APPEALS

INDUSTRY SPECIALIZATION PROGRAM

SETTLEMENT GUIDELINE

INDUSTRY:	All Industries
ISSUE:	Covenants Not To Compete
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UIL NO:	167.14-02
FACTUAL/LEGAL ISSUE:	Factual

APPROVED:

4/20/98

for REGIONAL DIRECTOR OF APPEALS — DATE

NORTHEAST REGION

5/20/98

NATIONAL DIRECTOR OF APPEALS — DATE

EFFECTIVE DATE: SEP - 1 1998

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SETTLEMENT GUIDELINES

Covenants Not to Compete
Effective Date: SEP -1 1998

STATEMENT OF ISSUE

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

EXAMINATION DIVISION'S 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.

BACKGROUND

During negotiations for the purchase of a business or the buy-out of a shareholder's stock holdings, the parties will sometimes agree that the seller will not operate or work for a competing business within a specified distance or territory for a specified time. This agreement that they enter into is commonly known as a "covenant not to compete" (CNC). If the terms of the agreement are reasonable and if the seller is truly being compensated for giving up its right to pursue its vocation, then the payment(s) made by the purchaser to the seller constitute ordinary income to the seller and the buyer is entitled to an amortization deduction for the payments.

Buyers have traditionally preferred to allocate as much of the purchase price as possible to the covenant not to compete (prior to new I.R.C. § 197) because that amount would be amortizable and would allow a deduction against ordinary income. The portion of the purchase price which was allocated to the transferred goodwill and going concern value represented a nondepreciable capital investment by the buyer.

Prior to 1987, sellers sought to allocate as little as possible to the covenant not to compete and to allocate as much as possible to other business assets (or the stock) including goodwill because the price received for the covenant not to compete was ordinary income while the amount received for existing assets would be taxed as capital gains. This tension between the buyer and seller of a business is known as "tax adversity."

Due to this conflicting interest of the seller and buyer there usually was an arms length negotiated allocation between the CNC and the purchase price for the business or stock.

The 1986 Tax Reform legislation eliminated the preferential taxation rate applicable to the taxation of Capital Gain Income as compared to the rate applied to Ordinary Income. With the elimination of the preferential rate and the adverse tax interests, a seller of a business will be more inclined to agree to a covenant not to compete. This will improve the chances of selling the business and help the seller in obtaining a higher sales price.

The Service is concerned that excessive amounts are being classified in these sales agreements as covenants not to compete. Consequently, we can expect to encounter overstated amortization deductions by buyers.

DISCUSSION

IRC § 167(a) is the controlling provision for the allowance of amortization for intangible assets prior to the enactment date of I. R. C. § 197. It requires that the following factors be present before a deduction is allowed:

The intangible asset is known from experience or other factors to be of use in a business or in the production of income.

The intangible asset has a limited period of duration the length of which can be estimated with reasonable accuracy.

Economic Reality

The economic reality theory is primarily concerned with business realities, which would cause reasonable persons, genuinely concerned with their economic future, to bargain for the covenant not to compete. Schulz v. Commissioner, 294 F. 2d 52, 54 (9th Cir. 1961). These concerns will be addressed via consideration of the following questions.

(a) Could the Seller continue to compete?

In order to answer this question we must first consider the responses to the following questions:

1) Did the seller(s) have business contacts that would allow the seller(s) to continue to compete?

Compare Sonnleitner v. Commissioner, 598 F .2d 464 (5th Cir. 1979), (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, (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).

2) Did the seller(s) have the financial resources to compete?

Compare Illinois Cereal Mills, Inc. v. Commissioner, T. C. Memo. 1983-469, affg, 789 F. 2d 1234 (7th Cir.), cert. denied, 479 U.S. 995 (1986) 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, had no intent to compete and lacked the financial resources to compete).

3) Were the seller(s) physically able to continue to compete?

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).

4) Were there any noncontractual restrictions that would have prohibited the seller from competing?

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. CI. 1979), (seller would need an FCC license to compete, which it was unlikely to obtain); Major v. Commissioner, (seller of freight firm would have to acquire interstate operating authorities, which were difficult to obtain from ICC).

5) Did the seller intend to compete or was the purchaser concerned about competition from the buyer?

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 realty test.

In Major v. Commissioner, the petitioner was the owner and operator of a trucking business. The prime asset in this business was the ICC operating authority for the routes that a freight firm operates. The Tax Court found that the buyer was primarily interested in the ICC operating authority and the buyer seemed indifferent to the possible threat of competition, because the former owner was of advanced age and in poor health. Another factor was the method of payment for the unpaid balance of the "covenant" in that 6-percent interest was charged on the entire balance due. These factors along with numerous other factors caused the Tax Court to conclude that the covenant possessed no more than an unascertainable de minimis value.

