NONCOMPETITION AGREEMENTS REQUIRE SUBSTANTIATION

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When a small business is sold, the buyer will often obtain a noncompetition agreement from the seller. This is particularly true in service businesses, but it is true in manufacturing, retailing, and other businesses as well. The buyer wants to ensure that the seller will not take the proceeds from the sale and start a competing business. Such a competing business could draw away the customers, employees, *etc.*, of the business that was purchased. This agreement could be included as one of the terms of the overall asset or stock sale agreement (then, it is called a covenant not to compete) or it can be created—and bargained for—as a separate asset sold by the seller to the buyer (then, it is called a noncompetition agreement). If it meets certain conditions, such a covenant is an amortizable intangible asset to the buyer.

When a small business is purchased, usually an allocation of the lump-sum purchase price among the assets acquired is performed for both financial and income tax accounting purposes, with a portion of the price allocated to the covenant not to compete. Before TRA '86, sellers preferred to have as much of the purchase price allocated to goodwill as possible, so that that portion of the proceeds would be taxable at lower capital gains rates. Buyers, on the other hand, preferred to have as much of the purchase price allocated to the covenant as possible, in order to amortize the allocated amount over the contractual term of the covenant. No amortization deduction is allowable for goodwill.

Subsequent to TRA '86, in most cases the seller is indifferent as to the allocation between goodwill and the covenant because favorable capital gains rates have been eliminated. That the buyer and seller no longer have adverse tax interests will likely mean that the Service will more zealously challenge purchase price allocations to covenants not to compete. There is no cost to the seller acquiescing to the buyer's unreasonably large allocation to the covenant.

Amortization of Covenants

Generally, four tests have been applied by the courts in determining whether a covenant not to compete may be amortized for Federal income tax purposes:

1 Whether the compensation paid for the covenant is severable from the price paid for the acquired goodwill.
2 Whether either party to the contract is attempting to repudiate an amount knowingly fixed by both the buyer and seller as allocable to the covenant.
3 Whether there is proof that both parties actually intended, when they signed the sale agreement, that some portion of the price be assigned to the covenant.
4 Whether the covenant is economically real and meaningful.

It must be established that the seller could compete against the buyer if not legally restrained by the covenant.[1] The mere stated intention to compete, absent the covenant, will likely not be enough to satisfy the IRS, due to the lack of adverse tax interests. The buyer must demonstrate that the seller possesses a viable means of competition. The mere potential of competition from the seller, due to his reputation with clients, will likely be construed to suggest that the covenant is merely to protect goodwill and thus is not severable from goodwill. A real and likely threat of competition from the seller—due to the seller's product knowledge, age, health, and financial

condition, as well as employee and customer loyalty, expertise, managerial skills, etc.,—will likely be required to meet this first test.[2]

The "repudiation" test will have less meaning now that the parties to a purchase do not have adverse tax interests. Few purchase agreement allocations will be repudiated since there is no incentive for the buyer and seller to disagree on the contractual allocation. Regulation 1.1060-1T(h) requires that the buyer and the seller agree to the same allocations on their respective tax returns.

The "intent" test can be met by documented negotiations between the parties as to the price to be paid for the covenant. If possible, these negotiations should occur before the total purchase price is made final. The inclusion of the agreed upon price of the covenant in the purchase agreement is recommended. This inclusion will provide stronger proof than a recitation of an intent in the agreement that part of the price will be allocated to the covenant. This allocation is important since the parties do not have adverse tax interests.

The "economic effect" test can be met by a careful appraisal of the value of the covenant, preferably before the final purchase agreement is signed. A reasonable value can be placed on a covenant by comparing the value of the firm's projected earnings (before interest, depreciation, and taxes) over the term of the covenant with the value without the covenant. The difference in the two business values (*i.e.*, with and without competition) is the fair market value of the covenant.[3]

Valuation of Covenants

The first question in covenant valuation is: "If the seller of the covenant were to compete, how would it be done?" Usually the answer is that the seller would either start a competing company or would join a present competitor. The second valuation question is: "Under the viable scenarios of competition, which would be the most damaging to the net sales of the company being purchased over the term of the covenant?" Once the most threatening means of competition are established, the effect of the potential competition to the company's net sales and net earnings, over the term of the covenant, can be projected.

