# NONCOMPETE AGREEMENT TAX CONSIDERATIONS IN CORPORATE ACQUISITIONS

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Corporate acquirers typically expect that seller noncompete agreements will be included in any corporate merger and acquisition (M&A) structure. This statement is true in most business acquisitions and this is particularly true in the acquisition of a professional services business.

If the seller of the target company is its parent corporation, then the buyer will expect a noncompete agreement from the corporate seller to prevent the seller corporation from competing with the target company during the term of the noncompete agreement. The buyer does not want to face competition from the corporate seller either from a seller's new start-up venture or from the seller's acquisition in the target company's industry.

If the sellers of the target company are individuals (and, particularly, if the sellers are employee-shareholders), then the buyer will expect a noncompete agreement directly with the selling shareholders. The buyer does not want the employee-shareholders to take the target company sale proceeds and start, acquire, or work for another company in the target's industry.

This discussion focuses on the type of M&A transaction in which the target company is a private corporation and the sellers are employee-shareholders. It summarizes the taxation and other considerations related to an M&A transaction in which employee-shareholders are selling the private C corporation stock to a C corporation acquirer. Some of these considerations also apply to the corporate acquirer's purchase of a subsidiary company of a parent corporation seller. However, the principal focus of this discussion will be taxation and valuation guidance related to the employee-shareholders' sale of a closely held corporation. It will also provide guidance related to the taxation and valuation of any intangible assets (including noncompete agreements) in such an M&A transaction.

In short, this discussion summarizes what tax counsel need to know about the valuation and amortization of noncompete agreements in private company acquisitions.

## Noncompete agreements

If there is a noncompete provision in the transaction stock purchase agreement or the asset purchase

agreement, then that provision is typically referred to as a noncompete or noncompetition covenant. If there is a separate contract between the transaction counterparties (outside of the stock purchase agreement or the asset purchase agreement), then that contract is typically referred to as a noncompete or noncompetition agreement.

However the transaction contract provisions are structured, the objectives of the parties are the same. The sellers want to sell the target company and receive the sale proceeds. The acquirer wants to protect its investment in the target company. Accordingly, the sellers agree not to compete in the industry or the profession of the target company for a specified period of time. Noncompete agreements are individually negotiated, and they vary as to the following terms and provisions:

- The definition of the target industry, industry segment, or profession;
- The definition of competition or noncompetition (versus, for example, nonsolicitation);
- The term or length of the noncompetition period;
- The geographic area covered by the noncompetition agreement; and
- The penalties for intentional or unintentional violations of the noncompetition provisions.

Noncompete agreements are contracts under state law. Each state may have its own interpretation of what noncompete agreement provisions are considered reasonable and enforceable under that state's laws. Accordingly, the tax counsel for each of the transaction counterparties should carefully draft and review the noncompete agreement terms and provisions. Both parties may retain valuation specialists to estimate the fair market value of any seller noncompete agreements.

Typically, the consideration paid by the buyer to the seller for a noncompete agreement is not part of the transaction purchase price paid for the stock of the C corporation target company. The noncompete agreement with the seller is generally considered to be an amortizable intangible asset that is acquired by the buyer. The value of that intangible asset is separate from the value of the target company stock that is acquired by the buyer.

The noncompete agreement intangible asset is generally amortizable by the buyer over a 15-year amortization period under Internal Revenue Code (Code) section 197(d). The payments received by the employee-shareholders as consideration for any noncompete agreement are typically considered ordinary income (and not capital gain) to the sellers. Therefore, the allocation of the total transaction consideration between the target company stock and the noncompete agreement is typically an important consideration to both the buyer and the sellers. This total consideration allocation is often an area of disagreement between the Internal Revenue Service (IRS) and both sets of transaction counterparties.

