August 18, 2011

Noncompetition Covenants: "Recovery Group v. Commissioner"

By: Elliot Pisem and David E. Kahen

Individuals often provide services to closely owned businesses in which they own an interest. When an individual ends a regular employment relationship with such a business, payments may be made for the redemption or other transfer of the individual's ownership interest, for ongoing consulting or transitional services, and for covenants that may preserve the business's earnings and value, such as a covenant by the individual not to compete with the business for a specified period of time after the buy-out. The tax consequences of these categories of payments vary greatly, and the individual, the business, and its remaining owners will thus typically have a keen interest in the precise classification of any payments for tax purposes.

Any payments received for services or for a covenant not to compete will result in ordinary income, but payments received as consideration for surrender of an ownership interest in the business will generally result in capital gain, and then only if the consideration received exceeds the individual's basis in the interest. From the perspective of the business, if conducted in corporate form, and its continuing owners, a payment for the redemption of stock (or its purchase by other owners) will generally not result in any immediate tax benefit, while a payment for services will be deductible over the period to which the services relate. If the business obtains a covenant not to compete from the individual, the deductibility of payments made for the covenant will depend on special rules explored by a recent case.

If a covenant not to compete is "entered into in connection with an acquisition (directly or indirectly) of an interest in a trade or business or substantial portion thereof," the covenant is considered a "section 197 intangible," and its cost must be capitalized and can be written off over a 15-year period only. These rules apply regardless of the term of the covenant and notwithstanding that the individual is required to take the payments made for the covenant into account as ordinary income at the time that they are received.

If, however, the covenant does not arise "in connection with an acquisition ... of an interest in a trade or business," the cost of the covenant may generally be written off by the corporation over the term of the covenant, producing a far better tax result in a typical situation of a covenant that has a term of not more than a few years.

The Conference Committee Report discussion of Internal Revenue Code section 197, as enacted in 1993, makes clear that the acquisition of stock of a corporation engaged in a trade or business is viewed as an indirect acquisition of an interest in a trade or business.[1] Further, both the regulations under section 197 and case law make clear that a redemption of stock or a partnership interest may constitute an acquisition of an interest in a trade or business for purposes of determining whether the covenant must be amortized over a 15-year period.[2] The issue recently addressed by the Court of Appeals for the First Circuit in *Recovery Group, Inc. v. Commissioner*, on review of a Tax Court memorandum decision against the taxpayers,[3] is whether a different result may apply where the ownership interest acquired is a minority interest.

"Recovery Group"

Recovery Group, Inc. ("Recovery") was an S corporation engaged in the business of providing consulting and management services to insolvent companies.

James Edgerly ("Edgerly"), a founder and employee of Recovery and the owner of 23% of its stock, decided in 2002 to leave the corporation, to sell his shares back to Recovery, and to settle certain debts between himself and Recovery. The corporation ultimately redeemed Edgerly's stock for a stated consideration of $255,908.

Simultaneously, Edgerly entered into a noncompetition and nonsolicitation agreement that prohibited him from, among other things, engaging in competing activities from July 31, 2002, through July 31, 2003. The amount allocated to the noncompetition covenant, $400,000, was comparable to

Elliot Pisem and David E. Kahen are partners in the law firm of Roberts & Holland LLP.

Edgerly's annual earnings. An additional amount of roughly $150,000 was to be paid to settle various debts.[4]

Of the $805,000 of total consideration described above, $205,000 was paid in the form of a check, and Recovery delivered to Edgerly its promissory note in the amount of $600,000 payable over three years.

The tax returns of Recovery for 2002 and 2003 reflected amortization of the cost attributed to the covenant over its twelve-month term. The IRS determined, however, that the covenant was a "section 197 intangible" and that the cost of the covenant therefore had to be amortized over a 15-year period. This disallowance of a portion of the amortization deductions claimed by Recovery in 2002 and 2003 resulted in notices of deficiency against Recovery[5] and its shareholders. The IRS also asserted accuracy-related penalties against Recovery under Code section 6662.