In Ansan Tool and Manufacturing Co.. Inc. v. Commissioner, T.C. Memo. 1992-121, the taxpayer amortized 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 found that the taxpayer's concerns were well-founded.

In Illinois Cereal Mills. Inc. v. Commissioner, petitioner (ICM) acquired the MOGUL Cereal binder business of CPC International, Inc. (CPC). CPC's sale of its MOGUL operations ended its cereal binder business. Nonetheless, the covenant not to compete was of considerable value to ICM because CPC was still selling resin-coated sand in the foundry market in competition with cereal binders. The Tax Court determined that a valid and valuable covenant not to compete existed and was based upon the continuing business of CPC and upon CPC's continuing business presence in ICM's markets. In addition, the court commented on CPC's substantial financial resources and excellent market reputation. Specifically, the court believed that CPC possessed the resources to reenter the cereal binder market.

In Ackerman v. Commissioner, T.C. Memo 1968-254, 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. Taxpayer contended that the covenant he had signed was lacking in any independent economic reality. His claim was premised on the argument that the covenant was in essence good will and the covenant not to compete was a nonseverable item that had no real value. The Tax Court rejected the petitioner's argument and concluded that the covenant had some independent basis in fact, noting:

Petitioner was 68 years of age at the time the agreements were executed. The covenant 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 the covenant not to compete was imperative and that a certain amount of money ($30,000) should be allocated to it.

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

The payment due from the covenant ended in the event of the petitioner's death.

In Sonnleitner v. Commissioner, supra, the petitioner had been a partner in a very successful cookie manufacturing business with a franchise for Oregon and Washington. After several years, the petitioner was offered another franchise in Texas. Petitioner accepted the offer and expended considerable time and effort away from (Oregon) his original base of operations. His Oregon partner, Smith, became dissatisfied with their new working relationship. Through a series of negotiations, they finally settled their dispute by having petitioner sell his shares to the company. As part of the settlement, petitioner accepted a covenant not to compete.

Sonnleitner, on his tax return, characterized the covenant payments that he received as payment for his stock even though the contract specified that it was for the covenant not to compete. At trial, petitioner raised two arguments, only the first is relevant to our discussion. His reason for treating the payment as part of the Capital Asset acquisition was that he felt the covenant had no basis in economic reality other than the contrivance of a tax benefit for the purchaser. He based his reason on three factors:

There was a covenant not to compete in the franchise agreements governing both the Oregon and Texas companies. He felt this barred him from competing with Smith. The 5th Circuit expressed the belief that “the provisions in the franchise agreement to which petitioner refers merely grant the franchisees' exclusive rights to manufacture and sell name brand cookies and restrict such manufacture and sales to the designated territory. These putative covenants would not prohibit taxpayer from establishing a competing cookie business in Oregon."

.The possibility of Smith withholding the unpaid part of the stock purchase price sufficiently deterred him from competing so as to render the covenant devoid of economic reality. The court responded to this contention by saying: "However, absent the covenant not to compete, Smith would have no legal basis for withholding the unpaid stock purchase price in reaction to taxpayer's competition."

.The covenant was unrealistic, because he lacked the ability to compete with Smith. Petitioner claimed that he was financially strapped with the debts of his Texas business. The Court took exception noting: "However, the fact that taxpayer offered to buyout Smith for $800,000 in July 1967 contradicts or at least questions his assertion of financial inability to compete. He apparently contemplated full ownership of both the Oregon and Texas companies."

The 5th Circuit in Sonnleitner also noted "that he had threatened to compete with Smith both before and after his move to Texas." In addition, the court also stated; l'As sales manager of the Oregon company for fourteen years, taxpayer certainly had the business contacts to compete with Smith. A further testament to taxpayer's business acumen was his recognition by the franchisor as outstanding salesman in 1963."

In Ullman v. Commissioner, 264 F. 2d 305 (2nd Cir. 1959), three brothers sold their stock in three linen supply companies of which they were the sole stockholders, to Consolidated Laundries.

A specific amount was listed in each of the purchase agreements for the covenants. The total of $350,000 for the covenants was to be paid over three years. The Ullmans treated the entire proceeds from the sale as the amount received for their capital stock, allocating nothing whatever to the covenants not to compete. Consolidated Laundries recorded $350,000 on its books as attributable to the covenants and amortized this cost over the seven-year period of the covenants.