## Amortization of the noncompete agreement

Under Code section 197(d), a noncompete agreement either with a parent corporation seller or with selling shareholders/employees should be amortizable by the acquirer over a 15-year cost recovery period. However, section 197(d)(1)(E) indicates that a noncompete agreement is not a section 197 intangible asset if the agreement is not entered into "in connection with an acquisition (directly or indirectly) of an interest in a trade or business or substantial portions thereof."[1]

Therefore, a noncompete agreement entered into with target company nonshareholder-employees should not be considered a section 197 intangible asset. Accordingly, such noncompete agreements with nonshareholder-employees should not be amortized over 15 years. Rather, acquirers would expect to be able to amortize such a noncompete agreement over the contract term of the agreement. Usually, such noncompete agreement contract terms are fairly short-term—such as two or three years. Nonetheless, the IRS may take the position that all of the transaction-related noncompete agreements should be amortized over 15 years.

Even though the counterparties to the noncompete agreements are not the sellers, the IRS may claim that the agreements were entered into as part of the business acquisition. This position will not change the value of the nonseller noncompete agreements, but it will spread out the acquirer's income tax amortization deductions over a longer period.

The courts have concluded that seller noncompete agreements should be amortized over the section 197 15-year period. The First Circuit affirmed such a Tax Court decision in *Recovery Group, Inc. v. Commissioner.*[2] In *Recovery Group*, the Tax Court ruled that a noncompete agreement related to the redemption of a 23 percent block of S corporation stock was a section 197 intangible asset. Even though the noncompete agreement had a one-year contractual term, the Tax Court ruled that the cost of the agreement had to be amortized over 15 years. The Tax Court (and the Court of Appeals) concluded that any noncompete agreement payment related to the purchase or redemption of stock must be amortized over the section 197 15-year period—regardless of the contractual term of the individual agreement.

## Tax incentives to understate the value of the noncompete agreement

Some acquirers would have an economic incentive to understate the target company purchase price allocation to the seller's noncompete agreement. The noncompete agreement value will be amortized over 15 years. Many other categories of target company assets may be depreciated over much shorter periods. Acquirers will typically receive cost recovery on the target company's receivables and inventory in the year after the acquisition. Acquirers will typically be able to depreciate the target company's machinery and equipment over periods of less than 15 years.

Such acquirers may have an economic incentive to allocate a very small portion of the target company purchase price to any seller noncompete agreement. The acquirer will amortize value allocated to the noncompete agreement intangible asset over a relatively long 15-year period. For this reason, the IRS may challenge the amount of the total transaction consideration that the acquirer allocates to any seller noncompete agreement. The IRS may claim that the allocation was understated—and that the agreement's actual fair market value is greater than the amount reported by the acquirer.

The seller shareholders may also have an economic incentive to understate the target company purchase price allocation to the noncompete agreements. Noncompete agreement payments received by a seller are treated as ordinary income. In contrast, payments received by a seller for the target company stock (a capital asset) or for the target company real estate, equipment, or goodwill (section 1231 assets) are treated as capital gains.

So, if both the acquirer and the selling shareholders have an economic incentive to understate the purchase price allocation to the noncompete agreements, the IRS will likely scrutinize the value assigned to that intangible asset. In particular, the IRS may challenge any transaction where little or none of the target company purchase price is allocated to any seller noncompete agreement. Depending on how the transaction is structured, the IRS realizes that the acquirer may be indifferent as to a purchase price allocation to goodwill or to the noncompete agreement. To the acquirer, these are both section 197 15-year amortization intangible assets. To the selling shareholders, the noncompete allocation results in ordinary income—while the goodwill (capital asset) allocation results in a capital gain.

## Tax incentives to overstate the value of the noncompete agreement

Because of the relatively lengthy 15-year amortization period, acquirers have the above-described incentive to understate the value of any noncompete agreement in section 1060 asset purchase transactions or stock purchase transactions that qualify for the section 338 election (i.e., that are treated as asset purchase transactions). In contrast, in stock purchase transactions that do not qualify for the section 338 election, the acquirer has an

economic incentive to overstate the value of any seller noncompete agreements.

