32nd Annual

Tax Symposium

NONCOMPETE AGREEMENTS IN BUSINESS TRANSACTIONS

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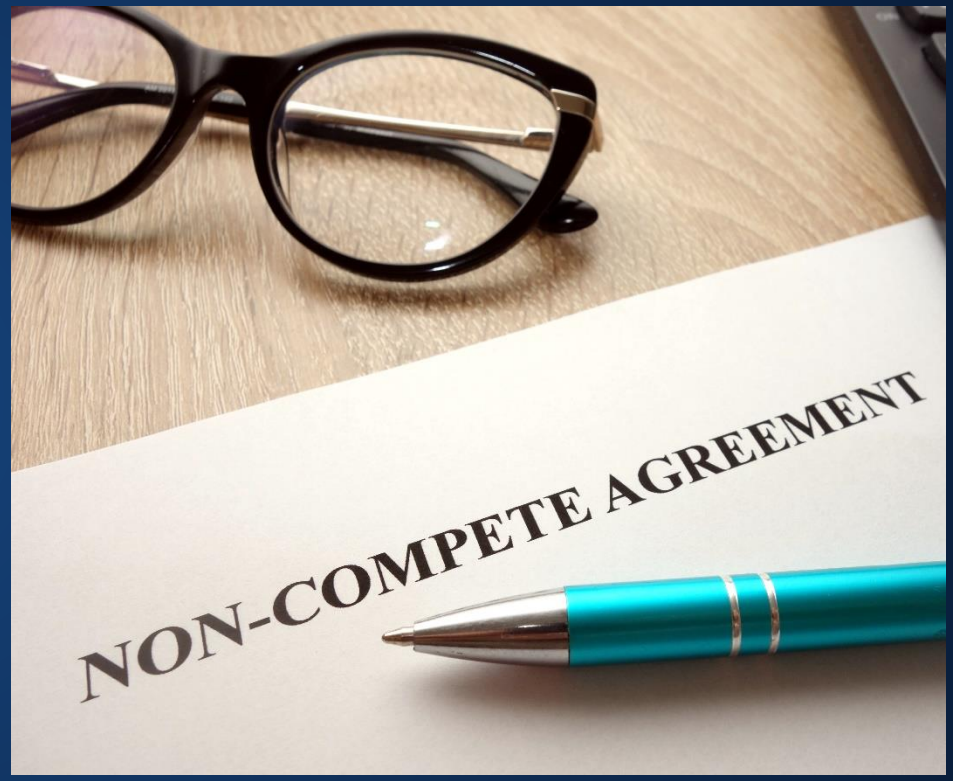
WHAT IS A NONCOMPETE AGREEMENT?

IN GENERAL:

- Contract between employee and employer that prohibits the employee from accepting future employment or operating a businesses that is in competition with the employer.
- This traditional form noncompete clause is being challenged by the NLRB and the Federal Trade Commission as being violative of Labor Rights and interferes with the labor market; position is that they should be unenforceable.
- Some states are deeming them unenforceable/invalid under state law.



NONCOMPETE AGREEMENTS IN BUSINESS TRANSACTIONS

- When used in the sale of a business, noncompete is usually a separate agreement between the selling member/shareholder and the buyer.
- Agreement is not to compete with the new owner; usually a simple paragraph, but usually included as part of separation/severance/consulting agreement.
  - Non-solicitation of employees and non disclosure of proprietary information.
- In this situation, these agreements are not being contested by NLRB, FTC nor are barred by various state laws.
- However, the noncompete still needs to meet some general tests.

