to the covenant, and more than likely would agree to the allocation suggested by the buyer. If the buy-sell agreement contains a covenant not to compete, but no amount has been specifically allocated in the agreement to the covenant, the buyer may attempt to allocate an inappropriate portion of the total consideration paid to the covenant.

Finally, problems arise when either the buyer or the seller claims a value for the covenant that varies from the specific allocation in the buy-sell agreement. This creates a potential whipsaw for the Service, which requires the examining agent to set up the issue with respect to both parties. In such a case, the Service is merely a stakeholder in the ensuing litigation.

For these reasons, covenants not to compete must be closely scrutinized.

DISCUSSION:

I.R.C. § 167(a) is the controlling provision for the amortization allowance for intangible assets acquired prior to the enactment date of section 197 (August 10, 1993).[1] Although section 167(a) does not specifically refer to intangible property, Treas. Reg. § 1.167(a)-3 recognizes that an intangible asset may be amortizable under certain circumstances. Treas. Reg. § 1.167(a)-3 requires that the following factors be present before a deduction is allowable:

* The intangible asset is known from experience or other factors to be of use in a trade or business or in the production of income for only a limited period of time, the length of which can be estimated with reasonable accuracy.

* The deduction for depreciation is not for goodwill.

Because a covenant not to compete usually contains a provision stating its duration, its limited life is known, and thus, the first element generally is met. Therefore, the focus generally is upon the genuineness and/or the value of the covenant. The courts have developed several tests for determining the validity and value of covenants not to compete.

Issues concerning covenants not to compete will generally arise in one of three contexts. The examining agent must be alert to the subissues that arise in each context.

First, an unrealistic value for a covenant not to compete may be specified in the agreement, or it may be unrealistic for the seller to have given a covenant. Under these circumstances, the "economic reality" test applies to determine the reasonableness of requiring a covenant of the seller, as well as the reasonableness of the amount purportedly paid for the covenant. For transactions occurring before 1993, the allocation to the covenant not to compete is likely to be excessive. Because of the enactment of section 197 for years after 1992 the value is more likely to be understated. These subissues concerning economic reality will usually surface in the examination of the buyer in a transaction after 1986.

Second, a lump sum purchase price for the business may have been stated in the buy-

[1] "Depreciation" and "amortization" are used interchangeably. Generally, "depreciation" refers to an allowance for the wear, tear, exhaustion or obsolescence of a tangible asset. "Amortization" refers to the periodic recovery of the cost of an intangible asset. Both terms, however, describe the same concept, cost recovery, for which authority is found in I.R.C. § 167(a).

sell agreement, but no allocation of a specified portion of it is allocated to a covenant not to compete that is included in the agreement. One party (usually the buyer), in its reporting position, unilaterally seeks to establish the value of the covenant. For transactions occurring before 1987, this subissue can generally arise in the examination of either the buyer or the seller; for tax years after 1986, the subissue is more likely to arise in the examination of the buyer. The "mutual intent" test is applied under these circumstances.

Third, the buy-sell agreement may specifically ascribe a value for the covenant not to compete, but one party unilaterally claims a different value in its reporting position. This issue can surface in the examination of either the buyer or the seller. Under these circumstances, the appropriate test is the "strong proof" doctrine or the "Danielson" rule (described below).

The Economic Reality Test

As noted above, the "economic reality" test applies when the Service has reason to question whether a covenant not to compete was really necessary or when there appears to be an excessive allocation to the covenant. This test may also be applied when one party to the transaction has ignored or denied the allocated amount for the covenant that is stated in the agreement.

The economic reality test is primarily concerned with whether a covenant not to compete has independent business or economic significance. This test was first enunciated in Schulz v. Commissioner, 294 F.2d 52, 54 (9th Cir. 1961), in which the court stated that "the covenant must have some independent basis in fact or some arguable relationship with business reality such that reasonable men, genuinely concerned with their economic future, might bargain for such an agreement." Where the seller is, objectively, likely to pose a threat of competition, courts will probably sustain some allocation to the covenant. There are a number of factors that should be considered.