The principal issue was whether the noncompetition covenant was, as stated 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," and therefore a section 197 intangible.

The Tax Court's 2003 decision in *Frontier Chevrolet* (affirmed by the Ninth Circuit Court of Appeals)[6] held that a redemption of 75% of the stock of a corporation coupled with the grant of a covenant not to compete constituted an acquisition of an interest in a trade or business for this purpose.

Given that holding, Recovery and its shareholders did not dispute that a grant of a noncompete in connection with a redemption of stock was potentially within the scope of section 197(d)(1)(E), but sought to persuade the Tax Court that a redemption of a minority interest should be distinguished. More specifically, Recovery argued that this provision was intended to apply only with respect to acquisitions of either the entire interest in a trade or business or a substantial portion thereof; and that a 23% stock interest should not be viewed as a "substantial portion" of the ownership interest for these purposes.

The Tax Court concluded, however, that the phrase "substantial portion thereof" should be read as modifying the phrase "trade or business," and not the word "interest." If there was an acquisition of a portion of the assets of the business, rather than an equity interest therein, a related noncompetition covenant would be subject to section 197 only if the portion of the assets acquired was a substantial portion of the assets of the business.

However, the Tax Court believed that the discussion of section 197 in the 1993 House Committee and Conference Committee Reports indicated a legislative intent to distinguish to some degree between an acquisition of assets and an acquisition of an equity interest in a business. The "acquisition of an interest" condition might be satisfied in the context of an acquisition of assets only where the assets constituted all or a substantial portion of the trade or business. In the context of the acquisition of an ownership interest in a trade or business, however, the Tax Court read the "acquisition of an interest" requirement to require only that a covenant was acquired in connection with the acquisition of any ownership interest, regardless of whether the ownership interest was "substantial."

The Tax Court further concluded that, even if the phrase "substantial portion thereof" were interpreted to modify the term "interest in a trade or business" and to limit the scope of the provision to the acquisition of a substantial interest, a 23% equity interest should be viewed as substantial.

On appeal by the taxpayers, the Court of Appeals for the First Circuit recognized that the statutory provision was ambiguous on its face, but concluded, by reference to the legislative history, that the category of noncompetition covenants intended to be categorized as section 197 intangibles includes any covenant entered into with the acquisition of any shares of stock in a corporation engaged in a trade or business -- whether or not those shares constitute a substantial interest in the corporation.

The Court of Appeals reasoned that, where an acquisition is made of assets, one abuse that was a key target of section 197 -- the reclassification of amounts paid for goodwill and going concern value as allocable to other property, including a short-term covenant not to compete, the cost of which would ordinarily be recoverable over a much shorter period than 15 years -- is limited to situations where a substantial portion of the assets of a trade or business is being acquired, since goodwill is relatively unlikely to be associated with an acquisition of a less-than-substantial portion of the assets.[7]

By contrast, in the context of a stock acquisition, where the acquisition of any portion of the stock of a corporation engaged in a trade or business includes a proportionate share of the value of the corporation's goodwill and going concern value, the potential abuse is different. Here, the inherent difficulty arises in distinguishing between the value allocable to covenant not to compete, which is properly amortizable over some period, and the value allocable to the completely non-amortizable stock acquired (a value that may include within itself a portion of the corporation's goodwill and going concern value). This difficulty is present regardless of the magnitude of the stock interest acquired, and the requirement of 15-year amortization serves to prevent a taxpayer from obtaining an unduly favorable result from an aggressive allocation of value to the covenant.

The opinions of both the Tax Court and the First Circuit Court of Appeals in Recovery Group strongly suggest that even a redemption or other acquisition of a single share of stock, or of less than a 1% interest in a partnership, may be sufficient to cause a covenant granted in the same acquisition to be treated as a section 197 intangible subject to amortization over a 15-year period. Indeed, this could be the case even if the stock or partnership interest can readily be valued by other means, such as by reference to trading prices in the case of publicly traded shares.