In the typical stock purchase transaction, the acquirer receives a carryover tax basis in the target company assets. That is, the acquirer does not get to depreciate or amortize any purchase price premium paid in excess of the target assets' tax basis. In such a transaction structure, the acquirer has an incentive to overstate the total consideration allocation to any noncompete agreements. Instead of a zero cost recovery on the purchase price premium, the acquirer may amortize the purchase price allocated to the section 197 noncompete agreements over 15 years.

In such a transaction structure, the IRS may carefully scrutinize the amount of the purchase price allocated to any seller noncompete agreement. The IRS may claim that the purchase price allocation is greater than the actual fair market value of any seller noncompete agreement.

### The substance of the noncompete agreement

The IRS's position is that, in acquisitive transactions, noncompete agreements only have value when the seller has an actual capacity to compete with the target company. In assessing the fair market value of any selling shareholder-employee noncompete agreement, the IRS will consider the seller's capacity to compete based on such factors as age, health, financial ability, technical expertise, industry contracts, regulatory or other restrictions, and geographic proximity.

In addition, in assessing the fair market value of any seller noncompete agreement, the IRS typically looks for one of the following conditions:

- The target company is a service-based business (or a knowledge-based business)—and not a capital-intensive business;
- The selling shareholder-employee has identifiable technical expertise (such as proprietary knowledge of process designs, product recipes or formulas, or other trade secrets);
- The selling shareholder-employee has personal relationships with suppliers, vendors, subcontractors, bankers, or other providers of goods and services to the target company;
- The selling shareholder-employee has personal relationships with key employees of and/or consultants to the target company;
- The selling shareholder-employee has personal relationships with customers, clients, patients, distributors, dealers, franchisees, and so forth; or
- The selling shareholder-employee is well known in the industry or profession for having unique experience, expertise, prominence, or eminence.

In assessing the fair market value of any seller noncomplete agreement, the IRS also considers the legal enforceability of the contract. Such legal enforceability is often an issue of state-specific contract law and employment law statutes and judicial precedent. These state-specific contract law issues may include the following factors:

- The term of the agreement; depending on the state and the industry or profession, courts generally consider two- to three-year terms to be reasonable;
- The scope of the agreement; this factor generally considers the extent of the restrictions on the seller's ability to earn a living; and
- The geographic area covered by the agreement; this factor generally considers whether the seller's noncompetition territory is local, regional, or national.

### The double taxation in the sale of C corporation shareholders

If the target company is a C corporation and the transaction is structured as an asset sale (or as a stock sale followed by a section 338 election), the selling shareholders may be subject to double taxation on the gain related to the sale. First, the target company itself will recognize a taxable gain on the sale of its assets to the acquirer (to the extent that the sale price exceeds the target company's asset tax

basis). Second, the selling shareholders also are subject to taxation when the target company distributes the remaining (after-tax) sale proceeds to the shareholders. That is, the selling shareholders are subject to tax on the gain related to the target company's distribution of the transaction sale proceeds.

For this reason, the selling shareholders in such a transaction have an economic incentive to overstate the allocation of the total transaction consideration to any noncompete agreements. The payments for the noncompete agreements are only taxed once to the selling shareholders. In addition, the selling shareholders have an economic incentive to overstate the allocation of the total transaction consideration to any intangible assets that are personally owned by those selling shareholders. For example, in a private company sale transaction, the selling shareholders may personally own trade secrets, customer/client relationships, or personal goodwill. The acquirer's payments for these personally-owned intangible assets is only taxed once to the selling shareholders. Whether these intangible assets are target-company-owned or selling-shareholder-owned, they are section 197 intangible assets to the acquirer. That means that, regardless of who the seller is, the acquirer will amortize the fair market value of the acquired intangible assets over the section 197 15-year period.