(a) Did the seller have the ability to compete with the buyer?

This question actually embraces a number of considerations:

* Seller’s customer network and experience

  Compare Sonnleitner v. Commissioner, supra (seller had business contacts and demonstrated selling ability) with General Insurance Agency, Inc. v. Commissioner, 401 F.2d 324 (4th Cir. 1968) (seller, widow of agency owner, was not considered serious competition because of her inability to manage the company successfully) and Schulz v. Commissioner, supra (seller did not have the business contacts and background necessary to compete, and economic conditions were such that it was unlikely that he could successfully compete).

* Seller's financial ability to compete

  Compare Illinois Cereal Mills, Inc. v. Commissioner, T.C. Memo. 1983-469, aff'd, 789 F.2d 1234 (7th Cir.), cert. denied, 479 U.S. 995 (1986) (seller had economic resources to compete with purchaser) with Krug v. Commissioner, T.C. Memo. 1981-522 (seller was ill and lacked the financial resources to compete).

* Seller's physical ability to compete, i.e., age and state of health

  See, e.g., Major v. Commissioner, 76 T.C. 239 (1981) (covenant had minimal value where the seller was of advanced age and had health problems).

* Noncontractual restrictions that would have prohibited the seller from competing in absence of the covenant not to compete, such as limited market entry

  This factor may be important where a covenant is granted in conjunction with the transfer of a franchise, license, or operating authority where market entry is limited. See, e.g., Forward Communications Corp. v. United States, 608 F.2d 485 (Ct. Cl. 1979) (seller would need an FCC license to compete, which it was unlikely to obtain); Major v. Commissioner, supra (seller of freight firm would have to acquire interstate operating authorities, which were difficult to obtain from ICC).

* Seller's intention to compete, either by acquiring or by starting a new business in the same market, or by seeking employment with an existing competitor

  A covenant not to compete is not meaningful if the grantor of the covenant (the seller) has stated his or her intention to retire or to leave the geographic area covered by the covenant, and thus, poses no real threat of competition. If the grantor has the ability to change plans and re-enter the market, the covenant is more likely to meet the economic reality test.

In Major v. Commissioner, 76 T.C. 239 (1981), the buy-sell agreement recited that the entire consideration paid was for the stock sold by the sellers. The buyer amortized a portion of the purchase price to a covenant not to compete, whereas the sellers reported all of the sales proceeds as capital gains. To prevent a whipsaw, the Commissioner disallowed the buyer's amortization deduction, and also recharacterized a portion of the sellers' gain as ordinary income; the Commissioner was merely a stakeholder in the litigation. The prime asset in the trucking business is the ICC operating authorities for the interstate routes that the freight firm operates. The Tax Court found that the buyer was primarily interested in the acquired corporation's operating authorities, which were extremely difficult to obtain directly from the ICC. The buyer seemed indifferent to the possible threat of competition from the sellers, because one of the sellers was 66 years old and in failing health due to diabetes. Another factor which influenced the court was a suspicious six percent interest charge on the unpaid balance on the "covenant." These led the Tax Court to conclude that the covenant possessed no more than an unascertainable de minimis value, and thus found that the sales agreement represented economic reality.

In Ansan Tool and Manufacturing Co., Inc. v. Commissioner, T.C. Memo. 1992-121, the Service unsuccessfully challenged the taxpayer's amortization of an amount allocated to a covenant not to compete executed in conjunction with its purchase of the interest of one of its shareholders in settlement of a derivative action. The shareholder was the president of the corporation, was primarily responsible for the company's sales and marketing activities, and was the person who attracted and dealt directly with the customers. The taxpayer's management was concerned that the shareholder might accept employment from a rival firm and take clients away, and thus it was of paramount importance that a covenant not to compete be included in the final buy-sell agreement. The court agreed that the taxpayer's concerns were well-founded.

