ANTITRUST UPDATE

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Tax and antitrust appear to the uninitiated to be totally separate and apart. Tax and antitrust converge on a number of occasions. We examine one of these convergences, covenants not to compete, by examining a transaction in year one and in year three.

THE TRANSACTION

YEAR ONE — THE NON-COMPETE

Suppose the client sells a business that has operations and/or sales in the United States, Canada, Europe and Asia, for $1 billion. The buyer wants a covenant not to compete that will prohibit the client from re-entering that business or a closely allied businesses for 25 years anywhere in the world. The client agrees to that non-compete and the parties allocate $100 million of the $1 billion purchase price to the non-compete. The client allocates $10 million of the $100 million to the United States, and the remainder of the $100 million for the non-compete to the rest of the world. However, substantially more than 10% of the client's services for the business were performed in the United States.

YEAR THREE — THE NEW BUSINESS

The client learns of an exciting new opportunity in Europe. It is a business that might be characterized as closely allied to the business that the client sold two years earlier. The client would like to acquire this business. If the covenant not to compete is found to be breached by such an acquisition, then the client may have to refund some portion of the $100 million paid for the non-compete.

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THE TAX ANALYSIS[1]

This section addresses only U.S. federal tax issues regarding covenants not compete. The section does not address the foreign tax treatment of payments for such covenants.

The general rule under U.S. tax law is that the payer amortizes the covenant not to compete if the covenant is acquired in the process of an acquisition of a company. The amortization period is 15 years under IRC §197.This amortization rule does not apply if the covenant not to compete is not acquired in such a manner. It is then amortizable over the life of the covenant under IRC §167. See, Langer, Heikken & Herron-Hinds, "Trekking Through The Employment Maze," *Mergers & Acquisitions: The Monthly Tax Journal*, May 2000.

Compensation received for a promise not to compete is sourced to the place where the promisor has forfeited the right to compete. *Korfund Co. v U.S.*, 1 TC 1180 (1943); Rev. Rul. 74-108, 1974-1 CB 248. The residence or nationality of the payer or the promisor do not play a part in the determination of the source of the income under *Korfund Co*.

If the covenant covers only a right to compete in one country, the entire amount of the income is sourced from that country. However, if the covenant not to compete covers more than one country, an allocation of the income between those countries must be made. If one such country is the United States, the basis upon which the fee is allocated as income from sources from within and without the United States must be reasonable and be based upon the facts and circumstances in each case. In some cases, it may be reasonable to make the allocation on the basis of the relative value of the taxpayer's services within and without the United States.

In other situations, an allocation may be made to the United States, based on other factors The amount allocable to the United States could be the amount which bears the same relationship to the amount paid under

the covenant not to compete as the number of days performing services within the United States bears to the total number of days of performing services to which the payments relate. *See* Treasury Regulations §1.861-4(b); see Rev. Rul. 76-66, 1976-1 CB 189. The Internal Revenue Service takes the position that if an allocation is not made on a reasonable basis, all the income under the covenant not to compete is U.S. source income and subject to taxation by the United States, subjecting the payer to withholding obligations under IRC §1441.

Most income tax treaties, including the OECD model treaty, do not specifically address payments received under covenants not to compete. See, Mann, "Finding A Nexus For Nonperformance of Services: The Assignment of Primary Taxing Authority Under The OECD Model," 11 *Emory Int'l L. Rev*. 111 (1997).

In our hypothetical, the client allocated 90% of the compensation for the non-compete to outside the U.S., thus paying tax on only a small portion of the compensation received for the non-compete.

If there is a reasonable basis for making that allocation, then this U.S. tax-advantaged treatment of the compensation for the non-compete should withstand tax challenge. In that case, and if the new acquisition is found to be a violation of the non-compete, then the client may be subject to a damages claim or a breach of contract claim for that portion of the non-compete compensation allocable to Europe.The client should not have any additional liability in the United States relating to the non-compete. That contractual liability may be some portion of the $90 million allocated to the rest of the world outside the United States, taking into consideration the fact that two years of the 25 years of the non-compete have already run.

If the IRS finds that the allocation of the compensation for the non-compete has been made on a non-reasonable basis, then the client may face the worst case scenario. The entire amount of the compensation will be subject to U.S. tax and the client will face a significant U. S. tax bill, including interest and possibly penalties. In addition, without income tax treaty protection, foreign taxing jurisdictions may take the position that payments under the covenant not to compete are sourced within their borders and therefore subject to their tax regimes. Furthermore, for contract law purposes, courts might not follow the IRS's re-allocation of all payments under the covenant to the United States, especially in the face of the client's allocation of 90% of the payments to non-U.S. jurisdictions. Therefore, the client may face a large U.S. tax problem, potential foreign tax liability and up to a potential $90 million in damages for breach of the covenant in Europe.

THE ANTITRUST ANALYSIS

Covenants not to compete that are ancillary to the sale of a business are acceptable under the antitrust laws so long as they are reasonable in the circumstances. *See, e.g., National Society of Professional Engineers v. United States*, 435 U.S. 679, 689 (1978) "The Rule of Reason…has been regarded as a standard for testing the enforceability of covenants in restraint of trade which are ancillary to legitimate transactions". The principle is that a covenant would be reasonable if it enables the buyer to get the benefit of his bargain, and no more. The scope of the non-compete and its duration are the major factors in this analysis. *See, e.g., Compton v. Metal Prods.*, 453 F.2d 38, 45 (4th Cir. 1971), *cert. denied*, 405 U.S. 968 (1972) "covenants not to compete which are unlimited as to space or time are invalid and unenforceable."

