NON-COMPETITION AGREEMENTS COMBINED WITH REDEMPTIONS CAN TRIGGER THE APPLICATION OF INTERNAL REVENUE CODE SECTION 197

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1. Introduction

Before the enactment of Section[2] 197 in 1993, taxpayers and the Internal Revenue Service ("**IRS**") engaged in numerous disputes regarding whether the amortization of intangible property for federal tax purposes was appropriate and, if so, the manner in which such amortization could be claimed. The United States Supreme Court even weighed in on the issue and, in a 1993 case, made clear that taxpayers bore a significant burden in proving their entitlement to amortization deductions related to intangibles. Later in 1993, Congress stepped in to significantly reduce the uncertainty surrounding the amortization of intangibles and adopted a uniform federal tax amortization standard for most intangibles. When applicable, Section 197 requires a taxpayer to amortize the adjusted basis of its intangible asset ratably over a 15-year period beginning with the first day of the month in which such intangible was acquired.[3]

Although certain intangibles need not be acquired in connection with an acquisition of an interest in a trade or business for Section 197 to apply to them, a covenant not to compete must be acquired in such a fashion for Section 197 to apply. An acquisition of an interest in a trade or business is typically thought of as a purchase of all (or substantially all) of the business assets from another party or the acquisition (whether taxable, tax-free or a combination thereof) of all of a target corporation's stock. In 2003, however, the United States Court of Appeals for the Ninth Circuit, in *Frontier Chevrolet Co. v. Commissioner*,[4] held that a redemption by a corporation of a certain portion of its stock was treated as an acquisition of an interest in a trade or business for purposes of Section 197 and that, as a consequence, a covenant not to compete entered into by such corporation in connection with the redemption was subject to amortization under Section 197. The *Frontier Chevrolet* case and some associated issues are described below.

2. Brief summary of the facts of *Frontier Chevrolet*

Frontier Chevrolet Company ("**Frontier**") was a corporation engaged in the trade or business of selling and servicing automobiles. In 1987, Roundtree Automotive Group, Inc. ("**Roundtree**"), a corporation engaged in the trade or business of purchasing and operating automobile dealerships and providing related consulting services, acquired all of the outstanding Frontier stock. Shortly after the acquisition, Dennis Menholt ("**Menholt**"), a long-term employee of Frontier, became executive manager of Roundtree and, over the next seven years, he acquired twenty-five percent of the outstanding Frontier shares. As a result, Roundtree owned seventy-five percent of Frontier's shares and Menholt owned the remaining twenty-five percent.

Effective August 1, 1994, Frontier and Roundtree entered into an agreement pursuant to which Frontier would acquire all of its shares owned by Roundtree, with such acquisition qualifying as a redemption within the meaning of Section 302(b)(3). As a consequence of the redemption of all of Frontier's stock owned by Roundtree, Menholt became the sole shareholder of Frontier.

Roundtree, Frontier and Frank Stinson, the President of Roundtree ("**Stinson**"), entered into a non-competition agreement ("**Covenant**") effective August 1, 1994 in connection with the redemption of Frontier's stock owned by Roundtree. The purpose of the Covenant was to induce Frontier to consummate the redemption and, as part of the agreement, Roundtree and Stinson agreed not to compete with the Frontier auto dealership for five years. Frontier agreed to pay Roundtree and Stinson $22,000 per month during the five-year term as consideration for complying with the restrictions set forth in the Covenant.

To fund the acquisition of its shares from Roundtree, Frontier was required to borrow from an unrelated party, which caused it to be highly leveraged. In fact, Frontier failed to meet certain minimum working capital requirements imposed by its franchisor and had to obtain a waiver of such requirements to continue holding its franchise. Furthermore, Roundtree and Stinson had the ability and knowledge to be able to compete (absent the Covenant) with Frontier in the agreed-to geographical area. Thus, the Covenant was the only mechanism by which Frontier could protect its business from competition by Roundtree and Stinson and, without the Covenant, Frontier may not have been able to raise capital or repay its loan.