In Illinois Cereal Mills, Inc. v. Commissioner, T.C. Memo. 1983-469, aff'd, 789 F.2d 1243 (7th Cir.), cert. denied, 479 U.S. 995 (1986), the taxpayer acquired the MOGUL cereal binder business from CPC International, Inc. CPC's sale of its MOGUL operations effectively ended its cereal binder business. Nonetheless, the covenant not to compete was of considerable value to the taxpayer because CPC would continue to sell resin-coated sand in the foundry market in competition with cereal binders. The Tax Court found that the covenant given by CPC was a valid and valuable one, based upon the continuing presence of CPC in one of the taxpayer's markets. In addition, the Tax Court noted CPC's substantial financial resources and its excellent market reputation. Specifically, the court believed that CPC possessed the resources to re-enter the cereal binder market.

In Ackerman v. Commissioner, T.C. Memo. 1968-254, similar factors were present. The taxpayer was the seller of an insurance agency who reported the entire purchase price as capital gain, despite an allocation of a portion of the purchase price to a covenant not to compete included in the sale agreement. The taxpayer contended that the covenant lacked any independent economic reality and that it was essentially a sale of his goodwill. The Tax Court rejected the taxpayer's argument, and in concluding that the covenant had economic reality, noted that:

* The taxpayer was 68 years old at the time the agreements were executed.

* The covenant not to compete had a duration of four years.

* During the negotiations for the sale of the insurance agency, the purchaser made it clear to the seller that a covenant not to compete was essential to the deal and that a certain amount of money should be allocated to it. ($30,000 was the amount specified in the contract.)

* At the time of trial, the taxpayer was 75 years old and still actively engaged in the insurance business, dealing with some of his old customers.

(b) Was the payment intended as compensation to the seller in lieu of his employment in a competing venture?

This issue goes to whether the amount purportedly paid for the covenant not to compete was actually paid as an inducement for the seller to refrain from competition. It embraces such questions as:

* Does the payment for the covenant realistically compensate the seller for his loss of earnings by not competing?

* If the payment for the covenant is to be made in installments, are the payments to the seller conditioned on his/her survival, or is the remaining balance of payments payable to the estate?

In <u>Ackerman</u>, <u>supra</u>, one of the factors which influenced the Tax Court to find that a portion of the purchase price was mutually intended as consideration for the taxpayer's covenant not to compete was the fact that the payments due with respect to the covenant during the term of the covenant terminated in the event of the seller's death.

(c) Are there any other factors that reflect the economic reality of the covenant?

Numerous additional factors have been considered by courts in reaching a determination concerning the economic reality of a covenant not to compete. They include:

* Formalities of the covenant

* Enforceability of the covenant

* Scope of the covenant

See, e.g., Dixie Finance Co., Inc. v. United States, 474 F.2d 501 (5th Cir. 1973) (court found covenants lacked economic reality where payments to shareholders were based upon percentage of stockholding, including payments to two shareholders who refused to sign the noncompetition agreement, and purchaser did not police the agreement to ensure that sellers abided by its terms); Montesi v. Commissioner, 40 T.C. 511 (1963), aff'd, 340 F.2d 97 (6th Cir. 1965) (court found covenants bona fide where noncompetition agreements were entered into with only some shareholders, and each covenant was for the same amount irrespective of the shareholder's stock ownership); Howard Construction, Inc. v. Commissioner, 43 T.C. 343 (1964), acq. 1965-2 C.B. 5 (court found that purchaser lacked concern about competition where covenant prohibited sellers from managing a similar business, but did not prohibit them from purchasing a similar business).

The Mutual Intent Test

Where a covenant not to compete was agreed to between the parties, but no specific amount of consideration has been allocated to the covenant, courts have looked to the "mutual intent" test to determine whether some allocation is called for.

The mutual intent test looks at whether the parties to the buy-sell agreement mutually agreed that some portion of the total consideration paid for the going concern was intended for the covenant not to compete. This test is applied where the agreement contains a covenant not to compete, but the purchase price is stated as a lump sum for the entire transaction, i.e., there is no express allocation of a specific amount to the covenant.