For example, in the decision in *Norwalk v. Commissioner*,[3] the Tax Court concluded that the goodwill purchased in the business acquisition was the seller's personal goodwill—and not the target company's institutional goodwill. In that case, the acquirer did not obtain noncompete agreements with the selling shareholder/employee. Based on the specific facts of that case, the Tax Court opined that there was acquired goodwill in the form of valuable client relationships. However, the valuable goodwill was an intangible asset that was owned personally by the selling shareholder. The goodwill was not an intangible asset that was owned by the target company. Therefore, that part of the transaction consideration was only subject to one level of taxation—to the selling shareholders and not to the target company.

The point is that the double taxation related to certain private company sale transactions can be avoided. That avoidance would occur if the sellers can demonstrate that they personally own—and control—valuable intangible assets. In the typical private company sale transaction, that valuable intangible asset is the sellers' personal goodwill.

Typically, the selling shareholder-employees will have a zero tax basis in the self-created personal goodwill. Therefore, the entire amount of the transaction consideration will be taxable gain to the sellers. However, the personal goodwill should be a section 1231 capital asset. Therefore, the amount of the transaction purchase price allocated to personal goodwill will only be taxed once—at a long-term capital gain tax rate. Depending on the sellers' level of taxable income, that capital gain tax rate may be 15 percent or 20 percent.

## Purchase price allocation to personal intangible assets

The IRS may likely examine an M&A transaction when a large portion of the transaction consideration is allocated to the sellers' personal goodwill. In most private company purchase price allocations, the IRS expects to see a large portion of the transaction consideration allocated to the target company's institutional goodwill.

When a material amount of seller personal goodwill is transferred in a target company purchase transaction, the transaction participants should obtain both legal advice and valuation specialist advice. Counsel will analyze the ownership of the transferred intangible assets. In addition, counsel will ensure that all of the transaction documents are properly prepared to document which parties are transferring which intangible assets.

The valuation specialist will identify which intangible assets exist with respect to the business acquisition transfer, and will identify all of the economic attributes related to each transferred intangible asset. Based on the identification and assessment of these economic attributes, the valuation specialist will estimate the fair market value of each

transferred intangible asset. This intangible asset valuation analysis will typically be used for both the sellers' transaction sale price allocation and the acquirer's purchase price allocation.

As a legal consideration, counsel will document that the seller-owned intangible assets were not previously sold, contributed, or otherwise transferred to the target company. If the sellers are shareholder/employees, then the counsel will review any employment agreements, shareholder agreements, or existing noncompete agreements. Counsel will consider whether such agreements previously transferred ownership of any existing or created intangible assets from the employees to the employer target company.

In particular, counsel will often draft two separate asset and/or stock purchase agreements: one agreement related to the transfer of personally owned intangible assets and one agreement related to the transfer of corporate-owned intangible assets. If there is only one set of asset purchase or stock purchase transaction documents, then counsel will ensure that there are separate contractual provisions related to the transfer of any personally owned intangible assets and the transfer of any corporate-owned intangible assets.

In *Martin Ice Cream Co. v. Commissioner*,[4] the Tax Court concluded that the customer relationships intangible asset transferred in the business acquisition had been personally owned by the shareholder-employee. The customer relationships intangible asset was not an asset owned or controlled by the target company. In reaching this conclusion, the Tax Court emphasized two issues:

1. The selling shareholder-employee did not have either an employee agreement or an existing noncompete agreement with the target company; and
2. The customer relationships intangible asset had never been transferred to the target company.

In the *Martin* decision, the Tax Court concluded that the target company did own other intangible assets that were also transferred in the business acquisition. Specifically, the Tax Court recognized that the target company owned the following intangible assets: distribution rights and corporate books and records. However, the court did not assign a significant amount of value to these corporate-owned intangible assets. The sale of the customer relationships intangible asset personally from the selling stockholder to the corporate acquirer avoided the double taxation on that portion of the total transaction proceeds. In addition, the sale of the personally owned intangible asset to the corporate acquirer was taxed to the selling shareholder at a lower capital gain tax rate.