On its federal income tax returns for 1994 through 1996, Frontier amortized its payments made pursuant to the Covenant over the fifteen-year period as provided by Section 197. In 1999, however, Frontier filed a claim for refund for 1995 and 1996, contending that its Covenant payments should be amortized over the life of the Covenant (i.e., five years). The IRS issued a deficiency notice to Frontier, which filed a petition with the Tax Court. The IRS and Frontier stipulated that the only issue to be decided by the court was whether Frontier was required to amortize the Covenant payments in accordance with Section 197. The court also acknowledged that the case before it was the first occasion it had to consider the relationship of the requirements of Section 197 and a covenant not to compete. Before examining the holding and rationale of the Tax Court and the Ninth Circuit Court of Appeals, however, a brief summary of the law in effect before the enactment of Section 197 is in order.

3. Treatment of non-compete agreements as a result of enactment of Section 197

Before the enactment of Section 197, a taxpayer was generally able to amortize the cost or other basis of intangible property used in a trade or business or held for the production of income if the property had a limited life that could be determined with reasonable accuracy. Accordingly, a taxpayer was allowed to amortize payments made pursuant to a covenant not to compete entered into in connection with the acquisition of an interest in a trade or business over the term of the covenant, provided that the term was for a definite, limited amount of time. Conversely, where the benefits of the covenant were of indefinite duration, a taxpayer could not deduct amounts paid pursuant to such covenant. The IRS often challenged taxpayers' assertions that they were entitled to any amortization deductions for certain intangibles and asserted (for example) that the property at issue did not have a limited life and, thus, could not be subject to amortization.

In *Newark Morning Ledger Co. v. United States*,[5] the United States Supreme Court addressed the controversial issue of amortizing intangible property and affirmed that a taxpayer may properly claim amortization deductions where the taxpayer can prove that the property at issue (i) can be valued and (ii) has a limited useful life that can be determined with reasonable accuracy. The Court characterized the taxpayer's burden of proof in such a case as "substantial" and stated that such burden "often will prove too great to bear."[6]

In adopting Section 197, Congress acknowledged that the IRS challenged many taxpayers' claims of amortization of intangible property and made clear in the legislative history to Section 197 that it had great concern over the significant backlog of cases in audit and litigation.[7] As a result, Congress urged the IRS "in the strongest possible terms" to expedite its settlement of cases regarding the amortization of intangibles.[8]

The intent of Section 197 was to eliminate significant controversy regarding the amortization of acquired intangible assets by specifying a single method and period for recovering the cost of most acquired intangibles.[9] Section 197(d) identifies those intangibles to which Section 197 applies, such as goodwill, going concern value, workforce in place, and franchises, trademarks and trade names (as well as covenants not to compete, as described below). Section 197(e) identifies those intangibles to which Section 197 does not apply, such as an interest in a corporation, partnership, trust or estate.

With respect to a covenant not to compete, Section 197(d)(1)(E) provides that Section 197 applies to such a covenant (or other arrangement to the extent that the arrangement has substantially the same effect as a covenant not to compete) entered into in connection with the direct or indirect acquisition of an interest in a trade or business (or substantial portion thereof). For this purpose, the legislative history and the regulations to Section 197 provide that an interest in a trade or business includes not only the assets of a trade or business, but also stock in a corporation that is engaged in a trade or business or an interest in a partnership that is engaged in a trade or business.[10]

4. Holding and Rationale of the Tax Court and Ninth Circuit

As stated above, Frontier entered into the Covenant "in connection with"[11] the stock sale agreement. Frontier contended, however, that it did not acquire an interest in a trade or business pursuant to the stock sale agreement because it was engaged in exactly the same trade or business both before and after the acquisition and it acquired no other assets. Frontier further contended that, because it did not acquire any interest in a trade or business, the Covenant could not constitute a Section 197 intangible and, thus, Frontier should be permitted to amortize the payments made pursuant to the Covenant over its life (i.e., sixty months).

