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Court applies 15-year amortization to one-year non-compete in acquisition of non-substantial percentage of stock

Many acquisitions in the EMC industry involve non-compete agreements, some for a very short period of time. A new court case sheds light on the application of Section 197 to such agreements when applied to stock acquisitions.

Section 197(d)(1)(E) states that a Section 197 intangible (subject to 15-year amortization) includes any non-compete agreement "entered into in connection with an acquisition (directly or indirectly) of an interest in a trade or business or a substantial portion thereof."

The First Circuit Court of Appeals (affirming a Tax Court decision) recently ruled that a one-year non-compete agreement entered into in connection with the acquisition of 23% of the stock of a company must be amortized over 15 years under Section 197. The fact that the percentage of the stock acquired was not a "substantial portion" of the company's total stock was deemed irrelevant.

The case (Recovery Group v. Commissioner, 1st Cir, No. 10-1886) involved the redemption of the shares owned by one of the company's founding shareholders and employees, representing 23% of the company's total outstanding stock, for approximately $256,000. As is common in such acquisitions, the company simultaneously entered into a non-compete agreement with the founding shareholder — in this case a one-year non-compete for $400,000 (comparable to one-year of his annual earnings).

The company deducted the payment for the non-compete agreement over its one-year term, arguing that in order for the non-compete to be considered a Section 197 intangible under Section 197(d)(1)(E), it must be entered into in connection with the acquisition of either the totality of the company's stock or a substantial portion thereof. The First Circuit, affirming the Tax Court position, disagreed, concluding that Section 197(d)(1)(E)'s substantiality requirement applied only to asset acquisitions and not to stock acquisitions. Consequently, a non-compete agreement entered into in connection with the acquisition of any stock, even if not "substantial," is considered a Section 197 intangible amortizable over 15 years.

Court's rationale

The First Circuit, finding the statute ambiguous, analyzed the intent behind the enactment of Section 197 — specifically, the elimination of tax incentives to allocate portions of a purchase price to shorter-lived assets, which had given rise to significant controversy and litigation between taxpayers and the IRS.

In asset acquisitions, if Section 197(d)(1)(E) had not been included, a buyer of assets constituting a trade or business would have had a significant tax incentive to allocate as a non-compete cost (with an amortizable life equal to the term of the non-compete) what was in fact purchase price attributable to 15-year Section 197 intangibles (such as goodwill and going concern). Section 197 attempts to eliminate this incentive by applying the same 15-year amortization rules to non-competes as to goodwill and going concern.

However, in asset acquisitions, goodwill and going concern are presumably transferred only where at least a substantial portion of the assets constituting a trade or business are sold. Therefore, when a non-substantial portion of assets are sold, Congress made Section 197(d)(1)(E) inapplicable, since the incentive to re-allocate between a non-compete and goodwill or going concern presumably does not exist.

The same cannot be said for stock acquisitions, however small. Goodwill and going concern generally constitute an essential component of the value of each share of stock, as each share represents a proportionate allotment of the value of the company's goodwill and going concern.

The First Circuit concluded that if Section 197(d)(1)(E) had not applied to a non-compete agreement entered into in connection with the acquisition of any corporate stock, a buyer of the stock would have a significant incentive to allocate to the cost of the non-compete what was in fact stock purchase price. The buyer would claim that the cost allocated to the non-compete could be recovered over its life, while the amounts allocated to the stock purchase price would not be deductible (i.e., amounts allocated to the stock purchase price would be added to basis and would be recovered only upon the disposition of the stock).

Conclusion

The First Circuit concluded that the goodwill and going concern components are still present even where a non-substantial portion of stock is transferred. Therefore, a taxpayer that pays for a non-compete in connection with the acquisition of a non-substantial portion of stock generally has the same incentive to overstate the cost of the non-compete as the taxpayer that acquires a substantial portion of stock.

Therefore, the one-year non-compete entered into in connection with the acquisition of a 23% stock interest was a Section 197 intangible, and its cost was recoverable over 15 years.

This new case may require EMC companies to re-think their strategies when structuring non-compete agreements in stock acquisitions, especially if the assumption previously had been made that Section 197 rules for non-compete agreements in stock and asset acquisitions were the same.

New case on depreciation of wireless telecom assets highlights importance of IRS safe harbors

Recently issued wireless telecommunications depreciation safe harbors take on increased significance in light of a recently decided Tax Court case.

In the case of Robert Broz v. Commissioner, 137T.C. No. 3, the Tax Court addressed depreciation recovery periods for cellular assets used by a telecommunications company. The assets in question were placed in service in various years from 1996 through 2001.