The Ullmans unsuccessfully argued that the price of the covenants as stated in the contract was simply a fictitious allocation designed to benefit the tax position of the buyer and that the amount they received represented goodwill. The Second Circuit noted the following:

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Petitioners were not in any real sense connected with the goodwill since they had little, if any, contact with customers.

Petitioners possessed technical knowledge and were in a position to supply that knowledge to aid in the financing of a competitive business and in anticipation of such a possibility and in order to forestall such activity the purchaser was willing to pay dearly for the covenants.

{b) Were the payments to the shareholders based upon a percentage of stockholdings?

In Dixie Finance Co.. Inc. v. United States, 474 F. 2d 501 (5th Cir. 1973), not all of the shareholders of the former loan companies were required to enter the noncompete agreements though all were paid in proportion to their stock holdings. The Fifth Circuit noted the following evidence which was presented at the District Court:

No extra consideration was given to those persons whose competition would be expected to have the most adverse effect on Dixie Finance; indeed, two stockholders, who refused to sign the noncompetition document were paid on the same basis as those who signed.

In Montesi v. Commissioner, 40 T.C. 511 (1963), .aff'd, 340 F.2d 97 (6th Cir. 1965), 65-1 USTC ~ 9173, each of the shareholders received identical payments under the covenant not to compete, the payments were not based upon stock holdings. The Sixth Circuit found the agreement to have substantial value. The factors that caused the courts to reach this conclusion were:

The Montesi store operations in Memphis prior to the sale were the most successful retail food marketing operations in the vicinity.

Within a few days after the five year expiration period of the covenant not to compete, the taxpayers were back in competition with the purchaser of their former business.

(c) Were the payments based upon the competitive worth of the payee?

This issue goes to whether the amount paid for the covenant 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 Ackerman, supra, a factor which influenced the Tax Court to find that a portion of the purchase price was intended by both parties as consideration for the taxpayer's covenant not to compete was that the pay ments for the covenant terminated in the event of the seller's death.

(d) Did the purchaser police the agreement?

In Dixie, supra, the 5th Circuit noted, "There was no effort to police the agreement to insure that Dixie received the benefit contracted for."

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

Other factors have been considered by courts in determining the economic reality of a covenant. They include:

.Formalities of the covenant

.Enforceability of the covenant .Scope of the covenant

In Howard Construction. Inc. v. Commissioner. 43 T.C. 343 (1964), QQg,. 1965-2 C.B. 5, the court found that purchaser lacked concern about competition where the covenant prohibited sellers from managing a similar business, but did not prohibit them from purchasing a similar business.

Mutual Intent

Where a covenant not to compete was agreed to between the parties, but no specific amount of consideration had 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 consideration paid for the going concern was intended for the covenant not to compete.

While the failure to allocate a portion of the purchase price to a covenant appears to be good evidence that the parties did not intend one, 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 .

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 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).

.The covenant was an essential part of the sales agreement or was separately bargained for.

The courts have tended to look at the actual contract negotiations to determine whether the parties intended the covenant to have any value.

Under these circumstances, the covenant has some value, but an ambiguity exists in the buy-sell agreement, namely just how much of the lump sum consideration was exchanged for the covenant. The court will assess the covenant's independent economic value.

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

It may be 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 no specific allocation to the covenant was included in the final agreement, this may be evidence that the parties could not reach an agreement.

.The seller and buyer never discussed a possible allocation to the covenant not to compete until their final meeting. At that meeting they agreed not to allocate any specific part of the purchase price to the covenant, but rather, would allow the Internal Revenue Service to determine its value when the first of the parties to the sale was audited.

.A covenant not to compete may 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.

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 p osition inconsistent with the specific allocation provided in the buy -sell 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.

An allocation in their written agreement is generally binding between the parties. 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.

Meredith CorR. v. Commissioner, 102 T.C. 406, used 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 indirectly from competing in the publishing market aimed at LHJ readers for five years. The noncom petition 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 present 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, relying on Commissioner v. Danielson. 378 F. 2d 771 (3d Cir.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 it is unenforceable because of mistake, undue influence, fraud, or duress.

The "strong proof' and "Danielson" rules are not applied when there is no allocated purchase price for the covenant not to compete.

Forward Communications Corp v. United States, supra, brings many of these factors together. The petitioner (Forward) commenced negotiation in March 1965, with Peoples Broadcasting Company (Peoples), to purchase the KVTV television station of Sioux City, Iowa. From the start, Peoples said that it would not sell the station for less than $3.5 million and Forward acquiesced to that basic price. The negotiations after that related largely to the clauses that Forward wanted to include in the agreement of sale.