The Tax Court reviewed the definition of "acquisition" in Black's Law Dictionary, and noted that it was defined as "[T]he gaining of possession or control over something" and "[S]omething acquired." In addition, the Tax Court noted that the term "redemption" is defined as "[T]he act or an instance of reclaiming or regaining possession by paying a specific price." Based in part on these definitions, the Tax Court concluded that the redemption was an "acquisition" within the meaning of Section 197 because Frontier received seventy-five percent of its stock as a result of the transaction with Roundtree.

The Tax Court then cited the legislative history of Section 197 for the proposition that an interest in a trade or business includes not only the direct acquisition of the assets of the trade or business but also the acquisition of stock in a corporation that is engaged in a trade or business.[12] When Frontier acquired the stock pursuant to the stock sale agreement, it indirectly acquired an interest (in the form of stock) in a corporation engaged in a trade or business.

Frontier then contended that Section 197 may apply if it had acquired a new trade or business, but that Section 197 does not apply because it merely continued its own existing business. The Tax Court stated that neither Section 197 nor its legislative history required the acquisition of a "new" trade or business for Section 197 to apply. Thus, the Tax Court held that Frontier acquired an "interest in a trade or business" within the meaning of Section 197 when it redeemed its stock from Roundtree and was required to amortize the Covenant over a fifteen year period.

The Ninth Circuit affirmed the Tax Court's holding and noted that Frontier acquired possession and control over seventy-five percent of its own stock and that the effect of the transaction was to transfer ownership of Frontier from one shareholder to another. In other words, Menholt, who previously owned twenty-five percent of the shares of Frontier, became the sole shareholder due to the redemption transaction.

It should be noted that the Ninth Circuit did not state whether the deemed transfer of control (i.e., more than fifty percent) of Frontier stock was a factor in its decision. The court did make clear in a footnote[13] that it only addressed the issue of whether the redemption of seventy-five percent of a taxpayer's stock constitutes an indirect acquisition of an interest in a trade or business for purposes of Section 197. In that footnote, the court stated that it was not addressing the issue of whether all stock redemptions made in connection with an execution of a covenant not to compete would constitute an acquisition of an interest in a trade or business with the meaning of Section 197. The court's rather narrow holding thus leaves unanswered the question of whether a redemption of a minority shareholder (e.g., a twenty-five percent shareholder) would have yielded the same result.

The court almost certainly would have come to the same conclusion had the redeemed shareholder held more than seventy-five percent of the taxpayer's stock, but would it have also done so if the redeemed shareholder held 50.1 percent of such stock? What if the redeemed shareholder owned forty-nine percent and held an in-the-money option to acquire 1.1 percent of the shares of the taxpayer's stock? What if the redeemed shareholder owned twenty-five percent and the remaining seventy-five percent was owned by millions of public shareholders? Presumably the Ninth Circuit would have come to the same conclusion if the redeemed shareholder owned 50.1 percent of the corporation's shares but, in other cases, it would have looked to all of the facts and circumstances to determine whether the redeemed shareholder effectively controlled the corporation, which determination may include (for example) the application of Section 318(a)(4) to attribute any options owned by a person to the ownership of the stock. It is unclear whether this type of attribution would apply in this situation.

5. Planning Opportunities

When a corporation redeems a shareholder's stock and that shareholder will continue to provide services to the corporation, it should consider entering into an employment agreement or consulting arrangement with the former shareholder. An agreement requiring the shareholder to perform services or provide property or its use to the corporation does not have substantially the same effect as a covenant not to compete to the extent that the amount paid under the agreement represents reasonable compensation for the services actually rendered or for the property or use of the property actually provided.[14] On the other hand, an arrangement that requires the former owner of a direct or indirect interest in a trade or business to continue to perform services (or to provide property or the use of property) that benefits the trade or business is considered to have substantially the same effect as a covenant not to compete to the extent that the amount paid to the former owner exceeds reasonable compensation for the services actually rendered (or for the property or use of property actually provided).[15]