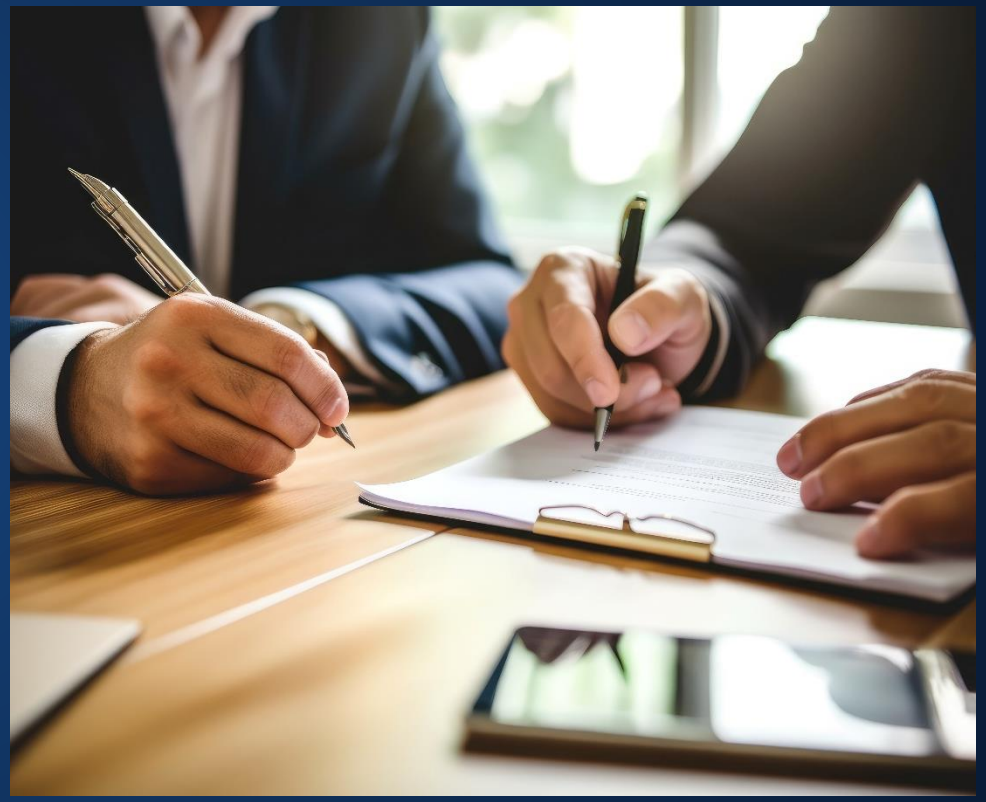
SAMPLE NONCOMPETITION CLAUSE

Non-Competition. Employee agrees that during his or her employment with the Employer and for a period of [INSERT AMOUNT](#)] years following termination of this Agreement regardless of the time, manner, reason or lack of same ("Restrictive Period") Employee will not, either directly or indirectly, for Employee's own account or as an agent, independent contractor, stockholder, employer, employee or otherwise in connection with any other person or entity, engage in the following in [INSERT GEOGRAPHIC SCOPE] become employed for, participate in the ownership, management, operation or control of, or have any financial interest in, any business engaged in the same or similar activities to those carried out by the Employer prior to Employee's separation from employment. This paragraph shall not restrict Employee from being a passive owner of not more than one percent of the outstanding stock of any corporation whose stock is publicly traded.

WHAT FACTS CONSTITUTE A BONA FIDE & ENFORCEABLE COVENANT?

Bona Fide – Former owner must have the capacity to compete with business being transferred. Must have one of the following:

- The acquired business is service or knowledge based vs. capital intensive,
- Former owner possesses a special technical knowledge or secret process,
- Former owner has long-standing relationships with suppliers or producers,
- Former owner has outstanding reputation, good will, outstanding marketing skill, relations = loyal customer base.