While the failure to allocate a portion of the purchase price appears to be good evidence that the parties did not intend one, Major v. Commissioner, supra, 76 T.C. at 250, the mere absence of an allocation to the covenant does not give rise to an inference that the parties affirmatively intended to make no allocation (or a zero allocation). Better Beverages, Inc. v. United States, 619 F.2d 424 (5th Cir. 1980). Therefore, courts have tended to look at the actual contract negotiations to determine whether the parties intended the covenant to have any value. Patterson v. Commissioner, 810 F.2d 562 (6th Cir. 1987); Better Beverages, supra.

Mutual intent is usually found where the parties bargained over the inclusion of the covenant not to compete, or where it was understood that the covenant was an essential part of the agreement. The "economic reality test" plays a role in this inquiry: the covenant not to compete must also have some independent basis in fact such that the parties might bargain for it. Mutual intent may also be found where:

* Other language in the agreement evidences the parties' intent that the consideration includes an unspecified amount for the covenant. See Illinois Cereal Mills, supra; Peterson Machine Tools, Inc. v. Commissioner, 79 T.C. 72 (1982).

* There is uncontroverted testimony regarding the parties' intent. See Kreider v. Commissioner, 762 F.2d 580 (7th Cir. 1985).

Mutual intent will usually be found where the covenant was an essential part of the sales agreement or was separately bargained for. See Ansan Tool and Manufacturing Co. v. Commissioner, supra; Peterson Machine Tool, Inc. v. Commissioner, 79 T.C. 72 (1982). Under such circumstances, the covenant has some value, but an ambiguity exists in the buy-sell agreement --the ambiguity being just how much of the lump sum consideration was exchanged for the covenant. The court will then proceed to resolve the ambiguity -- that is, it will assess the covenant's independent economic value. Patterson, supra. For example, in Ansan Tool and Manufacturing Co., supra, the taxpayer (the buyer) had insisted upon a covenant not to compete due to the seller's prominent role in the business. The seller was capable of competing in a new or existing business, and so the economic reality test was met. However, the stock purchase agreement made no allocation of a part of the purchase price to the covenant. The court held that the taxpayer had met its burden of establishing that the parties required a covenant, and therefore some allocation was called for.

Similarly, in Wilson Athletic Goods Manufacturing Co. v. Commissioner, 222 F.2d 355 (7th Cir. 1955), the parties did not, in their agreement, allocate a portion of the purchase price to a covenant not to compete which clearly possessed some value. In that case, a major sporting goods manufacturer purchased a shoe factory which produced athletic shoes marketed under the "Wilson" name. The Tax Court found that an unapportioned amount of the purchase price was allocable between goodwill and the seller's covenant. The Seventh Circuit reversed, finding that the taxpayer had demonstrated that all of the unapportioned amount was paid only for the covenant, since Wilson would market the shoes through its own channels and, thus, the seller's goodwill was not of value to it. See also Kinney v. Commissioner, 58 T.C. 1038 (1972) (both parties had attached considerable value to the covenant not the compete, but were unable to agree upon a precise allocation).

It may be, however, that while the parties engaged in negotiations over a covenant not to compete, no mutual agreement was ever reached concerning the allocation of price to the covenant. For example, if the parties discussed a price for the covenant, but a specific allocation to the covenant was not included in the final agreement, this may be evidence that the parties could not reach an agreement. See, e.g., Patterson v. Commissioner, supra, 810 F.2d at 573; Annabelle Candy Co. v. Commissioner, 314 F.2d 1, 4 (9th Cir. 1963). In Theophelis v. Commissioner, 751 F.2d 165 (6th Cir. 1984), aff'g 571 F. Supp. 516 (E.D. Mich. 1983), the seller and buyer never discussed a possible allocation to the covenant not to compete until their final meeting, when they agreed in effect not to allocate any specific part of the purchase price to the covenant, but rather, they would allow the Internal Revenue Service to determine its value when the first of the parties to the sale was audited. See also Forward Communications Corp. v. Commissioner, supra (covenant not to compete found to have no value or minimal value where parties agreed to pay a sum certain for the assets of the seller and the purchase price was not altered when the covenant was later added).