The scope of a covenant not to compete generally has two dimensions, the geographic dimension and the product dimension. For example, if the business being sold was active only in New York State, then a covenant prohibiting the seller to engage in the business in Europe might be considered unreasonably broad. *Cf., Lektro-Vend Corp. v. Vendo Co.*, 660 F.2d 255, 267 (7th Cir. 1981), *cert. denied*, 455 U.S. 921 (1982) stating that a covenant not to compete in area to which business sold may be extended was reasonable if reasonably enforced; *Domino's Pizza, Inc. v. El-Tan, Inc.*, 1995-1 Trade Cas. (CCH) ¶70,998 at 74,660-61 (N.D. Okla. 1995) which upheld covenant prohibiting operating pizza carry-out and delivery business within 10 mile radius of franchise location for 1 year following termination of franchise; *Verson Wilkins, Ltd. v. Allied Prods. Corp.*, 723 F. Supp. 1, 12-13 (N.D. Ill. 1989) in which territorial limits not restricted to extent necessary to protect goodwill were found unreasonable.

Similarly, if the business being sold was engaged in the sale of cheese, a covenant that prohibited the sale of bread might be considered overbroad. *Cf., Drury Inn-Colorado Springs v. Olive Co.*, 878 F.2d 340, 343 (10th Cir. 1989) which upheld restrictive covenant on

sale of land that no buyer could be potential hotel competitor with room rates within 20% of previous purchaser of adjacent site. In some cases, where the business being sold depends significantly on certain customer relationships, the covenant may specify that the seller will not solicit certain customers for business. *Cf., Newburger, Loeb & Co. v. Gross*, 563 F.2d 1057, 1082-83 (2d Cir. 1977), *cert. denied*, 434 U.S. 1035 (1978) in which a non-compete restricting trading at another firm between employer and securities trader was found reasonable where limited in practice to prohibition on trading for employer's customers.

The reasonableness of the duration of a covenant will turn generally on how long it may be needed to ensure that the buyer obtains the benefit of the business and the goodwill that it bought. It is not uncommon that 5 or 10 year covenants are upheld on legal challenge. See, e.g., *Tri-Continental Fin. Corp. v. Tropical Marine Enters.*, 265 F.2d 619, 620 in which a 10 year restriction upheld; *Alders v. AFA Corp.*, 353 F. Supp. 654, 656 (S.D. Fla. 1973) in which a 5 year restriction covering North America upheld, *aff'd*, 490 F.2d 990 (5th Cir. 1974). The longer a covenant lasts, the more susceptible it is to challenge as unreasonable. *Cf., Sound Ship Building Corp. v. Bethlehem Steel Corp.*, 387 F. Supp. 252, 256 stating that "Standing alone, a 20-year restrictive covenant is unreasonable. The fact, however, that the covenant was imposed (a) by a seller who retained at proximity a similar business interest (b) in the market where viable alternative sites were available (c) during a period of economic decline in the business, enable the court to find the covenant reasonable in time," *aff'd*, 533 F.2d 96 (3d Cir.), *cert. denied*, 429 U.S. 860 U.S. (1976).

Where a covenant not to compete is found to be overbroad, it is not uncommon that a court enforces the covenant "to the extent that a breach of the covenant has occurred within a reasonable geographic area and time period, and, where applicable, with respect to a product reasonably related to the legitimate purpose of the restraint." *Lektro-Vend Corp., 660 F.2d at 267*.

In the hypothetical, the client agreed not to enter into any closely allied business anywhere in the world for 25 years.

To the extent the business sold actually was conducted throughout the world, it may be argued that the covenant was reasonable in geographic scope. And it may be argued that the prohibition from engaging in any new business closely allied to the business sold is necessary to ensure that the buyer obtained the full benefit of its bargain. In that case, it would appear that the product scope of the non-compete was reasonable. *Cf., Drury Inn-Colorado Springs*. Therefore, to the extent the new business is arguably closely allied to the business that was sold, the client may be violating the non-compete if it acquired the new business.

It might be argued that the covenant is invalid since it is for 25 years. A court may be inclined to enforce a covenant to the extent that the covenant is reasonable. If so, then it is arguable that such a covenant can be at least 3 years in duration, so that a purchase of the new business in the third year of the term of the restriction would still be a violation of the non-compete.

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THE LESSONS

Some lessons that may be taken from the hypothetical and the analysis:

- A covenant not to compete should have a reasonable basis for its duration and geographic and product scope.
- A covenant that is found unreasonable may be unenforceable, or enforced by a court according to its view of what is reasonable in the circumstances.

- A covenant that is unreasonable may increase the business risk of later activities. There is some risk that a breach of the covenant may be found.
- The tax treatment of a covenant not to compete should have basis in business reality.
- If there isn't a business basis for the tax treatment of the covenant, then interest and penalties may be owing, plus additional taxes to the United States.
- There might not be a business basis for the tax treatment of the covenant, particularly in the geographic or product basis if more than one product line is involved for the allocation of the compensation for the covenant. In that event, there may be disproportionate damage exposure if the covenant is breached. In the hypothetical here, there might not be a reasonable basis for allocating $90 million of the compensation for the non-compete to outside the United States. In that event, a breach of the covenant outside the United States nonetheless exposes the client disproportionately to damages for breach of the covenant outside the United States.

Bottom line — Don't allow the client to be blinded by the short term tax advantages of an allocation that may not have reasonable basis.This short-term allocation may come back to haunt the client, both from a tax perspective and from a business/contractual perspective.

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