## Consulting agreements versus noncompete agreements

As an alternative consideration to asking the sellers to enter into noncompete agreements, the acquirer may consider asking the sellers to enter into consulting agreements. This alternative consideration is particularly relevant if the selling shareholders will not remain employees of the target company post-transaction. Obviously, the selling shareholders cannot be employees of and consultants to the acquired target company at the same time.

The payments made by the acquirer to the seller consultants are deductible to the buyer over the term of the consulting agreement. In other words, the consulting agreement payments are deductible to the buyer when the payments are made to the seller consultants—and not over a 15-year amortization period (as would be the case with noncompete agreement payments). Accordingly, the acquirer gets a much faster tax recovery on the fair market value of consulting agreements than on any fair market value assigned in the transaction to noncompete agreements.

To the selling shareholders, the payments received from a noncompete agreement and the payments received from a consulting agreement are both considered to be ordinary income. The only difference (and the only downside to the sellers) is that the consulting agreement payments are subject to FICA and other employment taxes.

In many cases, the sellers may already earn wages or self-employment income that would put them above the FICA and other employment tax withholding limitations. In such instances, these sellers would not be subject to such additional employment-related taxes.

However, the consulting payments will likely be subject to the 2.99 percent Medicare Health Insurance portion of self-employment taxes. In addition, the consulting payments may be subject to the additional 0.9 percent Medicare tax on earned income. However, the acquirer and the sellers may be able to negotiate a compromise with respect to such employment-related taxes. That is, there is a material present value benefit to the acquirer to deduct consulting payments immediately—compared to deducting noncompete payments over 15 years. This present value benefit may be large enough to encourage the acquirer to "make whole" the sellers with regard to the additional payroll taxes related to the consulting agreement (versus noncompete agreement) payments.

Of course, in such consulting agreement arrangements, the sellers should be expected to actually consult with the acquirer with respect to the target company. The IRS may scrutinize such a consulting agreement arrangement. If the selling shareholders do not actually "consult," then the IRS may recharacterize the consulting agreement payments as (15-year amortization) noncompete agreement payments.

## CONCLUSION

Tax counsel should be aware that a corporate acquirer typically expects that the sellers will enter into noncompete agreements with respect to the target company. This acquirer expectation is typical whether the seller is a parent corporation or an individual selling shareholder. However, this acquirer expectation is particularly relevant when the target company is a private company and the sellers are shareholder-employees.

There are income tax considerations to both the acquirer and to the sellers with regard to how the target company M&A transaction is structured. In particular, there are income tax considerations to both the acquirer and to the sellers with regard to what portion of the total transaction consideration is allocated to any noncompete agreements.

Much of this discussion applies to all target company acquisitions. However, this discussion focused on the type of M&A transaction where the target company is a private C corporation and the sellers are shareholder/employees.

In order to maximize the income tax benefits to all parties to the M&A transaction, all parties to the business transfer should consult with both tax counsel and valuation specialists.

The tax counsel will review: (i) the structure of any noncompete agreements and any other transaction agreements; and (ii) the ownership of any seller personally owned intangible assets that are transferred in the target company acquisition.

The valuation specialist will document the economic attributes of the noncompete agreements and any other intangible assets transferred in the M&A transaction. In addition, the specialist will develop a supportable and credible fair market value valuation of any noncompete agreements and any other transferred intangible assets.

The sellers may rely upon such an intangible asset valuation transaction for sale price allocation purposes. And, the acquirer may rely upon such an intangible asset valuation for transaction purchase price allocation purposes.

Notes

1 26 USC § 197.

2 Recovery Group, Inc., et al., v. Commissioner, 652 F.3d 122 (1st Cir. 2011).

3 Norwalk v. Commissioner, T.C. Memo. 1998-279.

4 Martin Ice Cream Co. v. Commissioner, 110 T.C. 189 (1998).