One clause that Forward proposed was a covenant by Peoples that it would not compete in Sioux City for five years. The 5-year period was chosen because Forward felt that after that period Peoples would lose its effectiveness in the Sioux City market. There was no provision in the contract for payment or for any allocation of the purchase price for the covenant not to compete.

At the closing Forward presented three checks to Peoples. One check for $250,000 did not contain any notations. Upon giving the seller this check, Forward informed Peoples that the amount on this check was what it was paying for the covenant not to compete. Peoples' representatives were reported to have been noncommittal.

The Court of Claims rejected Forward's allocation of $250,000 for the covenant, because it concluded that there was no bona fide mutual allocation of value to the covenant. The court employed four tests in arriving at its conclusion. These tests are discussed below:

.The first test is whether the compensation paid for the covenant is separable from the price paid for the goodwill. This test is stated in Ullman v. Commissioner, supra,

"It is well established that an amount a purchaser pays to a seller for a covenant not to compete in connection with a sale of a business is ordinary income to the covenantor and an amortizable item for the covenantee unless the covenant is so closely related to a sale of goodwill that it fails to have any independent significance apart from merely assuring the effective transfer of that good will."

.The second test is whether either party to the contract is attempting to repudiate an amount knowingly fixed by both as allocable to the covenant, the calculable tax effect that may fairly be assumed to have been a factor in determining the final price. This is referred to as the "Danielson rule", after Commissioner v. Danielson, Supra.

.The third test is one of mutual intent. Where there is no precise allocation of the purchase price in the agreement to the covenant not to compete, is there proof nevertheless that both parties intended when they signed the agreement that some portion of the price be assigned to the covenant? The leading case on this test is Annabelle Candy Co. v. Commissioner, 314 F .2d 1 (9th Cir. 1962).

.The fourth test is whether the covenant was economically real. The essence of this test is that however the parties divide the purchase price they cannot prevent the Commissioner from attacking the allocation to the covenant not to compete as sham or unreal rather than the product of bona fide bargaining. See Harvey Radio Laboratories, Inc. v. Commissioner, 470 F, 2d 118 (1st Cir. 1972).

The Claims Court in answering these four tests noted the following:

"First, the covenant was not a separable wasting asset but merely protective of the goodwill plaintiff acquired in the purchase. There was no evidence that Peoples had any plans to return to the Sioux City market right after it sold its station and transferred its license to plaintiff. Peoples could not have competed with plaintiff without an FCC license, and it could only have obtained such a license by purchase of the other existing television station in Sioux City or by applying for the long-unused UHF channel." The Court also noted that Peoples made substantial representations to the FCC as part of the license transfer application. In its FCC application, Peoples did not indicate an intent to reenter the Sioux City market."

Regarding the second question, the court noted "under the sales agreement Peoples was entitled to the full purchase price without any strings attached. Moreover, there is no testimony in the record that plaintiff made its tender of the purchase price conditional upon Peoples' acceptance of the allocation."

The court in commenting on the plaintiffs failure of the third test stated:

That plaintiff cannot meet the third test, that there be mutual intent to allocate $250,000 or some other value to the covenant, is apparent from the record. From the start of the negotiations in March 1965, Peoples insisted on the $3.5 million price for the assets other than the tall tower and taxpayer agreed to pay it.

The court also noted:

It was not a condition of the closing that Peoples agree to such an allocation, and plaintiffs president, Dudley and its attorney, Staples, conceded that Peoples did not agree.

Finally, regarding the fourth question concerning economic reality, the court stated:

There was no showing that Peoples was likely to incur any comparable loss of earnings by not competing in the Sioux City market for five years so that it would bargain for $250,000 in substitute compensation. There was no evidence that Peoples had plans to resume television broadcasting in the Sioux City area.

The court also observed, "On the other side of the transaction there was no showing that the $250,000 represented any approximation of what plaintiff stood to lose by Peoples' competition."

Valuation of a Covenant Not to Compete

Valuation becomes an issue when the allocation by one or both parties appears to be excessive. The value allocated to the covenant must reflect economic reality.

One method of valuing 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.

A second method values what the buyer acquired: protection of the continued profitability of the business from the seller's use of his or her contracts 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.

Courts will also look to the value claimed for the covenant relative to the values or the other assets acquired.

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 all intangible assets (including goodwill and going concern value) only if no better method is available.

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 § 197

New Code § 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 "§ 197 assets"), including goodwill and going concern value, over a 15-year period using the straight line method. No other deduction for depreciation or amortization is allowed for amortizable § 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 definition of I'§ 197 assets" specifically includes covenants not to compete.

Some of the same issues discussed above will continue to exist under § 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. Section 197 causes this difference in rates to be important only to the seller. Under § 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.

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