The potential loss of net sales from competition can usually be quantified only after (1) comprehensive interviews with top management of the acquired company, (2) rigorous analyses of historical results of operations of the acquired firm within its competitive environment, and (3) exhaustive analyses of the macro and micro price elasticities and market dynamics of the subject industry. Potential competition due solely to a transfer of goodwill should not be considered.

Usually, the input of the chief executive officer, the chief marketing officer, and the chief financial officer are all essential to the development of the projections of the impact of competition. Substantial professional judgement and expertise are required when the potential loss of sales is translated into the potential loss of earnings, as fixed costs and variable expenses must be carefully considered in the analysis. Merely multiplying the projected profit margins by the potential projected sales decrements may not be adequate to substantiate the valuation conclusion. Rather, a more rigorous comparative discounted net cash-flow analysis over the term of the covenant is required to quantify the fair market value of the noncompetition agreement. The steps in valuation of the covenant are as follows:

1 Project the decrement in the subject firm's net revenues due to the seller's hypothetical competition over the contractual term of the agreement. This projection contemplates two factors: (a) the competing seller will draw current customers away from the firm, and (b) the competing seller will attract potential new customers and therefore reduce the sales growth of the subject firm.

2 Project the increment in the subject firm's operating expenses due to the seller's hypothetical competition over the contractual term of the agreement. This projection of incremental operating expenses must consider (a) the increased salary expense that the buyer will have to pay to employees to keep them from defecting to the competing seller (*i.e.*, their previous boss), (b) the increased marketing expense associated with retaining

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old customers (who are now being called on by the competing seller), and (c) the increased marketing expense associated with prospecting new customers due to the competition caused by the seller.

3 Project the increment in capital (and other) investments due to the seller's hypothetical competition over the contractual term of the agreement. Incremental investments usually take the form of increased investments in accounts receivable and in plant and equipment. The increased receivables relate to the relaxed credit terms that must be granted to prevent current customers from "defecting" to the seller. The increased level of capital expenditures is due to the investments in plant, property, and technology required to dissuade current and potential customers from defecting.

4 Quantify the comparative business valuation cash flows associated with competition. The comparative cash flow analysis is: revenues less expenses less investments without competition, versus the same calculation with competition. The incremental difference in the two cash flow projections represents the damage that the seller could create if he were allowed to compete against the buyer.

5 Quantify the appropriate present value discount rate. This rate should reflect the summation of the current risk-free rate of return, the time value of money over the term of the covenant, and the nonsystematic risk associated with it.

6 Quantify the present value of the net cash flow associated with the potential competition of the seller versus the established (*i.e.*, acquired) firm. The present value of this net cash flow projection is the fair market value of the covenant.

Conclusion

Under Temp. Reg. 1.1060-T(d)(2), covenants not to compete are Class III assets. This means that noncompetition covenants are subject to the residual method of purchase price allocation. Thus, the value of a covenant could be reduced below its fair market value for Federal income tax purposes in a bargain purchase situation. A "bargain purchase" occurs when the actual purchase price paid for the business is less than the cumulative fair market value of the collective assets acquired.

A well-reasoned and fully documented appraisal of an acquired covenant not to compete will generally prove useful to the buyer of a business. First, it will help establish and negotiate the purchase price of the business. Second, it will be useful in substantiating a deduction associated with the amortization of the covenant. ■

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[1] *Forward Communications Corp.*, 608 F.2d 485, 44 AFTR2d 79-5917 (Ct. Cls., 1979).

[2] *Golden State Towel and Linen Service*, 373 F.2d 938, 67-1 USTC ¶9302, 19 AFTR2d 950 (Ct. Cls., 1967).

[3] *Better Beverages, Inc.*, 619 F.2d 424, 80-2 USTC ¶9516, 46 AFTR2d 80-5219 (CA-5, 1980).