In Broz, the Tax Court ruled that:

1) Cellular antenna towers are telephone distribution plant property properly included in asset class 48.14 of Rev. Proc. 87-56 and depreciated over 15 years.

2) Switches are computer-based telephone central office equipment included in asset class 48.121 of Rev. Proc. 87-56 and depreciated over five years.

3) Base station controllers and other cellular site equipment are telephone central office equipment properly included in asset class 48.12 of Rev. Proc. 87-56 and are depreciated over 10 years.

Interestingly, the Broz case addresses the depreciation recovery period of some of the same assets included in the wireless telecommunications industry depreciation safe harbors recently published by the IRS in Rev. Proc. 2011-22, which is effective for taxable years ending on or after December 31, 2010.

Rev. Proc. 2011-22 provides for more favorable depreciable lives than those allowed by the court in the Broz case. In the Rev Proc., cellular antenna towers are personal property with no class life depreciated over seven years, and base station controllers and other non-switch equipment at the cellular site are computer-based telephone central office equipment depreciated over five years.

Given the different recovery periods and effective dates provided in Broz and Rev. Proc. 2011-22, wireless telecommunications companies should evaluate their current depreciation recovery periods to identify potential opportunities or exposures. An accounting method change may be warranted to eliminate exposure or obtain more favorable depreciation deductions for assets placed in service in prior years.

Time-sensitive New Jersey VDA opportunity targets media content providers

On August 10, 2011, the New Jersey Division of Taxation (Division) announced a new voluntary disclosure agreement (VDA) initiative directed at the media industry, specifically encouraging certain "media and media content companies" to come into compliance with their New Jersey Corporation Business Tax (CBT) filing requirements. Generally, eligible companies include cable television networks, syndicators, and other media content providers. The initiative runs from August 15 until November 15, 2011.

New Jersey has historically been aggressive in asserting nexus over out-of-state companies lacking a physical presence in New Jersey. This uncertainty with respect to the nexus standard has been compounded by application of the state's "throwout" apportionment rule (before its repeal effective for tax periods beginning on or after July 1, 2010), which has the effect of increasing the New Jersey apportionment percentage. Eligible companies that fail to participate in the VDA initiative may be subject to an unlimited lookback and significant exposure for tax and penalties.

Under the VDA initiative announced by the Division of Taxation, the lookback period is limited to the current year plus the three previous years. Late-filing penalties are waived, although a 5% amnesty penalty may apply in limited circumstances (as under the state's general VDA program).

Specifically addressing the media industry VDA initiative, the Division sets forth apportionment rules for various revenue streams, including advertising, subscription, and syndication. To be eligible for this initiative, a company's receipts from licensing intangible property cannot exceed 10% of total gross receipts. In general, the Division states that it may grant discretionary apportionment relief from the throwout rule on "a case-by-case review."

The New Jersey VDA initiative for media and media content companies represents a significant opportunity to achieve substantial savings and, just as important, the potential to release substantial reserves with respect to New Jersey CBT. It is important to note that not all media companies may be eligible for the initiative given its restrictions. For example, the Division does not allow companies with over 10% of gross receipts from licensing intangible property to participate in the VDA initiative. However, many media companies, including cable television networks, syndicators, and other media content providers, could significantly benefit from participation in the program.

That said, the ultimate benefit from this program will depend on the application of the Division's apportionment guidelines, as stated in the terms of the initiative, for advertising, subscription, and syndication revenue, and the ability to obtain a favorable result with respect to throwout.

For more information, please do not hesitate to contact

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Recommended reading:

Global entertainment and media outlook 2011-2015

http://www.pwc.com/us/en/industry/entertainment-media/publications/global-entertainment-media-outlook.jhtml

2010 North American wireless industry survey

http://www.pwc.com/us/en/industry/communications/publications/2010-North-American-wireless-industry-survey.jhtml

Point of View: Wireless Customer Profitability

http://www.pwc.com/US/en/point-of-view/wireless-customer-profitability.jhtml

Communications Review: A journal for telecom, cable, satellite, and Internet executives

http://www.pwc.com/communicationsreview

EMC Perspectives: Technical accounting guidance for entertainment and media companies

- Film-financing and passive investor arrangements (Volume 1)
- Revenue recognition matters unique to the motion picture industry (Volume 2)
- Filmed entertainment: Cost capitalization, amortization, and impairment (Volume 3)
- Broadcast television: Acquired programming rights (Volume 4)

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US GAAP convergence & IFRS

www.pwc.com/usifrs

10 Minutes on essential business issues

www.pwc.com/us/en/10minutes/index.jhtml