In contrast, where the parties never even discussed the covenant, the courts have found mutual intent to allocate nothing to it. The court will not go further to examine the economic reality of the covenant. See, e.g., Lazisky v. Commissioner, 72 T.C. 495 (1975); Better Beverages, Inc., supra. In Better Beverages, a bottling and distribution company was purchased. The parties had entered into a letter of intent reflecting the intention to transfer all of the assets of the seller's company except real property and office equipment for $400,000. The letter agreement made no mention of a covenant not to compete and made no breakdown of the $400,000 among the various components of the business being transferred. After additional negotiations, the parties entered into a final sale agreement with three new conditions, including a covenant not to compete. Despite these adjustments, the total purchase price for the transfer remained $400,000, and there was no express allocation of the purchase price for any asset.

The sellers reported the purchase price as capital gain from the sale of the business, while the buyer characterized over one-half of the purchase price as payment for a covenant not to compete and claimed an amortization deduction with respect to the covenant. The government asserted protective deficiencies against both parties, and the refund actions by both parties were consolidated. The buyer presented affidavits to the district court to the effect that he considered the covenant "essential" to the transaction. The district court nevertheless granted summary judgment against the buyer in favor of the sellers, and the buyer appealed. The Fifth Circuit rejected the buyer's unilateral assertion of value because it was an inadequate indicator of the actual cost basis that the parties mutually intended at the time of the transaction to be allocated to the covenant. The buyer filed a petition for rehearing, and in Better Beverages, Inc. v. United States, 625 F.2d 1160 (5th Cir. 1980), the Fifth Circuit stated that the buyer had misread its earlier opinion as requiring the buyer to present proof of the exact value of the covenant agreed upon by the seller and buyer. The buyer need only prove that the parties agreed, expressly or impliedly, to allocate some portion of the lump sum purchase price to the covenant. The Fifth Circuit further stated at 625

F.2d 1161:

> Our holding is that, for tax purposes, to ascribe value to a covenant not to compete means the value which was the product of a realistic, bargained exchange between the parties and not some abstract figure of market value or what might have been a fair and equitable cost.

If nothing was paid for the covenant, there is nothing for the buyer to deduct. Theophelis, supra, 751 F.2d at 167.

The Strong Proof Doctrine and the Danielson Rule

The Strong Proof Doctrine and the Danielson Rule are applied only when the taxpayer takes a reporting position inconsistent with the specific allocation provided in the buy-sell agreement. For instance, the seller may treat the entire purchase price as capital gain, despite the fact that the agreement specifically allocates an amount to the covenant. Similarly, the buyer may claim amortization of an amount greater than that provided in the agreement. Although the Service is not bound by the allocation, the courts are likely to give effect to the agreed-upon allocation where the parties have adverse tax interests.

Between the parties, the allocation in their written agreement is generally binding. Where the parties clearly and unequivocally allocated a portion of the total consideration to the covenant, the Commissioner and the courts have refused to allow one of the parties subsequently to alter the tax consequences of the expressed amount unless he/she can overcome the contract terms by strong proof that the agreement does not reflect the parties' true intentions. This is known as the "strong proof" doctrine. Major v. Commissioner, supra, 76 T.C. 239, 247 (1981); Sonnleitner v. Commissioner, 598 F.2d 464 (5th Cir. 1979).

Meredith Corp. v. Commissioner, 102 T.C. No. 15 (March 14, 1994), provides an example of the Tax Court's use of the strong proof doctrine. The taxpayer was the purchaser of the assets of two national magazines, including the Ladies Home Journal ("LHJ"). The president of the selling corporation, Mr. Riordan, had a long professional history of editing and publishing magazines, and under his stewardship, the LHJ was made even more profitable than under its previous owner. Riordan intended to liquidate his corporation after closing the LHJ sale, and was considering permanent retirement. However, he had not ruled out the possibility of purchasing and selling magazine properties in the future. Taxpayer, the purchaser, felt that it was reasonable to expect that one of the six competitor magazines would become available for sale within the next five years, and conditioned the purchase of LHJ upon Riordan and his corporation executing noncompetition agreements that prohibited Riordan directly (or through his corporation, indirectly) from competing in the publishing market aimed at LHJ readers for five years. The noncompetition agreement with the corporation specified consideration of $10,000 for the corporation's forbearance; the agreement with Riordan referenced the $10,000 indirect payment through the corporation, plus $100,000 in direct payments under a 6-month consulting agreement. On its return, the taxpayer took the position that the noncompetition agreements had a value of $4,600,000. The court held that the taxpayer had failed to adduce the strong proof necessary to support its allocation of additional consideration to the noncompetition agreements, and held the taxpayer to the stated $10,000 direct payment.