Assuming that the selling shareholder is paid reasonable compensation for work performed, payments under an employment agreement or consulting arrangement should not be treated as payments for a covenant not to compete (which may otherwise cause such payments to be subject to Section 197). As long as the compensation under such agreement is reasonable for the services to be performed, such payments would not be considered to be an arrangement that has substantially the same effect as a covenant not to compete and would be deductible when paid or incurred. The redeemed shareholder, however, may prefer to be compensated pursuant to a covenant not to compete agreement instead of an employment or consulting arrangement so as to avoid the taxes associated with self-employment income, as payments for a non-compete agreement are not self-employment income absent a consulting arrangement.[16] This may be a negotiated item in a transaction taking into account the potential tax consequences to all affected parties.

6. Conclusion

Section 197(d)(1)(E) confirms that a covenant not to compete entered into in connection with an acquisition of an interest in a trade or business must be amortized over a fifteen year period. The Treasury Regulations[17] also confirm that the "acquisition of an interest in a trade or business" may take the form of a redemption in addition to a typical purchase of a business. It is not clear, however, what level of redemption in comparison to the remaining outstanding shares of a corporation would constitute the "acquisition of an interest in a trade or business." Presumably, the redemption would need to constitute the purchase of more than fifty percent of the stock of a corporation before a related covenant not to compete would be treated as a "Section 197 intangible" pursuant to Section 197(d)(1)(E). If the redeemed shareholder will continue to provide services to the acquiring taxpayer, it may be beneficial to enter into an employment or consulting arrangement with the redeemed shareholder. Payments made for actual services rendered will be deductible when paid or incurred and would not be required to be amortized over a fifteen year period under Section 197.

ENDNOTES

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2 References to "Section" herein are to the sections contained in the Internal Revenue Code of 1986, as amended, and all references to "Treas. Reg. Section" are to the Treasury regulations promulgated pursuant to the Internal Revenue Code.

3 Section 197(a); Treas. Reg. Section 1.197-2(f)(1).

4 329 F.3d 1131 (9th Cir. 2003), affirming 116 T.C. 289 (2001).

5 113 S.Ct. 1670, 123 L.Ed.2d 288 (April 20, 1993).

6 123 L.Ed.2d 288 at 306.

7 P.L. 103-66, page 777.

8 Id.

9 P.L. 103-66, page 760.

10 P.L. 103-66, page 764; Treas. Reg. Section 1.197-2(b)(9).

11 In a recent case, *Chief Industries, Inc. and Subsidiaries v. Commissioner*, T.C. Memo 2004-45, the Tax Court considered the issue whether payments made to settle outstanding obligations under an employment agreement were deductible when such payments were made simultaneously with the reacquisition of the employee's stock. In this case, the Tax Court held that even though the transactions were close in proximity, the settlement of the employment agreement claims did not produce a significant long-term benefit and were not "in connection with" or related to the redemption. Thus, the settlement payment was deductible when paid.

12 Treas. Reg. Section 1.197-2(b)(9) provides that "an acquisition may be made in the form of an asset acquisition (including a qualified stock purchase that is treated as a purchase of assets under Section 338), *a stock acquisition or redemption, and the acquisition or redemption of a partnership interest.* [emphasis added]. Treasury Regulation Section 1.197-2(b)(9) was adopted after the transaction at issue occurred.

13 See footnote 2 of the Ninth Circuit's opinion.

14 Treas. Reg. Section 1.197-2(b)(9). Note that the same principle applies whether the taxpayer acquires stock of another corporation (whether or not a Section 338 election is made), redeems its own stock, acquires assets, acquires a partnership interest or (if the taxpayer is a partnership) redeems a partnership interest. *Id.*

15 P.L. 103-66, p. 765.

16 *Barrett v. Commissioner*, 58 T.C. 84 (1972).

17 Treas. Reg. Section 1.197-2(b)(9).