Whether the IRS intends to apply the provision in such a manner remains to be seen. However, as a planning matter, taxpayers and their advisors appear to be on notice that any acquisition of an ownership interest in connection with, say, the departure of an employee and payment of amounts as severance and in consideration of a noncompetition covenant, may result in characterization of all or some portion of the amount paid (and not allocated to the ownership interest) as a section 197 intangible amortizable over 15 years. It remains to be seen whether this will cause taxpayers and their advisors to rethink the necessity of obtaining a covenant not to compete in some such situations.

One other point that may be worthy of comment is the Tax Court's treatment of the penalties asserted by the IRS for a "substantial understatement of income tax."[8] The Tax Court concluded, in light of the words of the statute and its earlier decision in *Frontier Chevrolet*, that there was not "substantial authority" for Recovery's position. Moreover, the existence of an issue regarding the appropriate period for amortization of the covenant had not been disclosed on the relevant tax return.

The Tax Court further found, however, that the parties had fully disclosed the facts of the proposed transaction to the outside accountant for the corporation; that this accountant had in turn reviewed the tax treatment of the amount to be paid for the noncompete with a colleague who was a tax specialist; and that the accountants were competent professionals with sufficient expertise to justify the taxpayers' reliance on their advice.

The court also concluded that the complex rules of section 197 in this context were unlikely to be known even to a sophisticated taxpayer or business person, and were not intuitive in their application, such that it was sensible and appropriate for the tax-payers to consult with their tax professionals and to rely on their advice in this context.

The Tax Court therefore concluded that Recovery and its executives had reasonably relied on their accountants in good faith to determine the appropriate treatment of this item, and it abated the penalty on the basis that there was reasonable cause for the error on the tax returns and that the taxpayers acted in good faith. The IRS did not appeal this ruling.

Thus, although both the Tax Court and the Court of Appeals ultimately concluded that the advice that the accountants provided was incorrect, the actions of the taxpayers in consulting with apparently competent accountants, fully disclosing the facts to them, and relying on their advice, at least spared the taxpayers from the imposition of penalties.

---

1 See P.L. 103-66, § 13261; H.R. 2264, reprinted in 1993-3 C.B. 394, at 572 (1993).

2 See Treas. Reg. § 1.197-2(b)(9); *Frontier Chevrolet Company v. Commissioner,* 91 AFTR 2d 2003-2338 (9th Cir. 2003), *aff'g* 116 T.C. 289 (2001). Section 197 distinguishes between intangibles acquired in connection with the acquisition of a trade or business or interest therein and those acquired under other circumstances for purposes of a number of other rules as well. See, e.g., IRC § 197(c)(2) (relating to self-created intangibles) and (e)(4) (exclusion of certain interests and rights acquired separately).

3 *Recovery Group, Inc. v. Commissioner*, 108 AFTR 2d 2011-5437 (1st Cir. 2011), *aff'g* 99 TCM 1324 (2010).

4 The Tax Court opinion indicates that the company's accountant "calculated the buyout numbers," but does not further discuss how the total consideration, or the amounts allocated to the stock redemption and to the noncompete in particular, were determined.

5 The deficiency asserted against Recovery apparently related to a "built-in gains tax" obligation under Code section 1374.

6 See footnote 3 and accompanying text.

7 See House Committee Report No. 103-11, H.R. 2141, reprinted in 1993-3 C.B. 167, at 342 (1993).

8 For further discussion of this penalty and related defenses, see E. Pisem and D. Weintraub, *'And if Tommy Told You to Jump Off the Brooklyn Bridge?': Taxpayers Follow Advice Straight into an Accuracy Penalty,* 115 Journal of Taxation No. 1 (July 2011).