Covenants Not To Compete and the Good Old (Pre-Section 107) Days

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As we have noted in these pages before (see Wood, "Making the Section 197 Intangibles Election," 2 M&A Tax Rep't 9 (April 1994), p. 1; and Bloom, "Covenants Not to Compete After Section 197," 2 M&A Tax Rep't 4 (November, 1993), p. 1), Section 197 can be a boon or bust to a taxpayer depending on the type of intangibles and their respective duration or life. In the case of covenants not to compete, Section 197 is usually a bust, for the fifteen-year amortization period prescribed by Section 197 can be quite onerous. Given the number of transactions still extant that were not subject to Section 197's strictures, it is still worth looking at authorities as they are decided in this area of seemingly unending interest.

Radio's Golden Age?

Take the recent case of *Charlton H. Buckley, et ux, v. Commissioner*, TC Memo 1994-470 (1994). There, the taxpayer (Henry Broadcasting) purchased from Grace Broadcasting substantially all of the assets of two radio stations operated in Salinas, California. Pursuant to the purchase agreement, Grace Broadcasting executed a covenant not to compete in commercial radio broadcasts within a 50-mile radios of Salinas for a period of three years. The price paid for the covenant was $2 million.

In December 1986, Henry Broadcasting struck again, this time purchasing from KFAB Broadcasting Co., for $21.8 million, substantially all of the assets of stations KFAB-AM and KGOR-FM in Omaha, Nebraska. Among the acquired assets was a lease for the studios for those two stations. The lease was to expire March 31, 1989, and the monthly rent was $1,800. At the option of the lessee, the lease was renewable for two consecutive five-year terms at $2,100 per month. As part of the negotiations between Henry and the owner of KGOR, Henry entered into a 10-year lease with Lee Enterprises Inc. to rent, for $100 per month, space for the KGOR transmitter and antenna.

More Purchases

Henry also purchased for $5.2 million substantially all the assets of stations KMJ-AM and KNAX-FM in Fresno, California from McClatchy Newspapers Inc. in December 1987. As part of those purchases, McClatchy and Henry entered into a covenant not to compete under which McClatchy agreed not to become associated in any manner with any radio station within 50 miles of Fresno. The agreement recited that the consideration for the covenant was $1.9 million. Notwithstanding the implication that McClatchy could compete in the absence of a covenant, under FCC regulations, McClatchy could not obtain a license for a broadcast station in Fresno because it also published a daily newspaper in that city.

In 1988, Henry sold KNAX in order to buy a station in Fresno with a stronger signal. Henry entered into a covenant not to compete with the buyer of KNAX that stated that, in exchange for $1 million, Henry agreed not to broadcast country music in the Fresno market for three years. In September 1988, Henry purchased from Professional Broadcasting Inc., for $4.3 million, substantially all the assets of station KFYE-FM in Fresno. Among the assets acquired was a transmitter lease.

Disputed Deductions

Henry's federal income tax returns for 1987 and 1988 allocated the purchase price for each of the radio stations among the assets acquired, including the intangibles. This allocation used methods acceptable under Generally Accepted Accounting Principles that were common in the broadcast industry, and estimated the useful lives of the intangible assets. The IRS disallowed deductions claimed for radio broadcast formats, the studio lease, the transmitter leases, and the two covenants not to compete. The IRS also determined additions to tax for negligence and valuation overstatement. According to the Service, the fair market values of

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the intangible assets were less than the amounts claimed by Henry, and their useful lives could not be ascertained with reasonable accuracy.

The Tax Court held that the taxpayer was entitled to amortization deductions, but in reduced amounts. Significantly, the court found that the approach of Henry's valuation expert was not consistent with a willing buyer-willing seller standard. While the court rejected the IRS's contention that it was impossible to determine the useful life of a radio station format with reasonable accuracy, it held that the taxpayer had not established the useful life of any of the formats except that of KFYE. The court concluded that when KFYE was purchased, the taxpayer did not intend to continue using the station's format (adult contemporary) for more than approximately three years. Consequently, the court upheld the five-year useful life employed by Henry in amortizing KFYE's broadcast format. The court determined the value of the format to be $300,000.

The parties' experts used the same method in valuing the studio leases, determining that the value of each lease equaled the present value of the cost savings Henry would realize over its useful life by not having to lease other facilities at market rental rates. The taxpayer's expert used this method for valuing the transmitter leases as well. Based on the entire record, the court concluded that, at the time the stations were acquired, the fair market value of the KFYE transmitter lease was $350,000, and that the KGOR transmitter lease was worth $60,000. The court also disagreed with the valuation each party's expert attached to the studio lease at the time Henry purchased KFAB and KGOR, concluding that its fair market value was $450,000.

Value of Covenants

The court determined that Grace's covenant not to compete was worth $500,000, but that McClatchy's covenant was worth less. As to the latter, the court had to agree with the IRS that the covenant was worthless because FCC regulations prevented McClatchy from operating a radio station in any case. Grace, on the other hand, would have offered substantial competition to Henry if it had reentered the Salinas market. ■