ENFORCEABLE NONCOMPETE

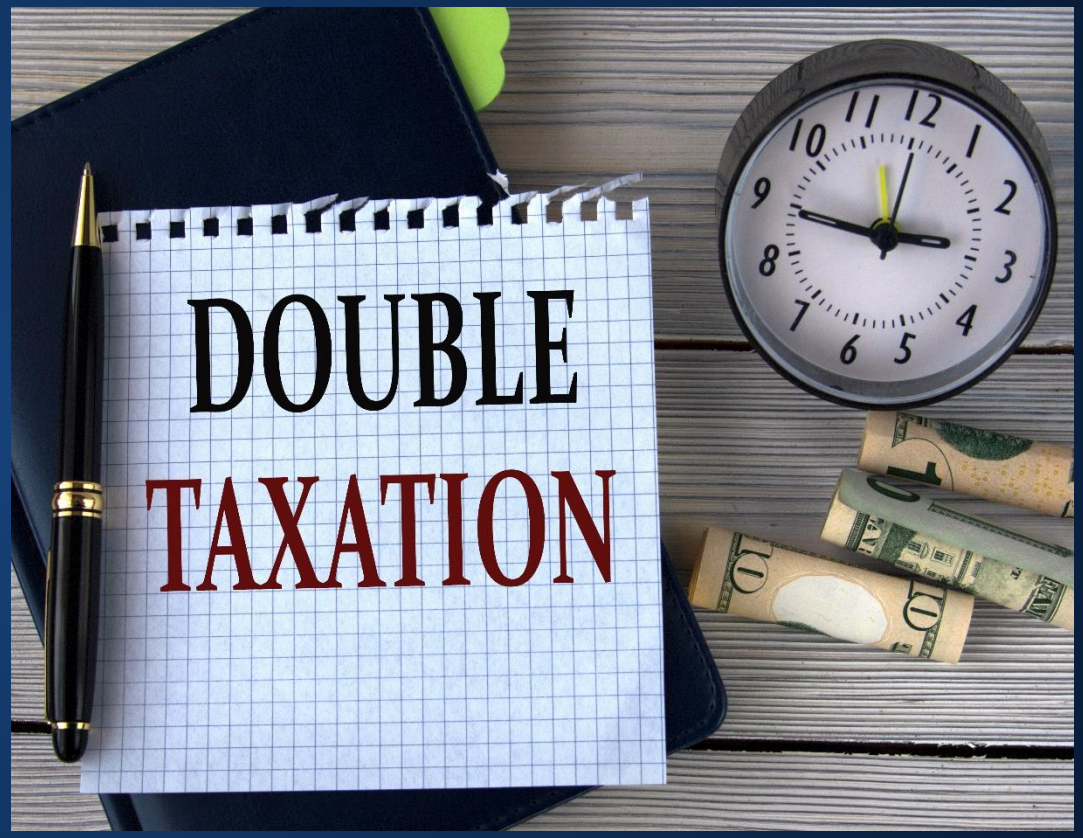
Even if Bona Fide Agreement, still must be legally enforceable.

Factors the Court reviews:

- Length of agreement, usually 3 years or less. This is also dependent upon the industry the company operates in. A dog grooming business will have a shorter period than a manufacturing business.
- Scope of agreement should not be overly broad. The scope of the agreement should not prohibit any employment in any unrelated industry.
- Geographic scope of the Covenant should be reasonable. Ergo, if dog grooming business is located in Grand Rapids, the geographic scope is excessive if it prohibits seller from working in Saginaw, Bay City, Flint, etc.

DOUBLE TAXATION OF ASSETS

- Potential for double taxation on sale of corporate-owned business assets.
  - Determine who owns the intangible assets, like goodwill, clients lists
    - Where shareholder owns, double taxation reduced
    - Norwalk, T.C. Memo 1998-279, Court determined goodwill not asset owned by corporation b/c no noncompete agreements with the shareholder-employees. The goodwill then attached to the shareholders individually and not asset owned by the corporation.



TAX CONSEQUENCES

- Covenants Not to Compete are a Section 197 Intangible. Under Section 197(d)(1)(E), are to be amortized over 15 years. This also applies to covenants entered into with a stock sale where no section 388 election applies.

WHAT IS FORM 8594?

- Form 8594, compliance made by IRS for reporting sale of business.
  - You will note that paragraph 6 of the 8594 relates to disclosure of covenants not to compete.
- Both buyer and seller have to fill out and file the 8594.
  - IRS is then provided with the buyer's depreciable basis in the asset transferred and how the seller determines a gain or loss.

TAX CONSEQUENCES

PURPOSE OF THE 8594

- Where goodwill for going concern value attaches, or may attach, to a group of assets that makes up a trade or business, both the seller and buyer must use the 8594 to report the transaction.
- Penalties For Not Filing. Amount of penalty dependent upon length of time taxpayer failed to submit the information.

TAX TREATMENT FOR PAYMENT UNDER NONCOMPETE

- Creates desire by purchaser to allocate purchase price to other assets that can be depreciated over less than 15 years, i.e., machinery, equipment, receivables, and inventory.
- Parties may allocate little to no value to covenant because of the 15-year amortization. However, IRS can audit and re-allocate purchase price away from other assets and more toward the covenant.
- Payments received for a covenant are treated as ordinary income, not capital gain.

IN CONCLUSION…

- Noncompete clauses as part of sale of business valid.
  - Will still have to meet the legal “smell tests” of being bona fide and valid with respect to restrictions.
- Determine who owns the intangible assets.
  - Shareholder/Member or Company.
  - 15-year amortization is not favorable and the desire by parties may be to allocate little or no value to the covenant.
    - IRS Examiner can shift purchase price allocation away from other assets and onto covenant if perceives that covenant is under valued.
- Both seller/purchaser must file the 8594.

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THANK YOU

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