Some appellate courts[2], relying on Commissioner v. Danielson, 389 U.S. 858 (1967), require an even stronger degree of proof before one party will be permitted to alter the allocation for tax purposes. Under the "Danielson rule," a party may contradict an unambiguous contractual term, for tax purposes, only by offering proof which would be admissible in an action between the parties to alter that construction or to show its unenforceability because of mistake, undue influence, fraud, or duress. 378 F.2d at 778-779. The "strong proof" and "Danielson" rules are not applied when there is no allocated purchase price for the covenant not to compete. If the terms of a contract are ambiguous or unclear on their face, the Danielson rule has no application. The Commissioner will not argue, however, that no allocation in the agreement is tantamount to a zero allocation for purposes of applying the Danielson rule.

Valuation of a Covenant Not to Compete

The value assigned to a covenant not to compete should be carefully scrutinized for economic reality. Valuation becomes an issue when the allocation by one or both parties appears to be excessive.

The taxpayer has the burden of proving that he is entitled to a deduction. Welch v. Helvering, 290 U.S. 111 (1933). Because the amount paid for a covenant not to compete represents compensation to the covenantor, the taxpayer bears the burden of proof for establishing the proper amount attributable to the covenant.

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[2] The Danielson rule has been adopted by the Third, Fifth, Sixth, and Eleventh Circuits. See Danielson, infra; Spector v. Commissioner, 641 F.2d 376 (5th Cir. 1981); Schatten v. United States, 746 F.2d 319 (6th Cir. 1984); and Bradley v. United States, 730 F.2d 718 (11th Cir. 1984). Although the Tax Court has rejected the Danielson rule, preferring the less stringent strong proof rule, under the doctrine of Golsen v. Commissioner, 54 T.C. 742 (1970), the Tax Court will follow a United States Court of Appeals opinion which is squarely on point where appeal of the Tax Court decision would lie in that circuit.

The value allocated to the covenant must reflect economic reality. In making this determination, the courts have looked to the same factors as those listed in the discussion of the economic reality test.

The value of the covenant to the purchaser comes from the increased profitability and the likelihood of survival of the newly-acquired enterprise that the covenant affords. The value to the seller, on the other hand, is measured by the opportunities foregone to re-enter a particular market for a given period. Better Beverages, Inc. v. United States, 619 F.2d at 430. Consequently, there generally is no correlation between the value of a covenant to the purchaser and its value to the covenantor. The Service should strive to arrive at a single value for a covenant not to compete, rather than allow the seller and the buyer to independently value the covenant according to its worth to the respective party.

One method to value a covenant is the compensation-based approach. Under this method, the covenantor's (seller's) average compensation (including salary, bonuses, and benefits) is calculated, this amount is projected over the life of the covenant, and a discount rate is applied to adjust the figure to present value. This method measures the loss of earnings anticipated by the seller as a result of his forbearance from competing in the specified market.

In some complex buy-sell agreements, however, a court may find the compensation-based approach too simplistic. Valuation texts, in discussing covenants not to compete, refer to a second method which values what the buyer acquired: protection of the continued profitability of the business from the seller's hostile use of his or her contacts in the market. This method calculates the present value of the economic loss to the buyer on the assumption that the seller re-entered the market. Such an approach was sanctioned by the Tax Court in Ansan Tool and Manufacturing Co. v. Commissioner, T.C. Memo. 1992-121, where the compensation-based method was determined inadequate for the unique arrangement between the taxpayer and the seller in a stock buy-out.

