SECTION 197 AMORTIZATION APPLIED TO NONCOMPETE COVENANT IN SMALLER STOCK ACQUISITION

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Noncompetition covenants are common when interests in businesses are sold. The buyer typically would like to amortize (deduct) the cost of the covenant as quickly as possible, so as to get the tax savings from the deduction sooner rather than later. Absent any special statutory treatment, the cost of the covenant is usually written off over the number of years that the covenant applies.

However, if Code Section 197 applies to the covenant, the buyer must amortize it slowly, over a 15 year term. In a recent case, the First Circuit Court of Appeals held that Section 197 applies to a one-year covenant not to compete when it was issued in conjunction with a redemption of a 23% corporate shareholder.

The case turned on whether Code Section 197(d)(1)(E) characterizes such a covenant as a section 197 intangible. That section includes as a section 197 intangible “any covenant not to compete (or other arrangement to the extent such arrangement has substantially the same effect as a covenant not to compete) entered into in connection with an acquisition (directly or indirectly) of an interest in a trade or business or substantial portion thereof.”

The taxpayer argued that the term "thereof" at the end of this provision requires that the interest sold any trade or business must be substantial, and that the 23% sold here is not substantial. Thus, the covenant would not be a section 197 intangible.

The IRS argued that the term "thereof" does not not modify the term "interest" but instead modifies the term "trade or business." Applying the IRS' interpretation, there are thus two circumstances that will treat the covenant as a section 197 intangible. The first is the purchase of an INTEREST in a trade or business, such as stock, no matter how small that interest is. The second is the purchase of assets of the trade or business (that is, the purchase of the trade or business itself), in which case the sale must be at least of a substantial portion of the total assets to trigger section 197 treatment.

At first, the IRS interpretation appears strange, if not outright ridiculous. However, if you look at it long enough, it does appear to be more reasonable, and if you keep looking at the clause, you soon have no idea what it really means.

The Tax Court accepted the IRS' interpretation. It based this in part on the policy of Code Section 197 to discourage over allocation of purchase price to a covenant by a buyer. However, this is probably not a fair basis on which to base the interpretation, since in a stock sale there is a natural tension between the buyer and seller that limits the ability of the buyer to over allocate purchase price to a covenant not to compete. This is because the covenant not to compete will be ordinary income to the seller, while the allocation of sale proceeds to the asset being sold would generate only capital gain. The buyer will thus be bargaining for a lower allocation of proceeds to the covenant not to compete.

Nonetheless, with this case the IRS' interpretation of Code Section 197(d)(1)(E) must be given due consideration in regard to any sales of interests in business entities that are accompanied by a covenant not to compete, no matter how small the percentage interest that is being sold.

Recovery Group, Inc., 108 AFTR 2d ¶ 2011-5114 (CA 1 7/26/2011)

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