Courts will also look to the value claimed for the covenant relative to the values of the other assets acquired. See, e.g., Patterson v. Commissioner, supra; Peterson Machine Tool, Inc. v. United States, supra. For example, in Dixie Finance Co. v. United States, 474 F.2d 501 (5th Cir. 1973), where the amount that the taxpayer allocated to the stock purchase was less than its fair market value, the court refused to allocate any of the purchase price to a covenant not to compete. In Wilson Athletic Goods Manufacturing Co. v. Commissioner, supra, on the other hand, the court found that the excess purchase price paid for the assets of a shoe manufacturer was allocable to a covenant where the buyer was not interested in acquiring the goodwill of the seller, and thus the goodwill had a zero value.

The Service generally disfavors using the "formula" approach. Rev. Rul. 68-609, 1968-2 C.B. 327. This method, which determines the capitalization of earnings in excess of the fair rate of return on net tangible assets, may be applied in determining the fair market value of intangible assets only if no better basis is available. Id.

Finally, there are situations where the same parties execute both a covenant not to compete and an employment contract. Both agreements need to be evaluated carefully because their provisions may overlap, and thus, so may their values. An employment agreement may convey similar benefits and cover the same time period as a covenant not to compete, and arguably its value is not separate and distinct from the value of the covenant.

Effect of Code Section 197

New Code section 197 was enacted on August 10, 1993, as part of the Omnibus Budget Reconciliation Act of 1993. Section 197 provides for the amortization of acquired intangible assets (called "section 197 assets") -- including goodwill and going concern value -- over a 15-year period beginning with the month of acquisition, using the straight line method. No other deduction for depreciation or amortization is allowed for amortizable section 197 assets. Except for a limited election for intangibles purchased after July 25, 1991, the legislation is not retroactive.

Section 197 applies to most intangible assets acquired after the date of enactment; the 15-year amortization provision generally does not apply to self-created intangibles, churned assets, and certain specified intangibles (such as separately acquired mortgage servicing rights, sports franchises, and off-the-shelf computer software). The definition of "section 197 assets" specifically includes covenants not to compete.

Some of the same issues described in the previous discussion will continue to exist notwithstanding the enactment of section 197. Effective for tax years beginning after 1992, the Omnibus Budget Reconciliation Act of 1993 increased the maximum ordinary income tax rate to 39.6 percent, while the net capital gain rate continues at 28 percent. For transactions subject to section 197, this difference in rates is important only to the seller. Under section 197, the buyer will be indifferent to whether an amount is allocated to goodwill or to a covenant not to compete because the buyer must amortize that amount over 15 years in either event. In fact, it may be beneficial to the buyer not to have the purchase contract state a specific amount as allocable to the covenant so that the buyer can allocate a greater portion of the purchase price to tangible assets with shorter recovery periods. For years after 1992, it may also be beneficial to the seller not to have the purchase contract state an allocation to the covenant so that the seller does not flag the transaction for the Service, which would require the seller to report the amount paid for the covenant not to compete as ordinary income rather than as capital gain.

EXAMINATION POSITION:

Any consideration paid for a bona fide covenant not to compete forms the cost basis of a fixed-life, depreciable intangible asset. However, a covenant not to compete is not amortizable unless the objective facts show that (1) the covenant is genuine, i.e., it has economic significance apart from the tax consequences, (2) the parties intended to attribute some value to the covenant at the time they executed their formal buy-sell agreement, and (3) the covenant has been properly valued.

Because a case involving a covenant not to compete requires factual development, examining agents are urged to consult a Service engineer or economist (or an outside expert in appropriate cases) for lifing and valuation assistance. Although a taxpayer generally has the burden of proof with respect to its claimed useful life and valuation, the Service should always be able to specifically demonstrate why a taxpayer's appraisal or assertions are erroneous. General guidance on critiquing taxpayers' appraisal may be found in the Intangibles Settlement Initiative Teleconference Handbook, Internal Revenue Service Document 9233 (2-94), Catalog Number 20566N.